

Investing in the Global Marketplace: Opportunities in International Equities

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Martin C. Schulz, J.D.
Managing Director
International Equity

Now more than ever, international equity plays a critical role in a well-balanced portfolio. International stocks represent a large and growing share of the global investment universe, and international stocks offer investors the potential to capitalize on faster long-term growth trends abroad. Investing in foreign stocks today also gives investors access to a broader range of investment opportunities, including important industry segments that are dominated by large non-U.S. companies.

In addition to an expanded opportunity set, international investing helps reduce portfolio risk through diversification. Since foreign companies and markets are subject to different influences and conditions than their U.S. counterparts, international stocks and U.S. equities often move in different directions. Because of these different performance patterns, allocations to non-U.S. stocks can help reduce portfolio volatility and risk over the long term.

FASTER GROWTH RATES IN FOREIGN ECONOMIES

Expanding Non-U.S. Economies

The growth rate of world GDP over the last several years has surpassed that of the U.S., a trend that is expected to continue for the foreseeable future. While emerging and developing economies will continue to be major contributors to global GDP gains, even advanced economies such as Singapore and Korea are expected to expand faster than the U.S. And even though the Eurozone as a group will likely struggle over the next few years, many developed European nations are undertaking major reforms today that could enable them to become strong, vibrant economies. Investors would be wise to consider the potential benefits of international stocks in this landscape.

Real World GDP Annual Percentage Change

	Projections						
	2010	2011	2012	2013	2014	2015	By 2019
World	5.2%	3.9%	3.2%	3.0%	3.6%	3.9%	3.9%
Advanced Economies	3.0	1.7	1.4	1.3	2.2	2.3	2.1
US	2.5	1.8	2.8	1.9	2.8	3.2	2.2
Euro Area	2.0	1.6	(0.7)	(0.5)	1.2	1.5	1.5
Japan	4.7	(0.5)	1.4	1.5	1.4	1.0	1.1
Other	4.5	2.7	1.5	2.1	2.9	2.9	3.0
Emerging and Developing Economies	7.5	6.3	5.0	4.7	4.9	5.3	5.3
China	10.4	9.7	7.7	7.7	7.5	7.3	6.5
Malaysia	7.4	5.1	5.6	4.7	5.2	5.0	5.0
Philippines	7.6	3.6	6.8	7.2	6.5	6.5	6.0
Brazil	7.5	2.7	1.0	2.3	1.8	2.7	3.5
Mexico	5.1	4.0	3.9	1.1	3.0	3.5	3.8
Nigeria	8.0	7.4	6.6	6.3	7.1	7.0	6.7

Source: World Economic Outlook 2014, International Monetary Fund (IMF)

Large and Growing Foreign Share of World GDP

While the U.S. has been the dominant economic powerhouse for the past century, the faster growth rates of foreign economies are leading to significant changes in shares of world income. In 2000, the combined GDP of non-U.S. markets represented 77% of global income; by 2025, the foreign share of global income is projected to grow to 82% (source: The Conference Board Global Economic Outlook 2014, November 2013). Investing in non-U.S. markets enables investors to benefit from increasingly richer economies.

Distribution of World Income 2000 and Projected 2025

	Projected 2025	2000
United States	18%	23%
Other Advanced Economies	30	42
Emerging/ Developing Economies	52	35
Total	100%	100%
Memo: Total Non-US Economies	82%	77%

Note: GDP shares are converted to U.S. dollars using purchasing power parities.

Source: The Conference Board Global Economic Outlook 2014, November 2013

BROAD RANGE OF INVESTING OPPORTUNITIES IN INTERNATIONAL EQUITIES

Growing Importance of International Equity Markets

The rise of the global marketplace over the last two decades has been nothing short of dramatic. From the 1970s through the 1980s, the number of publicly traded companies remained relatively static. Beginning in the 1990s, the business universe began to expand rapidly as countries such as China, India, and Russia entered the mainstream world economy. As a result, the number of listed companies on stock exchanges throughout the world grew from 26,093 in 1990 to over 47,000 in 2012. And it's not just giant corporations coming on the investing scene: 87% of non-U.S. stocks have market caps of \$2 billion or less.

