

A World of Opportunity

A Case for International Investing

August 2002

Diversification is a well-regarded maxim of portfolio management. As weary investors endure this punishing, (hopefully) once-in-a-generation U.S. bear market, everyone is left pondering alternative investments. Even the fittest of investors are being challenged to stay in the ring after repeated blows to the 401(k), not to mention their psyche. While the safety of cash, CD's and bonds is usually the reflex of choice, interest wanes at the meager yields. Options and hedge funds can buffer downside risk, but they are not appropriate for most investors. So what's left? Consider international investing.

International investing is often feared and overlooked as an investment class, largely because of unfamiliarity. In this month's *Fiscal Fitness*, we examine the characteristics of international investing and try to identify suitable investments.

First of all, "international" is defined as all countries outside the U.S. References to "Global" investing, on the other hand, would include the U.S. This distinction is important if you are looking to diversify your U.S. portfolio.

In 2000 and 2001, when foreign stocks failed to cushion investors' U.S. portfolios, many observers became skeptical about the benefits of foreign diversification. But things have changed in 2002. While most foreign funds are in the red this year (about -13%), they're not doing nearly as badly as their U.S. counterparts (-24% S&P). There are several factors that contribute to this favorable comparison to the U.S. markets. The decline of the U.S. dollar against other foreign currencies is a start. As the greenback slumps and foreign currency soars, foreign investments are likewise worth more. Further, U.S. stocks had generally outperformed foreign stocks for such a long time that many foreign companies are now looking more attractively valued. And domestic accounting/corporate fraud has heightened investor concerns therefore sending monies abroad.

There seems to be ebb and flow between international and domestic investments. You may remember the Asian Contagion and the Peso devaluation. Now, it seems, it is the United State's turn for some economic sniffles. Since the MSCI Index (widely recognized international index) began in 1968, it has averaged about 12.5% annually. Meanwhile the S&P 500's annual return for the same period was 12.6%, or pretty even. However, volatility of returns tells another story: the MSCI's standard deviation (risk) was 21.4 while the S&P 500 was 16.3 (lower is less volatile). In other words, international investing is a bumpier ride than the U.S. But, empirical evidence suggests a portfolio of 50% international and 50% domestic may actually *lower* the standard deviation (risk) of the overall portfolio to 12.8, or lower than the risk of the domestic portfolio alone. The blended portfolio's annual return improves to 13.7%.¹ Lower risk and higher returns are a combination that should get peoples' attention.

Once you've made the decision to diversify internationally, the next step is how you actually participate. We suggest most investors focus on quality, large cap mutual funds. The Artisan and Oakmark fund families have excellent international funds. Avoid the "emerging market" funds unless you have an iron stomach. And picking individual, international stocks is often difficult, confusing and time intensive. Most investors should leave foreign stock picking to the professional fund managers to decipher whether that foreign economy's fiscal and monetary policies, not to mention expected currency movements, will be favorable to local businesses.

How much exposure you should have to foreign investments depends on your inclination and time horizon. A good rule of thumb is 10-20%. Consider that you purchase goods from foreign firms every day. If you like their products, explore their stock. Limiting your portfolio to U.S. companies is ignoring a world of opportunity beyond our shores.

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¹ Fisher, Portfolio Research, 2000 pg. 41-46.