INTERNATIONAL INVESTING: A FOCUS ON EUROPEAN FUNDS

By John Markese

The European indexes are mostly up year-to-date, yet most European funds are down. Why? The Euro has been down hard against the dollar this year, and currency weakness has wiped out most of the stock gains.

For most Americans, Europe has always had an appeal as a tourist destination and, perhaps for those investors interested in diversifying internationally, as a destination for some of their investment funds. The promise of the European Union and its trade advantages, success stories such as Ireland emerging as a new European "Tiger," and the musing that Europe may experience in the first decade of the new century what the U.S. market did in the last decade of the last century may be a siren song for some of your money.

Mutual funds concentrated in European stocks are an easy and efficient way to send your money abroad, particularly for those investors unfamiliar with European firms, markets, governments, and of course, currency issues. Instant diversification and, hopefully, professional management savvy are available in European sector funds. While most international funds have a significant portfolio commitment to Europe, they are not an exclusive play on those countries that constitute Europe.

Table 1 provides investment characteristics of mutual funds concentrated solely in Europe; it also includes two international index funds with European investments for comparison. These funds are tracked in AAII's *Quarterly Low-Load Mutual Fund Update* and also recorded in the annual *Individual Investor's Guide to Low-Load Mutual Funds.*

From the country weightings, it is evident that while Europe encompasses numerous countries, these European sector funds tend to concentrate in the United Kingdom, France, Germany, and Switzerland. The top five countries in each portfolio—ranked by the market value of the stocks of those countries—make up at least two-thirds of the total portfolio value in each case.

The European exposure of the two international index funds is about 60%, and the European exposure of the Vanguard Total International Stock Index fund is composed entirely of the Vanguard International Equity European fund, itself an index fund. So, even broadly diversified international funds will generally provide significant European exposure, and an international index fund, because it is passively managed and won't shift funds among regions based upon portfolio manager expectations, will maintain its European investment presence over time.

Performance figures are given for both recent periods and through five years, in order to capture market factors that influence all markets, but not necessarily at the same time, due to different country and regional economic policies and growth rates. Year-to-date figures are mostly down for these funds, but one-, three-, and five-year annual returns are impressive for international funds overall—look at the performances of the two international index funds. While the five-year returns for these funds were below our domestic indexes, such as the Standard and Poor's 500 index, so were most domestic stock funds, and the one- and three-year returns were significantly better than domestic stock fund averages.

CURRENCY EFFECTS

Table 2 provides year-to-date percentage changes in some select European

John Markese is president of AAII.

TABLE 1. INVESTMENT CHARACTERISTICS OF EUROPEAN STOCK FUNDS

Fund Name (Ticker)	Country Exposure	Year to Date Return (%)	Annual Return 1 Yr (%)	Annual Return 3 Yr (%)	Annual Return 5 Yr (%)	Expense Ratio (%)	Risk Index*** (X)
Excelsior Pan European (UMPNX)	UK–27.8%, France–21.9%, Germany–15.4%, Switzerland–6.5%, Sweden–6.0%	–3.4	23.2	12.8	16.3	1.43	0.84
Fidelity Europe (FIEUX)	UK–30.8%, France–10.1%, Germany–10.1%, Switzerland–7.7%, Sweden–6.0%	0.3	23.1	15.9	17.8	0.89	0.82
Fidelity Europe Cap Appr (FECAX)	UK–28.2%, France–20.7%, Germany–10.1%, Netherlands–8.8%, Switzerland–6.5%	–7.2	14.1	13.9	16.8	0.97	0.89
INVESCO European/Inv (FEURX)	UK–25.7%, France–16.2%, Germany–13.7%, Sweden–8.5%, Finland–6.5%	3.2	48.2	26.2	23.5	1.56	1.12
Scudder Greater Europe Gr (SCGEX)	France–21.4%, Germany–17.3%, UK–14.7%, Netherlands–10.0%, Spain–6.7%	–7.9	19.9	20.6	21.4	1.46	0.91
T Rowe Price Int'l:Europn (PRESX)	UK–28.8%, France–13.7%, Netherlands–9.3%, Italy–7.8%, Switzerland–6.8%	–6.5	12.6	14.6	16.8	1.05	0.70
Vanguard Int'l Eq: European (VEURX)	UK–30.0%, France–19.1%, Germany–12.6%, Switzerland–8.6%, Netherlands–7.7%	–8.7	6.8	13.9	16.6	0.29	0.74
Schwab Int'l Index/Inv (SWINX)	Europe–58.5%	–10.7	6.0	11.0	11.2	0.41	0.75
Vanguard Total Int'l Stock Idx (VGTSX)	Europe–61.0%*	–10.8	3.7	8.3	na	0**	0.78

*Vanguard Int'l Equity European
**Fund of funds, no additional expenses
*** The average risk index for international funds is 1.00. Values below 1.00 represent below-average risk; values above 1.00 represent above-average risk.

