International Diversification, Part 2

As posted on our website, we originally addressed the importance of International Diversification on 11/5/16. While Trend now favors Foreign stocks, we felt these three Morningstar articles are worth sharing. The unedited versions are available at:

http://news.morningstar.com/articlenet/article.aspx?id=824219
http://news.morningstar.com/articlenet/article.aspx?id=812972
http://news.morningstar.com/articlenet/article.aspx?id=813493

What Is the Right Amount of International Diversification?

By John Rekenthaler | 09-01-17

Clear Heads

Tuesday's column elicited this response in the comments section: "Gee, all this mumbo jumbo … I could have had a V-8 and vodka with plenty of ice … I may have awoken with a headache but I wouldn't have gone to bed with one … "

Fair enough. That article came without cost, calories, or potential liver damage, which are three tallies in its favor when compared with the commenter's usual method of achieving a headache. However, it buried the central point—that while the famed (infamous from a Behavioral Finance perspective) Capital Asset Pricing Model suggests that all stock investors should own the same U.S. stock portfolio, real-world considerations argue otherwise. Sorry about that.

I will address today's topic of international diversification more directly.

Two Extremes

The first thing to note is that Tuesday's argument against the CAPM continues to apply. Given certain assumptions, some have argued that all investors around the globe should possess a single portfolio, which consists of an index of all publicly traded stocks and bonds. (For purposes of this discussion, we'll ignore other asset classes, as well as private securities.) However, those assumptions do not hold in practice, rendering that recommendation moot.

(For the clearest words ever written by a Nobel Laureate about investments, I recommend Sections 3 and 4 of "A Global Capital Asset Pricing Model", co-authored by Professor William Sharpe. Those passages will induce no headaches.)

In addition, there is the added complication of currencies. Famously, Jack Bogle has stated that because U.S. investors pay their obligations in dollars, they should invest in dollars. This implies U.S. investors should own only domestic securities. (They could also buy issues from countries that peg their currencies to the dollar, but that brings the risk of damage caused by sudden devaluations.)

That advice has been widely derided, as exemplifying an old-school mentality that might have been appropriate when the United States was *the* economic superpower, but which is hopelessly outdated today. Well, maybe. Then again, Bogle has not made a habit of being outmoded (aside from perhaps his criticism of exchange-traded funds, depending on your view of the matter), and in this particular opinion he is joined by Warren Buffett. Generally, I don't favor appeals to authority—but I make an exception when Bogle and Buffett join forces.

That gives us two initial international-allocation policies, one supported by a Nobel Prize winner (along with some other academic notables), the other backed by the nation's two most-credible investor advocates, who also have glowing academic records (Bogle being a Princeton graduate, and Buffett being the finest student that Ben Graham ever tutored). The first policy, that of owning the world stock and bond portfolio, leads to placing 62% of assets outside the U.S. The second policy leads to zero.

Who are you going to believe, the people advocating more than 60%, or those who say zero?

The Center Line

The answer, in practice, is usually "neither." Many investors (your columnist raises his hand) hold few international securities, but that shortage arises from neglect rather than intention. Push them, and they will confess that yes, they should be better diversified, but they just didn't get around to doing it. Their ideal position is greater than zero. But smaller than the world market weighting. Even the most globally minded of U.S. investors hesitate to go that far.

That, pretty much, is the science behind international diversification. Informed parties have arrived at radically different conclusions; neither investors nor their advisors care much for either answer; and thus a consensus has developed to split the difference, by investing 30% or so outside the U.S., and keeping the rest at home. The discussion is often high-minded and laden with data, as in this Vanguard paper (see Our thoughts below), but make no mistake: The final choice, ultimately, is arbitrary. It rests on intuition, not science.

Two Potential Benefits

That said, there are two pretty good reasons to observe the consensus, by landing somewhere between the two extremes.

The first is the traditional claim made for international investing, which is that it diversifies economic and political risk. If security prices in one's home country plummet, either because the economy collapses (high unemployment and/or inflation being the two likeliest culprits) or because of political instability, then solace can be found elsewhere. That proposition is simplicity itself, and it has protected many an investor over the years.

