ARE INTERNATIONAL STOCKS STILL USEFUL IN YOUR PORTFOLIO?

By Maria Crawford Scott

A long-term look at the performance record indicates that the benefits of international diversification are still evident. In the long run, a country's performance will be based on its economic growth and productivity.

There are few signs of life in the Japanese markets these days, and the "emerging" markets could more aptly be named the "submerging" markets. The average international stock mutual fund was down 10.9% for the first three quarters of 1998.

Is it time to slam the door shut on international investing?

Well, you certainly wouldn't want to send your money overseas without understanding what you are getting into. But a closer look at the overseas markets may prompt you to keep the doors open at least a crack with a portion of your portfolio.

A BENEFIT OR A DRAG?

In theory, foreign stocks offer substantial diversification benefits because they tend to be affected by different economic factors than the U.S. markets. The zigs and zags in return in these stocks do not always coincide with those of U.S. stocks despite the fact that the world's economies are becoming more interdependent, although over short time periods, such as days or weeks, they appear to be in lockstep. Emerging markets—such as Brazil, China, and India—typically have the weakest association with ours and with each other.

Over short time periods, a country's U.S. dollar returns may be affected by factors such as worldwide events or currency fluctuations, but over the long term, it will be based on the country's economic growth and productivity.

Of course, the recent strong performance of the U.S. stock market makes the diversification benefits a tougher point to argue: Why diversify into markets that aren't doing as well as ours?

A longer-term look at market performance, however, may help put the relationships into perspective. In addition, the international markets are quite diverse—different regions and countries have quite different performances that are not necessarily correlated with each other. Some regions and countries, in fact, have had returns recently that are quite competitive with those in the U.S.

Table 1 reports the performance of various international indexes over five-year time periods. These five-year segments are used to represent the zigs and zags of performance in different regions and countries over different time periods. All returns in the table are in U.S. dollars, the return a U.S.-based investor would receive.

The Morgan Stanley Capital International indexes are the most widely used indicators of foreign performance and are used here. The Europe and Australia, Far East (EAFE) index is the most comprehensive, covering 1,088 companies in 21 countries including Japan, Europe, Australia, and the emerging Asian markets (excluding China).

The EAFE index is composed of two parts. The MS Europe index covers 566 companies in 15 countries in Europe. MS Pacific covers 522 companies in Japan, Australia, New Zealand, Hong Kong, Malaysia, and Singapore.

The MS Emerging Markets index is relatively new, and covers 991 companies in 26 emerging markets in Asia, South America, Eastern Europe, and the Middle East.

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The diversity of foreign markets is also represented by indexes of the three leading world markets after the U.S.: Japan, the U.K., and Germany. The Japanese market is represented by the Tokyo Stock Exchange index, based on 1,000 securities listed on the Tokyo Stock Exchange. The U.K. market is represented by the Financial Times All Share index, consisting of 750 securities listed on London's International Stock Exchange, the third largest stock exchange in the world. The German market is represented by the DAX Index of 30 stocks traded on the Frankfurt Stock Exchange, the fourth largest in the world.

DIFFERENT PERIODS

The U.S. markets have done well recently, but remember the 1970s?

The five-year period of 1973 through 1977 produced the worst worldwide performance, with the S&P 500 down –0.3% over the period and Nasdaq down even more, a loss of 4.7%. Yet there were positive returns that were achieved: Britain turned in 7.4% over the same period.

Japan has fared poorly during most of the '90s, but it wasn't always so. From 1983 to 1987, it turned in a whopping 28.2% annual rate of return—the largest of the single-country indexes for any five-year period, and competitive even compared to the S&P 500's annual rate of return of 16.3%.

Despite this impressive single-country return, you would have fared even better over this period by investing in the Pacific region—an amazing 40.2% annually for five years, from 1983 through 1987. And Europe distinguished itself over this period as well, at 27.4%.

The best U.S. returns over a five-year period were 20.2% for the S&P 500 from 1993 through 1997. Yet they were matched by the 20.7% annualized five-year returns in the Germany DAX.

THE LONG-TERM PERSPECTIVE

Are you giving up any returns over the long run by sending your money overseas?

Not necessarily. Foreign markets have done quite well over longer stretches:

- For the 25 years ended December 31, 1997, the MS EAFE index produced an 11.9% annualized total return in U.S. dollars versus 12.9% for the S&P 500 and 10.3% for the Nasdaq (however the Nasdaq returns do not include dividends).
- MS Europe was the best long-term regional investment over the period, with an annual average return of 13.5%.
- The best overall performance, in U.S. dollar terms, over the 25-year period was put in by the British All Share index, up 15.1%.
- Even the worst regional return—MS Pacific index—turned in a 9.9% annual rate of return, low given the volatility, yet still not a bad rate of return.

