"I am extraordinarily patient, provided I get my own way in the end."

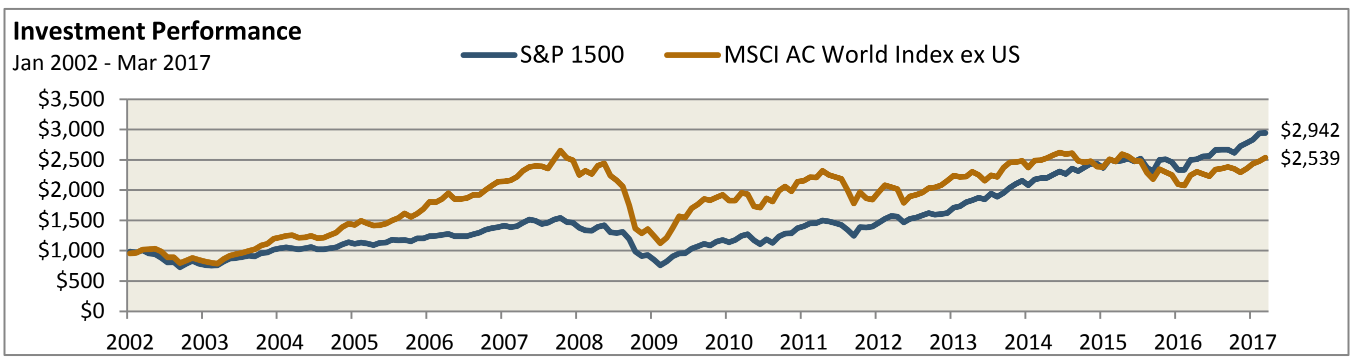
Margaret Thatcher

Diversification, as a fundamental component of prudent investment management, has tested the patience of investors over the most recent bull market in US equities. International equities have trailed by a significant margin in relative performance since late 2011, weighing on the returns of a globally diversified portfolio versus a US only investment strategy. In this piece, we take a longer view of global diversification and compare the current valuations of US and international markets.

Relative Performance

Broad adoption of US investor diversification into international equities began over 20 years ago. However, for the purposes of comparison, we will focus on the last 15 years, a period covering two bull markets and one bear market. It is worth noting that during this time frame, the returns have been meaningfully positive for both cohorts. As shown in Chart A, a $1,000 investment in US equities would have grown to $2,942 while an international equity investment would have grown to $2,539.

Chart A



However, the interim time periods of the 2002-2007 bull market and the more recent 2009-2017 bull market have seen very different results.

In the bull market following the dot-com bubble, Chart B, international equities significantly outperformed their US counterpart. Foreign stock results reflected the faster growth rate of their underlying corporate earnings. Since the current bull market began in 2009 the reverse is true, as shown in Chart C. US equities trounced international equities as the US economy recovered more quickly and US corporate earnings grew at a much faster rate than their foreign counterparts.

Chart B

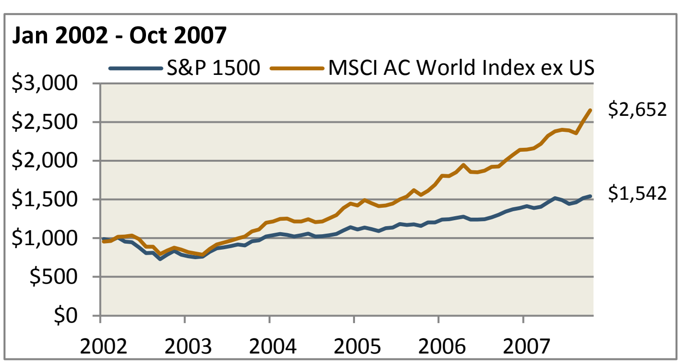
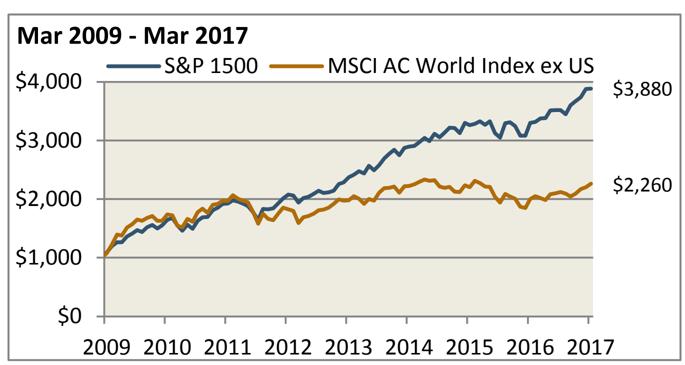