However, the usefulness of such an insurance plan has been declining, and steeply at that. We all know why: Each year, the global economy becomes more interconnected, not only because the giant multinational firms grow ever stronger (Apple, Toyota, Google , and so forth), and generate their revenue across so many borders, but also because manufacturing is widely spread. If Samsung's sales slow, South Korea will scarcely be the only country to feel the chill. The company's largest mobile-phone factory is in … Vietnam.

That logic holds particularly true for U.S. investors. These days, it remains possible, albeit improbable, that a secondary financial market such as Australia or Sweden could perform much worse than the global averages. And likelier yet for a tertiary market. But it is difficult indeed to see how the U.S. could fail while others remain standing. Certainly, that did not occur in 2008, when international diversification yielded no advantage.

So, while above zero, the economic/political payoff to U.S. investors for buying the securities of companies ... that reside elsewhere isn't very high. On that subject, my sympathies lie largely with Buffett/Bogle. The greater benefit of diversifying internationally would seem to come from currency movements. As currency fluctuations are largely uncorrelated with stock and bond prices, owning multiple currencies rather than only the U.S. dollar will lower portfolio risk, all things being equal.

Of course, this being a messy topic, all things are not equal. Yes, portfolios become more stable as their holdings become less correlated. On the other hand, currency movements bring additional volatility, which makes portfolios *less* stable. The two effects work in opposite directions; which will prove the strongest remains to be seen, and is beyond the ability of anybody to predict.

Wrapping Up

In summary:

1) The desired amount of international diversification has not been proven.

2) Most investors split the difference, by investing considerably less than the high estimate, and more than the low estimate.

3) While this heuristic cannot be defended on scientific grounds, it does have some support from investment logic.

Sometimes, despite all the research that is conducted, all the time spent on the subject, and all the money that rides on the decision, the investment community can't arrive at a "correct" solution. This would be one of those times.

John Rekenthaler has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

Home Bias Blues: Investors Really Should Get Out More

By Ben Johnson, CFA | 06-21-17

If diversification is the only free lunch in investing, investors are leaving a lot on the lunch table. Diversification is measured across a number of dimensions: individual stocks, industries, sectors, and so on. Most investors' portfolios are fairly well spread along these lines. However, when it comes to investing overseas, many decide to ditch diversification at the border.

"Home bias" is the term used to describe investors' tendency to tilt their portfolios in favor of domestic stocks (bonds, too, but I'm going to focus on stocks). Here, I'll discuss how home bias is measured, the factors that underpin this phenomenon, and why it's probably a good idea to expand your horizons a bit--especially given current valuations.

A Baseline for Bias

There are a number of measures of home bias that have been derived by academics through the years. But, for the sake of simplicity, I believe it's easiest to measure your home bias by comparing your current allocation to international equities with the portion of the market capitalization of global stock markets made up of stocks domiciled outside of the United States. Exhibit 1 provides a snapshot of the makeup of the global market as of the end of March. As you can see, U.S. stocks make up about 53% of the world's public equity market cap, with foreign stocks accounting for the remaining 47%. (This breakdown is based on stocks available to a U.S. investor. Otherwise, the U.S. percentage of World Market Cap drops from 53% to 36%.) So, for example, using a market-cap-weighted portfolio of global stocks as our arbiter, any U.S. investor's stock portfolio that has an allocation of more than 53% to U.S. stocks is showing a home bias. ...

Exhibit 1 The Makeup of the Global Stock Market

	Total Value ($ Trillion)	Weight (%)	Weighted Avg Mkt Cap ($ Bil)	# of Securities
U.S.	23.9	53.2	136.1	3,503
Developed	16.2	36.0	47.5	5,442
Emerging	4.8	10.8	47.7	4,373
Global	45.0	100	94,654	13,318

Source: Dimensional Fund Advisors. Data as of March 2017.

