Geographic location is increasingly less meaningful when it comes to investing. At one time, all markets were largely domestic and the fortunes of companies largely depended on the local environment. But international trade now accounts for nearly two-thirds of world gross domestic product (GDP), up from less than half just 10 years ago and one-third about 30 years ago, according to the World Bank. The world increasingly has become a single global marketplace in which companies sell and operate. Investors should consider global developments when investing and consider investing globally by including U.S. and internationally based companies in portfolios.

Why consider a global perspective now? I believe that a global perspective is crucial to investing and that geography is not of paramount importance when it comes to allocating portfolios. However, certain country- and region-specific factors still should be considered. These factors point to potential for more-consistent relative performance by international stocks, which lagged U.S. stocks in the first half of this decade.

Wider Opportunity
Global stock market exposure that combines U.S.-based and non-U.S. stocks has delivered better performance than owning only U.S. stocks over the long term. Historically, the better performance by global stocks over the long term is the result of a wider set of opportunities than that provided by domestic stocks alone.

Half the global stock market, measured by the MSCI World Index, is made up of U.S.-based companies, with the other half based outside the United States. Looking at developed global stock market performance, represented by the MSCI World Index, we can see the many long-term periods when global stocks outperformed the U.S. stock market. Specifically, global stocks outperformed U.S. stocks for all but 11 of the 34 rolling 10-year periods since the inception of the MSCI World index in 1970. It’s worth noting that those periods of U.S. stock outperformance from 1995 to 2006 all included the late 1990s technology stock bubble in the United States.

Managing Risk
Rewarding performance is not just about gains; it’s also about minimizing losses. International stocks have provided returns similar to those of U.S. stocks over the long term but have suffered fewer losses. The lesser frequency of losses for global stocks can be seen by examining five-year rolling periods over the past 45 years of monthly data, which reveals that of the 540 periods there were 80 when the MSCI USA Index suffered a loss compared to 67 for the MSCI World Index.

The lesser magnitude of losses for global stocks can be seen in the worst 10-year period for both indexes over the past 45 years, which was from February 1999 to February 2009. That period included both the bursting of the Internet bubble and the associated recession that took place from 2000 to 2002 and the global financial crisis in 2008 and 2009. Importantly, global stocks lost an annualized 2.5 percent over that difficult period, while U.S. stocks fell a significantly greater annualized 4.2 percent, as illustrated in figure 1. (Because global stocks include U.S. stocks, it is worth noting that developed-market international stocks measured by the MSCI EAFE Index lost only 1 percent on an annualized basis during that period.) That may not seem like a dramatic difference, but compounded over the 10-year period it amounted to a 25-percent difference in portfolio value.

When economic growth in the United States was stronger than in the rest of the developed world, global stocks outperformed U.S. stocks. That may seem counterintuitive, but it’s true. Relative GDP growth often is used to make a decision on investing in...
certain regions or countries, but it has not been a good barometer of relative market performance.

Periods of relatively stronger U.S. economic growth are not rare. Over the past 45 years, U.S. economic growth has exceeded that of the major economies that make up the Group of Seven (G7) countries over a four-quarter period two-thirds of the time, as illustrated in figure 2. During those periods, the United States averaged 3.4-percent GDP growth compared with 2.8 percent for the G7 countries. Surprisingly, during those four-quarter periods when U.S. growth was stronger, the MSCI World Index posted an average gain of 14 percent, outperforming the MSCI USA Index’s 13.3-percent return, measured in dollars since the inception of the MSCI World and MSCI USA indexes in 1969.

Although you take risks when you invest in any stock or security, international investing has some special risks. These include geopolitical events, changes in currency exchange rates, potential for illiquid markets, and different tax and accounting regimes. Over the past 45 years of data presented here, these factors have affected relative performance. Historically, these risks have been offset by the greater risk diversification from investing globally, which has had lesser frequency and depth of downturns compared with investing only in the United States.

This may be because we live in an increasingly interconnected world that offers many offsetting factors. Geopolitical events around the world can affect markets far from where they actually operate. Likewise, U.S. political events can affect markets around the world. In addition, currency moves can provide some diversification and even have offsetting effects. For example, a rising dollar may reduce dollar-based returns on international investments, but weaker foreign currencies may stimulate sales growth for businesses in those regions, helping to lift stocks and acting to offset the drag on returns.

