Why Should You Diversify?

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Equity markets have experienced a sharp decline to start 2016, leading some investors to reevaluate their asset allocation. As US stocks have outperformed developed ex US and emerging markets stocks over the last few years, some investors might consider reevaluating the benefits of investing outside the US. From January 1, 2010, through February 29, 2016, the S&P 500 Index had an annualized return of 11.66% while the MSCI World ex USA Index returned 2.26% and the MSCI Emerging Markets Index returned −2.28%. While there are many reasons a US-based investor may prefer a home bias in their equity portfolios, using return differences over the last few years as the sole input into this decision may result in missed opportunities that the global markets offer. We recognize that stocks in non-US developed and emerging markets have delivered disappointing returns relative to the US over the last few years. However, it is important to remember that:

1) International stocks help provide valuable diversification benefits.

2) Recent performance is not a reliable indicator of future returns.

Investors can benefit from consistent exposure in their portfolios to both US and non-US equities.

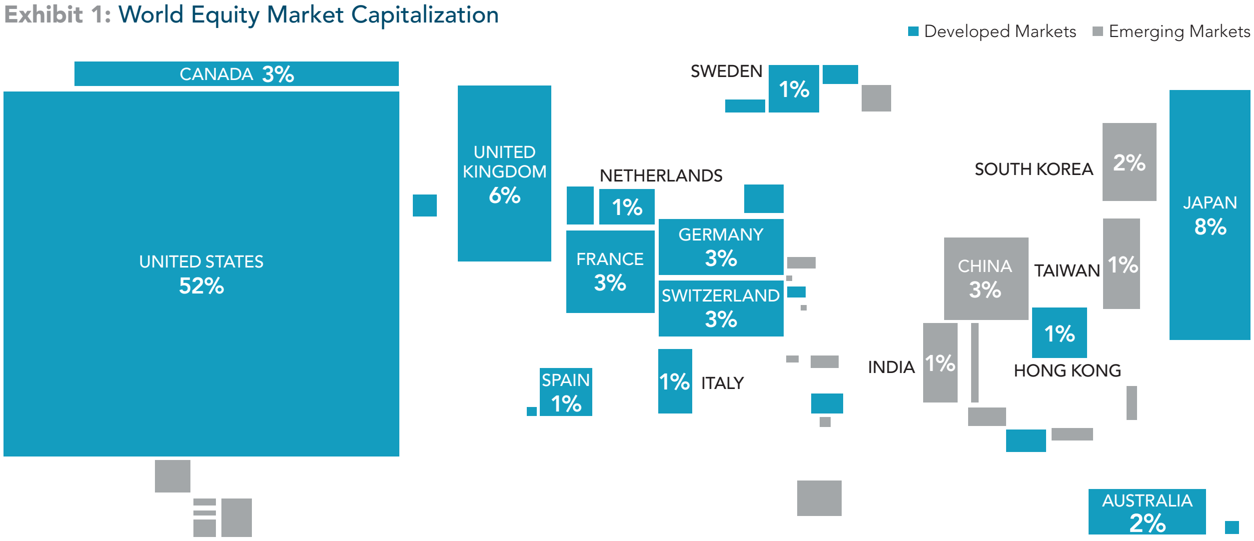
THERE'S A WORLD OF OPPORTUNITY IN EQUITIES

The global equity market is large and represents a world of investment opportunities. As shown in **Exhibit 1** (next page), 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 cap and represent more than 10,000 companies in over 40 countries. A portfolio investing solely within the US would not be exposed to the performance of those markets.

THE LOST DECADE

We can examine the potential opportunity cost associated with failing to diversify globally by reflecting on a recent period from 2000–2009. During this period, often called the "lost decade," the S&P 500 Index recorded its worst

Exhibit 1: World Equity Market Capitalization



As of December 31, 2015. Market cap data is free-float adjusted from Bloomberg securities data. Many nations not displayed. Total may not equal 100% due to rounding. For educational purposes; should not be used as investment advice. China market capitalization excludes A-shares, which are generally only available to mainland China investors.

ever 10-year performance with a total cumulative return of –9.1%. However, when you look 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.[1] 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

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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 19 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 global diversification.

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 1996, the average return of the best-performing developed market country was 37.5%, while the average return of the worst-performing country was –15.7%. Over the last 20 calendar years, the US has been the best-performing country twice, and the worst performing once. Diversification implies an investor's portfolio is unlikely to be the best or worst performing, but diversification provides the means to achieve a more consistent outcome and most importantly helps reduce and manage catastrophic losses that can be associated with investing in just a small number of stocks or a single country.

