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Global Equity Mandates

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The implementation of public equity allocations through broad global mandates may optimize returns for long-term investors. This paper will examine the potential benefits and challenges of global equity mandates, and it will feature historical data comparing the global equity investment approach to a more traditional domestic/international split. The implementation process and the importance of selecting suitable managers will provide a basis for further discussion.

Many consultants and institutional investors take a focused approach to asset allocation and manager implementation whereby they use specialist managers. This approach proves beneficial if the specialization increases a manager's ability to add value. If this is not the case, or is no longer the case, specialization may overly constrain the scope of an opportunity set.

An informed understanding of the different areas of specialization and their accompanying constraints can maximize investment efficiency. However, given that appropriate constraints may be subject to changes over time and the proficiency of a particular manager, the decision to pursue or avoid certain areas requires careful deliberation. This paper will attempt to explain why the role of specialization is changing in public equities, and why the past benefits of specialization in domestic or international equities may now limit the ability of select managers to add value.

International diversification

Historically, there was a demonstrable diversification benefit to complementing a domestic portfolio with international stocks, but this benefit has materially declined over the past few decades. The high degree of correlation between the S&P 500 and MSCI EAFE, as displayed in Figure 1, is indicative of their similar performance. There are several plausible explanations for this increasing correlation, ranging from the globalization of trade to the opening of capital markets (i.e., countries allowing increased levels of foreign investment) and increased informational efficiency (via the internet).

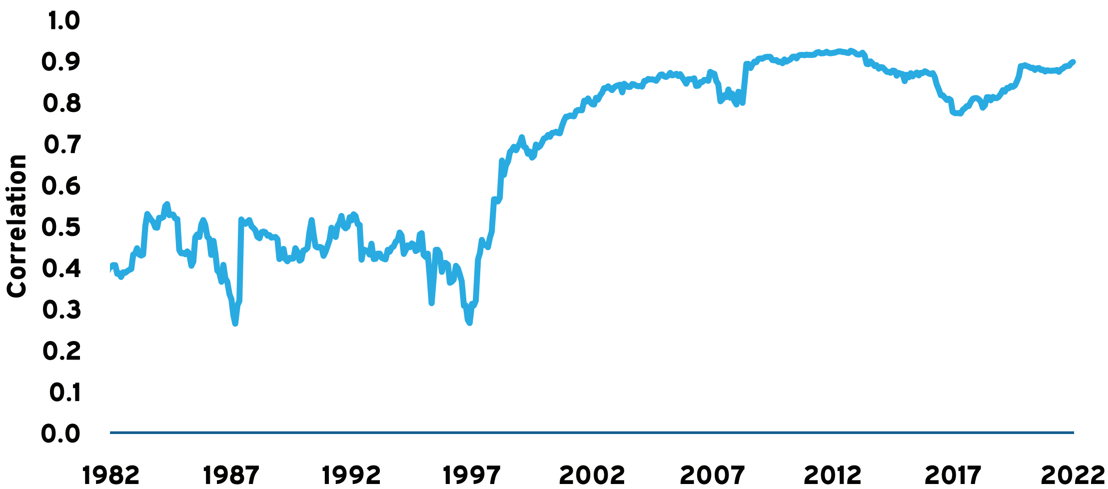

FIGURE 1

Rolling 5-Year Correlation of S&P 500 vs. MSCI EAFE

Source: MSCI. Data as of May 2022.

The benefit of international diversification has decreased during crucial times for US investors. Negative economic shocks tend to drive correlations across asset classes up, particularly in regional equity markets. The Global Financial Crisis (GFC) and the COVID-19 pandemic saw already high correlations among global equities spike even higher as prices tended to drop in unison (see Figure 2), though this may be in large part due to both of these events being global rather than regional phenomena.

