ACG Insights: Think Global Not Local

Executive Summary

- **Global growth is expected to come from outside the United States as global middle-class consumption ascends from nations like China and India**
- **Since the early 1990s, the globally diversified portfolio and the traditional 60% stock and 40% bond portfolio have traded market leadership, sometimes for lengthy periods.**
- **The recent strong historical performance of U.S. stocks and bonds have lowered expected returns for these asset classes over the next 10 years, making a globally diversified portfolio more attractive than the Traditional 60% stock and 40% bond portfolio**
- **No one knows which asset classes will outperform in the 2020s, making a globally diversified portfolio the best choice for long-term investors**

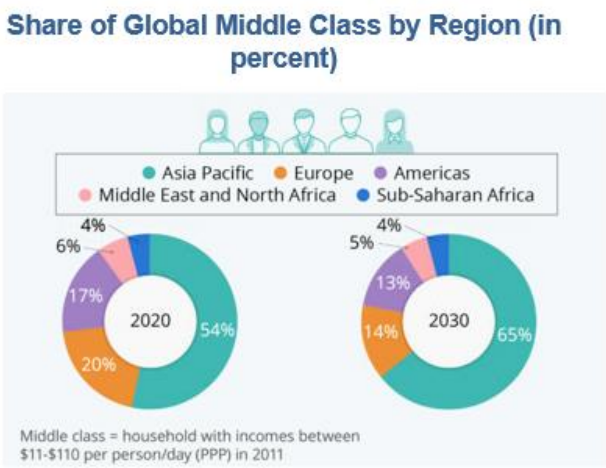
Background

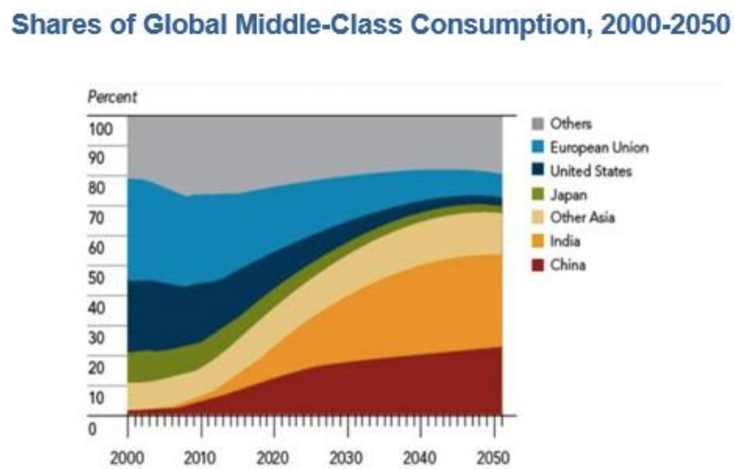
The 2010s was the decade of U.S. stocks and bonds as the Traditional 60-40 portfolio (60% U.S. stocks and 40% U.S. bonds) outperformed a globally diversified portfolio. U.S stocks benefited from the rise of Tech giants like Google, Facebook, Apple, and Amazon as they solidified their global dominance as well as Tech unicorns that transformed the U.S. economy and society. In the fixed income markets, low rates and quantitative easing were a boon to investors who held bonds as monetary policy pushed prices to all-time highs. Investors who held the traditional 60-40 portfolio saw handsome returns of almost 10% per annum throughout the decade, while putting money in a diversified basket saw less impressive annual returns of around 6.5%. Investors who stuck with similar positioning into the 2020s were rewarded, as U.S. stocks continued to outperform thanks to monetary and fiscal stimulus, and the rise of remote work due to COVID-19. U.S. stocks and bonds are currently at historically high valuations with U.S. stocks approaching valuations last seen since the dotcom boom. This is not to say that a crash is around the corner, but it acknowledges that asset returns going forward are most likely to be lower due to mean reversion, or the tendency for asset returns to revert to their historical mean over time. While low forward returns are likely the fate of U.S stocks and bonds, their international counterparts are trading at more attractive valuations. Investors could be rewarded by considering investments outside of the traditional U.S. stocks and bonds paradigm.

