A David Vaughan Investments, Inc. White Paper

Investing Globally: Can U.S. Investors Achieve International Diversification Through Domestic Stock Portfolios?

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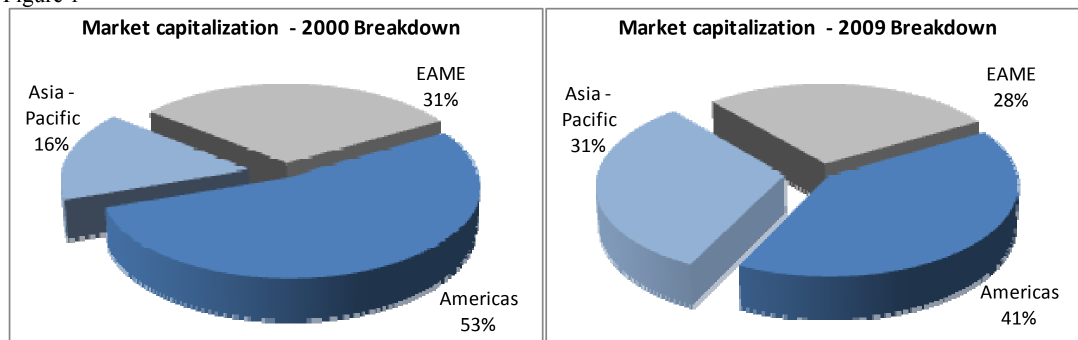
Introduction

We often get asked by clients and prospects about the merits of international investing. Given that our firm was founded upon the idea of owning dividend paying, domestic blue chip stocks, stepping across the pond would clearly take us into a new frontier. But are we missing an opportunity? Arguments in favor of investing globally are widely known. Factors often cited include, among others, greater diversification and risk reduction, opportunity for higher rates of return, international markets are too large to ignore, foreign economies are better managed than the U.S. economy, and the world is growing faster than the U.S. Yes, these are all valid arguments, some more than others. However, our belief is that U.S. domestic investors can capture many of the benefits of international markets but within a significantly less volatile domestic environment.

Trends in Global Market Capitalization

According to the World Federation of Exchanges, the Americas region represented 53% of global market capitalization in 2000. In 2009, that number had declined to 41%. The charts in Figure 1 below show the trends in global market capitalization from 2000 to 2009. Even though the Americas are still the largest region (although much less than before), the Asia-Pacific share has grown significantly, while the Europe–Africa–Middle East (EAME) area has almost remained stable.

