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Brian Werdesheim
Stan Yang
Savannah Pincus
Valerie Yang

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INTERNATIONAL DIVERSIFICATION: Evolving Perspectives and Implications

How changes to investing internationally impact asset allocation for clients and advisors

THE SUMMA GROUP
of Oppenheimer & Co. Inc.

Oppenheimer & Co. Inc.
10880 Wilshire Boulevard
Los Angeles, CA 90024

(800) 421-4314 Phone
(310) 446-7406 Fax
summa.group@opco.com

INTRODUCTION

During the past 30 years, the discussion about optimizing diversified portfolios with international exposure has been debated and discussed across the retail and institutional investment landscape. When we look back to the Spring of 1993, this was a time when India, China and other emerging growth countries were the darlings of the investment world. The India story was a compelling one that focused on the one of the largest middle class populations in the world and one of the most well-educated. Today, India is a vibrant economy and possesses a capital market that has been a top performer in 2023. The timeline may have taken longer but it's hard to negate the long-term investment thesis for India and other emerging market countries.

...we look to examine the rationale behind investing in companies that are domiciled outside of the USA.

We have vivid recollections of the early 90's when firms like Brandes Investment Partners, Templeton and others were espousing the virtues of international investing. Charles Brandes was a relatively early adopter of the benefits of owning stocks outside the US. Members of the Summa Group recall when their total assets under management were less than $50 million only to watch their total asset base reach in excess of $100 billion less than 20 years later. In our paper, we look to examine the rationale behind investing in companies that are domiciled outside of the USA. The reasons for doing so are still well intact but the dynamics have changed and are impacting the benefits of investing in economies that may be growing faster than the US. On a going forward basis, we must ask ourselves, "What is the optimal level of international diversification if the objective is to strike the most desirable balance between risk and return?"

Private wealth management teams like The Summa Group and institutions like the Yale Endowment have strong opinions about how to structure asset allocations to ensure their clients and beneficiaries are being prudent with regard to international investing. As of this writing, we find ourselves examining a prolonged period where US markets continue to outperform the European, Asian, Middle Eastern, and Latin American markets by a significant margin. We are strong believers in "mean reversion" which suggests markets that have outperformed for extended periods of time will eventually be supplanted by markets that have underperformed. This reality applies not only to domestic-international markets but also to style and market cap disparities that are well entrenched when you look at massive disparities between growth and value and small cap and large cap stocks.

While it is convenient to rely on historical data to help determine the optimal level of international diversification, we must look beyond the quantitative metrics and understand some of the fundamental dynamics that impact how we should reach this important decision. In this paper we will give historical context and discuss the concept and use of the "efficient frontier", but mean reversion, economic innovation, geopolitical environments, central bank policies, and myriad other factors must be considered when constructing asset allocations for private clients. There is an art and a science to all of this and we look at various factors that impact our decisions.

PART I:
Historical Context of Investing Internationally

How It All Began

Over the years, numerous economists and portfolio strategists have published research papers on why investors should include international equities/stocks in their investment portfolios. We can't really discuss the history of modern-day international investing without mentioning the name of Sir John Templeton. When it came to investing, quite simply, Templeton did not care where a company was located; he was interested in it if the stock was selling at a discount to its intrinsic value. Templeton entered the mutual fund business in 1954 by launching the Templeton Growth Fund, a global equity fund. At the time he launched his fund, most Americans rarely considered investing in foreign markets.

One could argue that international investing didn't really become mainstream until Harry Markowitz, a Nobel Prize-winning American economist, introduced the concept called the "efficient frontier." The concept wasn't widely accepted until sometime after he was awarded a Nobel Prize in Economic Sciences in 1990. Here are some of the key elements of the efficient frontier:

- The efficient frontier is a graphic representation of the trade-off between risk and return for a set of investment portfolios with various degrees of diversification.

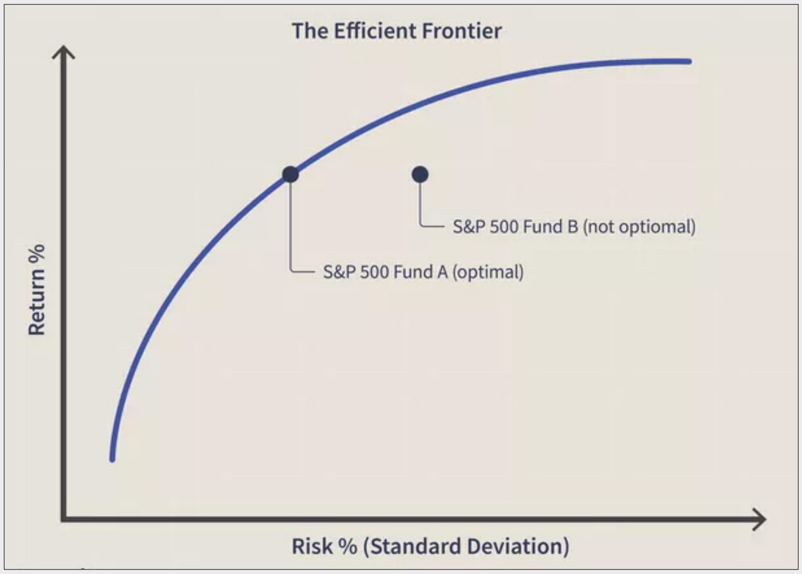


Figure 1. The curvature of the efficient frontier graphically shows that diversification can affect a portfolio's risk versus reward profile. Source: Investopedia

