

Expand your horizons

Making the case for an allocation to a global active equities manager



KEY TAKEAWAYS

- > Do not discount the potential diversification benefits of global stocks.
- > There are many high-quality, industry-leading companies headquartered outside the U.S.
- > A single manager with a global mandate is likely to be more cost-effective than a series of country- or region-specific managers.

Given the stout performance of U.S. equities over the past decade, it's no surprise that investors don't show much love for global stocks. Unfortunately, the distorting effect of this near-term perspective—recency bias, as it's known—is not only shortsighted, but it could undermine longer-term investment goals.

In a world where low-growth is the rule rather than the exception, investors should remember that domestic stocks do not always outperform their global counterparts. In fact, investors might consider the potential benefits of expanding their horizons to find an active equities manager with a vetted process, strong risk protocols and, most importantly, a global mandate. This might improve the risk-return characteristics of an investment portfolio and even enhance outcomes.

Cast a wider net

U-Wen Kok, chief investment officer of the RS Global team and portfolio manager of the Victory RS Global and International Funds, is a professional investor who views the investment universe through a very wide lens. She gravitates toward dynamic companies trading in liquid markets with attractive growth potential and moderate risk profiles. Yet so many of these, she points out, are headquartered outside the U.S. and trade on foreign exchanges.



U-Wen Kok, CFA
Chief Investment Officer,
RS Global

“Investors really should reassess their exposure to markets outside of the U.S., not only to reduce home country bias, but also to increase the opportunity set for dynamic companies demonstrating attractive returns on invested capital,” suggests Kok. “Plus, adding equities with different correlations can help investors withstand bouts of market volatility.”

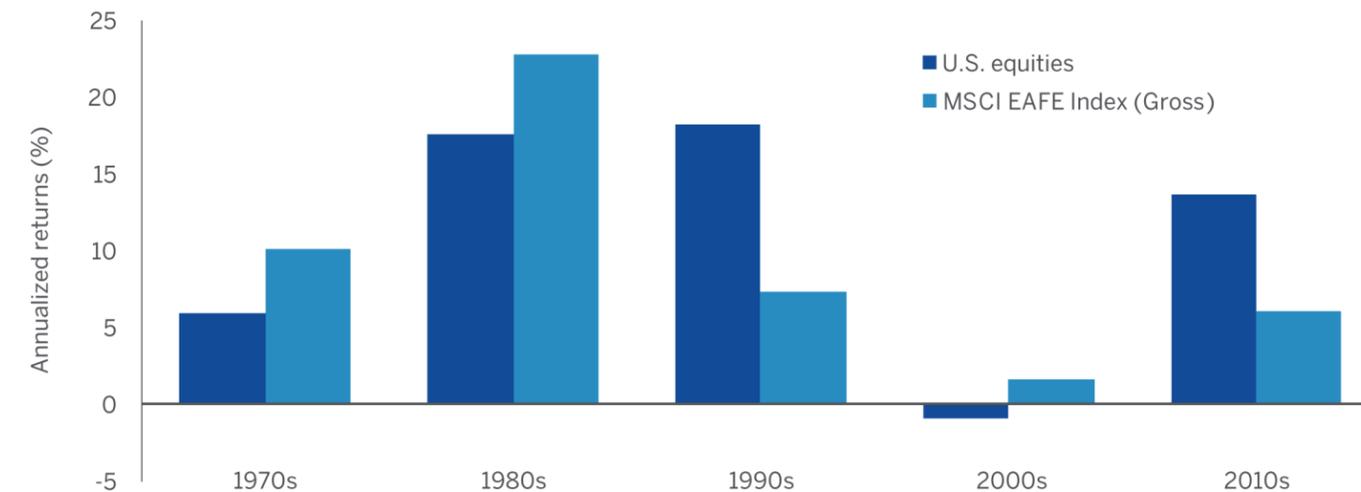
What Kok is alluding to is a phenomenon common to both retail and institutional investors. Home country bias is loosely defined as the tendency to invest disproportionately in one's domestic markets. Investors are predisposed to think that their small slice of the world is the center of the universe and, by extension, they assume that local companies are safer and offer greater potential.

That may be misguided on several counts. For starters, populating an equities portfolio with a narrow geographic focus could boost portfolio volatility and undermine performance over time. Economic cycles in different regions do not always move in sync, and adding global equities with different correlations could improve diversification benefits.

