Go Global !

In theory international diversification should reduce portfolio volatility and improve risk-adjusted returns. But portfolio managers appear reluctant to put this into practice.

by Ian Orton

The onset of a bear market should have reminded investors that equities are not risk-free assets. Research has shown that over the medium to long term equities not only provide positive returns, they also outperform all other asset classes. But over shorter time frames equity prices can go down as well as up, as many people are currently finding to their cost.

Of course this should not worry knowledgeable investors. A properly diversified portfolio should, in theory at least, reduce the risk associated with falling equity markets, especially over relatively short time periods. Moreover, over longer time periods, a properly diversified portfolio should also produce a more predictable profile of investment returns.

Common sense suggests that portfolios should be diversified in terms of asset classes, that is between bonds, cash, equities and property; industrial sectors; and geographical markets. A more sophisticated investor might also argue the point that long positions should be matched by short positions.

In general most wealth managers adhere to at least part of this argument. Irrespective of the extent to which they are invested in different asset classes, the increased use of pooled investment vehicles such as mutual funds generally means that private client portfolios are well diversified as far as exposure to individual stocks are concerned. But when it comes to geographical coverage the picture changes significantly. Most private client portfolios tend to have a very explicit domestic bias.

This is especially the case for investors that live in big economies such as France, Germany, the UK and US. (Investors that live in smaller countries must take a more international investment perspective if they are to achieve any reasonable level of portfolio diversification). Take the asset allocation of a typical UK private client equity portfolio, for example. Instead of having around 90 percent of its assets invested in foreign equities and the remainder in domestic stocks to reflect the UK's weighting in the FTSE and MSCI global indices the reality is very similar to a mirror image. A private client portfolio will probably have at most 30 percent of its assets invested in foreign markets.

Does this matter? Not when it comes to generating absolute performance. As Ken Fisher, a proponent of the view that it makes very good sense to take a global investment perspective points out, it doesn't really matter where a portfolio of equities is invested over the long term. "All correctly constructed equity indices that cover the world's major stock markets end up with almost identical 30 year returns," he says. "All have annual average returns for the last 30 years of around 13.8 percent, plus or minus 0.75 percent."

"But choice of benchmark isn't just about getting the best return," he continues. It's about stomaching volatility. This is the reason my firm tends to benchmark client portfolios against the MSCI World Index. It has the broadest coverage and the least volatility."

The asset allocation for an investor following this approach would mean that currently just over 50% of the portfolio would be invested in North America; around 25% would be placed in mainland European stocks; 10% each in Japan and the UK; and the remainder in Asian equities.

But as already discussed the likelihood of a typical private client portfolio having anything like this allocation is very small. This is especially surprising given that with the virtual abolition of capital and foreign currency controls investors now have much more freedom of investment choice and that the costs of investing in foreign markets have fallen considerably in recent years.

As usual there is no shortage of explanations for the current state of affairs. "The long-term risk-return trade-off associated with tracking, or benchmarking a portfolio against global indices is probably more favourable than adopting a domestic bias," concedes Michael Hughes, the chief investment officer at Baring Asset Management (BAM) in London. "But most European and US investors would still have done very well over the past 15 years in both absolute, and risk-adjusted terms through adopting a domestic bias."

Chris Woods, the chief investment officer at State Street Global Advisors (UK) makes a similar point. "A greater bias to international stocks over the past five years or so would probably have brought diversification benefits," he concedes. "But performance would have suffered as a consequence."

It is also worth pointing out that as a consequence of globalisation a portfolio dominated by domestic stocks is likely to have a much bigger exposure to the world economy than was the case a decade ago. More than 50% of the constituents of the FTSE 100, for example, generate the majority of their earnings from outside the UK.

Moreover, some researchers dispute the view that a global investment approach provides significant diversification benefits. They point out that, with the obvious exception of Japan, global stockmarkets have become increasingly correlated over the past decade.

Research from Goldman Sachs suggests that country influences can have a significant effect on equity returns. But at 12 percent this currently trails both stock specific factors, which account for around 60 percent of returns associated with constituents of the FTSE World Index. It is also smaller than the influence of global sector effects. These account for around 20 percent of total returns. In other words diversification-minded investors should perhaps place greater emphasis on getting the sector allocation right rather than focusing on geographical considerations.

Nonetheless, this does not necessarily invalidate the case for a global investment perspective. Specific country effects may be relatively muted at present but this does not necessarily mean that this will always be the case. At present economic cycles around the world have more or less coalesced (with the obvious exception of Japan). But this is by no means a permanent state of affairs. A similar state of affairs held during the first half of the 1970s, for example. Over the next fifteen years or so, however, economies moved increasingly out of step. In this context a global investment perspective could have generated positive diversification benefits.

Similarly the current interest in economic sectors should not be overestimated. "The relative strength of sectoral influences may be cyclical," points out Andrew November, head of global strategy at

Scottish Widows Investment Partners, the investment management arm of Lloyds TSB. "At present it probably makes good sense to focus more on sectoral influences from both a performance and risk management point of view. But once economies move out of synchronisation geographical considerations could play a much bigger role in the asset allocation process.

In other words over a 30 year time perspective there is still a very good case for maintaining a global, rather than a domestic, perspective. Indeed, for UK investors there are very good reasons for maintaining a significant exposure to foreign stocks.

The UK stock market is dominated by just four sectors, energy (oil and petroleum), financials, pharmaceuticals and telecommunications. Energy and pharmaceuticals have proven an effective foil to the downturns experienced by the telecommunications sector over the past fifteen months. But many investment professionals would still maintain that an exposure of this nature still constitutes a significant concentration of risk, especially over the short term.

Nonetheless, proponents of the view that private client portfolios should have a heavy bias towards domestic stocks can marshal a number of other arguments in their defense. Too great an allocation to international equities may expose investors to foreign exchange risk.

This is an important consideration. Unless the client maintains an international lifestyle, the proceeds of investment will probably be spent in the country of residence. As a consequence it may not make good sense to have the bulk of a portfolio denominated in a foreign currency. The foreign exchange markets can be very volatile. An adverse currency movement could have a significant impact on portfolio returns, especially in the short term.

A number of investment professionals point out that this argument is probably overstated, however. Foreign currency exposure can now be hedged on a cost effective basis over the short term. Over a long investment time horizon the effect of foreign currency movements is probably neutral. Furthermore, given the increased involvement of many domestic firms in international markets, investors are probably already assuming more foreign exchange risk than before.

There are also a number of more pragmatic, or 'feel good' factors especially for investors that opt for a segregated portfolio management service. Investing in domestic firms, for example, can provide a considerable degree of comfort, even in an era in which international tensions have diminished. There are still considerable variations between countries in such areas as accounting practices, business culture and company law, for example, and this can weight the asset allocation argument in favour of the domestic economy. Local companies are usually much better known by investors than foreign companies!

Cynics could also point out that there is a certain comfort factor in adopting an asset allocation that is broadly similar to one's peers.

Nonetheless, most investment professionals expect the foreign content of private portfolios to increase in the years ahead. This is especially the case in Europe where the creation of Euroland, or the single currency area, will probably result in a significant rebalancing of portfolios. The recent boomlet of pooled investment funds that target 'global champions' or 'world leaders' is also testament to an increase of interest in investing in foreign markets.

But there are more pragmatic reasons for adopting a global approach to investing. As Guy Monson, the chief investment officer of Bank Sarasin points out it is only by adopting a global investment perspective that investors can secure access to world class companies!