SPRING 2012

in Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE

Considering International Diversification

Last year was challenging for globally diversified stock portfolios. While the S&P 500 Index was up 2.1 percent in 2011, the MSCI EAFE Index, which is basically the international equivalent of the S&P 500, was down 12.1 percent. The MSCI Emerging Markets Index was down 18.4 percent.

So what lessons can we take with us from 2011? The most immediate lesson is to ignore forecasters no matter how intelligent they sound. Forecasting financial market movements is incredibly difficult. Some forecasts will be fulfilled while most will not. Moreover, over longer periods of time, we have scant evidence that anyone can successfully foretell financial market movements.

In the face of 2011 (and other years when international equities have underperformed U.S. equities), some pundits have been quick to dismiss the value of global diversification. Our view that investors should globally diversify is based upon a longer-term view of global diversification and the size of the international equity market compared with the U.S. equity market (profiled in the sidebar).

In a piece in the May/June 2011 issue of the *Financial Analysts Journal*, Cliff Asness, Roni Israelov and John Liew examined the long-term benefits of global diversification in their article entitled "International Diversification Works (Eventually)." They found that while local stock portfolios (described as portfolios in which an investor owns only home country equities) and globally diversified stock portfolios tend to perform similarly over shorter down-market periods, the advantage of global diversification begins to shine as the time horizon lengthens.

For example, they found that the worst five-year holding period returns for locally diversified stock portfolios averaged –57 percent while the globally diversified stock portfolios lost 39 percent during its worst five-year period. While both lost substantial amounts (which is expected because this analysis looked at the worst five-year holding period returns for each portfolio), this shows that global diversification significantly lessened the size of the loss.

The other primary finding of this study is that globally diversified stock portfolios tend to do relatively well over longer holdings periods when local portfolios are doing poorly. During the periods of the worst five-year losses for the local portfolios, the globally diversified stock portfolios lost only 16 percent, mitigating the risk of the investor's home country stock market.

One other data point illustrating the long-term value of global diversification is the historical returns of U.S. stocks and international stocks. Over the period of 1970–2011, the average annual returns of the S&P 500 and the MSCI EAFE were 11.3 percent and 11.3 percent, respectively. So over the longer term, we have seen almost identical returns to U.S. and international stocks.

Instead of focusing solely on the short term (such as looking at 2008 or the third quarter of 2011), investors should view international diversification as a long-term addition to their portfolio. As research has found, over longer holding periods, a globally diversified stock portfolio tends to experience less severe losses than a local stock portfolio and tends to do relatively well when a local stock portfolio is doing poorly.

Global Equity Markets

One reason for global diversification in a stock portfolio is the amount of the world's stock market value that is now located outside of the United States. In past decades, the United States represented more than 50 percent of the value of the world's stock markets. That is no longer the case.

As of March 2012, the U.S. stock market represented just 46 percent of the value of the world's stock markets. Developed market international stocks represented 41 percent of the world's stock market value, and emerging market stocks represented 13 percent. Thus, an investor who chooses to invest in only U.S. stocks is ignoring 54 percent of the value of the world's stock market.

Because investors have collectively assigned a great value to international and emerging stock markets, it is not prudent for U.S. investors to ignore more than half of the value of the world's stock markets. Having exposure to the entirety of the world's stock markets is a more defensible strategy.

The Good Old Days?

By Jim Parker

While not seeking to downplay the very real anxiety generated by global events that took place in 2011, particularly in relation to their effects on investment portfolios, it's worth reflecting critically on our often secondhand memories of the "good old days."

A brief review of the history of the 20th century would be dominated by world wars, civil wars, pandemics, natural and nuclear disasters, terrorist attacks, and economic crises in the way of labor shortages, the failure of monetary systems and financial crises.

Taken in sum, it seems fairly clear that tragedy and uncertainty will always be with us. But the important point to take away from it is that previous generations have stared down and overcome far greater obstacles than we face today. And while it is easy to focus on the bad news, we mustn't overlook the good either.

Alongside the wars, depressions and natural disasters of the past century, there were some notable achievements for humanity — like women's suffrage, the development of antibiotics, civil rights, economic liberalization, the spread of prosperity and democracy, space travel, advances in our understanding of the natural world, and enormous advances in telecommunication. (Oh, and the Beatles.)

