

THE REAL ROLE OF FOREIGN STOCKS IN AN INVESTOR'S PORTFOLIO

By Meir Statman

Investors like the theory behind diversification looking forward, but when investors look at the past, they don't want diversification or a reduction in risk. They want to have been in the best-performing asset class, which over the last few years was large-cap U.S. stocks.

Foreign stocks in investors' portfolios have not done nearly as well as their U.S. counterparts in recent years. In the late '80s, the foreign markets, particularly the emerging markets of Asia, were the stars, producing stellar returns that outshone even above-average returns in the U.S.

But since the late '90s, it has been the U.S. markets that have produced the eye-catching returns. Over the last five years, from 1995 through year-end 1999, the S&P 500 returned 28.5% annually compared to 13.1% for the Morgan Stanley Capital International EAFE index.

Even those who do not succumb to the isolationist impulse are starting to question the benefits of international diversification.

But the real lesson from the recent performance of foreign stocks concerns the way investors tend to think about their portfolios and the role they assign to foreign stocks. If you are re-thinking your own commitment to foreign stocks, you may want to check your reasoning in light of these tendencies.

THE THEORY

Traditional financial theory today teaches investors to consider all of their investments as a whole and in combination. Risk is identified as volatility of returns, and the focus should be on the expected returns and return volatility for the portfolio as a whole, rather than focusing on returns and volatility of the individual assets. Under this approach, the optimal allocation to foreign stocks is the combination that produces the best return for the least amount of risk at the level of risk that the investor is willing to undertake.

Determining the optimal allocation depends on estimating various parts of the equation: the expected return of each asset; the expected volatility in

**TABLE 1. RETURN, VOLATILITY AND CORRELATIONS
FOR FIVE ASSET CLASSES: 1969-1997**

	Large-Cap U.S. Stocks	Small-Cap U.S. Stocks	Foreign Stocks	Bonds	Cash
Average annual return (%)	13.4	14.0	14.1	8.8	6.8
Volatility*	16.5	23.9	21.9	7.0	2.6
<i>Correlations**</i>					
Large-cap U.S. stocks	1.000				
Small-cap U.S. stocks	0.818	1.000			
Foreign stocks	0.479	0.425	1.000		
Bonds	0.397	0.255	0.085	1.000	
Cash	-0.067	-0.046	-0.189	0.233	1.000

* As measured by standard deviation—the amount by which most returns varied around the average return. The larger the standard deviation, the greater the volatility and therefore the greater the risk.
** The closer the correlation to 1.000, the more similar assets behave, with returns moving in the same direction by similar amounts.

Meir Statman is the Glenn Klimek professor of finance in the Department of Finance at the Leavey School of Business, Santa Clara University.

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TABLE 2. EXAMPLES OF OPTIMAL PORTFOLIOS BASED ON HISTORICAL STATISTICS: 1969-1997

	Conservative	Moderately Conservative	Moderate	Moderately Aggressive	Aggressive
Large-cap U.S. stocks (%)	17	28	39	52	57
Small-cap U.S. stocks (%)	0	0	0	0	2
Foreign stocks (%)	13	18	23	28	41
Bonds (%)	31	42	38	20	0
Cash (%)	39	12	0	0	0
	100%	100%	100%	100%	100%
Avg annual portfolio return (%)	9.5	10.8	11.8	12.7	13.7
Volatility of portfolio return	5.8	8.4	11.0	13.2	16.2

returns; and the correlations among the various assets—how their returns behave relative to each other. These parameters can't be known in advance, but long-term historical figures are often used as reasonable approximations.

Consider five asset classes: large-capitalization stocks (represented by the S&P 500), small-capitalization stocks (represented by the bottom five deciles of U.S. stocks), foreign stocks (represented by the MSCI EAFE index), five-year Treasury bonds, and cash. Table 1 presents the average annual rates of return and variations in return for these asset classes from 1969 through 1997.

Note that the volatility of foreign stocks was higher than the volatility of large-cap U.S. stocks. However, the returns of foreign stocks were also higher over the overall period. Most important, the correlation between foreign stocks and large-cap U.S. stocks is much lower than the correlation between U.S. large caps and U.S. small caps. The low correlation between foreign stocks and domestic stocks provides important diversification benefits.

What would optimal allocation portfolios look like based on these historical figures?

Table 2 presents optimal allocations for five portfolios ranging from a "conservative" to an "aggressive" portfolio. All have a fairly significant portion invested in foreign stocks.

Of course, these portfolios are

based on historical averages; changes in returns, volatility and correlations would lead to different optimal portfolio allocations, including the allocation to foreign stocks. The point is not to rigidly follow a mathematical model that is sensitive to various inputs, but rather to understand the real benefits of diversification, which depend on a proper accounting of the correlations between assets.

WHAT MOST INVESTORS SEE

Most investors fail to build their portfolios based on the benefits of diversification. Instead, investors tend to build portfolios as pyramids of assets, in which layers of assets are associated with particular goals and particular attitudes toward risk, and in which correlations between assets are overlooked. The bottom layer, for example, is for downside protection, where investors tend to put Treasury bills and money they can't afford to lose. Another layer is for upside potential, the potential for being rich. This layer is where more moderate investors would put stocks in general; other people would put Internet IPOs and lottery tickets as their upside potential layer.

Typical investors who bought foreign stocks in the 1990s bought them for the upside-potential layer of their portfolios—they expected foreign stocks to make them rich. Investors thought they would be a good upside-potential asset because

they were extrapolating the high foreign stock returns of the 1980s into the future.

Today, those same investors extrapolate the more recent dismal performance of foreign stocks and conclude that upside-potential money instead belongs in Internet IPOs.

The bad news for those who ventured into foreign stocks in the 1990s is

that the returns were dismal. But those returns demonstrate that the correlations between foreign stocks and domestic stocks are indeed low: When U.S. stocks were flying high, Japanese stocks were burrowing underground. And it is the low correlation of foreign stock returns with returns of other portfolio assets that makes foreign stocks attractive in optimal portfolios.

CONCLUSIONS

Investors like the idea of diversification in theory, but often fail to carry it out in practice. Risk has meaning when looking forward into the future, but fades away when looking at the past. Often, when investors look at the past, they do not want diversification and they do not want a reduction in risk. They want to have been in the best-performing asset class, which over the last few years was large-cap U.S. stocks.

It is important to keep this all-too-human tendency in mind when you are reviewing your own portfolio allocation, and trying to decide what to do about portions of it that are not doing well. Don't jettison an entire asset class without considering its beneficial features—in particular, the risk-reduction benefits they can provide because of their low correlation with other assets. Make sure you are focusing on your portfolio as a whole, rather than the risk of each asset class in isolation. ♦