CERITY PARTNERS

The Case for International Investing:
Four common beliefs dispelled

November 30, 2018

Tom Cohn, Principal, and Ben Pace, Chief Investment Officer
Cerity Partners LLC

Advice-driven financial service.

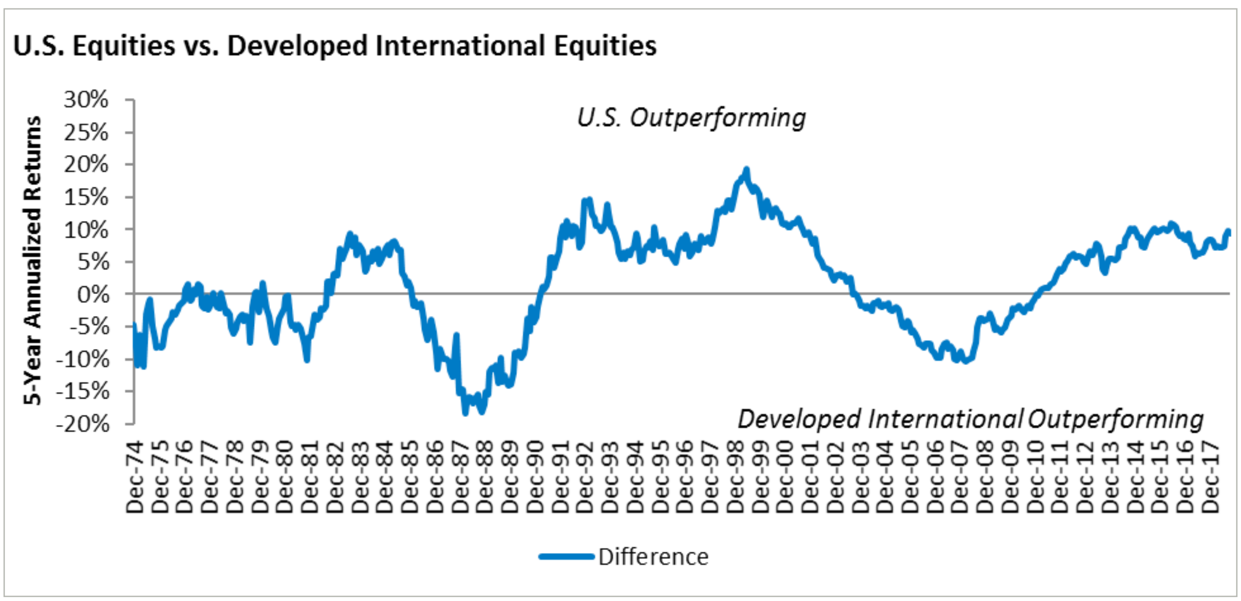
Key Takeaways:

Many investors have grown skeptical about the value of portfolio diversification. Those who have held a globally diversified equity portfolio may be particularly wary since their international holdings have underperformed U.S. equities by more than 9% annualized over the past five years. While not dismissing the frustration that many investors have felt, Cerity Partners continues to believe strongly that international diversification provides considerable long-term benefits to U.S. investors. In this paper, we will dispel four popular arguments often used against international investing, and make a case for continued exposure to foreign stocks in portfolios.

Argument #1: U.S. stocks always beat international stocks.

It's easy to say in hindsight that U.S. stocks would have outperformed in recent years given the headwinds other parts of the world have faced. In Europe, there was the euro-debt crisis; in Japan, the two-decade-long debt deflation trap; and in emerging markets, the slowing of China's amazing growth machine and the subsequent end of the commodity bull market. But it is also easy to forget the potential headwinds, if milder, that the U.S. faced: the debt overhang from the financial crisis, fears of a double-dip recession, debt ceiling crises and the potential negative consequences of quantitative easing (the Fed bond buying program). As it turned out, the risk manifested itself primarily in overseas markets, but never fully materialized in the U.S.; hence the outperformance of U.S. equity markets in the post-crisis years. However, just because certain trends persist for a while, doesn't mean they'll last forever. A longer look back at history reminds us that we should be patient with international investing. The graph below illustrates the lengthy periods of both outperformance and underperformance of U.S. stocks relative to foreign stocks.

