The abundance of options in world equity markets and recent high correlations among countries have left investors confused about how to use global investing to achieve portfolio diversification. This article provides a discussion of key topics in global investing so investors can understand and make informed decisions about country-focused investment strategies.

Are Investors Reluctant to Go Global?

Most investors likely consider global investing, but the majority of investors—regardless of where they live in the world—exhibit a significant home-country bias. However, a country-focused approach to a global equity mandate that includes exposure to both developed and emerging countries can enhance performance, so investors should mind this tendency to avoid going global.

Consider how this bias shows up in U.S. college endowments, where U.S. exposure accounts for 54–75 percent of investments and larger endowments are more likely to invest globally than smaller ones. At the same time, the United States represents roughly 43 percent of world market cap (as defined by the MSCI AC World Index).

Most investors likely consider global investing, but the majority of investors—regardless of where they live in the world—exhibit a significant home-country bias.

Non-U.S. developed countries show a similar bias (table 1). This non-U.S. home-country bias is substantially larger than U.S. home bias (which can be explained, in part, by the large U.S. weight in the MSCI Index). Foad (2008) found even more home-country bias in nondeveloped markets.

Two fundamental reasons drive this bias:

Familiarity. Investors are more comfortable investing in what they know. Microsoft, Apple, and Caterpillar feel like home to a U.S. investor; America Móvil, Teléfonos de México, and Cemex are comfortable destinations for a Mexican investor. But does the typical U.S. investor have the inside track on even a handful of the 500 companies in the S&P 500? If so, is that information advantageous? Of course not. A U.S. investor can no more predict the S&P 500 than he can predict the German DAX or the Mexican Bolsa.

The familiarity of domestic stocks creates a false sense of security.

Risk. Investors are risk-averse. U.S. investors typically seek to avoid investments that expose them to currency fluctuations, political and economic risks (including nationalization and expropriation), a lack of generally accepted accounting standards, a lack of publicly available information concerning issuers, and low levels of government regulation. Meanwhile, U.S. investors tolerate other risks in their own markets such as presidential elections with unknown results for more than a month, fraud perpetuated by the largest companies on the exchange, abuse of generally accepted accounting principles to hide poor results, and inconsistent government regulation among industries. Indeed, risk is present at home and offshore.

Regardless, investing globally has advantages. Despite recent correlation increases at the country and sector levels, diversification among countries generally offers lower overall portfolio volatility. Investors also benefit from a broader selection of equities, sectors, and countries.

Consider that during the past 20 years the United States has never ranked as the top-performing country among

<table>
<thead>
<tr>
<th>Home-Country Weight in MSCI World Index</th>
<th>Home-Country Allocation</th>
<th>Rest of World</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>2%</td>
<td>63%</td>
</tr>
<tr>
<td>Canada</td>
<td>3%</td>
<td>49%</td>
</tr>
<tr>
<td>Japan</td>
<td>12%</td>
<td>60%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>11%</td>
<td>64%</td>
</tr>
</tbody>
</table>

Source: Alliance Bernstein – Pension Study 2009

© 2011 Investment Management Consultants Association. Reprint with permission only.
developed markets. The United Kingdom hasn’t claimed a spot among the top 10 developed countries in the past 20 years. But in the past decade Indonesia and Peru have ranked in the top 10 markets seven and eight times, respectively.

Country Effects versus Sector Effects

Historical Research

Ever since diversification pioneer Bruno Solnik (1974) concluded that investors should diversify across countries due to modest cross-market correlations, researchers have been trying to understand why the economies and markets of various countries move asynchronously. Low correlations among countries generally are attributed to inter-country differences in monetary policy, fiscal policy, economic cycles, sector composition of equity markets, tax regimes, foreign policy, economic systems, and politics.

From the 1970s into the early 1990s, the country effect was the dominant driver of equity market returns across both developed and emerging countries. In the late 1990s, correlations started to rise across countries, regions, and sectors, and country effects no longer dominated sector effects in explaining variability in returns (see, for example, Lessard 1974, Baca et al. 2000, Cavaglia et al. 2000, Hamelink et al. 2001, and Lin et al. 2004). As a result, many investment firms shifted their research and organizational structures from a country focus to a sector focus (Fay 2004).

At the same time, the sector effect grew in importance but the country effect remained dominant (see, for example, Griffin and Karolyi 1998, Gerard et al. 2007, L’Her et al. 2002, Isakov and Sonney 2003, and Phylaktis and Xia 2006). Del Negro and Brooks (2005) concluded that “outside of the U.S. and beyond the TMT (telecommunications, media, and technology) and biotechnology sectors, there is only weak evidence that sectors are more important than countries.” Estrada et al. (2005) concluded that though sector effects have grown stronger, country effects have been, on average, more important, and it is unknown which will be dominant in the future.

