

14.4: Investing Internationally- Risks and Regulations

Learning Objectives

1. Identify the unusual risks of foreign investing compared to domestic investing.
2. Discuss the use of the Economic Freedom Index.
3. Explain the role of international investments in an investment strategy.



Figure 14.4.1 . © 2010 Jupiterimages Corporation

Investing is global. While the financial markets and the capital markets may resemble a global village, it is also true that investing in assets governed by foreign standards and regulations creates additional concerns.

Investments in foreign securities are used to diversify an investment portfolio's economic risk. The United States, most nations in Europe, and Japan have highly developed economies. Other economies may be developing, such as India and China, or may be emerging, such as Nigeria and Bolivia, and may be using different strategies to achieve different rates of growth. The world economy is truly global, however, because although different economies may be in different stages of development, they are all intimately linked through trade.

Different economies offer different kinds of opportunities because of where they are in their progress toward free-market economic diversification and stability. Along with different opportunities, however, they also offer different risks.

These risks run the gamut from the challenge of interpreting information correctly to the risk that too much or too little regulation will interfere with market forces. International investing also embodies risks relating to foreign markets, economies, currencies, and politics.

Investment Information

A general concern in international investing is the flow and quality of information. You make investment decisions by gathering and evaluating information. That information is useful to you because you know how to interpret it, because you know the standardized way in which that information was gathered and prepared.

In the United States, financial statements are prepared using Generally Accepted Accounting Principles or GAAP, the rules that frame accounting judgments. Those statements may then be audited by an independent certified public accountant (CPA) to assure that the accounting rules have been followed.

In other countries, however, accountants do not use GAAP but prepare financial statements by somewhat different rules. Some of those differences relate significantly to asset valuations, a key factor in your decision to invest. When you read financial reports written for foreign companies, therefore, you need to remain mindful that they are written under different rules and may not mean

the same as financial reports following the U.S. GAAP. At the very least, you should determine whether the statements you are reading were independently audited.

Other countries also have different standards and procedures for making information available to investors. One reason that the SEC requires filings of annual and quarterly reports is to make information publicly and readily available. Other countries may not have such corporate filing requirements. Information may be harder to get, and the information that you do get may not be as complete or as uniform.

Other kinds of information are also important. A good brokerage or advisory firm will have analysts and researchers “on the ground,” tracking economic and cultural influences in foreign countries as well as corporations with promising earnings.

Market, Economic, and Currency Risks

Unless a foreign security is listed on an American exchange, you or your broker will have to purchase it through a foreign exchange. In the United States, a substantial volume of trade keeps markets liquid, except in relatively rare times of crisis. This may not be true on some foreign exchanges. In active major capital markets such as in Western Europe and Japan, there will be plenty of liquidity, but in some emerging markets, such as in Africa, there may not be. This means that your risk in holding an investment increases, because you may find it difficult to sell when you want to, just because the market is not liquid at that time.

Market risk also affects pricing. Market liquidity and the volume of trade helps the market to function more efficiently in the pricing of assets, so you are more likely to get a favorable price when trading.

Foreign investments are often used to diversify domestic investments just because foreign economies are different. They may be in different business cycles or in different stages of development. While the United States has a long-established, developed market economy, other countries may have emerging market economies with less capitalization and less experience in market-driven economic patterns.

Other economies also have different strengths and weaknesses, sources of growth and vulnerabilities. The U.S. economy is fairly well-diversified, whereas another economy may be more dependent on fewer industries or on commodities or natural resources whose prices are volatile. Prospects for economic growth may differ based on health care and education, tax policies, and trade policies. You want to be sure that your investment is in an economy that can nurture or at least accommodate growth.

Perhaps the greatest risk in international investing is **currency risk**, risk to the value of the foreign currency. To invest overseas, you may have to use foreign currency, and you receive your return in foreign currency. When you change the foreign currency back into your own currency, differences in the values of the currencies—the exchange rate—could make your return more or less valuable.

Tim decides to invest in a French business when the exchange rate between the euro (France) and the dollar (U.S.) is €1.00 = \$1.00. So, Tim buys €1,000 of the French company’s stock for \$1,000 (assuming no transaction costs for the currency exchange or for broker’s fees). One year goes by and Tim decides to sell the stock. The stock is the same price, €1,000, but the exchange rate has changed. Now €1.00 = \$0.87. If Tim sells his stock, even though its value has not changed, his €1,000 will only come to \$870. Tim has incurred a loss, not because the value of the investment decreased, but because the value of his currency did.

The exchange rate between two currencies fluctuates, depending on many macroeconomic factors in each economy. At times there can be considerable volatility. Exchange rates are especially affected by inflation, especially when the spread in exchange rates between two countries is greater. When you are investing abroad, consider the time period you expect to hold your investment and the outlook for exchange rate fluctuations during that period.

Political Risks

Governments protect an economy and participate in it as both consumers and producers. The extent to which they do so is a major difference among governments and their economies.

The government’s role in an economy influences its growth potential. When investing in a foreign company, you should consider the government’s effect on its growth. Economic and political stability are important indicators for growth.

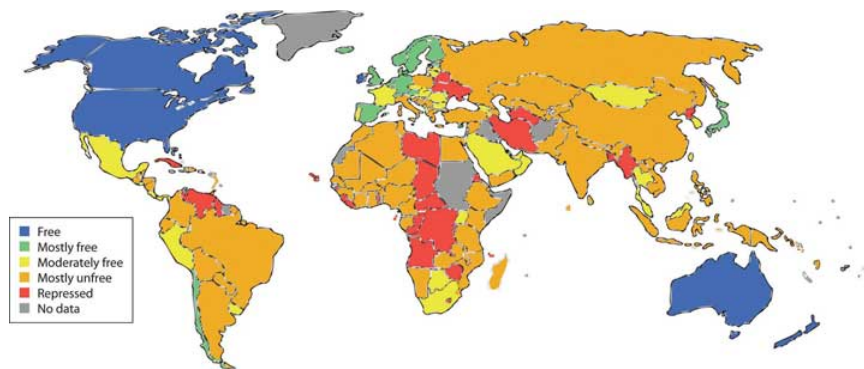
Because investing is long term, investors try to predict an investment’s performance, and forecasting requires a stable context. The type of economy or government is less relevant than its relative stability. A country given to economic upheaval or with a history of weak governments or high government turnover is a less stable environment for investment.

