



Christopher Kuehne, MS, CFP
*Certified Financial Planner
NAPFA-Registered Financial Advisor
Fee-Only Financial Planning
Investment Management Services*

Hedging Your Bets—Investing in Foreign Stocks Help

Traditionally, it has been thought that investors could reduce the risk of their portfolios by investing in international stocks. In theory, a portfolio holding both domestic and foreign stocks would perform just as well as a portfolio holding only domestic stocks but with less risk. Historically there has been a low correlation between domestic and international stocks—when domestic stocks go down, international stocks tend to go up.

But in the late 1990's when researchers looked at short-term market cycles, they found that the risk-reducing potential of such diversification was exaggerated. As a consequence, many analysts went so far as to recommend that investors reduce or eliminate their international exposure. At the time, I was skeptical of this conclusion and kept my clients' allocation of foreign stocks intact.

A new study, however, finds that while international stocks do a poor job of reducing risk when an investor focuses on short holding periods, in the long term they perform as well as originally thought while at the same time reducing risk. The authors looked at two hypothetical American investors from 1950 through May 2004. The first investor focused on one-year periods; the second on ten-year periods. In those time periods, if the first investor only bought domestic stocks, his portfolio's biggest 12-month decline would have been 47.5%, after inflation. If he had split his portfolio equally between US, Japan, Germany, France and Britain, his worst 12-month loss would have been about 45.4%--not much of a difference.

But, if one looks at long-term results, one finds over a 10-year period of holding only domestic stocks, the worst cumulative loss would have been 40% compared to 47.5% when looking at one-year holding periods. And, with a portfolio equally divided among the countries mentioned above, the worst 10-year decline would have been 11.3%--a significant difference compared to the 45.4% if the investor only held onto this portfolio for only a year.

The average investor tends to jump into an investment after it has been doing really well for quite a while (i.e. late in its up-cycle) and then tends to panic and jump out on the way down. Hence the old "shoot yourself in the foot" school of investing: buy high and sell low. The lesson here is that longer time horizons are necessary for successful investing; in this case that's the only time span when low correlations between U.S. and foreign stocks show up.

As I'm always telling my clients, diversification is crucial. Investors must look beyond our shores for protection from the inevitable ratcheting down of U.S. returns. As this new study shows, global diversification is one important way to protect investors from short, sharp market plunges. That way, when one segment of your portfolio is lagging, hopefully another is increasing and on balance, over time, your investment holdings overall will increase.