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International Equity Investing: The long term case for Quality

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Introduction

The portfolio benefits of including international equities have been well documented. International equities provide:

1. better geographic diversification - the Australian stock market represents around 3% of global stock markets;
2. better sector diversification - Australia is dominated by resources and financials with limited opportunities in technology and health care; and
3. exposure to different economic cycles.

Despite these diversification benefits, Australian investors are underweight international equities. According to Towers Watson, after the US, Australian pension funds have the largest home bias in domestic equities. The bias to domestic equities is understandable as local stocks are more easily understood and recognised by investors and they are easier to trade. As a result, most Australian investors are missing opportunities that are only available offshore.

The most recent economic cycles highlight the importance that investors have a diversified portfolio including international shares to maximise returns.

Prior to the "GFC", the investment case for international equities was not compelling. In June 2007 the five year return for international equities, as measured by the MSCI World ex Australia Index was 5.2% p.a. compared with the 19.3% p.a. experienced on the local exchange as represented by the S&P/ASX 200 Accumulation Index. The result for Australian investors overexposed to domestic equities was positive.

By failing to include international equities in their holdings however most Australian investors have missed the stellar returns experienced by international equities since the GFC. Driven by sustained low interest rates and an improving US economy the five year return of the MSCI World ex Australia Index as at 31 March 2015 has risen to 14.32% p.a. while the S&P/ASX 200 Accumulation Index over the same time period has fallen to 8.39% p.a.

A diversified portfolio that includes both domestic and international equities would have resulted in less volatile returns over these different cycles.

Naturally investors need to be cautious about what shares to buy and when to buy them. Investing in international equities is for the long term and the principals for investing are the same as investing locally.

Selecting quality international equity stocks

Over the long term, those equity investment strategies that have done well have focused as much on capital preservation as achieving growth. Benjamin Graham, the father of value investing highlighted the importance of capital preservation "Once you lose 95% of your money, you have to gain 1,900% just to get back to where you started."

"Graham will always be remembered as the father of value investing" (Novy Marx, 2013) and is perhaps second most famous investor in the world, surpassed only by his pupil, Warren Buffett. Buffet and Graham have been able to demonstrate long term outperformance using similar investment methods.

Graham is perhaps best known for his 'margin of safety' and buying stocks on the basis of valuation metrics, but according to Robert Novy Marx (2013), "Graham never advocated just buying cheap stocks." Novy Marx states "Graham was just as concerned with the quality of a firm's assets as he was with the price that one had to pay to purchase them." In The Intelligent Investor (1973), the tome Buffett calls "the best book about investing ever written," Graham said investors should demand from a company "a sufficiently strong financial position and the potential that its earnings will at least be maintained over the years." Five quality criteria that Graham insists a company should meet for inclusion in an investor's portfolio are:

1. "Adequate" enterprise size, as insulation against the "vicissitudes" of the economy;
2. Strong financial condition, measured by current ratios that exceed two and net current assets that exceed long term debt;

3. Earnings stability, measured by 10 consecutive years of positive earnings;
4. A dividend record of uninterrupted payments for at least 20 years; and
5. Earnings-per-share growth of at least one-third over the last ten years.

Academics identify these demands as 'Quality' factors. Quality "has no universally accepted definition," (Novy Marx, 2012) but an analysis of well known factors identified in academic research, demonstrates quality companies are commonly characterised by low debt, stable earnings growth and other metrics such as strength of balance sheet, low leverage, accounting policies, accruals, and cash flows (Bender et al, 2013).