Recent Research

Recent research supports Estrada et al. (2005). Labarge (2008) states: “Our investigation of country versus sector effects found that the relative importance of country versus sector factors changes over time and depends on a number of considerations. Thus, investors seeking global representation in their investment portfolios should continue to consider diversifying broadly across both country and sector.” Country effects tend to dominate sector effects in emerging markets (see figure 1) (Kang et al. 2010), while both effects tend to be cyclical (and somewhat
Is Global Diversification Waning?
An Accuvest proprietary analysis examined the trend of correlations between countries over time. This study included MSCI single-country indexes (gross of dividends) since 1985, with a subset of 38 countries with single-country exchange-traded funds (ETFs).

Figure 3 presents the average 12-month correlation of the country basket to the MSCI World Index. The correlations, though volatile, have trended upward since the early 1990s. Note that the current level of local currency correlation, 0.74, has been hit roughly five times since 1985 and that a two-year drop has followed each peak in correlation (see figure 3 and table 2). This pattern doesn’t seem predictive but it is evidence that correlations are cyclical.

Does Increased Correlation Equal Decreased Cross-Sectional Volatility?
As country correlations increase, volatility tends to decrease, as shown in figures 4 and 5.

Figure 4 shows that the average monthly differential between the best- and worst-performing countries during 1991–2010 was just more than 33 percent. Dispersion was consistently high through the 1990s, with two or three short exceptions, and has been lower than average since 2002.

A similar pattern is illustrated in figure 5. Since 2003, dispersion of returns has been lower than average and now sits at approximately one standard deviation below the long-term average of 6.5 percent. Current levels of volatility are at multi-year- and multi-decade-lows, and the recent trend of volatility has been downward.

This analysis implies that of late it has been difficult to reduce risk (or create alpha) by allocating among different countries. In the past five years correlation also has risen among

---

**TABLE 2: AVERAGE 12-MONTH CORRELATION OF COUNTRY UNIVERSE (LOCAL CURRENCY) TO MSCI AC WORLD INDEX**

<table>
<thead>
<tr>
<th></th>
<th>Since 1986 LC</th>
<th>Since 1995 LC</th>
<th>Since 1986 USD</th>
<th>Since 1995 USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current 12-Month Trailing Correlation</td>
<td>0.74</td>
<td>0.74</td>
<td>0.82</td>
<td>0.82</td>
</tr>
<tr>
<td>Average 12-Month Correlation</td>
<td>0.58</td>
<td>0.64</td>
<td>0.59</td>
<td>0.66</td>
</tr>
<tr>
<td>Max 12-Month Correlation</td>
<td>0.88</td>
<td>0.88</td>
<td>0.92</td>
<td>0.92</td>
</tr>
<tr>
<td>Min 12-Month Correlation</td>
<td>0.16</td>
<td>0.37</td>
<td>0.13</td>
<td>0.29</td>
</tr>
</tbody>
</table>

Source: Accuvest Global Advisors

---

**FIGURE 3: AVERAGE 12-MONTH CORRELATION OF COUNTRY UNIVERSE TO MSCI AC WORLD INDEX (LOCAL CURRENCY) THROUGH DECEMBER 2010**

**FIGURE 4: MONTHLY RANGE OF RETURNS FOR COUNTRY BASKET (HIGH-LOW) THROUGH DECEMBER 2010**

---

© 2011 Investment Management Consultants Association. Reprint with permission only.
business, then a U.S. company that does 70 percent of its business outside the United States should generate better global diversification than a U.S. company that does all its business in the United States.

We tested this hypothesis with proprietary research that started with a basket of the 10 largest stocks in each of 29 different equity markets. We then measured the correlations of the stocks to a series of indexes including the local market, the MSCI ACWI, the MSCI EAFE, the MSCI Emerging Markets, the S&P 500, and a series of 10 MSCI ACWI sector indexes. The data source was Bloomberg.

Results indicate that during the past three years cross correlations have been high and industry effects in developed markets significantly affected the variability of stock market returns, but the stocks in each country basket still correlated more with their home markets than with any global sector. For example, the average correlations for the U.S. basket were 0.73 with the S&P 500; 0.64 with the EAFE; and 0.60 with Emerging Markets. The industrials sector was the most highly correlated sector at 0.70. Notably, the correlations were higher than historical average correlations, but in no case was the basket more closely correlated to any global sector than it was to its home country. In fact, over the past one-, three-, five, and 10-year periods, in 99 percent of the cases, the average correlation of the 10-stock basket was higher to its home country than any global sector.

