

Why Should You Diversify?

When international stock returns lag, investors may feel tempted to double down on their home market. Historical data suggests the long-term benefits of diversifying globally.

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As 2019 approaches, and with US stocks outperforming non-US stocks in recent years, some investors have again turned their attention towards the role that global diversification plays in their portfolios. For the five-year period ending October 31, 2018, the S&P 500 Index had an annualized return of 11.34% while the MSCI World ex USA Index returned 1.86%, and the MSCI Emerging Markets Index returned 0.78%. As US stocks have outperformed international and emerging markets stocks over the last several years, some investors might be reconsidering the benefits of investing outside the US.

While there are many reasons why a US-based investor may prefer a degree of home bias in their equity allocation, using return differences over a relatively short period as the sole input into this decision may result in missing opportunities that the global markets offer. While international and emerging markets stocks have delivered disappointing returns relative to the US over the last few years, it is important to remember that:

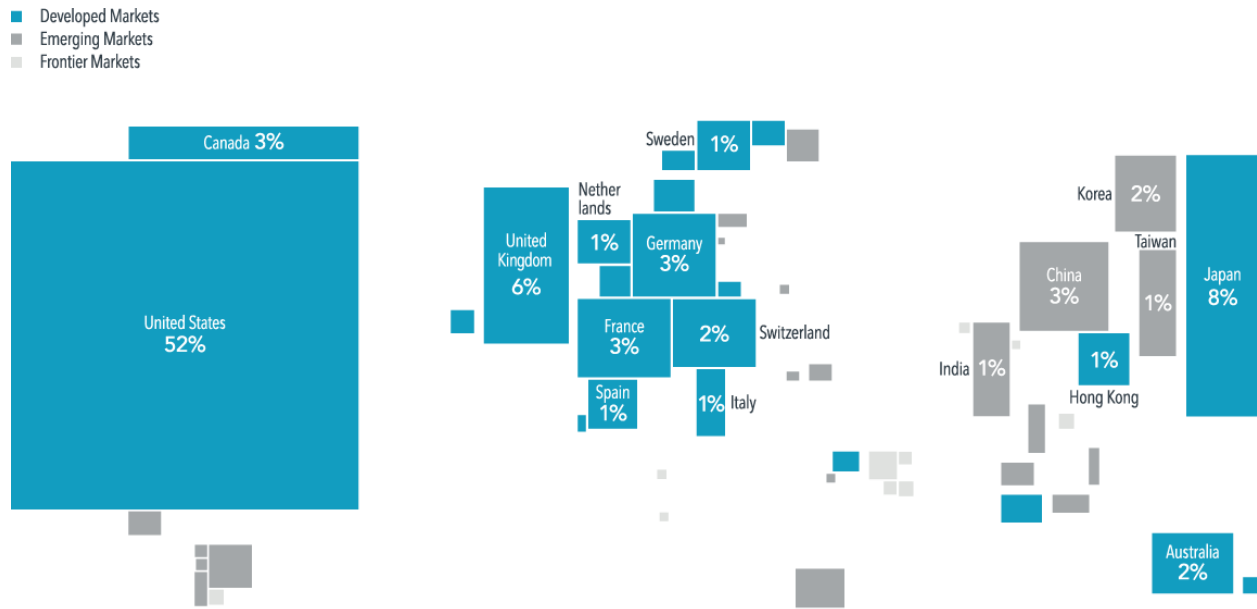
- 1) Non-US stocks help provide valuable diversification benefits.
- 2) Recent performance is not a reliable indicator of future returns.

There's a World of Opportunity in Equities

The global equity market is large and represents a world of investment opportunities. As shown in **Exhibit 1**, nearly half of the investment opportunities in global equity markets lie outside the US. Non-US stocks, including developed and emerging markets, account for 48% of world market capitalization¹ and represent thousands of companies in countries all over the world. A portfolio investing solely within the US would not be exposed to the performance of those markets.

