

How Much Should I Invest in International Stocks?

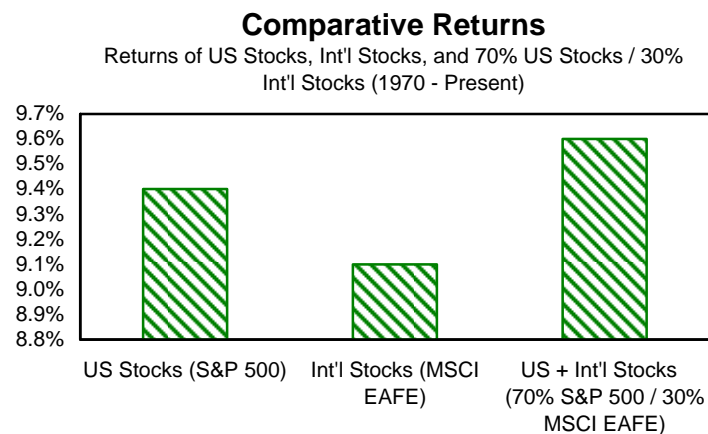
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International stocks are an important part of a well-diversified portfolio, which can enhance portfolio diversification, reduce expected volatility and increase expected return.

But what percentage of international stocks is enough? In this article, we will examine the advantages of international stocks that most investors miss, and discuss the percentage of international stocks that is most advantageous for the typical U.S. investor.

The Benefits of International Investing

Over long periods of time, a portfolio that has combined U.S. and international stocks generally has outperformed a portfolio limited to either U.S. or international stocks. To illustrate, over the past thirty-eight years the annualized return for U.S. stocks was 9.4%, while international stocks returned only 9.1%.¹ By contrast, a 70% U.S. stock/30% international stock portfolio enjoyed a higher return of 9.6%, and was less volatile to boot.



	U.S. Stocks (S&P 500 Index)	International Stocks (MSCI EAFE Index)	U.S. and International Stocks (70% S&P; 30% EAFE)
Annual Return (Jan 1970 - June 2009)	9.4%	9.1%	9.6%
Volatility (Annualized Standard Deviation ²)	15.6	17.2	14.6

¹Source: DFA Returns Program, rebalanced annually.

¹ Records of international stock returns are generally available back to January 1, 1970.

² Standard deviation is a statistical measure of the historical volatility of a portfolio. The higher the standard deviation, the higher the historical volatility of the portfolio.

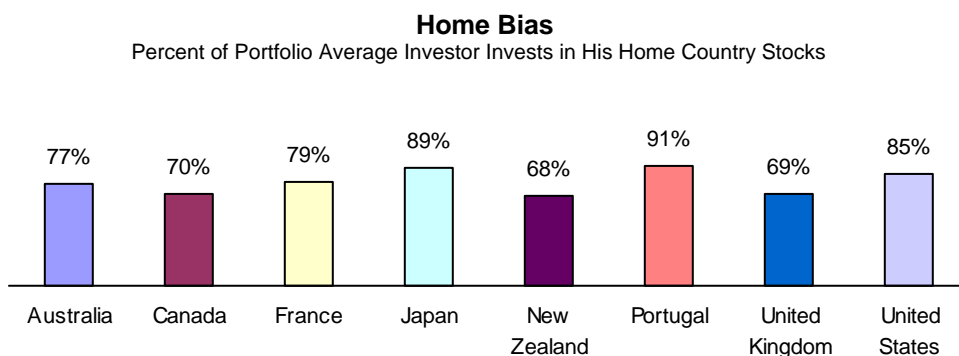
Thus, diversification into international stocks offers an investor an increase in long-term expected returns combined with a reduction in expected volatility.

Home Bias

Despite the long-term performance advantage international stocks offer, most investors concentrate the vast majority of their investments in their home country. To illustrate, the average Japanese investor allocates *ninety percent* of his portfolio to stocks of Japanese companies, even though Japanese companies comprise only thirteen percent of world stocks.

By the same token, in Canada the average investor allocates seventy percent of his portfolio to Canadian stocks – even though Canadian stocks make up *less than three percent* of world stocks.

To a U.S. investor, concentrating almost all of an investment portfolio in Japanese or Canadian stocks may sound peculiar, but U.S. investors evince a similar [home bias](#),³ investing an average of 85% of their stock portfolios in U.S. companies.



International Stocks: How Much Is Enough, How Much Is Too Much?

Most U.S. investors are surprised to learn that U.S. stocks account for *less than half* of world stocks.⁴ The U.S. investor who eschews international stocks misses more than half the investment opportunities in the world. The fundamental investment principal of diversification demands that a U.S. investor at least consider a substantial investment in international stocks. But how much should she invest?

The World Market Cap Approach

Advocates of the World Market Cap Approach contend that if stock markets are [efficient](#), as many argue, then there is no reason to overweight U.S. stocks or those of any other country. They thus base the asset allocation decision solely on [market capitalization](#). International stocks

³ Steiman, Bradley G., When Home Bias and Hot Bias Collide, *Northern Exposure*, June 2008; or [click here](#).

⁴ [Click here](#) for an interesting map of the world showing market capitalization by country as of December 31, 2008.

represent more than half of world stocks,⁵ so an apostle of the market cap approach would invest more than half of his stock portfolio in international stocks.

The percentage of foreign stocks would change over time along with changes in relative world market cap. In the past few years, the percentage of U.S. stocks mostly has hovered between forty and sixty percent of world market cap.

