

SHOULD YOU BE INVESTING OVERSEAS?

Terrorism and the weak U.S. dollar have made many Americans reluctant to travel abroad. Should you send investment money instead?

Despite the fact that half of the value of world stocks lies outside of the United States, Americans have long been reluctant to invest abroad. A recent University of Michigan study noted that American investors are less likely than many European investors to invest internationally, and in fact hold 92 percent of their stock allocation in domestic equities (though multinational U.S. companies reflect international exposure).

It hasn't helped that American stocks strongly outperformed foreign stocks through most of the 1990s, and then when American stocks tumbled in 2000 through 2002, many foreign markets followed. Yet financial planners frequently recommend that clients invest 10 to 20 percent of their equities in foreign stocks, and perhaps 10 percent of their bond allocation in foreign bonds. Why?

Let's start with a concept that's engendered much debate in recent years when it comes to international investing: correlation. One of the keys to designing a portfolio is spreading your money among different types of assets that are not correlated well to each other—that is, as some types of investments go through a rough stretch, other assets might be performing well, or at least holding their own. Experts contend that this strategy, properly executed, reduces volatility while maintaining or even boosting overall returns.

Proponents have long advocated including international investments partly because they haven't been strongly correlated to U.S. investments. Critics argue that as world economies integrate, markets move increasingly in sync with each other, thus reducing the diversification benefits of investing abroad.

Proponents concede that recent years have seen closer movement between U.S. and foreign markets, but they believe that this correlation is cyclical. They point to numerous periods over the

last 30 years or more when correlation was low and when specific countries or economies performed quite differently from the United States. Moreover, the U.S. market is particularly uncorrelated with the emerging markets of less-developed nations, and with international small-cap stocks and international bonds.

Even during the last decade, when U.S. and developed foreign markets tended to move in the same direction, they outperformed each other by at least ten percent in six of those ten years. For example, while the Wilshire 5000—which represents most of the publicly traded stocks in America—returned 29 percent in 2003, the Dow Jones World Stock Index—which excludes the United States—rose 38.6 percent. For the same year, Morgan Stanley Capital International reported emerging markets returning 42 percent.

Proponents also argue that U.S. investors are usually encouraged to diversify their domestic stocks (and bonds) by owning growth and value stocks, and small- and large-cap stocks—yet the correlation between these types of stocks is higher than with foreign stocks.

Beyond the issue of correlation, however, proponents argue that international securities have a place in American-concentrated portfolios simply because some of the best companies in the world are outside U.S. borders and are often available at cheaper prices. The price/earnings ratio for emerging markets at the end of 2003, for example, was around 11, according to Merrill Lynch—less than half the P/E of U.S. stocks.

Investing abroad has its risks, naturally, as does any form of investing. In addition to the usual risks faced by domestic stocks, foreign stocks face several additional risks. Changes in U.S. currency values against other major currencies can have a major impact on return. The strong U.S. dollar during much of the 1990s eroded the value of many foreign investments, while the recent weak dollar, which some experts predict will continue for a while, has boosted their value. Changes in the political stability of foreign nations present another major risk to U.S. investors. Foreign markets, especially emerging markets, typically are less “transparent” than American markets and their regulations can be looser. The lower-trading volumes in some nations can make transactions more costly while increasing volatility.

These risks, plus the greater challenge of assessing individual foreign stocks, is why financial planners typically recommend that the average investor stick to international mutual funds instead of trying to buy individual shares. And there are more foreign mutual funds to choose from these days, including index, large-cap, small-cap, international bond, and emerging markets for both stocks and bonds.

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