GLOBAL INVESTING

THE ECONOMY IS DEGLOBALIZING. SHOULD MY PORTFOLIO TOO?

October 29, 2020

Northern Trust
Global Asset Allocation

Daniel Phillips, CFA
Director, Asset Allocation Strategy
dp61@ntrs.com

James McDonald
Chief Investment Strategist
jxm8@ntrs.com

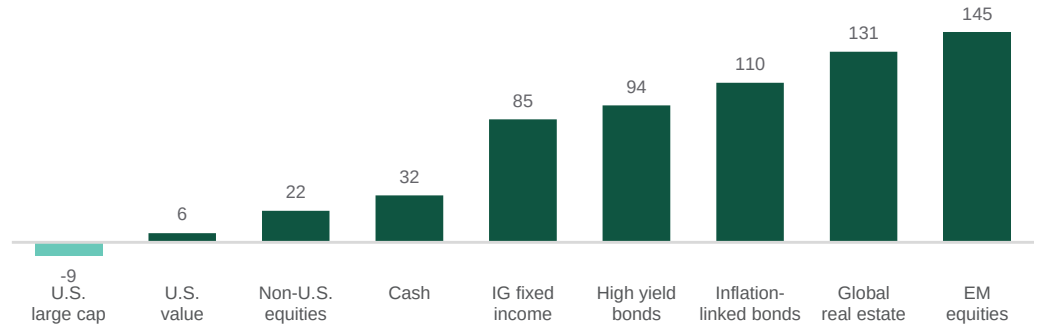
Cutting to the chase, the answer to the question posed above is no. In fact, less economic globalization may increase the diversification benefits of a global portfolio — as regional economies become less synchronized and aggregate earnings become more domestically oriented. Those already investing globally should stay the course. Those with a home country bias in their portfolio have a nice opportunity to broaden their international exposure.

One often-received question is why invest in equity markets outside the U.S. This question has become more frequent over the past decade as U.S. equities have outperformed non-U.S. equities by 8% annually. Many advisors respond to this by showing the famous "quilt chart" — displaying, in stacked box format, how the top performing regions tend to change year-by-year. While we agree with the quilt chart's message, we think Exhibit 1 is a far more powerful way to make the case for global investing. Interestingly, the sentiment around U.S. stocks today is increasingly similar to that found at the turn of the century — that is, the firm belief that U.S. stocks could do no wrong. Yet, in the decade that followed U.S. stocks — as measured by the S&P 500 Index — had a negative return (cumulatively -9%). Meanwhile, nearly all other broad asset classes were able to provide positive returns, and sometimes meaningfully so. This is a "quick and dirty" way to show the potential dangers of concentrated investing. We will develop a more robust case for global investing in the pages that follow.

EXHIBIT 1: THE LAST TIME U.S. STOCKS COULD DO NO WRONG…

Market returns during the '00s were strong — that is for areas other than U.S. large caps.

CUMULATIVE RETURNS FROM 12/31/1999 THROUGH 12/31/2009



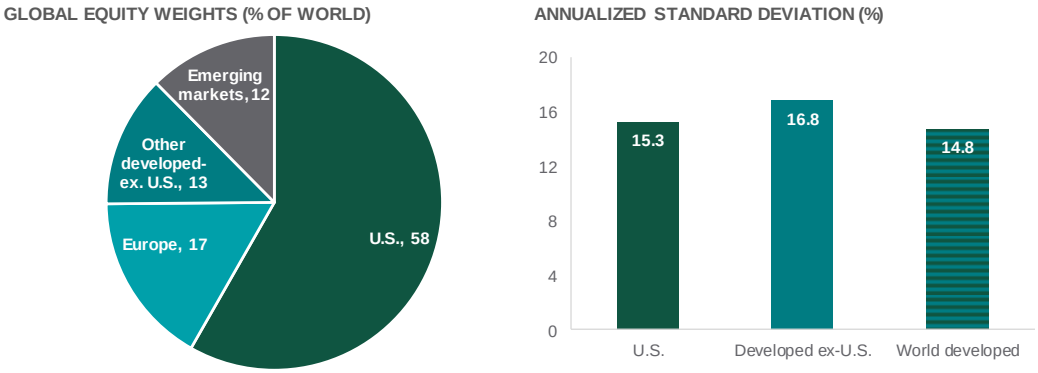
Source: Northern Trust Asset Management, Bloomberg. Asset class indices (in order): S&P 500; MSCI U.S. Value; MSCI World ex-U.S. IMI; Bloomberg Barclays U.S. Treasury Bills: 1-3 Months; Bloomberg Barclays U.S. Agg; Bloomberg Barclays U.S. High Yield; Bloomberg Barclays U.S. TIPS; MSCI ACWI IMI Core RE; MSCI EM IMI.