Reflecting this global expansion in businesses, non-U.S. stock markets now comprise a significant and increasing share of world equity markets. In 2012, U.S. companies accounted for 35% of world stock market capitalization, a decline of 4 percentage points from 2005. The share of emerging and developing economies more than doubled over the seven-year time span, while in 2014 non-U.S. developed country equities now represent 46% of global capitalization.

The bottom line: Overlooking international stocks means that investors are ignoring two-thirds of the world's investing opportunities.

**Global Stock Market Capitalization
(% of Total)**

	2012	2005
United States	35%	39%
Euro Area	12	15
Other Advanced Economies	34	37
Emerging/Developing Economies	19	9
Total	100%	100%

Source: 2014 World Development Indicators: Stock Markets, World Bank

A Wider and More Extensive Set of Investing Opportunities

Non-U.S. companies are taking more and more positions among the top-ranked and largest global companies. A comprehensive list of the world's largest and most powerful companies, the 2014 Forbes Global 2000 includes companies from 62 countries, up from 46 in its initial ranking in 2003. Asia accounts for a full one-third of the list, followed by North America and Europe. While the U.S. is the leader with 564 companies, China added more names to the 2014 list than any other nation. Even Africa – the region with the fewest Global 2000 members – contributed seven new companies to the list this year, four of which are based in Nigeria.

Growth of International Companies in Forbes Global 2000

Region	% of Companies in Forbes Global 2000	
	2014	2003
Asia	34%	27%
North America	31	42
Europe	25	26
Middle East	4	1
Central and South America	3	2
Oceania	2	2
Africa	1	1
Total	100%	100%

Source: Forbes, The World's Biggest Public Companies (www.Forbes.com/global2000/list)

Access to Important Industry Segments

Forgoing non-U.S. companies would also mean missing investing opportunities in important industry segments, including luxury apparel (Louis-Vuitton, Hermès, Christian Dior, Prada, Michael Kors, etc.), diversified chemicals (Bayer, BASF, Saudi Basic Industries), and pharmaceuticals (Roche, Novartis, Sanofi, GlaxoSmithKline).

Major Foreign Companies Selected Industry Segments

Luxury Apparel			Diversified Chemicals			Pharmaceuticals		
Company	Country	Market Value (\$B)	Company	Country	Market Value (\$B)	Company	Country	Market Value (\$B)
Hermès International	France	\$34.8	Bayer	Germany	\$111.3	Roche Holding	Switzerland	\$253.7
Christian Dior	France	\$34.4	BASF	Germany	\$102.3	Novartis	Switzerland	\$227.4
Kering Group	France	\$25.8	Saudi Basic Industries	Saudi Arabia	\$94.4	Sanofi	France	\$137.1
Prada	Italy	\$20.8	Lyondell-Bassell Industries	Netherlands	\$48.2	Glaxo-SmithKline	UK	\$128.8
Michael Kors	Hong Kong	\$19.4	Linde	Germany	\$37.0	AstraZeneca	UK	\$82.3
Burberry Group	UK	\$10.2	Sasol	South Africa	\$37.0	Teva Pharmaceutical Inds	Israel	\$44.6
Hugo Boss	Germany	\$9.2	Shin-Etsu Chemical	Japan	\$24.2	Takeda Pharmaceutical	Japan	\$37.0

Source: Forbes, The World's Biggest Public Companies (www.Forbes.com/global2000/list)

Attractive Valuations and Dividend Yields

In addition to growth trends and economic development, valuations and yields play an important role in assessing equity opportunities. In the aggregate, international stocks today offer attractive valuations and dividend yields when compared with U.S. equities, presenting investors with the potential for significant gains over the long term. Investment managers that have the capacity to uncover the best combination of country-specific trends, individual company prospects, and attractive valuations and yields can produce significant added value to a portfolio.

