# Diversification unbound:

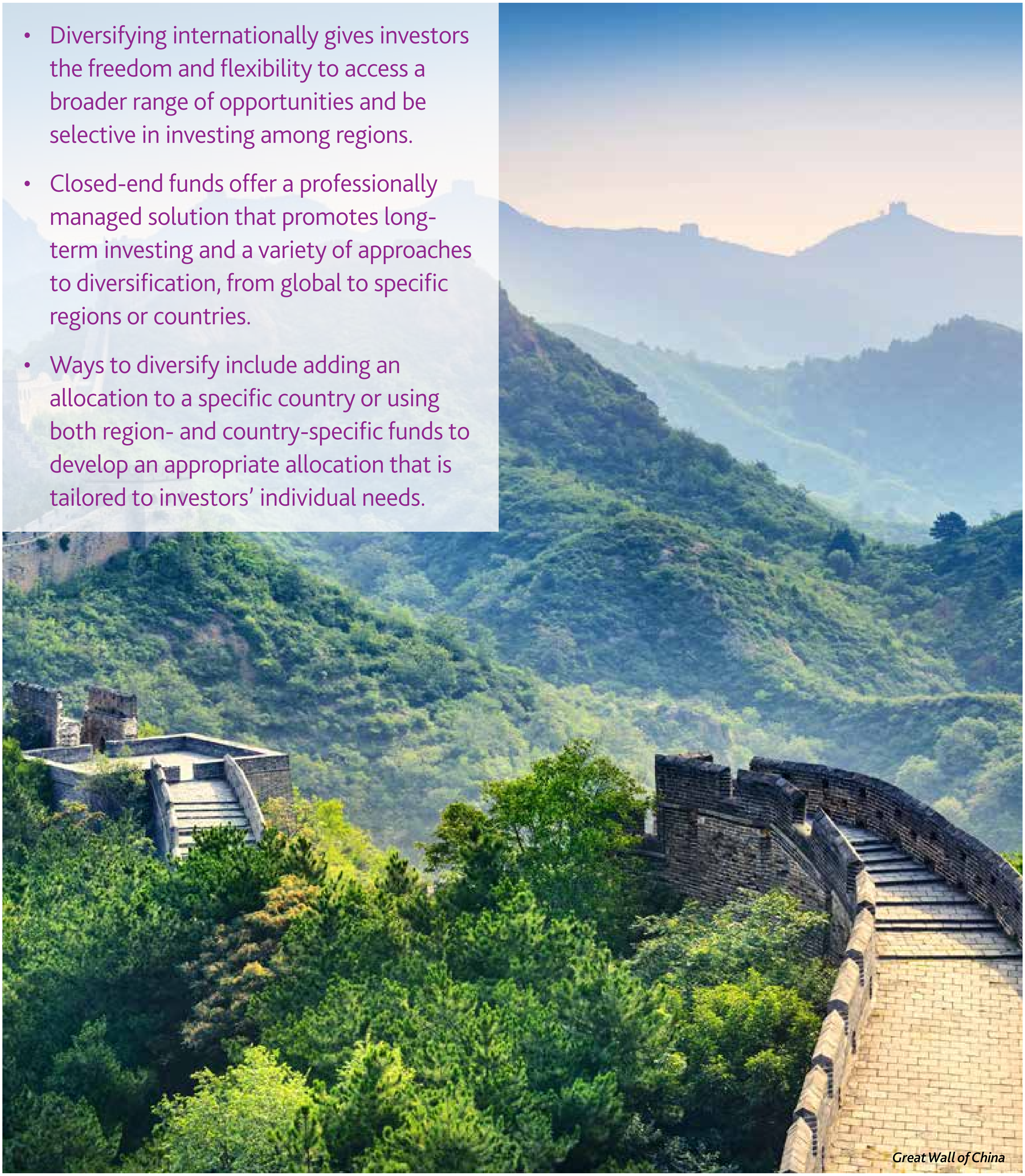
Gaining international exposure with closed-end funds

2018


Aberdeen

# Key points

- Diversifying internationally gives investors the freedom and flexibility to access a broader range of opportunities and be selective in investing among regions.
- Closed-end funds offer a professionally managed solution that promotes long-term investing and a variety of approaches to diversification, from global to specific regions or countries.
- Ways to diversify include adding an allocation to a specific country or using both region- and country-specific funds to develop an appropriate allocation that is tailored to investors' individual needs.



