DIAMOND HILL

INVESTED IN THE LONG RUN

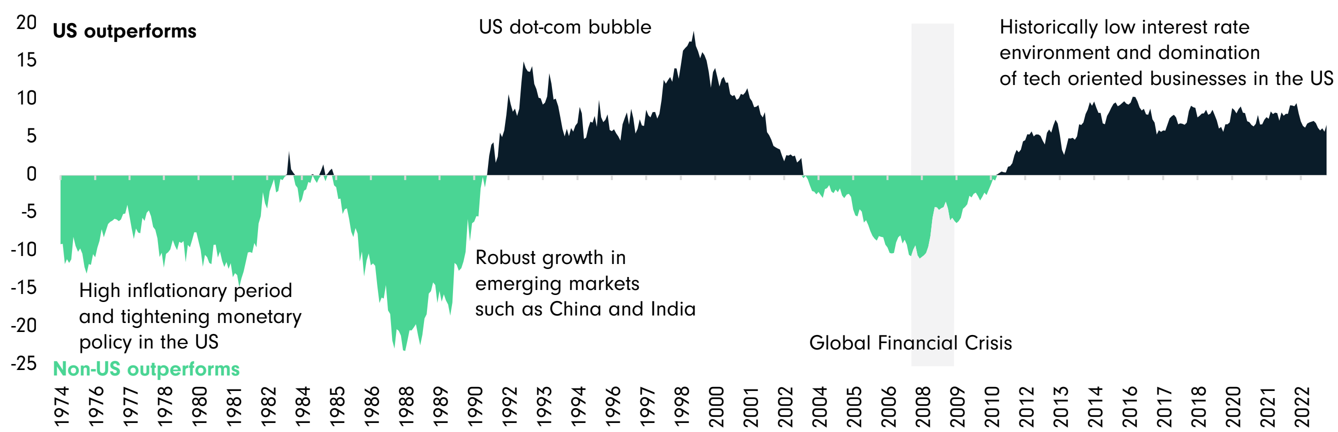
Seizing Opportunities Beyond Borders

Feb 2024

Though most investors recognize and acknowledge the well-known benefits of diversification, there are plenty of reasons (or maybe excuses) when the rubber meets the road for not following through via asset allocation decisions. One topic that investors continue to debate is the need for non-US exposure in a well-diversified equity allocation. Especially given that returns for US investors in domestic stocks have been consistently higher than returns for non-US stocks for over a decade. Today's question is whether global diversification even has a place in equity portfolios.

While recent performance would suggest an allocation to non-US stocks is not required to achieve solid returns, history indicates the outperformance of US stocks over international stocks tends to be cyclical (Exhibit 1). Extended outperformance of either US or non-US stocks can mask the need to maintain diversification. Regardless of what returns look like in 2024 and beyond, we believe international stocks play an essential role in an investor's portfolio for reasons beyond relative performance.

Exhibit 1 — US vs International Equity Returns (%)



Source: FactSet. US represented by S&P 500 Index. Non-US represented by MSCI World ex-USA Index.