International and U.S. Valuations and Dividend Yields As of June 30, 2014

Index	P/E (forward)	Dividend Yield
MSCI ACWI (All Country World)	13.77x	2.54%
MSCI EAFE	13.36x	3.37%
MSCI Emerging Markets	10.37x	2.68%
S&P500	14.93x	1.91%

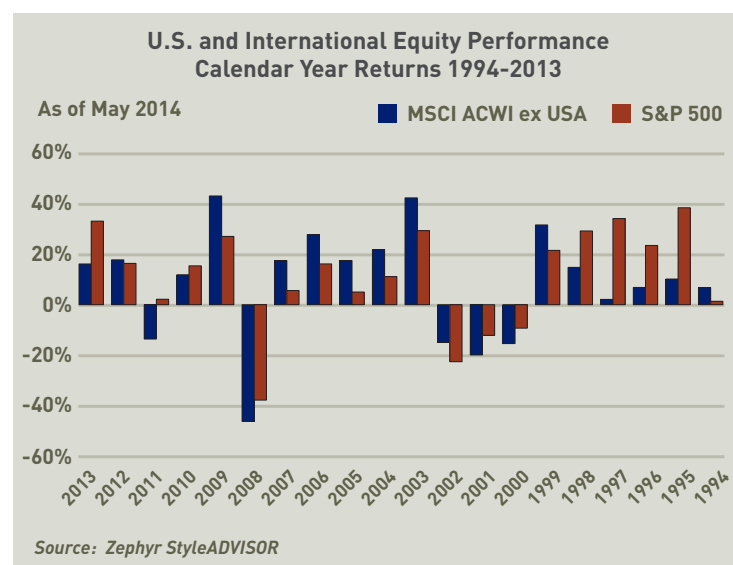
Source: Bloomberg

DIVERSIFICATION BENEFITS OF INTERNATIONAL EQUITIES

Portfolio Volatility Reduced with Diversification

The key to diversification is correlation, which measures how closely returns of different investments track each other. Securities that are perfectly correlated (correlation = 1.00) – that is, their returns typically move in the same direction – provide no real diversification benefit. Investments that are not highly correlated offer the potential of less risk for an expected return or the opportunity for a higher return for a given level of risk.

The different patterns of equity returns of U.S. and non-U.S. stocks reflect variations in the environments in which companies operate. Foreign companies are subject to certain market, political, and economic conditions that are unlike those faced by U.S.-based companies. In addition, countries vary in terms of



stage of economic development and competitive advantages. Non-U.S. stocks do not move in lock-step with U.S. equities, and the differences can be substantial. For example, investors who did not have exposure to international stocks would have missed out on the gains from 2003 to 2007 when foreign equities significantly outperformed U.S. shares. As a result, investors have the potential to lower portfolio volatility by allocating assets to international stocks.

International and U.S. Stock Correlations

The opportunity for diversification benefits with foreign stocks is reflected in the imperfect correlations with U.S. equities, as represented by the S&P 500. As shown below, international stocks have correlations with U.S. equities less than 1.00, with mid and small cap international stocks posting lower correlations than large cap international equities with large cap domestic stocks. Both domestic and international large cap companies are in most cases globally integrated companies with multinational operations and thus subject to similar market conditions. Mid and small cap foreign companies, on the other hand, are more likely to be in more localized competitive environments. Similarly, emerging market stocks have lower correlations with developed country stocks of all market caps, providing investors with significant diversification benefits. By adding international stocks – especially mid and small cap equities and emerging market stocks – an international investment manager can diversify the portfolio and reduce volatility and risk over the long term.

