FIRST EAGLE
INVESTMENT MANAGEMENT®

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Leave Home: Non-US Potential Opportunities for Retirement Savers

At First Eagle, we've long held that the United States does not have a monopoly on good companies. While we think most market participants would agree with this sentiment, data suggest 401(k) plan participants in general continue to be significantly underexposed to international equities relative to their share of the global opportunity set. This bias both deprives retirement savers the opportunity to own high-quality non-US businesses and limits their ability to capture the potential risk/return benefits global equity diversification historically has provided.[1]

Dynamics that emerged in the aftermath of the financial crisis—up to and including the recent turbulence surrounding the Covid-19 pandemic—appear to have reinforced this longstanding domestic predisposition, which is evident in both participant-directed allocations as well as allocation vehicles like target-date funds. Closer examination, however, reveals a far more nuanced global investment environment, one that long-term investors, in particular, ignore at their own peril. Through thoughtful plan design and consistent communication, plan sponsors may be able to build retirement programs that provide participants with investment options consistent with the global opportunity set and allow meaningful access to non-US strategies and the diversification benefits they may provide.

1. Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Key Takeaways

- Retirement savers are no different than other investors in general as they demonstrate "home-country bias" in their portfolio allocations. Plan sponsors, however, may be uniquely positioned to influence this ingrained behavioral tendency and potentially improve participant outcomes.
- Long-term investors, in particular, may benefit from the diversification benefits—including potentially better risk-adjusted returns over time—that may be gained through exposure to foreign markets subject to a variety of unique risk factors and performance drivers.
- Though relative performance in recent years has favored the US, equity market leadership has been more balanced over the long term. Market dynamics of late, meanwhile, suggest that now may be a good time for those skeptical about the potential benefits of international diversification to take a second look.
- Leveraging a long history of global stock-picking, First Eagle selectively constructs portfolios that seek to participate in international market advances while mitigating the downside in an effort to avoid the permanent impairment of capital and thus increase return potential over the long term.

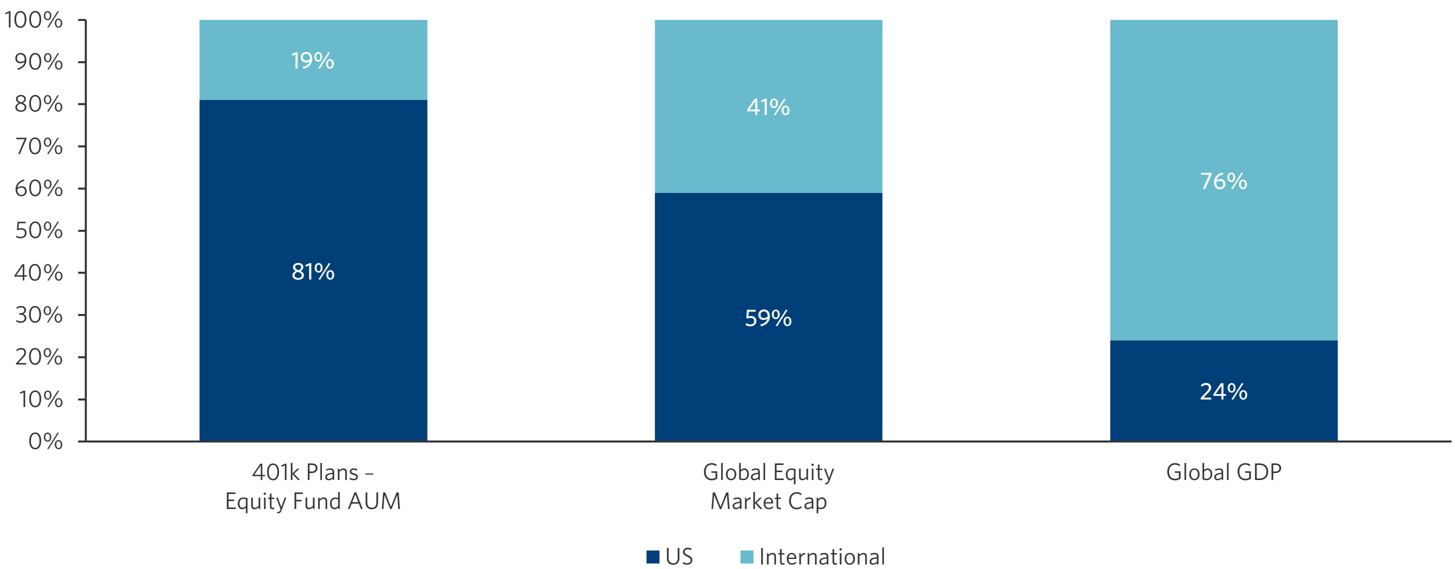
International Markets Represent a Fertile Environment