Market-based economies thrive when markets thrive, so anything the government does to support markets will foster a better environment for investing. While some market regulation is helpful, too much may work against market liquidity and thus investors. A central bank that can encourage market liquidity and help stabilize an economy is also helpful.

In 1995 the Heritage Foundation and the *Wall Street Journal* created the Index of Economic Freedom (IEF) to try to measure a country's welcoming of investment and encouragement of economic growth. Using data from the World Bank and the International Monetary Fund (IMF), the IEF is based on ten indicators of economic freedom that measure the governments' support and constraint of individual wealth and trade.

Figure 14.9 shows the Index of Economic Freedom compiled by the Heritage Foundation for 2009 (reproduced courtesy of the Heritage Foundation). The blue countries, notably the United States, Canada, and Australia, are the most "free" and the red countries (concentrated in central and sub-Saharan Africa, parts of the Middle East, and some states of the former U.S.S.R.) are the least.

Figure 14.4.2 2009 Index of Economic FreedomThe Heritage Foundation, "The Link between Economic Opportunity and Prosperity: The 2009 Index of Economic Freedom," <http://www.heritage.org/index> (accessed June 2, 2009).



Governments can change, peacefully or violently, slowly or suddenly, and can even change their philosophies in governing, especially as they affect participation in the global economy. Fiscal, monetary, and tax policies can change as well as fundamental attitudes toward entrepreneurship, ownership, and wealth. For example, the sudden nationalization or privatization of companies or industries can increase or decrease growth, return potential, market liquidity, volatility, and even the viability of those companies or industries. Because changes in fundamental government policies will affect the economy and its markets, you should research the country to learn as much as possible about its political risks to you as an investor.

Foreign Regulatory Environments

One of the largest political risks is regulatory risk: that a government will regulate its economy too little or too much. Too little regulation would reduce the flow of information, allowing companies to keep information from investors and to trade on inside information. A lack of regulatory oversight would also allow more unethical behavior, such as front-running and conflicts of interest.

Too much regulation, on the other hand, could stifle liquidity and also increase the potential for government corruption. The more government officials oversee more rules, the more incentive there may be for bribery, favoritism, and corruption, raising transaction costs and discouraging investment participation.

In addition to a body of laws or rules, regulation also requires enforcement and judicial processes to ensure compliance with those rules. If there is little respect for the rule of law, or if the rule of law is not consistently enforced or is arbitrarily prosecuted, then there is greater investment risk. Inappropriate levels of regulation lead to increased information costs, transaction costs, and volatility.

Often, foreign investments seem promising in part because economic growth may be higher in an emerging economy, and often, they are. Such economies often have higher levels of risk, however, because of their emergent character. Before you invest, you want to be aware of the political and regulatory environment as well as the economic, market, and investment-specific risk.

Summary

- The flow, quality, and comparability of information are concerns in international investing.
- Investing internationally may pose unusual risks compared to domestic investing, such as
 - market or liquidity risk,
 - economic risk,
 - currency risk,
 - political risk,
 - regulatory risk.
- The Index of Economic Freedom measures a country's economic environment, growth potential, and regulatory cost, which affect investment risk.
- Greater investment risks require more research to gauge their effects on an investment opportunity and the overall investing environment.

Exercises

1. Go to the Web site of the International Accounting Standards Board (IASB) at www.iasb.org/Home.htm. What is the IASB's mission? See www.iasb.org. What is the value of this mission for international investing today? What are the International Financial Reporting Standards (IFRS)? How could the IFRS strengthen the global economy and aid investors in the international markets? Read the 2009 Technical Summary at www.iasb.org/NR/rdonlyres/4CF.../Framework.pdf. Write a summary of the IASB's "Framework for the Preparation and Presentation of Financial Statements." If adopted by countries in which you wish to invest, how would this framework work to your advantage? Now read Investopedia's explanation of the differences between international accounting standards (IAS) and the generally accepted accounting standards (GAAP) used in the United States at <http://www.investopedia.com/ask/answers/05/iasvsgaap.asp?viewed=1>. What would be the advantage of every country having the same GAAP?
2. Use the currency converters at <http://www.xe.com/ucc> and <http://www.oanda.com/convert/classic> to sample differences between foreign currencies and the U.S. dollar. For example, how much is one euro worth compared to the U.S. dollar? On the foreign currency exchange what are the minimum bid and ask prices for euros? Did the price rise or fall compared to the previous day? Check foreign exchange rates at <http://www.x-rates.com>. Choose three currencies to compare with the American dollar (USD) and look at the tables or graphs showing the comparison history of those currencies. Which of the three currencies has been the most volatile? Which currency is presently closest to par with U.S. dollar?
3. Examine the Index of Economic Freedom at www.heritage.org/Index. What is economic freedom? In the 2009 Index, which economies are freer than the United States? Visit the World Bank at <http://www.worldbank.org> and the IMF at <http://www.imf.org/external/about.htm>. What role do these organizations play in international finance? For example, what is the World Bank doing to help increase investment opportunities in developing countries such as the Republic of Indonesia? How does the IMF seek to strengthen the international financial markets?

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