- Risk is measured by the standard deviation (or volatility) of portfolio returns. Lower correlation (less synchronization) of portfolio securities results in lower portfolio standard deviation.
- Each point on the graph represents a different portfolio with different combinations of assets.
- The curve, which represents the efficient frontier, is the set of portfolios that offer the highest expected return for a given level of risk, or the lowest risk for a given level of expected return.
- The portfolios that fall along the curve are efficient portfolios, optimally diversified.
- Successful optimization of a portfolio's return versus risk paradigm should place the portfolio along the efficient frontier line.

The concept of "diversification" became one of the key reasons for including international equities in one's portfolio.

A key finding of the efficient frontier was that the optimal portfolios – those that fall along the efficient frontier curve – usually exhibit a higher degree of diversification. The concept of "diversification" became one of the key reasons for including international equities in one's portfolio. We will address this concept in more detail.

It wasn't until 1986 that the first international stock market index, the MSCI EAFE Index, was launched. Two years later in 1988, the MSCI EM Index was launched. Therefore, many measurable historical charts and data only go back to the mid-1980s.

Historical Rationales for Investing in International Equities

Over the years, advocates of international investing have given us several reasons for including international equities in one's portfolio. Two of the reasons in particular are worth a closer look.

The first reason is that some of the most compelling investment opportunities have been and continue to be located outside the US. Case in point, since 1970, there has not been a single calendar year where the US was the best performing stock market. Additionally, as shown in Figure 2, the US ranks only 7th out of the top 10 countries on annualized return (from 1970 to 2021). However, over the more recent periods (particularly since the Great Financial Crisis of 2008), the US has been one of the top performers. In the context of a well-diversified portfolio, it would make sense to incorporate some (not dominant) international exposure. We will discuss how best to do that throughout the remaining sections of this paper.

Rank	Country	Annualized Return*
1	Hong Kong	13.41%
2	Denmark	12.65%
3	Sweden	12.01%
4	Netherlands	11.46%
5	Switzerland	10.63%
6	Singapore	9.90%
7	**USA**	**9.86%**
8	Norway	9.33%
9	Belgium	9.09%
10	France	8.97%

Figure 2. Data shown is from 1970 - 2021. Source: Morningstar. Analysis: Manning & Napier. Based on the performance of individual MSCI country indices.

Correlation measures how closely two assets move together, and diversification is based on the idea that certain types of risk can be reduced by investing in assets that are not correlated.

The second reason is that international exposure can help diversify a portfolio. This ties back to Markowitz's efficient frontier theory, as previously mentioned, and ultimately boils down to correlation. Correlation measures how closely two assets move together, and diversification is based on the idea that certain types of risk can be reduced by investing in assets that are not correlated. As shown in Figure 3, in the past, correlations between US and international stocks were relatively low, meaning that they moved independently of each other and had dissimilar return profiles, which offered strong diversification benefits. However, correlations between US and international stocks have risen in recent years (we will address this concern in the later section).

S&P 500/EAFE Correlation: Rolling 5-year Periods

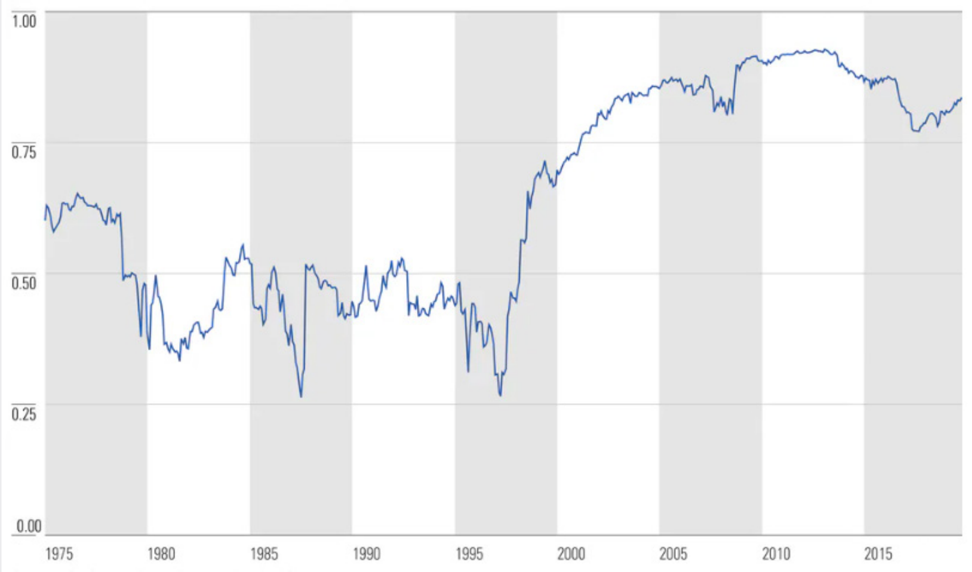


Figure 3. Source: Morningstar Direct. Data as of 10/31/2019.

