Labs: Portfolio Diagnostics Services

PORTFOLIO DIAGNOSTICS REPORT

Myths, Misconceptions and Blind Spots

Overcoming the Home Bias in Equity Investing

By Janus Henderson's Portfolio Construction Services Team

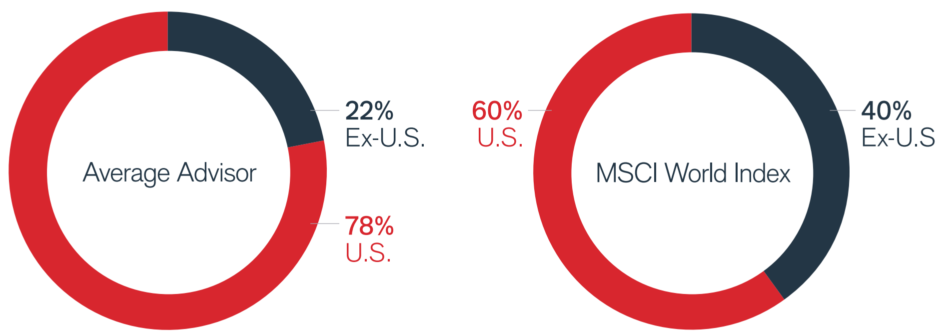
It's been well documented that in addition to providing access to invest across a broader market, international diversification may lead to long-term gains, as well as the potential to both enhance income and lower volatility. And yet, considerable bias to U.S. investments persists in portfolios.

With the recent outperformance of U.S. markets, valuation opportunities abroad, and several key global elections behind us, many of the advisors we have conversations with during our Portfolio Construction Services consultations are revisiting their mix of international exposure in portfolios.

Indeed, the industry has already seen substantial flows into international equities. Over the last three years flows into the Morningstar International Equity category have been more than triple that of the U.S. Equity category.

To focus on home bias and other prominent industry trends, we track average allocations across the thousands of advisor models on which we've run analyses. Using our proprietary model analysis database, we've found that, even in the face of these large inflows, the average advisor's global developed equity allocation consists of only 22% international equity while the MSCI World Index is comprised of 40%.

Average Advisor Global Equity Allocation vs. MSCI World Index



Given this persistent underweight to international equities in advisors' portfolios, we think there is still plenty of potential for this trend of international fund flows to continue. We also believe a number of myths, misconceptions and blind spots influence investors' thinking when it comes to international exposure. Here, we share the ways we see home bias skewing portfolios and address some of the most common concerns we hear about investing abroad.

Janus Henderson
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Myths, Misconceptions and Blind Spots

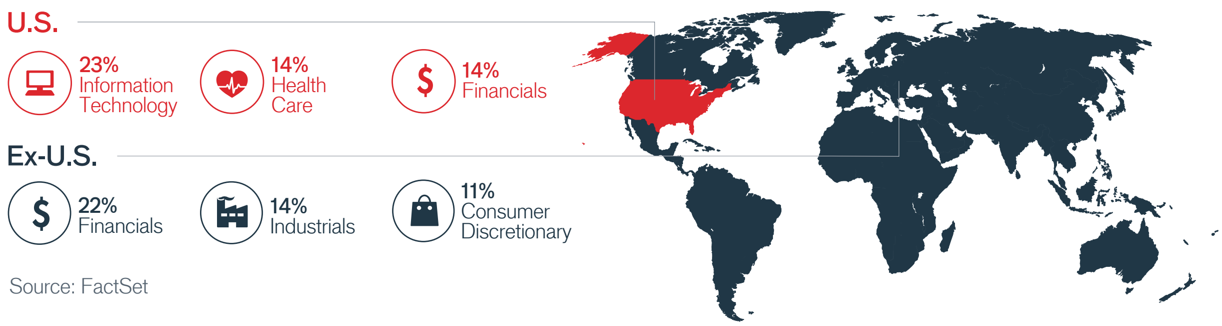
Myth: Multinationals Make a Portfolio Global

> Most large companies today are global, so it doesn't matter whether I own a U.S.-based global company or an overseas-based global company.

