THE BRANDES INSTITUTE

INVESTING IN THE U.S.A.

A Brief Guide to Managing Home Country Bias

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EXECUTIVE SUMMARY

1. Many U.S. equity investors typically prefer U.S. equities—but this "home country bias" may prevent them from taking advantage of opportunities in emerging and other developed markets.

2. Why does this bias exist? It often reflects one of three things: fear; performance; and/or values.

3. Financial advisors can use specific tactics to address these issues and potentially overcome clients' "home country bias." Jump to the "How to Address" bullet points below for details.

HOME COUNTRY BIAS

Many U.S. equity investors typically prefer U.S. equities. The United States comprises less than half the globe's market cap, but its shares account for more than 70% of the average U.S. investor's holdings[1]. "Home country bias" (HCB) —i.e., a strong preference to own domestic stocks—is probably not unique to the United States. At the same time, such a bias may prevent investors from taking full advantage of the potential opportunities in developed and emerging markets. And there is a subset of investors who are highly resistant to owning any international equities and pursuing the advantages non-U.S. exposure can bring. Below is a brief guide on why these investors may feel that way and what financial advisors can do to address it.

There is a tendency in existing studies on home country bias to presuppose universal motivations for its existence: comfort with the familiar and discomfort with the unfamiliar.

I encourage you not to *assume* this is your clients' motivation. It is certainly prevalent, but it is also an oversimplification that can cause misunderstanding and sabotage valuable conversations. Instead, when confronted with a client who is averse to non-U.S. equities, ask, "Why?" Below is one suggested script for addressing the subject with such a client:

"Mr./Ms. Client, it's considered a good practice to have international exposure in equities. What is it that makes you want to avoid having them in your portfolio?"

The answers will usually fall under at least one of the three main drivers of HCB: 1) Fear, 2) Performance, 3) Values.

FEAR

There are different strains of emotion with HCB (e.g., discomfort, anxiety, worry) but they can all be classified as forms of fear. We have already gotten the answer to the first question, "why." But there is a follow-up question that often goes unasked—"*Where* are you reluctant to invest?" It may be a binary issue for the client (i.e., U.S. vs. non-U.S.), but digging deeper can point to a more complex rationale. It could be the client is actually just fearful of emerging markets or of certain regions/countries and views them as unstable. Getting to this level of specificity may reveal that the client is open to a number of international funds, provided the exposure is within his or her comfort zones.

HCB is a more narrow application of what behavioral finance calls the *familiarity bias*. Briefly put, what is unfamiliar is more uncertain; uncertainty can provoke anxiety. One fruitful (and logical) remedy is to make the unfamiliar more familiar. Provide information to the client—an article, a report, a stat sheet—and ask them to peruse it. Some clients won't be receptive, but others will take the opportunity to educate themselves. Armed with greater familiarity, they may become more comfortable.

Many investors take comfort in knowledge—so much so that it doesn't matter if that knowledge is *irrelevant*! Recognizing the name of a company or its location doesn't make it a safer investment, let alone a better one. It just feels that way. But keep in mind: *familiar does not equal safe*. This highlights an important mental shift—getting clients to move from what feels risky to what actually *is risky*. A good approach is to dig into the numbers (e.g., valuation ratios, book value, dividends, debt).

When it comes to grounding people in facts, numbers tend to be a better language than words. Show them how attractive non-U.S. equities may be on multiple fronts. Remind them of the potential benefits of diversification. Show them how they may be able to take advantage of market cycles and move money away from U.S. equities (which outperformed international and emerging markets for the past 10 years) and into non-U.S. equities (where they might be missing out on potential opportunities, depending on their risk tolerance).[2]

Lastly, it can be useful to remind the client that international equity exposure need not be large to be significant. Recognition that the allocation is overall a smaller percentage vs. U.S. holdings can be reassuring.

HOW TO ADDRESS:

- Answer the question where; establish if the problem is binary or more nuanced
- Provide information to increase familiarity
- Establish that familiar does not equal safe
- Use numbers to ground clients in objective risk measures
- Emphasize the exposure is a small percentage of the portfolio

PERFORMANCE

Emotional reactions to unfamiliarity are not the only reason people avoid international equity exposure. Another, more rational reason is the analysis of performance.
The United States has the largest economy in the world, our markets have been providing appealing opportunities to long-term investors for decades, and since the financial crisis, our market has outperformed key international and emerging market indices[3]. For many clients who resist non-U.S. equity exposure, the argument is simple; they want to invest in the best.

There is no need to disagree with the client. In fact, I believe it's better to work with the client's logic.

"Invest in the best" makes sense—to a point. But "the *best*" is not the same thing as "*the only*." This distinction should become clearer to the client through this process—and you can get there without arguing.

Another approach to data/performance-driven investors is to dig a little deeper into the data with them. The United States has been providing superior returns for the past decade. But the truth is more complex.

