Second Quarter 2019 Knowledge College

Headline Risk – Should Investors Pay Attention?

There is no shortage of geopolitical tensions to fill headlines. U.S.-China trade negotiations, Brexit, developing nuclear powers in Iran and North Korea and straining relationships between Russia and the West all serve as recent examples. The question is should investors care, or more importantly, act, on these headlines? These events undoubtedly influence investor returns, perhaps not in the way you may think.

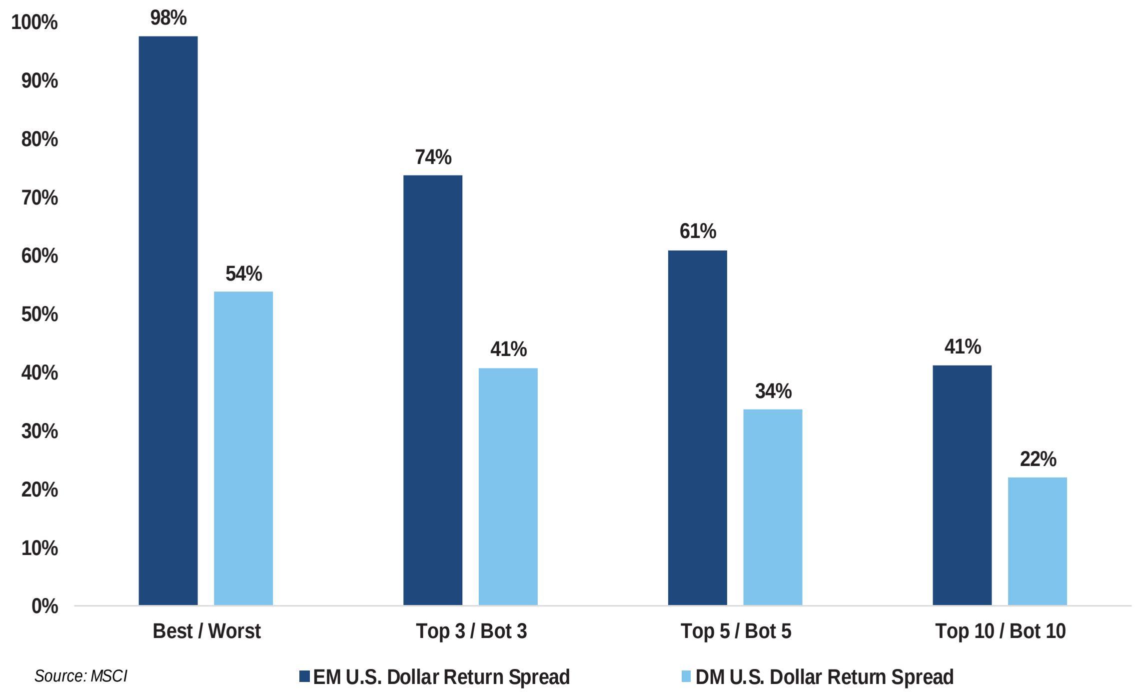
Often when portfolio managers invest in assets outside of a single country they start at the security level seeking those securities that have the best chance, by their estimation, to outperform indexes and peers in the future. While this is indeed a very important part of the process, we have found there is another important part of investment selection, the country in which portfolio managers choose to invest. Headlines like the ones above along with economic conditions, elections and long-term demographics, among many other factors, influence the prices of securities in a given country.

To demonstrate the volatility related to country allocations, we analyzed country returns based on the constituents of the MSCI EM and MSCI ACWI ex US indexes and evaluated the returns of high and low performers over a 18-year period. The results in Exhibit 1 showcase the return spread between high and low returners are substantial, in addition to some other interesting observations:

- Historical annual country return spreads within emerging markets have been 80 to 88 percent larger relative to developed markets, putting greater emphasis on country allocations in emerging markets.
- After removing the largest return outlier in emerging markets, annual country return spreads in emerging markets remained 40 to 60 percent larger relative to developed markets.
- Return dispersions between high and low performers within EM relative to DM is persistent over time, indicating there likely is nothing unique about recent geopolitical events despite being seemingly more frequent today than they have been in the past.

