Article

The benefits of international diversification

Throughout recorded market history, it is exceptional to find a single market that has consistently performed amongst the top stock markets globally. It is even more difficult to predict which market will be the next top performer in any given year. This simple reasoning is probably the best advocate of international diversification, especially considering investment portfolios of a long-term horizon.

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
FRA 40%	SWE 78%	CAN 4%	NLD 6%	NLD 20%	DEU 60%	SWE 34%	CAN 27%	SWE 40%	HKG 37%	JPN -31%	AUS 69%	SWE 31%	NLD 1%	DEU 27%
DEU 28%	JPN 61%	FRA -5%	AUS 0%	AUS -4%	SWE 61%	NLD 30%	JPN 24%	DEU 33%	DEU 33%	USA -39%	SWE 60%	HKG 20%	USA 0%	HKG 24%
USA 29%	HKG 55%	AUS -12%	USA -13%	JPN -11%	CAN 52%	AUS 27%	AUS 13%	FRA 32%	CAN 28%	FRA -45%	HKG 55%	CAN 18%	GBR -6%	NLD 23%
GBR 15%	CAN 52%	GBR -14%	GBR -16%	CAN -14%	NLD 50%	CAN 21%	SWE 8%	AUS 27%	AUS 25%	CAN -47%	CAN 53%	JPN 13%	AUS -15%	SWE 19%
SWE 13%	FRA 28%	USA -14%	CAN -21%	GBR -18%	AUS 45%	HKG 21%	DEU 8%	HKG 26%	FRA 11%	DEU -47%	NLD 43%	USA 13%	CAN -14%	FRA 18%
JPN 4%	USA 21%	DEU -16%	HKG -21%	HKG -21%	FRA 38%	FRA 16%	FRA 8%	GBR 26%	USA 4%	GBR -51%	GBR 37%	AUS 10%	JPN -16%	AUS 16%
AUS 4%	DEU 19%	HKG -17%	FRA -23%	FRA -22%	JPN 35%	GBR 16%	HKG 5%	CAN 16%	NLD 4%	SWE -51%	FRA 28%	DEU 6%	SWE -18%	USA 14%
CAN -7%	AUS 15%	SWE -22%	DEU -23%	USA -24%	HKG 32%	DEU 14%	USA 4%	USA 13%	GBR 5%	AUS -52%	USA 24%	GBR 5%	HKG -18%	GBR 11%
HKG -8%	NLD 10%	JPN -29%	SWE -28%	SWE -31%	GBR 27%	JPN 15%	GBR 4%	NLD 10%	SWE -1%	HKG -53%	DEU 21%	NLD 3%	FRA -19%	CAN 7%
NLD -25%	GBR 10%	NLD -36%	JPN -30%	DEU -34%	USA 27%	USA 9%	NLD -3%	JPN 5%	JPN -5%	NLD -56%	JPN 4%	FRA -7%	DEU -20%	JPN 6%

Source: Index Fund Advisors statistics

Drawing from the annual market returns map presented, it is not hard to understand why holding a globally diversified portfolio has historically out-performed domestic-only portfolios on a risk-adjusted return basis.

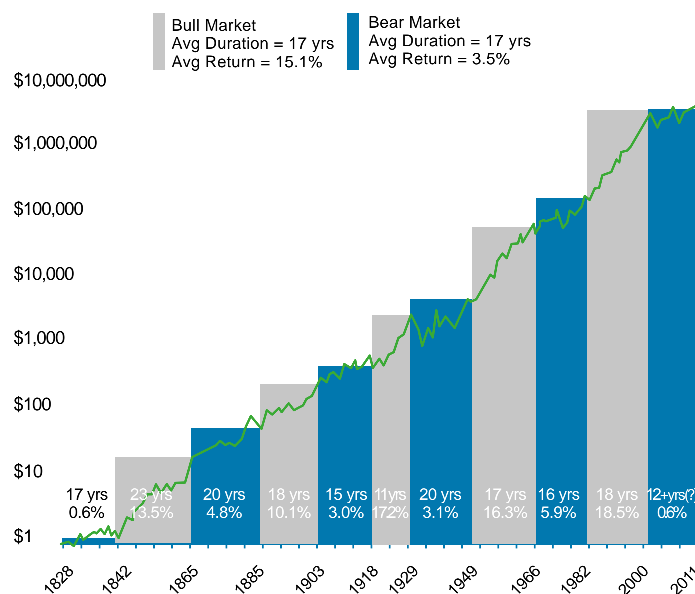
Investing globally is not about maximising performance in any given year. The main benefit from investing in countries with low cross-correlations is to improve the risk-adjusted performance of a portfolio - that is taking less risk for the same level of return or earning a higher return for the same level of risk.