Beyond that, Mac Rygiel, an analyst for RS Global team, simply wonders why any investor would want to ignore such a wide swath of industry-leading companies that are competing on par—or even besting—their U.S. counterparts.

U.S. VERSUS INTERNATIONAL EQUITIES (As of December 31, 2019)

Don't be unduly influenced by recent performance. International equities can provide diversification benefits, including periods when they outperform U.S. stocks.



Past performance does not guarantee future results.

Sources: RS Investments, FactSet. U.S. equities represented by S&P 500 Index. International equities represented by MSCI EAFE Index. Indexes are unmanaged and not available for direct investment and do not represent the performance of a single fund or any of the RS Funds.

Consider that the MSCI All Country World Index, widely considered the best gauge of the world's total equity market, includes 49 countries. As of year-end 2019, the total market capitalization of the companies within the index—defined as the market value of outstanding shares of a company—was approximately \$69 trillion, according to World Bank statistics. Yet, 57% of this value is based outside the U.S. in dynamic global markets. Clinging to a U.S.-centric perspective may be unnecessarily limiting.

Why do investors fall prey to home country bias and subsequently under allocate to far-away markets? Perhaps it's simple human nature that

has us gravitating toward the familiar. Or perhaps it's an exaggerated perception of foreign risk. Whatever the reason, the good news is that investors can easily and quickly take corrective action to balance and re-allocate to global stocks.

“Accessing these markets is not nearly as hard as it used to be,” says Adam Mezan, associate portfolio manager and research analyst for the RS Global team. “Liquidity, transparency, and accounting standards in global markets are excellent, and it's relatively easy to trade non-U.S. securities today.”

Still, many investors wonder how they should harness the potential of global



Mac Rygiel, CFA
Equity Analyst,
RS Global

markets. Some choose to allocate via an array of funds with country- or region-specific mandates.

However, such a multi-manager approach could increase the costs of allocating globally, Rygiel points out. Plus, it may not be feasible for individual investors to do their diligence on so many regional managers, and even some sophisticated institutions are questioning the merits of a multi-manager approach.

Mezan suggests that a better approach may be to identify a single active manager with global capabilities—someone who has a broader view and seeks to optimize overall portfolio risk and return exposures. A single



Adam Mezan, CFA
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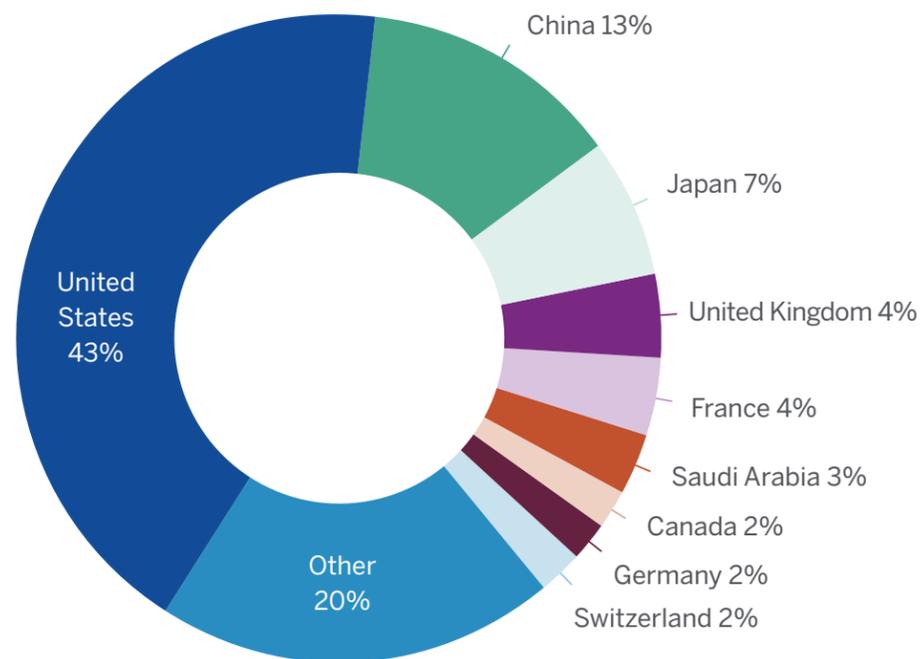
manager can implement a consistent investment philosophy across different countries and have a more holistic context by which to allocate capital.

