Regardless of where they live, investors have a significant opportunity to diversify their equity portfolios by investing outside their home market. Despite this opportunity, investors on average have maintained allocations to their home country that have been significantly larger than the country’s market-capitalization weight in a globally diversified equity index.

In each market we examined, our analysis indicated that volatility was reduced most with an allocation to international equities of between 40% and 50%. While this observation may help investors determine the appropriate mix of domestic and international equities, volatility reduction is not the only factor to consider.

This paper concludes that although no one answer fits all investors, global market-capitalization weight serves as a helpful starting point in determining the appropriate allocation between domestic and international equities. In practice, many investors will consider an allocation to international equities well below global market-capitalization weight based on their sensitivity to a number of considerations, including volatility reduction, implementation costs, taxes, regulation, and their own preferences.

**Acknowledgments:** This paper is a revision of a Vanguard research paper first published in 2008 as *International Equity: Considerations and Recommendations* by Christopher B. Philips and revised again in 2014 as *Global Equities: Balancing Home Bias and Diversification* by Christopher B. Philips.
As of September 30, 2018, U.S. equities accounted for 55.1% of the global equity market and non-U.S. equities accounted for the remainder. Other developed equity markets that we will discuss in this paper and their percentage of global market capitalization include the United Kingdom (5.4%), Canada (3.0%), and Australia (2.1%).

While the United States is the largest developed market, its size relative to the entire global equity market has fluctuated over time and was as low as 29% in the 1980s (Figure 1). A portfolio invested solely within an investor’s home market, regardless of domicile, excludes a large portion of the global opportunity set.

**Figure 1. Historical mix of global equity market capitalization**

![Graph showing historical mix of global equity market capitalization](image)

**Notes:** The U.S. market is represented by the MSCI USA Index; the non-U.S. market is represented by the MSCI World Index ex USA from 1969 through 1987 and the MSCI All Country World Index ex USA thereafter. Data are as of September 30, 2018.

**Sources:** Thomson Reuters Datastream, FactSet, and MSCI.

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**Notes on risk**

All investing is subject to risk, including possible loss of principal. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income. Diversification does not ensure a profit or protect against a loss. Investments in bonds are subject to interest rate, credit, and inflation risk. Investments in stocks or bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk. These risks are especially high in emerging markets. *Past performance is not a guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.*
At a high level, the benefit of global diversification can be shown by comparing the volatility of a global index with that of indexes focused on individual countries. In Figure 2, the benefit of diversification is clear. While the United States had the lowest volatility of any individual country examined, its volatility was slightly higher than that of the global market index. Other countries examined had volatilities that were 15% to 100% greater than the global market index.

Can multinational corporations provide enough exposure?

One common question about exposure to stocks outside one’s home market is whether domestic multinational companies have enough coverage of foreign markets embedded in their prices. The thinking goes that, because many large domestic firms generate a significant portion of their revenue from foreign operations, the diversification benefits of global investing are already reflected in their prices and performance.

While this aspect of globalization cannot be ignored (and certainly can have an impact on investors’ portfolios), we believe it still makes sense for investors to hold international equities, for several reasons. First, simply focusing on domestic companies means an investor has no stake in leading global companies that are domiciled outside their home market. Second, many firms seek to hedge away currency fluctuations of their foreign operations. Although this can help smooth revenue streams, foreign exchange can be a diversifier for an investor’s portfolio. Finally, a portfolio made up solely of domestic firms is likely to have less-diversified sector exposures than the global equity market portfolio.

Figure 2. Volatility of returns for country and the global market

Notes: Country returns are represented by MSCI country indexes; the global market return, including both developed and emerging markets, is represented by the MSCI All Country World Index. All data are from January 1, 1970, through September 30, 2018.

Sources: Vanguard, Thomson Reuters Datastream, and MSCI.
Given global exposure, how much?

The decision to invest globally is only the first step. The next step is to determine an appropriate allocation.

The standard financial-theory approach, whether for a global allocation or for an allocation within a specific country or market, is to invest proportionally according to market capitalization. This method assumes that markets are reasonably efficient and that stock prices reflect all the available information, investment positions, and expectations of the investing community.

U.S. investors who follow a market-cap-weighted approach would invest 55.1% of their equity portfolio in U.S. equities while investors in countries such as Japan, the U.K., Canada, and Australia would allocate less than 10% of their equity portfolio to their domestic stock market. Scott et al. (2017) found that, in practice, most investors in these markets exhibit a strong home bias and overweight domestic equities relative to their global market-capitalization weight.

Another factor to consider in determining how much to allocate outside domestic equity markets is diversification. One way to evaluate the expected diversification benefits of international equities is to analyze the impact on portfolio volatility as incremental allocations of international equities are added to a domestic equity portfolio. Figure 3 shows the results from the Vanguard Capital Markets Model® (VCMM) of a ten-year forward-looking minimum-variance analysis between domestic stocks and international stocks across four developed markets—the United States, Canada, the United Kingdom, and Australia.