Exhibit 1

Average Annual Country Return Spreads



Source: MSCI

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Given the material influence country allocations have on return, is there opportunity to add value through country selection? To test this idea we evaluated all emerging markets managers with a 10-year track record and found their "skill" in selecting countries was quite low. Of the 87 portfolios, only 22 percent added value from country selection in a majority of quarters during the 10-year period. Just as importantly, none of the managers added value consistently throughout the period. One partial explanation for the lack of success is country returns, on both a relative and absolute basis, are random and very volatile, illustrated in Exhibit 2, making it difficult for portfolio managers to accurately predict which countries are poised to outperform year over year. For example, no single top performer held the top spot the following year. Moreover, the majority of the time the top performing country fell to the bottom half in the following year. That said, top quartile emerging markets managers consistently outperform the benchmark over rolling three-year periods. With such lack of success in country selection, where is this outperformance derived from?

We believe key elements include security selection and risk management. A process focused on managing country volatility is far more likely to add to successful outcomes relative to an approach that derives country allocations from stock selection.

Exhibit 2

Key
RUSSIA
KOREA
COLOMBIA
SRI LANKA
JORDAN
PERU
MEXICO
TAIWAN
THAILAND
MALAYSIA
CZECH REPUBLIC
CHILE
INDONESIA
HUNGARY
MOROCCO
BRAZIL
SOUTH AFRICA
PHILIPPINES
ARGENTINA
INDIA
PORTUGAL
CHINA
PAKISTAN
POLAND
GREECE
ISRAEL
TURKEY
EGYPT

