Vanguard®

Research note

Are investors truly embracing international diversification?

Vanguard research | October 2010

Authors
Christopher B. Philips, CFA
Francis M. Kinniry Jr., CFA
Yan Zilbering

Lately we have seen a coalescence of opinion that the significant cash flows into international equity funds represent investors' growing comfort with diversification beyond U.S. borders. As Figure 1 shows, allocations to stock funds investing abroad now account for 30% of all U.S. equity mutual fund holdings. Since the early 2000s, investors have roughly doubled their allocations to international equities. While some of this growth in assets can be attributed to market performance, the majority represents incoming cash flows. The result is that today's mutual fund investors, in aggregate, hold much more diversified portfolios across global equities than ever before.

It's well known that, historically speaking, a portfolio of U.S. and non-U.S. stocks would have experienced lower average volatility than a portfolio of U.S. stocks alone (Philips, 2009). Indeed, we believe that investors should strive to be more diversified rather than less, and Vanguard suggests that most investors consider allocating 20%–40% of their equity holdings to stocks abroad. We also believe that, within an allocation to non-U.S. stocks, countries and regions should be represented in proportion to their global market-capitalization weightings. To that end, it's also encouraging to see investors' allocations to emerging markets approach the global weighting of those markets. According to Figure 1, as of August 31, allocations to emerging markets accounted for just over 20% of international equity investments, rapidly nearing their current market weight of 25% (of non-U.S. equities).

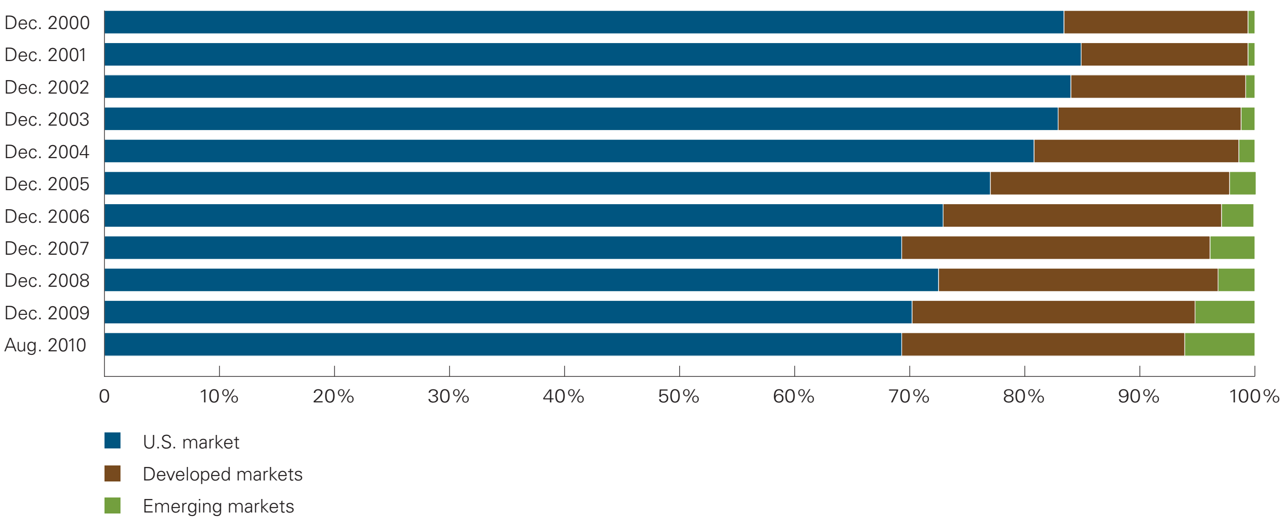
Although these trends appear positive from a diversification perspective, the recent rate of growth and the drivers of that growth warrant a closer look. For example, allocations to emerging markets have increased more than tenfold since 2000, far above the growth rate attributable to market performance alone. Figure 2 looks at net cash flows over the 1-, 3-, 5-, and 10-year periods through August 31 for U.S. and international equity mutual funds and ETFs. Several points are worth noting.

- First, cash flows to non-U.S.-focused funds were significantly positive over all the periods.
- Second, emerging markets captured most of the cash moving into international equities in the most recent time spans: 66% over 1 year and *97% over 3 years*.
- That stands in sharp contrast to the longer periods, in which emerging markets captured more proportionate percentages of the international cash flows: 30% over 5 years and 25% over 10 years.
- Looking at this another way: Of the $149 billion that flowed into emerging market stocks over the past decade, 83% arrived during the last 5 years, 59% in the last 3 years, and 29% in just the last year.

Figure 1. Evolution of equity mutual fund assets: A move toward markets abroad

December 2000 to August 2010

Historical asset allocation based on AUM



Sources: Vanguard and Morningstar. Data exclude funds-of-funds and leveraged products.

