

# THE CASE FOR INVESTING INTERNATIONALLY

How to use current trends to identify new opportunities for increasing international equity allocations



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*In this latest edition of Buffalo Funds' PM Insights, our International Fund portfolio managers, who operate within the international equity asset classes on a daily basis, share their view of international markets. Based on a multitude of global market factors, we believe now is the time for investors to rethink international equity exposure and consider increasing international stock allocations.*

## TOPICS COVERED

1. Introduction to Investing Internationally
2. Impact of Trade Wars
3. Economic Cycle & Gross Domestic Product (GDP) Growth
4. Credit Cycles
5. Relative Valuations

## CONTRIBUTORS



**Bill Kornitzer, CFA**  
Portfolio Manager  
26 years experience



**Nicole Kornitzer, CFA**  
Portfolio Manager  
18 years experience

## SUMMARY

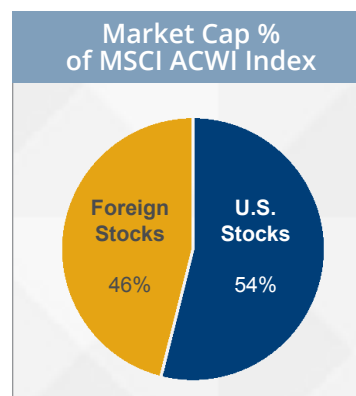
- International equities have underperformed their domestic (U.S.) counterparts over the past 3, 5, and 10-year periods<sup>1</sup>, as international economies have lagged the U.S. by a couple of years.
- International equities appear ready to take a leadership role, and the international market cycle has a long recovery ahead.
- Valuations appear cheaper for most international stocks compared to U.S. stocks, and the credit cycle in global markets is still very accommodative.

## INVESTING INTERNATIONALLY

Seasoned, educated investors know the historical and theoretical benefits of allocating a portion of their overall portfolio to international equities. The primary potential benefit is exposure to faster-growing economies and companies located outside of the U.S., combined with better risk-adjusted returns because of diversification, when compared to a U.S. equity-only portfolio.

While some investors consider international equities “mainstream”, many do not realize the pool of U.S. listed companies is dwarfed by the number of international listings. According to The World Bank there are nearly eight times the number of foreign stocks as U.S. stocks.

Over the last 10 years the number of listed companies in the U.S. has decreased by 16%, while the number of foreign listed companies has remained relatively flat.



Source: MSCI; as of 12/31/17

Additionally, the cumulative market capitalization of international companies makes up almost half of the world's total equity investment universe, as measured by the market capitalization of the MSCI ACWI Index, a broad-based global benchmark.

Based on the sheer number of public companies listed in foreign markets, it is hard to argue that international equities can be as efficiently priced as their U.S. counterparts. It is also likely that most investors have little actual investment exposure corresponding to the market cap weightings in the index.

We believe that because of domestic bias, many U.S. investors consider international equity to be mere window dressing and allocate minimal exposure to the asset class when devising an investment plan.

Until recently, international equities have not been particularly rewarding over the past 10 years, and investors with significant foreign exposure may not be feeling particularly predisposed in favor of the asset class.

One of the tenets of asset allocation between domestic U.S. equity and international equity is that they often take turns outperforming, and sometimes the outperformance is dramatic and long-lasting. The S&P 500 has made a significant run over the past 10 years outperforming the MSCI EAFE Index by 3.8% on an annualized basis through 7/31/18.

Statistically speaking, reversion to the mean -- "what goes around, comes around" -- appears to be in play. While we cannot guarantee if this trend is set to continue, we will point out additional factors in support of investing in international equity today.

## IMPACT OF TRADE WARS

According to the World Trade Organization (WTO), the U.S. has been involved in 255 trade disputes in 2018. However, even though the phrase "trade war" has been in the news so consistently of late, trade disputes are pretty common -- it just usually doesn't get amped up to this level of rhetoric. We don't think the markets are terribly concerned despite the frequent daily volatility.

