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Is International Investment Diversification Prudent for the Individual or Corporate Investor?

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Abstract

This paper examines the benefits of international diversification for the individual and corporate investor and attempts to determine whether international diversification is prudent. Although research supports as well as refutes the claim that international diversification improves performance, results vary due to the non-static nature of national markets' returns, standard deviations, and correlations. As a result, data for the research are dependent on the period of study. As global markets have become more synchronized and US equities have had an unusual increase in value recently, studies relying on newer data argue against the benefits. However, because domestic investing limits diversification potential, international diversification is prudent for long-term investors.

JEL Codes: G11, G15, G23

Keywords: International, Diversification, Prudent, Investors, Corporate Investors

Introduction

For many years, US investment professionals and academics have extolled the virtues of international diversification. Due to the difference in national market correlations and opportunities, diversifying internationally should enable investors to reduce portfolio variance and enhance returns, thereby improving overall performance.

As performance is determined by three variables – return, standard deviation, and correlation – the instability in each of these variables generates inconsistency when measuring the benefits of international diversification. As US investors began actively investing abroad to improve diversification, correlations between foreign national markets and the United States have increased. In the 1970s, rolling 3-year correlation between the S&P 500 and the MSCI World Index (ex US) ran between 0.4 and 0.5. In the 1980s, the correlation moved up to between 0.5 and 0.6. In the 1990s, the correlation had increased to between 0.6 and 0.7. For the last 10 years, correlation has averaged above 0.9.[1] In addition, the US equity markets have experienced outsized performance when compared with other national indices. Consequently, the wisdom of diversifying into foreign markets has been questioned; in addition, due to recent studies that contain this data, conclusions have been drawn against international diversification. However, the body of long-term research supports prudence in diversifying internationally.

Discussion

Although the US economy is the largest on the globe, it does not represent the full extent of investment opportunities. Morgan Stanley's global equity benchmark, the MSCI ACWI Index, composed to eliminate home bias, has a weighting to US equities of 52%[2]. Investors recognize the limitation of domestic-only investing and have been actively investing abroad for some time. In 2005, Strauss (2005) noted that US investors invested more in international and global funds than in US-focused funds. After a pause during the Great Recession, the trend has continued. According to Schwab[3], net inflows into ETFs during 2017 were 5% to the United States, 20% to international developed markets, and 16% to emerging markets.

[1] Source: Standard & Poor's

[2] Source: MSCI https://www.msci.com/documents/1296102/1362201/MIS-ACWI-brochure-2017.pdf/e23b68bf-5d62-4ac0-8f5b-4ba783789aa5

[3] Source: Schwab https://www.schwab.com/resource-center/insights/content/what-are-fund-flows-telling-us-about-trends-and-risks-in-the-global-stock-market

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As Jeff Everett, Templeton's Chief Investment Officer, noted (Ross, 2001) many of the world's largest companies are located outside the United States. As a result, investing solely in the United States means missing many potential opportunities. In addition, beyond the United States and other developed markets, emerging markets may offer better growth opportunities. Many developed markets are aging, and growth trends have slowed; whereas, some developing countries are experiencing dramatic growth (Mueller & Ball, 2006).

As developing countries need high levels of investment to fund this growth, the demand for securities and all kinds of financial claims remains high (Bartram & Dufey, 2001). This demand creates investment opportunities not available in the United States.

For individual investors, investing internationally theoretically offers increased diversification and, therefore, should be prudent. Beyond expanding potential growth opportunities, national markets generally do not move in tandem. This lack of perfect correlation enables investors to reduce portfolio volatility. Combining lower variance with better growth opportunities allows for improving risk-adjusted returns.

While investing abroad may widen growth opportunities and broaden diversification, it also increases risk. Risks involved in international investing include increased costs, foreign exchange controls, weak or inconsistent laws regarding property rights, taxes, inadequate regulations regarding security trading and ownership, and insufficient laws regarding disclosure. Many of these issues can be surmounted based on today's varied means of investing, and some of these constraints can actually offer opportunity. For example, in the markets where information is lacking, having good intelligence offers investors an advantage.

For corporate investors, the benefits and risks are not the same; however, they are not too dissimilar. International diversification for corporate investors means investing in businesses outside of the United States. The benefits offered to companies for investing abroad include hedging currency risk, reducing national systematic risk, lowering taxes, reducing political risk, and expanding into different markets. The risks include increasing managerial difficulties, increasing costs, and increasing political risks. To note, political risk is mentioned as both a potential benefit and risk; and for many companies diversifying in certain countries, this is the case. Take the Las Cristinas Mine in Venezuela, for example. Before Crystallex International Corp, a Canadian company, received any mining concessions, it had to form a joint venture with Venezuela's state-owned mining administrative entity, Corporación Venezolana de Guayana. Without this partnership, Crystallex would not have had access to the mine's riches. However, having business interests in Venezuela makes the company vulnerable to expropriation, as we have witnessed with ConocoPhillips, IDC, and Flughafen Zürich, to name a few.