Implications for Investors

Is a country-focused investment strategy a sensible investment strategy? Both historical and recent research indicates that countries do matter. In the past decade, sector and industry effects have become more important, but they haven’t eclipsed country effects in emerging and developed markets. Therefore, exposures to developed and emerging markets are just as important as exposure to developed and emerging sectors.

Why are country correlations increasing and why is cross-sectional volatility decreasing? Many academics and practitioners believe globalization is behind these trends, because the country of domicile of a stock is less important than where the company does business, especially when global fiscal and monetary policies are in sync across countries and regions.

Europe led this synchronization in the 1990s by establishing the European Union and its single currency unit, the euro. Other countries and regions have followed suit by adopting similarly easy fiscal and monetary policy, which has significantly decreased the volatility of gross domestic products (GDP) and other economic results. As a result, GDP correlation has increased significantly among countries.

During the past four years, “risk on” and “risk off” have been big watchwords for portfolio managers. As investors took risk off in 2007–2008, correlation between risky assets spiked, which included stocks of all capitalizations, sizes, and geographies. Real estate, hedge funds, high-yield bonds, and emerging market bonds showed similar correlation increases. Coaker (2010) states: “High correlations are a sign that investors are worried the crisis has not passed.” In other words, this change has less to do with fundamentals and more to do with systemic problems in the world financial markets.

In another twist, cross-sectional country volatility increased between mid-2007 and early 2009. This is inconsistent with the common belief that all risky assets are highly correlated. This was a cue for portfolio managers to be long risky assets. As cross-sectional volatility increased, the opportunities for generating alpha through country selection increased.

Do Global Stocks Equal Diversification?

If the domicile of a stock is less important than where the company does business, then a U.S. company that does 70 percent of its business outside the United States should generate better global diversification than a U.S. company that does all its business in the United States.

We tested this hypothesis with proprietary research that started with a basket of the 10 largest stocks in each of 29 different equity markets. We then measured the correlations of the stocks to a series of indexes including the local market, the MSCI ACWI, the MSCI EAFE, the MSCI Emerging Markets, the S&P 500, and a series of 10 MSCI ACWI sector indexes. The data source was Bloomberg.

Results indicate that during the past three years cross correlations have been high and industry effects in developed markets significantly affected the variability of stock market returns, but the stocks in each country basket still correlated more with their home markets than with any global sector.

For example, the average correlations for the U.S. basket were 0.73 with the S&P 500; 0.64 with the EAFE; and 0.60 with Emerging Markets. The industrials sector was the most highly correlated sector at 0.70. Notably, the correlations were higher than historical average correlations, but in no case was the basket more closely correlated to any global sector than it was to its home country. In fact, over the past one-, three-, five, and 10-year periods, in 99 percent of the cases, the average correlation of the 10-stock basket was higher to its home country than any global sector.

Implications for Investors

Is a country-focused investment strategy a sensible investment strategy? Both historical and recent research indicates that countries do matter. In the past decade, sector and industry effects have become more important, but they haven’t eclipsed country effects in emerging and developed markets. Therefore, exposures to developed and emerging markets are just as important as exposure to developed and emerging sectors.
emerging countries can benefit from the country-focused investment model. Desynchronization of fiscal and monetary policies among countries likely will increase cross-sectional volatility in various global markets. Along with the increased dispersion in returns, expect an increased opportunity set for investors seeking alpha through country selection.

From an implementation perspective, the number of single-country ETFs has grown in the past five years. Forty single-country ETFs—and an additional 10 ETFs dedicated to single-country, small-cap stocks—provide lots of choices for country-focused portfolio managers, who can express investment opinions with targeted implementation vehicles that minimize single-security risk.

David J. Garff, CIMA®, is founder and president of Accuvest Global Advisors in Walnut Creek, CA. He earned a BA in economics and Spanish translation from Brigham Young University and an MBA in finance from the Haas School of Business, University of California, Berkeley. Contact him at david.garff@accuvest.com.

Endnote

1 The country universe includes Austria, Australia, Belgium, Brazil, Canada, Chile, China, Colombia, Egypt, France, Germany, Hong Kong, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Malaysia, Mexico, Netherlands, Peru, Poland, Russia, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Kingdom, and the United States. Vietnam, which does have a single-country ETF, was excluded due to an extremely short index history.

References


Disclaimer: The comments in this paper reflect the research and analysis of Accuvest Global Advisors (AGA). AGA does not recommend specific investments based on this analysis as global investing and international allocations may not be suitable for all investors. Investors should seek advice from their financial advisor before investing internationally regarding their general suitability.