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Non-U.S. Equities: Why We're Always Invested

AFTER MORE THAN A DECADE, IT'S EASY TO FORGET THE BENEFITS OF OWNING NON-U.S. STOCKS

It's well known that the potential return and ongoing risk in a portfolio is a function of its asset allocation and diversification decisions. The combination of these strategies provides both the possibility of growth and potential protection against loss. Holding a broad range of investments helps lessen the impact that one underperforming asset or asset class can have on the portfolio.

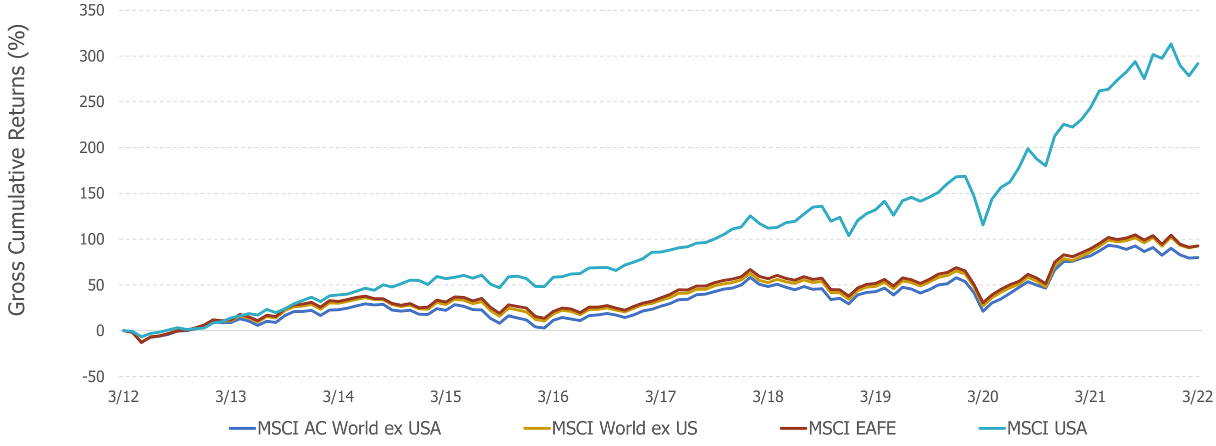
That's not to suggest that anyone will be comfortable when a portion of his or her portfolio underperforms. Especially if those losses persist over a long period of time.

To say that non-U.S. stocks, long an important component of smart asset allocation design, have failed to keep pace with U.S. stocks would be generous. From the beginning of 2012 to the end of 2021, the MSCI USA Index has routed the MSCI ACWI ex USA Index, and not by a small amount.

IT'S BEEN HARD TO BEAT THE U.S.

While it's true that exchange rates can have a big impact on dollar-denominated returns, very little of this nine-year performance gap can be attributed to currency movements. The difference is even more fundamental: It's earnings.

U.S. markets have outperformed non-U.S. markets by a wide margin in the last 10 years



Source: FactSet. As of March 31, 2022

The superior performance of U.S. companies, particularly those in the technology sector, has been mostly due to earnings-growth rates much higher than those of non-U.S. companies.

U.S. companies across the board have outperformed their overseas counterparts in every sector. Beyond tech stocks, non-technology companies including those from the financial, health care, and communication-services sectors, have traded higher.

The outsized contribution of the U.S. technology sector cannot be overstated. Not only have technology stocks been among the best performers of the past decade, but they represent a meaningfully larger share, about 12%, of the U.S. market than non-U.S. markets.

NOTHING OUTPERFORMS FOREVER

In this environment, who can blame investors for wanting to minimize their allocation to non-U.S. equities, maybe even avoid the asset class altogether. After all, we tend to hold a much larger allocation to our country of residence, the so-called "home-country bias", even in normal markets. But failing to look at shares of non-U.S. companies overseas, regardless of a performance gap, overlooks the benefit of complementary assets — securities that might speed up when the U.S. eventually slows down. And we can say with certainty that U.S. equities won't outperform forever.

Over the past four-plus decades, stock market leadership has alternated between U.S. and non-U.S. equities several times.

Risk Reduction at a Minimal Cost
01/31/1970 - 03/31/2022

Description	Annualized Return	Annualized Standard Deviation
MSCI USA	10.83	15.21
MSCI EAFE	9.22	16.73
67% MSCI USA / 33% MSCI EAFE	10.51	14.40

Source: FactSet

What's the benefit to diversification?
Reducing risk. By adding non-U.S. stocks to a U.S. equity portfolio, investors would have reduced risk by 0.81% and would have only given up 0.32% on their investment return from 1970 - 2022.

In fact, there have been lengthy periods of both outperformance and underperformance of U.S. stocks relative to non-U.S. stocks. Allocating to both asset classes still makes sense because it is impossible to predict which one will outperform in the future.

STILL A VALUABLE SOURCE OF DIVERSIFICATION

After this extended run of underperformance, it's easy to forget that an allocation to non-U.S. stocks still improves a total portfolio's expected risk-return profile versus a portfolio that includes only U.S. equities.

Said another way, holding securities in a variety of countries that react differently to market and economic conditions is still a benefit. By allocating to markets that experience downturns and upturns at different times and degrees than the U.S., investors can reduce overall portfolio volatility.

Bottom Line

Owning a diversified portfolio means that some assets will perform well while others don't. Over what has essentially been a one-way market for the last 10 years, allocations to non-U.S. stocks have been a relative drag on portfolio returns. But there is still a case to own them. Allocating to non-U.S. equities will eventually allow investors to take advantage of the potential periods of non-U.S. outperformance while gaining the benefits of diversification at the portfolio level. Remember, a market can't move in one direction forever.

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