Analysis

For both individual and corporate investors, the basic rule of diversification – improve risk-adjusted returns – should apply for international diversification. Prudent investing dictates broad diversification, because it lowers risk and stabilizes returns. This theory should hold true for diversifying internationally, and many studies agree, but there are also studies that disagree, making it difficult to form a decisive conclusion. Research results are time dependent and, therefore, vary.

For corporate investors, studies showing the benefits of international diversification include research by Agmon and Lessard (1977). They examined valuations of US firms listed on the NYSE and found investors benefitted from international diversification because multinational companies enjoyed better valuations than the single country companies did. Bolstering their conclusions, Markides and Ittner (1994) analyzed 276 US firms from 1975 to 1988 and found that international acquisitions created value for the acquiring company. Dos Santos, Errunza, and Miller (2008) echo Markides and Ittner's results in their research. They analyzed cross-border acquisitions by US companies from 1990 to 2000 and found significant valuation creation due to the acquisition.

However, Krapl's more recent research (2015) refutes the previously cited studies. Krapl examined the effects of corporate diversification on risk and found that

international diversification increased earnings and equity risk. He also found the lack of correlation did not provide any benefits for lowering volatility in cash flows.

Table 1[4] illustrates the difference in correlations in the world's largest developed markets. It also highlights how correlations vary over time.

[4] Source: Morningstar Direct

Table 1

Jan 2008–Dec 2002	*CAC 40*	*FSE DAX*	*FTSE 100*	*MSCI Japan*	*MSCI North America*
CAC 40	1				
FSE DAX	0.919795	1			
FTSE 100	0.842972	0.80972	1		
MSCI Japan	0.496100	0.47395	0.49136	1	
MSCI North America	0.768724	0.77299	0.84337	0.49889	1
Jan 2003–Dec 2007	CAC 40	FSE DAX	FTSE 100	MSCI Japan	MSCI North America
CAC 40	1				
FSE DAX	0.936057	1			
FTSE 100	0.784582	0.75755	1		
MSCI Japan	0.501805	0.44732	0.45857	1	
MSCI North America	0.786522	0.80551	0.73635	0.42253	1
Jan 2008–Dec 2012	CAC 40	FSE DAX	FTSE 100	MSCI Japan	MSCI North America
CAC 40	1				
FSE DAX	0.907283	1			
FTSE 100	0.914208	0.85464	1		
MSCI Japan	0.719648	0.70997	0.71974	1	
MSCI North America	0.881881	0.85834	0.89765	0.72306	1
Jan 2013–Dec 2017	CAC 40	FSE DAX	FTSE 100	MSCI Japan	MSCI North America
CAC 40	1				
FSE DAX	0.854396	1			
FTSE 100	0.892895	0.80474	1		
MSCI Japan	0.595940	0.59014	0.54369	1	
MSCI North America	0.835193	0.79922	0.90453	0.52276	1

As illustrated in Table 1, over the 20-year period, the correlation between the CAC and DAX Indices declined; whereas, the correlation between the DAX and MSCI Japan Indices increased. Also, during the period encompassing the Great Recession, a time of increased market stress, from January 2008 to December 2012, correlations moved closer to 1.

For individual investors, although correlations between US equities and equities outside the United States have steadily risen since the 1970s, thereby reducing the benefits, the lack of perfect harmonization still enhances diversification. Even though international trade has increased and national economies are more interdependent, differing economic cycles still exist. Although systematic risk is undiversifiable within a country, it may be nonsystematic and diversifiable when international markets are considered. National stock markets vary in return and risk. In general, emerging markets offer higher return and risk than developed markets. Table 2[5] highlights the difference in returns and risk in the major developed markets over the last 3 years. It provides 3-year price returns and standard deviation from February 1, 2015 through January 31, 2018 for the indices in Table 1.

[5] Source: Morningstar Direct

Table 2

	Annualized Return	*Standard Deviation*
CAC 40	5.99	14.44
FSE DAX	4.44	16.96
FTSE 100	3.73	10.14
MSCI Japan	7.77	16.27
MSCI North America	11.58	10.03

Asness, Israelov, and Liew (2011) analyzed national indices around the globe from January 1950 to December 2008. Their research demonstrated the difference in country-specific economic performance over the long-term protects investors against the negative effects of a single market. International diversification improves portfolio performance, even though during times of crisis, correlations among markets become more synchronized.

In addition to the difference in return and risk, the differences in valuations of equity markets can provide opportunities not available through domestic investing. At the end of 2017, the S&P 500 had a 12 month forward looking P/E ratio of 18. Small capitalization US stocks had a P/E ratio of 25. On the other hand, international developed stocks had a P/E ratio of 15 and emerging market stocks had a P/E ratio of 13[6]. Consequently, foreign markets may offer more opportunity than the US market for equity investors simply because foreign markets are cheaper.

Booth and Fama (1992) analyzed portfolios with a 10% exposure to international stocks from 1971 to 1991. By deconstructing the compounded returns of the portfolio into the contributions of each asset, and calculating the difference of this contribution from the asset as a stand-alone, they were able to calculate the diversification benefits. What they found was that international stocks provided a significant diversification benefit to the performance of the portfolio.

