4 Reasons to Invest Internationally

June 22, 2021

Investing overseas has long been a prudent strategy to increase diversification and alpha potential within an overall equity allocation. In recent years, non-U.S. investment allocations have dwindled as the U.S. stock market has continued its ascent and investors have followed those gains. But no investment category—not even one as broad and deep as U.S. stocks—is permanently better than another. All categories cycle eventually and irregularly, and equity markets are particularly adept for catching investors off guard. While the list is long, here we highlight four reasons investing internationally remains a sound investment strategy, and why investors should assess their equity allocations today to ensure they are properly diversified and well positioned for the next 10 years—and beyond.

1. Too Big to Ignore

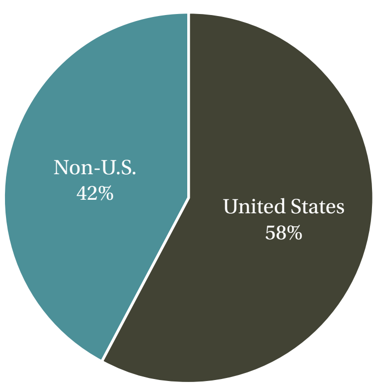
More than 40% of the world's market capitalization lies outside the U.S., and 80% of today's investable securities are of foreign issue (Exhibit 1). By investing only in U.S. stocks, or only in your country of domicile, you may be missing out on a large piece of the pie and hampering your alpha potential.

Over the past 20 years, the number of investable U.S. securities has declined, partly because of the rise of private equity and venture capital. At the same time, the number of investment opportunities outside the U.S. has grown substantially.

Developed and emerging markets worldwide have experienced significant economic progress over the past two decades, with new industries and businesses emerging. Consider the Chinese internet industry, which was in its infancy in 2000. For example, Alibaba (the Amazon of China) was established in 1999 and didn't go public until 2014, a mere seven years ago. Today, it is the largest e-commerce company in the world. Chinese social media company TikTok launched its wildly popular app in 2016 and now has more than 2.6 billion users worldwide. While the Chinese tech industry might be one of the most dramatic growth stories, similar progress has occurred in global industries such as travel, 5G adoption, autos, luxury goods, manufacturing and health care, to name a few.

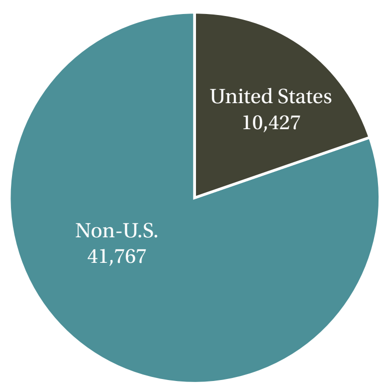
EXHIBIT 1: THE MASSIVE NON-U.S. OPPORTUNITY

Market Cap Weights of MSCI AC World Index



Source: MSCI, as of 5/31/2021.

Non-U.S. Opportunity Set of Investable Securities



Source: FactSet, as of 3/31/2021.

2. We Are All Global

More than ever before, businesses are competing on a global scale. Researching a company for potential investment requires a deep look into its industry and competitors, regardless of location. For example, you can't fully understand U.S. consumer products company Procter & Gamble without understanding the industry in which it operates and two of its largest competitors, U.K.-based Unilever and French personal care company L'Oreal.

Additionally, businesses are earning revenue from all parts of the globe. Going back to our Procter & Gamble example, the company earns over half (roughly 56%) of its revenues outside the U.S.—it's truly a global business. In looking at a handful of select companies in Exhibit 2, it's clear that where a company happens to be domiciled doesn't necessarily dictate where it earns the bulk of its revenues and, even more so, that significant revenue is being generated outside the U.S. The question for investors today is, why limit where you invest based on geography, especially if your goal is to find the opportunities with the most long-term potential?

