CAPITAL GROUP®

Guide to international investing:

How to go global in an uncertain world

International markets have lagged for years. Will that ever change?


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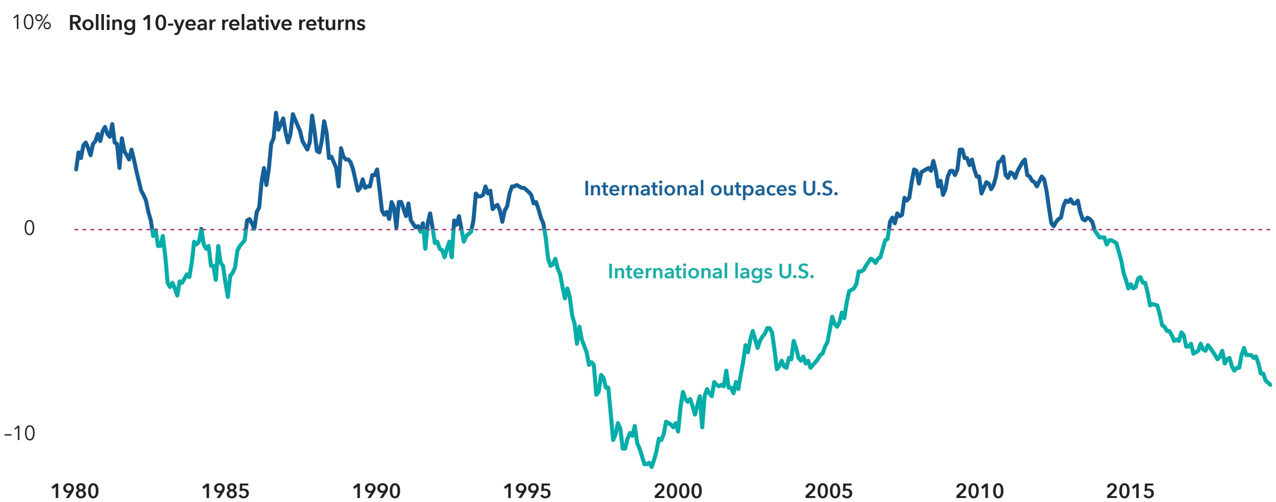
If you feel like international equities in your portfolio aren't holding up their end of the bargain, then you're not alone. It's one of the most common investment concerns we hear today. Not to mention that the global landscape remains full of uncertainties. A trade war with China, slowing global growth and Brexit are just a few. After a decade of dominance by U.S. stocks, you might be wondering: Why bother investing outside the U.S.?

There have always been reasons not to invest in international stocks. And this guide is not a prediction that markets are set to rise in the near term. But for long-term investors, we believe international equities hold great promise, and there are many reasons to stay invested. International investing has changed dramatically in recent years, but one thing that has not changed is its rightful place in a well-diversified portfolio.

Rolling 10-year relative returns



SOURCES: MSCI, Refinitiv Datastream, RIMES, Standard & Poor's. As of 8/31/19. Annualized 10-year total return of S&P 500 Index versus the MSCI World ex USA Index.

This guide will cover:

- **4** ways international investing has changed
- **3** reasons to consider investing in non-U.S. markets today
- **2** decisions to make on portfolio construction
- **1** answer to your key question on asset allocation

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Think all the best stocks are in the U.S.? Think again.

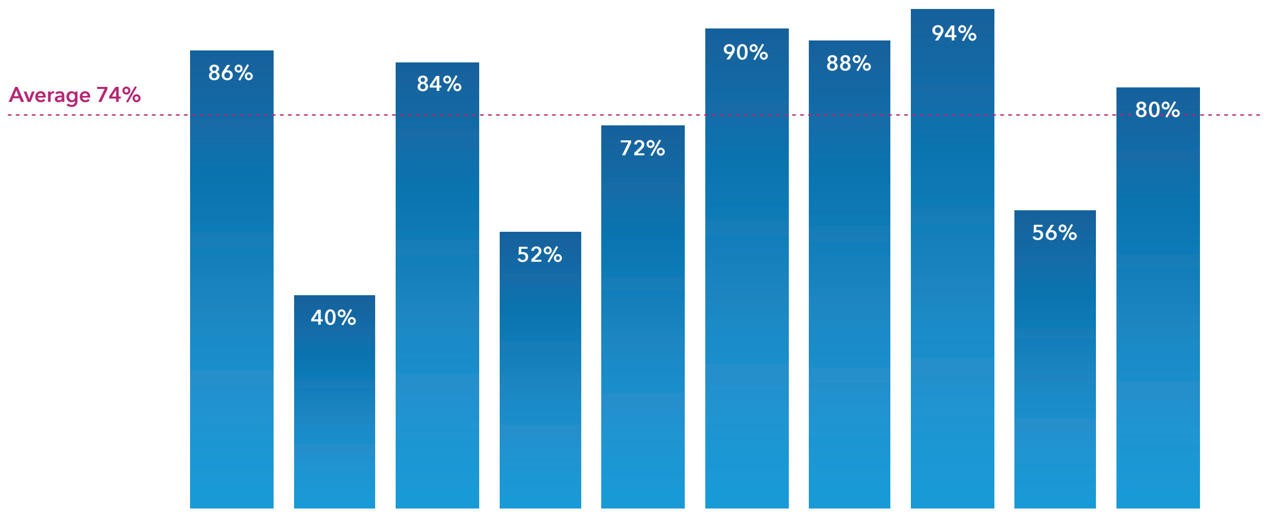
International equities have trailed U.S. markets over the past 10 years, but the index-based returns that most investors follow don't tell the whole story. On a company-by-company basis, the picture is quite different. In fact, it may come as a surprise that the companies with the best annual returns each year have been mostly based outside of the United States.