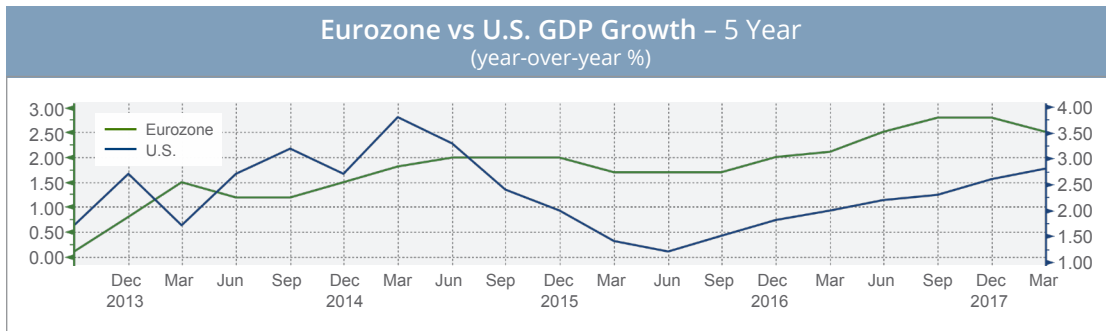
The current issue is not really about free trade versus tariffs but about changing the current tariff regime. These potential changes undoubtedly can have adverse impacts on certain industries and global trade in general. However, it is instructive to note that much of the trade noise we hear is to some degree part of the current negotiation strategies being carried out between countries. Usually this process takes place behind closed doors, and when tariffs or penalties are imposed, it typically doesn't garner much press.

We do see the potential for a slight slowdown in the rates of economic growth around the world but nothing that derails economies and puts them into a recession. And, trade actions aren't everlasting. To the extent that they did cause some severe economic consequences, we think that the tariff structures would be quickly amended and put back to where they were. It might provide some good long-term investing opportunity if the volatility does increase.

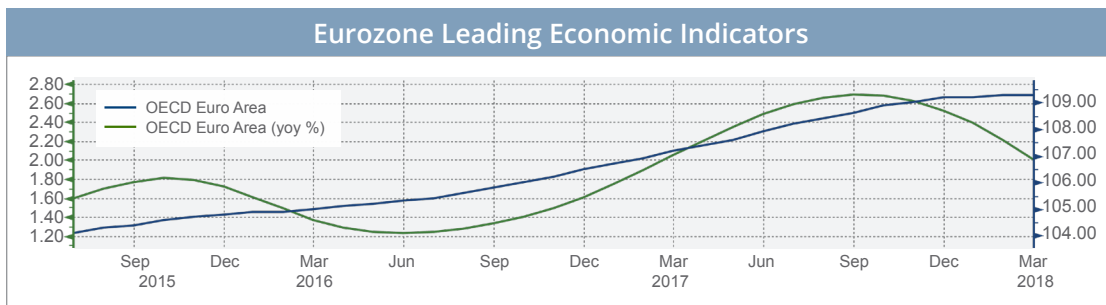
Also, trade wars and tariffs aren't always negative. For example, Japan and Europe just signed a "free trade" agreement which means those countries should potentially benefit from additional trade, at the expense of companies in other jurisdictions. Or take the case of the increased rhetoric between the U.S. and China -- arguably the tension could accrue to the benefit of European suppliers. In some context, these "trade wars" might just benefit international companies, especially those with high barriers to entry and substantial intellectual property, whose products are not easily substitutable.

