Nationwide®
is on your side

Mutual funds

White paper

Global investing: Open for opportunities

The case for portfolio diversification with international equities

Mark Hackett
Chief of Investment Research,
Nationide Financial

KEY HIGHLIGHTS

- U.S. stocks have outperformed international stocks since the market bottom in 2009, but current valuations appear to favor developed and emerging international stocks.
- Sectors and industry exposures in international stock indices are substantially different than the S&P 500, offering different diversification and income benefits.
- Most international economies continue to lag the U.S. in vaccine distribution and business re-opening, which may lead to strong relative performance when the U.S. growth cycle peaks.

SUMMARY

The U.S. equity market has consistently outperformed international stock markets since the end of the financial crisis due to faster economic growth, expanding price-to-earnings multiples and greater exposure to the technology sector. Because of the structural, political and demographic challenges facing international markets, many investors are wondering if the time for international exposure in a diversified portfolio has passed. While the duration and magnitude of underperformance has been severe, exposure to international markets may continue to provide diversification benefits. Moreover, the stage may be set for international stock markets to catch up to U.S. stock markets.

PERFORMANCE: GOING GLOBAL CAN LOWER RISK

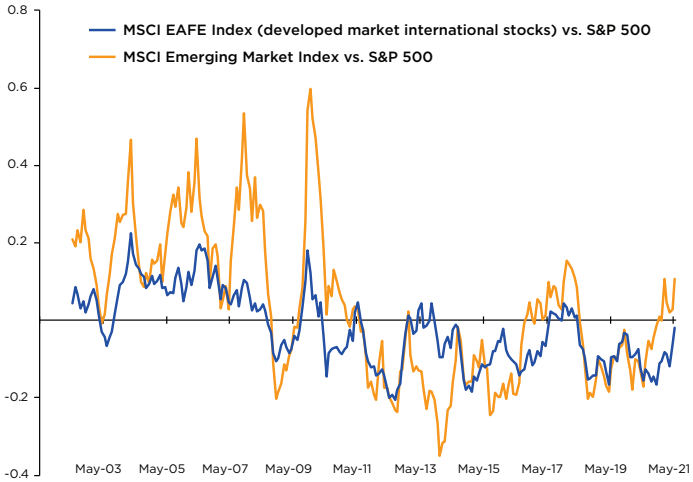
The S&P 500® Index has outperformed the MSCI EAFE by an average of 7.5% and the MSCI Emerging Market Index by 6.5% annually since the end of the financial crisis. Through that period, the U.S. has experienced faster economic and earnings growth, but has also benefitted from substantial expansion of stock valuations. On a rolling yearly basis, the international indexes have mostly underperformed the S&P 500 (See Chart 1 on following page).

Periods of outperformance and underperformance of international stocks versus U.S. stocks tend to be lengthy; the last extended period of outperformance for international stocks occurred after the technology bubble of the late 1990s and early 2000s. There are other similarities to that period, including elevated valuations in the technology sector and substantial outperformance of growth stocks relative to value. International equity markets tend to be dominated by cyclical and traditional value sectors, including financials, industrials and consumer cyclicals, while the S&P 500 is dominated by technology. Through April 2021, international stocks substantially outperformed U.S. markets as investors shifted to pro-cyclical and value-oriented stocks, though that trend reversed modestly in June as growth returned to leadership. If value sectors begin to catch up to growth, international equities are likely to follow suit.