EXHIBIT 2: SIGNIFICANT REVENUE GENERATED IN NON-U.S. MARKETS

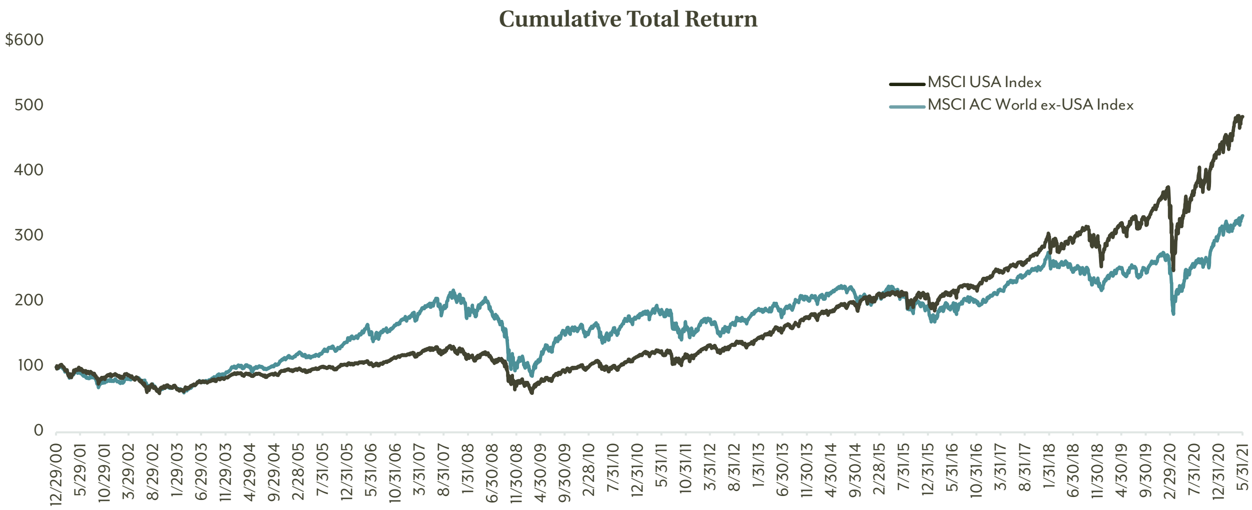
		GEOGRAPHIC REVENUE BREAKDOWN		
	MARKET CAP	COUNTRY OF DOMICILE	U.S.	OTHER
Unilever United Kingdom	$156B	4.7%	18.5%	76.8%
Samsung South Korea	$492B	15.6	15.3	69.1
Diageo United Kingdom	$112B	6.4	36.2	57.4
Roche Switzerland	$296B	1.8	47.4	50.8
Walt Disney Co. United States	$318B	68.1	68.1	31.9
Safran France	$63B	23.0	13.6	63.4

Source: FactSet, as of 5/31/2021. Estimated revenue data as of 12/2020. As of 5/31/2021, Diamond Hill owned shares of Unilever PLC, Samsung Electronics Co. Ltd., Diageo, Roche Holding Ltd., Walt Disney Co. and Safran S.A.

3. Performance Fluctuates Over Time - Be Ahead of the Curve

Over the past decade, allocations to U.S investments have risen—in part because outsized U.S. returns naturally led to a larger share of portfolios and because investors were drawn to superior returns. (Exhibit 3).

EXHIBIT 3: U.S. STOCKS WON'T OUTPERFORM FOREVER



Source: FactSet, as of 5/31/2021.

But are we nearing a turning point in this U.S.-led tide? It is conceivable that the market leadership U.S. equities have enjoyed over the past decade will not continue into perpetuity. In fact, U.S. stocks underperformed seven out of 10 years from 2002-2011. For diversification and risk management purposes, having an appropriate allocation to both U.S. and non-U.S. investments—depending on your specific investment goals—remains a sensible approach to asset allocation. And today may be an ideal time to consider refocusing on overseas investments.

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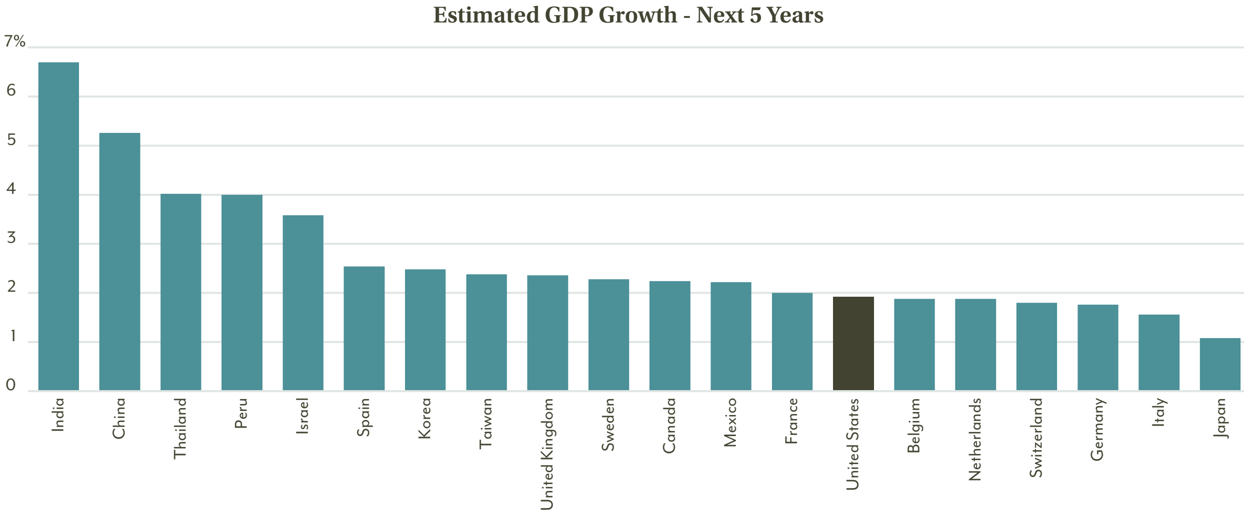
4. Higher Growth Rates Abroad (and Better Fundamentals)

Because U.S. stocks have outperformed so handily over the past decade, the idea of rebalancing investment allocations to include more non-U.S. investments has merit—a tribute to the adage of buying low and selling high. Not only do investors have the probability of mean reversion on their side, but fundamentally, many non-U.S. stocks are particularly well positioned. GDP growth, for one, is estimated to be between 1%-3% annually for the next five years in the U.S. while many non-U.S. economies are poised for more significant growth (Exhibit 4).