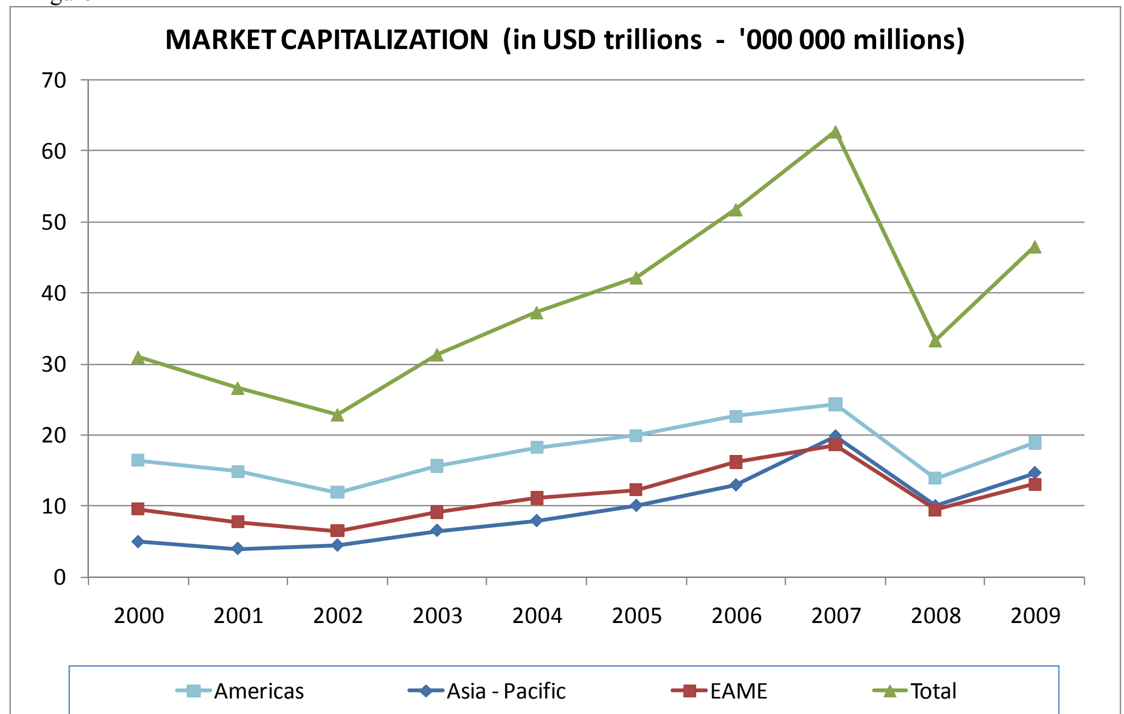
Figure 1



Source: World Federation of Exchanges

The graph in Figure 2 simply shows the trend in global market capitalization during the past decade. Despite the apparent difference in the growth rates of each region, the degree of correlation in the trend suggests globalization is having a meaningful impact on the diversification benefits of investing internationally.

Figure 2



Source: World Federation of Exchanges

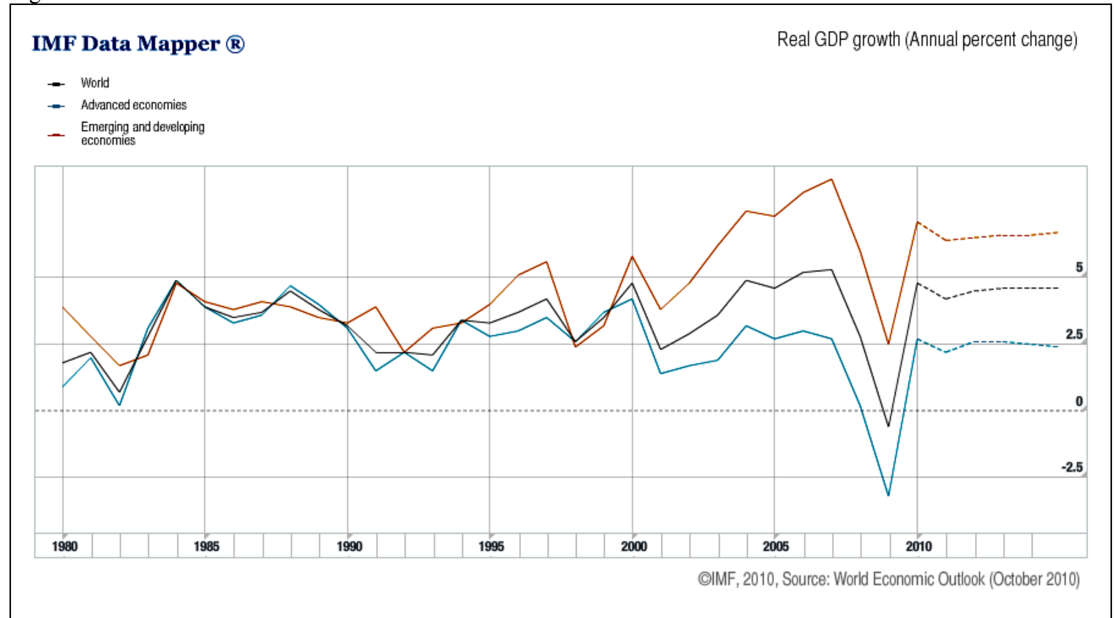
Trends in Global Correlations

Investors traditionally have added international components to their portfolios as a means of seeking greater diversification or excess performance. Market correlations play a significant role in defining how meaningful the diversification benefits might be to a portfolio. The global business cycle has become more closely correlated in the recent decade than that experienced in the middle of the century.

According to the Vanguard Economic Strategy Group, since 1950 the global business cycle has accounted for approximately 50% to 60% of the variation in real Gross Domestic Product (GDP) growth across both major developed and emerging market economies. Business cycles of developed markets have been the most highly correlated given that they represent the largest share of the world's economic output. Between 1950 and 2007, Vanguard reports that the correlation in annual real GDP growth between developed markets and the world economy was 74%. Vanguard concludes in their article that cross-country correlations in real GDP growth rise whenever 1) asset-price shocks are systemic and 2) the world's largest economies are severely impaired in the process. It seems in times of stress when the investor need for diversification is greatest, market correlations are not supportive.

