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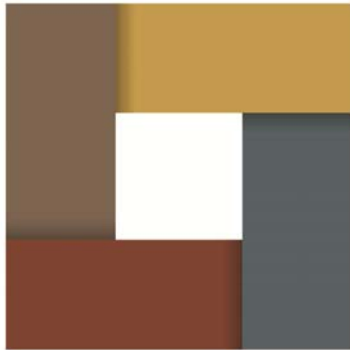

Personal Wealth Management

GHP Global Markets

Is International Diversification Still Worthwhile?

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Foreign markets performed poorly in 2014 and were a drag on our client portfolios (see Figure 1). What patterns can we decipher and is it wise to maintain our allocation to foreign stock markets?

Figure 1	
Index	**2014 Return**
MSCI Europe, Australasia and Far East Index (EAFE)	-4.2%
MSCI Emerging Markets Index	-2.1%
MSCI Europe Index	-5.6%
MSCI Asia ex Japan Index	2.2%
MSCI Japan Index	-3.4%
MSCI Emerging Markets Latin America Index	-12.0%

Source: Bloomberg, L.P.

A few years ago developing countries such as China, Brazil and Russia were booming and a number of analysts argued that foreign stocks should comprise the majority of a client's portfolio. They emphasized the changed position of the U.S. economy from 40% of total world Gross Domestic Product (GDP) in the early 1960's to about 20% today (see Figure 2). Similarly, U.S. stock market capitalization is now just 37% of the global total (Bloomberg, L.P.). Most publicly traded companies are listed outside of the United States, and many professional investors felt client portfolio allocations should reflect this new reality. Some argued further that the United States was losing competitiveness relative to faster growing

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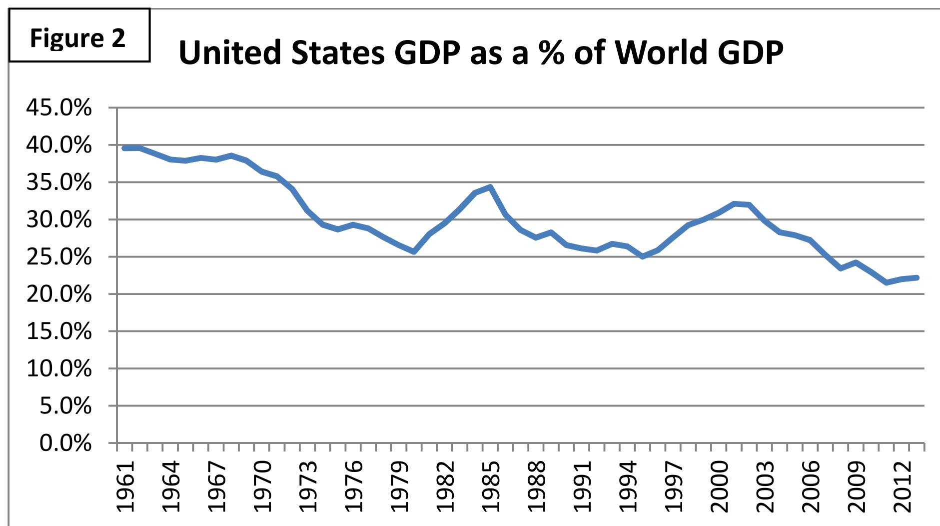
emerging markets. While we believe in international diversification, we never agreed with this perspective.



Source: Bloomberg, L.P.

