

# Why Global Diversification Matters

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Over the past few years, some investors have begun to question the merits of global asset allocation. They wonder whether the risks abroad justify investing money outside the United States—and whether there truly are diversification benefits to doing so. Some have even challenged Modern Portfolio Theory itself, which emphasizes the long-term benefits of a diversified portfolio.

In some ways it's natural. It's an unpredictable world, and investors worry about market volatility both at home and abroad. Everything from political questions in the wake of the U.K.'s "Brexit" vote in the summer of 2016 to the recent U.S. elections to anticipation of the Federal Reserve raising rates have indeed contributed to market swings.

Moreover, in investing—as in sports and other areas of life—people often exhibit familiarity bias ("home-country bias" in this case). We're inclined to believe in and root for the things that we know best. While this may be human nature, home-country bias limits an investor's universe of available opportunities. Worse, it may not be prudent given the nature of today's global markets: According to MSCI data, roughly half of all global companies are based outside the United States, which corresponds to global gross domestic product (GDP) ratios.

Do you really want to limit your investment opportunities by half? How can you overcome home-country bias?

## **As the saying goes...**

Times like these show why the adage "don't put all your eggs in one basket" is so vital for investors. An investment sector that performs well one month or year might be a poor performer the next. For example, as the chart below shows, emerging market stocks were the worst performer in 2008—only to rebound back to the top in 2009 and also 2017. More recently, international developed stocks were among the top performers in 2017, after placing near the bottom in 2016.

Over the long run, there's no discernible pattern to the rotation among the top performers, so it doesn't make much sense to concentrate all your investments in a particular region or asset class. A globally diversified portfolio—one that puts its eggs in many baskets, so to speak—tends to be better positioned to weather large year-over-year market gyrations and provide a more stable set of returns over time.

