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This month, we review the logic for including foreign stocks in a portfolio. There are three main takeaways from this Paradigm. First, including foreign stocks is likely to continue to add value to a diversified portfolio over very long periods of time. Second, the benefit, as with active managers, appears to be less going forward than in the past. Third, this topic is becoming part of the dialogue regarding the proper level of diversification.

Logic for Including Foreign Stocks.

The logic for investing overseas appeared to have started with four main factors for improving risk-adjusted returns: low correlation of price movements between the various stock markets, access to different companies, the potential for higher growth, and a hedge against the dollar.

Over time, a fifth factor seems to have been added. This factor was that the U.S. stock market represented less than 50% of the world total. Therefore, investors were not properly diversified by only investing in U.S. stocks. Currently, the U.S. represents slightly under 40% of the total world stock market.

Low Correlation of Price Movements

The low correlation of price movements between U.S. and foreign stock markets implied that portfolio returns might be the same with less overall portfolio volatility.

Although the correlation of price movements has increased, economic cycles and market movements still vary by region. In the past ten years, the annual returns for foreign and domestic markets have varied by roughly 10 percentage points four times. Buying what is most attractive plus adjusting the overall equity exposure between U.S. and foreign markets might still add value.

Access to Different Companies

This remains true. Technology may be more prevalent in one market while resource-based companies may be more prevalent in another market. Also, company size can vary leading to markets that are more dependent on major companies.

Technology is a good example. The S&P 500 is comprised of over 20% technology companies while the most analogous foreign stock index is roughly 7% technology.

Using the same two indices, we can address concentration, too. In the S&P 500, the ten largest companies currently make up 22% of the index, and for the foreign index the largest ten companies account for only 12% of the index.

Major differences are likely to continue and are likely to result in price movements that vary by region.

Potential for Higher Growth

The importance of this factor appears to be fading as companies become more global. Morningstar, an investment research firm, estimates that companies in the S&P 500 now earn 40% of their profits from outside the U.S. Although no exact numbers exist, twenty to thirty years ago foreign earnings for the S&P 500 were probably in the 20-25% range.

If an investor is considering investing overseas for higher growth, it appears they might have to increase their risk profile. This could be accomplished by investing in emerging or frontier markets or by investing in a single country. An investor considering this approach is cautioned to have at least at ten-year horizon due to economic and stock market risks.

A Hedge Against the Dollar

This factor may have made sense when first used. However, the past 15 years shows that changing currency values works both ways.

Five years ago, we wrote that a declining dollar had added 0.5% per year to foreign stock returns over the previous ten years. However, over the past decade an appreciating dollar has reduced foreign returns by over 1.5% per year when translated back into U.S. dollars.

U.S. Market is Roughly 40% of the World Market

One side of the argument focuses on the opportunities inherent in non-U.S. markets, the need in a global economy not to be narrowly focused on your home market, and the imperfect correlation of stock returns across regions. For this group, especially if one is willing to include emerging market stocks, a weighting in U.S. stocks under 40 is prudent.

The other side of the argument focuses on the power of the U.S. economic machine, the innovation in the U.S. as represented by the sheer number of major global brands, and the diminished effect on returns from including foreign stocks. For this group, U.S. stocks provide ample diversification, although including some foreign is prudent, too.

Determining the proper level of diversification is likely to be a mainstream discussion point in the future. Even the late John Bogle, Vanguard's founder, said this is one of the main differences he observed among approaches to constructing an appropriate portfolio.

We believe foreign stocks will continue to provide benefits in a diversified portfolio. However, the benefits may not be as great as in the past. Finally, this discussion will continue and evolve.

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