Why Invest Internationally?

Investing solely in U.S. companies may limit an investor’s opportunity set and prevent them from reaping the potential rewards of holding a well-diversified portfolio. While the U.S. may offer excellent opportunities, an investor focused only on the U.S. market may be missing out on equally or more attractive opportunities from around the world. In this piece, we share our perspective on why investing in non-U.S. equities makes sense and what we believe are two key benefits: (1) potential diversification and (2) potential for higher rates of return. Our comments are intended to serve as a framework as each individual’s goals and objectives are different.

**Diversification – Don’t put all your eggs in one basket**

Most investors are familiar with the phrase, “don’t put all your eggs in one basket”, referring to the concept of diversification. Diversification can mean a lot of different things in the context of investing. Asset class, company size, investment strategy, geography, and number of securities all factor into portfolio diversification. A single stock portfolio can be a risky proposition compared to a diversified portfolio of stocks. This idea can also be extended to asset classes, and a portfolio comprised solely of U.S. stocks may carry higher concentration risk in terms of geography compared to an equity portfolio comprised of both domestic and international securities. One way to measure diversification is by examining correlation. Correlation is a statistic that measures the relationship between two variables and has a value between -1 to +1. A negative one correlation indicates that the two variables are perfectly inversely correlated, meaning that they move in exact opposite directions and magnitudes; a positive one indicates that the two variables are perfectly correlated, meaning they move in exactly the same direction and magnitude; and a zero would indicate that the two variables have no relationship with each other. The chart below examines the correlation between three different indices over the past 10 years: the S&P 500 Index (representing U.S. Stocks), the MSCI EAFE Index (representing International Stocks), and the MSCI Emerging Markets Index (representing the Emerging Markets).

**Exhibit 1: Correlation of Equity Markets**

![Rolling Correlation of Annual Returns](chart.png)

Sources: Standard & Poor’s, MSCI, and internal calculations from Cornerstone; reflects a rolling 24 month time period. Past performance is no guarantee of future results.

The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market; this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. The Morgan Stanley Capital International (MSCI) EAFE (Europe, Australasia, and the Far East) Index is a free float-adjusted market-capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The Morgan Stanley Capital International (MSCI) Emerging Markets Index is a free float-adjusted market-capitalization index that is designed to measure equity market performance of emerging markets. An investment cannot be made directly into an index.
As you can see from Exhibit 1, the rolling correlation of monthly returns of the indices has varied. The markets had been trending toward a less correlated posture until early 2007. While the U.S. market was declining, the international markets were still on the rise, partly because of stronger overseas currencies. On the other hand, there was a significant period, from approximately Q1 of 2008 through Q1 of 2010, where all three generally moved in the same direction. Although diversification did not work during this period of time, it is important to understand why. Recall that at the peak of the financial crisis, governments and central banks around the world coordinated policy to combat the crisis. These measures can’t go on in perpetuity; eventually, countries and markets will diverge. We are beginning to see evidence of this now as the correlations between markets have dropped significantly from crisis levels. Investors with a long-time horizon should not let recent events undermine the benefits of long-term diversification. Bear in mind, however, that diversification cannot ensure a profit or protect against loss in a declining market.

In addition, currency valuations can be volatile and will impact the U.S. Dollar return of a foreign investment. Despite the currency volatility, investors should not shy away from these investments since exchange rates for different currencies versus the U.S. Dollar do not move in lockstep with each other and, therefore, provide an additional layer of diversification. At the same point in time, it is possible that some currencies may be appreciating relative to the U.S. Dollar while other currencies may be depreciating relative to the U.S. Dollar. Currencies tend to move in different directions and serve as another way to diversify a portfolio.

**Potential for higher rates of return**

International equity affords an investor the potential to earn higher rates of return as compared to a domestic-only portfolio. A country’s economic growth rate is a function of many variables, including demographics, incomes, technological advances, education, free market orientation, and labor force productivity. Economic growth rates are important as faster economic growth typically leads to more business profitability. As you can see in Exhibit 2, regions do not experience identical growth rates, and Developing Asia was the only region to avoid contracting during the financial crisis. A U.S.-only equity portfolio exposes the investor to U.S. centric growth rates and can leave out other investable opportunities with faster economic growth rates.

**Exhibit 2: Expanding the Opportunity Set**

"In this dynamic world we live in, new opportunities are being created every day – especially in unimagined places, inconceived products, and unexpected returns.”

Eddie Ramos, CFA, Senior Vice President, Lead Portfolio Manager, International Equity Cornerstone Capital Management LLC
A global equity portfolio draws from a broader universe. The U.S. represents about 25%\(^1\) of the global economy, measured by real Gross Domestic Product, while the U.S. stock market, as measured by the MSCI All Country World Index, represents about 49% of the world’s stock market capitalization. Exhibit 3 is a breakdown by global sector allocation and is another “lens” to gain perspective on the global equity landscape. The U.S. clearly dominates the information technology sector, along with health care. The U.S., however, plays a much smaller role in the materials’, telecommunications’, and financials’ sectors. While the U.S. is an important part of the global economy, it is not the only place to invest!

