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# Research

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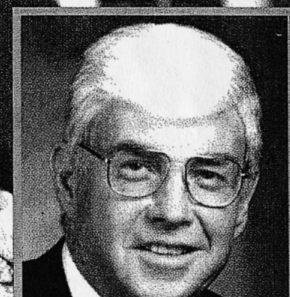
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## Ken Fisher on Global Investing

THE SUPREME PORTFOLIO  
STRATEGIST TELLS HOW  
TO BUILD A SAFE HAVEN IN  
VOLATILE WORLD MARKETS

**Kenneth L. Fisher**  
Fisher Investments

- **Is the Era of Eurosclerosis Over?**
- **Post-Crisis Asia Investing**
- **A Progress Report on Latin America**
- **Q&A With Commonwealth's Joseph Deitch**
- **Jack Kemp Quarterbacks Digital Economy**





BY KENNETH L. FISHER

# The Perverse Logic of Global Investing

**Over the long term, adding volatile foreign equities to your domestic portfolio is the best way to assure the smoothest and lowest-risk ride to higher equity returns.**

**T**HE TERM "INTERNATIONAL" is wrongly defined in finance. When our industry says "international," we mean what the man on the street or Webster's Dictionary correctly refer to as "foreign." Mere semantics? No.

"Foreign" means outside your country. "International" means between several countries, like an "international treaty," which might include America. "International" doesn't mean every or any thing outside one's own country, as does "foreign." The difference between these two words goes to the heart of choosing a benchmark, which is the first concern of finance theory.

Although correctly picking a benchmark should be the first step of portfolio management, most investors use it as the last step. Investors typically use benchmarks like rulers — applied afterwards to measure how well we did. But in

finance theory, we're supposed to start by carefully picking our benchmark, and then always managing against it, almost like a navigator uses a map to help get to a destination. You don't pull out the map only after arriving to measure if your trip was done well or not.

If we wanted to drive from San Francisco to New York we could conclude from a map that the fastest, smoothest, least curvy (i.e. volatile) and least risky route is Interstate 80, door-to-door. But on the way we might encounter unexpected traffic, road construction, roadside attractions — any number of things that would lead us to veer off I-80. That is managing against a benchmark, because we improve the trip by veering off course. Yet throughout the trip, we never discard our map. That is essential.

Investors are supposed to continually analyze their benchmark's components, assigning to each one expected return and risk values, and purposefully veering from that benchmark in order to construct a portfolio with the greatest total expected return relative to risk, (which in lay language means maximizing the odds of beating the benchmark).

Note, this isn't the same as maximizing return, something finance theory doesn't even permit us to contemplate. That is because trying to maximize return means ignoring risk. And fully half of portfolio management is supposed to be about risk control. How do you control risk? By combining assets with similar long-term expected returns, but whose prices correlate negatively to each other in the short-term. One zigs while the other zags, creating the least total volatility relative to expected return.

## "COLLECTING" STOCKS

Most investors don't think about benchmarks while building portfolios. It isn't natural. Behavioral finance teaches that

humans think about investing like collectors. They have some background, training, intuition and access to tools — together these form biases. Some folks like antique cars; others like paintings. Some like both and own two collections.

One investor likes value

stocks, believes in them, and thinks they're simply safer and do better in the long term. The quality growth guy thinks the same about his collection. Someone else believes in small stocks, or emerging markets or technology. Some folks have two collections, maybe big growth and emerging markets. Most folks limit their collecting. Why? They think that way. They don't collect everything. The antique car collector may covet paintings, too, but probably thinks guys who collect movie memorabilia and beanie babies are weird.

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Growth can't be better than value, or vice versa. Small can't be better than big. Emerging markets can't be permanently better or worse than, say, U.S. value or tech. Saying otherwise says you either disbelieve in capitalism or don't understand how it works.

Some finance professors try periodically to mislead us on

this; they often succeed for a while. In the early 1980s they preached that small stocks are permanently better. Lots of folks swallowed it, hook line and sinker, only to gag on it for years. They're still suffering.