The World Is Getting Flatter

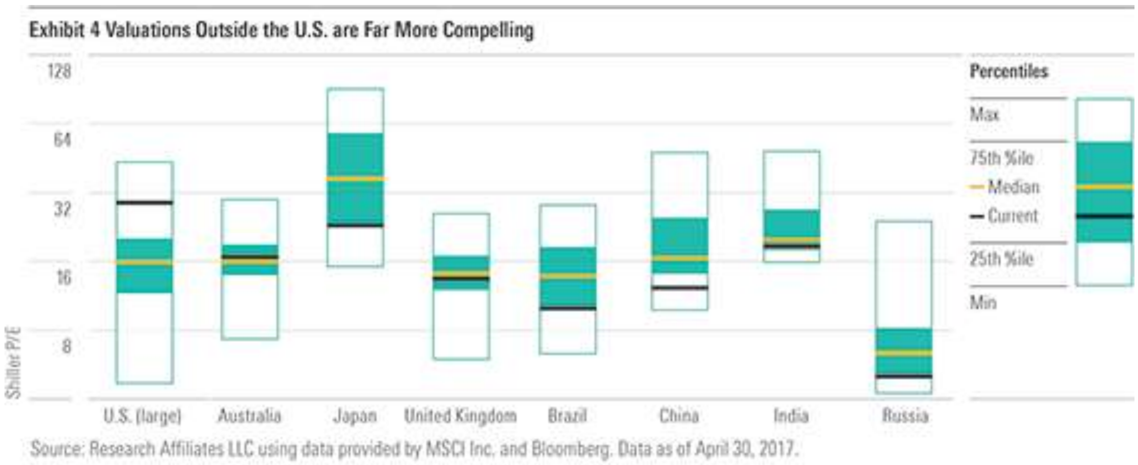
There are plenty of legitimate reasons--tangible and intangible--that explain why investors might choose to favor their domestic equity market. But I would argue that some of these have grown flimsier with time. Furthermore, in my opinion, even when considering them all together, they don't warrant the degree of home bias that exists in many investors' portfolios today.

Among the concrete explanations behind home bias, I believe those relating to investment and informational costs and currency risks have become less convincing with time and will likely weaken further in the future. The world is increasingly flat, and barriers to the movement of information and capital continue to come down. The cost of investing in overseas markets has declined with time, and new markets will continue to open to new investors. ... These are no longer good excuses to favor domestic stocks.

Avoiding currency risk is another justification that no longer holds water. In recent years, we have seen a variety of ETFs offering exposure to various foreign stock markets that manage currency risk on investors'

Exhibit 3 It's Not Always Like This

Source: Morningstar Direct. Relative wealth chart plotting MSCI USA GR Index versus MSCI ACWI ex-USA GR Index. Data from Dec. 1987 to Apr. 2017.



behalf. Some hedge this risk outright; others hedge away a portion of the risk, while the newest additions manage it dynamically. The growth in the number and variety of these convenient and cost-effective tools that allow investors to take currency risk out of the equation mean that currency risk is no longer a good excuse for home bias.

Back to Diversification

Ultimately, making the case for greater exposure to international stocks is somewhat easier and more compelling than knocking down the pillars of home bias. In my mind, it boils down to this:

1) U.S. stocks and foreign stocks have not and will not ever move in unison (see Exhibit 3).

2) Pairing assets that zig and zag at different times in response to different fundamental drivers (changes in rates, inflation, differences in fiscal and monetary policies, and so on) is generally a good way to reduce portfolio risk and thus (in theory) boost your odds of sticking to your plan.

3) Perhaps most fundamentally, there will be times when valuations across global markets are out of sync (see Exhibit 4). (Exhibit 4 uses the Shiller P/E, a dubious valuation metric that we have previously expressed some of our concerns about, particularly with respect to market timing. However, other metrics would show similar results. It is also worth noting that the Geopolitical risks in Russia and Brazil, markets we wouldn't touch, justify lower valuation.) It is at these moments when taking from your leaders (U.S. stocks of late) to add to your laggards (developed ex-U.S. stocks of late) can make the most meaningful contributions to your long-term returns. (In "International Diversification - 11/5/2016", which is available on our website, we shared findings from Gary Antonacci that trend is a superior approach.)

