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For use by investment professionals.

The Case for Global Investing

As U.S. stocks have outperformed developed international and emerging-markets stocks in recent years, we’re starting to hear more people question the benefit of investing outside of the United States. This is an important question, and we acknowledge that owning foreign stocks has been an unsatisfying experience over the past couple of years. Moreover, given some of the current economic and geopolitical forces, it can appear likely to continue this way.

The first key point is to remember that equity markets and asset classes in general go through cycles and it is unwise to extrapolate recent performance trends far into the future (as we see many investors doing). Furthermore, investors often suffer from extreme overconfidence that they can predict these shifts and correctly time their buys and sells accordingly (data show actual investor returns lag indexes by hundreds of basis points due to timing errors).

As an example, we were hearing the same question back in the late 1990s/early 2000s after U.S. stocks enjoyed a similar streak of outperformance over international stocks. As shown in the chart at right, in the market cycle that followed from 2002–2007, international stocks trumped U.S. stocks by a wide margin, and emerging markets did even better, outperforming the S&P 500 by more than 20 percentage points annualized.

Because markets move in cycles, there will always be periods where global diversification doesn’t appear to “work.” In our view as long-term investors, the case for global investing remains compelling and extends beyond the simple matter of capturing returns as market leadership rotates.

The Role of Global Investments in our Portfolios

We have investments outside the United States as part of our very long-term or strategic allocations, which are the starting point for our investment process. These allocations are intended to be an appropriate blend for a long-term investor as they reflect the mix of core asset classes we believe offer the best long-term return potential for a given level of risk. In keeping with this objective, the equity portion of our strategic allocation is globally diversified and weighted 60% U.S. stocks, 20%...
developed international, and 20% emerging markets. Accessing this broad opportunity set, we believe, improves our ability to generate competitive returns and to manage risk over our longer-term investment horizon.

**Broader Opportunity Set**

Holding a globally diversified portfolio enables us to access a much broader investment opportunity set, which should, in turn, enhance portfolio performance over time. This is the most important reason for maintaining exposure to global markets. In 1970, U.S. GDP accounted for 47% of the world’s total economic output (GDP). Today it is closer to 20%, while emerging markets now comprise roughly half the world’s total output. Likewise, in terms of stock market capitalization, in 1970 the U.S. market comprised 66% of the world’s total stock market value. By 2013 it had declined to roughly 49%, with emerging markets comprising 11%, and the remainder in developed international markets. In other words, businesses around the globe are launching, innovating, producing, and growing, and their stocks have the potential to grow as well. If an investor chooses to only invest in U.S. stocks, they are excluding themselves from over half of the world’s total investment opportunity set. Moreover, they are limiting their opportunity to invest in what we believe are some of the world’s most attractive companies domiciled outside the United States.

We can also point to several factors that, in our view, support the case for continued strong relative economic growth for emerging markets in particular. A high proportion of the world’s population is in rapidly developing economies and these are becoming a more significant force in the global economy. Emerging markets will likely derive similar productivity benefits as the developed world did through its industrialization over the past two centuries. However, this productivity improvement in emerging markets is happening at a more rapid rate, we believe, in part due to the adoption of Internet and communications technologies developed in the 1990s.

In addition to the prospects of better productivity, we see emerging-market economies in general as less encumbered by debt than the developed world. Moreover, in general their demographics are more favorable for growth (populations that are in general larger, underutilized, and younger). These forces support the idea that emerging-market economies are likely to grow at a superior rate relative to developed markets economies for an extended time period. In the short term, superior economic growth does not necessarily mean strong emerging-markets earnings or stock-market returns but over the very long term we believe it is a strong positive for both and an opportunity we want to capture for our clients.

**Diversification**

A second important reason for owning a globally diversified portfolio is that it should provide a much smoother ride than just being invested in U.S. stocks alone. By diversifying investments across different asset classes and securities that react differently to market and economic conditions investors are able to effectively reduce overall portfolio risk and volatility over time. This is the broad goal of portfolio diversification. We believe this concept extends to the equity allocation of a portfolio and that a diversified global equity allocation should produce better longer-term risk-adjusted returns than the stocks of any single country held in isolation.
This has been the case historically as shown in the chart below, which extends back to 1970 when data for the developed international market index begins, and incorporates emerging markets starting in 1988 when their index returns became available. Looking at rolling 10-year periods, the global portfolio (comprised of 60% S&P 500 and 40% non-U.S. stocks) generated an average return of 12.5%, beating the S&P 500’s average return of 11.3%. (The results were similar using rolling five-year periods.) Moreover, the global portfolio beat the S&P 500 in 71% of the rolling 10-year periods (there are 420 such periods going back to 1970).

Countries around the world are in different stages of their economic and market cycles, and at any given time one particular market can and will outperform others. Consistently predicting which market will outperform, and more importantly getting the short-term timing right, is impossible. If an investor concentrates their exposure in only one market—even if it’s the U.S. market—they run the risk of that market undergoing an extended period of underperformance that could have a lasting negative impact on their portfolio. And human nature is such that most people also won’t be able to stand being heavily invested in an underperforming market for too long. This discomfort may lead them to sell in disgust at low prices and chase the recent country market winners, probably just as those markets approach their highs for the cycle.

That is why diversification—consistently owning a variety of asset classes, strategies, and managers that should perform differently depending on the environment—enables us to create portfolios that should perform at least reasonably well across a wide range of possible scenarios and outcomes. But it takes discipline to be a long-term diversified investor, because any given asset class can lag in any given year or even over multiple years, and with 20/20 hindsight it is easy to start questioning why you owned those particular assets in the first place.

**Valuation Matters**

In addition to our belief in the long-term benefits of investing globally, we also believe that valuation matters and is a key component of future market returns—and future returns are all that matter from this point forward. Therefore, there are times when it makes sense to over- or underweight markets or asset classes to tilt the odds of success more in your favor. So today’s popular argument that Europe and Japan are economic basket cases and that emerging-markets companies face risks that U.S. companies don’t face doesn’t necessarily mean there aren’t compelling investment opportunities in...
those markets. Depending on a company’s stock market valuation relative to its business fundamentals and future earnings potential (i.e., the price you are paying in the stock market to capture the potential value of that particular investment) the expected returns for many companies in those non-U.S. markets may more than compensate an investor for those types of risks. Whereas even if the United States is the strongest and most stable economy in the world, that doesn’t mean its stock market offers the best risk/return profile right now.

As we said at the outset, the first key point of global investing is to remember that equity markets and asset classes in general go through cycles and it is unwise to simply assume that current performance trends will persist into the future. Global diversification only works when you stick with it all the time—you can’t pick and choose when you want to be diversified because you never truly know when you will need to be.

—Litman Gregory Investment Team

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