While the recent rises in correlations between US and international stocks mean less global diversification benefit, we will closely examine other various rationales for including international stocks in one's portfolio even in today's environment in the later section.

Historical Allocations to International Equities

As international exposure became more and more mainstream, their market share of the global equity market grew accordingly. However, within investor portfolios, allocations to international equities vs. domestic equities did not keep up with the market cap allocation between the two. According to Vanguard, investors should use a market-cap-weighted approach. Figure 4 shows a historical mix of global stock market capitalization.

Historical Mix of Global Equity Market Capitalization

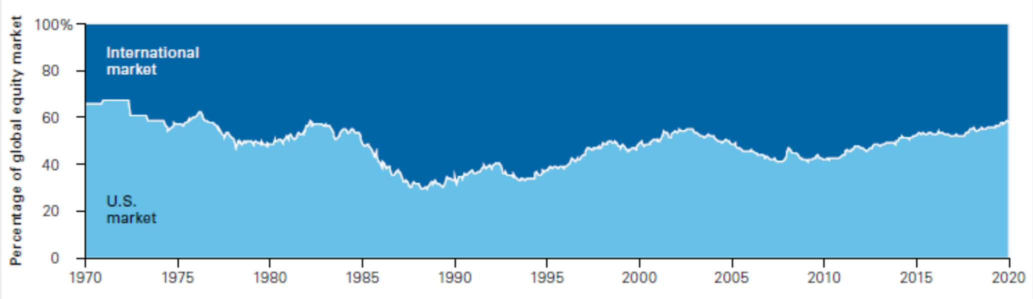


Figure 4. Data from the time period from 1/1/70 to 9/30/2020. The US market is represented by the MSCI USA Index. The non US market is represented by the MSCI World ex USA Index from 1/1/70, through 12/31/87, and the MSCI All Country World ex USA Index thereafter. Sources: Vanguard calculations, based on data from FactSet and MSCI.

This would indicate that a typical portfolio's international exposure would be in the 70% range in the late 1980s – which was very much so not the case. What has actually been the average allocation to international stocks over the years? According to ICI's Fact Book, the average equity allocation to international stocks has fluctuated between 6.5% and 27.6% between 1984 and 2022 as seen in Figure 5.

Historical Mix of Global Equity Portfolio Allocation

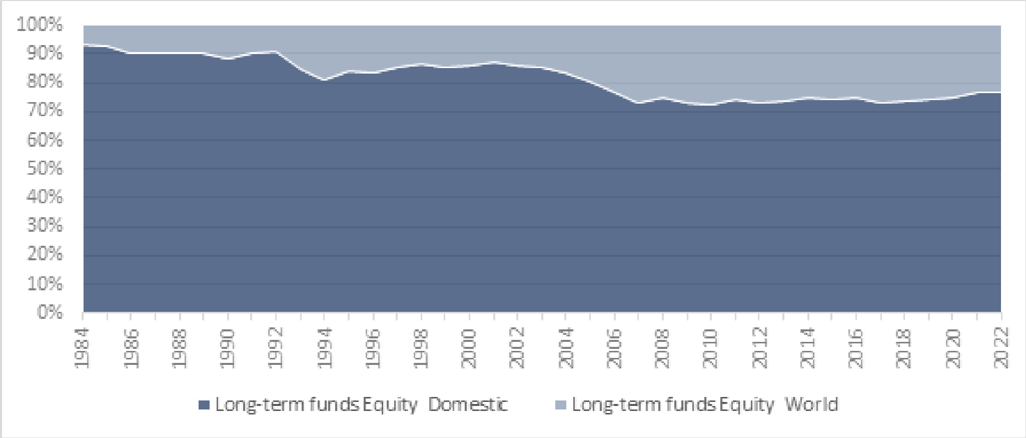


Figure 5. US mutual fund allocations to domestic vs. world (international) equities from 1984 through 2022. Allocations shown as percentage of total equity exposure. Source: 2023 ICI Fact Book.

...home country bias happens when investors are over-exposed to domestic equities...

This historical under-allocation to international stocks can best be explained by something called "home country bias." According to Morningstar, home country bias happens when investors are over-exposed to domestic equities because there's a certain emotional connection to investing in domestic companies. Home country bias tends to create too much concentration risk.

All of this historical context brings us to present day. It's true that international stocks have been underperforming the US counterparts for the better part of a decade, particularly since the end of the Global Financial Crisis (2007 – 2008). In the next section, we will closely examine the various causes for this recent underperformance.