## ECONOMIC CYCLE & GDP GROWTH

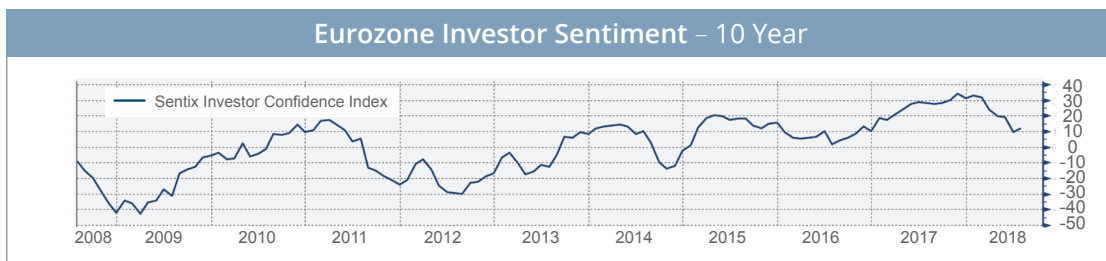
Typically, international economic cycles have lagged the U.S. by 1-3 years. However, there are signs that the global environment is finally improving. In fact, since 2015, Eurozone GDP growth has surpassed that of the United States. While overseas growth data is strengthening, Eurozone leading economic indicators and investor sentiment in the region is also trending higher.



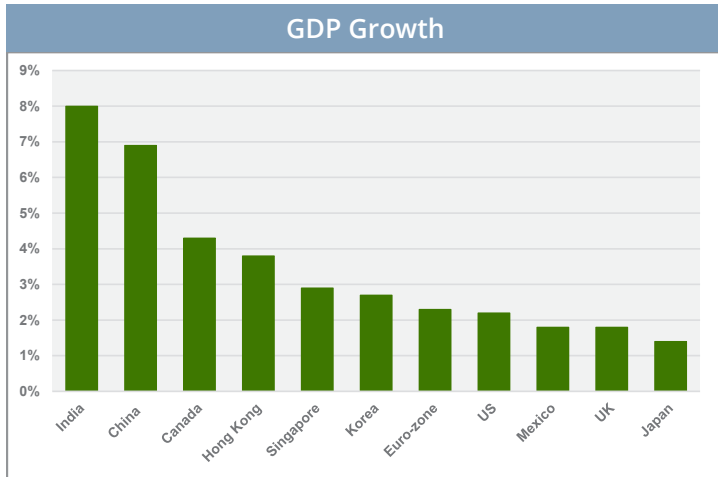
Source: Bloomberg Finance



The long-term average of the leading economic indicators is set to 100. Values higher than 100 indicate optimism; below indicates pessimism.  
Source: Bloomberg Finance

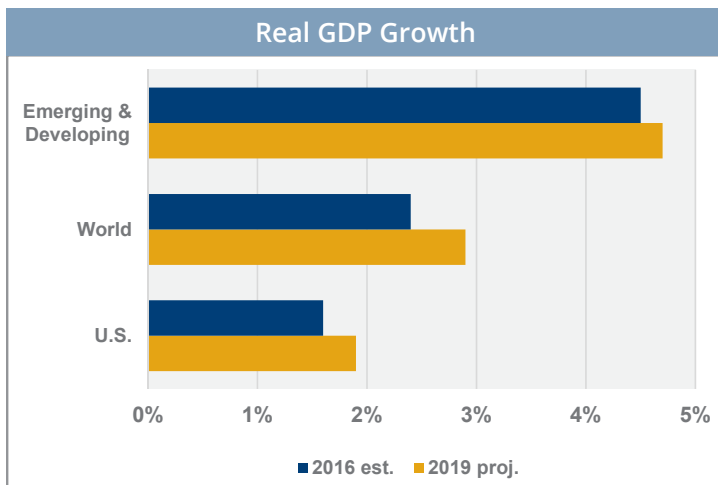


A reading above zero indicates optimism; below indicates pessimism.  
Source: Bloomberg Finance