Today, while the United States and Europe are gripped by tough economic times, much of the developing world is thriving. Populous nations such as China and India are emerging as prosperous nations with large middle classes. And smaller, poorer economies are making advances too.

The United Nations in the year 2000 adopted a Millennium Declaration that set specific targets for ending extreme poverty, reducing child mortality, and raising educational and environmental standards by 2015. In East Asia, the majority of 21 targets have already been met or are expected to be met by the deadline. In Africa, about half the targets are on track, including those for poverty and hunger.

Alongside these gains, new communications technology is improving our understanding of different cultures and increasing tolerance across borders while providing new avenues for the spread of ideas in education, health care, technology and business.

Through forums such as the G20 and APEC, international cooperation is increasing in the field of trade, addressing climate change and lifting the ability of the developing world to more fully participate in the global economy.

Rising levels of education and health and work force participation also mean the foundations are being built for a healthier and peaceful global economy, dependent not on debt, fancy derivatives and fast profits but on sustainable, long-term wealth building.

Anxiety over recent market developments is completely understandable, and it is quite human to feel concerned about events in Europe. But amid all the bad news, it is also clear that the world is changing in positive ways that provide plenty of cause for hope and, at the very least, gratitude for what we *already* have. These are ideas to keep in mind when we scan the news and long for the "good old days."

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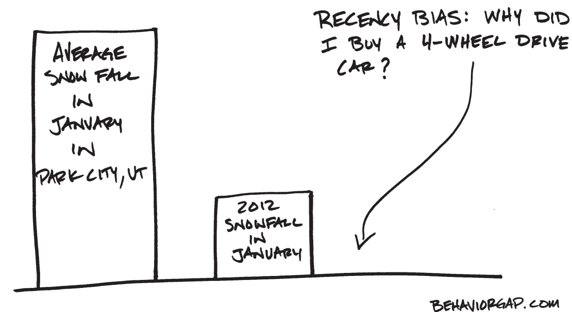
Perspectives

Perspectives features different topics of interest that offer viewpoints on improving quality of life. This quarter, Carl Richards, author of *The Behavior Gap: Simple Ways to Stop Doing Dumb Things With Money* (2012), discusses why tomorrow's market probably won't look anything like today's. The following was featured February 13 in *The New York Times'* Bucks blog on NYTimes.com.

Every day we rely on habit to get a lot of things done. We commute the same way to work every day, we eat at the same restaurants and we shop at the same stores. We rely on habit to help us make things easier because few people want to reinvent their lives every day. But this habit of forming habits also does something else. In academic circles, it's called the recency bias, and it can trick us into making decisions we might not make otherwise.



The recency bias is pretty simple. Because it's easier, we're inclined to use our recent experience as the baseline for what will happen in the future. In many situations, this bias works just fine, but when it comes to investing and money it can cause problems.

When we're watching a bull market run along, it's understandable that people forget about the cycles where it didn't. As far as recent memory tells us, the market should keep going up, so we keep buying, and then it doesn't. And unless we've prepared for that moment, we're shocked and wondered how we missed the bubble.

When the market is down, we become convinced that it will never climb out so we cash out our portfolios and stick the money in a mattress. We ***know*** the market isn't going back up because the recency bias tells us so. But then one day it does, and we're left sitting on a really expensive mattress that's earning nothing.

The point isn't that you should have predicted the timing of the bubble or the upswing but that you should have considered both possibilities as potential outcomes and planned accordingly. Instead of taking the long view and considering as many factors as possible (the market goes up AND down), we settle into a rut and keep behaving as though nothing will ever get us out of it.

Being prepared and recognizing that the bias exists costs very little. I think of it like the winter weather kit anyone who lives in the mountains should keep in their car. Even though I've never been stranded traveling in the winter, I know I should have a kit in the car with water, food and other stuff to help me survive if I do. We've got to get over this idea that because something has never happened (not in the last six months anyway) that it won't happen in the future.

All things considered, it's pretty easy to put some plans in place to help see us through the ups and downs. So quit letting yesterday be the only thing to determine what you do tomorrow with your money.

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