5. The Case for International Diversification for U.S. Private Investors

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Times of geopolitical uncertainty show the importance of sufficient international diversification for wealth preservation. With the trend towards a multipolar world picking up steam, geographic diversification will even become more important in the decades to come. This article will examine the topic from the lens of U.S. private investors.

Building portfolios which are diversified across various geographies are robust to different global scenarios. In our view, this is the most promising way to earn consistent returns and to reduce drawdowns. Going back in history, there have been many events which destroyed or had the potential to destroy the wealth of millions of investors. Events, such as wars, debt crises, hyperinflationary periods, monetary reforms, or the bursting of asset bubbles show that focusing on one single country when making investment decisions is suboptimal even when in that market in recent history the stock market outperformed its global peers.

Home Bias Common Among Private Investors

International diversification is however not always intuitive, especially for investors living in countries with large and liquid financial markets. Since 2008, the U.S. stock market has outperformed international stocks. Recency bias may cause U.S. investors to focus too much on their home market, ignoring the fact that historically there has been a constant change between leading and lagging stock markets. Between 2000 and 2010, referred to as the “lost decade”, the U.S. stock market performed poorly, significantly underperforming other markets. In investing as well as in other areas of life people are often driven by a familiarity bias. They are inclined to believe in things they know best, especially as the world seems to become increasingly unpredictable. As a result of recency bias coupled with a familiarity bias, investors tend to heavily overweight their home market and to significantly underweight or even ignore foreign assets.

As of February 2022, U.S. stocks represented roughly 60% and non-U.S. stocks accounted for around 40% of the MSCI All Country World Index, which includes roughly 3000 constituents across 48 countries and covers approximately 85% of the global investable equity universe. While the U.S. stock market currently has the largest share of the MSCI World, its size relative to the entire global equity market has strongly fluctuated over time and was as low as 29% between 1987 and 1990. Generally speaking, investors focusing exclusively on their home market exclude a large part of the global opportunity set. On the other hand, looking at a broader set of stock markets across the world can give investors diversification benefits without sacrificing returns.

Leaders and Laggards Constantly Change

Taking the past 25 years as a reference, there was a constant change between leading and lagging markets. During the 5-year period between 1996 and 2000, the best global equity market was Europe, gaining 195%, and significantly outperforming the U.S. market, which increased by 114%. Between 2001 and 2005, as well as between 2006 and 2010, emerging markets equities delivered very strong returns, while most developed markets suffered from the technology bubble and the financial crisis of 2008. From 2011 to 2015, Japanese stocks performed strongly, predominantly driven by Prime Minister Shinzo Abe’s quantitative easing program and a push to make Japanese companies more shareholder friendly by encouraging them to return money to shareholders through dividends and share buybacks. Between 2016 and 2020, the U.S. equity market delivered the highest returns, driven by its large share of technology companies in an environment where investors strongly preferred growth over value stocks. This constant change of over- and underperforming markets is almost impossible to predict. Thus, it is highly uncertain which equity market might be the winner over the coming years. Relying on the most recent champion will most likely not be the optimal solution. To master this challenge, it makes sense to diversify across regions and countries. This allows investors to profit from a global opportunity set instead of focusing on one single country, hoping to hit a home run.

Valuation metrics, such as the Price-Earnings ratio have historically been solid predictors of stock market performance. Lower Price-Earnings ratios resulted in higher returns over subsequent periods of 5 or 10 years and vice versa. Valuation has a tendency to mean revert, meaning that expensive markets tend to fall while cheap markets tend to increase over longer periods of time. Thus, no country can consistently outperform, as this would inevitably lead to overvaluation and a subsequent reversal. After years of strong returns, the U.S. stock market is currently among the most expensive globally. The current Price-Earnings ratio of the S&P 500 Index is around 18.2 based on 12-months forward consensus expectations. Despite the recent market correction this is still 7% above the 10-year average Price-Earnings ratio of 16.9. Euro area stocks on the other hand do not seem to be expensive based on valuation. With a Price-Earnings ratio of 13.5, the valuation of the Euro STOXX Index is currently slightly below its average of the past 10 years. Thus, U.S. investors with a longer-term horizon may wish to underweight the U.S. and overweight the Euro area in a globally diversified portfolio, hopefully improving future expected returns.

