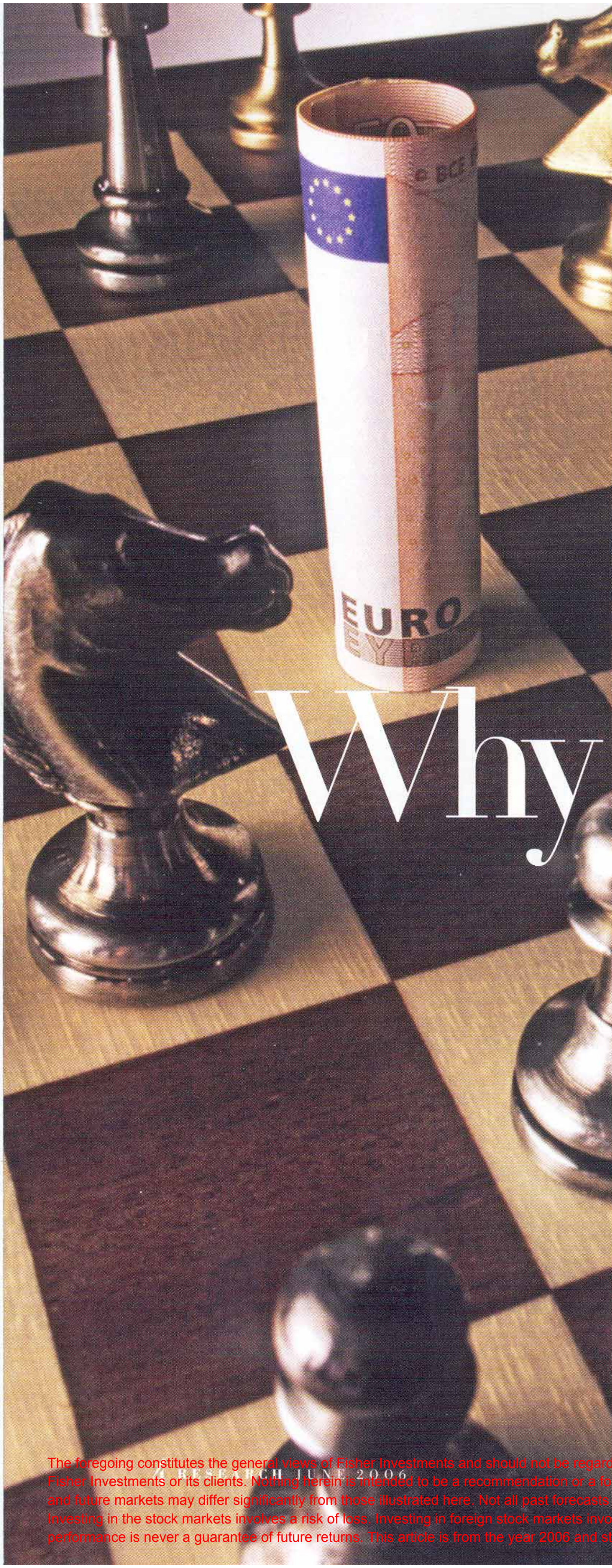


BY DAVID J. DRUCKER

Critics say U.S. exposure is all you need, but that's not so.

Why Foreign

Rumor has it that foreign investing is pointless now that foreign and U.S. markets move in tandem. Is the premise correct?

Yes and no. How high a correlation do you need between U.S. and foreign investments before you proclaim them redundant? Using the EAFE Index of Europe, Australasia and Far Eastern stocks — probably the foreign index most highly correlated with U.S. stocks — it's easy to spot periods in which correlations are low enough to warrant investing overseas. As the table on page 6 shows, only in one of the past 20 years has the S&P 500 zigged when the MSCI EAFE zagged — 1992. In virtually *every* year, though, returns varied widely — a phenomenon that can be exploited.

