E Q U I T I E S

International Diversification Works (Eventually)

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Critics of international diversification observe that it does not protect investors against short-term market crashes because markets become more correlated during downturns. Although true, this observation misses the big picture. Common, short-term crashes can be painful, but long-term returns are far more important to wealth creation and destruction. We show that over the long term, markets do not tend to crash at the same time. This finding is no surprise because even though market panics can be important drivers of short-term returns, country-specific economic performance dominates over the long term.

What drives the difference between the short- and long-term benefits of diversification? One hypothesis is that short-term market downturns are, at least partly, about panics and broad-based selling frenzies. Long-term results, however, tend to be more about economic performance.

We explored this hypothesis by decomposing returns into (1) a component arising from multiple expansion (or contraction) and (2) a component arising from economic performance. By investigating the dynamics of these return contributors, we tried to offer additional insight into why global diversification can disappoint over the short term but be the free (and hearty!) lunch that theory and common sense say it should be over the long term.

Diversification protects investors against the adverse effects of holding concentrated positions in countries with poor long-term economic performance. Over longer horizons, underlying economic growth matters more than short-lived panics with respect to returns, and international diversification does an excellent job of protecting investors.