



A Death Greatly Exaggerated **Understanding and Profitting from EAFE: Current Prospects**

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A common way investors voyage into overseas markets is through a mutual or exchange-traded fund that tracks the MSCI Australasia Far East Index, better known by its acronym, EAFE. This well-established benchmark, which dates back to 1969, tracks approximately 85 percent of the world's developed markets outside of the Americas. But as this article explores, it may not be the most effective index to gain international exposure.

Market-cap weighted, measuring only stocks' free float, or the portion of their equity that's readily tradable (i.e., shares not closely held or government owned), EAFE is the international equivalent of the S&P 500. Like its US counterpart, the index provides heavier exposure to the world's largest companies, industries, sectors, and national markets. For example, despite the disastrous year commercial banks have had, they still make up nearly 14 percent of the index. And though the Nikkei Index has gone nowhere over the past 15 years, more than one-fifth of EAFE is invested in Japanese stocks.

This exposure and a rallying greenback have contributed to a difficult trailing 12 months, with the index off nearly 14 percent in dollar terms through the beginning of September. That's about 2.5 percent below the US market. However, EAFE has proven its long-term value. Over the past decade, a period in which the effects of currency translation have been more balanced, the index is up 6.74 percent. That's over three full percentage points better than the S&P 500.

Asset managers have gravitated to this international benchmark to gain easy-to-obtain, broad, non-discretionary market exposure. More than \$50 billion alone is invested in Barclay's EFA ETF, and Fidelity's and Vanguard's open-end fund versions. However, few investors appear to question whether a strictly market-cap weighted approach is the most profitable way to invest. Because it focuses on the largest companies, EAFE emphasizes aggregate past performance and underweights the smaller stocks that have been leading the market. Further inflows into EAFE-tracking funds exaggerate these differences.

Concerns about the shortcomings of market cap weighting have fueled interest in fundamental indexing, which is based on metrics that may better reflect prospective earnings growth than market capitalization alone. For instance, the ETF creator WisdomTree has devised 30 international funds that are weighted by absolute dividends. Its logic: cash dividends provide an objective measure of a



company's value and profitability, and there's evidence that higher dividend yielding stocks outperform the market. WisdomTree's EAFE equivalent is the Dividend Index of Europe, Far East, Australia, and Asia, aptly known as DEFA. Its performance topped the EAFE benchmark over the trailing 1-, 3-, 5- and 10-year periods through August.

Rob Arnott, chairman of the Pasadena, Calif.-based investment advisory Research Affiliates--who with FTSE has devised 40 international ETFs marketed through various distributors including PowerShares--has championed an approach that integrates revenues, cash flow, book value along with dividends in devising his indices. Arnott claims that "relying on just dividends leaves out too much of the market and ends up producing portfolios that are heavily tilted to financials and utilities." His international equivalent is the FTSE RAFI Developed Ex-US 1000 Index. It basically matched EAFE over the past year, and outperformed the index over the trailing 3 and 5 years through August.

So is EAFE the most effective way to direct assets overseas or are there better means for investing in developed foreign markets?



Defining EAFE

Arun Kumar, executive director of MSCI Barra, the firm that creates, maintains, and licenses the index, is quick to highlight that EAFE was designed to accurately represent the international market. “It shouldn’t be judged as a fund,” he explains. But its wide acceptance as a benchmark to gauge the performance of active foreign fund managers and its ability to be licensed has transformed EAFE into one of the leading international investment vehicles.

More than 1,000 stocks from twenty-one nations comprise EAFE, ranging from New Zealand’s \$128 billion economy to Japan’s \$4.4 trillion economy.

Geographically, it reaches from the northwestern-most corner of Europe (Ireland), across the continent to the southeast edges of Asia and Australia. Business-wise, it’s made up of 68 industry groups crossing 10 sectors. Average market capitalization of an EAFE holding is \$34 billion.

	MSCI EAFE Index (Market Cap Weighted)	MSCI EAFE GDP Index (GDP Weighted)
Japan	21.35%	19.72%
United Kingdom	20.87%	12.46%
France	10.72%	11.50%
Germany	8.91%	14.93%
Switzerland	6.89%	1.91%
Australia	6.64%	4.23%
Spain	4.07%	6.47%
Italy	3.82%	9.50%
Sweden	3.48%	2.05%
Netherlands	2.66%	3.45%
Hong Kong	2.17%	0.93%
Finland	1.60%	1.10%
Singapore	1.18%	0.73%
Belgium	1.14%	2.04%
Norway	1.11%	1.75%
Denmark	0.99%	1.40%
Greece	0.73%	1.41%
Austria	0.64%	1.68%
Ireland	0.62%	1.16%
Portugal	0.30%	1.00%
New Zealand	0.10%	0.58%

But when you drill into the index’s market-cap weighted composition, a more focused index emerges. Six countries make up more than three-quarters of the index, led by the UK and Japan, each representing more than 21 percent of the index, followed by France (10.87%), Germany (9.20%), Switzerland (7.46%), and Australia (6.49%). EAFE’s currency exposure is also concentrated, with nearly 80 percent of the index denominated in euros, pound sterling, and yen. While sector exposure is better balanced with the top five (financials, industrials, consumer discretionary, materials, and consumer staples) representing two-thirds of the index, financials dominate the index, accounting for more than one-quarter of EAFE.

EAFE’s country weightings are shown in the sidebar, as of June 2, 2008.



EAFE's weak showing over the past year through August, with the index having lost nearly 14 percent, has pulled down what had been very strong performance across all periods. Three-year annualized returns were 8.57 percent, five-year gains remained an impressive 14.34 percent, while 10-year gains have moderated to 6.74 percent.