*Great Wall of China*

# Expanding opportunities for diversification[1]

## A world of choices

We live in an era of unprecedented choice. For example, between 1975 and 2015, the average number of items in a supermarket ballooned from an average of 8,948 to 40,000 to 50,000, according to the Food Marketing Institute, a trade group. Investment options have followed suit; where investors may have seen just a few readily available opportunities to diversify internationally 40 years ago, there are now thousands of ways to achieve this objective in a portfolio.

However, the majority of investors don't seem to recognize the benefits of investing outside their home country. A recent survey by the International Monetary Fund (IMF) showed that U.S. investors allocated more than 70% of their equity assets to the U.S., despite the fact that the U.S. represents less than 50% of overall global market capitalization.[2] Yet home bias can mean missing out on a wider range of investment opportunities that may have the potential for strong returns.

Diversifying internationally gives investors the freedom and flexibility to access a broader range of opportunities and be selective in investing should some regions not seem as attractive as others. Additionally, lower correlations among certain asset classes can help reduce portfolio volatility. We believe that, when diversification is unbound, possibilities abound.

In this paper, we will look at the reasons investors should consider diversifying beyond their backyard and the many ways that closed-end funds can help meet this objective.

## What do we mean by diversification?

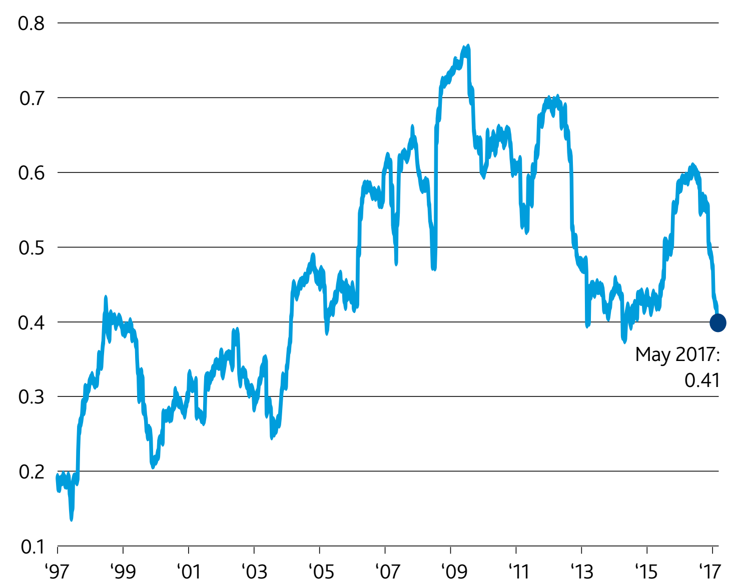
The term "diversification" seems to be thrown around a lot when it comes to investing. But what exactly are we referring to? According to modern portfolio theory (MPT), the risk of investment loss can be diversified away to a certain extent by constructing a portfolio with asset classes that have low correlations to one another, or that move differently in relation to another. Table 1 on the following page lists correlations between various asset classes, regions and countries.

Correlations are measured in a range from -1.0 to 1.0. A correlation of 1.0 means that assets move in lock-step with one another; when one asset moves up or down, the other asset would move proportionately in the same direction. Similarly, for a correlation of -1.0, the two asset classes would move in opposite directions in some constant of proportionality to one another. A correlation of zero would mean that the relationship between the movements of two asset classes cannot be predicted.

