Does International Investing Really Offer Diversification?

by Michael Schmidt,CFA (Contact Author | Biography)

Does international investing really offer diversification to a U.S.-based investor? There certainly is enough information available to the investing public to suggest it does, and institutional investors have been on board for more than 20 years. The premise for investing in international assets is typically driven by the benefits that the diversification offers to a U.S.-based investor. Taking a look at the long term correlations between non-U.S. assets and U.S. assets, it's obvious that the theory applies, as adding low-correlated assets to any portfolio can reduce overall risk. While this seems to be generally accepted in investing theory, a more in-depth evaluation provides some compelling evidence that this is not always the case - especially in the short term and during times of dramatic swings in global markets.

International Markets

Taking a look at non-U.S. markets, there are two distinct categories for both stocks and bonds: developed and emerging markets. Emerging markets are then broken down further into sub-categories. While there are some variations in how these classifications are decided, a good source for their origins has been defined by the Financial Times and London Stock Exchange (FTSE).

Developed countries, as of the September 2008 FTSE classification are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Singapore, South Korea, Spain, Sweden, Switzerland, United Kingdom and United States.

Developed markets are generally considered to be larger and more established, and are perceived to be less risky investments. The remaining countries are broken down into emerging markets then sub-categorized as advanced, secondary and frontier emerging markets with varying levels of size, gross domestic product (GDP), liquidity and populations. They include countries like Brazil, Vietnam and India. These markets are considered to be less liquid, less developed and more risky in nature. Like the stock markets, there are bond markets in some but not all of these countries. They are dominated by government-related issues as corporate bonds are issued far less frequently outside of the U.S. (To learn more, read *Evaluating Country Risk For International Investing*.)

The Benefits of International Investing

There are two major benefits of adding international asset classes to a portfolio of U.S.–based investments: the potential to increase total return and the potential to diversify the total portfolio. The potential to increase total returns is evident because U.S. stocks underperform international markets in most periods.

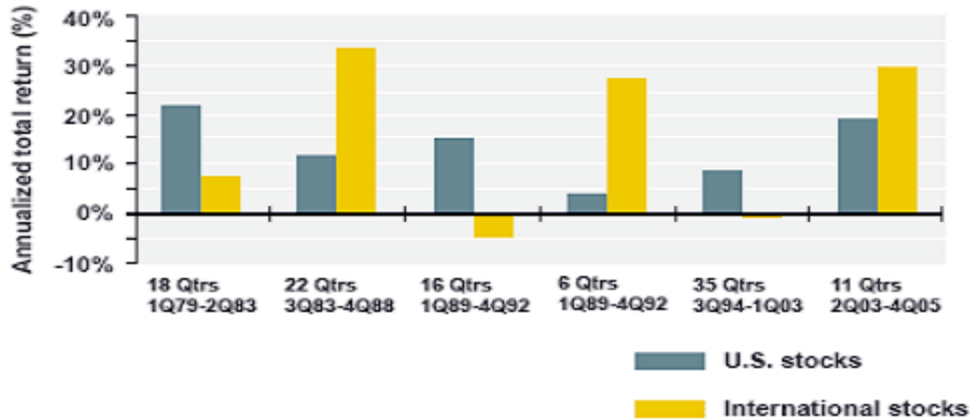

Figure 1: Regional returns are cyclical: U.S. vs. international stock performance.
Source: Schwab Center for Investment Research with data provided by Ibbotson Associates.

Figure 1 shows how international stocks have outperformed U.S. stocks over various time periods. While this trend has reversed or changed direction during market movements, the long-term difference is obvious.

This brings us to the second concept of diversification: adding low correlated assets to reduce overall risk.

Figure 2: Three- year rolling correlation of monthly returns: U.S. and international stocks.
Source: Schwab Center for Investment Research with data provided by Ibbotson Associates.

