An Alternative Approach to International Growth Investing

Very different from domestic growth investing.

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Consultants and financial planners have popularized the distinction between value and growth investing in the U.S., in both the institutional and retail marketplace, and many financial advisors recommend their clients invest in both styles to diversify portfolio risk. This has been a successful strategy over the last decade, as the U.S. equity markets have experienced extreme disparities between growth and value returns as measured by Russell 1000 Growth and Value indexes.

Financial advisors and consultants have begun to apply the same style distinctions to international stock portfolios (portfolios primarily invested in stocks outside the U.S.). In the retail marketplace, Morningstar and Lipper have recently added value and growth style boxes to their analysis of international stock portfolios. In the institutional marketplace, some large pension plans now hire both international growth and value managers to diversify portfolio risk. According to InterSec Research Corp., 51% of initial international equity fundings were placed in either value or growth investments between 2000 and 2004.

Despite the substantial increase in international growth and value mandates, there has been relatively little research on the implications of adherence to style benchmarks in the structuring of international portfolios, although authors have addressed related topics. Fama and French [1998] find evidence that value stocks tend to outperform growth stocks outside the United States. Sinquefield [1996] presents preliminary evidence that a

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EXHIBIT 1

Spreads Between U.S. Value and Growth Securities Are Volatile

	Russell 1000 Value Index	Russell 1000 Growth Index	Spread: Value – Growth	Yr/Yr Change in Spread
12/31/1995	38.3%	37.2%	1.2%	n/a
12/31/1996	21.6%	23.1%	(1.5%)	2.7%
12/31/1997	35.2%	30.5%	4.7%	6.2%
12/31/1998	15.6%	38.7%	(23.1%)	27.8%
12/31/1999	7.4%	33.2%	(25.8%)	2.7%
12/31/2000	7.0%	(22.4%)	29.4%	55.2%
12/31/2001	(5.6%)	(20.4%)	14.8%	14.6%
12/31/2002	(15.5%)	(27.9%)	12.4%	2.4%
12/31/2003	30.0%	29.8%	0.3%	12.1%
12/31/2004	16.5%	6.3%	10.2%	9.9%
Average				**14.8%**

Source: AIM. As of 12/31/04.

superior international portfolio can be obtained by focusing on value stocks and small-cap stocks, while Chanwit [2004] argues that the benefits of investing in emerging market stocks are not as great as widely believed. To our knowledge, no research has analyzed the relative merits of using growth and value indexes in structuring international portfolios.

Our analysis will discuss more broadly the limits to the distinction between international growth and value investing. We show that international equity investing should not mimic the construction of the MSCI EAFE Growth index, but rather should follow a strategy of building a growth portfolio with substantial exposures to both smaller market capitalization stocks and emerging markets equities. We believe such a strategy is likely to provide better diversification relative to both an international value equity portfolio and a U.S. equity portfolio.

CRITIQUE OF GROWTH AND VALUE IN INTERNATIONAL PORTFOLIOS

Data vendors and consultants use various techniques to distinguish growth from value stocks. These metrics, which include price-to-book value and projected earnings growth, lead to significant distinctions with respect to performance and index composition for growth and value stocks in the U.S. When these same metrics are applied to non-U.S. stocks, though, the differences between performance and index composition for growth and value stocks are less distinct.

Return Analysis of Growth and Value Stocks

Differences in performance between growth and value stocks in the U.S. have been significant over the past decade. Exhibit 1 highlights the spreads in annual returns between U.S. growth and value stocks, as measured by the Russell 1000 Growth and Russell 1000 Value indexes over the past ten years (third column). The last column in Exhibit 1 calculates the year-over-year percentage point change in the spread between growth and value returns. For example, the one-year spread between growth and value stocks at year-end 1997 was 4.7 percentage points, while the one-year spread between growth and value stocks at year-end 1998 was 23.1 percentage points. The difference in the spread, therefore, was 27.8 percentage points.

Over the entire period, the average year-over-year change in spreads between growth and value returns was 14.8 percentage points. Based on monthly returns over the same ten-year period, the standard deviation of spreads (i.e., tracking error) between U.S. growth and value stocks was 13.7%.

