Why Diversifying Your Investments Globally Makes More Sense Today Than Ever?

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Investor Spotlight

Investing in other markets has since long been advocated as an ideal diversification strategy for investors. However, foreign-focussed funds or ETFs still don't feature prominently in an ordinary investor's portfolio. A look at the asset allocation in numerous 401(k) accounts managed by large financial services firm show that on an average only 15-20% of the 401(k) accounts own foreign-focussed funds or ETFs.

In investing circles, the phenomenon of preferring stocks of one's home country over stocks of other countries is called "home bias". This home bias stops investors from capitalizing on numerous benefits of investing globally, the most important of them being the cushion that foreign investments provide against turmoil in one's home markets.

To understand why diversifying one's investments to other regions is so crucial in this age one only needs to look at the Japanese stock market. After peaking at 38,957.44 in December 1989, the Nikkei 225

hasn't been able to cross that mark in the last 25 years and currently trades at around 17,400 levels. Even a smart investor wouldn't have been able to make money during this period if his or her portfolio primarily constituted of Japanese stock. However, in the same 25 years most equity markets around the world have returned 200% or more.

No one is denying that investing in other markets comes with its own set of risks, but then any form of investment has its own inherent risks. The thing that really matters is whether the risk outweighs the rewards and if valuation is what really drives the market, currently the rewards of investing outside the US for a US-based investor outweighs the risk by a huge margin.

The CAPE

CAPE is an acronym for Cyclically Adjusted PE (ratio), it is also known as the Shiller-PE ratio after the famous economist and Yale University professor Robert Shiller, who invented and introduced this ratio in his book, Irrational Exuberance. CAPE is basically the price of a security divided by average inflation-adjusted earnings from the previous 10 years. Today it is widely considered as one of the best valuation tool for equity markets and a great measure to assess whether a market has become too expensive to invest.

The US equity markets has had a brilliant run in the last 5 years, but that has also made US equities one of the most expensive to own right now. When figures from as far as 1880 are taken, the mean CAPE of S&P comes at 16.56, while the median comes to 15.93. Currently the CAPE of S&P 500 stands at 27.09, which means US stocks are currently over 70% more expensive than they have been on an average in the past.

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Wellershoff & Partners Ltd, a reputed Switzerland-based research firm, regularly comes up with its CAPE analysis of global equity markets. According to its latest report, the cumulative real returns of the US stock market for the last 5 year has been 7% and the annual real returns for the next 5 years is expected to be 1.4%, which when compared to other

developed economies is higher only to Ireland's figure of -0.6%.

The report mentions, "While Ireland has an even lower expected return, the US remains among the most overvalued equity markets, with the second-lowest expected returns globally. At a mere 1.4%, expected annual real returns for the US are several percentage points below international markets, indicating the US stock market is significantly overvalued. For a US investor, the benefits of international diversification have rarely been greater than they are today."

The Ideal Portfolio

The figures mentioned above prove that if return is what one is looking for in the foreseeable future, US isn't really the best option to place your bet on. However, that doesn't mean one must dump all US stocks and funds from one's portfolio because when it comes to stability and innovation, US still leads the pack among all the countries in the world. So, that leads us to the question - What percentage of funds one must earmark for global investments in one's portfolio?

While there is no rule of thumb as to what percentage of a portfolio must be allocated to investment in other markets, one can start with as low as 10-15% and gradually increase it to 40-50%. What that mix will do is, it will provide the necessary balance to your portfolio for combating the losses if the US market were to suddenly take a downturn while at the same time safeguarding you against turmoil in foreign economies.

Numerous financial products are available today if one wants to invest in foreign equity or debt, from ADRs to international and global mutual fund to ETFs. However, each has its own pros and cons and one must consult a financial advisor to understand the risk associated and to determine which of them would be ideal for one's portfolio.

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