Exhibit 1: There's a World of Opportunity in Equities

Percent of world market capitalization as of December 31, 2017



The Lost Decade

We can examine the potential opportunity cost associated with failing to diversify globally by reflecting on the period in global markets from 2000–2009. During this period, often called the “lost decade” by US investors, the S&P 500 Index recorded its worst ever 10-year performance with a total cumulative return of –9.1%. However, looking beyond US large cap equities, conditions were more favorable for global equity investors as most equity asset classes outside the US generated positive returns over the course of the decade. (See Exhibit 2.) Expanding beyond this period and looking at performance for each of the 11 decades starting in 1900 and ending in 2010, the US market outperformed the world market in five decades and underperformed in the other six.² This further reinforces why an investor pursuing the equity premium should consider a global allocation. By holding a globally diversified portfolio, investors are positioned to capture returns wherever they occur.

Exhibit 2: Global Index Returns

January 2000–December 2009

	Total Cumulative Return (%)
S&P 500 Index	-9.10
MSCI World ex USA Index (net div.)	17.47
MSCI World ex USA Value Index (net div.)	48.71
MSCI World ex USA Small Cap Index (net div.)	94.33
MSCI Emerging Markets Index (net div.)	154.28
MSCI Emerging Markets Value Index (net div.)	212.72

Pick a Country?

Are there systematic ways to identify which countries will outperform others in advance?

Exhibit 3 illustrates the randomness in country equity market rankings (from highest to lowest) for 22 different developed market countries over the past 20 years. This graphic conveys how difficult it would be to execute a strategy that relies on picking the best country and the resulting importance of diversification.