WHAT INVESTMENT THEORY TELLS US

Investment textbooks spend a lot of time on the efficient market hypothesis — the assertion that markets with adequate liquidity and without meaningful constraints will efficiently price in all available information. There is a great debate over how efficient markets are in the near term, but broader agreement that markets are fairly efficient over the long term. If true, then most equity securities (and all securities for that matter) are priced reasonably appropriately. In turn, that suggests the market-capitalization weights of all securities represent the most efficient portfolio. If we roll these weights up into the three major regions, we get a portfolio that looks like the pie chart in Exhibit 2. U.S. stocks make up 58% of the global equity market, leaving Europe with 17%, the remaining developed countries with 13% and emerging markets with 12%. Respecting the efficient market hypothesis, we use this breakout as our strategic starting point for client portfolios.

EXHIBIT 2: WHAT THE GLOBAL PORTFOLIO LOOKS LIKE

Efficient market theory implies the most efficient portfolio is the global market cap-weighted one.



Source: Northern Trust Asset Management, Bloomberg. Weights as of 9/30/2020. Annualized standard deviation of monthly total returns in U.S. dollars based on data from 12/31/1969 through 9/30/2020.

Empirical research supports the above theory. The right panel of Exhibit 2 looks at the long-term risk metrics as measured by standard deviation for the U.S., non-U.S. developed and aggregate developed market indexes. We find an interesting result: U.S. equities have a 15.3% standard deviation[1] and non-U.S. developed markets have a 16.8% standard deviation but the combined standard deviation of 14.8% is actually *lower* than both. This is the famous (and sole) “free lunch” in investing. Aggregate standard deviation is not a weighted average of the underlying investments. Instead, any time the correlation between the two investments is less than a perfect “1,” there are diversification benefits to take advantage of. And, should the global economy continue to decouple, there is reason to believe that correlations between the regions will fall. This is because economic cycles may become less synchronized and revenues may become more domestically oriented. We did not include emerging markets in this analysis as the most common emerging market indexes did not start until the late 1980s (vs. the 12/31/1969 start date for developed markets). Emerging markets come with higher standard deviation, but the fact still stands that bringing all regions (including emerging markets) together should result in a lower standard deviation than the simple weighted average — and increase long-term portfolio efficiency.

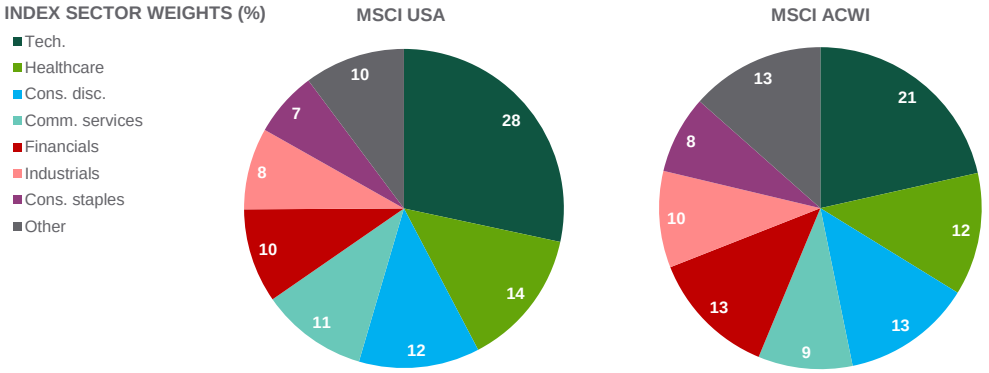
[1] Standard deviation confuses some as they struggle to recollect their Stats 101. But it’s actually fairly simple. One standard deviation (plus or minus) effectively represents ~68% of potential outcomes (assuming normally distributed returns). As such, a 15.3% standard deviation means there is a 68% chance that an asset class’s annual return will fall within +/- 15.3% of the expected outcome. Interestingly, since equity market return forecasts often fall between 5-10%, the range of potential outcomes completely dwarfs the return forecast (humbling many a forecaster).

