Why Diversify Internationally?

September 4, 2017

by Dana D’Auria

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

While the trend has reversed year-to-date, U.S. stocks have handily bested a composite of their overseas brethren for several years. An investment in the S&P 500 five years ago ending in April would have returned about 13.7% annualized, while an investment in the MSCI All Country World ex-USA index would have netted only about 5.6%, with less risk.

The outperformance of U.S. stocks has had many investors asking whether global diversification is worth the trouble. But while it is tempting to view recent performance as evidence that U.S. stocks are all an investor needs, the loss of diversification associated with a US-only portfolio should give investors pause. U.S. stocks make up only about half of the market value of global equities. Constraining your investment to this degree leaves out a huge pool of opportunity in the equity space.

Equity investments outside the United States can be broadly divided into two main groups: international-developed and emerging markets. The first features investments in developed economies, such as Japan, the United Kingdom, Canada, Australia, Germany and France. The second represents investments in developing economies. The so-called BRICs, Brazil, Russia, India and China, are well-known emerging-market economies. From time to time, index providers will reclassify a country based on economic improvement, or vice versa, but the labels have remained largely fixed.

International developed investments are generally considered to be safer, but also with lower expected return than their emerging counterparts. The MSCI World ex-USA index of international developed stocks returned about 5.4% from January 1988 through April 2017. The MSCI Emerging Markets index returned about 10.9% over the same period. But that outperformance came with considerable additional volatility, as the annualized standard deviation of the developed index was about 16.8% vs. about 22.9% for the emerging markets benchmark.

You can opt for an investment that includes both international developed and emerging stocks, or one or the other. Investments labeled “global ex-US” will generally contain both, but it’s important to ask the question about what types of economies your assets may be exposed to in any given fund.

For American investors, investing internationally brings both benefits and risks. You diversify across different markets, factors, industries and specific stocks. This increases the number of baskets, so to speak, across which your eggs are spread. However, you do take on potential political risks associated with different countries and often there are additional costs, such as stamp duties or withholding taxes. Currency risk is another consideration. U.S. investors who invest internationally essentially experience two different returns on their investments. The first return is the local stock return of the actual holdings they purchase. The second return comes from the change in the value of the U.S. dollar relative to the currency in which the local stock is denominated. When a U.S. investor buys overseas, he is effectively translating his U.S. dollars to the local currency in order to purchase the stock. If the U.S. dollar gains in value relative to the local currency, the investor will lose on the currency portion of the deal because whatever earnings the stock achieved on local terms must be translated back to U.S. dollars. Of course, if the dollar depreciates relative to the other currencies, the opposite occurs.

So, how to get started? Just as it is difficult to time markets or pick the specific stock winners in the domestic arena, the same is true when investing overseas. Most investors will do best with a broadly diversified holding that spreads dollars across a number of overseas markets. Investors can gain market-cap-weighted exposure to overseas economies at very low cost in a number of mutual fund and ETF vehicles, such as the Vanguard FTSE All-World ex US Index Fund.

Another option is to use a fund or portfolio that will seek factor exposure within non-US economies. Various smart-beta products in the international space will overemphasize those stocks associated with market factors that have tended to outperform historically, such as value and momentum. These products require a significant level of vetting, but academic evidence suggests that factor exposures may add additional risk-adjusted portfolio return over time.
Investing internationally certainly carries additional risks and considerations relative to domestic investing. Nevertheless, for most economies, the diversification benefits of international investments may make them a worthwhile inclusion for many investors. Investment memories can be short, but it wasn’t that long ago that the S&P was not a top global performer. The infamous Lost Decade is rarely remembered for what it was – not a 10-year period of loss for stocks, but a 10-year period of loss for U.S. large cap stocks. An investment in the international index from January 2000 to December 2009 returned investors 3.12% annualized. Not exactly crushing it, but the cumulative difference in return between that and the S&P was more than 40% over the period.

We can’t predict when that will happen again, but we are best served by assuming it will.

Dana D’Auria is director of research for Symmetry Partners, LLC, a Registered Investment Advisor located in Glastonbury, Connecticut. The firm designs and manages portfolios made available through a group of select advisors, including a suite of factor-based mutual fund and ETF portfolios.

1 Source: Zephyr STYLEADVISOR. As of April 2017. Risk as measured by 5-year standard deviation.

2 Source: MSCI

3 Source: Zephyr STYLEADVISOR. As of April 2017.

4 Source: Zephyr STYLEADVISOR.