SageBroadview

Home Bias and Global Diversification

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By pursuing a globally diversified approach to investing, one doesn't have to attempt to pick winners to achieve a rewarding investment experience.

Every day we enjoy the benefits of an interconnected world. We might start our day with a cup of coffee that originated in South America, check our email on a smartphone designed in California and manufactured in Taiwan, then shower and change into clothes woven from Egyptian fabrics before driving a German-made car or riding in a French-built train to work.

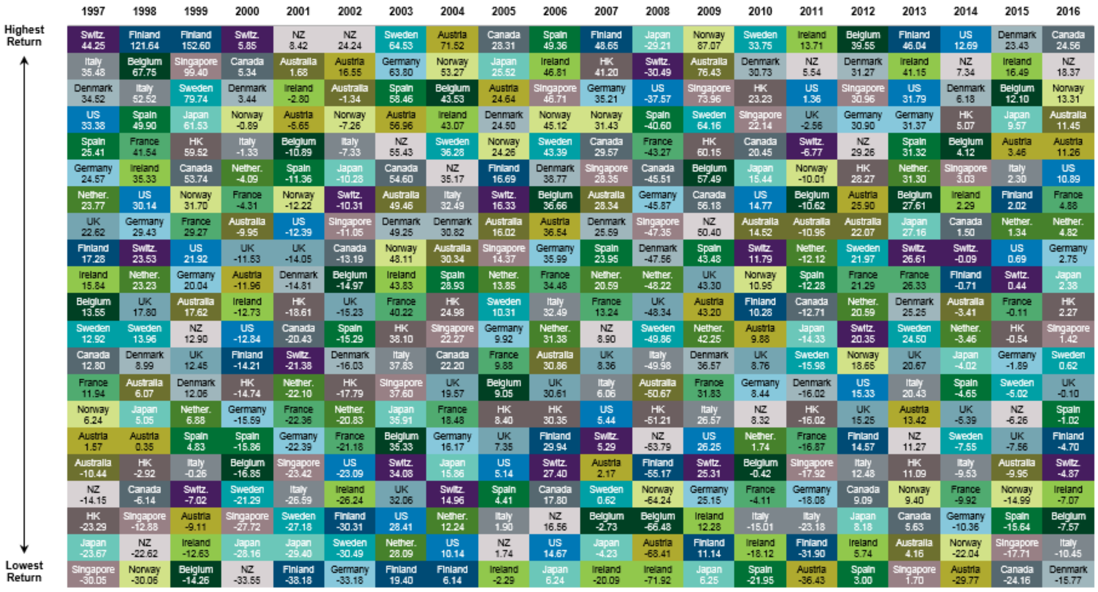
As consumers, we rarely think twice about the benefits of access to the cornucopia of goods the global market has to offer. Yet, as investors, we will often concentrate our portfolios in favor of our home market at the expense of global diversification. For example, while US stock markets represent just over 50% of the value of global equity markets, many US investors tend to allocate around 70% of their equity assets to domestic stocks.[1] This phenomenon, which can be observed across countries around the world, is known in the investment community as "home-country bias."

Given that certain frictions may be associated with investing abroad, a home-country bias may make sense for an investor in certain cases. For example, for tax-deferred investors in the US, foreign dividend tax withholdings may present a disadvantageous tax drag on international investments. In general, however, neglecting the benefits that global diversification has to offer may increase risks and decrease the investment opportunity set.

As **Exhibit 1** illustrates, 13 different developed countries (out of 21) had the best-performing equity market in a given calendar year for the 20 years ended in December 2016, and no country had the best-performing market for more than two consecutive years.

1. Willis Towers Watson, Global Pension Assets Study 2017.

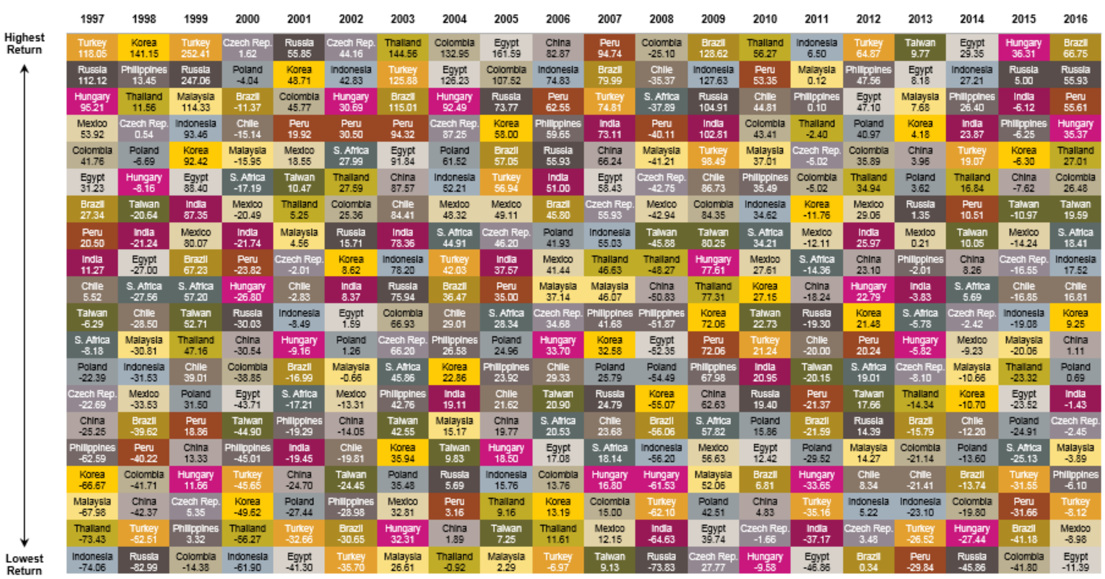
Exhibit 1: Equity Returns of Developed Markets
Annual Return (%)



In US dollars.
Source: MSCI developed markets country indices (net dividends). MSCI data © MSCI 2017, all rights reserved.
Indices are not available for direct investment. Index performance does not reflect expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

This trend was also observable in emerging markets. As **Exhibit *2*** illustrates, 13 different emerging market countries (out of 20) had the best-performing market in a given year, and no country had the best-performing market in consecutive years.

Exhibit 2: Equity Returns of Emerging Markets
Annual Return (%)



In US dollars.
Source: MSCI emerging markets country indices (gross dividends). MSCI data © MSCI 2017, all rights reserved.

Indices are not available for direct investment. Index performance does not reflect expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

This data shows that it is difficult to know which markets will outperform from year to year. By holding a globally diversified portfolio, investors are instead well positioned to capture returns wherever they occur.

Due to the recent positive performance of international stocks, investors today may be less worried about a global approach to investing than they may have been in the past. Over the last several years, however, strong performance in the US equity markets has led some market participants to question the value of holding a globally diversified portfolio. In different market environments, and as sentiments about global diversification and its value ebb and flow, it is helpful to remember that history has not shown any one market around the world to be a consistent outperformer.

Clearly, attempting to pick only winning markets in any given period is a challenging proposition. By pursuing a globally diversified approach to investing, one doesn’t have to attempt to pick winners to achieve a rewarding investment experience. By expanding the investment opportunity set beyond their domestic stock market, investors can help increase the reliability of outcomes. While diversifying globally implies an investor’s portfolio will not be the best performing relative to any one stock market, it also means it will not be the worst performing.

Source: Dimensional Fund Advisors LP.