ARE U.S. INVESTORS GLOBALLY DIVERSIFIED?

HOW INADEQUATE INVESTMENT STRATEGIES CAN HARM PORTFOLIO PERFORMANCE

- The U.S. Slice of the Global Market Pie Keeps Shrinking
- International Stocks can be Less Risky than Familiar Local Stocks
- International Stocks can Provide Better Global Diversification than U.S. Multinationals

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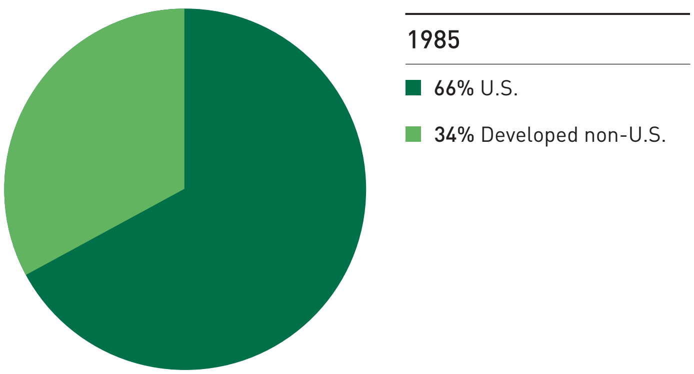
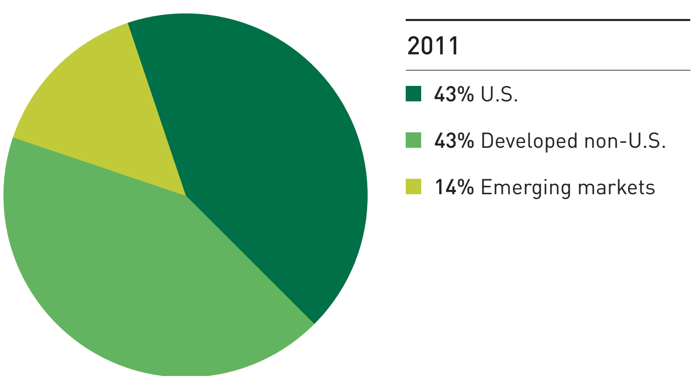
Each day the U.S. is becoming a smaller part of the world economy. And by not exposing their portfolio to new, growing economies many U.S. investors are potentially lowering their investment returns and increasing portfolio risk.

Back in 1985, the global equity market was worth about $2 trillion USD, with U.S. stocks accounting for 66% of that market. Since then, the global market has grown to $55 trillion USD. And most of that growth has come from outside of the U.S, with the U.S. only accounting for 43%.

U.S. equities now represent less than half of world equities. Emerging markets, on the other hand, have increased their share almost five fold in the last 15 years.





Source: Russell Global Index, S&P Citigroup BMI Index, Bloomberg; July 2011

THE U.S. SLICE OF THE GLOBAL MARKET PIE KEEPS SHRINKING

It's clear that U.S. dominance in the global markets is weakening. In the coming years, this trend will continue, because emerging markets are expected to grow much faster than developed nations like the U.S. The International Monetary Fund estimates the global economy will grow 3.3% this year. Emerging markets will account for 64% of that growth. That's up from 30% just ten years ago.[1] The IMF also predicts that China will overtake the U.S. as the world's largest economy in less than 5 years.

THE INFLUENCE OF HOME-COUNTRY BIAS ON PORTFOLIO DIVERSIFICATION

Many U.S. investors have not adjusted their investment strategy to this increasingly global market. Only 40% invest outside of America.[2] And this doesn't necessarily mean they are well diversified. It simply means that they have some type of investment outside of the U.S.

In fact, a global pension asset study done by Tower Watson Consulting in 2011, showed retirement plan managers allocating, on average, 70% of their client portfolios in domestic stocks.[3] Considering the U.S. now accounts for less than half of the global market cap, many investors are failing to take full advantage of the opportunities available worldwide.

It is reasonable to believe that a home-country bias influences many diversification decisions. Typical investors appear to prefer investing in familiar local stocks. And because international stocks are less familiar than domestic ones, many U.S. investors tend to associate foreign equities with too much risk. So they end up investing only a small amount of their portfolio in those stocks, or completely ignoring them.

INTERNATIONAL STOCK CAN BE LESS RISKY THAN FAMILIAR LOCAL STOCKS

In the past decade, we have seen many examples of familiar stocks that performed much worse than their foreign counterparts. The energy sector provides a good example.

U.S. oil giant Exxon Mobil has had a great run between 2002 and 2011. But, as shown in the the chart on page three, some of its foreign counterparts performed much better.

Norwegian company Statoil performed over three times better, while returns from Brazilian company Petrobras were almost six times higher.

