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Home country bias?

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Michael Crook, Head Americas UHNW and Institutional Strategy, michael.crook@ubs.com; **Ainsley Carbone**

- Most investment advisors, including UBS, recommend that investors hold globally diversified equity portfolios.
- Statistically speaking, US equity portfolio and global equity portfolios have performed similarly over the last 48 years.
- Investors should expect decade-plus periods of alternating leadership by global and US portfolios.
- Investors that use US equities as the benchmark for a global equity portfolio are likely going to find a global portfolio uncomfortable.
- Even so, we believe retirees should consider holding globally-diversified equity portfolios instead of only investing in US equities.

Most investment advisors, including UBS, recommend that investors hold globally diversified equity portfolios. However, the sustained outperformance of US equities over the last eight years has challenged that view and many of the investors we work with are pushing back against global diversification.

This month, we take a deep dive into global equity portfolio performance, hypothesize that there's a behavioral finance reason strategists and investors disagree when it comes to non-US equities, and discuss two specific reasons retirees should keep some non-US exposure in their portfolios.

Although this report has been written with a US audience in mind, we hope our readers in other parts of the world also find the general themes instructive in thinking about their own home-country bias. Unless otherwise indicated, all performance data is presented in USD.

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What do 48 years of data tell us about global equity portfolios?

Since 1970 (the earliest data we have available), we have had four major cycles in US versus non-US equity performance: 1970-1988, 1989-2001, 2002-2009, and 2010-2017. Over that extended period, and with significant caveats, US equities have outperformed a global portfolio (one that includes US equities, non-US developed equities, and emerging markets equities), but average annual returns have not been statistically different.

We focus on analyzing global equity portfolio performance instead of international equity performance because most US investors are selecting between holding a US portfolio and a global portfolio, not a US-only portfolio and an non-US portfolio.

Do US equity portfolios really outperform global equity portfolios?

Although 48-year cumulative returns point to US outperformance (Fig. 1), that conclusion is highly dependent on the starting point.

- Statistically speaking, US equity portfolio and global equity portfolios have performed similarly over the last 48 years.
- Over 48 years, US equities have outperformed a global portfolio 51% of the time on a calendar year basis, meaning that the frequency of outperformance has also been roughly equal.
- Investors should expect decade-plus periods of alternating leadership by global and US portfolios (Fig. 2).

What about risk and volatility?

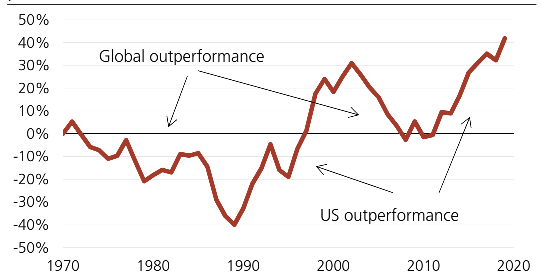
Equities are equities:

- Investors shouldn't expect meaningful volatility reduction from adding international equities to a US equity portfolio.
- In fact, global equity portfolios have historically been slightly more volatile than US-only portfolios over the last 48 years (Fig. 3).

The bottom line: We don't believe US equities structurally offer better returns over long periods than global portfolios, but long periods of relative outperformance or underperformance are not uncommon.

Fig. 1: Alternating US/ global leadership occurs over long cycles

Performance of a global portfolio versus a US-only portfolio



Source: Thomson Reuters Datastream, Bloomberg, Morningstar Direct, UBS. As of September 21, 2018.

Fig. 2: Four major cycles of global versus US leadership

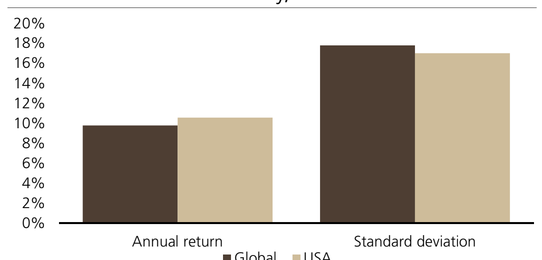
Total return for specified period

	Global	USA	Gap
1970-1988	1027%	577%	-450%
1989-2001	158%	462%	304%
2002-2009	51%	13%	-37%
2010-2018	119%	215%	97%

Source: Thomson Reuters Datastream, Bloomberg, Morningstar Direct, UBS. As of September 21, 2018.

