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## No Place Like Home? Market Bias Perceptions and Realities

*Recent volatility rocked global markets, presenting investors with an opportunity to revisit asset allocation and geographic exposure. Although investors tend to prefer investing in their home country, evidence shows doing so may blind them to global opportunities. In this month's Edge, we examine home market bias compared with the benefits of investing globally, remind investors of the risks in each, and outline steps to help correct that imbalance.*



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**W**ell, the bout of volatility that we have been warning of came, and then went, with surprising suddenness at the beginning of February, and as of this writing, more than half of the losses have already been recouped within a matter of a few weeks. Investors should not expect this to be the last word on volatility. Rather, the February storm should be a wake-up call to ensure their portfolios are positioned the way they want them to be before the next storm hits, because

when it does, there may not be time or space to adjust and react.

Home market bias is one of the greatest imbalances in most portfolios. Investors in the US, and indeed throughout the world, exhibit a remarkable predilection to overweight investments in their own country. Although that tendency, as we will see, is understandable, it makes less sense in today's world than ever before, and it leads to

less-than-optimal results, chronic frustration, and a planet of missed opportunities.

**Home market bias**

Home market bias has long been an issue for advisors urging clients to diversify away from their local market; yet, even with the surge in international investing in recent years, that bias remains deeply entrenched. Although much of the asset allocation data is a few years old, the general outlines have barely changed: In country

after country, market after market, investors put a significantly larger share of their assets in their own country's equities relative to their country's weighting as a percentage of global equities. That is even more true of fixed income.

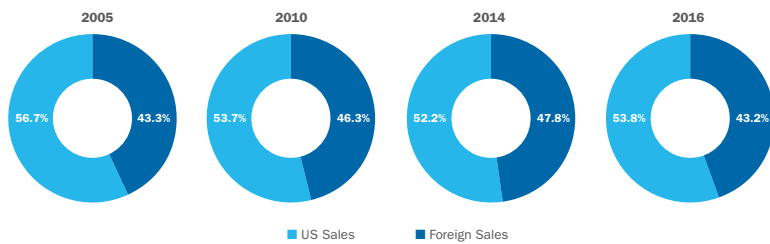
But where home bias with fixed income may make sense, given favorable tax treatment that governments afford to their own citizens' government bonds purchases, it makes less sense for equity investments in a world in which large cap companies, especially, derive an ever-larger share of revenues from around the globe than from their own country. Over the past five years, for instance, between 43% and 47% of the sales of S&P 500 companies have come from outside the United States (see Figure 1). At the same time, the overall market capitalization of the US stock market relative to global markets is somewhere between 40% and 50%, depending on which indices and data sets are used.

Yet, investors stubbornly tend to concentrate their investments at home. According to Vanguard, US investors at the beginning of 2015 had nearly 80% of their equity allocation in US stocks. The relative bias is actually even more extreme in other countries: In Australia, which has barely 2.4% of global market cap, investors place 66% of their assets in Australian stocks; in Japan, which has a 7% weighting, Japanese investors held 55% of their assets in Japanese stocks (see Figure 2). Newer data may reflect a slightly more balanced allocation, but evidence from fund flows suggests that the skew has not changed appreciably.

The home market focus shouldn't come as a surprise. We all have the conceit of thinking we understand our own country better than others, and that may be true much of the time. Foreign markets can seem alien, the rules unclear, and the risks greater. US domestic investors, for instance, are likely to view emerging markets as less regulated, more prone to volatility, and more opaque in their disclosure requirements. That also is often true.

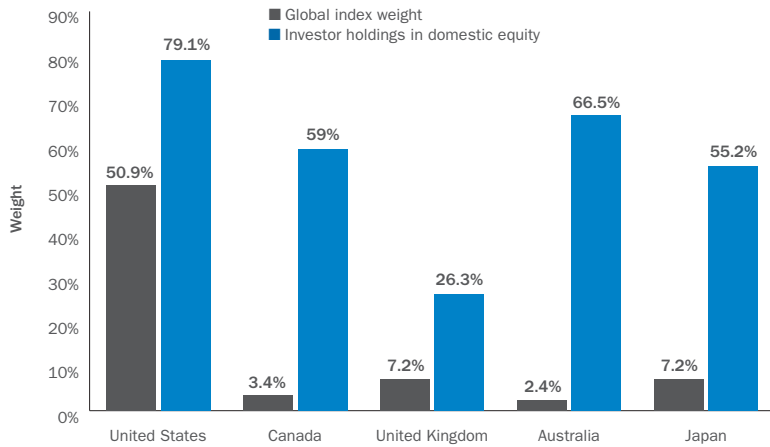
And yet, that bias can also blind domestic investors to the risks at home. In the mid-2000s, for instance, when I was running a fund focused on US and Chinese companies that were taking advantage of the burgeoning Chinese market, most US investors were concerned about the stability of the Chinese banking and financial system, given widespread stories of state involvement in banks

**Figure 1:**  
Proportion of Foreign Sales in S&P 500



Source: S&P Dow Jones Indices

**Figure 2:**  
Equity market home bias by country



Source: Vanguard, based on data from the IMF's Coordinated Portfolio Investment Survey (2014), Barclays, Thomson Reuters Datastream, and FactSet.

