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1988-2015 – A Review of Global Asset Class Investing – *Benefits and Risks*

By Ian A. Post, CFA

Global Asset Class investing is often touted as a strategy that can reduce portfolio volatility and potentially increase returns. To benefit from this approach investors must overcome a psychological hurdle to investing in unfamiliar areas of the world. Because of this 'home bias', investors tend to overweight their equity allocation toward their home country. For example:

- While Canadian equities represent just 3.4% of the global equity market, investors there, on average, hold 59% of their equity exposure in Canadian stocks.
- The average U.S. investor holds roughly 80% of their equity exposure in U.S. stocks compared to the U.S. global allocation of about 50%.[1 2]

We find that investors who succumb to home bias experience higher portfolio volatility without the benefit of conclusively higher expected returns.

We can analyze this scenario using the period from 1988[3] - 2015 from the perspective of a U.S. investor by assuming the default equity allocation for U.S. investors is 100% U.S. stocks (0% international) as represented by the S&P 500. We then analyze what happens as we add incremental exposure to international stocks.[4]

The chart shows that, initially, as we move away from a 100% U.S. equity portfolio, adding international exposure reduces portfolio volatility. During this period, the maximum benefit occurs when international equity exposure is between 20% and 30% of the equity portfolio. Additional international equity beyond 30% begins to reduce the benefit. Interestingly, at a 50% international allocation, roughly equivalent to the global market, portfolio volatility is equal to the U.S. only equity portfolio.

We also see that during this period, as we add international exposure, realized returns decline. The U.S. only equity portfolio returned 10.3% annually vs. 9.9% for a 90 - 10 U.S. International blend and 9.5% for an 80% - 20% blend.

The answer to the question, do investors experience higher portfolio volatility due to home bias is yes. During the period 1988 - 2015, adding international exposure to domestic equities increased diversification and thereby reduced portfolio volatility. Regarding returns, the answer is less clear. During this period, international exposure reduced realized returns. However, returns tend to be more random than volatility suggesting that we may see periods when adding interna-

tional exposure increases returns. Without any special insights into future returns, investors are better off assuming U.S. and international equity returns will be similar in the future and focus instead on strategies that reduce volatility.

Designing a portfolio with an allocation to international equities helps diversify domestic equity portfolios, reduces volatility and potentially increases returns so work to overcome any home bias you may have and blend some international flavor into your portfolio.

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[1] Vanguard: "The Global Case for Strategic Asset Allocation and an Examination of Home Bias" – July 2016 [2] Dimensional Fund Advisors: As of August 2016, the Global Market was composed of 52.7% U.S., 36.7% International Developed, 10.6 % Emerging Markets. [3] MSCI launched its All Country World ex. U.S. index in 1988 that covered the entire global market excluding the U.S. [4] U.S. stocks are represented by the S&P 500 Index and international stocks are represented by the MSCI All Country World Ex. US Index.