A study of large 401(k) plans by financial data company BrightScope[2] found that plan participants favored domestic fund options over international funds within their equity allocations by a ratio of more than four to one. As a result—shown in Exhibit 1—401(k) allocations to non-US equity funds fall far short of international companies' share of the global equity market and of international economies' share of global output. From the plan participant's standpoint, domestic-heavy retirement portfolios are failing to make the most of the diversification benefits—including potentially better risk-adjusted returns over the long term—that may be gained through exposure to foreign markets subject to varying economic fundamentals, interest rate regimes, political conditions, risk factors and other endogenous performance drivers. For plan sponsors and their financial professionals, limited access to international investment options may result in suboptimal long-term performance, ultimately impairing participation and savings rates. It's also important that the international options provided are well-aligned with the plan's participant base, many of whom may already be somewhat uncomfortable with the idea of a meaningful allocation to non-US securities. Managers like First Eagle that seek to mitigate downside volatility and seek to provide a smoother ride for retirement savers over the long term may represent an attractive segue for participants already fighting to overcome their domestic tendencies.

Limited access to international investment options may result in suboptimal long-term performance.

Exhibit 1. "Home-Country Bias" Evident in 401(k) Allocations

As a % of Total



Note: Global Equity Market Cap is represented by the MSCI ACWI Index. Global GDP is expressed in current US dollar terms as of 2019.
Source: Brightscope, MSCI, World Bank; data as of October 2020.

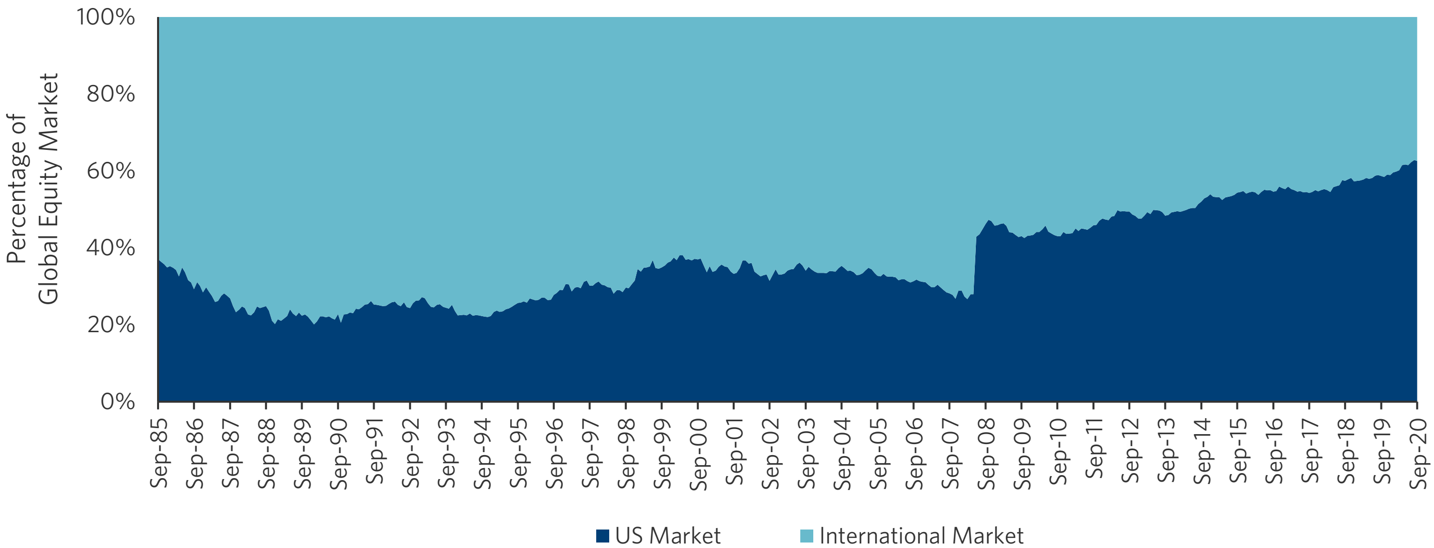
The concept of "home-country bias" has long plagued investors of all types and geographies. While the psychological root of home-country bias remains debatable—academics in the field of behavioral finance have attributed it to everything from home-market overconfidence to familiarity to patriotism[3]—we do know that investors who fail to venture beyond their own backyards, 401k plan participants among them, are depriving themselves of opportunities to own great international businesses. This tendency also serves as a challenge to ERISA fiduciaries seeking to promote favorable participant outcomes through 401(k) plan design and administration.