How have U.S. markets done so much better while non-U.S. companies have regularly produced higher returns? There are two key reasons for this apparent paradox:

- Many more companies are headquartered outside the U.S. While this may seem obvious, it is an important point. As an investor, why would you limit where you invest based on geography?
- Indexes do not necessarily represent the best growth opportunities, especially outside the U.S. Fundamental research of individual companies is often a better way to uncover attractive investments.

We'll explore both ideas in greater detail, but first let's dig into how non-U.S. markets have changed in recent years, and why investors need to rethink their approach to international investing.

What percentage of the top 50 stocks each year are non-U.S.?



Index return	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019 YTD
U.S.	15.1%	2.1	16.0	32.4	13.7	1.4	12.0	21.8	-4.4	18.3
Non-U.S.	11.2%	–13.7	16.8	15.3	-3.9	-5.7	4.5	27.2	–14.2	8.8

SOURCES: MSCI, RIMES. 2019 as of 8/31/19. Returns in U.S. dollars. S&P 500 and MSCI ACWI ex USA used for U.S. and non-U.S. returns.

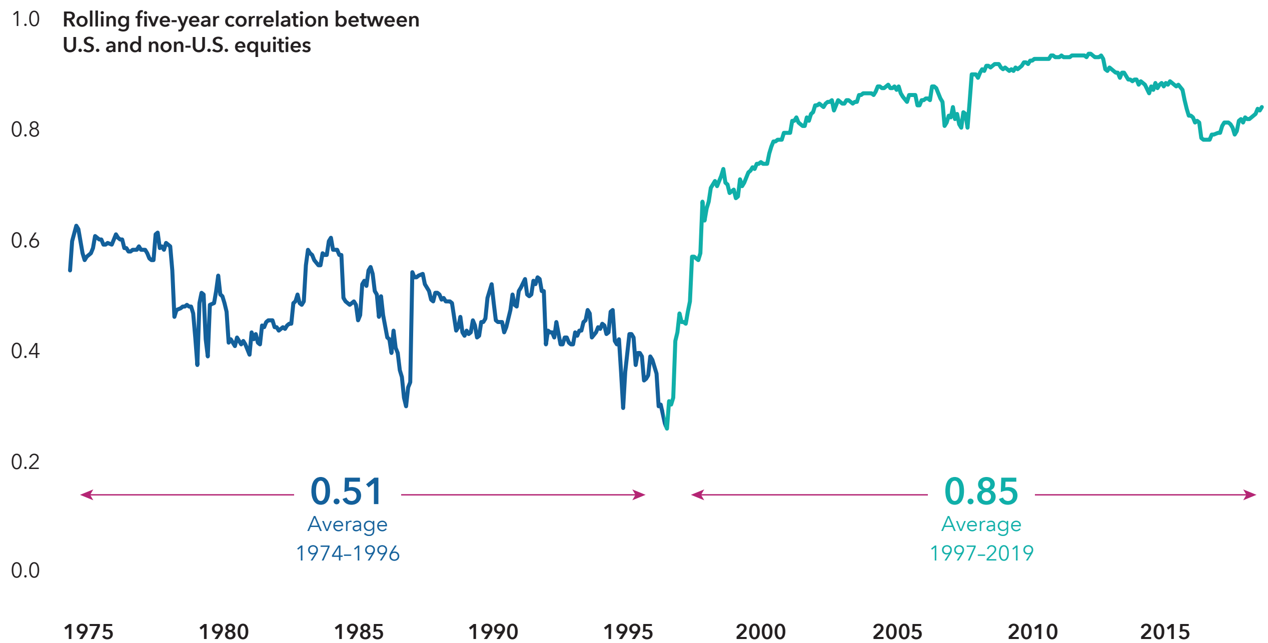
1. No more free lunch from diversification

In some ways, international investing used to be much easier – as simple as dividing your stock portfolio into two buckets, U.S. and non-U.S. The result? Instant diversification. But not anymore. The easy button is gone.

That's because correlations between U.S. and non-U.S. markets have more than doubled over the last 25 years. Correlation indicates the tendency of two assets to move in the same direction. In portfolio construction, lower is generally better because it can help reduce risk.

But why have correlations risen so much? Globalization is partially responsible. Without overlooking the impact of escalating trade tensions in recent years, companies and countries are more integrated than ever. As companies have become more global, the lines between U.S. and non-U.S. indexes have started to blur, and correlations between the two have risen. This reduces the diversification benefits of blindly allocating to both areas, but this index-based analysis is incomplete. As we'll see, a focus on companies rather than broad indexes can help overcome this trend.

Higher correlations have reduced geographic diversification benefits



SOURCES: Capital Group, MSCI, Standard & Poor's. S&P 500 Index and MSCI World Index ex USA used to represent U.S. and non-U.S. equities, respectively. Includes all five-year rolling periods ending between 12/31/74 and 8/31/19.

2. Revenue is more important than real estate

If real estate is all about "location, location, location," investing may be all about "revenue, revenue, revenue." As the shift toward globalization continues, the address of a company's headquarters has become less important to its growth prospects than where it makes money.

