International Stocks are Overrated

By Carl Scholtz

I have looked at countless investor statements managed by other investment advisors and I consistently see the same mistake: too much international. I scratch my head. For many years, I have heard about how investors need a sizeable weight (20-40%) of their stock portfolio in international stocks. The primary rationale is typically either that international stocks provide good diversification against U.S. stocks or that international stocks are very inexpensive and thus attractive. These reasons all sound good on the surface, but I believe this line of thinking is a big mistake that has cost investors dearly.

Let's start with the data. How have international stocks performed? The short answer: not well. First, let's break up the international stock universe into two primary buckets: developed markets (re: Europe, Japan) and emerging markets (re: China, Latin America). For the most part, investors typically place large portions of their portfolio in the "safe" developed market bucket and place a small weight in the "risky" emerging market bucket. I have laid out the total return data below against the most common U.S. stock index, the S&P 500.

Market	Months End - 11/30/21	5-year	10-year	20-year	30-year
US Market:	S&P500	127.81%	347.26%	495.56%	2136.25%
Developed Markets:	Euro Stoxx 600 (Europe)	59.34%	170.21%	213.55%	892.76%
	FTSE 100 (UK)	26.28%	87.49%	183.32%	509.17%
	Nikkei 225 Index (Japan)	67.24%	298.08%	259.11%	79.20%
Emerging Markets:	MSCI Emerging Markets Index	60.19%	112.09%	275.50%	501.23%

Yes, so in looking at the data, clearly international stocks have been a place to avoid. That fact is obvious. The real questions are whether an investor should have known ahead of time to avoid this area and whether an investor should avoid this area going forward. I believe the answer to both questions is yes. I will walk you through the two primary arguments commonly used for owning them.

1. **Misconception #1: International stocks provide good diversification.** While there is modest truth here, I think the benefits of this diversification are minimal. International stocks are highly correlated with U.S. stocks and the reason is apparent. Given the United States' huge impact on the global economy, when our economy (and therefore our companies have a problem) – every economy has a problem. Further, most of the S&P 500 is driven by companies with substantial international exposure. Over 42% of the sales from S&P 500 companies are international. So, when Europe's economy is weak so are both the European indices and the S&P 500. Look at the table below and decide for yourself whether the international markets provided good diversification benefits in a down market. Did they protect you?

Market	Index	Covid Crash 02/2020 - 03/2020	Financial Crisis 08/2008 - 02/2009	Tech Bust 01/2000 - 02/2003
US Market:	S&P 500	-33.79%	-40.98%	-40.15%
Developed Markets:	Euro Stoxx 600 (Europe)	-35.08%	-38.13%	-48.44%
	FTSE 100 (UK)	-32.66%	-27.27%	-45.32%
	Nikkei 225 Index (Japan)	-27.78%	-42.88%	-54.83%
Emerging Markets:	MSCI Emerging Markets Index	-31.15%	-51.41%	-38.43%

2. **Misconception #2: International stocks are attractive because they are cheap.** I have heard this argument for the past ten years a thousand times. And as I've said all along, they are cheap for a reason. First of all, it's important to understand that stocks follow a company's profit growth in the long-run. Not surprisingly, one of the biggest drivers of company profits is GDP growth. In Europe and Japan, there has been and will continue to be structurally less GDP growth (see table). Europe and Japan have much less friendly government policies for economic growth and even worse demographics (aging population) than the United States. These are major headwinds long-term. Second, and even more importantly, there is a general lack of technology companies and innovation in Europe and Japan compared to the United States. There is no "Silicone Valley" in Europe. For whatever reason, technological innovation has not taken hold in most other countries like the United States. This is a significant problem because technology is where most of the world's wealth is created. As a point of reference, the European stock index (Euro Stoxx 600) is comprised of an 8% weight in technology companies. Instead, the Euro Stoxx 600 index is littered with old-line, capital intensive industrials, broken banks, and other slow growth, mature companies. The S&P 500, on the other hand, is close to 40% weighted in technology (if you include some key communication names like Google, Facebook, and Netflix). If technology is the engine of wealth creation, why would I put any money in something with just an 8% weighting?

Avg Real GDP Growth			
	5-year	10-year	20-year
United States	1.93%	2.08%	1.95%
Euro Area (19 countries)	1.18%	1.00%	1.07%
Japan	-0.23%	0.38%	0.53%

Emerging markets are a bit of a different story in that they do have the "potential" for higher GDP growth and wealth creation. I thus find a small investment here more suitable, but they have been correctly labeled very risky. Whether it's the Chinese gov't changing the rules and wiping out industries to fit party politics or a currency crisis in Argentina, emerging markets can be a very wild ride and often not worth the extra risk. It is difficult to trust that any political policies stay stable, the accounting is accurate, or that some unforeseen negative event will not occur. It's hard to understand the true risks for any local investor, let alone one residing in the United States.

Having said all of this, I do want to mention that I don't think international stocks will underperform every year compared to the S&P 500. They certainly will not. Every dog has its day. The more important point I'm making is that they will structurally underperform and are not worth messing with. If you look out 10-, 20-, 30- years, the European and Japanese stock markets are virtually certain to lag the United States unless drastic political, cultural, and educational changes occur immediately.

So, under what circumstances would I invest internationally? Actually, I already do. I have and will continue to invest internationally, but only in individual stocks – not whole indices and certainly not a large portion of a portfolio. There is no question that some outstanding companies are based internationally such as Tencent, Alibaba, Taiwan Semiconductor, ASML and Airbus. These are innovators and wealth creators. What I will not do is invest overseas in baskets of stocks simply to invest overseas. That approach sounds an awful lot like "diworsification" – a term dubbed by Peter Lynch many years ago. Essentially, when you do that, you are degrading the overall portfolio as a means of spreading your bets around different areas. I'd prefer to only invest in the good areas.