Making the Case for Globalizing Equity Portfolios

By Ben Valore-Caplan, CIMA®

Not so long ago conventional American investment wisdom held that the stocks of companies based outside the United States were speculative, risky investments to be considered in only limited quantities. Similarly, the dollar was perceived—rightly or wrongly—as the world’s most stable currency, safer and more reliable than any other. Domestic accounting standards were considered more exacting and the regulatory regime more rigorous than in other developed economies.

It’s still common to see fine-print disclaimers that non-U.S. investments have currency, economic, and political risk, but such disclaimers are rare for domestic equities. Even so, it generally is understood that these risks are inherent in equities as an asset class, regardless of the nation where a particular company is based.

This conventional wisdom is based on two false presumptions: that the U.S. economy is stable and that investing in companies based outside the United States is inherently more risky than investing in comparable U.S. peers. Oddly, these assumptions often are presented as permanent conditions, as if the global economy were a static system with constant roles and relationships. But such a global economy would be quite dysfunctional; it would undermine the very dynamic qualities required to create economic growth and return on investment.

Within that U.S.-centric framework, it’s reasonable and prudent to maintain a significant underweight to non-U.S. equities relative to their market-capitalized weight in the global economy. Some have justified doing this in part with an economic rationale (“Korea is just too politically unstable”) and in part with a behavioral one (“I’m just more comfortable investing at home”).

Thus, although the nation with the top equity returns varies year-to-year, moderate-risk portfolios of U.S. investors that seek long-term appreciation commonly are allocated approximately five parts U.S. equity to one part non-U.S. equity. For example, it is common to see portfolios allocated roughly 50-percent U.S. equities, 10-percent non-U.S. equities, and 40-percent domestic fixed income, even among small and mid-sized institutional and ultra-high-net-worth investors.

Indeed, U.S. asset allocation models almost always dramatically underweight non-U.S. equities in favor of U.S. equities, underscoring the disconnect between the economic reality of a global economy and the behavioral prejudices of U.S. investors. One often sees caps on allocations to both developed and emerging markets that force the efficient frontier to be less efficient than it would be if similar constraints were used for both U.S. and non-U.S. equity allocations.

U.S. equities represent no more than 50 percent of the world’s stock market capitalization,¹ and that percentage is likely to decline over time. Globalization has led most large-cap companies and many mid- and smaller capitalization companies to be multinational.

By definition, most of these companies do business across currency regimens, compelling them to hedge currency risk internally while also diversifying currency exposures through how and where they acquire materials, compensate employees, and distribute products or services.

So, if you are advising a small institution or ultra-high-net-worth client, and the investment goals include managing risk to provide for a moderate, long-term real return, what role should non-U.S. equities play? That is the question facing family offices, nonprofit boards, corporate financial officers, and other stewards of significant wealth.

Case Study

The case study that follows illustrates one investment advisor’s experience guiding a small institution’s journey toward enhanced diversification and more-prudent risk management. Table 1 provides a description of the client and the investment objectives.

Historically, the client used strictly stocks, bonds, and cash to manage long-term reserves that served multiple functions, including fulfilling regulatory requirements and covering the cost of capital. The client was uncomfortable using other asset classes or investment

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<th>TABLE 1: CLIENT PROFILE</th>
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<th>Type of Client</th>
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structures due to concerns about real and perceived risks. With this limitation present, the determination about suitable and effective allocations to non-U.S. and U.S. equities took even greater importance.

Investment Policies
The organization’s investment policies restricted non-U.S. equity investments to a maximum of 10 percent of the total equity exposure, which was roughly set by policy at 67.5 percent. Thus, any recommendation to use more than 6.75 percent non-U.S. equities would require board approval.

Establishing a Base Case
Often discussions about changes in investment policies start with the current target allocation as the “base case.” Any recommendations then must justify a change from the base case to the new allocation. Due to human behavior, this process can be skewed by peoples’ aversion to change.