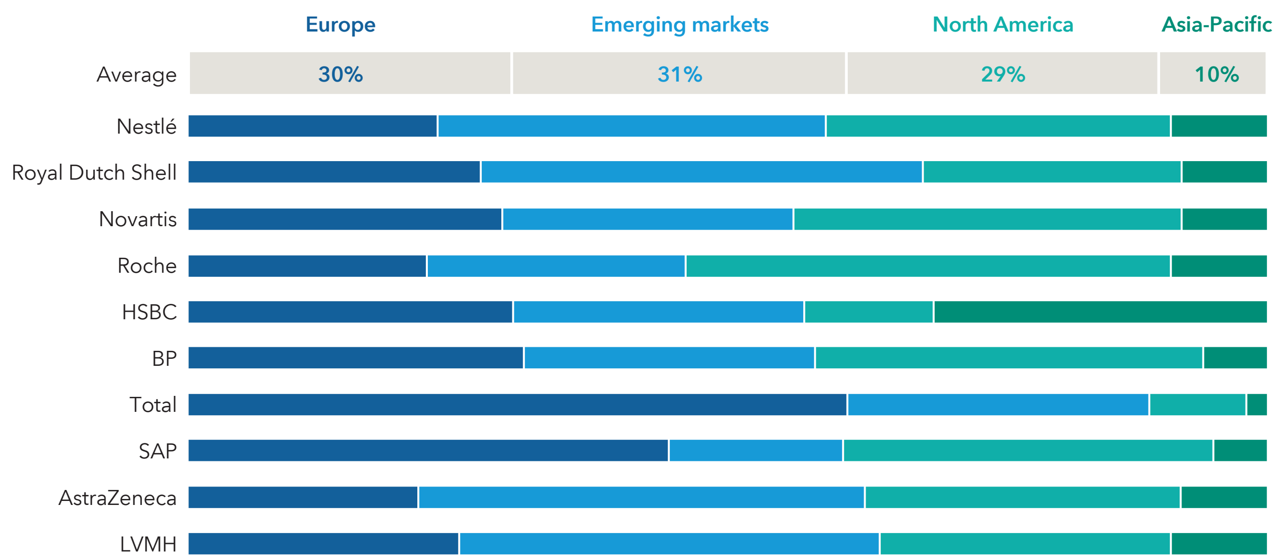
Consider that a company's products are often made with parts manufactured in several countries and then sold to customers throughout the world. This rise of multinational companies means investors should re-evaluate how they think about global stocks. Instead of where it's based, look at where it earns its revenue.

For example, the 10 largest companies in Europe generate less than a third of their revenue from their home region. Political strife or an economic slowdown can still hinder European stocks, but will affect every business differently. A careful examination of revenue exposure can help investors identify companies that are less likely to be disturbed by macro headwinds.

The bottom line? Follow the money, not the mail.

Many European companies derive the bulk of their revenue from outside the region

Revenue exposure of the 10 largest companies in Europe



SOURCES: Capital Group, FactSet, MSCI. Average shown is the market capitalization-weighted average of the 10 largest companies in the MSCI Europe Index as of 8/31/19. Country revenue exposure is as of 12/31/18.

3. It's about companies, not indexes

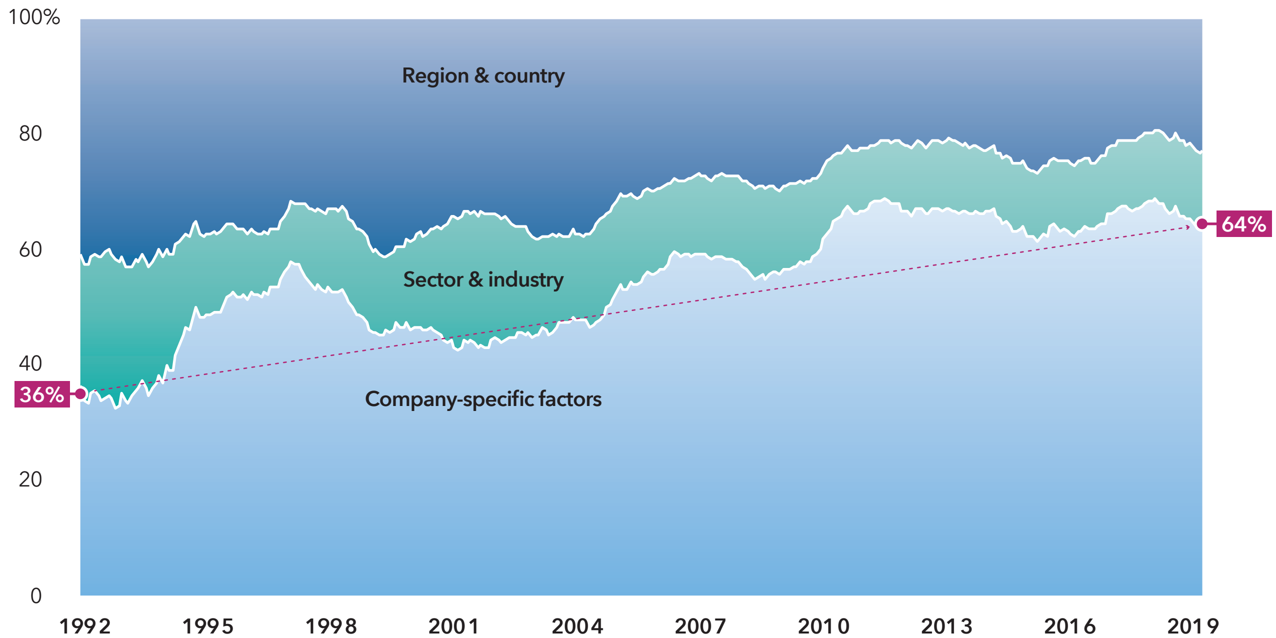
With the location of company headquarters becoming less significant and correlations on the rise, where should investors look for returns? It comes down to company fundamentals.