If one asset class has negative performance, another asset class with low correlation to the first asset class wouldn't have the same degree of negative performance or, in the case of negative correlation, would experience positive returns. MPT suggests that enhancing portfolio diversification with a mix of asset classes with low, negative or no correlation to one another should help increase returns on a risk-adjusted basis.[3] Since global market correlations have been moving lower recently (as shown in Chart 1), and many asset classes have low or negative correlations to one another, international diversification makes sense.

**Chart 1: Global equity market correlations**

Rolling 1-year correlations, 30 countries




Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. For illustrative purposes only. All return values are MSCI Gross Index (official) data. Chart is for illustrative purposes only. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.** Please see disclosure page for index definitions. Countries included in global correlations include Argentina, South Africa, Japan, UK, Canada, France, Germany, Italy, Australia, Austria, Brazil, China, Colombia, Denmark, Finland, Hong Kong, India, Malaysia, Mexico, the Netherlands, New Zealand, Peru, Philippines, Portugal, Korea, Spain, Taiwan, Thailand, Turkey, United States. Guide to the Markets –U.S.Data are as of May 31, 2017.

We believe that, when diversification is unbound, possibilities abound.

[1] Diversification does not ensure a profit or protect against a loss in a declining market.

[2] International Monetary Fund, "Coordinated Portfolio Investment Survey," June 2016.

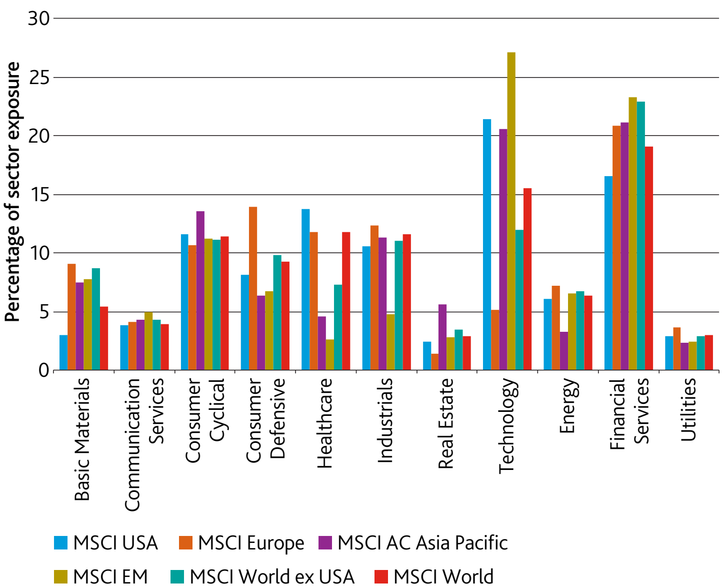
[3] Ross, Sean. "How is correlation used in modern portfolio theory?" Investopedia, March 5, 2015.

## You can't go home again

At first glance, investors may have reservations about investing outside of their home country, especially if they live in the U.S. After all, the U.S. is one of the most diverse markets in the world, has experienced moderate economic growth, and represents a large share of what's available in the global market. But investing in only one country can still be limiting.

As you can see in Chart 2 below, each region has a different concentration of certain sectors of the global equity market. Choosing not to invest outside of one's own home country can mean missing out on some of the current and future leaders in various industries.