Since 1969, based on five-year rolling periods, the U.S. has outperformed the rest of the developed world only ***56% of the time.*** Periods of outperformance and underperformance tend to occur in cycles. Today, many fundamental factors are tilting in favor of U.S. equities while international markets (including emerging markets) are faced with several headwinds including a rising dollar, political strife in the eurozone and slower growth in China. Many of these events are already reflected in the valuation gap between the U.S. and the rest of the world. The type of thinking that would cause investors to abandon international equities now would have caused them to abandon U.S. stocks coming into this cycle (bull market). Let's take a closer look at Perpetual Education Trusts to help you decide if they make sense for you.



Argument #2: International investing offers limited diversification benefits.

It's true correlations between U.S. and overseas markets have been rising for the past 30 years. Globalization and the interconnectedness of the financial system have increased correlations among asset classes. Without a significant shift in the global backdrop, it is doubtful that we will return to the days of the 1970s or 1980s when markets were more disparate. But that doesn't mean there aren't any benefits from spreading out global exposure. Research by AQR Capital Management (AQR) has shown the benefits of diversification come not necessarily over the short run but over the long term.

"Common, short-term crashes can be painful, but long-term returns are far more important to wealth creation and destruction. We showed that over the long term, markets do not tend to crash at the same time. This finding is no surprise because even though market panics can be important drivers of short-term returns, country-specific economic performance dominates over the long term."
– AQR (Clifford S. Asness, Roni Israelov, and John M. Liew), International Diversification Works (Eventually), Financial Analysts Journal, May 1, 2011

A breakdown of country returns over the past 20 years shows the potential long-term benefits of international investing. Of the 23 countries in the MSCI World index, the U.S. market had the best return over the trailing 10-years at 13.2% per year. During this time, the benefits of diversifying outside the U.S. were minimal. However, when we run the same analysis for the prior ten years, the results reverse. The U.S. ranked 17 out of 22 countries—ranking behind Japan, the U.K., France and Germany. In this case, exposure to the international markets would have helped investors. International investing works over the long term by diversifying exposure to country and economic-growth risk.

Country Returns	10/31/2008 to 10/31/2018		10/31/1998 to 10/31/2008	
Country	Return	Rank	Return	Rank
United States	13.2%	1	0.4%	17
Hong Kong	11.7%	2	3.8%	8
New Zealand	11.7%	3	3.2%	10
Denmark	11.6%	4	7.1%	5
Sweden	10.7%	5	3.1%	11
Netherlands	9.7%	6	-0.6%	19
Belgium	9.6%	7	-5.1%	21
Singapore	9.5%	8	7.4%	3
Australia	8.9%	9	7.8%	2
Switzerland	8.2%	10	2.4%	13
Norway	7.9%	11	7.3%	4
Japan	6.7%	12	0.6%	16
Germany	6.7%	13	1.4%	14
France	6.4%	14	2.6%	12
United Kingdom	6.4%	15	0.6%	15
Canada	5.7%	16	9.9%	1
Finland	5.1%	17	4.5%	6
Austria	3.5%	18	3.3%	9
Ireland	2.9%	19	-6.0%	22
Spain	2.5%	20	4.4%	7
Israel	2.3%	21	-	-
Italy	0.1%	22	0.4%	18
Portugal	-1.3%	23	-2.4%	20

Source: Factset
Note: Returns are annualized

Argument #3: The U.S. is the world's predominant capital market.

