OUTSIDE THE FLAGS

Jim Parker,
Vice President
DFA Australia Limited

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The World Cup of Investing

When you talk about Ireland, cricket is not the first sport that springs to mind. Yet in the 2007 World Cup, the Irish defeated highly rated Pakistan, on St Patrick's Day no less. Picking the best countries to invest in can be just as unpredictable.

On paper, some countries look much stronger than others. In that immortal cricket match, the Pakistan team was full of star professionals. Ireland, by contrast, was a team of no-name amateurs that had never beaten a test-playing nation. Yet Ireland stunned the cricketing world, winning the game by three wickets.

Minnows don't just win on the sporting field. In three of the past four years, tiny New Zealand has been one of the world's top performing developed world equity markets, holding first position in 2011, fifth in 2012 and second in 2014.

Denmark, a country not much bigger than New Zealand, has been another top performer, holding second position on the developed world market tables in 2010 and 2012 and third position after the Kiwis last year.

This isn't to say that those two nations will continue to excel. Look at the example of Spain, which was the worst performing market in 2010 and 2012 as the euro zone crisis dragged on, only to vault into third position globally in 2013.

Country returns are unpredictable and don't necessarily reflect what's going on in those markets' economies at the time. In 2013, amid deflation and continuing sluggish growth, the Japanese equity market put in its best one-year performance in four decades.

In fact, if you assign a colour to each developed market and rank them from the top to bottom performers for each year over the last decade in percentage terms, the resulting haphazard pattern resembles a quilt by a sight-impaired seamstress.

Table 1 – Developed Equity Markets 2004-2014 (% in $USD)

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Austria 71.5	Canada 28.3	Spain 49.4	Hong Kong 41.2	Japan -29.2	Norway 87.1	Sweden 33.8	New Zealand 5.5	Belgium 39.6	USA 31.8	USA 12.7
New Zealand 49.7	Japan 25.5	Singapore 46.7	Germany 35.2	Switzerland -30.5	Australia 76.4	Denmark 30.7	USA 1.4	Denmark 31.3	Germany 31.4	New Zealand 7.3
Belgium 43.5	Austria 24.6	Norway 45.1	Norway 31.4	USA -37.6	Singapore 74.0	Hong Kong 23.2	UK -2.6	Singapore 31.0	Spain 31.3	Denmark 6.2
Norway 38.4	Denmark 24.5	Sweden 43.4	Canada 29.6	Spain -40.6	Sweden 64.2	Singapore 22.1	Switzerland -6.8	Germany 30.9	Netherlands 31.3	Hong Kong 5.1
Sweden 36.3	Norway 24.3	Denmark 38.8	Singapore 28.4	France -43.3	Hong Kong 60.2	Canada 20.5	Norway -10.0	New Zealand 29.3	Belgium 27.6	Belgium 4.1
Italy 32.5	Switzerland 16.3	Belgium 36.7	Australia 28.3	Canada -45.5	Belgium 57.5	Japan 15.4	Belgium -10.6	Hong Kong 28.3	Japan 27.2	Singapore 3.0
Denmark 30.8	Australia 16.0	Austria 36.5	Denmark 25.6	Germany -45.9	Canada 56.2	USA 14.8	Australia -11.0	Austria 25.9	Switzerland 26.6	Canada 1.5
Australia 30.3	Singapore 14.4	Germany 36.0	Spain 24.0	Singapore -47.4	New Zealand 50.4	Australia 14.5	Netherlands -12.1	Australia 22.1	France 26.3	Switzerland -0.1
Spain 28.9	Netherlands 13.9	France 34.5	Netherlands 20.6	Denmark -47.6	Spain 43.5	Switzerland 11.8	Spain -12.3	Sweden 22.0	Denmark 25.2	Australia -3.4
Hong Kong 25.0	Sweden 10.3	Italy 32.5	France 13.2	Netherlands -48.2	UK 43.3	Norway 10.9	Canada -12.7	France 21.3	Sweden 24.5	Netherlands -3.5
Singapore 22.3	Germany 9.9	Netherlands 31.4	New Zealand 8.9	UK -48.3	Austria 43.2	Austria 9.9	Japan -14.3	Netherlands 20.6	UK 20.7	Japan -4.0
Canada 22.2	France 9.9	Australia 30.9	UK 8.4	Sweden -49.9	Netherlands 42.3	UK 8.8	Sweden -16.0	Switzerland 20.4	Italy 20.4	Spain -4.7
UK 19.6	Belgium 9.0	UK 30.6	Italy 6.1	Italy -50.0	Denmark 36.6	Germany 8.4	Denmark -16.0	Norway 18.7	Austria 13.4	UK -5.4
France 18.5	Hong Kong 8.4	Hong Kong 30.4	USA 5.4	Australia -50.7	France 31.8	New Zealand 8.3	Hong Kong -16.0	USA 15.3	New Zealand 11.3	Sweden -7.5
Germany 16.2	UK 7.4	Switzerland 27.4	Switzerland 5.3	Hong Kong -51.2	Italy 26.6	Netherlands 1.7	France -16.9	UK 15.3	Hong Kong 11.1	Italy -9.5
Japan 15.9	USA 5.1	Canada 17.8	Austria 2.2	New Zealand -53.8	USA 26.3	Belgium -0.4	Singapore -17.9	Italy 12.5	Norway 9.4	France -9.9
Switzerland 15.0	Spain 4.4	New Zealand 16.6	Sweden 0.6	Norway -64.2	Switzerland 25.3	France -4.1	Germany -18.1	Canada 9.1	Canada 5.6	Germany -10.4
Netherlands 12.2	Italy 1.9	USA 14.7	Belgium -2.7	Belgium -66.5	Germany 25.2	Italy -15.0	Italy -23.2	Japan 8.2	Australia 4.2	Norway -22.0
USA 10.1	New Zealand 1.7	Japan 6.2	Japan -4.2	Austria -68.4	Japan 6.3	Spain -22.0	Austria -36.4	Spain 3.0	Singapore 1.7	Austria -29.8

Source: MSCI developed markets country indices (net dividends). MSCI data copyright MSCI 2015, all rights reserved. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

Table 1 shows you the percentage performances of all the developed markets over the past decade, ranked from top to bottom.

This lack of a pattern in country returns is actually good news for the diversified investor. It means if you spread your equity allocation internationally, you reduce the risk of any one bad performance having an undue effect on your portfolio.

In other words, the chances are that if one part of your global portfolio is struggling, another will be doing significantly better. That's the power of diversification.

Obviously, it isn't as simple as that. There are questions about how much you want to bias your portfolio to your home country.

Another question is around what you do about currencies. Some people choose to leave their international portfolio unhedged against currency moves. In this case, a depreciating home currency can soften the blow of falling international markets and magnify the windfall from rising markets, once you convert to your local currency.

On the other hand, a rising home currency can pare back your international returns if you are unhedged.

It works the opposite way for hedged investors. You are protected when your home currency is rising, but you also don't get the benefit when it falls.

The research shows no clear investment case one way or the other. So some people choose to have a dollar each way and be 50% hedged and 50% unhedged.

However, once you resolve with your advisor these questions around home bias and currency hedging, there is a strong case for international diversification.

It provides you exposure to a broader array of economic forces, companies and sectors than were you to keep all your money in your home market. It spreads your risk and it means you're not taking a more concentrated bet than you need to.

To use our cricketing analogy, being internationally diversified means you're more likely to slowly and steadily accumulate runs than trying to hit every ball for six.

Now, who do you think is going to win the 2015 World Cup?

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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