The case for a global perspective

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What the Masters can teach us about investing

Markets have become more globally diversified of late, forcing investors to adopt a broader, worldwide perspective. This is a theme relevant even in championship golf, where the national diversity of players in the 2015 Masters tournament bears an uncanny resemblance to stocks in the MSCI All Country World Index. Just as top players can be found on the world’s golf courses, savvy investors can be found on the world’s stock exchanges. But the lessons don’t stop there.

Geographic distribution of players at the Masters and stocks in the MSCI All Country World Index

<table>
<thead>
<tr>
<th>Masters players</th>
<th>MSCI AC World Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% U.S.</td>
<td>51%</td>
</tr>
<tr>
<td>16% Europe*</td>
<td>16%</td>
</tr>
<tr>
<td>13% Emerging Markets</td>
<td>14%</td>
</tr>
<tr>
<td>12% U.K.</td>
<td>7%</td>
</tr>
<tr>
<td>7% Asia Pacific</td>
<td>9%</td>
</tr>
<tr>
<td>2% Canada</td>
<td>3%</td>
</tr>
</tbody>
</table>

* Excluding the U.K. Source: Charles Schwab, MSCI data as of April 10, 2015.

Picking companies, not countries

Like picking the proper club, it’s important to pick the right stock. And when investing globally, the sector to which that stock belongs, such as financials or technology, matters more to performance than the company’s home country or region (page 14).
Global stocks have tended to provide returns similar to those of U.S. stocks over long-term periods in the past. Valuations point to similar 5–10% annualized total returns across the world’s major regions in the future (page 10).

Avoiding the traps
During the worst 10-year period for stocks over the past 45 years, U.S. stocks fell an annualized 4.2%, while global stocks lost 2.5% and international stocks measured by the MSCI EAFE Index lost only 1.0% (page 6).

Knowing the course
For the first 45 years, the Masters champions were from only 2 countries. In contrast, winners in the past 35 years have come from many different countries. As the world economy becomes more diverse, broad exposure to many different countries makes more sense than betting on just one (page 22).

We believe a global perspective that incorporates portfolio allocations to U.S. and international stock markets along with global benchmarks for performance are vital to successful long-term investing.

Geographic location is increasingly less meaningful when it comes to investing. At one time, all markets were largely domestic and the fortunes of companies largely depended on the local environment. But international trade now accounts for nearly two-thirds of world gross domestic product, up from less than half just 10 years ago and one-third about 30 years ago, according to the World Bank. The world has increasingly become one global marketplace for companies to sell and operate. Investors should consider global developments when investing and consider investing globally by including U.S. and internationally based companies in portfolios.

In this paper, we will explore several factors that support this core investing belief:

- **Wider opportunity.** Global stocks have tended to deliver better performance than U.S. stocks over the long term, due in part to their wider opportunity set. More than 50% of the world’s stock market capitalization lies outside the U.S., including many of the top 10 stocks in each sector.

- **Stocks are not shares of a country.** When buying the stock of a company based in a certain country, it’s important to realize it is not like owning a share in that country. The sector that a stock belongs to, such as financials or technology, matters more to performance than the company’s home country or region.

- **Themes that span the globe.** Key long-term investing themes are not confined by borders. These include broadening global economic output, population trends, big data, and mobilization.

Why consider a global perspective now? We believe that a global perspective is crucial to investing and that geography is not of paramount importance when it comes to allocating portfolios. However, there are country- and region-specific factors to consider that point to the potential for more consistent relative performance by international stocks after lagging U.S. stocks in the first half of this decade.

A global perspective means approaching investing differently. It takes the decision about what country’s stocks to invest in and refocuses it on seeking to invest in great ideas that span the stocks of many countries. It requires measuring investment success differently. And it takes the long and broad view to help manage risk and keep tracking toward goals. The increase of money flows into global stocks, per data from the Investment Company Institute, shows how more and more investors are adopting a global perspective.
Wider opportunity

In this section, we will demonstrate that global stock market exposure that combines U.S.-based and non-U.S. stocks has delivered better performance than owning only U.S. stocks over the long term. Historically, the better performance by global stocks over the long term is the result of a wider set of opportunities than is provided by domestic stocks alone.

You can’t get there from here

With nearly half of U.S.-based companies’ sales coming from outside the U.S., according to data from FactSet, it may seem that owning U.S. stocks provides plenty of international exposure. Unfortunately, you can’t get the benefits of true global exposure by simply owning the U.S.-based multinational companies in the Standard & Poor’s 500 stock index.

Based on past stock price patterns, these multinational companies behave more like U.S. stocks than the geographic breakdown of their revenues may imply. One reason may be that they tend to be owned largely by U.S. investors who buy them to get exposure to the U.S. market; thus, their buying and selling often reflects the economic and market outlook for the U.S.

Global exposure has been more rewarding

Half the global stock market, measured by the MSCI World Index, is made up of U.S.-based companies, with the other half based outside the U.S. During the first half of the decade of the 2010s, U.S.-based stocks have outperformed their worldwide peers. However, over the long term, global stock market exposure has been more rewarding for investors. Over the past four decades, investing globally has averaged an additional 0.2% per year compared with the U.S. stock market. That may not sound like much, but over those 40 years it amounts to a difference of 195% (MSCI USA Index +2,501% and the MSCI World Index +2,696%).

A decade is a long time, and so it’s worth noting that global exposure has been more rewarding than domestic stocks during three of the past four decades. Global stocks outperformed U.S.-based stocks in the 1970s, 1980s, and 2000s. Even in the 1990s, the one decade when U.S. stocks outperformed, the stocks in many global sectors (such as health care, energy, utilities, and telecommunications services) outperformed their domestic counterparts.