Despite the extended period of underperformance, exposure to international stocks in a diversified portfolio has lowered volatility relative to a portfolio

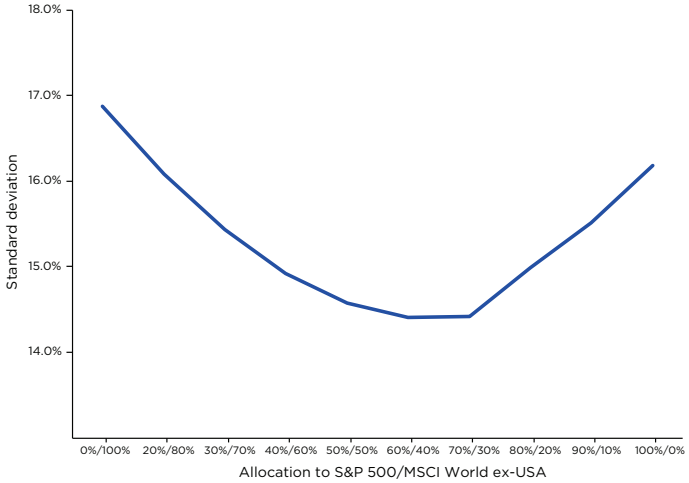
solely comprised of U.S.-only stocks. As illustrated (See Chart 2 below), a portfolio with a 40% allocation to the MSCI World Index had a 14.4% standard deviation over the 51 year period from 1970 to 2021. In comparison, the standard deviation of the S&P 500 over that time was 16.2%. Moreover, the balanced portfolio had a better Sharpe ratio, reflecting the diversification benefit of investing internationally.

Chart 1: Relative performance vs. S&P 500 Index (trailing 12 mos.)



Source: FactSet, 06/30/21.
Past performance does not guarantee future results.

Chart 2: Portfolio standard deviation, 1970-2021



Source: Morningstar, 06/30/21.

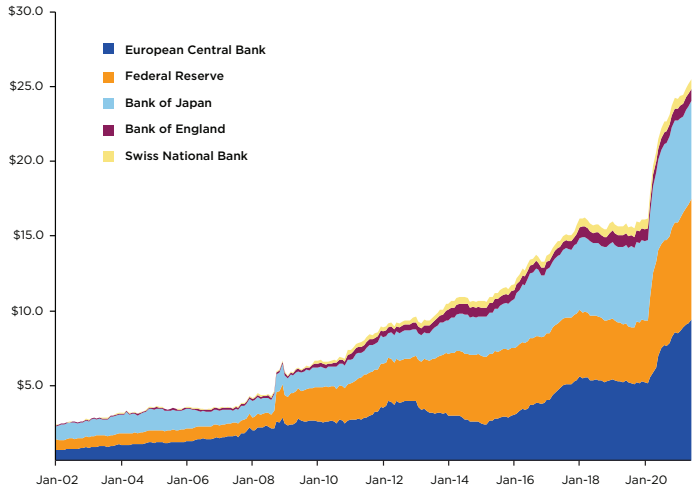
RECOVERY: GLOBAL STOCKS CLOSE THE GAP

The global economy staged a remarkable recovery from the lockdowns in 2020, helped in large part by aggressive fiscal and monetary support (See Chart 3 below), along with earlier vaccine distribution and resumption of mobility and business activity. The rest of the world has also benefitted from aggressive fiscal and monetary spending, but economic re-openings in other countries have generally lagged the U.S. Recent data from global economies suggest a strong recovery may be in the offing.

It's not unusual for the U.S. to lead the rest of the world out of recession, as historical patterns show the U.S. is often among the strongest economies in the early stages of a global recovery. But as the U.S. economic recovery matures, the rest of the world often catches up, performing better in the mid-to-late phases of the global expansion. This is particularly true for emerging markets that are reliant on developed market consumers and businesses to drive their economic growth.

