MEKETA

Developed ex-US equities

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CONTRIBUTORS
FRANK BENHAM, CFA, CAIA
BRADEN CLARK

Investors tend to overweight exposures to what is familiar, such as domestic markets. This has been particularly easy for US-based investors, given the large share of global market cap represented by the US stock market. Nevertheless, most US-based institutional investors have been investing overseas for decades, recognizing that international stocks offer diversification benefits as well as an expanded opportunity set within an equity portfolio.

In this paper, we examine the composition of developed markets outside the United States and compare them to the US, as well as changes over time. We analyze the case for investing in developed ex-US markets, as well as explore the complex intricacies of these markets including volatility and currency exposure. We conclude by navigating the question of implementation, including the role of active and passive managers. Though the diversification benefits appear to have decreased since earlier decades, investments in these markets can play a role in most equity portfolios.

Key takeaways

- Developed ex-US equities represent over a quarter of global GDP and nearly a quarter of total world market capitalization. Exposure to these markets offers the opportunity for investors to take advantage of global growth and innovation beyond US markets.

- Despite the increased correlation with US equities over the past 30 years, non-US developed equities continue to offer some diversification benefits, particularly as correlations tend to weaken during regional market disruptions. They also offer increased exposure in sectors underrepresented in the US market.

- The MSCI EAFE Index[1] has shifted over time, with notable changes in the country and sector weights. For instance, the industrials sector has nearly doubled in the past two decades, and financials remain prominent compared to the tech-heavy US market. Despite Japan being the largest exposure and the UK's influence having diminished, the index is heavily weighted to Europe.

[1] Note that the MSCI EAFE Index also excludes Canada from the Index.

- While non-US developed markets have historically underperformed US equities on average, they have outperformed during certain periods. Their higher volatility due to currency risks can be mitigated through hedging.

- While active management has seen cyclical out performance, active EAFE equity managers have delivered modestly positive excess returns on average since the early 2000s. Notably, they have produced higher excess returns on average than their active US equity counterparts over this same period.

Why international equities?

Economies in developed countries outside the US constitute approximately 26% of global GDP[2] and constitute approximately 22% of world market capitalization.[3] Further, certain industries are represented more broadly overseas than they are in the US. For example, natural resources (e.g., timber, mining, energy) and basic industries (e.g., steel, chemicals, paper) are now a much smaller part of the US equity base than they were thirty years ago. As an increasing number of companies and industries operate in multinational environments, owning only US stocks limits investors' access to global growth opportunities. To participate more fully in these opportunities, investors should consider non-US equity investments.

[2] Source: International Monetary Fund, World Economic Outlook (April 2025).

[3] Source: MSCI EAFE, MSCI ACWI Fact Sheets, as of June 2025.

The MSCI EAFE Index is perhaps the most widely followed index related to developed ex-US equity markets. It represents developed markets outside of North America, including Europe, Australasia, and the Far East. The MSCI EAFE Index contains approximately 700 large and middle capitalization stocks based in 21 countries (see Appendix).[4] As of June 2025, the four largest countries in the benchmark were Japan, the United Kingdom, France, and Germany, which collectively accounted for approximately 58% of the index (see Figure 1).[5]

[4] Source: MSCI EAFE Fact Sheet, as of June 30, 2025.

[5] Source: MSCI, data as of June 30, 2025. The data we have access to is July 29, 2005 to June 30, 2025.

The composition of the MSCI EAFE Index has undergone significant shifts over the past four decades. While Japan and the UK have long been the two largest country weights, their relative positioning has changed over time. For example, in the late 1980s, Japan reached a peak index weight of approximately 60% before its market crash in the early 1990s.[6] By 2005, the United Kingdom had overtaken Japan, with the latter declining to 21% of the index. However, their positions have since reversed again. As of June 2025, the UK's weight has fallen to just under 15%. This decline is attributed to the contraction of major UK industries, Brexit, and slower equity growth relative to other developed markets. Over the years, Germany's unification and economic expansion have led it to a leading position, with consistent growth mirrored by its neighboring economies such as France and Switzerland.

[6] Source: "Why the MSCI EAFE Index Has Been Mediocre", Morningstar, 2017.