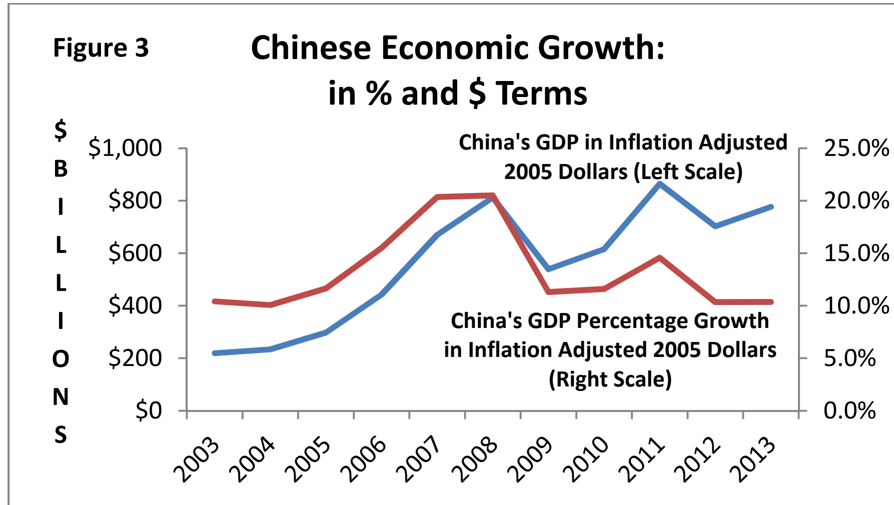
Rather than decline, the U.S. improved its competitive position during the recent “Great Recession”. Unlike most foreign countries, companies in the United States rapidly cut costs to restore profitability. Banks and other financial institutions recapitalized their balance sheets and even the government eventually reduced its budget deficit. Unemployment fell and job creation accelerated. As economic growth rebounded in the United States over the past five years, the U.S. dollar appreciated relative to its major trading partners - exactly the opposite outcome predicted by America’s detractors.

Meanwhile, economic growth in China and Brazil decelerated and the Russian economy hit a wall as oil prices collapsed. Europe continues to struggle with ongoing banking and financial problems. Reduced demand from China pressured commodity exports from a variety of other developing countries. All of these factors help explain poor stock market performance outside the United States in 2014.

Despite mounting fears about foreign markets, however, we believe a modest allocation still makes sense. First, economic pressure is a catalyst for change and improvement. Just as the financial crisis and recession in the United States was painful in the short-run, over the long-run American companies adapted and prospered. We believe the same process is at work in Europe, albeit with a significant lag and uneven outcomes. Some countries such as the United Kingdom and Spain have implemented painful, but necessary, reforms and are already recovering. Others, such as Italy and France, may slide into a deeper recession.

Second, China’s economy continues to expand, just at a slower rate. Eventually investors will realize some simple mathematical truths. When China’s $9.4 trillion economy grows by 4% this adds $375 billion to their total yearly output. Ten years ago the Chinese economy grew 17% from $1.64 trillion in 2003 to $1.93 trillion in 2004, amounting to an annual increase of $290 billion (Bloomberg, L.P.) People

tend to forget that a small percentage of a much larger number is actually better than a large percentage of a small number (see Figure 3).



Source: Bloomberg, L.P.

Third, energy importers will benefit significantly from lower oil prices even as exporters sink. Most countries in the world import energy. This should provide a stimulus to many newly industrializing countries and a nice boost for consumers in developed economies.

Fourth, stock market valuations are quite reasonable around the world. The Price-to-Earnings Ratio (P/E) for the MSCI EAFE Index (Europe, Australasia, and Far East) is 14 and the MSCI Emerging Markets Index P/E is 11. Even more specifically, the U.K.'s FTSE 100 Index trades at a P/E of 13.5, Spain's IBEX 35 P/E Ratio is 13.9 and the German DAX Index P/E is 12.2. Hong Kong's Hang Seng Index P/E Ratio is 10.7 and Korea's KOSPI Index P/E is 10.7 - just a sampling of the modest valuations to be found in many countries (Bloomberg, L.P.).

The nature of diversification is that some parts of our portfolios do well while others might languish for a time. We prefer, of course, when everything works simultaneously, but diversification is necessary because financial markets are unpredictable. Many foreign markets are experiencing problems, just as the U.S. did over the past several years. We emphasize countries where we believe these problems are being addressed and deemphasize countries that refuse to adjust appropriately. In addition, our funds focus on companies that remain profitable with solid balance sheets and reasonable valuations. We continue to believe that is the recipe for long-term investment success, in the United States and around the world.