Figure 2. Net equity cash flows to U.S.-focused funds and international funds

Cumulative cash flows as of August 31, 2010 ($ billions)	United States	International	Developed markets	Emerging markets
1 year	–$79.4B	$67.0B	$22.9B	$44.1B
3 years	–$113.8B	$90.5B	$2.6B	$87.9B
5 years	–$19.6B	$413.0B	$288.3B	$124.7B
10 years	$441.3B	$598.7B	$449.0B	$149.7B

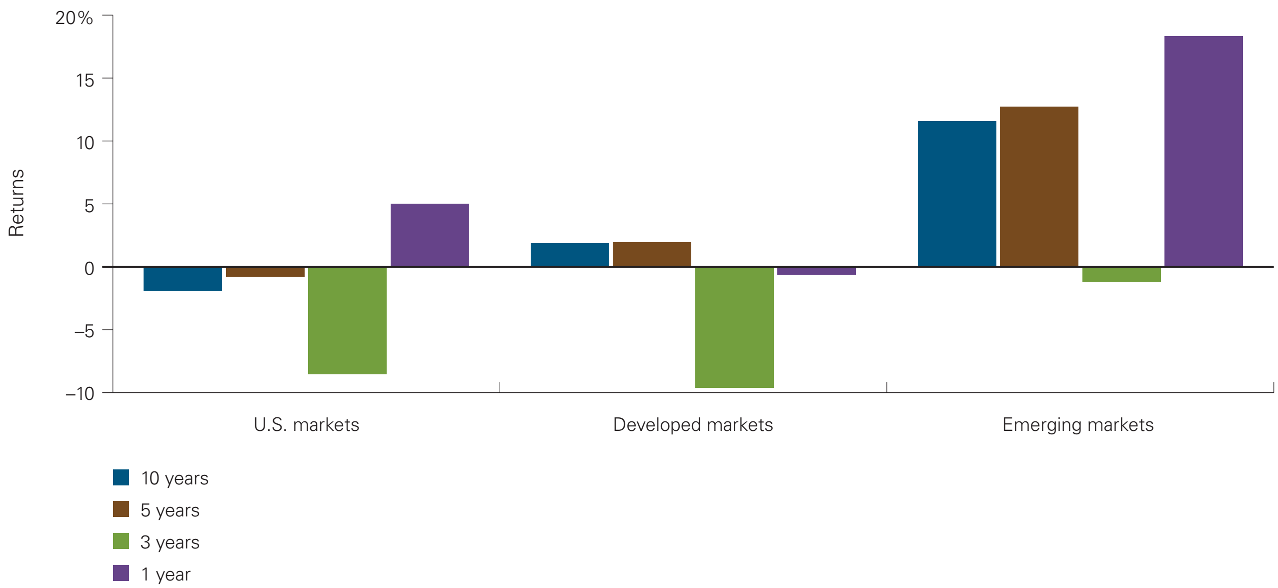
Sources: Vanguard and Morningstar. Data exclude funds-of-funds and leveraged products.

From this data it is clear that the interest in non-U.S. funds is really an interest in emerging market stocks, and that it has surged in recent periods. It's likely no coincidence that the surge in cash flow comes during a period in which both the U.S. stock market and developed markets abroad significantly underperformed emerging markets (Figure 3).

Aside from past performance, investors today may be further motivated by a belief that rapid economic growth will lead to continued outperformance for emerging market stocks. However, as shown in the recent Vanguard research paper *Investing in emerging markets: Evaluating the allure of rapid economic growth* (Davis et al., 2010), strong economic growth does not necessarily lead to exceptional stock returns. In fact, there is *zero* historical correlation between economic growth and a country's stock market returns.

Indeed, this research found that emerging markets' significant outperformance over the last decade was driven primarily by a systematic tightening of valuations between developed and emerging markets. In other words, relative to the U.S. market, emerging markets were undervalued in the early 2000s, whereas they tend to be more similarly valued today (see Figure 4). We therefore would caution investors against pinning too much on a