Source: Bloomberg Finance

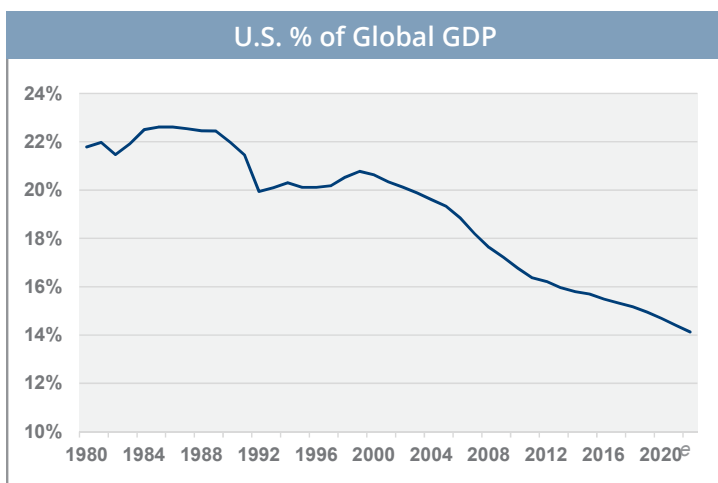
Bloomberg shows the latest quarterly GDP growth by country, with major growth in Asia, followed by the Eurozone and the U.S.



Source: World Bank

GDP is growing faster outside the U.S. and is projected to continue to outpace U.S. growth.

Faster GDP growth suggests the international share of the total global economic pie will continue to get larger.



Source: IMF

Indeed, the International Monetary Fund (IMF) predicts the U.S. share of global GDP will continue to decrease going forward.

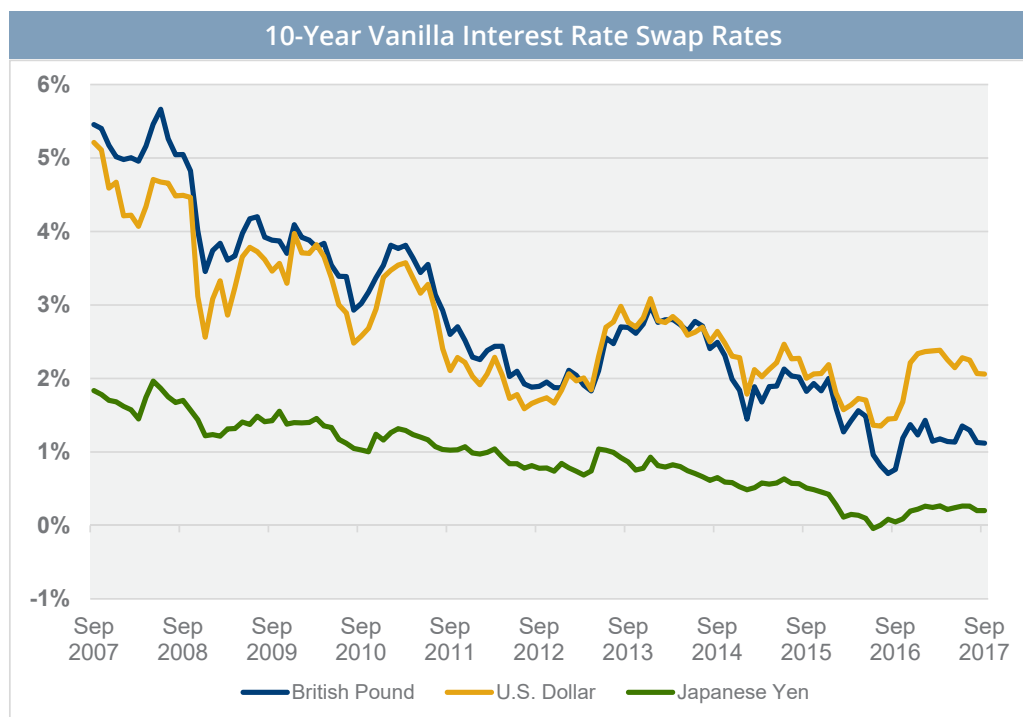
This could lead to increased market capitalization of foreign companies relative to the U.S., which could act as a natural tailwind for international equities.