Exhibit 2 provides a similar analysis of international growth and value stocks, as measured by the MSCI EAFE Growth and MSCI EAFE Value indexes.[1] During this period, the average year-over-year change in spreads between international growth and value returns was 8.2 percentage points, slightly more than half of the average year-over-year change in spreads between U.S. growth and value stocks. Based on monthly returns over the same ten-year period, the standard deviation of spreads (i.e., tracking error) between international growth and value stocks was 7.3%, slightly more than half of the tracking error between U.S. growth and value stocks.

EXHIBIT 2

Spreads Between Non-U.S. Value and Growth Securities Are Less Volatile

	MSCI EAFE Value Index	MSCI EAFE Growth Index	Spread: Value – Growth	Yr/Yr Change in Spread
12/31/1995	9.3%	13.2%	(3.9%)	n/a
12/31/1996	8.0%	4.3%	3.7%	7.6%
12/31/1997	(0.2%)	3.2%	(3.4%)	7.1%
12/31/1998	19.5%	20.6%	(1.1%)	2.3%
12/31/1999	18.7%	33.9%	(15.2%)	14.1%
12/31/2000	(5.0%)	(22.6%)	17.6%	32.8%
12/31/2001	(16.4%)	(26.6%)	10.2%	7.4%
12/31/2002	(11.5%)	(20.3%)	8.8%	1.4%
12/31/2003	43.2%	34.0%	9.2%	0.4%
12/31/2004	24.3%	16.1%	8.2%	1.0%
Average				**8.2%**

Source: AIM / MSCI. As of 12/31/04.

EXHIBIT 3

Comparison of Russell 1000 and MSCI EAFE Growth Indexes

Russell 1000 Growth

Sector	Portfolio Weighting
Technology	25.9%
Health Care	23.7%
Retailing	9.9%
Consumer Staples	9.3%
Financial Services	9.3%

MSCI EAFE Growth

Sector	Portfolio Weighting
Health Care	14.5%
Utilities & Communications	14.1%
Financial Services	13.6%
Technology	12.0%
Retailing	7.0%

Source: FactSet. As of 12/31/04.

Sector Analysis of Growth and Value Stocks

The composition of sector weightings in the U.S. and international growth indexes helps explain why spreads between international growth and value returns vary less than the spreads in their U.S. counterparts. Exhibit 3 compares the composition of the most heavily weighted sectors in the Russell 1000 Growth and MSCI EAFE Growth indexes.

As a large proportion of global technology firms are located in the U.S., it is not surprising that technology stocks represent the highest sector weighting in the Russell 1000 Growth index. Outside the U.S., however, technology is much less significant. In fact, the technology weighting in the MSCI EAFE Growth index is less than half the technology weighting in the Russell 1000 Growth index, and is only the fourth-largest sector in the MSCI EAFE Growth index.

Exhibit 4 highlights the importance of this difference in index composition for the relative volatility of growth versus value by comparing both returns and risk (i.e., standard deviation of returns) of technology stocks relative to the overall global equity market, represented by the MSCI World Index. Global technology stocks have been roughly twice as volatile as global stocks in other sectors over the past three-, five-, and ten-year periods. As expected for a very volatile sector, the returns for technology stocks have varied tremendously over time, but have been higher than the general market over ten years, the longest time period reflected in Exhibit 4.

As of year-end 2004, the financial services sector is the fifth-largest in the Russell 1000 Growth index, representing 9.3% of the benchmark. The financial services sector is the third-largest sector in the MSCI EAFE Growth index, representing 13.6% of the benchmark.

Exhibit 5 attempts to evaluate the significance of this difference in index composition for growth versus value by comparing both returns and risk (i.e., standard deviation of returns) of financial services stocks relative to the overall global equity market, represented by the MSCI World Index. While showing high relative returns over all three of these periods, global financial services stocks

Exhibit 4
Technology Returns versus Overall Market

3 YEARS	MSCI World	MSCI World Technology
Return	7.0%	(2.3%)
Std Dev	14.9%	28.2%
5 YEARS	MSCI World	MSCI World Technology
Return	(2.4%)	(17.5%)
Std Dev	15.6%	35.0%
10 YEARS	MSCI World	MSCI World Technology
Return	8.1%	10.4%
Std Dev	14.5%	31.1%

Source: FactSet. As of 12/31/04.