Figure 2 represents the long-term correlation of non-U.S. assets to U.S. assets. While the evidence is clear, most people who practice the concept of diversification with international assets are probably not aware of the recent changes in correlation. Constructing a portfolio by combining international and U.S. assets has historically produced return patterns resembling lower risk as defined by standard

deviation. Historically, adding as little as 10% in non-U.S. assets to a U.S.-based portfolio can reduce the standard deviation of the total portfolio by 0.7-1.1% over a five-year periods. At first glance this may not be considered substantial, but when viewed over long time periods, there is compelling evidence to suggest a long-term commitment to non-U.S. assets. (To learn more, read *Understanding Volatility Measures*.)

The Downside of International Investing

Most readers may want to stop here or cover their eyes, and remain with the strategy they already have in place. It sounds good, makes sense and has worked in the past, so why read on? The answer lies in the far right side of Figure 2 and the changes in correlation over time. Yesim Tokat, Ph.D., an analyst with Vanguard's Investment Counseling & Research group, authored a paper titled "International Equity Investing from the European Perspective: Long-Term Expectations and Short-Term Departures" (October, 2004). His research calls into question the perceived benefits of diversification with international investments.

Targeting short time periods and recent trends make a decent argument to exclude these assets unless they are adding higher returns without a significant increase in risk. This research can be easily picked apart by criticizing the short-term focus of the time frames.

What is really compelling about this research is that during bear markets, international investing has produced higher returns and has failed to reduce volatility. During bull markets, international investing has increased diversification rather than leading to higher returns as seen in Figure 3. (To learn more, read *Digging Deeper Into Bull and Bear Markets*.)

January 1973–June 2004

	Bear		Bull	
Market	Average	Volatility	Average	Volatility
Europe	–30.20%	19.48%	27.52%	13.23%
United States	–24.52	21.91	25.23	16.87
Pacific	–22.40	20.37	22.78	20.16
60% Europe/30% U.S./10% Pacific	–27.72	18.64	26.36	12.49

Figure 3: Annualized performance of international equities in European bear and bull markets.
Note: All returns are in synthetic euros
Source: Thomson Financial Datastream

This ties directly to the increase in correlation of asset classes, but does not necessarily tell us why. Theories are varied and most reference the globalization and integration of international markets.

Conclusion

Modern portfolio theory has defined investment strategies for both institutions and individuals since it was first presented. Constructing a portfolio of non-U.S.-based assets, particularly in developed stock markets, has both increased total returns and decreased volatility. There has, however, been a trend of increased correlation between the U.S. and non-U.S. markets. This increase in correlation has called

the concept of diversification into question. Research focusing on short time periods and bull and bear markets has caused a chink in the armor. It can be argued that short time periods only exist for now and the historical trends will prevail. It is important to take note of the increase in correlations, which may be due to globalization and integration as a long-term trend. If it continues, history may have to be rewritten. (To learn more, read *Modern Portfolio Theory: An Overview*.)

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Michael Schmidt, CFA earned an MBA from Loyola University of Chicago and is a Chartered Financial Analyst. Mr. Schmidt contributes to the CFA Institute as part of the Educational Advisory Board helping shape future CFA exams and has been part of the annual grading team since 2001. He has spent 20 years working for management and consulting fields, such as William M. Mercer, INDATA and Coastal Asset Management. His roles there included asset allocation and integration of pension investment assets. As an analyst at Mellon Bank, Northern Trust and Evergreen, he provided buy side research while publishing reports on various buy side sites like Dutton, Investrend and InvestSource. He has also managed investment portfolios for the institutional and the ultra high-net-worth arena with specialties in value and quantitative equity styles and multiple fixed income strategies. Mr. Schmidt is currently working for the NASD (now FINRA) Dispute Resolution Board as an arbitrator, chairperson and professional mediator. He has also testified as an expert witness for claimants/plaintiffs and respondents/defendants. Mr. Schmidt also consults to the website Invest Safe as an expert witness. You can contact Mr. Schmidt through this page or locate his consulting services on www.liveperson.com

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