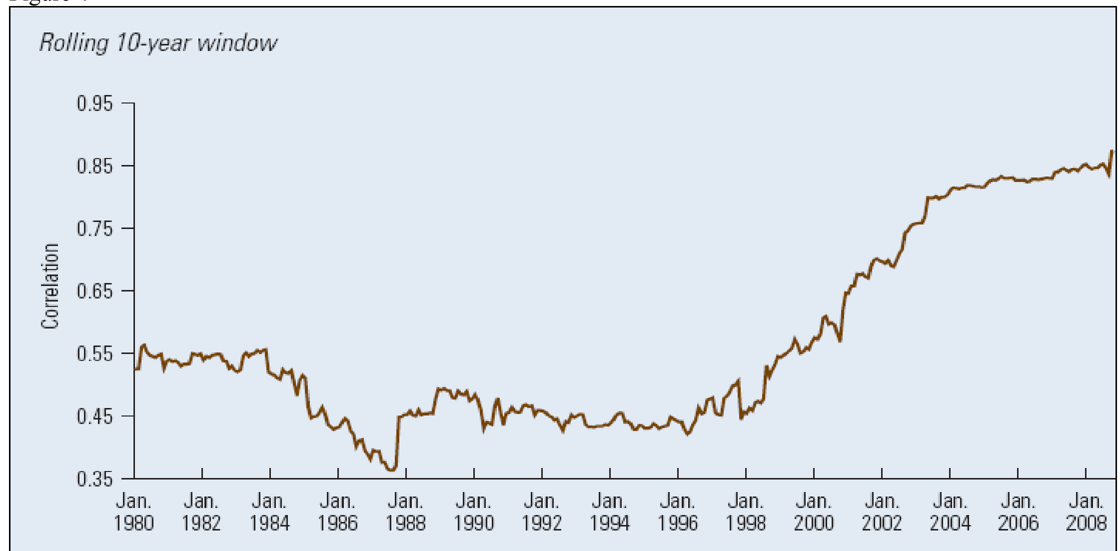
Data tracking global real GDP growth from 1980 to 2010 is shown in Figure 3. Clearly, business cycles have become more highly correlated in more recent years.

Figure 3



We now see that global business cycles as measured by trends in GDP have become more closely correlated. However, does that carryover into the financial markets? The chart in Figure 4 below measures the 10-year correlations of monthly stock market returns between the U.S. (MSCI U.S. Broad Market Index) and a broad international index (MSCI EAFE + Emerging Markets Index). Quite obviously the correlation between these two indices has grown substantially higher during the past decade. The apparent convergence of global financial markets and business cycles implies that the diversification benefits of owning international equities may not be as significant as once believed.

Figure 4



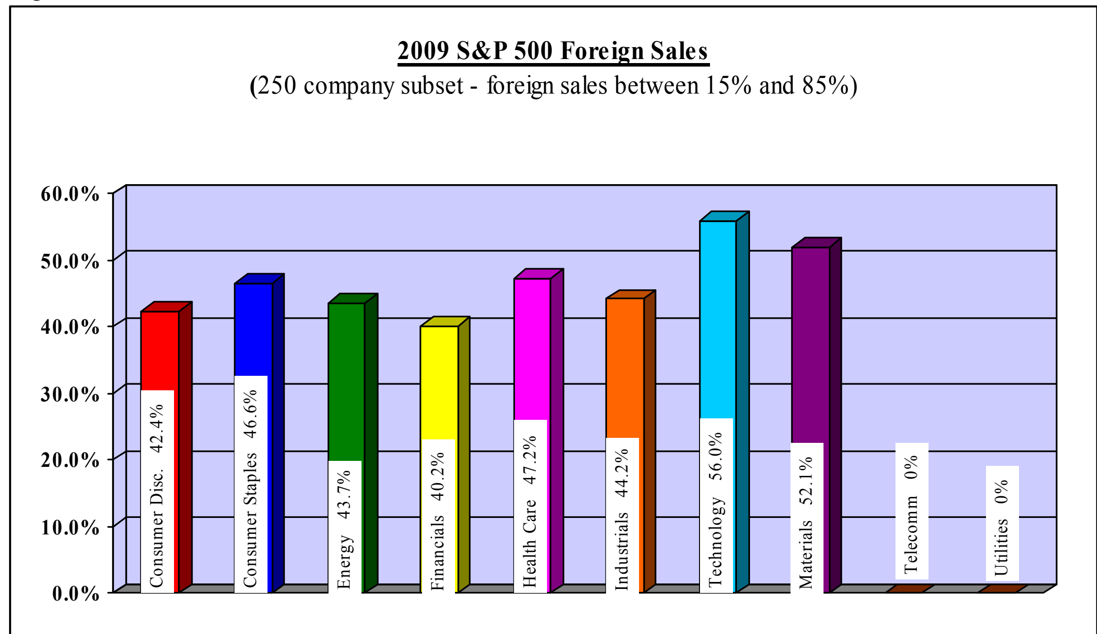
Source: Vanguard Capital Markets simulation and MSCI data