Exhibit 5
Financial Services Returns versus Overall Market

3 YEARS	MSCI World	MSCI World Financial Services
Return	7.0%	10.9%
Std Dev	14.9%	17.9%
5 YEARS	MSCI World	MSCI World Financial Services
Return	(2.4%)	4.5%
Std Dev	15.6%	17.8%
10 YEARS	MSCI World	MSCI World Financial Services
Return	8.1%	9.2%
Std Dev	14.5%	17.9%

Source: FactSet. As of 12/31/04.

have been slightly more volatile than stocks in other global sectors. Thus, unlike technology, the higher weighting of financial services stocks in the MSCI EAFE Growth index does not drive large differences between growth and value stocks across the globe.

The financial services sector is not only one of the largest sectors in the MSCI EAFE Growth index, but is also the largest sector in the MSCI EAFE Value index, as illustrated in Exhibit 6. Exhibit 6 also shows that utilities and communications is the second-largest sector in the MSCI EAFE Growth index and the third-largest sector in the MSCI EAFE Value index. Given these overlapping sectors at the top of the two MSCI EAFE style indexes, it is not surprising that their returns are so closely correlated—89% over the last ten years, as of year-end 2004.

The correlation of the U.S. style indexes (measured by the Russell 1000 Growth and the Russell 1000 Value), on the other hand, was significantly lower over the same time period (71%), which reflects the greater distinction in sector composition among the U.S. style indexes.

While health care represents the second-highest weighting in both the U.S. and international growth indexes, it has a much higher weighting in the U.S. growth index (23.7%) than in the international growth index (14.5%). Exhibit 7 explains this difference by describing the health care sector weightings of the Russell 1000 Growth and MSCI EAFE Growth indexes at the industry level. More specifically, while pharmaceuticals represent nearly identical weightings in the U.S. and international growth indexes, the industries outside pharmaceuticals represent 11.8% of the health care sector weighting in the Russell 1000 Growth index, but only 1.9% of the health care sector weighting in the MSCI EAFE Growth index.

The higher weighting of these non-pharmaceutical health care industries in the Russell 1000 Growth index helps drive a greater distinction between growth and value stocks in the U.S. than internationally. These industries have offered, in aggregate, higher return and higher volatility than other global stocks over most time periods.

For example, over a five-year period, the return for global health care providers was 15.4% with a volatility of 18.9%. The MSCI World Index yielded a lower return (–2.4%) and lower volatility (15.6%).

ALTERNATIVE APPROACH

We believe it is essential that investors look beyond the MSCI EAFE Growth index—a large-capitalization, developed markets benchmark—when seeking growth internationally. As an alternative, investors pursuing an international growth strategy should consider investments in small-capitalization and emerging markets stocks. An international portfolio with substantial investments in these two asset classes, as well as more traditional MSCI EAFE Growth stocks, when combined with the MSCI EAFE Value index, has generally achieved a superior risk-return relationship than an international portfolio that is half of the MSCI EAFE Growth index and half of the MSCI EAFE Value index.

We also believe investors can achieve better global diversification relative to their U.S. stock portfolio by

EXHIBIT 6

Significant Overlap in Largest Sectors of MSCI EAFE Growth and MSCI EAFE Value Indexes

MSCI EAFE Growth		MSCI EAFE Value	
Sector	**Portfolio Weighting**	**Sector**	**Portfolio Weighting**
Health Care	14.5%	Financial Services	41.3%
Utilities and Communications	14.1%	Utilities and Communications	11.5%
Financial Services	13.6%	Energy	10.4%

Source: FactSet. As of 12/31/04.

