The Case for International Investing

AZZAD ASSET MANAGEMENT WHITE PAPER SERIES

INTRODUCTION

The thought of international investing can leave some investors uneasy. Headlines about a Chinese slowdown, emerging market volatility, and a Eurozone in crisis can leave us with the impression that the future of international investing looks bleak. That impression, however, is not accurate. International investing is a crucial part of portfolio returns, and those who avoid it do so at their own peril. In addition, much of global growth in the coming years is expected to come from outside the United States. But the performance of stock markets around the world can differ dramatically from one country to the next and from one year to the next.

Drawing on the expertise of Scout Investments, which runs Azzad Asset Management's international portfolio, this paper explains why international stocks should be a part of any diversified portfolio.

DIVERSIFICATION

The benefits of international diversification are primarily driven by three factors: how different countries' markets perform, an expanded investment opportunity set, and the volatility of the individual markets. Let's start with the first one.

Building a portfolio with a variety of investments reduces the overall ups and downs of the portfolio and increases its returns.

An important motive for international investing has been to implement the theory of portfolio diversification in a real-world setting and take advantage of stock markets that perform differently at different times.

Many people who invest in different countries' stock markets or in international mutual funds do so because of the risk-reducing power of international diversification. There has been much discussion that globalization and the integration of world financial markets have reduced the benefits of diversification by increasing the correlation (or similar performance) among countries.

Certainly, correlations of all major foreign markets with the S&P 500 were elevated during the 2008 financial crisis and for several years after that. Those correlations have, however, weakened considerably over the past few years, meaning that markets now perform differently. This helps make the case for international equity diversification.

The decrease in portfolio risk that occurs with the sequential addition of stocks to a portfolio is one of the best-known principles in investing, and real-world results have repeatedly validated it.

Note: Diversification cannot protect against a loss or guarantee a gain.

OPPORTUNITY ABROAD

A factor we consider even more important than correlations is the vast size of the international investment opportunity set.

While the U.S. currently makes up nearly 50% of global equity market value, higher growth rates in developing countries are highly likely to lead to a growing share of total global market capitalization outside of the United States.

The world has also seen a tremendous growth in venues for equity listings from about five equity markets 100 years ago to over fifty now.

Along with the growth of the global economy and increase in the number of equity markets, US-based investors have gained access to a growing number of high quality non-U.S. companies. A strict reliance only on U.S.-based companies is an active decision to ignore half of the world's opportunities.

U.S. consumers have already made the jump to a globalized world. A high percentage of the manufactured goods we use in the United States was made elsewhere – computer chips, eyeglasses, automobiles, and everything in between.

When it comes to investing, investors should take advantage of a wide geographic opportunity set.

Globalization has provided an expanded universe of investment opportunities, both in the number of "investable" markets abroad and the accessibility of quality, growing companies.

U.S. investors who limit their investments to the domestic market are missing out on more than half of the world's market capitalization. Moreover, U.S.-only investors are neglecting sectors and companies that may provide higher growth and returns than their counterparts in the U.S.

INDIVIDUAL MARKETS VS. THE GLOBE

Diversification across countries and regions can be expected to yield higher risk-adjusted returns.

The table on page 3 illustrates the variation in performance of world markets. For the last ten years, no single country or region has consistently been the top or bottom performer.

Looking at the most recent period, in three of the last four years, the S&P 500 has been the best performing index. Prior to that, however, the S&P 500 occupied one of the bottom two slots for 5 of 6 years.

This continues to reinforce the idea that diversification among global markets is prudent. In addition, since the 2008 financial crisis and more specifically, the last three years, the S&P 500 index significantly outperformed MSCI's All Country World ex-US index.

There are a number of plausible explanations for U.S. equity outperformance, including

Global Calendar Year Returns (2005-2014)

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
EM 34.00%	Europe 33.72%	EM 39.42%	Japan -29.21%	EM 78.51%	Canada 20.45%	S&P 500 2.11%	Pacific Ex. Japan 24.57%	S&P 500 32.39%	S&P 500 13.69%
Canada 28.31%	EM 32.14	Pacific Ex. Japan 30.73%	S&P 500 -37.00%	Pacific Ex. Japan 72.81%	EM 18.88%	Europe -11.06%	Europe 19.12%	Japan 27.16%	Canada 1.50%
Japan 25.52%	Pacific Ex. Japan 32.02%	Canada 29.57%	Canada -45.51%	Canada 56.18%	Pacific Ex. Japan 16.91%	Canada -12.71%	EM 18.22%	Europe 25.23%	Pacific Ex. Japan -0.47%
Pacific Ex. Japan 13.81%	Canada 17.80%	Europe 13.86%	Europe -46.42%	Europe 35.83%	Japan 15.44%	Pacific Ex. Japan -12.79%	S&P 500 16.00%	Canada 5.63%	EM -2.19%
Europe 9.42%	S&P 500 15.79%	S&P 500 5.49%	Pacific Ex. Japan -50.50%	S&P 500 26.46%	S&P 500 15.06%	Japan -14.33%	Canada 9.09%	Pacific Ex. Japan 5.49%	Japan -4.02%
S&P 500 4.91%	Japan 6.24%	Japan -4.23%	EM -53.33%	Japan 6.25%	Europe 3.88%	EM -18.42%	Japan 8.18%	EM -2.60%	Europe -6.18%

Source: MSCI index data; S&P index data

Federal Reserve monetary policy, a slowdown in China, and emerging market potential. And while U.S. equities have outperformed their non-U.S. peers in every major category in the last three years, a change in that pattern has already started, marking what could be the start of strong international equity performance in the near future.

U.S. equities face a number of challenges in coming quarters, including compressed margins, tighter labor markets, and wage growth. Further dollar strength and rising U.S. interest rates could also put pressure on U.S. competitiveness relative to European companies.

TAILWINDS OVERSEAS

Adding to headwinds facing U.S. markets are tailwinds for international markets, like weak currencies and lower energy prices. European equities, in particular, stand to benefit in the near future from a relatively lower price-to-earnings multiple to U.S. equities. There are many countries still offering negative yielding debt in contrast to equities that have a positive yield and potential growth opportunities.

With increasing hurdles for U.S. markets, more opportunities abroad, and the benefits diversification can provide, now may be a good time to revisit your allocation to international equities.

ABOUT AZZAD ASSET MANAGEMENT

Since 1997, the mission of Azzad Asset Management, advisor to the Azzad Mutual Funds and sponsor of the Ethical Wrap Program, has been to provide investment performance without compromising their values.

Azzad is proud to serve as investment advisor to the Azzad Wise Capital Fund, the first halal, socially responsible fixed-income fund investing in:

- Sukuk
- Islamic bank deposits
- Ethical dividend-paying stocks

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