2. BrightScope and Investment Company Institute, "The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2017" (August 2020). The BrightScope Defined Contribution Plan Database contains detailed information from audited Form 5500 reports for more than 55,000 large private-sector 401(k) plans (i.e., plans with between four and 100 investment options and typically with 100 participants or more).
3. Nicolas Coeurdacier and Hélène Rey, "Home Bias in Open Economy Financial Macroeconomics," NBER Working Paper 17691, National Bureau of Economic Research (December 2011, revised July 2013).

Just as it does not have a monopoly on quality companies, the US does not have a stranglehold on the global investment opportunity set.

Just as it does not have a monopoly on quality companies, the US does not have a stranglehold on the global investment opportunity set—far from it, in fact. The current tilt toward the US in terms of market capitalization depicted in Exhibit 2 represents a multidecade high, in part the product of the longest equity bull market in US history, which ended early this year with the Covid-19 pandemic. From March 9, 2009, through February 19, 2020, the S&P 500 Index posted a total return of 522% and the tech-heavy Nasdaq gained 766%, compared to a relatively scant 216% gain by the MSCI EAFE Index over the same period. This long-term outperformance trend picked right up where it left off following the Covid-related selloff; from March 24, 2020, through September 30, 2020, the S&P 500 and Nasdaq have outpaced the MSCI EAFE Index by 13% and 24%, respectively. As you can see in Exhibit 2, however, this ratio has varied over time.

Exhibit 2. The Locus of Global Equity Markets Has Varied over Time



Note: The US market is represented by the MSCI USA Index, the non-US market is represented by the MSCI World Index ex USA from 1985 to 1987 and the MSCI All Country World Index ex USA thereafter. Data as of September 30, 2020.

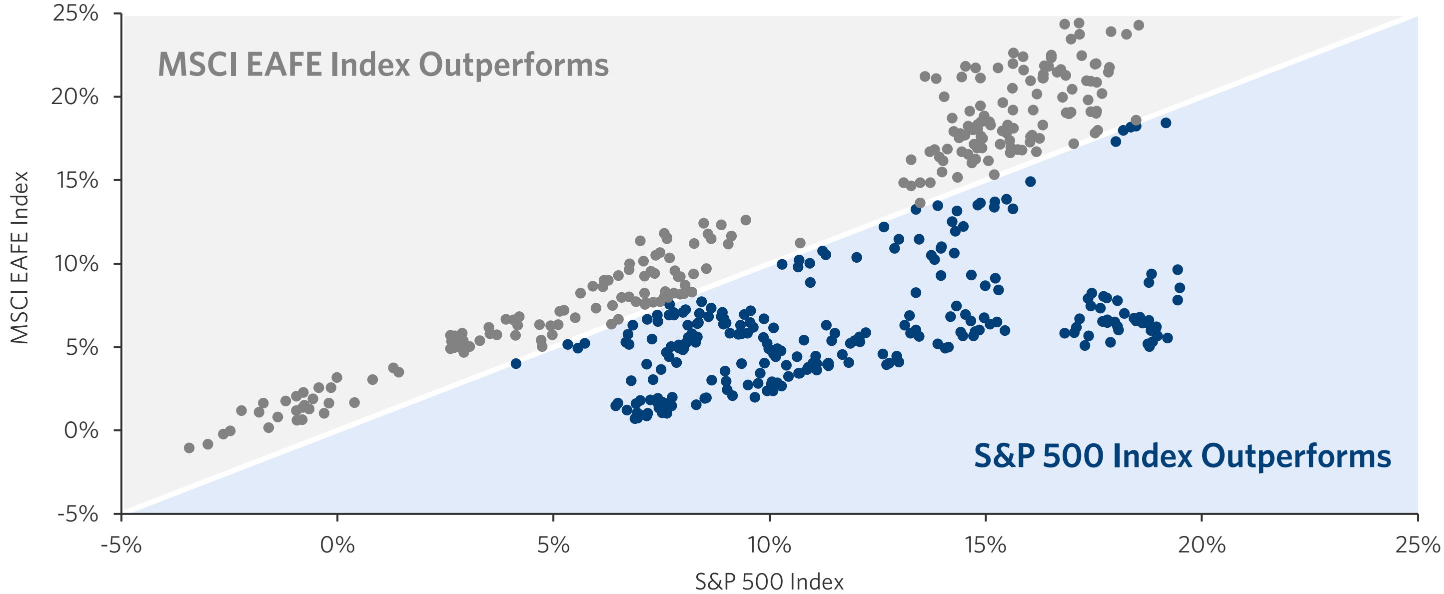
Sources: Thomson Reuters Datastream, FactSet and MSCI.