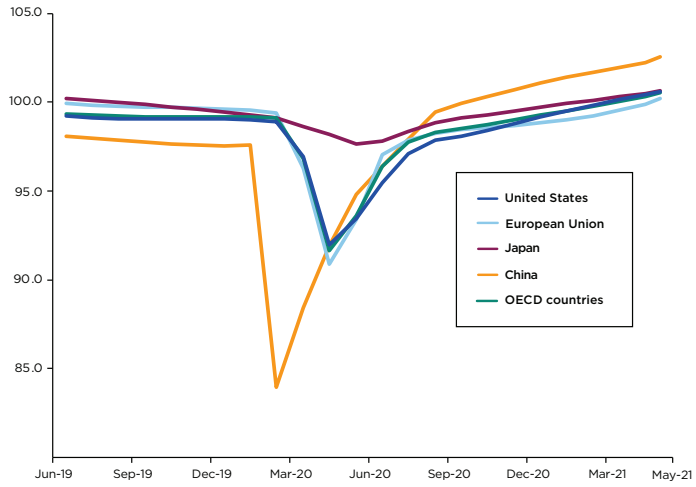
Leading indicators show a balanced recovery among geographies. (See Chart 4 below.) China was the earliest economy to slip into recession and showed the sharpest decline, but China has also experienced the strongest recovery from recession lows. Trends in the U.S. and among advanced OECD economies are largely consistent in their declines and recoveries.

Chart 3: Global central bank balance sheets ($ trillion)



Source: Federal Reserve Bank of St. Louis (FRED), 06/30/21.

Chart 4: Leading economic indicators of major global economies



Source: FactSet, 06/30/21.

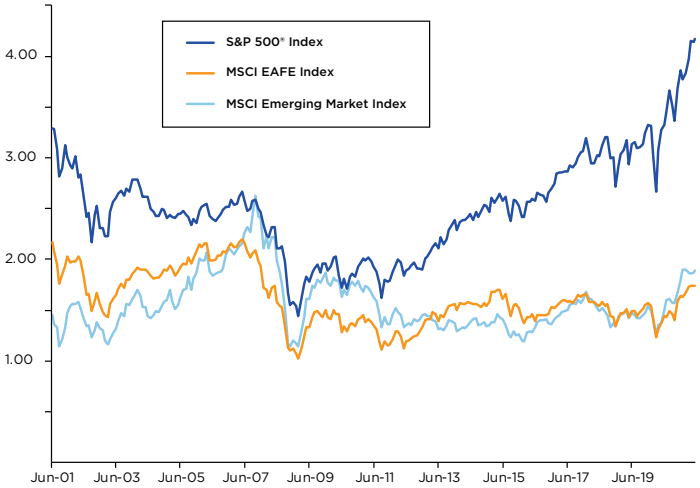
VALUATION: OPPORTUNITIES AT A RELATIVE DISCOUNT

International stock indices have substantial sector and industry exposure differences to the S&P 500® Index. For example, the MSCI EAFE Index is comprised of more pro-cyclical and value factors; as of June 30, 2021, the financial, industrial and consumer discretionary sectors comprise 46% of the MSCI EAFE Index. Conversely, the S&P 500 is more exposed to growth factors, with technology, consumer discretionary and health care comprising 53% of the U.S. index's weight. The differences in sector exposure tends to lead to extended periods of outperformance and underperformance, but also provides a diversification benefit to investors.

The post-financial crisis period is notable for the strong performance of growth stocks versus value and domestic U.S. equities versus international. This outperformance has created a stark valuation difference between U.S. and international stocks. The price-to-book ratio for the S&P 500 tripled from 1.4x to 4.2x since 2009, while the price-to-book multiple expansion for the MSCI EAFE and Emerging Markets indices has been far more modest. (See Chart 5 below.) Valuation is traditionally a poor predictor of near-term returns but has strong inverse correlation with longer-term results; stocks purchased at modest valuations have historically produced better returns. This occurred following the technology bubble, where international markets enjoyed an extended period of outperformance.