Mitigating Home Country Bias: A Pragmatic Approach

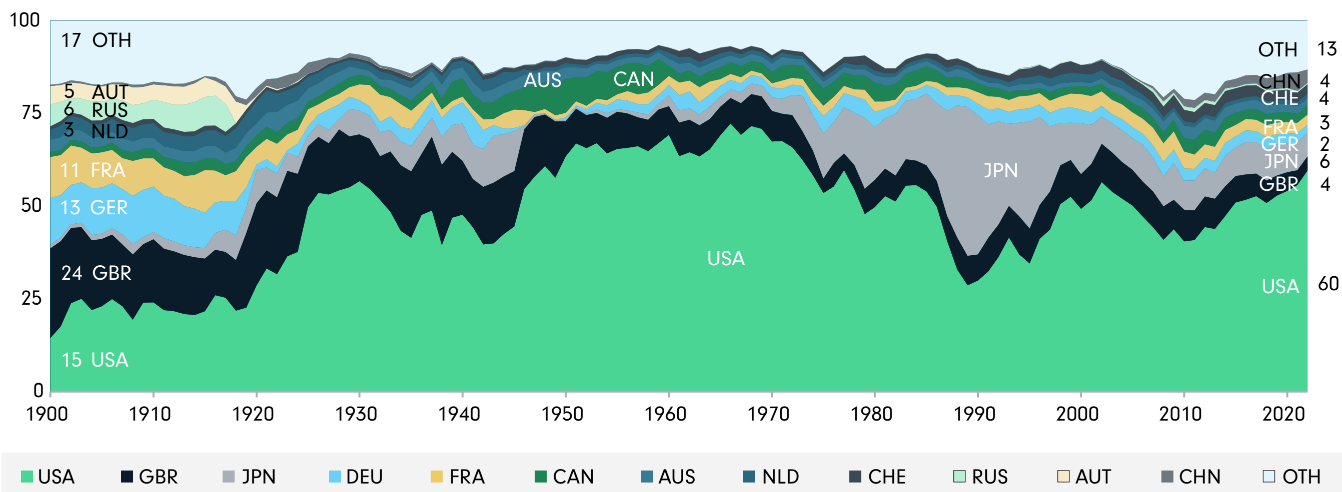
Home country bias causes an investor's portfolio to be dependent on a subset of companies in a specific geography. However, the impermanence of one country's dominance is evident throughout history.

Fluctuations in global economies are inherent, as demonstrated by the changes in equity market capitalization of major world economies such as the UK, Japan and the US (Exhibit 2). For example, the UK once represented 24% of the world's equity market capitalization but now only represents 4%. Similarly, Japan experienced massive success in the post-World War 2 era until 1989 and then faded as a global market leader.

The US comprised 15% of the world's market cap at the beginning of the 20th century and continued to rise into the late 1960s when its market cap reached roughly 70% of the world's total (Exhibit 2). However, that percentage slowly declined over the next several decades. By the early 1990s, the US's share was roughly 30%. Given the strength of the US stocks over the past 30 years — notwithstanding significant market events such as the dot com bubble burst, global financial crisis, and COVID-19 — the US represents 60% of the world's market cap today.

Long-term investors would do well to recognize these historical fluctuations as the current proportion of the US's equity market is likely unsustainable over the long term. If utilizing global market cap as a guideline, today's numbers suggest investors should have roughly 40% of their overall equity allocation designated to non-US equities. Ignoring proper diversification exposes investors to home country bias and jeopardizes long-term investment outcomes.

Exhibit 2 — The Evolution of Equity Markets Over Time (%)



Unveiling Premier Companies

Some of the world's finest companies are headquartered outside the US. While Americans readily recognize leading companies in the US, a broader awareness of outstanding global enterprises remains less common. This knowledge gap often stems from factors like advertising, news exposure, personal purchasing habits and social interactions, which can contribute to home-country bias in investment decisions. By limiting investments to familiar local entities, investors may miss out on investing in companies with discounted stock prices and similar or superior growth and profitability that have less name-brand recognition within the US.

For example, industries such as beverages and spirits, personal care products and semiconductors are areas where the market leaders are based outside the US. For instance, Diageo and Unilever are non-US-based companies that may not be known by name to US consumers but have iconic brands and extensive histories. Diageo owns popular brands such as Johnnie Walker, Guinness, Tanqueray, Smirnoff, and Ketel One. Unilever owns Hellmann's mayonnaise, Dove body wash, Ben & Jerry's ice cream, Seventh Generation cleaning products, and AXE body sprays. In addition to these well-known brands in the US, both companies have strong distribution in emerging markets where rising GDP per capita propels individuals into the middle class, fostering increased spending and growth.

Semiconductors, while often designed in the US, are typically manufactured abroad, particularly in Asia — Taiwan Semiconductor Manufacturing is the market leader in this space and has evolved into a manufacturing powerhouse, leveraging lower labor costs and government incentives to become the global leader in semiconductor production.