International portfolio diversification benefits are generally found to be less important for US investors, due to the sheer size of US capital markets and the fact that much of it can be achieved indirectly at home through investing in country funds, depositary receipts and a growing

number of multinational firms that sell their products and services all over the world and are therefore more dependent on global rather than domestic conditions. Nonetheless, US-based portfolios do stand to benefit from broad international diversification since in periods of financial crisis, correlations tend to converge and the risk of currency devaluation increases.

For those of us on the other side of the Atlantic, and particularly in the EU, the issue of international diversification became much more relevant since the creation of the euro. The unification of monetary policy among the member states and the absence of currency risks led to a significant increase of the correlation between financial markets across European countries, limiting the benefits arising from Europe-wide portfolio diversification.

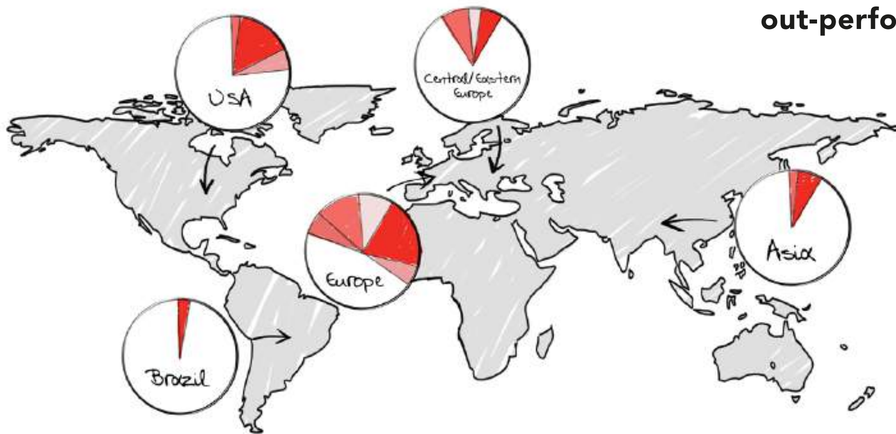
Independent national markers tend to react to factors such as changes in domestic monetary and fiscal policies. The magnitude of change as well as the time lag between different cycles provides for considerable diversification benefits when investments in different markets are held in combination.



The bigger picture: Long-term trend of the US market,
Source: Investment Wealth Monitor IMCA

Thus, in order to more efficiently diversify, one has to look beyond the large global giants in search of less correlated investments, in the form of smaller, quality companies that are more dependent on the conditions of their local economies. With their returns being driven mostly by local factors, they become a more effective diversifier than international large-cap stocks.

"Holding a globally-diversified portfolio has historically out-performed domestic-only portfolios on a risk-adjusted return basis"



While understanding that porfolio returns will be mainly driven by the top-performers of each year, one of the most persistent mistakes made when building a portfolio is evaluating potential investments in isolation, instead of considering how their addition affects the overall risk and return of the portfolio as a whole. When assets of a portofolio are negatively correlated, high volatility is actually a good thing.

Investors should be willing to trade off some upside potential to remove some of the downside risk that comes with it. Risk-averse investors should therefore also consider including a small allocation of alternative investments with low or negative correlation to traditional assets, such as commodities.

Commodities tend to perform best in periods of rising inflation (which can negatively impact the returns of traditional asset classes) and during periods of supply shocks. Their addition to a portfolio has historically reduced the tail risk (both good and bad) of investing in a portfolio that only includes traditional stocks and bonds

Long-term portfolios, such as pension and retirement schemes, for example, should definitely include commodities in their portfolio since they are more susceptible to the risk of unexpected inflation. Even a small allocation of alternatives can have a meaningful impact on the overall portfolio.

Last but not least, international investors should be careful not to commit to what is called the "availability bias" – believing that recent outcomes will recur, and repeatedly invest on the same basis. Actively rebalancing a portfolio should entail shifting from overperforming to underperforming investments, not the other way around.

Michael Hadjihannas

Mr. Hadjihannas is the Director of Client Services at Emergo Wealth. He is a holder of the advanced certification issued by the Cyprus Securities and Exchange Commission and he has more than 15 years of experience in the financial services industry, inter alia in the fields of wealth management and investment advice. He is an experienced public speaker and he has taught on a wealth of subjects such as financial market mechanisms and structure, technical analysis and money management, as well as the creation and optimisation of algorithmic trading programs.

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