INTERNATIONAL INVESTING: IT STILL MAKES SENSE TO DIVERSIFY

By Albert J. Fredman

Despite its advantages, you need to accept certain facts about international investing. First and foremost is that correlations among the world's major markets often converge to unity when U.S. stock prices are plunging during brief market shocks. The heavy selling typically produces a worldwide domino effect during severe global traumas.

Insurance should be the major reason for investing globally. Even though foreign markets generally move in the same direction as the U.S. market, they do so to different degrees. World market leadership rotates from year to year and decade to decade. Thus, having a modest portion—perhaps 20% to 25%—of your investments in foreign equities has been viewed as an important dimension of a well-diversified portfolio. It insures against a decline in the U.S. dollar and arguably protects against an extended period of poor domestic equity performance.

That said, a perilous downside has become abundantly clear since the mid-1990s, as a highly unfavorable risk-reward equation seems to have erased the alleged advantages of international investing. American investors have become increasingly discouraged with non-U.S. equities because they've earned reduced returns while being heavily exposed to wide currency swings and political dangers around the globe. Conversely, international diversification would have worked wonderfully during the same period for individuals who lived in countries such as Australia or Japan and placed a share of their wealth in U.S. equities.

Yet, with the prospects for lower U.S. equity returns during the next 10 to 15 years, many stateside investors are probably wondering if this is the time to add a layer of international diversification. After all, the S&P 500 isn't immune to long stretches of dismal performance. The 1973-74 recession resulted in large stock-market losses during that time. Because of this setback, Treasury bills actually outperformed stocks over the 15 years ended December 1974 when the S&P 500 average annual total return amounted to a mere 4.31%!

From a longer-term perspective, foreign stock markets have gradually increased in stature, as worldwide expansion has been a catalyst for the dynamic growth of many non-U.S. companies. These firms dominate major industries such as household appliances, metals, automobiles, and electronics. In 1970, the U.S. stock market comprised about two-thirds of the world's total stock market value. In May 2001, the U.S. market share had declined to about 50% of the $18.6 trillion of world market capitalization, as represented by the 46 countries in the Morgan Stanley Capital International (MSCI) all country index.

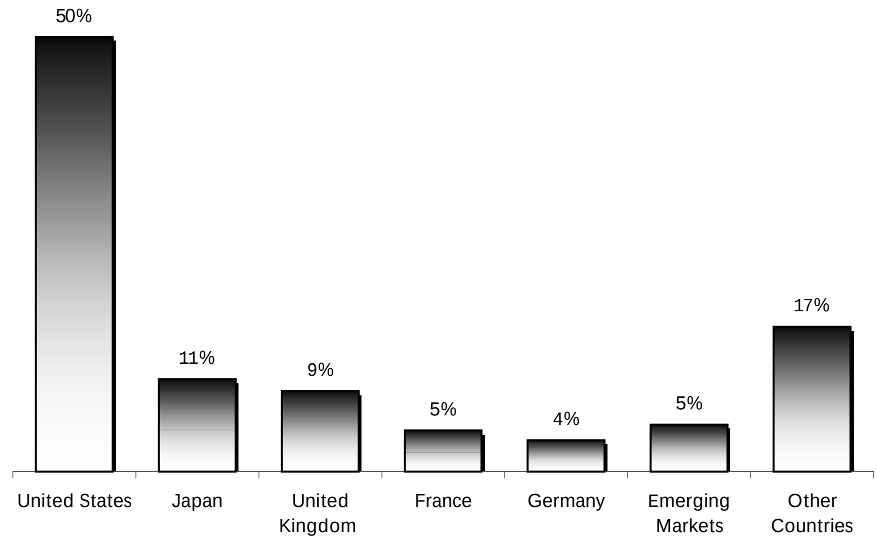
Figure 1 breaks down the share of world market capitalization accounted for by the five largest stock markets and the emerging markets as a whole. The four largest stock markets—the U.S., Japan, the U.K., and France—accounted for 75% of world market capitalization. The MSCI emerging market (free) index includes 26 countries, but amounts to just 5% of total world market cap. A country's relative weighting can change dramatically over time, as Japan's did. At the peak of its speculative bubble in the late 1980s, Japan's market cap noticeably exceeded that of the U.S.

CORRELATIONS

Correlation coefficients are used to measure how closely a pair of stock

Albert J. Fredman is a professor of finance at California State University, Fullerton (E-mail: afredman@fullerton.edu). Prof. Fredman is co-author of several mutual fund books.