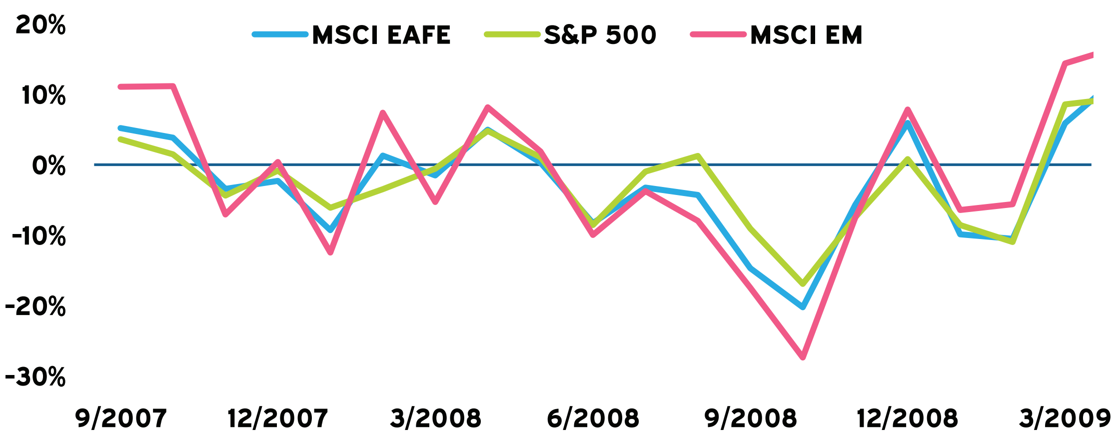

FIGURE 2

Monthly Returns of Equity Markets During the GFC

Source: Bloomberg. Data is for the period from September 2007 through March 2009.

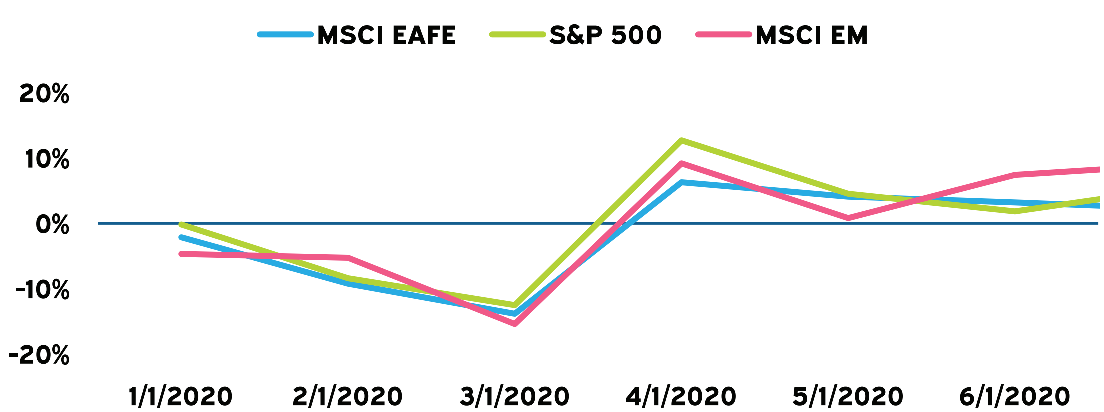

FIGURE 3

Monthly Returns of Equity Markets During COVID

Source: Bloomberg. Data is for the period from January 2020 through June 2020.

If the diversification benefits of investing overseas are no longer as compelling, one potential reaction would be to question the value of investing in international equities at all. Choosing to do so, however, would severely constrain an institutional investor's opportunity set. An exclusively domestic approach would eliminate approximately 40% of the world's equities from consideration (see Figure 4).