1. Source: Annual country index return data from the Dimson-Marsh-Staunton (DMS) Global Returns Data, provided by Morningstar, Inc.

Exhibit 3: Equity Returns of Developed Markets

RETURNS % — HIGH

1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Spain 40.1	Switzerland 44.2	Belgium 67.7	Singapore 99.4	Switzerland 5.9	N. Zealand 8.4	N. Zealand 24.2	Sweden 64.5	Austria 71.5	Canada 28.3	Spain 49.4	Hong Kong 41.2	Japan −29.2	Norway 87.1	Sweden 33.8	N. Zealand 5.5	Belgium 39.6	USA 31.8	USA 12.7	Denmark 23.4
Sweden 37.2	Italy 35.5	Italy 52.5	Sweden 79.7	Canada 5.3	Australia 1.7	Austria 16.5	Germany 63.8	Norway 53.3	Japan 25.5	Singapore 46.7	Germany 35.2	Switzerland −30.5	Australia 76.4	Denmark 30.7	USA 1.4	Denmark 31.3	Germany 31.4	N. Zealand 7.3	Belgium 12.1
Hong Kong 33.1	Denmark 34.5	Spain 49.9	Japan 61.5	Denmark 3.4	Austria −5.6	Australia −1.3	Spain 58.5	Belgium 43.5	Austria 24.6	Norway 45.1	Norway 31.4	USA −37.6	Singapore 74.0	Hong Kong 23.2	UK −2.6	Singapore 31.0	Spain 31.3	Denmark 6.2	Japan 9.6
Norway 28.6	USA 33.4	France 41.5	Hong Kong 59.5	Norway −0.9	Belgium −10.9	Norway −7.3	Austria 57.0	Sweden 36.3	Denmark 24.5	Sweden 43.4	Canada 29.6	Spain −40.6	Sweden 64.2	Singapore 22.1	Switzerland −6.8	Germany 30.9	Netherl. 31.3	Hong Kong 5.1	Austria 3.5
Canada 28.5	Spain 25.4	USA 30.1	Canada 53.7	Italy −1.3	Spain −11.4	Italy −7.3	N. Zealand 55.4	N. Zealand 35.2	Norway 24.3	Denmark 38.8	Singapore 28.4	France −43.3	Hong Kong 60.2	Canada 20.5	Norway −10.0	N. Zealand 29.3	Belgium 27.6	Belgium 4.1	Italy 2.3
Netherl. 27.5	Germany 24.6	Germany 29.4	Norway 31.7	Netherl. −4.1	Norway −12.2	Japan −10.3	Canada 54.6	Italy 32.5	Switzerland 16.3	Belgium 36.7	Australia 28.3	Canada −45.5	Belgium 57.5	Japan 15.4	Belgium −10.6	Hong Kong 28.3	Japan 27.2	Singapore 3.0	Netherl. 1.3
UK 27.4	Netherl. 23.8	Switzerland 23.5	France 29.3	France −4.3	USA −12.4	Switzerland −10.3	Australia 49.5	Denmark 30.8	Australia 16.0	Austria 36.5	Denmark 25.6	Germany −45.9	Canada 56.2	USA 14.8	Australia −11.0	Austria 25.9	Switzerland 26.6	Canada 1.5	USA 0.7
USA 23.2	UK 22.6	Netherl. 23.2	USA 21.9	Australia −10.0	UK −14.0	Singapore −11.0	Denmark 49.3	Australia 30.3	Singapore 14.4	Germany 36.0	Spain 24.0	Singapore −47.4	N. Zealand 50.4	Australia 14.5	Netherl. −12.1	Australia 22.1	France 26.3	Switzerland −0.1	Switzerland 0.4
Denmark 21.8	Belgium 13.6	UK 17.8	Germany 20.0	UK −11.5	Denmark −14.8	Canada −13.2	Norway 48.1	Spain 28.9	Netherl. 13.9	France 34.5	Netherl. 20.6	Denmark −47.6	Spain 43.5	Switzerland 11.8	Spain −12.3	Sweden 22.0	Denmark 25.2	Australia −3.4	France −0.1
France 21.2	Sweden 12.9	Sweden 14.0	Australia 17.6	Austria −12.0	Hong Kong −18.6	Belgium −15.0	France 40.2	Hong Kong 25.0	Sweden 10.3	Italy 32.5	France 13.2	Netherl. −48.2	UK 43.3	Norway 10.9	Canada −12.7	France 21.3	Sweden 24.5	Netherl. −3.5	Hong Kong −0.5
