

DC Insights

Going global, again: DC plans should embrace a less U.S.-centric approach

Most defined contribution participants have minimal exposure to investments outside the U.S. and are not able to benefit from the long-term growth of some of the world’s most dynamic companies and industries. Just as defined benefit plans did in the 1990s, defined contribution plans should move away from a largely U.S.-centric investment view. Plan sponsors can encourage this by providing international and global equity options in their DC lineups.

Taking that one step further, we think global portfolios should be included and encouraged over separate U.S. and non-U.S. portfolios, as investment managers can provide better results with broader mandates than they can by combining the separate components.

Missing out

Most defined contribution participants have minimal exposure to investments outside the United States. While the majority of the world’s equity market capitalization is outside the U.S. — and there is a growing comfort level among participants to invest there — the average participant allocates only 9% to non-U.S. equities, according to Callan Associates.¹

That is out of line with the size of overseas markets and the opportunities they represent. Stocks outside the U.S. compose 53% of the MSCI World Index and 58% of the MSCI All Country World Index, which includes emerging markets.²

Additionally, a participant’s income and other forms of investment, such as real estate, are also likely to be denominated in U.S. dollars, resulting in a highly U.S.-centric base of assets. With regard to equities, that has been to the participant’s detriment over the past decade. During that time, U.S. stocks provided an annualized return of 5.9%, compared to 8.7% for non-U.S. stocks and 14.3% for emerging markets stocks.³

DC participants have a lower exposure to international equity than their DB counterparts⁴

	% assets in Int'l Equity
Defined benefit plans	17%
Defined contribution plans	9%

Benefits of broader opportunities

Professional investors are more aware of the benefits of a broader investment universe. While U.S. companies are leaders in many areas, stocks outside the U.S. have provided the best opportunities over the past 10 years in diverse industries such as chemicals, metals and mining, industrial conglomerates, luxury goods, health care equipment, financial services and telecommunications.

From an economic perspective as well, opportunities outside the U.S. are rapidly expanding. While the U.S. is still the largest economy in the world, it is only about one-fifth of the global economy. Global portfolios can tap into a large part of the wealth creation taking place outside U.S. borders.

Professionally managed defined benefit plans allocate 17% to non-U.S. (developed market) equities — nearly double that of the average participant — and many are considering increases through global mandates.⁴ Separate allocations to emerging markets represent additional assets outside the U.S. for many DB plans. This commitment is in the context of an even broader set of options available to institutional investors, including hedge funds and private equity. These institutional investors “went global” in the 1990s and are continuing to do so.

Encouraging the shift

Nearly all DC plans now offer a non-U.S. equity option. But it is often a single option, competing with multiple U.S. equity choices. A stepped-up educational effort could be part of the solution, but we think having a global equity option would also go a long way toward encouraging this shift.

According to Callan Associates, only 8.5% of DC plans have a global equity option. When a global portfolio is made available, the average participant allocation to it is 8.7%.¹

There’s going global, and there’s going global

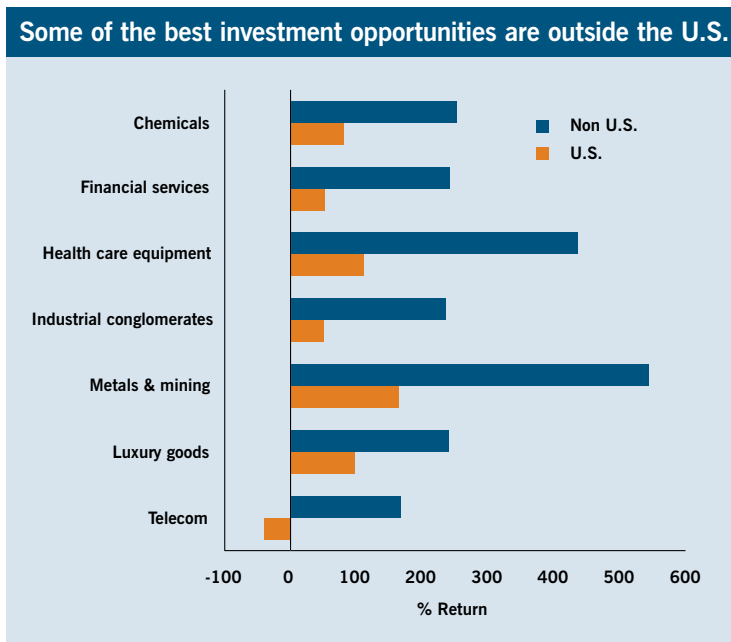
Providing global options in DC plans alongside U.S. and non-U.S. options would very likely increase participant exposure to markets outside the U.S. Ideally, global equities should be presented as preferable to a combination of separate U.S. and non-U.S. portfolios.

A true, world-wide mandate seeks out the most attractive investment opportunities, regardless of geography, on a real-time and flexible basis. Managers that have been given this broad

mandate can choose investments from a wider universe to assemble a portfolio of “best of world” companies, which will differ from a portfolio that combines “best of region” with another “best of region.”

For example, a manager might consider Siemens to be the best industrial company in the world, even though that manager may view General Electric as the best industrial company in the U.S. A truly global portfolio, therefore, might have a large position in Siemens, whereas the bolted together portfolio might have a smaller position in each company.

Being able to invest in the highest investment conviction on a world-wide basis is powerful; it should lead to better results than a patchwork of regional portfolios. At Capital Guardian, this is borne out with our own results, which are consistently better for global equities than with a hypothetical combination of U.S. and non-U.S. equities (based on the weightings in the MSCI World Index).



Ten-year cumulative returns for MSCI EAFE+Canada and MSCI USA Index as of 12/31/07. Source: RIMES

The stocks in our global portfolios represent our strongest investment convictions on a world-wide basis. The weight of different regions, countries and industries in the portfolio are the result of forward-looking, bottom-up decisions rather than index weightings that are based on the past.

Investing in a global portfolio also mitigates the likelihood of participants chasing returns between U.S. and non-U.S. markets, and getting burned by the cyclicity. Instead you have professional judgment shaping the allocation based on a global perspective, rather than a U.S.-centric one.

Expanding the concept to “all-country” portfolios

While most global portfolios have some exposure to emerging markets, “all-country” portfolios usually have a more significant investment in emerging markets. These markets, while they can experience wider fluctuations in value, are expected to continue growing at a much faster rate than developed markets over the coming decades. For that reason they can be appropriate for long-term investments such as a DC retirement account. We believe in most cases the best global option is an all-country one.

Helping participants

Adding a global equity option to a DC plan fills a void and makes good investment sense. It should result in participants having a more appropriate level of exposure to equities outside the U.S that is more in line with how professional investors allocate assets. We believe most participants will be comfortable with greater non-U.S. exposure. All they need are attractive global equity options in their plan, and perhaps a little nudge. ■

¹Callan Associates' DC Index (June 2007)

²As of 12/31/07

³S&P 500 Index with income reinvested, MSCI EAFE Index with net dividends reinvested, and MSCI Emerging Markets IMI with net dividends reinvested as of 12/31/07

⁴Callan Associates Total Plan Sponsor Database as of 1Q 2007

Projections regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Results may vary over time and with each simulation. An investment cannot be made directly in an index. This is for illustrative purposes only and not indicative of any investment.