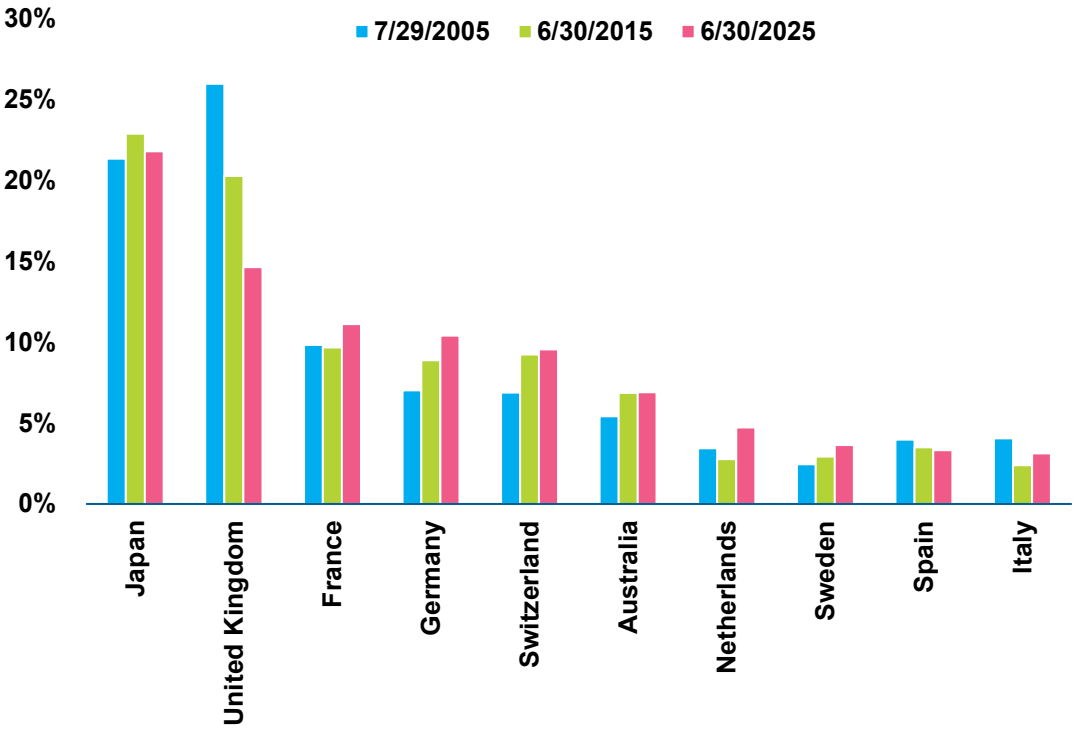

FIGURE 1
MSCI EAFE Index: Top 10 Country Weights

Source: MSCI, data as of June 30, 2025.

The dramatic growth observed in Asia's emerging markets has not been reflected to the same extent in the EAFE benchmark. Apart from Japan, only two other Asian countries are represented, and the index continues to be dominated by Western Europe (see Figure 2).

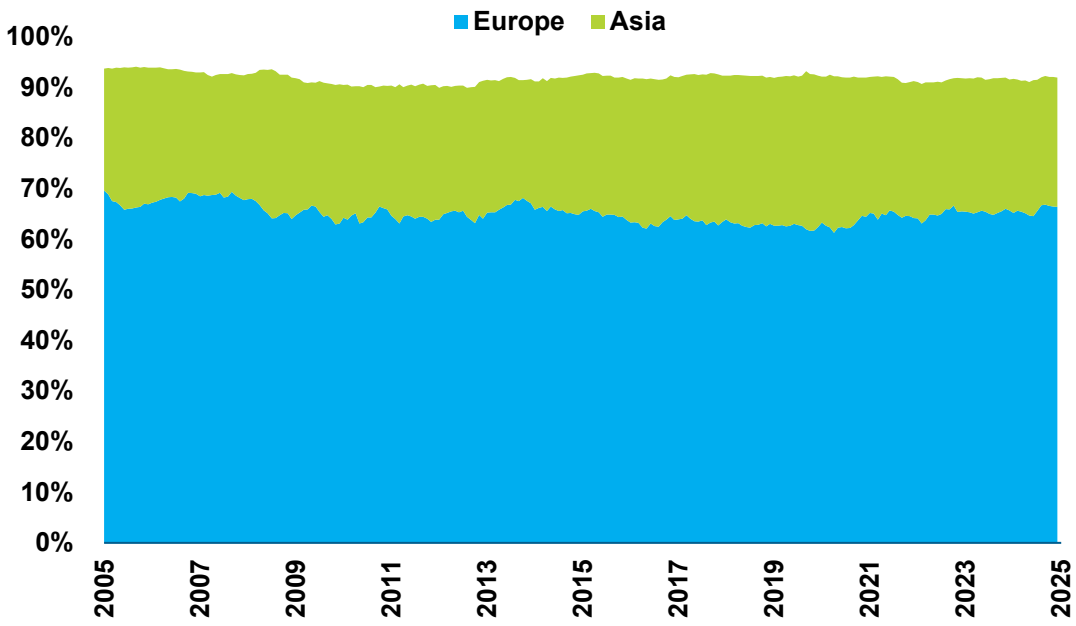

FIGURE 2
MSCI EAFE Index: Changes in Europe and Asia Weights

Source: MSCI, data range from July 29, 2005 through June 30, 2025.

Understanding the composition differences between domestic and international equity markets is essential when evaluating portfolio diversification and performance. For example, the US market maintains a higher weight in information technology, which has been a primary driver of earnings and market returns in recent years.[7] In contrast, the MSCI EAFE is heavily tilted toward financials and industrials, highlighting EAFE's greater dependence on older, slower-growing (though less volatile) sectors.

Since 2005, the MSCI EAFE Index has experienced a dramatic transition in sector composition, driven by significant growth in industrials and (to a lesser extent) information technology. The industrials sector has risen from a weight of 10.0% in June 2005 to 19.0% as of June 2025, nearly doubling its presence in the index. Meanwhile, the energy sector has experienced a substantial decline, and while the relative size of the finance sector has diminished, it remains the largest sector in the EAFE Index.

[7] Source: Meketa Corporate Earnings white paper, published February 2025. From 2004-2024, information technology had an annualized average US earnings growth of 11.9%, whereas the growth rate for financials was 1.5%.

