Investment Management

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Insights from Omar Aguilar

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Perspective on global equity markets through a behavioral finance lens

Piecing together the home bias puzzle

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With the U.S. bull market charging past one obstacle after another over the past 10 years, your clients may be expressing a desire to invest primarily in domestic equities. This approach may even seem entirely sensible on the surface. After all, why face the economic, political, and currency-related risks of investing internationally when U.S. stocks seem to keep posting one record high after another in spite of short-term knockdowns. Isn't information on companies near home far more transparent and reliable? Why should a client ever invest overseas?

The home bias is a global phenomenon

At one time or another, your clients may have expressed comments similar to those just mentioned, reflecting our innate predisposition toward the comfortable and familiar. Your clients aren't alone, either. This same preference has been demonstrated around the world: investors in Australia, Europe, Japan, the U.K., and many other countries have historically shown a similar predisposition toward investing in domestic-based opportunities. In behavioral finance terms, this tendency is known as "the home bias." We focus on this bias and its effects in this edition of our recurring behavioral finance insights series, which we created to give advisors a practical tool that translates behavioral finance theory into actionable practice.

Key takeaways

- From a behavioral finance perspective, the home bias represents a preference for domestic investments.
- Focusing too heavily on domestic equities may cause your clients to miss out on the wealth of overseas stock market opportunities.
- Older generations are more likely to be affected by the home bias than younger generations.
- When planning asset allocations for 2020 with your clients, consider exploring the wealth of low-cost international investment opportunities.

Addressing transitory and structural concerns

A variety of transitory concerns may be convincing your clients to focus on domestic equities. Advisors have told us that their clients worry about: (1) slowing global growth; (2) the trade war between the U.S. and China; (3) political uncertainty in Italy; (4) the ongoing fallout from Brexit; and (5) escalated Middle East tensions. Although such concerns always merit thoughtful discussion, we believe that a sound portfolio construction framework is one that can weather current events over multiple market cycles. We think this approach better empowers investors to ignore the inevitable ebb and flow of media headlines surrounding the latest hot topic and instead focus on their long-term financial goals. Structural concerns may also be deflating your clients' interest in overseas investments. For example, corporate governance may be a dissuading factor, coinciding with a tendency for an investor to perceive that financial oversight in their home country is more robust than overseas. Uncertainty regarding transaction costs and liquidity are other potential concerns. However, these roadblocks are far less menacing today than they were a decade ago. Thanks in part to the rapid expansion of passive investing, many markets that were previously unreachable are not only available now, but the reliability and transparency of holdings-related information have also improved, supporting potential liquidity in the process. The drive toward low costs is another plus for investors.

> Nearly half of the global market for equities is comprised of developed international markets and emerging markets.

Nearly half of the global market

The sheer size of the international equity market is another reason why it merits consideration. The pie chart on the left below demonstrates this point, showing that although U.S. equities comprised 54% of the MSCI AC World Index as of December 31, 2018, the remaining 46% represented European, Japanese, United Kingdom, emerging market, and other countries' equities. Using this data as a proxy, a client's choice to ignore international markets translates into an active decision to ignore almost half of the available universe of stock market opportunities. In addition, data from Cerulli Associates in partnership with the Investments & Wealth Institute and the Financial Planning Association revealed that the home bias is firmly entrenched among financial advisors, with U.S. allocations representing 70% of their assets, developed international allocations representing 22%, and emerging markets representing 8% (see the chart at bottom right).

International equities are nearly half of the global market

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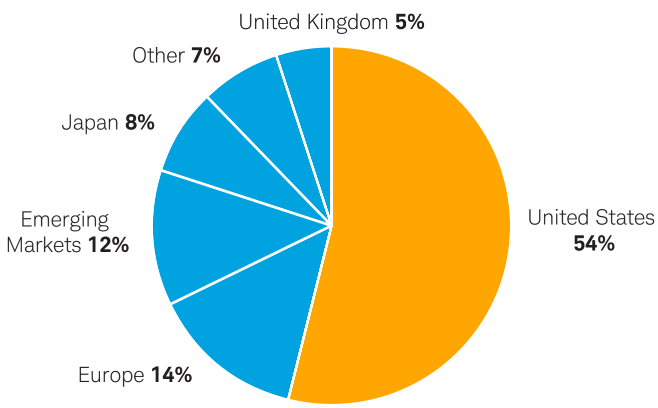
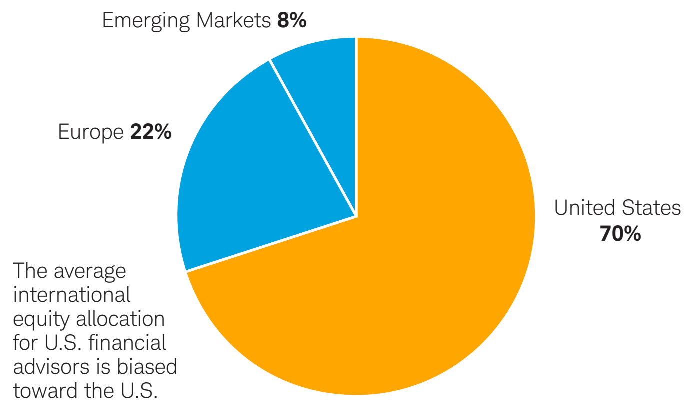


