# Seeking Opportunity in Adaptive Markets: Why Does Global Diversification Make Sense?

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- Financial markets are supposed to be efficient, but investor behavior is sometimes driven by greed or fear (not logic).
- Investors often allocate the equity portion of their portfolios to domestic stocks, but unpredictable behavior and uncertain outcomes make it difficult to predict asset class performance.
- Balancing risk exposures across the globe may reduce risk without reducing return —that's why our strategies invest in global equities.

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Investors spend a great deal of time thinking about the future, but know very little about what will actually happen moving forward. That's precisely why diversification is important. When we don't know which asset will perform best over any given period, we can increase our chances of investing success by spreading portfolio risk across as many different assets and exposures as possible. This balancing of exposures allows for lower potential risk at any given level of expected return, increasing our confidence in achieving investment objectives (including both generating attractive returns and reducing the odds of significant losses) over any time horizon.

### International Equities: A Tool to Balance Risk

Meaningful diversification benefits can be achieved by spreading a portfolio's equity holdings across the globe rather than concentrating in a single country. Even if we think that domestic equities will outperform international equities over a given horizon, it's possible that expectation will turn out to be wrong. We believe this uncertainty creates a permanent role for international equities in our portfolios with equity exposure at all times. There is always a chance that U.S. equities will underperform (as seen in Exhibit 1), and timing the cycle of outperformance and underperformance is difficult. Few investors would think that a portfolio that held only one stock, one industry, or even one sector was sufficiently diversified. Why would a portfolio holding only one country be any different?

### A Permanent Allocation

Importantly, our exposure to international stocks is (1) not a tactical (temporary) trade and (2) is not an

**Exhibit 1: U.S. Equites Don't Always Win**

| 1970-1974 | 1975-1979 | 1980-1984 | 1985-1989 | 1990-1994 | 1995-1999 | 2000-2004 | 2005-2009 | 2010-2014 | 2015-2019 |
|---|---|---|---|---|---|---|---|---|---|
| MSCI Japan 103.09% | MSCI UK 275.98% | MSCI Japan 116.1% | MSCI Japan 461.91% | MSCI Pacific ex-Japan 98.11% | S&P 500 251.12% | MSCI Pacific ex-Japan 33.34% | MSCI Pacific ex-Japan 68.02% | S&P 500 105.14% | S&P 500 73.86% |
| MSCI Europe ex-UK 14.79% | MSCI Pacific ex-Japan 218.44% | S&P 500 99.44% | MSCI Europe ex-UK 339.81% | S&P 500 51.74% | MSCI Europe ex-UK 180.00% | MSCI UK 1.78% | MSCI Europe ex-UK 26.06% | MSCI UK 39.44% | MSCI Japan 44.93% |
| S&P 500 -11.32% | MSCI Japan 131.09% | MSCI UK 56.80% | MSCI UK 238.84% | MSCI UK 50.91% | MSCI UK 150.99% | MSCI Europe ex-UK -0.71% | MSCI UK 12.47% | MSCI Pacific ex-Japan 33.37% | MSCI Europe ex-UK 32.70% |
| MSCI Pacific ex-Japan -30.39% | S&P 500 99.58% | MSCI Pacific ex-Japan 17.70% | MSCI Pacific ex-Japan 165.97% | MSCI Europe ex-UK 29.61% | MSCI Pacific ex-Japan 25.05% | S&P 500 -10.98% | S&P 500 2.11% | MSCI Japan 30.57% | MSCI Pacific ex-Japan 31.92% |
| MSCI UK -51.56% | MSCI Europe ex-UK 76.29% | MSCI Europe ex-UK 6.40% | S&P 500 152.62% | MSCI Japan -16.69% | MSCI Japan 10.2% | MSCI Japan -28.35% | MSCI Japan -3.94% | MSCI Europe ex-UK 24.53% | MSCI UK 17.36% |

**Sources: SEI, MSCI, S&P. Index performance is measured over five full year periods. Returns are cumulative. Past performance does not guarantee future results. MSCI returns are net of withholding taxes. Returns prior to 3/31/1986 for the MSCI Japan Index (Net), MSCI Europe ex UK Index (Net) and MSCI United Kingdom Index (Net) and prior to 8/31/1987 for the MSCI Pacific ex-Japan Index (Net) are backtested. Back-tested performance, which is hypothetical and not actual performance, is subject to inherent limitations because it reflects application of an Index methodology in hindsight. No theoretical approach can take into account all of the factors in the markets in general and the impact of decisions that might have been made during the actual operation of an index.**

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“overweight”. We hold international equities strategically, meaning it is a core element of our baseline portfolios even when we don’t have strong tactical views. In the absence of a crystal ball, diversifying can reduce our exposure to any given risk. And diversifying into international equities does not mean we are “overweight” international versus the United States.

As of July 30 2020, our international exposures are approximately aligned with their weights in the global equity markets, meaning we are roughly neutral, not overweight international. In some portfolios we are, if anything, moderately “underweight” international relative to its capitalization weight in the global market.

