EUROPEAN STOCK FUNDS: SENDING YOUR MONEY ABROAD

By John Markese

With the economic union near, and restructuring and privatizations in progress, Europe seems alluring. But European stock funds differ, and the actively managed funds have placed both stock and country bets.

Thinking about sending some of your money on a trip to Europe?

Maybe to you, the Far East seems too chancy right now and Latin America is a question mark as always, but Europe, with the economic union on the near horizon and mergers, restructuring, and privatizations in progress, seems alluring.

Investing in European stocks directly, however, unless they are listed on a U.S. exchange, is difficult to accomplish because of the quality and availability of information, and the complexities involved in stock transactions overseas. So for many investors that leaves stock mutual funds specializing in Europe.

WORLDS APART

Even though all of the funds specializing in European stocks have Europe or European in their names, they may not act alike. Portfolio composition differs by country weightings, hedging policies, and investment approach, and the performance figures spotlight these differences.

The following tables compare the characteristics and performances of the European stock funds tracked in AAII's *Quarterly Low-Load Mutual Fund Update*.

Table 1 compares the performance of eight European funds and one Eastern European fund, Vontobel Eastern European Equity, as a contrast. For benchmarks, the averages for all international stock funds, the Morgan Stanley Capital International Europe total return index, and the Standard and Poor's 500 index are reported.

The recent appeal of the European stock funds is obvious; they have come close to matching the considerable returns on the S&P 500 index over the last one, three, and five years, and have much more than doubled the average returns for all international stock funds for the same periods.

And this performance was accomplished with, on average, a bit less risk than the Standard and Poor's 500 index and the average international stock fund, as measured by the standard deviation of total return. Standard deviation is a summary statistic that indicates the range of actual historical returns around the average return; two-thirds of returns fall within plus or minus one standard deviation from the average return. The larger the standard deviation, the greater the risk. To put some numbers into perspective, the standard deviation of an emerging market stock fund, a Latin American fund or an Asian fund would likely be nearly twice that of a European fund. While there is insufficient data (three years are required) to calculate a standard deviation for the Vontobel Eastern Europe fund, its standard deviation is probably closer to the emerging markets' end of the risk spectrum than the European fund mark.

Fund expenses detract from fund performance dollar for dollar. The expense ratio, stated as a percentage of your fund value on an annual basis, includes management expenses, advisory fees, and other fund expenses including 12b-1 fees, an annual sales charge that goes to marketing. The expense ratio does not include front-end or back-end sales charges, purchase fees or redemption

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TABLE 1. INVESTMENT CHARACTERISTICS OF EUROPEAN-FOCUSED MUTUAL FUNDS

Fund	Annual Return (%) 1 Year	3 Years	5 Years	3-Year Standard Deviation* (%)	Expense Ratio (%)	Load/ Redemption Fee
Excelsior Pan European	38.0	26.4	18.3	10.7	1.45	—
Fidelity Europe	41.0	28.8	22.5	10.0	1.18	3% F load
Fidelity Europe Cap Apprec.	45.2	28.7	na	12.3	1.07	3% F load
INVESCO European	35.7	29.0	21.5	12.2	1.25	—
INVESCO European Small Co.	14.2	24.8	na	11.7	1.62	—
Scudder Greater Europe Grth	47.8	34.0	na	10.7	1.50	—
T. Rowe Price European Stk	34.5	26.5	21.6	10.1	1.06	—
Vanguard Int'l Eq Index: European	42.5	28.1	22.4	11.1	0.35	0.5% purchase fee
Vontobel Eastern Euro Eq	–7.3	na	na	na	1.71	2% redemption
International Average	**11.1**	**13.4**	**11.4**	**12.1**	**1.41**	**—**
MSCI Europe Index	**42.4**	**27.8**	**22.6**	**11.0**	**—**	**—**
S&P 500 Index	**47.9**	**32.7**	**22.3**	**11.7**	**—**	**—**

**A measure of volatility indicating the range of actual returns around the average.*

Source: AAII Quarterly Mutual Fund Update, April 1998

The actively managed European funds have placed both stock and country bets.

fees, or brokerage costs.

The average expense ratio for a domestic stock fund is 1.1%, but for an international fund it is 1.4%. International funds by their natures are more expensive, and emerging market funds are even more expensive than European funds. For example, the Vontobel Eastern European fund has an expense ratio of 1.71%, high even for a foreign stock fund. At the other extreme, the Vanguard International Equity Index: European has a very low expense ratio of 0.35%, as would be expected of any passively managed index fund. Expenses always seem so much more important in down markets, while years of exceptional returns act to mask high expenses. But over the long haul, very high expenses relative to other similar funds are hard for a fund manager to overcome.