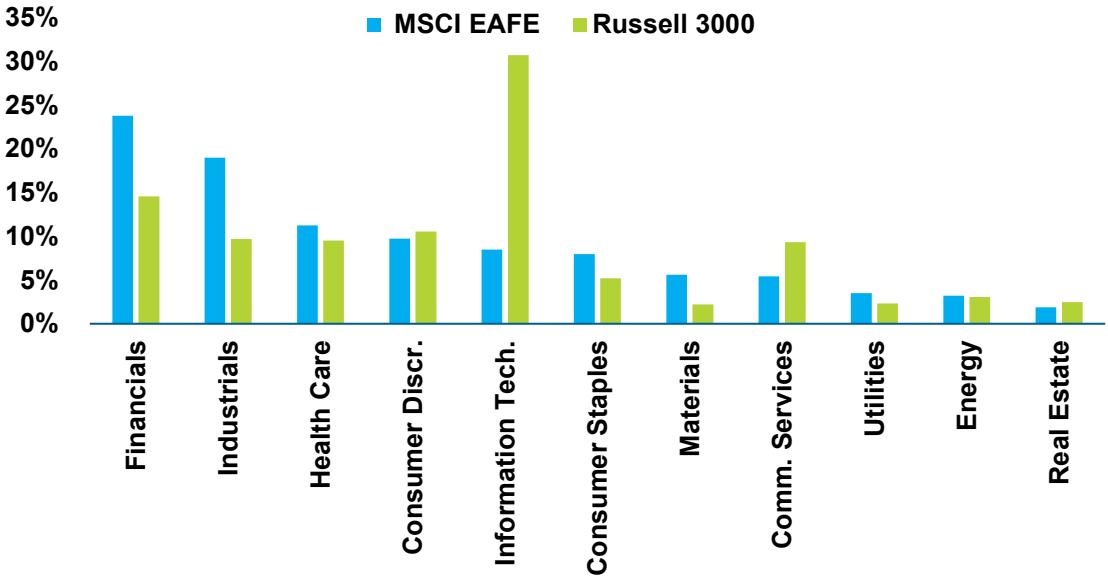

FIGURE 3
MSCI EAFE and Russell 3000 Sector Weights

Source: FactSet. Indices: MSCI EAFE USD and Russell 3000. As of June 30, 2025. Sector classification for the Russell 3000, originally based on the ICB framework, has been converted to the GICS standard to ensure consistency with MSCI EAFE sector classifications. Note that real estate was not categorized as a standalone sector until 2016, having previously been included under financials. Also note that there are some key differences in GICS and ICB in terms of classification, particularly in the communication services sector. For example, Google and Meta are classified as communication services in GICS but technology in ICB.

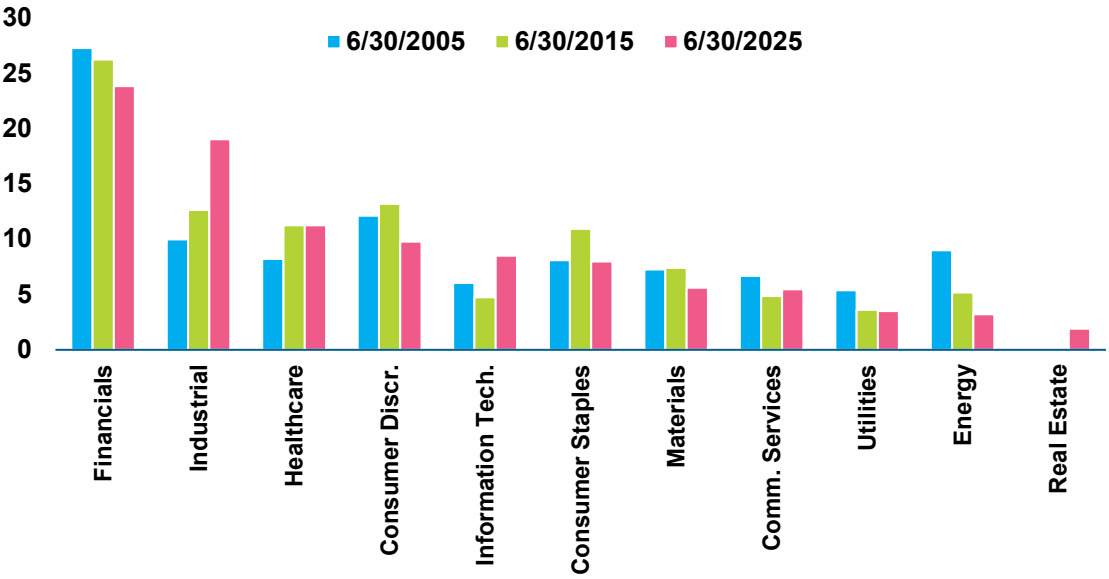

FIGURE 4
MSCI EAFE Index: Sector Weights

Source: Bloomberg, data as of June 30, 2025. Note that real estate was not categorized as a standalone sector until 2016, having previously been included under financials.

Despite these shifts, the concentration of the largest companies in the index has remained relatively stable over time, with the EAFE Index maintaining a balanced distribution across its largest firms. This balance provides a stark contrast to both the US and emerging markets indices, where a small number of companies dominate the market capitalization.

June 2015		June 2025	
Nestlé *Switzerland, Consumer Staples*	1.8%	**SAP** *Germany, Information Tech.*	1.7%
Novartis *Switzerland, Healthcare*	1.7%	**ASML Holding** *Netherlands, Information Tech.*	1.7%
Roche Holding *Switzerland, Healthcare*	1.5%	**Nestlé** *Switzerland, Consumer Staples*	1.4%
Toyota Motor *Japan, Consumer Discretionary*	1.4%	**Novartis** *Switzerland, Healthcare*	1.2%
HSBC Holding *UK, Financials*	1.3%	**Roche Holding** *Switzerland, Healthcare*	1.2%
BP *UK, Energy*	0.9%	**Novo Nordisk** *Denmark, Healthcare*	1.2%
Sanofi *France, Healthcare*	0.9%	**AstraZeneca** *UK, Healthcare*	1.1%
Bayer *Germany, Healthcare*	0.9%	**HSBC Holdings** *UK, Financials*	1.1%
Shell *UK, Energy*	0.8%	**Shell** *UK, Energy*	1.1%
Commonwealth BOA *Australia, Financials*	0.8%	**Commonwealth BOA** *Australia, Financials*	1.1%
Total	**12.1%**	**Total**	**12.8%**

FIGURE 5
Largest 10 Positions in the MSCI EAFE Index

Source: Bloomberg, data as of June 30, 2025, and June 30, 2015. Market capitalization weights in global indices calculated in USD. Note that exchange rate movements, particularly currency depreciation or appreciation relative to the US dollar, can materially influence the USD-denominated market cap weight of non-US companies, even when their local currency valuations remain stable.

The composition of the largest companies in the index has undergone some changes since 2015. At that time, the top three companies were all Swiss, reflecting the country's strong market presence. However, these companies have since shifted down in the ranking. Similarly, Toyota, once a dominant force among Japanese companies and a fixture in the Top 10, has fallen out of this group. Today, the top positions are dominated by European companies, while firms located in Asia (or with increased exposure), such as Toyota and HSBC, have struggled to maintain their standing.[8]

[8] Note that HSBC (Hong Kong and Shanghai Banking Corporation) is headquartered in London, UK, but is greatly exposed to Asia.