PART II:
Recent Underperformance of International Equities

International equities have faced a prolonged period of underperformance compared to their US counterparts, as illustrated in Figure 6. Let's take a look into the reasons behind this trend.

US vs. International Equity Index Performance

Figure 6. Date range: 12/31/1984 - 12/29/2023. Source: YCharts.

One primary factor contributing to the discrepancy between international and US stock prices is the unrelenting strength of the US dollar. The dollar's robustness has served as a significant headwind for international markets, making exports more expensive and consequently impacting the competitiveness of foreign companies.

Currency Effect on International/US Equity Returns

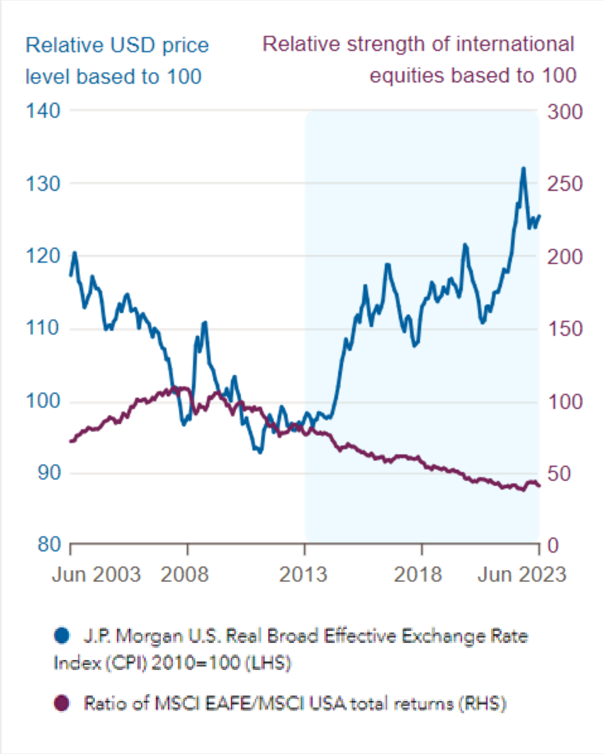


Figure 7. The currency exchange effect has dented international and global equity portfolio results in the last decade. Source: Capital Group.

The ultra-low interest rate environment in the US, has played a pivotal role in bolstering US growth stocks – specifically the tech sector.

Additionally, there is the trend of de-globalization, which gained momentum in the mid to late 2010s. This trend notably intensified around 2018 and 2019 due to escalating trade tensions between the US and China, marked by the imposition of tariffs. The COVID-19 pandemic significantly amplified this trend by exposing vulnerabilities in global supply chains and prompting concerns about over-reliance on foreign production and suppliers. This dual impact – from trade disputes to pandemic-induced disruptions – prompted movements toward reshoring production, emphasizing domestic output. This shift of de-globalization that has developed over the course of the last decade, has negatively impacted countries reliant on exports, as decreased global interconnectedness has limited their market reach. Consequently, these export-driven economies – and their respective stock markets – have suffered, contributing to the underperformance of international equities.

The ultra-low interest rate environment in the US, especially prevalent in the years leading up to 2022, has played a pivotal role in bolstering US growth stocks – specifically the tech sector. These stocks thrived under such conditions, with investors favoring them due to their perceived resilience in a low-rate environment. This disproportionate growth of the tech-heavy US market further widened the performance gap between domestic and international equities.

Apart from these primary factors, other elements have also contributed to the relative underperformance of international equities. Economic cycles, geopolitical uncertainties, and varying regulatory landscapes across different countries have created a complex web of challenges for international markets – and, more specifically, for investors of international markets. These complexities can expose investors to risk, but more than anything, they affect investors' perception of risk. Investor sentiment plays a large role in market performance.

In summary, the confluence of a strong US dollar, the trend of de-globalization, the impact of ultra-low interest rates on specific sectors, and various cyclical factors have collectively contributed to the underperformance of international equities compared to the US market over the past decade.

Some investors view this as an opportunity. In the next section, we will discuss key factors that investors seeking a well-diversified portfolio should be considering.

Time and time again, we see investors too focused on the rearview mirror, blinded to the opportunities ahead.

PART III:
A Forward-Looking View on Investing Internationally

Investors often suffer from recency bias, which causes them to extrapolate recent trends into the future. Time and time again, we see investors too focused on the rearview mirror, blinded to the opportunities ahead. Here, we'll take a forward-looking view to assess both opportunities and risk.

Cyclical Historical Performance of International and Emerging Market Equity

US equities outperformed international equities in the past decade, due to de-globalization, ultra-low US interest rates, and a strong US dollar. However, this is not a permanent trend. Historically, US and international equities have alternated cycles of outperformance, influenced by various economic and geopolitical factors. Figure 8 illustrates these cycles. International equities led for seven years in the 2000s and for almost six years in the 1980s, with a remarkable margin of nearly 300%.

