Investment Insight
U.S. Stocks Not the Only Game in Town

If you go fishing, there's one simple rule to remember: fish where the fish are.

Do you want to limit yourself to half the lake or seek out the best opportunities where available? Investing shouldn't be any different.

International stocks’ underperformance over the past decade has been well documented — many have referred to it as a “lost decade.”

As shown below, red bars are periods when U.S. stocks outperform, and blue bars are when international stocks outperform. There was a recent period of 12 straight years (2009–2021) where international stocks underperformed U.S. stocks.

**Exhibit 1**

U.S. vs. International Stocks
Performance difference for each calendar year
International stocks minus U.S. stocks (1971-2022)


The dispersion gets even uglier when looking at total return. U.S. stocks beat international stocks by more than 400%.
Exhibit 2

<table>
<thead>
<tr>
<th></th>
<th>Total Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Stocks</td>
<td>587%</td>
</tr>
<tr>
<td>Int'l Stocks</td>
<td>170%</td>
</tr>
</tbody>
</table>


But it’s important to point out: Historically, this is not an anomaly. The market moves in cycles—what trails will often end up leading, given time.

Historical Context

Equity leadership among regions or asset classes can persist for longer than we expect—but it never lasts forever.

Dating back to 1970, U.S. stocks have performed better than international stocks approximately 60% of the time.

We measure this by using relative performance data between the two markets, which can be seen below. U.S. stocks have been the leading regime in 32 of the 52 years depicted.

Exhibit 3: International (EAFE) and U.S. Stock Performance Cycles

But how much of that U.S. outperformance can be attributed to returns post global financial crisis? Almost all of it.

From 1970 to 2007, international stocks were the leading regime 51% of the time, or 19 of the 37 years.

This does not mean the future will look like the past. U.S. stocks could continue to outperform — nobody knows for sure — but the data strongly implies that international stocks should be included in a diversified portfolio.

Layer in the fact that international stocks have outperformed U.S. stocks the past 18 months (you have to squint to see it!), and there’s certainly reason to believe a regime change could be lurking.

Of course, this could be a mere blip as some have been in the past, but at the very least, investors should be paying attention.

The Diversification Benefit

Something we often like to remind investors of: The U.S. is a huge equity market, but it’s far from the only game in town.

U.S. equities represents 60% of the global equity market cap, meaning the other 40% — not an insignificant number — of global market cap exists outside the U.S.

Exhibit 4

![Exhibit 4](image)

Source: MSCI.

In addition to market cap, there are many other benefits of investing internationally that broadens the exposure to:
- **Population**: The U.S. is only 4% of global population.
- **GDP**: The U.S. is only 25% of global GDP.
- **Market breadth**: 85% of all public equities exists outside the U.S.

Sources: Population (Worldometer), GDP (YCharts), Market Breadth (World Federation of Exchanges)

Investing abroad also provides considerable industry diversification. The weighting to technology stocks is nearly 20% higher in the U.S. as compared to international.

### Exhibit 5

<table>
<thead>
<tr>
<th>Sector</th>
<th>U.S. minus Int'L</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology</td>
<td>-1.9%</td>
</tr>
<tr>
<td>Industrials</td>
<td>-1.1%</td>
</tr>
<tr>
<td>Financial Services</td>
<td>-6.0%</td>
</tr>
<tr>
<td>Basic Materials</td>
<td>-5.2%</td>
</tr>
<tr>
<td>Communication Services</td>
<td>-3.4%</td>
</tr>
<tr>
<td>Consumer Defensive</td>
<td>-2.6%</td>
</tr>
<tr>
<td>Consumer Cyclic</td>
<td>0.8%</td>
</tr>
<tr>
<td>Utilities</td>
<td>-0.6%</td>
</tr>
<tr>
<td>Energy</td>
<td>-0.2%</td>
</tr>
<tr>
<td>Healthcare</td>
<td>0.0%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct.

### Long History of Changing Leadership

The chart below is another reason why international diversification is effective.

The pie chart on the left shows the size of the global equity market in 1900, while the pie chart on the right shows the same data as of January 2023. Items to note:

- At the start of the 20th century, the U.K. equity market was the largest in the world, accounting for almost a quarter of world market cap, overshadowing the U.S. (15%).
- Over the next century, U.K. stocks fell to 4% of total equity market cap while U.S. stocks went from 15% to roughly 60%!
Different countries had widely differing fortunes over the past 100 years. It seems plausible this will be true in the future as well. Hitching your assets to a single country is not a smart asset-allocation decision.

**But U.S. Companies Are More Global Than Ever!**

The globalization argument is often cited as a reason to ignore international equities. In fact, the largest U.S. companies now derive nearly 40% of their revenue abroad.

It’s a legitimate argument. Correlations have increased over time between the two markets — that’s certainly true. But look at the return splits between the two markets over recent five-year trailing periods.
Correlations during these periods were very high (generally in the range of 0.8 using Morningstar data), but the returns were very different.

Since stocks generally go up over time, investors should expect that different markets will be correlated with one another, but correlation says nothing about the differences in performance. It’s just the statistical relationship that shows they’re generally moving in the same direction.

Another interesting thought experiment would be to flip the argument around. If advisors like the U.S. market, why not access it through cheaper valuations through multinational firms domiciled outside the U.S.?

For example, one could gain exposure to U.S. healthcare through pharmaceutical companies that are domiciled in Ireland purely for tax purposes. Or one could own a company like Total, the energy company, which trades at six times earnings while its peer Exxon Mobil trades at 10 times earnings. The long-term drivers — and stock returns — of these two businesses are similar, but the European multinationals offer a valuation discount.

By investing abroad, you’re not only gaining exposure to different countries, industries, currencies, and individual companies, but there’s also a cultural element that might be underappreciated. No matter how globalized the world becomes, there will always be cultural differences.

These differences will affect the way that investors in certain countries or regions will invest. Global diversification allows intelligent investors to take advantage of the reactions, biases, and mistakes of investors in other markets. Even with increased correlations, investors around the globe are never going to be completely in sync with one another.

**Valuations Always Matter Eventually**

At times in market cycles, international stocks can represent better value. It appears that way now.

U.S. stocks are nearly 40% more expensive than international stocks right now. Even factoring in a “valuation premium” for U.S. stocks, that spread remains wider than historical norms, potentially indicating an attractive entry point.
Valuations should not be used as a market timing tool, but they do inform the possible path of long-term returns. At this moment, the long-term outlook for international stocks appears to be compelling.

**Summary**

Diversification tends to be an acknowledgement that we have an imperfect view of what will happen in the future. Diversifying outside of U.S. stocks provides important benefits for investors, providing significant exposure to a portion of the world’s market cap, stocks, GDP, and population that can’t be replicated investing in the U.S. alone.

There’s the old saying, “Trees don’t grow to the sky.” If something cannot continue forever, it must stop.

The returns of the past decade—in isolation—might lead many to believe international stocks serve no purpose. But history shows the opposite might be true. 

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