OTHER ANGLES ON DIVERSIFICATION

Diversification is often discussed in the context of standard deviation (per the previous page). But there are other benefits of casting a wider investment net. For one, the global equity portfolio has more sector balance. As seen in Exhibit 3, the global equity market (MSCI ACWI) has more even sector exposures than U.S. equities alone (MSCI US).This is not the main reason to invest globally — active managers can adjust sector weights to their liking — but it is an additional benefit for passive investors, especially those weary of the high U.S. technology exposure. Note we have grouped the sectors (utilities, materials, energy and real estate) that have become notably smaller over the past decade. Remember this, we will come back to it later.

EXHIBIT 3: A WELL-ROUNDED INVESTOR

Going global results in a more even mix of the various economic sectors.

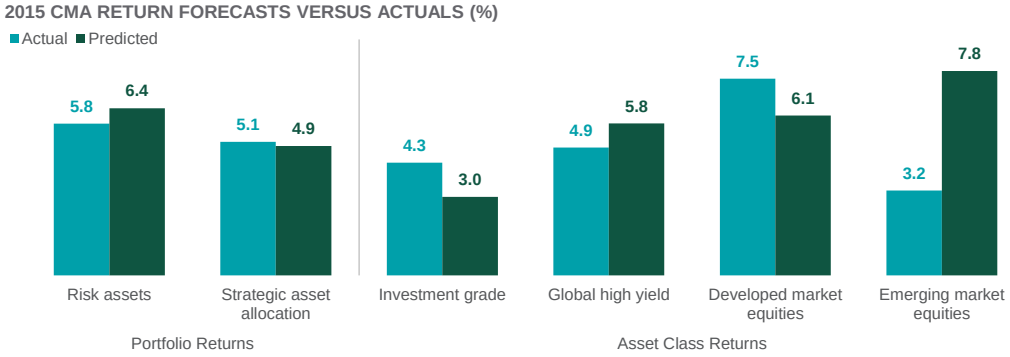


Source: Northern Trust Asset Management, Bloomberg. Index weights as of 10/26/2020.

A second benefit of broad diversification is it tends to increase the accuracy of our return assumptions for the overall portfolio. As an example, Exhibit 4 shows our five-year return assumptions from our *2015 Five-Year Outlook* alongside the actual returns. Forecasting individual asset classes can be difficult but combined forecasts in the overall portfolio are generally closer to the mark. This is especially important when determining how much money to put away now for a future goal (college, trip, etc.). When we "promise" a certain return, we use all tools at our disposal to deliver — and diversification is a big tool that enables us to do so.

EXHIBIT 4: THE UNDERESTIMATED BENEFIT OF DIVERSIFICATION

Diversification not only smooths out returns; it also makes predicting portfolio returns easier.



Source: Northern Trust Asset Management, Bloomberg, Actual data from 6/30/2015 – 6/30/2020. Past performance is no guarantee of future results. Returns and forecasts are in U.S. dollar terms.

