International Equities – Do we still need direct exposure?
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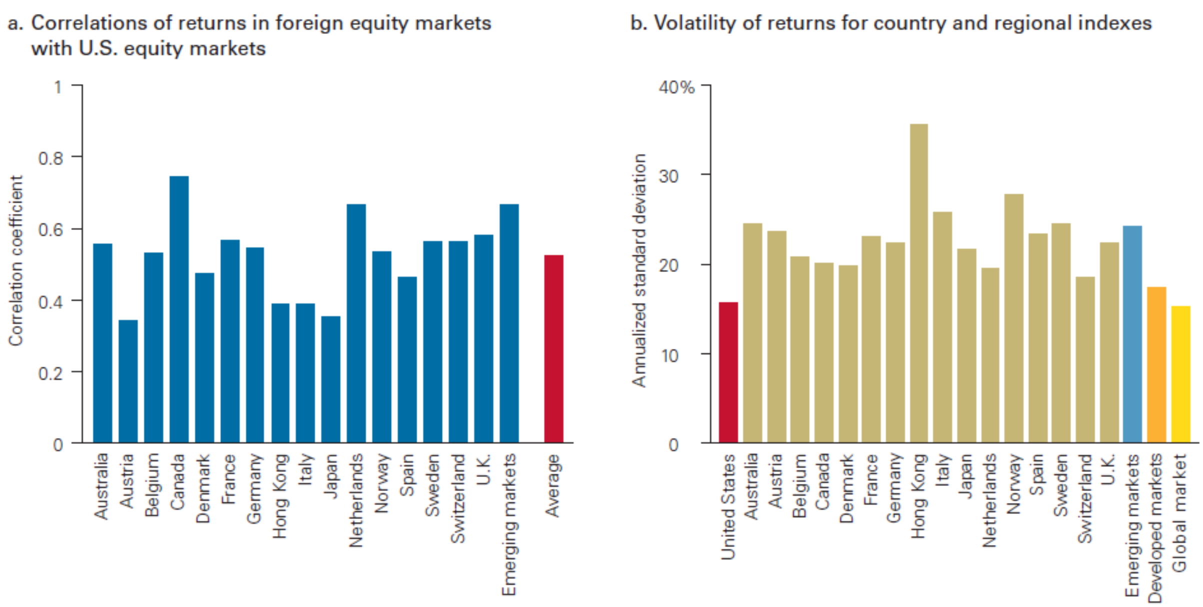
Several weeks ago a client of ours asked us a very intelligent question. So good in fact that I thought it worth writing a short article about. This question is one that has been a topic of many financial articles lately and could be on your minds as well. The question goes something like, "Because most mega-cap stocks in the U.S. derive a significant portion of their income from overseas, do we still need to worry about international diversification by buying companies headquartered outside the U.S.?"

A lot of investors think it is possible to invest abroad without leaving home. After all, companies such as Coca-Cola, Exxon and McDonald's get over half their sales from foreign markets. As a matter of fact, most companies in the S&P 500 are multinationals that are doing 30-40% of their business overseas. Because many of these firms generate a significant portion of their revenue from foreign operations, many investors think the diversification benefits of global investing are already reflected in the prices and performance of these large U.S. companies. Plus, it is far more comforting owning stocks whose names you have heard of and can pronounce correctly, not to mention avoiding all of the currency swings and occasional political turmoil.

Over the past several years, U.S. multinational stocks have also outperformed those in the foreign markets. It seems interesting to me that a lot of the recent criticism of international diversification centers on the fact that U.S. stocks are up over 12.7% annualized for the past 3 years while foreign developed markets are up only 5.0% annualized during the same period. In other words, U.S. multinational companies have enjoyed big gains just like the rest of the U.S. stock market. And there lies the problem – THESE COMPANIES DON'T BEHAVE LIKE FOREIGN STOCKS!



Notes: Country returns represented by MSCI country indexes; emerging markets represented by MSCI Emerging Markets Index; developed markets represented by MSCI All Country World Index ex USA; global market, including both developed and emerging markets, represented by MSCI All Country World Index. Emerging market data begin in 1988; all data through December 31, 2011.

Sources: Vanguard, Thomson Reuters Datastream, and MSCI.

Beyond the obvious opportunity to invest across a broader market, non-U.S. equities have diversified the returns of U.S. equities, on average, across time. The idea behind this diversification benefit is that when you invest in markets outside the U.S., you expect the returns to be similar to that of U.S. stocks, but with a different pattern to the returns. That way, your foreign stocks might post gains when U.S. shares are suffering, thus smoothing out your portfolio's performance. The first way to test this logic is to look at the historical correlations of returns. As you can see in *figure a*., different economies and markets produce returns that vary from those of the U.S. Secondly, in *figure b.,* you will note the volatility experienced in the U.S. and non-U.S. markets. Isn't it interesting that combining exposures of higher volatile countries with that of the U.S., actually creates a lower total volatility (re: global market)?

Besides the diversification benefits, couldn't we also look at growth opportunities? For the simple reason of limited space, let's look at a couple of basic valuation metrics to compare the S&P 500 (U.S. large cap stocks) with the MSCI EAFE index (developed markets of Western Europe, Japan, Australia, and Canada).

INDEX	P/E RATIO	PRICE / BOOK	DIVIDEND YIELD
S&P 500	17.98	2.33	2.19%
MSCI EAFE	15.91	1.53	3.25%

If it was true that U.S. multinational companies always provide the same opportunity, wouldn't the valuation metrics be equal? The measures above do not suggest so. Instead, these current valuation measurements suggest more opportunity in companies outside the U.S.

The case for investing internationally is clear: One is diversification – the spreading of risk among a variety of investments that do not gain and lose value at the same time. The other is growth – participating in the potential for growth in foreign economies. As of December 31, 2011 U.S. equities accounted for 46% of the global equity market. A portfolio investing solely in the U.S. stock market automatically excludes well over one-half of the global opportunity set.

We will continue to hold exposures to non-U.S. equities in your investment portfolios. The relatively low valuations of non-US developed and emerging markets as compared to their long-term averages should provide opportunity in the future. By staying invested, we are more likely to benefit when valuations revert to more sustainable long-term levels (the exact timing of which we don't believe anyone can accurately predict). Please call or come see us if you have any questions or would like to discuss your investment allocation in greater detail.

John Harrell, CFP®, AAMS
Portfolio Analysis

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