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International Diversification Part 2: Not so crazy

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews, and I'm joined by my co-host, Marcelo Taboada. Marcelo, how are you today?

Marcelo: Keith, I'm good. I'm a bit happy that we're starting to get some cold weather. It sounds crazy, but I like it.

Keith: I'm not sure I even know how to respond to that. A week ago, it was 27 degrees and beautiful, and everybody was out and about. And now it's a lot colder.

Marcelo: I secretly love it because you get to stay home and read more. There's less social activity. I love social activities, but I feel like it's a breakdown of the seasons. I love that stuff.

Keith: Oh, good for you. Marcelo, in today's episode, we're looking forward to part two of international investing. Last week, we covered part one, and we're going to do a little bit of a review of that, spend a few moments, and then jump into part two. Part two will focus on the idea that Canadians should be investing outside of Canada. The question is how much in the United States and how much in EFI (Europe, Asia, Far East, and emerging markets). We'll discuss valuations and expected returns.

But before we get to that part, let's do a very quick review of what we discussed last week about international investing. Do Canadians do enough of it?

Marcelo: The answer is no, but there's a bit of a caveat there. We are getting better. As we discussed in the last episode, Canadians allocate 52 percent of their stock allocation into Canadian markets. That's down from previous years. Canada still only represents about 3 percent of the global stock market. So it is a problem when you have more than half of your portfolio in a market that represents only 3 percent, for concentration issues and things like that. Canada is almost a regional economy, similar to Australia. It won't be as developed as the U.S. economy or the European market, so it is an issue.

Keith: All right. Fair enough. And we discussed the fact that maybe 20 years ago, Canadians might have held 20 percent of their investments outside of the country. There were limits as to what we could do then. Now we've crept up to about 45-48 percent of our equity

portfolios in non-Canadian investments. We touched base on a very interesting report from Vanguard that suggested Canadians should have about 70 percent of their portfolio in non-Canadian assets.

Marcelo: Yes. They don't go as far as saying you should have a specific allocation to the U.S. market and international markets and emerging markets, but this is a discussion we're going to have today. I think a lot of people would say, "Oh, I'll do 30 percent in Canada, but I'll just put the rest in the U.S.," and then forget about the rest.

Keith: Some people might consider doing that. The primary reason is people will look back and see the returns over the last five or ten years and think, "Wow, look at the U.S. market, look at the S&P 500." We're talking about high teen returns, whereas EFI and emerging markets will be significantly lower. The tendency is to put money where the great historical returns have been.

Marcelo: It doesn't help that Warren Buffett has said many times that all you need in your portfolio is the S&P 500, right?

Keith: Until lately. Okay. So that's some of the framing. We've talked about what individuals are doing. We're going to piggyback off a report from AQR, Cliff Asness, who's a tremendous investor and very strong in analytics. What's the name of the report and what's the concept behind it?

Marcelo: It's called "International Diversification: Still Not Crazy After All These Years." The premise is that yes, the U.S. market has outperformed international markets, but it hasn't always been the case throughout the history of the stock market. There are periods where international markets have outperformed the U.S. So even though it may seem like the U.S. is outperforming everything over long periods of time, it's not the case all the time. There's an interplay between valuations and how much people are paying for growth or earnings.

Keith: You're absolutely right. It's an interesting report. It gets a little technical, but we'll make it straightforward. The premise is that if you go back and look at stock returns over the last 120 years, the U.S. market has produced the highest return. Particularly from a Canadian perspective, the best data starts around 1970 when the EFI index was created and tracked. The AQR report starts its analysis from 1990 to today, showing that U.S. stocks have outperformed by about 4.5 percent over international stocks. But the research highlights that this return came because valuations changed dramatically. In 1990, U.S. stocks were 50% cheaper than international stocks. Today, U.S. companies are one and a half times more expensive than international companies. If you take away that valuation expansion, the U.S. market outperformed international stocks by only 1-1.5 percent, which is very different. The report concludes that you can't expect the same level of superior performance unless valuations become even more excessive, which is practically impossible.

Marcelo: Things tend to go through periods of euphoria, but over long periods, valuations do matter. How much people are paying for things matters. If you're coming in at higher valuations, the expected return will be lower.

Keith: So for today's show, you looked at PEs. We'll start with PEs. Price earnings ratios. What are today's PEs look like? Generally speaking.

Marcelo: So, before we dive into the price to earnings ratios of the indices that we're discussing today, I know this could be a bit of an abstract thing for people. So let me just define what it is. So, the PE ratio is a simple but popular metric used by investors and institutions to determine the relative value of a company's stock. So, in this definition, price means the current price per share of a stock. So $10, $20, and earnings means company's profit per share over a specific period of time.

