Why Invest in International Markets?

August 23, 2019
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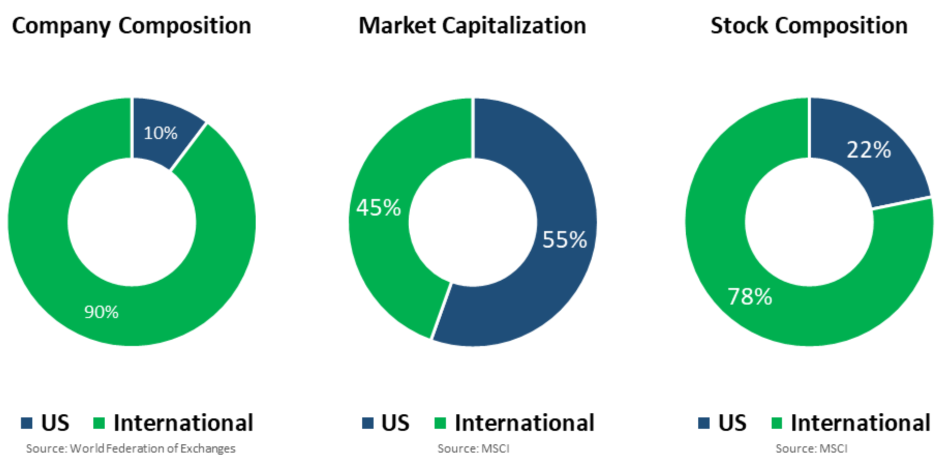
Incorporating international equities into a portfolio has long been considered best practice to achieving investors' goals. However, with the US market being the clear leader in the broad bull market over the last decade, it has naturally led to investors questioning the benefits of having direct international equity exposure. This research paper will revisit the benefits of holding international equity and why it is essential for clients to maintain their foreign equity exposure as part of their long-term plan.

Evolution

The integration of global financial markets has expedited the evolution of international markets within the expanded equity universe. Since the financial crisis, investors have demanded stronger corporate governance and increased transparency to protect shareholders if they want to receive capital from investors. Following demands from investors, countries are requiring more independent board members and stronger risk-control systems that align shareholder interest. Accounting standards globally are converging, allowing for more transparency and comparability across regions and leading to more investor confidence. Accessibility of international markets to foreigners continues to progress. China, the second largest economy in the world has been lifting restrictions on foreign investment to access China's mainland shares. Easing restrictions has increased liquidity and reduced volatility in these markets. Major global index providers have responded to the government's progressive actions by increasing their inclusion in their respective indices.

Opportunity Set

Outside of the domestic market the opportunity set is much larger and continues to grow. According to the World Federation of Exchanges, of the over fifty thousand companies listed globally, only ten percent of these companies are in the US. Narrowing this universe further, we examine the MSCI ACWI index in the chart below which provides a broad measure of the equity opportunities across the globe. Approximately half of the market capitalization and 22% of the stock composition are domiciled domestically. US investors over allocate their equity portfolios to domestic companies - the typical US investor has 75% of their equity portfolio allocated to US companies.



Beyond the fact that the sheer number of international companies is much larger, firms domiciled outside of the US have significantly less analyst coverage than companies based in the US. Less analyst coverage means that earnings revisions occur more slowly and may potentially lead to companies temporarily deviating further from their intrinsic value.

