OUTSIDE THE FLAGS

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World Cup of Investing

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It's been a banner year for New Zealand sport, with a world championship win in women's netball, the narrowest of world cup losses in men's cricket and an upcoming attempt by the All Blacks to win an historic third consecutive rugby world cup.

It's fair to say that just as NZ punches above its weight in global sport, its share market has been an outperformer in recent years. But it's also worth keeping a sense of perspective, both in terms of history and the size of the opportunity.

In sport, the women's netball team, the Silver Ferns, waited 16 years to win the world cup, and then defeated Australia by just a single goal. Even the All Blacks, historically the world's best rugby team, took 24 years to repeat their 1987 world cup triumph.

NZ shares aren't world beaters every year either. It's true the Kiwi share market has been the developed world's second-best performer in four of the past 10 years. In fact, it has posted positive annual returns for every year since the GFC.

But you only have to cast your mind back a little bit further to find years when the Kiwi market was a relative struggler. In 2000, it was the worst performing developed market in the world. In 2005 and 2006, it was the third worst, albeit with positive returns.

If you go back even further, the NZ market was hit harder than most by the 1987 crash and its aftermath. The market, as measured by the S&P/NZX All Index fell by nearly 50% in 1987 and did not turn cumulatively positive till nearly a decade later.

Such was the pain generated by the 1987 crash in New Zealand that an entire generation of investors was turned off equities. The tragedy is that so many sought solace instead in poorly performing and illiquid property finance schemes.

There are a couple of lessons from all this for investors. Firstly, just as World Cup winners are hard to predict, there is no evidence that you can consistently outguess prices and pick which country will be the best market performer from year to year.

