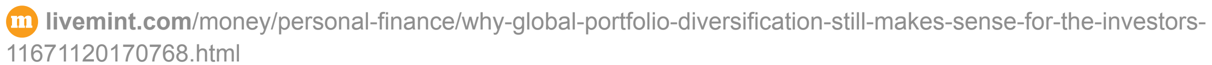
Why global portfolio diversification still makes sense for the investors



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Premium
Why global portfolio diversification still makes sense for the investors

Diversification and low volatility are important aspects of building a safe portfolio. The volatility of the returns is a measure of risk, expressed as a percentage. The higher the percentage volatility, the higher the risk.

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Much has been said about how Indians have traditionally had a big ‘home bias’ in their investment portfolios. I often get asked by investors - “India is doing so well, why should I look at investing abroad?" This is followed up by an argument of how well the Indian equity markets have done recently. Between this perception and the LRS (liberalised remittance scheme) remittance limits, Indian investors ended up sticking to domestic investments. However, prudent investors understand the importance of global portfolio diversification and that it is not a fad or a ‘the timing is not great right now’ issue. It’s a long-term, strategic move for your portfolio and family legacy planning.

Global returns compared: apples and oranges?

First up, let’s see if the Indian equity markets indeed outperformed global markets.

Having heard a lot from Indian investors on how well the domestic markets have performed, LCR Wealth conducted an analysis to compare the performance of markets in India, the US, Brazil and Europe. The analysis was based over a 22-year period, from 31 December 1999 through the end of 2021. The period begins at the peak of the dot-com era, which crashed in March 2000 and also includes the GFC and Covid routs. And for sure, the Indian Nifty 50 outperformed the other indices with a nominal return of 1,065%, as against the 386% return of the S&P 500, 513% of Ibovespa, and 12.5% of the Euro Stoxx 50.

On adjusting the nominal ret urns for the annual inflation rate of each currency, the Nifty 50 was still the top performer, with an inflation-adjusted return of 213%. The S&P 500 returned 192% after the adjustment for inflation, but the Ibovespa returned only 58%. (By this time, we have lost interest in the Euro Stoxx 50.)

Wait a minute! What about currency exchange rates? Even though Nifty 50 had a higher inflation-adjusted return than the S&P 500, the rupee did not gain as much as the dollar between 2000 and 2021. Once you adjust for both inflation and FX rates, the Nifty 50 produces a return of 90%, whereas the S&P 500 stays at 192%. In summary, over the 22-year period, the S&P 500 did better than the other major indices by 100% or more in Purchasing Power Parity (PPP) terms. This outperformance would remain the same even if we kept any of the other three currencies as the constant for the analysis.

This becomes an important consideration, especially if you anticipate dollar-denominated expenses in the future. As per Knight Frank, nearly 40% of all expenses borne by wealthy Indians are dollar-dependent. This means that changes in the dollar can have a significant impact on the overall net worth of families.

Portfolio risk management

Diversification and low volatility are important aspects of building a safe portfolio. The volatility of the returns is a measure of risk, expressed as a percentage. The higher the percentage volatility, the higher the risk. Having exposure to different geographies can provide diversification benefits, and if planned well, reduce the volatility of your portfolio. For example, the volatility of a 100% Nifty 50 portfolio over the 22-year period is 29.92% with an annualized return of 3.10%. But adding a 20% allocation to the S&P 500 lowers volatility by 2.49%, to 27.43%, while raising the annualized return by 0.51%, to 3.61%.

One of the main risks in investments is liquidity risk, loosely translated as the risk of not able convert the investment to cash at the time of need. Developed markets like the US markets have much more depth and are inherently more liquid. Especially during times of crisis, it pays to be at least partly invested in a “safe haven" market. International investors who had US exposure during the 2008 Global Financial Crisis had the flexibility to make changes to their portfolios due to the relatively more liquid nature of that market (as compared to their home countries). There is a reason why the best foreign companies seek out the largest and most liquid markets to list their shares, and the US continues to be a popular choice.

Developed markets are also a lot more efficient, with markets pricing in any new information almost immediately. Investor protections are also generally better in more developed markets. Together, these factors lead to improved price stability, increased net returns, and less disparity between retail and institutional investors. In addition, not participating in overseas markets could lead to investors missing out on quality ideas that are just not available in India.

This is not to say that Indian investors should only invest abroad, but rather it becomes obvious that they should allocate at least a small portion of their portfolio in the markets overseas.

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