FIGURE 1. WORLD MARKET CAPITALIZATION WEIGHTS*



**Percents of MSCI all country index as of May 31, 2001.*
Source: Data provided by The Vanguard Group.

markets tends to move in relation to each other. A perfect positive correlation of 1.0 indicates identical fluctuations—both tend to move up and down at the same time by similar amounts. The lower the correlation, the better the diversification—ideally, one market should zig when another zags. This often doesn't hold in practice though. Time series of stock prices in different countries are generally positively correlated, but the coefficients are typically well below 1.0. The correlation between the U.S. market and most foreign exchanges is 0.5 or less. With a coefficient of more than 0.7, the U.S. and Canadian markets are an exception because of the close economic ties of the two nations. Conversely, the U.S./Japanese correlation has tended to run close to 0.3. Emerging markets have even lower correlations with the U.S., offering a particularly heavy layer of diversification.

Some researchers have argued that the benefits of international diversification have diminished over time. Correlations among major world markets have trended upward due to factors such as advances in communication technology and the breakdown of trade barriers. Economies and stock markets have become increasingly integrated, as markets have advanced.

Other researchers hold that markets are still largely uncorrelated, pointing to the weak link between Japanese and U.S. equities during the past decade.

Rather than debate these issues, it is more instructive to recognize several facts about global diversification.

The first fact is that international diversification may fail you when you need it most because foreign markets often tumble in sync with the S&P 500. Correlations among the world's major markets often converge to unity when U.S. stock prices are plunging during brief market shocks. The heavy selling typically produces a worldwide domino effect during severe global traumas such as the 1987 U.S. stock market crash and the 1997 East Asian financial crisis. Conversely, cross-market correlations do not increase during bull market rampages. A simple explanation is that fear is a stronger emotion than greed. Thus, international investing can be hard on the emotions.

Second, large multinationals, such as Finland's Nokia, don't provide as high a degree of diversification as smaller companies whose profits are driven more by the health of the local economy. The correlation of the price movements of multinationals—operating in areas such as technology and telecommunications—with their counterparts in other nations has increased markedly in recent years. Foreign funds holding mid-sized and smaller firms offer greater diversification because they have more exposure to local companies, insulating them from global trends. Yet these companies carry greater risk than the foreign big caps.

You can learn how a fund manager diversifies by company size by going to Morningstar.com (www.morningstar.com) and reviewing the "Style Box Details." You'll see the portfolio's median market cap and the percentage allocation among giant, large, medium, small, and micro-cap stocks.

CURRENCY FLUCTUATIONS

Two major factors affecting the returns to a U.S. investor from a foreign stock are:

- The performance of the target market in local currency, and
- The performance of the country's currency relative to the U.S. dollar.

A country's currency generally reflects the health of its economy and foreign investors' eagerness to place their money there. Strong, prosperous countries tend to have strong currencies. Adverse currency movements can lead to major setbacks for unhedged international investors. Nevertheless, good international diversification should include pure exposure to different currencies as well as stock markets.

Currency fluctuations can have a substantial impact on the returns of investors with large holdings in emerging markets. Devaluations are often inevitable because they are the medicine needed to cure a sick economy, but unsuspecting investors have to contend with the adverse side effects. If a developing market doubles in local currency, but its currency depreciates 50% relative to the dollar, an American investing in that country would just break even. Far worse scenarios can occur. During the 1997 Asian financial crisis, a typical East Asian market tumbled 40% in local currency. In addition, a 40% currency loss brought a U.S. investor's Asian position down 80% in a short period.

Less extreme currency fluctuations are commonplace in developed markets. In 1997, the MSCI EAFE index, a popular benchmark for developed foreign markets, returned 13.8% in local currency, but only 2.1% in dollars, because the greenback soared. Conversely, in 1998 the dollar weakened and the EAFE returned 12.6% in local currency but 20.3% in dollars. The Euro lost ground to the dollar in 1999 and 2000. An unhedged European stock fund would have been heavily impacted by the Euro's 19.6% slide over the two years ended December 2000.

Some funds, such as Longleaf Partners International, try to hedge away all or a portion of these currency fluctuations by using instruments such as currency forward contracts. Others, like T. Rowe Price International Stock, avoid hedging. International index funds are normally unhedged. Whether or not a manager hedges can have a major impact on a fund's performance relative to its unhedged peers. Hedging costs money and demands an accurate forecast to be successful. Unfortunately, currency trends are notoriously difficult to predict. Further, currency hedging may increase a fund's performance correlation with U.S. markets, reducing the diversification benefits of international investing.