Historical performance

One of the key tenets behind investing in developed markets outside the US is that doing so can provide diversification benefits. This is evident in the historical cyclicality of the markets, whereby international stocks have outperformed US stocks significantly over some periods, while the reverse has also occurred (see Figure 5). For example, in the 1980s, developed ex-US equities averaged 22.0% gains annually compared to 16.6% annually for domestic equities.[9] However, developed ex-US stocks underperformed US stocks by 10.7% annually over the subsequent decade, mainly

[9] Source: Investment Metrics, monthly returns as of June 30, 2025. Indices: MSCI EAFE USD and Russell 3000. For the period from January 1980 to December 1989.

because of a steep decline by 10.7% annually over the subsequent decade, mainly because of a steep decline for Japanese stocks. Since the Global Financial Crisis (GFC), international equities have lagged US stocks, largely driven by a gap in earnings growth over this period.[10]

[10] See Meketa research paper "Can Listed US Companies Sustain Earnings Growth?" Published February 2025.

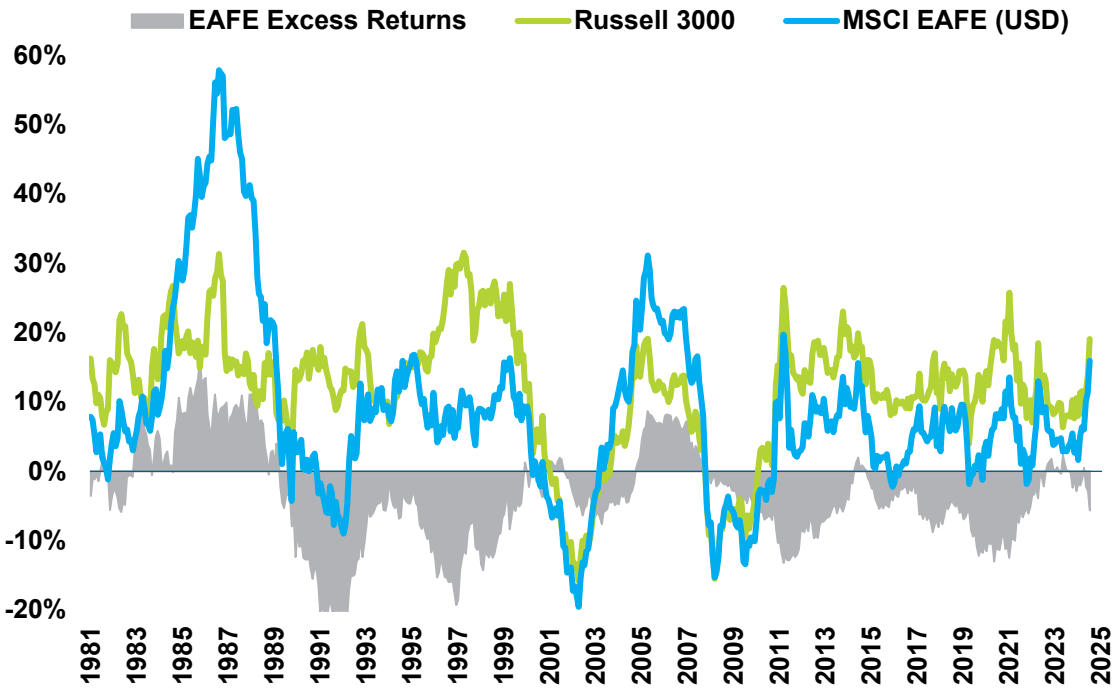

FIGURE 6
Rolling 3-Year Returns for MSCI EAFE and Russell 3000

Source: Investment Metrics, monthly returns as of June 30, 2025. Indices: MSCI EAFE USD, MSCI EAFE Local Currency, Russell 3000. For the period December 1981 through June 2025. Unless otherwise noted, all performance shown in this paper is in US dollars.

For the entire period January 1979 through June 2025, EAFE stocks returned 8.5% annually versus 12.1% for US stocks. This gap has widened over the past fifteen years, a period during which US equities have been the second best performing major asset class, trailing just behind US private equity.[11] Whether an investor believes US equities will continue to outperform non-US equities largely comes down to their view on relative earning growth and pricing.

[11] Source: Investment Metrics, Cambridge Associates. For the period ending December 31, 2024, the CA US Private Equity composite returned 15.8% annualized over the trailing 15 years while the Russell 3000 returned 13.6%.

At the same time, EAFE stocks have exhibited more volatility than their US counterparts, at least for a US-based investor, at 16.8% for EAFE versus 15.5% for US (see Figure 7). However, this higher volatility is due primarily to currency fluctuations on top of share price fluctuations. In local currency terms, EAFE volatility is 14.2%, slightly lower than US equities. Volatility for both US and non-US markets has shown clear cyclicality, reflecting shifts in economic conditions, investor sentiment, and currency effects.

In contrast, correlation data have shown distinct trends. In the 1980s and early 1990s, correlations were fairly modest, averaging less than 0.5 (see Figure 8). However, correlations between developed ex-US equities and US equities increased in the late 1990s, and they have stabilized at those higher levels of ~0.8, reflecting the continued integration of global markets. Arguably, if the recent trend toward deglobalization continues, correlations could decline in the future.