Cycles of US Outperformance

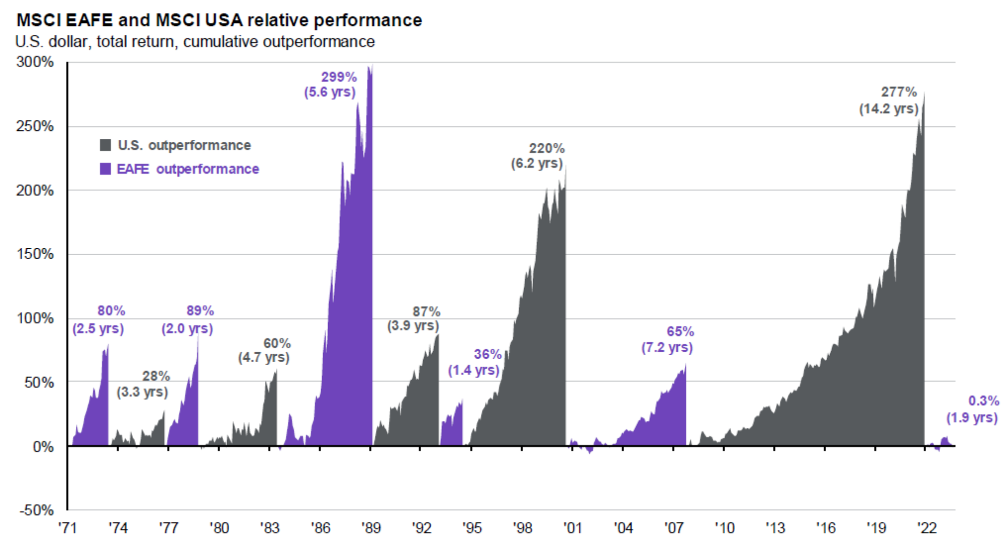


Figure 8. Data as of December 31, 2023. Source: J.P. Morgan Guide to the Markets. FactSet, MSCI, J.P. Morgan Asset Management. Regime change determined when cumulative outperformance peaks and is not reached again in the subsequent 12-month period.

History suggests periods of extended performance in one direction eventually reverts to the mean. In fact, the reversion of international underperformance may have already started in some areas of the market. For example, in the fourth quarter of 2022, value stocks of the international space began to outperform their US counterparts – a trend which continued through 2023. Investors that have written off international markets as a source of opportunity very well could miss out on a powerful long-term rally, and ultimately could see their portfolios underperform.

Current Tailwinds for International Equity

Apart from the favorable cyclical trends and the potential that international equities are reverting to the mean, we believe there are solid fundamental tailwinds that can offer significant long term growth opportunities to the international space.

A weakening dollar is beneficial to international equities – and vice versa.

1. US dollar has peaked and is weakening

Due to increasing interest rates, the US dollar experienced a steady rise throughout 2022, peaking in October. As inflation tamed down over the course of 2023, and the Fed paused its hiking cycle, the US dollar trended downward since its peak. A weakening dollar is beneficial to international equities – and vice versa. In fact, the Euro has appreciated against the dollar by 8.4% over the trailing 12-month period ending in mid-October 2023. International equities have begun to reap the benefits of this currency tailwind, evidenced by the MSCI EAFE rising over 18% in 2023.

US Dollar Index (DXY)

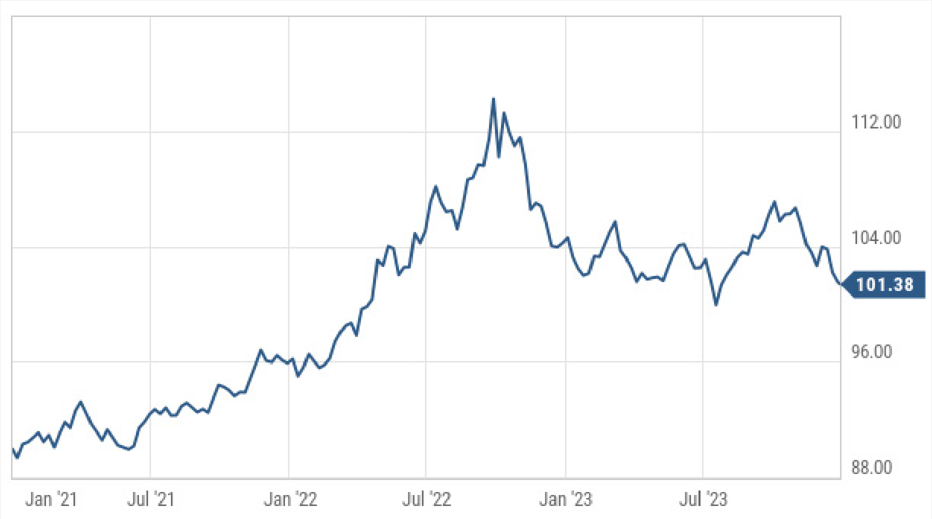


Figure 9. ICE US Dollar Index. Date range: 12/31/2020 - 12/29/2023. Source: YCharts.

