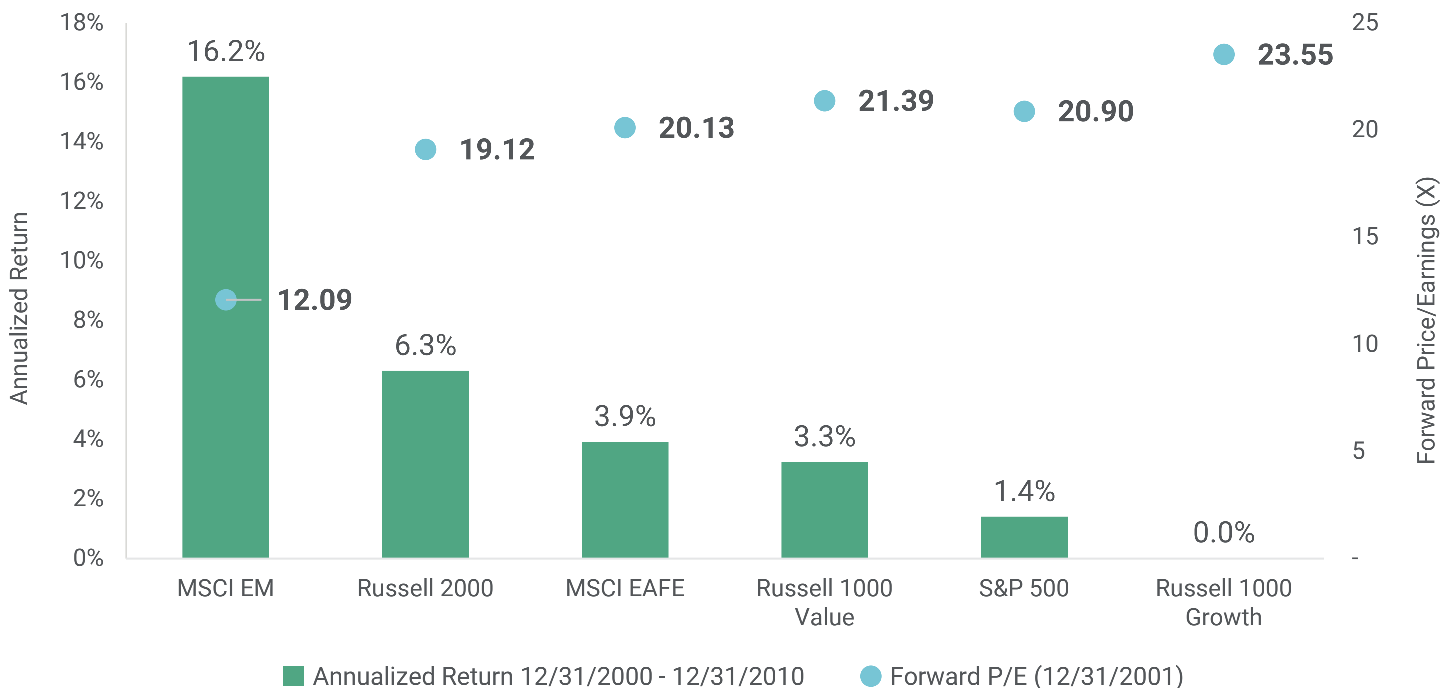
The Importance of Global Diversification and Asset Allocation

Recency bias or chasing the "hot dot" is a common investing belief that a stock or an asset class that has done well recently will continue its strong performance. In our opinion, this method of allocating capital often goes against one of the central tenets of investing, namely diversification. We believe diversification is key as it helps investors to improve its long-term risk/return potential by having their capital in a variety of asset classes whose performance tends not to correlate with each other.

Over the last two decades, we have seen many examples of investors falling for the hot dot trap. After the "lost decade" of the 2000s, during which the U.S. market (S&P 500) saw paltry returns while emerging markets equities (MSCI Emerging Markets Index) performed well, many wanted to invest in emerging markets (EM), especially its main constituents, the BRICs (Brazil, Russia, India, and China). However, when viewed alongside valuations, the outperformance of EM equities relative to U.S. stocks during this period did not come as a surprise as EM equities started at a much more attractive valuation level than U.S. stocks.