## **How key asset classes compare to a diversified portfolio**

## Schwab Asset Class Quilt®

|                       | 2008   | 2009                        | 2010                        | 2011                        | 2012                        | 2013                        | 2014                       | 2015                        | 2016                       | 2017                        | Ann. Return                | Standard Deviation          |
|-----------------------|--------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|-----------------------------|
| Core Bonds            | 5.2%   | EM                          | US Sm Cap 26.9%             | TIPS 13.6%                  | REITs 24.1%                 | US Sm Cap 38.8%             | REITs 22.7%                | US Lg Cap 1.4%              | US Sm Cap 21.3%            | EM                          | US Sm Cap 8.7%             | Comm. 23.1%                 |
| Int'l Dev Bonds       | 4.4%   | High Yield Bonds 63.5%      | REITs 24.6%                 | Core Bonds 7.8%             | EM 18.2%                    | US Lg Cap 32.4%             | US Lg Cap 13.7%            | EM Bonds 1.3%               | High Yield Bonds 16.7%     | Int'l Dev                   | US Lg Cap 8.5%             | EM 22.8%                    |
| T-bills               | 1.8%   | EM Bonds 34.2%              | EM 18.9%                    | EM Bonds 7.0%               | EM Bonds 17.9%              | Int'l Dev 22.8%             | Core Bonds 6.0%            | REITs 0.6%                  | US Lg Cap 12.0%            | US Lg Cap 21.8%             | High Yield Bonds 7.8%      | REITs 21.7%                 |
| TIPS                  | -2.4%  | REITs 34.0%                 | Diversified Portfolio 15.4% | High Yield Bonds 6.7%       | Int'l Dev 17.3%             | Diversified Portfolio 12.9% | US Sm Cap 4.9%             | Core Bonds 0.5%             | Comm. 11.4%                | Diversified Portfolio 16.8% | EM Bonds 7.0%              | US Sm Cap 19.9%             |
| EM Bonds              | -14.8% | Diversified Portfolio 33.0% | High Yield Bonds 15.1%      | Int'l Dev Bonds 4.4%        | US Sm Cap 16.3%             | High Yield Bonds 6.6%       | EM Bonds 4.8%              | T-bills 0.0%                | EM 11.2%                   | RUS Sm Cap 14.7%            | REITs 5.9%                 | Int'l Dev 18.5%             |
| High Yield Bonds      | -28.4% | Int'l Dev 31.8%             | US Lg Cap 15.1%             | US Lg Cap 2.3%              | US Lg Cap 16.0%             | REITs 2.8%                  | TIPS 3.6%                  | Int'l Dev -0.8%             | EM Bonds 9.9%              | Int'l Dev Bonds 10.5%       | Diversified Portfolio 5.8% | US Lg Cap 15.1%             |
| Diversified Portfolio | -30.8% | US Sm Cap 22.2%             | EM Bonds 12.8%              | REITs 1.8%                  | High Yield Bonds 15.4%      | T-bills 0.1%                | Diversified Portfolio 3.0% | TIPS -1.4%                  | Diversified Portfolio 9.0% | REITs 9.2%                  | Core Bonds 4.0%            | High Yield Bonds 12.4%      |
| US Sm Cap             | -33.8% | US Lg Cap 26.5%             | Comm. 9.0%                  | T-bills 0.1%                | Diversified Portfolio 14.0% | Comm. -1.2%                 | High Yield Bonds 2.1%      | Diversified Portfolio -2.2% | REITs 6.8%                 | EM Bonds 8.2%               | TIPS 3.5%                  | Diversified Portfolio 12.4% |
| US Lg Cap             | -37.0% | Comm. 13.5%                 | Int'l Dev 7.8%              | Comm. -1.2%                 | TIPS 7.0%                   | Core Bonds -2.0%            | T-bills 0.0%               | US Sm Cap -4.4%             | TIPS 4.7%                  | High Yield Bonds 6.8%       | Int'l Dev Bonds 2.4%       | EM Bonds 9.6%               |
| Int'l Dev             | -43.4% | TIPS 11.4%                  | Core Bonds 6.5%             | Diversified Portfolio -2.5% | Core Bonds 4.2%             | EM -2.6%                    | EM -2.2%                   | High Yield Bonds -5.3%      | Core Bonds 2.6%            | Comm. 5.8%                  | EM 2.0%                    | Int'l Dev Bonds 8.3%        |
| REITs                 | 43.4%  | Int'l Dev Bonds 7.5%        | TIPS 6.3%                   | US Sm Cap -4.2%             | Int'l Dev Bonds 4.1%        | Int'l Dev Bonds -3.1%       | Int'l Dev Bonds -3.1%      | Int'l Dev Bonds -6.0%       | Int'l Dev Bonds 1.5%       | Core Bonds 3.5%             | Int'l Dev 1.9%             | TIPS 6.1%                   |
| Comm.                 | -46.5% | Core Bonds 5.9%             | Int'l Dev Bonds 4.9%        | Int'l Dev -12.1%            | Comm. 0.1%                  | EM Bonds -4.3%              | Int'l Dev -4.9%            | EM -14.9%                   | Int'l Dev 1.0%             | TIPS 3.0%                   | T-bills 1.1%               | Core Bonds 3.2%             |
| EM                    | -53.3% | T-bills 0.2%                | T-bills 0.1%                | EM -18.4%                   | T-bills 0.1%                | TIPS -8.6%                  | Comm. -33.1%               | Comm. -32.9%                | T-bills 0.3%               | T-bills 0.8%                | Comm. -10.2%               | T-bills 0.5%                |

**Source:** Morningstar Direct and the Schwab Center for Financial Research. Data is from January 1, 2008, to December 31, 2017. Asset class performance represented by annual total returns for the following indexes: S&P 500® Index (U.S. Lg Cap), Russell 2000® Index (U.S. Sm Cap), MSCI EAFE® net of taxes (Int'l Dev), MSCI Emerging Markets Index<sup>SM</sup> (EM), S&P United States REIT Index and S&P Global Ex-U.S. REIT Index (REITs), S&P GSCI® (Commodities), Bloomberg Barclays U.S. Treasury Inflation-Protection Securities (TIPS) Index, Bloomberg Barclays U.S. Aggregate Bond Index (Core Bonds), Bloomberg Barclays U.S. VLI High Yield TR Index (High Yld Bonds), Bloomberg Barclays Global Aggregate Ex-USD TR Index (Int'l Dev Bonds), Bloomberg Barclays Emerging Markets USD Bond TR Index (EM Bonds), Bloomberg Barclays Short Treasury 1–3 Month Index (T-Bills).