A longer-term view also reveals that the relative performance of domestic and international stocks historically has been cyclical. Exhibit 3 plots the relative performance of the S&P 500 and MSCI EAFE over rolling 10-year periods beginning in 1970. During this 50-year span—comprising 480 discrete measurement periods—US stocks outperformed only 53% of the time. Without attempting to speculate on the future drivers of relative equity market performance, 50 years of history suggests to us that it's reasonable to expect that international equities may reclaim the lead at some point.[4] Of course past performance does not guarantee future results.

4. We wrote about the importance of applying a long-term investment approach to the long-term investment horizons of retirement portfolios in our May 2020 paper, "401k Investment Menu Design: Hope for the Best, Prepare for the Worst." https://www.feim.com/sites/default/files/401k-Investment-Menu-Design_R-TL-NPD-401KMD-P-US_0.pdf

Exhibit 3. US and Non-US Equity Markets Have Traded Leadership over the Long Term

Rolling 10-Year Returns; Periods Ended January 31, 1980, through December 31, 2019



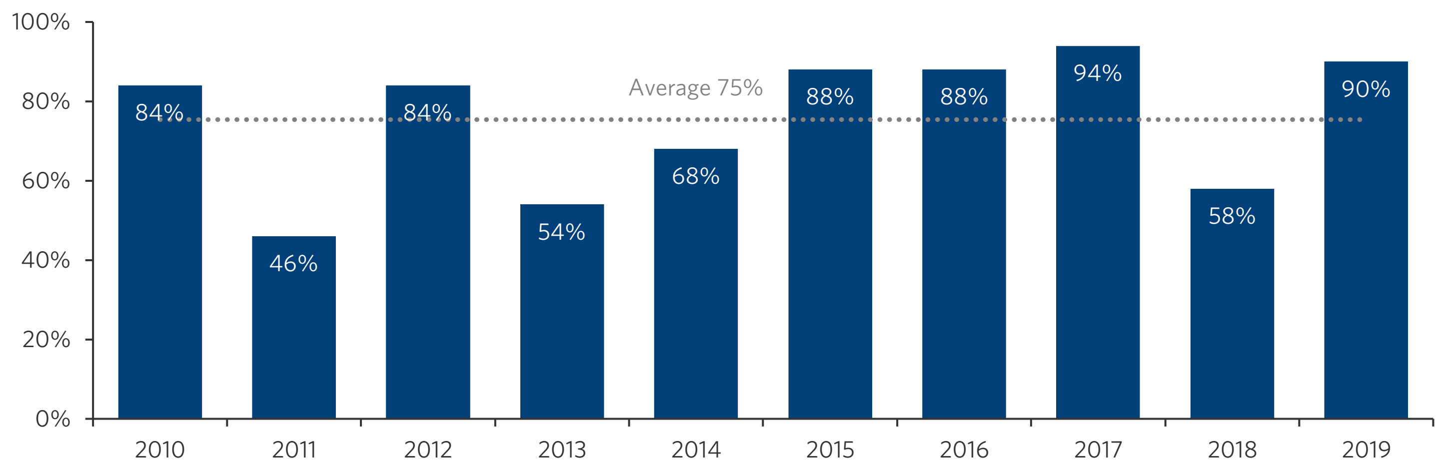
Source: FactSet.

Past performance does not guarantee future results, which may vary.