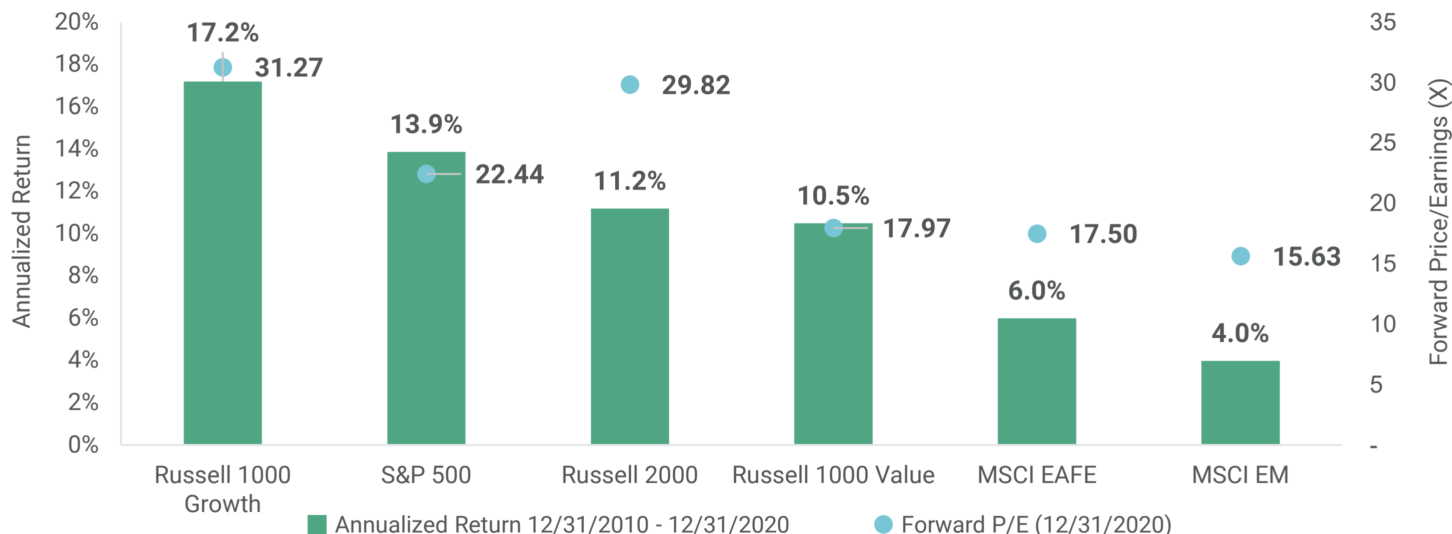
THE "LOST" DECADE



DECEMBER 31, 2000 TO DECEMBER 31, 2010. Source: Brandes, FactSet, MSCI. Returns include reinvestment of all dividends and are reduced by any applicable foreign withholding taxes, without provisions for income taxes, if any. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.

Over the last decade, we saw a repeat of this phenomenon, but in reverse. For the past 10 years, U.S. stocks, especially growth stocks, outperformed other major asset classes, and a new acronym was born to highlight the dominance of a group of stocks: the FAANGs (Facebook, Apple, Amazon, Netflix, Google). Now many investors seem convinced these stocks are all one needs to own for the next decade to guarantee a good investment outcome. However, if we look at valuations, it may not be too surprising that after their decade of strong performance, U.S. stocks (in particular U.S growth and U.S. small-cap stocks) traded at more expensive valuations than international and emerging markets stocks.