## CREDIT CYCLES

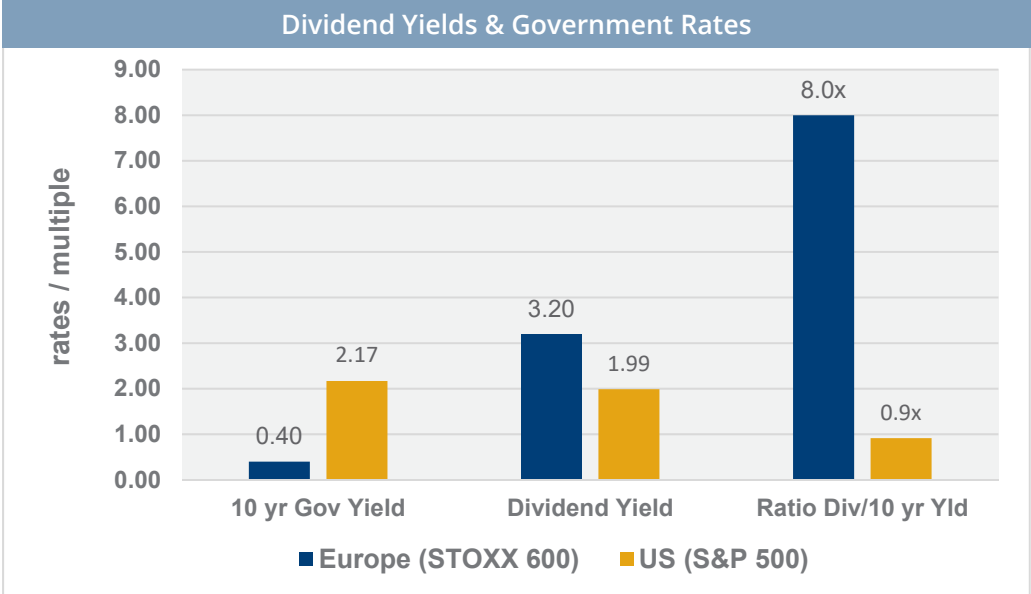
Another factor highlighting the case for investing internationally is related to the global credit cycle. In general, credit cycles for global markets are still highly accommodative, with many foreign central banks attempting to expand the overall money supply to boost their economy, while the U.S. has begun to tighten on a relative basis. In theory, looser monetary policy should help economic growth and should also spur asset classes.

Credit expansion and accommodative monetary policy have historically been positive for economic growth, and both Europe and Japan are still leaning on the monetary accelerator.

To the extent that the base level of interest rates influences asset valuations, lower rates might suggest that higher valuations are appropriate in lower interest rate economies, all other things being equal.



Many economists also posit that there should be a tight relationship between interest rates and dividend yields. However, the rate and yield relationships in different economic regions currently does not seem to support those theories.



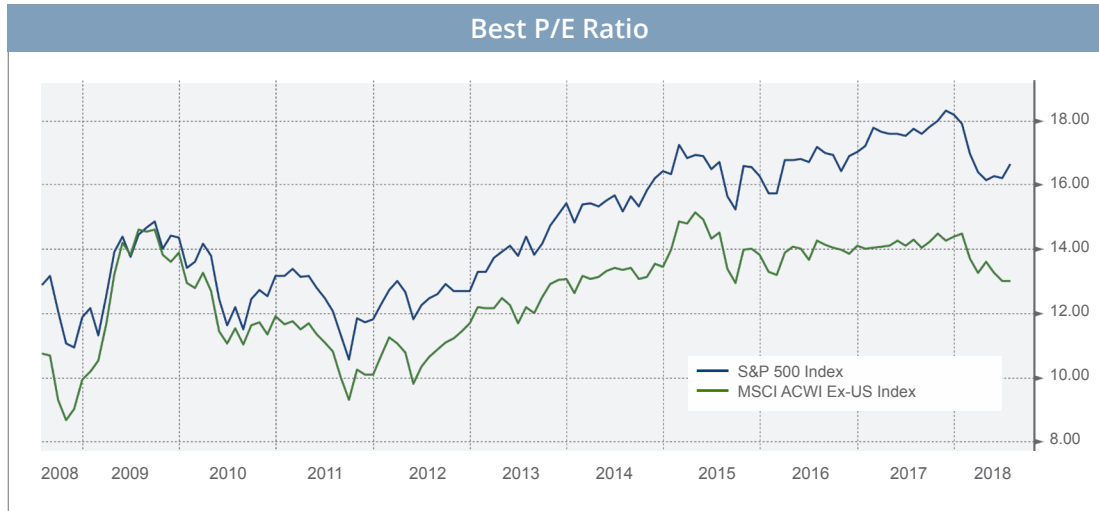
Source: Bloomberg Finance

This may foreshadow an increase in the variance of returns across global markets, increasing the benefits from diversification through international investment.