EXHIBIT 7

Health Care Sector Weightings

Russell 1000 Growth		MSCI EAFE Growth	
	Portfolio Weighting		**Portfolio Weighting**
Health Care Sector	23.7%	Health Care Sector	14.5%
Pharmaceuticals	11.9%	Pharmaceuticals	12.6%
Health Care Equipment & Supplies	4.6%	Health Care Equipment & Supplies	1.2%
Health Care Providers & Services	3.7%	Health Care Providers & Services	0.5%
Biotechnology	3.5%	Biotechnology	0.2%

Source: FactSet. As of 12/31/04.

EXHIBIT 8

MSCI EAFE Growth, Emerging Markets, and Small-Cap Indexes

	MSCI EAFE Growth	MSCI Emerging Markets	MSCI EAFE Small-Cap
3-Year Annualized Return	7.4%	22.8%	22.3%
5-Year Annualized Return	(6.8%)	4.6%	7.3%
10-Year Annualized Return	3.3%	3.3%	2.7%

Source: AIM / MSCI. As of 12/31/04.

including small-capitalization and emerging markets stocks in their international growth portfolio, since the returns of these two asset classes are much less correlated with the returns of the U.S. stock market than the returns of the MSCI EAFE Growth index. A modest allocation of an international growth portfolio to small-capitalization and emerging markets stocks, despite the liquidity constraints on both asset classes, should allow investors to achieve better global diversification than would an international growth portfolio confined entirely to the MSCI EAFE Growth index.

As Exhibit 8 highlights, the MSCI EAFE Growth index has substantially underperformed both the MSCI EAFE Small-Cap and MSCI Emerging Markets indexes over the last three and five years. The MSCI EAFE Growth index, however, has performed in line with the MSCI Emerging Markets index and slightly outperformed the MSCI EAFE Small-Cap index over the last ten years.[2]

During the last decade, the volatility of these three indexes was also substantially different. Exhibit 9 highlights the annual returns and year-over-year change in annual index returns over the past ten years.

During this period, the average year-over-year volatility in returns for MSCI EAFE Growth stocks was 20.0%, lower than the average volatility of the MSCI EAFE Small-Cap index at 22.5% and substantially lower than the average volatility of the MSCI Emerging Markets index at 39.5%.

More important, the returns of both the MSCI EAFE Small-Cap and the MSCI Emerging Markets

Exhibit 9

Comparison of Growth, Small-Cap, and Emerging Markets Securities

	MSCI EAFE Growth		MSCI EAFE Small-Cap		MSCI Emerging Markets	
	Return	Yr/Yr Change	Return	Yr/Yr Change	Return	Yr/Yr Change
12/31/1995	13.2%	n/a	(2.0%)	n/a	(5.2%)	n/a
12/31/1996	4.3%	8.9%	(0.1%)	1.9%	6.0%	11.2%
12/31/1997	3.2%	1.1%	(24.6%)	24.5%	(11.6%)	17.6%
12/31/1998	20.6%	17.4%	5.4%	30.1%	(25.3%)	13.7%
12/31/1999	33.9%	13.3%	17.7%	12.2%	66.4%	91.7%
12/31/2000	(22.6%)	56.5%	(9.2%)	26.9%	(30.6%)	97.0%
12/31/2001	(26.6%)	3.9%	(14.3%)	5.1%	(2.4%)	28.2%
12/31/2002	(20.3%)	6.2%	(9.6%)	4.7%	(6.0%)	3.6%
12/31/2003	34.0%	54.4%	57.8%	67.4%	56.3%	62.3%
12/31/2004	16.1%	17.9%	28.2%	29.6%	25.9%	30.4%
Average		**20.0%**		**22.5%**		**39.5%**

Source: AIM / MSCI. As of 12/31/04.

indexes were less correlated (84% and 72%, respectively) with the returns of the MSCI EAFE Value index than were the returns of the MSCI EAFE Growth index to the MSCI EAFE Value index (89%) over the past ten years.

One explanation of why smaller-capitalization companies have been less correlated with the MSCI EAFE Value index is that the performance of retail stocks, which represent a significant weighting in the MSCI EAFE Small-Cap index (10.0%), is tied more closely to the local economy than the global economy. Meanwhile, the stocks of emerging markets companies tend to be driven more by commodity prices than by global equity markets. While basic materials has a modest weighting in the MSCI EAFE Value index (5.9%), this sector represents the second-highest weighting in the MSCI Emerging Markets index (16.8%), as well as a significant weighting in the MSCI EAFE Small-Cap index (8.6%).