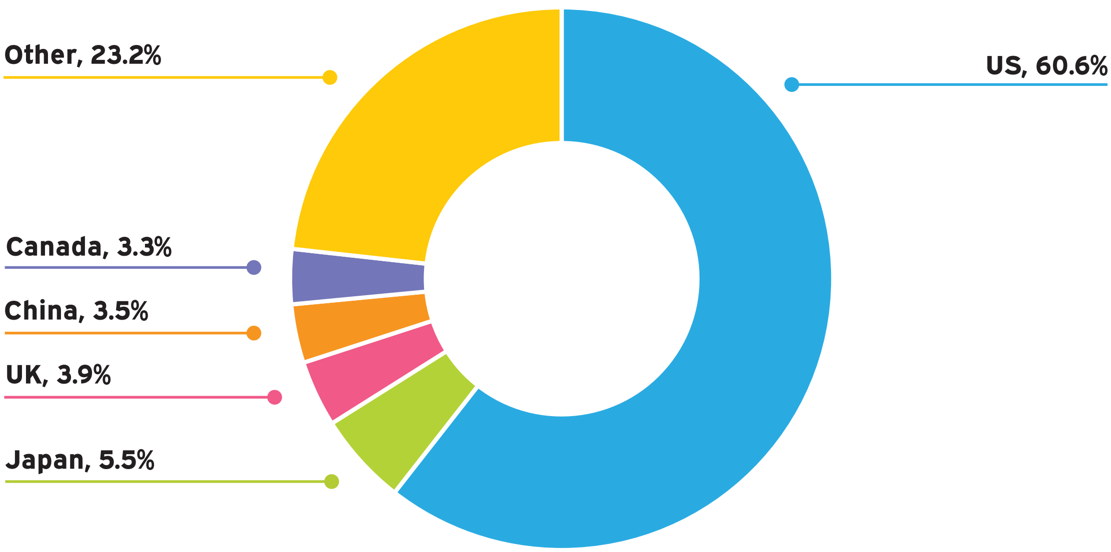

FIGURE 4

MSCI All Country World Index Regional Weights

Source: MSCI. Data as of May 2022.

Further, relative performance of US versus non-US investments tends to move in cycles as illustrated by Figure 5. For example, equity returns in the 1980s were dominated by the Japanese equity market. In the early 2000s, emerging market equities substantially outstripped developed markets. And the 2010s saw dramatic outperformance of US equities, illustrating the cyclical nature of equities.

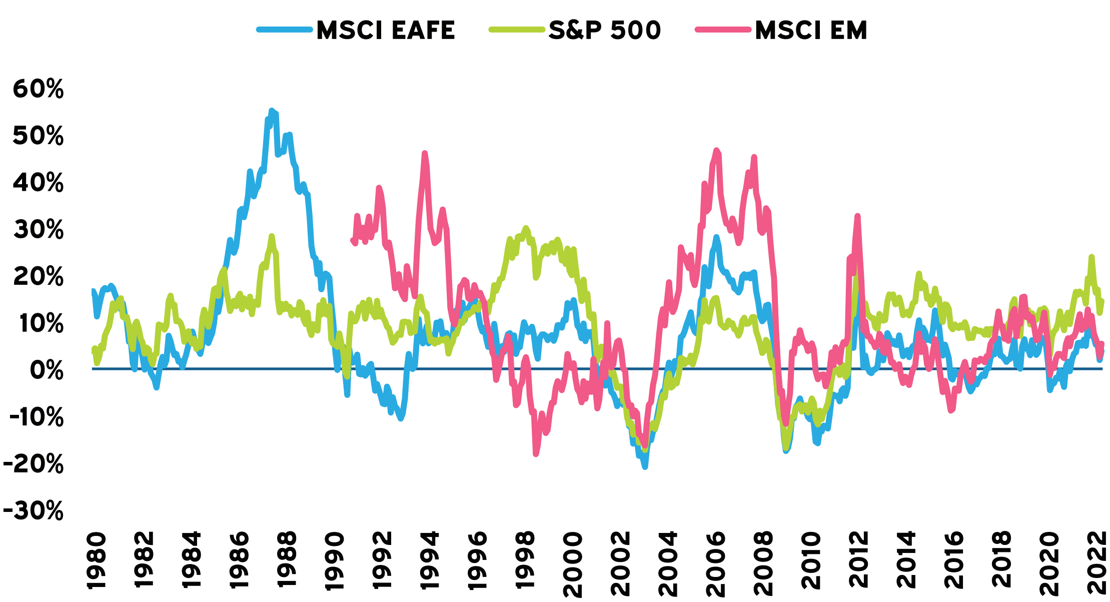

FIGURE 5

Rolling 36-Month Performance of US vs. Non-US Assets

Source:Bloomberg. Data from January 1980 - May 2022.