## RELATIVE VALUATIONS

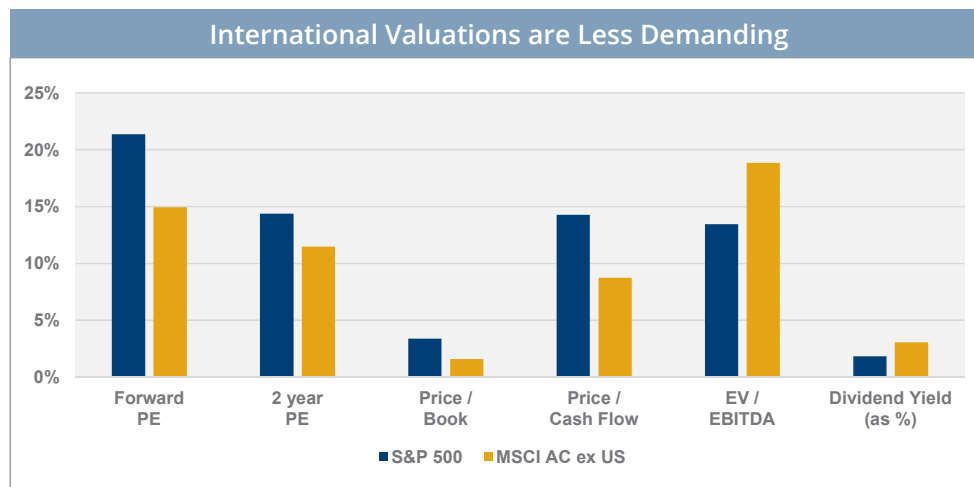
Valuations appear relatively cheaper for international stocks compared to U.S. equities.

We believe much of the outperformance of the S&P 500 Index over the last five years was due to multiple expansion. As indicated in the chart below, valuation multiples between the S&P 500 and the MSCI ACWI Ex-US Index were similar and correlations fairly tight in the early part of the last decade. However, over the last five years, the valuation gap between the U.S. and global markets has continued to expand and is now at its widest levels.



Source: Bloomberg Finance

When we look at various other valuation metrics, the data is similar: ratios are higher across the board for U.S. equities compared to their international counterparts.




Source: Bloomberg Finance

While we can't predict how these metrics will compare over the next five years, it does raise the question: *Will domestic market outperformance driven by further relative multiple expansion continue, or will there be a slow, steady reversion to the mean historical trends?*



## SUMMARY CONCLUSION

We are fairly optimistic about the potential impacts of the trade wars. As they currently exist, we think the effects are relatively minimal. Focusing on companies with wide economic moats, strong intellectual property, and being propelled by secular tail winds should help them weather economic turbulence caused by changing tariff regimes.

With the potentially faster pace of global economic growth overseas, the continuing harmonization of the global investment climate, the loose monetary policies of central banks, favorable credit cycles in international markets, and relative valuations inexpensive compared to the U.S., we believe now is the right time to rethink international equity exposure. 

## ABOUT THE AUTHORS

### **Bill Kornitzer, CFA, Portfolio Manager**

Bill has been with the Buffalo Funds since 2004 and has 26 years of professional investment experience. Previously Bill was with USAA, Ernst & Young, and Arthur Andersen. At the Buffalo Funds, he works with equity portfolios, and his focus areas include technology, financial services, telecommunications, and food and beverage. Bill received a B.S. from Virginia Tech and an M.B.A. from Drexel University.

