SilverOak
WEALTH MANAGEMENT LLC

December 2019

Why Invest in Internationally Equities?

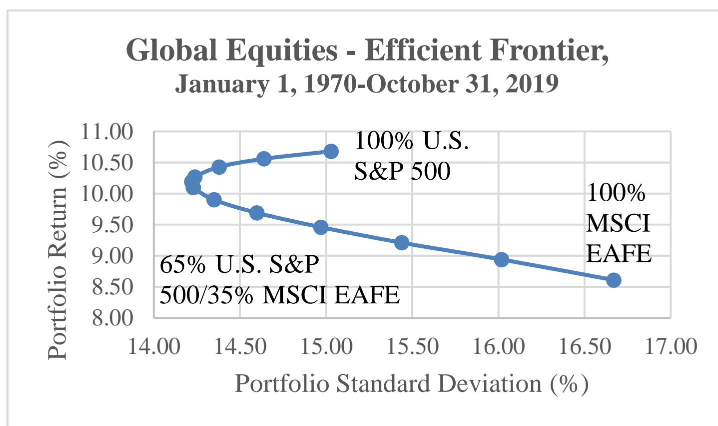
With U.S. equities outperforming seemingly year after year, many investors may wonder – why invest in international equities? After all, the U.S. has many of the best companies in the world and despite a polarized political environment, the U.S. remains one of the most stable democracies embracing capitalism in the world. However, there are many reasons U.S. investors should look internationally for a portion of the portfolio.

Casting a wider net

By including non-U.S. companies in a portfolio, you are able to broaden the opportunity set. Non-U.S. companies make up roughly 58% of the global market cap.[1] There are more than 46,000 non-U.S. public companies compared to 5,400 U.S. companies.[2] The U.S. currently only accounts for 25% of global GDP. [3] While investing in international companies may seem "foreign" to many investors, there are many companies headquartered outside the U.S. that are household names for U.S. investors, including Toyota, Adidas, Nestle, Anheuser-Busch InBev and Samsung. For investors seeking income, many international companies have higher dividends than their U.S. counterparts. Capital markets in most Asian countries are opening up to outside investment and are increasingly being included in global indices such as those created by MSCI and FTSE. Due to the large investment pool, international companies tend to be under-researched by investors and thus could be less-efficiently priced. While increasing the opportunity set does not automatically lead to better results, if you did not invest internationally, you may miss out on attractive opportunities.