Exhibit 1: Equity Returns of Developed Markets

New Zealand (1999-2018)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Highest Return	Finland 155.9	Switz. 24.8	NZ 15.2	NZ -1.1	Sweden 31.1	Austria 55.9	Canada 36.1	Spain 44.3	Finland 36.2	Japan -6.8	Norway 50.2	Sweden 24.6	Ireland 13.9	Belgium 32.0	Finland 46.4	US 18.7	Denmark 40.9	Canada 22.3	Austria 55.2	Finland 2.4
	Singapore 102.0	Canada 24.1	Australia 8.0	Austria -7.2	Germany 30.5	Norway 39.3	Japan 33.1	Portugal 42.3	HK 29.4	Switz. -8.5	Australia 41.7	Denmark 21.8	NZ 5.7	Denmark 24.1	Ireland 41.5	NZ 13.0	Ireland 33.0	NZ 16.2	HK 33.5	NZ 1.9
	Sweden 82.1	Denmark 21.9	Ireland 3.3	Australia -21.5	Spain 26.2	Belgium 30.5	Austria 32.2	Ireland 41.8	Germany 23.9	US -17.8	Singapore 39.7	HK 14.8	US 1.5	Singapore 23.8	US 32.1	Denmark 11.8	Belgium 28.0	Norway 11.2	Singapore 32.9	US 0.7
	Japan 63.6	Norway 16.8	Austria 0.3	Norway -26.2	Austria 25.1	Ireland 30.0	Denmark 32.0	Singapore 41.7	Norway 20.4	Spain -21.8	Sweden 31.8	Singapore 13.8	UK -2.4	Germany 23.8	Germany 31.7	HK 10.6	Japan 25.1	Australia 9.4	Denmark 32.1	HK -2.2
	HK 61.6	Italy 16.3	Belgium -5.3	Italy -26.2	NZ 23.8	Sweden 23.9	Norway 31.8	Norway 40.2	Canada 18.7	France -25.3	HK 28.6	Canada 12.2	Switz. -6.6	NZ 22.2	Spain 31.6	Belgium 9.6	Austria 18.1	Austria 9.2	Nether. 29.6	Norway -3.1
	Canada 55.7	Nether. 13.0	Spain -5.8	Japan -28.6	Canada 23.2	NZ 22.9	Finland 23.8	Sweden 38.5	Singapore 17.6	Canada -28.3	Belgium 26.5	Japan 7.5	Norway -9.9	HK 21.3	Nether. 31.6	Singapore 8.5	Italy 16.8	US 8.9	France 26.2	Switz. -3.6
	Norway 33.4	France 12.8	Norway -6.7	Switz. -28.6	Australia 19.1	Italy 20.4	Switz. 23.4	Denmark 34.0	Australia 17.6	Germany -28.7	Canada 25.4	US 6.9	Belgium -10.5	Austria 19.1	Belgium 27.9	Ireland 7.7	Finland 16.5	France 3.0	Italy 25.9	Singapore -3.9
	France 30.9	Australia 6.1	US -6.9	Singapore -29.2	Denmark 18.9	Denmark 18.9	Australia 23.0	Belgium 32.0	Denmark 15.1	Singapore -30.7	NZ 20.8	Australia 6.7	Australia -10.8	Australia 15.4	Japan 27.5	Canada 6.9	Nether. 15.7	Nether. 2.9	Norway 25.8	Portugal -5.7
	US 23.5	Portugal 5.7	UK -8.7	Canada -30.9	Norway 18.0	Australia 18.5	Singapore 21.3	Austria 31.9	Portugal 13.6	Denmark -30.9	Spain 15.2	Switz. 4.1	Nether. -12.0	Sweden 15.3	Switz. 26.9	Switz. 5.2	Portugal 15.2	Portugal 1.7	Germany 25.2	Australia -6.7
	Germany 21.6	UK 4.3	Denmark -9.5	Portugal -31.4	Ireland 14.6	Spain 17.2	Nether. 20.7	Germany 31.4	Spain 13.6	Nether. -31.8	UK 15.1	Norway 3.3	Spain -12.2	France 14.7	France 26.6	Finland 4.6	US 15.0	Germany 0.9	Spain 24.6	France -7.5
	Australia 19.1	Austria 3.8	HK -13.5	Belgium -32.3	Portugal 14.0	HK 13.6	Sweden 17.0	France 29.9	Nether. 10.5	UK -32.0	Austria 15.0	Finland 2.7	Canada -12.6	Nether. 14.0	Denmark 25.5	Australia 1.7	Switz. 14.7	Japan 0.5	Japan 21.6	Japan -7.6
	NZ 14.4	Ireland 2.9	Canada -15.4	UK -32.5	France 11.7	Portugal 13.3	Germany 16.6	Italy 28.0	France 3.8	Sweden -34.0	Nether. 14.2	Austria 2.3	Japan -14.2	Switz. 13.8	Sweden 24.8	Nether. 1.7	France 14.0	HK 0.4	Portugal 21.4	Nether. -7.8
	UK 13.9	US 2.7	Switz. -16.5	Spain -32.6	HK 10.0	Singapore 11.1	France 16.5	Nether. 26.9	NZ -0.2	Italy -34.1	Portugal 12.8	UK 1.3	Sweden -15.9	Norway 12.2	UK 21.0	Japan 1.1	HK 13.6	Singapore -0.4	Switz. 20.1	Sweden -8.4
	Denmark 13.5	Finland 1.1	Portugal -17.1	Denmark -33.2	Italy 9.8	Canada 11.1	Belgium 15.7	Australia 26.4	UK -0.7	Australia -35.0	Denmark 9.7	Germany 1.0	Denmark -15.9	US 9.1	Italy 20.7	Spain 0.4	Germany 12.0	Sweden -1.2	Finland 20.1	UK -9.0
	Nether. 8.3	HK 0.5	Nether. -17.2	HK -34.6	Singapore 9.6	UK 8.7	HK 15.0	UK 26.2	Italy -2.8	HK -35.8	France 5.9	NZ 0.9	HK -15.9	UK 9.0	Austria 13.7	UK -0.4	Sweden 8.4	UK -1.9	UK 19.9	Denmark -10.3
	Spain 6.2	Germany -0.5	France -17.5	Nether. -37.0	Japan 8.3	France 7.7	UK 13.9	HK 25.9	US -3.4	Portugal -37.0	Italy 1.7	Nether. -5.2	France -16.8	Finland 8.3	NZ 11.5	Sweden -2.6	NZ 7.0	Spain -2.8	US 18.8	Spain -11.1
	Italy 1.0	Spain -0.8	Germany -17.5	France -37.3	Belgium 7.8	Germany 5.6	US 11.5	Finland 25.5	Switz. -3.5	NZ -39.2	US 1.4	Belgium -7.2	Singapore -17.8	Italy 6.4	HK 11.4	Italy -4.7	UK 5.5	Finland -6.4	Sweden 18.2	Canada -12.2
	Switz. -5.8	Belgium -2.0	Singapore -18.6	US -38.8	Switz. 6.8	Japan 5.3	Spain 10.7	Switz. 23.1	Austria -6.4	Finland -41.0	Switz. 0.6	France -10.7	Germany -18.0	Canada 3.2	Portugal 11.3	France -5.1	Australia 2.8	Switz. -6.6	Australia 17.6	Italy -12.8
	Portugal -7.7	Sweden -7.2	Italy -22.0	Ireland -41.3	UK 5.2	Switz. 4.5	Italy 8.1	Canada 13.8	Sweden -7.8	Norway -52.9	Germany 0.5	Portugal -17.4	Portugal -22.9	Japan 2.3	Norway 9.7	Germany -5.6	Norway -2.9	Ireland -8.8	Belgium 16.2	Germany -17.5
	Austria -7.9	Singapore -14.8	Sweden -22.6	Finland -44.5	US 2.3	Nether. 2.0	NZ 7.9	NZ 12.6	Belgium -10.9	Belgium -55.9	Ireland -9.8	Italy -20.8	Italy -23.1	Ireland 0.0	Canada 5.9	Norway -17.9	Spain -3.7	Belgium -9.3	Ireland 15.8	Ireland -20.8
	Ireland -11.5	Japan -15.3	Japan -25.0	Sweden -44.7	Nether. 2.0	US 0.1	Portugal 4.1	US 10.8	Japan -12.3	Austria -58.4	Finland -10.7	Ireland -23.7	Finland -31.8	Portugal -2.1	Australia 4.4	Austria -26.0	Singapore -6.1	Italy -12.1	Canada 13.8	Belgium -22.5
Lowest Return	Belgium -13.1	NZ -21.7	Finland -34.3	Germany -46.8	Finland -4.9	Finland -3.5	Ireland 3.6	Japan 2.6	Ireland -26.8	Ireland -63.0	Japan -14.7	Spain -27.3	Austria -36.3	Spain -2.6	Singapore 1.9	Portugal -35.0	Canada -13.4	Denmark -17.3	NZ 9.5	Austria -23.0

