WHY INVEST IN GLOBALLY DIVERSIFIED PORTFOLIOS?

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Globally Diversified Portfolios

Let's start at the beginning. What exactly is a globally diversified portfolio? At First Command, we define it as a portfolio containing investments in a variety of asset classes – stocks, bonds and so-called real assets like real estate and commodities – spread across a number of different countries and regions. And we are convinced that it is the best way to manage our clients' money.

Why are we so certain of that? Because we believe a globally diversified approach to money management intersects neatly with the objectives of our clients and our time-tested 60-year-old investment philosophy, which is comprised of the following four investment disciplines:

1. Start investing as early as possible and let time be your ally.
2. Invest on a regular basis through good *and* bad markets.
3. Do not let short-term investment performance interfere with your long-term financial plan.
4. Manage the risks of your investments.

Because we encourage our clients to begin investing early in life and to consistently invest through good and bad markets, they are well positioned not only to endure the frequent fluctuations in the value of various asset classes across the globe, but to benefit from them. But they are also insulated from extreme volatility and risk simply by the broad diversification inherent in a globally diversified approach. It boils down to this: investing in a globally diversified portfolio ensures that you will always have some of your money invested in the best performing assets at any given time, but that you will never have all of your money invested in the worst-performing assets. Though no single investment approach can guarantee a profit or protect against a loss in all circumstances, experience has taught us that global diversification is a sound way for us to keep our clients on track toward their long-term financial goals while managing, to the extent possible, the investment risks (both seen and unseen) in the capital markets.

The late great statesman and Prime Minister of Great Britain, Sir Winston Churchill once stated:

> *"Many forms of Government have been tried, and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed it has been said that democracy is the worst form of Government except for all those other forms that have been tried from time to time…."* [1]

In my experience, the same could be said about investing in a globally diversified portfolio. It is not perfect and it could be the worst form of investing *but for all others.* We invest our clients' capital with an objective of growing it in a prudent fashion that will enable them to pursue life-long goals such as purchasing a home, educating their children and comfortably retiring on their own terms. And though long-term growth of assets is the primary objective, we understand that it is equally important to avoid the permanent loss of assets when bad things happen in this "world of sin and woe". Peter Bernstein[2], a famous U.S. investor, declared that "diversification is an explicit statement that we do not know what the future holds."[3]

A World of Investment Opportunities

One of the reasons we invest globally is that the U.S. does not have sole ownership of all of the world's investment opportunities. Far from it, in fact. Let's take a quick look at some statistics that support this.

	U.S.	Outside the U.S.
Global Economic Output[4]	24%	76%
Global Stocks[5]	40%	60%
Global Stocks & Bonds[6]	36%	64%
Listed Companies[7]	9%	91%
Global Population[8]	4%	96%

The above table shows that most of the world's economic output, marketable securities, listed companies, and population are outside of the United States Take a look at the following graphic[9], which provides stunning perspective on where the center of global population truly lies today.

