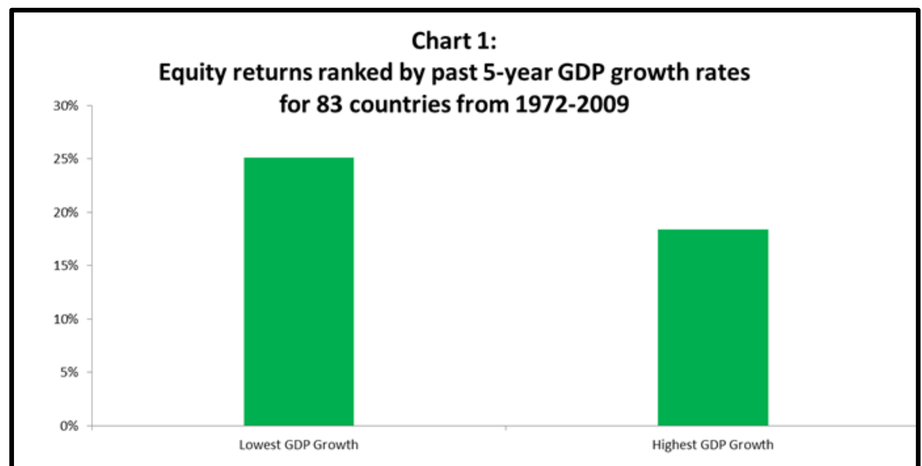
International Investing: Think Globally, But Invest Locally

"If foreign economies are growing faster than the U.S., shouldn't we invest in foreign company stocks? And, doesn't investing abroad also provide effective diversification?" These are questions we're often asked.

International investing – direct buying and selling stocks of foreign domiciled companies – has been an option available to individual investors for decades. Proponents claim superior returns and diversification as primary advantages.

Higher growth ≠ Higher returns

Decades of data show that the relationship between economic growth (GDP) and stock market returns is much weaker than people think.[1] For example, from 1991 to 2011, while the U.S. grew 2.5% annually, the Chinese economy was the fastest growing in the world averaging a whopping 9.4% annually. Over this same time period, however, China's stock market return averaged -5.5%, while the U.S. stock market return averaged 7.9%.[2]



Source: Dimson, Marsh, and Staunton, *Credit Suisse Global Investment Yearbook, 2010*

In fact, researchers have found that over longer periods, the notion that higher growth = higher returns doesn't necessarily add up.[3] **Chart 1**, above, looks between 1972 and 2009, a period that both here and abroad captures high growth and low growth periods, boom and bust economic cycles, and bull and bear markets. It's also a period when trading and advisory fees fell, liquidity rose, and transparency improved. A period, arguably, when the world moved toward greater democratization (of markets leastwise), and the transmission and communication of information across borders vastly improved. In other words, the investment environment was a favorable one for a U.S.-domiciled investor seeking to capture the advantages of international investing.

[1] Dimson, Marsh and Staunton, *Credit Suisse Global Investment Yearbook 2010*, pg. 9.
[2] Johnson, Steve, "Rising GDP not always a boon for equities", *Financial Times*, 14 April 2013.
[3] Dimson, Marsh and Staunton, *Credit Suisse Global Investment Yearbook 2010*, pg. 17
Ritter, Jay, *Economic Growth and Equity* Returns, Pacific-Basin Financial Journal, University of Florida, Gainesville, 9 August 2005.

As you can see, high growth performance was good, but low growth was even better. The authors of this study cite several possible reasons for this, but one of the more interesting is the assertion that companies who benefit from emerging market growth may be the ones domiciled in the developed world (e.g., the U.S.-domiciled companies).[4]

Diversification

We believe diversification is a critical component of prudent portfolio management, but *how* one achieves it is just as important. After all, in periods of market stress, if all of your assets move in the same direction, diversification, pursued for its own sake, can destroy value rather than protect it.

Advisors and the popular press present international investing as an effective way to enhance returns and diversify risk. **Table 1**, below, shows the correlation of stock markets around the world for the 10-year period between 1998 – 2007.[5] This was a time of meaningful growth in the popularity of international investing concomitant to unprecedented growth in economies like Brazil, Russia, India, China – so-called BRIC countries. The green highlights indicate markets that outperformed the U.S. market during this period.