Looking Ahead
We can never be sure what lies ahead for markets. But the long history of valuations and performance gives us some indication. Historically, there has not been much of a relationship between valuation and future market performance over the short to intermediate term. But that relationship strengthens over longer periods such as 10 years.

Figure 3 shows how the price-to-earnings (PE) ratio is a strong indicator of returns over the next 10 years for various countries and regions. The graphs have the PE flipped upside down to show that the higher the price of the stocks, the lower the returns turn out to be. Over a 10-year period, the average annualized return closely tracks the inverse of the PE at the start of that period. This very consistent historical pattern offers some insight as to what returns may be over the coming 10 years.

For example, the annualized 10-year return of the MSCI World Index ranged from a high of about 18 percent in the late 1970s, when the PE was a low 10, to the annualized losses for the 10-year period that began in 2000, when the PE had soared over 30. As of the end of 2014, the MSCI World Index PE indicates that returns over the coming 10 years may be near the middle of a 5–10-percent range. Figure 3 also shows that this is the same long-term return outlook that is indicated by the PE for other major regions around the world, including the United States, Europe, and the 21 countries in the MSCI EAFE ex Japan Index.

I believe this is strong historical evidence that there is no reason based on valuation to favor only U.S. stocks in a portfolio over the long term.

Opportunity
The main reason global markets have tended to perform better than the U.S. stock market during more than half of the past 45 years: Opportunity. Much of the world’s stock market capitalization lies outside the United States, as shown in figure 4, both in total and on an investable index basis. As global liquidity improves, the geographic breakdown of the world’s investable stock market is likely to migrate toward the total market capitalization. Based on the constituents of the MSCI World Index, at least half of the top 10 stocks in the global financial, health care, telecommunications services, energy, and materials sectors are based outside the United States. The much larger opportunity set includes a broader range of values and prospects for growth, offering the potential for better performance over the long term.

The value of a wider opportunity is evident when considering that the best-performing stocks in a global sector most often are not U.S. stocks. In fact, in 2014 the 10 highest-performing stocks in the MSCI World Index did not include any U.S.-based companies. Furthermore, few U.S. stocks were among the top 10 performers in any sector.

Stocks Are Not Shares of a Country
When buying the stock of a company based in a certain country, it’s important to realize that it’s not like owning a share in that country. The stock sector, such as financials...
The Case for a Global Perspective

or technology, matters much more to performance than the company’s home country or region.

One way to see why thinking about geography first when making investment decisions makes little sense is by looking at U.S. stocks and their locations at the state level. Few investors, for example, would consider how much to allocate to stocks of companies based on whether they are headquartered in Texas or New York. Yet state economies can vary dramatically. Investment performance by state can vary widely as well. New York–headquartered companies outperformed those based in

Figure 3: Valuations Point to Similar Long-Term Returns for U.S. and Global Stocks

Figure 4: The United States Contains Only a Portion of the World’s Equity Opportunities

Past performance is no guarantee of future results.
Source: Charles Schwab, FactSet data as of May 13, 2015

Investable Market Capitalization

Total Market Capitalization

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Texas by 61 percent over the three years ending 2014, measured by the Bloomberg Texas State Index and Bloomberg New York State Index.

Of course, this seems silly. Unless investing in very small companies that primarily serve the local market where a company is headquartered, a company’s home state matters relatively little compared with its sector and other global macroeconomic drivers. New York stocks were led higher by a 40-percent weight in financial-sector stocks, and the energy-sector stocks that make up a third of Texas-based companies have lagged the overall stock market. And, of course, stocks in both Texas and New York rose due to the overall growth in the global economy, profits, and investor demand.

Yet when investing outside the United States, investors often make decisions based first on country or region rather than sector. We can show just how backward that thinking is.

**Correlation and Common Sense**

Let’s look beyond the United States to see the same sector impact we observed with New York and Texas to show that the high correlation between sectors across countries makes common sense.