**Exhibit 3: United States Strong in Health Care and Technology, But Smaller Role in Other Sectors**

<table>
<thead>
<tr>
<th>Sector Weight (%)</th>
<th>Consumer Discretionary</th>
<th>Consumer Staples</th>
<th>Energy</th>
<th>Financials</th>
<th>Health Care</th>
<th>Industrials</th>
<th>Information Technology</th>
<th>Materials</th>
<th>Telecom</th>
<th>Utilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>11.5%</td>
<td>10.5%</td>
<td>9.9%</td>
<td>21.6%</td>
<td>10.2%</td>
<td>10.5%</td>
<td>12.0%</td>
<td>6.0%</td>
<td>4.3%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Canada</td>
<td>0.2%</td>
<td>0.1%</td>
<td>0.1%</td>
<td>1.3%</td>
<td>6%</td>
<td>0.1%</td>
<td>3.2%</td>
<td>3.0%</td>
<td>0.6%</td>
<td>2%</td>
</tr>
<tr>
<td>Europe</td>
<td>2.2%</td>
<td>3.4%</td>
<td>3.3%</td>
<td>4.9%</td>
<td>2.7%</td>
<td>3.1%</td>
<td>2.6%</td>
<td>2.1%</td>
<td>1.1%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Japan</td>
<td>1.8%</td>
<td>0.5%</td>
<td>0.8%</td>
<td>1.3%</td>
<td>5%</td>
<td>1.5%</td>
<td>0.1%</td>
<td>0.7%</td>
<td>0.2%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Pacific Rim ex. Japan</td>
<td>0.2%</td>
<td>0.3%</td>
<td>0.2%</td>
<td>2.0%</td>
<td>1.1%</td>
<td>1.1%</td>
<td>0.2%</td>
<td>0.9%</td>
<td>0.1%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>0.9%</td>
<td>1.0%</td>
<td>1.2%</td>
<td>1.3%</td>
<td>3.1%</td>
<td>1.4%</td>
<td>1.1%</td>
<td>1.0%</td>
<td>0.9%</td>
<td>1.1%</td>
</tr>
</tbody>
</table>

Source: Factset

Another source of returns for non-U.S. portfolios is gaining exposure to other currencies besides the U.S. Dollar. As described above, non-U.S. equity returns are impacted by fluctuations in exchange rates. A decline in the U.S. Dollar, all else being equal, will increase the rate of return on an investment in an overseas company. Of course, the opposite also holds true, namely, an appreciating U. S. Dollar, all else being equal, will decrease the rate of return on an investment in an overseas company. The point is that holding a global portfolio introduces the potential for additional returns due to currency exposure\(^2\).

Finally, there is widespread agreement that alpha (a measure of a portfolio manager’s value and outperformance) potential and market efficiency are inversely correlated; that is, the more inefficient the market, the greater potential for alpha. Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility of a fund and compares its risk-adjusted return to that of its index. The excess return of the fund relative to the return of the benchmark is the fund’s alpha. Market efficiency refers to the degree in which security prices reflect all relevant information at a given point in time and is a function of many things, including the availability of information, accounting standards, corporate disclosures, regulatory practices, and the tendency for stocks in some parts of the world to trade based on non-fundamental information. Regulation Fair Disclosure, commonly referred to as Regulation FD, is a Securities and Exchange Commission (SEC) rule that took effect in the United States in 2000 and mandates that all publicly traded companies must disclose material information to all investors at the same time. Similar rules do not exist in many other countries outside of the U.S. This has been another factor that has tended to make non-U.S. markets relatively less efficient and, therefore, giving a manager the potential to add greater alpha in these regions.

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\(^{1}\) United States Department of Agriculture, Economic Research Service

\(^{2}\) Foreign securities may be subject to greater risks than U.S. investments, including currency fluctuations, less liquid trading markets, greater price volatility, political and economic instability, less publicly available information, and changes in tax or currency laws or monetary policy. These risks are likely to be greater for emerging markets than for developed markets.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country’s borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

The MSCI All Country World Index (ACWI) is a free float-adjusted market-capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices, comprising 24 developed and 21 emerging market country indices.
**Additional risks may be properly managed**

International investing does entail additional risks. Some of these risks, such as liquidity, exist in both the U.S. and international markets. Investors should also be aware that other countries can have different political and regulatory structures. Currency exposure is an additional risk incurred by overseas investing. Finally, in extreme cases, some countries may impose capital controls which effectively limit your ability to sell out of an investment in a timely manner. Despite all of these risks, we believe that these risks can be properly managed and are worth taking in order to realize potential return.

**“International investments provide the opportunity to achieve returns similar to U.S. equities while providing diversification. Currently, international markets are trading at a discount to their 18-year average book value which could provide additional returns when global growth recovers.”**

Andrew Ver Planck, CFA, Senior Vice President, Lead Portfolio Manager, Quantitative Equity Cornerstone Capital Management LLC

**Why now?**

While we believe investors should have a strategic asset allocation to international equities, we also feel there are some tactical reasons why an investor would want to enter these markets today. Our framework considers fundamental factors as well as valuation metrics.

The chart below compares the annualized return for three indices over the past three- and five-year time horizons. Clearly, the U.S. market, as measured by the S&P 500, has had a good run versus international equities, as measured by the MSCI EAFE and MSCI ACWI ex-U.S. indices. As a result of the recent outperformance of U.S. equities, international equities look relatively attractive from a valuation perspective. For example, the MSCI ACWI ex-U.S. Index is currently trading at a 39% price-to-book discount to the S&P 500, and the MSCI EAFE is trading at a 44% price-to-book discount. Both are among the highest discounts we have seen since the year 2000.

**Exhibit 4: International Equities are Undervalued and Provide Investment Opportunities**

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Price-to-Book Comparison
Quarterly Snapshots Q3 2000 to Q2 2013
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Adopting a narrow investment perspective can lead to sub-optimal investment choices and even less desirable outcomes. It is important to stay focused on the long term and not be overly swayed by relatively short-term events. International investing gives the investor exposure to other regions and companies of the world that are driven by different growth factors and influenced by local consumers. The addition of overseas equities provides additional sources of return while improving the diversification of the portfolio.
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Before you invest

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