Later in the 1980s they preached value as permanently better. Here as well, many folks still believe, still suffer. By 1990, emerging markets were seen as "better" because they were supposedly less efficient, leading to superior results. Still suffering. All this was anti-capitalistic, anti-finance theory, ignorant hokum. Yet, collectors regularly fall for this.

No category can be "better" for very long. If one is perceived as superior — meaning an expected excess return relative to other categories — investment bankers busily begin creating new supply. I-bankers aren't perfect, but they're greedy, which is close enough. So they create new supply until they can't find demand.

## SUPPLY TRUMPS DEMAND

Securities prices are set by supply and demand for securi-



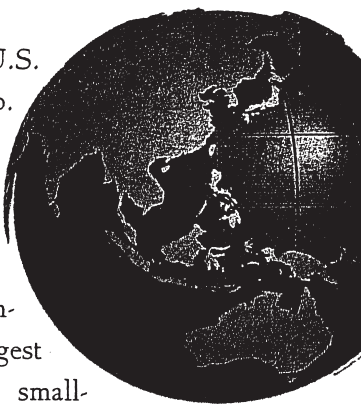
ties. In the short term supply is rigid, so demand is usually more powerful than supply in short-term pricing. In the very long term, supply almost solely sets pricing.

This confuses normal investors. The brain thinks relatively well about demand. And often. It comes from evolution from our hunter-gatherer origins. But in nature, supply, like rain, or the quantity of bunnies and berries, was permanently regressing around a mean — very unlike securities markets.

Our brains don't think often or well about securities supply. We process information about shifts in supply poorly. Yet with enough time, the ability to create new securities supply is near infinite. Securities have an "elastic" supply relative to price. If we raise a category's price modestly, we get big long-term supply increases. It is the central pricing mechanism that makes capitalism such an efficient resource allocator. Sub-categories can't monopolize superiority — they get priced away by supply. Eventually all categories render similar returns.

For example, take U.S. small-cap versus big-cap. Fact: In the last 73 years small stocks beat big ones by a measly 1 percent per year. Eliminate 1933 and 1943, the two years beginning the century's two biggest bull markets (historically, small-cap is almost completely an early bull market phenomenon), and then the 1 percent edge disappears completely. Just those two years. Otherwise, small-cap and big-cap did exactly the same, return-wise (for more on this, see my June 1999 article in *Research*, "Investing With Style"). Yes, big and small varied in volatility along the way. They wiggle differently; but they return similarly. Ditto for growth versus value.

Now let's take domestic versus foreign. In the mid-1980s, foreign clobbered domestic. In the 1990s, domestic dominated. The MSCI EAFE Index began in 1968. From its creation through December 1999, EAFE's average annual return was 12.8 percent. The S&P 500's was 12.9 percent. How much closer do you want? Volatility is another



story. EAFE's standard deviation was 21.4 — way above the S&P's 16.3. Foreign is bouncier than domestic. Conclusion: Thinking about risk is more important than thinking about return.

And that returns us to thinking about benchmarks. Because by broadening your benchmark, you maximize the potential choice set for blending negative correlations, thereby reducing your risk. Take the S&P and EAFE. If you annually blend the two, re-balancing them 50/50, combining the bouncier and riskier EAFE with the less bouncy, less risky S&P, your 30-year standard deviation drops further, becoming even less risky than the S&P. Free lunch.

Once again, you don't get the average of the two standard deviations. Though EAFE is at 21.4 and the S&P at 16.3, the blend is much lower at 12.8. Most folks have difficulty fathoming this as they contemplate indexes. But it is simple math, simple reality.

## A WORLD OF OPPORTUNITY

So, what is the best benchmark? That which renders that very long-term equity return with the least risk. Which is that? The whole world, of course, proxied by the MSCI World Index, offering the smoothest and lowest-risk ride to high equity returns and the broadest choice set and the greatest latitude to manage against because there are more negatively correlated stocks, industries and nations outside than inside America.

The U.S. market is worth \$17 trillion. The S&P 500 captures \$10 trillion of it. The non-U.S.

market is another \$17 trillion. EAFE captures \$10 trillion there. The whole world is \$34 trillion. The MSCI World captures \$21 trillion, the world's biggest, broadest benchmark.