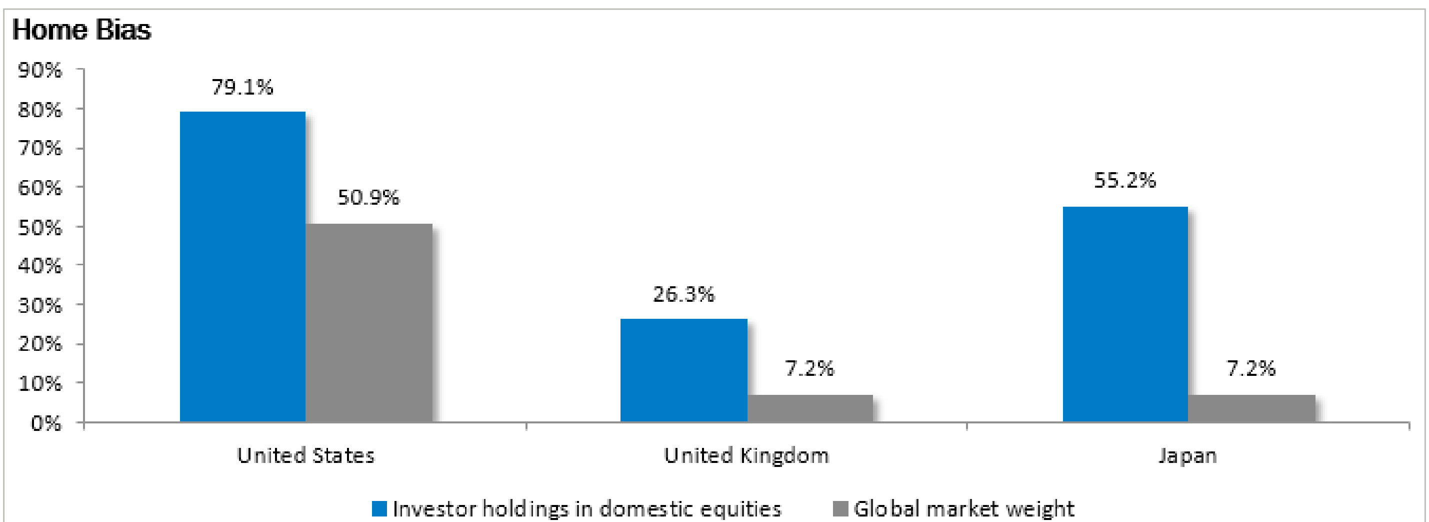
A look back at history provides some cautionary lessons on the ebbs and flows of global dominance. At the turn of the 20th century, London was the financial capital of the world and epicenter of global trade. Sterling was the world's reserve currency, and the British Empire was the preeminent global power. The U.K. had the largest share of global stock market capitalization at 25%. However, over the course of the 20th century and into the 21st, the country's share dwindled to 6%, as its imperial power and global economic dominance faded.

Global Market Capitalizations

1899			2017		
1	UK	25%	1	USA	51%
2	USA	15%	2	Japan	9%
3	Germany	13%	3	UK	6%
4	France	12%	4	France	3%
5	Russia	6%	5	Russia	3%
6	Austria	5%	6	Germany	3%
7	Belgium	4%	7	China	3%
8	Australia	4%	8	Canada	3%
9	South Africa	3%	9	Switzerland	3%
10	Netherlands	3%	10	Australia	2%

Source: Credit Suisse Global Investment Returns Yearbook 2018

And the U.K. is far from the only example. Wars, inflation, lack of institutional development and economic stagnation have led to falling returns on capital and declining economic power in many countries. While the chances of this occurring in the U.S. seem low today, we should be aware of our own biases in assessing probabilities. Home bias is the tendency to overweight your holdings to your home country. A 2014 Vanguard study found evidence of this bias across global investors.



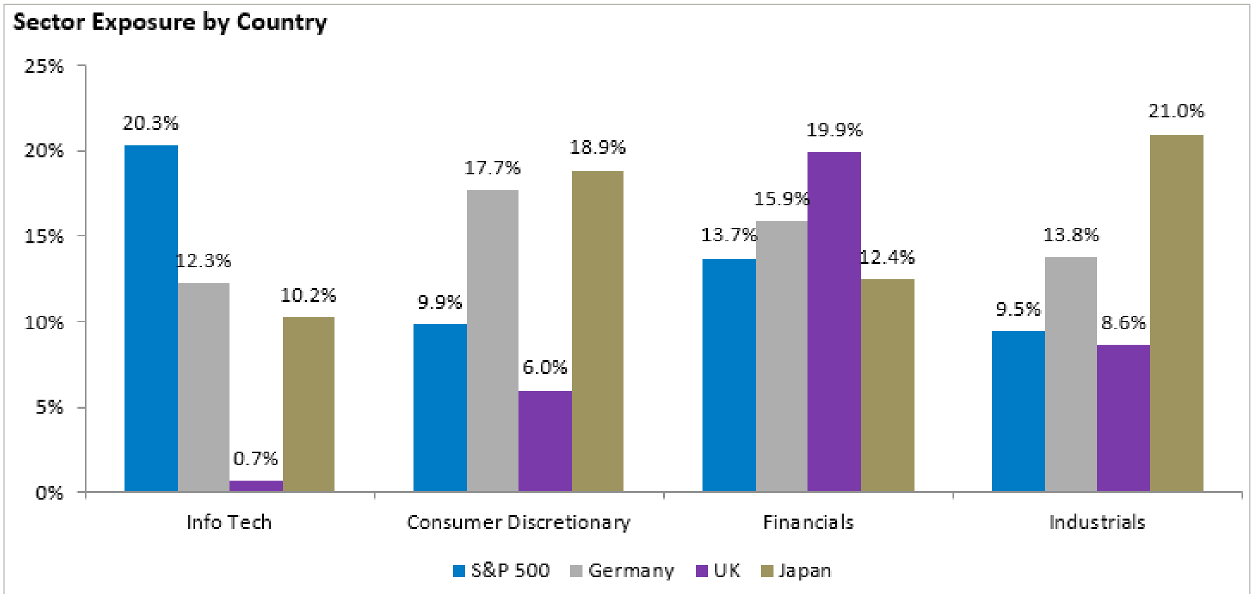
Note: Data as of 12/31/2014
Source: Vanguard, The global case for strategic asset allocation and an examination of home bias