In New Zealand dollars. Source: MSCI country indices (net dividends) for each country listed. Does not include Israel, which MSCI classified as an emerging market prior to May 2010. MSCI data © MSCI 2019, all rights reserved. Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

The table in **Exhibit 1** ranks annual stock market performance in NZ dollar terms for 22 different global developed markets, from highest to lowest, over the past 20 years. Each country has its own colour (NZ is in black). Can you see a predictable pattern?

The conclusion is that if you can't predict which country is going to perform best from year to year, it's better to be broadly diversified across *all* of them. That way, you are more likely to capture the returns wherever they happen to occur.

The second lesson is you need to be mindful of how much your international portfolio is biased to your home market. Remember that NZ accounts for a tiny proportion of the global share market, at around 0.01% or one tenth of one per cent.

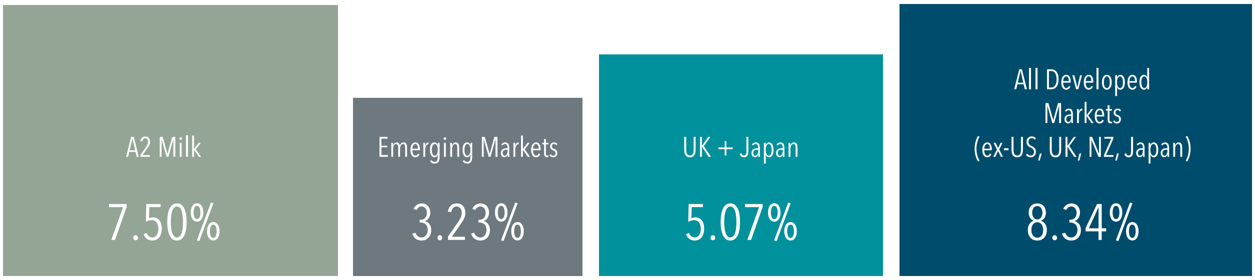
Of course, there are rational reasons for having a greater weight to your home market than its natural size in global terms might demand. These can include tax benefits, familiarity with local names, and the possible higher costs of investing abroad.