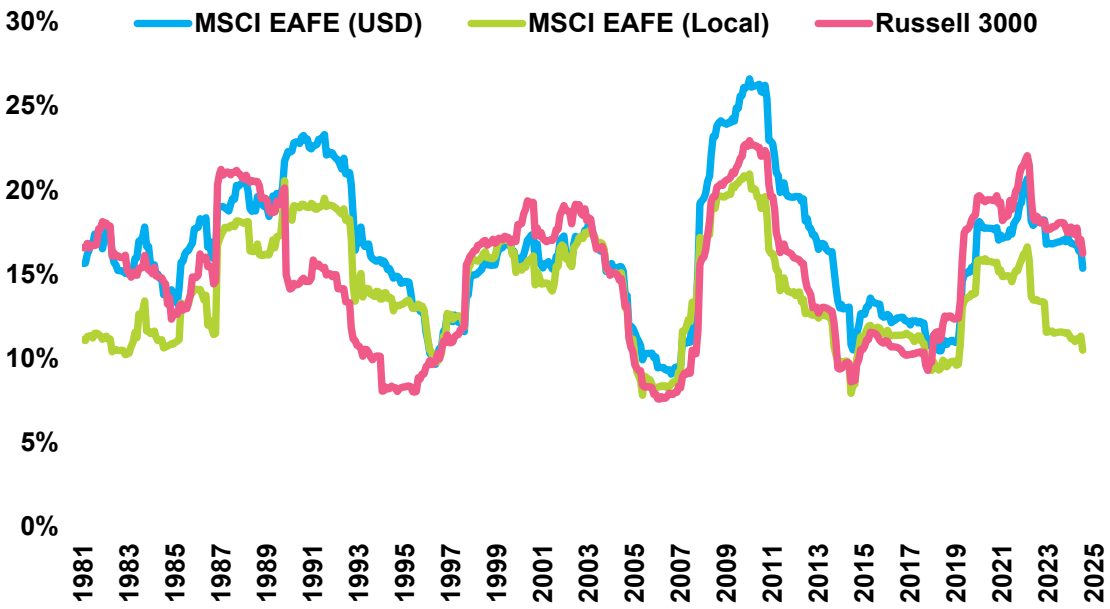

FIGURE 7
Rolling 3-Year Volatility for MSCI EAFE and Russell 3000

Source: Investment Metrics, monthly returns. Indices: MSCI EAFE USD, MSCI EAFE Local Currency, Russell 3000. For the period December 1981 through June 2025.

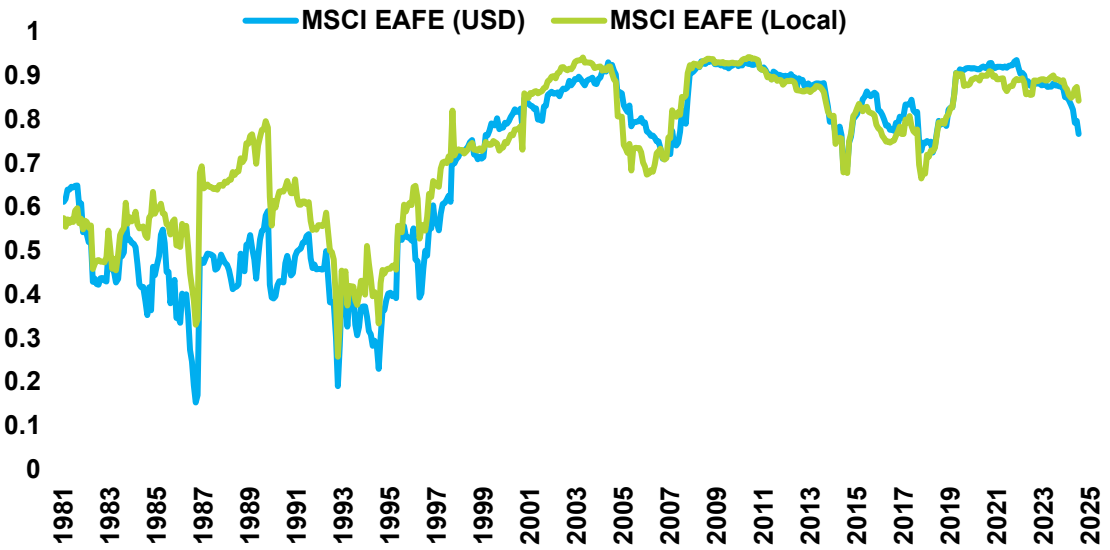

FIGURE 8
Rolling 3-year Correlations with Russell 3000

Source: Investment Metrics, monthly returns. Indices: MSCI EAFE USD, MSCI EAFE Local Currency, Russell 3000. For the period December 1981 through June 2025.

Although correlations have settled at higher levels, episodic divergences still occur, especially during regional and global stress events. Given the heavy European weight in EAFE (~66%), regional events such as Brexit and the Eurozone debt crisis had a disproportionate impact on performance, during which US stocks significantly outperformed. However, during broader global shocks such as COVID-19 and the GFC, this performance gap narrows, emphasizing the more uniform impact of systemic events across markets.

Looking ahead, recent structural shifts like deglobalization and geopolitical fragmentation may further weaken long-term correlations between US and developed ex-US markets and potentially restore some of the diversification benefits these markets have historically offered.