Low Correlation of International Equities with S&P 500

June 1994 – May 2014

	MSCI EAFE LARGE VALUE	MSCI EAFE LARGE GROWTH	MSCI EAFE MID VALUE	MSCI EAFE MID GROWTH	MSCI EAFE SMALL VALUE	MSCI EAFE SMALL GROWTH	MSCI EM (EMERGING MARKETS)	S&P 500
MSCI EAFE Large Value	1.00	0.90	0.95	0.89	0.91	0.86	0.77	0.81
MSCI EAFE Large Growth		1.00	0.84	0.95	0.81	0.88	0.79	0.80
MSCI EAFE Mid Value			1.00	0.89	0.97	0.91	0.75	0.72
MSCI EAFE Mid Growth				1.00	0.88	0.96	0.80	0.77
MSCI EAFE Small Value					1.00	0.94	0.75	0.68
MSCI EAFE Small Growth						1.00	0.79	0.69
MSCI EM (Emerging Markets)							1.00	0.73
S&P 500								1.00

Source: Zephyr StyleADVISOR

INTERNATIONAL INVESTING: THE VALUE OF ACTIVE MANAGEMENT

Once an investor decides to allocate a certain proportion of assets to the international arena, the next question is whether to use passive investment managers, such as exchange traded funds (ETFs) and index mutual funds, or active managers. Investors who believe that active managers are unlikely to beat a benchmark find passive strategies attractive because of their low management costs. However, international investing offers investors the very real potential to earn excess returns through active management for the following reasons:

Flexibility

Unlike passive managers, active international investment managers have the flexibility to seek opportunities wherever and whenever they materialize. Passive strategies attempt to simply replicate the composition and weights of an index. Active managers have the capacity to look for attractive candidates, sell overvalued stocks, and go beyond just the most recognizable names in making portfolio decisions.

This flexibility is especially important in international investing. For example, if an active manager believes that prospects for certain stocks in Germany

represent more attractive opportunities than in the rest of Europe, the manager can overweight the portfolio to those German stocks. A passive strategy, on the other hand, would not overweight those stocks -- the portfolio's holdings would reflect stocks and their weightings in the benchmark index. An active manager is able to put money to work in the best opportunities.

Market Inefficiencies Because research coverage is often limited, many international stocks are relatively undiscovered and under-owned by investors. This is especially true for mid and small cap companies as well as for corporations domiciled in developing markets. As a result, these securities can be undervalued when compared with better-known foreign stocks. Active investment managers can turn limited information into an advantage through fundamental research and connections with local contacts and company management teams.

Downside Protection Managers of active strategies can take steps to cushion the portfolio during down markets. Passively managed portfolios, on the other hand, are structured to produce results in line with the stocks in the index: Passive managers cannot act to reposition the portfolio even if the management team thinks some stocks will decline. For example, a passive strategy would have maintained Eurozone country weightings consistent with its benchmark throughout the multi-year euro crisis, even though the challenges faced by different countries varied significantly. An active manager would, on the other hand, have the chance to construct a portfolio to minimize downside risk.

SELECTING AN INTERNATIONAL INVESTMENT MANAGER

What should an investor look for in selecting an international investment manager? While choosing an investment manager for the international space must be based on each investor's specific needs, there are key criteria to consider. Ideally, an investment manager should:

- Employ a time-tested philosophy and process.
- Incorporate both growth and value styles to be able to perform in different environments.
- Invest in large, mid, and small cap companies to take advantage of the full range of opportunities across the market capitalization spectrum.
- Have the flexibility to participate in both developed and emerging markets.
- Possess the research and analytical resources to identify opportunities around the globe.

Selecting an active manager with a well-established philosophy and process and the capacity to invest across the full range of styles, market caps, and developed and emerging economies gives an investor the best chance to gain the return and diversification benefits of international investing.

SUMMARY AND CONCLUSIONS

International stocks today play a major role in an investment portfolio. Investing in international equities offers investors the opportunity to tap into a growing investment universe of companies and the potential to capitalize on long-term growth trends abroad. Foreign stocks also give investors access to a broader range of industry segments and the opportunity to take advantage of relatively lower valuations and higher dividend yields than are available in the U.S. In addition, allocating assets to international stocks enhances diversification and helps reduce portfolio volatility and risk.

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