Yesim Tokat, in his 2006 article titled "International Equity Investing: Investing in Emerging Markets" states that historical evidence suggests the performances of equity markets in large economies have a significant impact on the performances of equity markets in smaller economies. Further, Tokat shows that since the early 1970's more than 70% of developed international stock markets experienced bear markets when the U.S. was in a bear market. If a given U.S. investor objective is to have portfolio components that move inversely to one another, international stocks appear to have lost some significance in that regard during the past decade.

Domestic Companies with Foreign Revenue

Standard & Poor's recently reported 2009 foreign sales statistics for the S&P 500 Index companies. Standard & Poor's acknowledges the data is difficult to analyze as many companies do not fully report foreign data choosing to categorize sales by market or region. However, the results remain valuable in understanding the depth of international revenues found in S&P 500 companies. Standard & Poor's identified 322 companies that report foreign sales, of which 250 companies have foreign sales between 15% and 85%, 62 companies have foreign sales less than 15% and 10 companies have foreign sales greater than 85%.

Figure 5



The chart in Figure 5 identifies the percentage of international revenues found in each of the S&P 500 economic sectors based upon the 250 companies with foreign revenues between 15% and 85%. In 2009, foreign sales represented 25.2% of total S&P 500 sales revenue and over 64% of the S&P 500 companies had some type of foreign sales.

Based upon the S&P data, it is easy to see how a U.S. common stock portfolio containing domestic multinational companies could have significant foreign exposure.

The Effect of Foreign Currency

Pundits will argue that a portfolio of U.S. based multinational companies is missing a large component of return – foreign currency. When investors buy foreign stocks they are also implicitly gaining exposure to various foreign currencies. U.S. investors who own stocks denominated in foreign currencies benefit when the U.S. Dollar depreciates (foreign currencies appreciate). Some analysts suggest the effect of currency on international investments smoothes out over long time periods. Evaluating the return streams from the primary international equity benchmark, the MSCI EAFE (Europe – Australia- Far East) Index, provides greater clarity on the impact of currency. The chart in Figure 6 shows rates of return for the EAFE Index in U.S. Dollars versus rates of return in local currencies. Clearly there is a meaningful difference.