The world is compelling for more reasons. Take industries. Technology is 29 percent of the S&P as I write. Yet it's only 10 percent of overseas and 20 percent of the world. So this year, as tech bounced, it bounced you more here — up in January and February and down in March





and April — than overseas. MSCI World could smooth that out for you.

Suppose you manage a foreign-only portfolio (what most folks mistakenly call “international”). Well, lots of stuff overseas is foreign to most of us. For example, the industry categories aren’t always comparable. Take Japan’s Hitachi. It is counted within the foreign tech sector. Hitachi is a huge multi-industry giant making almost every darned

thing imaginable, even elevators. In America it would be categorized as capital goods, not tech. Hence, the comparable foreign tech weight is less than its official 10 percent number. Does this impact benchmark returns for the next 30 years? No. Tech can’t have a higher or lower 30-year return than non-tech. But it can bounce along the way. Knowing that foreign stocks are both less tech-heavy than domestic stocks and less tech-heavy than first meets the

**HOW do you control risk? By combining assets with similar long-term expected returns, but whose prices correlate negatively to each other in the short term.**

eye gives you another major tool.

In small countries, a stock or two may dominate. Say we’re building an international (which means “between two or more countries”) portfolio of Finland and Spain. Well, basically Finland is Nokia, period. In Spain you can’t escape Bilbao Vizcaya and Santander, the big banks. So, our portfolio is wireless and banking and volatile.

But think of the potential to use extremes like this to blend negative correlations. In portfolio theory we do that for a smoother, less risky ride. We know some will fall short-term. That doesn’t bother us. At other times they provide an insurance-like function for us. For example, this spring, when tech imploded, how could you stabilize a tech portfolio? Add some pharmaceuticals. They are fundamentally short-term negatively correlated to tech. In the short-term, when tech is stellar, pharmaceuticals are doggy. When tech falls, pharmaceuticals usually rise. Why? Because the demand for technology products is elastic but for drugs it’s inelastic.

## ECONOMICS 101

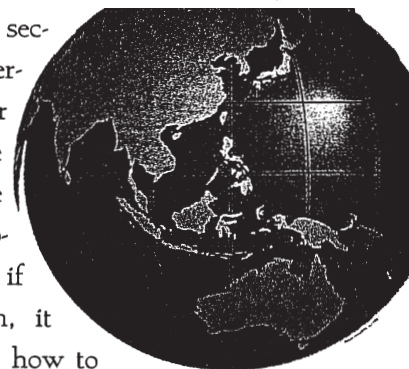
Remember what you learned in Economics 101. Something has an elastic demand if, when the price falls modestly, people want much more of it — and conversely, if the price rises modestly, people want lots less of it. Tech has very elastic demand. Falling prices drive tech’s growth; without falling prices, tech stagnates.

But some industries have inelastic demand. When their product prices fall modestly, we don’t want very much more of it and when their prices skyrocket, our demand falls very little (like gas, booze, tobacco, water, and most especially, pharmaceuticals). A 20 percent rise in drug prices won’t keep most folks from their heart medication. And if you halve the price folks won’t take twice what their doctor prescribed. Pharmaceuticals aren’t product-pricing sensitive; they are sensitive to our overall economic growth. As we get richer, disproportionately more goes to healthcare.