TABLE 1. COMPARING 10-YEAR ANNUALIZED ROLLING RETURNS

End of 10-Year Periods (Thru Dec.)	MSCI EAFE Index in U.S. $ (%)	MSCI EAFE Index in Local Currency (%)	S&P 500 Index (%)
1980	13.78	9.73	8.45
1981	10.62	8.94	6.48
1982	7.05	6.53	6.71
1983	11.11	12.11	10.63
1984	14.80	17.43	14.75
1985	16.34	15.94	14.28
1986	22.23	19.53	13.79
1987	22.78	18.64	15.23
1988	22.25	20.38	16.26
1989	22.77	21.49	17.49
1990	16.99	15.19	13.88
1991	18.50	14.86	17.53
1992	17.11	13.08	16.11
1993	17.87	12.82	14.87
1994	17.89	10.43	14.33
1995	13.95	8.72	14.83
1996	8.74	6.07	15.25
1997	6.56	7.67	18.01
1998	5.85	5.82	19.18
1999	7.33	6.82	18.19
2000	8.56	9.83	17.44

Source: Data provided by The Vanguard Group

THE PERFORMANCE STORY

During much of the 1990s, the U.S. had experienced low inflation and exceptionally strong corporate profit growth. The situation was far different elsewhere. The poor performance of the large Japanese market for most of the 1990s was a major drag on the composite returns of non-U.S. markets.

A long-term performance analysis will put world market returns in perspective. Table 1 compares the MSCI EAFE index, made up of 20 major countries in Europe, Australasia, and the Far East, with the S&P 500. Although it excludes smaller markets, the EAFE is still a good proxy for foreign stocks in general. A number of international index funds track the EAFE or its components. The table compares 10-year annualized rolling returns on the EAFE (in both U.S. dollars and local currency) with the S&P 500. The first 10-year period ranges from December 1970 to December 1980. The second is from December 1971 to December 1981, and so on. All told, 21 rolling 10-year periods are covered.

Foreign market returns are usually quoted in U.S. dollars because that's what American investors earn. Comparing numbers in Table 1 reveals some striking differences between EAFE returns in U.S. dollars and those in local currency. In the 10 years ended December 1994, the EAFE returned 17.9% in dollars yet only 10.4% in local currency. The 17.9% greatly exceeded the 14.3% earned on the S&P 500. Conversely, the S&P 500 beat the EAFE in local currency terms. Thus, trends in foreign exchange rates played a major role in returns earned by U.S. investors.

During the five most recent rolling 10-year periods, highlighted in Table 1, the S&P 500 far outpaced the EAFE in both dollars and local currency. The annualized S&P 500 returns were more than twice the dollar EAFE returns in the majority of these periods. During the latter half of the 1990s, the U.S. market soared on the coattails of the tech boom. Although technology is an important part of other economies—such as Japan, Korea and Taiwan—these markets were weighed down by a variety of problems, including Japan's economic malaise and the Asian currency crisis. Understandably, countless investors became discouraged with foreign stock returns.

From a longer-term perspective, however, the outcome was more favorable for non-U.S. markets. In 15 of the 21 periods the dollar EAFE outperformed the S&P 500, whereas in 10 of the 21 periods the EAFE in local currency outperformed the S&P. Over the full 1970-2000 period, the dollar EAFE and the S&P 500 returns were 12.2% and 12.9%, respectively. The EAFE returned a less favorable 10.8% in local currency over this 30-year period.

Those with a contrarian bent may feel that it makes sense to overweight foreign markets when they have had an extended run of poor performance relative to the U.S. market, as seen since the mid-1990s with the EAFE. In fact, contrarians may be so bold as to assign high weights to laggard stock markets, such as Japan's. The theory is that all of the world's markets should converge toward a global mean return over several decades. This kind of market timing is dangerous, however. We simply don't know when foreign markets will surge and we don't know which ones will take the lead. Individuals should pick their normal long-term asset-allocation weight for a diversified package of non-U.S. markets and stick with it.

EMERGING MARKETS

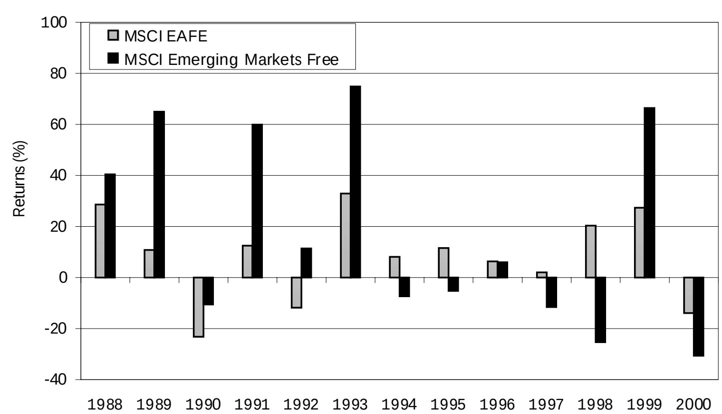
Emerging markets recently accounted for about 5% of total world stock market value (see Figure 1), down considerably from their lofty 13% level in 1994. Developing economies are found in Southeast Asia, Latin America, Eastern Europe, and Africa. These markets are the most volatile of all, soaring in one year and plunging in the next. Developing markets are suitable for risk-tolerant individuals with time horizons of beyond a decade. Problems in countries such as Argentina, Brazil, Indonesia, and Turkey have been widely publicized this year. Emerging markets can be viewed as a spice—a little goes a long way in a portfolio. It's important to have exposure to many emerging markets spread across different regions of the world to ensure against country or regional fiascoes. Individuals can choose between a dedicated emerging-markets fund and a diversified foreign-stock fund that maintains anywhere from a tiny stake to up to 30%, or so, in developing markets.

