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GETTING GOING

By JONATHAN CLEMENTS



Stormy Markets: Foreign Stocks Often Offer a Safe Harbor

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Don't run home in tears.

So far in 2007, both U.S. and foreign stocks have had a turbulent time. The utterly predictable response: Pundits are once again proclaiming you can't reduce risk by investing overseas.

Convinced? Don't be. Foreign shares remain a great way to diversify a U.S. portfolio.

1 PODCAST

Hear Jonathan Clements discuss² the wisdom of international diversification and whether investors should bring assets back to the U.S.



Different strokes. Suppose you own the broad U.S. stock market, as represented by the Dow Jones Wilshire 5000 index, and you want to diversify. Which of these two investments should you add to your portfolio?

An investment that, over the past 10 years, has climbed in every year that the U.S. stock market has climbed and fallen in every year that the U.S. market has fallen.

An investment that, in each of the past 10 years, has always done at least three percentage points better or worse than the U.S. market. In fact, in three of those years, the performance gap was 10 percentage points or more.

The second investment certainly sounds like the better diversifier. But it's a trick question. The reason: In both cases, I am describing Morgan Stanley Capital International's Europe, Australasia and Far East index.

Foreign Affairs


Investing abroad? Consider a mix of these four no-load funds.

Fund	Minimum	Expenses
Dodge & Cox International	\$2,500	0.66%
Harbor International	2,500	1.24
T. Rowe Price	2,500	1.24

This might have you scratching your head. Why do many experts argue that foreign shares provide scant diversification for U.S. investors?

It's true that, since the mid-1990s, there has been a marked increase in the correlation between U.S. and foreign stocks. But just because U.S. and foreign shares rise and fall at the same time doesn't mean they generate the same return.

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"People hear that the correlation is very close, and they don't realize that the returns can be totally different," says Meir Statman, a finance professor at Santa Clara University in California. "It's one thing to say that markets go down together. It's another thing to say they go down by the same percentage."

Also consider the longer-term story. Despite their close correlation, Morgan Stanley's EAFE index has soared a cumulative 101% over the past five calendar years, easily outpacing the Dow Jones Wilshire 5000's 45% gain.

Permanent position. Folks will no doubt look at foreign stocks' impressive five-year performance and pronounce, "Oh yes, international-equity exposure is a key component of a well-diversified portfolio." But what they're actually thinking is, "Boy, I need to get me some of those hot foreign stocks."

As Prof. Statman notes, "People will speak the language of diversification when what they really want to do is chase returns. The moment that returns disappoint, people will forget about diversification."

This, of course, is foolish. If you pile into foreign stocks after they have posted healthy gains and abandon them when they slump, you could find yourself buying and selling at just the wrong time.

My advice: Stop treating international investing as an optional extra. Foreign shares account for more than half of the world's stock-market value, so they deserve a permanent place in your portfolio. Consider earmarking 20% or 30% of your stock portfolio for foreign shares -- and then stick with your target percentage, come what may.

The best way to build your permanent position is with mutual funds. Richard Schroeder, a financial planner in Amherst, N.Y., suggests buying Harbor International and Dodge & Cox International to tap into larger companies, T. Rowe Price International Discovery for smaller-company exposure and Vanguard Emerging Markets Stock Index for a pure play on fast-growing developing markets. Vanguard's fund is available as both a mutual fund and an exchange-traded fund.

"If you're investing overseas to avoid tomorrow's 400-point drop in the Dow Jones Industrial Average, you'll be disappointed," Mr. Schroeder argues. "But over a few years, you'll get widely divergent results. I think U.S. investors should have at least 20% of their stock allocation overseas."

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