THE COUNTRIES

Table 2 provides a financial travelogue of the fund portfolios through the European continent. The big six, in terms of stock market size are (in descending order): the U.K., Germany, France, Switzerland, the Netherlands, and Italy. European mutual funds often have significant weightings in "other" countries, which vary from fund to fund, and may include countries such as Denmark, Portugal, Finland, and even Turkey. The Vanguard International Equity Index: European country portfolio weightings closely follow the market capitalizations of the various countries as a percentage of all European markets. The Vontobel Eastern European country weightings highlight the dominance of Hungary, Poland, and Russia and the relative insignificance of each of the other countries.

While all the funds geographically are invested in Europe, the country choices and country weightings differ, as do the actual stock selections within each country. Whether France is overweighted relative to the Morgan Stanley Europe index and Germany is underweighted, or in the case of Excelsior Pan European, the "other" category is close to 18% of the portfolio, these portfolios can differ more than domestic U.S. funds.

CURRENCY RISK

Beyond the country risks and stock risks of these funds lies currency risk. Returns to U.S. investors are in dollars. If the dollar strengthens on an exchange rate basis against European currencies, or against the European Monetary Unit next year, the return on these funds will decline in proportion to the dollar's appreciation against the European currencies, regardless of how the markets or individual stocks are performing. If the dollar weakens relative to the European currencies, returns on these European funds will be boosted, again, regardless of how the individual markets or stocks are behaving.

Nonetheless, few funds do any position hedging—hedging against adverse currency changes in the portfolio holdings. However, most funds do engage in some transactional currency hedging, hedging to offset currency risk on a particular trade, such as selling the stock of a company in one country and currency and buying stock in another company, country, and currency.

A EUROPEAN VACATION

Why invest in a European fund?

As with any foreign investment, not only are exceptional returns desirable, but also a reduction in

TABLE 2. EUROPEAN-FOCUSED FUND DIVERSIFICATION BY COUNTRY

	Excelsior Pan European (UMPNX)	Fidelity Europe (FIEUX)	Fidelity Euro Cap. Apprec (FECAX)	INVESCO European (FEURX)	INVESCO Euro Small Co. (IVECX)	Scudder Greater Europe Grth (SCGEX)	T. Rowe Price European Stk (PRESX)	Vanguard Int'l Eq Index: European (VEURX)
U.K.	15.0%	34.5%	29.7%	32.8%	31.4%	23.8%	25.5%	32.2%
Germany	11.2	9.9	5.3	12.8	5.4	11.7	8.1	14.7
France	18.1	10.2	20.1	13.8	10.2	19.7	13.4	11.7
Switzerland	9.4	9.4	6.5	6.7	2.2	9.1	9.4	11.7
Netherlands	6.7	5.5	8.5	5.9	11.5	5.9	16.5	8.4
Italy	3.8	3.9	5.9	7.2	5.9	7.8	5.3	6.0
Ireland	3.4	3.4	3.1	1.9	5.4	1.5	0.2	0.6
Spain	3.8	2.6	2.3	1.2	0.8	4.0	4.2	3.9
Sweden	5.1	9.7	4.5	2.8	6.8	3.1	5.4	3.8
U.S.	4.0	2.6	5.8	0.7	1.6	0.8	0.0	0.0
Other	17.9	8.3	8.3	13.8	18.2	12.3	7.8	7.0

	Vontobel Eastern European Eq (VEEEX)
Croatia	4.8%
Czech Republic	3.0
Estonia	0.6
Hungary	35.7
Lithuania	2.8
Poland	26.7
Romania	1.6
Russia	23.6
Slovenia	0.8

Source: Individual funds' most recent annual reports.

overall portfolio risk. The expectation is that U.S. and foreign markets do not move in unison, so risk reduction for the portfolio is achieved when investments in different parts of the world move in different directions. In the very short-term—days, weeks, and months—the U.S. markets and Europe can move in lockstep, particularly when the U.S. market takes a dive. But over longer-term time periods, geographical regions will be propelled by unique combinations of economic and social factors. On average, only about one-third of the variation in the return of these European funds was explained by movements in our market, the Standard and Poor's 500 index, over the last three years.

With the turmoil in Asia and the problems in Russia, Japan, and some Latin American economies, it is easy to keep your money at home. And even developed Europe and the European Union may stumble. But then, so may the U.S. economy.

International diversification is valuable in the long term, a concept easily forgotten during the decade-plus bull market in U.S. stocks. European stock funds are not identical, even beyond the stock differences of Europe and Eastern Europe. If you do decide to send some portion of your investments to Europe, read the prospectus and annual fund reports carefully—the prospectus is your travel guide and the annual report is your country-by-country map. ✦