Figure 1: Going global has historically been more rewarding

<table>
<thead>
<tr>
<th>Decades</th>
<th>1970s</th>
<th>1980s</th>
<th>1990s</th>
<th>2000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI World Index</td>
<td>8.68%</td>
<td>5.69%</td>
<td>18.76%</td>
<td>11.41%</td>
</tr>
<tr>
<td>MSCI USA Index</td>
<td>8.48%</td>
<td>3.33%</td>
<td>15.57%</td>
<td>18.11%</td>
</tr>
</tbody>
</table>

Total return in U.S. dollars for MSCI World Index and MSCI USA Index. Inception date of December 31, 1969.
Looking at developed global stock market performance, represented by the MSCI World Index, we can see the many long-term periods when global stocks outperformed the U.S. stock market. Specifically, global stocks outperformed U.S. stocks for all but about 11 of the 34 rolling 10-year periods since the inception of the MSCI World index in 1970, as shown in Figure 2. It’s worth noting that those periods of U.S. stock outperformance from 1995 to 2006 all included the late 1990s technology stock bubble in the U.S.

The lesser magnitude of losses for global stocks can be seen in the worst 10-year period for both indexes over the past 45 years, which was from February 1999 to February 2009. That period included both the bursting of the Internet bubble and associated recession that took place from 2000 to 2002 and the global financial crisis in 2008 and 2009. Importantly, global stocks lost an annualized 2.5% over that difficult period, while U.S. stocks fell a significantly greater annualized 4.2%, as illustrated in Figure 3. (Since global stocks include U.S. stocks, it is worth noting that developed-market international stocks measured by the MSCI EAFE Index lost only 1.0% on an annualized basis during that period.) That may not seem like a dramatic difference, but compounded over the 10-year period it amounted to a difference of 25% in portfolio value.

Managing risk
Rewarding performance is not just about gains; it’s also about minimizing losses. International stocks have provided returns similar to those of U.S. stocks over the long term but have suffered fewer losses.

The lesser frequency of losses for global stocks can be seen by examining 5-year rolling periods over the past 45 years of monthly data, which reveals that of the 540 periods there were 80 periods when the MSCI USA Index suffered a loss, but only 67 for the MSCI World Index.

Figure 2: Global stocks have outperformed U.S. stocks most of the time on a rolling 10-year horizon.

Source: Charles Schwab, Bloomberg data as of April 5, 2015.
Past performance is no guarantee of future results.

Figure 3: Similar returns, lower losses over the long term …

International = MSCI EAFE Index, World = MSCI World Index, U.S. = MSCI USA Index.
Source: Charles Schwab, Bloomberg data as of April 5, 2015.
When economic growth in the U.S. was stronger than in the rest of the developed world, global stocks outperformed U.S. stocks. That may seem counterintuitive, but it’s true. Relative GDP growth is often used to make a decision on investing in certain regions or countries, but it has not been a good barometer of relative market performance.

Periods of relatively stronger U.S. economic growth are not rare. Over the past 45 years, U.S. economic growth has exceeded that of the major economies that make up the Group of Seven (G7) countries over a four-quarter period two-thirds of the time, as illustrated in Figure 4. During those periods, the U.S. averaged 3.4% GDP growth compared with 2.8% for the G7 countries. Surprisingly, during those four-quarter periods when U.S. growth was stronger, the MSCI World Index posted an average gain of 14.0%, outperforming the MSCI USA Index’s 13.3% return, measured in dollars since the inception of the MSCI World and MSCI USA indexes in 1969.

Although you take risks when you invest in any stock or security, international investing has some special risks. These include geopolitical events, changes in currency exchange rates, potential for illiquid markets, and different tax and accounting regimes. Over the past 45 years of data we have presented in this section, these factors have affected relative performance. Historically, these risks have been offset by the greater risk diversification from investing globally, which has had a lesser frequency and depth of downturns compared with investing only in the U.S.
This may be because we live in an increasingly interconnected world that offers many offsetting factors. Geopolitical events around the world can affect markets far from where they actually take place. Likewise, U.S. political events can affect markets around the world. In addition, currency moves can provide some diversification and even have offsetting effects. For example, a rising dollar may reduce dollar-based returns on international investments, but those weaker foreign currencies may stimulate sales growth for businesses in those regions, helping to lift stocks and acting to offset the drag on returns.

Beyond large caps

It is also worth noting that it isn’t just large-cap developed-market international stocks; world small-cap and emerging market stocks have also historically performed better than U.S. stocks over the long term.

- World small-cap stocks produced a 13.1% annualized total return for the 12 years through the end of 2014, while the MSCI USA Small Cap Index returned 12.9%.
- Emerging market stocks have posted an annualized rise of 8.7% compared with the MSCI USA Index’s 8.3% from the inception of the MSCI Emerging Markets Index in 1988 through the end of 2014.

Looking ahead

We can never be sure what lies ahead for markets. But the long history of valuations and performance gives us some indication. Historically, there has not been much of a relationship between valuation and future market performance over the short to intermediate term. But that relationship strengthens over longer periods.

The dots in the charts in Figure 5, for example, represent the price-to-earnings ratio (PE) of the S&P 500 each year since World War II and the subsequent return of the S&P 500 over the next 1, 3, 5, and 10 years.

- Over a one-year period, there is no discernable trend between the PE ratio at the end of a year and the return of the S&P 500 over the next year. Many other factors seem to take precedence over valuation on a one-year horizon.
- Over a period of three years, a pattern begins to emerge: The more you pay in valuation, the lower your returns. But valuation is clearly still not a dominant factor in determining future performance.
- Over five-year periods, the pattern becomes more pronounced.
- At 10 years, a strong relationship exists between valuation and future returns.
Applying this relationship to the valuation of stocks in different regions tells us something very interesting about long-term relative returns. Figure 6 shows how the PE is a strong indicator of returns over the next 10 years for various countries and regions. The charts have the PE flipped upside down to show that the higher the price of the stocks, the lower the returns turn out to be. Over a 10-year period, the average annualized return closely tracks the inverse of the PE at the start of that period. This very consistent historical pattern offers some insight as to what returns may be over the coming 10 years.