Quality-oriented quants

If investors agree with the merits of a more diversified, global approach to equities, the questions turn to tactics. What is that best philosophy, and can one manager really cover a diverse array of so many publicly traded equities?

The RS Global team's solution to this challenge is to employ quantitative systematic investing to narrow the universe and help focus the resources of an experienced team. The goal of

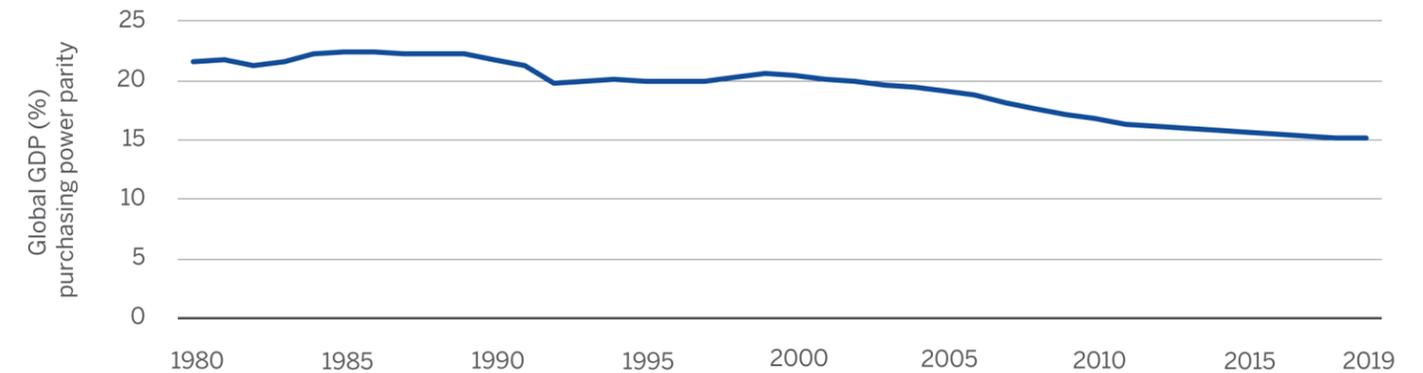
COUNTRY BREAKDOWN OF TOTAL MARKET CAPITALIZATION OF STOCKS WITHIN MSCI ACWI (As of December 31, 2019)



Sources: FactSet, MSCI.

U.S. SHARE OF GLOBAL GDP DECLINING (As of December 31, 2019)

Over the last decade, United States' share of global gross domestic product (GDP) adjusted for purchasing power parity (PPP) has been falling. If an investor chooses to only invest in U.S. stocks, they are excluding over half of the world's total investment opportunity set.



Sources: IMF, World Bank.

marrying a quantitative and fundamental approach is to consistently capture alpha—i.e. generate excess returns relative to a benchmark index—and to do so in a cost-effective manner relative to peers.

“In our view, both a purely quantitative and a purely qualitative approach have flaws,” suggests Kok. “A purely quantitative approach may be overly complex, as well as noisy and backward-looking. On the other hand, a pure research-driven approach can be skewed by analyst bias at various stages of the process. We think our way is better.”

The RS Global team aims to sidestep the pitfalls of the “pure” approaches by employing a data-driven process that begins by systematically analyzing a

very large universe of global companies. Individual analysis is only conducted on stocks that have already been selected by the team's screening models and whose model recommendations have been vetted thoroughly for data quality issues. From there, the team builds a portfolio of quality companies—those that appear well positioned to create consistent shareholder value.

RS Global's proprietary quantitative models are built to be sophisticated but intuitive. The overarching approach uses various investment factors, which have been selected to have low correlations, among other attributes. It's a decidedly quality-oriented bias, though sentiment, value, and other factors also play a role.

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DEBATING THE HEDGE

One of the big challenges that managers with such a diverse geographic mandate have is balancing currency exposure. This is a thorny issue today, especially given the on-again, off-again central bank interventions that have become commonplace around the world. Monetary policies can shift abruptly and can impact the performance of equities. Some managers choose to employ an overt currency overlay program in an attempt to fully hedge their exposure to global equities. In theory, this can help isolate alpha from stock selection and offer investors pure exposure to company-specific fundamentals.