It’s a global world

Until fairly recently, the steady march of globalization in trade and commerce led to the theory that many large companies should be considered “domestic” or “international” by domicile only. Companies based in different countries or regions were competing directly for customers in the same country. Hence it followed that these companies could likewise be viewed as direct competitors for investors’ capital.

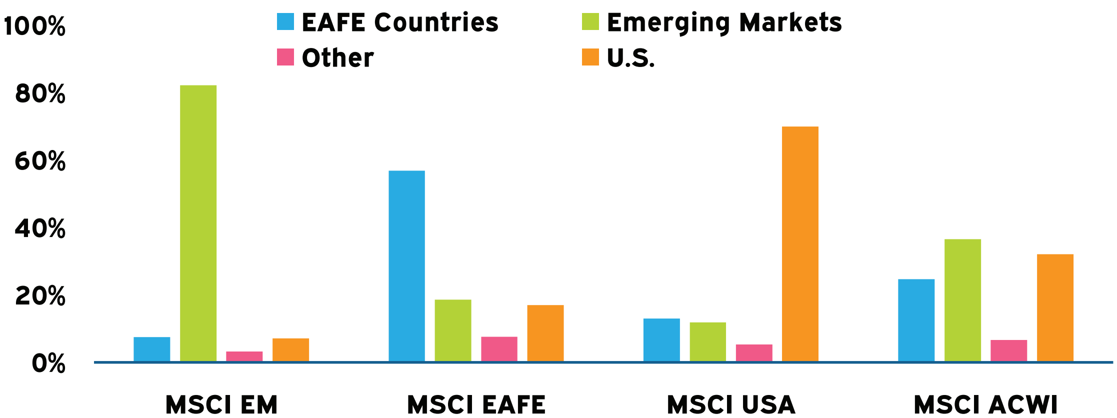

FIGURE 6
MSCI Index Constituent Revenue Source
Source: MSCI. Data as of May 2022.

As illustrated in Figure 6, regional barriers do create differences in revenue streams, supporting a need for greater flexibility in a global equity mandate. As of May 2022, roughly 43% of MSCI EAFE revenues came from outside of EAFE countries, 30% of the revenue in MSCI USA came from outside of the US, and 18% of MSCI Emerging Markets revenue came from outside emerging markets. Yet some of these numbers are down significantly from their peak. For example, external revenue rates hit 33% in 2018 for MSCI Emerging Markets, but they have since declined due primarily to the COVID-19 pandemic and the widespread consequences of sanctions issued during the 2022 Russian invasion of Ukraine (see Figure 7).

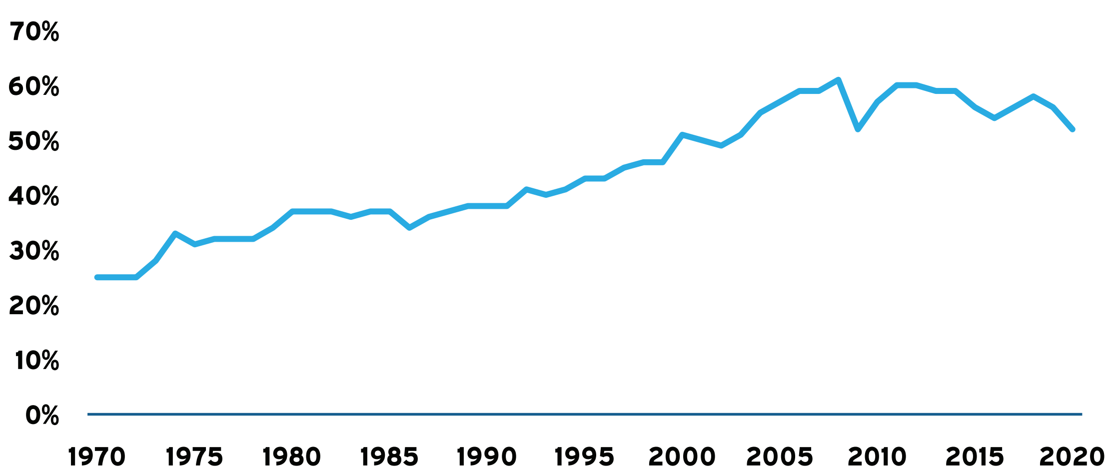

FIGURE 7
Global Trade as Percentage of World GDP
Source: World Bank.

