

DOES INTERNATIONAL DIVERSIFICATION STILL MAKE SENSE?



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We have all heard it before: “do not put all of your eggs in one basket”, but what does this truly mean in the investment industry? By diversifying your investment portfolio, you put yourself in a position to reduce risk and increase growth potential. A common way that experienced investors diversify their portfolio is via international investments. An investor may ask themselves why they should invest in international markets if there are plenty of investment opportunities in the United States, but they may be subconsciously ignoring the bigger picture. According to Diamond Hill and research gathered through FactSet, more than 40% of the world’s market capitalization lies outside of the US.¹ The United States market does not always correlate to the performance of foreign countries, therefore adding international diversification can lower the volatility of a portfolio. Vanguard, along with other reputable companies recommend that at least 20% of an investor’s given portfolio should be invested in international stocks and bonds.² An investor seeking broad diversification abroad can invest through some combination of international funds, global funds, regional funds, and emerging market offerings.

Shift In Performance

As we arrive at the halfway point of 2022, the uncertainty behind the decisions of investors has increased rapidly. Considering the high inflation, aggressive monetary tightening, potential for recession, and market volatility, it is conceivable as to why an investor could be hesitant to expand into foreign assets. While now may seem like a challenging time to consider different methods of investing, there may be no better time to invest internationally. According to Charles Schwab: “The start of a new economic cycle with a rising inflation outlook may signal a switch to international stock outperformance in the years ahead.”³ For further evidence regarding this possible international stock outperformance this chart shows how around every decade, the United States market and the international market seem to trade places as market leaders. Starting from the 1980’s you can see the International market outperforming the United States market until the 1990’s where they trade roles. This has continued in the following decades of the 2000s and 2010s and this change can be looked to as a precedent of where the market could go in the coming years. Along with this comparison Table 1, Exhibit 1 displays U.S. stocks minus global stocks and illustrates those trends, regardless of length, tend to change over time.⁴

Table 1:

	19680s Jul 81-Jul 90	1990s Jul 90-Mar 01	2000s Mar 02-Dec 07	2010s Dec 07-Feb 20
U.S.	14.8%	13.8%	4.8%	7.6%
International	21.0%	4.7%	11.1%	1.1%
Difference	6.2%	8.8%	6.3%	6.5%

Source: <https://www.schwab.com/learn/story/why-invest-internationally>

Exhibit 1: US Minus Global Stocks:
Monthly Rolling Annual Returns, 1987-2021



Source: <https://www.artisanpartners.com/content/dam/documents/insights/vr/Insights-The-Case-for-Investing-Outside-the-US-vR.pdf>

Investment Opportunities

A quantitative reason to look towards international investment as a means of diversifying is that the economy is more globally focused than it has ever been before. A threat to consider that is affecting the current global economy is the war in Ukraine, which is negatively impacting trade and forcing companies to bring supply chains on shore. While this is a factor, businesses are still competing on a global scale and earning revenue from all parts of the globe. While the U.S. has led the market for investors in the last decade or so, it is reasonable to believe we are approaching a turning point in a U.S. equity led market. Ignoring the potential of international investments can also be causing investors to miss out on country-specific opportunities. There may be more valuation-based expansion in companies overseas, however, geopolitical uncertainty, a lack of catalysts, and fears of stagflation due to rapidly rising prices are risks that undervalued international equities face.⁵ Despite these risks, while the U.S. has led in growth, there may be companies in different countries that may be highly undervalued due to their location, which could catch up in value in coming years with the potential to provide large returns to investors. In addition to disregarding attractively valued companies, a portfolio constructed with a U.S. bias may also be unintentionally leading to sector concentration issues. Different countries have markets led by certain sectors based off what their country produces most efficiently and effectively. For example, the Canadian stock market has a large exposure to the energy sector, the Japanese market to the financial sector, and the U.S. Stock market to the technology sector.⁶

Returning to earlier points on the change in trend, we may be due now for a change in market leadership. According to the International Monetary Fund, emerging and developing economies have recently accounted for nearly 80% of global economic growth.⁷ Broadly, the first half of 2022 has demonstrated a decrease in market performance globally, and this may reinforce the notion that now is a sub-optimal time to invest. When examining country specific performance over the last 6 months, an admittedly short time frame, we have seen the MSCI EAFE suffer more losses than the MSCI USA. However, we can see that the MSCI Europe has suffered less downside impact than the US, which could signify a change in the coming months and years.⁸ While the US equity market has outperformed international equity for the past 11.1 years⁹, it is important to examine the possible change in trend, with the potential to be part of a large growth cycle for international investment.

