BUSINESS

Milwaukee Journal Sentinel
JSOnline.com/business

Saturday, December 27, 2014

D

Take another look at international funds

401(k) ADVISER
MICHAEL J. FRANCIS

It has been a tough few years for international stock funds.

For the fourth year in the last five, the average international large blend fund underperformed the average U.S. large blend fund, according to Morningstar. So far this year, it has been outperformed by a whopping 16.1%, after having lagged by 12.1% last year.

The severe underperformance by international stock funds has been disappointing and more than just a little frustrating for experts who routinely preach the virtues of diversification.

Importantly, it is also reminiscent of March 2009, when this column recommended that investors not lose faith in their U.S. equity holdings. Bottom line, now is no time to give up.

There are a number of compelling reasons why now may be one of the most opportune times to invest internationally in the past 30 years.

Greater freedoms

The first reason is expanding economic and political freedom around the globe.

Short-term turmoil aside, many regions of the world are experiencing an expansion in freedoms and economic prosperity unlike any time before in world history. Among the factors driving these trends are the globalization of manufacturing, adoption of new technology, investment in infrastructure and younger demographics.

As a result, some of these regions will witness faster economic growth than the U.S. over the next 35 years. With that growth will come higher incomes, higher consumption and higher stock prices.

But all international markets are not the same.

The financial industry divides international stocks funds into three broad categories: developed, emerging and frontier. Developed market funds focus on Europe, Japan and Australia, while emerging market funds feature the so-called BRIC nations: Brazil, Russia, India and China. Frontier market funds invest in companies found primarily in Africa, the Middle East, Southeast Asia and South America.

The foreign developed markets are considered the safest and are also the most like the U.S. in terms of demographics and economic growth potential. Emerging markets are compelling because they represent such a large share of world population. Frontier markets are easily the riskiest, but also the most exciting in terms of future growth potential.

Valuation

The second reason to take a serious look at international funds right now is valuation.

Successful investors know that it's not just about buying fast-growing companies, it's also important to buy them at reasonable prices.

Currently, by most historical measures, international stocks sell at steep discounts to their historic averages, while U.S. stocks trade at premium prices. So right now appears to be an opportunity to buy international stocks at relatively cheap prices.

The other factor to consider is currency.

When you buy foreign shares, you use your U.S. dollars to buy companies that are valued in foreign currencies. Thanks to this summer's huge rally in the dollar, your dollars buy a lot more in foreign assets than they did even six months ago.

Investor psychology

Given that foreign economies are responsible for at least two-thirds of the world's economic output, it is amazing that international stock funds account for only about 8% of all 401(k) assets, according to the Investment Company Institute.

Behavioral psychologists suggest three theories to help explain this apparent underinvestment in international stocks.

The first is called "home bias," the natural desire to invest in things familiar or local.

The second is called "naive diversification," a tendency for some 401(k) participants to spread their retirement assets evenly across their U.S.-heavy 401(k) plan menu.

The third is called "loss aversion," the natural desire to avoid something that is causing you pain.

A combination of these biases likely explains why the average 401(k) investor has about 90% of his or her stock fund holdings in companies located in a country that represents less than one-quarter of the world's economic output and one-tenth of its population.

Take action

As painful as the past few years have been for those properly diversified internationally, now is not the time to discard this wise long-term strategy.

To the contrary, while not calling for a wholesale shift to international from the U.S., a minimum of 25% of your portfolio's stock holdings should be dedicated to international funds. For long-term investors, a 50% exposure makes sense.

As part of your New Year's resolution, take a look at your retirement account's exposure to international funds and rebalance your portfolio if you are lacking in this important asset class.

Spread the wealth

Foreign economies are responsible for at least two-thirds of the world's economic output, yet international stock funds account for only about 8% of all 401(k) assets, according to the Investment Company Institute.

	Domestic	Foreign		
	U.S.	Developed	Emerging	Frontier
INDEX	S&P 500	MSCI EAFE	MSCI EM	MSCI FM
Country exposure	U.S.	Japan, U.K., France, Switzerland, Germany, Australia, Hong Kong, Spain, Sweden, Netherlands	China, South Korea, Taiwan, South Africa, Brazil, India, Mexico, Russia, Malaysia, Indonesia	Kuwait, Nigeria, Argentina, Pakistan, Morocco, Kenya, Oman, Vietnam, Kazakhstan, Lebanon
Average age	38	41	33	32
Current % of world GDP	22%	32%	32%	4%
Projected % of 2050 world GDP	18%	23%	46%	6%
Current % of world population	4%	8%	56%	12%
Projected % of 2050 world population	4%	6%	49%	14%
Current valuation (trailing P/E)	19	16	13	10

Sources: MSCI, U.S. CIA, World Bank, HSBC, United Nations, Morningstar Direct

Journal Sentinel

The material in this column is provided for informational purposes only. Neither the information nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Francis Investment Counsel does not offer personal tax or legal advice. Michael J. Francis is president and senior investment consultant of Francis Investment Counsel LLC, a registered investment adviser based in Brookfield. He can be reached at michael.francis@francisinvco.com.