Exhibit 10 compares two international portfolios consisting of growth and value stocks. The first portfolio (column 2) does not include any small-capitalization or emerging markets stocks in the international growth portion, while the second portfolio (column 3) includes equal weights of 12.5% for both of these asset classes. Over the past three and five years, the international growth portfolio, including small-capitalization and emerging markets stocks, achieved significantly higher returns with similar or less risk than the standard MSCI EAFE Growth portfolio. Over ten years, the risks and returns of the portfolios were nearly identical.

The benefit of adding small-capitalization and emerging markets stocks to an international growth allocation is also clear in data from the S&P/Citigroup indexes. These data reveal similar results to those presented in Exhibit 10. Most important, given the 10-year limitation on the availability of MSCI data, the data from the S&P/Citigroup indexes highlight that over a 15-year period ending December 2004, adding small-capitalization and emerging markets stocks to an international growth portfolio yielded higher returns (6.0% annualized) than the international growth portfolio that did not include small-capitalization or emerging markets stocks (5.2% annualized), with slightly less risk (16.6% versus 16.7%).

Moreover, the returns of small-capitalization and emerging markets stocks had significantly lower correlations (55% and 69%, respectively) with the S&P 500 index than have the returns of the MSCI EAFE Growth index to the S&P 500 index (76%) over the past ten years. Once again, these lower correlations can be attributed to the higher percentage of retail companies in the MSCI EAFE Small-Cap index, as well as the higher percentage of basic materials companies in the MSCI EAFE Small-Cap index and the MSCI Emerging Markets index. As a result, investors who have exposure to these asset classes as part of their international equity allocation can achieve better portfolio diversification relative to U.S. stocks.

Data from the S&P/Citigroup indexes also confirm that the returns of small-capitalization and emerging markets stocks have had a much lower correlation with the S&P 500 index (52% and 56%, respectively) than have the returns of the PMI EPAC Growth Index (S&P/Citigroup Primary Market Growth Index for Europe, Pacific, Asia Composite regions) to the S&P 500 index (67%) over the past 15 years. Indeed, over the last 15 years, the correla-

EXHIBIT 10
Comparison of Growth and Value International Portfolios

3 YEARS	50% MSCI EAFE Value + 50% MSCI EAFE Growth	50% MSCI EAFE Value + 25% MSCI EAFE Growth / 12.5% MSCI EAFE Small Cap / 12.5% MSCI Emerging Markets
Return	11.8%	15.6%
Std Dev	15.6%	15.4%
5 YEARS	50% MSCI EAFE Value + 50% MSCI EAFE Growth	50% MSCI EAFE Value + 25% MSCI EAFE Growth / 12.5% MSCI EAFE Small Cap / 12.5% MSCI Emerging Markets
Return	(1.2%)	2.1%
Std Dev	16.0%	16.0%
10 YEARS	50% MSCI EAFE Value + 50% MSCI EAFE Growth	50% MSCI EAFE Value + 25% MSCI EAFE Growth / 12.5% MSCI EAFE Small Cap / 12.5% MSCI Emerging Markets
Return	5.5%	5.6%
Std Dev	15.1%	15.2%

Source: AIM / MSCI. As of 12/31/04.

EXHIBIT 11
Comparison of International and U.S. Stock Global Portfolios

3 YEARS	50% S&P500 + 50% MSCI EAFE	50% S&P500 + 25% MSCI EAFE Value + 12.5% MSCI EAFE Growth / 6.25% MSCI EAFE Small Cap / 6.25% MSCI Emerging Markets
Return	7.7%	9.5%
Std Dev	14.9%	14.7%
5 YEARS	50% S&P500 + 50% MSCI EAFE	50% S&P500 + 25% MSCI EAFE Value + 12.5% MSCI EAFE Growth / 6.25% MSCI EAFE Small Cap / 6.25% MSCI Emerging Markets
Return	(1.6%)	(0.0%)
Std Dev	15.5%	15.6%
10 YEARS	50% S&P500 + 50% MSCI EAFE	50% S&P500 + 25% MSCI EAFE Value + 12.5% MSCI EAFE Growth / 6.25% MSCI EAFE Small Cap / 6.25% MSCI Emerging Markets
Return	8.9%	8.9%
Std Dev	14.5%	14.5%