Japan is a prime example of the dangers of home bias and the risks of over-concentration in any one country. In the late 1980s, Japanese investors had every reason to spurn the international markets. Japan's economic growth outpaced the U.S. by 1.3% per year in the back half of the eighties. As the Japanese economic miracle that began after WWII persisted, Japan's companies became the envy of their global competitors due to their manufacturing prowess and technical efficiency. This growth resulted in strong market performance. A U.S. investor who invested in Japan between 1985 and 1990 earned 41% per year compared to "just" 20% per year in the U.S. Then, the Japanese stock (and real estate) bubble popped. Investors heavily weighted in Japan paid for it dearly in the coming decades.

Argument #4: I get international exposure through U.S. multinational companies.

According to Standard & Poor's data, about 44% of sales for companies in the S&P 500 index come from overseas. However, research shows that U.S. stocks with global exposure are heavily influenced by the U.S. stock market. Also, holding non-U.S. stocks provides important diversification benefits in terms of country and currency exposure. Furthermore, while U.S. companies operate across the globe, there are significant structural variations among stock markets in different countries.

As the home of Silicon Valley, the U.S. stock market has a heavier weight in technology companies compared to the rest of the world. On the other hand, Germany, which is renowned for its manufacturing export machine, has higher exposure to companies in the industrial and materials sectors. The Japanese stock market is more heavily weighted to companies in the consumer discretionary and industrials sectors. If we look at Japan, approximately a third of revenues for companies in the FTSE Japan index come from overseas sales. No one is going to argue that you can be well diversified by investing solely in Japanese stocks.



Notes: S&P 500 = iShares Core S&P 500 ETF, Germany = iShares MSCI Germany ETF, Japan = iShares MSCI Japan ETF, UK = iShares MSCI United Kingdom ETF
Source: iShares Website

By focusing on just U.S. companies, an investor is implicitly making sector bets. Technology and healthcare stocks have led global markets in recent years, and U.S. investors have benefitted from these sector biases. But while the U.S. continues to be a leader in innovation and technology, it is important to remember that sector leadership tends to be cyclical, and investors can be punished for being in ones that fall out of favor. Another consequence of only buying U.S. domiciled companies is that you're explicitly betting domestic companies will be the "winners" in their respective industry. A healthy allocation of non-U.S. stocks can help expand return opportunities and diversify risks specific to the home market.

Cerity Partners' continued commitment to international investing

At Cerity Partners, we build stock portfolios by first looking at each equity market in relation to its global market capitalization. If U.S. equity markets represent 56% of global stock market capitalization, an investor should aim to have 56% of the equity portfolio in U.S. equities. From there, we consider valuations, fundamentals and return expectations to formulate our portfolios. We strive to balance the tradeoffs between risk and return by finding ways to create real diversification. International investing is one way this can be achieved.

We believe in both the continued vibrancy of U.S. markets and the importance of a sizable allocation to international equities. The last seven years have been particularly kind to U.S. markets, but there is no guarantee that this situation will continue indefinitely. The case for international investing at the moment is simple: an expanded opportunity set, diversified sector exposure, and valuations that favor international and emerging equities over the U.S. Contact Cerity Partners to learn more.

Tom Cohn is a Principal in the Cleveland office and has more than five years of experience in various investment management roles. He is a member of the Investment Committee, Investment Manager Selection Sub-Committee, the Compliance Sub-Committee and the Performance Monitoring Sub-Committee.

Ben Pace is the Chief Investment Officer and a Partner in the New York office. He leads the firm's Investment Committee and is a member of the Executive Committee. He has more than thirty years of experience in investment management. Ben has been featured in the Wall Street Journal and Reuters, and is a frequent commentator on Bloomberg TV and radio, Fox TV and CNBC, appearing regularly on network programs such as Power Lunch, The Closing Bell, Squawk Box, and Worldwide.