It’s worth noting that the U.S. stock market is still very well-represented in a globally-diversified portfolio. Comprising roughly 60% of the global public equity market by market capitalization (as measured by the MSCI ACWI Index), U.S. equities can be a dominant source of risk and return even for an investor whose equity portfolio is fully globally diversified. As such, global diversification is not a bet against the U.S. stock market; it simply ensures that an investor is not relying solely on the U.S. stock market.

**Consider the Risks**

While diversification cannot eliminate risk from investing in capital markets, its potential risk reduction benefits are evergreen. Nevertheless, we recognize that there is always demand for insight into how international equities might outperform the U.S. over any given period. While we do not profess to be able to predict the future, there are a variety of current narratives that support that possibility in today’s market.

**U.S. Stocks are Expensive**

The market has already priced in significantly higher earnings growth for U.S. equities compared to their international counterparts. This can be witnessed in various valuation metrics, with the price-to-earnings (P/E) ratio[1] perhaps the most famous. As of 6/30/2020, the MSCI USA Index traded at a forward P/E of 22.3x compared to only 16.1x for the MSCI ACWI ex-USA Index. This starting point in terms of valuations makes the “bar” for U.S. equities higher and harder to clear. Even if U.S. earnings growth does outpace that of the rest of the world, its equities returns may well lag in the event that the differential is not as wide as is currently expected. Predicting which economies will perform best is far from easy; predicting which markets will perform best is even harder.

**COVID-19 is a Wildcard**

The COVID-19 situation is clearly extremely fluid and difficult to predict. Since we can’t know how the pandemic will evolve, we can attempt to limit portfolio risk by spreading our exposures out as broadly as we can. The current climate, however, provides a possible narrative for international equities outperforming the U.S. While they have certainly not eradicated the virus, most other developed nations appear to have their outbreaks far more under control than does the U.S. at present. To the extent that this supports further domestic demand in these economies and boosts trade among them, the rest of the developed world may see a sharper economic recovery compared to the U.S. This situation is, of course, highly volatile, and in the coming months, the locations of virus “hot spots” may well change dramatically. The fact that we cannot predict such changes, or their impacts on regional and global economic performance, shows exactly why we believe diversification is so important.

**Political Change Impacts the Economy**

The 2020 election season will clearly impact the future course of U.S. economic policy and performance for the foreseeable future. The future of the tax cuts enacted during the Trump Administration is in question. Ongoing economic and political tensions with China may dampen the growth outlook. Increased regulation and/or taxation of large technology companies has gained more political support, potentially undercutting the prospects for the sector that has contributed disproportionately to U.S. outperformance in recent years. The same can be said for uncertainty in the energy patch. Put simply, while political developments are always hard to predict, the current climate is especially volatile, and possible scenarios in which U.S. equities may underperform the rest of the world abound.

**Concentrated Market Leadership**

The U.S. stock market is more dominated by the largest few names than it has been at any other time in recent memory. The top five names constitute over 20% of the S&P 500 Index. Microsoft and Apple combine to total more than 11% of the index. The information technology sector constitutes more than 26% of the index, and this doesn’t even include Facebook, Alphabet or Amazon. These technology-related stocks are categorized in communications services (Facebook and Alphabet) and consumer discretionary (Amazon), sectors which constitute another 11% and 10.5%, respectively. It is clear that an investment in the S&P 500 has become

[1] Forward price-to-earnings (forward P/E) is a version of the ratio of price-to-earnings (P/E) that uses forecasted earnings for the P/E calculation.

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increasingly concentrated. And the higher the concentration in potentially highly-correlated stocks and industries, the higher the probability that a large portion of the index will decline simultaneously. To the extent that this makes the U.S. market more fragile than usual, we believe it supports a meaningful exposure to non-U.S. equities as a way of managing that concentration risk.

### A Prudent Approach

None of the scenarios described above is a prediction, but all are possibilities. We are humble enough to know that any forecast is fraught with uncertainty, and we believe it is better to be prepared for a wide range of outcomes than to assume that the best-case scenario is the only possible result. As thoughtful portfolio managers, we are intentionally increasing the level of diversification in our portfolios by investing in international stocks—not just domestic stocks.

### Index Definitions

**MSCI Emerging Markets Index:** a free float-adjusted market-capitalization-weighted index designed to measure the performance of global emerging-market equities.

**MSCI United Kingdom Index:** The MSCI United Kingdom Index is designed to measure the performance of the large- and mid-cap segments of the U.K. market. The Index covers approximately 85% of the free float-adjusted market capitalization in the U.K.

**MSCI Europe ex UK Index:** The MSCI Europe ex UK Index is a free float-adjusted market-capitalization-weighted index that captures large- and mid-cap representation across 14 developed-market countries in Europe (Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden and Switzerland). The Index covers approximately 85% of the free float-adjusted market capitalization across European developed markets excluding the U.K.

**MSCI Japan Index:** The MSCI Japan Index is designed to measure the performance of the large- and mid-cap stocks in Japan.

**S&P 500 Index:** an unmanaged, market-weighted index that consists of 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

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