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On time, too late to invest internationally?

By **Susan Weiner**
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International stocks delivered strong returns during 2002, 2003 and 2004. The most commonly used measure of international stock performance, the MSCI EAFE Index, increased in price by a whopping 18 percent last year. That looks mighty attractive compared to the roughly 9-percent return delivered by U.S. stocks, as measured by the Standard & Poor?s 500. Given that record, you may wonder: Is it too late to jump on the international investing bandwagon?

It?s almost always good to invest part of your portfolio outside the U.S., say experts. Moreover, international investments look particularly attractive right now.

International Diversification Reduces Risk. Diversification is the reason why international investments typically are part of an investment portfolio invested for the long-term. The point of diversification is that holding investments that are less than perfectly correlated ? whose prices don?t move up or down, or maybe not even in the same direction, at the same pace ? should reduce the variability of your portfolio?s returns, while perhaps even boosting returns modestly over the long run. If international investments perform even somewhat differently from U.S. investments, then in combination the two kinds of investments should reduce the risk of your portfolio, as defined by variability of returns.

To oversimplify, less positive returns for U.S. investments in one year might be offset by more positive returns for international investments in the same year. And the reverse might be true when international investments underperform.

The correlation between U.S. and international investments has increased during recent decades as global markets have become more deeply entwined. ?There?s still enough difference, however, for investors to benefit from risk reduction,? says Carol McMullen, who runs Eastern Investment Advisors, the asset management division of Eastern Bank.

Weak Dollar Favors International Investments. In addition to diversification, U.S. investors can potentially benefit from some powerful, although temporary, factors favoring international investments. For starters, there has been the weakness of the U.S. dollar vs. foreign currencies. In recent years, rising foreign currencies have increased the value of non-U.S. returns when translated into dollars.

The dollar is likely to weaken more, according to Ivka Kalus-Bystricky, a principal with State Street Global Advisors (SSgA). The outsized currency returns of the last three years, however, aren?t likely to repeat soon, she says. She finds international stocks attractive even if the dollar were to strengthen.

For starters, companies in some foreign countries are experiencing much faster earnings growth than their U.S. counterparts, says Kalus-Bystricky, a portfolio manager for SSgA?s International Growth Opportunities strategy. Looking ahead, U.S. corporate earnings are expected to grow at an annual rate of 7 percent vs. 9 percent for Europe, 11 percent across emerging markets and 17 percent in Japan.

Stock valuations ? often measured by price-to-earnings (P/E) ratios, or how much investors pay relative to a company?s earnings ? are also more attractive outside the U.S. For example, the P/Es on EAFE stocks are roughly 40 percent cheaper, says Kalus-Bystricky. For her part, Eastern Investments? McMullen particularly likes what she sees in Eastern Europe. ?They have very good valuations and good growth,? she says.

Where to Invest? Given that international investing makes sense, where exactly should you invest? In both developed (as represented by EAFE) and emerging markets? In both the stock and bond markets? In individual securities, mutual funds or exchange-traded funds (ETFs)? When deciding, the experts say, you should be guided by a financial advisor who considers your own specific goals, risk tolerance, time horizon and other factors in constructing a well-diversified portfolio. You should never put all of your eggs in a foreign basket.

Kalus-Bystricky favors investing in both developed and emerging markets. Some financial planners caution that emerging markets can be risky in terms of politics, economics, legal and accounting standards and other factors. Gayle Buff of Buff Capital Management in Newton notes that for long-term investors, ?It is believed the future growth rates in these markets will be substantially greater than in developed markets, so it may make sense to invest in these markets, as long as one is prepared to ride out the inevitable peaks and valleys.?

Because non-U.S. bonds also can benefit from dollar depreciation, some financial advisors recommend them along with stocks. Non-U.S. bonds can be tricky. ?Global bonds have a strong currency component which is a difficult factor to predict.In addition, they?re less liquid and it?s more difficult to get information on them than on stocks,? says McMullen. Others warn that if U.S. interest

rates continue to rise, foreign bonds may lose some of their attraction.

Jennifer Lane of Compass Financial Planning prefers to keep her clients? bond investments conservative. She shuns non-U.S. bond investments. ?I don?t even recommend high yield bonds,? she adds, referring to one of the riskiest classes of U.S. bonds.

Investing in individual non-U.S. securities ? either stocks or bonds ? rather than in professionally managed pools of money, such as mutual funds, doesn?t make sense for most people. It?s too tough to obtain and analyze their information. Also transaction costs are high. Accordingly, advisors suggest that you buy either mutual funds or ETFs, which are similar to index mutual funds but are priced and traded similarly to stocks.

Whether you invest in a mutual fund or ETF may depend on how highly you value active management by a skilled portfolio management team that picks stocks based on their research and analysis. Passive management, as in index funds or ETFs, simply seeks to replicate the effects of investing in an index such as EAFE.

Lane believes that active management is best for the challenges of foreign investing. ?I look for experienced international managers who work for experienced fund families with a deep bench of international managers,? she says.

Some favor ETFs. ?ETFs are very inexpensive relative to traditional mutual funds investing in foreign markets and provide excellent diversification,? says Buff. For example, iShares? EAFE ETF gives you the diversification of the entire EAFE index for only 0.35 percent in expenses. An actively managed international fund?s expenses could easily run 1.35 percent or more. That 1 percent difference could trim a 10-percent return down to 9 percent.

In conclusion, you haven?t missed the boat on international investing. And, you?re in for an interesting ride.

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