Don’t put your eggs all in one country: Invest globally

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It’s human nature to root for your home team, and many investors follow suit with their portfolios. Home country bias is common for US investors. However, developed international markets (MSCI EAFE Index) have outpaced domestic (S&P 500) over each of the last 4 calendar years. This leads the US “Homer” investor to wonder if they should consider investing outside the United States.

Decreasing Risk and Increasing Potential

The primary advantage of investing overseas is adding diversification to your portfolio. The performance of foreign stocks depends largely on issues that will not affect US stocks in the same manner. This creates a low correlation between the 2 investments and can actually help reduce the risk and enhance returns of your overall portfolio. Although some may argue that as the world globalizes, foreign and domestic markets will begin to move more in step with one another, there currently remains a low correlation between the 2 investment classes.

Another reason for international investing is currency diversification. Many economists believe that given the current trade deficit of the United States, the dollar will ultimately be forced to weaken. As the dollar weakens, international investments benefit since they are typically denominated in foreign currencies. Although some international investments may hedge against foreign currency fluctuations, the majority of international funds do not. This provides added diversification to a globally invested portfolio.

In addition, the United States makes up only 50% of the total world equity capitalization. That means that if you invest only in the United States, you will be missing half of the opportunities available.

How Much and Where to Invest?

There is an old joke in investment circles: “Brazil is the country of the future…and always will be.” The question for investors becomes: how much to invest internationally and where? Many investors put 20%-25% of their equity portfolio into international investments. This provides enough exposure to diversify the portfolio without over-allocating to any single asset class. In addition, you should consider your risk tolerance and time frame along with any investment decision.

My preference is to avoid buying unmanaged investments internationally. Unmanaged investments can include passive international indices and unmanaged individual stock portfolios. If an army marches into a country, I would prefer a manager who can quickly evaluate the situation and exit the investment position. In addition, many managers travel internationally to visit their potential investments. The average investor loses the benefit of the international local knowledge that a professional provides.

Another reason to avoid international indexing is the international taxes that can be generated from investment in foreign countries. The Internal Revenue Service allows a foreign tax credit for some of the taxes paid internationally in a taxable portfolio. However, if you are invested in an international market index fund that is a fund of funds, you may lose the benefit of receiving the foreign tax credit. Consult with your tax professional to see how this may apply to your portfolio.

Lastly, international companies often are only available through ordinary shares versus American depositary receipts (ADRs). That means that the smaller investors will have higher administrative and duty costs, if they are even able to purchase the ordinary shares. Because of economies of scale, a fund manager can purchase the ordinary shares and the administrative and duty costs can be significantly reduced.

How to Select International, Actively Managed Investments

When looking for international investments, do the research or work with an investment advisor. When we look for international investments, a few of the areas we analyze are how the fund’s portfolio is allocated, how long the investment manager has been in place, what the fund expenses are, and how the manager has performed in down markets.

Once you establish your risk tolerance and time frame, an international allocation to your portfolio will both diversify and broaden your investment options. With a well-diversified portfolio, you increase your chances of reaching your financial goals and avoid being a US investment “Homer.”
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