A study by Empirical Research Partners shows that in 1992 most of an emerging market company's return could be explained by its sector or region, and only 36% was accounted for by the business itself. That was at a time when investing in emerging markets (EM) was a relatively new concept, and the macro environment drove returns. In many portfolios they were grouped together as a basket of higher growth but riskier assets.

Today that relationship has flipped. As EM companies have become more established on the global stage, 64% of their stock returns can be explained by company fundamentals. This is the same proportion found in developed markets. So no matter where you invest, company fundamentals matter most.

Sector and country-specific issues will still influence business profits, but the best companies are often led by strong management teams able to overcome external factors. This is where bottom-up research becomes essential — and can be the difference between investing in a company that succumbs to macro headwinds, or one that becomes the next big growth story.

Composition of emerging markets' returns



SOURCE: Empirical Research Partners. As of 8/31/19. Data shows the percentage of emerging markets' returns that can be attributed to various factors over time, using a two-year smoothed average.

4 ways international investing has changed

4. Indexes don't tell the whole story

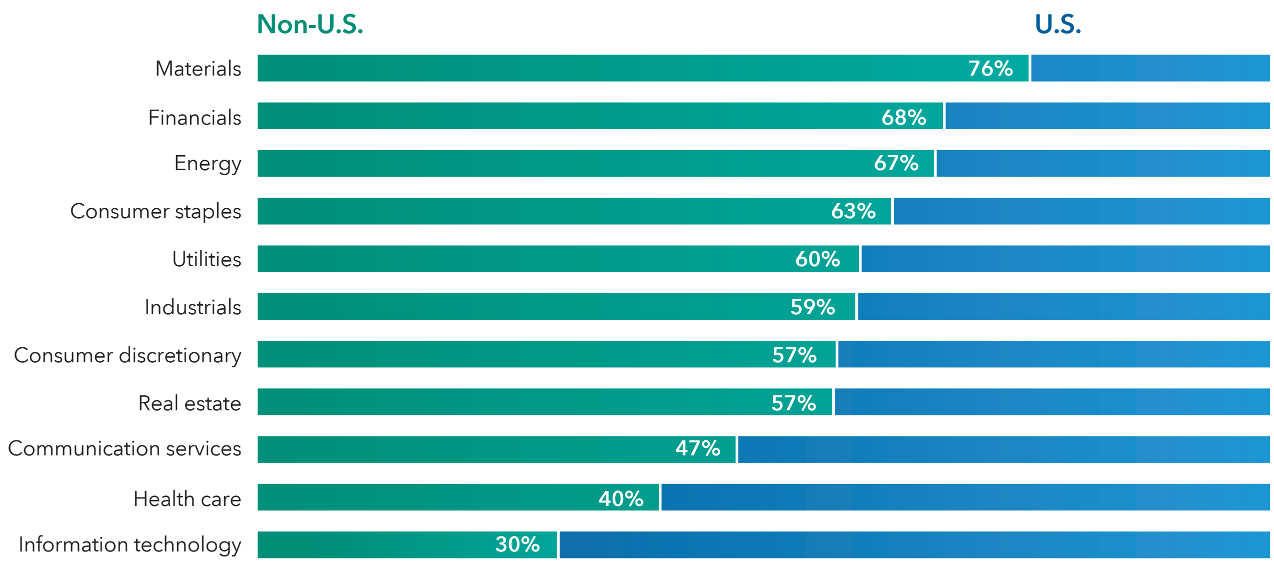
There are many reasons for lackluster non-U.S. returns over the last decade: a strong U.S. dollar, political turmoil and trade tariffs – just to name a few. But another factor is the way in which we typically measure international markets.

International indexes generally have a greater concentration of value-oriented stocks in "old economy" sectors such as materials, financials and energy. Contrast that with the U.S., where technology, health care and consumer tech dominate the Standard & Poor's 500 Composite Index. That alone accounts for much of the decade-long return disparity between U.S. and non-U.S. stocks.

That's not to say that growth can't be found in international markets. It just requires more work to uncover promising companies that may be hidden within indexes. And that's where company-by-company analysis becomes so critical. The average stock in Europe may be growing slower than one in the U.S., but growth can still be found by those who look past index averages and examine each opportunity based on its individual characteristics.

Non-U.S. indexes are more heavily weighted toward lower growth sectors

Regional exposure of each sector within MSCI ACWI



SOURCES: MSCI, RIMES. As of 8/31/19.

Currency effects have been minimal in the long run

Another headwind for U.S. investors in recent years has been the strong dollar. But the greenback won't flex its muscles forever, as currency strength tends to move in long cycles.

In times of dollar appreciation, many equity investors turn to currency-hedged investment vehicles or complex option strategies to offset currency exposure. Both approaches come with additional costs and risks. While it may have benefits within bond portfolios, extensive hedging may not be the answer for most long-term stock investors.

Currency cycles can be lengthy, but over the long haul their impact largely cancels out. During the past 40 years, the U.S. Dollar Index's average annual return over rolling five-year periods has been just –0.25%.

In our view, a better approach to dealing with currencies is to analyze how individual businesses could be affected by currency moves. During periods of currency weakness, manufacturers that purchase parts overseas may be hurt by higher input costs. At the same time, exporters may benefit as their products can be priced more competitively in foreign markets. Though volatility and dollar strength can be unsettling for international investors, it's important to recognize that individual companies can still thrive and generate longer term gains.