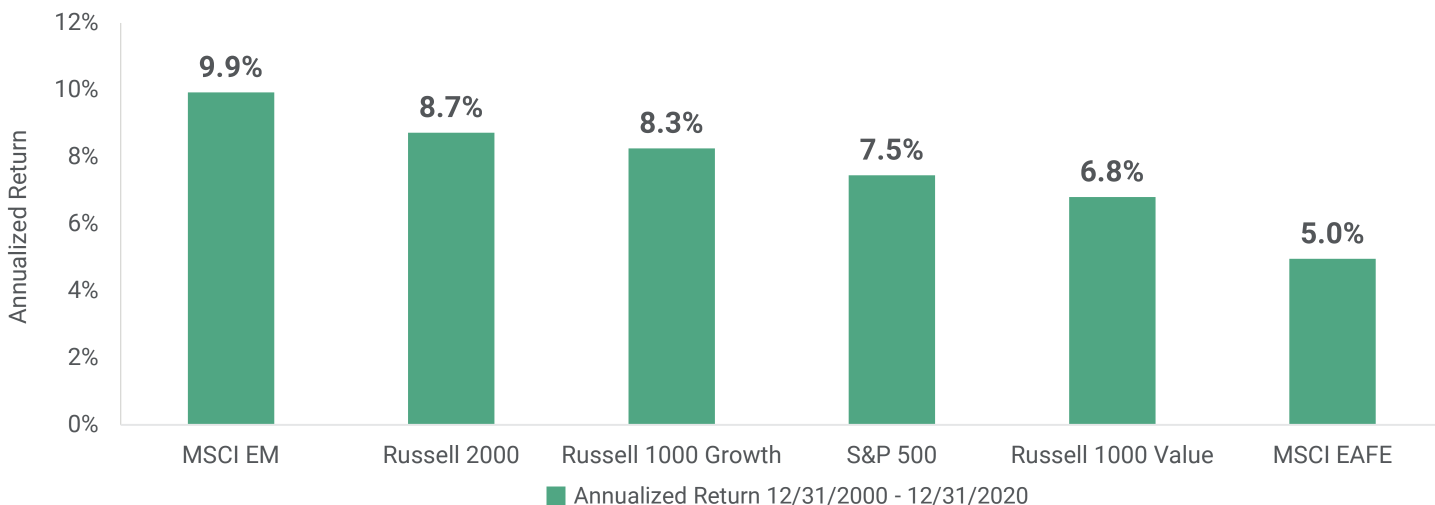
THE LAST DECADE



DECEMBER 31, 2010 TO DECEMBER 31, 2020. Source: Brandes, FactSet, MSCI. Returns include reinvestment of all dividends and are reduced by any applicable foreign withholding taxes, without provisions for income taxes, if any. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.

No one knows what will happen over the next decade, but we are skeptical about the belief that U.S. growth stocks' outperformance will continue indefinitely, especially given their valuation today relative to EM and international stocks. What we do know is that markets have tended to cycle and style leadership has tended to change, as we've seen with emerging markets and U.S. growth stocks switching places between top to worst performer (emerging markets) and worst to top performer (U.S. growth stocks) in the past 20 years.

LAST 20 YEARS



Rank	EM	US Small	US Growth	US	US Value	International
2001-2010	1	2	6	5	4	3
2011-2020	6	3	1	2	4	5

DECEMBER 31, 2000 TO DECEMBER 31, 2020. Source: Brandes, FactSet, MSCI. Periods of greater than one year have been annualized. Returns include reinvestment of all dividends and are reduced by any applicable foreign withholding taxes, without provisions for income taxes, if any. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.

As such, we believe the importance of portfolio diversification should not be downplayed when allocating capital.

Correlation: A statistic that measures the degree to which two securities move in relation to each other. **Forward Price/Earnings:** Price per share divided by earnings per share expected over the next 12 months or next fiscal year.

The MSCI EAFE Index with net dividends captures large and mid cap representation of developed market countries excluding the U.S. and Canada. **The MSCI Emerging Markets Index** with net dividends captures large and mid cap representation of emerging market countries. Data prior to 2001 is gross dividend and linked to the net dividend returns. **The Russell 1000 Growth Index** with gross dividends measures performance of the large cap growth segment of the U.S. equity universe. Securities are categorized as growth or value based on their relative book-to-price ratios, historical sales growth, and expected earnings growth. **The Russell 1000 Value Index** with gross dividends measures performance of the large cap value segment of the U.S. equity universe. Securities are categorized as growth or value based on their relative book-to-price ratios, historical sales growth, and expected earnings growth. **The Russell 2000 Index** with gross dividends measures the performance of the small cap segment of the U.S. equity universe. **The S&P 500 Index** measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

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Diversification does not assure a profit or protect against a loss in a declining market.

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