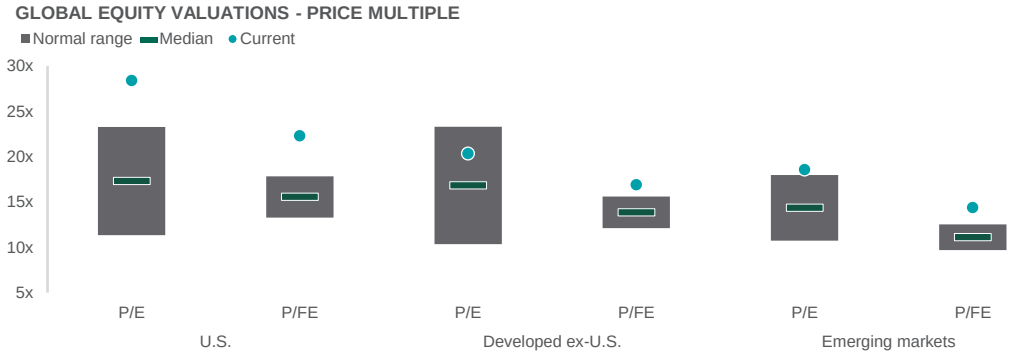
WHAT CURRENT MARKET DATA TELLS US

An obvious retort is that, had the portfolio been invested entirely in U.S. equities, the investor would have had enough money for that planned trip and then some (making for a much more fun vacation!). That's a fair argument — if we had a crystal ball. Hindsight on market returns is always 20/20. While investing solely in U.S. equities would have been the right play over the past decade, it certainly wasn't the right play the decade prior (see Exhibit 1) and may not be the right play over the next decade. We can — and do — make tactical recommendations in an attempt to capture these trends, such as the U.S. equity dominance over the past decade. However, we always begin with the diversified global portfolio.

While making calls on the financial markets can be tough, we do have some guideposts to rely on. For instance, we know that long-term market returns are materially influenced by valuations, which surprisingly provide more information on future returns than future earnings growth rates. This is quite an interesting finding because we know current valuations with certainty but we cannot say the same for future earnings growth. It is true that low (or high) valuations need a catalyst before being actionable. Valuations can stay low or high for extended periods of time, and the predictive power of valuations is greater the longer the investment horizon. However, valuations still should play a central role in the asset allocation process. Exhibit 5 shows current (as of 9/30/2020) price-to-earnings and price-to-forward-earnings ratios for the three major equity regions.

EXHIBIT 5: VALUATIONS HAVE GOTTEN STRETCHED

U.S. stocks have gotten expensive – both versus history and versus other major regions.



Source: Northern Trust Asset Management, MSCI. Data as of 9/30/2020. Indices are MSCI U.S., MSCI World ex-U.S. and MSCI Emerging Markets. Normal range = +/- one standard deviation. P/E represents price over trailing 12-month earnings per share and P/FE represents price over estimated future earnings per share of the next 12 months.

Valuations are above long-term averages everywhere. This can be partly explained by the currently low interest rate environment. But, U.S. equities have notably elevated valuations — both on a historical basis (well outside of the normal range) and versus other regions. There is a credible argument that U.S. valuations should be higher than peer valuations, in part because of the higher allocation to sectors with greater growth prospects (notably technology). But we find that only accounts for ~2 valuation "points" — and right now the current gap between U.S. and non-U.S. developed and emerging market equity valuations is 8 and 9 valuation points, respectively.

As for the fundamental outlook, the potential catalysts for non-U.S. equities to outperform are similar to the catalysts we cited in our recent report on value investing. Many revolve around the potential for smaller gains out of the technology sector (28% of U.S. equity market) — whether it be regulatory changes or the power of natural competition. Other potential catalysts include a U.S. political regime change and a broader rotation into traditional value/cyclical stocks.

