International Investing

What Investors Need to Know

Over the past several years, the performance of international markets have trailed the markets here in the United States. Will the trend continue this year?

So far in 2017, international markets are outperforming domestic markets and you may be wondering whether now is the time to allocate a portion of your portfolio to international holdings. The short answer is yes – most investors would be well served by allocating to markets outside the U.S. Here are some thoughts for you to think about.

Many opportunities outside the U.S.

Over half of the world's investing opportunities are based outside of the United States. Major multi-national corporations like Nestle and Royal Dutch Shell are examples of large corporations headquartered outside of the U.S. Look at the products in your home that you use every day. Where was your television or your computer made? What type of car do you drive? Did you know that Toyota and Volkswagen were the world's top two largest automakers in terms of sales for 2016, ahead of General Motors?

Fast growth

Many of the world's fastest growing economies are located outside of the U.S. too. Confining your investments to the United States limits your opportunities to invest in innovative and successful companies operating in a number of these countries.

Developed markets and emerging markets

Developed markets are those countries whose economies are among the most advanced. The stock markets of these countries are highly developed, have solid regulatory bodies (like the SEC in the U.S.), large market capitalizations and are highly liquid. These countries generally have high per-capita levels of income. Of the 23 markets classified as developed by index developer MSCI, besides the U.S. and Canada, all are in Europe, the Middle East (Israel) and Asia. Examples include the United Kingdom, Hong Kong and Australia.

Emerging markets represent countries whose economies are developing and growing rapidly. Their stock markets are less mature than those of developed market countries and may lack their level of liquidity and regulation. These countries generally have lower per-capita incomes than developed market countries. The BRICs (Brazil, Russia, India and China) are examples of emerging market countries as are the PIGS (Portugal, Italy, Ireland, Greece and Spain).

Historical performance

Let's examine how domestic markets have performed relative to developed international markets. We can compare the S&P 500 Index (a measure of large-cap U.S. stocks) with the MSCI EAFE Index – a core index for tracking stocks of developed foreign markets.

Since 1970, on a calendar year basis, the S&P 500 Index has outperformed the MSCI EAFE Index in 24 out of 47 years or 51% of the time. On a rolling three - and five-year basis, it was virtually a dead heat at 50% for each. At the seven-year interval, the U.S. has outperformed 48% of the time. In other words, it looks like a coin flip to see which markets outperform over both shorter and longer time frames.

Correlation with U.S. stocks

It is true that he correlation between U.S. large cap stocks and both developed international equities and emerging market equities has narrowed in recent years. This is likely due to the continued globalization of world economies. The reality is that the markets do not move in tandem with one another and can provide investors a measure of diversification.

Mutual funds versus individual stocks

For most individual investors, investing in managed accounts like mutual funds and ETFs makes sense in general. Mostly because it can be very difficult to analyze and monitor a portfolio of individual stocks. And depending upon how much you have to invest, it is harder to build a well-diversified portfolio using just individual stocks.

When it comes to the international portion of your portfolio, this makes even more sense. For one, it can be difficult for smaller investors to research non-U.S. stocks. While some major investment custodians have broadened the ability to trade in foreign markets, there are still restrictions and it is not as easy or efficient as trading domestic stocks. If you venture beyond American Depository Receipts (ADRs), which are shares of foreign stocks that trade on U.S. exchanges, you are likely to encounter substantial transaction costs too.

For most individual investors, using a managed account like a mutual fund or ETF makes sense when investing internationally. Besides the professional management, many large fund companies have offices in various parts of the world supporting their foreign investing efforts.

Even with passive index products, the fund or ETF has the ability to invest in the broad array of individual stocks that comprise an index like the MSCI EAFE Index (Europe Africa Far East).

Currency fluctuations and hedging

As a U.S. investor investing in foreign stocks, your return has two components. One are the gains and losses on the individual stocks, bonds or funds that you invest in. The other is the gains or losses in the foreign currency or currencies (in the case of a fund or ETF) relative to the value of the U.S. dollar.

Some investors and fund managers choose to hedge against these fluctuations in the foreign currencies. Hedging can make sense if you are fairly certain that the foreign currency will fall (or rise) against the dollar. It can also make sense if you want to simply do your best to negate the impact of currency fluctuations on your holdings. A number of mutual funds investing in non-U.S. stocks hedge against currency fluctuations.

The flip side is that predicting the fluctuations in currencies is difficult. World events and other unpredictable factors have a way of cropping up. Additionally, currency fluctuations can also serve as another way to diversify your portfolio.

International fixed income

Investing in international bonds can provide diversification but also carries risks. Foreign bonds and foreign bond funds can provide you with exposure to a variety of economies from countries around the world as well as the interest rate environments of these various countries.

The risk comes into play for many of the same reasons associated with international equities – foreign economies and companies rise and fall.

In addition, there is much interest rate uncertainty around the world and some central banks have resorted to negative interest rates. There is also the added issue of foreign currency fluctuations much like with foreign stocks.

Summary

It is common for many investors to want their money “close to home.” But by ignoring international investments, you may be shortchanging yourself. Over half of the total investing opportunities are outside of the United States. International investments can provide both diversification and growth opportunities for investors.

They also present some risks that are different than for domestic investments and investors need to understand and manage these risks.

Meet with a qualified professional.

A key to incorporating international investing into your financial plan is to seek the advice of a qualified financial professional. Regular reviews will help decrease your insecurity about international investing and help you make the best choices for your situation. Call me to discuss how international investing can play a role in your financial plan