**Exhibit 2: US Equity vs. International Equity:
5-Year Monthly Rolling Returns (1/31/2975-3/31/2022**



Source: <https://www.hartfordfunds.com/dam/en/docs/pub/whitepapers/CCWP014.pdf>

Exhibit 3: Performance by Geography



Source: Factset

Emerging Markets Vs. Foreign Developed

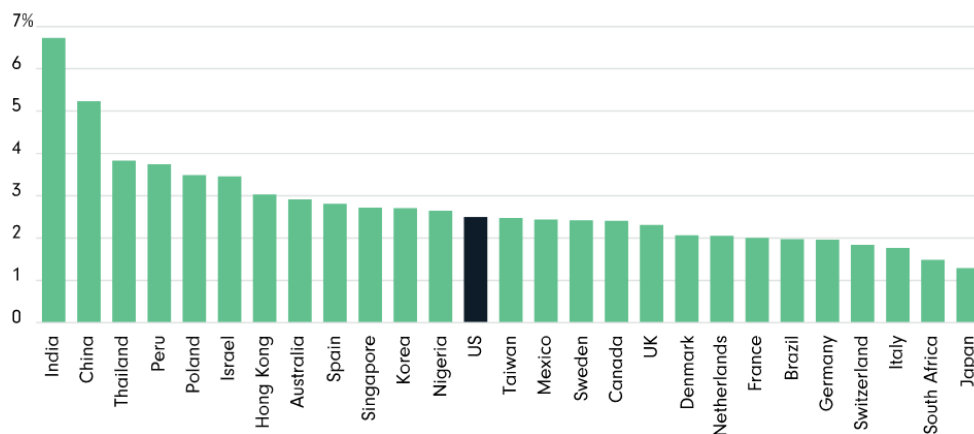
When considering international diversification, investors should also be confronted with the decision of investing in emerging markets versus developed non-U.S. countries. Emerging markets are commonly looked at as an investment with potential for higher growth and are countries that are on the way to becoming developed countries. Emerging market equities are currently trading at a 30% valuation discount to developed markets and are offering investors higher dividend and free cash flow yields.¹⁰ Qualitatively, EM countries also can be seen to have highly educated populations, which allow companies to hire a high-quality workforce at a much lower cost than would be possible in a developed economy. Considering the current macro environment, increases in commodity prices has resulted in improved terms of trade for commodity-exporting countries like Brazil and Chile, which are rich in natural resources. Regarding the resources and the workforce of these countries, it is important to remember that there are products developed and refined in EM countries that can be exported to developed countries for higher returns. An example of this is Samsung Electronics which is based in South Korea, and Gruma, one of the leading tortilla manufacturers, which is based in Mexico. Emerging market equity exposures can be much more volatile than developed markets; however, the opportunity for great returns should be accounted for and considered when creating a diversified portfolio. As far as developed non-U.S. countries go, there are other advantages such as manufacturing and selling uniquely European Products such as Louis Vuitton and L'Oréal.¹¹ In these countries there also may be different views on corporate governance, such as

separating the chairman from the CEO, which can lead to more effective shareholder engagement and be an attractive quality to investors.