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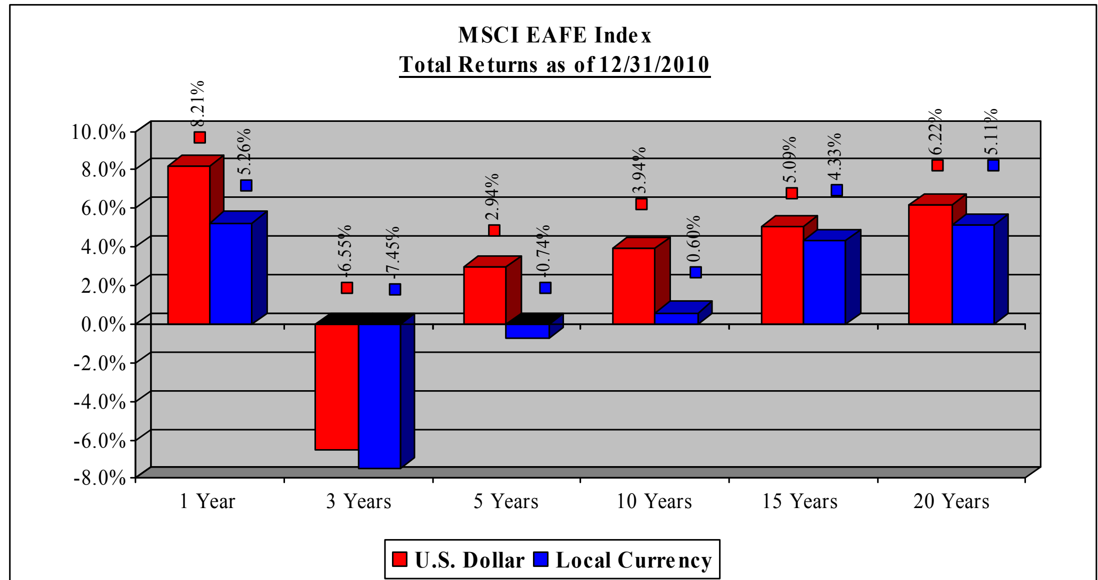
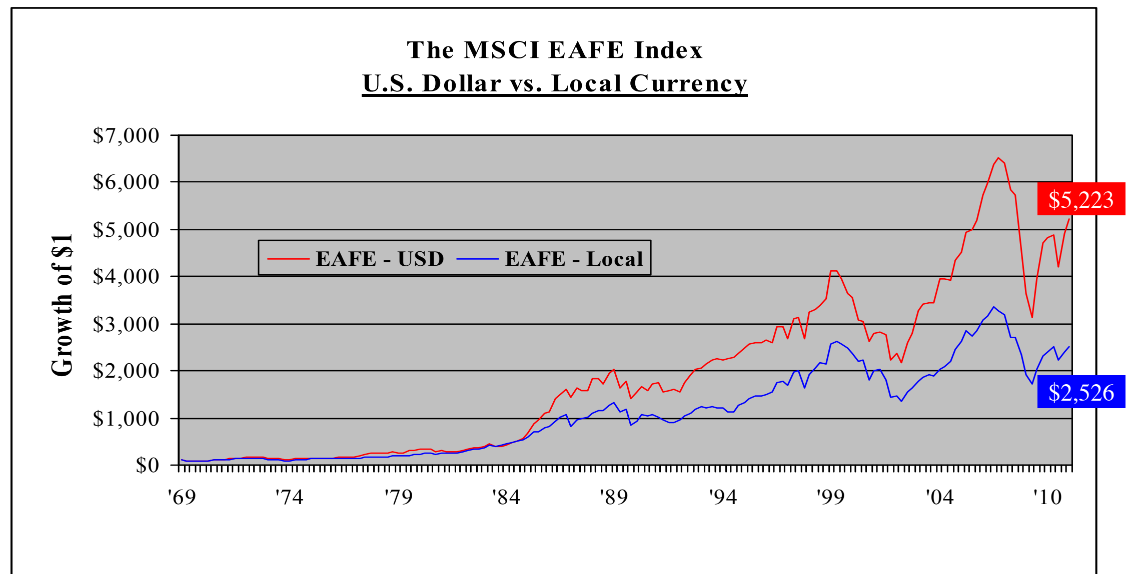
Figure 6



While the chart in Figure 6 measures the percentage difference between U.S. Dollar and local currency returns, the graph in Figure 7 below shows what occurs when those small differences are compounded over long periods of time.

Figure 7



The strong Dollar years of the mid-1980s can been seen and correspond to years when local currency returns exceeded Dollar returns. Conversely the decline of the Dollar from its more recent peak in 2002 to lows in 2009 clearly account for a significant portion of U.S. investor returns. Since 1970, currency has accounted for over one-half of the total return of the MSCI EAFE Index. The currency decision is clearly as important as any country, regional or sector bet an investor could make.

Research Samples

Significant research has been performed by the academic and business community on the diversification benefits of international investments. Not surprisingly, the investment community seems to focus on the research that supports their sales thesis which emphasizes the need for a globally diversified portfolio containing multiple asset classes. However, there is meaningful research that has exposed the shortcomings of international investing by highlighting both its strengths and weaknesses.

In their 2004 article “International Portfolio Diversification Benefits: Cross-Country Evidence from a Local Perspective”, Joost Driessen and Luc Lavern find that country risk appears to be a good determination of diversification benefits, with countries having higher country risk offering a greater potential benefit of global diversification.