Source: Charles Schwab, FactSet data as of January 15, 2015.

Figure 6: PE relationship over the next 10 years
The PE ratio for the S&P 500 Index is shown on the horizontal axis, and the vertical axis shows return over the following 1-, 3-, 5-, or 10-year period.
For example, the annualized 10-year return of the MSCI World Index ranged from a high of about 18% in the late 1970s, when the PE was a low 10, to the annualized losses for the 10-year period that began in 2000, when the PE had soared over 30. As of the end of 2014, the MSCI World Index PE indicates that returns over the coming 10 years may be near the middle of a 5–10% range. Figure 6 also shows that this is the same long-term return outlook that is indicated by the PE for other major regions around the world, including the U.S., Europe, and the 21 countries in the MSCI EAFE ex Japan Index.

We believe this is strong historical evidence that there is no reason based on valuation to favor only U.S. stocks in a portfolio over the long term.

Figure 6: Valuations point to similar long-term returns for U.S. and global stocks

Source: Charles Schwab, FactSet data as of May 13, 2015.
Past performance is no guarantee of future results.
The case for a global perspective

Opportunity

As we have illustrated, global markets have tended to perform better than the U.S. stock market during more than half of the past 45 years and over rolling 10-year long-term periods during those same 45 years. The main reason: opportunity. Much of the world’s stock market capitalization lies outside the U.S., as you can see in Figure 7, both in total and on an investable index basis. As global liquidity improves, the geographic breakdown of the world’s investable stock market is likely to migrate toward the total market capitalization. Based on the constituents of the MSCI World Index, at least half the top 10 stocks in the global financial, health care, telecommunications services, energy, and materials sectors are based outside the U.S. The much larger opportunity set includes a broader range of values and prospects for growth, offering the potential for better performance over the long term.

Figure 7: The U.S. contains only a portion of the world’s equity opportunities

Total market capitalization is based on market cap of exchange-listed companies. Investable market capitalization based on MSCI World Index.
The value of a wider opportunity is evident when considering that the best-performing stocks in a global sector are most often not U.S. stocks. In fact, in 2014 the 10 highest-performing stocks in the MSCI World Index did not include any U.S.-based companies. Furthermore, few U.S. stocks were among the top 10 performers in any sector, as shown in Figure 8:

**Figure 8: U.S.-based companies rare among top 10 performers in each sector**
Number of U.S.-based companies in top 10 performers by sector in 2014

<table>
<thead>
<tr>
<th>Sector</th>
<th>Number of U.S.-based companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health care</td>
<td>2</td>
</tr>
<tr>
<td>Consumer staples</td>
<td>1</td>
</tr>
<tr>
<td>Telecom services</td>
<td>1</td>
</tr>
<tr>
<td>Utilities</td>
<td>1</td>
</tr>
<tr>
<td>Materials</td>
<td>0</td>
</tr>
<tr>
<td>Information technology</td>
<td>0</td>
</tr>
<tr>
<td>Industrials</td>
<td>0</td>
</tr>
<tr>
<td>Consumer discretionary</td>
<td>0</td>
</tr>
<tr>
<td>Financials</td>
<td>0</td>
</tr>
<tr>
<td>Energy</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Charles Schwab, FactSet data as of January 16, 2015.
The case for a global perspective

Going abroad to come home
Not every company covers all the markets or products in a sector, leaving gaps in a domestic-only portfolio that can result in a different magnitude of performance. U.S.-based companies do not even provide exposure to all the markets or products produced for the U.S.

Just as it is true that there are some U.S.-based companies that gain much of their revenue abroad, there are global companies that derive much of their revenue in the U.S. As you can see from the small sample of companies in Figure 9, major categories and popular brands are offered to U.S. consumers by non-U.S.-based companies.

Figure 9: Different companies serve different U.S. market segments

<table>
<thead>
<tr>
<th></th>
<th>U.S.-based</th>
<th>Non-U.S.-based</th>
</tr>
</thead>
<tbody>
<tr>
<td>Autos</td>
<td>General Motors</td>
<td>Toyota</td>
</tr>
<tr>
<td>Beverages</td>
<td>Coca-Cola</td>
<td>Anheuser-Busch InBev</td>
</tr>
<tr>
<td>Banks</td>
<td>Bank of America</td>
<td>Santander</td>
</tr>
<tr>
<td>Energy</td>
<td>Exxon</td>
<td>BP</td>
</tr>
<tr>
<td>Sportswear</td>
<td>Nike</td>
<td>Adidas</td>
</tr>
<tr>
<td>Consumer technology</td>
<td>Apple</td>
<td>Sony</td>
</tr>
<tr>
<td>Industrials</td>
<td>General Electric</td>
<td>Siemens</td>
</tr>
<tr>
<td>Consumer staples</td>
<td>Kraft-Heinz</td>
<td>Unilever</td>
</tr>
</tbody>
</table>

As you can see, exposure to global companies is necessary even when seeking exposure to just the U.S. economy.

Takeaways
In this section, we showed that it’s important to maximize your opportunity set of stocks to include those of many countries in order to increase the potential magnitude of performance and help to minimize losses over the long term. Specifically, we made the case that:

- Global stocks have outperformed U.S. stocks in two-thirds of the 10-year periods since 1969.
- Global stocks have experienced fewer longer-term periods of losses and lesser worst-period losses than U.S. stocks.
- Relative valuations do not support favoring only U.S. stocks over the long term.