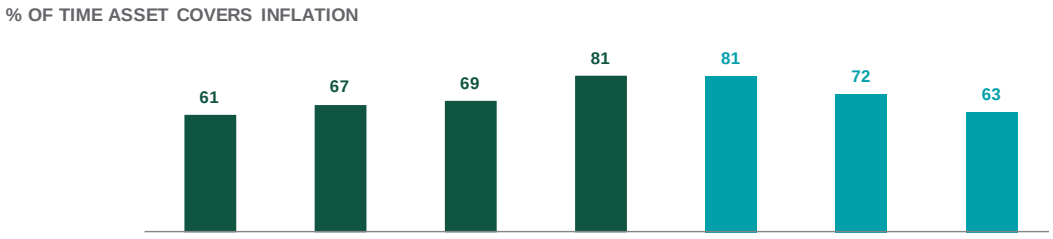
IT'S MORE THAN JUST GOING GLOBAL

We believe a truly diversified portfolio involves more than just investing globally. It also means investing in other asset classes that serve a specific purpose in the portfolio. Asset classes beyond broad global equities that we include in our risk asset portfolio include real assets (global listed infrastructure, real estate and natural resources) and high yield.

Starting with real assets, first we must acknowledge that the underlying equities within all three of these asset classes do show up in our broad global proxy index (MSCI ACWI). Still, as we highlighted earlier, the sectors in which these real asset equities reside (utilities, materials, energy and real estate) have become a smaller slice of the global equity pie. Because we value what these asset classes can bring to the portfolio, we look to increase their weight in the portfolio above and beyond their weight in the global equity market. Natural resources have the best exposure to unexpected inflation — a prospect that is becoming an increasingly bigger risk case given the amount of fiscal and monetary expansion. As seen in Exhibit 6, natural resources "cover" (or outperform) inflation 81% of the time. Further, its gains during "high" inflation periods far outpace the returns of all other asset classes — and certainly traditional equities and fixed income. This makes sense, as natural resources represent a key input to most finished goods — and as the prices of those natural resources go higher, often times so do the prices of the end product.

EXHIBIT 6: THE CASE FOR REAL ASSETS

A major reason for real asset exposure is the inflation sensitivity it provides the portfolio.



Annualized return during:	Fixed income	Global equities	Inf.-linked bonds	Futures-based commodities	Natural resources	Global listed infrastructure	Global real estate
High inflation	4.2	7.6	7.4	13.5	21.5	14.0	9.1
Normal inflation	4.6	8.0	4.0	-4.9	2.6	7.9	8.7

Source: Northern Trust Asset Management, Bloomberg. Data from 12/31/2001-9/30/2020. High inflation (above 2.8%) is the 75th percentile of the data. Normal inflation is below 2.8%.

Listed infrastructure shows a similar relationship to inflation — as companies within are more easily able to pass through inflation to the end buyer. For example, many utilities (~40% of the S&P Global Infrastructure Index) are able to directly pass through higher energy costs to the customer. They are also able to pass through tax increases, which make them an interesting asset class in the event of a presidential victory by Democratic candidate Joe Biden, who may increase corporate taxes. Contrary to popular belief, global real estate does not show much inflation sensitivity — certainly not to the extent of natural resources and listed infrastructure. However, it does bring other benefits to the portfolio. Perhaps most important, it provides exposure to a number of compensated risk factors — not only the market factor (equity risk) but also term (interest rate risk) and default (credit risk). Because of these many risk exposures, global real estate is the equity-based risk asset most likely to "zig" when the broader market "zags." This increases diversification in a portfolio. Also, while global real estate has fallen on hard times (due to things like the Amazon effect, exacerbated by the pandemic), it remains one of the best performing asset classes over the long term. We strongly believe global real estate can still provide a return premium and, at currently inexpensive valuation levels, looks attractive for investors with longer investment horizons.

Finally, we come to high yield. High yield belongs in the hall of fame of asset classes. It's a fixed income asset class by definition but acts more like equity in practice. It has a 0.8 correlation to equities versus a 0.5 correlation to investment grade fixed income. And, as such, we include it in our risk asset portfolio. Interestingly, high yield's equity exposure is asymmetric. Since 1994, global high yield has captured 55% of global equity upside but only 33% of global equity downside (see Exhibit 7). Because of this asymmetric equity exposure, the average monthly return of global high yield is right in line with global equities over this time frame — but with a materially lower risk profile (10% standard deviation versus 15% for global equities).