Because many of today's larger companies have global sales and suppliers, some argue there is little benefit to diversifying stocks by geography. It is true that companies are more global than ever. For instance, 30% of the total revenue of companies in the S&P 500 comes from outside the country.[1]

However, investing in multinationals through domestic markets doesn't necessarily provide broad or balanced international exposure. It's important to consider that no two countries have the same sector exposure footprint. The U.S. is skewed toward technology and health care sectors, while the ex-U.S. portion of MSCI World has its highest concentration in financials and industrials. Therefore, an equity investor in solely U.S. equities may be subject to large biases to a short list of U.S. sectors:

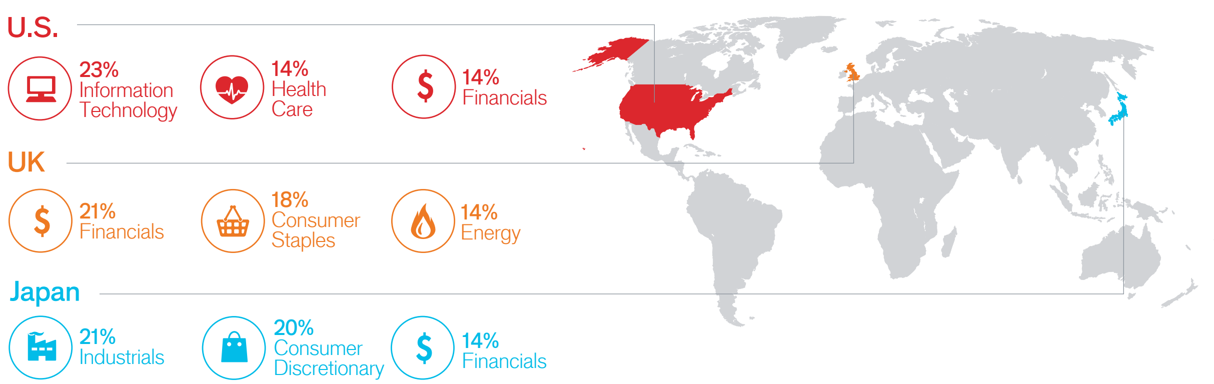
Sector Exposure of the MSCI World Index



Source: FactSet

Home bias is not solely a U.S.-centric challenge. London investors face similar structural exposure issues. Their domestic market is dominated by financials and consumer staples. Similarly, asset allocators in Tokyo drift toward sectors like industrials and consumer discretionary as they drive the Japanese economy. Regardless of where investors are located, familiarity bias drives investment selection. For example, observe these varying sectors in the top 3 largest countries in the MSCI World Index:

Sector Exposure in the 3 Largest Markets in the MSCI World Index



Source: FactSet

These differences in sector exposures create structural challenges for U.S.-based investors as well as investors elsewhere, potentially leaving them vulnerable to being overweight or underweight to particular sectors and economies. True international investing may potentially alleviate these challenges as it allows access to different exposures.