2. International equities are trading at deep discount

Due to the sustained outperformance of US equities, international equities are comparatively cheap. Over the past 15 years, the MSCI EAFE has traded at an average discount of 19% to the S&P 500 (Figure 10). This gap widened to 41% by the end of September 2023, the deepest discount in the last 15 years. Similarly, emerging market equities (MSCI EM) are trading well below their 15-year average valuation to the S&P 500. These valuations present highly attractive entry points for investors.

MSCI EAFE & EM Index P/E Discount to S&P 500

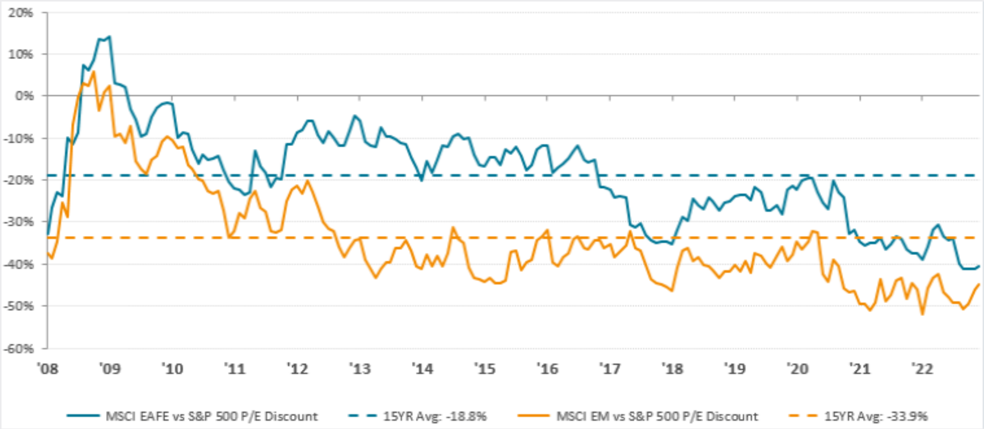


Figure 10. Monthly trailing 12-month P/E ratios. 15-year data as of 9/30/2023. Source: Oppenheimer Asset Management, Morningstar Direct.

3. More opportunity for growth

Television headlines often highlight the negatives—wars, attacks, and geopolitical turmoil. However, the world is vast and constantly evolving, offering an ever-changing opportunity set. Consider the expansion of the MSCI ACWI Index, which has grown from encompassing 23 countries in 1997 to 49 countries in 2021. The growth of the index reflects the increasing integration and interdependence of the world economy, as well as the diversification and innovation of the global markets. Amidst the chaos portrayed in the media, however, it's easy to overlook the rapid growth occurring in several bright spots around the globe. Brazil and India are prime examples of such bright spots.

Brazil:
After a challenging period in the 2000s, Brazil made significant economic changes from 2016 to 2022. It reformed its state-owned businesses, like Petrobras, which has undergone a dramatic transformation in the past few years. The company hired experienced executives, cleaned up its balance sheet, and improved its corporate governance. As a result, the company earned as much as Chevron (a company with three times the market cap) last year and paid $60 billion in dividends since 2021, which is 60% of its current market value.

In this time, Brazil also reformed policies to lower its debt and improve business operations. These changes strengthened Brazil's economy, while higher prices for its natural resources have positioned the country at the forefront of the energy transition. Moreover, Brazil managed inflation proactively, raising interest rates well ahead of global peers. Now, the country is poised to cut interest rates, fostering further economic growth. We believe the uptrend of Brazil's economy is only getting started, lending to an attractive runway for its equity market.

India:
India stands out as a pro-business country in contrast to the rest of the world, where endless stimulus in the US and Europe, regulatory crackdowns in China, and even nationalization in France prevail. Since Modi came into office, India has implemented policies that aim to reduce corruption and crony capitalism, shrink the government's role in the economy, encourage private sector investment, and boost infrastructure spending. GQG Partners forecasts that India's reforms will have a significant impact on the global economy, given that one in every six people in the world lives in India. This could be similar to the China boom in the early 2000s.

Other notable growth stories include South Korea and Taiwan, both serving as pivotal innovation hubs driving the global economy. South Korea's dominance in the DRAM semiconductor market and Taiwan's robust presence in chip manufacturing and substantial competitive advantage in PC and server manufacturing establish them as essential players in shaping and propelling the world economy.

We believe these are just a few of the bright spots in the international markets, and leaders of future global economic growth. Investors could find more opportunities in these areas.

Potential Headwinds on International Equities

While we have high conviction in the many tailwinds of the current international equity environment, it is worthwhile to address a few headwinds that are garnering the attention of international equity bears.

One of these headwinds is weaker earnings forecasts. Figure 11 shows the next 12 months consensus estimate for global earnings: US is leading Europe, Japan, and EM. Research from Oppenheimer Asset Management also shows that earnings in developed international markets over the next 12 months is expected to contract, while earnings growth in the US and EM are expected to increase.

