Educate U

Let Your Portfolio Travel The World

How International Investing Impacts Your Portfolio

International Investing has always been a tool used by seasoned investors to "reduce risk and achieve higher returns". So what does that really mean. How can you decrease risk and increase your returns at the same time?

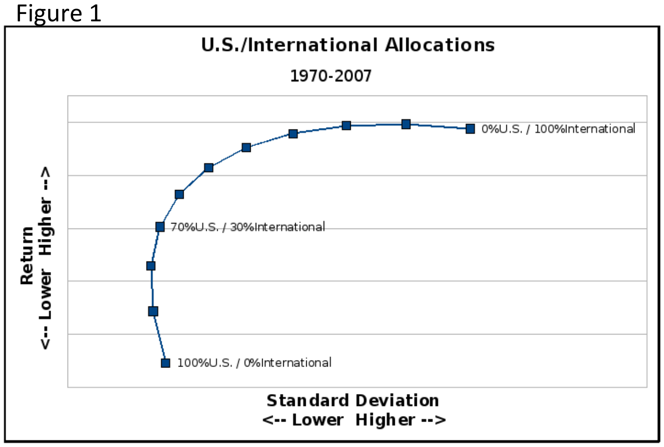
Well, the reduction of risk theory is derived from the assumption of reduced correlation. In general, you want to reduce the correlation of one investment with another. For example, if you own a technology stock, buying another technology stock really doesn't reduce your risk. But, if you own a technology stock, and you bought a consumer cyclical stock, like a car company, then, you are more diversified.

Why Purchase International Securities?

Reduction of Risk — As mentioned above, with international investing, purchasing an international security can reduce your risk. Reducing your (unsystematic) risk is all about correlation. When investing, you do not want to pick two stocks that are perfectly correlated with each other. If you do, as one goes down, so does the other one. Gold and Silver prices are correlated very close to each other. (So are US and Canadian Stocks.) Not many people say — "I own a lot of gold, but I need to diversify. Let's buy Silver". In other words, just because US stocks go down (or up) doesn't mean similar stocks in another country mirrors our returns. The more independent to assets are to each other, the more diversified your portfolio.

On the right (Figure 1) is a graph that shows the impact of international securities regarding risk (standard deviation) and return. You can see that for 27 years, ending in 2007, you would actually receive a higher return for each unit of risk when you held 70% US securities (S&P 500) vs. 30% international securities (85% EAFE, 15% developed markets). Over the past several years, this trend has actually been flattening out, hence reducing the return for each unit of risk you take. In other words, international securities has not had the same diversification effect as in the past.

Figure 1



Growth — Another reason, is the potential for growth. Investing internationally does contain risks, and with risks comes rewards (we hope). Without any risk, our money would be buried in the back yard. And, in fact, international returns usually does outpace US returns. Theory goes that investing in international stocks can give you a higher return given the level of risk within your portfolio.

We must remember that, although we all feel more comfortable investing in what we know, and certainly, the United States is the dominant world economy, imagine missing more than half of the investments in the world. In fact, as of the end of 2010, 8 of the 10 largest automobile companies were based outside of the US. Firms, like Nestle (Switzerland) and Unilever (Netherlands/UK), make products like Gerber baby foods, Dryer's Ice Cream, Dove soap, Slim-Fast, Vaseline, and even Powerbar.

But more importantly, the demographics of the world continue to change. Population growth has been reduced in developing countries, allowing for the average age to increase. This means the economies of these countries are expected to grow faster than the US economy. This gives us growth opportunities that are simply not found here in domestic securities. There is no doubt that the world economy will continue to grow, many faster than the US economy.

Types of International Investing

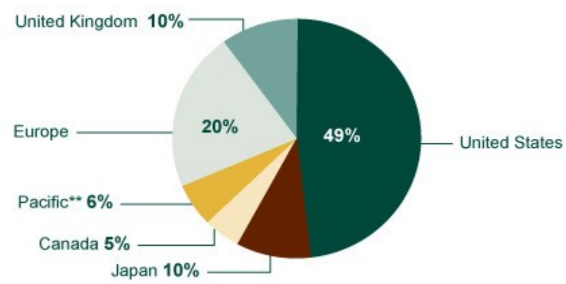
Developed — Depending on who defines the list, there are approximately 24 countries that are considered developed markets. The MSCI EAFE Index (Europe, Australasia, Far East) measures the equity market performance of developed markets, excluding the US and Canada. As of May 30, 2011, it consists of the following countries: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The MSCI World index includes all of the above, plus Canada and the United States. (See Figure 2)

Emerging — MSCI Barra classifies 21 countries as emerging markets. As of May 30, 2011, it consists of the following countries: Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungry, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

Frontier Markets — A sub-set of Emerging Markets, it consists of over 25 countries. These countries include: Argentina, Bangladesh, Slovenia, Croatia, Sri Lanka, Jordon, Qatar, Pakistan, and Oman.