Prior to the COVID-19 outbreak, it appeared that global equity mandates could capture the broadest investment set, but international disparities in pandemic response have sharpened the lines that were previously blurred by globalization. Though trade and commerce have become more integrated over the past few decades, recent events have reshaped the geopolitical map and given investors reason to think that we have have reached or passed the point of peak globalization.

Overly consrtrained?

While the result of holding separate domestic and international equity strategies is effectively a global portfolio, it may be less efficient than an approach that allows a global fund manager to build a portfolio of the best opportunities across the globe while tactically taking advantage of any regional dislocations created by market volatility. Regionally constrained managers may invest in lower conviction ideas for the sake of portfolio diversification even though more attractive stocks may be available outside of their geographic boundaries. A narrowly focused manager may not recognize that some investments do not compare as favorably, either fundamentally or valuation-wise, to other peers outside of their regional purview.

To illustrate this concept in a hypothetical example, imagine that a domestic equity manager is analyzing banks for potential inclusion in a portfolio. To diversify, the manager buys four US banks. In this case, however, the fourth most attractive bank in the US may only be the 20th most attractive bank in the world. Because the manager is constrained to owning only US securities, the 20th globally best bank finds its way into the portfolio, bypassing 16 others in the process, representing a potential opportunity cost.

An alternative approach

Global equity mandates remove many of the barriers of regional constraints and, ideally, allow investors to benefit from the greatest breadth of investment opportunities regardless of a company's country of domicile. This allows for a more efficient and timely flow of capital to the best investment opportunities, be they in specific companies, sectors, or regions.

The potential benefits of a global equity mandate can often only be realized if managers can be identified with the experience, skills, and resources necessary to analyze and compare companies across the globe. Fortunately, advancements in the availability of information and communication technologies in recent years have arguably made it less important for portfolio managers to have "on the ground" presences in each country in which they invest. Additionally, the greater standardization of global accounting standards has enhanced the reliability of the information as well as the legibility across regions. These factors have significantly increased the number of investment teams with the ability to execute global equity portfolios, and they have provided broader opportunity sets for investors seeking to implement global mandates.

There is some statistical evidence that the added freedom provided in a global equity mandate has improved the opportunity for excess returns. The best metric for evaluating this is perhaps the interquartile return spreads for a given universe. Wider spreads imply that active managers are generating more differentiated returns (versus each other). Therefore, there may be greater potential for active managers to add (or detract) value. Active managers are tasked with identifying and exploiting inefficiencies, so if any inefficiency is related to geography or coverage, then all the better, so long as they are capable of investing in these areas. The narrower the mandate, in theory, the harder it is for active managers to differentiate themselves. As Figure 8 shows, inter-quartile spreads for global equity managers have typically been wider when compared to developed foreign (i.e., EAFE) and US large cap over the trailing three-, five-, and ten-year periods.