At the same time, index-level performance alone may present a somewhat distorted view of US superiority. As shown in Exhibit 4, non-US companies comprised 75% of the MSCI ACWI Index's top 50 gainers on average over the past 10 years, suggesting there have been plenty of attractive opportunities across geographies for investors able to identify them.

Exhibit 4. Perhaps Surprisingly, Top-Performing Companies Have Been Concentrated Outside the US

Percentage of Non-US Stocks Among Top 50 Performers in MSCI ACWI



Index Returns

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
US	15.1%	2.1%	16.0%	32.4%	13.7%	1.4%	12.0%	21.8%	-4.4%	31.5%
Non-US	11.2%	-13.7%	16.8%	15.3%	-3.9%	-5.7%	4.5%	27.2%	-14.2%	21.5%

Note: For Index Returns table, US = S&P 500 Index and Non-US = MSCI AC World ex-USA.

Source: FactSet, as of March 12, 2020.

Past performance does not guarantee future results.

Current Considerations for International Equity Investment

As bottom-up stock pickers, First Eagle invests in individual companies based on their unique business characteristics and qualities. That is not to say we are not cognizant of broader market-level trends, however, and current dynamics suggest to us that now may be a good time for those skeptical about the potential benefits of international diversification to take a second look.

The S&P 500 Index today trades at around 23 times trailing 2019 peak earnings from 2019, while the MSCI EAFE is around 15 times its earnings peak in 2018. While there are a number of valid reasons that US markets may trade at a higher valuation than those overseas—from the size and diversity of the opportunity set to sector-level exposures—a valuation premium of roughly 50% is worthy of attention. Further, this number may understate the relative expensiveness to of the US markets, as operating margin expansion for US companies outpaced those in the EAFE during the last business cycle.[5]

In addition to overexposure to richly valued domestic markets, US-centric retirement investors—particularly those whose market exposure comes via passive investment vehicles or benchmark-hugging active portfolios—also face increased sector- and company-specific risks due to recent market dynamics. The latest leg of the equity market rally has been notable for its lack of breadth, resulting in top-heavy markets, particularly in the US. More than 28% of the S&P 500 falls within the information technology sector, which has rallied 45% over the 12 months ended September 30. And as shown in Exhibit 5, the 10 largest stocks in the S&P 500—six of which are classified as info tech—comprised 29% of the index as of August 31, 2020, a 6% increase over the prior year and a higher percentage than at any point in at least 40 years. Against this backdrop, disappointing performance by just a few companies could have an outsized impact on retirement portfolios.

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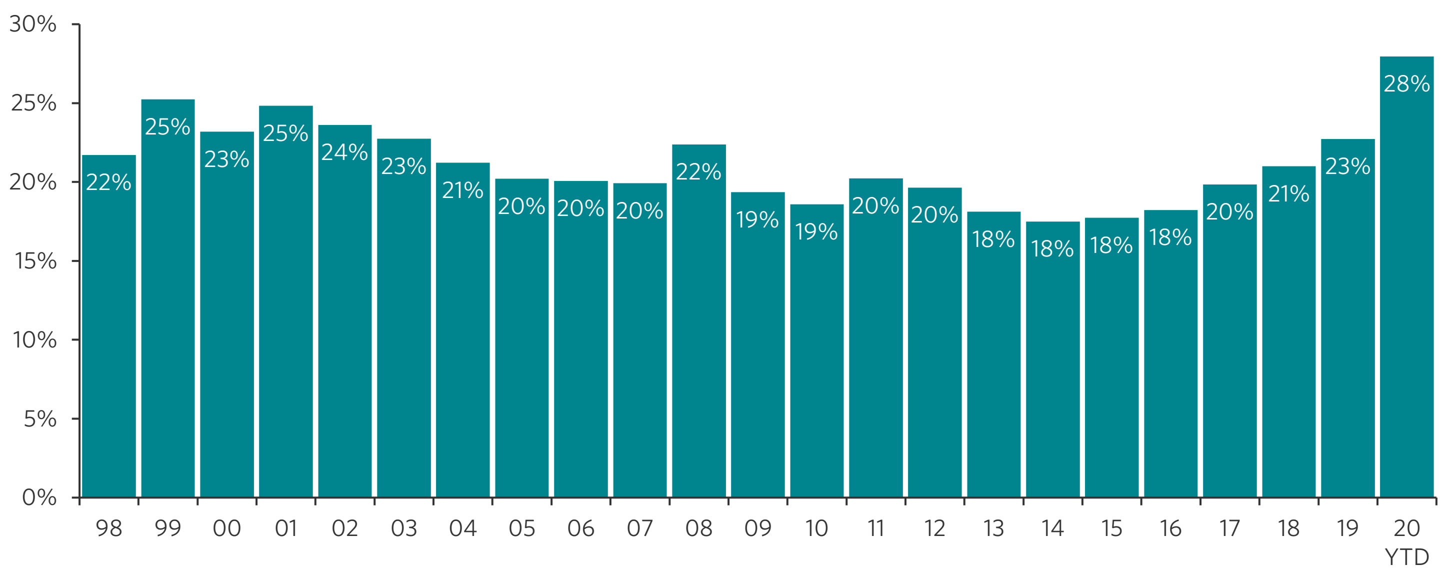
Exhibit 5. The US Equity Market Has Become Increasingly Top-Heavy