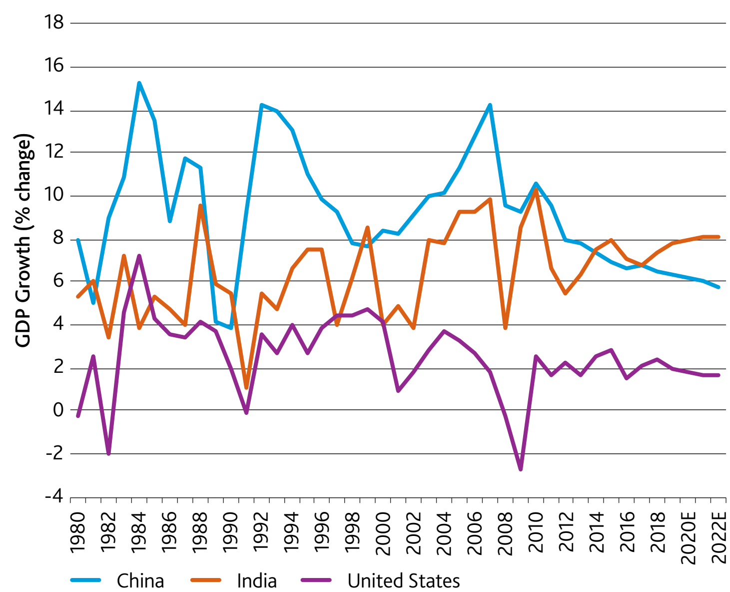
### Chart 2: Sector exposure varies across regions




Source: Morningstar Direct, December 31, 2017. For illustrative purposes only. Indexes are unmanaged and have been provided for comparison purposes only. No fees or expenses are reflected. You cannot invest directly in an index.

Additionally, investing outside of your home country can provide exposure to economies experiencing faster growth, such as those in China and India. During the global financial crisis in 2008, the U.S. economy contracted and then recovered, and continues to maintain a modest level of growth. On the other hand, the Chinese and Indian economies continued to grow during this time and are currently experiencing a much faster pace of growth as noted in Chart 3 below.

### Chart 3: Economic growth in China, India and the U.S.




Source: Morningstar Direct, December 31, 2017. Projections are offered as opinion and are not reflective of potential performance. Projections are not guaranteed and actual events or results may differ materially. For illustrative purposes only.

### Table 1: Correlations among regions

| | MSCI USA | MSCI Europe | MSCI AC Asia Pacific | MSCI EM | MSCI World ex USA | MSCI World | MSCI India | MSCI China | MSCI Japan | MSCI Israel | MSCI EM Latin America 10-40 | MSCI Singapore | MSCI Indonesia | MSCI Chile | MSCI Australia |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| MSCI USA | 1.00 | | | | | | | | | | | | | | |
| MSCI Europe | 0.85 | 1.00 | | | | | | | | | | | | | |
| MSCI AC Asia Pacific | 0.75 | 0.77 | 1.00 | | | | | | | | | | | | |
| MSCI EM | 0.76 | 0.81 | 0.88 | 1.00 | | | | | | | | | | | |
| MSCI World ex USA | 0.86 | 0.96 | 0.91 | 0.91 | 1.00 | | | | | | | | | | |
| MSCI World | 0.96 | 0.95 | 0.85 | 0.84 | 0.96 | 1.00 | | | | | | | | | |
| MSCI India | 0.51 | 0.59 | 0.69 | 0.73 | 0.67 | 0.60 | 1.00 | | | | | | | | |
| MSCI China | 0.56 | 0.55 | 0.70 | 0.75 | 0.65 | 0.60 | 0.46 | 1.00 | | | | | | | |
| MSCI Japan | 0.59 | 0.60 | 0.89 | 0.63 | 0.73 | 0.69 | 0.51 | 0.47 | 1.00 | | | | | | |
| MSCI Israel | 0.55 | 0.55 | 0.48 | 0.55 | 0.57 | 0.58 | 0.45 | 0.31 | 0.37 | 1.00 | | | | | |
| MSCI EM Latin America 10-40 | 0.69 | 0.74 | 0.75 | 0.90 | 0.83 | 0.77 | 0.60 | 0.62 | 0.52 | 0.49 | 1.00 | | | | |
| MSCI Singapore | 0.69 | 0.70 | 0.77 | 0.82 | 0.78 | 0.75 | 0.60 | 0.67 | 0.54 | 0.44 | 0.72 | 1.00 | | | |
| MSCI Indonesia GR US | 0.45 | 0.46 | 0.55 | 0.60 | 0.53 | 0.49 | 0.47 | 0.44 | 0.38 | 0.30 | 0.50 | 0.63 | 1.00 | | |
| MSCI Chile | 0.55 | 0.60 | 0.61 | 0.73 | 0.66 | 0.61 | 0.54 | 0.50 | 0.40 | 0.40 | 0.75 | 0.59 | 0.42 | 1.00 | |
| MSCI Australia | 0.74 | 0.80 | 0.83 | 0.84 | 0.87 | 0.82 | 0.60 | 0.63 | 0.59 | 0.52 | 0.77 | 0.74 | 0.52 | 0.61 | 1.00 |

Source: Morningstar Direct, December 31, 2017.