The diversified portfolio is a hypothetical portfolio consisting of 18% S&P 500, 10% Russell 2000, 3% S&P U.S. REIT, 12% MSCI EAFE, 8%, MSCI EAFE Small Cap, 8% MSCI EM, 2% S&P Global Ex-U.S. REIT, 1% Bloomberg Barclays U.S. Treasury, 1% Bloomberg Barclays Agency, 6% Bloomberg Barclays Securitized, 2% Bloomberg Barclays U.S. Credit, 4% Bloomberg Barclays Global Agg Ex-USD, 9% Bloomberg Barclays VLI High Yield, 6% Bloomberg Barclays EM, 2% S&P GCSI Precious Metals, 1% S&P GSCI Energy, 1% S&P GSCI Industrial Metals, 1% S&P GSCI Agricultural, 5% Bloomberg Barclays U.S. Treasury 3–7 Yr. Including fees and expenses in the diversified portfolio would lower returns. The portfolio is rebalanced annually. Returns include reinvestment of dividends, interest and capital gains. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. **Past performance is no indication of future results**  
**Diversification strategies do not ensure a profit and do not protect against losses in declining markets.**

## Why consider a global allocation?

The short answer is that it's almost impossible to avoid international exposure in today's globally interlinked economy. Nearly half the revenues of the U.S. companies in the Standard & Poor's 500® Index come from overseas. And more than half the world's market capitalization now lies outside the United States.

Some might say that argues against global diversification, that everything is so interconnected, overseas investments might simply overlap domestic ones. But that's not the case: Companies tend to act in ways that reflect their "country of domicile." They tend to respond to local

economic and geo-political events more than events outside their borders. And different countries' economies often tilt toward different market sectors or industries.

In addition, certain circumstances—call them “new market realities”—are likely to persist for the foreseeable future. Increased globalization and interconnectivity, increased volatility, lower bond yields, and lower expected stock returns than in the past all suggest that it's prudent for investors to branch out globally. Global diversification can help in managing risk and positioning your portfolio for long-term growth.

As the data below illustrates, there are potentially attractive investment opportunities outside of the U.S. While the U.S. markets have performed well recently, the emerging markets and individual countries have delivered strong results over time. Canada was the top-performing market in 2016 and the bottom performer in 2017. Its results were largely impacted by energy prices. And of course various countries are at different stages of global and economic growth.

If you don't invest globally, you're not only narrowing your opportunity set but ignoring an important tool to help manage volatility. Though not without risk, a global allocation provides diversification benefits and is one of the underpinnings of modern wealth management.

