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4 Reasons to Invest Internationally

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INVESTED IN THE LONG RUN

Investing overseas has long been a prudent strategy to increase diversification and alpha potential within an overall equity allocation. In recent years, non-US investment allocations have dwindled as the US stock market has continued its ascent and investors have followed those gains. But no investment category—not even one as broad and deep as US 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.

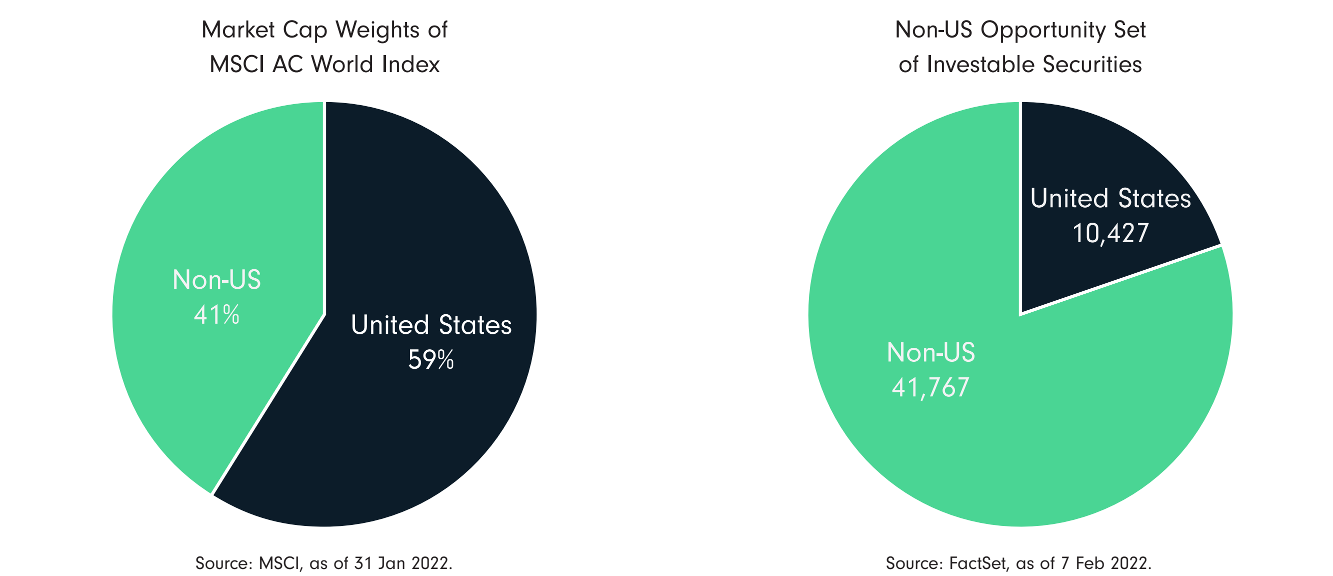
1. Too Big to Ignore

More than 40% of the world's market capitalization lies outside the US, and 80% of today's investable securities are of foreign issue (Exhibit 1). By investing only in US 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 US 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 US 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-US Opportunity



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 US consumer products company Procter & Gamble without understanding the industry in which it operates and two of its largest competitors, UK-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 US—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 US. 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-US Markets