The client had a board with an aversion to non-U.S. equities, but no one with the organization was able to rationally justify that position. These conditions complicate efforts to increase non-U.S. equity exposure from 6.75 percent to 15 or 20 percent, potentially leading to a less diversified and ultimately less effective portfolio.

The investment advisor team thought that it would be helpful to start from a different context. Rather than opening the discussion with the base case they began with economics and the organization’s objectives. By focusing on those two factors, the investment advisors hoped to achieve a healthy discussion about asset allocation without the base case biasing the outcome.

The Premises
In discussion with the board, investment advisors laid out five premises, each one building on the logic of the previous. After securing consensus on each premise, they moved on to the next.

Premise I: The organization should make decisions based on economic factors rather than behavioral biases. Common sense, yes, but commonly applied, no. Even the most-sophisticated board members understand how their own investment decisions have been colored by assumptions or biases not based on economic fundamentals. Premise I eliminates some key obstacles to making well-reasoned allocation decisions, namely:

- What will my friends/colleagues think?
- What are my friends/colleagues doing?
- It’s un-American to invest in companies based outside the United States.
- But this is how we’ve always done it.

Premise II: The organization believes that diversification is a powerful risk-management tool for many reasons, including because it helps spread risk, reduce correlations, and increase the universe of available investments. Again, the premise is common sense, yet affirming it early in a discussion grounded everyone in the reality of why they were discussing allocation in the first place.

They started this part of the discussion without charts and analytics. By allowing people to draw on what they instinctively know about investing, the investment advisors found that the conversation flowed quite smoothly.

Once that intuitive connection had been established, they could move on to reviewing efficient frontier models.

Premise III: An investment advisor should start making asset class assumptions, including constraints set in efficient frontier modeling, with the market weight of various asset classes in the eligible investment universe. This is where the conversation shifts. If U.S. equities represent nearly 50 percent of global equity-market capitalization, and non-U.S. equities represent the other nearly 50 percent, then that is where the conversation must begin. Again, note that the premise no longer is the tremendous overweight to U.S. equities prevalent in so many investor portfolios. Let’s start with the market first, then determine the allocation that is most appropriate.

Premise IV: Having started with the market-cap weight, the advisors and client should equal-weight, overweight, or underweight based only on economic factors. Assuming that consensus was reached on Premises I, II, and III, Premise IV is pretty easy to accept. It certainly makes it difficult for noneconomic factors to color the discussion. Specifically, accepting Premise IV compels investors to articulate a convincing case for why they should overweight U.S. equities.

Thus a board member who wanted to keep 45 percent of a balanced portfolio in U.S. equities, with just 15 percent in non-U.S. equities, needed to justify increasing the U.S. equity exposure by about 50 percent more than the market weight and decreasing the non-U.S. exposure by roughly 50 percent of the market weight. That would be a difficult task for even the most sophisticated U.S.-centric investor.

Having had this conversation with many sophisticated boards over the past few years, the investment advisor has not yet heard a rational argument that would justify the persistence of a conscious overweight to U.S. equity. One could argue that U.S. stocks are cheap or expensive this week versus Japanese stocks, or that the downward/upward pressure on the dollar or interest rates would support European retailers over U.S. retailers, but all of those arguments are tactical market-related issues that change frequently. Fundamentally, they are not important relative to the broader asset allocation discussion.

Premise V: Sound, rational consideration of the global equity markets would require at least a 50/50 allocation to U.S. and non-U.S. equities and perhaps even the freedom to simply consider equities as a global asset class and no longer obsess about differentiating between U.S. and non-U.S. equities. It is getting much harder
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...to define U.S. equities versus non-U.S. equities in the first place. Should one base the definition on where the company generates its revenues? Or its profits? How about where its headquarters is located? Where it was incorporated? Where it maintains the largest number of employees? Customers? Suppliers? How about the nationality of its board members? Or the nationality of its stock holders? If it is governed by regulations and regulators around the world, then which one—if any—should matter most?