### Why diversify across borders?

Schwab Asset Class Quilt®

| 2008                       | 2009                      | 2010                      | 2011                       | 2012                      | 2013                      | 2014                      | 2015                       | 2016                      | 2017                      |
|----------------------------|---------------------------|---------------------------|----------------------------|---------------------------|---------------------------|---------------------------|----------------------------|---------------------------|---------------------------|
| Japan<br>-29.1%            | Emerging Markets<br>79.0% | Nordic Countries<br>26.0% | United States<br>2.0%      | Germany<br>32.1%          | United States<br>32.6%    | United States<br>13.4%    | Japan<br>9.9%              | Canada<br>25.5%           | Emerging Markets<br>37.8% |
| Switzerland<br>-29.9%      | Australia<br>76.8%        | Canada<br>21.2%           | United Kingdom<br>-2.5%    | Nordic Countries<br>23.4% | Germany<br>32.4%          | World<br>4.7%             | Nordic Countries<br>3.0%   | Australia<br>11.7%        | France<br>29.9%           |
| United States<br>-37.1%    | Canada<br>57.4%           | Emerging Markets<br>19.2% | Switzerland<br>-6.0%       | France<br>22.8%           | Spain<br>32.3%            | Canada<br>2.2%            | United States<br>1.3%      | United States<br>11.6%    | Germany<br>28.5%          |
| Spain<br>-40.1%            | Nordic Countries<br>48.5% | Japan<br>15.6%            | World<br>-6.9%             | Australia<br>22.3%        | France<br>27.7%           | Switzerland<br>0.7%       | Switzerland<br>1.2%        | Emerging Markets<br>11.6% | Spain<br>27.7%            |
| World<br>-41.9%            | Spain<br>45.1%            | United States<br>15.5%    | Australia<br>-10.8%        | Switzerland<br>21.5%      | Switzerland<br>27.6%      | Emerging Markets<br>-1.8% | France<br>0.8%             | World<br>8.5%             | Nordic Countries<br>26.8% |
| France<br>-42.7%           | United Kingdom<br>43.4%   | Australia<br>14.7%        | Spain<br>-11.2%            | Emerging Markets<br>18.6% | Japan<br>27.3%            | Australia<br>-3.2%        | Germany<br>-1.3%           | France<br>6.0%            | World<br>24.6%            |
| Canada<br>-45.2%           | World<br>35.4%            | World<br>13.2%            | Canada<br>-12.2%           | World<br>16.8%            | Nordic Countries<br>26.5% | Japan<br>-3.7%            | World<br>-1.8%             | Germany<br>3.5%           | Japan<br>24.4%            |
| Germany<br>-45.5%          | France<br>33.3%           | Switzerland<br>12.9%      | Japan<br>-14.2%            | United States<br>16.1%    | World<br>23.4%            | Spain<br>-4.4%            | United Kingdom<br>-7.5%    | Japan<br>2.7%             | Switzerland<br>23.6%      |
| United Kingdom<br>-48.3%   | United States<br>27.1%    | Germany<br>9.3%           | France<br>-16.0%           | United Kingdom<br>15.3%   | United Kingdom<br>20.7%   | Nordic Countries<br>-4.8% | Australia<br>-9.8%         | United Kingdom<br>0.0%    | United Kingdom<br>22.4%   |
| Australia<br>-50.0%        | Switzerland<br>26.6%      | United Kingdom<br>8.8%    | Nordic Countries<br>-17.1% | Canada<br>9.9%            | Canada<br>6.4%            | United Kingdom<br>-5.4%   | Emerging Markets<br>-14.6% | Spain<br>-0.5%            | United States<br>21.9%    |
| Nordic Countries<br>-53.0% | Germany<br>26.6%          | France<br>-3.2%           | Germany<br>-17.5%          | Japan<br>8.4%             | Australia<br>4.3%         | France<br>-9.0%           | Spain<br>-15.4%            | Nordic Countries<br>-3.1% | Australia<br>20.2%        |
| Emerging Markets<br>-53.2% | Japan<br>6.4%             | Spain<br>-21.1%           | Emerging Markets<br>-18.2% | Spain<br>4.7%             | Emerging Markets<br>-2.3% | Germany<br>-9.8%          | Canada<br>-23.6%           | Switzerland<br>-4.0%      | Canada<br>16.9%           |

Source: Charles Schwab & Co., Inc., with data from FactSet, MSCI as of December 31, 2017. Geographical performance is represented by annual total returns for the following: MSCI AC World, MSCI USA, MSCI Japan, MSCI United Kingdom, MSCI Switzerland, MSCI Germany, MSCI France, MSCI Canada, MSCI Australia, MSCI Nordic Countries, MSCI Spain, MSCI EM (Emerging Markets). Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Past performance is not guarantee of future results. Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

## Why does diversification work?

A diversified portfolio owns a portion of many asset classes, so it can benefit from owning top performers without bearing the full effect of owning bottom performers. By avoiding the extreme peaks and valleys of each individual asset class, a diversified portfolio can help manage volatility over time, and can help outperform a less-diversified portfolio over the long run.



Source: Morningstar Direct and the Schwab Center for Financial Research. Data is from January 1, 2001, to December 31, 2017.

