11.11: International Investing

While the majority of people invest in stocks and bonds from their home country, there are reasons to consider investing at least a portion of one's assets with an international perspective. International investing may be beneficial due to increased diversification benefits and more opportunities. Complications with international investing can include currency issues, tax complications, information, and potentially greater risk. However, there are also ways to invest internationally while reducing the complications.

There has been ample evidence to document that international stock and bond markets do not always move in the same direction. Therefore, the correlations across the various national markets are less than one. See Table: Correlations, Returns and St. Deviations Across National Equity Markets (table based on returns from single country exchange traded funds from January 2011 – December 2020). If you remember from Chapter Seven, we can reduce the risk of our portfolio by investing in countries that have low correlations with our home markets. While these risk reductions are real, there is also evidence to suggest that the correlations are highest at the times when markets are crashing. This means that the diversification benefits are smallest when they are needed the most.

Another reason to invest internationally is the increased opportunities. There are many great companies that exist outside the US. By expanding our horizons to include these companies, we can develop stronger portfolios. Also, some developing and emerging markets might offer the opportunity for higher returns (although likely with more risk) that might appeal to many investors. Note that returns vary significantly from country-to-country across time period. Therefore, while the US appears to be the dominant market in the table above (with the highest average return and virtually lowest standard deviation), that does not imply that it will (or won't) be the dominant market over the next 5-10 years.

While there are advantages to investing internationally, it can also lead to many complications. Countries outside the US don't follow the same Generally Accepted Accounting Principles (GAAP) and thus financial statement analysis can be challenging. Also, tax complications can occur when profits are made in other countries. Additionally, we have currency issues to worry about as investing in different countries means investing with different currencies and introducing exchange rate risk (the table above is reported based on US dollar returns). Finally, getting information and trading while the markets are open can sometimes be a challenge.

If we do decide to invest internationally, there are a few different ways to accomplish this.

International Mutual Funds and ETFs

International mutual funds allow us the advantages of international investing while letting a professional manage the currency, tax, and information issues. In addition to traditional mutual funds, there are Exchange Traded Funds that allow us to purchase a basket of stocks from a specific country that represent an index of that country's stocks. Note that while mutual funds eliminate the hassle of currency conversion, they are still affected by currency fluctuations.

Direct International Purchases

Most large brokerage firms allow their customers to make purchases of stocks outside the US. However, these purchases need to be made in a foreign currency which entails an additional transaction. In addition, investors may face additional tax issues. Finally, due to time differences, many foreign exchanges are open during inconvenient hours for trading. These complications make direct international purchases the most difficult method of international investing.

US Listed (ADR's) International Stocks

Many international companies are listed on the US exchange. Many of these are structured as American Depository Receipts (ADR's). These allow us to buy stock in many foreign firms (Nokia and Sony for instance) in the US markets. This eliminates many of the extra hassles. Specifically, our purchases are in dollars and trading takes place during normal US hours. As with the International Mutual Funds, the currency risk is not eliminated, merely the need for trading in different currencies.

Multinational Firms Based in the US

Finally, we might be able to get some of the same benefits by investing in companies with substantial international activities. For instance, Coca-Cola gets a substantial amount of its revenues and profits from outside the US and thus might provide us with some international diversification. Unfortunately, it appears that the benefits from investing in Multinationals are not as good (from a diversification standpoint at least) as other strategies for investing internationally.