Some argue that the decision should be based on the currency in which a company does business, but who does business in one currency anymore? For many companies, compensation, materials, taxes, capital expenses—all of these are transacted in numerous currencies, across multiple linguistic frameworks, and in the context of varied (and at times competing) regulatory and tax regimes.

Thus if companies—even small and mid-sized companies—are multinational, shouldn’t investors allow managers, or at least asset allocations, to reflect that complexity? Does it really make sense to maintain a false definition of corporate nationality when economic reality has moved on to a different paradigm?

Implementation

Assuming that an investor wishes to shift from a U.S.-equity overweight to one that is more global, an advisor can offer recommendations that facilitate the process and potentially increase its efficacy.

Phase-in the allocation shift.

Some investors are quick to shift toward a more-globalized equity portfolio once all the objectives, risks, investment time frame, costs, etc. have been fairly and appropriately considered.

Others, however, find it helpful to phase in the allocation shift. Sometimes a board understands that such diversification makes sense for them, yet they are reluctant to take action. In those cases, an advisor can suggest a two- or three-step phase-in that would take the allocation from the current orientation toward the new target.

Some advisors recommend that those phases be implemented approximately every six months, with a desired completion date clearly designated. Six months tends to be long enough to provide the benefits of dollar-cost-averaging into the change while not being so long as to dilute the impetus to make the shift.

Diversify the number and styles of managers.

When recommending that clients shift their equity allocations more globally, advisors may need to rethink the recommended allocations to managers. When there is a large overweight to U.S. equities, there often is a large overweight to U.S. equity managers. In contrast, the exposure to non-U.S. managers tends to be more concentrated. For example, an investor might have domestic large-value, domestic large-growth, domestic mid-cap, and domestic small-cap managers, and yet concentrate all non-U.S. equity exposure with just one non-U.S. equity manager.

Indeed, it is not uncommon to find portfolios of institutions and ultra-high-net-worth families that have just one non-U.S. manager. Quite often that manager is a large-cap developed-markets value manager, because until 2007, those managers usually charted best over one, three, five, and seven years. But non-U.S. growth outperformed non-U.S. value in 2007 and emerging markets continued to provide both diversification and absolute return benefit, underscoring the need to diversify the number and style of non-U.S. managers.

Recommending that an investor diversify among a number of non-U.S. managers is yet one more way of addressing any fear that greater non-U.S. equity exposure increases—rather than diversifies—equity risk in the portfolio.

Create a feedback mechanism.

For some clients, once a portfolio’s equities have been reallocated toward increased non-U.S. exposure, the advisor can compare the performance of the new allocation to the previous allocation over the first 12–18 months. In such an analysis, managers must be held constant, with asset allocation as the only variable.

Of course, any such analysis is hypothetical and has limitations, especially with large cash flows. Such comparisons, however, allow the investor to see whether the allocation shift has provided downside protection, upside participation, or volatility changes. Such comparisons seem to help some investors feel more comfortable moving toward what they know makes sense.

Conclusion

Several insightful investors such as TII\(^3\) and Yale University\(^4\) have been willing to overweight non-U.S. equities to U.S. equities when their analyses have supported such a move. Harvard\(^4\) and CalPERS\(^5\) have given equal weights to U.S. and non-U.S. equities. Still, the globalization of investment portfo-

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lios is trailing the globalization of the economy and of investment markets.

This situation creates opportunities for investment advisors wishing to serve sophisticated clients and those for whom risk management trumps the easy familiarity of home-biased investing. There is value to be added by investment advisors who are willing and able to guide clients through globalizing portfolios to whatever degree is appropriate given their objectives and risk tolerance.

The advisor who can make the economic case has some chance at successfully diversifying clients. But far better positioned is the advisor who can create a healthy process for considering the decision relatively free of biases, prejudices, and fears that may not be accurate or reasonable in a genuinely global economy.

Ben Valore-Caplan, CIMA, is a senior vice president of investments with UBS Financial Services Inc. and a UBS institutional consultant in Denver, CO. Contact him at ben.valorecaplan@ubs.com.

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Endnotes
1 UBS Global Asset Management.