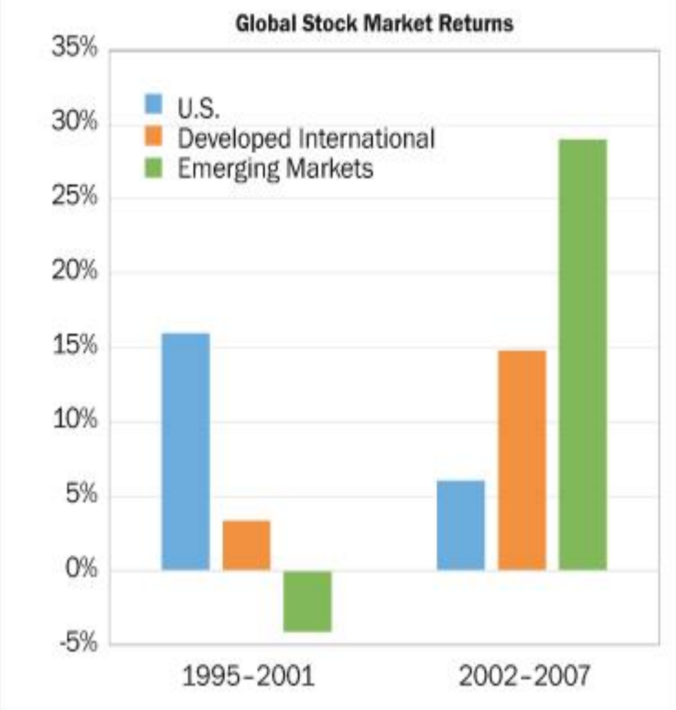
The Case For Global Equity Exposure
(despite "everyone" knowing the United States is the place to be)

After another year of outperformance for U.S. stocks versus other markets—for the fourth time in the past five years versus developed international stocks, and the third time in the past four years versus emerging markets—we're starting to hear more people question the benefit of investing outside the United States. This is an important question, and we acknowledge that owning foreign stocks has been an unsatisfying experience over the past couple of years. Moreover, given some of the current economic and geopolitical forces, it can *appear* likely to continue this way. So we feel it is worth spending a few paragraphs addressing the topic.

The first key point is to remember that equity markets and asset classes in general go through cycles and it is unwise to extrapolate recent performance trends far into the future (as we see many investors and commentators doing). Furthermore, investors often suffer from extreme overconfidence that they can predict these shifts and correctly time their buys and sells accordingly (data show actual investor returns lag indexes by hundreds of basis points due to timing errors). As an example, we were hearing this same question back in the late 1990s/early 2000s after U.S. stocks had a similar streak of outperformance. As shown in the chart at right, in the market cycle that followed from 2002–2007, international stocks trumped U.S. stocks by a wide margin, and emerging markets did even better, outperforming the S&P 500 by more than 20 percentage points annualized. (Of course, toward the end of the latter period people were asking why they didn't have *more* exposure to emerging markets . . . only to see emerging markets meaningfully trail the U.S. market since then.)

Equity Markets Go Through Cycles and It Is Unwise to Extrapolate Recent Trends Far Into the Future



Because markets move in cycles, there will always be periods when global diversification doesn't appear to "work." In our view as *long-term* investors, the case for global investing remains compelling and extends beyond the simple matter of capturing returns as market leadership rotates.