Exhibit 3: Equity Returns of Developed Markets

Annual Return (%)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
High	Finland	Finland	Switzerland	New Zealand	New Zealand	Sweden	Austria	Canada	Spain	Finland	Japan	Norway	Sweden	Ireland	Belgium	Finland	USA	Denmark	Canada	Austria
	121.6	152.6	5.9	8.4	24.2	64.5	71.5	28.3	49.4	48.7	-29.2	87.1	33.8	13.7	39.6	46.0	12.7	23.4	24.6	58.3
	Belgium	Singapore	Canada	Australia	Austria	Germany	Norway	Japan	Portugal	Hong Kong	Switzerland	Australia	Denmark	New Zealand	Denmark	Ireland	New Zealand	Ireland	New Zealand	Hong Kong
	67.7	99.4	5.3	1.7	16.5	63.8	53.3	25.5	47.4	41.2	-30.5	76.4	30.7	5.5	31.3	41.2	7.3	16.5	18.4	36.2
	Italy	Sweden	Denmark	Ireland	Australia	Spain	Belgium	Austria	Ireland	Germany	USA	Singapore	Hong Kong	USA	Singapore	USA	Denmark	Belgium	Norway	Singapore
	52.5	79.7	3.4	-2.8	-1.3	58.5	43.5	24.6	46.8	35.2	-37.6	74.0	23.2	1.4	31.0	31.8	6.2	12.1	13.3	35.6
	Spain	Japan	Norway	Austria	Norway	Austria	Ireland	Denmark	Singapore	Norway	Spain	Sweden	Singapore	UK	Germany	Germany	Hong Kong	Japan	Australia	Denmark
	49.9	61.5	-0.9	-5.6	-7.3	57.0	43.1	24.5	46.7	31.4	-40.6	64.2	22.1	-2.6	30.9	31.4	5.1	9.6	11.4	34.7
	France	Hong Kong	Italy	Belgium	Italy	New Zealand	Sweden	Norway	Norway	Canada	France	Hong Kong	Canada	Switzerland	New Zealand	Spain	Belgium	Austria	Austria	Netherlands
	41.5	59.5	-1.3	-10.9	-7.3	55.4	36.3	24.3	45.1	29.6	-43.3	60.2	20.5	-6.8	29.3	31.3	4.1	3.5	11.3	32.2
	Ireland	Canada	Netherlands	Spain	Japan	Canada	New Zealand	Finland	Sweden	Singapore	Canada	Belgium	Japan	Norway	Hong Kong	Netherlands	Singapore	Italy	USA	France
	35.3	53.7	-4.1	-11.4	-10.3	54.6	35.2	16.7	43.4	28.4	-45.5	57.5	15.4	-10.0	28.3	31.3	3.0	2.3	10.9	28.7
	USA	Norway	France	Norway	Switzerland	Australia	Italy	Switzerland	Denmark	Australia	Germany	Canada	USA	Belgium	Austria	Belgium	Ireland	Finland	France	Italy
	30.1	31.7	-4.3	-12.2	-10.3	49.5	32.5	16.3	38.8	28.3	-45.9	56.2	14.8	-10.6	25.9	27.6	2.3	2.0	4.9	28.4
	Germany	France	Australia	USA	Singapore	Denmark	Denmark	Australia	Belgium	Denmark	Singapore	New Zealand	Australia	Australia	Australia	Japan	Canada	Netherlands	Netherlands	Norway
	29.4	29.3	-10.0	-12.4	-11.0	49.3	30.8	16.0	36.7	25.6	-47.4	50.4	14.5	-11.0	22.1	27.2	1.5	1.3	4.8	28.3
	Portugal	USA	Portugal	UK	Canada	Norway	Australia	Singapore	Austria	Portugal	Denmark	Spain	Switzerland	Netherlands	Sweden	Switzerland	Switzerland	Portugal	Portugal	Germany
	27.5	21.9	-10.3	-14.0	-13.2	48.1	30.3	14.4	36.5	24.0	-47.6	43.5	11.8	-12.1	22.0	26.6	-0.1	0.9	3.6	27.7
	Switzerland	Germany	UK	Denmark	Portugal	Ireland	Spain	Netherlands	Germany	Spain	Netherlands	UK	Norway	Spain	France	France	Finland	USA	Germany	Spain
	23.5	20.0	-11.5	-14.8	-13.8	43.8	28.9	13.9	36.0	24.0	-48.2	43.3	10.9	-12.3	21.3	26.3	-0.7	0.7	2.8	27.0
Netherlands	Australia	Austria	Hong Kong	Belgium	Portugal	Hong Kong	Sweden	France	Netherlands	UK	Austria	Finland	Canada	Netherlands	Denmark	Australia	Switzerland	Japan	Japan	
23.2	17.6	-12.0	-18.6	-15.0	43.0	25.0	10.3	34.5	20.6	-48.3	43.2	10.3	-12.7	20.6	25.2	-3.4	0.4	2.4	24.0	
UK	New Zealand	Ireland	Canada	UK	France	Portugal	Germany	Italy	France	Sweden	Netherlands	Austria	Japan	Switzerland	Sweden	Netherlands	France	Hong Kong	Portugal	
17.8	12.9	-12.7	-20.4	-15.2	40.2	24.7	9.9	32.5	13.2	-49.9	42.3	9.9	-14.3	20.4	24.5	-3.5	-0.1	2.3	23.8	
Sweden	UK	USA	Switzerland	Spain	Hong Kong	Singapore	France	Netherlands	New Zealand	Italy	Portugal	UK	Sweden	Norway	UK	Japan	Hong Kong	Singapore	Switzerland	
14.0	12.5	-12.8	-21.4	-15.3	38.1	22.3	9.9	31.4	8.9	-50.0	40.4	8.8	-16.0	18.7	20.7	-4.0	-0.5	1.4	22.5	
Denmark	Denmark	Finland	Portugal	Denmark	Italy	Canada	Belgium	Australia	UK	Australia	Denmark	Germany	Denmark	USA	Italy	Spain	Germany	Sweden	Finland	
