By the close of 2018, the investment climate had changed significantly from just a year earlier.

In our final quarterly letter of 2017, we noted, “The S&P 500 Index was up 19% in 2017, and the MSCI EAFE Index, which measures the major international equity markets, was up 25% (as of 12/31/2017).” Roll forward 12 short months and the story was much different, with the S&P 500 Index down 4.4% in 2018, declining 9.0% in December alone. U.S. markets experienced one of the worst Decembers since the Great Depression. International markets did not fare any better in 2018, with the MSCI EAFE Index off 13.8% and the MSCI Emerging Markets Index down 14.6%.

While none of this may be news to you, we reference it to reiterate the points we made a year ago and have been making for the past several years. The current market volatility, and resulting declines, are no surprise to us considering how extended valuations have been—especially in the U.S. market.

For the past number of years, we have written about high valuations, the impact of central bank manipulation of interest rates, and the general investor complacency that tends to occur when there is little volatility and markets appear to only go up. We continue to believe that valuations always matter and that the price you pay for an investment has a significant bearing on long-term returns. These are key principles of our fundamental, bottom-up value investment approach.

How should investors navigate the current volatility and market uncertainty? Our answer is the same today as it was a year ago—and essentially the same as it has been for more than 40 years: Try to look beyond current market conditions and take a long-term view—of at least five years. A long-term mindset also means considering valuations and rebalancing to a normal asset-allocation model. At the end of 2017, many investors may have allowed their asset allocations to get out of balance and may have, among other things, been over-allocated to the U.S. market, especially to technology companies, and under-allocated to non-U.S. markets.

Now that the markets have entered a period of increased volatility where valuations are being readjusted, we believe the outlook for the value investing approach is better than it has been in the recent past. We caution investors to take a long-term view, which takes into account an appropriate asset allocation that strikes a balance between U.S. and international markets, as well as the value and growth investment styles.

The past 10 years have been very difficult for value investing, with the broad value index (the MSCI World Value Index) underperforming its growth counterpart (the MSCI World Growth Index) for more than 130 months—the longest such period on record, as shown in Exhibit 1.
It’s likely that when we look back on this period it may be known as the nuclear winter for value investing.

In light of current valuation discrepancies, we’d like to draw your attention to a November 2018 research paper from Brandes Institute Advisory Board member Wim Antoons titled “The CAPE Ratio and Future Returns: A Note on Market Timing.” In the paper, Wim notes that as of June 30, 2018, the Shiller cyclically adjusted price earnings (CAPE) ratio for the S&P 500 stood at 32, an unusually high level. He points out that, "historically, high CAPE ratios generally have been followed by low returns in the subsequent 5- and 10-year periods and that low CAPE ratios generally have been followed by strong returns over subsequent 5- and 10-year periods."

Exhibit 2 shows the median 15-year annualized returns for a number of developed markets from various CAPE ratio levels. Generally, the higher the CAPE ratio, the lower the subsequent returns.
However, Wim cautions that while a CAPE ratio of 32 suggests low returns over the subsequent five-year period, he believes investors should not use the ratio to try to time the market over short periods. He notes that short-term returns from the middle of 2018 could continue to be high. Indeed, in the short term, Wim was correct, as the U.S. markets continued to rise through the middle of November.

In summary, we believe it is timely and relevant to emphasize some of the conclusions from Wim’s paper as it reinforces many of the points we have been making for the past several years:

- A long-term view is essential
- A sensible asset allocation strategy is vital
- Never ignore valuations

Here is an excerpt from Wim’s conclusion:

“Today, many global equity funds have underperformed the MSCI World Index for an extended period. The U.S. market accounts for 60.7% of the MSCI World Index as of June 30, 2018. In my opinion, a global approach to equities should be more diversified. I believe it makes sense to diversify toward emerging markets, Europe and Asia. Although one cannot predict short-term equity market results, the high valuation of Japanese equities in 1989 and the high weight for them at that point in the MSCI World Index could serve as a warning today for the United States.

Wise investors invest worldwide, not based on index weight, but based on valuation and earnings growth. To me, it definitely makes sense as a global investor to underweight U.S. stocks now based on valuation and overweight other regions. I believe the spread between value and growth stocks is, from a historic point of view, very high. The high CAPE currently is (mostly) related to the technology sector where investors have chased high-growth companies at high price levels. Active management focused on the careful selection of well-managed and reasonably priced companies still makes sense in this expensive market and, I believe, will make a large difference for patient investors in the future.”

Disparate valuations among markets worldwide have fortified our belief in the importance of a global investing mindset. Accordingly, we urge you to consider expanding your investment horizons and look at some of the attractive valuations currently offered outside the U.S. market (see Exhibit 3).
While CAPE ratios may not be the best predictors of near-term investment performance, we believe they can provide a useful insight into both relative and absolute long-term returns.

As we welcome the new year, it may be a good time to reflect on the importance of having a long-term outlook. Regardless of market conditions, we believe a disciplined, value investing approach should remain an integral part of investor portfolios.

We thank you for your continued confidence in Brandes and wish you a very happy new year.

Cyclically Adjusted Price Earnings (CAPE) Ratio: A valuation measure, generally applied to broad equity indices, that uses real (inflation-adjusted) per-share earnings over a 10-year period; also known as Shiller PE ratio.

Price/Earnings: Price per share divided by earnings per share.

The S&P 500 Index with gross dividends measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

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The MSCI EAFE Index with net dividends captures large and mid cap representation of developed market countries excluding the U.S. and Canada.

The MSCI World Index with net dividends captures large and mid cap representation of developed markets.

The MSCI World Growth Index with gross dividends captures large and mid cap securities across developed market countries exhibiting growth style characteristics, defined using long-term forward earnings per share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend.
The MSCI World Value Index with gross dividends captures large and mid cap securities across developed market countries exhibiting value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

The MSCI Emerging Markets Index with gross dividends captures large and mid cap representation of emerging market countries.

Wim Antoons’ opinions do not necessarily reflect the views of Brandes Investment Partners.

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