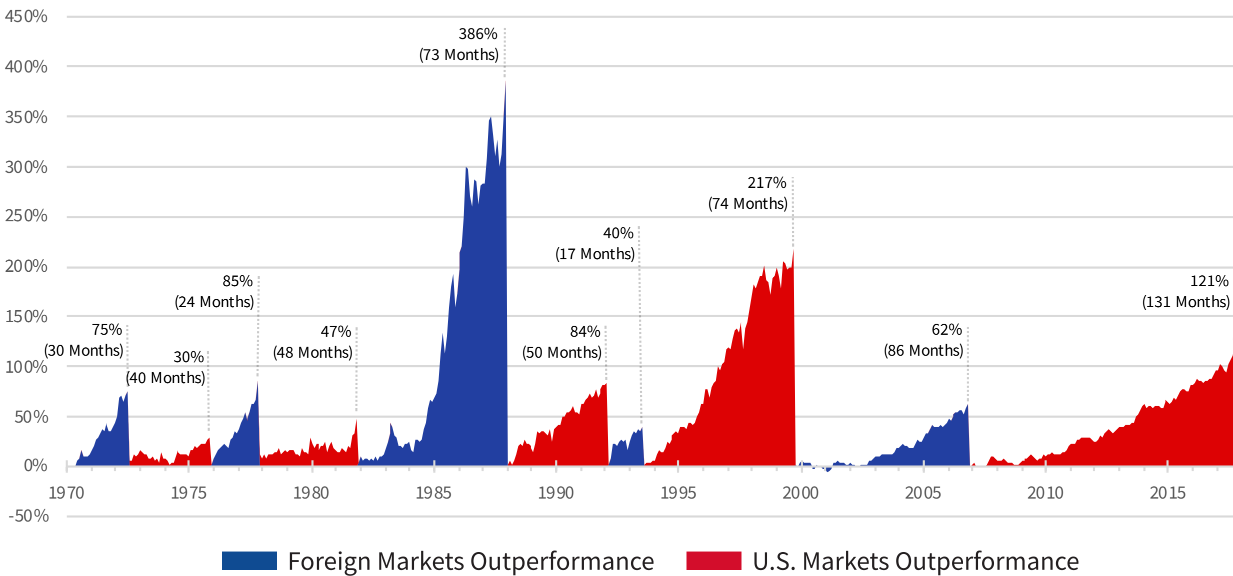
Generally speaking, First Command's strategic (think long-term) asset allocations contain 20% – 30% foreign stocks and bonds. Why do we only allocate this amount to foreign securities and not much larger amounts based on the information above? We do so first and foremost because the primary reason is that our clients are primarily located here in the United States. They buy things in U.S. dollars. They pay bills in U.S. dollars. They use their capital assets to support their financial goals in U.S. dollars. Because of this, we intentionally have a home country bias with regard to our asset allocations.

But there is a second reason that we don't invest as much money in foreign companies as the distribution of world population, output and opportunities might suggest we should and that is simply that we don't have to! The simple truth is that we can achieve robust exposure to worldwide growth by investing in dynamic U.S. companies that derive a meaningful portion of their revenue from doing business overseas.

Leadership of U.S. and Foreign Stocks Changes

We diversify between U.S. and foreign stocks because we do not know what the future holds. Diversification helps us manage risk by not putting all of our eggs in one basket and allows us to always participate in what is doing well. This is important because the investment performance leadership changes between U.S. and foreign stocks over time. See the below chart.[10]

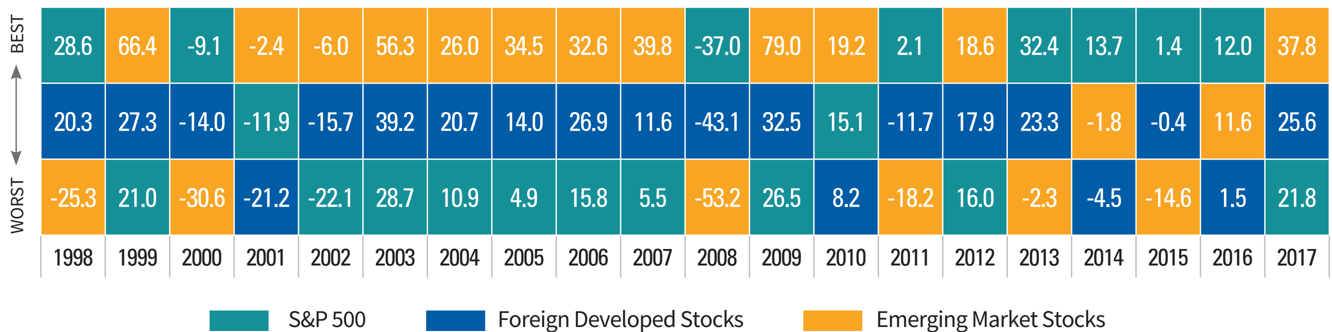
MSCI EAFE* and MSCI USA Relative Performance**
U.S. Dollar, Total Return, Cumulative Outperformance



Source: MSCI and Bloomberg (2018)
Cycles of outperformance include a qualitative component to determine turning points of leadership. Data through 9/30/2018.
**This index is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.*
***This index is designed to measure the performance of equity securities listed on U.S. stock exchanges that are in the top 85% by market capitalization.*

As you can see in the above chart, sometimes U.S. stocks outperform foreign stocks and sometimes foreign stocks outperform U.S. stocks.

The same story is told by looking at the last 20 years of calendar returns.[11] The green boxes are U.S. stock returns as measured by the S&P 500 Index. The yellow boxes are Emerging Market stock returns and the blue boxes are Foreign Developed Stock returns.