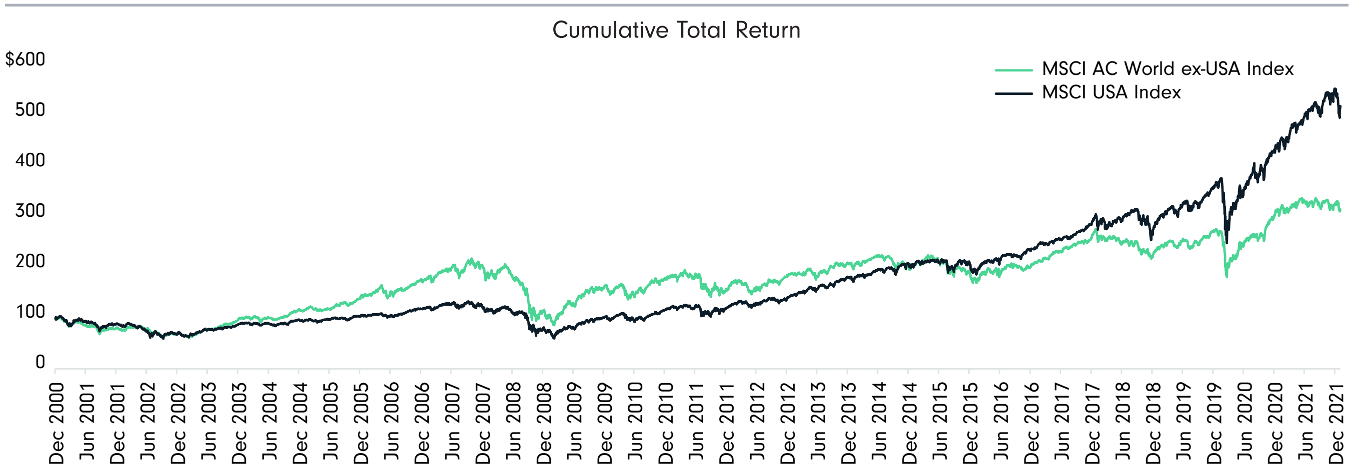
		Geographic Revenue Breakdown		
	Market Cap	Country of Domicile	US	Other
Unilever United Kingdom	$130B	4.7%	18.5%	76.8%
Samsung South Korea	$362B	15.6	15.6	68.8
Diageo United Kingdom	$116B	6.3	38.1	55.6
Roche Switzerland	$306B	3.2	42.6	54.2
Walt Disney Co. United States	$254B	68.1	68.1	31.9
Safran France	$51B	23.0	14.2	62.8

Source: FactSet. Market Cap as of 31 Jan 2022. Estimated revenue data as of most recent available.

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

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

Exhibit 3: US Stocks Won't Outperform Forever



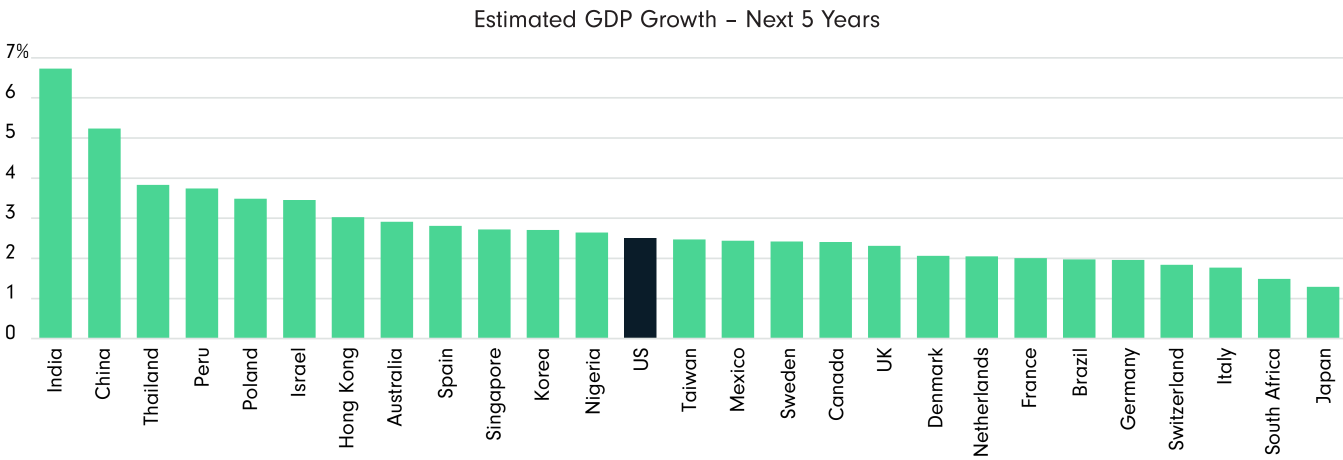
Source: FactSet, as of 31 Jan 2022.

But are we nearing a turning point in this US-led tide? It is conceivable that the market leadership US equities have enjoyed over the past decade will not continue into perpetuity. In fact, US stocks underperformed seven out of 10 years from 2002-2011. For diversification and risk management purposes, having an appropriate allocation to both US and non-US 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.