Expanding Opportunity Set

The global financial markets have seen rapid growth over the last decades as economies continue to develop and engage in global trade. Globalization has created prosperity for many as standards of living in developing nations converge towards advanced nations. In future decades, global growth will likely come from nations that are developing rather than developed ones like the U.S. In fact, global middle-class consumption has expanded and diversified to nations that are not located in North America or Europe. The below exhibits show the share of global middle class by region and the shares of global middle-class consumption.

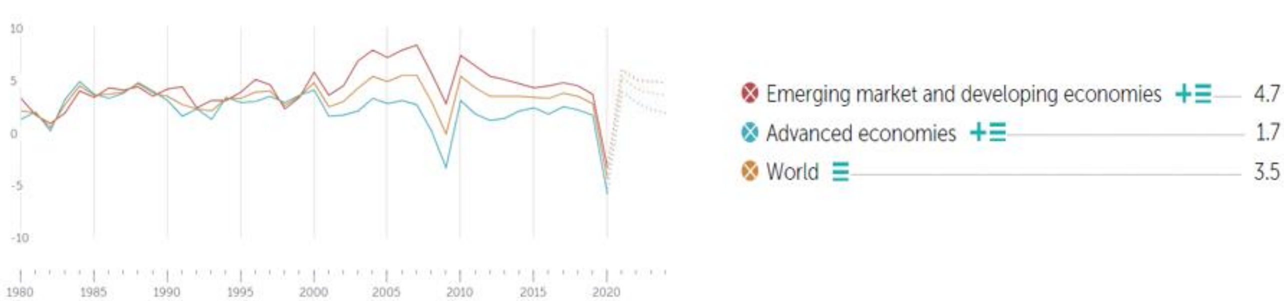
Exhibit 1: Global Middle Class by Region and Consumption[1]





In 2020, nearly 40% of the global middle class came from Europe and North America but by 2030 their share is expected to decline to under 30%. Global middle-class consumption will not come from these same developed nations as developing nations like China and India increase their share.

Exhibit 2: Economic Growth Rate of EM, Developed (1980-2025)[2]



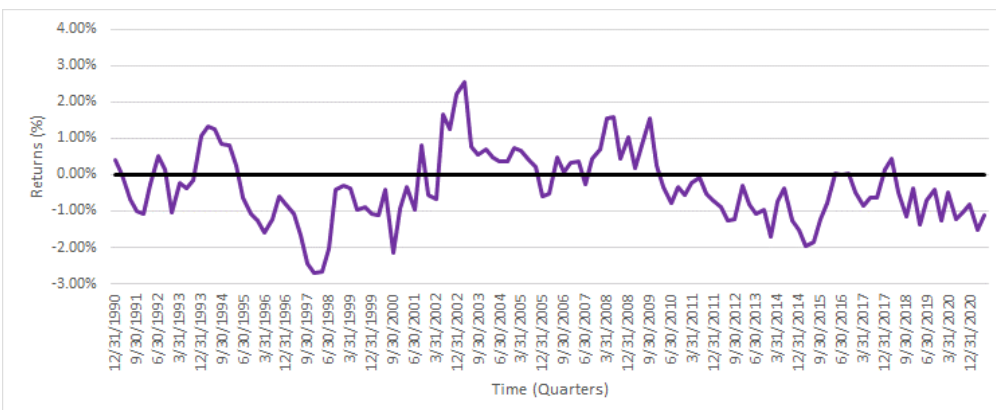
[1] Brookings Institution; OECD
[2] IMF

As more and more global growth comes from outside of the United States via an ascendant global middle class, investors are missing out on new opportunities by not allocating capital towards them. Nations outside the United States have demographic advantages such as younger populations, which act as a powerful tailwind for economic growth. According to the IMF, by 2025 Advanced Economies like the United States are expected to grow at less than a 2% rate. In contrast, the Emerging and Developing economies are expected to grow by nearly 5%. More companies coming from these developing nations are competing on the global stage. The rise of companies like Alibaba, Tencent and other Chinese tech companies are prime examples. A domestic only bias may have worked in the past, but in the future it could hurt.