For example, technology stocks in Europe behave much more like other technology stocks around the world than they do other European stocks. Table 1 shows that every one of the 10 sectors of Europe’s stock market has a higher correlation with the same global sector than with overall European stocks. For example, the total return in dollars of the MSCI Europe Financials Index since its inception in July 2000 has a 0.95 correlation with the MSCI World Financials Index, but only a 0.47 correlation with the MSCI Europe Index. The dominance of a stock’s sector over geography when it comes to performance is even more consistent when looking at returns in local currencies.

This means that a stock is much more likely to behave like other stocks in the same sector—wherever those companies are headquartered—than like the country in which it is based. For example, it would be easy to assume that stocks in Europe’s consumer discretionary sector have languished over the past few years given Europe’s double-digit unemployment rate, a return to recession in some European countries during that period, and banks’ tightening of lending to households for much of that period. Furthermore, since June 30, 2012, the unemployment rate in Europe has been above the March 2015

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<th>Correlation of MSCI Europe Sector Indexes to MSCI World Sector Indexes and MSCI Europe Index</th>
<th>Europe Sector and World Sector</th>
<th>Europe Sector and Europe</th>
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<tbody>
<tr>
<td>Consumer staples</td>
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<td>0.79</td>
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<td>Materials</td>
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<td>Information technology</td>
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</tbody>
</table>

Correlation measured using monthly data from July 2000–December 2014

All indexes calculated using total return in local currency.

MSCI World Index, MSCI World Information Technology Index, MSCI World Health Care Index, MSCI World Industrials Index, MSCI World Consumer Discretionary Index, MSCI World Consumer Staples Index, MSCI World Energy Index, MSCI World Telecommunications Services Index, MSCI World Financials Index, MSCI World Utilities Index, MSCI World Materials Index, MSCI Europe Index, MSCI Europe Information Technology Index, MSCI Europe Health Care Index, MSCI Europe Industrials Index, MSCI Europe Consumer Discretionary Index, MSCI Europe Consumer Staples Index, MSCI Europe Energy Index, MSCI Europe Telecommunications Services Index, MSCI Europe Financials Index, MSCI Europe Utilities Index, MSCI Europe Materials Index.

Source: Charles Schwab, Bloomberg data as of 12/31/2014

**Figure 5: Sectors Define Stock Performance More than Home Country**

MSCI Indexes Total Return in dollars

MSCI Japan Index, MSCI Japan Consumer Staples Index, MSCI World Consumer Staples Index.

Past performance is not guarantee of future results.

Source: Charles Schwab, Bloomberg data as of January 15, 2015

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Digging Deeper for Diversification
Regional and country-specific factors seem to have more influence on the performance of international small-cap and emerging-market stocks than on their large-cap developed-market peers.

Our analysis reveals that, although sector correlation remains high, unique home-country factors are more significant drivers of performance than sectors for the emerging-market asset class. This means it is still possible to obtain country-specific diversification benefits in the global stock markets using the stocks of companies based in emerging markets.

Themes That Span the Globe
Key long-term megatrends, such as broadening global economic output, population trends, big data, and mobilization, cut across borders. The following are some of examples of these megatrends.

More Diverse Global Growth
One region or group always appears to be outgrowing the others. A recent example is Brazil, Russia, India, and China, or BRIC. The real story, however, may be that some regions have grown and some have contracted but economic growth is becoming more geographically diverse.

As shown in figure 6, about 200 years ago the BRIC nations dominated the world economy. The United States was a small emerging market. As times changed, the United States grew and the BRICs shrank in their relative contributions to global GDP until the start of the 21st century.

The world economy has changed over time. This means that trying to predict the next hot region or country misses the point that growth may be becoming more globally diversified. We often think of the structural problems facing Europe as representative of the non-U.S. economic climate. In fact, the world economy is becoming much more diverse, with nearly 50 percent of world economic output coming from outside the historically dominant “UCIE”—United States, China, India, and Europe. Those countries once accounted for about 75 percent of world output.

The more diverse global economy makes generalizations about international investing difficult. In addition, it makes predicting the next big growth area more about broad exposure to many different countries than betting on one or a handful of rebounding former giants.

Population Changes
The world’s population is changing in the following important ways:

Growth. Most growth is coming from emerging-market countries, and the United
Nations projects that the population in many developed countries will shrink.

Age barbell. Many developed nations have aging populations that are burdening healthcare and pension systems. At the same time, many emerging-market countries have very young populations that are challenging employment growth to keep up with demand, according to data from the United Nations.