Aggregate Weighting of 10 Largest Stocks in S&P 500 Index



Source: FactSet; data as of September 30, 2020.

Past performance does not guarantee future results.

Meanwhile, the primary tailwinds supporting the relative value of the US dollar since the global financial crisis—capital flows seeking favorable interest rate differentials and the ongoing accumulation of dollar reserves—have eased due to a combination

5. Source: Bloomberg; as of September 9, 2020.

of Covid-response policies and various trade skirmishes. This may pave the way for a resumption of the dollar's gradual structural decline, which took hold with the breakdown of the Bretton Woods agreement in the early 1970s thanks to aggressive dollar-supply growth and persistent current account deficits. Periods of dollar weakening traditionally have been supportive of non-US equity markets and, combined with the stark difference in valuations mentioned earlier, may help drive relative performance back toward historical means after the long period of US outperformance.

Plan Sponsors Can Forge the Way

Given the prevalence of home-country bias across the investor spectrum, it's not surprising that 401(k) plan participants would tend to favor domestic stocks over foreign opportunities that seem, well, foreign; a study by the Federal Reserve found the nearly six in 10 working Americans with self-directed retirement savings expressed low levels of comfort in making investment decision for their account.[6]

While retirement savers are no different than investors in general in demonstrating home-country bias, plan sponsors and their financial professionals may be uniquely positioned to influence this ingrained behavioral tendency for the potential benefit of participant outcomes. The aforementioned BrightScope study showed that while the average large 401(k) plan offered 13 different equity investment options, only three of these were international funds; the disparity in offerings may be conveying a message to participants, however unintentional, about the relative benefits of these asset classes.

Thoughtful plan design and ongoing communication can equip participants with the tools needed to build resilient.

Thoughtful plan design and ongoing communication can equip participants with the tools needed to build resilient, diversified portfolios that seek to 1) preserve invested principal, 2) grow both income and principal in defense against the ravages of inflation, and 3) generate a consistent stream of income in retirement. Investment menus composed of strategies with diverse risk and return characteristics and complementary performance drivers may encourage participants to construct portfolios that offer the potential for reduced short-term volatility and limited downside capture. This, in turn, likely would encourage adherence to long-term plans that seek a steady compounding of assets in real terms over time.

While we believe the broad and diverse opportunity set available in international equity markets could be a key element of retirement portfolios, their breadth and diversity demand a selective investment approach. In our view, flexible, benchmark-agnostic active managers with a proven track record of successful stock picking may be well positioned to construct international portfolios that offer differentiation from the primary indexes as well as the potential for enhanced risk-adjusted returns.

6. Board of Governors of the Federal Reserve, "Report on the Economic Well-Being of U.S. Households in 2019," (May 2020).

Authors

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Michael Rosenberg is head of Retirement Investment Solutions at First Eagle Investment Management, responsible for distribution strategy for defined contribution assets, as well as sales, servicing and relationship management in the retirement market. Prior to joining First Eagle in November 2016, Michael was executive vice president and director of investment-only defined contribution distribution for Prudential Investments, where he managed a team that worked with plan sponsors, consultants, financial intermediaries and retirement platforms around the country. Before that, Michael was director of retirement services at Goldman Sachs and also worked at Capital Resource Advisors and at ABN AMRO marketing retirement plan services. Michael earned a BS from Northern Illinois University and an MBA from Keller Graduate School of Management.

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