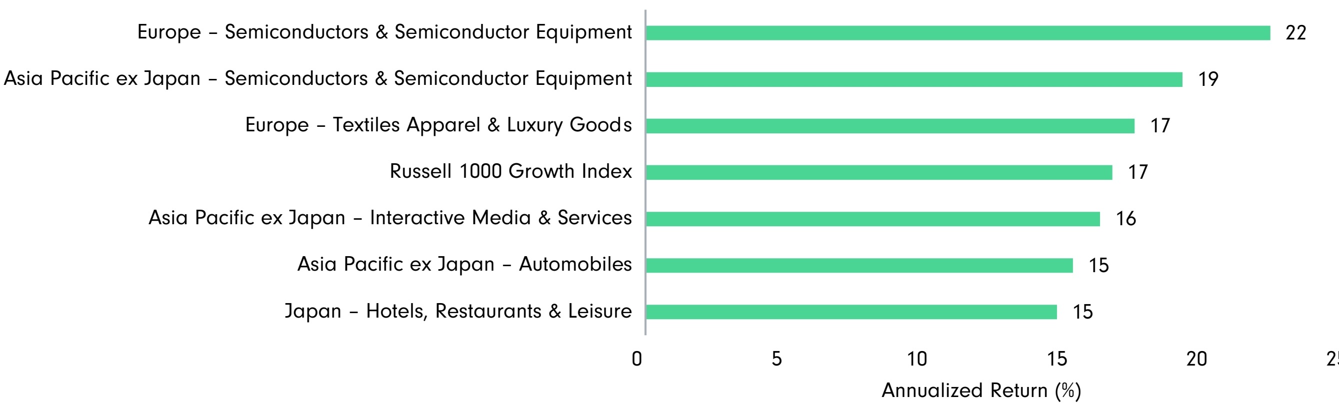
These non-US-based companies, which may be unfamiliar to the average US consumer, offer strong return potential even when US stocks outperform non-US stocks. Expanding investment horizons beyond US borders presents an avenue for investors to tap into the success of these global enterprises.

Concentration and Valuation Risk within the US Equity Market

The success of US large-cap growth stocks since the global financial crisis is no secret. This small group of stocks (whether the FANGS in 2013 or the Magnificent Seven today) has outperformed many other segments of the global equity universe, as well as other asset classes, such as private investments.

The common ex-post question is, "Why invest in anything other than US large-cap growth?" In hindsight, it is a reasonable question, given the strength of returns. However, the query ignores other segments of the global equity universe that have had similar returns, however, masked by their inclusion in a well-diversified index like the MSCI ACWI ex-US Index. For example, industries such as semiconductors and European luxury goods have experienced more robust returns than US large-cap growth over the past ten years (Exhibit 3).

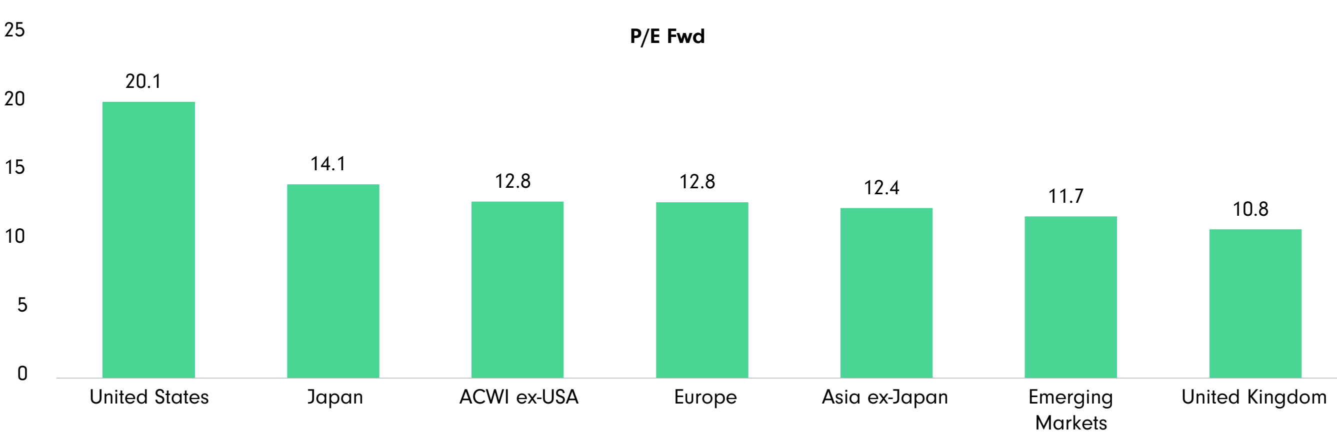
Exhibit 3 — Notable Region/Industry Performance vs. Russell 1000 Growth Index, 2009-2023 (%)