## Finding a good value

A common piece of advice for investors is to buy low and sell high with an aim to maximize returns. Valuations can help determine whether an asset class or region is relatively expensive or cheap within the current market environment. Because of its strong stock market performance over the past several years, the U.S. equity market is looking expensive relative to other areas of the world, as shown in Table 2 below. Diversifying into less expensive regions can help investors toward achieving their return objectives.

**Table 2: Valuations for the U.S. equity market have become more expensive**

| Trailing P/Book | World | Europe | USA | EM |
|---|---|---|---|---|
| Current | 2.4x | 1.9x | 3.2x | 1.7x |
| 5 year average | 2.1x | 1.8x | 2.8x | 1.5x |
| 10 year average | 2.0x | 1.7x | 2.5x | 1.7x |
| Max since Jan 98 | 4.2x | 4.3x | 5.8x | 3.0x |
| Min since Jan 98 | 1.2x | 1.1x | 1.5x | 0.9x |
| Date of high since Jan 98 | Dec-99 | Mar-00 | Dec-99 | 7-Oct |
| Date of low since Jan 98 | 9-Feb | 9-Feb | 9-Feb | Aug-98 |
| **Current Premium/Discount to** | | | | |
| 5Y average | 10.90% | 7.60% | 15.60% | 13.90% |
| 10Y average | 20.70% | 13.40% | 29.30% | 1.50% |

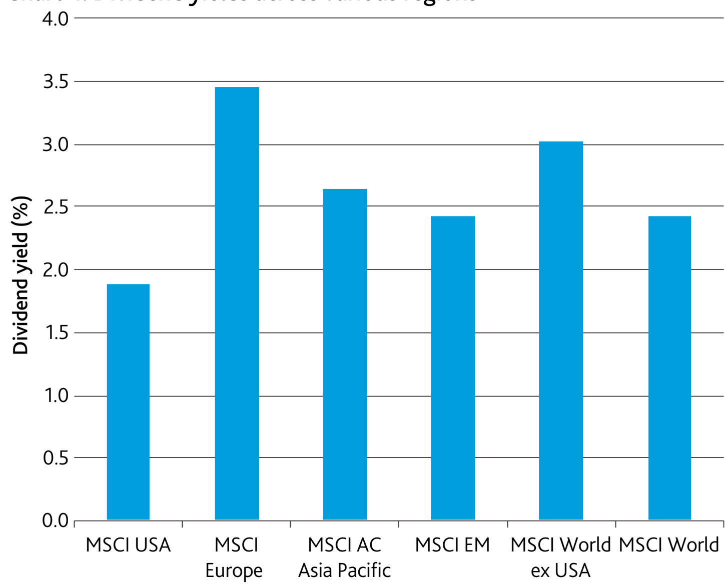
Source: RIMES, MSCI, Morgan Stanley Research, data as of December 31, 2017. Regions are represented by their respective MSCI indexes. For illustrative purposes only.

### Dividends make a difference

While some investors might not give a second thought to whether or not a stock they invest in pays a dividend, studies have shown that dividend-paying stocks have historically outperformed those that don't. Currently, the U.S. market has a dividend yield of around 2%, while other countries such as Spain, Australia and the UK all have dividend yields exceeding 3%.[3] This can make a significant difference in the compounding of returns and how quickly investments grow over time. Chart 4 compares various regions and their dividend yields. Choosing to diversify among international stocks allows investors an opportunity to generate income and potentially achieve greater returns.