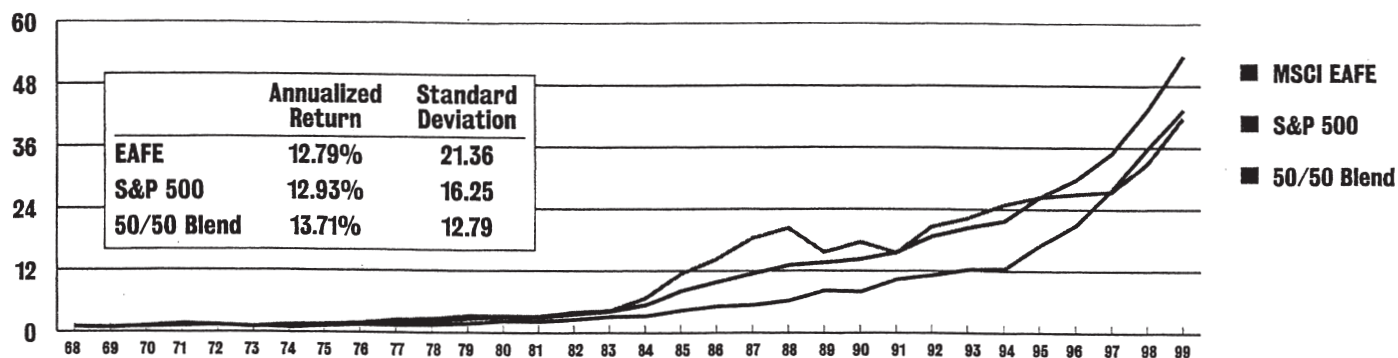
On tech, consider Moore’s law. Gordon Moore, one of Intel’s co-founders and its second CEO, theorized a 20 percent drop in semiconductor pricing would double demand. Genius-like, he went beyond elasticity economics and presumed that if Intel doubled production, it would learn enough about how to make semiconductors cheaper to justify the 20 percent drop in price (“riding down the learning curve,” as it was called). Put together, Moore’s law has changed the world for 30 years and will for a long time.

But Moore’s law is about product demand and supply. It doesn’t mean that tech stocks will have a higher long-term return than drug stocks. That many politicians want to legislate drug prices won’t mean drug stocks will have a lower long-term return. Securities supply determines eventual pricing, not product demand or product supply.

So you get the same very long-term return from a portfolio of drugs and tech combined, but with vastly lower volatility. Collectors who like tech won’t believe this. Nor will pharmaceutical fanatics. They will both suffer from collector’s faith. The only way to beat blending negative corre-



## BENEFITS OF BROAD DIVERSIFICATION



50/50 Blend represents an annually re-balanced portfolio of 50% EAFE and 50% S&P 500 returns.

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lations is to exquisitely time moves in and out of sectors so you get the best of both worlds, owning a category as it soars and avoiding it as it snores. If you can do this, you need no advice from me. But few collectors ever successfully trade against their collections — that takes near genius. And if you think you're a genius, you are probably a fool.

### MANAGING RISK

Another fundamental tenet of portfolio management is always knowing you may be wrong. So portfolio management allows that you may be a genius while assuming you probably aren't, because even a genius can sometimes be wrong.

Global capability offers a world of opportunities to find and blend negative correlations. For example, U.S. and U.K. markets tend to correlate highly. But American small-cap and U.K. small-cap markets don't. They are often negatively correlated. American small-caps move when

they do primarily because they have lower foreign revenue content percentage-wise than big stocks (see "Investing With Style," June 1999). Before an American economic expansion begins, small stocks do well in advance, discounting that improvement which they



capture through their high domestic revenue content. But as the rest of the world's economies catch up, or our economy sours, big stocks lead because their higher proportion of foreign revenue stabilizes their forward earnings.

It works sort of backwards in the U.K., because in the U.K. it is the small stocks that have high proportions of foreign revenue, not big stocks. With few exceptions (like Glaxo), big U.K. stocks tend to be oriented to the U.K. domestic market in energy, supermarkets, foods, building, banking, etc. The smaller fry can grow only by exporting specialty items to Europe, and therefore have a higher proportion of foreign revenue.

So, despite U.K. and U.S. major markets correlating highly, linking U.S. small-cap with U.K. small-cap usually reduces the risk of both by blending negative correlations.

Most investors, like collectors, think of their collections separately. They envision foreign separately from domestic the way they think their antique cars aren't connected to their impressionist paintings. But portfolio management argues that you think global; manage against a benchmark; and don't try to maximize return. The best way to maximize return in the long term is to forget about it in the short term; instead focus on risk control. And think of using the world's opportunities to reduce volatility.

Ignoring risk is perverse. Reducing risk isn't perverse, even if the requisite methodology seems so. ■

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