### **Nicole Kornitzer, CFA, Portfolio Manager**

Nicole has been with the Buffalo Funds since 2004 and has 18 years of professional investment experience. At the Buffalo Funds, Nicole works with equity portfolios, and her previous focus areas have included pharmaceuticals, medical diagnostics, and biotechnology. Her current focus is on European equities. Nicole received a B.A. from the University of Pennsylvania, an M.A. from Columbia University, and an M.B.A. from INSEAD.

## ABOUT THE BUFFALO FUNDS

The Buffalo Funds are a family of 10 actively-managed mutual funds offering a variety of domestic equity, international equity, and income-generating investment strategies. Located in Mission, Kansas (a suburb of Kansas City), employee-owned Kornitzer Capital Management, Inc. (KCM) has been the exclusive investment advisor to the Funds since inception in 1994.

At KCM, we believe that patient investing backed by solid, intelligent research is the best way to achieve potential long-term financial rewards. Disciplined investment decisions are made using a distinct, time-tested investment approach guided by trend analysis, rigorous fundamental company research, and strict security valuation parameters.

Our fund family is characterized by a long-term growth investment strategy and a team-based, idea-sharing management style. "Trends and Patience" is our mantra, and our great strength.



## INTERESTED IN MORE INFORMATION?

For questions or to speak with a relationship manager about adding any of the 10 Buffalo Funds to your portfolio, contact:

**Christopher Crawford**  
ccrawford@buffalofunds.com  
(913) 647-2321

**Scott Johnson**  
sjohnson@buffalofunds.com  
(913) 754-1537

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## DEFINITIONS & DISCLOSURES

<sup>1</sup>Average Annual Returns

As of 7/31/18	3 Yr	5 Yr	10 Yr
<b>MSCI ACWI Ex-US Index</b>	6.00	5.59	3.16
<b>S&amp;P 500 Index</b>	12.52	13.12	10.67

**Past performance is not a guarantee of future results. Index performance is not illustrative of fund performance. Please call (800) 49-BUFFALO for fund performance.**

Opinions expressed are subject to change, are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

The S&P 500 Index is a capitalization weighted index of 500 large capitalization stocks which is designed to measure broad domestic securities markets. The MSCI ACWI Index is a capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International (MSCI) and is comprised of stocks from both developed and emerging markets. The MSCI ACWI Ex-US Index excludes the United States. The MSCI EAFE Index serves as a benchmark of the performance in major international equity markets as represented by 21 major MSCI indexes from Europe, Australia, and Southeast Asia. The Sentix Investor Confidence Index rates the relative six-month economic outlook for the Eurozone. The data is compiled from a survey of about 2,800 investors and analysts. A reading above zero indicates optimism; below indicates pessimism. The STOXX 600 Index represents 600 European stocks from 18 European countries, covering approximately 90% of the European stock market. It is not possible to invest directly in an index.

P/E or "Price-Earnings" Ratio measures the current share price relative to its per-share earnings. Correlation is a statistic that measures the degree to which two securities move in relation to each other. Dividend Yield is a ratio that indicates how much a company pays out in dividends each year relative to its share price. Forward PE is the market price per share of a company divided by the expected earnings per share. 2 year FPE is the Forward PE with expected earnings calculated out 2 years. Price / Book is a ratio used to compare a company's current market price to its book value. Price / Cash Flow is a ratio that measures the value of a stock's price to its cash flow per share. EV / EBITDA is a ratio that measures a company's return on investment (ROI). "EV" stands for enterprise value. "EBITDA" stands for earnings before interest, taxes, depreciation and amortization. OECD stands for Organisation for Economic Co-operation and Development.

**Mutual fund investing involves risk; Principal loss is possible. The Fund may invest in smaller companies, which involve additional risks such as limited liquidity and greater volatility than larger companies. The Fund may invest in foreign securities which will involve political, economic and currency risks, greater volatility and differences in accounting methods. This risk is greater in emerging markets. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Past performance does not guarantee future results.**

*Diversification does not guarantee a profit or protect from loss in a declining market.*

*The Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The summary and statutory prospectuses contains this and other important information about the investment company, and may be obtained by calling (800) 49-BUFFALO or visiting buffalofunds.com. Read carefully before investing.*

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