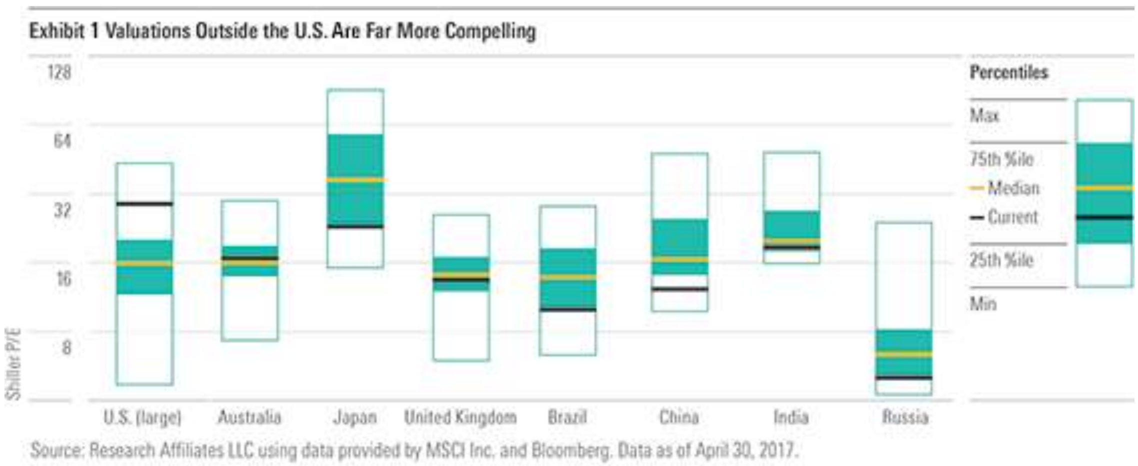
Have U.S. Stocks Become Too Expensive?

By John Rekenthaler | 06-23-17

Market-Timing?

I had intended to rebut Ben Johnson's "Home Bias Blues" article, in which he argues that U.S. investors should hold more foreign securities. There are valid reasons for dining in, which I planned to raise. However, Ben acknowledges those arguments and counters them effectively. So … I agree with his column. This article will be no Point/Counterpoint.

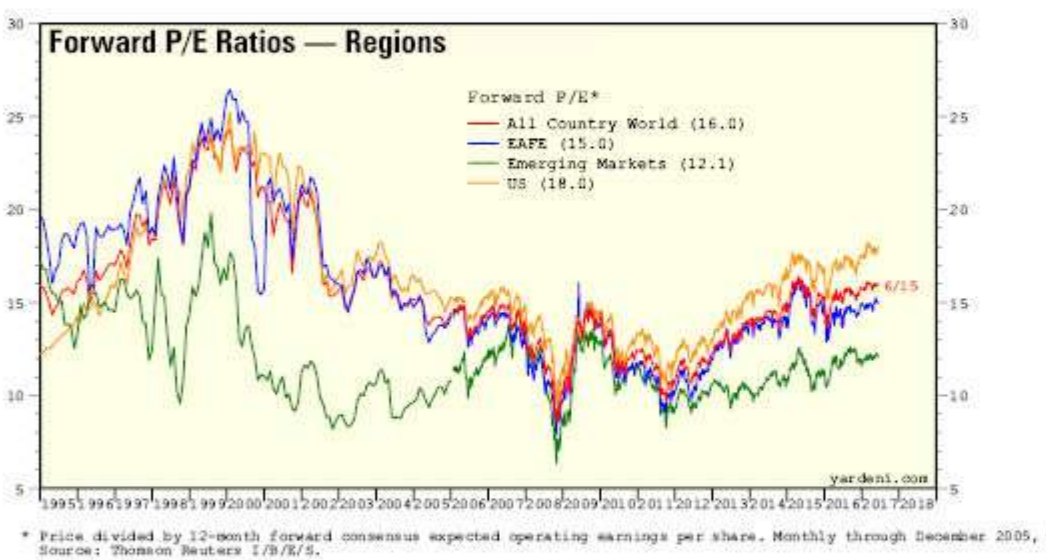
However, I do wish to examine one of Ben's side points, which is that now is a particularly good time to look elsewhere, because U.S. stocks have become unusually costly relative to their peers. Ben brandishes a chart, courtesy of Research Affiliates, showing that that U.S. stocks are now relatively expensive, while other countries' stocks look to be cheap. The obvious conclusion is to favor the latter over the former.



