INVESTMENT
MANAGEMENT

Insights from Omar Aguilar

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Perspective on global equity markets through a behavioral finance lens

The comforts of home

Winter 2017

With the U.S. bull market seemingly unstoppable in 2017, a client's desire to invest primarily in domestic equities may seem intuitively sensible. After all, why diversify into overseas stocks when media headline after media headline highlights the Dow Jones Industrial Average, the S&P 500® Index, and the Nasdaq Composite Index breaking one record high after another? Why face the economic, political, and currency-related risks of investing internationally when information on domestically based equities seems far more transparent, U.S. markets more liquid, and the U.S. bull market still energetic?

Many of your clients have probably expressed a preference for a portfolio heavily tilted toward domestic equities this year. Such a preference is understandable on multiple levels, and certainly not unique to your U.S.-based clients. Investors in Australia, Europe, Japan, the U.K., and many other developed and emerging markets alike have historically shown a similar propensity to invest in domestic-centered opportunities. This behavioral tendency is called "the home bias."

Human nature is complex, and behavioral finance—the study of how emotional, cognitive, and psychological factors influence investment decisions—is an emerging discipline compared with Classical Finance Theory, or even Modern Portfolio Theory. Behavioral finance helps to explain the difference between expectations for efficient, rational investor behavior and actual results. In this edition, we explore the home bias and provide key takeaways to help advisors prepare clients for the challenges that may arise in 2018.

Key takeaways:

- From a behavioral finance perspective, the home bias represents a propensity to focus on domestic investments.
- However, such an approach ignores a wealth of overseas opportunities and can be a performance-inhibiting choice.
- From a generational standpoint, baby boomers are more likely to be affected by the home bias than millennials.
- When planning for 2018 with your clients, consider reducing momentum-based exposures in the U.S. and focusing instead on higher-quality companies.
- In addition, consider exploring the wealth of low cost, index-based opportunities among developed international and emerging markets with your clients.

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Piecing together the home bias puzzle

A considerable number of factors may be convincing your clients to remain heavily tilted toward domestic opportunities. Concerns about corporate governance could be one factor, coinciding with a tendency for investors to perceive that financial oversight in their home country is more robust than among other developed international markets. Your clients may also demonstrate more general optimism regarding the domestic outlook compared with developed international markets, whether or not that perspective has been justifiable. Worries over potential tax considerations, concerns over geopolitical risks, uncertainty regarding direct transaction costs, and fears about liquidity constraints are other influences that may be playing into your clients' seemingly innate desire for a heavily domestic-focused portfolio. However, most of these considerations are no longer applicable in today's increasingly low cost, transparent investing environment.