> We would all appreciate having the ability to see clearly into the future, but unfortunately none of us has a crystal ball.

**Chart 4: Dividend yields across various regions**




Source: Morningstar Direct, December 31, 2017. For illustrative purposes only.

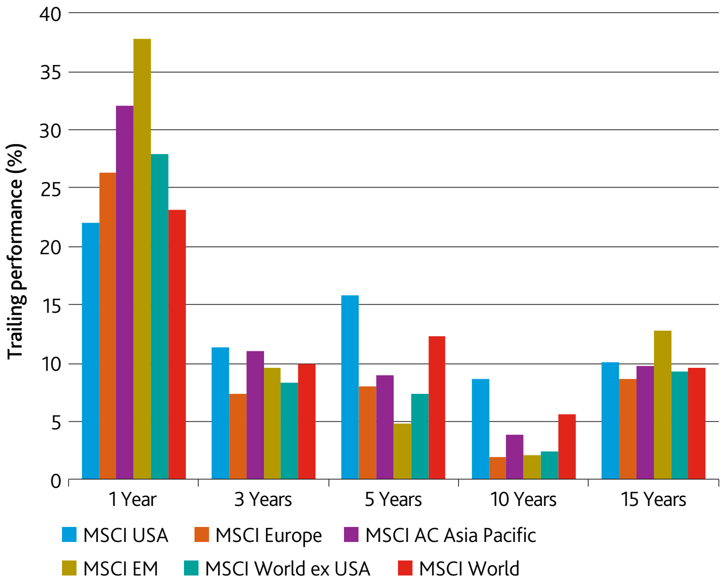
## A shortage of psychics

We would all appreciate having the ability to see clearly into the future, but unfortunately none of us has a crystal ball. The U.S. equity market has performed well for the past several years, but it's uncertain how long this trend can continue. We can't predict the next geopolitical hotspot or the next international success story, so it gives us even more of a reason to make sure our investments are diversified.

Chart 5 on the following page shows the medium- and long-term performance of various regions of the globe. Top performers and underperformers change all the time. By breaking free of the limitations of investing solely in domestic equities, and instead investing across a broad range of industries and locales, there is a better chance that you can capitalize on the most attractive opportunities worldwide.

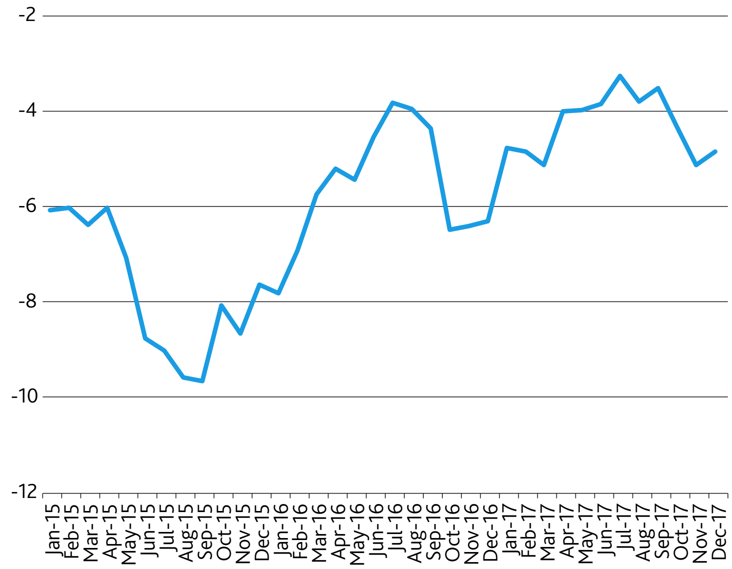
[3] Moore, Simon. "Five Ways to Protect Your Stock Portfolio." Forbes, June 7, 2017.

