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The Danger of Looking Back – Lessons from “Lost Decades”

Our industry’s most ubiquitous disclaimer, “Past performance is no guarantee of future results,” is good advice. Despite this advice, many investors make decisions based on the emotional journey of past performance – money follows performance. US investors are now pulling money out of international stocks following a decade of flat returns and 6 years of underperformance relative to US stocks; meanwhile, at RiverFront, we are adding to our international holdings.

In 1983, at a graduate training program in Tokyo, my colleagues and I had a series of lectures on the comparisons between Japan and the US. These lectures nearly always ended with the discussion of how poorly investors in US stocks had done over the previous “lost decade”. The Dow Jones famously hit 1000 in 1972 and did not surpass that level until 1982. Over the same decade Japan’s Nikkei Dow Index rose from 2700 to 8000.

The 1972-1982 “lost decade” was followed by one of the greatest bull markets in US history – the Dow is now over 18,000. Knowing that stocks had suffered a lousy decade between 1972 and 1982 was not helpful in predicting future returns. Much more helpful, in our view, was knowing that US stocks had a consistent long-term trend and had gone from well above that trend in 1972, to an extreme distance below trend in 1982. That information suggested that investors had gone from optimism to extreme pessimism. It would have been hard to predict the magnitude of US success in the subsequent 25 years, but not so hard to recognize favorable – risk-reward characteristics in the market. Along the journey, the Dow hit another milestone at 10,000 in 1999 and spent another 14 years before decisively breaking out to the upside in 2013, another “lost decade”. Once again, looking back during 2009-2013 at poor 10-year returns was not helpful in mapping out the future.

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Turn now to Europe, Australia and the Far East (MSCI EAFE Index), the main benchmark for non-US developed market stocks. Once again we are looking back at a lost decade. At Riverfront, we like to look at total returns, net of inflation or real total return. On this basis the EAFE Index is little changed from 2006. Indeed, it is little changed from the 2000 peak. Just as with the US in 1982 and 2009, an investor looking back is going to be frustrated, but 2000 (especially) and 2006 were both periods where the index was above trend. Today, it is well below trend (see Weekly Chart on page 2). Buying well below trend is no assurance of outsized returns, which require above-average earnings growth; but, we believe this distance below trend serves as a reliable indicator of investor pessimism and thus, favorable valuations.

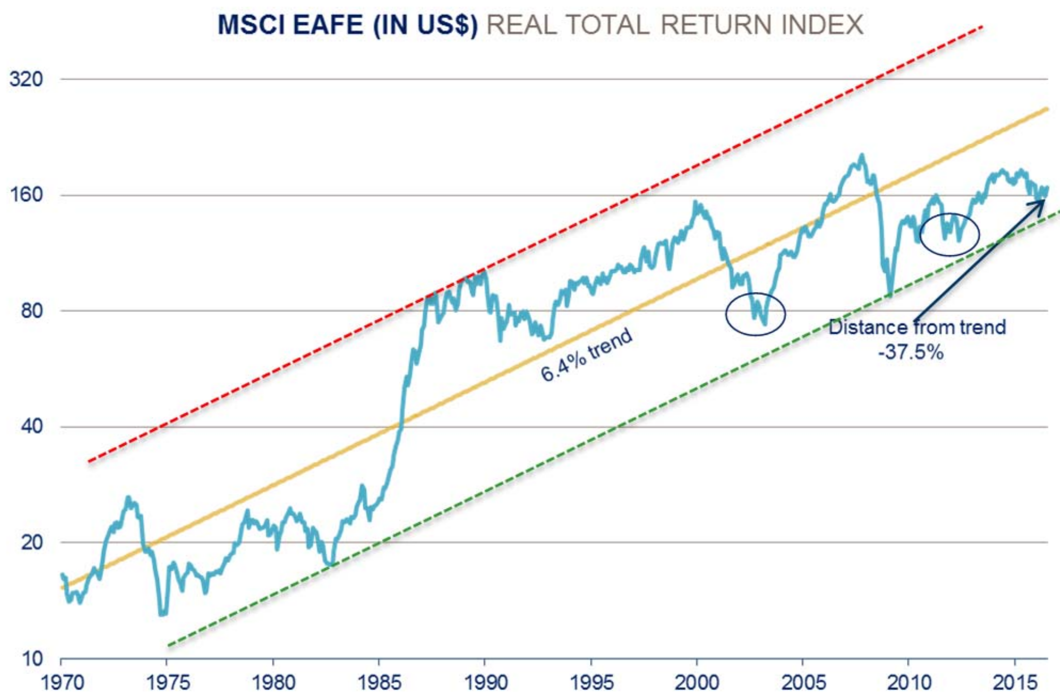
Confidence among US investors about investing internationally is currently low. Only last week the *Wall Street Journal* highlighted outflows from European funds over the last 6 months: “Flows were negative for the 29 weeks through August 24, according to data tracker EPFR Global. That marks a record since the company began collecting this data in 2002.”[1] We understand the emotion behind this. International stock markets have now had a five-year stretch of underperforming both US stocks and US bonds, leaving investors frustrated. However, as we suggest, looking backwards is not likely to give us a good guide to future returns, so let’s look forward.

[1] *http://www.wsj.com/articles/cash-keeps-pouring-out-of-european-stocks-1472673420*

We are currently optimistic about the prospects for international markets. Despite multiple political shocks (Brexit being the latest one), we believe that an economic and earnings recovery is underway in Europe. This belief was supported by the latest corporate survey reports for August conducted by Markit. Even the UK has shown a rebound in the last month. Germany remains the most robust economy and its retail sales accelerated in August. We believe there is more potential for profit margin expansion outside the US where the economic recovery is 4-5 years behind.

As you can see in the Weekly Chart below, international stocks at the end of July 2016 were 37.5% below the gold trend line (blue arrow). This is a similar distance below trend to the bear market lows of 2002 and 2011 (blue circles), which suggests to us that the economic recovery in Europe has not yet been priced into these stocks. We think this presents an opportunity in international stocks over the next several years.

THE WEEKLY CHART: ATTRACTIVE RISK/REWARD FROM CURRENT LEVELS



Source: RiverFront Investment Group, MSCI. Data from Jan 1970 through July 2016. Past performance is no guarantee of future results. The MSCI EAFE Index measures the equity market performance of developed markets, excluding the US & Canada. The index consisted of indices from 22 developed markets. MSCI presents the data for this index in terms of US dollars and in terms of local currencies. The chart above reflects index data in terms of US dollars. It is not possible to invest directly in an index.

Important Disclosure Information

Past performance is no guarantee of future results.

ETFs are subject to substantially the same risks as those associated with the direct ownership of the securities comprising the index on which the ETF is based. Additionally, the value of the investment will fluctuate in response to the performance of the underlying index. ETFs typically incur fees that are separate from those fees charged by RiverFront. Therefore, investments in ETFs will result in the layering of expenses.

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Strategies seeking higher returns generally have a greater allocation to equities. These strategies also carry higher risks and are subject to a greater degree of market volatility.

Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

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