So, in other words, a company's price to earnings ratio is how much investors pay per dollar of annual company earnings. So, if a company's PE ratio is 10, that means its share costs 10 times the profit it makes on a per share basis, in a year. So just in the same way that you can calculate a P/E ratio of a stock, you can calculate the P/E ratio of the S&P 500 or the S&P TSX Composite or the MSCI EFI.

So we look at the S&P 500, it's 23 right now. If you look at the MSCI EFI, which tracks the international markets, excluding emerging markets, it's about 14. MSCI emerging markets is 14. So very similar. I mean, there's decimal points there, but we're not going into that. And the Canadian market is about 16.

Keith: So again, one of the big premises, and we've spoken about our investment approach many times is we are not trying to do any market timing and shift assets around based on valuations. We have very globally diversified portfolios. We recommend that to all investors, Canadian stocks, US stocks, international and emerging market stocks. So in this entire discussion, it is important that we mentioned we're not in any of this valuation discussion, suggesting that individuals leave a region entirely in a portfolio. But it is good to look at this stuff to have indications because history does repeat itself. So what you're saying now is U.S. stocks are more expensive than the other stocks, and in particular, we're talking U.S. versus non-U.S., but still international. So Europe, Far East, and emerging markets.

Marcelo: Yes. You're paying 23 per level of earnings in the United States and 14 in international markets.

Keith: The AQI report is very clear to say that there's probably sunnier times ahead for the returns of international securities. So if we look at the last five years now, I knew this information going back. Into the eighties and nineties. I was doing my MBA in 1991, and I remember looking in one of my finance courses, sort of how things had done. And for those listeners that do remember the eighties and nineties, this is when European and Japanese

companies were doing extremely well. With regards to returns, Marcelo, believe it or not, there was a period of time when most companies would say America or North America is doomed. Everybody should adopt the Japanese method of managing companies. They ship executives all over the world into Japan because everybody thought that Japan had the secret formula in terms of creating wealth.

Marcelo: Correct me if I'm wrong, but I think at some point the Tokyo real estate market was worth more than the entire U. S. stock market.

Keith: You had the Nikkei floating around the same level where it is today in 1990. But that said, this is part of this whole valuation and this topsy turvy. So when we look at five decades worth of data, we find very distinct stories here. How many times do you think the U. S. beat EFI in those five decades? How many decades?

Marcelo: Well, if I had to guess, I would say since 1970s till today. So 50 years, I would say two.

Keith: Which two?

Marcelo: The tech boom, so 90 to 2000 and then 2010 to 2020.

Keith: You're 100 percent correct. So the U S market outperformed in the nineties and in the last, 12 to 13 years. The international and emerging market markets outperformed in the other three decades and depending on which decade you look, if you look at the end of the decade, you see very different valuation stories back to this whole Japan and Europe valuations in the late eighties, things were so expensive. Then they subsequently had lower returns. The US market was cheaper, and it subsequently had higher returns. Fast forward to today, what the AQR report and what a lot of individuals are talking about is U.S. markets have higher valuations and the international securities have lower valuations, hence probably better future expected returns.

Marcelo: I mean, it's hard to deal with this concept of PEs and how much are you paying for stuff because you could easily say, okay, based on valuations, I'm not going to invest in the US market. But that's how markets work. And sometimes people will bid the prices up and with diversification, you also want to be there for when those things happen, right? You don't want to time things based on valuations, but if you have a diversified portfolio, you still want to be able to profit from those times where people are bidding prices up.

Keith: We've been holding diversified portfolios for close to 25 years in similar allocations. Think of it a third in Canada, a third in the US, and a third outside of North America. And we're not suggesting that anybody tinkers around with that. In fact, even within your valuations of the US market, you have different components within the US market with very different valuations. So, the S&P 500 is driven a lot by the top 100, in fact, a lot by the top 20 companies.

Marcelo: Well, there's the magnificent seven, eight right now in the S&P 500, which are absolutely dominating the index.

Keith: Yep, but even within the US economy, you've got small value companies, which there's a lot of individuals saying that they're effectively pricing in a recession and they're lower than their valuations have ever been, so therefore their future returns could be higher. And so, when we look at these future returns, it does kind of matter as to where prices currently are. We've referred to a Vanguard report quite a bit with clients in the last six months that speaks about expected returns in general global regions. Do you want to just highlight what those sorts of expected numbers are, just the higher and the lower numbers?

Marcelo: Basically, they say that whatever's done really well in the past year or two or decade, it has lower expected returns. So, when you look at growth stocks for example, or small cap growth stocks, they tend to be lower expected returns going forward. Same thing with the US market. So, what they identify as the ones having the highest expected returns are emerging markets when it comes to regions and when it comes to asset classes, they're looking at small cap value as the one with the highest expected return because they've had lower returns in the last 10 years.