BROADER OPPORTUNITY SET

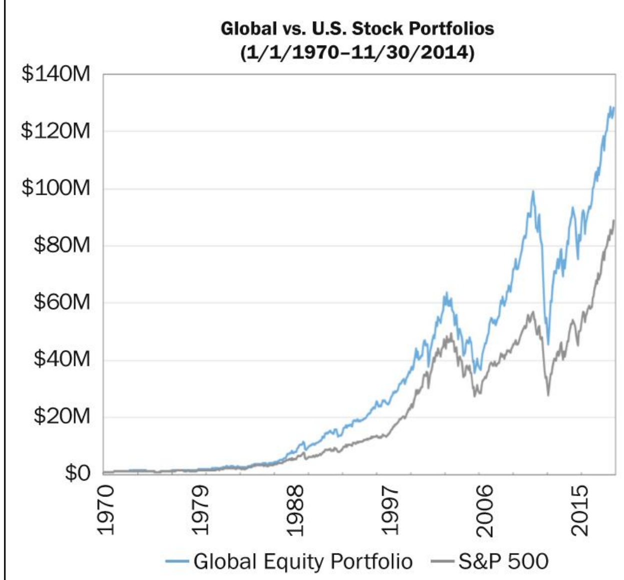
The most important reason to hold a globally diversified portfolio is to access a much broader investment opportunity set. In 1970, U.S. GDP accounted for 47% of the world's total GDP. Today it is closer to 20%, while emerging markets now comprise roughly half the world's total output. Likewise, in terms of stock market capitalization, in 1970 the U.S. market comprised 66% of the world's total stock market value. By 2013 it had declined to roughly 49%, with emerging markets comprising 11%, and the remainder in developed international markets. In other words, businesses around the globe are launching, innovating, producing, and growing, and their stocks have the potential to do so as well. If an investor chooses to only invest in U.S. stocks, they are excluding themselves from over half of the world's total investment opportunity set. Moreover, they are limiting their opportunity to invest in some of the world's most attractive companies domiciled outside the United States.

DIVERSIFICATION

A second important reason for owning a global stock portfolio is the benefit of diversification. A diversified global equity allocation should produce better longer-term risk-adjusted returns than any single country held in isolation. This has been the case historically as shown in the chart below, which extends back to 1970 when data for the developed international market index begins, and incorporates emerging markets starting in 1988 when their index returns became available. Looking at rolling 10-year periods, the global portfolio (comprised of 60% S&P 500 and 40% non-U.S. stocks) generated an average return of 12.5%, beating the S&P 500's average return of 11.3%. (The results were similar using rolling five-year periods.) Moreover, the global portfolio beat the S&P 500 in 71% of the rolling 10-year periods (there are 420 such periods going back to 1970). Countries around the world are in different stages of their economic and market cycles, and at any given time one particular market can and will outperform others. Consistently predicting which market will outperform, and more importantly getting the short-term timing right, is impossible. If you concentrate your exposure in only one market—even if it's the U.S. market—you run the risk of that market undergoing an extended period of underperformance that could have a lasting negative impact on your portfolio. And human nature is such that most people also won't be able to stand being heavily invested in an underperforming market for too long. This discomfort may lead them to sell in disgust at low prices and chase the recent country market winners, probably just as those markets approach their highs for the cycle.

That is why diversification—consistently owning a variety of asset classes, strategies, and managers that should perform differently depending on the environment—enables us to create portfolios that should perform at least reasonably well across a wide range of possible scenarios and outcomes. But it takes discipline to be a long-term diversified investor, because you *know* you will own some asset classes that are laggards in any given year or even over multiple years, and with 20/20 hindsight it is easy to start questioning why you owned those particular assets in the first place.

Despite the Recent Outperformance of U.S. Stocks the Case for Global Equity Exposure Remains a Compelling One



	ANNUALIZED RETURN	STANDARD DEVIATION	STARTING VALUE	ENDING VALUE
GLOBAL EQUITY PORTFOLIO	11.4%	14.9%	$1M	$128,383,142
S&P 500	10.5%	15.4%	$1M	$88,750,665

From 1970 to 1987, global equity portfolio is 60% S&P 500 and 40% MSCI EAFE. From 1988 onward, portfolio is 60% S&P 500, 20% MSCI EAFE, and 20% MSCI Emerging Markets. Source: Morningstar.

VALUATION MATTERS

In addition to our belief in the long-term benefits of investing globally, we also believe that valuation matters and is a key component of future market returns—after all, future returns are all that matter from this point forward. Therefore, there are times when it makes sense to over- or underweight markets or asset classes to tilt the odds of success more in your favor. So today's popular argument that Europe and Japan are economic basket cases and that emerging-markets companies face risks that U.S. companies don't face, doesn't necessarily mean there aren't compelling investment opportunities in those markets. Depending on a company's stock market valuation relative to its business fundamentals and future earnings potential (i.e., the price you are paying in the stock market to capture the potential value of that particular investment) the expected returns for many companies in those non-U.S. markets may *more* than compensate you for those types of risks. Whereas even if the United States is the strongest and most stable economy in the world, that doesn't mean its *stock market* offers the best risk/return profile right now. We'll talk more about how we view valuations and fundamentals for U.S. versus international markets in our newsletter.