Yes and no. The "Yes" argument is straightforward: Research Affiliates is a reputable firm, and that chart's data makes a compelling claim.

Another Angle

For the "No" argument, let's observe a different view of global price/earnings ratios ~~purloined from~~ provided by Yardeni Research. This graph takes a regional rather than country perspective, sorting the world into three categories: non-U.S. developed markets (MSCI EAFE Index, in blue), emerging markets (green), and the United States (yellow). The red line then combines the other three lines to illustrate the MSCI All Country World Index (The All Cap version of which is our primary benchmark).



- Source: Yardeni Research

That red line looks odd. In theory, it blends the yellow, blue, and green lines, yet only the first two seem to matter. No matter where the green line is drawn, the red line lands midway between the yellow and blue. This occurs because, despite their huge populations and land masses, the emerging countries remain a small slice of the global stock market. The money--and corporate profitability--is not yet where the people are.

The green line of emerging markets currently falls well below U.S. levels, but that's nothing new. The emerging markets were even further behind in 2001. Which provides a useful test. If Ben's thesis is correct--that countries with lower-cost stocks offer higher future returns--then the emerging markets should have outstripped the U.S. since 2001.

Score one for Mr. Johnson. The emerging markets have gained 9% annually since 2001, as opposed to just under 6% for the S&P 500. On that occasion, at least, the cost signal worked.

Whether it will do so for emerging markets in the future is unclear. At the start of 2009, U.S. stocks carried a forward P/E ratio (based on expected operating earnings) of 24, with the emerging markets at 9. Quite the gap. These days the divergence is much smaller, at 18 versus 12. That difference is roughly the average between the two regions during the past 20-plus years, so it may not narrow. On this measure, at least, I would hesitate to call U.S. stocks relatively expensive.

The evidence from EAFE (acronym stands for Europe, Australasia and Far East) is stronger. After hugging American valuations for 15 years, EAFE's P/E ratio has gradually lost relative ground during the past several years. At 15 compared with the U.S.' 18, the P/E ratio for non-U.S. developed markets trails by the largest margin since at least the mid-1990s--and its absolute level isn't terribly high, either. This chart supports Ben's claim.

But Then Again …

The next chart does not. There is EAFE, and then there is EAFE. By which I mean the major non-U.S. markets consist of two distinct regions: Western Europe and Japan. Those entities have behaved very differently indeed. Japanese stocks had far higher P/E ratios than did U.S. equities throughout the 1990s, and even sometimes in the years following. They have since dropped below U.S. levels.

Stocks in continental Europe and the United Kingdom have steadily churned along, selling at P/E ratios about 25% below those of the U.S. This held true in the early 2000s, the late 2000s, and today.

- Source: Yardeni Research

Thus, upon further examination, that blue EAFE line misled. Rather than show one region that had been priced for years similarly to U.S. stocks but that has recently been left behind by American increases, the EAFE line subsumed two regions--one of which had been *far* more expensive than the U.S, but no longer is, and one that reliably and consistently has sold at a moderate discount to the U.S. If there is any cost argument to make, it is that Japan is now desirably cheap--not that the U.S. is relatively expensive.