Markets Move in Cycles

A Global Diversified Portfolio has failed to outperform the Traditional 60-40 over the last decade which has sparked questions of why investors should create a diversified portfolio of foreign stocks and bonds. Investors who chose to forego a globally diversified portfolio in favor of the 60-40 outperformed close to 3% annually. Investors must not forget; however, that prior to the 2010s a globally diversified portfolio outperformed a 60-40 portfolio. As a matter of fact, in the 2000s a Global Diversified Portfolio outperformed the 60-40 portfolio on average by roughly 2.5% per annum. Exhibit 3 shows going back to the early 90s, the Global Diversified Portfolio and 60-40 Portfolio would trade periods of out and underperformance.

Exhibit 3: Global Diversified Portfolio vs. Traditional 60-40 (1-Year Moving Average)[3]



Investors should think beyond recent market performance when constructing portfolios by considering all market environments. The winners of today could become the laggards of tomorrow. ACG's philosophy is to create a diversified portfolio across many asset classes so that we have exposure to multiple return drivers. Trying to predict asset classes that are going to do well tomorrow is practically impossible; investment professionals and economists have poor track records in predicting future market performance. With this knowledge in mind, we believe it is prudent for investors to think long-term and sidestep market predictions by building portfolios that can survive even the most turbulent financial storms.

[3] Morningstar

What's on the Horizon?

Exhibit 4: ACG Forecasted Returns Over Time[4]

Asset Class	2011	2021	Change Over Time
All U.S. Cap Equity	7.00%	6.03%	-0.97%
International Equity - Dev	8.80%	6.71%	-2.09%
International Equity -EM	9.70%	8.71%	-0.99%
Core Plus Fixed Income	3.40%	3.01%	-0.39%
Global Fixed Income	4.00%	4.15%	0.15%
High Yield Fixed Income	4.30%	5.01%	0.71%
TIPS	2.90%	2.76%	-0.14%
Global Real Estate	6.10%	5.30%	-0.80%
Commodities	7.00%	4.42%	-2.58%
Private Equity	9.10%	9.09%	-0.01%

2021 has been a continuation of a strong U.S. equity rally that began following the COVID-19 selloff of early 2020. From March 23rd, 2020, to August 31st, 2021, the S&P 500 has more than doubled its returns. Investors who invested in U. S. equities were rewarded with the fastest rebound from a 30%+ drop in the S&P 500's history. Unfortunately for investors, stock returns have been so good that future returns are projected to be lower. As pictured in Exhibit 4, ACG's expected returns for All Cap Equity over the next 10 years have been revised lower by about 100 basis points from when compared to our 2011 capital market assumptions. We believe that the strong historical performance of U.S. stocks and their now high valuations means investors should expect lower returns going forward. Investors have a few decisions they can make to help compensate for lower forward return expectations. One is to increase their allocation to U.S. equities in attempt to replicate past returns, but that exposes investors to higher risks or volatility. Another option is to consider allocating more of their portfolio to equities outside of the U.S. or other asset classes that have better expected returns. To illustrate this point, we projected $100 invested over a forward 10-year period in both the Global Diversified Portfolio[5] and a Traditional 60/ 40 Portfolio[6] and assuming 4%, 4.5% and 5% annual spending rates, Exhibit 5.