ROB LOVELACE
Portfolio Manager

3 reasons to consider investing in non-U.S. markets today

1. Fish in a bigger pond

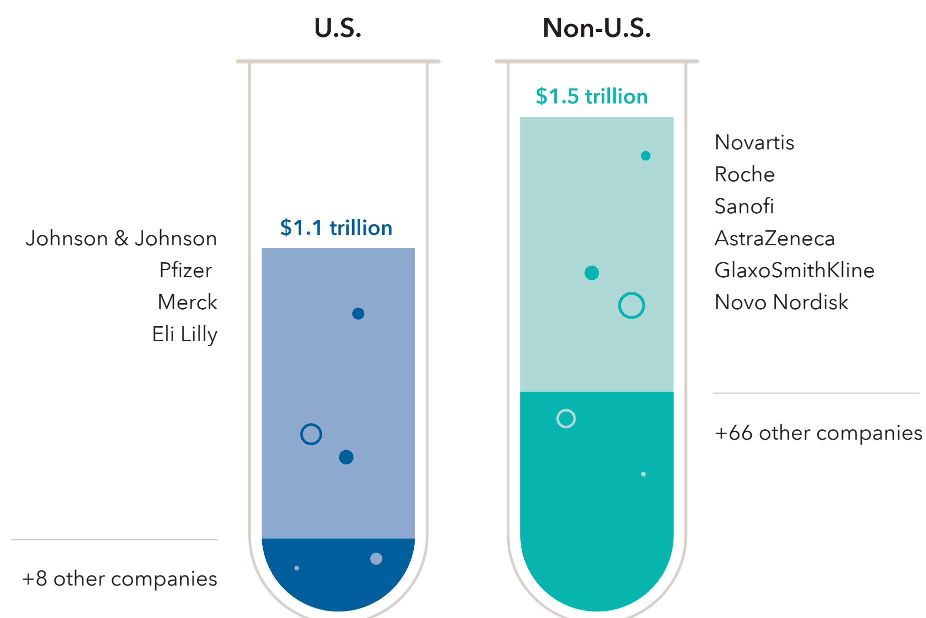
If you were going fishing, would you limit yourself to half the lake, or would you want to seek opportunities wherever they were available? Investing shouldn't be any different. One of the greatest benefits of global investing is that it allows you to consider the world's best companies, no matter where they are located.

In certain sectors, European companies are among the world's most dominant players, including large pharmaceutical companies Novartis, AstraZeneca and Novo Nordisk. The luxury goods industry is another example, centered in France, Italy and Switzerland with companies such as LVMH, Kering and Richemont.

Outside Europe, the story remains just as valid. Japan is home to many cutting-edge robotics firms, including Murata and FANUC. Some of the world's most successful technology companies are based in Asia: Samsung, Taiwan Semiconductor, Tencent and Alibaba, to name a few.

To have a well-rounded and robust portfolio of stocks, investors should consider international markets – even if you think the U.S. market in aggregate will continue to do better in the short term.

Market capitalization of MSCI ACWI Pharmaceuticals Index (USD)



SOURCES: MSCI, RIMES. As of 8/31/19. Companies listed represent the 10 largest by market capitalization.

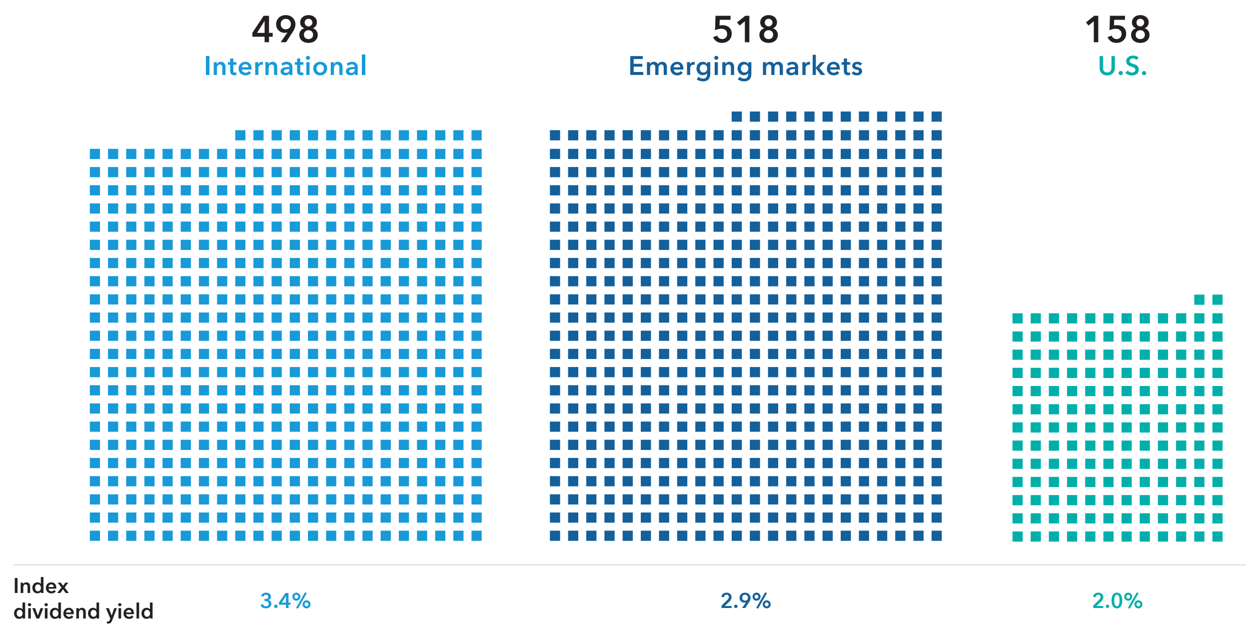
2. Greater dividend opportunities

The idea of fishing in a bigger pond may be even more beneficial to income investors. That's because outside the U.S., more companies have tended to pay dividends and have done so at higher levels. There were more than six times as many non-U.S. stocks with yields over 3%, as of August 31, 2019.

