

Financial Planning

Small-World Investing

Do international stocks really give you higher returns with less risk?

By Gene Fama Jr.

November 1, 2007- International investing, practically unheard of as recently as three decades ago, has come of age. Today's advisors and plan sponsors are allocating more and more assets to foreign stocks. Putting some money overseas, the thinking goes, can diversify a domestic portfolio and even increase its expected return. Sure enough, international stocks have performed well. That means we should do what we always do when recent returns mesh with popular belief: Revisit the theory and challenge the popular wisdom to see how it stands up to economic logic.

Investing is uncertain. The absence of clear evidence increases our need for reasons to justify what we do. Is there a reason to expect international stocks to increase returns? Is there a reason for them to increase diversification? An investigation of these questions should help us decide whether, and how, we should invest internationally.

When investing globally, advisors generally favor mutual funds or exchange-traded funds that imitate or sample from Morgan Stanley's Europe, Australasia, Far East (EAFE) index of large-cap stocks in developed countries. Although this approach is easy to implement, it is limiting. Historical returns for international developed markets as measured by EAFE are indistinguishable from those of the U.S. market as measured by the S&P 500. In dollar-denominated terms over their common data history of 1970 to 2005, EAFE returned 11.17%, a virtual photo finish with the S&P 500's return of 11.11%. When measured in local currencies, the EAFE loses ground: Its 9.50% return lags the U.S. market by an average of 160 basis points per year. This data challenges any popular wisdom that overseas markets outperform the U.S. market.

LARGE-CAP CONUNDRUM

But returns aren't everything. Even with similar average returns, EAFE stocks should be included if they add diversification that significantly reduces total portfolio volatility. After all, the goal of portfolio design is to capture average return with reduced risk, thereby enhancing the total portfolio's expected compound return—the actual money we spend.

Unfortunately, the evidence suggests that there is little diversification to be gained from adding large-cap international stocks to a portfolio. The correlation of 0.71 between a broad-based international portfolio and the S&P 500 since 1970 is pretty high (see "Global Exposure" on page 148 of the November 2007 print edition of *Financial Planning*). This correlation has grown 12% in recent years, to 0.71, as markets have become increasingly global.

Lowered barriers to trade, increased outsourcing and distribution channels like the Internet have shrunk the developed world. Capital flows ever more freely; currency trades more readily. To say that another developed country has a greater expected return than the U.S. is to say that a company like Sony has to promise more return in exchange for capital than a company like Coca-Cola. With our kids glued to PlayStations and kids overseas guzzling soda, this seems improbable to me. As for diversification, big global conglomerates in developed countries seem as likely to bring us to exotic and distant lands as a Prius stuck in traffic. Add the various commissions, stamp duties and tax costs for trading internationally and EAFE quickly resembles an expensive S&P 500 fund.

TRUE DIVERSIFICATION

Does all this suggest we should invest only in the local markets? After all, U.S. stocks have proven remarkably resilient despite doom predictions.

Displaying "hometown bias," investors tend to allocate disproportionate assets to their own countries, industries and even their own companies. We saw the risk of this in an exaggerated form when Enron employees sunk their 401(k) savings in the company's stock. To the extent that other countries have their own good and bad tidings, they diversify hometown risk (strong recent correlations notwithstanding).

Unbeknownst to many, there are international securities beyond the usual large-cap arena that can help. International small-cap and value stocks offer greater diversification. This, too, stands to reason: More of their commerce is conducted locally, especially compared with multinational conglomerates. So 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.

Let's see how this works in some sample portfolios developed by my colleagues Rex A. Sinquefeld and Jacobo Rodriguez for a recent study, as outlined above.

PORTFOLIO PROOF

Portfolio 1 is the basic 60% stock/40% bond portfolio favored by many investors. Portfolio 2 adds a 20% stake in EAFE large cap, a significant allocation that doesn't do much to improve its risk/return profile. However, Portfolios 3 through 7 gradually up the allocation to broad-based, passive global small-cap and value components.

Notice the increased returns in the portfolios that include international small-cap and value stocks, and how those returns increase as those allocations rise. In particular, notice the disparities between Portfolio 1, Portfolio 5 (which introduces both international small and value stocks) and Portfolio 7 (representing various areas of the small and value universes both domestic and foreign). Portfolio 5 generates a much higher annualized return than Portfolio 1—116 basis points—with less volatility. Meanwhile, Portfolio 7 has an annual average return that is 220 basis points higher than Portfolio 1.

What's more, in spite of an 8% increase in the equity allocation, Portfolio 7 achieves this huge increase without a corresponding increase in standard deviation. This suggests that the diversification benefits of small-cap and value stocks reduce risk enough to allow a bigger equity stake—the type of risk-budgeting and creative asset allocation so valuable to modern sponsors and investment planners.

Since this analysis considers only standard deviation in a world of multiple risks, it is anything but complete. Yet, it serves to illustrate the power of thinking differently. Seeking economic reasons instead of the ever-illusory "proof" so many investors yearn for can lead to compelling solutions that bring distinction and a sense of purpose to our lives as investors. In the process, we might just achieve a few goals that elude traditional approaches—like truly investing our money overseas in an ever-shrinking world.

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