US vs. Non-US: Why Diversify? — July 2020

OVERVIEW

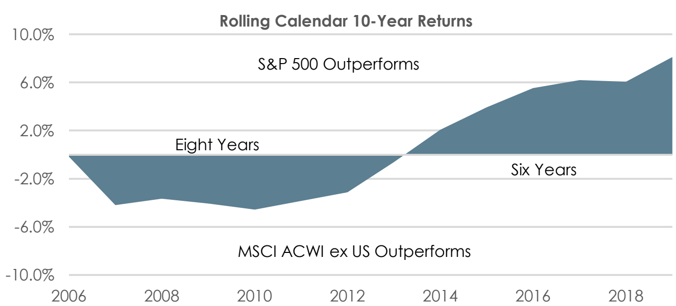
- **Over the past ten years US equities have outperformed their non-US peers, however history shows outperformance cycles through time**
- **Contributing factors include differences in index compositions, narrow US leadership, and currency headwinds for non-US equities**
- **Abandoning a diversified approach could result in missed opportunities as the recent trends can reverse quickly and without warning**

Background

2019 closed out another year of US equity (S&P 500) outperformance vs. its non-US counterpart, (MSCI ACWI ex US). In fact, the S&P 500 has outperformed the MSCI ACWI ex US index in eight of the last ten calendar years. This persistence may lead investors to question the relevance of maintaining a globally diversified equity portfolio. Notwithstanding this recent US outperformance, there are multiple factors to consider, including similar extended periods of non-US equity outperformance in the past, differences in sector compositions within the indexes, the impact of the US dollar, and narrow leadership within the US markets.

Recent Performance Overshadows Past Cycles

Relative asset class performance moves in cycles and currently, within global equities, the US is enjoying a superior run. Over the past ten calendar years through 2019, the S&P 500 index outperformed the MSCI ACWI ex US index by just over 800 bps (annualized) and outperformed in eight of the last ten calendar years. Looking back to the ten calendar years ending 2010, the MSCI ACWI ex US outperformed the S&P 500 index by more than 450 bps (annualized), and similarly outperformed in seven of those prior ten years. A review of rolling calendar ten-year periods highlights the cyclicality of returns. The S&P 500 outperformed the MSCI ACWI ex US over the preceding six rolling calendar ten-year periods, however the MSCI ACWI ex US outperformed the S&P 500 for eight consecutive rolling ten-year calendar periods prior.



Source: ACG Research

Differences Between the US and Non-US Equity Indexes

There are notable differences with respect to the composition of the two indexes, adding to the discussion around the divergence in performance. Most recently, the Information Technology (IT) sector weight within the S&P 500 was 27.5%, more than twice that of the MSCI ACWI ex US at just 11.0%. The IT sector has been one of the best performing sectors in global equity over the last ten years, and many of the prominent IT companies are US domiciled. On the flip-side, the MSCI ACWI ex US index carries heavier weights to the more traditionally value-oriented sectors, such as Financials and Materials, and acknowledging these sector weighting differences as well as a low interest rate environment in the US that served, in part, as a catalyst to higher valuations for asset-light, long-duration equities (specifically growth-oriented technology stocks), this diversion in performance is easier to understand.

US Dollar Trends are a Factor

When investing outside the US, currency movements can further impact performance as US-based investors translate the performance of their non-US investments back to US dollars. When the US dollar is weak, the impact is positive, and when the US dollar is strong, the impact is negative. Over the ten years ending December 31, 2019, the impact of the US Dollar, which was generally in a strengthening trend, negatively impacted non-US equity returns by approximately 2% annually. For the ten years ending December 31, 2010, when non-US equities outperformed US equities, the US Dollar was weakening, providing an added benefit. Timing a reversal in the trend of the US dollar, or any currency is difficult. However, should a reversal occur, this will likely serve as an added tailwind to US investors holding non-US assets.

As of December 31, 2019	Total Return, (% Annualized)			
Non-US Equity Benchmarks	1-Yr	3-Yr	5-Yr	10-Yr
MSCI ACWI Ex USA GR USD	22.13	10.40	6.01	5.45
MSCI ACWI Ex USA GR LCL	2137	8.98	7.33	7.38
US Dollar Impact	0.77	142	-132	-193

Source: Morningstar, ACG Research (USD = US Dollar, LCL = Local Currency)

Narrow Leadership in the US – Diversification Outside the US

Within the S&P 500, leadership has been narrow in terms of names and sectors. By the end of 2019, Alphabet (Google), Amazon, Apple, Facebook, and Microsoft contributed 27% of the S&P 500's cumulative three-year return. While not all are classified as IT companies, they arguably have elements of IT within their business models and benefitted from the aforementioned constructive environment (low interest rates). For US equity dominance to continue, either the growth rates must continue, or the valuation multiples mustn't contract. The MSCI All Country World Index consists of nearly 3,000 stocks in 49 developed and emerging market countries, offering global diversification. Focusing on absolute returns by country highlights the differentiated return opportunities within this index. Over the past ten calendar years ending 2019, the top performing country has been from the emerging markets region nine times, and the one time a developed country topped the list, it was not the US. The US made the top ten five times with its best showing fourth in 2011.

ACG's Position

Maintaining a long-term focus, while following a strategic and diversified asset allocation program can help manage portfolio volatility and improve risk-adjusted returns. While the recent outperformance of US equities vs. their non-US peers has been clear-cut, abandoning a globally diversified approach could be shortsighted as history shows that relative performance cycles over time. This also is the case with foreign currency effects, which have been a recent headwind as well. The recent outperformance of the S&P 500 has been driven by a small number of stocks which seemingly would need to continue to drive the US markets higher. However, by including non-US equities, investors would increase and diversify the opportunity set and may further benefit by revisiting their asset allocation targets and re-balance as needed.

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