Interestingly, the two worst single-country indexes—Japan with a 6.4% annualized return over 25 years and

TABLE 1. INTERNATIONAL RETURNS OVER DIFFERENT TIME PERIODS

	Average Annual Return*: 5-Year Periods					Average Annual Return* Through Year-End 1997			
	'73–'77	'78–'82	'83–'87	'88–'92	'93–'97	10 years	15 years	20 years	25 years
Morgan Stanley Indexes									
MS EAFE	2.8	11.7	34.9	1.6	11.7	6.6	15.3	14.4	11.9
MS Europe	3.5	9.1	27.4	9.6	19.7	14.5	18.6	16.2	13.5
MS Pacific	1.8	14.7	40.2	–3.6	1.6	–1.0	11.1	12.0	9.9
MS Emerging	na	na	na	18.5	5.0	11.5	na	na	na
Major Foreign Markets (Index)									
Japan (Tokyo Stock Ex)	0.6	12.6	28.2	–4.7	–1.5	–3.1	6.4	7.9	6.4
Britain (All Share)	7.4	17.8	22.1	13.1	15.8	14.5	17.0	17.1	15.1
Germany (DAX)	1.7	0.4	16.5	9.4	20.7	14.9	15.5	11.5	9.5
S&P 500	–0.3	13.9	16.3	15.7	20.2	18.0	17.4	16.5	12.9
NASDAQ**	–4.7	17.2	7.9	15.4	18.3	16.9	13.6	14.5	10.3
Russell 2000	na	na	8.6	15.1	16.4	15.7	13.3	na	na

** In U.S. dollars, dividends included except for Nasdaq*
***Without dividends*

Source: Chase Investment Performance Digest—1998 edition, Chase Global Data & Research, 73 Junction Square, Concord, Mass. 01742; 978-371-9100; www.chaseglobaldata.com.

Germany with a 9.5% rate of return—are both countries that were often in the past held up as shining examples of excellent economic growth and development.

The long-term figures, of course, encompass the 1970s, one of the worst periods for the U.S. markets and marked by disastrously high rates of inflation. What if you feel that the U.S. has overcome those problems and is unlikely to see a repeat performance?

The U.S. markets have been particularly strong over the past 15 years, since 1982, but even then, the European stocks have done well: 18.6% for the past 15 years versus 17.4% for the S&P 500. The U.K. turned in the strongest of the three non-U.S. markets over this period, with a 17.0% return that closely matches the S&P 500. And Europe in general, and the U.K. and German markets in particular, outpaced both the Nasdaq and the Russell 2000 over the past 15 years.

AN OVERSEAS CHECKLIST

Although the headlines are screaming "global meltdown," the benefits of international diversification are still evident. However, investing worldwide is not a simple process. Here is a checklist of things to keep in mind:

- Foreign stocks have additional risks compared to their U.S. counterparts: country risk, the risk that political conditions within a country will affect economic conditions; and currency risk, the risk that changes in the relative value of the dollar and the currency will affect an investor's return. Currency risk is one reason returns for foreign firms are so volatile; the turmoil in the Asian currencies last year and the subsequent tanking of their stock markets illustrates the role that currency risk can play.
- These risks can be reduced by diversification. Country risk can be diversified by investing either in a mutual fund that holds many countries or in an assortment of single-country funds. Currency risk can be tempered to some extent by diversification among countries with different currencies and by investing over long-term time periods, since favorable and unfavorable currency fluctuations more or less tend to balance out over time.
- To have a meaningful impact on your portfolio, a commitment of at least 10% should be committed to international investments to provide long-term diversification benefits.
- If you are using mutual funds to invest internationally, make sure you know the percentages that are allocated to the different countries and regions. Many fund managers overweight and underweight certain regions and countries at various times; the performance of many broad-based international mutual funds recently were hurt by overcommitments to the emerging markets.
- It's a good idea to keep reasonably up-to-date on major world stock markets, economies, and currencies. This information is readily available in publications such as The Wall Street Journal and Barron's. That way you'll have a better understanding of why particular funds perform as they have.
- International investing should be a long-term commitment. It is difficult to know which region or country will do well over any particular time period. Don't sell out of more volatile regions on bad news. If you think you might be tempted to do so, avoid the more volatile areas. ✦