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## **Tell Me Again Why Foreign Investing Is Such A Hot Idea**

We have written many times in this newsletter about the folly of chasing performance. As the fund advertisements say, past performance is no guarantee of future results. Even those who may pay lip service to this concept, however, sometimes forget that it is applicable on a broader scale as well. Financial columnists who might hesitate to jump on a hot stock or join a mutual fund bandwagon think nothing of condemning entire asset classes to the dustbin of history based on a few short periods of subpar performance. For the 29 calendar years from 1966 through 1994, large US company stocks performed better than small company stocks, foreign stocks and intermediate government bonds only once. Now large company stocks have been the best performing asset for three straight years, and you might think from general market commentary that other types of investments have ceased to exist.

***The only "fundamental flaw" of international investments have been their recent performance***

Nowhere is this performance whipsaw effect more evident than with foreign investments. A major financial publication recently began an article on foreign investments with an observation that the idea of international diversification was "fundamentally flawed." The only fundamental flaw discussed in the article, however, was that foreign stocks have gone up less than US stocks for a few years. To help gain some perspective, enclosed is "The Pendulum of International Investing." On each of the three charts, returns are shown along the vertical axis and risk is shown along the horizontal axis. The most desirable position on the chart is up and to the left (high return and low risk). The lines on each chart show the risk/return tradeoffs for various mixes of US stocks and foreign stocks.

Chart 1 on the top left is for the five years ended in 1990. During that period, owning any US stocks lowered portfolio returns. Japanese industrial supermen were supposedly taking over the world economy and the Nikkei average was nearing 40,000. Everyone was bubbling about "Europe 1992" and the formation of what was supposed to be a single European economy, trading block and currency. Excitement over the reunification of the two halves of Germany was igniting interest in emerging markets. Nobody needed to be convinced of the wonders of international investing.

Chart 2 on the bottom left shows the five years ended in 1997. This chart is almost a mirror image of the first – owning any foreign stocks dragged down portfolio returns. Now everyone talks about "Eurosclerosis" and the weakening prospects for a united Europe. The Nikkei has fallen below 16,000 and Japan

seems mired in an endless and worsening recession. China's takeover of Hong Kong and the meltdown of the Asian "tigers" have led to skepticism towards emerging markets. Extrapolating only this recent experience, international investing seems like a terrible idea.

Chart 3 steers away from extrapolating short periods and shows the experience of foreign diversification going back to 1970. Investing in foreign stocks is neither a panacea (the 1991 view) nor worthless (the current view). Since foreign stocks tend to move at different times than the U.S. market, investing about 30 percent of an equity portfolio in "risky" foreign stocks actually cut portfolio risk over the periods shown on all three charts and has increased returns in the long run. While the past does not necessarily predict the future, we are much more inclined to follow this long-term experience as opposed to the whipsaws demonstrated by the short-term charts.

***By one valuation measure, foreign stocks are selling at about a 37 percent discount from the US***

If we lived in Switzerland or Hong Kong, we would be unlikely to even consider restricting our horizon only to domestic investments. Investing is a hedge against future purchases of goods and services by you or your heirs. Of your purchases 15 years from now, what percentage will either be foreign or have significant foreign content? Most often, people's answers are in a range of around 20 to 35 percent, about same percentage "sweet spot" on the enclosed charts for including international investments in a portfolio. It would have been silly in 1990 (at Dow 2400) to believe that the case for investing in the US was "fundamentally flawed" because of superior foreign stock returns for a few years. It is equally silly to dismiss international investing now.

The recent short-term chart leads us to believe that foreign diversification may be an even better idea now, if you believe the pendulum may swing back again. Many valuation comparisons among foreign markets are somewhat questionable due to accounting differences, but price/cash flow ratios even out a lot of the variations. Using this measure as reflected in portfolio statistics for international index funds, the MSCI EAFE index of international stocks is about 37 percent cheaper than the US market (as measured by the S&P 500). The MSCI emerging markets index is about 35 percent cheaper than the US market and the MSCI Europe index is about 45 percent cheaper. For both long-term asset allocation reasons and shorter-term valuation and sentiment reasons, we believe the case for foreign diversification is compelling, not as an end in itself but as part of a well thought out portfolio.

If you would like to know more about how Sigma includes foreign investments and other asset classes in diversified, rational, long-term investment programs for our clients, contact us.

# The Pendulum of International Investing