4. Higher Growth Rates Abroad (and Better Fundamentals)

Because US stocks have outperformed so handily over the past decade, the idea of rebalancing investment allocations to include more non-US 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-US stocks are particularly well positioned. GDP growth, for one, is estimated to be between 2% to 3% annually for the next five years in the US while many non-US economies are poised for more significant growth (Exhibit 4).

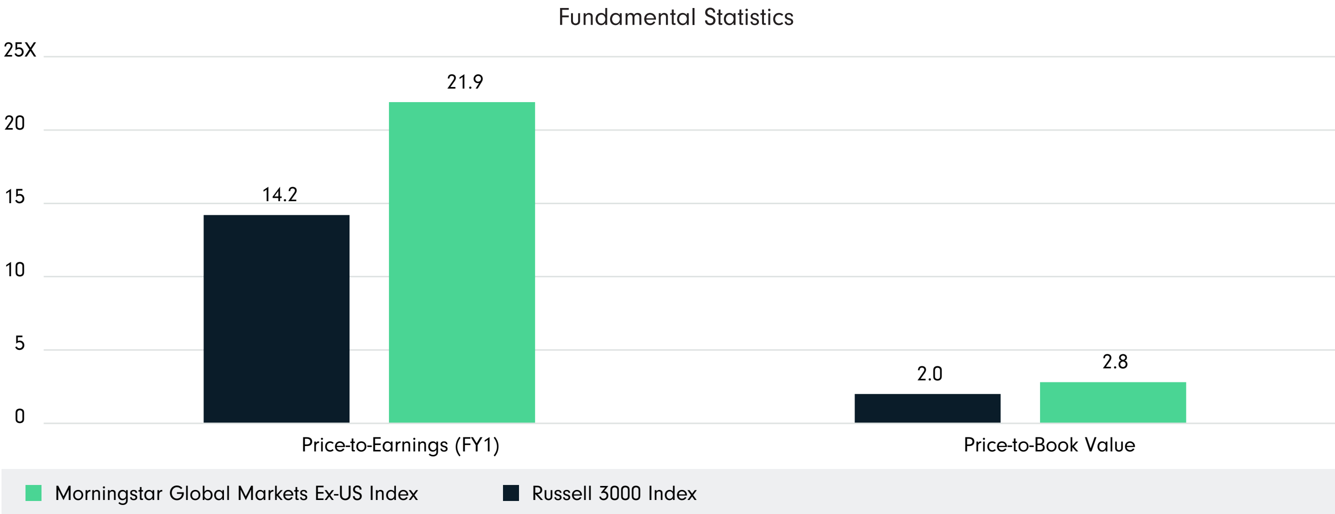
Exhibit 4: Strong Economic Growth Outside the US



Source: IMF 2022-2026 estimates, latest available.

From a valuation perspective, non-US stocks look compelling (Exhibit 5). This doesn't make US stocks a category to avoid. Rather, in the US, 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-US Stock Fundamentals Look Compelling



Source: FactSet, as of 31 Dec 2021.

Summary

While the past decade of US 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

US investors in non-US 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 31 Jan 2022, Diamond Hill owned shares of Alibaba Group Holding Ltd, Unilever PLC, Samsung Electronics Co Ltd, Diageo, Roche Holding Ltd, Walt Disney Co and Safran SA.

The MSCI All Country World Index measures the performance of large- and mid-cap stocks across 23 developed and 25 emerging markets. The MSCI All Country World ex-USA Index measures the performance of large- and mid-cap stocks in developed (excluding the US) and emerging markets. The MSCI USA Index measures the performance of large- and mid-cap stocks in the US. The Morningstar Global Markets ex-US Index measures the performance of the stocks located in the developed and emerging countries (excluding the US) as defined by Morningstar. The Russell 3000 Index measures the performance of roughly 3,000 of the largest US companies. The indexes are unmanaged, market capitalization weighted, include net reinvested dividends, do not reflect fees or expenses (which would lower the return) and are not available for direct investment. Index data source: London Stock Exchange Group PLC and Morningstar, Inc. See diamond-hill.com/disclosures for full disclaimers.

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