Sources: Charles Schwab Investment Management; MSCI AC World Index, as of 12/31/18.

Home bias is clear in strategy allocations



Sources: Charles Schwab Investment Management; Asset Allocation for Moderate Risk Investors Databank, 2017. Cerulli Associates, in partnership with the Investment and Wealth Institute and the Financial Planning Association, 2018.

The ebb and flow of market leadership

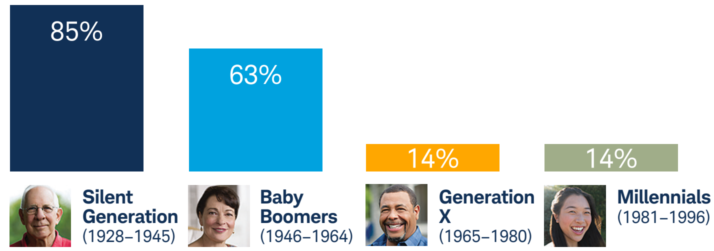
U.S. equities have been one of the world's bright spots since the markets began to recover from the Great Recession (the longest recession since World War II), but how long will that outperformance last? When taking a long-term view, U.S. market leadership has waxed and waned over time. The chart below illustrates this point, revealing that the outperformance of the S&P 500® Index compared with the MSCI EAFE® Index since approximately September 2009 was preceded by a period of underperformance by U.S. stocks from approximately late 2003 to late 2008. Although past performance doesn't guarantee future results, in this instance, it does illustrate the potential importance of investing overseas.

Older generations stay too close to home

When speaking with your clients about international opportunities, keep in mind that older generations are particularly at risk from the home bias. Data from Investments & Wealth Institute suggested that 63% of Baby Boomers (1946–1964) demonstrated a home bias within their portfolios. This bias was even more prevalent among The Silent Generation (1928–1945), 85% of whom appear to be affected by the home bias. These generations grew up during times when investing overseas was far from the comparatively transparent experience available today amid a broad array of international investment opportunities.

Explaining the present-day realities to your Boomer and Silent Generation clients could potentially deepen the level of trust that you enjoy. The following chart illustrates how the home bias differs by generation.