But in sticking close to home, you can also forfeit the benefits of global diversification, such as improving the reliability of outcomes and getting exposure to sectors either not available or only sparsely represented in your domestic market.

You can also end up with a handful of individual stocks representing a significant part of your portfolio, which exposes you much more to the idiosyncratic factors related to those companies than if you had been more diversified.

Exhibit 2: Case Study: Home Bias in New Zealand

Impact on Concentration: Top Holding



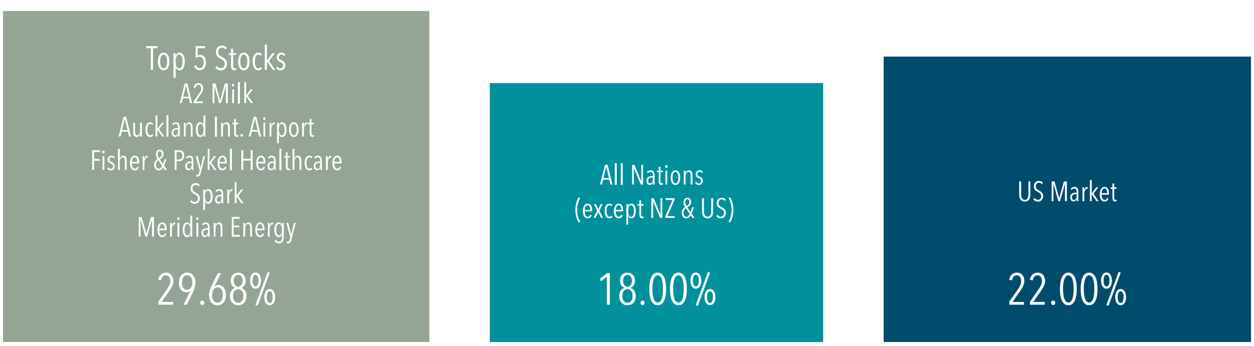
All data as of June 2019. Market Weight Portfolio is MSCI ACWI IMI Index.
60% New Zealand Portfolio is MSCI ACWI IMI rescaled with 60% allocation to New Zealand.

Exhibit 2 shows the impact, as of June 2019, for New Zealand investors with 60% of their equity allocation in their home market. In this case, a single company, A2 Milk, represents 7.5% of the portfolio – or more than all the emerging markets (China, India, Russia, Korea etc.;) This one company has a greater weight in this home-biased portfolio than the United Kingdom and Japan together!

But it's not just A2 Milk. **Exhibit 3** shows that with a 60% home bias to New Zealand, just five stocks – A2 Milk, Auckland International Airport, Fisher & Paykel Healthcare, Spark, and Meridian Energy – would account for just under 30% of your portfolio. That's more than for the entire US market or for all other countries outside NZ and the US.