It is not hard to find similar episodes of outperformance by foreign companies in other industries. The table on page three shows total returns of some of the most popular U.S. stocks as compared to a few of their foreign counterparts, across different sectors, since March 30, 2001.

Some of those international stocks were perceived as risky simply because they were unfamiliar names. But, based on the data, investors affected by this home-country bias missed great investment opportunities in other countries.

TOTAL PERCENTAGE RETURNS SINCE MARCH 30, 2001

AUTOMOTIVE	
Ford	-34.96
Volkswagen (Germany)	323.31
Tata (India)	2349.00
FINANCIAL	
Bank of America	-29.71
Royal Bank of Canada	480.61
Itau Unibanco (Brazil)	928.11
RETAIL	
Wal-Mart	8.21
Tesco (U.K.)	134.61
Pao de Acucar	392.24
TECHNOLOGY	
Intel	-9.13
Taiwan Semiconductor	44.37
Samsung (South Korea)	515.37

Source: Bloomberg, July 2011

INTERNATIONAL STOCKS CAN PROVIDE BETTER GLOBAL DIVERSIFICATION THAN U.S. MULTINATIONALS

Besides home-country bias, many investors may mistakenly believe their portfolio has international exposure because they rely on U.S. multinationals.

These are large U.S. corporations that generate a significant portion of their revenues from abroad. Some examples include Intel, Caterpillar, McDonalds, Google, and Johnson & Johnson. All these companies generated more than half of their sales outside the U.S. in 2011.

Conventional wisdom dictates that in buying those big companies' stocks, investors get exposure to international markets and a globally diversified portfolio. However, that might not be the case.

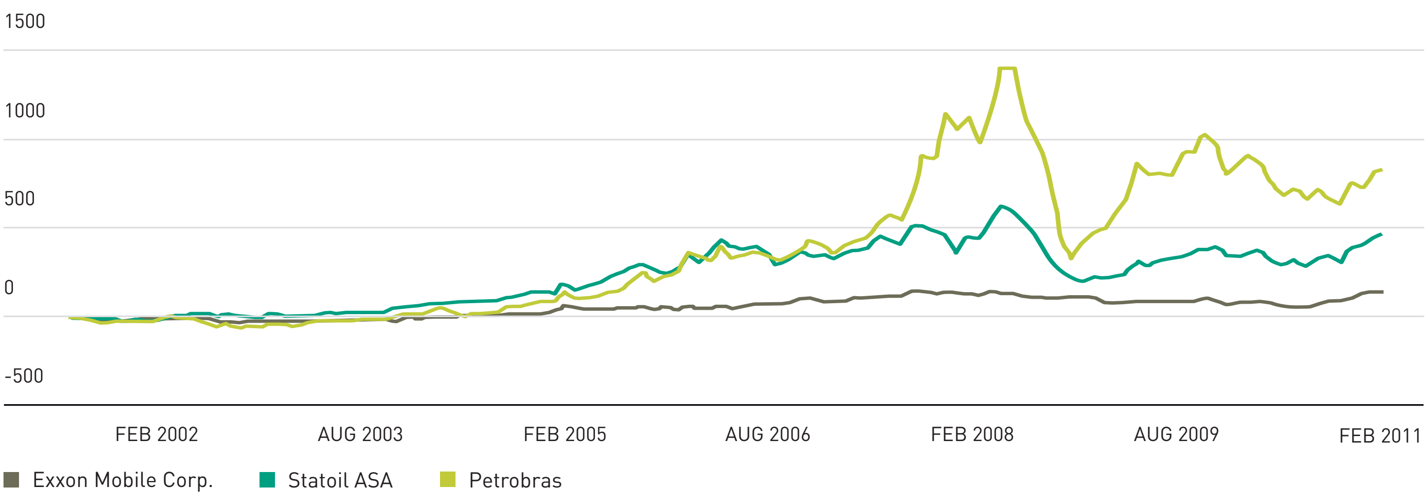
Although some U.S. companies with global operations generate a significant portion of their revenues from abroad, they do not provide the same kind of diversification benefits a truly global portfolio does.

These companies tend to be owned by U.S. investors, whose investment decisions are impacted by the ups and downs of the U.S. equity market. In fact, the Journal of Investing published a study showing that U.S. multinational stocks tend to move with the swings of the U.S. market, irrespective of the location of their foreign operations.[4] The research concluded these large U.S. companies provide little in the way of global diversification.

In 2011, for example, the company Caterpillar generated 64% of its sales from outside the U.S. So there's no question this is a company with deep ties to foreign markets. Yet, the historical correlation between the stock and the S&P 500 index is pretty high. According to data from Bloomberg, the correlation over the last five years is 0.76. In other words, the stock has moved in the same direction of the U.S. equity market almost 80% of the time. Thus, Caterpillar is not giving portfolios the benefits of true global diversification.