Yet, just putting some money in each of the S&P 500 and MSCI EAFE, alone, would be a simplistic strategy given all the possible ways of dissecting the global economy. What weighting should be given to domestic vs. foreign, developed vs. emerging markets, large-caps vs. small-caps, and should countries or sectors be rotated? In other words, shouldn't we apply the same thinking to the global economy that we apply when investing in the U.S. economy and its markets?

Of the first cut — domestic vs. foreign — Ken Fisher, founder, CEO and chief investment officer of Woodside, Calif.-based Fisher Investments, a $31 billion money manager, says, "Think about it this way: There's a time and place when the U.S. is better than things foreign, but how much do you want to bet on that? If you had certain knowledge, you'd be 100 percent U.S. or 100 percent foreign, but none of us has certain knowledge; we only have opinions leading to conclusions."

Investing is *Essential*

As to how much we should invest in each, though, Fisher says we must first get past a faulty mindset typical of American investors. "Americans have difficulty accepting the notion of managing a portfolio globally against a global benchmark." Fisher says his own bias is to use an all-world index in which the U.S. presence is about 50 percent and non-U.S. the other 50 percent.

However, most Americans aren't prepared to use such a benchmark. "Americans want to put maybe 20 percent in foreign investments; they try to throttle down the foreign part when investing globally." It's not the way they'd think if they were managing a U.S. portfolio against U.S. benchmarks, says Fisher, who is now investing more than half of his own clients' money overseas.

In other words, not only should we be open to investing a sizable portion of our portfolios in foreign securities, but country allocations should be rotated, not static, meaning greater foreign-to-U.S. allocations, at times. "We may be getting close to the end of that run; in 2007, we'll rethink things," says Fisher, in reference to his overweighting of foreign vs. domestic.

It's not difficult to find agreement on this issue. However, you have to separate the long-term from the short-term outlook, says Jay Chitnis, chief investment strategist for YieldQuest Investment Group in Atlanta. "Short-term, we're bearish, especially in emerging markets. All the good news that's out there has already been priced in."

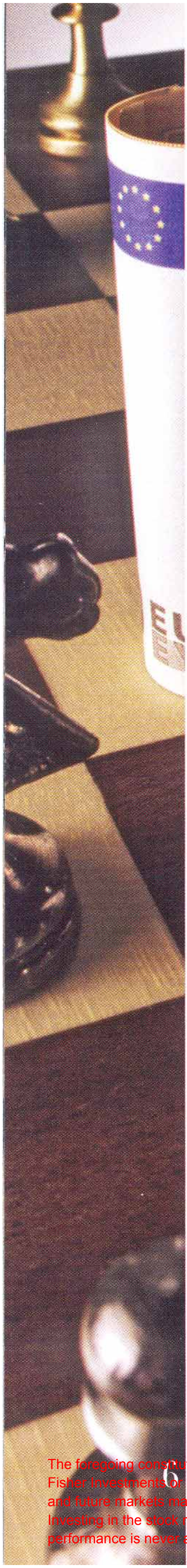
One of many indicators Chitnis follows is fund-flow statistics. "If you look at fund flows into emerging markets, for example, they are presently about four standard deviations higher than average fund flows over the last calendar quarter— they're off the charts, too much money is going in. When there's this much extreme sentiment, we want to take the other side of the trade. After the inevitable correction, we'll back the truck up again."

What indicators does Fisher consider? "Market capitalization is the most important consideration. After the U.S., the major countries from a market capitalization standpoint are Japan, the U.K., Germany, France, Switzerland and Canada. If you get the 'big weights' right, you don't have to worry too much about the smaller weights."

Concentrating on those countries that provide the largest components of global capitalization, Fisher next takes the price-earnings multiple for each country, inverts it into an earnings-price ratio, and compares that to the country's 10-year government or corporate bond rates. "That gives you a sense of relative cheapness, one market to another." Fisher takes into account many other indicators, of course, including relative yield curve movements among countries, and supply and demand shifts within each country's market sectors.