Note: Data as of December 31, 2014 from the International Monetary Fund, or IMF, in US dollars. Domestic investment is calculated by subtracting total foreign investment (as reported by the IMF) in a given country from its market capitalization in the MSCI All Country World Index. Given that the IMF data is voluntary, there may be some discrepancies between the market values in the survey and the MSCI ACWI.

and lack of clear disclosure about bad loans. Yet, as the massive financial crisis of 2008-2009 demonstrated, the real risks at the time were with the US banking system. Home bias here magnified perception of risk where there was little and created a false sense of confidence in the US banks. The same is true for other countries: in Japan, for instance, local investors are less likely to view the sluggish growth rates and massive debt levels as immediate concerns, whereas those issues loom large for non-Japanese investors contemplating investing in Japan.

The real risks of home market bias are that viable opportunities are overlooked. Study after study and paper after paper has shown how attractive international markets are in terms of valuation, projected growth, and the overall opportunity set of a still-rapid and massive emergence of a global middle class. Yes, similar arguments were made as recently as 2015, when emerging markets equities did very poorly, which only reinforced the sense among many investors that nonhome market investing, although promising, may simply be too risky.

The past two years, however, have exhibited very strong developed and emerging markets gains relative to the US, even as US markets have been strong as well (see Figure 3). In terms of fundamentals, rarely has the global economic and investing environment seemed so benign, with synchronous global growth in almost every corner of the world, according to the International Monetary Fund (IMF), and a still relatively low interest rate and inflation backdrop. Yes, investors must be attentive to signs of significant inflation or sharply rising rates, but as of now, those concerns are not bolstered by the actual data. Legitimate concerns, for sure, but for the moment, just that.

This moderate global economic picture is undercut by waves of anxiety about global political stability, which is reflected in most countries, including the US. In times of anxiety, home country bias can be even more pronounced, as people embrace the false comfort of staying close to home, which only accentuates the gap between valuations and opportunities not seized. Given the weighting of US investors as part of the global mix, their bias toward US markets can skew valuations even more, making those stocks comparatively even more expensive.

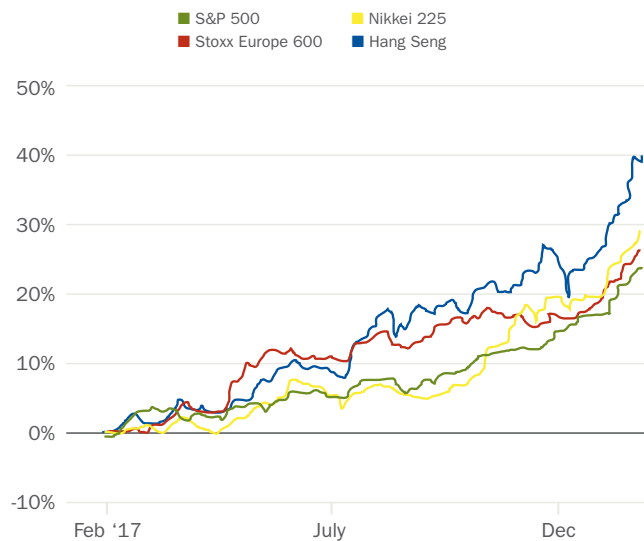
### Home may be where the heart is....

Home offers many comforts and conveniences. But investing too heavily at home, especially for US investors, risks bidding up our equities at the expense of global opportunities. It also can lead to an inaccurate risk-reward analysis, making the world out there seem riskier and the world at home safer than either actually is.

When challenging that bias, a few steps are in order. First, investing in larger companies almost always means investing globally, even if investors think they are investing locally, because the percentage of large S&P 500 companies deriving revenue from abroad is in the mid-40% range. Removing domestic banks, utilities, and many health care companies, whose revenues are more heavily domestic, the percentage of business of many large retail, tech, industrial, and consumer companies that is derived from outside the US easily surpasses 50%. So, even though it may feel as though those companies are “home market” investments, they are, in fact, more global than they appear. Recognizing that may make it easier to contemplate other nonhome market investments.

Second, investing in smaller, more regional global companies can often be best accessed through active managers who understand the dynamics

**Figure 3:**  
**World Stocks versus S&P 500**



Source: Wall Street Journal, FactSet. Indices measured in USD terms. Data is from 1/30/2017 to 1/26/2018.

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of those countries, markets, and companies. It is hard enough for an individual advisor or investor to assess the retail industry in the US, but it is almost impossible to do that for the retail industry in Spain, South Korea, and Brazil. That is where skilled managers truly can add value.

And finally, markets can and do diverge, so broader geographic exposure becomes its own form of diversification. In times of real crisis, every market may rise or fall in sync, but absent that, broader

exposure can be its own form of protection, even if it feels riskier at first.

Trade tensions, the rise of nationalism, and some degree of global retrenchment notwithstanding, we still live in a world of globalized commerce and capital, and the ease of investing globally has never been greater. It's never too late to look at the world at large and venture out, and never too late to challenge the false comforts of home market bias. Why not start now? ■

### February Takeaway:

February's stock market volatility was a wake-up call for investors to reposition portfolios to withstand the next storm. Looking over their investments, most will discover a fair amount of home market bias, the tendency people have worldwide to overweight their own countries. American investors overall have equity allocations that are close to 80% in US stocks, reflecting the perception that domestic markets are safer and more transparent. But the 2008-2009 financial crisis made investors painfully aware of the hidden risks in the US banking system. In addition, investors are likely more exposed globally than they think, given that the large cap companies of the S&P 500 derive between 43%-47% of revenues from outside the United States. In short, most investors would do well to rethink their home market bias and consider investing more globally, either through ETFs in larger companies in developed markets or by tapping into skilled active managers who can identify regional global opportunities in smaller companies.

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