International dividend investors don't have to give up growth potential either. For example, Asian semiconductor manufacturers TSMC and Samsung each had dividend yields above 3%. Likewise, European pharmaceuticals such as Roche and Novartis are on the cutting edge of cancer research and offer both the potential for capital appreciation and consistent dividend payouts.

At this late stage of the economic cycle, a sharper focus on dividend-paying companies and lower volatility portfolio strategies may be a good idea. But with such a large pool of stocks available, deep fundamental research is key. Indeed, not all dividend-payers are created equal. Many companies appear solid on the surface but carry significant debt burdens and may be on the cusp of losing their investment-grade credit rating. A missed payment or a downgrade could send share prices tumbling, so investors should focus on companies that are most likely to maintain consistent dividend payments.

Number of companies with dividend yields higher than 3%



SOURCES: Capital Group, MSCI, RIMES. As of 8/31/19. Regions represented by MSCI USA, MSCI World ex USA and MSCI Emerging Markets indexes.

3. International stocks are on sale

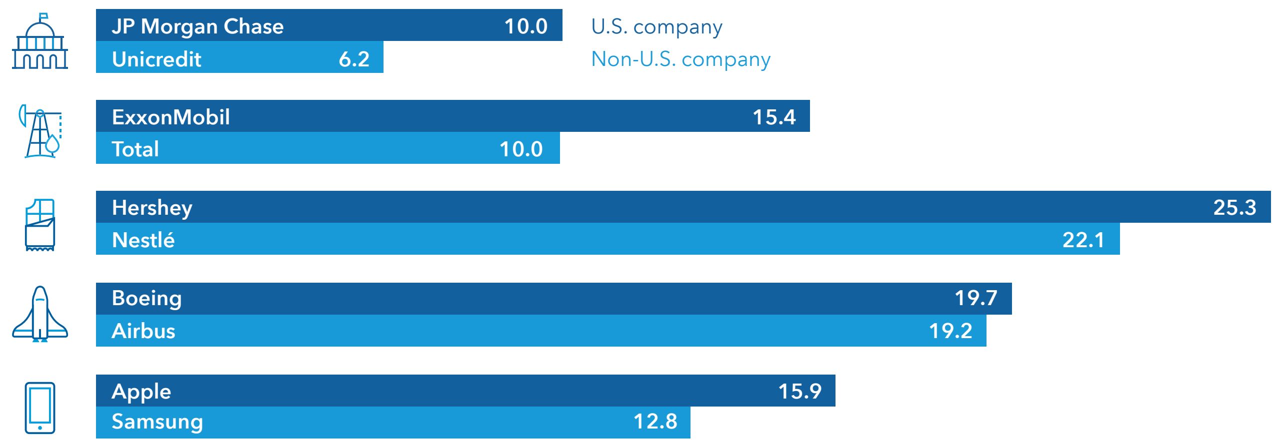
Valuations matter. There is evidence that stocks trading at a discount average higher long-term returns in future periods than those selling at a premium. But the key phrase here is *long term*, because there is almost no correlation between valuations and short-term returns.

This may not help those trying to time the market, but it's great news for investors looking to hold onto non-U.S. assets for the long haul. In nearly every sector, there are comparable non-U.S. companies trading at lower valuations than their American-domiciled counterparts. Unicredit and Samsung are just two examples.

Companies overseas often trade at a discount due to political or economic issues in their home countries, even if these factors don't directly affect the business itself. Over the long term, company fundamentals drive stock returns, not geopolitical turmoil or a company's address.

Valuations of similar companies are often lower outside the U.S.

Forward price-earnings ratios



	United States	Developed international	Emerging markets
Current P/E	16.6	13.2	11.6
15-year average	14.8	13.3	11.1

SOURCES: IBES, MSCI, Refinitiv Datastream, Standard & Poor's. As of 8/31/19. Forward price-earnings ratios are for S&P 500, MSCI World ex USA and MSCI Emerging Markets indexes.

Investment opportunities in China are growing rapidly

The headlines on China have been all about trade disputes of late, but there is an emerging trend that should make long-term international investors take notice.

The veil is lifting on China's domestic stock market, positioning it to become a much larger slice of the investable universe. Securities of more than 800 Chinese-domiciled companies, known as A-shares and traded locally on the Shenzhen and Shanghai stock exchanges, are expected to become available to investors outside the country for the first time in the next few years.

That is a stock picker's dream come true. If even a small fraction provide attractive investment opportunities, the extensive research needed to identify them should be worth the effort. Imagine finding the next Alibaba, Tencent or Ctrip. Investors should remain selective, however, as macro headwinds and transparency concerns are among the more significant risks.