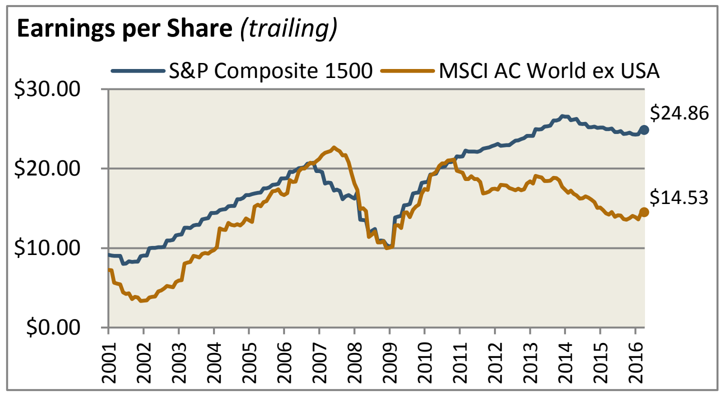
Chart C



Earnings Growth

In the US, profits have expanded rapidly since the Recession of 2008-2009. From the low point in the fourth quarter of 2009, US earnings per share are up nearly 2½ times. While earnings growth has slowed since 2015, with flat results through much of 2016, this was primarily driven by two factors that are unlikely to recur. First, the collapse of crude oil prices from over $100 per barrel to less than $30 per barrel drove profits at energy companies down over 50%; and second, a rise in the value of the US dollar hurt overseas profits for US firms. Absent these factors, earnings growth has remained positive. If oil prices and the dollar holds relatively stable, we expect US profits to grow again in 2017.

Internationally we are also beginning to see evidence of earnings improvement. In the fourth quarter of 2016, international earnings rose faster than in the US. With higher commodity prices helping emerging markets and local demand driving growth in Europe, we believe this trend could continue.

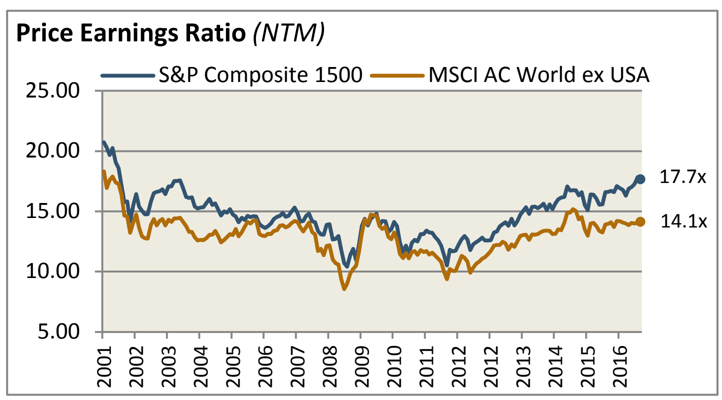


The present gap between US and international profit margins is very wide. Yet there is no historical evidence that this gap should be permanent. Well managed foreign companies have an opportunity to translate moderate revenue growth into faster earnings growth.

Valuations

From the low point in 2009, equity valuations in the US rose from 10-11 times expected profits to 17-18 times estimated earnings today. At present levels, further multiple expansion is limited, which implies earnings growth needs to accelerate to move US stock prices higher.

Outside the US, the price earnings ratio bottomed at 9-10x in 2009 and now sits at ~14x expected profits, suggesting that there may be more room for multiple expansion outside the domestic market, particularly if foreign growth accelerates.



While international markets appear "cheap" relative to the US via simple comparison, we recognize that there are many economic and political challenges abroad that could justify the current difference in valuations. Among these are central bank policies, populist movements, future trade policies, EU solidarity and the impact of Brexit.

Summary

The combination of better international economic growth and attractive relative valuations indicate an improving outlook for international equities. We expect further evidence of economic strength from foreign countries and earnings growth from foreign companies. At Aureus, after being underweight international equities for many years, we have started to increase our allocation. Following many years of disappointing returns for investors, we now have the prospect of competitive returns from markets abroad.