Highest Return

Lowest Return

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
55.5%	150.5%	143.5%	132.4%	161.6%	82.9%	94.4%	-11.1%	190.7%	77.4%	6.0%	64.2%	65.0%	29.3%	36.3%	66.2%	73.5%	1.6%
48.0%	43.7%	125.3%	126.2%	107.2%	73.8%	79.6%	-25.1%	128.1%	73.9%	0.1%	47.1%	51.0%	26.6%	10.4%	55.6%	54.7%	-0.4%
45.1%	41.9%	114.4%	91.5%	73.6%	68.0%	74.1%	-28.3%	126.2%	55.7%	-0.9%	46.4%	34.6%	25.6%	4.2%	54.8%	54.1%	-0.5%
43.0%	33.9%	100.4%	85.6%	73.1%	67.3%	73.1%	-34.7%	104.2%	53.3%	-2.7%	39.2%	11.0%	23.9%	0.9%	40.4%	47.3%	-4.4%
34.0%	30.5%	94.1%	61.1%	63.8%	62.1%	66.2%	-35.8%	102.8%	44.2%	-5.0%	35.9%	10.9%	22.8%	-0.5%	35.4%	42.2%	-4.4%
19.9%	30.3%	91.8%	61.1%	62.3%	58.2%	58.4%	-37.9%	97.5%	43.4%	-6.0%	34.5%	10.4%	19.0%	-2.3%	34.3%	39.9%	-5.5%
18.4%	28.0%	87.6%	50.6%	57.0%	55.6%	55.3%	-40.2%	88.9%	37.0%	-11.2%	32.5%	9.1%	18.9%	-6.1%	26.6%	38.8%	-5.5%
10.0%	27.3%	83.3%	48.3%	56.4%	51.0%	54.2%	-41.2%	85.6%	34.2%	-12.0%	29.1%	8.2%	18.7%	-6.7%	26.5%	38.4%	-6.0%
5.0%	24.8%	78.3%	46.1%	56.1%	47.4%	47.7%	-42.9%	84.3%	33.9%	-12.1%	26.0%	7.7%	16.5%	-6.8%	18.5%	38.4%	-6.1%
4.6%	15.4%	76.5%	44.9%	49.1%	45.4%	46.1%	-43.1%	79.2%	33.9%	-14.4%	22.8%	3.9%	13.0%	-7.8%	17.9%	36.1%	-7.3%
-2.3%	8.3%	75.1%	41.4%	45.8%	45.3%	46.0%	-46.5%	77.6%	27.6%	-14.7%	22.7%	3.6%	10.5%	-11.7%	17.0%	35.5%	-7.5%
-3.6%	7.9%	69.5%	35.9%	37.6%	41.4%	40.4%	-48.5%	76.6%	26.7%	-15.2%	21.2%	2.6%	9.4%	-13.7%	15.6%	34.5%	-8.9%
-9.0%	4.3%	66.4%	28.0%	34.7%	39.2%	39.2%	-50.8%	71.9%	26.3%	-18.4%	20.2%	0.8%	8.0%	-13.8%	8.7%	28.6%	-9.2%
-9.4%	1.6%	64.4%	25.8%	33.5%	37.1%	37.8%	-52.2%	71.3%	21.8%	-19.6%	18.7%	0.2%	5.2%	-14.4%	4.9%	27.5%	-10.7%
-14.0%	1.0%	57.5%	25.7%	28.3%	35.0%	32.9%	-52.4%	65.6%	20.9%	-20.4%	16.7%	-2.7%	-0.7%	-17.7%	3.6%	25.1%	-11.1%
-17.0%	-0.7%	57.1%	24.7%	26.8%	33.9%	31.9%	-52.6%	64.0%	20.8%	-20.9%	14.3%	-3.3%	-2.1%	-18.4%	0.9%	24.6%	-11.5%
-17.2%	-8.9%	48.4%	22.1%	24.2%	33.7%	26.5%	-54.4%	62.3%	19.1%	-21.4%	13.7%	-3.8%	-4.4%	-19.5%	0.1%	24.2%	-12.9%
-19.4%	-13.3%	45.9%	22.1%	22.6%	28.7%	24.5%	-54.8%	57.8%	15.2%	-21.8%	7.8%	-5.5%	-9.3%	-20.1%	-1.1%	24.1%	-14.0%
-19.7%	-13.8%	45.7%	19.8%	20.9%	20.5%	24.3%	-55.3%	56.6%	14.9%	-23.1%	5.2%	-5.8%	-10.7%	-22.4%	-1.4%	23.8%	-15.5%
-19.8%	-14.0%	43.0%	19.1%	19.8%	20.0%	24.0%	-56.2%	53.9%	12.4%	-27.7%	4.6%	-6.2%	-11.1%	-23.5%	-3.9%	16.3%	-16.5%
-22.0%	-20.3%	41.9%	16.5%	17.9%	17.1%	23.0%	-56.5%	52.1%	6.5%	-28.0%	4.5%	-10.5%	-13.0%	-23.7%	-5.0%	16.0%	-18.9%
-24.7%	-24.7%	41.5%	15.2%	16.1%	13.6%	18.1%	-59.6%	41.5%	4.6%	-30.1%	3.9%	-14.6%	-14.0%	-25.4%	-5.0%	11.1%	-19.7%
-25.7%	-25.3%	40.6%	10.8%	15.1%	12.6%	16.8%	-61.5%	40.4%	4.4%	-33.6%	2.5%	-16.0%	-14.2%	-25.5%	-6.6%	9.5%	-20.9%
-27.7%	-29.5%	35.1%	9.0%	13.4%	11.1%	15.0%	-62.3%	39.7%	-2.5%	-35.4%	0.0%	-21.1%	-19.8%	-31.7%	-8.5%	5.2%	-24.8%
-29.6%	-30.7%	35.0%	5.5%	8.7%	3.0%	12.2%	-64.6%	26.5%	-9.5%	-37.2%	-0.6%	-22.0%	-27.4%	-31.9%	-9.2%	5.1%	-34.8%
-31.4%	-31.3%	32.8%	3.0%	6.4%	-5.3%	8.4%	-66.0%	25.0%	-9.6%	-38.9%	-4.7%	-23.5%	-38.2%	-41.4%	-11.5%	2.5%	-36.8%
-32.8%	-35.8%	32.0%	1.9%	2.3%	-7.2%	-4.0%	-73.9%	-5.1%	-11.3%	-46.9%	-12.0%	-26.8%	-40.0%	-41.8%	-12.1%	2.1%	-41.4%
-41.3%	-50.7%	26.6%	-1.2%	-1.9%	-30.9%	-13.6%	-74.2%	-5.3%	-44.9%	-62.8%	-37.1%	-29.8%	-46.3%	-61.3%	-24.9%	-24.4%	-50.8%

