

# As the World Turns

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Applying the DRS to Foreign Developed Markets



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## **The World Spins Madly On**

Let's turn back the calendar a year and remember where we were in summer 2016.

Great Britain made the monumental decision to leave the European Union. Marine Le Pen was threatening to do the same in France, as well as abandon the Euro as a common currency. Markets were nervously watching Italian banks, wondering if another round of bailouts was pending. In the U.S., Donald Trump made opposition to free trade and international cooperation central themes of his candidacy.

How did the international stock markets respond?

Between June 30th of 2016 and 2017 international stocks were up over 20%.

The 20.83% gain of the MSCI EAFE was better than the 17.90% return on the S&P 500. Granted, some say a rebound in international markets was long overdue. Since the Financial Crisis of late 2007 to early 2009, the stock markets of developed, non-U.S. nations have lagged the S&P 500 by a wide margin. It was Europe's turn to have a moment in the sun, but predicting it would have been difficult if one only paid attention to the negative headlines a year ago.

It is for this reason that Swan Global Investments unveiled its [expanded line-up of investment solutions](#) over the last few years. While the Defined Risk Strategy was originally applied to U.S. large cap stocks, the line-up [now includes U.S. small cap stocks](#), [emerging markets](#), and foreign developed markets.

## **Is Diversification Keeping Its Promises?**

### **Multiple Asset Classes**

The promise of diversification has always been two-fold. First, different asset classes or styles will go in and out of favor, with different investments typically taking turns as "king of the mountain." Swan believes that it is difficult, if not impossible, to consistently predict which asset class will have the best returns going forward. Lacking 20/20 foresight into the future, the next best option is to cover all your bases by diversifying into multiple asset classes.

## Mitigating Risk

The second promise of diversification is to mitigate losses on the downside. Unfortunately, when markets sell off significantly, correlations tend to increase, and global markets tend to go down together. Traditionally, many international managers sought to mitigate downside risk by rotating in or out of different countries or regions.

### The Problem with this Kind of Diversification

These two elements of diversification, however, require the kind of market-timing that Swan has always been against. The two reasons for this stance are illustrated in the table below:

Calendar Year As of June 2017								
2000	2001	2002	2003	2004	2005	2006	2007	2008
France: -4.06%	Emg Mkt: -2.37%	Emg Mkt: -6.00%	Germany: 64.79%	Emg Mkt: 25.95%	Emg Mkt: 34.54%	Germany: 36.79%	Emg Mkt: 39.78%	Japan: -29.11%
UK: -11.53%	UK: -14.05%	Japan: -10.11%	Emg Mkt: 56.28%	UK: 19.57%	Japan: 25.63%	France: 35.42%	Germany: 35.93%	France: -42.71%
Germany: -15.27%	Germany: -21.99%	UK: -15.23%	France: 41.03%	France: 19.22%	France: 10.59%	Emg Mkt: 32.59%	France: 14.03%	Germany: -45.50%
Japan: -28.07%	France: -22.09%	France: -20.83%	Japan: 36.15%	Germany: 16.66%	Germany: 10.52%	UK: 30.66%	UK: 8.39%	UK: -48.32%
Emg Mkt: -30.61%	Japan: -29.28%	Germany: -32.90%	UK: 32.06%	Japan: 15.95%	UK: 7.38%	Japan: 6.33%	Japan: -4.14%	Emg Mkt: -53.18%
2009	2010	2011	2012	2013	2014	2015	2016	YTD
Emg Mkt: 79.02%	Emg Mkt: 19.20%	UK: -2.52%	Germany: 32.10%	Germany: 32.40%	Emg Mkt: -1.82%	Japan: 9.90%	Emg Mkt: 11.60%	Emg Mkt: 18.60%
UK: 43.37%	Japan: 15.59%	Japan: -14.19%	France: 22.82%	France: 27.66%	Japan: -3.72%	France: 0.78%	France: 6.02%	France: 17.93%
France: 33.26%	Germany: 9.32%	France: -16.00%	Emg Mkt: 18.63%	Japan: 27.35%	UK: -5.35%	Germany: -1.27%	Germany: 3.50%	Germany: 16.04%
Germany: 26.56%	UK: 8.80%	Germany: -17.45%	UK: 15.30%	UK: 20.71%	France: -8.99%	UK: -7.51%	Japan: 2.73%	Japan: 10.11%
Japan: 6.39%	France: -3.23%	Emg Mkt: -18.17%	Japan: 8.36%	Emg Mkt: -2.27%	Germany: -9.76%	Emg Mkt: -14.60%	UK: -0.04%	UK: 10.04%

  

<span style="display:inline-block; width:15px; height:15px; background-color:yellow; border:1px solid black;"></span> MSCI U.K.	<span style="display:inline-block; width:15px; height:15px; background-color:orange; border:1px solid black;"></span> MSCI France	<span style="display:inline-block; width:15px; height:15px; background-color:grey; border:1px solid black;"></span> MSCI Germany
<span style="display:inline-block; width:15px; height:15px; background-color:blue; border:1px solid black;"></span> MSCI Japan	<span style="display:inline-block; width:15px; height:15px; background-color:green; border:1px solid black;"></span> MSCI EM (Emerging Markets)	

Source: Zephyr StyleADVISOR, Swan Global Investments

The above table displays only four countries, plus emerging markets, but two key take-aways are readily apparent:

- First of all, there doesn't appear to be any rhyme or reason as to which countries or regions will be the worst-performing at any given time. With little reason, how do people time the markets effectively?

- Second, during the worst years like 2000-2002 or 2008, we see markets moving down in lock-step. The high correlation among the markets during downturns means there is little to no risk protection.

## **The DRS and Foreign Developed Markets**

This is why Swan Global Investments brought its philosophy of “always invested, always hedged” to both developed and emerging international markets. When in favor, global investing can boost the returns of a U.S.-centric portfolio. When markets sell off, the DRS investments are hedged to protect against major losses.

By adding international equities to Swan’s line-up, investors have access to a larger opportunity set. During those times when foreign developed markets are in favor (or foreign emerging markets or U.S. small cap, for that matter) investors can participate in their rallies. While the past year or so has been good for foreign markets, there is no guarantee that it will continue on indefinitely. Any of the aforementioned events or new, unforeseen crises could potentially turn the bull market in international equities into a bear. However, by applying the Defined Risk Strategy to foreign developed, emerging markets and U.S. small cap stocks we believe we have developed the building blocks to create a better global portfolio.

### **About the Author:**



Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan’s Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research for 11 years at Zephyr Associates.

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