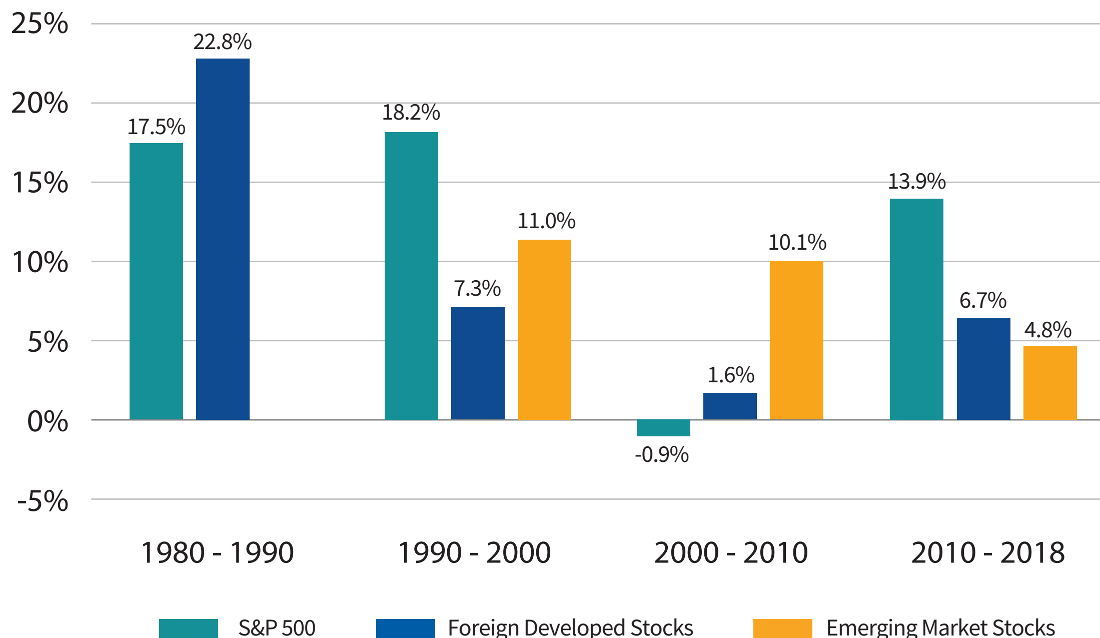
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
BEST	28.6	66.4	-9.1	-2.4	-6.0	56.3	26.0	34.5	32.6	39.8	-37.0	79.0	19.2	2.1	18.6	32.4	13.7	1.4	12.0	37.8
	20.3	27.3	-14.0	-11.9	-15.7	39.2	20.7	14.0	26.9	11.6	-43.1	32.5	15.1	-11.7	17.9	23.3	-1.8	-0.4	11.6	25.6
WORST	-25.3	21.0	-30.6	-21.2	-22.1	28.7	10.9	4.9	15.8	5.5	-53.2	26.5	8.2	-18.2	16.0	-2.3	-4.5	-14.6	1.5	21.8

Source: Morningstar Direct

The performance leaders for the last 20 calendar years are shown below.

Performance Leader	Calendar Years
Foreign Developed Stocks (MSCI EAFE) and Emerging Market Stocks (MSCI EM) ***outperformed*** U.S. stocks (S&P 500)	10
Emerging Market Stocks (MSCI EM) ***outperformed*** U.S. stocks (S&P 500)	12
U.S. stocks (S&P 500) ***outperformed*** Foreign Developed Stocks (MSCI EAFE) and Emerging Market Stocks (MSCI EM)	8

Lastly, let's look at U.S. stock returns versus international stock returns over the last 4 decades.[12] As you can see below, investment performance leadership changes through the decades as well.



Avoid Behavioral Investing Mistakes

If you had the ability to perfectly time these changes in leadership of stock outperformance, you could generate very robust investment returns. However, investors have a horrible history when it comes to timing the markets to avoid losses and generally that investment strategy has led to subpar investment returns or even permanent losses. Many investors tend to invest in what has been doing well recently. This is a well known phenomenon called “recency bias” and frequently leads to disappointing investment returns. Recency bias is a cognitive bias that convinces us that new information such as recent outperformance of a specific asset class (like the S&P 500) is more valuable than older information. In other words, our brains fool us into thinking that future returns of an investment will be similar to the most recent historical returns of that investment.

