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Should you invest internationally?

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With the current turbulence in the financial markets, many investors are now questioning the advisability of investing in foreign markets. However, investors may not have all the facts about the merits of investing overseas.

The primary benefit associated with foreign investing is diversification. When combining assets with differing risk and return characteristics, you increase the odds that your portfolio will meet your goals with the lowest level of risk.

While US stocks have traditionally exhibited relatively low correlations with international stocks, something interesting has happened during the last 10 years. From 1992 to 1997, the Standard and Poor's 500 (S&P 500) Index (a common benchmark for the US stock market) and the Europe, Asia, and Far East (EAFE) Index (the common international benchmark) had their lowest five-year correlation ever. Then, we saw the highest five-year correlation period between these indexes

from 1998 to 2003. These results are often cited as a reason to reduce or eliminate foreign exposure.

What investors need to understand is that the correlation between the US markets and the foreign markets is never static—the relationship is constantly changing. With many larger companies now competing on a global basis, it is more difficult to assess the significance of a foreign company's exposure to US markets. However, the fluctuation remains. Fortunately, smaller foreign companies—influenced more by their local economies—exhibit lower correlations and enhance the diversification opportunities.

Due to the ever-changing nature of the markets, it can often be a mistake to tilt your investment allocations based on recent history. While international markets are currently running parallel with US markets, the '70s and '80s were periods when foreign markets outperformed US markets. In addition, an investor needs to consider the consequences of not investing in international markets. Currently, more than 36,000 traded stocks exist in the world. Approximately two-thirds of all companies and 50 percent of the world's equity market capitalization are domiciled outside of the United States. As a result, many good investment opportunities could be missed if investors stay stateside.

Understanding the international risks

Investing overseas does have risks. Primarily, investors need to understand that politics, currency, and the markets themselves can have a positive or negative impact on international investments. The political climate can have a great impact on the international markets, depending on the stability and actions of the foreign governments. The recent conflict in Iraq, for example, had an impact on oil prices, thus causing a short-term concern for investors and the oil companies. Currency also plays a critical role. For example, in the late '90s, the US dollar was strong against foreign currencies, creating a disadvantage for foreign investments. However, foreign investing does provide an invaluable hedge against declines in the value of the US dollar. Lastly, the international markets pose their own concerns, including information reliability, (i.e., accounting standards), the reporting process, and the ability to trade foreign companies.

Investing internationally—be smart

If international investing is right for you, think before you leap. Investment managers generally recommend investors place 10 to 25 percent of their stock portfolio in foreign investments. In addition, investors are commonly advised to

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dedicate a small portion of their foreign exposure to smaller foreign companies, which may provide increased diversification benefits.

For the average investor, the easiest way to invest internationally is with a mutual fund that automatically provides a diversified mix of foreign investments. Other options include exchange traded funds, which allow you to take advantage of the strengths of stock ownership and indexing, and American Depository Receipts (ADR), which are shares of foreign stock issued by a US bank.

If history is any indication of what the future holds, adding international funds to your diversified portfolio may simply be the most prudent strategy you can take.



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