Figure 2 illustrates that emerging markets performed exceptionally well from 1988 to 1993 compared to the developed markets, as tracked by the EAFE. Markets in Latin America and East Asia soared in 1993, attracting widespread interest. These markets stumbled in 1994 when the Fed began raising interest rates to cool the U.S. economy and Mexico devalued its peso. The East Asian and Russian crises of 1997 and 1998 also precipitated global emerging-market shocks. The beaten-down markets experienced a large run up in 1999 when the worst appeared to be over.

For the 13 years ended December 2000, emerging markets delivered a 12.4% average yearly return, which exceeded the EAFE's 7.3% return over that period. However, the 38% annual standard deviation of emerging-market returns was more than twice the 17% EAFE value, indicating far more extreme price fluctuations. Major credit problems confronted Argentina, Brazil, and Turkey as of this writing.

Nevertheless, emerging markets have recently attracted the attention of investors and fund managers. Many big, diversified foreign-stock funds—which focus largely on developed markets—now have 12% or more of their portfolios allocated to emerging markets. A major advantage of these markets is that they offer the lowest correlations of returns when paired with the U.S. market or other foreign markets, thereby enhancing an investor's international diversification.

FIGURE 2. YEARLY EAFE RETURNS VS. EMERGING MARKET RETURNS (U.S. $)



Source: Data provided by The Vanguard Group.

GETTING EXPOSURE

You can find a handful of large, broadly diversified foreign stock funds with relatively modest costs and impressive long-term performance to round out your domestic holdings. Masters' Select International (MSILX), a newer fund with a favorable record, uses a mix of five managers who each employ a different stock-picking style. About 18% of its assets recently were allocated to emerging markets.

An assortment of international index funds also exists. Indexing is a simple, low-cost way to achieve international diversification (see, for example, the Mutual Funds columns "The Index Fund Advantage: Low-Cost Passive Investing," in the May 1999 *AAII Journal*, and "Using Index Funds As a Part of Your Asset Allocation Strategy," in the July 1999 issue, both available on our Web site). Management fees and trading costs are both greater in foreign markets, making indexing ideal for long-term investors. In addition, indexers avoid management risk. The performance records of foreign stock funds vary widely. How can you know today which one will be a five-star performer over the next decade or two? A fund of three Vanguard international index funds, Vanguard Total International Stock Index (VGTSX) provides exposure to the EAFE as well as an 11% stake in emerging markets.

With their big-cap bias, most index funds don't provide the kind of exposure to smaller companies and emerging markets that is needed to achieve the most beneficial non-U.S. diversification. Those seeking greater diversity can combine a small-cap foreign fund with an index fund tracking the EAFE. No-load international funds with a small-cap focus include Nicholas-Applegate International Small Cap Growth (NAGPX), Oakmark International (OAKIX), Oakmark International Small Cap (OAKEX), and Westcore International Frontier (WTIFX).

The single-country and regional funds targeting developing markets are suitable only for large, sophisticated investors. For most individuals, emerging markets can be accessed either through diversified foreign stock funds or dedicated emerging markets funds. The latter are available from large fund companies including Dreyfus, Fidelity, T. Rowe Price, and Vanguard. Vanguard Emerging Markets Stock Index fund (VEIEX) targets the most liquid developing markets based on a customized index. Representing 13 countries, its 426-stock portfolio recently had 27% of its $855 million in assets in its top 10 holdings. With a $4.6 billion median market cap, the fund has considerable exposure to mid-sized and smaller stocks.

PATIENCE AND DISCIPLINE

Global investing can be emotionally challenging. Patience and discipline are vital because—as we've seen all too clearly in recent years—foreign markets can be exceedingly volatile and can generate long stretches of dismal performance.

View a good foreign stock fund as a core part of your portfolio. Down markets can be a good time to add to a position.

International diversification is best suited for investors with time horizons of one to four decades. ✥

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