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Global Asset Allocation

By Mike Skoric

Most people have heard plenty about asset allocation within investment portfolios. Based largely on Modern Portfolio Theory, the idea is that as we add more stocks to a portfolio, the overall risk is reduced and risk-adjusted returns improve. A similar benefit applies to adding different asset classes to a portfolio. Nevertheless, many domestic investors still tend to have a sub-optimal level of diversification within their portfolios. One common reason is what is known as a "home country bias," or the propensity to favor markets that investors are most familiar with. However, of the approximately $70 trillion of global stock market capitalization, less than half is in the United States.

By having a portfolio solely focused or significantly overweight domestic equities, we forgo other global opportunities that may offer superior returns. These include companies in mature (developed) international markets like France, the United Kingdom, and Japan; companies in faster growing (emerging) markets such as Brazil, China, Russia, and India; or companies in smaller (frontier) markets like those in Argentina, Egypt, Kenya, and Vietnam. While there is no magical formula, there are tools that help us create more efficient portfolios based on the theoretical notion that an optimal allocation can produce maximum return for a certain level of risk.

As with global equities, there are similar dynamics in global bond markets. Along with traditional domestic bonds, one should also look at high-yield bonds, convertible bonds, preferred stocks, REITs, etc. Also consider bonds issued by foreign countries and companies that will typically offer higher yields. When investing in foreign bonds, the currency effect is also critical and needs to be taken into account. If investors wish to assume the risks and potential rewards of foreign currency shifts vis-à-vis the U.S. dollar, they can purchase foreign bonds issued in local currencies. If investors are satisfied with just the higher income offered by foreign bonds, they can focus on dollar-denominated foreign bonds or on bond funds / ETFs where derivatives are used to neutralize the impact of currency movements on overall returns.

While large-cap domestic stocks have been the market leader over the past decade, emerging market stocks have started to outperform U.S. equities in the second half of 2020. This could be the beginning of a longer-term trend given the higher economic growth rates of many emerging market economies and the unusually large valuation discounts compared to their own long-term averages and relative to U.S. stocks.

In an increasingly globalized world, it makes sense to take a global investment perspective. This is simply one example of the kind of fundamental shifts that we look to identify and exploit in the process of asset allocation and construction of client portfolios.

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