

# Investment portfolios need international diversification

BY Michael Francis, for *SBT*

When it comes to a portfolio diversification strategy, many of the 401(k) plan participants we work with are still stuck in the '80s and '90s, invested only in U.S. stock and bond funds.

This is not surprising, given that, for most of the past 25 years, U.S. stocks and bonds have enjoyed prolonged bull markets. But today, the global economic and capital market landscape is different, and a new asset allocation strategy is required.

The next generation of investors should consider additional diversification, beyond traditional stock and bond funds to protect their savings against the ravages of inflation. In short, we recommend building a more diverse portfolio by adding the following alternative asset classes:

## Emerging market equities

While many investors may already own international funds that are focused on the "developed" markets of Europe and the Far East, significant economic growth is occurring in emerging markets around the globe. As new technologies connect developing countries (i.e. China, India, Brazil, Russia, etc.) with modern economies and bring nearly half of the world's

population into the global work force, the global capital markets will undergo significant changes.

But while these markets offer the potential for higher returns, they can be very volatile. Consider that the Morgan Stanley Capital International Emerging Markets Index soared as high as 66 percent in 1999 and swooned as low as negative 30 percent in 2000. However, over the long run, the added diversification and return potential of these markets should play an important role in a retirement portfolio that has capital appreciation as a primary objective.

We recommend that investments outside the U.S. comprise at least 30 percent of a retirement portfolio's equity exposure, with emerging markets representing roughly one-half of that exposure.

## Commodities and hard assets

It is important to seriously consider adding investments tied to "real assets" such as real estate, oil, gold, aluminum, and agricultural commodities like soy beans, sugar, and wheat to your portfolio. History has shown there are lengthy periods when stocks and bonds won't perform well, and often, it is during these periods that hard-asset linked investments perform well. Consider the 1970's when stocks and bonds delivered miserable results while hard assets delivered double-digit returns.

To invest in commodities, we prefer index mutual funds that tie investor returns to a broad basket of commodity prices, do not subject returns to the potential errors in judgment by investment managers, and are reasonably low cost. Currently such funds are available through fund companies such as PIMCO, Merrill Lynch, Credit Suisse, and Oppenheimer. To gain exposure to real estate, we recommend buying actual property and not mutual funds. Many investors feel real estate investment trusts (REITs) are proxies of owning actual real estate, but history has proven this assumption inaccurate. 2007 was a textbook case in point where commercial real estate prices held firm, while the average REIT mutual fund lost 15 percent of its value.

Commodity index funds can be every bit as volatile as the stock market and owning real estate has liquidity issues, therefore, it is important not to overdo your exposure. We recommend investors limit their exposure to this category from 5 to 25 percent of their portfolio.

## Absolute return strategies

Absolute return investing describes a number of investment strategies that seek to generate a positive return, regardless of what is going on in the U.S. stock and bond markets. These are most often private funds available only to "accredited investors" that utilize arbitrage opportunities of one type or another. While traditional investors in stocks or bonds generally seek to post a

return that beats or matches a benchmark such as the S&P 500, absolute return strategies generally shoot for results benchmarked against inflation (i.e. inflation plus 4 percent).

Absolute return strategies are often found in hedge funds and can carry extremely high fees and some minor liquidity issues. Thus, investors seeking to add an absolute return strategy to their portfolio of investments should limit their exposure to this category to no more than 20 percent of your overall portfolio.

While I am not suggesting the elimination of U.S. stocks and bonds from a well diversified portfolio, I believe more can be done by most investors to better protect their savings from the economic twists and turns to come. By adding additional investment diversification through emerging markets, hard assets, and absolute return strategies, I believe investors take the next step toward achieving their long term investment goals.



Michael Francis, CIMA, JD, is president and senior investment consultant of Francis Investment Counsel LLC, a registered investment adviser based in Pewaukee. He can be reached at [michael.francis@francisinvc.com](mailto:michael.francis@francisinvc.com).