



International Investing: What To Do When You're Long-Term Bullish and Short-Term Bearish

By Elaine Floyd, CFP®

The case for international investing has been gaining visibility for several years now. Although the United States continues to lead the world in total output of goods and services, the rest of the world is catching up. Global GDP growth has exceeded U.S. GDP growth in recent years and the spread is widening. In 2006 the global economy grew at a rate of 5.4% compared to 2.9% for the U.S.

Productivity growth in the U.S. is also falling behind: Manufacturing productivity and labor cost trends in the U.S. grew at a rate of 3.3% in 2005, placing it ninth among the 16 economies measured by the Bureau of Labor Statistics. High productivity is one of the best leading indicators of real, non-inflationary, economic growth, especially when it is invested in infrastructure and other building blocks of a strong, local economy.

While the United States will always have a strong position in the global economy, analysts and investors are starting to step back and understand our place in the world. Our GDP represents just 28% of the world's total. The market value of our public companies represents less than half the world's market capitalization. The mere fact that more people are traveling outside the United States means Americans are gaining a broader perspective of the world and our place in it. Where international investing was once done on a small scale for diversification purposes, it is now reflecting the larger trend toward globalization and the desire to take advantage of once-in-a-lifetime opportunities outside our home country. As world markets become better regulated, more transparent, and increasingly open to foreign investors, global investment opportunities are available to all.

Emerging markets appear especially promising from a macroeconomic point of view. According to the World Bank, emerging markets grew faster over the last decade (1995-2005) than in the two previous decades and faster than high-income countries. World output in 2005 amounted to about \$61 trillion, 45% more than in 1995. The share of emerging markets in global output increased from 39% to 46%. This acceleration in growth was attributed to better functioning internal markets, further integration into world markets, and rising demand for many commodities. As these developing countries work to reduce deficits, build reserves, and establish more cautious monetary and financial policies, they are becoming less vulnerable to economic shocks.

Despite the clear, fundamental reasons for investing overseas, the periodic volatility in these markets may be throwing investors for a loop. The question then becomes: do you hold on, believing in the long-term potential of the non-US markets, or do you time



the markets, getting out when near-term uncertainty raises the risks to unacceptable levels and going back in when the risks appear to have subsided?

"We made the decision two to three years ago to increase our allocation to international equities," says Phuong Tranvan, chief investment strategist with Highmount Capital in New York, a \$1.3 billion multi-family office. "Our current recommendation is 25% to 30%." Emerging markets represented about 2-3% of the total allocation until recently; "due to the high volatility in these markets we took emerging markets off the table as a risk-reduction measure for clients." Tranvan is now watching and waiting to see if the recent market turmoil affecting the U.S. subprime mortgage market bleeds into the real U.S. and global economies.

Ted Feight, an advisor who manages \$2 billion with Creative Financial Design in Lansing, Michigan, is also bullish on international equities. "We're losing the jobs in this country," he says. "If we want to profit we have to go where the jobs are and where the money is being made." Feight maintains a target allocation of 25% in developed international equities and 15% in emerging markets. However, he does not implement this allocation with clients all at once. Rather, he establishes each client's risk profile and may allocate a small portion to international equities until the client gets comfortable with the concept and sees positive results. He implements his asset allocation strategy with ETFs and controls risk by placing trailing stops 12% under the current price. His clients are currently out of emerging markets and Feight says they may not get back in until April or May of 2008 when he looks for many of the uncertainties which are disturbing the current markets to become resolved.

This dichotomy between long-term bullishness and short-term nervousness in international investing was addressed by Yesim Tokat, an investment analyst with Vanguard, in a [paper](#) titled "International Equity Investing: Long-Term Expectations and Short-Term Departures." He writes, "In the end, investors deciding how much to allocate internationally must weigh the expectations of long-run risk-adjusted return against the potential regret of underperforming benchmarks or peer-group averages over shorter investment horizons."

Tokat identifies two different objectives for investing internationally. In the long run, the primary benefit of international investing is diversification. In the short term it is higher returns or lower volatility. As long as international and U.S. stock returns are imperfectly correlated in the long run, a diversification benefit will exist. However, in the short term, realized return, volatility, and correlations may vary considerably from reasonable long-term expectations.

Tokat notes that during U.S. bear markets the primary benefit of international investing was higher returns, not volatility reduction. His studies showed that a 20% allocation to



stocks in EAFE during bear markets provided, on average, 2.18% greater return and 0.73% lower volatility than a portfolio made up of U.S. stocks alone. During bull markets, by contrast, the benefit of international investing was diversification. His study showed that during U.S. bull markets, a 20% allocation to stocks in EAFE provide, on average, 0.79% less return and 1.03% lower volatility than a U.S.-only portfolio.

He concludes, "The appropriate allocation to international investments ultimately hinges on an investor's short-and long-term objectives."

If clients are feeling conflicted about international equities and looking for definitive answers, do what Ted Feight does and bring them into the process. Review their return objectives and risk tolerance by asking them to rank on a scale of 1 to 10 the importance of capital preservation, growth, low volatility, inflation protection, and cash flow. Give them some allocation guidelines, keep them apprised of world economic events, and encourage them to decide for themselves how much they want to allocate to international equities at any given time based on the interplay between their long-term and short-term objectives. International investing is here to stay, but it may need to be more actively managed than all-U.S. portfolios have been managed in the past.

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