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The Case for Global Diversification

Understanding the risks and potential rewards of investing in international stocks

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Introduction

International stocks provide investors with access to global markets, offering diversification beyond domestic equities. While the S&P 500 has historically outperformed many international indices, investing in global stocks—both from developed and emerging markets—remains a crucial strategy for achieving long-term financial goals. This report explores international stocks, their risk and reward profile, and why mutual funds and exchange-traded funds (ETFs) offer an efficient way to gain exposure to these markets.

What Are International Stocks?

International stocks are shares of companies based outside of an investor's home country. These stocks are typically classified into two main categories:

- Developed Markets: Countries with stable economies, mature financial markets, and established regulations. Examples include the United Kingdom, Germany, Japan, and Canada.
- Emerging Markets: Countries with rapid economic growth, expanding industrialization, and higher volatility. Examples include China, India, Brazil, and South Africa.

Key Characteristics of International Stocks

- Geographic Diversification: Reduces reliance on a single economy.
- Currency Exposure: Investments can benefit or suffer from foreign exchange fluctuations.
- Economic Growth Differentiation: Varying economic cycles across countries can create opportunities.
- Sectoral Differences: Some economies may have stronger industries (e.g., technology in the U.S., manufacturing in Germany, and consumer growth in China).

Why a Diversified Portfolio of International Stocks is Beneficial

Holding international stocks can enhance portfolio diversification and reduce overall risk by spreading exposure across different economies and industries.

Benefits of Global Diversification

- Reduces Over-Reliance on U.S. Markets: While the S&P 500 is strong, it is heavily concentrated in a few technology companies.
- Cyclical Advantages: Different markets experience growth at different times.
- Access to Faster-Growing Economies: Emerging markets often have higher growth potential than developed nations.
- Currency Hedging: Exposure to multiple currencies can help protect against inflation and U.S. dollar depreciation.

Historical Performance: International vs. U.S. Stocks

Below is a table comparing the historical annualized returns of the S&P 500 versus international developed and emerging market stocks:

Year Range	S&P 500 Annualized Return (%)	MSCI EAFE (Developed Markets) (%)	MSCI Emerging Markets (%)
1970-2023	10.6%	8.4%	9.2%
1990-2023	9.3%	5.5%	7.8%
2010-2023	8.5%	5.2%	4.3%

While the S&P 500 has outperformed in recent decades, international stocks have experienced strong periods of relative performance in different market cycles.

The Role of Mutual Funds and ETFs in International Investing

Investing in individual international stocks presents challenges, including geopolitical risks, currency fluctuations, and access to foreign markets. Mutual funds and ETFs simplify international investing by offering diversified exposure.

Why Use International Mutual Funds and ETFs

- Broad Diversification: Exposure to multiple countries and sectors in a single investment.

- Risk Management: Professional fund managers handle currency risks, geopolitical risks, and company selection.
- Liquidity: ETFs allow intraday trading, and mutual funds offer end-of-day liquidity.
- Cost Efficiency: Passive ETFs tracking international indices provide lower-cost access to global markets.

Comparing Investment Vehicles

Feature	Individual International Stocks	Mutual Funds	ETFs
Diversification	Limited	High	High
Trading Flexibility	Low	End of day pricing	High
Management	Self-directed	Professional	Index/Active
Costs	Varies	Higher fees	Lower fees
Accessibility	Complex (foreign exchanges)	Simple	Simple

Understanding Risk in International Markets

International investing carries distinct risks beyond those seen in domestic markets. The table below highlights key risks:

Risk Type	Description
Currency Risk	Fluctuations in foreign exchange rates can impact returns.
Political Risk	Government instability, trade policies, and regulatory changes can affect markets.
Liquidity Risk	Some international markets have lower trading volumes, making transactions harder.
Economic Risk	Inflation, interest rates, and economic growth vary by country.
Sectoral Concentration	Some markets rely heavily on specific industries (e.g., commodities in Brazil).

Why International Investing Still Makes Sense

Despite the S&P 500’s strong historical performance, international stocks remain a crucial part of a diversified portfolio for several reasons:

1. The Dominance of the “Magnificent 7” in the S&P 500: A significant portion of the S&P 500’s returns in recent years has been driven by a handful of technology companies (Apple, Microsoft, Amazon, Google, Tesla, Meta, and Nvidia). If these stocks experience slower growth or underperformance, international markets may outperform.
2. Reversion to the Mean: Historically, market leadership rotates between U.S. and international stocks. The S&P 500 does not always outperform.
3. Valuation Differences: Many international markets trade at lower price-to-earnings ratios than the U.S., providing potential upside if valuations normalize.
4. Diversification Against U.S. Market Risks: Events like high inflation, economic slowdowns, or regulatory changes in the U.S. could make international investments more attractive.

Conclusion

International stocks provide investors with diversification benefits, access to emerging economies, and potential for strong returns over time. While the S&P 500 has led performance in recent decades, historical cycles suggest that global markets remain a critical component of a well-balanced portfolio.

Mutual funds and ETFs provide an efficient way to gain international exposure while managing risks associated with currency fluctuations, political instability, and economic uncertainty. By maintaining a diversified global allocation, investors can enhance their portfolio’s long-term growth potential and reduce reliance on a single market.

Disclosures:

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