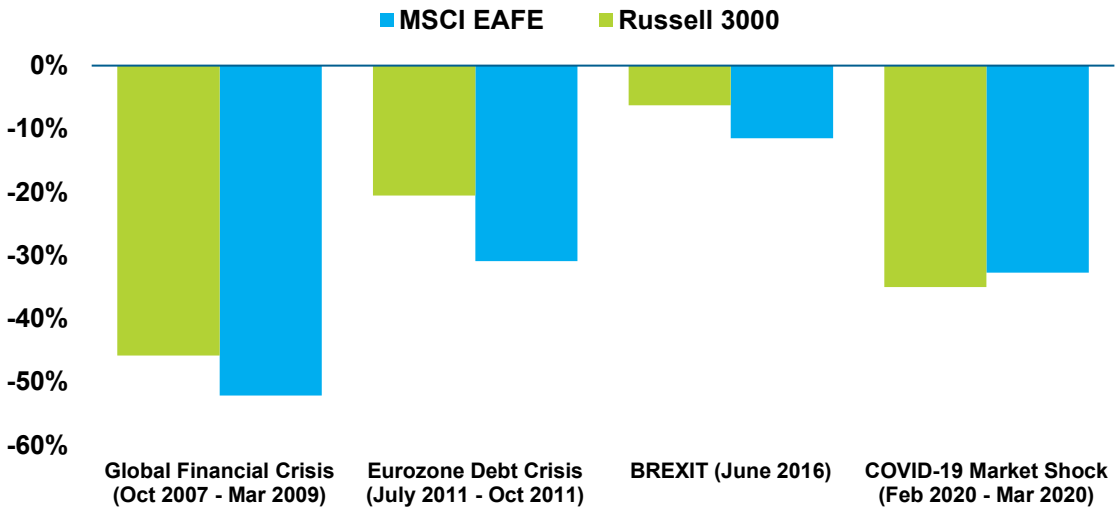

FIGURE 9
Cumulative Returns during Historical Scenarios

Source: Meketa Asset Allocation Tool for GFC and COVID-19 Shock. For BREXIT, we use the period from June 8-27, 2016. This captures the peak on June 8 and culminated in a sharp one-day drop on June 24 after the referendum vote; markets recovered from lows after June 27. For the Eurozone Debt Crisis, we analyze the period of July 4-October 4, 2011. This window reflects the most intense phase of the Eurozone crisis marked by key events, with the MSCI EAFE peaking on July 4 and bottoming on October 4.

Currency issues

Investments in international markets expose US investors to currency risk, generated by the market fluctuations of the US dollar relative to international currencies. These currency movements can act either as a headwind or tailwind for US-based investors in foreign markets. If the foreign currency weakens versus the dollar, then an investor's final return will be negatively impacted by the currency movement. On the other hand, a strengthening foreign currency (i.e., weakening dollar) enhances the returns of foreign assets for US-based investors. Thus, an investor's final return consists of two components: the appreciation or depreciation of the investment itself, plus the change in value of the foreign currency.

Since 2000, the net impact of currency movement on US dollar returns has been effectively zero (see Figure 9). Yet this masks the substantial volatility in currency movements that can lead to dramatic short-term differences. There have been many instances where the difference between the local currency and USD returns have been +/- 10% over a 12-month period.

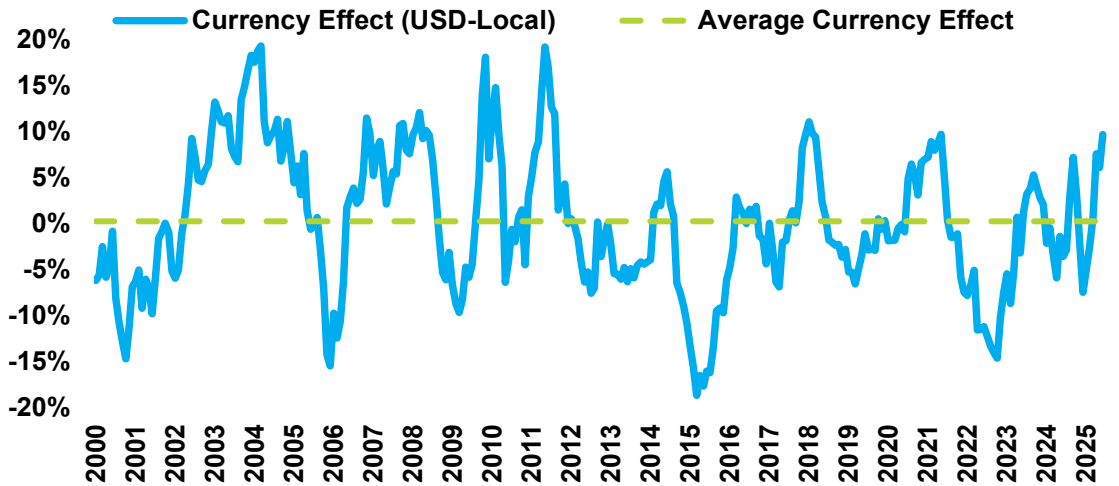

FIGURE 10
Currency Effect for MSCI EAFE (Rolling One-Year USD vs. Local Currency)

Source: Investment Metrics, monthly returns as of June 30, 2025. Indices: MSCI EAFE USD, MSCI EAFE Local Currency. Calculated based on one-year rolling returns. For the period January 1, 2000 to June 30, 2025.

The effect of currency movements can be mitigated or even eliminated by purchasing the appropriate hedging instruments such as futures contracts, forward contracts, swaps, or options. Institutional investors with an informed understanding of currency risk in foreign investments are well-positioned to deal with its effects in their portfolios. The decision to hedge or not hedge currency risk should be based on several factors that are specific to each investor.[12]

[12] See Meketa research paper "Currency Hedging" published September 2022 for a fuller discussion of currency considerations.

- **Currency outlook:** A currency-hedging decision can be implemented strategically or tactically. If an investor does not have any views on the return of a currency or does not want exposure to currency risk, then a strategic decision to hedge away currency risk might be warranted. However, if current market conditions lead to expectations of positive currency returns, an investor can tactically lower or remove hedges to attempt to capture these returns. However, currencies are very volatile, can deviate from equilibrium for long periods of time, and may be influenced by external non-market factors (e.g., central bank intervention). With many factors to be considered, tactical currency bets can be very risky.

  There is one additional caveat for US investors: the US dollar is considered the base currency of the world, and as such, it has historically behaved as a safer haven during periods of market stress, generating foreign currency losses to investments in foreign assets during these times.

- **Size of foreign currency exposure:** The larger the allocation to foreign investments, the more foreign currency risk there is in a portfolio. Hence, there might be some threshold of foreign currency exposure up to which the investor does not hedge but over which they choose to hedge. Hedging foreign currency exposure likely represents a more important question for non-US investors whose portfolios are not as heavily tilted towards domestic assets.

- **Cost of hedging:** For US investors, the cost of hedging currency exposure is related to the short-term interest rate differential between the US and the other currency's country or region, known as the cost of carry.[13] The larger the difference between a foreign currency's local interest rate and that of the US, the higher the cost to hedge it for US investors.