Source: MSCI
[1]Returns are U.S. Dollar returns

Disclosures

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When referencing asset class returns or statistics, the following indices are used to represent those asset classes. Each index is unmanaged and investors can not actually invest directly into an index: Cash –Citigroup 90 Day T-Bill; TIPS – Bloomberg Barclays US Treasury TIPS; Aggregate Bond – Bloomberg Barclays US Aggregate Bond Index; Municipal Bond – Bloomberg Barclays Municipal 5-Year Bond; High Yield – Bloomberg Barclays US Corporate High Yield; Foreign Bond – Bloomberg Barclays Global Aggregate Ex USD; Local Currency Denominated Emerging Markets Debt – JPMorgan GBI-EM Global Diversified Unhedged Index; Large Value – Russell 1000 Value; Large Blend – S&P 500; Large Growth – Russell 1000 Growth; Small Value – Russell 2000 Value; Small Blend – Russell 2000; Small Growth – Russell 2000 Growth; International – MSCI EAFE; Emerging Markets – MSCI EM; REITs – FTSE NAREIT Equity REITs; Commodities – Bloomberg Commodity Index; MLP – Alerian MLP; Hedge Funds – HFRI Fund of Funds Composite Index; Balanced – 5% Bloomberg Barclays US Treasury TIPS, 10% Bloomberg Barclays US Aggregate Bond Index, 4.5% Bloomberg Barclays Global Aggregate Ex USD, 4.5% Bloomberg Barclays Global Aggregate Ex USD (Hedged), 9% Bloomberg Barclays US Corporate High Yield, 2% JPMorgan GBI-EM Global Diversified Unhedged Index, 16% S&P 500, 5% Russell 2000, 12% MSCI EAFE, 7% MSCI EM, 5% FTSE NAREIT Equity REITs, 5% Bloomberg Commodity Index, 5% Alerian MLP, 10% HFRI Fund of Funds Composite Index; Domestic Equity Indices – Russell 1000, Russell 1000 Growth, Russell 1000 Value, Russell Mid-Cap, Russell Mid Cap Growth, Russell Mid-Cap Value, Russell 2000, Russell 2000 Growth, Russell 2000 Value; International Developed Markets – MSCI EAFE; US Dollar – US Dollar Index; Unhedged Developed Fixed Income – Bloomberg Barclays Global Aggregate Ex USD (Hedged); Real Assets – Bloomberg Commodity Index; Materials, Financials, Energy, Oil & Gas, Healthcare, Information Technology, Consumer Related Sectors – Dow Jones Sector Indices; Small Cap Securities – Russell 2000, Russell 2000 Growth, Russell 2000 Value; Large Cap Securities – Russell 1000, Russell 1000 Growth, Russell 1000 Value; Mid Cap Securities Russell Mid Cap, Russell Mid Cap Growth, Russell Mid Cap Value; Growth; Russell 1000 Growth, Russell Mid Cap Growth, Russell Small Cap Growth; Value – Russell 1000 Value, Russell Mid Cap Value, Russell 2000 Value; Fixed Income Markets – Bloomberg Barclays US Treasury TIPS, Bloomberg Barclays Municipal 5-Year Bond, Bloomberg Barclays Aggregate; Investment Grade Corporate Securities – Bloomberg Barclays US Credit; Long Maturity Treasuries –Bloomberg Barclays US Treasury 20+ Year; Shorter Dated Issues – Bloomberg Barclays US Treasury 1-3 Year; Industrial-, Financial-and Utility- Related Credits – Bloomberg Barclays Fixed Income Sector Indices; BB-Rated, B-Rated and CCC-Rated – Bloomberg Barclays Fixed Income Credit Quality Indices; MBS –Bloomberg Barclays US MBS; ABS – Bloomberg Barclays ABS; Crude Oil – Bloomberg Composite Crude Oil; Australia, New Zealand, Japan, China, India, Taiwan, South Korea, Brazil, Mexico, Chile, South Africa, Turkey, Egypt, Hungary, Poland, Russia, Canada, United Kingdom, Spain, Germany, Italy, France – MSCI Country Index Gross Return USD; Natural Gas – Bloomberg Natural Gas.

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