A combination of imperfectly correlated returns across countries and lower global market volatility means that investors in each market examined will likely realize diversification benefits from incremental allocations to international stocks. In each market, the marginal benefit to international diversification declines as allocations to international equities increase and the downward-curving lines in Figure 3 illustrate that volatility actually begins to rise with allocations of greater than 40% to 50% to international equities. Similar conclusions can be drawn from a historical minimum-variance analysis in all of these markets in Figure A-1, on page 11 in the Appendix.

IMPORTANT: The projections and other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from VCMM are derived from 10,000 simulations for each modeled asset class. Simulations as of December 31, 2017. Results from the model may vary with each use and over time. For more information, please see the Appendix.
Figure 3. Adding international equity is expected to reduce the total volatility of a portfolio across markets

10-year expected reduction in volatility—United States

10-year expected reduction in volatility—Canada

10-year expected reduction in volatility—Australia

10-year expected reduction in volatility—United Kingdom

Note: Ten-year expected returns are based on the median of 10,000 simulations from VCMM as of December 31, 2017, in local currency.
Source: Vanguard.
Qualitative considerations

In determining their appropriate allocation to international equities, local investors across the world also are influenced by embedded home biases. These biases can result from regulatory constraints, tax considerations, and behavioral tendencies.

For example, U.S. investors maintained an allocation to U.S. stocks that was approximately 1.5 times greater than the market capitalization of U.S. stocks. Next-closest in terms of bias to their home market were investors in the United Kingdom, who maintained a home bias that was approximately 3.7 times greater than the market capitalization of U.K. stocks (Scott et al., 2017).

Real-world considerations may support allocations to international equities that differ from those suggested by market proportions or a minimum-variance analysis like the one used in Figures 3 and A-1.

Broadly, such considerations involve barriers to investment, such as limitations on the repatriation of investment income, tax considerations, and higher transaction and friction costs (for instance, commissions, opportunity costs, and market-impact costs). Although barriers to cross-border investment have been falling, transaction and investment costs may be higher outside an investor’s home market.

While market-capitalization weight is a valuable starting point, a number of other critical factors should be examined when considering an appropriate allocation to international equities. Investors should carefully weigh the trade-offs, such as volatility reduction, implementation cost, tax considerations, and their own preferences.

Changing diversification benefit

A primary change in the global equity market that has influenced global diversification is the increase in average return correlations. As shown in Figure 4, correlations between returns of stocks in the United States and those outside the United States have increased significantly, from approximately 0.35 in the 1980s to 0.80 as of September 30, 2018. Although longer-term correlations were stable through the 1980s and early 1990s, they increased fairly dramatically between 1994 and 2010. Since then, the trend in long-term correlations across equity markets actually began to flatten, perhaps implying that a ceiling to correlations among equity markets has been reached.

Figure 4. Historically, correlations have risen, meaning less impact from global diversification

Rolling correlations between U.S. and international stocks

Notes: Country returns are represented by MSCI country indexes; emerging markets are represented by the MSCI Emerging Markets Index. Emerging-market data began in January 1988. Data are through September 30, 2018.

Sources: Vanguard and FactSet.
An economic rationale for this outcome is that, despite globalization, factors unique to a country’s markets and economy will prevent perfect correlation between the equity markets of any two countries.

Vanguard’s long-term forecasts of correlations across countries support this rationale. Using our asset simulation model, the VCMM, we generated forward-looking correlations for domestic and international equity over a 30-year period. The results in Figure 5 illustrate that from the Canadian, U.S., Australian, and U.K. investor perspectives, domestic equity market correlations with international equity markets are all expected to be imperfect, implying a continued diversification benefit.

**Figure 5. Imperfect correlations across domestic and international equity markets are likely to continue**

<table>
<thead>
<tr>
<th>Domestic equity and unhedged international equity 30-year median correlations</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
</tr>
<tr>
<td>United States</td>
</tr>
<tr>
<td>Australia</td>
</tr>
<tr>
<td>United Kingdom</td>
</tr>
</tbody>
</table>

Notes: Correlations are for domestic equities to each country’s international equity market.
Sources: Vanguard, from VCMM forecasts as of December 31, 2017 (see Figure A-3, in the Appendix).

**Diversification of return opportunities**

Another benefit of global diversification is the opportunity to participate in whichever regional market is outperforming. This is a critical component of diversification that correlation does not effectively capture. For example, while the United States may lead over some periods, another country or region will invariably lead at other points.