Source: FactSet, 31 Dec 2008 through 31 Dec 2023.

Additionally, valuation-conscious investors can look beyond US borders and find many attractive opportunities. US stocks trade at roughly 20 times forward price-to-earnings, while P/Es of non-US stocks are much cheaper. P/E multiples for Japanese, European and emerging markets stocks range from 11 to 14x (Exhibit 4).

Exhibit 4 — US equities trade at a significant premium to non-US equities



Source: MSCI, as of 31 Dec 2023.

Enhancing Portfolio Returns: Active Investing in International Markets

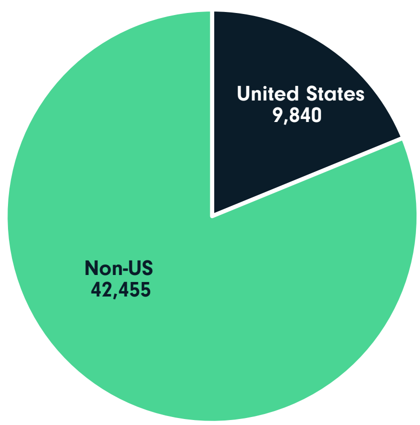
Non-US benchmarks often combine stocks using specific criteria to maximize returns and minimize risks, but they lack the rigor of an active, fundamental approach. Relative to the US, inefficient capital allocation and destruction of economic value can be common in non-US businesses, which means that passive benchmarks are often comprised of companies a prudent investor may not want exposure to.

In non-US markets, factors such as government ownership, unique cultural considerations, or dominant shareholders with misaligned interests can lead to suboptimal business practices. Avoiding such elements can be advantageous to long-term investors instead of simply buying a generic basket of securities to gain exposure to one or more markets.

Because active managers are not required to own every stock within a benchmark, they can avoid the less attractive or riskier areas of global markets. They also can exploit inefficiencies in the market by over- or under-weighting certain countries, sectors or individual stocks.

The vast number of listed companies outside the US also presents a broad opportunity for active investors to identify attractive investments. There are over 40,000 listed securities outside of the US compared to less than 10,000 in the US (Exhibit 5). Additionally, the US is home to large pools of capital and is well-covered by sell-side analysts. Outside the US, pools of capital and analyst coverage are significantly less in many markets, creating the potential for larger information gaps and inefficient stock prices.

Exhibit 5 — Opportunity Set of Investable Securities



Source: FactSet, as of 19 January 2024.

Summary

Recognizing and seizing opportunities abroad is essential for US investors. Investing in the world's best companies, mitigating home country bias, and adopting an active investment strategy can help build a robust and resilient investment portfolio. By remaining disciplined and focused on the long term, investors can position themselves to achieve their portfolio objectives.

S&P 500 Index measures the performance of 500 large companies in the US. **MSCI World ex-USA Index** measures the performance of large- and mid-cap companies across 22 of 23 developed markets countries, excluding the US. **Russell 1000 Growth Index** measures the performance of US large-cap companies with higher price/book ratios and forecasted growth values. The indexes are unmanaged, include net reinvested dividends, do not reflect fees or expenses (which would lower the return) and are not available for direct investment. Index data source: Bloomberg Index Services Limited. See diamond-hill.com/disclosures for a full copy of the disclaimer.

As of 31 December 2023, Diamond Hill owned shares of Diageo PLC, Unilever PLC and Taiwan Semiconductor Manufacturing Co Ltd.

The views expressed are those of Diamond Hill as of February 2024 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal. Past performance is not a guarantee of future results.