Risks to Consider

Many of the risks associated with investing in international markets are targeted at emerging economies/markets. While emerging market funds offer investors the potential for greater returns than developed markets if implemented in a long-term investment strategy, there is also the potential for greater drawdown. Emerging market equity funds have greater risk associated with them due to their volatility, which can primarily be attributed to currency risk, swings in commodity prices, political risks, and changes in monetary policy. In the current global economy, emerging markets are facing tighter financial conditions and may have higher risks of capital outflows.¹² The recent equity sell-off in China also raised concerns of a growth slowdown not just for China but also other emerging markets economies due to how linked China is with the rest of the developing world, but the rally that has occurred since has shown that the equity sell-off may provide opportunities for long-term investors.¹³ Other risks to be considered are the potential lack of liquidity in international investments and the potential for higher transaction costs than investing domestically.¹⁴ Potential benefits from investing in foreign countries such as differing tax regimes should also be looked at and can possibly allow investors to compound returns faster overtime. Even though U.S. stocks have outperformed over the last decade, allocating a portion of a portfolio to non-U.S. investments holds merit due to the possibility of long-term growth from a possible market “bottom.” It is feasible that we will see many countries experience significant growth in the coming years, and as seen according to the International Monetary Fund, the U.S. is in the middle of the pack for projected GDP growth.¹⁵

Exhibit 4: Estimated GDP Growth - Next 5 Years



Source: <https://www.diamond-hill.com/insights/a-365/article/4-reasons-to-invest-internationally/>

Conclusion

In recent months we have seen shifts in market dynamics and relationships, and it is reasonable to expect volatility will continue. Inflation, as measured by the Consumer Price Index (CPI) has increased 9.1% over the last 12 months, which is the highest year over year increase since 1981.¹⁶ The Fed has willingly tried to counteract inflation with recent rate hikes, which has the potential to send the United States into a recession over coming quarters. There has also been a number of geopolitical issues such as the war in Ukraine, which have increased commodity prices by disrupting production and trade.¹⁷ With no end to the conflict in sight, the war will continue to negatively impact the global economy. A combination of these factors has reduced investor confidence and will likely continue to provide market volatility. To best combat portfolio losses, it would be wise for investors to continue to diversify their portfolios, and now, more than ever, may be an opportune time to invest internationally and to follow the mantra: “do not put all of your eggs in one basket.”

References:

¹ Diamond Hill Article: <https://www.diamond-hill.com/insights/a-365/article/4-reasons-to-invest-internationally/>

² Vanguard Article: <https://investor.vanguard.com/investor-resources-education/understanding-investment-types/why-invest-internationally>

³ Schwab Article: <https://www.schwab.com/learn/story/why-invest-internationally>

⁴ Artisan Fund Insights: <https://www.artisanpartners.com/content/dam/documents/insights/vr/Insights-The-Case-for-Investing-Outside-the-US->

vR.pdf

⁵ Regions July Primary Chart Deck

⁶ Artisan Fund Insights: <https://www.artisanpartners.com/content/dam/documents/insights/vr/Insights-The-Case-for-Investing-Outside-the-US-vR.pdf>

⁷ International Monetary Fund: <https://www.imf.org/en/Publications/GFSR/Issues/2022/04/19/global-financial-stability-report-april-2022>

⁸ FactSet Market Data

⁹ Hartford Funds: <https://www.hartfordfunds.com/dam/en/docs/pub/whitepapers/CCWP014.pdf>

¹⁰ Lazard Asset Management: <https://www.lazardassetmanagement.com/research-insights/outlooks/emerging-markets>

¹¹ Artisan Fund Insights: <https://www.artisanpartners.com/content/dam/documents/insights/vr/Insights-The-Case-for-Investing-Outside-the-US-vR.pdf>

¹² IMF Report: <https://www.imf.org/en/Publications/GFSR/Issues/2022/04/19/global-financial-stability-report-april-2022>

¹³ Bloomberg Article: <https://www.bloomberg.com/news/articles/2022-06-30/china-s-world-beating-stock-rally-is-forecast-to-strengthen-more>

¹⁴ Blackrock Article: <https://www.blackrock.com/us/individual/education/equities/emerging-markets>

¹⁵ Diamond Hill Article: <https://www.diamond-hill.com/insights/a-365/article/4-reasons-to-invest-internationally/>

¹⁶ U.S. Bureau of Labor Statistics <https://www.bls.gov/cpi/>

¹⁷ BBC News Article: <https://www.bbc.com/news/business-61235528>

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