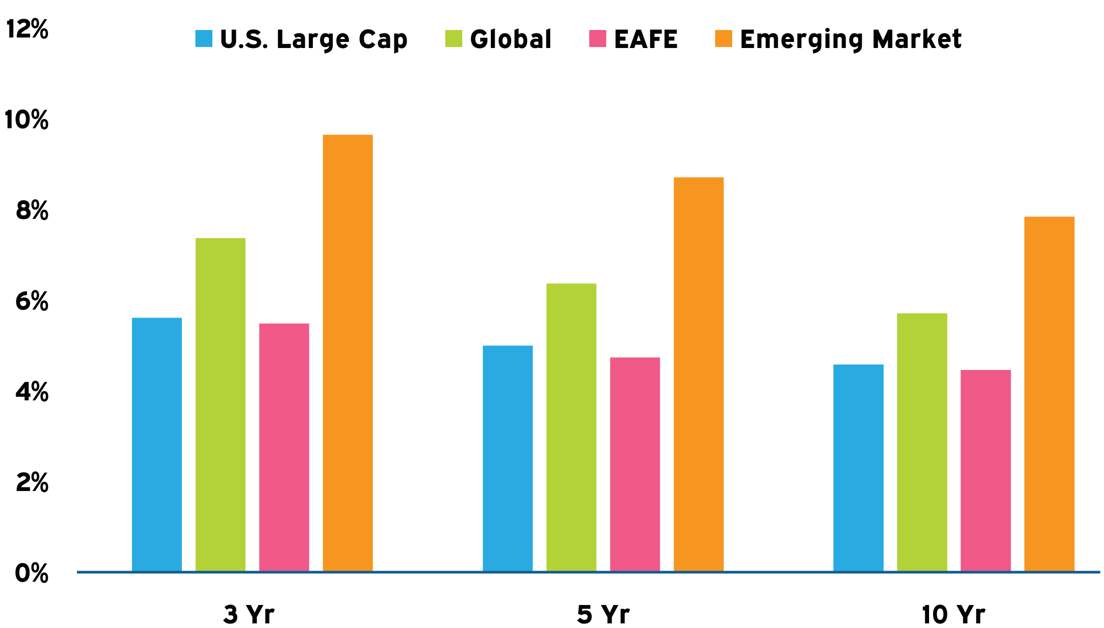

FIGURE 8
Interquartile Spread of Active Managers by Region
Source: Morningstar as of May 2022.

However, some investors seem to conflate the greater opportunity set for adding value with the odds of managers successfully doing so. In the past, superficial comparisons of global equity peer groups to their self-chosen benchmark indicated that the average manager added value (before fees). This was particularly true in the decade of the 2000s, but it is no longer true today (see Figure 9). Perhaps the greater flow of information has leveled the playing field, or perhaps managers benefited from a collective overweight to emerging markets in the 2000s, or perhaps greater index concentration has made it more difficult for managers to outperform benchmarks that have grown more "top heavy."

	10-Year ER From 6/22 (%)	10-Year ER From 6/21 (%)	10-Year ER From 6/20 (%)	Average # of Funds
Global	-0.32	-0.02	0.00	146
US	-0.69	-1.12	-0.91	364
EAFE	0.12	0.31	0.00	251

FIGURE 9

10-Year Excess Returns by the Median Manager

Source: Morningstar. Returns are reported gross of fees and calculated as the 10-year excess return in a given month. Foreign, global, and US large cap funds were chosen by Morningstar Institutional Category with MSCI EAFE GR, MSCI ACWI GR, and Russell 1000 TR serving as benchmarks, respectively.

It is important to note that while the universe information shown in Figure 9 is accurate, as with any time series data set, it may contain a level of survivorship bias. Both intuition and past research imply that most managers who dropped out of a universe were underperforming.[1] Therefore, we caution against making a case for global equity (or any) mandates based solely on the reported performance of managers in a universe such as eVestment or Morningstar.

[1] See "Survivorship Bias and Mutual Fund Performance" by Rohleder, Scholz, Wilkens (2010), Mutual Fund Survivorship" by Cahart, et al (2001), and "Survivor Bias and Improper Measurement" by Barrett and Brodeski (2006).

Other considerations

Any analysis of a manager's track record must consider the benchmark. For global equities, the most widely used benchmarks are the MSCI World index and the MSCI All Country World index (ACWI). The main difference is that the former encompasses developed markets only, while the latter also includes emerging markets. Thus, a given manager's propensity to invest in emerging markets should be the main determinant of which benchmark is used. While historical positioning can be a valuable guide, it is also instructive to get a clear sense of the manager's true investable universe. For example, a manager may have historically held a low weighting to emerging market stocks due to risk or valuation concerns, but that allocation may rise significantly if those concerns subside. As a reference, the MSCI ACWI index included approximately 12% in emerging market stocks.[2]

[2] Source: MSCI, as of May 2022

Manager fees must also be considered. In the eVestment Alliance database, the stated separate account fees for a $50 million mandate are quite similar for the Global Large Cap peer universe and for the Foreign Large Cap universe. In fact, the top quartile and median fees are almost identical (see Figure 10).