Source: www.morningstar.com; *AAII's* Quarterly Low-Load Mutual Fund Update; *data as of 9/14/00.*

countries and indexes. While these indexes reflect pure value changes (before any income and without any management or trading expenses), they do give an idea of overall stock performance country-by-country. Notice that almost all of these indexes are up, but most of the European funds are down.

Why?

Currency.

U.S. investors investing internationally will have all of their international stock portfolio gains or losses translated back to U.S. dollars. Thus, for U.S. investors, the total return for international investing consists of the portfolio performance plus the performance of the currencies in which those stock investments are denominated versus the U.S. dollar.

For U.S. investors, here's the bottom line:

- *In the best of all possible worlds:* Your international stock portfolio does well and the dollar weakens relative to those currencies—a double boost.
- *In the worst of all possible worlds:* Your foreign stock investments tank and the dollar strengthens against those foreign currencies—a double whammy.

The new European currency unit—the Euro—covers most of the major European economies, although not all European nations are part of the European Union. And the Euro has been down hard—almost 15% against the dollar year-to-date in early fall, and down about 27% since early 1999. Most recently, it has been near its all-time low. So, this currency weakness more than wiped out the stock gains.

For most of these funds, it's not the best of all possible worlds. These funds choose not to hedge the currency risk in foreign exchange markets, and even if they did, it would probably not be a perfect hedge, one-to-one, nor would it be cheap to do so.

A LOOK AT EXPENSES

International stock funds have higher expenses than domestic stock funds, averaging 1.50% annually, compared to domestic funds' average expense of closer to 1.00%. This expense ratio includes the management fee and fund administration costs, along with any 12b-1 charge (a sales load ostensibly for marketing), but does not include any transaction costs, brokerage fees, or the spread between bid and asked prices.

The rates of return figures are after expenses. TheVanguard International Equity European, Schwab International Index, and the Vanguard Total International Stock Index funds are all index funds and have low administration and management expenses—dramatically lower than the actively managed funds, an important advantage. The Vanguard Total International Index has a zero expense ratio because it is a fund of funds, made up of the Vanguard European, Pacific, and Emerging Markets Stock Index funds, and charges no additional expenses on top of the individual index fund charges, which are low, at 0.29%, 0.37%, and 0.58%, respectively.

A LOOK AT RISK

Foreign stocks have all the risks that domestic stocks have plus currency risk. In spite of exchange rate gyrations, the average international stock fund falls somewhere between the average domestic aggressive growth fund and the average domestic growth fund in total variability of return. And there is the added risk-reduction benefit that, although average domestic and international stock funds might have similar risk long term, domestic funds may zig while international funds zag, reducing the overall variability of a diversified portfolio. As of late, however, investing in Europe has not provided as much additional diversification as it once did.

The last column in Table 1 gives the risk index for each fund compared to all international funds. The INVESCO European fund, with a risk index of 1.12, is 12% more volatile than the average international fund, and T. Rowe Price International Europe is only 70% as volatile as the average international fund.

Keep in mind the risk index when comparing fund performances—funds with higher risks should be expected to produce higher returns.

Diversifying your portfolio, reducing risk without reducing return, makes sense, and investing internationally is one diversification trip that's easy to make with mutual funds.

Just remember that when you travel, you have to convert to the local currency and then back to greenbacks. ✥

TABLE 2. YEAR 2000 COUNTRY PERFORMANCE

Exchange	Index	Year-to-Date Gain/Loss (%)
Britain	London FT 250-Share	+7.20
France	Paris CAC 40	+10.25
Germany	Frankfurt Xetra DAX	+0.69
Italy	Milan MIBtel	+12.89
Netherlands	Amsterdam AEX	+0.88
Spain	IBEX 35	–3.68
Sweden	Stockholm General	+7.49
Switzerland	Zurich Swiss Market	+6.11

Source: The Wall Street Journal, September 14, 2000