

יועצי השקעות ישראל | Israel Investment Advisors

Look for Israel Beyond the Indexes

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Quantity

While most American investors are familiar with the Dow Jones Industrial Average or the S&P 500 Index, fewer are familiar with the MSCI Europe, Australasia and Far East (EAFE) Index or the MSCI Emerging Markets Index (EM). The EAFE index covers 21 developed countries excluding the United States and Canada. The EM index covers 23 less developed countries. The EAFE tracks countries with approximately 50% of total world stock market value and the EM index accounts for about 10%. More than \$3 trillion in fund assets are benchmarked against these two widely followed indexes.

MSCI is a powerful determinant of global capital flows due to the rise of passive index mutual funds and exchange traded funds (ETFs). In 2010 MSCI determined that Israel was no longer an emerging market, shifting Israeli stocks from the EM to the EAFE. Israeli investors initially welcomed the news since the total stock market capitalization (i.e. total stock market value) of EAFE countries is approximately \$31 trillion rather than \$6 trillion for emerging markets.

Prior to its transition the Israeli stock market comprised approximately 2.7% of the MSCI Emerging Markets Index. To replicate the EM index, funds such as the Vanguard Emerging Markets ETF with \$37 billion in assets under management, or the iShares MSCI Emerging Markets ETF with \$22 billion were required to own Israeli shares. Despite approaching \$200 billion in total value, the Israeli stock market is just 0.4% of the EAFE - almost a rounding error. Moreover, very few Israeli companies are large enough to meet the EAFE's market capitalization and liquidity requirements.

Almost all foreign portfolio investment left Israel after its removal from the EM in July 2010, with only a small fraction returning in subsequent years. Due to its miniscule weighting on the EAFE even most active international portfolio managers ignore Israeli stocks (index funds are "passive" investment vehicles vs. "active" portfolios where a human being is the decision maker). Although divestment was

the result, it is important to note that MSCI's decision was unrelated to the boycott, divestment and sanctions movement (BDS).

Quality

The major indexes are "market capitalization weighted" favoring large companies and countries. At 25% China is the largest country weighting in the MSCI Emerging Markets Index and the four most populous emerging markets - Brazil, Russia, India and China (the so called BRIC countries) - account for 42%. Similarly, Japan comprises 23% of the EAFE index. Investors who match their portfolios to these indexes are betting that size matters most.

With a population of 8.5 million and GDP of \$300 billion Israel is a small country relative to China with its 1.3 billion people and \$10 trillion GDP. At \$35,000, Israel's GDP per capita far exceeds China's \$7,380. Israel is a democratic country governed by the rule of law. China's political system is authoritarian with a corrupt judiciary that lacks independence. Stockholder rights are weak and inefficiently protected in China, whereas the Israeli system is similar to the United States. Yet stock market investors channel billions into China, simply mimicking the MSCI Emerging Markets Index.

Transitioning from an emerging market into an industrialized country is very difficult. Of the 21 developed countries in the EAFE, 15 industrialized during the 19th century (14 of which are in Western Europe). Ireland, Israel, Portugal, Spain, Hong Kong, and Singapore are the six countries included in the EAFE that industrialized after World War II. South Korea and Taiwan are the only other countries in the world that fully industrialized, but MSCI maintains their 26% weighting in the EM even though their GDP per capita exceeds Portugal's - the poorest country in the EAFE.

MSCI Europe, Australasia, and the Far East Index (EAFE)				MSCI Emerging Markets Index (EM)			
Country	Index Weighting	Market		Country	Index Weighting	Market	
		Capitalization (\$ Billions)	GDP per capita			Capitalization (\$ Billions)	GDP per capita
Japan	23.0%	\$4,838	\$42,000	China	25.0%	\$6,151	\$7,380
United Kingdom	19.0%	\$3,132	\$42,690	South Korea	14.0%	\$1,250	\$27,090
France	10.0%	\$1,804	\$43,080	Taiwan	12.0%	\$920	\$22,598
Switzerland	9.0%	\$1,482	\$88,790	India	8.0%	\$1,569	\$1,610
Germany	9.0%	\$1,709	\$47,640	Brazil	7.0%	\$652	\$11,760
Israel	0.4%	\$200	\$34,990				

Source: www.ishares.com; www.doingbusiness.com; Bloomberg, L.P.

Of the 21 countries in the EAFE only 6 have a British Common Law heritage: The United Kingdom, Australia, Ireland, Singapore, Hong Kong, New Zealand and Israel. Hong Kong respects the rule of law for now, but is ruled by authoritarian China. The Hong Kong stock market is filled with companies connected to the mainland. The other five join the United States and Canada as the world's only developed Common Law countries. Countries with a Common Law heritage dominate technological and financial innovation. Israel is no exception.

If size rather than quality is the most important determinant of investment performance, then investing in the EAFE or EM is the best approach. While these indexes play an important role for a portion of a global stock portfolio, other criteria such as the rule of law, investor protections, innovation, disposable income and general economic dynamism are even more important indicators of quality.

Israel: Small but High Quality

Israel is a small, yet high quality, piece of the global economy that is often ignored by investors. Investors are often burned when they forget basic company fundamentals such as valuation, cash flow or debt levels. The same is often true when global investors disregard country fundamentals such as the rule of law or democracy. China is a very big and exciting development story, but Israel already has governance institutions the Chinese may never develop. In fact, Israel's combination of economic, political and legal attributes is shared by only seven other developed Common Law countries. For all of these reasons investors must look beyond the major indexes to include investments in Israeli stocks.