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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

The yield on ten year German bonds fell below 1.0% for the first time this month

Factset.com reports that S&P 500 earnings grew 7.6% in the 2nd quarter of 2014 as compared to last year.

Foreign Stocks: How much is enough?

The American stock market has been one of the world's premier performers since the subprime crisis. Just about every American stock index has returned significantly more than major foreign stock aggregates over the past five years. A lot of folks have forgotten that there are opportunities in foreign capital markets as well.

In terms of market capitalization, US stocks comprise just under 50% of the world's total. An important question for investors to consider is how much of their own portfolios should be deployed in foreign stocks. This edition of *Intelligent Money* will review some of the key issues surrounding investment overseas.

The Basis for International Diversification

Portfolio management has long been guided by the principal of diversification. Holding a broad swath of assets cancels out much of the risk attributable to company-specific fortunes. Don't put all your eggs in one basket, or country. It makes sense, then, for investors to take advantage of the growth opportunities available to public companies overseas.

There are some caveats. Not all markets are created equal. Many foreign markets trade much more thinly and are less transparent than American stock exchanges. Most of our own consumption is denominated in dollars as well, making US companies especially suitable for holding.

Two key questions loom. What is the "foreign market" and how much of it should a prudent investor put in their portfolio?

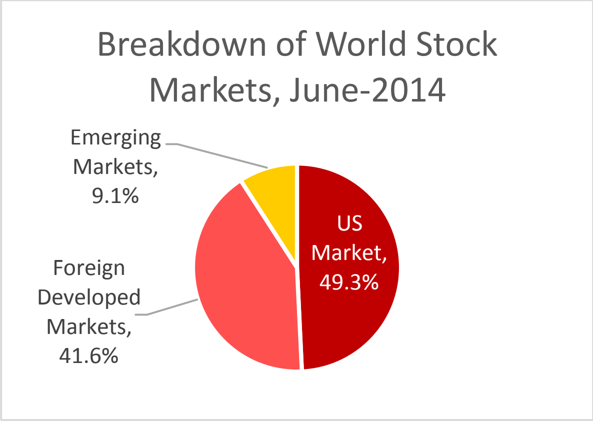
What is the World Stock Market?

At yearend, the aggregate market capitalization of the world's stock markets was about $54 trillion. A significant fraction of this stock is not actually tradable because it is closely held by governments, company founders, or certain institutions. About $43 trillion is considered available for trade. This stock is often referred to as *free float* in the press. Most major stock indices only account for this free floating stock when they assign weights to companies.

The influence of American stocks in the world market has varied over time. Just after the devastation of World War II, America was about the only place to trade stocks. By the late 1980s, over 70% of the world's stock was outside the US. That period coincided with a great bull market in Japanese equities. For most of the past twenty years, the US market has hovered about where it is, at or near half the world's free float.

The very largest private corporations are American. Nine of the top ten stocks are headquartered in USA. There are some huge companies overseas but much of their ownership remains in government hands and not part of the free float. For example, only about 30% of the stock in mainland Chinese companies is tradable. In the United States, over 90% of outstanding stock is freely available.

For the purposes of our discussion, we'll break down foreign stocks into two segments: developed markets and emerging markets. Foreign countries fall into one of these two categories. As the name implies, developed markets are characterized by high incomes, stable political institutions, and a transparent stock exchange mechanism. Think Western Europe and Japan. Emerging markets have lower national incomes with evolving political and economic institutions. They are typically characterized by high economic growth rates. There's not a bright line separating a developed market from an emerging one. In fact, different indices have discrepancies in their attribution of developed and emerging markets. Korean and Taiwanese stocks can be found in both developed and emerging market funds.



Benefits to Foreign Stock Ownership?

The benefits of diversification are typically measured in reduced portfolio risk. Risk is often referred to as volatility - the level of variability in portfolio returns over time. Investors naturally prefer less volatility.

The historical record of domestic and foreign equity returns to date reveals some pitfalls. Stock markets have tended to move together or *correlate* more closely in recent years. When highly correlated assets combine, overall risk remains relatively intact. Not good if you’re building an investment portfolio.

In fact, foreign stocks have offered no risk reduction since the subprime crisis in 2008. Their volatility has been high and overall returns have been low. US stocks have been among the world’s best performers in the last five years.

Despite these disclaimers, the long term data still show that foreign stocks reduce risk by a measurable amount in investment portfolios. Investors can capture most of the benefit of foreign diversification with portfolio weights well short of the 50% market cap representation of non-USA stocks.

Recent research from the [Vanguard Group] suggests that most of the risk reduction available with international diversification can be captured with a 20% to 40% weighting to foreign stocks. The chart at the bottom the page reveals that most of the benefits can be achieved with comparatively shallow exposure to markets outside the US. The line on the chart below represents overall change in the risk level of an all stock portfolio as foreign stocks are added. The highlighted green range covers the lowest risk mixture of foreign and domestic stocks.

The scale of the risk reduction is highly sensitive to the measurement period. The charted depicted takes the long view - reviewing stock market returns from 1970 the present. If we exclude first twenty years of the series, the benefits are considerably less.