Home bias differs by generations

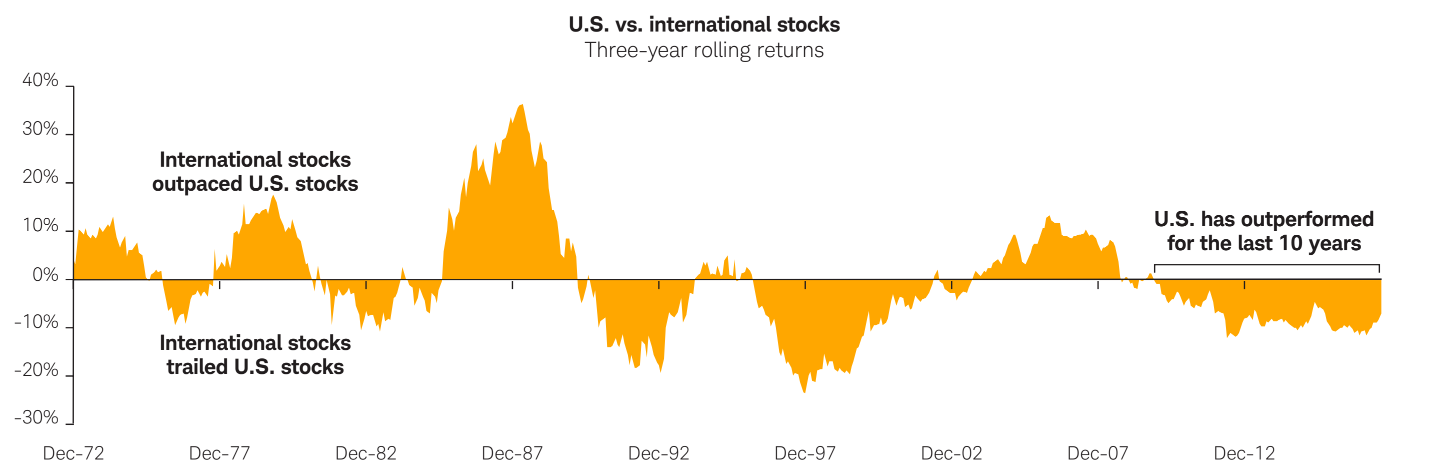


Sources: Charles Schwab Investment Management; Investments & Wealth Institute (IWI), 2019.

Younger generations embrace international investing

Generation-X (1965–1980) and Millennials (1981–1996) appear far less susceptible to the home bias than Boomers or Silents. By the very nature of their day-to-day interactions—which often range far and wide—these generations tend to be more receptive to international investment opportunities, with only 14% of each of these generations showing signs of being affected by the home bias. This represents a meaningful opportunity for advisors to discuss international diversification with their younger-generation clients.

U.S. and international markets alternate leadership



Sources: Charles Schwab Investment Management; Bloomberg. Data from 12/01/72 to 08/31/17. Data represents the rolling three-year total return of the S&P 500 Index versus the total return of the MSCI EAFE Index.

Past performance is no guarantee of future results. Indexes are unmanaged; do not incur management fees, costs, and expenses; and cannot be invested in directly.

On the horizon

As 2019 starts winding down, intermittent market volatility seems likely to persist amid ongoing trade tensions between the U.S. and China, which have been a significant catalyst for market movements. Central banks (including the U.S. Federal Reserve) around the world easing monetary policies to combat decelerating global growth, and political uncertainty in the U.K. related to Brexit also represent challenges and may play a role in the market's near-term performance. In addition, don't forget the 2020 U.S. presidential election, which could significantly influence where the markets finish next year.

With this backdrop in mind, now seems like an excellent time to emphasize quality stocks and carefully monitor shifts in economic growth domestically and internationally. Re-evaluating your clients' relative portfolio risks may also be worth considering, as the most optimistic scenarios regarding several of the previously mentioned challenges seem to be priced into the markets. We expect to lean toward higher-quality growth companies in cyclical sectors like technology, consumer discretionary, and industrials if these conditions persist, while potentially looking to trim exposures to momentum-based strategies, and wouldn't be surprised to see stocks of firms in the financials, energy, and health care sectors underperform over the near-term.

From a behavioral finance standpoint, we suggest examining your clients' portfolios with a careful eye toward whether the home bias has slanted their asset allocations too heavily toward domestic securities. Also, remember that when you discuss international opportunities with clients, younger generations are likely to be far more receptive to such conversations than older generations. Silents and Baby Boomers in particular might appreciate and benefit from an enhanced understanding of how international investment opportunities have evolved, particularly over the past decade.

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Omar Aguilar is Chief Investment Officer (Equities and Multi-Asset Strategies) of Charles Schwab Investment Management, Inc. (CSIM), a subsidiary of The Charles Schwab Corporation. Aguilar joined CSIM in 2011 and is responsible for equity and asset allocation mutual funds, ETFs, and separately managed accounts. Aguilar has more than 20 years of broad investment management experience in the equity markets, including managing index, quantitative equity, asset allocation, and multi-manager strategies. Aguilar received a BS in actuarial sciences and a graduate degree in applied statistics from the Mexico Autonomous Institute of Technology (ITAM). He was a Fulbright scholar at Duke University's Institute of Statistics and Decisions Sciences, where he earned his MS and PhD.

The S&P 500 Index is designed to measure the performance of 500 leading publicly traded companies from a broad range of industries.

The MSCI ACWI is a market capitalization-weighted index that captures large and mid-capitalization across 23 developed markets and 26 emerging markets countries.

The MSCI EAFE Index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed markets in Europe, Australasia, and the Far East.

Please visit schwabfunds.com/glossary for additional index information. Indexes are unmanaged, and do not incur fees, and it is not possible to invest directly in an index.

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