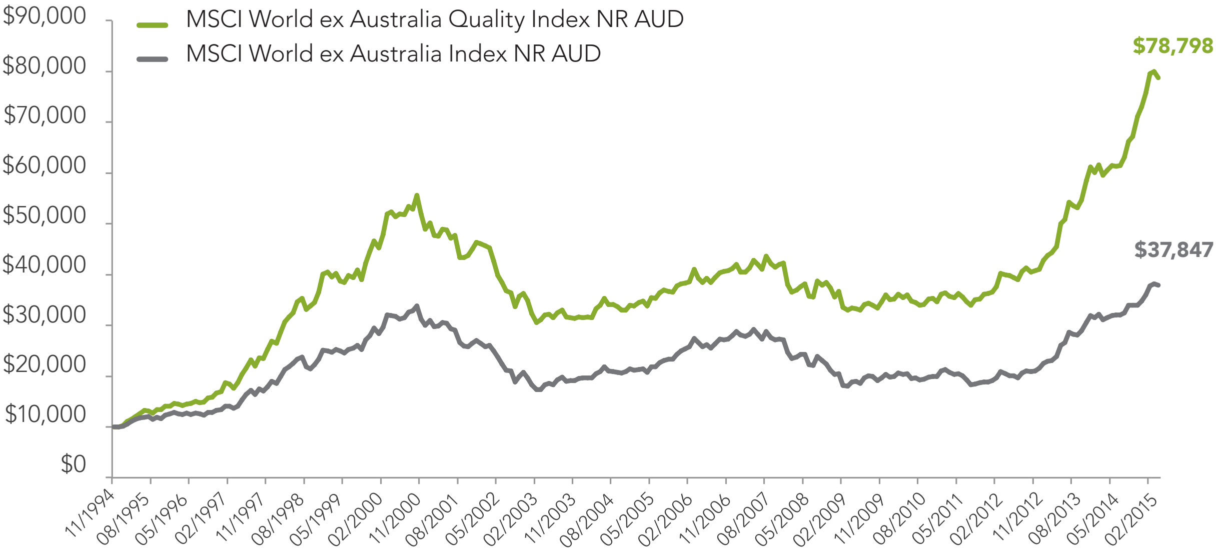
MSCI, the world's largest index providers and the creator of the first ever international index, states, "Quality growth companies tend to have high return of equity (ROE), stable earnings that are uncorrelated with the broad business cycle and strong balance sheets with low financial leverage. Many active strategies emphasise quality growth as an important factor in their security selection and portfolio construction." (MSCI, 2014). Based on this, MSCI Quality scores are based on three fundamental factors:

1. return on equity;
2. stable earnings growth; and
3. debt to equity ratio.

There is parallel between MSCI's quality factors and the characteristics Graham insisted investors should demand from companies. Graham defined a strong financial position as one where long term debt does not exceed current net assets and there is a high ROE. Graham argued that the best way to determine whether earnings will be maintained is to examine the earnings of the company over its past ten years. This is almost exactly what MSCI seeks to do with its Quality factors!

MSCI uses its three factors for its Quality Indices, which includes the MSCI World ex Australia Quality Index. The MSCI World ex Australia Quality Index demonstrates historical outperformance against its parent, the Australian investor's standard international equities benchmark, the MSCI World ex Australia Index (the Parent Index).

Chart 1: Cumulative index performance – net returns (30 November 1994 to 30 April 2015)



Source: Bloomberg, iRate, as at 30 April, 2015. You cannot directly invest in an index. Index performance returns differ from fund returns. Past performance is not a reliable indicator of current or future performance of an index or fund which may be lower or higher.

Quality for the long term

MSCI notes that its factor indices "are highly cyclical" (Gupta et al, 2014). So while the MSCI World ex Australia Quality Index is able to illustrate outperformance over the long term there will be economic periods in which the Quality factors result in underperformance.

Gupta and his MSCI colleagues, as part of research analysing the performance of indices in different economic conditions, conducted a bivariate analysis of the performance of the MSCI World Quality Index, the MSCI World Index and MSCI's World Sector Indices. The analysis classified four different economic conditions identified by rising and falling OECD growth and inflation and analysed the performance of various indices during these times. The results demonstrate that Quality consistently outperforms in all but one of four economic conditions, namely during periods of rising growth and falling inflation. A summary of the analysis is below.

Table 1 - Summary of bivariate analysis of MSCI quality and sector indices in economic cycles from December 1975 to December 2013

ECONOMIC CONDITIONS	QUALITY FACTOR PERFORMANCE	SECTOR COMMENTS
Rising Inflation / Rising Growth	Moderate outperformance	IT sector outperforming, financials and telecommunications underperforming
Falling Inflation / Rising Growth	Moderate Underperformance	Energy and materials outperforming, health care and consumer sectors underperforming
Falling Inflation / Slowing Growth	Strong outperformance	Health care and consumer staples outperform, materials, energy and industrials underperform
Rising Inflation / Slowing Growth	Strong outperformance	Health care, energy and consumer staples outperform, consumer discretionary and materials underperform

Source: Market Vectors, Gupta et al, 2014

MSCI World Quality Index traditionally has its strongest relative performance during economic downturns. Recall the importance of capital preservation Graham discussed. Reinforcing this defensive characteristic, Gupta et al also illustrates that the Quality factor has significantly less volatility than its parent index with much less variation through all economic conditions.

Table 2 – Annualised tracking error in economic cycles from December 1975 to December 2013

ECONOMIC CONDITIONS	MSCI WORLD INDEX	MSCI WORLD QUALITY INDEX
Full History	15.0%	5.9%
Rising Inflation / Rising Growth	10.1%	6.0%
Falling Inflation / Rising Growth	12.7%	6.1%
Falling Inflation / Slowing Growth	16.3%	5.7%
Rising Inflation / Slowing Growth	18.9%	5.2%

Source: Market Vectors, Gupta et al, 2014

In other words, MSCI Quality outperforms in most economic cycles with less overall risk.