While the theory supporting foreign stock diversification is strong, the actual data is more cautionary. Reliable stock return data for the universe of foreign stocks is considerably shorter than US stock returns. When does a foreign stock market become viable enough to be included in any index? A statistically reliable record is still under construction. Prudence suggests that investors use foreign stocks, but underweight them relative to their representation in the capital markets.

The evolution of overseas stock markets and modern investment products has made foreign investing cheaper and easier. Twenty years ago, the only entrée to foreign markets for retail investors was through individual stocks or expensive mutual funds. Today, there are a number of indexed exchange-traded funds (ETFs)

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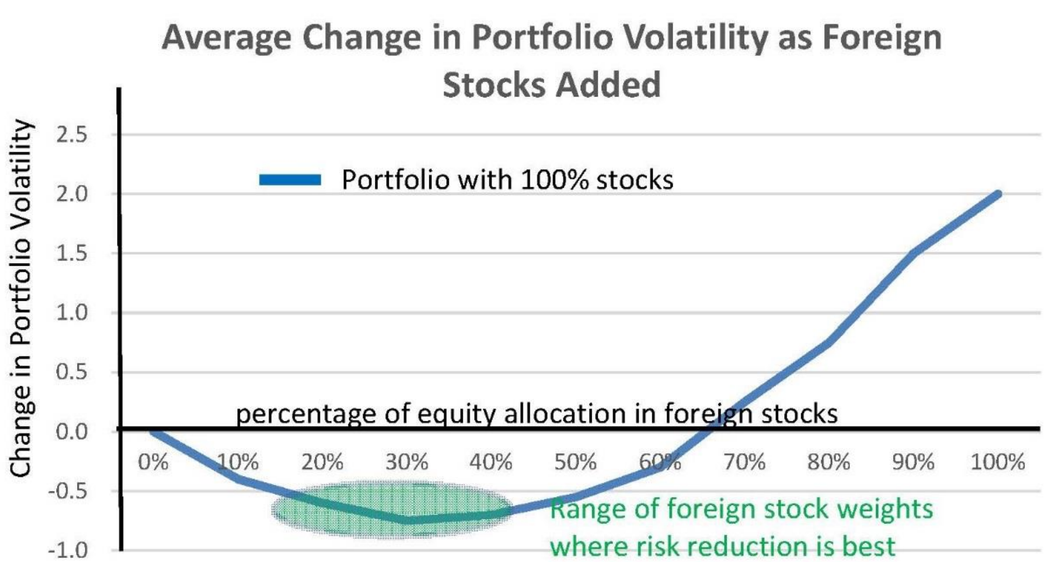

Sources: Vanguard, Thomson Reuters Datastream, and MSCI
Data ranges from 1970 through 2013

"Over the last 25 years, foreign 'value' stocks have generated an annual return premium of almost 3% annually."

and mutual funds that provide broad exposure to foreign equities at low cost. Key product vendors include Vanguard, Blackrock, Schwab, and Fidelity investments.

Special Considerations with Foreign Investing

For many years, researchers have consistently found that American stocks with prices that are low relative to fundamental measures like earnings and revenue generate superior returns. This phenomenon has been dubbed the "Value Effect". Consequently, many investment professionals overweight low priced stocks to capture additional returns.

One might reasonably ask whether this value effect extends to foreign markets. The data thus far confirms that value stocks outperform their peers overseas as well. Over the last 25 years, foreign "value" stocks have generated an annual return premium of almost 3% annually. While foreign stock databases are newer than their American counterparts, every indication suggests that a value effect is worldwide.

Another issue to consider with foreign equities is their overall ability to improve portfolio returns. In other words, do foreign stocks outperform US stocks? The jury is still out. The number of data points is still too small.

Using 1970 as a starting point, foreign stocks have lagged American equities by about one percent annually. However, during the first couple of decades of this period, there was very little emerging market participation in the foreign stock data. Stock returns in these developing economies have been good. With all the changes in the composition of foreign stock indices, comparison of US and foreign stock market returns remains difficult.

While there is evidence that the inclusion of foreign stocks can reduce risk in the long term, the historical record of foreign stocks as short term "crisis insurance" is poor. That is, stocks from all countries tend to move together (and downward) in times of economic dislocation. The meltdown in 2008 is only the most recent case in point.

There are other examples. Foreign stocks fell hard during the dotcom bust in 2001-02 and during the stock market's crash in 1987. International diversification is a long term phenomenon. It will not insulate an investment portfolio from a recession or an international crisis. Participation in world markets will most likely smooth returns over long periods of time. That's a useful if unspectacular outcome.

Suggestions for additional reading

Carolyn Geer, Diversify Your Portfolio With International Stocks, ***Wall Street Journal,*** August 7, 2013

Eugene Fama and Kenneth French, Size, Value, and Momentum in International Stock Returns ***Journal of Financial Economics,*** May 2012

Christopher Phillips, Global equities: Balancing Home Bias and Diversification, Vanguard Research, February 2014