In the next section, we will show that the sector a stock belongs to matters more to how it moves than the company’s home country or region.
Stocks are not shares of a country

When buying the stock of a company based in a certain country, it’s important to realize that it’s not like owning a share in that country. The stock sector, such as financials or technology, matters much more to performance than the company’s home country or region.

Stating the obvious

Deciding whether to buy the stock of a Europe-headquartered health care company based on Europe’s unemployment rate is a lot like deciding to take a drug based on the company that made it rather than what it is designed to treat. The country isn’t irrelevant, but it’s not the first thing to evaluate.

One way to see why thinking about geography first when making investment decisions makes little sense is by looking at U.S. stocks and their location at the state level. Few investors, for example, would consider how much to allocate to stocks of companies based on them being headquartered in Texas or New York. Yet state economies can vary dramatically. Three U.S. states were in recession in March 2015, for example, while 18 were experiencing booming growth, according to the Philadelphia Fed Coincident State Indexes (see Figure 10).

Figure 10: State economies’ growth can vary from that of the overall U.S.
March 2015 State Coincident Indexes: Three-month change

Source: Federal Reserve Bank of Philadelphia.
Investment performance by state can vary widely as well. New York–headquartered companies outperformed those based in Texas by 61%, and the Dow Jones Industrial Average by 11%, over the three years ending 2014, measured by the Bloomberg Texas State Index and Bloomberg New York State Index.

Silly state of mind

Of course, this seems silly. Unless investing in very small companies that primarily serve the local state market, where a company is headquartered matters relatively little compared with its sector and other global macroeconomic drivers. New York stocks were led higher by a 40% weight in financial-sector stocks, while the energy-sector stocks that make up a third of the Texas-based companies lagged the overall stock market. And, of course, stocks in both Texas and New York rose due to the overall growth in the global economy, profits, and investor demand.

And yet, when investing outside the U.S., investors often make decisions first by country or region, rather than by sector. We can show just how backward that thinking is.

Correlation and common sense

Now let’s take a look outside the U.S. to see the same sector impact we observed with New York and Texas. We will show that the high correlation between sectors across countries is common sense.

For example, technology stocks in Europe behave much more like other technology stocks around the world than they do other European stocks. Figure 11 shows that nearly every one of the 10 sectors of Europe’s stock market has a higher correlation with the same global sector than with overall European stocks. For example, the total return in dollars of the MSCI Europe Financials Index since its inception in July 2000 has a 0.96 correlation with the MSCI World Financials Index, but only a 0.64 correlation with the MSCI Europe Index.

Figure 11: Sectors define stock market performance more than geographic region

Correlation of MSCI Europe Sector Indexes to MSCI World Sector Indexes and MSCI Europe Index

| Europe Sector and World Sector | Europe Sector and Europe |
| Consumer staples | 0.99 | 0.85 |
| Materials | 0.99 | 0.92 |
| Health care | 0.98 | 0.85 |
| Energy | 0.98 | 0.94 |
| Consumer discretionary | 0.97 | 0.93 |
| Industrials | 0.97 | 0.98 |
| Utilities | 0.96 | 0.89 |
| Telecom | 0.94 | 0.90 |
| Financials | 0.96 | 0.64 |
| Information technology | 0.69 | 0.23 |

What is correlation?

Correlation measures the degree and type of relationship between two things. Statistically, the degree to which they move similarly over a period of time can range from -1.0, when they always move in opposite directions, to +1.0, when they always move in the same direction, with zero showing no consistent relationship between them.

Correlation measured using monthly data from July 2000 through December 2014.
All indexes calculated using total return in U.S. dollars.
MSCI World Index, MSCI World Information Technology Index, MSCI World Health Care Index, MSCI World Industrials Index, MSCI World Consumer Discretionary Index, MSCI World Consumer Staples Index, MSCI World Energy Index, MSCI World Telecommunications Services Index, MSCI World Financials Index, MSCI World Utilities Index, MSCI World Materials Index, MSCI Europe Index, MSCI Europe Information Technology Index, MSCI Europe Health Care Index, MSCI Europe Industrials Index, MSCI Europe Consumer Discretionary Index, MSCI Europe Consumer Staples Index, MSCI Europe Energy Index, MSCI Europe Telecommunications Services Index, MSCI Europe Financials Index, MSCI Europe Utilities Index, MSCI Europe Materials Index.
Source: Charles Schwab, Bloomberg data as of December 31, 2014.
What this means is that a stock is much more likely to behave like other stocks in the same sector—wherever those companies are headquartered—than like the country it is based in. For example, it would be easy to assume stocks in Europe’s consumer discretionary sector have languished over the past few years given Europe’s double-digit unemployment rate, a return to recession in some European countries during that period, and banks’ tightening of lending to households for much of that period. Furthermore, since June 30, 2012, the unemployment rate in Europe has been above the March 2015 reading of 11.3% for the eurozone and nearly double the April 2015 level of 5.4% in the U.S. Yet Europe’s consumer discretionary stocks, measured by the MSCI Europe Consumer Discretionary Index, are up a surprisingly strong annualized 23% in dollars from June 30, 2012, through March 31, 2015, very closely matching the 24% return of the MSCI USA Consumer Discretionary Index.

The dominance of a stock’s sector over geography when it comes to performance is even more consistent when looking at returns in local currencies. In fact, when local currencies are used, the global sector accounts for more of the movement of each region’s sector than the home country in every sector, as you can see in Figure 12. The correlations for nearly all of Europe’s sectors with the movements of the global sector are very high.