But the reality may be a bit more muddled. Implementing a hedging strategy with currency forwards or futures across a wide swath of market currencies—including the Euro, Swiss Franc, Canadian and Australian Dollars, British Pound, and others—can quickly become cost-prohibitive and unwieldy. Plus, getting the currency overlay wrong might undermine even the best stock picker.

There have also been studies¹ questioning the merits of currency hedging in a global equity portfolio. In fact, it may only provide modest risk reduction, and the benefits of currency hedging tend to diminish over time. The RS Global team has chosen not to conduct an overt currency overlay program in its strategies.

“I believe that currency hedging becomes less effective when a company is a multinational player with operations in many regions,” says Kok. “It’s exceedingly difficult to implement anything more than a partial hedge given that most large developed market companies have global customers and are thus impacted by multiple currency movements on revenues, expenses, cash flow, and earnings. And who’s to say you are going to get the hedge right? Does that really mitigate risk? I’m not sure it does.”

Of course, that doesn’t mean that the RS Global team ignores the potential ramifications of currency movements. To the contrary. The team takes a holistic view of the entire portfolio and actively manages overall currency exposures based on the operations of the individual companies and the size of the holdings in the portfolios.

“We are very aware of how a significant currency movement in one direction or another could impact fund performance,” says Rygiel. “We want to know what would happen to the portfolio if, for example, the Euro and Yen moved up 5% over one day.”

He explains that once a certain scenario is identified and considered a cause for concern, the team can attempt to mitigate risks to the overall portfolio by trimming positions or reallocating as needed. And it’s not only currency risks that get scrutiny in their stock monitoring process. The team can run similar what-if scenarios to help gauge potential impact of interest rate movements, yield curve shifts, or oil price spikes.

The RS Global team also has created proprietary global/international risk classifications for its investable universe. This classification system is based on sector and regional “buckets” and uses a combination of clustering analysis and fundamental intuition to identify stocks that possess similar fundamental and return characteristics. According to Kok, having the tools to assess stocks within each bucket allows the team to manage risk across the portfolio. Therefore, they can then take larger active positions in some stocks without exposing the strategies to unintended regional, sector or macro biases.

CURRENCY HEDGING OCCASIONALLY MAY OFFER SOME ADVANTAGES, BUT THE TRUE LONG-TERM BENEFITS APPEAR LIMITED

Performance of MSCI EAFE (USD) vs MSCI EAFE (Hedged) 1990–2019



Sources: FactSet, MSCI.

“Our models are constructed in a manner so that any data issues can be quickly identified,” explains Mezan. This commitment to transparency is of particular concern to those investors who worry that quantitative models may be complex ‘black boxes’ of information. That’s not what we have.”

Rather than spending time looking for new ideas, the team is able to focus its efforts on analyzing businesses, enhancing the qualitative models, and interviewing both sell-side analysts and company management. All this is done to better understand the companies that are already vetted by the models.

“In the end, I believe that our approach, coupled with its strong portfolio risk controls, can help mitigate some of the inherent volatility of global stocks over multiple market cycles,” Kok claims. “But all that aside, I truly believe that investors should step back to rethink diversification and evaluate if and how an allocation to global equities can impact their overall investment objectives.” ^{VC}

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¹ “To hedge or not to hedge? Evaluating currency exposure in global equity portfolios” Vanguard Research, September 2014, Karin Peterson LaBarge, Charles Thomas, Frank Polance, and Todd Schla.

“The Case for Not Currency Hedging Foreign Equity Investments: A U.S. Investor’s Perspective” GMO White Paper, April 2015, Catherine LeGraw.

To learn more about the Victory RS Global and Victory RS International funds, contact your financial advisor or visit www.victoryfunds.com

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Diversification cannot assure a profit or protect against loss in a declining market.

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The MSCI ACWI Index is a free float-adjusted, market capitalization-weighted index that measures the performance of stocks in 23 developed and 26 emerging markets.

The MSCI EAFE Index is a free float-adjusted, market capitalization-weighted index that measures the performance of stocks in the developed markets, excluding the United States and Canada.

The MSCI EAFE US Dollar Hedged Index represents a close estimation of the performance that can be achieved by hedging the currency exposures of its parent index, the MSCI EAFE Index, to the USD, the "home" currency for the hedged index.

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