Faster Growth

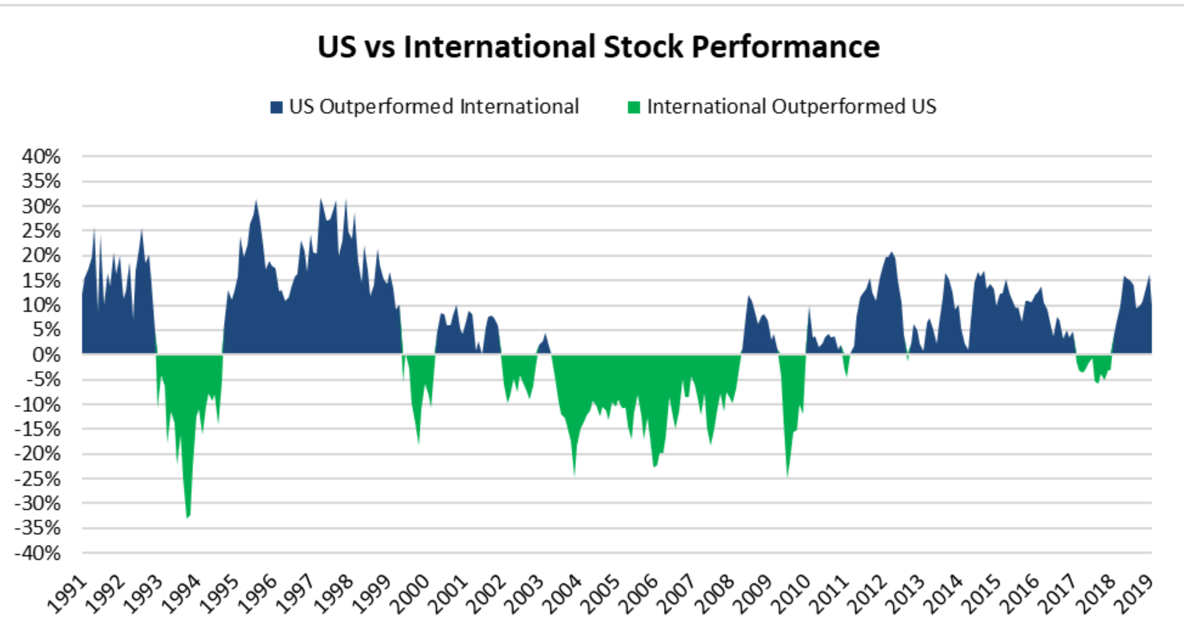
International companies can provide direct exposure to fast growing countries with structural tailwinds. Elevated growth rates can be seen in developing emerging markets, especially within China and India where growth rates are expected to be in the mid to high single digits next year. In comparison, the US economy is considered mature with a projected growth rate next year of approximately two percent. Although the US is the biggest economy in the world today, its dominance is shrinking as a percentage of global GDP. Economists have forecasted that China's economy will become the largest within the next few years and India will surpass the US by 2030. With 95% of the global population located outside of the US it is important to capture structural changes happening internationally. Significant changes in these economies include the emergence of the middle class, rapid adoption of technology and the creation of financial infrastructure.

Not all US companies can provide direct exposure to dominant players in key industries. For example, leading luxury handbag companies are predominantly based in Europe, while most premium alcohol companies are domiciled outside the US.

Excluding international companies can limit a portfolio from owning the top performing companies in a given year. Referencing the MSCI ACWI index as a global proxy once again, eight of the top ten highest returning companies in 2018 were based outside of the US. Therefore, owning only US companies in the US led broad bull market doesn't necessarily translate to owning the top performing companies.

Effects of Behavioral Biases

Since the financial crisis, there has been a broad resurgence in stock prices with the US market being the clear leader. Strong local performance has caused investors to be increasingly tempted to alter their international equity exposure and in the process have exhibited recency bias. Recency bias is thinking that a trend is likely going to continue because it has occurred in the recent past while discounting the extended history. Considering a longer time horizon by looking at the chart below, we can conclude that domestic markets don't always outperform international markets. In fact, before the financial crisis international markets outperformed domestic markets from 2002-2007. Market leadership can persist for extended periods and changes at irregular intervals. These changes are difficult for anyone to predict so it is important to maintain a disciplined long-term view of the marketplace.