<table>
<thead>
<tr>
<th>Europe Sector and World Sector</th>
<th>Europe Sector and Europe</th>
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<tbody>
<tr>
<td>Consumer staples</td>
<td>0.99</td>
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<tr>
<td>Telecom</td>
<td>0.97</td>
</tr>
<tr>
<td>Financials</td>
<td>0.95</td>
</tr>
<tr>
<td>Information technology</td>
<td>0.65</td>
</tr>
</tbody>
</table>

Correlation measured using monthly data from July 2000 through December 2014. All indexes calculated using total return in local currency.
Sectors are more important than geography not just at the regional level but also at the individual country level. As detailed in Figure 13, for example, U.S. stocks perform more like their global sector than their home country, with the exception of utilities (where nearly all sales are derived domestically) and industrials.

Figure 13: Sectors define stocks’ performance more than home country
Correlation of MSCI USA Sector Indexes to MSCI World Sector Indexes and MSCI USA Index

<table>
<thead>
<tr>
<th>USA Sector and World Sector</th>
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<tbody>
<tr>
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<td>0.97</td>
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<td>Industrials</td>
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<td>Telecom</td>
<td>0.94</td>
</tr>
<tr>
<td>Utilities</td>
<td>0.73</td>
</tr>
<tr>
<td>Financials</td>
<td>0.92</td>
</tr>
<tr>
<td>Materials</td>
<td>0.89</td>
</tr>
</tbody>
</table>

Correlation measured using monthly data from July 2000 through December 2014.
All indexes calculated using total return in U.S. dollars.
MSCI World Index, MSCI World Information Technology Index, MSCI World Health Care Index, MSCI World Industrials Index, MSCI World Consumer Discretionary Index, MSCI World Consumer Staples Index, MSCI World Energy Index, MSCI World Telecommunications Services Index, MSCI World Financials Index, MSCI World Utilities Index, MSCI World Materials Index.
MSCI USA Index, MSCI USA Information Technology Index, MSCI USA Health Care Index, MSCI USA Industrials Index, MSCI USA Consumer Discretionary Index, MSCI USA Consumer Staples Index, MSCI USA Energy Index, MSCI USA Telecommunications Services Index, MSCI USA Financials Index, MSCI USA Utilities Index, MSCI USA Materials Index.
Source: Charles Schwab, Bloomberg data as of December 31, 2014.

MSCI Indexes total return in dollars.
MSCI Japan Index, MSCI Japan Consumer Staples Index, MSCI World Consumer Staples Index.
Past performance is no guarantee of future results.

Furthermore, Figure 14 shows how closely the performance of Japanese consumer staples stocks has tracked global consumer staples stocks over the past five years while deviating widely from Japan’s stock market. Clearly, Japanese consumer staples stocks behave much more like global consumer staples stocks than other Japanese stocks.

Figure 14: Sectors define stocks’ performance more than home country

MSCI Japan net USD
MSCI Japan Consumer Staples net USD
MSCI World Consumer Staples net USD

Past performance is no guarantee of future results.
Something healthy in the state of Denmark

In some countries the entire market is dominated by one sector, such as energy or health care, resulting in the country’s stock market closely tracking the ups and downs of that single global sector. A traditional approach would suggest looking at the economic fundamentals of each country and the valuation of its stock markets.

A first glance at Figure 15 reveals that Norway seems cheap and attractive, relative to Denmark, especially given the economic fundamentals of faster growth, less risk of deflation, a lower unemployment rate, and a budget surplus.

But on closer examination, this large valuation difference between Denmark and Norway results just from the different sectors that dominate the two markets.

- Almost half of Denmark’s market capitalization is in health care, with 29% in just one company: Novo Nordisk.
- Similarly, almost half of Norway’s market capitalization is in energy, with 28% in just one company: Statoil.

Denmark’s dominant sector, measured by the MSCI World Health Care Index, has a PE ratio of 24, while Norway’s dominant sector, energy, is 13, measured by the MSCI World Energy Index as of the end of 2014. Viewed this way, both countries appear to be valued fairly, or even attractively, when sector representation is considered.

This means that stock selection is less about the merits of the underlying economies or countrywide valuations and more about sector composition. Recognizing that world oil prices mean a lot more to Norway’s energy companies and the MSCI Norway Index than Norway’s unemployment rate is important to making successful investment decisions.

Starting with sectors

To further illustrate the importance of sectors over geography, we can start with just three European stock market sectors and construct a portfolio that delivered performance very similar to the U.S. stock market, and materially different from the wilder ride of Europe’s stock market, over the past 15 years. Figure 16 shows how remarkable starting with sectors can be in determining performance when we take the stocks in one region or country and can derive the performance of another county.

### Figure 15: Denmark and Norway fundamental factors

<table>
<thead>
<tr>
<th>Fundamental factor</th>
<th>Denmark</th>
<th>Norway</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015 GDP estimate*</td>
<td>1.7%</td>
<td>2.3%</td>
</tr>
<tr>
<td>CPI</td>
<td>1.5%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>5.9%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Budget deficit (-) or surplus (+) as % of GDP</td>
<td>-3%</td>
<td>12%</td>
</tr>
<tr>
<td>Stock market PE ratio</td>
<td>22</td>
<td>9</td>
</tr>
</tbody>
</table>

* Bloomberg-tracked economist consensus estimate as of December 31, 2014.
† MSCI Denmark Index and MSCI Norway Index PE ratios.
This combination of European sectors in Figure 16 works well at replicating the performance of the U.S. stock market since the MSCI USA Index has a higher weighting in the health care and information technology sectors relative to Europe’s stock market. The key point is not that home country doesn’t matter at all to the performance of the stock of a company but rather that it matters less than the sector.