  It is worth noting that when US interest rates are higher than foreign interest rates, US-based investors effectively get paid to hedge their currency exposure. In such scenarios, the implicit interest rate costs are reversed, allowing investors to receive a positive return on currency hedging. For example, if the Japanese yen yields 1% and the US dollar yields 2%, the investor can effectively earn 1% annually from hedging.

  Finally, transaction costs vary based on the type of hedge and frequency of implementing the hedge. Rolling over contracts more frequently provides a better hedge (i.e., less basis risk) but incurs greater trading costs.

[13] The three-month government bond rates are most commonly used.

Some investors may choose to delegate the currency hedging decision to their asset managers, who may be better positioned to make such decisions on a daily basis. Ideally a hedging arrangement would include clear guidelines on the extent of currency positioning allowed and its purpose (e.g., just for hedging, not for currency speculation).

Active versus passive management

For the past two decades, equities in non-US developed countries have been a moderately "efficient" asset class, which suggests that active managers face challenges in adding value but still have ample opportunity to do so. Since 1990, the median EAFE Equity manager achieved an average annualized outperformance of 193 basis points, before fees. However, this figure declined significantly in the early 2000s and has remained relatively flat ever since. Over the past five years, median outperformance has averaged 78 basis points, with a modest uptick observed as of recently.[14] Notably, since inception, EAFE managers have outperformed their US equity counterparts, whose median excess returns have remained more compressed in recent years.[15] It is important to note that fees will reduce the net return even lower. As with other markets, manager outperformance has been highly cyclical.

[14] Source: Meketa analysis of data from eVestment Alliance. Data as of December 31, 2024. Gross of fees. Due to the small number of funds at inception, some of the asset classes' early year relative returns may be skewed. For more information on see Meketa's Manager Alpha Whitepaper.

[15] From December 1989 to December 1990, the EAFE equity universe posted a median outperformance of 1.9%, compared to 0.26% for US Large Cap equity managers. More recently, as of December 2024, US Large Cap equity managers reported a median excess return of -1.52%, while EAFE managers achieved 1.30%.

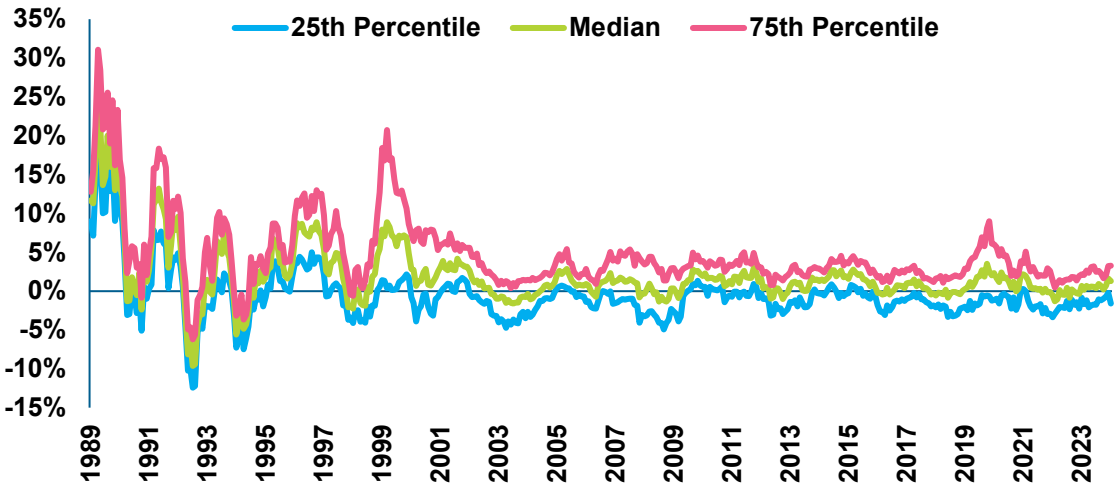

FIGURE 11
Rolling Median Outperformance MSCI EAFE Equity

Source: Meketa analysis of data from eVestment Alliance. Data as of December 31, 2024. Gross of fees. Due to the small number of funds at inception, some of the asset classes' early year relative returns may be skewed. For more information see Meketa's Manager Alpha Whitepaper.

Interquartile spreads (the range between the 75th and 25th percentile) can be interpreted as how much potential value lies in selecting superior active managers within each asset class. Since 1990, the interquartile spread for non-US developed countries was 5.23%, but it has decreased to 4.73% in the last five years.[16] This decline in the spread implies diminishing opportunities for added value through active management. Meanwhile, the average number of funds in the analysis for non-US developed countries has increased from 81 in 1989 to 95 over the last five years.[17] This growth in fund coverage suggests heightened competition among fund managers, which may lead to a narrowing of the interquartile spreads.

[16] Source: Meketa analysis of data from eVestment Alliance. Data as of December 31, 2024. Gross of fees.

[17] Source: Meketa analysis of data from eVestment Alliance. Data as of December 31, 2024.

Implementation

Investing in developed ex-US markets presents distinctive implementation challenges. The inherent nature of operating in markets with different languages and cultures can create communication and operational hurdles. Similarly, differences in regulatory environments and legal differences may require specialized knowledge to navigate effectively. As a result of this greater due diligence and complexity, investing in these markets often incurs higher costs and management fees.

Active management in developed ex-US equities may be desirable, especially if institutional investors want a different mix of countries, sectors, and capitalization than what can be achieved through the investable benchmarks. Some managers will also invest outside the traditional EAFE countries (i.e., in emerging markets or North America) to outperform their benchmark. The vast majority will construct portfolios that are diversified by country and industry.