Fig. 3: Return and volatility differences are small

Annual return and volatility, 1970-2018



Source: Thomson Reuters Datastream, Bloomberg, Morningstar Direct, UBS

Markowitz versus Kahneman

Strategists tend to rationalize ex-US underperformance as a normal part of a multi-year cycle we discussed earlier, but investors push back and ask why they own international equities in the first place.

There is a clear disconnect in these mindsets. This is where we think it comes from:

Portfolio theory, as developed by Harry Markowitz:

- Most strategists, academics, etc are trained to think investors are trying to maximize risk-adjusted return at the portfolio level across a long, multi-cycle time horizon.
- If you think like a strategist, the performance of non-US equities isn't viewed in terms of outperformance or underperformance to the US, because the US market isn't the benchmark.

Behavioral finance, as developed by Daniel Kahneman, among others:

- Prospect theory, the idea that investors value gains and losses differently, is a central idea in behavioral economics.
- As a rule of thumb, the pain of a loss is 2x the joy of a similarly sized gain.
- If a global portfolio produces the exact same return as a US equity portfolio, an investor that implicitly uses the S&P as his or her benchmark will be less satisfied with the global portfolio, because periods of outperformance do not compensate (psychically) for equally sized periods of underperformance.

What should investors do?

We recommend that investors hold globally-diversified equity portfolios, but the behavioral aspect of benchmarking against a US equity index might make doing so untenable.

If the US market is your implicit equity benchmark:

- You should probably have much less in international equity than a global portfolio would suggest.
- You might miss out on some long-term outperformance, but it's (psychologically) worth it to avoid the long, frustrating periods of underperformance.

If you don't benchmark your entire equity portfolio to the US market:

- Maintain a global portfolio, knowing that we will go through long US/non-US leadership cycles.

Do international equities play an important role for retirees?

Over the very long run (multiple market cycles), global equity portfolios and US equity portfolios will likely have similar returns. Unfortunately, as John Maynard Keynes pointed out, "over the long run we are all dead." Our task, which is to manage portfolios effectively through the next cycle, requires considering the risks and opportunities that could derail or enhance our ability to meet our objectives.

We expect better returns from non-US equities than US equities over the next part of the cycle. Why do we have that view?

- The earnings boost from US tax cut is fading.
- The US economic cycle is further along than most other regions.
- Emerging markets trade at an 18% discount to their long-term average, whereas US equities trade at an 18% premium. Valuations in the technology sector, which has created a large portion of US outperformance, appear particularly stretched.

There's also a specific portfolio risk that non-US equities can be useful for hedging: inflation. Domestic inflation generally leads to currency depreciation. In environments with higher-than expected inflationary pressures, the foreign currency exposure inherent in non-US equity allocations can help hedge against losses of purchasing power.

The 1970s are a good example of such a period (Fig. 4). Inflation averaged 7.25% between 1970 and 1979, and the dollar declined by 30% over the decade. Non-US equities returned an average of 11% per year, whereas US equities averaged 6% per year. Net of inflation, non-US equities actually appreciated in value, but US equities lost over 10% of their purchasing power during the decade. We do not expect a repeat of the 1970s, but non-US exposure adds some peace of mind to hedging the (potentially inflationary) fiscal and monetary risks we face in the US.

Fig. 4: Global equity portfolios have done better during periods of dollar depreciation

Cumulative return by decade

	Global	USA	USD Change
1970-1979	116%	77%	-30%
1980-1989	514%	404%	9%
1990-1999	203%	433%	9%
2000-2009	9%	-9%	-24%
2010-2018	119%	215%	18%

Source: Thomson Reuters Datastream, Bloomberg, Morningstar, UBS. As of September 21, 2018.

Appendix

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