Urbanization. As more of a country’s population concentrates in cities, companies have readily available labor forces that help to keep wage costs low and facilitate rapid growth. But growing urban populations also strain basic city services, creating pressing demand for infrastructure spending.

The most significant trend for investors may be the rise of the global middle class. The World Bank estimates that by 2030, 93 percent of the global middle class will be in emerging-market countries. Figure 7 shows the expected growth in global middle-class consumption by region. The rapidly expanding middle class in emerging markets is likely to be a major investment theme of the coming decade. Global providers of household products, financial services, autos, and many other categories may benefit from the middle-class megatrend.

In addition to the sale of consumer goods, demand for financial and healthcare services is also likely to rise. Rising incomes may mean more savings and wealth accumulation among emerging-market citizens. In addition, consumers moving from lower-calorie diets high in grains and vegetables to higher-calorie diets containing more meat, dairy, and sugar can lead to health problems when combined with a less-active lifestyle resulting from increasing urbanization. Healthcare services may experience increasing demand to treat high blood pressure, heart diseases, and diabetes.

Big Data
Enormous and growing amounts of data are created and stored every day. In fact, 90 percent of the world’s data was created only in the past two years, much of it unstructured and challenging to use, according to IBM. So-called big data presents a major technological challenge for companies that wish to use it. This major theme spans the globe as data is gathered from mobile phones, satellites, airplanes, shipping containers, social media, weather stations, automobiles, web browsers, and checkout counters, among many other sources.

The implications are global and far-reaching, as illustrated in the following:

- Asian manufacturers increasingly can track supplies as they make their way around the world. This improves the efficiency of supply chains.
- U.S. designers may be able to speed up product development and testing and respond to problems in real time using data from actual users.
- European healthcare systems might better detect threats and streamline services and improve the accuracy and availability of patient data.
- Latin America farmers could improve crop yields with data on soil conditions, weather simulations, and seed yield.

The increasing availability of big data levels the playing field because such information used to be available to only the largest

Continued on page 20 ♦
companies with the most integrated global databases. Now big data is increasingly available to companies in industries and countries that previously lacked access to this important competitive edge.

Mobile Commerce

We tend to think of developed countries, especially the United States and Japan, as quick adopters of new technologies, and that the emerging world is slow to catch up. The trend in mobile technology has challenged that notion.

The adoption pattern of cellphones in emerging-market countries such as Turkey, Chile, and Lebanon is similar to that in the United States, according to data from the Pew Research Center. In fact, the percentage of adults who own a cellphone in China—an emerging-market country—is higher than in the United States (see figure 8).

One reason is the ease and preference of making payments in emerging-market countries using technology rather than traditional banking services or carrying cash. In some African countries, as much as one-third of all consumer purchases take place using a mobile phone. Just 17 percent of Americans claim to have made a payment using a cellphone in the past year, according to a 2014 report from the Community Development Research Section of the Federal Reserve, but a 2014 report from the Pew Research Center shows that 68 percent of Kenyans, 29 percent of South Africans, and 25 percent of Russians have used cellphones to make or receive a payment.

The ability to deliver goods and services and to receive payment via mobile phone is a potential revolution in the ability to access a new and rapidly growing global consumer base.

Parting Thought: The Big Picture

For decades investors have asked, “What is the right international stock-market weighting for a portfolio?” This has become the wrong question, or, at least, it is now being asked the wrong way, because geography is no longer a primary driver of performance among large-cap stocks. The better question now is, “How do you allocate to best represent global opportunity and fully benefit from a global perspective?”

In general, portfolios that range from as little as a 25-percent long-term target for international stocks up to 50 percent or more of total stock-market exposure may benefit from global opportunity and perspective. The international weighting necessary for truly global exposure is likely to continue to increase over time as the opportunity set evolves and globalization becomes even more entrenched. Over shorter periods, tactical asset allocation over- or underweights to international stocks relative to the long-term target weighting may have the potential to add or preserve a portfolio’s value.

A global perspective means approaching investing differently. It takes the question about which country’s stocks are good investments and refocuses it on seeking the best investments in great ideas that span the stocks of many countries. It requires measuring investment success differently by using global benchmarks for performance, and it takes the long and broad view to help manage the risk of declines.

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