Why Diversify Outside the U.S.?

In recent years U.S. stocks have outperformed foreign stocks and have done so with lower risk. From 2004 – 2014, U.S. stocks returned 8.4% per year with a standard deviation (risk measure) of 15.3%, while non-U.S. stocks returned 7.6% per year with a standard deviation of 18.9%. [1] Economic reports tell us that the U.S. economy is stronger now than many other economies around the world, so why should investors bother to diversify internationally?

Diversification and Historical Perspective

Diversification is one of the few "free lunches" in the investment world. Proper diversification produces higher portfolio returns at lower risk. While U.S. stocks have performed exceptionally well relative to international stocks recently, a longer view gives a different perspective. Looking at data since 1970, the benefit of diversification is apparent.

International market returns trailed U.S. market returns slightly for the period from 1970 - 2014, but the different return pattern of international stocks relative to U.S. stocks made it beneficial to have equity exposure to both regions; that is, in many years one region was strong while another was weak.

This chart shows that hypothetical equity portfolios diversified by either 75% U.S./25% international or 50%/50% produced a slightly higher annualized return with significantly lower risk than either the full U.S. equity portfolio or a full international portfolio.[1] Modern Portfolio Theory states that diversification produces higher returns at lower risk, and we see that in this data.

Stock Portfolio Return and Risk 1970 – 2014 [1]

	100% U.S.	75% U.S./ 25% Int'l	50% U.S./ 50% Int'l	100% Int'l
Annualized Return	**10.4%**	**10.5%**	**10.5%**	**10.1%**
Annualized Risk (Standard Deviation)	**15.7%**	**14.9%**	**14.9%**	**17.2%**

Global diversification should lower risk in the near-term as well. Correlation between U.S. and international stock markets has been low, averaging only 0.50 over the past year.[2] This means that U.S. and foreign stocks are not moving up and down together at the same time. This effect lowers risk for internationally-diversified investors.

Only a few years ago, global stock investing was expensive and limited in scope. But today many countries and international sectors may be efficiently accessed using low-cost ETFs, which are the building blocks for Sharper Granite portfolios.

Global Economic Cycles and Valuation

Looking at economic cycles, the U.S. is at a very different point in its economic cycle than many other countries, and the performance pendulum may be shifting because of this.

Stock performance is based not on corporate strength or weakness, but rather on performance *relative to expectations*. Because Japan and other parts of the world are emerging from recent recessions, investors and analysts set the bar much lower for their corporations' economic results.

Returns are most powerful when troubled economies emerge from recession. When conditions are poor, more possibilities exist for positive economic surprise. New bull markets that are born as economies recover are the strongest. The current U.S. bull was born in April, 2009, and generated an S&P 500 Index total return of 40% in its first twelve months.[3]

The U.S. ended its federal asset purchase programs and has begun a cycle of increasing short-term interest rates. This process typically characterizes the late-stage of an economic expansion. Once interest rates have been rising for a while, stock returns may become more challenging. Borrowing costs become higher for individuals and corporations; stock dividends become less attractive to investors relative to bond yields; and a stronger currency lowers corporate profits overseas.

Meanwhile, Europe, Japan and China are now executing stimulus plans similar to the U.S. plans initiated eight years ago. They are in the economic recovery stage, characterized by high investment risk but also high potential returns.

Because of the slow growth in Europe, expectations are low for European corporate earnings. While the price-to-earnings (P/E) valuation is 17.8 for S&P 500 stocks, the P/E for European stocks (MSCI Europe Index) is 14.9 and for emerging markets (MSCI EM Index), the P/E is 1.6. [2] This valuation gap has been widening lately with European stock indexes about 20% cheaper than the S&P 500 Index.[4] Historical periods that begin with European stocks 25% cheaper than U.S. stocks have resulted in European outperformance 88% of the time over the following 5-year horizon, and the odds of outperformance have been 60% for the following 12-month periods.[4]

Strengthening U.S. Dollar

As is typical with countries late in the economic cycle, the U.S. dollar is strengthening. The prospect of increasing interest rates in the U.S. while rates decline elsewhere around the world, in conjunction with low oil prices, is strengthening the dollar in a way not seen in decades. Currently, the dollar sits just beneath the 12-year high it reached in 2015 with respect to the euro.[2, 5] While a strengthening dollar is good for those holding U.S. bonds and cash, it is challenging for U.S. companies that sell goods overseas.

Just as the strong dollar creates a headwind for U.S. corporations, so too it creates a tailwind for international corporations selling goods to the U.S. This is another important reason for international exposure now. The wrinkle here is that foreign dividends are being paid in local currency. For this reason Sharper Granite is currently hedging some international dividends so that they are paid in dollars rather than euros or yen.

Diversification, global economic cycles, and U.S. dollar strength are all important reasons for current international exposure. Sharper Granite investment strategy presently tilts toward international equities, but does so substantially hedging foreign currency, so that much of the overseas dividends is effectively paid in dollars. For more details on this strategy and how it may impact your portfolio, please contact your advisor.

Notes and Acknowledgements:

1. "What's the Sense in Diversifying outside the U.S.?" Russell, U.S. equities represented by S&P500 Index 1970 - 1978 and Russell 3000 Index 1979 – 2014; international equities represented by MSCI EAFE Index 1970 – 1987 and MSCI All Country World ex-U.S 1988 – September, 2014
2. Morgan Stanley (MSCI), Standard & Poor's, FactSet, J.P. Morgan, March 17, 2017
3. S&P 500 Index data is as of March 31, 2015; No index perfectly represents its sector, and it is impossible to invest directly in an index
4. Riverfront, October 13, 2014; FactSet, J.P. Morgan, March 20, 2017
5. Yield difference between (10-Yr Treasury = 2.46%) and (10-Yr TIP = 0.45%) is 2.01%, Bloomberg, March 20, 2017

All forms of securities investing involve risk of loss for which clients should be prepared. There are no guarantees or insurances of principal preservation and market fluctuations of any level may occur and impact portfolio value. Past performance is not a good predictor of future performance. [Spring 2017]