**Figure 6** demonstrates the near-term benefits of global diversification. By including both broadly diversified U.S. and non-U.S. equities in a portfolio, the investor should obtain a return that falls between those of the U.S. market and those of the non-U.S. market. For example, in the mid-1980s and most of the 2000s, exposure to diversified non-U.S. equities would have allowed a U.S. investor to participate in the outperformance of those markets. On the other hand, exposure to U.S. equities for most of the 2010s would have benefited global investors domiciled outside the United States.

Return differentials between equities in the United Kingdom, Australia, and Canada and equities in their international markets have also been observed over time, supporting the case for international diversification in multiple markets (see **Figure A-2**, on pages 12–13 in the Appendix).
We expect that the return patterns between domestic and international equities will continue to differ regardless of where an investor lives, leading to a continued benefit from diversification. Again using the VCMM, Figure 7 illustrates the forecasted distribution of ten-year returns for domestic and global equity markets. Note that Vanguard expects domestic equity returns to differ from historical and forward-looking global equity returns, illustrating the time-varying nature of equity market performance on a relative and an absolute basis.

**Impact of currency exposure**

Investments in foreign markets are exposed to fluctuations in foreign exchange rates. Long term, currency has no intrinsic return—there is no yield, no coupon, no earnings growth. Therefore, long term, currency exposure affects only return volatility. If an investor does not want that volatility, it can be hedged or removed from the international holdings. Primary factors to consider in the equity-hedge decision include currency contribution to volatility, currency correlation with the underlying asset, and investor risk tolerance.1

While currency volatility can be a major driver of risk for fixed income return volatility, for international equities, currency volatility generally plays less of a role long term. In Figure 8 we illustrate the annualized volatility of unhedged international equities and the currency-hedging impact (blue bar). In all regions, the hedging effect is relatively marginal and, sometimes, reduces volatility.

As Figure 8 shows, there are times when hedging may actually lead to higher volatility—note the slightly higher risk for Australian and Canadian investors over the period studied. These results are driven in part by the relationship between the local currency and the underlying asset. For the countries we analyzed, the equity/currency correlation has been dynamic and varied through time. Depending on the investor’s home market, there have been periods when hedging one’s international equity increased volatility (positive correlation) and times when hedging the international equity reduced volatility (negative correlation).

**Figure 7. Vanguard 10-year return expectations—domestic vs. international equity**

<table>
<thead>
<tr>
<th></th>
<th>Distribution of geometric returns (percentiles)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5</td>
</tr>
<tr>
<td><strong>Canadian equity</strong></td>
<td></td>
</tr>
<tr>
<td>Canadian equity</td>
<td>-2.4%</td>
</tr>
<tr>
<td>Unhedged global equity ex-Canada</td>
<td>-2.2%</td>
</tr>
<tr>
<td><strong>U.S. equity</strong></td>
<td></td>
</tr>
<tr>
<td>U.S. equity</td>
<td>-2.4%</td>
</tr>
<tr>
<td>Unhedged global equity ex-U.S.</td>
<td>0.8%</td>
</tr>
<tr>
<td><strong>Australian equity</strong></td>
<td></td>
</tr>
<tr>
<td>Australian equity</td>
<td>-0.7%</td>
</tr>
<tr>
<td>Unhedged global equity ex-Australia</td>
<td>-2.9%</td>
</tr>
<tr>
<td><strong>U.K. equity</strong></td>
<td></td>
</tr>
<tr>
<td>U.K. equity</td>
<td>-3.5%</td>
</tr>
<tr>
<td>Unhedged global equity ex-U.K.</td>
<td>-3.8%</td>
</tr>
</tbody>
</table>

*Note:* Ten-year expected returns are based on the median of 10,000 simulations from VCMM as of December 31, 2017, in local currency.

*Source:* Vanguard.
Countries are ranked by the World Bank each July and divided into four income groups (based on annual gross national income per capita). The groups are: low-income, $1,005 or less; lower-middle-income, $1,006–$3,955; upper-middle-income, $3,956–$12,235; and high-income, $12,236 or more.

Therefore, the equity hedge decision also depends on investor objective. Those with a long investment horizon who are comfortable with equity’s high potential return and volatility may be disposed to accept short-term currency volatility. Those with shorter horizons or an explicit objective to minimize volatility may prefer to hedge the currency risk.

**Role of emerging markets**

Emerging markets are economies or markets that are just entering the global arena or do not meet the criteria to be considered developed economies. For example, the World Bank classifies emerging markets as economies below the upper-middle-income threshold. MSCI, FTSE, and other benchmark providers may consider additional criteria, such as the maturity of financial markets, the structure of transaction settlement, and the freedom of capital, among others.

Many countries (among the better-known ones are the BRICS: Brazil, Russia, India, China, and South Africa) may meet one or more of these criteria, but not all. Those that successfully develop economically, politically, and financially (such as the United States from the 1800s through the 1900s) would be expected to enjoy strong long-term equity market returns.