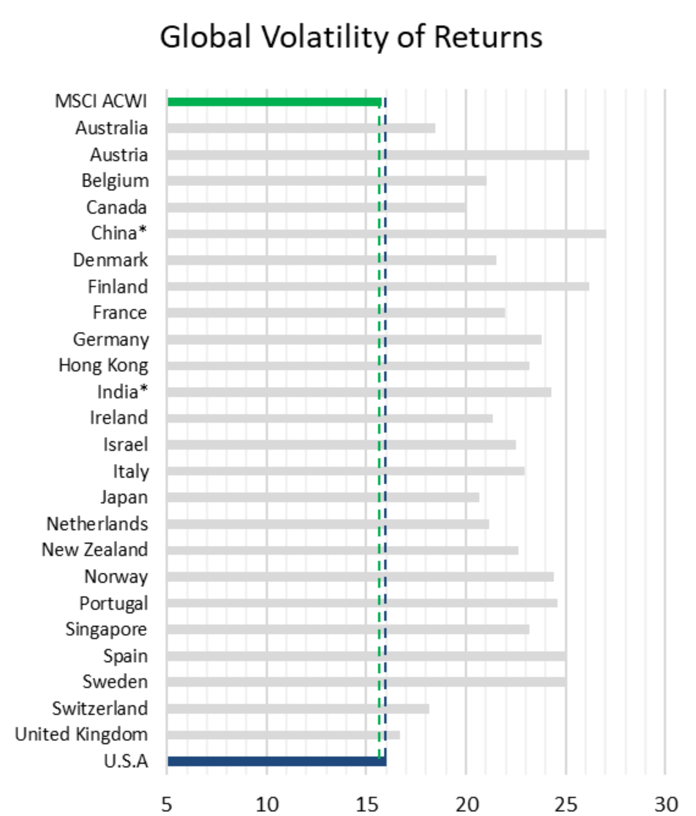
Source: Bloomberg L.P. Performance calculated using annualized rolling 12-month return periods. US stocks measured using the S&P 500 Index, international stocks measured using the MSCI ACWI Ex-USA Index. All data was taken from 1991 to 2019.

Additionally, other behavioral biases that are common in investors' portfolios are home country bias and familiarity bias. Investors wish to hold a larger proportion of their portfolio in companies they are familiar with while discounting the growth prospects of the firm. People naturally like to be comfortable and they find comfort in things they know well. These tendencies are not uncommon and can be observed in our everyday lives. For example, people tend to root for the local sports team because they are constantly exposed to the local team through their surroundings. Overcoming behavioral biases takes recognition, discipline and a detailed plan focused on the long-term.

Diversification

The most common counterargument against having international equities incorporated into an investment portfolio is the assumption that foreign revenue generated by domestic companies provides the same diversification benefit as investing directly in foreign companies located internationally. This strategy is the equivalent to putting all your eggs in one basket. Some investors may remember the unintentional consequences experienced from holding concentrated US technology stocks during the dotcom bubble. Incorporating international companies can lower the portfolio's exposure to unsystematic risk because they are exposed to a wider range of forces, allowing for a different return pattern and sector makeup than the US market can provide. Each country has different economic drivers and demographics, resulting in countries being at different points in their economic cycle. Companies adapt to their local market and respond differently to social, environmental and geopolitical events. This means that the impact of a single material event should be dampened.

Another advantage of investing directly in international companies is the benefit of exposure to a basket of international currencies. Domestic companies frequently hedge their foreign revenue to smooth out their revenue streams to be able to meet liquidity needs. While this is a benefit to the domestic company it may be costly to the investor. Hedging minimizes the diversification benefit of foreign currencies because strong currencies don't move in lockstep with stock prices.

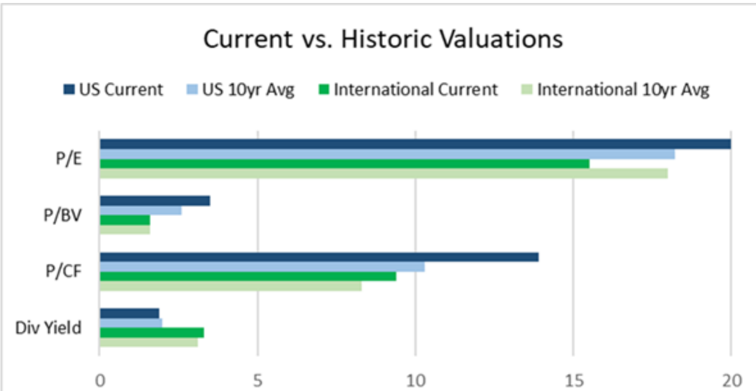


Source: Bloomberg L.P. Volatility calculated by annualized standard deviation. All data derived from the MSCI ACWI index and individual MSCI country indices within the range 1987-2019. *Indicates countries that are classified as emerging markets, all other countries are developed markets.