Abid, Leung, Mroua, and Wong (2014) studied mean variance optimization and stochastic dominance for international and domestic diversification taken from a US investor's point of view and obtained less compelling results. Their study, which included the 30 largest market capitalization stocks in the United States along with 20 international market indices from 1993 to 2012, found domestic diversification outperformed international diversification at lower risk and vice versa at higher risk levels. Their stochastic dominance test, however, did find some internationally diversified portfolios dominated domestically diversified portfolios at lower risk levels.

Research from McDowell (2017) contradicts the theory of international exposure improving diversification and provides data demonstrating no performance benefit. For the period from 1988 to 2014, he found that naïve international diversification did not lower risk or provide better risk-adjusted returns.

Looking at the major developed markets since the turn of the century seems to corroborate his results. Naïve international diversification from January 2000 through December 2017, obtained by equally weighting the indices presented in Tables 1 and 2, would not have provided better performance for US investors. The returns, standard deviation, and Sharpe ratios of a portfolio composed of equally weighting the CAC 40, FSE DAX, FTSE 100, MSCI Japan, and MSCI North America Indices is shown in Table 3[7], along with the same data for each individual index.

Table 3

Name	*Return*	*Std. Dev.*	*Sharpe Ratio*
International Diversification	1.37	16.73	0.07
Paris CAC 40	-0.58	17.53	0.02
FSE DAX	0.74	20.86	0.13
FTSE 100	0.31	13.59	-0.03
MSCI Japan	0.25	17.76	0.10
MSCI North America	3.12	14.37	0.26

As highlighted in Table 3, the internationally diversified portfolio performed significantly worse than the MSCI North America Index. In fact, the internationally diversified portfolio's performance was in the lower half of the group.

To be sure, this period includes an unusual stint for American stocks. With the 22% return in 2017, the S&P 500 has provided a positive return for 9 consecutive years.

[6] Source: J.P. Morgan Asset Management Weekly Recap U.S. January 2, 2018

[7] Source: Morningstar Direct

Since 1926, this has only happened one other time – in the 1990s. In addition, US equity markets have exhibited very low volatility. Since its inception in 1990, the CBOE Volatility Index has never had a less volatile year than 2017.

For bond investors, studies support the theory of improved diversification through international exposure. Levy and Lerman (1988) analyzed the bond market from 1960 to 1980 and discovered that US investors who diversified internationally would have earned twice the rate of return of US investors investing domestically without an increase in risk. Supporting their results is the work conducted by Jorion. Jorion (1992) created a mean variance optimized portfolio composed of the United States and foreign bonds over the 1978 to 1988 period. He found that the mean variance portfolio did not outperform the world index but significantly outperformed the US index.

Conclusions

The benefits of international diversification are, in many respects, similar to the benefits of diversifying portfolios by adding exposure to commodities (Cheung & Miu, 2010) or real estate (Case, 2016). In some periods, the benefits to portfolio performance are apparent; in other periods, the benefits are more difficult to discern. Much of the difference is due to the length of the study or the period in which the research was conducted. Correlations, volatility, and returns are not static and vary over time. As a result, the benefits of diversification shift and underperformance from time to time will occur. Recent performance has been affected by the increased relationship in the movement of global equity markets. Correlations for US stocks with foreign stocks has increased over the last 40 years and will probably remain higher than in the past due to increased international trade and capital flow. Subsequently, the benefits of international diversification will be reduced. In addition to increased synchronization, the US markets have had strong performance since the Great Recession; therefore, studies using recent data cannot prove a benefit. However, without perfect omniscience, determining when to diversify and when not to diversify internationally is impossible.

We know that the US market comprises roughly half of the world's total market capitalization; therefore, half of the investment opportunities reside outside of the United States. Consequently, constraining investment to the US market constrains diversification. As a result, broader diversification via foreign exposure has a higher probability of enhancing portfolio performance than domestic diversification alone, over the long term. As a result, international diversification for individual and corporate investors is prudent.

Recommendations

Long-term investors should invest internationally to broaden diversification, but investors need to be mindful that the benefits do not always exist. In addition, international investing can increase costs and risks. Foreign exchange controls, regulations, transaction costs, and taxes can diminish returns. In addition, currency, lack of liquidity, and political risks have to be addressed.

To gain international exposure, investors have several options (Adams, 2002). First, investors can invest directly though foreign bourses. For most investors this method is difficult because it involves additional research and resources, dealing in foreign currencies, and working in different time zones. Investors can gain access to many foreign companies through ownership of American Depository Receipts (ADRs). ADRs trade like US stocks on American exchanges, but access to information still needs to be addressed. Investors can also gain international exposure via mutual funds or exchange traded funds that invest overseas. This method shifts the issues of access to information, working in different time zones, etc., to the fund company. The downside to this method is that fund companies charge a fee for this service. Finally, investors can invest in domestic companies that conduct a substantial amount of business abroad. This method reduces some of the benefits but is the easiest for investors.

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