Global Earnings Estimates

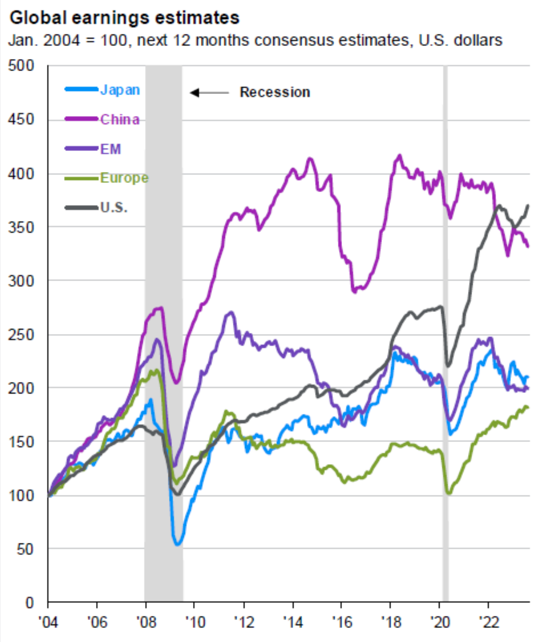


Figure 11. Global earnings expectations over the next twelve months, based on consensus estimates, in US dollars. January 2004 = 100. Data as of December 31, 2023. Source: J.P. Morgan Guide to the Markets, FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.

Another challenge is a possible global economic slowdown, which could reduce the demand for commodities and harm commodity exporters like Brazil. Regulatory risks in emerging market countries that have the potential to reverse reforms could also affect companies and their profitability. There is no free lunch!

Correlation of US Equity vs. International Equity

The diversification benefit that international equity exposure provided was strongest from 1980 to 1998, when correlations between international and US equities were between 30-50%. From 1998, the long-term correlation between the two started increasing to between 80% and 90%. The precise cause of this shift is difficult to pinpoint, but globalization and internet revolution have likely played a role. In addition, during the global recession of 2008 and the 2020 pandemic, correlation of all asset classes tends to rise toward 1, which could also skew the correlation upwards.

Rolling 10- and 20- Year Correlation: MSCI USA vs. MSCI EAFE

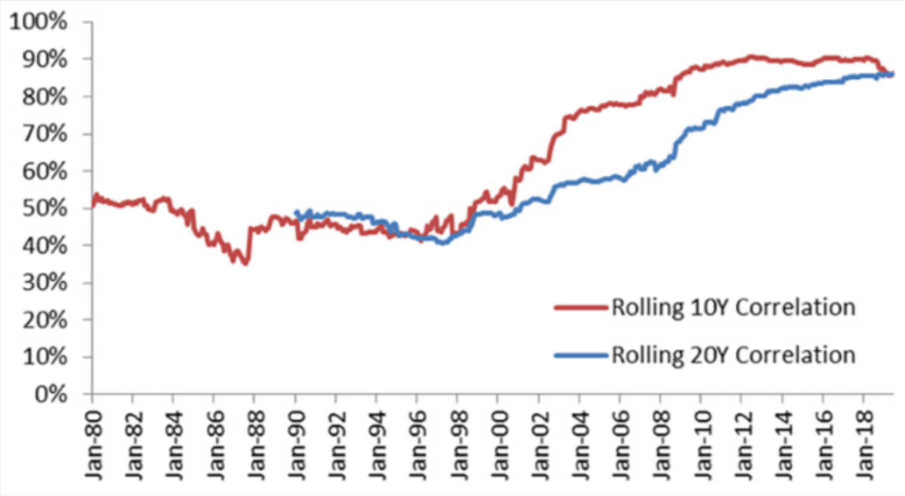


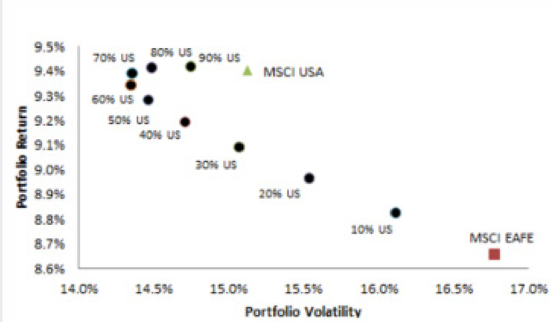
Figure 12. The correlation trend between the MSCI USA and MSCI EAFE over rolling 10- and 20-year periods from January 1970 to June 2019. Source: CFA Institute, Bloomberg.

Lately, the narrative has brought into question the value of international exposure within the equity bucket, on the basis that rising correlations diminish the diversification benefit of international equity exposure. We believe, however, that this is just a small slice of the pie. Holding international exposure for the mere benefit of diversification discredits the stark opportunities at a fundamental level.