DAVID POLAK
Investment Director

2 decisions to make on portfolio construction

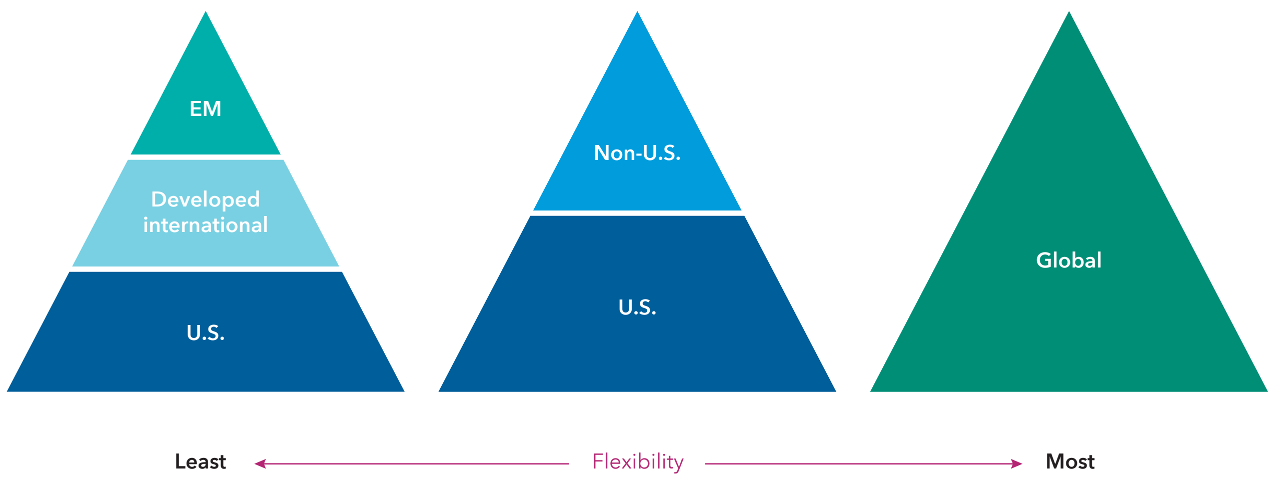
1. Regional or global?

When markets are uncertain, it can be good to have some flexibility in your portfolio. Deciding on the right balance between traditional regional funds and more flexible global funds is one of the first key asset allocation decisions investors need to make.

A region-based approach is the most traditional, typically including three dedicated geographic segments: U.S., developed international and emerging markets. This allows portfolios to be constructed with specific geographic allocations in mind.

On the opposite end of the spectrum, a more flexible approach would include global funds. These mandates typically allow portfolio managers to dynamically shift their holdings and choose companies that they find most attractive from anywhere in the world. Of course, both approaches have their merits, and investors may want to consider combining dedicated international funds with a more flexible global strategy.

There are many ways to build a diversified portfolio



SOURCE: Capital Group. Diagrams are for illustrative purposes only and do not reflect actual portfolios.

2. Active or passive?

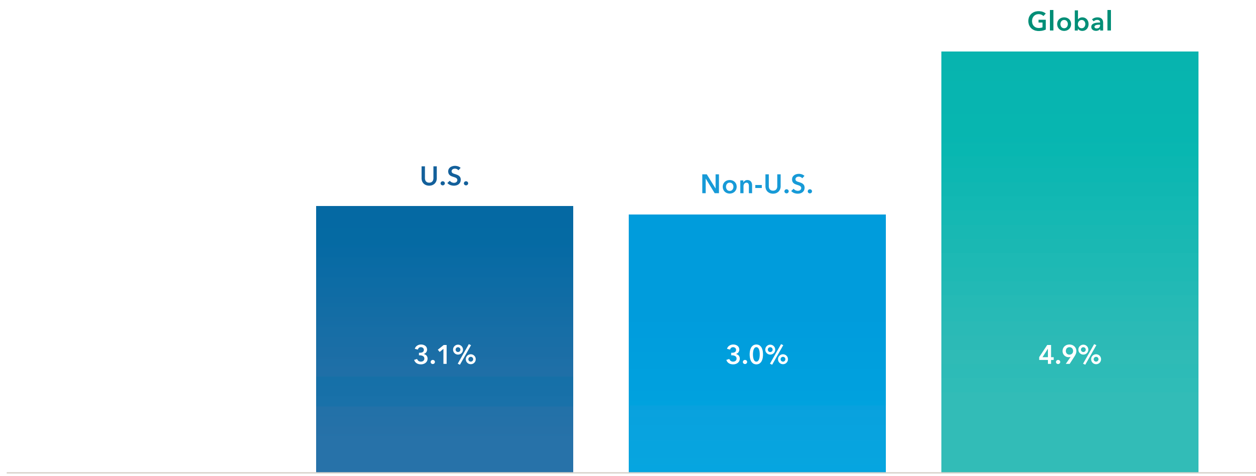
Much of this report has emphasized fundamental research of individual companies as one way to overcome international investing headwinds. But at a time when index investing has become increasingly popular and non-U.S. equities have lagged, is it worth the effort? Or would all investors be better served investing in a passive U.S.-only index fund?

The truth is, the average active mutual fund may not offer an advantage over the index, and passive funds only seek to replicate rather than beat their benchmarks. But investors don't need to settle for average. Not when you consider that the top quartile of active funds outpaced the indexes by a wide margin in the 20 years ending December 31, 2018.

Global fund managers have shined the brightest, outpacing the MSCI ACWI by 4.9% per year. These funds also handily beat top quartile U.S.-only funds, in a period when U.S. indexes dominated. One explanation is that these global managers were most successful in benefiting from flexible mandates which allowed them to choose from the best companies, no matter where they were located.