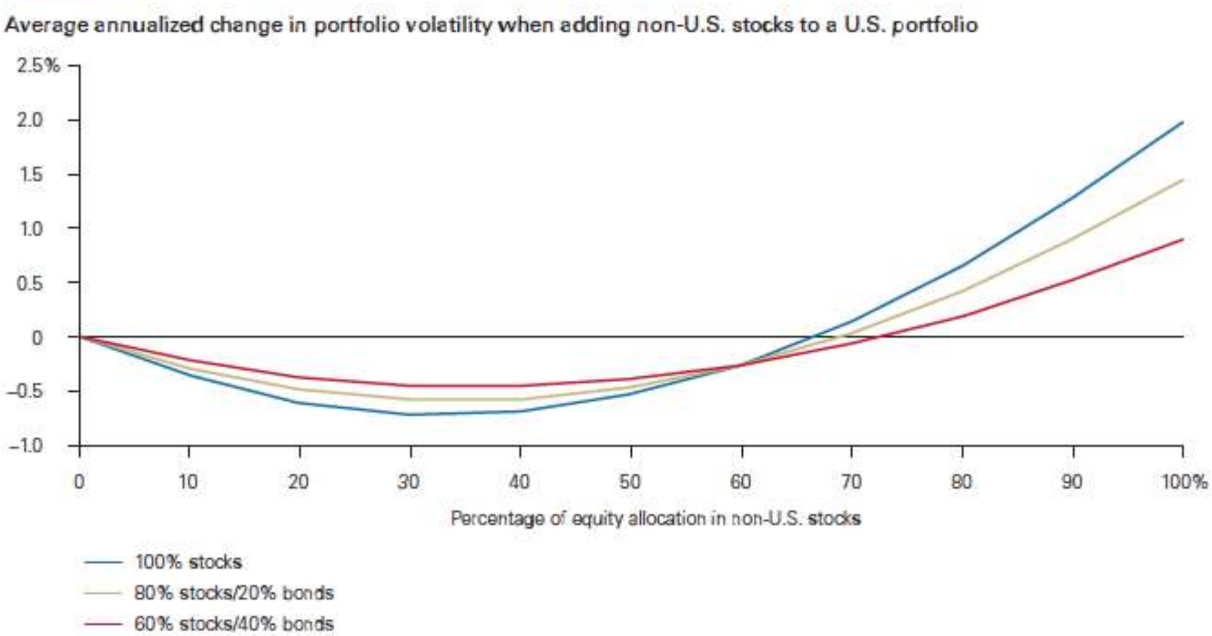
Forward P/E ratios on operating earnings are but one way of gauging stock valuations (albeit a sound one). Other measures will yield other results. Nonetheless, Yardeni's figures suggest that, if U.S. stocks are indeed too expensive when compared with the global alternatives, this is something we will learn only in hindsight; based on current information, reasonable minds can differ.

I heartily endorse Ben's recommendation that U.S. investors increase their international-stock exposure--admittedly, it's advice that I have yet to follow--but I do not believe that *now* is a particularly good time to do so. All times are appropriate for diversifying overseas, this one being no more or less than others. ...

Our thoughts

Our continuing recommendation of a 40% allocation to International Stocks for clients whose primary objective is Capital Appreciation and for whom we are buying individual stocks is at the high end of the range that has historically been most effective in reducing volatility. As noted by Jon Seed in “Passive” Investing: Theory and Practice in a Global Market, "While Vanguard recognizes that the diversification benefits of international equities are real, they suggest that anywhere between 20-40% is “adequate.” Vanguard buttresses this

Figure 3. Adding non-U.S. stocks has historically reduced the total volatility of a portfolio



Notes: U.S. equities represented by MSCI USA Index; non-U.S. equities represented by MSCI World Index ex USA from 1970 through 1987 and MSCI All Country World Index ex USA thereafter. Bond data represented by Salomon High Grade Index from 1970 through 1972, Lehman Long-Term AA Corporate Index from 1973 through 1975, and Barclays U.S. Aggregate Bond Index thereafter. Data through December 31, 2013.

Sources: Vanguard, Thomson Reuters Datastream, and MSCI.

conclusion by showing that most of the benefits of international equity diversification dissipates quickly."

It is important to note, however, that International Stocks are riskier. The Maximum Drawdown, our preferred measure of **Risk**, of the MSCI ACWI ex USA AC index was 1.2 and 1.6 times that of the S&P 500 during its last two corrections. Therefore, clients whose objectives include Capital Preservation may have a reduced exposure. Clients investing in individual stocks whose objective is or includes Income will also have less international exposure. At HCM each client's portfolio is a function of their Risk Profile and objectives.