Exhibit 3: Case Study: Home Bias in New Zealand

Impact on Concentration: Top 5 Holdings



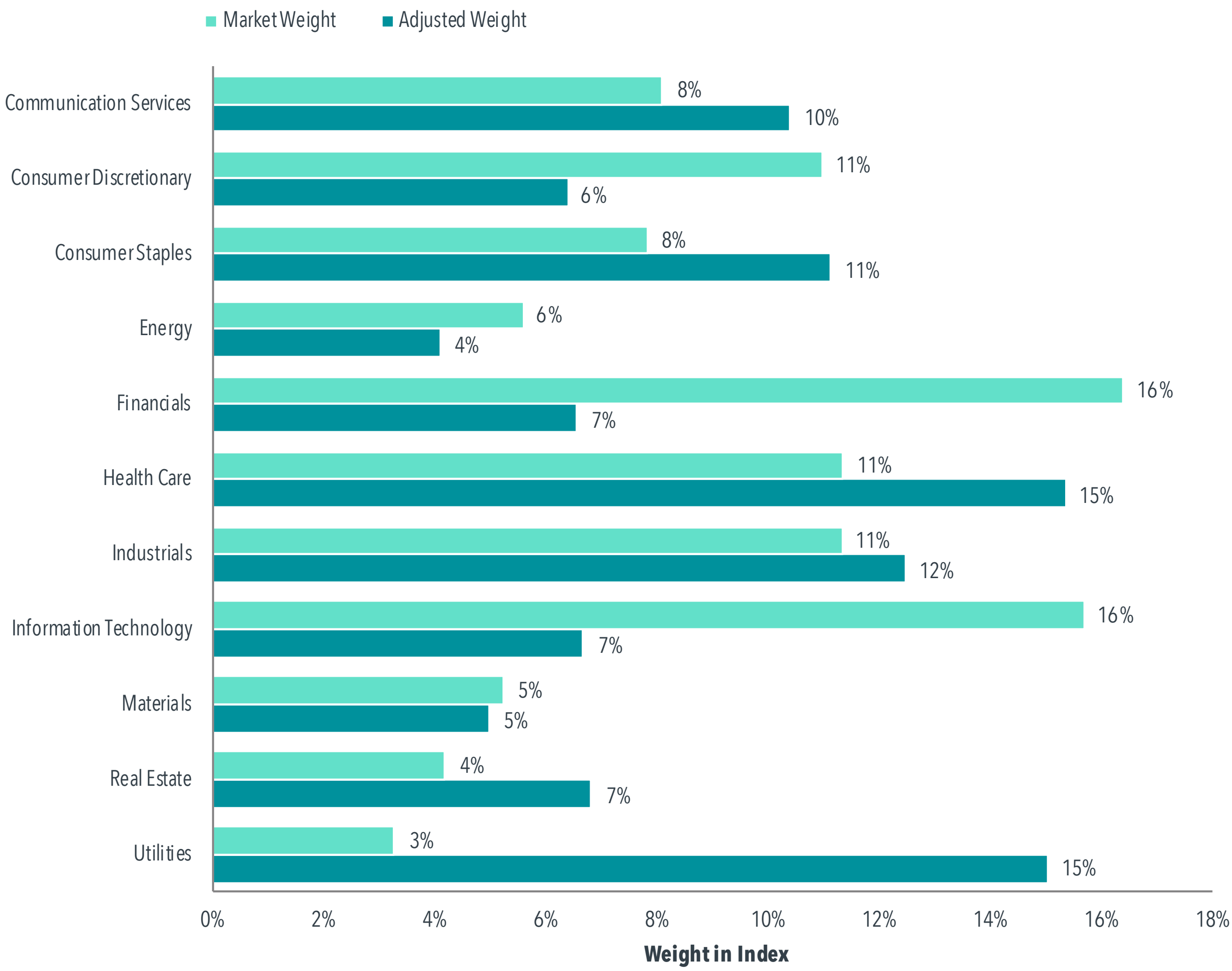
All data as of June 2019. Market Weight Portfolio is MSCI ACWI IMI Index.
60% New Zealand Portfolio is MSCI ACWI IMI rescaled with 60% allocation to New Zealand.

It isn't just the stocks that you hold through a home bias; it's also about what you're missing out on. **Exhibit 4** compares sector exposures with a 60% home bias (in blue) compared with a global weighting (in green). For instance, a home biased portfolio gives you just a 7% allocation to technology, compared to 16% in the global portfolio.

In other words, a New Zealand investor with a strong home bias would have been underweight one of the global market's top performing sectors in recent years.

Exhibit 4: Case Study: Home Bias in New Zealand

Impact on Concentration: Sectors



All data as of June 2019. Market Weight Portfolio is MSCI ACWI IMI Index.
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Think of it this way: The All Blacks have nearly always fielded great teams, but they don't win the World Cup every time. Other countries occasionally come to the fore, and by all accounts, the 2019 competition will be among the most evenly contested on record.

Likewise, while the NZ share market has been a strong performer in recent years, history shows there is no pattern to country-by-country returns and there will be years when the local market lags the rest.

NZ is a tiny market in international terms and while there are reasons for holding a greater weight in your home market than its natural weight, too much of a domestic bias can leave you with a highly concentrated portfolio.

We've seen that countries can go from top-of-the world to the bottom from year-to-year, so it makes sense to spread exposure. That way, you better positioned to capture the performance of global markets, where and when it occurs.

Being globally diversified also makes you less reliant on a handful of local stocks, with all the idiosyncratic risks they pose, and sets you up to capture the returns of other opportunities and sectors that you might not find at home.

At the end of the day, while there's no World Cup for investing, this would be the best way to win it if there were.

The author would like to thank Ross Orlando of our global portfolio management team for his assistance in researching this article.

"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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