Generally speaking, investors experience four primary feelings, or "behavioral seasons," when investing in globally diversified portfolios:[13]

1. **Fear of Loss** – this happens when the global equity markets (U.S. **and** International) are in decline.
2. **Fear of Missing Out** – this generally occurs when U.S. stocks are outperforming international stocks, but could occur when the opposite is true.
3. **Fear of Loss while experiencing Fear of Missing Out** – this is a combination of #1 and #2 above.
4. **Content** – this feeling is the absence of any fear outlined above.

An analysis of these different categories going back to 1976 indicates that these behavioral seasons are experienced by investors in varying frequencies:

Category of Behavioral Season	Percentage of Time
Fear of Loss	6%
Fear of Missing Out	41%
Both Fear of Loss and Fear of Missing Out	14%
Content	39%

Another way to look at this is that investors may only be content with their globally diversified portfolio only 39% of the time and may be experiencing fear or regret of one sort or another 61% of the time. These fears and regrets may cause investors to make decisions that lead to subpar investment results or loss of capital.

The Hazards of Rear-View Mirror Investing

What happens when investors switch their focus to categories of stocks that have done well in the recent past? Below we have constructed four scenarios based on actual stock market performance. These scenarios clearly illustrate the potential negative outcomes for a hypothetical investor who pursues recent winning streaks versus sticking with a globally diversified portfolio.[14]

Scenario 1: 1989-2002. From 1983 through 1988, foreign developed stocks outperformed U.S. stocks. What would have happened if our hypothetical investor responded to this winning streak by moving out of a globally diversified portfolio to focus on foreign developed stocks? Over the next 13 years, the investor would have underperformed the globally diversified portfolio by 9.39% annually [13].

Returns from 1989 through 2002	Cumulative Return	Total Return (Annualized)
Foreign Developed Stocks	28.82%	1.95%
Globally Diversified Stocks	307.92%	11.34%

Scenario 2: 2002-2008. From 1989 through 2002, U.S. stocks outperformed foreign developed stocks. What would have happened if our hypothetical investor responded to this winning streak by moving out of a globally diversified portfolio to focus on U.S. stocks? During the next six years, the investor would have underperformed the globally diversified portfolio by 3.41% annually [13].

Returns from 2002 through 2008	Cumulative Return	Total Return (Annualized)
US Stocks	27.37%	3.94%
Globally Diversified Stocks	55.81%	7.35%

Scenario 3: 2008-October 2018. From 2002 through 2008, foreign developed stocks outperformed U.S. stocks. What would have happened if our hypothetical investor responded to this winning streak by moving out of a globally diversified portfolio to focus on foreign developed stocks? During the next decade, the investor would have underperformed the globally diversified portfolio by 5.31% annually [13].

Returns from 2008 through 10/31/2018	Cumulative Return	Total Return (Annualized)
Foreign Developed Stocks	28.51%	2.45%
Globally Diversified Stocks	116.67%	7.76%

Scenario 4: 1989-October 2018. What would have happened if our hypothetical investor had pursued all of the scenarios listed above? For this final scenario, we look at what would happen to an investor who pursued a market timing approach versus sticking with a globally diversified portfolio over this nearly 30-year period. From 1989 through October 2018, the investor would have underperformed the globally diversified portfolio by 6.65% annually [13].

Returns from 1989 through 10/31/2018	Cumulative Return	Total Return (Annualized)
Market Timing Portfolio[15]	110.86%	2.53%
Globally Diversified Stocks	1,277.08%	9.18%

In short, our hypothetical investor experienced the best outcomes by committing to long-term investing in a globally diversified portfolio. Market timing based on recent winning streaks for U.S. and foreign developed stocks tended to result in lower returns. But by staying fully invested in a combination of U.S. and foreign developed stocks, the investor always participated in what did well.

