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Why Dad is Right About International Investing

Q: My dad tries to help me make investment decisions, and he says I need to be in some international investments to diversify my portfolio. I'm 31, and I use a 401(k) for saving. It seems risky to buy a mutual fund that invests in other countries. What do you think?

A: We're glad to hear you're saving in your 401(k). This is something you'll be very grateful for when it comes time to retire. Your 401(k) gives you both tax-deferred growth and it lowers your taxable income, said **Claudia Mott**, a certified financial planner with **Epona Financial Solutions** in Basking Ridge.

"If your employer matches your contribution, please be sure to take advantage of this 'free' money by having a pre-tax withdrawal level that qualifies for the match, as long as it within your budget to do so," she said.

Your dad is on the right track by saying that your 401(k) portfolio will be more diversified if you add some international to the mix. With the U.S. economy representing about 20 percent of world gross domestic product, Mott said you miss out on a large chunk of the global economy if you don't include some direct investment in international funds. "Being diversified means owning a number of different types of investments so that if one performs poorly another will provide better returns," Mott said. "In the long-run, this give and take is one of the contributors to better portfolio performance."

Even though many U.S. companies derive a great deal of their business from outside the U.S., there are a host of well-established non-U.S companies that would be a compliment to any portfolio, she said. Investing in these companies through a mutual fund is an easy way to add them. However, before you include a non-U.S. fund in your portfolio, check to be sure that your current funds do not have some international exposure already.

"Most 'target date' retirement funds are designed to include both U.S. and international investments in both the equity (stock) and fixed income (bond) asset classes," Mott said. "If you own a target date fund, you may have as much as 15 percent international already. Mott said given your concern for risk, you will want to consider an international mutual fund that invests in the companies of "developed" countries such as Germany, Japan and England rather than an emerging markets fund. She said your 401(k) provider should have information on the mutual funds objective and investment style, but if not, it can easily be located at Morningstar.com or at the fund provider's website.

"Because emerging markets funds invest in countries whose economies are smaller or less established in the world marketplace, their performance is often more volatile which may not be the right fit for you," she said.

With over 30 years of growth ahead for your 401(k), you want to have a well-diversified portfolio to maximize both growth and appreciation potential. Excluding almost 80 percent of the world's gross domestic product and some very well-known non-U.S. companies by limiting your investments to U.S. only mutual funds would be omitting an essential piece of the pie, she said. Indeed, it's easy to understand why an investor might have reservations about putting money in overseas markets, said John Zeltmann, a certified financial planner with Regent Atlantic Capital in Morristown. "With general themes of political unrest, financial infrastructures that are less developed than that of the United States, and a general history of volatile investment returns, investing in countries outside of the U.S. certainly carries its fair share of uncertainty," he said. But in that uncertainty lies opportunity.

Zeltmann said as a young investor, you should embrace the risk that comes with these potentially riskier countries. Especially with a 401(k), you won't be using these funds for upwards of 30 years, so there's plenty of time for you to benefit from a globally diversified portfolio, he said. He said embracing risk in the name of improving overall returns is the foundation of modern portfolio theory, a method of investing founded by Nobel Laureate, Harry Markowitz, in the 1950s and adopted by investors around the world as a cornerstone to investment management practices. "Modern portfolio theory suggests that one can optimize the returns they generate from their portfolio by diversifying across multiple asset classes that don't move in concert with one another," Zeltmann said. "In other words, when you combine two asset classes like domestic and foreign stocks, which have exhibited low tendencies to move together, one can improve the expected returns he achieves in his portfolio."

So what might this look like? Zeltmann offered this example over the past 15 years:
From Dec. 31, 2001 to Dec. 31, 2010, international large-caps outperformed U.S. large caps by a cumulative 60 percent. The MSCI EAFE, an international large-cap index, had a total return of 91 percent vs. 31 percent for the S&P 500, its domestic counterpart. During the past four years, U.S. stocks have cycled back into favor over international stocks with a 54 percent outperformance for U.S. stocks. The S&P 500 had a total return of 78 percent vs. 24 percent for the MSCI EAFE index. Zeltmann said reinforcing Markowitz's theory, in both time periods, the MSCI EAFE index exhibited a higher level of risk (as measured by annualized standard deviation) than the S&P 500: 18.7 percent for the MSCI EAFE vs. 16.0 percent for the S&P 500 during the 2001-2010 time period, and 15.1 percent vs. 11.2 percent, respectively, for the later time period.

"We don't know when these shifts in dominance between foreign and domestic markets will occur, which is why it's important to have exposures to both asset classes so that you avoid the biggest risk of all – missing out on the potential return offered by various markets around the world when they do make their run," Zeltmann said.
He said you need to remember that as a young investor, time is on your side. And while it may seem counter-intuitive, so is the "risk" presented by foreign investments.
"Take advantage of the opportunity you have now to expose your investment assets to that risk in an effort to potentially build additional wealth down the road," he said.

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