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Avoid a Patriotic Portfolio

Investors often favor stocks from their home country, harming the diversification of their portfolios.

By Annalyn Kurtz, Contributor March 30, 2018, at 9:00 a.m.

EVEN IN TODAY'S protectionist climate, with uncertainty surrounding global geopolitics and trade disputes, U.S. investors would do well to diversify their portfolios and invest in stocks both at home and abroad, financial advisors say.

While the mantra "there's no place like home" may be true for Dorothy, homesick for Kansas – she certainly didn't intend it as wise investing advice.

"Throughout history, there have been different regimes that have tried different sorts of protectionist or tariff type strategies, and throughout those episodes, the case for diversifying beyond your own home, local market is still very strong," says Fran Kinniry, a principal in Vanguard Investment Strategy Group.

Even though it's home to the world's largest economy and largest stock exchange, the United States only accounts for about 50 percent of worldwide market capitalization. With globalization playing out over the last 30 years, investors have gradually increased their holdings of foreign stocks, but still U.S. investors tend to heavily overweight their portfolios in U.S. stocks. U.S. mutual fund investors kept only 27 percent of their overall equity allocation in non-U.S. funds as of 2013, a Morningstar study shows.

"United States-based investors who ignore investment opportunities outside of the U.S. are missing out on approximately half of the investable stock market opportunities in the world," says Ajay Kaisth, a financial planner at KAI Advisors in Princeton Junction, New Jersey.

The phenomenon, which economists call the home bias puzzle, is common throughout the world. In 2010, Canadians kept only 76 percent of their stock market investments in Canadian stocks. Likewise, stockowners in Japan, Germany, the United Kingdom and even the Philippines – which on a global scale, has a tiny stock market – overweight their holdings of their home country equities.

Why do investors do this? There are many reasons. Perhaps they fear foreign currency risks, or they truly do believe their home country will deliver the best returns. But more often than not, it often comes down to basic psychology: People tend to prefer the familiar and fear the unknown. As a result, they tend to be biased toward their home country.

Whatever the reason, that patriotism is usually misdirected. As Kinnery notes, a long line of research shows that holding a globally diversified portfolio can reduce both risk and volatility over the long term. There's a smoothing effect that comes from the fact that non-U.S. stocks and U.S. stocks are not perfectly correlated, meaning they don't always move in tandem.

"They have similar risk profiles, but their patterns of return – meaning the short-run patterns – are very different," he says. "When you put the two together, you do not give up any return and you lower your risk."

Analysts at Charles Schwab are predicting U.S. large-cap stocks will underperform international large-cap stocks over the next 10 years, with U.S. large caps averaging 6.5 percent annual returns, in contrast with 7.2 percent returns for international large caps between 2018 and 2027.

While it's difficult to accurately predict which market or country will outperform or underperform in any given time period, Kaisth says, "by holding a globally diversified portfolio, investors are better positioned to capture market returns, where they occur."

So how much exactly is the right amount to allocate to foreign equities?

The answer, of course, varies depending on each investor's goals, but generally, keeping 20 percent to 40 percent of a stock portfolio in international investments is the "sweet spot" for most investors, says Rick Brooks, director and portfolio strategist at Blankinship & Foster in Solana Beach, California.

"This is a tough one for most investors, since they are most comfortable investing in things they know well and understand," he says. "Large institutions like pensions and endowments will often weight their portfolios by economic activity, but this is hard to do for individual investors."

Among its target-date retirement funds and other single-fund solutions, Vanguard's baseline it to keep about 40 percent of its equity allocation in international stocks.

If you're an American investor who doesn't hold international stocks at all – 40 percent might seem like a lot to start with.

"If you have 100 percent U.S. stocks, the most important thing is to get started by adding diversification by adding 10 percent or 20 percent," Kinniry says. "The exact amount you have is not nearly as important as that you have some."

Along the way, it's also important that investors take time to question and confront their own biases, whether it's the home bias or other common behavioral quirks, says George Kiraly Jr., founder and chief investment officer of LodeStar Advisory Group in Short Hills, New Jersey.

"Our investment biases show up in many ways – where we live, our past experiences, and even our field of expertise can influence the way we allocate our assets," he says. "It's important that investors are aware of these biases. Developing a disciplined investment plan can help minimize their influence."