Key Takeaways

Please keep the following in mind (and remind yourself of them from time to time) if you are invested in a globally diversified portfolio:

- Investing in a globally diversified portfolio is a long-term investment strategy. This strategy is not intended to be used over short time periods and definitely not to be used in conjunction with any market-timing strategy. This buy-and-hold strategy is meant to be maintained through good and bad markets.
- You cannot judge the success or failure of a globally diversified portfolio in any one year. Because it is a long-term investment strategy, its effectiveness is best judged over multiple business cycles and bull/bear equity markets.
- There will be times in the short term when a globally diversified portfolio will not show well against the S&P 500. You will still have exposure to the S&P 500 in a globally diversified portfolio, but your portfolio may not keep up with the S&P 500 if international stocks are lagging. This is the price you pay for being in foreign developed stocks and emerging market stocks when leadership changes. Mentally prepare yourself for these times and do not let it deter you from your long-term investment plan.
- Investors generally will be content with their globally diversified portfolio around 40% of the time, while experiencing fear of loss or fear of missing out on higher returns the other 60% of the time.[16] Do not let your fears distract you from your long-term investment plan.

Summary

None of us have crystal balls. If we did, we could always pick the winners every year and avoid the losers. We could time the markets perfectly and generate high investment returns. We could spot the “seen” and “unseen” risks with more clarity and take appropriate precautions. But investing in globally diversified portfolios is not about achieving outsized investment returns. It is about growing your wealth prudently, managing investment risk, avoiding a permanent impairment (or loss) of capital, and enabling you to pursue your life-long goals. At the end of the day, a portfolio is successful if it is the investment vehicle that carries you across the finish line and provides you with the assets you need to live the life you desire. And we believe that globally diversified portfolios offer a balanced approach that is well suited to the pursuit of this objective.

Endnotes

1. Winston Churchill, November 11, 1947.
2. Peter L. Bernstein (January 22, 1919 – June 5, 2009) was an American investor, financial historian, and economist. For more information, please see https://en.wikipedia.org/wiki/Peter_L._Bernstein.
3. Managing Investment Portfolios – A Dynamic Process by John L. Maginn, CFA, Donald L. Tuttle, CFA, Jerald E. Pinto, CFA, and Dennis W. McLeavey, CFA, 3rd Edition, p. xiii (2007). In full, he is quoted as "for many, diversification was something for sissies, because diversification is an explicit statement that we do not know what the future holds."
4. J.P. Morgan Asset Management Guide to the Markets, 4Q 2018, p. 67 (September 30, 2018).
5. World Bank (https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?locations=US)(2018). The market capitalization of listed U.S. companies is $32.12 trillion. The market capitalization of all of the listed companies in the World are $79.22 trillion.
6. J.P. Morgan Asset Management Guide to the Markets, 4Q 2018, p. 67 (September 30, 2018).
7. World Bank (https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?locations=US)(2018). There are currently 4,336 listed companies in the United States. In the entire world, there are 47,372 listed companies. A listed company is a company that is listed on a stock exchange where it can be bought or sold.
8. Bloomberg 2018.
9. Map: More than half of humanity lives within this circle by Caitlin Dewey (May 7, 2013)(https://www.washingtonpost.com/news/worldviews/wp/2013/05/07/map-more-than-half-of-humanity-lives-within-this-circle/?utm_term=.1ff23cf5aabf).
10. Bloomberg and Morningstar (2018).
11. Morningstar (2018).
12. Morningstar (2018). Indices used: for U.S. stock returns - S&P 500 (total return), for foreign developed stocks returns - MSCI EAFE (gross return), and for emerging market stock returns - MSCI EM (gross return). Please note the data for emerging market stocks only goes back to 1987 so the first full decade of returns were for the 1990s.
13. Taken from a presentation entitled "Behavioral Seasons" by Brian McClard, CFA, Director of the Investment Strategy Group of RonaldBlueTrust, pages 3-5 (October 15, 2018). I found this analysis to be highly insightful.
14. For these scenarios, the globally diversified portfolio consists of 72% U.S., 20% foreign developed, and 8% emerging market stocks.
15. This can also be called the "Recency Bias Portfolio" or the "Chasing Performance Portfolio".
16. "Behavioral Seasons" by Brian McClard, CFA, Director of the Investment Strategy Group of RonaldBlueTrust, pages 3-5 (October 15, 2018).

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The First Command Retirement Income Planning process has been designed to assist individuals in the pursuit of their retirement income goals. However, no financial plan, strategy or investment can assure that retirement income goals will be met.

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