Market Insights

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The Benefits of International Diversification

This article addresses why we still recommend including international assets as part of a well-diversified portfolio, even though times of crises make the benefits of international diversification seem weak.

In 2008 and 2009, the U.S. stock market decline triggered comparisons to the Great Depression. Further exacerbating losses was the fact that international equity markets also experienced equally significant losses. Many investors wondered what the point of international diversification was if all markets behaved similarly and provided no portfolio protection. The 2010 paper "International Diversification Works (in the Long Run)" examined that question.[1]

The authors observed that global market correlations did indeed tend to rise during times of crises, meaning investment returns behaved more similarly. It seemed that diversification failed when investors most needed its benefits. However, the authors found that global market crashes tend to be a short-term phenomenon. While short-run diversification was weak, there were meaningful differences in realized returns over longer periods.

The study found that short-term returns are more influenced by short-term changes in risk aversion. For example, crashes could result from heightened risk aversion if everyone panicked at the same time. On the other hand, long-term returns are driven more by realized economic performance. In fact, the authors found that country-specific economic performance explained about 16 percent of quarterly returns and 43 percent of 15-year returns. That percentage increases linearly for longer time periods.[2]

Diversification does provide benefits to long-term investors. It protects portfolios against the negative effects of holding concentrated positions in countries with poor long-term economic performance. While international diversification might not protect from "terrible days, months, or even years," over longer periods of time, it should produce a higher risk-adjusted return versus holding a portfolio of assets from a single country.[3] For most investors, a longer period of time should be the only time horizon they should consider.

1. Clifford Asness, Roni Israelov and John Liew, **International Diversification Works (in the Long Run).** Working Paper, March 3, 2010.
2. Ibid.
3. Ibid.

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