**Chart 5: Trailing performance of domestic and international equities**




Source: Morningstar Direct, December 31, 2017. For illustrative purposes only. **PAST PERFORMANCE IS NOT AN INDICATION OF FUTURE RESULTS.** Performance of the indexes above is not necessarily indicative of the performance of any Aberdeen product.

**Chart 6: Average monthly premiums and discounts* for closed-end fund peer group, January 2015-December 2017**




Source: Morningstar Direct, December 31, 2017. For illustrative purposes only. Peer group is Morningstar US Closed-End Funds.*Data definition: The monthly premium/ discount from its NAV at the closing price.

## Open possibilities with closed-end funds

One way to efficiently gain international diversification within a portfolio is through using closed-end funds. Closed-end funds issue a fixed number of shares, meaning that the managers of these funds have a stable pool of capital to use when investing for the long term, even when redemptions occur. With a stable level of assets to work with, closed-end funds can remain fully invested in less liquid markets over market cycles. And because of their unique structure, these funds are suitable for a high-conviction investment strategy that aims to diversify internationally and ride out short-term market dislocations while maintaining a focus on the long term.

Another benefit to using this unique vehicle is that closed-end funds can also trade either at a premium or a discount to net asset value (NAV) or their underlying portfolio. When a fund trades at a discount, investors can buy shares at a lower price while gaining exposure to international investments and actively managed strategies. Conversely, when CEFs trade at a premium, investors will have to buy at a higher price. In a recent Closed-end Fund Association survey, 88% of respondents said the discount associated with a closed-end fund was a deciding factor in whether or not to invest in a fund.[4]

Premiums and discounts tend to vary throughout the year (see Chart 6 above) because prices are established by the competitive markets. This reflects supply and demand for closed-end funds in the current market environment. Price differences are influenced by investor perceptions, fears and needs for specific types of investments, among other factors, according to the Closed-end Fund Association.

While closed-end funds can help investors manage risk, changes in exchange rates and other risks will also affect the investments. Therefore, closed-end funds should be used as part of a larger portfolio that is broadly diversified.

This is also relevant when it comes to evaluating the other unique capabilities of closed-end funds. Because closed-end funds trade on stock exchanges, there must be both a buyer and a seller for a trade to occur, which can make it more challenging to buy or sell a fund in certain market environments. Investors might also need to pay a premium on a closed-end fund, which would result in purchasing shares at a price that exceeds a fund's NAV.

Additionally, higher volatility can occur when a closed-end fund uses leverage. Such factors should be examined before investing, keeping in mind that closed-end funds are best-suited for long-term investors looking for exposure to specific areas of the world, whether they are specific countries or broader regions.