	Global Large Cap	Foreign Large Cap	US Large Cap
25th Percentile	0.54%	0.58%	0.47%
Median	0.65%	0.65%	0.55%
75th Percentile	0.75%	0.75%	0.61%
Number of funds	374	274	909

FIGURE 10

Separate Account Fees by Manager Universe

Source: eVestment Alliance, as of May 2022.

As expected, both are materially higher than the fee that would be charged by a comparable US Large Cap manager. Broad generalizations of management fees are difficult to make, however, as they require various assumptions and, in this case, use only the managers' reported fee schedule (i.e., they do not assume any negotiation of fees[3]). Custody costs, along with intangible costs such as legal and tax considerations, are generally higher for global and foreign mandates than they are for domestic mandates.

[3] Most if not all managers are often willing to negotiate; hence, the actual fee paid could be lower, especially for larger mandates.

Potential challenges

A move toward global equity mandates is not without challenges. For one, investors cede some control over what has historically been a major asset allocation decision (i.e., the domestic versus international equity weighting) to the underlying global equity manager(s). If investors exclusively use global managers, they can no longer deliberately overweight the United States or underweight Europe, for example. However, increased globalization has rendered the ability to overweight or underweight regional *economies* much less precise. Overweighting "the United States' economy" and overweighting "US-based companies" have different meanings today, as illustrated previously in Figure 6. Still, investors who want to maintain dedicated exposure to a certain region can keep a combination of global and regional managers. This is similar to how a manager can have a team of all generalists versus dedicated sector/regional specialists – there is no single right way to invest/allocate.

Global portfolios also present some challenges from a risk management and efficiency standpoint. If there are multiple global equity portfolios on the roster, it is possible that they would take offsetting positions, which are inefficient for an investor. Alternatively, the managers might simultaneously overweight or underweight particular regions, sectors, or companies, adding risks that the investor did not intend when constructing the portfolio. Hence, a sophisticated investor would probably want to set appropriate expectations (e.g., ranges for active risk) and understand each manager's structural investment biases to help build a balanced portfolio and engage in risk management.

Manager research takes on heightened importance when evaluating global equity mandates. Many global equity strategies are the result of a domestic equity manager or international equity manager looking to expand their opportunity set and/or their client base. Unfortunately, the skills and experience that allowed them to be successful within their original opportunity set may not translate to success elsewhere. Furthermore, broadening the investable universe without adding resources may dilute a manager's research efforts and therefore alpha potential.

Some managers have created global equity strategies by simply combining existing domestic and international portfolios. While the result is technically a global strategy, this approach often fails to utilize the added freedom that a truly integrated global effort could provide. As both portfolios are essentially constructed in isolation, there is often no material benefit that justifies combining them. Finally, just as the broader opportunity set may enable skilled managers to add more value, it also allows sub-par managers to symmetrically detract more value. For example, due to the greater breadth of their opportunity set, global equity managers are more likely to be significantly underweight in certain areas of the market (e.g., European financial stocks). Ultimately, the skill of the manager involved will determine whether these underweight areas prove to be helpful or harmful.

Conclusion

Global equity mandates can remove the barriers of regional constraints and, ideally, allow investors to benefit from the best investment opportunities wherever they occur in the world. The historical performance implies that there are greater potential rewards, in the form of excess returns, for skilled global equity managers than for domestic or foreign-only equity managers.

The period of globalization around the turn of the century made global equity mandates more relevant, and the speed and flow of information around the world has made their execution more feasible. Managers with the ability to manage a truly global portfolio do exist, but the added degrees of freedom require a heightened level of scrutiny from a due diligence perspective. Assuming suitable managers can be identified, and the institutional investor is comfortable delegating certain strategic decisions, global equity mandates can be a valuable part of a public equity allocation.

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