[1] FactSet

Myths, Misconceptions and Blind Spots

Misconception: All Global Managers are Created (Globally) Equal

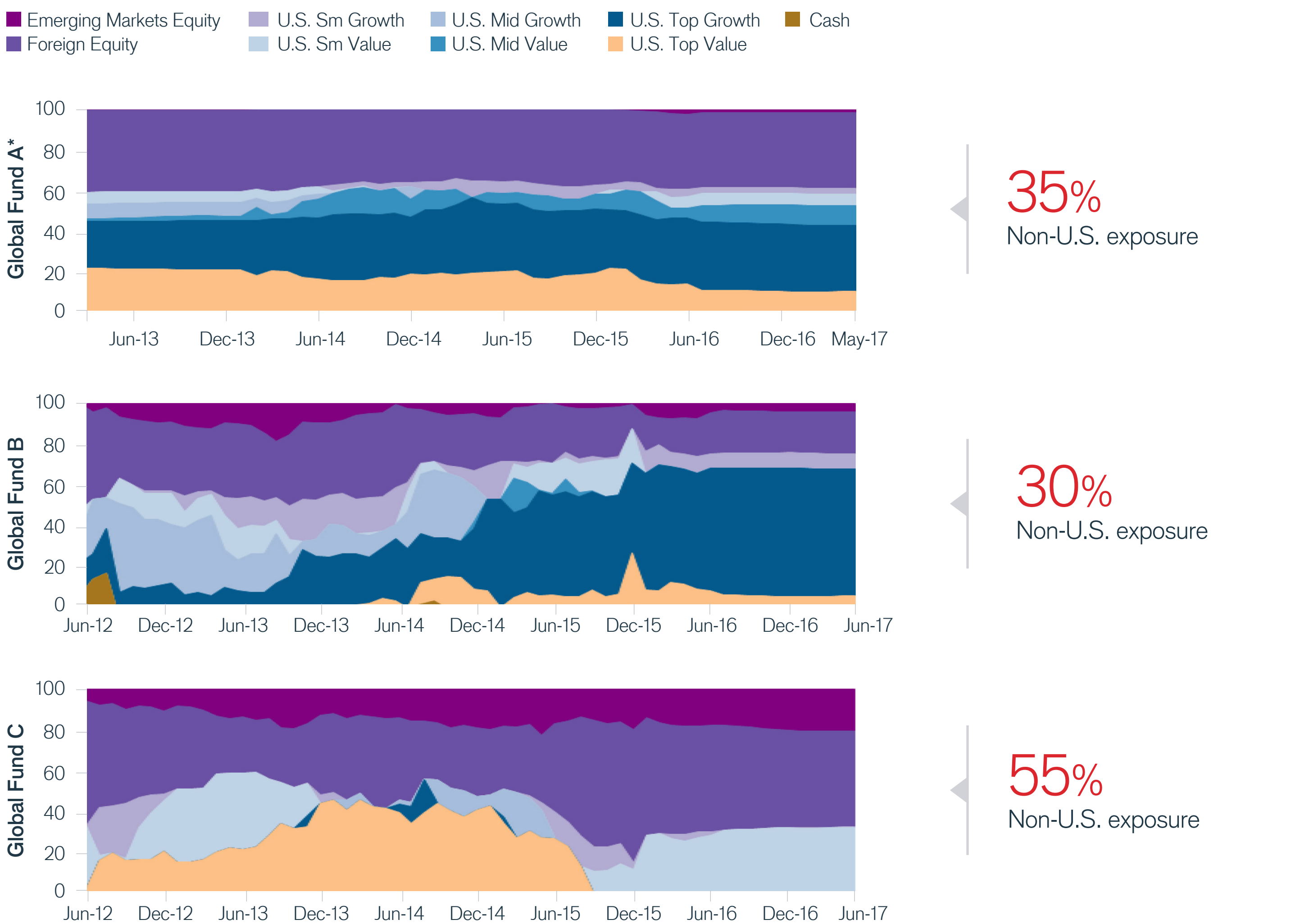
> I've allocated to global managers, so I have sufficient non-U.S. exposure.

We often hear – and even more often see the evidence – that financial advisors are going global by using global managers in portfolios. In fact, the Morningstar World Stock category is the second most popular category in the Morningstar International Equity group for active managers and its constituent funds are held in 21% of our advisor portfolios.

Yet, investors might not realize just how U.S.-centric many of these global strategies are. For example, below is the U.S. vs. non-U.S. exposure over time for each of the fastest-growing global equity mutual funds in the category, based on trailing three-year inflows:

Thinking Globally, Investing Locally

5-Year Rolling Style Map of Exposures Driving Returns (6/1/12 — 5/31/17)



Source: Returns-based Factor Analysis from Janus Henderson Portfolio Diagnostic Analysis
Produced with MPI Stylus Software

Based on the above factor breakdowns, consider an advisor who moves 10% into one of these global managers: given the U.S. exposure in these funds, only about 40% of that position on average – or 4% of the model – is actually being allocated to international equities. Global strategies can be compelling, but it is easy to over-allocate to U.S. stocks with these strategies.

* Global Fund A has an inception date of March 2013

Myths, Misconceptions and Blind Spots

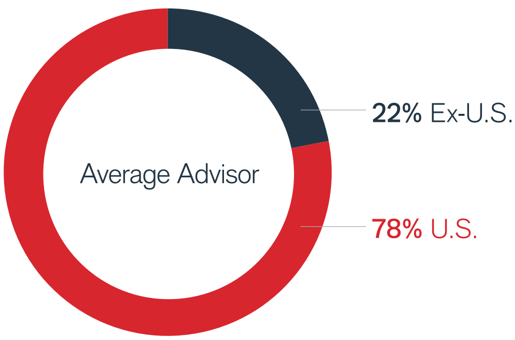
Blind Spot: Income Portfolios

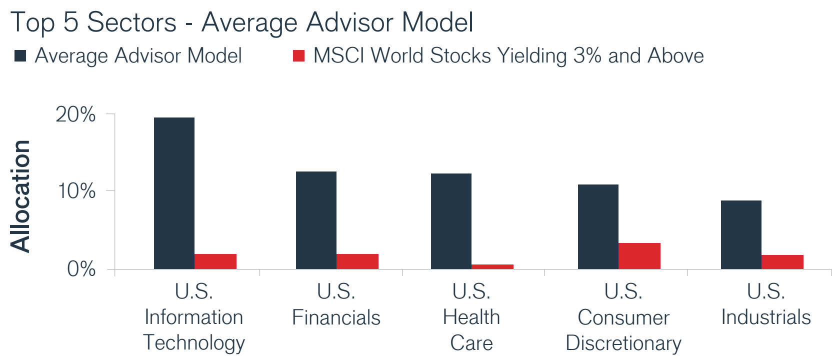
> I'm an income investor and there's no yield in equities.

