THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

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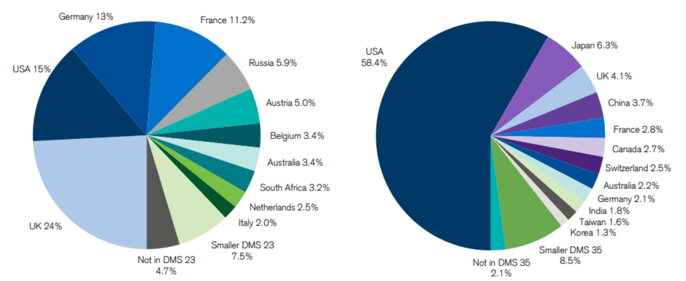
Asset Allocation

THE CASE FOR INTERNATIONAL DIVERSIFICATION

By Michael Chu, Senior Wealth Advisor

The United States currently makes up about 60% of the global stock market by market capitalization. Of course, mixes ebb and flow over time. The graph below shows the sizes of stock markets around the world at the end of 1899 vs. the start of 2023. As you can see, the U.S. stock market was only 15% but has since grown to dominate the rest of the world.

Relative sizes of world stock markets
end-1899 (left) vs. start-2023 (right)



Sources: Elroy Dimson, Paul Marsh and Mike Staunton, DMS Database 2023, Morningstar; data for the right-hand chart from FTSE Russell All-World Index Series Monthly Review, December 2022. Not to be reproduced without express written permission from the authors.

Even when we look at just the past decade, U.S. stocks won hands-down vs. their foreign counterparts. So the question arises: What's the point of owning international stocks? A valid question, not just in terms of performance, but also in that the U.S. has the majority of the biggest and best companies in the world. And many of these companies are multinational and get a decent portion of their revenues from overseas.

Chart #2: America vs. The World (Annual Returns)

Timeframe	World ex-US	S&P 500
1970-1978	10.9%	4.6%
1979-1984	9.8%	15.4%
1985-1988	41.4%	17.8%
1989-1999	7.8%	19.4%
2000-2007	6.1%	1.7%
2008-2021	3.6%	11.0%
2022-2023	-3.0%	-8.1%

Data: Ben Carlson

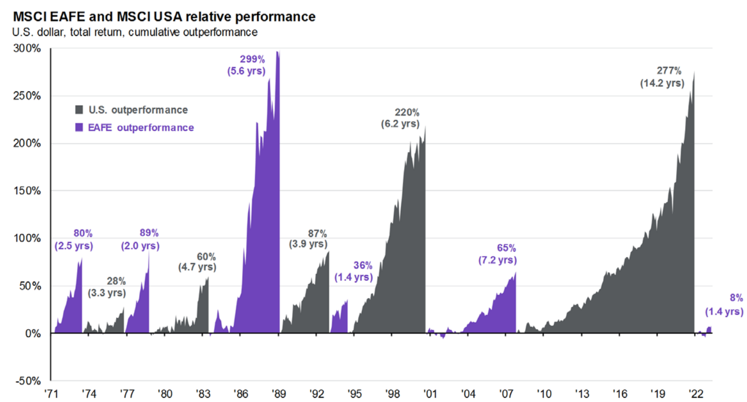
So again, based on this, what's the point of owning international stocks?

Well, as usual, the devil is in the details. Ben Carlson of Ritholtz Wealth Management did a study going back to 1970: U.S. stocks were up 10.5% on average, while international stocks were up 9.1%. The U.S. stocks were still faring better, but not by a huge margin. Interestingly, the annual win percentages were about the same: The U.S. stock market was better 28 times and international stocks were better 25 times. Above are the annualized returns over various periods.

As you can see in chart #2, U.S. stocks enjoyed a huge run coming out of the Great Financial Crisis in 2008. But international stocks did much better in the 1970s, '80s and early 2000s. Much of the U.S. outperformance has taken place during the latest cycle. In fact, if we look at returns from 1970-2012, the annual returns between U.S and international stocks are almost exactly the same.

Chart #3 does a good job of visualizing the length of relative performance. With a very long 14-year run for U.S. stocks, perhaps a reversal is in order?

Chart #3



Source: FactSet, MSCI, J.P. Morgan Asset Management.
Regime change determined when cumulative outperformance peaks and is not reached again in the subsequent 12-month period.
Guide to the Markets – U.S. Data are as of April 30, 2023.

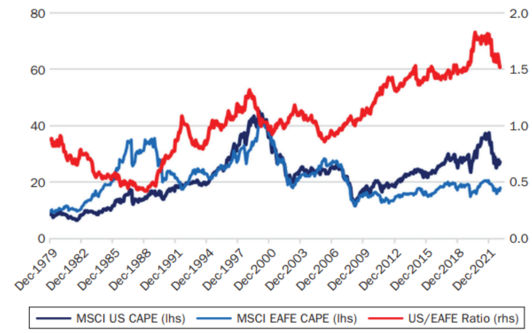
Cliff Asness of AQR Capital Management has also put out a research piece about the strength of U.S. stocks. Asness says that since 1990, the vast majority of the U.S. outperformance has been due to changes in valuations. In 1990, U.S. valuations were about half compared to international stocks. But at the end of 2022, U.S. stocks were 1.5 times international stocks. If you adjust for the tripling of valuations, then the difference in earnings growth is not significant. Chart #4 is a visual representation of how valuations have changed.

Basically, international stocks went from being relatively expensive to relatively cheap, while U.S. stocks went from relatively cheap to relatively expensive. Will this trend continue? It's possible, but probably not. AQR concludes, "International diversification is still worth it, even if it hasn't delivered for U.S.-based investors in 30 years. Most of the U.S. equity outperformance during this period reflects richening relative valuations, hardly a reason for raising or even retaining U.S. overweights today. If anything, historically wide relative valuations point the other way. Today is an unusually bad time to take the wrong lessons from the past. Unfortunately, rarely has doing the right thing been so hard (and it's never easy)."

Diversification is hard because there's always something that's going to underperform – but nobody knows what it will be. If we only knew someone who could predict the future, there would be no need to diversify. Perhaps the lesson from all this is that we should just view diversification as giving up the ability for a grand slam so you don't strike out at the plate. Or, going for that huge golf swing over the water... We might hit it over, but more times than not, it's better to take two conservative and more reliable shots. Investment-wise, this is like accepting good and consistent returns to avoid the potential for terrible returns.

Chart #4

Valuations of US and Other Equity Markets, January 1980–February 2023



NOTES: Country-level CAPE (cyclically adjusted price-to-earnings ratio) metrics are created by comparing the recent equity index price with 10-year past average earnings. The EAFE composite is created by taking country-level data and weighting it according to the MSCI weights.

SOURCE: Bloomberg, MSCI, Consensus Economics.

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