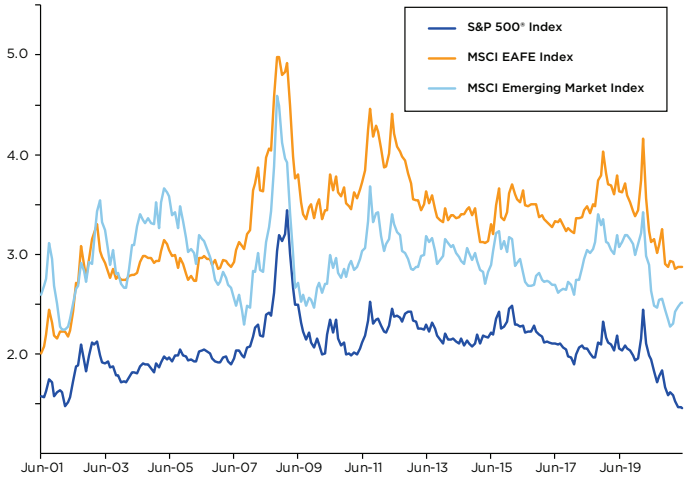
The sector exposures also lead to a substantial yield advantage for international equities over U.S. stocks. As of June 30, 2021, the MSCI EAFE and Emerging Market indexes yielded 2.9% and 2.5% respectively, a solid advantage over the 1.5% dividend yields for the S&P 500. (See Chart 6 below.) In periods of strong price returns, investors pay less attention to dividends. But as the cycle matures and returns become more difficult to achieve, a 100-basis point advantage in yield will provide a tailwind for relative returns.

Chart 5: Price-to-book ratio (next 12 months) for major global stock indexes



Source: FactSet, 06/30/21.
Past performance does not guarantee future results.

Chart 6: Dividend yield (next 12 months) for major global stock indexes



Source: FactSet, 06/30/21.
Past performance does not guarantee future results.

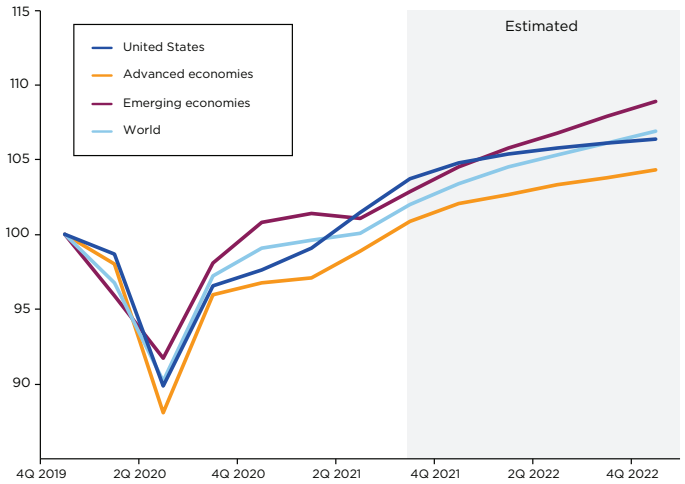
GROWTH: EARNINGS WILL LIKELY BE KEY

Growth for developed international markets has been sluggish since the global financial crisis. From 2013 through 2019, the U.S. grew an annualized rate of 2.5%, slightly ahead of the 2.2% annualized rate of growth for advanced economies (which includes the U.S.) but below the 4.3% annualized pace of growth for developing economies and global pace of growth of 3.3% annualized. (See Chart 7 on following page.) Between 2019 and 2022, the United States is forecast to grow a cumulative 6.4%, compared with 4.3% estimated growth for advanced economies and 8.9% estimated growth for emerging economies. While population growth and other demographic trends may continue to push domestic growth above that of the developed world, U.S. growth is likely to lag the developing world.

Earnings growth will likely be key in determining the long-term relative performance of domestic U.S. stocks versus international markets. The recovery in earnings in 2021 is strongest outside of the United States, with notable strength in emerging markets. (See Chart 8

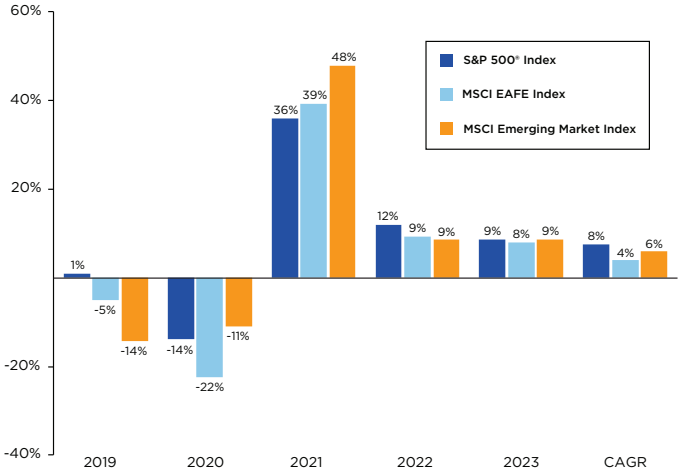
below.) Beyond this year's recovery, expected growth rates are similar among the U.S. and international stocks indexes, highlighting the substantial valuation gap and opportunity available from international equity markets.