EXHIBIT 7: THE CASE FOR HIGH YIELD

High yield's asymmetric return profile has provided similar returns to global equities with lower risk.

Source: Northern Trust Asset Management, Bloomberg. Data from 1/29/1993 – 9/30/2020. Global equities = MSCI ACWI; Global high yield = Bloomberg Barclays Global High Yield Index.

The one deficiency of high yield is its tax inefficiency. Current tax law charges a maximum of 23.8% on long-term capital gains (LTCG) and qualified dividends (QD), while high yield returns are mostly charged at the income tax rate — almost always higher than the LTCG/QD rate and certainly higher for the highest income earners (37%). However, a Biden presidency may introduce a wildcard in the tax rate calculus. One Biden platform proposal calls for an increase in LTCG/QD rates to the income tax rate for those making over $1 million. If passed, high yield would be back on a level tax playing field with equity markets, increasing the appeal for highly-taxed investors who have been unable to tuck their high yield holdings away in tax-exempt or tax-deferred accounts.

Regardless of who wins the election – and what tax changes we may see – our *Five-Year Outlook* themes of Retooling Global Growth (prioritizing resiliency over efficiency) and Reimagining Capitalism (shifting monetary gains from capital to labor) are expected to benefit fixed income holders at the expense of equity holders (good-but-not-great economic growth, low interest rates and better-capitalized balance sheets). And high yield sits at the sweet spot to benefit – especially given the low interest rate environment and the search for yield. In fact, our five-year high yield return forecast is higher than our five-year equity return forecasts across the major regions. Here's the upshot: high yield always belongs in a well-diversified portfolio – and may become even more desirable in the years ahead.

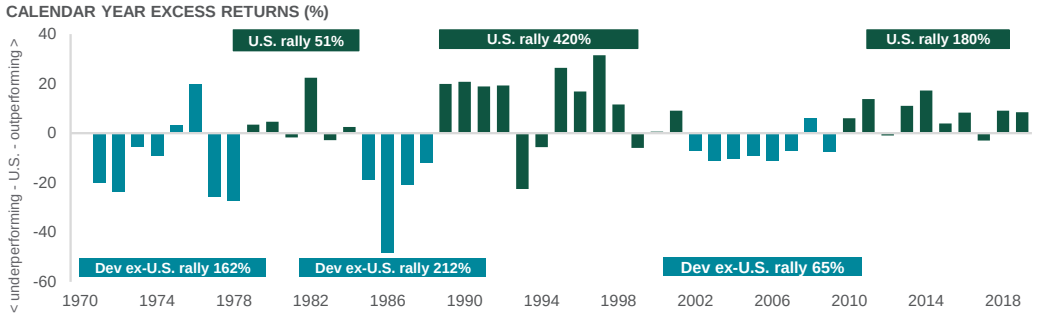
Currently, we recommend strategic allocations (as a percentage of the risk asset portfolio) of 10% to high yield, 3% to global real estate, 3% to listed infrastructure, and 4% to natural resources. Further, we recommend a tactical overweight to both high yield and listed infrastructure as a way to mitigate downside amid current volatility.

SO WHY ISN'T MY GLOBAL PORTFOLIO WORKING?

We've just spent six pages explaining why the global portfolio — combined with the "supporting" asset classes of global real estate, listed infrastructure, natural resources and high yield — is the optimal starting point portfolio for any investor. And yet a simple study of the past decade would conclude that a portfolio of 100% U.S. equities was far superior. We touched on the "hindsight is 20/20" argument, but let's go a bit deeper. It may be hard to believe — as U.S. equities have fairly consistently outperformed for the past 10 years — but non-U.S. equities have had their day in the sun too. Notable non-U.S. outperformance occurred throughout the 1970s, the mid-1980s and most of the 2000s (as highlighted in Exhibit 1 as well). Exhibit 8 shows these fairly pronounced cycles.

