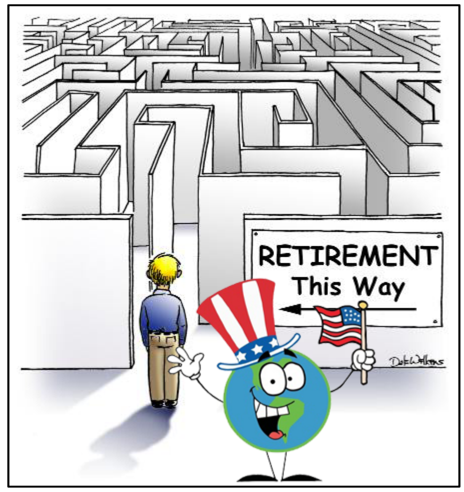
Don't let "home bias" impair your returns

Navigating the Retirement Maze



"Nobody goes there anymore. It's too crowded."
– Peter "Yogi" Berra, Hall of Fame catcher, manager, coach (1925 - 2015)

When I meet with prospective clients and review their existing portfolios, it's almost a safe bet that I know what I will find: a preponderance of US stocks, bonds, and domestic mutual fund holding same. In the years since I became a financial planner, I have learned that emotional biases drive investor behavior far more than facts or statistics. (To my college psychology professor who this engineering major never took seriously, I offer my belated apologies. Humans are truly creatures of their emotions, especially when it comes to investing.)

Many of these prospects have praised either their own financial prowess or that of their advisor or broker when discussing the strong performance of their predominantly US portfolios. Behavioral experts call this "hindsight bias," where people are convinced that they knew all along that the US market was the place to be for the past eight years. I view it as getting lucky: doing the right thing for the wrong reasons.

Most financial experts recommend a diversified portfolio because different asset classes take turns leading the investment pack each year. Diversification also reduces portfolio volatility and produces steadier gains over time. So why are so many US investors fixated on US securities, when they only represent 53 percent of the total value of global equities? Time to introduce two more behavioral biases.

There's no place like home

When we look at recent trends, we have a tendency to extrapolate them forward. If the market has been going up, then we envision a pattern of continuing gains. In actuality, a phenomenon known as market momentum is very real, and does account for a certain degree of market pattern continuation. But we tend to read too much into this and believe that increasing markets beget further increases, rather than heeding the warning found on nearly every fund prospectus: "Past performance is not a guarantee of future results." This is called "recency bias," and afflicts many professional as well as individual investors. Remember how everyone got caught up in the "dot-com frenzy"? Recall the phrase "this time it's different"? Only after it crashed and burned was it rechristened the "dot-com bubble."

The recent strong performance of the US market only partly explains the tendency of investors to ignore non-US stocks and bonds. Another factor is known as "home bias," the tendency of investors to stick with securities of their own country. There are a number of reasons for this. First, investors tend to be more comfortable with companies with which they are familiar. They like having a portfolio of stocks whose products they recognize and frequently see in the news.

Second, investors worry about the additional risks of foreign markets: currency fluctuations, political turmoil, questionable accounting practices. Memories of incidents like the debt defaults of Argentina and Russia, economies that rise and fall with the prices of certain commodities, and perceived rampant corruption can taint one's view of investments outside of the US. But while there is risk in investing in only one foreign country or company, owning hundreds or thousands of companies across a range of countries tends to mitigate those risks significantly.

Foreign stock and bond funds also tend to have higher management fees than their domestic counterparts because of the higher costs associated with running those funds, which goes counter to the "low fee" mantra that most investors seem to be chanting these days. Finally, there is sometimes a sense of nationalistic pride of "buying American" when it comes to investments. Together, these predispositions can leave an investor underexposed in foreign markets, resulting in an undiversified portfolio.

Why consider the other 47 percent

There are two important reasons for adding international stocks to your portfolio: diversification and value investing. Diversification is often referred to by financial professionals as the only "free lunch" in investing. By assembling a portfolio of investment classes that are not closely correlated (i.e., prices tend to move in different directions over time), volatility decreases and risk-adjusted performance improves. To augment the basic stocks and bonds mix, adding other assets with low correlations to stocks yields even better diversification. Asset classes perform differently in various economic environments, so one asset class falling in price might be compensated by others that are performing well. Real estate, different sized companies (large/mid/small capitalizations), commodities, high yield bonds, and international stocks and bonds all contribute to a diversified portfolio.

The other reason for adding non-US stocks and bonds to your portfolio is that they are currently better values than most US stocks, and thus have higher forecasted gains. US stock prices have been on a tear since 2009, but a phenomenon called "mean reversion" – where prices that grow in excess of their intrinsic value will eventually revert to their actual values – eventually puts the brakes on stock prices growing faster than their earnings. The boom and subsequent bust of both the dot-com stocks and the real estate market are examples of this. That isn't to say that US stocks will correct that strongly, but it does imply that the past nine years of solid gains are likely to be followed by much more modest growth.

Research Affiliates, an investment management firm, forecasts that based on valuations today, US large cap stocks will only gain 29 percent over the next ten years, barely keeping up with inflation. Compare that to their predictions of 95 percent for non-US developed markets, and 135 percent for emerging markets. While few advisors would recommend a purely non-US portfolio, adding significant portions of these stocks will likely improve your portfolio gains going forward.

Get out of town and prosper

While the prospect of investing in foreign markets may seem daunting, there are many funds, both passive and active, that can easily accomplish this for you. The biggest challenge may be the limitation of your 401(k) or 403(b) Plan fund choices. If your employer doesn't offer these options for you in their retirement plans, maybe it's time to find another employer. Which, incidentally, would allow you to roll over your current plan into a brokerage account that includes these options aplenty. Being heavily invested in the US market may have served you well the past eight or nine years, but don't expect similar return going forward. Going global is your best bet for continued growth.

George Gagliardi is a financial advisor with Coromandel Wealth Management in Lexington, where he helps clients develop and implement investment and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor. This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should *only be given after an individual situation has been reviewed.*