**Correlations remained high in varied market conditions**

The correlation between sectors at the local and global levels is very high over the full history of the MSCI sector data that stretches back more than 14 and a half years. It’s worth breaking down this time period to study correlation during different periods.

- **Global bear markets and recessions.** During the downturns in 2001 and 2007–08, the average 3-year correlation across all 10 European sectors and their global sectors rose to 0.99. This means that during those periods of declines when an investor would benefit most from lower correlations, stocks across the globe moved lower in lockstep.

- **Powerful bull markets.** The lowest average 3-year rolling correlation was a relatively high 0.79 seen over the 36-month period ending August 2013, a period of strong gains.

- **Diverging central bank policies.** Even during periods of differing central bank policies (such as the period from June 2004 to November 2005 when the U.S. Fed raised interest rates to 4% from 1%, while the ECB maintained rates at a low 1%), sector correlations averaged 0.97.
Correlation is not performance

While stock market sectors across countries tend to be highly correlated, that doesn't mean their performance is the same—just that they tend to follow the same pattern. Correlation tells us how similarly sectors move together, but not how much they move. In other words, the same sectors in different countries produce gains of different magnitudes while still moving up and down in a synchronized way.

To see why owning stocks based only in the U.S. makes little sense, let's go back to our example of U.S. states. If financial-sector stocks (or any other sector) in Texas move similarly to financial stocks based in all the other states, would it make sense to own just Texas stocks? Certainly not. Limiting stock exposure only to those companies based in Texas would make sense only if they were always the best value—or if they are now and will always be the best of the stocks in every sector. While Texas has some fantastic companies, the idea that they are always the most attractive and have the most potential of all the stocks from all the other states is not realistic.

Similarly, owning only U.S. stocks eliminates the opportunity to reap the benefits of owning stocks based outside the U.S. that may offer better values or prospects. Over time, that limitation can inhibit performance.

In 1999, for example, the technology sector soared in different countries and regions around the world as the Internet bubble inflated to its peak. Although they all moved higher together over the 12 months, the MSCI Japan Information Technology Index rose 234% in 1999, the MSCI Europe Information Technology Index gained 116%, while the tech sector of the U.S.'s S&P 500 Information Technology sector was up a smaller, though still staggering, 78%, as seen in Figure 17.

**Figure 17: Non-U.S. technology sectors posted stronger gains in 1999**

Digging deeper for diversification

Regional and country-specific factors seem to have more influence on the performance of international small-cap and emerging market stocks than on their large-cap developed-market peers.

In general, small-cap stocks have a higher correlation with the world index than with the local country or region. For example, the MSCI Japan Small Cap Index has a correlation of 0.80 with the MSCI Japan Index, but a higher 0.84 correlation with the MSCI World Index and an even higher 0.88 with the MSCI World Small Cap Index. The correlations for small-cap stocks across countries and regions, however, are somewhat lower than what we saw with the all-cap sector indexes and suggest some geographic diversification benefits from investing in international small-cap stocks. The limited history of the MSCI country and region small-cap sector indexes (just five years), however, keeps us from drawing a hard conclusion or seeing how the correlation has evolved over time.

While sector correlation remains high, our analysis reveals that unique home-country factors are more significant drivers of performance than sectors for the emerging market asset class. This means it is still possible to obtain country-specific diversification benefits in the global stock markets using the stocks of emerging market–based companies.

Takeaways

In this section, we have made it clear that the sector a stock belongs to defines its behavior more than the company’s home country or region.

- In general, the stocks of big, global companies are much more likely to behave like other stocks in the same sector—wherever those companies are headquartered—than like those of the country they are based in.
- It isn’t that home country doesn’t matter at all to the performance of the stock of a company, but that it matters less than the sector the stock belongs to.
- Correlations across sectors remained high even in varied market conditions.
- When investing, a global perspective on developments in sectors across countries is essential to understanding the drivers of performance.
- Small-cap and emerging market stocks still offer some geographic diversification to stock portfolios.

In the next section, we will consider long-term investing themes that may drive the performance of different global sectors.
Themes that span the globe

Key long-term megatrends, such as broadening global economic output, population trends, big data, and mobilization, cut across borders.

More diverse global growth

One region always appears to be outgrowing the others—the most recent Brazil, Russia, India, China, (BRIC) era is an example. The real story, however, may be that some regions have grown and some have contracted, but economic growth is becoming more geographically diverse.

As shown in Figure 18, 200 years ago the BRIC nations (Brazil, Russia, India, and China) dominated the world economy. The U.S. was a small emerging market. Of course, times have changed, and the U.S. grew as the BRICs shrank in their contribution to global GDP until the start of the current century.

Figure 18: Increasing regional diversity in the global economy
Percentage of world GDP by country/region over time

The world economy has changed over time. This means that trying to predict the next hot region or country misses the point that growth may be becoming more globally diversified. We often think of the structural problems facing Europe as representative of the non-U.S. economic climate. In fact, the world economy is becoming much more diverse, with nearly 50% of world economic output coming from outside the historically dominant “UCIE,” or the U.S., China, India, and Europe. Those countries once accounted for about 75% of world output.

The more diverse global economy makes generalizations about international investing difficult. In addition, it makes predicting the next big growth area more about broad exposure to many different countries than betting on one or a handful of rebounding former giants.

Population changes
The world’s population is changing in important ways:

- **Growth.** Most growth is coming from emerging market countries, while the United Nations projects that the population in many developed countries will shrink.

- **Age barbell.** Many developed nations have aging populations burdening health care and pension systems. At the same time, many emerging market countries have very young populations, straining employment growth to keep up, according to data from the United Nations.

- **Urbanization.** As more of a country’s population is concentrated in cities, companies have readily available labor forces, which help to keep wage costs low and facilitate rapid growth. But they also place a strain on basic services in the cities, creating a pressing demand for infrastructure spending.