But a good chunk of this performance was generated by the falling dollar, which began declining more than five years ago. Despite the greenback's rebound in August, one-year dollar-based EAFE returns were 2.81 percent better than the index measured in local currencies (-13.96% versus -16.77%). More than 40 percent of the index's gains over the past three years were due to the weakening dollar; over the trailing five years, more than 31 percent, and over the past decade, nearly 37 percent of dollar-based EAFE returns were attributable to currency.

This doesn't negate the value of the index. Currency exposure is an inherent quality of unhedged cross-border investing that many investors seek. But foreign exchange rates never move in just one direction, and investors should be concerned with facing a headwind from less beneficial currency translation going forward. Utilizing a proven currency overlay manager can help smooth returns, especially when the dollar is strengthening.

Inopportune Exposure and Missed Opportunities

Given the growing maturity and uncorrelated performance of emerging markets, much has been made of late that EAFE is a passé means of going international—that a more ideal index should include these newer economies. But as we are being reminded today, emerging markets are more volatile and remain linked to developed markets, and that there's an investment purpose in distinguishing between the two.

There is, however, a more legitimate concern about EAFE's non-discretionary exposure to various national markets, regardless of past performance. As mentioned earlier, Japanese stocks have consistently been among the weakest performing shares across the developed market. They have been in the bottom quintile of the 21 markets tracked over the trailing 3- and 5-, and 10-year periods.

Performance of UK stocks, the largest national market in the index (21.81%), has been only marginally better than Japan over the same time frame. This means that over 40 percent of the EAFE has been in markets that have been seriously struggling for a long time.

Then there's the diametric problem of minimal exposure to small markets that have been consistently strong performers and the outright exclusion of a major



foreign developed market. Through July, four markets repeatedly appear in the top seven spots in 1-, 3-, 5-, and 10-year time frames: Singapore, Norway, Denmark, and Canada. Total exposure of the first three markets makes up only 3.23 percent of EAFE. Canada is not even included.

While past performance does not assure anything, price trends are real. The increasingly complex metrics that go into formulating more fundamental indices exclude perhaps the most important metric of all: absolute performance. The existence of price trends argues for tweaking national market weightings according to long-term performance.

While international investors should maintain some exposure to Japan and the UK, it makes sense to pare back EAFE's weighting until these markets show they can once again generate value. Investors could accomplish this by simply shorting a country-specific fund. At the same time, enhancing specific country or regional exposure can also be done easily by going long country-specific ETFs.

Variations on a Theme

MSCI has devised a version of EAFE that equal weights individual stocks, mitigating the differences among countries to more evenly reflect changes in individual share values on the index. For example, the weight of Singapore and Hong Kong shares, which is just 1.23 and 2.18 percent, respectively, in the market-cap-weighted index is boosted to 3.16 and 4.68 percent in the equal-weighted version.

At the same time, the standing of France and the UK are diminished from 10.84 and 21.64 percent to 7.34 and 12.20 percent, respectively.

But where the equal-weighting approach breaks down in practical terms is with Japan. Instead of declining, the country's weight actually soars from 21.34 to 35.96 percent—a change that diminished EAFE's performance over the last decade.

Believing that there's a material distinction between the size of a nation's economy and its stock market, MSCI also devised a GDP-weighted EAFE index. A few country representations significantly change. *Italy's soared from 3.82 percent to 9.50 percent. Switzerland and the UK, in contrast, fell from 6.89 and 20.87 percent to 1.91 and 12.46 percent, respectively.*

Performance history is inconclusive about whether the equal- or GDP-weighted variation is a better benchmark. Both are trailing EAFE over the past year, with the equal-weighted version underperforming by 414 basis points. Equal weighting is behind 162 basis points per annum over each of the last three years.



Five-year returns top EAFE by an annualized clip of 68 bps.

GDP weighting makes a bit more compelling case, topping EAFE by 63 and 87 bps over the trailing three- and five-year periods.

COMPARATIVE ANNUALIZED TOTAL RETURNS OF MSCI EAFE INDICES

	1 Year	3 Year	5 Year	10 Year
EAFE	-13.96	8.58	14.34	6.74
EAFE GDP Weighted	-14.27	9.21	15.21	NA
EAFE Equal Weighted	-18.10	6.96	15.02	NA

Data: thru 29 August 2008
Source: MSCI Barra

Non-MSCI Alternatives

Until markets started turning south a year ago, both RAFI's and WisdomTree's alternatively-weighted international indices performed very well relative to EAFE. But the collapse of shares over the past year, especially value-oriented stocks, has weighed more heavily on these two relative newcomers. While the performance gap between the benchmark and these alternatives closed over the past year, RAFI and WisdomTree have sustained their lead over EAFE across all time periods.

COMPARATIVE PERFORMANCE OF ALTERNATIVELY-WEIGHTED INTERNATIONAL INDICES

	1-Year	3-Year	5-Year	10-Year
FTSE RAFI Developed ex US 1000 Index	-13.85	9.75	15.68	NA
WisdomTree DEFA Index	-12.67	10.21	16.61	10.88
MSCI EAFE	-13.96	8.58	14.34	6.74

Data: Returns are annualized thru 29 August 2008.
Source: MSCI Barra, FTSE, and WisdomTree.

In support of traditional, market-cap weighted indexing, John Bogle, founder of the Vanguard Group exclaims, "Never think you know more than the markets; nobody does." It's hard to argue with a legend who has brought such benefits to individual investors through his ultralow-cost index funds.

But it's easy to forget that he was a maverick when decades ago he suggested that indexing was a cheaper, more profitable way of gaining exposure to markets



than more expensive active management.

Bogle was proven right. And while the new generation of indices no doubt has its own Achilles heels, they too have proven the value of thinking outside the box.

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