Chitnis says he is more likely to rotate his exposure to different world regions, rather than countries. "We've always estimated regional valuations and then added value by rotating between greed and fear." Chitnis also moves stepwise into higher or lower domestic vs. foreign allocations. "We usually [move gradually] in and out of countries rather than moving in one fell swoop," he says.

Chitnis is more bullish over the long-term than short-term. "Right now, sentiment is ridiculously bullish; it's at an extreme, so we're not buying. But long-term — we see advantages to foreign investments. First, with the possible exception of Europe,



most foreign countries have a higher growth profile than the U.S." Second, says Chitnis, foreign countries, and especially emerging market countries, have dramatically altered their balance sheets in the last five to 10 years, going from debtor to creditor countries. "They're loaning us money now and, as a result of their balance-sheet strength, the likelihood of their having future currency problems is dramatically diminished."

The last point Chitnis makes is that, yes, correlations have tightened and there is less diversification benefit than there once was to investing globally, but "...there's still some lack of correlation, which should help from a Modern Portfolio Theory standpoint."

Correlation of S&P 500 to MSCI EAFE, 1986-2005

Year	S&P 500	EAFE
1986	18.7%	69.5%
1987	5.3	24.6
1988	16.6	28.3
1989	31.7	10.5
1990	-3.1	-23.5
1991	30.5	12.1
1992	7.6	-12.2
1993	10.1	32.6
1994	1.3	7.8
1995	37.6	11.2
1996	23.0	6.1
1997	33.4	1.8
1998	28.6	20.0
1999	21.0	27.0
2000	-9.1	-14.2
2001	-11.9	-21.4
2002	-22.1	-15.9
2003	28.7	38.6
2004	10.9	20.3
2005	4.9	13.5

The Callan Periodic Table of Investment Returns (1986-2005)
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Arijit Dutta, one of Morningstar's international mutual fund analysts, is less sanguine about the global scenario, finding greater opportunity in the distinction between small- and large-cap foreign stocks. "Overall, our position on international investing is that there are some diversification benefits, but it seems that small-cap funds are more prominent diversifiers since large-cap funds are more correlated."

Although Dutta says it would be difficult to characterize large- or small-caps, as a group, according to correlation coefficients, he says specific funds are easy to correlate. "Looking at a group of specific large-cap international funds, we find correlations with the S&P 500 of around .67 to .72, whereas small-cap fund correlations can be as low as .42 to .50." (This means foreign stock returns tend to be positive when U.S. returns are positive, as confirmed by investment returns of the past 20 years, but small-cap foreign-stock returns diverge more widely with U.S. stock returns than do foreign large-cap stock returns).

So what does Dutta recommend in the way of small-cap foreign stock funds? "I don't currently have any picks. There are a couple of funds I like, but the category has done so well the past few years [that] the few funds that are really good have too much in assets now; some have even closed." He does like certain funds for the long haul, though — names like Artisan International, Harbor International Growth and Icap International.

Chitnis prefers to make global investments using exchange-traded funds. "We can now get a nice variety of foreign ETFs." That said, he doesn't overlook certain foreign fund families, like Matthews, that are adding significant alpha.

So, is global investing essential to a well-rounded portfolio? Yes, says Fisher: "Global investing is a perspective that helps you see all of the pieces better. If you had no foreign diversification last year when foreign stocks were outperforming domestic stocks, you would have lagged world performance. In the long run, I believe domestic and foreign probably do about the same. In the short term, though, one tends to do better than the other, and that [advantage] vacillates."

Global exposure will lower your volatility, says Fisher. Although foreign stocks tend to be a little more volatile than U.S. stocks, the two, together, are less volatile than either by itself.

Just remember: Global investing isn't as simple as plugging in a 10 percent or 20 percent allocation to a broad-based international stock mutual fund. Doing a good job for your clients will mean making (or finding someone else to make) reasoned decisions about country weightings and timed opportunities — once you've adopted a truly global perspective. ®