

THE LONG RUN

Reynders, McVeigh Capital Management, October 2018

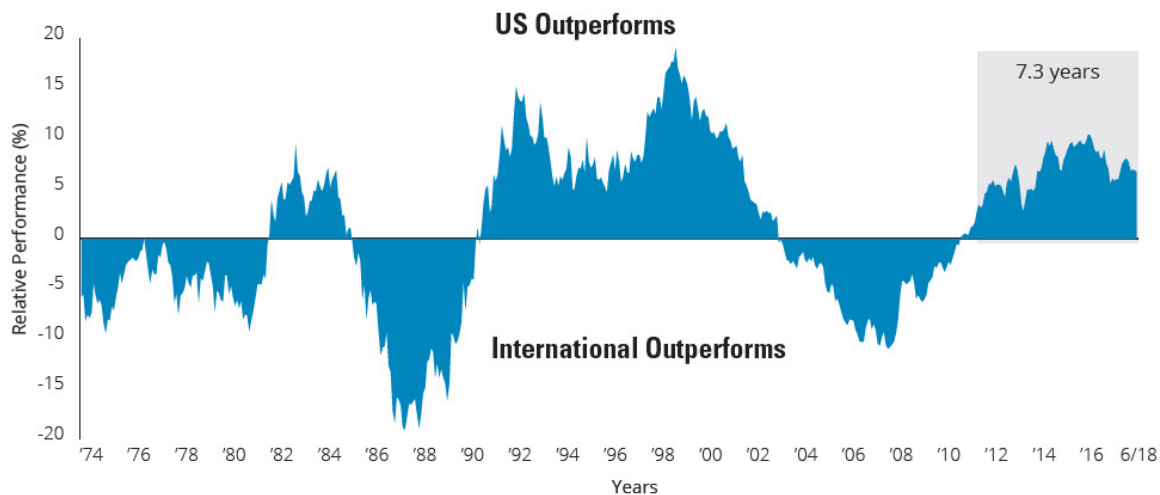
“When you find yourself on the side of the majority, you should pause and reflect.”
- Mark Twain

The Standard & Poor’s 500 Index (“S&P”) is on a tear. After retrenching a bit from its extraordinary sprint up in January, the S&P posted new highs again in September and has provided a total return of 10.56% through three quarters in 2018. This is after delivering a total return of nearly 22% in 2017.

According to FactSet, companies in the S&P reported earnings growth of 25% in each of the first two quarters of 2018 and are expected to report an average of 20% earnings growth in the third quarter. Concerns over whether the Federal Reserve’s determination to hike interest rates may slow growth, or whether the administration’s new tariff regime might lead to debilitating trade wars, have not dampened investor enthusiasm for S&P stocks.

For many years now, the S&P has been a notable outperformer compared with the rest of the world. The chart below shows the history of outperformance and underperformance of U.S. stocks versus international stocks since 1970, based on rolling 5-year returns.

US Equity vs. International Equity 5-Year Rolling Returns (1/1/1970-6/30/2018)



The chart shows the values of the S&P 500 index’s returns minus the MSCI World Index’s returns. When the line is above 0, domestic stocks outperformed international stocks. When the line is below 0, the international stocks outperformed domestic stocks.

Data source: Morningstar; Calculations: Hartford Funds, 7/18

Performance data quoted represents past performance and does not guarantee future results. The performance shown above is index performance and is not representative of any Hartford fund’s performance. Indices are unmanaged and not available for direct investment. US equity is represented by S&P 500 Index; International equity is represented by the MSCI World ex USA Index. For illustrative purposes only.

2018 adds a powerful and unprecedented punctuation mark to this chart. The S&P has had a performance differential of nearly 15% over the international developed market MSCI EAFE index and an astonishing differential of more than 20% over the emerging market MSCI EM index. Historians would be hard-pressed to find another year of such U.S. equity exceptionalism.

A careful analysis of a couple of the economic factors that have supported recent U.S. outperformance provides a reasonable argument that long-term investors might do well to consider rebalancing portfolios to be less dominated by leading U.S. index holdings:

- **Earnings at U.S. companies have been supported by recent reductions in regulation and tax cuts.** Many of these benefits are one-time in nature. While investors hope to see follow-on impacts of tax cuts, including significant increases in capital expenditures, Fidelity Investments estimates that earnings growth for S&P companies in 2019 will likely return to historic trend at around 7% – a far cry from the bawdy 20% growth we are enjoying today.
- **“America first” policies, including the redesigning of trade agreements and a new tariff regime, have created apparent wins for the United States. The damage that has been created, however, will likely come back to impact our economic outlook.** While much of the news coverage analyzes how these policies might create some modest negative outcomes for American consumers in the form of higher product prices in certain industries, the larger impacts will likely present themselves with the continued breakdown of the global economic coordination that marked the powerful global growth of 2017. Current U.S. economic policies are exacerbating weaknesses in important markets that drive global growth and help to lift all ships across the world. It is hard to imagine continued isolated growth for companies in the United States without a better growth picture developing overseas. A short-term “win” for us may, in fact, lead to lost opportunities in the longer view as we weaken critical partners.

These factors, combined with the recent performance disparity that has international stocks trading at a forward price-to-earnings ratio (“P/E”) of 13 and S&P companies trading at a forward P/E of 17, suggest that there are likely values to be found in discounted growth opportunities overseas.

But there is more to the story. Not unlike in 2000, when high-flying technology growth names dominated the S&P (and drove the index to an amazing forward P/E of 25), high-priced growth stocks have dominated the investment landscape in recent years and have been drivers of index performance. Bloomberg points out that, in the third quarter of 2018, the performance disparity between S&P growth companies and S&P value companies reached the record gap originally set back in 2000. As a result, we are also finding opportunities in underpriced value stocks here in the United States.

In times like these, when certain statistics and comparatives begin to bump up against historic boundaries, clients often wonder what we might do in the case of a market reset. The answer is that we have already been doing the critical work necessary to reposition portfolios in advance of any dislocation, or market adjustment. Our discipline demands that we rebalance accounts regularly to maintain long-term equity allocation targets for balanced accounts. This means locking in equity gains and investing them into protected reserves of cash and high-quality fixed income year-by-year during bull market advances such as the one we are currently experiencing. In equity portfolios, we have reduced positions in high-flying technology names and reinvested in sustainable growth opportunities trading at more reasonable valuations in the United States and, increasingly, overseas.

Taking these factors into consideration, our current growth portfolio reduces our exposure in the United States. Even with the strong performance of companies in the United States this year, our global Core Equity Composite has outperformed both the S&P and the MSCI World Index through three quarters of 2018. We are finding productive investments away from the herd – and we are very comfortable with our positioning in portfolios away from crowded index weightings.

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