Ideal Level of International Exposure:

Since international equity offers diversification benefits, adding it into the portfolio will dampen volatilities and increase return. However, what's the ideal amount of international equity, so the portfolio will reach the optimal risk adjusted return potential? Research with data dating back to 1970s shows that adding 30%-40% international equity may increase return and reduce volatility in the portfolio. In Figure 13, the efficient frontier curve and table show that when introducing 30-40% international equity, the portfolio reaches its highest risk adjusted return potential.

Model Portfolios – Return vs. Volatility



% US	% EAFE	Per Annum Return	Per Annum Volatility	Return / Volatility
100%	0%	9.4%	15.1%	0.62
90%	10%	9.4%	14.8%	0.64
80%	20%	9.4%	14.5%	0.65
70%	30%	9.4%	14.4%	0.65
60%	40%	9.3%	14.3%	0.65
50%	50%	9.3%	14.5%	0.64
40%	60%	9.2%	14.7%	0.63
30%	70%	9.1%	15.1%	0.60
20%	80%	9.0%	15.5%	0.58
10%	90%	8.8%	16.1%	0.55
0%	100%	8.7%	16.8%	0.52

Figure 13. January 1970 to June 2019. Model portfolios rebalanced monthly. Return and volatility figures based on annualized monthly data. Source: CFA Institute, Bloomberg.

However, that doesn't take account of the diminishing correlation benefit over the years. Since correlations actually increased to the 80% range, the optimal allocation to international equity also decreased. The efficient frontier has shifted to the right. See Figure 14, which shows the impact of US equity allocation on the efficient frontier of a global equity portfolio. The red curve represents the efficient frontier for a diversified portfolio based on the current assumption that correlation for US and international is 86%. Per the efficient frontier curve in Figure 14, the amount of international exposure without increasing portfolio volatility has dropped, and it looks like between 20% and 30% is the new optimal point. Therefore, one could draw the conclusion that adding a level of around 20% to 30% international equity is the ideal for a diversified portfolio.

Efficient Frontier of Global Equity Portfolio by US Equity Allocation

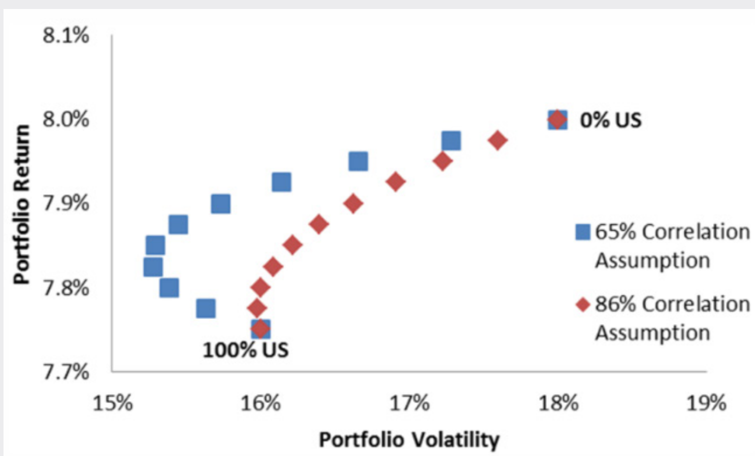


Figure 14. Source: CFA Institute, Bloomberg.

CONCLUSION

As shared in our paper, there are many factors that have contributed to the relative outperformance of international markets. Clearly, the dollar's strength, Covid, and the reality of money flows have created headwinds for non-US markets. Experience tells us to never attempt to pick tops or bottoms but to analyze data and facts to make sound allocation decisions. The Summa Group remains steadfastly committed to international investing and during our history our exposures have fluctuated based on valuations, macro-economic themes, and other factors that impact the global capital markets. We believe there will be a time in the future where the benefits of investing outside of the US will be more pronounced. Nobody has a crystal ball when it comes to picking the top performing stock market each year, but it is interesting to note that the US has never been the top-performing market on a calendar year basis. As shared in our paper, the US ranks 7th out of the top 10 markets in the world when it comes to annualized returns for the 1970-2021 period. This is not to say that US exposure is not a vital component of a well-diversified investment portfolio, but more so to point out the fact that opportunities are aplenty in foreign markets as well.

It appears the US is entering a period of interest rate cuts which typically leads to US dollar weakness. While a softening dollar is only one factor and not a certainty, it would provide tailwinds for international companies as their relative currency strength would provide stronger demand and better earnings. For now, we focus on the long-term benefits of international exposures as many of the world's best and fastest growing companies across banking, healthcare, finance, and manufacturing reside outside of the United States.

Mark Mobius, arguably one of the most prolific and early proponents of international investing, and Charles Brandes, who was early in the game, were absolutely right in their convictions. Trees do not grow to the sky and capital markets around the world will continue to provide important diversification benefits to individual and institutional investors alike. Whether a 20% allocation to international equities is the magic number or a higher percentage can be debated but we continue to be very optimistic about the equity markets of both mature and developing countries outside of the USA.

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