Source: AIM / MSCI. As of 12/31/04.

tions of all three international indexes with the S&P 500 index are even lower than over the last 10 years.[3]

Thus, investors seeking diversification between international and U.S. portfolios achieved higher returns with less risk by including small-capitalization and emerging markets stocks in their international allocation, as opposed to an international allocation based solely on the large-capitalization, developed markets, core benchmarks for either MSCI or S&P/Citigroup.

Exhibit 11 compares two global portfolios consisting of international and U.S. stocks. The first portfolio (column 2) invests the international portion in the MSCI EAFE index; this portfolio does not include any small-capitalization or emerging markets stocks in its international portion. The second portfolio (column 3) includes an equal weighting of both asset classes at 12.5% of the international portfolio.

Over the past three and five years, the portfolio whose international allocation included small-capitalization and emerging markets stocks achieved higher returns, with similar risk, than the portfolio whose international allocation did not include small-capitalization and emerging markets stocks. Over the past ten years, the risk and return data were identical.

Data from the S&P/Citigroup indexes confirm the results presented in Exhibit 11, again highlighting how investors seeking diversification between international and U.S. portfolios have benefited by including small-capitalization and emerging markets stocks in their international allocation. In addition, the S&P/Citigroup data highlight that, over the 15-year period ending December 2004, adding small-capitalization and emerging markets stocks to an international growth portfolio produced higher returns (8.6% annualized) than an international growth portfolio that did not include small-capitalization or emerging markets stocks (8.2% annualized), with identical risk (14.2%).

CONCLUSION

As we have illustrated, growth investing in international stocks is very different from growth investing in U.S. stocks. The tracking error between international growth and international value returns has been significantly lower than the tracking error between U.S. growth and U.S. value returns. Therefore, a portfolio consisting of both international growth and international value equities, as defined by the MSCI EAFE index, generally offers less portfolio diversification than a portfolio consisting of both U.S. growth and value equities.

In addition, the sector weightings of the MSCI EAFE Growth index offer less growth than those of the Russell 1000 Growth index, which has a significantly higher exposure to technology and health care and less of an exposure to financial services. We think growth investors in international equities should consider additional investment opportunities outside the MSCI EAFE Growth index—an index of large-capitalization stocks from industrialized non-U.S. countries—to supplement their international growth portfolios.

An alternative approach is to consider an international growth portfolio with investments in small-capitalization and emerging markets stocks. These two asset classes offer the potential for higher returns than the MSCI EAFE Growth index, with lower correlations than the MSCI EAFE Growth index with the MSCI EAFE Value index. As a result, a diversified portfolio whose growth portion includes investments in small-capitalization and emerging markets stocks can achieve similar or better returns with similar or lower overall volatility than a parallel portfolio whose growth portion is composed solely of the MSCI EAFE Growth index.

Moreover, the returns of international small-capitalization and emerging markets stocks have shown much lower correlations with the returns of the U.S. stock market than did the returns of the MSCI EAFE Growth index. Thus, investors seeking global diversification can obtain a better stock portfolio with substantial investments in small-capitalization and emerging markets stocks.

ENDNOTES

This article represents the opinions of the authors and not necessarily those of MFS Investment Management.

[1]Returns are calculated with net dividends reinvested. Returns prior to May 2003 have been restated by MSCI according to its current multifactor model methodology for distinguishing between growth and value stocks.

[2]The Small-Cap index uses price returns. Returns using net and gross dividends reinvested are not available for the entire ten-year period. For the Emerging Markets index, returns are calculated with gross dividends reinvested. Returns with net dividends reinvested are not available for the entire ten-year period.

[3]Like the MSCI EAFE Growth index, the S&P/Citigroup PMI EPAC Growth index includes large-capitalization, developed markets, growth stocks.

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