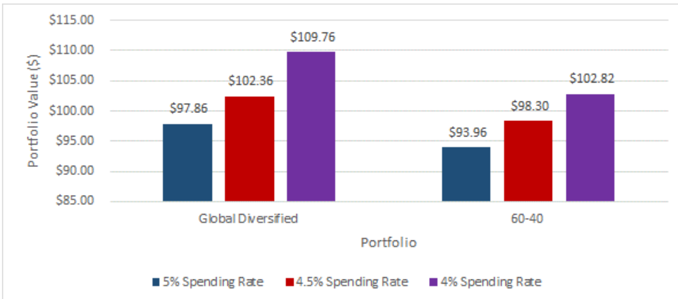
[4] ACG Research

[5] Global Portfolio: (30%) Russell 3000; (15%) MSCI ACWI ex USA; (20%) Bloomberg Barclays U.S. Aggregate Bond; (30%) Bloomberg Barclays Global Aggregate ex USA; (5%) Bloomberg Barclays U.S. High Yield 1-5 Yr. – **10-Year Expected Return = 4.76% & Expected Risk = 7.53%**

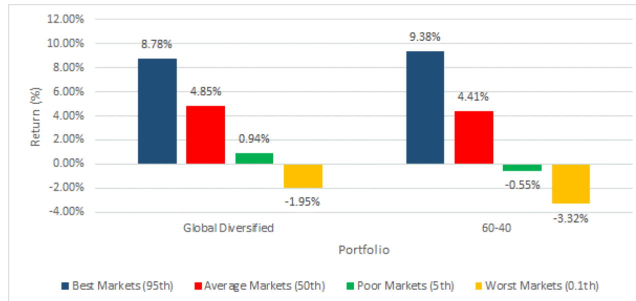
[6] Traditional 60-40 Portfolio: (60%) Russell 3000; (40%) Bloomberg Barclays U.S. Aggregate Bond – **10-Year Expected Return = 4.31% & Expected Risk = 9.70%**

Exhibit 5: Global Diversified Portfolio vs. Traditional 60-40 Portfolio[3,5,6]

Portfolio Value After 10-Year Period



Portfolios in Various Market Environments



The chart on the left of Exhibit 5 shows that based on our capital market assumptions, the Global Diversified Portfolio is expected to generate an annual return of 4.76%, enough to meet hypotheticals 4% and 4.5% spend rates, while the lower expected return from U.S. stocks and bonds, 4.31%, means that the Traditional 60-40 portfolio would fail to meet the return needs of all but a hypothetical 4% spending rate. On the right-side chart of Exhibit 5, we ran a Monte Carlo simulation to determine what portfolio returns would look like in a wide range of market environments. We found that in the worst markets of the simulation, 0.1th percentile of returns, the Global Diversified Portfolio fell nearly half as much as the Traditional 60-40 portfolio. The global focus and broad diversification of the Global portfolio makes it a more resilient portfolio relative to the Traditional 60-40. The bottom line is if U.S. stocks and bonds continue their historically strong performance, we expect the future returns from these asset classes to not only trend lower but expose investors to increasing risks. To reduce these risks and generate higher returns, investors should consider asset classes outside of U.S. stocks and bonds.

Conclusion

It is easy for investors to fall victim to recency bias. In the 2010 decade we saw the emergence of U.S. mega tech stocks dominate global markets. These stocks have paid immense rewards to investors who remained patient and could see their long-term vision. The strong performance has investors today questioning whether international assets, or other asset classes, can replicate their strong historical performance. The COVID-19 global pandemic proved to be an acceleration of past trends as work-from-home stocks and other tech stocks rose rapidly in value. Despite advantages in investing with a U.S. bias, investors should continue to look for other sources of diversification and return. In the past the winners of today quickly turned into the losers of tomorrow as market regimes can change quickly (ex. “Nifty fifty” in the 60s to the “dotcom stocks” of the 90s). During the turning points of these market periods investors continued to pass their “ball” to the hottest shooters of the day, but were caught off guard once those shooters went ice cold. We acknowledge that it is difficult to predict when investment themes go in and out of style and opt to put our clients’ money in many baskets instead of a few. We believe this is a proven winning strategy that allows our clients to sleep at night knowing they have a portfolio that can weather the vicissitudes of the market.

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