Quality as a defensive investment strategy

The Quality factor tends to be more defensive, generating its most sustained relative outperformance in weaker macroeconomic environments. Table 3 below, highlights periods of relative outperformance for Quality:

Table 3 – Periods of quality outperformance

FINANCIAL MARKETS CRISIS	YEAR	MSCI WORLD QUALITY INDEX
Dotcom crash	2001	+4.82%
GFC	2008	+9.08%
Eurozone Crisis	2011	+10.02%

Source: MSCI. Outperformance is the respective calendar year return of the MSCI World ex Australia Quality Index relative to the MSCI World ex Australia Index. You cannot directly invest in an index. Index performance returns differ from fund returns. Past performance is not a reliable indicator of current or future performance of an index or fund which may be lower or higher.

While Quality will be impacted by these types of market events, in the past the level of retracement has typically been less severe than the broader market.

The importance of Quality

History has shown that it is nearly impossible for investors to 'time' the market. Benjamin Graham did not encourage investors to speculate and his pupil, Warren Buffett invests only for the long term. Quality companies outperform in the long term. One company that illustrates the Quality characteristics that Graham identified is Inditex.

Inditex[1] is a Spanish multinational clothing company is the biggest fashion group in the world. It operates over 6,200 stores worldwide and owns a number of brands. For Australian's Inditex most recognisable brand would be Zara.

Inditex's most recent Annual Report showed an annual profit of €2.4 billion on equity of €8.8 billion. This represents a ROE of more than 26%. The data for the most recent five years in euros is:

Table 4 – Example: Inditex financial results, 2014

	2010	2011	2012	2013	2014
Profit (m)	1,314	1,732	1,932	2,361	2,377
Earn./Sh. (c)	0.42	0.56	0.62	0.76	0.76
Equity (b)	5,025.44	5,857.67	6,900.49	7,930.37	8,846.09
Debt (b)	5	4	2	4	2
ROE	26.2	29.6	28.0	29.8	26.9
Total Debt/Equity	0.75	0.11	0.03	0.08	0.05

Source: FactSet

[1] Inditex is used by way of example only and this does not constitute a recommendation to invest in Inditex.

Three things stand out in this data:

- The ROE is high;
- The growth in earnings per share over the five years has been quite steady; and
- The debt to equity ratio is low.

Historically, investing in companies at the time they showed the characteristics that Inditex is currently showing, has delivered significant outperformance to the broader market. Inditex is just one of the companies identified by MSCI as having the fundamental financial characteristics that justify inclusion in its Quality Index.

Chart 2 – Five year performance ending April 2015: Inditex versus MSCI World Index (%)

Source: Morningstar Direct. Returns in Australian dollars, as at 30 April, 2015. Past performance is not a reliable indicator of current or future performance of an index or fund which may be lower or higher.

Investing in quality companies makes sense. Companies that exhibit MSCI's Quality factors outperform over the long term. It would be virtually impossible for an Australian investor to know all the companies in the developed world, to analyse their performance and to execute the trades.

MSCI analyses the 1,500+ companies in the Parent Index and selects only the top 300 with the best combined results demonstrating high ROE, low earnings variability and low financial leverage for inclusion in its Quality Index.

You can now make the 300 quality companies identified by MSCI in its MSCI World ex Australia Quality Index a part of your portfolio via a single trade on the ASX. The Quality index is tracked by an exchange traded fund (ETF) called the Market Vectors MSCI World ex Australia Quality ETF with ASX trading code QUAL.

In summary

Investing internationally can provide Australian investors with important diversification benefits. Investing directly can be costly, as can actively managed funds. Up until now the choice on the ASX has been limited to market capitalisation based index trackers, which includes the good stocks with the bad. QUAL addresses this by only including the top 300 companies based on MSCI's Quality factors.

QUAL provides investors with:

1. A diversified portfolio of 300 of the world's highest 'quality' companies, all physically held;
2. Fully transparent portfolio holdings published on a daily basis;
3. Access to sectors such as IT and Health care that contain the world's best companies such as Google, Apple, Roche Holdings and Johnson and Johnson;
4. Exposure to an international equity strategy which has demonstrated significant long term outperformance with relative lower volatility compared to the equivalent market capitalisation weighted Parent Index; and
5. An innovative, first of a kind ETF from Market Vectors, the ETF business of Van Eck Global, based in New York. Van Eck Global has been offering its innovative international investment solutions since 1955.

QUAL is unhedged to foreign currency exposure

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