Figure 2

MSCI World as of 12/31/10*



*The MSCI World Index is an unmanaged, capitalization-weighted stock index measuring the performance of selected stocks in 24 developed countries as of 12/31/2010.

**Pacific includes Australia, Hong Kong, New Zealand and Singapore.

Source: Thomson Reuters.

Risks of International Investing

There are a number of risks that are not found in domestic securities. They are:

Change in Currency Exchange Rate — Although this can be hedged away, this risk can have either a positive or negative impact on your return. When you (or a fund) purchases a foreign security, it does so in its local currency. Certainly when you value that stock again, you must convert it back to US dollars. If the currency has fallen against the dollar, it will cost more to buy that dollar back.

Less / Imperfect Information — Many countries do not report in the same manner as US companies report. They may not be required to accrue expenses, or report material impacts in their finances. Most importantly, they usually do not follow the same accounting standards the US, or other developed nations follow. This can make stocks more volatile and more difficult to analyze.

Political, Economic, and Social Changes — This risk has multiple impacts. In more developed nations, the social and political impacts tend to be less (with, of course, the recent Euro crisis of Italy, Greece, Spain, and other Euro zones). The political and social risks of China are very real, as they continue to move towards a capitalist economy. Certainly civil and political unrests can make an impact on any firm, and a revolution can cause short term havoc on investment returns.

Lack of Liquidity — Some countries, especially countries that have more restrictive governments, can have thinner trading volumes and larger spreads. This might make it difficult to liquidate some securities, or not receive a "fair" price at times.

Other factors

The cost of international investing is higher than domestic investing. Holding the securities directly (via an American Depository Receipt, or ADR) can still impact withholding taxes. And, there are custody fees for ADR's. If investing in a mutual or exchange traded fund, those management fees are almost always higher than their domestic cousins. In part because managers may have offices internationally, and may have a larger staff to cover a larger universe.

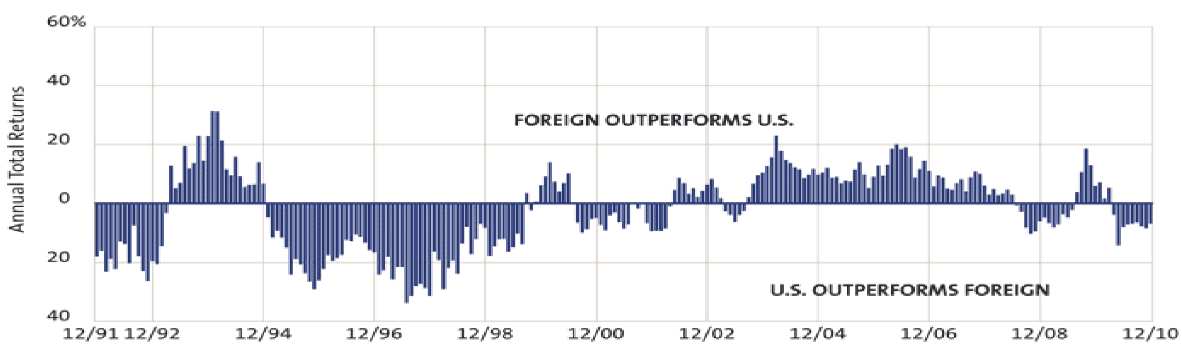
Conclusion

It is difficult to argue that international investing does not have its place in long term investing. But, international investing can still be very frustrating. Although these markets can reduce risk due to their lower correlation, returns over the past few years have been much worse than domestic stocks. In fact, during the bull market of the mid 1990's, international stocks lagged far behind US stocks. (See Figure 3 below, supplied by T Rowe Price Associates.) International securities are, once again, lagging domestic returns, with only a few bright spots across the world.

Remember, investing for *The Long Run requires patience and fortitude.* If investing yourself, perform your due diligence in what types of international investing you purchase, remember that your investments may go down while everything else is going up (and visa versa), and always watch out for expenses.

Figure 3

Cycles of Performance (December 1991—December 2010)
Rolling 12-Month Returns



Annual Total Returns

	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10
MSCI EAFE Index	12.50	-11.85	32.94	8.06	11.55	6.36	2.06	20.33	27.30	-13.96	-21.21	-15.66	39.17	20.70	14.02	26.86	11.63	-43.06	32.46	8.21
S&P 500 Index	30.47	7.62	10.08	1.32	37.58	22.96	33.36	28.58	21.04	-9.10	-11.89	-22.10	28.68	10.88	4.91	15.79	5.49	-37.00	26.46	15.06

Sources: MSCI EAFE Index and S&P 500 Stock Index.
Analysis by T. Rowe Price Associates, Inc.