Keith: You're absolutely right. So the Vanguard report will speak about expected returns. Canada is expected to have better returns. So all regions with lower prices, lower valuations are expected to have better returns in the next decade or two. Canada, International, emerging market, US is expected to have lower returns than some of these regions, but within the United States there's two different areas. There's value securities and growth companies, and Vanguard suggests that growth companies have the lower return and value. And so again, we're not in any way suggesting that individuals start changing portfolios dramatically. I think the number one thing we are suggesting to listeners is if they don't have international equities, non-Canadian, non-US equities in their portfolio, they should take a hard look at that and really introduce them and make sure they have reasonable weightings to those securities in a diversified fashion.

Marcelo: And honestly, there's really no excuse now. I mean if you talk to me 30 years ago, the accessibility to this type of funds that were either very expensive or very hard to get, now you can buy an ETF that gives you access for this for 10, 20 basis points, which is super good. You can get a fully diversified portfolio through Tangerine or a RoboAdvisor that has international stocks. So, there's really no excuse for Canadians not to be doing this.

Keith: This a hundred percent. We're starting to get the wrap up here, Marcelo, but before we get to the wrap up, I want to ask you a question. It is spoken about in the AQR report. It's this idea that sometimes investors might say, “why should I invest in a diversified international or non-local security when markets crash or correct in these big moments, 2020, 2008, 2001, it seems like no matter what you own all goes down about the same. So, there's no benefit to this international diversification, hence, why should I do it?”

Marcelo: Right. And that's true in the short term. I mean, the world is connected now. It's globalization. Everything is interconnected. So, it is like they say, the US sneezes and the world catches a cold. So, it's sort of like along those lines. Every time something happens in Europe or in other parts of the world that affects everybody. Think about the pandemic. The pandemic has affected every single country. You have hugely connected countries through globalization. It's normal that this happens, but this is not the case over long periods of time. So, when you start looking at data from crashes over one, two years, yes, they may be very similarly going down at the same time, but once you start looking at data from 5, 10, 15, 20 years, the picture starts changing. And that's the main point that yes, it will crash all at the same time. Absolutely. The data shows that, but it's not going to be the case long term.

Keith: You're right. And the AQR report has a very, very good section which essentially says, expect them all to go down in similar fashions with these moments. However, international diversification does work and is beneficial to all investors because primarily it reduces the risk. There's one very big risk that you don't get stuck if you're only in your local region in a lost decade because that lost decade will be incredibly painful, and you will not get the returns you deserve if you're stuck in a concentrated positions with no proper diversification. So that's where the benefit is. It's a five and ten year benefit and longer.

Marcelo: And you look at countries in the international markets, in the emerging markets, they're developing, they're booming. Some countries like Nigeria, they're booming in terms of population and their economy is growing. So as an investor, you don't want to miss that. You don't want to bet on one single country. I mean, we don't advocate for that, but you want to have access to all of this growth that's available for people.

Keith: Yeah, you want access to Europe, you want access to Asia, you want access to emerging markets. So, Marcelo, this has been a great part two, I think we've covered off what we wanted to do here, and in particular, make sure that our listeners hear us say that it's not just the US market, you need to be balanced between the US and international securities for Canadians. What's our takeaways here?

Marcelo: Well, my takeaways, what I said before in the last podcast, it's like a balanced diet. You're going to hate it sometimes, but it works. And long term, it is the best approach because you're going to go through periods where people are going to say, “you know what, there’s areas of my portfolio that are not working. Why do I have that? Why do I even bother?” But history shows that when that happens, the expected return of those things that people are talking about and complaining tends to be higher going forward just because of valuation. Reversion to the mean, that tends to happen constantly. So, it's painful, but sometimes you have to eat the spinach to lose the weight, right?

Keith: Oh, good analogy. So that's a great takeaway. I would simply add, and you alluded to it a little bit five minutes ago, today, more than ever before, Canadians have access to investment strategies and solutions, whether they're low-cost exchange traded funds, or I know that we're using dimensional fund advisor strategies to capture that international equity waiting for our clients, but everybody's got access, and everybody can use it. And

we're talking about 20 basis points for international investing. This is unheard of. You couldn't do that 20 years ago, and it's a great time because valuations are attractive. So, make sure that your portfolio has Canadian securities, US Securities, EFI, (Europe, Far East) and emerging markets in a well-diversified portfolio. Marcelo, thank you so much for part two of international investing. I think we covered a lot. And to our listeners, I hope you're doing well, and we look forward to hearing from you and see you next time.

Marcelo: Thank you for listening.

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