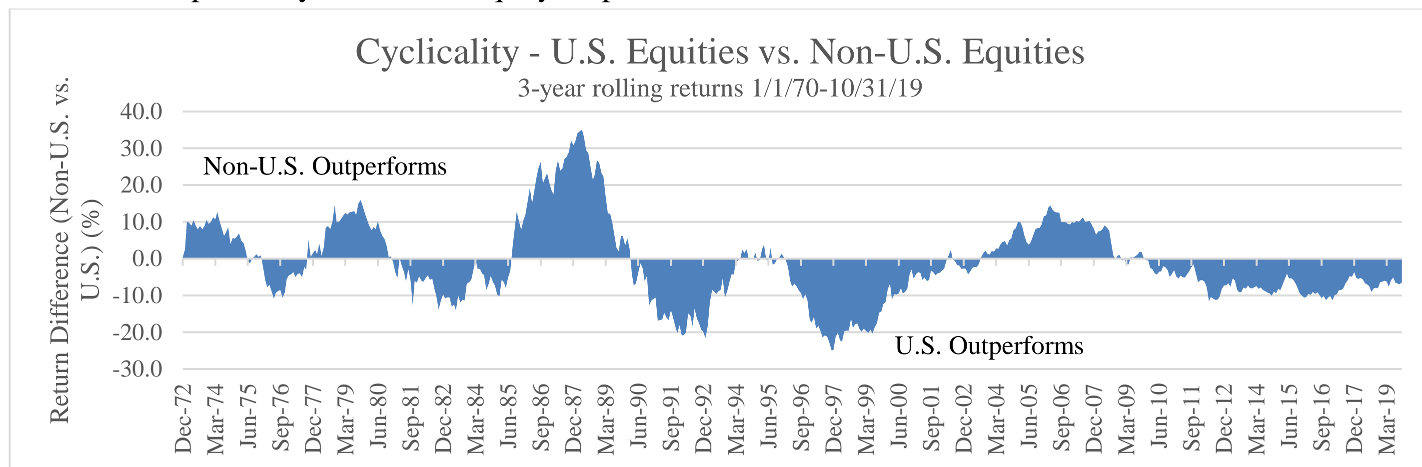
Diversification lowers risk

Diversification is a pillar of investing as it smooths returns and lowers volatility. An important rationale for including non-U.S. securities is that it reduces risk over the long-term. In the graph to the left, you can see that a mix of 65% U.S. stocks and 35% MSCI EAFE lowered volatility for the period of 1970 to 2019. Despite increased globalization of trade, countries around the world still have different economic cycles, fiscal and monetary policies, currencies, sector weightings and market dynamics. Thus, just as investors diversify amongst asset classes and investment styles, they should also diversify globally as part of their investment plan.



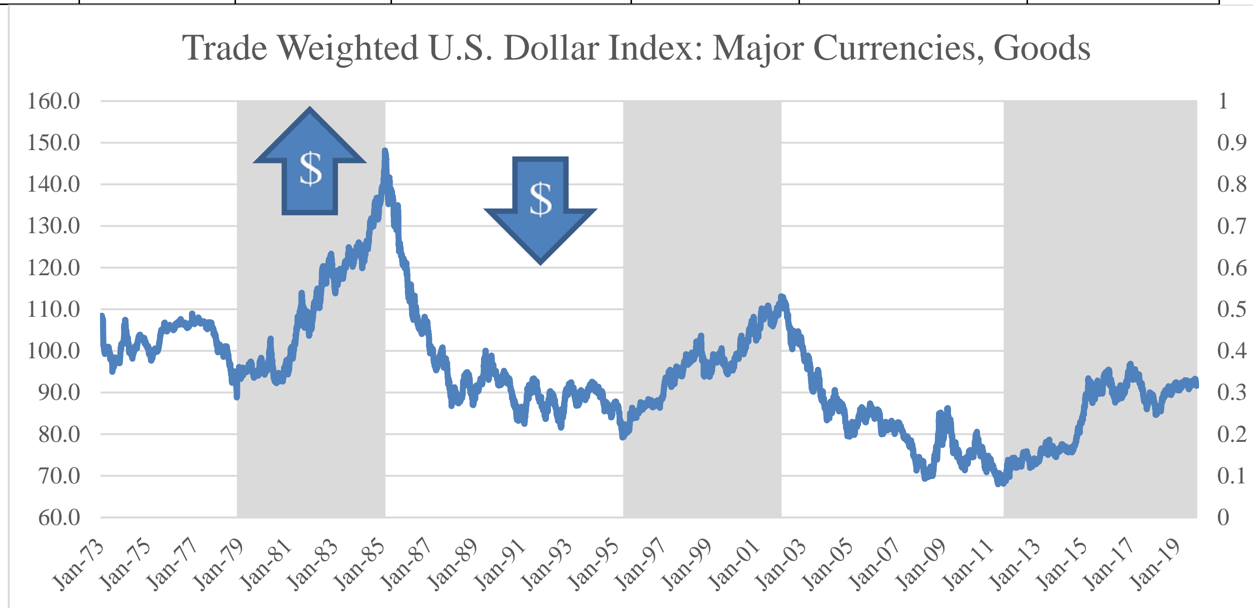
Markets are inherently cyclical

Like many relationships in the markets, there is a cyclicality between U.S. and non-U.S. equity performance. The U.S. hasn't always been the best place to invest. There have been many periods in which non-U.S. equities outperformed such as 2002-2007, 1985-1990, and much of the 1970s. The graph below shows the cyclicality of rolling return differences between the regions (3yr rolling – EAFE vs. S&P 500). Since 1970, over 10 year rolling periods, international equities have outperformed U.S. equities 48% of the time, even after the past ten years of U.S. equity outperformance



Currency plays a role in returns investors receive, and for the past seven-plus years currency has been a headwind for international equities as the U.S. dollar has appreciated. As shown in the graph below, currency tends to trade in multi-year trends. At some point, the current trend will reverse and provide a tailwind for international equities. However, currency impact tends to be neutral over the long-term.