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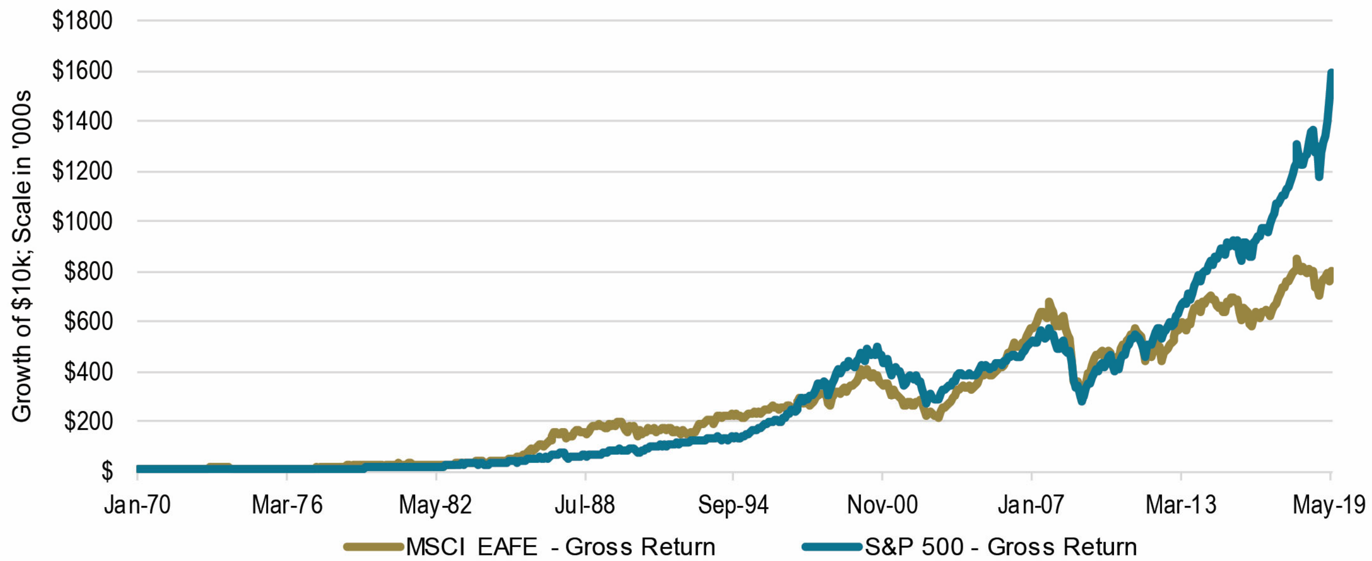
Over the last 10 years, U.S. equities have outperformed international equities by a significant margin. But for the preceding *40 years*, international and U.S. stocks had total returns that were virtually even. See Exhibit 1 on the next page.

Exhibit 1: Since 2009, U.S. Stocks Have Outperformed Non-U.S. Stocks; Will That Continue?
Growth of Hypothetical $10 Million Investment Between January 1, 1970 and June 30, 2019



Source: MSCI, via FactSet, as of 6/30/19. Cumulative return. This hypothetical example is for illustrative purposes only. It does not represent the performance of any specific investment. Actual results will vary. One cannot invest directly in an index. Past performance is not a guarantee of future results.

So the performance argument is a legitimate one, but not necessarily a *historical* one. Viewed over the long term, the data may suggest now could be a particularly compelling buy-low opportunity for international stocks.

HOW TO ADDRESS:

- Don't disagree with clients; the United States has been a terrific place to invest
- Work with their "invest in the best" logic; best country, best sector, best fund, best company… being the best should not lead to being *the only*
- Explore data deeper; a performance argument is not the same as a historical argument

VALUES

There are some people who will eschew international investing for a very different reason; they want to support their country. It is not based on emotions (e.g., fear, anxiety). It is not based on data analysis (e.g., performance). It is a rationale based on something altogether different—their values.

Many investors are animated by a sense of patriotism. When you invest in U.S.-based equities, you are investing in the U.S. economy. This sentiment was perhaps more conspicuous in the '70s and '80s when the "Made in America" movement was prominent (my parents wouldn't have been caught dead in a "foreign" car). But this viewpoint still exists today and may become heightened in a highly polarized political environment. The desire to support our country is a noble one, and it deserves to be recognized as such.

It is also likely fruitless and potentially counterproductive to use emotional/rational arguments to challenge a client's sense of patriotism. Patriotism is a deep-seated value. It makes the most sense to discuss the potential vulnerabilities and disadvantages to a U.S.-only approach. In this case, it may require a different asset allocation strategy to account for the client's convictions.

HOW TO ADDRESS:

- Validate their motivation
- Make the client aware of potential downside (e.g., less diversification)
- Plan in a way that accounts for this potential portfolio weakness

SUMMARY

The home country bias is a natural tendency. Some clients will be highly resistant to the idea of international equity exposure, which may cost them diversification and opportunity. HCB has different root causes (i.e., fear, performance, values), and these causes are not mutually exclusive. Start by asking "why?" and you likely will find three main drivers to the clients' resistance. From there you can use different strategies tailored to their individual rationale and have a positive impact on their investing decisions.

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End Notes and Disclosures

[1] https://www.investopedia.com/terms/h/home-country-bias.asp
[2] For the 10-year period ending Dec. 31, 2018, the S&P 500 Index delivered an annualized return of 13.1% vs. 6.3% for the MSCI EAFE Index and 8.0% for the MSCI EM Index. Past performance is not a guarantee of future results. One cannot invest directly in an index.
[3] For the 10-year period ending Dec. 31, 2018, the S&P 500 Index delivered an annualized return of 13.1% vs. 6.3% for the MSCI EAFE Index and 8.0% for the MSCI EM Index. Past performance is not a guarantee of future results. One cannot invest directly in an index.
Book Value: Assets minus liabilities. Also known as shareholders' equity.

The MSCI EAFE Index with net dividends captures large and mid cap representation of developed market countries excluding the U.S. and Canada.

The MSCI Emerging Markets Index with net dividends captures large and mid cap representation of emerging market countries.

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The S&P 500 Index with gross dividends measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

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