In 2009 MSCI Barra Research, the industry leader in creating international benchmarks, studied international diversification during the 2008-2009 financial crisis. They found that investors seeking diversification opportunities would have benefited from being able to partially hedge out market exposure and invest more granularly in regions, countries or styles. They stated that in times of crises, diversification opportunities can be limited due to overall market effects.

Finally, in a 1998 National Bureau of Economic Research (NBER) working paper, Jim Rowland and Linda Tesar concluded that if a U.S. investor were to take a stepwise approach to portfolio diversification, the largest utility gain comes from the inclusion of U.S. multinational equities. Multinationals do not, however, exhaust the gains from international diversification, U.S. investors could have obtained additional benefits by taking short positions in foreign markets.

Three different research articles all concluding that international diversification is somewhat elusive. Driessen and Lavern indicate the greatest diversification comes from the riskiest countries, MSCI Barra suggests focusing more granularly on regions or countries and the NBER suggests owning U.S. multinationals as a first step and then consider shorting foreign markets thereafter. Clearly, there is no silver bullet.

Synopsis

So what’s an investor to do? Capitalizations of non-U.S. markets are growing as developing countries seek to improve infrastructure and their citizens seek to improve lifestyles. Opportunities abound for corporations to profit in these areas. However, international markets have become much more intertwined as globalization spreads around the world. Economic growth is now highly correlated across all major developed economies. In recent market crises asset values have declined around the world with no apparent risk reduction from owning a globally diversified portfolio.

U.S. equities decline with rising geopolitical or financial risk in foreign countries and international equities decline in tandem with U.S. crises. Most research today suggests that international diversification is best obtained by investing in the least developed (most risky) parts of the world. For risk averse investors this is little consolation and difficult to execute.

Historically, currency has represented over one-half of the total return from investments in international stocks to a U.S. investor. This implies that the currency bet is more important than the decision to invest in international stocks.

Standard & Poor’s data validates the international reach of many U.S. based companies. As previously stated, foreign sales represented 25.2% of total S&P 500 sales revenue and over 64% of the S&P 500 companies had some type of foreign sales in 2009.

Conclusion

We believe U.S. investors can achieve international diversity through domestic stock portfolios and do it within a risk averse, disciplined manner. The issue of increased market correlations is likely here to stay. Our approach in building equity portfolios creates diversification at the sector and security level not the asset class level. Our risk characteristics and ability to preserve capital in declining markets is a function of sector and security selection rather than broad asset class allocations. Our more granular approach is consistent with the MSCI Barra research results discussed previously.

The 1998 NBER working paper discussed previously indicated the largest gain in utility for a U.S. investor seeking additional diversification comes from owning U.S. multinational companies. The issue of currency exposure and how best to manage that exposure is also addressed by owning U.S. multinationals. As U.S. investors buying Dollar denominated investments our foreign currency risk is limited to that which is within the companies we buy.

Who better to manage the foreign currency exposure of those companies than the managements therein? Aside from having deep knowledge about the countries in which they operate, U.S. multinationals have both foreign currency assets and liabilities that often times naturally offset one another. The combination of local country knowledge and natural currency positions reduces the volatility created by currency risk.

As reported by Standard & Poor's, significant foreign sales revenue lives within many of the S&P 500 Index companies. Not surprising, our Model Equity Portfolio companies also have meaningful foreign sales revenue. Our Model Equity Portfolio is currently comprised of 77 companies, of which 48 have sources of foreign revenue. The average foreign sales revenue of those 48 companies is 44%. Further, 21 of the 77 Model Equity Portfolio companies have foreign revenue of at least 50%. Beyond this diversity at the company level is diversification at the economic sector level. The Model Equity Portfolio has holdings with foreign revenue represented in six of the ten economic sectors comprising the S&P 500 Index, further broadening the risk reduction benefits of the strategy.

DVI is confident that our U.S. Equity strategy and process is positioned to benefit from growth in international markets. Our approach is different. While the traditional Wall Street approach emphasizes direct foreign investment as the means of gaining international exposure, we believe owning U.S. multinationals achieves a comparable outcome with meaningful diversification benefits. We will continue to seek the benefits of international opportunities by thinking globally and investing locally.

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