Investing in Sector Leaders Requires a Global Approach

During the past 30 years, the correlation between the S&P 500 Index and the MSCI World ex U.S. Index was around 0.70 on average. Global economies are linked by international money flows and supply chains, but individual countries have different sensitivities to economic events due to heterogenous sector exposures and different social and demographic profiles. While the U.S. equity market is heavily exposed to technology, Switzerland is dominated by defensive healthcare companies, and the Euro area by consumer stocks and industrial names. This makes the Euro area more and Switzerland less exposed to cyclical swings of global economic activity. Moderate correlations between individual markets imply that weak returns in one country may not necessarily be observed in every country, which offers the potential for risk diversification in a portfolio context.

There is another consequence of heterogenous sector weights across different countries: it is almost impossible to invest in the respective sector leaders by simply focusing on one's home market. A typical example is the luxury goods sector, which is dominated by European companies. There is simply no way to find another Hermes, another Louis Vuitton, or another Christian Dior outside of Europe. The same goes for defensive food and beverage stocks: Nestlé, Heineken, Carlsberg, Pernod Ricard, and Davide Campari are exclusively found in Europe. There is also no equivalent for Ferrari, for Unilever, for Logitech, or for Givaudan in any other market outside of Europe. Thus, U.S. investors focusing exclusively on their home market clearly miss out on all those icons.

Currency Diversification Reduces Macro Tail Risks

Currency diversification is another important factor, which is probably most relevant for fixed income investors. According to purchasing power parity theory, long term currency moves are primarily driven by inflation differences between countries. The theory assumes that a rise in a country's price level should be accompanied by a proportional decrease in the country's currency. Thus, the currency of a country with relatively higher inflation rates tends to depreciate in the long term against currencies of countries with relatively lower inflation. The development of the U.S. Dollar versus the Swiss Franc during the past 50 years is a good example for this relation. Around 50 years ago, one U.S. Dollar was worth four Swiss Francs. Today, one U.S. Dollar is worth less than one Swiss Franc. This represents a depreciation of more than 75% over 50 years, which is equivalent to 2.8% per year. During the past 50 years, the average U.S. inflation rate was 3.9%, while Swiss inflation was 2.1% on average. The structurally higher inflation in the U.S. explains a major part of the U.S. Dollar's depreciation since the 1970s. Most recent consumer price inflation rates are 7.9% for the U.S. and 2.2% for Switzerland, potentially pointing to further downside for the U.S. Dollar versus the Swiss Franc in the medium or longer term. Currency diversification is a way to escape from the likely devaluation of one's home currency on inflation or even more severe economic shocks.

Other factors worth consideration with regards to currency diversification are a country's budget deficit and trade deficit, as both may put additional pressure on a country's currency. A budget deficit occurs when a country's spending exceeds its revenues. A trade deficit indicates that a country is importing more than it exports. Budget deficits and trade deficits are often correlated, which is called twin deficit. A high twin deficit points to imbalances and is in tendency negative for a country's currency. The U.S. has been running a significant twin deficit for decades, while Switzerland's budget and trade balance has been positive for decades. The U.S. Dollar's role as the world's reserve currency, its high liquidity, and its status as a safe haven are certainly stabilizing factors. However, even for a reserve currency, high and persistent deficits generally matter and may lead to currency weakness in the longer run if not addressed.

International Diversification is Key in a Multipolar World

During the past decades, globalization led to increasing interrelations between countries. This development was driven by democratization of previously totalitarian states, improved mobility of capital and labor, the rapid growth in air travel facilitating transport logistics, and new technologies to share information across the world in real time. The dissolution of the Soviet Union in 1991, for example, created hundreds of millions of new consumers for global brands and a large labor force eager to take advantage of new opportunities in the western world. As a result, the global economy has become increasingly interdependent, leading to a rising correlation between individual countries' economic cycles. Globalization led to decreasing benefits of international diversification, as the world trade cycle and the reaction of capital markets to global developments became increasingly synchronized.

As previously stated, geographic diversification will become more important in the coming decades as the trend towards a multipolar world is picking up steam. Tomorrow's world will likely be dominated by three large economic centers of gravity: the U.S., Europe, and China. Countries like Australia, Japan, and Russia will struggle to find their place and may form coalitions with smaller or larger trading partners. The emergence of China, as a large and fast-growing economy with an independent financial system is an example for this development. Slower global growth, increasing debt levels, lower asset yields, and the rising risk of geopolitical conflicts increase the chances of diverging financial performance across countries in the future. The war between Russia and Ukraine and its implications on both countries' financial markets is a recent example of rising geopolitical risks. Given the long-term trend towards a multipolar world, sufficient international diversification becomes even more relevant for wealthy U.S. investors searching for attractive risk-adjusted returns and long-term capital protection.

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