Is Your Portfolio Truly Global?

By Ronald Florance, CFA®

Globalization is nothing new. As early as 100 B.C., the Silk Road encouraged the trade of goods from the Mediterranean region through Asia to the Pacific Ocean. Propelled by the industrial revolution of the 19th century, globalization took off as faster boats, trains, and eventually airplanes accelerated the efficient exchange of people, products, and ideas. Today we are going through a new commercial revolution brought on by the Internet. Technology has promoted connections like nothing we have ever seen. This is the core idea of globalization today: the sharing of products, viewpoints, ideas, art, and lifestyles around the world irrespective of borders.

For investors, globalization is an extension of international investing, and this also is not new. The MSCI EAFE Index, the primary benchmark index for international investing, launched in 1986. Japan and the United Kingdom constitute about 50 percent of the EAFE Index with the remainder of Europe and Australia accounting for most of the balance. In 1998, MSCI launched its emerging-markets index, and this benchmark has grown from less than 1 percent of the world’s equity markets based on capitalization to approximately 13 percent today. Global investing today goes beyond traditional equity investments. Investors considering international exposure have many options in fixed income, currency, private equity, and alternative strategies; these all offer broad exposure that encompasses currency, economic, and financing diversification. Not all these strategies need to be in every global portfolio, but they should be evaluated as possible opportunities to maximize the investment efficiency of the portfolio.

The fact is that, although most investment advisors talk about global investments, most are focused on little beyond the comfort zones of Europe and Japan. Does that make sense considering where people live now? Figure 1 highlights the world’s density of the human population, which illustrates that more people live inside the circle than outside the circle. I would challenge any advisor to present an investment strategy that truly reflects that reality.

Most portfolios reflect a home-country bias. This is the tendency for investors to overweight their home-country capital markets and currency in a portfolio. This is done all over the world—it is hardly a U.S.-investor phenomenon. Most investors overweight their home countries, and they should. There are good and bad reasons for doing this. Good reasons include the following:

- Prudent liability matching
- Overweight exposure to the main liability currency
- Providing capital to the home-country economy

Investors should overweight the currency that matches their primary liability currency. They also should support their home-country economies by providing capital and liquidity to home-country capital markets. These are all sound reasons. Unfortunately, too many times the home-country bias is based on inappropriate reasons. These include ignorance of global opportunities, prejudices against other economic systems, and simple stubbornness to evolve. Home-country bias should be based on sound reasons and at reasonable levels in the investment portfolio.

In looking at current industry averages, we found a wide range of international allocations. Interestingly, philanthropic portfolios and target-date funds tend to have the highest international allocations. Most institutions have international allocation recommendations that are much higher than what actual client portfolios hold. The U.S. home-country
bias for investors is very high, as shown by the following samples of international allocations that we’ve found in our research:

- Philanthropic portfolios: 23-percent international equity
- Private banks: 19-percent international assets
- Private clients: 6-percent international assets
- Balanced target-date funds: 26-percent international assets

It is also common to see strategies that utilize U.S. multinational companies. According to Standard & Poor’s, foreign sales accounted for more than 45 percent of total sales for companies in the S&P 500 Index. Recall that this benchmark excluded foreign companies before 2002, so this level of foreign sales is impressive for a pure-play U.S. index. General Electric, Coke, Intel, and others are certainly global brands, and there is definitely some validity to this approach. On a portfolio level though, these companies provide limited diversification benefit and therefore constrain how much foreign exposure an investor will ever get. Further, the global opportunity differs from the simplistic, colonial approach of taking a U.S. business into new international markets. The ideal refrigerator in India probably differs from the models that have populated U.S. kitchens for 50 years, and Alibaba is more in sync with Chinese culture than Amazon. Consider that the biggest global online shopping day is not the Monday after U.S. Thanksgiving; it is November 11th, or 11-11. This is “Singles Day” (notice the ones in the date), a shopping holiday for single people in greater Asia. The holiday was created so that single people in Asian countries who are deciding to marry later in life shop for themselves at steep discounts. This isn’t to say that General Electric or Amazon are not effective operators, but more that the global economy has strong competitors and nuanced opportunities that are distinct from the landscape in the United States.

**How Much to Allocate Internationally**

So how much should you allocate to international assets to make a global portfolio? This question has a variety of answers based on your perspective and analytical approach. The Vanguard Group, where I was once employed, has produced a number of studies that utilize quantitative techniques and modern portfolio theory (i.e., mean-variance optimization). In studies published in 2005 and 2012, allocations of 25–50 percent benefited portfolios with the potential for both higher expected returns and greatest reduction in volatility (see figure 2). The results though did vary widely, and the investor’s perspective was paramount in determining how to incorporate currency volatility, potentially less liquidity, different tax regimes, and other issues involved in foreign investing.