An examination of the Dow Jones Industrial Average performance provides an excellent example of the benefits of multinational vs. global diversification strategy.

U.S. OIL GIANT EXXON MOBILE GROSSLY UNDERPERFORMED INTERNATIONAL COUNTERPARTS



Source: Bloomberg, July 2011

This is a domestic equity index composed of 30 largely multinational companies. In fact, in 2011, 20 of those companies generated over 40% of their sales from abroad.

As an index composed of multinationals, many investors would expect the Dow to have a strong correlation with other major international markets. But an analysis of historical correlation shows that many other markets around the globe do not move in lockstep with the Dow.

Over the past 15 years, for example, the correlation between the Dow and a portfolio focused on Latin America was 0.69. The correlation with a portfolio focused on the Pacific region was 0.62. And with Emerging Asia was 0.70. Since those numbers are well below 1, a portfolio based solely on the Dow would get significant diversification benefits from those other markets.

The truth is, that it's impossible to construct a purely domestic portfolio that can give you the returns of a portfolio that includes global equities. A 2008 analysis from Wilshire Consulting proved this.

Using portfolio optimization software, they constructed a mix of U.S. stocks that most closely tracked the returns of the Dow Jones Wilshire Global Index. They used this index as a proxy for a global portfolio.

The study concluded that "the ability of U.S. investors to mimic the returns of the global market by holding only U.S.-based securities is rather limited".[5]

GLOBAL DIVERSIFICATION REDUCES RISK OVER THE LONG-TERM

The 2008 stock market crash discouraged many investors from truly diversifying their portfolios. We had a broad-based selling frenzy, with markets across the globe falling in tandem. This led many investors to question the benefits of global investing. Investors felt diversification failed when they most needed it. But, as analysis has shown, that was not the case.

A recent research report published by the Financial Analyst Journal shows that, although international diversification may not protect portfolios during short-lived panic crisis, it does offer great benefits over longer horizons.[6]

The research compared the average return of a pure domestic portfolio to that of a global portfolio during the worst periods in the U.S. market. Specifically, it looked at the worst 1, 5 and 10 years of the U.S. stock market since 1950. The table below shows the results of the research.

INTERNATIONAL DIVERSIFICATION REDUCES DOWNSIDE PERCENTAGE IN BAD TIMES

	U.S. PORTFOLIO	GLOBAL PORTFOLIO
Worst 1 year	-47.5	-47.3
Worst 5 Years	-44.8	-31.9
Worst 10 Years	-39.9	-15.7

Source: Financial Analyst Journal, March 3, 2010

Notice that in the year the U.S. had the worst performance, the global portfolio performed just as bad. But as the investment horizon increases, the benefits of global diversification become very clear.

Long-term diversification mitigates country-specific events, partially protecting portfolios against local crashes or downturns. Some of the losses suffered in the U.S., for example, can be offset by other markets that are performing better.

Looking at the worst ten performing years of the U.S. stock market, the global portfolio outperformed the domestic market by 24.2%. Based on this performance, it is apparent that a pure domestic portfolio has much more downside risk for investors than a global one.

It is important to note that an investor experiencing a downdraft of 40% in their portfolio will need to gain 67% just to get back to the original asset level. In comparison, with a downdraft of 16%, they will only need a gain of 19% to recoup their losses.

By reducing the losses during bad times, the global portfolio emerges from crisis with a larger asset base, allowing the portfolio to recover much more quickly.

BENEFITS OF A GLOBAL INVESTMENT STRATEGY

Based on current trends, international stocks will continue to grab a larger share of the global markets in the years to come. As shown in this report, a domestic-only investment strategy can no longer provide the long-term performance necessary to grow and diversify wealth.

To gain the benefits of global diversification, many U.S. investors will have to overcome their home-country bias and adapt to the changes in the global economy. By doing so, these investors will expand their investment horizons—allowing them to find new opportunities to reduce risk and gain potentially higher returns.

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Call 877.613.3837 to talk to an EverBank Wealth Management advisor today and find out if you are missing out on global opportunities that could give you more confidence in the strength of your finances.

1. "World Economic Outlook", International Monetary Fund, January 2011
2. Franklin Templeton Global Investor Sentiment Survey, March 2011
3. Global Pension Asset Study, Tower Watson, February 2011
4. "U.S. Multinationals as Vehicles for International Diversification", Journal of Investing, 2000
5. "Examining the Home-Country Bias", Wilshire Consulting, April 16, 2008
6. "International Diversification Works (Eventually)", Financial Analyst Journal, March 3, 2010