	Cumulative Returns (%)					
	5/1/1971-10/31/1978	**11/1/1978-2/28/1985**	**3/1/1985-4/30/1995**	**5/1/1995-1/31/2002**	**2/1/2002-7/31/2011**	**8/1/2011-10/31/2019**
MSCI EAFE Index	132.90%	58.03%	423.69%	10.46%	95.94%	47.00%
S&P 500 Index	20.96%	168.82%	296.89%	145.30%	37.65%	179.53%



Follow the growth

Despite strong equity gains over the past 10 years, the U.S. economy has slowed just like other developed nations. Long-term economic growth is likely to be higher in areas like emerging markets due in part to younger demographics, productivity gains and the rise of the middle class consumer. Themes that have played out in developed nations like infrastructure, increased internet penetration, e-commerce, health care demand, and increased banking are only beginning to occur in many emerging markets. With the economic rise of many Asian countries, there are now many regional and global brands emerging. It is important to note the different consumer tastes between cultures in the east and west, which U.S. companies have not always navigated as successfully as their regional counterparts.

Do I already have exposure?

A common argument against international investing is that U.S. multi-nationals are already providing non-U.S. exposure. For example, Apple, 3M, Coca-Cola, etc. derive approx. 60+% of their revenue overseas. There are a couple of flaws with that argument.

First, not all U.S. companies are global. Foreign sales as a percentage of US companies can be difficult to accurately determine as it is not required to be reported. Generally, large multi-nationals generate about 40-50% of their revenues from overseas, while mid and smaller companies tend to get much less. In addition, domestic vs. non-U.S. revenues vary by sectors. Tech tends to be more global, while many financials and consumer companies are often more domestically focused. Multinationals tend to hedge non-U.S. currencies, thus from a portfolio standpoint you are not receiving the currency diversification.

Furthermore, stocks tend to be correlated to the fluctuations of their domestic market rather than where they get their revenue. The U.S. broad equity market is diversified; however, if it was your sole equity investment, you would be more exposed to risks from changes in U.S. taxes, politics, regulations, trade, and sector concentrations.

Putting it all together

A common question regarding international exposure is how much is necessary, or asked another way, what is an appropriate allocation? Standard theory is that markets are efficient and all available information is reflected in the price of securities. Thus, it makes sense to start with the global market cap as a guideline, in which international equities make up roughly 50% of the universe. This may feel like a lot of international exposure for investors, especially considering that, on average, U.S. investors only have 20% of their equity exposure in international equities. [4] Empirical research and academic studies, while backward-looking, say that 20-40% exposure gives you the most benefit. [5]

At SilverOak, we create globally diversified portfolios where international equities are an integral piece of the allocation. However, relative to the global market cap, where international equities make up roughly 50%, we have a slight home bias. This is due to the U.S. market being highly diversified with high quality companies, great liquidity, and strong regulations. In addition, having a slight home bias likely reduces behavioral biases. As a result of our process, our portfolios are in line with many academic studies and market practitioners.

There will always be global political risks and economic challenges to give investors pause. However, it's important to remember that investment returns depend on expectations for the future and the price paid, not necessarily the quality of the company or historical returns. Market prices theoretically reflect the positive and negative attributes of each market. Just when investors think a trend signals "this time is different" or is permanent, it tends to reverse. By including international equities in a portfolio, you broaden your opportunity set which can help in achieving growth and diversifying risk in meeting your investment goals.

Disclaimer:

Information and analysis provided in this white paper are for general and educational purposes only. Any opinions expressed in this summary are not intended to be accounting, legal, tax or investment advice.

Investment decisions should be made based on an investor's specific circumstances taking into account items such as, risk tolerance, time horizon and goals and objectives. All investments have some level of risk associated with them and past performance is no guarantee of future success.

© 2019 SilverOak Wealth Management LLC

Sources:

1) The World Federation of Exchanges
2) The World Federation of Exchanges
3) International Monetary Fund
4) Scott, Brian, James Balsamo, Kelly McShane and Christos Tasopoulos, 2017. *The Global Case For Strategic Asset Allocation and an Examination of Home Bias*. Valley Forge, PA.: The Vanguard Group
5) Philips, Christopher, 2012. *Considerations for Investing in Non-U.S. Equities*. Valley Forge, PA.: The Vanguard Group
6) Scott, Brian, Kimberly Stockton, Scott Donaldson, 2019. *Global Equity Investing: The Benefits of Diversification and Sizing Your Allocation*. Valley Forge, PA.: The Vanguard Group