Chart 7: Cumulative real Gross Domestic Product growth (2019-2022 est.)



Source: FactSet, 06/30/21.
Past performance does not guarantee future results.

Chart 8: Earnings growth of major global stock indexes



Source: FactSet, 06/30/21.
Past performance does not guarantee future results.

CONCLUSION

The global recovery from the coronavirus pandemic has arrived, and central banks around the world remain committed to driving economic growth. The rest of the world is mostly behind the U.S. in terms of business re-opening, vaccination distribution and economic trajectory. But as other countries and regions catch up with the U.S., equity markets are likely to reflect the opportunity for economic expansion. Given the severe valuation and performance gaps, international stock markets could see an extended period of outperformance that has not been seen since the years following the technology bubble. Additionally, given the greater dividend yield and diversification benefit, exposure to international equities is important for a well-balanced portfolio.

Key takeaways

1

At current valuation levels, international stocks **appear to offer better potential** relative to U.S. stocks for future return opportunities.

2

Adding international stocks to a portfolio of predominantly domestic U.S. stocks offers **potential for greater diversification and lower risk.**

3

The U.S. has mostly led the global economic recovery from the pandemic recession, but **other global regions are poised to close the gaps in growth.**

ABOUT THE AUTHOR

Mark Hackett serves as Chief of Investment Research. As a leader for Nationwide's capital markets analysis, Mark develops content to educate financial advisors and their clients on financial markets and implications for investors. In this role he is responsible for asset class research, market commentary, white papers and topical market pieces. Mark brings more than 20 years of experience in the asset management industry, including roles in research for both Nuveen and Vanguard Group and as a portfolio manager for Nuveen. He began his investment career at the Vanguard Group as a research associate in the fixed income group.

Mark has been interviewed by and quoted in numerous media outlets, including The Wall Street Journal, CNBC.com, CNN Money, The Associated Press Money and several others. He also contributes weekly market commentary to the Nationwide Advisor Advocate Blog.

He earned his Bachelor of Science in Business Administration with concentrations in Finance and Economics at the University of Richmond, holds Chartered Financial Analyst (CFA) and Chartered Market Technician (CMT) designations and is a member of the CFA Institute.

This material is not a recommendation to buy or sell a financial product or to adopt an investment strategy. Investors should discuss their specific situation with their financial professional.

Except where otherwise indicated, the views and opinions expressed are those of Nationwide as of the date noted, are subject to change at any time and may not come to pass.

S&P 500® Index: An unmanaged, market capitalization-weighted index of 500 stocks of leading large-cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance.

MSCI EAFE® Index: An unmanaged, free float-adjusted, market capitalization-weighted index that is designed to measure the performance of large-cap and mid-cap stocks in developed markets as determined by MSCI; excludes the United States and Canada.

MSCI Emerging Markets® Index: An unmanaged, free float-adjusted, market capitalization-weighted index that is designed to measure the performance of large-cap and mid-cap stocks in emerging-country markets as determined by MSCI.

Nationwide Funds are distributed by Nationwide Fund Distributors LLC (NFD), member FINRA, Columbus, Ohio.

Nationwide Investment Services Corporation (NISC), member FINRA, Columbus Ohio.

STAY CONNECTED

@NWFinancial
nationwidefunds.com

Shareholders: 800-848-0920
Intermediaries: 877-877-5083

MFM-4248AO (08/21)