



Financial Fables

International Investing

There are reasons for the things we do—reasons based in financial principles. How we invest internationally is based on reasons that we believe should increase expected return and also improve diversification.

When going international, the traditional approach generally favors funds or ETFs that imitate Morgan Stanley's Europe, Australasia, Far East Index (EAFE) of large cap stocks in developed countries. Although this approach is easy to implement, it's limiting. Historical returns for EAFE are virtually identical to the US market's S&P 500 index, over their common data history of 1970 to 2005. However, returns aren't everything. Even with similar average returns, an EAFE component should be added if it increases diversification that significantly reduces total portfolio volatility. Unfortunately, because markets have become increasingly more global, the evidence suggests that not much diversification is gained from adding a large cap international component to a portfolio.

Before dismissing international investing, we should consider home bias, an idea that crops up often in finance. Investors tend to allocate disproportionate assets to their own countries, industries, and even to their own companies. We saw the risk of this in exaggerated form when Enron employees sunk their 401(k) savings into the company's stock. Put simply: you don't want the same economic forces that wipe out your local economy, your paycheck, and your house price to simultaneously wipe out your investment portfolio. To the extent that other countries have their own good and bad tidings, they diversify risk at home (strong recent correlations notwithstanding).

Fortunately, there are international securities beyond the usual large cap arena that can help offset home bias. We know from troves of research over the past twenty-five years that small cap and value stocks are riskier than large cap and growth stocks and reward investors with greater expected returns over time. This is also true internationally.

Even more crucially, international small cap and value stocks offer greater diversification. It only stands to reason that smaller companies should be more indigenous to local markets. More of their commerce is conducted locally, especially as compared to multinational conglomerates. Small cap and value stocks not only expose us to greater expected returns in international economies—in a very real sense they expose us to the international economies themselves.

Basing decisions on economic reasons can lead to compelling solutions that just might achieve a few goals that elude traditional approaches—like wisely investing our clients' money overseas in an ever-shrinking world.