Figure 19: Global middle-class consumption in trillions of U.S. dollars

![Figure 19: Global middle-class consumption in trillions of U.S. dollars](image)

Source: Charles Schwab; data from Homi Kharas, *The Emerging Middle Class in Developing Countries*, OECD, 2010.
But the most significant trend for investors may be the rise of the global middle class. The World Bank estimates that by 2030, 93% of the global middle class will be from emerging market countries. Figure 19 shows the expected growth in global middle-class consumption by region. The rapidly expanding middle class in emerging markets is likely to be a major investment theme of the coming decade. Global providers of household products, financial services, autos, and many other categories may benefit from the middle-class megatrend.

In addition to the sale of consumer goods, demand for financial and health care services is also likely to rise. Rising incomes may mean more savings and wealth accumulation among emerging market citizens. In addition, consumers moving from lower-calorie diets high in grains and vegetables to higher-calorie diets containing more meat, dairy, and sugar can lead to health problems when combined with a less active lifestyle resulting from increasing urbanization. Health care services may see increasing demand to treat high blood pressure, heart diseases, and diabetes.

The implications are global and far-reaching:

- Manufacturers in Asia can increasingly track supplies as they make their way around the world. This improves the efficiency of supply chains.
- Designers in the U.S. may be able to speed up product development and testing and respond to problems in real time using data from actual users.
- Health care systems in Europe might better detect threats and streamline services and improve the accuracy and availability of patient data.
- Farmers in Latin America could improve crop yields with data on soil conditions, weather simulations, and seed yield.

The increasing availability of big data levels the playing field from what used to be available only to the largest companies with the most integrated global databases. Now the revolution in big data is increasingly available to companies in industries and countries that previously lacked access to this important competitive edge.

**Mobile commerce**

We tend to think of those in developed countries, especially in the U.S. and Japan, as quick adopters of new technologies, with the emerging world slow to catch up. The trend in mobile technology has challenged that notion.
The adoption pattern of cellphones in emerging market countries such as Turkey, Chile, and Lebanon does not look very different from those in America, according to data from the Pew Research Center. In fact, the percentage of adults who own a cellphone in China and Russia—two emerging market countries—is even higher than in the U.S.

One reason is the ease and preference of making payments in emerging market countries using technology rather than traditional banking services or carrying cash. In some African countries, as much as one-third of all consumer purchases take place using a mobile phone. While 17% of Americans claim to have made a payment using their cellphone in the past year, according to a report from the Community Development Research Section of the Federal Reserve in March 2014, a February 2014 report from the Pew Research Center shows that 68% of Kenyans, 29% of South Africans, and 25% of Russians have used their phones to make or receive a payment.

The ability to deliver goods and services and receive payment through the platform of the mobile phone is a potential revolution in the ability to access a new and rapidly growing global consumer base.

**Takeaways**

In this section, we have shown that having a global perspective is crucial when it comes to evaluating the megatrends of the next decade.

* More diverse global growth makes predicting the next big growth area more about broad exposure to many different countries than betting on one or a handful of rebounding former giants.
* The rapidly expanding middle class in emerging markets is likely to be a major investment theme of the coming decade.
* The increasing availability of big data has far-reaching global consequences, offering access once available only to the largest companies with the most integrated global databases.
* Mobilization is a potential revolution in the ability to access a new and rapidly growing global consumer base.

In the next section, we will share a parting thought about the increasing adoption of a global perspective.
Parting thought: The big picture

The portfolio allocation to international stocks that is necessary to enjoy the benefits of truly global exposure has increased over time along with globalization.

The wrong question

For decades investors have asked: “What is the right international stock market weighting for a portfolio?” This has become the wrong question, or, at least, it is now being asked the wrong way, since geography is no longer a primary driver of performance among large-caps stocks. The better question now is: “How do you need to allocate to represent the global opportunity and fully benefit from a global perspective?”

Globalization means even a portfolio invested entirely in U.S. stocks is at least indirectly influenced by global developments, and many U.S. stocks have direct exposure to international markets through foreign sales and operations. Likewise, a portfolio invested entirely in non-U.S. stocks still has at least indirect exposure to the U.S., the world’s largest economy. This globalization means that the optimal international stock market weighting for a portfolio is a wide range rather than a precise number.

The right allocation

In general, portfolios that range from as little as a 25% long-term target for international stocks up to 50% or more of total stock market exposure may benefit from the global opportunity and perspective. This allocation derives from the facts presented in this paper, including the fact that U.S. stocks currently make up about half the world’s investable stock market value and that stocks in all sectors behave much like their global peers. The international weighting necessary for truly global exposure is likely to continue to increase over time as the opportunity set evolves and globalization becomes even more entrenched.

Over shorter periods, tactical asset allocation over- or underweights to international stocks relative to the long-term target weighting may have the potential to add or preserve the value of a portfolio.

Investing differently

A global perspective means approaching investing differently. It takes the decision about what country’s stocks to invest in and refocuses it on seeking to invest in great ideas that span the stocks of many countries. It requires measuring investment success differently by using global benchmarks for performance. And it takes the long and broad view to help manage the risk of declines. Fortunately, consistent money flows favoring world stock funds show how more investors are adopting a global perspective, as shown in Figure 21.

Figure 21: Investors are increasingly adopting a global perspective
Cumulative monthly money flows to U.S. and world stock funds in billions of dollars since 2006

Important disclosures

The information provided here is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

All expressions of opinion are subject to change without notice in reaction to shifting market, economic, or geopolitical conditions. Data contained herein from third-party providers is obtained from what are considered reliable sources. However, its accuracy, completeness, or reliability cannot be guaranteed.