Whatever the theoretical merits of a market cap portfolio may be, most U.S. investors would agree that investing more than half of their portfolios in foreign stocks would defy common sense. And indeed there are several good reasons that the prudent U.S. investor would preserve a significant home bias in her portfolio. These are:

1. *Currency Risk.* Unlike U.S. stocks, international stocks are denominated in foreign currencies and therefore are subject to currency risk. Foreign currency valuations can vary greatly and rapidly relative to the U.S. dollar. Too high an allocation to foreign stocks can increase expected portfolio volatility without an increase in expected return.
2. *Investment Costs.* Investors in U.S. stocks enjoy the most transparent and efficient markets in the world. Trading volume on U.S. exchanges is the highest in the world, while trading costs generally are the lowest. In the U.S., governmental fees imposed on stock transactions are negligible. By contrast, many other countries impose substantial taxes on stock trades, reducing the investor's expected return. Moreover, the laws of many developing nations levy higher fees and taxes on foreign investors than on local investors.
3. *Transparency.* U.S. laws require companies whose shares are publicly traded in the U.S. to fully disclose all relevant investment information to investors. The Securities and Exchange Commission and other securities authorities actively enforce the law and pursue violators vigorously. Although frauds inevitably do still occur, in general U.S. companies arguably offer investors more transparency than international stocks.

Given the additional costs associated with foreign investing, U.S. investors may be able to obtain exposure to the risk factors that drive stock returns more efficiently through investments in U.S. stocks. Thus, the primary benefit from investments in international stocks will come purely from diversification. If there is no diversification benefit, there is no reason to invest in foreign stocks.

⁵ As of December 31, 2008, international stocks represented 54% of world market cap. As of June 30, 2009, international stocks comprised 59% of world market cap. Cf. FTSE All-World Index, June 30, 2009. One way to invest in a diversified world market cap stock portfolio is through the recently-introduced Vanguard Total World Stock Index ETF (symbol VT), which tracks the FTSE All-World Index.

The Thirty Percent Solution

Foreign stocks do offer a substantial diversification benefit. However, it seems clear that the vast majority if not all of the diversification benefit can be realized without taking the international stock component of the portfolio all the way to market weight.

To illustrate, from 1970 to present, a portfolio containing thirty percent international stocks provided a slightly higher return with slightly less volatility than a portfolio containing sixty percent international stocks.

	70% U.S. Stocks/ 30% International (70% S&P; 30% EAFE)	40% U.S. Stocks/ 60% International (40% S&P; 60% EAFE)
Annual Return (Jan 1970 - June 2009)	9.6%	9.5%
Volatility (Annualized Standard Deviation)	14.6	14.9

**Source: DFA Returns Program, rebalanced annually.*

Thus, there is no evidence that an allocation of sixty percent of the portfolio to international stocks provides any more long-term diversification benefit than thirty percent.⁶

Sometimes human intuition can lead to the same place as statistical data – only sooner. Over the decades what might loosely be described as a consensus emerged among investment professionals that a thirty percent allocation to international stocks “felt about right.” This consensus was based on “feel” rather than on hard statistical evidence – hard evidence has not been available until the past few years, and even the evidence cited above still is not as robust as we would like because the time series of returns available for foreign stocks is short compared to U.S. stocks.⁷ But as the hard evidence is becoming available it is worth noting that the evidence appears to support these professional investors’ longtime views.

Conclusion

International stocks are an important component of a well-diversified stock portfolio. Based on world market capitalization, sixty percent of a U.S. investor’s stock portfolio might be allocated to international stocks. A number of other considerations argue for reducing that exposure, however. While no fail-safe formula defines the best combination of U.S. and international

⁶ A true world market cap portfolio would have had varying weights of U.S. and international stocks, as the ratio changed over the years. The MSCI World Index provides a world portfolio with floating market cap. Comparing the S&P and EAFE portfolios shown above to the MSCI World Index (gross div.) for the maximum period available (1975-present), the 70/30 portfolio returned 11.3% with a standard deviation of 14.5, while the MSCI World Index returned 10.7% with a standard deviation of 14.9. (Source: DFA Returns Program, July 9, 2009.) Thus, it would appear based on the available data that the traditional 70/30 portfolio has outperformed a floating world market cap portfolio as well.

⁷ U.S. stock performance has been tracked back to 1926, while foreign stock performance has been tracked only back to 1970.

stocks, the available evidence suggests that the traditional portfolio of 70% U.S. stocks and 30% international stocks has historically offered enhanced returns with reduced risk, and probably is a well-reasoned choice for most U.S. investors.

Additional Notes

When we refer to U.S. or international stocks in this paper, we always refer to these stocks as an asset class, and not as individual stocks. To illustrate, while we would recommend adding an international stock component to most U.S. stock portfolios, we would add that component in the form of a very well-diversified index fund of international stocks, not just one or two individual international stocks. One or two stocks, or, really, anything fewer than thirty stocks, would provide insufficient diversification. Index mutual funds generally provide very wide diversification with very low expenses. I do not recommend actively-managed mutual funds in the international stock asset class because I have not seen any that have historically outperformed a properly-designed index fund.

Also note that this paper is intended only to address general investment principles. Nothing in this paper is intended as a specific recommendation for any investor. Before making any investment decision, the reader should consult a qualified [fee-only](#) financial advisor to determine the right portfolio in his particular financial circumstances. This article is not intended to take the place of that consultation. The advice of a qualified professional on the investor's specific financial circumstances is indispensable.

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