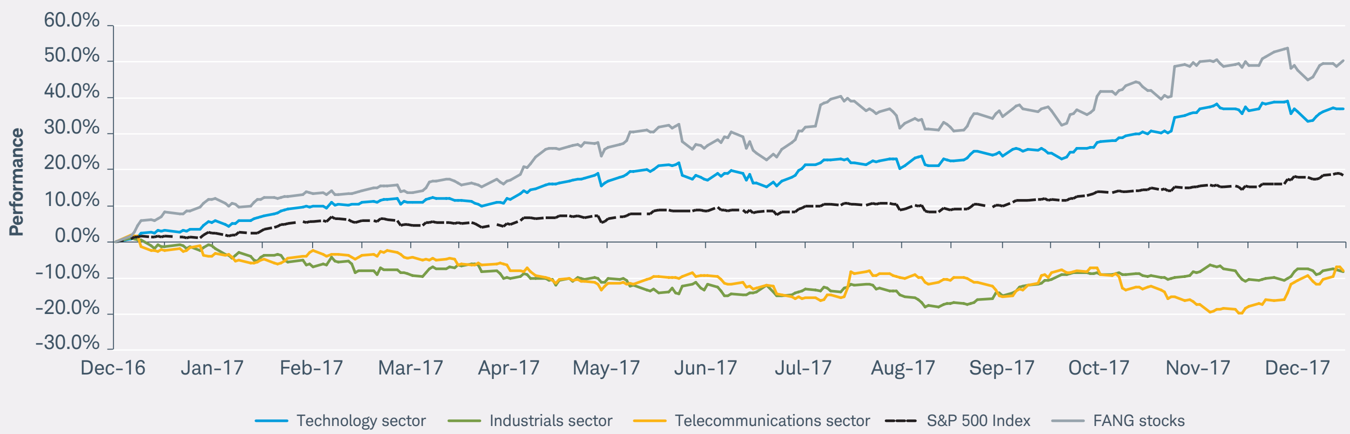
A technology-driven performance in 2017

Neither the unprecedented political climate in the U.S. nor heightened tensions with North Korea have dented consumer and investor confidence for long this year. Select gauges of both confidence measures have recently been registering their highest levels in more than a decade, while the S&P 500 Index has broken through one record high after another. These results may be convincing some of your clients that a heavily concentrated portfolio in U.S. large caps is the correct long-term approach. However, deconstructing this year's performance by the S&P 500 Index in the chart below helps to underscore the potentially overlooked concentration risks that a home-biased approach can represent.

Comprising more than 20% of the S&P 500 Index this year based on market capitalization, the Technology sector frequently drives the index's performance, and has generated roughly 150% of the returns of any other single sector in 2017. Woven into this year's Technology sector story have been the "FANG" stocks—Facebook, Amazon, Netflix, and Google—which have often led the momentum-based charge, while featuring prominently in media headlines and generating returns ranging from approximately 40% to nearly 60%.[1] However, with forward-looking P/E ratios for the U.S. Technology sector continuing to rise in 2017, how much room is there for further stretching in 2018?

A closer look at S&P 500 Index, select sectors, and FANG stock returns for 2017

Technology solidly outperformed other sectors in 2017, but how much room is there for further stretching in 2018?



Sources: Charles Schwab Investment Management, Inc.; Bloomberg. Data illustrates the cumulative price performance of the S&P 500 Index, selected sector indexes within the S&P 500 Index, and FANG stocks—using a blended benchmark that includes Facebook, Amazon, Netflix, and Google—from 12/31/2016 through 12/14/2017, with each index normalized to a starting value of zero percent.

A wealth of emerging opportunities overseas

What some of your home-biased clients may not realize is that several industry-leading international companies have generated equally if not stronger results than the FANG stocks this year. For example, Alibaba and Tencent—both on the forefront of the e-commerce wave in China—have risen by 98% and 111%, respectively, so far in 2017.[2] Companies such as Sina, a global Internet media company, and Baidu, which operates an Internet search engine, have also generated returns this year that are nearly as strong or stronger than those of Facebook, Amazon, Netflix, or Google.[3] As the world's second-largest economy, China is rapidly evolving from its former status as a noteworthy emerging market to an economic powerhouse on the rise. As the performances of these international companies help to illustrate, a wealth of investment opportunities exist beyond the U.S. that are worth careful consideration.

Another point that may have escaped some of your home-biased clients is that developed international markets and emerging markets alike have been outperforming U.S. large caps in 2017. The U.S. bull market is more than eight years old and easily one of the longest on record. By comparison, many overseas economies—particularly emerging markets, which are benefiting from the synchronized global economic recovery—are still in the early innings of their own turnarounds. The chart below helps to illustrate the relative upside potential of international markets, underscoring why a conversation with your clients about overseas opportunities could potentially strengthen your relationships.

> When speaking with your clients, keep in mind that baby boomers are particularly at risk from the home bias.

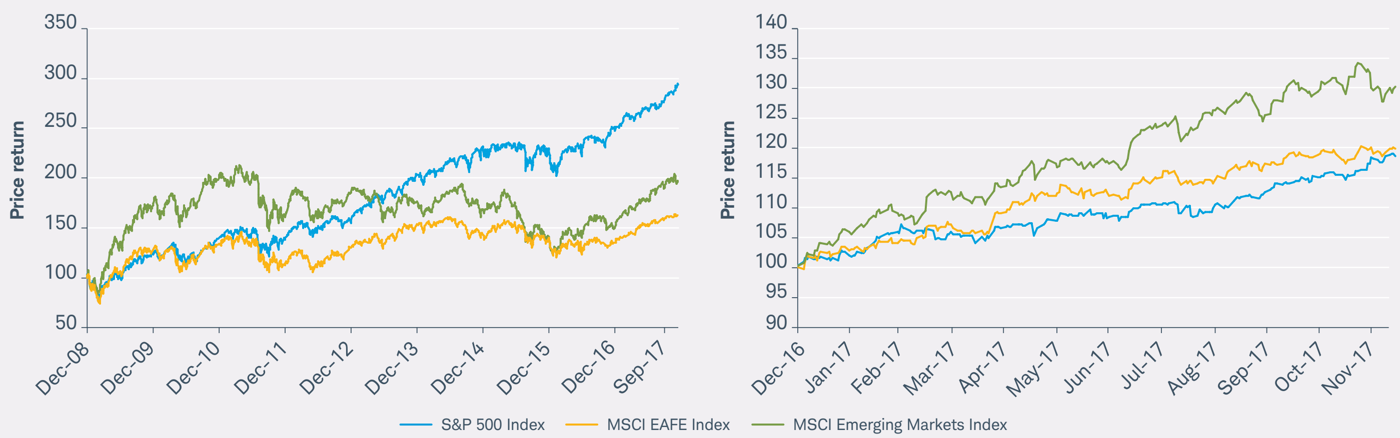
Baby boomers often stay too close to home