International investments include additional risks, such as differences in financial accounting standards, currency fluctuations, geopolitical risk, foreign taxes and regulations, and the potential for illiquid markets. Investing in emerging markets may accentuate these risks.

Past performance is no guarantee of future results, and the opinions presented cannot be viewed as an indicator of future performance.

Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

Indexes are unmanaged, do not incur management fees, costs, and expenses, and cannot be invested in directly.

MSCI World Index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed markets. As of May 2015, the MSCI countries include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the U.K., and the U.S.

The MSCI EAFE Index is an equity index that captures large- and mid-cap representation across developed-markets countries around the world, excluding the U.S. and Canada. With 909 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 emerging markets (EM) countries. With 836 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI World Index captures large- and mid-cap representation across 23 developed markets (DM) countries. With 1,634 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the U.S. market. With 630 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the U.S.

The MSCI EASEA Index (also known as the MSCI EAFE ex Japan Index) is an equity index that captures large- and mid-cap representation across developed-markets countries across the world, excluding Canada, Japan, and the U.S. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The Standard and Poor’s 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI Europe Index captures large- and mid-cap representation across 15 developed-markets countries in Europe. With 443 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across the European developed markets equity universe.
The MSCI World Small Cap Index captures small-cap representation across 23 developed-markets countries. With 4,275 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.

The MSCI World Information Technology Index is designed to capture the large- and mid-cap segments across 23 developed-markets (DM) countries. All securities in the index are classified in the information technology sector as per the Global Industry Classification Standard (GICS®).

The MSCI World Health Care Index is designed to capture the large- and mid-cap segments across 23 developed-markets (DM) countries. All securities in the index are classified in the health care sector as per the Global Industry Classification Standard (GICS®).

The MSCI World Materials Index is designed to capture the large- and mid-cap segments across 23 developed-markets (DM) countries. All securities in the index are classified in the materials sector as per the Global Industry Classification Standard (GICS®).

The MSCI World Industrials Index is designed to capture the large- and mid-cap segments across 23 developed-markets (DM) countries. All securities in the index are classified in the industrials sector as per the Global Industry Classification Standard (GICS®).

The MSCI World Financials Index is designed to capture the large- and mid-cap segments across 23 developed-markets (DM) countries. All securities in the index are classified in the financials sector as per the Global Industry Classification Standard (GICS®).

The MSCI World Energy Index is designed to capture the large- and mid-cap segments across 23 developed-markets (DM) countries. All securities in the index are classified in the energy sector as per the Global Industry Classification Standard (GICS®).

The MSCI World Telecommunications Services Index is designed to capture the large- and mid-cap segments across 23 developed-markets (DM) countries. All securities in the index are classified in the telecommunications services sector as per the Global Industry Classification Standard (GICS®).

The MSCI World Utilities Index is designed to capture the large- and mid-cap segments across 23 developed-markets (DM) countries. All securities in the index are classified in the utilities sector as per the Global Industry Classification Standard (GICS®).

The MSCI World Consumer Discretionary Index is designed to capture the large- and mid-cap segments across 23 developed-markets (DM) countries. All securities in the index are classified in the consumer discretionary sector as per the Global Industry Classification Standard (GICS®).

The MSCI World Consumer Staples Index is designed to capture the large- and mid-cap segments across 23 developed-markets (DM) countries. All securities in the index are classified in the consumer staples sector as per the Global Industry Classification Standard (GICS®).

MSCI Japan Index is designed to measure the performance of the large- and mid-cap segments of the Japanese markets. With 314 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

The MSCI Japan Consumer Staples Index is designed to capture the large- and mid-cap segments of the Japanese markets. All securities in the index are classified in the consumer staples sector as per the Global Industry Classification Standard (GICS®).

The MSCI Japan Information Technology Index is designed to capture the large- and mid-cap segments of the Japanese markets. All securities in the index are classified in the information technology sector as per the Global Industry Classification Standard (GICS®).
The MSCI Europe Information Technology Index is designed to capture the large- and mid-cap segments of the European markets. All securities in the index are classified in the information technology sector as per the Global Industry Classification Standard (GICS®).

The MSCI USA Information Technology Index is designed to capture the large- and mid-cap segments of the U.S. equity universe. All securities in the index are classified in the information technology sector as per the Global Industry Classification Standard (GICS®).

The MSCI USA Health Care Index is designed to capture the large- and mid-cap segments of the U.S. equity universe. All securities in the index are classified in the health care sector as per the Global Industry Classification Standard (GICS®).

The MSCI USA Materials Index is designed to capture the large- and mid-cap segments of the U.S. equity universe. All securities in the index are classified in the materials sector as per the Global Industry Classification Standard (GICS®).

The MSCI USA Industrials Index is designed to capture the large- and mid-cap segments of the U.S. equity universe. All securities in the index are classified in the industrials sector as per the Global Industry Classification Standard (GICS®).

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The Bloomberg State Index of Texas is a capitalization-weighted index consisting of equities domiciled in Texas.

The Bloomberg State Index of New York is a capitalization-weighted index consisting of equities domiciled in New York.
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Jeffrey Kleintop analyzes and discusses international markets, trends, and events to help U.S. investors understand their significance and financial implications. In this role, Kleintop provides research, commentary, and actionable insights through written reports, video content, conference calls, and in-person events.

Kleintop is frequently cited in a range of national media outlets including The Wall Street Journal, The New York Times, Barron's, and Financial Times. He is a regular guest on high-profile news networks including CNBC, Bloomberg, Fox Business News, PBS, and ABC News. Kleintop has been cited in The Wall Street Journal as one of “Wall Street’s best and brightest,” and he has been a featured or keynote speaker at dozens of industry events annually, including the Barron’s Top Financial Advisor Summit and the Financial Planning Association conference.

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