Harry Markowitz pioneered the concept of modern portfolio theory in the early 1950's that is widely accepted within the financial community today. He states that the only "free lunch" in finance is diversification because diversification lowers portfolio volatility for a given level of return. To be clear, correlation between countries has increased due to globalization over the past few decades. Increased correlation has reduced the diversification benefit international equities provide but if countries remain imperfectly correlated there will continue to be a case for holding international equities for diversification purposes. Referencing the chart to the left, the benefits of diversification can be seen by examining the global portfolio represented by the MSCI ACWI index. Holding a basket of volatile markets provides lower portfolio volatility than any of the individual countries because they are imperfectly correlated. The benefit is extended because it may help investors overcome behavioral temptations of market timing given the lower level of volatility experienced

Valuation

The current US bull market is now the longest in history and although bull markets don't die of old age the divergence in market prices has created an opportunity in global markets that are earlier on in their economic cycle. Based on the P/E ratio, international markets are still trading at a discount relative to their historical averages while offering an attractive dividend yield. Across the three price ratios seen in the chart, US markets are trading at more than a 20% premium to their international counterparts. Although investment decisions can't be based solely on fundamentals, it appears that international markets' stock prices have already priced in slower global growth and geopolitical tensions.



Source: Bloomberg LP. US data compiled from the MSCI US Index. International data compiled from the MSCI ACWI Ex-US Index.

Conclusion

While the US has been the clear leader in the broad bull market since the financial crisis, market leadership has proven to be erratic and can persist for extended periods of time. International companies reside in faster growing economies that are exposed to different demographics, geographies and economic forces with a larger pool of candidates to choose from at discounted multiples. For these reasons, international companies combined with domestic companies provide a powerful tool to help clients achieve their goals. As we continue to monitor the transformation in the global marketplace, we stress the importance of having a globally diversified equity portfolio as part of a long-term strategic view of the markets.

Important Information

Views expressed are as of the date indicated; they are based on the information available at the time and are subject to change based on economic, capital market, and other conditions. Any investment decision should be based on an individual's own goals, time horizon, and tolerance for risk.

Past performance is no guarantee of future results. Investing involves risk, including the risk of loss of principal invested.

Diversification does not ensure a profit or guarantee against a loss. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, or economic developments. Investments in the securities of smaller, less well-known companies typically carries more risk than investing in larger, better-established companies since smaller companies generally have a higher risk of failure and, historically, have exhibited a greater degree of volatility.

Investing in non-U.S. markets entails a different set of risks than that typically associated with U.S. markets, including the possibility of currency fluctuations, political and economic instability, accounting changes, and foreign taxation, all of which can potentially have a material favorable or unfavorable impact on performance. Securities may be less liquid and more volatile. Investments in emerging or developing markets involve exposure to economic structures that are generally less diverse and mature, and to political systems which can be expected to have less stability than those of more developed countries. Securities may be less liquid and more volatile than U.S. and longer-established non-U.S. markets.

Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market.

Although bonds generally present less short-term risk and volatility than stocks, bonds are subject to interest rate risk (the risk that bond prices fall in response to an increase in interest rates) and default risk (the risk that an issuer will be unable to make timely payments of principal and interest due on the bond). In addition, bonds and many short-term investments entail great inflation risk (the risk that an investment's returns will fail to keep pace with increases in the prices of goods and services) than stocks. Lower-quality fixed income securities generally offer higher yields but also involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Any fixed income security sold or redeemed prior to maturity may be subject to loss.

The value of an investment in commodities and/or commodity-linked derivatives can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions. Investments in real estate and related securities can be significantly affected by changes in real estate market and economic conditions, property taxes, tax laws, and interest rates. Such investments can be volatile on their own and should generally form only a small portion of an investor's diversified portfolio to enhance diversification and act as a potential hedge against inflation. Real Assets may not be suitable for all investors.

Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.