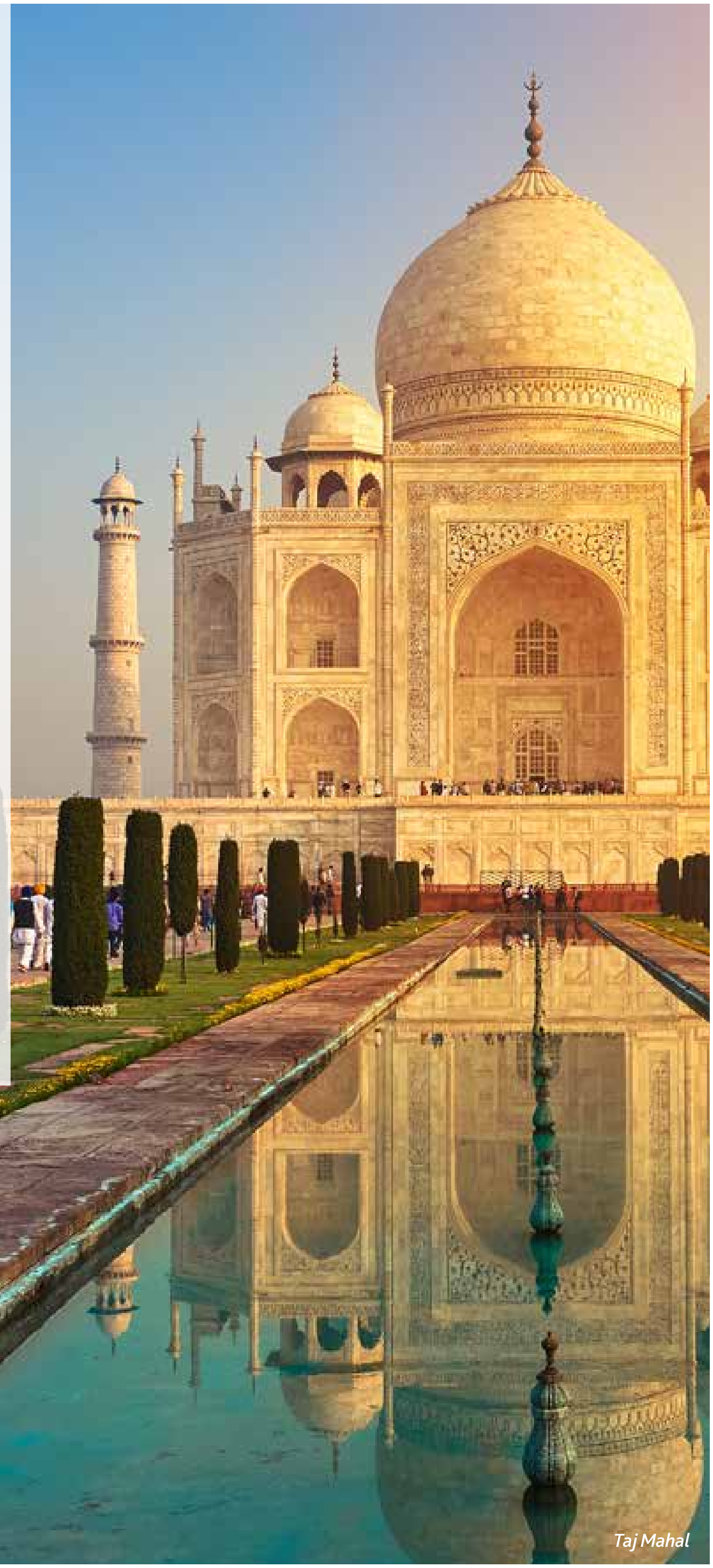
Closed-end funds can help investors efficiently gain international diversification over the long term.

[4] Source: Closed End Fund Center

# Conclusion

International diversification can benefit investors and their portfolios over the long term, provided that investors are willing to look beyond their home turf to discover the new opportunities offered through international investing. Not only can an allocation to investments outside one's home country provide a wider range of investment opportunities, but it can also offer the potential for greater returns with lower volatility for the portfolio overall.

Closed-end funds can help long-term investors achieve greater diversification while gaining the benefits of an actively managed approach. Ways to diversify include adding an allocation to a specific country or using both region- and country-specific funds to develop an appropriate allocation that is tailored to their individual needs. Ultimately, there is a world of possibilities when diversification is unbound, and few limits to the possibilities that are available when investors are free to invest in all parts of the globe.



*Taj Mahal*

## Aberdeen closed-end funds

Aberdeen Asset Management Inc. is a wholly-owned U.S. subsidiary of Aberdeen Asset Management PLC, one of the world's largest asset managers. We know the global markets from a local level upwards, drawing on more than 2,700 staff members, across 39 offices in 26 countries as of March 31, 2017. We invest globally, and follow a predominately long only, active management strategy - we do not chase market fads.

We package our skills to offer a suite of U.S. closed-end funds that provide access to the world's emerging markets, specific regions, or particular countries. Each fund benefits from Aberdeen's diligent company research process and disciplined portfolio construction. Our range of funds includes specialized choices that are designed to maximize the potential from specific markets and industry sectors, which makes them a unique opportunity for new and experienced investors.

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Ref: US-201217-54437-4
026905-0118-PHL
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