N. Zealand 17.2	Canada 12.8	Denmark 9.0	N. Zealand 12.9	USA −12.8	Canada −20.4	UK −15.2	Hong Kong 38.1	Singapore 22.3	Germany 9.9	Netherl. 31.4	N. Zealand 8.9	UK −48.3	Austria 43.2	Austria 9.9	Japan −14.3	Netherl. 20.6	UK 20.7	Japan −4.0	Germany −1.9
Australia 16.5	France 11.9	Australia 6.1	UK 12.5	Hong Kong −14.7	Switzerland −21.4	Spain −15.3	Italy 37.8	Canada 22.2	France 9.9	Australia 30.9	UK 8.4	Sweden −49.9	Netherl. 42.3	UK 8.8	Sweden −16.0	Switzerland 20.4	Italy 20.4	Spain −4.7	Sweden −5.0
Germany 13.6	Norway 6.2	Japan 5.1	Denmark 12.1	Germany −15.6	Netherl. −22.1	Denmark −16.0	Singapore 37.6	UK 19.6	Belgium 9.0	UK 30.6	Italy 6.1	Italy −50.0	Denmark 36.6	Germany 8.4	Denmark −16.0	Norway 18.7	Austria 13.4	UK −5.4	N. Zealand −6.3
Italy 12.6	Austria 1.6	Austria 0.4	Netherl. 6.9	Spain −15.9	France −22.4	Hong Kong −17.8	Japan 35.9	France 18.5	Hong Kong 8.4	Hong Kong 30.4	USA 5.4	Australia −50.7	France 31.8	N. Zealand 8.3	Hong Kong −16.0	USA 15.3	N. Zealand 11.3	Sweden −7.5	UK −7.6
Belgium 12.0	Australia −10.4	Hong Kong −2.9	Spain 4.8	Belgium −16.8	Germany −22.4	Netherl. −20.8	Belgium 35.3	Germany 16.2	UK 7.4	Switzerland 27.4	Switzerland 5.3	Hong Kong −51.2	Italy 26.6	Netherl. 1.7	France −16.9	UK 15.3	Hong Kong 11.1	Italy −9.5	Australia −10.0
Austria 4.5	N. Zealand −14.1	Canada −6.1	Italy −0.3	Sweden −21.3	Singapore −23.4	France −21.2	Switzerland 34.1	Japan 15.9	USA 5.1	Canada 17.8	Austria 2.2	N. Zealand −53.8	USA 26.3	Belgium −0.4	Singapore −17.9	Italy 12.5	Norway 9.4	France −9.9	Norway −15.0
Switzerland 2.3	Hong Kong −23.3	Singapore −12.9	Switzerland −7.0	Singapore −27.7	Italy −26.6	USA −23.1	UK 32.1	Switzerland 15.0	Spain 4.4	N. Zealand 16.6	Sweden 0.6	Norway −64.2	Switzerland 25.3	France −4.1	Germany −18.1	Canada 9.1	Canada 5.6	Germany −10.4	Spain −15.6
Singapore −6.9	Japan −23.7	N. Zealand −22.6	Austria −9.1	Japan −28.2	Sweden −27.2	Sweden −30.5	USA 28.4	Netherl. 12.2	Italy 1.9	USA 14.7	Belgium −2.7	Belgium −66.5	Germany 25.2	Italy −15.0	Italy −23.2	Japan 8.2	Australia 4.2	Norway −22.0	Singapore −17.7
Japan −15.5	Singapore −30.0	Norway −30.1	Belgium −14.3	N. Zealand −33.5	Japan −29.4	Germany −33.2	Netherl. 28.1	USA 10.1	N. Zealand 1.7	Japan 6.2	Japan −4.2	Austria −68.4	Japan 6.3	Spain −22.0	Austria −36.4	Spain 3.0	Singapore 1.7	Austria −29.8	Canada −24.2

LOW

Source: MSCI developed markets country indices (net dividends) with at least 25 years of data.

A DIVERSIFIED APPROACH

Over long periods of time, investors can 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 term, they may perform quite differently over shorter cycles. While the performance of different countries and asset classes will vary over time, there is no reliable evidence that performance can be predicted in advance. An approach to equity investing that uses the global opportunity set available to investors can provide both diversification benefits as well as potentially higher expected returns.

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