9.0	12.1	-14.2	-22.0	-16.0	37.8	22.2	9.0	30.9	8.4	-50.7	36.6	8.4	-16.0	15.3	20.4	-4.7	-1.9	0.6	22.5	
Australia	Netherlands	Hong Kong	Netherlands	Hong Kong	Singapore	UK	Hong Kong	UK	Italy	Hong Kong	France	New Zealand	Hong Kong	UK	Austria	UK	Sweden	UK	UK	
6.1	6.9	-14.7	-22.1	-17.8	37.6	19.6	8.4	30.6	6.1	-51.2	31.8	8.3	-16.0	15.3	13.4	-5.4	-5.0	-0.1	22.3	
Japan	Spain	Germany	France	Netherlands	Japan	France	UK	Hong Kong	USA	Portugal	Italy	Netherlands	France	Finland	New Zealand	Sweden	New Zealand	Spain	USA	
5.1	4.8	-15.6	-22.4	-20.8	35.9	18.5	7.4	30.4	5.4	-52.2	26.6	1.7	-16.9	14.6	11.3	-7.5	-6.3	-1.0	21.2	
Austria	Italy	Spain	Germany	France	Belgium	Germany	USA	Finland	Switzerland	New Zealand	USA	Belgium	Singapore	Italy	Hong Kong	Italy	UK	Finland	Sweden	
0.4	-0.3	-15.9	-22.4	-21.2	35.3	16.2	5.1	29.9	5.3	-53.8	26.3	-0.4	-17.9	12.5	11.1	-9.5	-7.6	-4.7	20.6	
Hong Kong	Switzerland	Belgium	Singapore	USA	Switzerland	Japan	Spain	Switzerland	Austria	Finland	Switzerland	France	Germany	Canada	Portugal	France	Australia	Switzerland	Australia	
-2.9	-7.0	-16.8	-23.4	-23.1	34.1	15.9	4.4	27.4	2.2	-55.2	25.3	-4.1	-18.1	9.1	11.0	-9.9	-10.0	-4.9	19.9	
Canada	Portugal	Sweden	Italy	Ireland	UK	Switzerland	Italy	Canada	Sweden	Norway	Germany	Portugal	Portugal	Japan	Norway	Germany	Norway	Ireland	Belgium	
-6.1	-8.9	-21.3	-26.6	-26.2	32.1	15.0	1.9	17.8	0.6	-64.2	25.2	-11.3	-23.1	8.2	9.4	-10.4	-15.0	-7.1	18.6	
Singapore	Austria	Singapore	Sweden	Finland	USA	Netherlands	New Zealand	New Zealand	Belgium	Belgium	Ireland	Italy	Italy	Ireland	Canada	Norway	Spain	Belgium	Ireland	
-12.9	-9.1	-27.7	-27.2	-30.3	28.4	12.2	1.7	16.6	-2.7	-66.5	12.3	-15.0	-23.2	5.7	5.6	-22.0	-15.6	-7.6	18.1	
New Zealand	Ireland	Japan	Japan	Sweden	Netherlands	USA	Portugal	USA	Japan	Austria	Finland	Ireland	Finland	Portugal	Australia	Austria	Singapore	Italy	Canada	
-22.6	-12.6	-28.2	-29.4	-30.5	28.1	10.1	-1.9	14.7	-4.2	-68.4	11.1	-18.1	-31.9	3.5	4.2	-29.8	-17.7	-10.5	16.1	
Norway	Belgium	New Zealand	Finland	Germany	Finland	Finland	Ireland	Japan	Ireland	Ireland	Japan	Spain	Austria	Spain	Singapore	Portugal	Canada	Denmark	New Zealand	
-30.1	-14.3	-33.5	-38.2	-33.2	19.4	6.1	-2.3	6.2	-20.1	-71.9	6.3	-22.0	-36.4	3.0	1.7	-38.2	-24.2	-15.8	11.7	

In addition, concentrating a portfolio in any one country can expose investors to large variations in returns. The difference between the best- and worst-performing countries can be significant. For example, since 1998, the average return of the best-performing developed market country was approximately 44%, while the average return of the worst-performing country was approximately -16%. Diversification means an investor's portfolio is unlikely to be the best or worst performing relative to any individual country, but diversification also provides a means to achieve a more consistent outcome and more importantly helps reduce and manage catastrophic losses that can be associated with investing in just a small number of stocks or a single country.

A Diversified Approach

Over long periods of time, investors may benefit from consistent exposure in their portfolios to both US and non US equities. While both asset classes offer the potential to earn positive expected returns in the long run, they may perform quite differently over short periods. While the performance of different countries and asset classes will vary over time, there is no reliable evidence that this performance can be predicted in advance. An approach to equity investing that uses the global opportunity set available to investors can provide diversification benefits as well as potentially higher expected returns.

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