The 60/40 portfolio is a hypothetical portfolio consisting of 60% S&P 500® Index Stocks and 40% Bloomberg Barclays U.S. Aggregate Bond Index bonds. The diversified portfolio is a hypothetical portfolio consisting of 18% S&P 500, 10% Russell 2000, 3% S&P U.S. REIT, 12% MSCI EAFE, 8%, MSCI EAFE Small Cap, 8% MSCI EM, 2% S&P Global Ex-U.S. REIT, 1% Bloomberg Barclays U.S. Treasury, 1% Bloomberg Barclays Agency, 6% Bloomberg Barclays Securitized, 2% Bloomberg Barclays U.S. Credit, 4% Bloomberg Barclays Global Agg Ex-USD, 9% Bloomberg Barclays VLI High Yield, 6% Bloomberg Barclays EM, 2% S&P GSCI Precious Metals, 1% S&P GSCI Energy, 1% S&P GSCI Industrial Metals, 1% S&P GSCI Agricultural, 5% Barclays U.S. Treasury 3–7 Yr. Including fees and expenses in the diversified portfolio would lower returns. The portfolio is rebalanced annually. Returns include reinvestment of dividends, interest and capital gains. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. **Past performance is no indication of future results. Diversification strategies do not ensure a profit and do not protect against losses in declining markets.**

To illustrate the value of diversification, let’s compare the growth of \$100,000 invested in three hypothetical portfolios prior to two extreme periods: the bursting of the tech bubble—which inflated in the late 1990s—and the Great Recession of 2007–2009. If an investor had held only U.S. large-cap stocks, as represented by the S&P 500®, their portfolio would be worth over \$283,000. Had they invested the same amount in a more conservative blend of 60% stocks and 40% bonds, they’re portfolio would have weathered the market storms a bit better, but would have trailed during the recent bull run (\$268,644). But had they been globally diversified, with assets varied enough to temper market turbulence and positioned to take advantage of overseas opportunities, their \$100,000 stake would have grown to \$338,920.

## The only “free lunch” in finance

Nobel Prize–winning economist Harry Markowitz, the father of Modern Portfolio Theory (MPT), was the first to demonstrate that a diversified portfolio can deliver improved performance and lessened risk relative to individual asset classes. This notion that you’d get something for nothing is nearly unheard of in economics. And it’s why Markowitz famously called diversification “the only ‘free lunch’ in finance.”

The key concept behind the “free lunch” is correlation—or rather, a lack of it. Typically, the performance of individual asset classes aren’t perfectly correlated. If asset values do not move up and down in perfect harmony, then a diversified portfolio will have less risk than the weighted average risk of its parts.

Unfortunately, as we’ve experienced increasing bouts of volatility around the globe, correlations have been rising over the last several years, testing the precepts of MPT. We live in a more complex world than when Markowitz wrote his seminal work, with an expanded number of asset classes and markets that are more interconnected than at any time in our history.

However, it’s important to understand that even during periods of market stress, when correlations tend to increase, diversification still provides benefits as long as assets don’t move in perfect lockstep. It’s also important to recognize that asset allocation strategies can be dynamic—both in choosing which asset classes to include and in making tactical adjustments to reflect changes in the market, the global economy and even your personal circumstances.

### **What a globally diversified portfolio looks like**

Today, asset allocation has evolved beyond domestic stocks, bonds and cash to include global diversification across equities, fixed income and nontraditional investments.

- **Equities:** Large caps, small caps and international, including emerging markets
- **Fixed income:** Treasuries, corporate bonds, municipal bonds, international bonds, emerging market bonds, high yield bonds
- **Nontraditional investments:** Commodities, real estate investment trusts (REITs) and others

Strategic asset allocation requires a long-term view, and it shouldn’t be unduly influenced by short-term considerations. This is an investment strategy for the long haul that requires patience and discipline. The right mix of assets for you and your goals should be based on your risk tolerance, cash flow needs, investing experience and time horizon, among other factors. And you should revisit your allocation periodically, if there is a change in your circumstances or whenever your goals or objectives change.