Our team at Robertson Stephens recently looked at various weighting schemes based upon global economic realities. If you allocated international assets by population, the portfolio would have more than 95 percent allocated internationally. If you allocated by share of global gross domestic product (GDP), nearly 78 percent of the portfolio would be international. Both these approaches seem very aggressive in their international allocations for U.S.-based investors. If you used market capitalization as your target weight, then the bonds allocation would be 76 percent to international and the equity allocation would be 55 percent (see figure 3). Even the
market-cap approach seems aggressive. None of these allocations are close to what U.S. investment firms recommend or what U.S. investors implement.

An additional approach would be to focus on opportunity. The relatively high allocation to U.S. strategies—home-country bias notwithstanding—is a function of the opportunities created by the U.S. economy. Since 1950, U.S. GDP has grown from $300 billion to more than $14 trillion. That's extraordinary. This growth is the result of many factors such as public support, natural resources, legal systems, and, importantly, people. The U.S. growth represents past growth, but we want to focus on future growth. We said at the outset that technology has unleashed economic forces in the most remote corners of the globe, but the critical factor for allocating into the opportunity represented by the global portfolio is seeking out where people are producing and consuming goods, products, and services.

This is an exercise in analyzing world demographics with an eye to the future. According to data gathered by the United Nations, population growth rates are highest in Africa and the Middle East (see figure 4). All the top 30 fastest-growing nations by population are African or Middle Eastern. So are 42 of the top 50 nations with the fastest-growing populations. Although these countries are diverse, they are all a subset of what are known as frontier markets, which have economies that are generally too small to be considered emerging but are developed enough to be investable. In combination with emerging markets, frontier markets represent where economic activity will be in the not-too-distant future, which may actually be now: China has more than 1 billion cell phone numbers today and India has nearly 900 million cell phone numbers, but the United States has fewer than 400 million.

Why is this phenomenal global growth concentrated in emerging and frontier markets? One reason is that the sharing of technology, ideas, and capital via globalization has given developing nations a huge leg up in economic growth, and they are playing catch-up with the developed world. In developing economics, this is explained by the fact that the lower a nation's level of production, the higher the nation's marginal return when adding an additional input to production. In other words, developing economies benefit much more on the margin from the addition of another worker or factory machine than does a developed economy, so the sharing of technology and capital through globalization has propelled emerging economies to grow at rates that are practically unattainable in the developed world.

Yet it is also important not to discount North America and Western Europe. In the United States, the consumer accounts for 70 percent of economic activity, and the European Union has an economy on par with China and the United States. Investments in markets such as Germany, the United Kingdom, and the United States should not be overlooked just because they do not seem exotic enough for a global portfolio. The truth is that these countries and other developed nations represent a significant aspect of the global picture.

A truly prudent global investment strategy takes all this into account and adjusts for individual or institutional characteristics. We advocate starting with a cap-weighted global model. This strategy is straightforward: It overweight liquidity, provides a reasonable balance between expected returns and risks, and has historic precedent for efficient implementation and performance. Investors then layer on the prudent home-country bias. With fixed-income and cash-flow-oriented assets we
tend to have a higher home-country bias because these investments presumably are designed to provide cash flow for near-term spending. Therefore we recommend a 75-percent domestic allocation and 25-percent international allocation to fixed-income investments. Other asset classes, including equities, hard assets, and alternatives, have a lower home-country bias. These investments are designed for growth over income and should be positioned to take advantage of global growth opportunities. Therefore we recommend a 65-percent domestic and 35-percent international allocation. This is higher than most current strategy recommendations and portfolios. Obviously, individual considerations of liquidity, cash flow, taxes, and other idiosyncratic financial issues need to be evaluated to produce each individual strategy, but this allocation is a good starting point for the discussion (see figure 5).

Final Thoughts
Today’s global portfolio requires more than just adding some shares of an international mutual fund. A worthwhile global strategy is about investing in the economic opportunities that our global economy presents today and tomorrow. The technology revolution in communication and social media has global consumers more connected than ever. Per capita GDP is growing in emerging and frontier markets as the developed world ages. The process for developing a truly global strategy includes understanding the changing global economic engine, defining appropriate global asset classes and investments, and creating a prudent global asset allocation that includes global economic realities along with investor home-country biases. Most U.S. investors are underallocated to the global economy, and we should encourage investors to broaden their investment geography.

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