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# Intelligent Money

*Current thinking from Haven Financial Advisors*

## Foreign Investing



Louis Kokernak CFP, CFA  
Haven Financial Advisors  
Austin ~ Dallas

voice 512 514 6250

toll-free 800 898 5480

fax 800 888 5480

[louis@havenfinancial.com](mailto:louis@havenfinancial.com)

### **Special Notes of Interest:**

- Between 1970 and 1996, a survey by S&P of the debt of 113 governments counted 69 defaults on foreign currency debt. (Note that S&P counts any debt restructuring as a default)
- In the last 3 years, dollar reserves among OPEC countries have fallen from 75% to 61% of their total holdings.

The fall of the dollar in currency exchange markets has caught the attention of investors. Unlike past declines in the US currency, this one is coupled with the ascendance of a real alternative to the dollar: the Euro. In actions likely to undermine the dollar's value on currency markets, 70 percent of central bank reserve managers said they had increased their exposure to the euro over the past two years. Moreover, expansion of the European Union means that more productive capacity will be denominated or linked to the Euro.

Most Americans will pay for the vast majority of goods and services in dollars. We've thought little about the need for currency or investment diversification. Yet foreign investment does offer real benefits in terms of risk reduction. Public companies headquartered overseas represent a growing fraction of the worldwide market capitalization. In another 30 years, the American stock market should comprise only one quarter of the worldwide stock market. We ignore foreign stocks at our peril.

The costs of overseas investment remain high but are getting lower. Foreign companies and securities exchanges have been subject to regulation that is less transparent than their North American counterparts. However, foreign exchanges have adopted electronic trading systems that have reduced the cost of transacting shares. The venerable New York Stock Exchange (NYSE) may adopt fundamental restructuring to meet this foreign challenge. Reforms under consideration include extended trading hours and transparent trader access to stocks listed on foreign exchanges. Indeed, a global 24 hour stock exchange is on the horizon.

The most important innovations are occurring with the securities themselves. More and more Exchange-Traded Funds (ETF) are available –offering access to foreign markets at reasonable cost. There is an ETF that invests solely in blue-chip companies in developed foreign markets at a cost of only 0.35% annually. Such inexpensive access to foreign markets would have been unthinkable for individual investors five years ago.

Overseas equity investing does offer the potential for exposure to other established currencies. However, most companies actively hedge their own currency exposure. This is especially true of economies driven by exports such as Germany and Japan. It is indeed difficult to quantify currency exposure with stocks.

Another important overseas opportunity are its bond markets. With American interest rates on the rise and the dollar falling, many investors have reasonably sought alternatives to low yielding US treasury securities. In past low interest rate environments, investors have parked their fixed income asset allocations in cash or invested in lower credit quality bonds. The former offers preservation of principal while the latter offers greater return with the risk of loss.

While there are still few options in the public markets to invest in foreign bonds, the landscape is changing. A strategic issue to consider is whether to assume currency exchange risk. As most bonds in developed overseas markets are denominated in foreign currencies, exchange rate movements are the major source of short term volatility. Some bond funds hedge this currency exposure in the futures market.

The number of dollars held in overseas



## Foreign Investing (Cont)

central banks has exploded in the past five years. Survey data indicates that foreign banks will not permit this trend to continue. Under these circumstances, it appears prudent to shift some currency exposure away from the dollar.

The question is how to do this. Two years ago, there were few alternatives short of trading directly in the foreign exchange markets. Since April 2004, PIMCO has offered an unhedged version of its foreign bond fund. Its performance has dominated its hedged counterpart as the dollar has fallen. Investors that are comfortable with currency diversification might welcome an investment vehicle with reasonable fees and exposure to foreign exchange rates—especially those that spend considerable time outside the US.

There are some key benchmarks of foreign bond performance that investors should be familiar with. A key distinction in overseas markets is the line between developed and emerging economies. Western Europe, Australia, and Japan comprise most of the former with sovereign and corporate credit

ratings similar to the United States. The JP Morgan Non-US Government Bond Index covers this market. Foreign bond funds will often use it as a benchmark.

Apart from these developed markets, there is another tier of countries generally characterized by high growth rates but less reliable political and economic infrastructure. The JP Morgan Emerging Market Bond Index (EMBI) covers about 30 countries and serves as a recognized benchmark. Mexico, Brazil, and Russia are major constituents of the index. Because of the small size of the member economies, the EMBI constitutes less than 3% of the market capitalization of the developed economy debt market.

As world economies grow, foreign investments will command more attention of the US investor. Fortunately, competition and innovation in domestic securities markets will offer easier ways for us to take ownership and creditor positions abroad.

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## Emerging Market Debt

The history of Emerging Market Debt as an asset class is relatively short. Most recognized index data does not reach back beyond the 1990s. In fact, only \$24 billion in emerging market debt was outstanding in 1992. It has since increased more than tenfold. We are cautioned against drawing inferences from such a small data sample.

But this short time horizon has produced some interesting history. As a group, emerging market credit ratings have actually improved with nearly 50% of issuers enjoying an investment grade. Even Latin America is running a current account surplus for the first time in 50 years. Emerging economies are accumulating hard currency reserves.

The overall volatility of emerging market debt has fallen in absolute and relative terms with respect to the S&P 500 and the Lehman Brothers Aggregate Bond Index. In fact, Emerging Market Debt is much closer in volatility to the latter bond benchmark.

The majority of debt issued by emerging markets is denominated in the dollar to attract investor interest. There are over \$230 billion in

bonds so denominated. Thus, the investor assumes little no currency exposure with a broad investment in emerging market debt. Another attractive feature of emerging market bonds are their low correlation to core asset class holdings for Americans. From 1997 through 2003, the EMBI exhibited very low correlation ( $\rho = 0.21$ ) with the price movements of US Bonds. At the same time, the EMBI's return was 16.31% - surpassing both domestic stock and bond returns over the same period.

Again, emerging market debt has not truly withstood the test of time. These bonds are now trading at historically tight spreads to the US Treasuries. Any major political or economic crisis in a major emerging market might drastically increase this trading spread. Even as this article is written, Argentina has roiled the debt markets as it tries to emerge from default with a debt restructuring offer that has been poorly received by investors.

On balance, though, the portfolio characteristics of emerging market bonds are attractive and warrant consideration in a world where demographic trends favor developing economies.

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