When selecting non-U.S. and global fund managers, remember that it's impossible to cover the entire world from New York. Consider partnering with investment managers whose research teams travel the globe and have access to company management.

Excess returns of top-quartile active mutual funds vs. index



Annualized total return (%)	U.S.	Non-U.S.	Global
Top-quartile mutual fund	8.7	7.3	9.5
Average mutual fund	5.2	3.9	4.8
Index	5.6	4.2	4.5

SOURCES: Capital Group, Morningstar, MSCI, Standard & Poor's. Average annualized returns for the 20-year period ending 12/31/18. Data include all active funds in the following Morningstar categories. For the United States: U.S. large value, large blend and large growth. For non-U.S.: foreign large value, foreign large blend and foreign large growth. For global: world stock. S&P 500, MSCI ACWI ex USA and MSCI ACWI are used to represent U.S., non-U.S. and global indexes, respectively.

1 answer to your key question on asset allocation

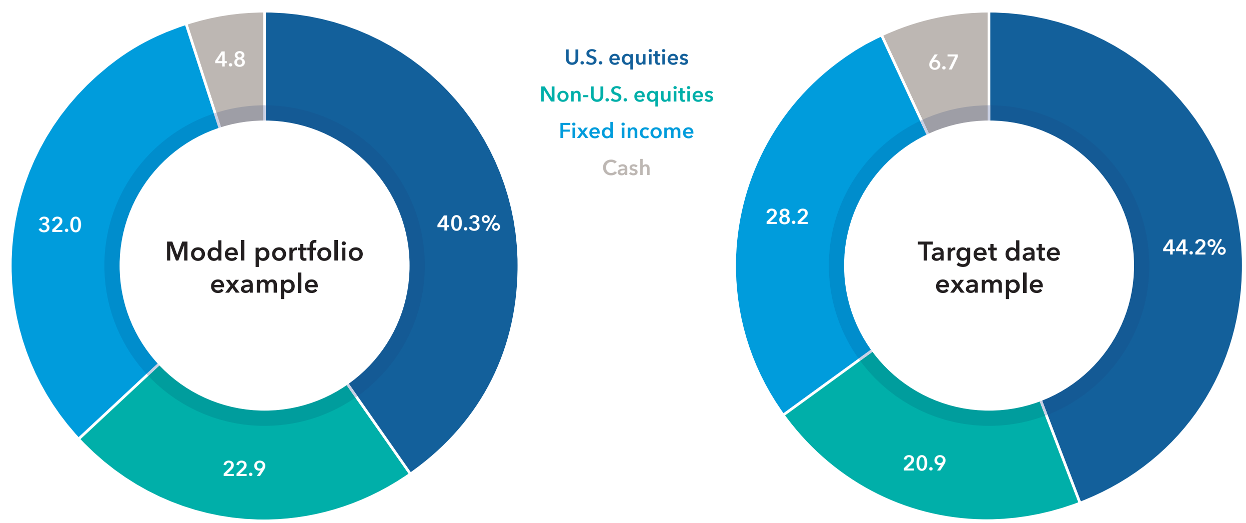
How much international equity do you really need?

When it comes to answering the question, "How much international equity do you need?" the simple answer may be, "More." Whether it's due to a home bias or a lack of rebalancing during the long U.S. bull market, many investors may find themselves underexposed to non-U.S. equities.

At Capital Group we don't make top-down asset allocation decisions based on geography, and we don't believe there is a magic number to target. But as a rule of thumb, having about a third of your equity allocation within non-U.S. stocks may be appropriate. For a standard 60/40 portfolio, that would be 40% U.S. equity, 20% non-U.S. and 40% fixed income. Our objective-based model portfolios and target date series – including the two examples on this page – may also provide good starting points for discussions around international exposure levels for various risk profiles and life stages.

Digging one step deeper, the type of equity should vary depending on an investor's risk tolerance. In the current late-cycle environment, investors may want to consider more conservative portfolios, which generally include more dividend-paying equities with a history of lower volatility. Outside of equity, investors can seek additional diversification by allocating a portion of their fixed income portfolio to international bond funds.

Sample portfolio allocations



SOURCE: Capital Group. As of 6/30/19. The model portfolio example is American Funds Moderate Growth and Income Model Portfolio℠. The target date example is American Funds 2030 Target Date Retirement Fund®. Although the target date funds are managed for investors on a projected retirement date time frame, the fund's allocation strategy does not guarantee that investors' retirement goals will be met. American Funds investment professionals manage the Target Date Fund's portfolio, moving it from a more growth-oriented strategy to a more income-oriented focus as the fund gets closer to its target date. The target date is the year in which an investor is assumed to retire and begin taking withdrawals. Investment professionals continue to manage each fund for 30 years after it reaches its target date. Changes in the equity allocation within the underlying equity-income and balanced funds may affect the overall equity exposure in the target date funds.

Guide to international investing: 10 things you need to know

4 ways international investing has changed	3 reasons to consider investing in non-U.S. markets today	2 decisions to make on portfolio construction	1 answer to your key question on asset allocation
No more free lunch from diversification	Fish in a bigger pond	Regional or global?	How much international equity do you need?
Revenue is more important than real estate	Greater dividend opportunities	Active or passive?	
It's about companies, not indexes	International stocks are on sale		
Indexes don't tell the whole story			

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The return of principal for bond funds and for funds with significant underlying bond holdings is not guaranteed. Fund shares are subject to the same interest rate, inflation and credit risks associated with the underlying bond holdings.

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Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.

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