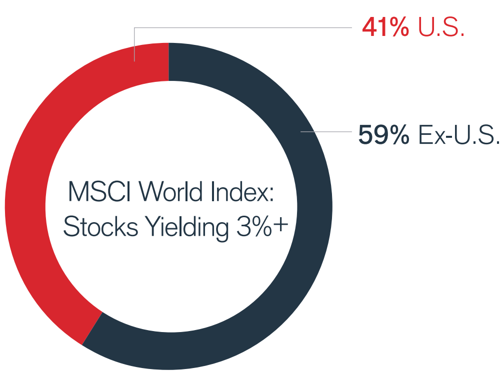
A third refrain we hear is that traditional equity portfolios do not offer enough yield to satisfy income needs. We believe this is a half-truth at best, because the yield on many portfolios is suppressed due to home bias and the resulting concentration in crowded, relatively low-yielding U.S. stocks.

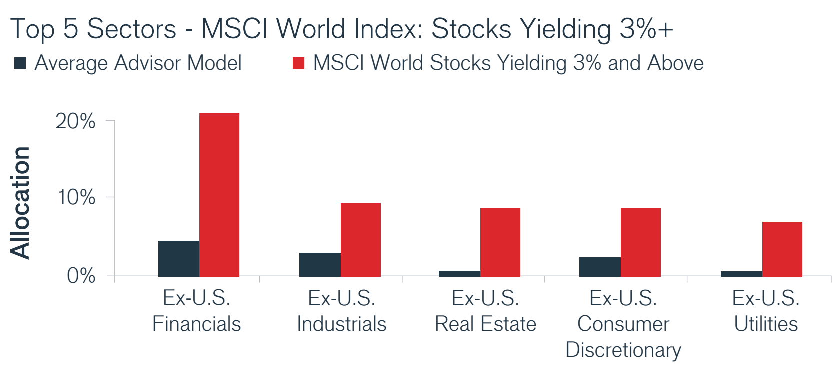
For example, instead of comparing the average advisor global equity portfolio to the MSCI World Index we now compare it to stocks in the MSCI World Index yielding at least 3% and show the discrepancies among the top 5 sector allocations in each.

Average Advisor Global Equity Allocation vs. MSCI World Stocks Yielding 3% and Above









The international high income equity universe is arguably much larger than what most investors find in their more familiar U.S. hunting grounds. A properly diversified global equity portfolio should have the ability to provide meaningful income benefits on top of total returns and diversification, provided it suits investor needs.

Conclusion: Home bias persists, even in the face of good intentions to go global

In our analysis of advisor portfolios, we see persistent home bias. When relying on U.S.-based multinationals and U.S.-skewed global managers for international exposure, it is important to be fully aware of potential shortfalls accompanying each approach. Otherwise, portfolios may be missing out on international equity income opportunities, not to mention the potential diversification of both growth and risks compared to U.S.-based holdings. While international investments can present a unique set of risks investors should consider carefully, adding foreign exposure can enhance portfolio diversification, potentially lowering risk over long-term horizons while allowing investors to take advantage of growth potential outside the U.S. As such, we believe many advisors face a substantial opportunity to adjust portfolio allocations, now with a greater awareness of the role these mistaken beliefs may have in perpetuating home bias within equity allocations.

About Janus Henderson's Portfolio Construction Services Team

The PCS Team performs customized analyses on advisor portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of thousands of models emerge trends, themes and potential opportunities in portfolio construction that we believe will be interesting and beneficial to any investor.

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Past performance is no guarantee of future results.

Investing involves market risk and it is possible to lose money by investing. Investment return and value will fluctuate in response to issuer, political, market and economic developments, which can affect a single issuer, issuers within an industry, economic sector or geographic region, or the market as a whole.

Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

MSCI World IndexSM is an unmanaged, free float-adjusted market capitalization weighted index composed of stocks of companies located in countries throughout the world. It is designed to measure equity market performance in global developed and emerging markets. The index includes reinvestment of dividends, net of foreign withholding taxes.

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