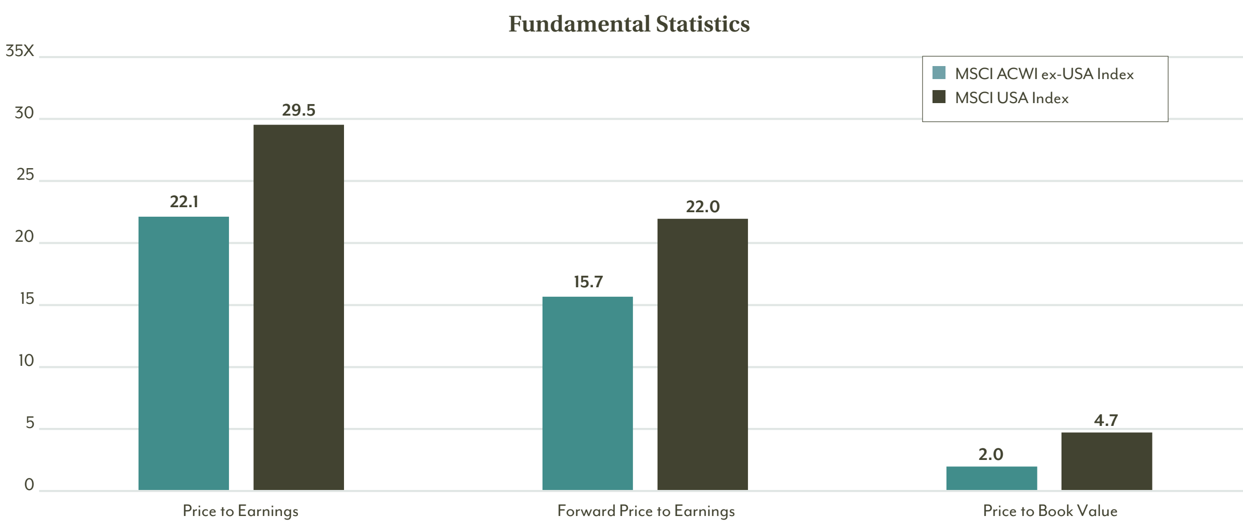
EXHIBIT 4: STRONG ECONOMIC GROWTH OUTSIDE THE U.S.



Source: IMF 2022-2026 estimates, latest available.

From a valuation perspective, non-U.S. stocks look compelling (Exhibit 5). This doesn't make U.S. stocks a category to avoid. Rather, in the U.S., stock returns are more likely to come from improving fundamentals at the company level—an argument for bottom-up, disciplined stock selection—whereas there appears to be more room for valuation expansion overseas. Identifying investments that are trading at a discount to what they are worth gives investors an edge in positioning their portfolios to perform well over the long term.

EXHIBIT 5: NON-U.S. STOCK FUNDAMENTALS LOOK COMPELLING



Source: MSCI, as of 5/31/2021.

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Summary

While the past decade of U.S. equity returns has been rewarding for investors, performance trends ebb and flow—and past returns are not indicative of what's to come. Investing overseas provides an immense universe of potentially interesting long-term opportunities for investors, especially now when fundamentals are comparatively attractive.

To Hedge or Not to Hedge

U.S. investors in non-U.S. stocks have a choice when considering the impact of foreign exchange (FX) on returns—to hedge or not to hedge currency risk. In our recent blog, *To Hedge or Not to Hedge*, we explore this debate more comprehensively.

As long-term, intrinsic value investors, we carefully evaluate the impact of currency when estimating the intrinsic values of our holdings. However, we choose not to hedge currencies because the cost does not seem to justify the benefits for investors with long time horizons. Choosing not to hedge FX at the portfolio level doesn't mean we ignore the impact of currency. How currencies may impact the strength of a balance sheet or could alter a company's competitive position, cash flow generation potential or cost structures–among other factors–can often impact our long-term estimate of intrinsic value. Ultimately, the impact of FX is most often one of myriad factors impacting the long-term trajectory of a quality company's cash generation potential, which favors our approach to deep, fundamental research.

As of 5/31/2021, Diamond Hill owned shares of Alibaba Group Holding Ltd, Unilever PLC, Samsung Electronics Co. Ltd, Diageo, Roche Holding Ltd., Walt Disney Co. and Safran S.A.