The costs associated with international investments are higher than for US stocks. International stocks require foreign custody, with fees above those of US custody. International governments sometimes levy withholding taxes on dividends or other gains, thus increasing costs and reducing returns. Finally, international security trades often must be executed through brokers outside the US, who may charge higher fees or be subjected to transfer taxes. Still, the additional costs are relatively small compared to the benefits, and markets continue to become more globalized, many of these costs should continue to decline.

Summary

Developed ex-US equities represent a diverse array of countries across Europe, Australasia, and the Far East. Historically, these equities have generated slightly lower returns to US benchmarks. Additionally, developed ex-US equities have exhibited higher annualized volatility levels compared to US equity. While the correlation between US and non-US equities has converged over the past 30 years, developed ex-US equities continue to offer meaningful diversification benefits, due to their distinct regional exposures, sector compositions and currency dynamics.

Nevertheless, investing in developed equities outside the US may present increased opportunities for accessing diverse and innovative markets while potentially producing returns above the benchmark. However, in recent years the potential for generating alpha has declined. In evaluating developed ex-US exposure, it can be informative to examine implementation approaches, currency dynamics, and associated costs to determine how – or whether – such an allocation fits within stated portfolio objectives and constraints.

Appendix | Benchmarks: EAFE vs EAFE IMI

The MSCI EAFE and the MSCI EAFE IMI (Investable Markets Index) are both global developed equity indices created by MSCI, but they differ in terms of the coverage of the companies they include. Both serve as reasonable proxies for investors seeking a benchmark for their developed non-US market exposure.

	MSCI EAFE	MSCI EAFE IMI
Coverage	Large and mid-cap stocks	Large, mid, and small-cap stocks
Number of Constituents	~700 stocks	~2,700 stocks
Inception Date	1986	2007

FIGURE 12
EAFE vs EAFE IMI Characteristics

Source: MSCI EAFE and EAFE IMI Factsheets, as of June 30, 2025.

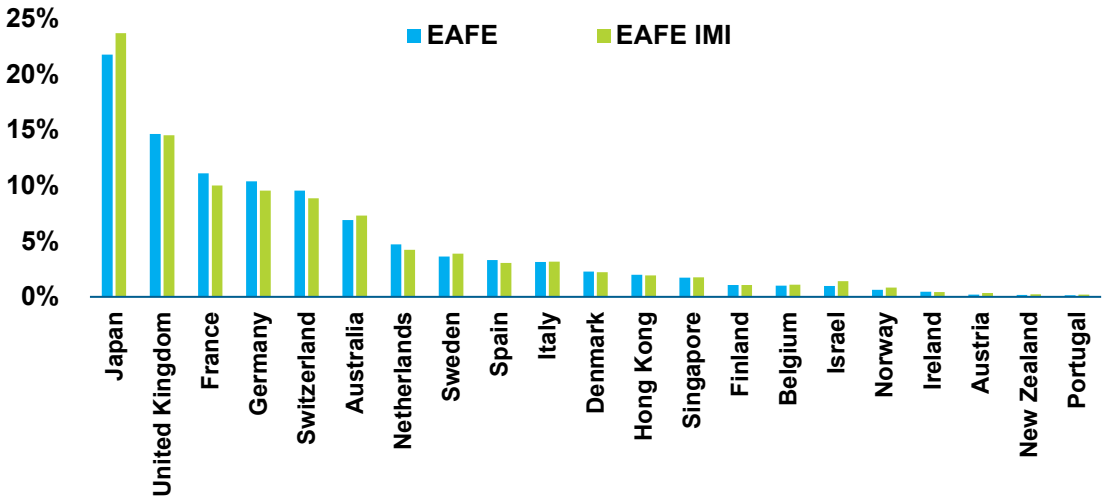

FIGURE 13
Country Weights EAFE vs EAFE IMI

Source: MSCI, data as of June 30, 2025.

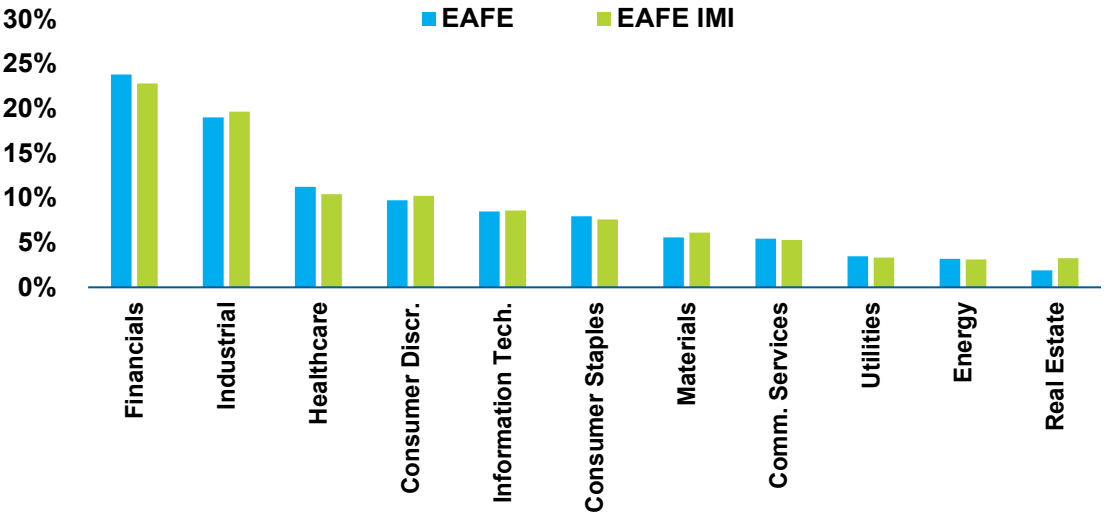

FIGURE 14
Sector Weightings EAFE vs EAFE IMI

Source: MSCI EAFE and MSCI EAFE IMI Factsheets, as of June 30, 2025.

In summary, the MSCI EAFE IMI provides a more extensive representation of the developed ex-US equity market by including small cap stocks. Investors should choose between these indices based on their preferences for market coverage, risk tolerance, and investment strategy.

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