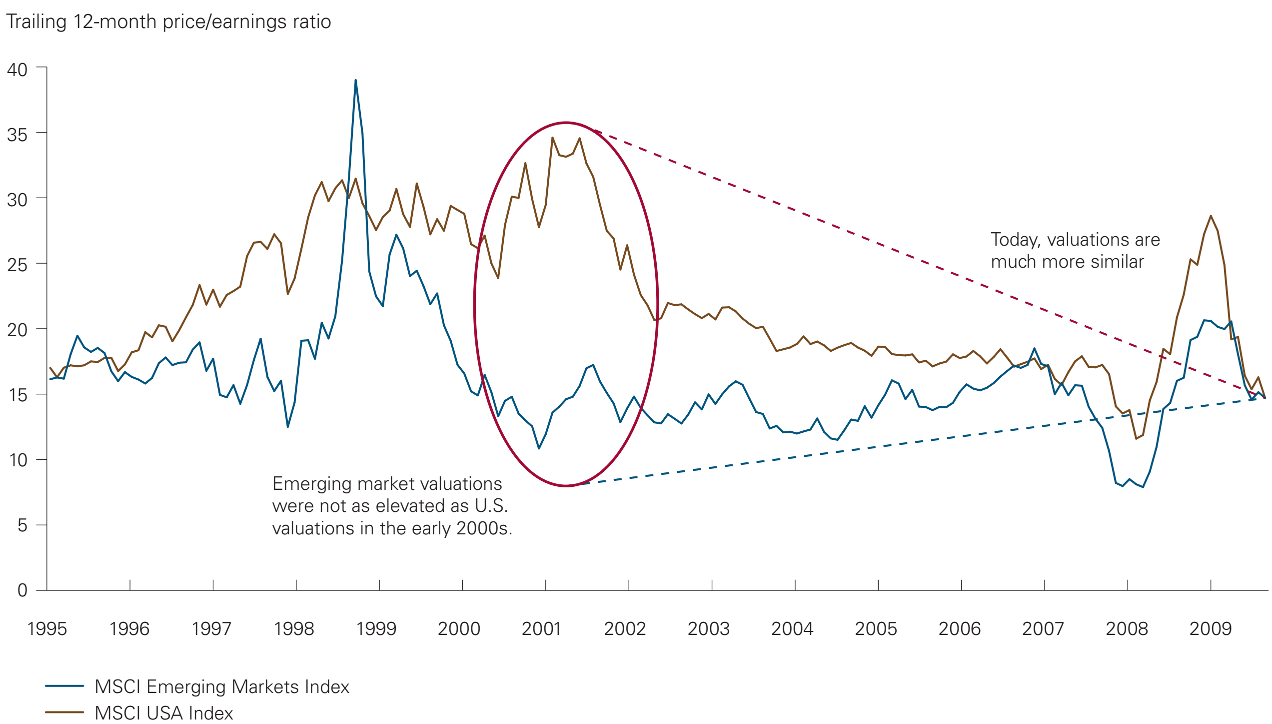
Figure 3. Annualized returns for U.S., developed market, and emerging market stocks for periods ended August 31, 2010



Sources: MSCI and Thomson Reuters Datastream. U.S. stocks are represented by the MSCI USA Index, developed markets by the MSCI World ex USA Index, and emerging markets by the MSCI Emerging Markets Index.

Note: The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Figure 4. Emerging market stocks and U.S. stocks: The valuation gap has narrowed



Sources: Thomson Reuters Datastream and MSCI. Data through August 31, 2010.

belief that economic growth will propel emerging markets toward future outperformance matching that of the past decade.

It is certainly encouraging to see investors taking a more global view in their portfolio allocations, and especially to note that they are coming closer to global market-cap weightings for their international holdings. However, we see reason for concern in the speed and magnitude of the reallocation to emerging markets over the past three years. What's striking is the apparent positive correlation between trailing returns and cash flows. If those cash flows prove to be "sticky," remaining invested even should the U.S. market enjoy a period of outperformance, then our concerns will be unfounded. However, the risk is that if U.S. stocks do outperform for a time, many investors will reallocate back to the U.S. market after the fact, launching a new round of buying high and selling low.

To repeat: We believe that investors should focus on becoming more diversified. We suggest that most investors consider allocating 20%–40% of their equity portfolios to international stocks, and that they weight these stocks to match the global market weightings of countries and regions. At this point, the aggregate allocation to emerging markets is still low relative to those markets' capitalization. However, we are concerned about trends in cash flow, market returns, and valuation data indicating that investors today are basing decisions either on past performance or on questionable assumptions about the effect of economic growth. If investors are motivated largely by unrealistic expectations, their commitment to diversification might not last long enough for them to realize its potential benefits.

References

Davis, Joseph H., Roger Aliaga-Díaz, C. William Cole, and Julieann Shanahan, 2010. *Investing in emerging markets: Evaluating the allure of rapid economic growth*. Valley Forge, Pa.: The Vanguard Group.

Philips, Christopher B, 2009. *Considerations for International Equity*. Valley Forge, Pa.: The Vanguard Group.

Connect with Vanguard® > vanguard.com

Vanguard research >
Vanguard Center for Retirement Research
Vanguard Investment Counseling & Research
Vanguard Investment Strategy Group

E-mail > research@vanguard.com

Vanguard®

P.O. Box 2600
Valley Forge, PA 19482-2600

ICRIEID 1010