Table 1: Return Correlations Between the U.S. and Foreign Markets ($USD)
1998 - 2007

	France	*Swiss*	*Indonesia*	*Mexico*	*China*	*Russia*	*Japan*	*Korea*	*Spain*	*Hong Kong*	*Germany*	*India*	*Brazil*	*U.S.*
U.S.	0.97	0.71	0.41	0.33	0.16	0.08	0.72	0.61	0.84	0.33	0.88	0.50	0.60	1.00

Source: Bloomberg

The data shows that for the most part markets moved together during this period (i.e., correlation > 0); it's the *magnitude* of movement that varied more. **Table 2** below demonstrates this point.

Table 2: Annualized Rates of Return ($USD)
1998 - 2007

France	Swiss	Indonesia	Mexico	China	Russia	Japan	Korea	Spain	Hong Kong	Germany	India	Brazil	U.S.
11.8%	7.5%	19.0%	17.2%	18.7%	18.4%	2.4%	25.3%	13.2%	17.7%	9.8%	18.6%	14.7%	5.9%

Source: Bloomberg

Looking at the figures, perhaps it's easy to see why so many investors were attracted to international investing. The problem with this viewpoint is that correlations and returns are very dynamic; they can and do change meaningfully. The story of international investing since Great Financial Panic of 2008 is more different than the one told before it. **Table 3** shows the correlation of stock markets from 2008 to 2012.

Table 3: Return Correlations Between the U.S. and Foreign Markets ($USD)
2008 – 2012

	France	*Swiss*	*Indonesia*	*Mexico*	*China*	*Russia*	*Japan*	*Korea*	*Spain*	*Hong Kong*	*Germany*	*India*	*Brazil*	*U.S.*
U.S.	0.91	0.97	0.87	0.94	0.84	0.87	0.96	0.95	0.80	0.88	0.92	0.87	0.73	1.00

Source: Bloomberg

Note the number of occurrences close to 1.0 (perfect correlation). Since the Panic, markets have moved together, some in virtual lockstep. And, note the green highlights once more as markets that outperformed the U.S. since then.

[4] Dimson, Marsh, and Staunton, *Credit Suisse Global Investment Yearbook 2010*, pg. 9.
[5] A correlation of 1.0 indicates perfect correlation while a correlation of -1.0 indicates perfect negative correlation. Correlations between 0 and 1 suggest market movements in the *same* direction. Correlations between -1 and 0 suggestmarket movements in *opposite* directions.

Table 4 shows returns over this period for the U.S.-domiciled investor.

Table 4: Annualized Rates of Return ($USD)
2008 – 2012

France	Swiss	Indonesia	Mexico	China	Russia	Japan	Korea	Spain	Hong Kong	Germany	India	Brazil	U.S.
-6.1%	2.5%	11.6%	6.2%	-11.0%	-6.4%	-0.4%	-0.1%	-9.2%	-4.1%	-3.2%	-7.2%	-3.7%	1.7%

Source: Bloomberg

If directional market movements are more closely tied together, what accounts for the disparity in market performance? 2008 turned international markets on their heads. The U.S. stock market – one of the most durable, transparent, and time-tested of any across the globe – was down over 30% in that year, but most of the rest of the world was down even more. Deeper wounds often require more time to heal.

Think Globally, But Invest Locally

"If foreign economies are growing faster than the U.S., shouldn't we invest in foreign company stocks? And, doesn't investing abroad also provide effective diversification?" Maybe not, we would assert. High growth does not necessarily translate into high return, and dynamic correlations constantly change the relative attractiveness of investing abroad for the U.S.-domiciled investor.

For these reasons, we believe constructing a portfolio of high-quality, U.S.-based companies with international reach combined with high-quality bonds that are consistently *uncorrelated* with stocks provides a more effective means to enhance returns and diversify risk for the U.S.-domiciled investor.

We remain focused on understanding current trends in fundamentals because it gives us the best probability of success.

For more information on this or any other topic of interest, feel free to contact us

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