Because of the higher idiosyncratic, political, economic, and financial risks in emerging-market countries, equities in these markets have historically exhibited greater downside risk than those in developed markets. However, because individual emerging markets are relatively uncorrelated across countries, the risk of investing in all countries is lower. In addition, the unique development patterns of these emerging markets help them to diversify the returns of developed and international markets. Emerging markets also have delivered higher average returns, albeit with higher volatility, than those of developed markets.

The combination of higher expected returns, higher expected volatility, and moderate correlations between emerging and developed markets suggests that a modest allocation to emerging markets is warranted. For many investors, a market-weighted allocation via a mutual fund or exchange-traded fund that is invested across international equities can be a good way to incorporate emerging markets into a diversified portfolio. Such an allocation would ensure constant investment at the market weighting and would help to insulate investors from emerging markets’ potentially severe swings in performance.

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2 Countries are ranked by the World Bank each July and divided into four income groups (based on annual gross national income per capita). The groups are: low-income, $1,005 or less; lower-middle-income, $1,006–$3,955; upper-middle-income, $3,956–$12,235; and high-income, $12,236 or more.
Conclusion

In light of our quantitative analysis and qualitative considerations, we have demonstrated that domestic investors should consider allocating part of their portfolios to international equities. In determining how much to allocate between domestic and international equities, a helpful starting point for investors is global market-capitalization weight. In practice, many investors will consider an allocation below this starting point based on their sensitivity to a number of considerations, including volatility reduction, implementation costs, taxes, regulation, and their own preferences.

References


Appendix

Figure A-1. Adding international stocks has historically reduced the volatility of a domestic stock portfolio

(Panels cover different periods due to data availability. In each case, we used the longest period possible with the available data.)

a. Average annualized change in portfolio volatility when adding non-U.S. stocks to a U.S. portfolio

b. Average annualized change in portfolio volatility when adding non-U.K. stocks to a U.K. portfolio

c. Average annualized change in portfolio volatility when adding non-Australian stocks to an Australian portfolio

d. Average annualized change in portfolio volatility when adding non-Canadian stocks to a Canadian portfolio

Notes: Data are through September 30, 2018. U.S. equities are represented by MSCI USA Index; non-U.S. equities are represented by MSCI World Index ex USA from January 1, 1970, through May 1987, and MSCI All Country World Index ex USA thereafter. Bond data are represented by Salomon High Grade Index from January 1, 1970, through 1972, Lehman Long-Term AA Corporate Index from January 1, 1973, through 1975, and Bloomberg Barclays U.S. Aggregate Bond Index thereafter. Sources: Vanguard and Morningstar.

Notes: Data cover January 1, 1999, to September 30, 2018. Australian equities are represented by MSCI Australia Index; non-Australian equities are represented by the MSCI All Country World Index ex Australia Index. Bond data are represented by the Bloomberg Barclays Global Aggregate ex Australia (hedged to AUD). Sources: Vanguard and Morningstar.

Notes: Data cover January 1, 2001, to September 30, 2018. Canadian equities are represented by the MSCI Canada Index; non-Canadian equities are represented by the MSCI All Country World Index ex Canada Index. Bond data are represented by the Citi World Global Bond Index ex Canada (hedged to CAD). Sources: Vanguard and Morningstar.
a. Trailing 12-month return differential between U.K. and non-U.K. stocks

Notes: Data cover September 30, 2000, to September 30, 2018. U.K. equities are represented by the MSCI UK Investable Market Index; non-U.K. equities are represented by the MSCI All Country World Index ex UK Index. Sources: Vanguard and FactSet.

b. Trailing 12-month return differential between Canadian and non-Canadian stocks

Notes: Data cover September 30, 2000, to September 30, 2018. Canadian equities are represented by the MSCI Canada Investable Market Index; non-Canadian equities are represented by the MSCI All Country World Index ex Canada Index. Sources: Vanguard and FactSet.
About the Vanguard Capital Markets Model

IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. VCMM results will vary with each use and over time.

The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based.

The Vanguard Capital Markets Model® is a proprietary financial simulation tool developed and maintained by Vanguard’s primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include U.S. and international equity markets, several maturities of the U.S. Treasury and corporate fixed income markets, international fixed income markets, U.S. money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta).

At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

Notes: Data cover September 30, 2000, to September 30, 2018. Australian equities are represented by the MSCI Australia Investable Market Index; non-Australian equities are represented by the MSCI All Country World Index ex Australia Index.
Sources: Vanguard and FactSet.

Figure A-2 (Continued). Trailing 12-month return differentials

c. Trailing 12-month differential between Australian and non-Australian stocks

![Graph showing trailing 12-month return differentials between Australian and non-Australian stocks from 2000 to 2018. Australian stocks outperform non-Australian stocks in most years, with significant differences in 2001, 2002, and 2008.]