When speaking with your clients about international opportunities and the potential benefits of diversification, keep in mind that baby boomers are particularly at risk from the home bias. Research supports this point, revealing that only about 16% of the average baby boomer's portfolio is invested in overseas opportunities, compared to 20% for the typical investor.[4]

Baby boomers grew up during a time when investing overseas was far from the comparatively transparent experience available today amid a broad array of low cost ETFs and index-based mutual fund options. Boomers are risk takers by nature, but prefer to be confident about their endeavors. Taking the time to explain the present-day realities could potentially deepen the level of trust that you enjoy with your clients.

Large-cap U.S. stocks have outperformed since 2008,

but are now generally trading at stretched valuations, while international equities seem attractively priced by comparison.



Sources: Charles Schwab Investment Management, Inc.; Bloomberg. Data for both charts illustrates the price returns of the S&P 500 Index, the MSCI EAFE Index, and MSCI Emerging Markets Index from 12/31/07 through 12/14/17, and from 12/31/16 through 12/14/17, with each index normalized to a starting value of 100.

Millennials tend to range far and wide

Millennials, the largest living generation, are far less susceptible to the home bias than boomers. Data tends to drive the decisions made by millennials, who are predisposed toward skepticism and tend to rely on their own insights and research to spot potential investment opportunities. By the very nature of their day-to-day interactions—which range far and wide—millennials tend to be more receptive to conversations regarding overseas opportunities, as underscored by research showing that approximately 23% of millennial portfolios are invested in international investments.[5] This is a noteworthy percentage given how much smaller the average millennial account is compared to the average baby boomer account.

On the horizon

As we turn toward 2018, select stocks and sectors could prove vulnerable in the New Year, while market volatility seems poised to increase. Consider speaking with your clients about the potential benefits of reducing exposure to momentum-based strategies that have outperformed in 2017 and increasing exposure to higher-quality companies that emphasize prudent capital expenditures and quality earnings streams. Consumer cyclicals, multinational companies that materially benefit from overseas commerce, Health Care, and select Technology stocks like semiconductors also appear to present potential opportunities worthy of consideration.

From a behavioral finance standpoint, examine your clients' portfolios with a careful eye toward whether or not the home bias has tilted their allocations too heavily toward domestic investments. Remember that baby boomers are predisposed to being more reluctant than your millennial clients when discussing international diversification opportunities. When preparing for such conversations, revisit some of the factors discussed earlier in this edition that may be contributing to your clients' home-bias influences, and keep in mind the upside potential that international developed and emerging markets represent for your clients.

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Past performance is no guarantee of future results.

[1] Charles Schwab Investment Management; Bloomberg; total returns from 12/31/16 to 12/18/17; Facebook (Facebook Inc-A); Amazon (Amazon.com Inc.); Netflix (Netflix Inc); Google (Alphabet Inc-CL A; Alphabet Inc-CL C).

[2] Charles Schwab Investment Management; Bloomberg; total returns from 12/31/16 to 12/18/17; Alibaba (Alibaba Group Holding-SP ADR); Tencent (Tencent Holdings Ltd-UNS ADR).

[3] Charles Schwab Investment Management; Bloomberg; total returns from 12/31/16 to 12/18/17; Sina (Sina Corp); Baidu (Baidu Inc.-SPON ADR).

[4] *Millennial and baby boomer investors survey: Data report;* Securian Financial Group, June 2016.

[5] *Ibid.*

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