EXHIBIT 8: SOMETIMES A CYCLE IS JUST A CYCLE

U.S. stocks have outperformed for a while, but cycles of outperformance are fairly commonplace.



Source: Northern Trust Asset Management, Bloomberg. U.S. rally = excess return of MSCI United States over MSCI World ex-U.S. Data through 12/31/2019. Past performance does not guarantee future results.

Real assets have also underperformed over the last decade but — certainly with respect to natural resources — that is to be expected in an environment of low inflation. Looking at the bigger picture, it is likely broad equities would not have done as well as they did had inflation been higher. So, while the portfolio sacrificed returns due to its real asset exposure, the overall portfolio performed quite well because low inflation kept interest rates low and pushed broad equity valuations higher. Should our risk case of higher inflation take hold, our real assets exposure may help to dampen the potential negative return impact of a reversion toward long-term broad equity valuations.

CONCLUSION: THE GLOBAL PORTFOLIO REMAINS THE OPTIMAL STARTING POINT

It's understandable that investors may be growing impatient with their global portfolio, but we urge those with a global portfolio to stay the course and those without to adopt one. The theory that the global portfolio is the most optimal portfolio is supported by the risk efficiency of the global portfolio as compared to a 100% U.S. equity portfolio (or 100% European equity portfolio, etc.). A global portfolio provides broader sector diversification and allows for more confidence in hitting forecasted return targets. Meanwhile, supporting asset classes such as high yield and real assets can further improve overall portfolio efficiency and provide a smoother ride with protection against key risks such as inflation. Investors fixated on the returns of the past decade would benefit from reviewing the return experience of the early 2000s — and other periods of sustained non-U.S. equity outperformance. With U.S. valuations elevated and increased scrutiny on the high-flying technology sector (28% of U.S. equities), a global portfolio is the prudent approach now more than ever.

Special thanks to Tom O'Shea, Investment Strategist, and Colin Cheesman, Investment Analyst, for data research.

What do you think of this commentary? **Click one:** *Like it* — *Just okay* — *Don't like it*

IMPORTANT INFORMATION. **For Asia-Pacific markets, this information is directed to institutional, professional and wholesale clients or investors only and should not be relied upon by retail clients or investors.** The information is not intended for distribution or use by any person in any jurisdiction where such distribution would be contrary to local law or regulation. Northern Trust and its affiliates may have positions in and may effect transactions in the markets, contracts and related investments different than described in this information. This information is obtained from sources believed to be reliable, and its accuracy and completeness are not guaranteed. Information does not constitute a recommendation of any investment strategy, is not intended as investment advice and does not take into account all the circumstances of each investor. Opinions and forecasts discussed are those of the author, do not necessarily reflect the views of Northern Trust and are subject to change without notice.

This report is provided for informational purposes only and is not intended to be, and should not be construed as, an offer, solicitation or recommendation with respect to any transaction and should not be treated as legal advice, investment advice or tax advice. Recipients should not rely upon this information as a substitute for obtaining specific legal or tax advice from their own professional legal or tax advisors. Information is subject to change based on market or other conditions.

Past performance is no guarantee of future results. Performance returns and the principal value of an investment will fluctuate. Performance returns contained herein are subject to revision by Northern Trust. Comparative indices shown are provided as an indication of the performance of a particular segment of the capital markets and/or alternative strategies in general. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Gross performance returns contained herein include reinvestment of dividends and other earnings, transaction costs, and all fees and expenses other than investment management fees, unless indicated otherwise.

Northern Trust Asset Management is composed of Northern Trust Investments, Inc. Northern Trust Global Investments Limited, Northern Trust Fund Managers (Ireland) Limited, Northern Trust Global Investments Japan, K.K, NT Global Advisors Inc., 50 South Capital Advisors, LLC, Belvedere Advisors LLC, and investment personnel of The Northern Trust Company of Hong Kong Limited, and The Northern Trust Company.