

# Fiduciary Perspective

## Fall 2006

### Investing Overseas

#### INTRODUCTION

Are you a U.S. citizen with your income and expenses denominated in U.S. dollars? Do you often wonder why then you should bother to invest overseas? In this day and age we all are affected by globalization. We work for multi-national companies, vacation overseas, and wear and use products made by international companies. However, interestingly enough, many of us still do not invest a representative percentage of our portfolios overseas. The purpose of this *Fiduciary Perspective* is to explain why international investing is an important part of a well-rounded portfolio.

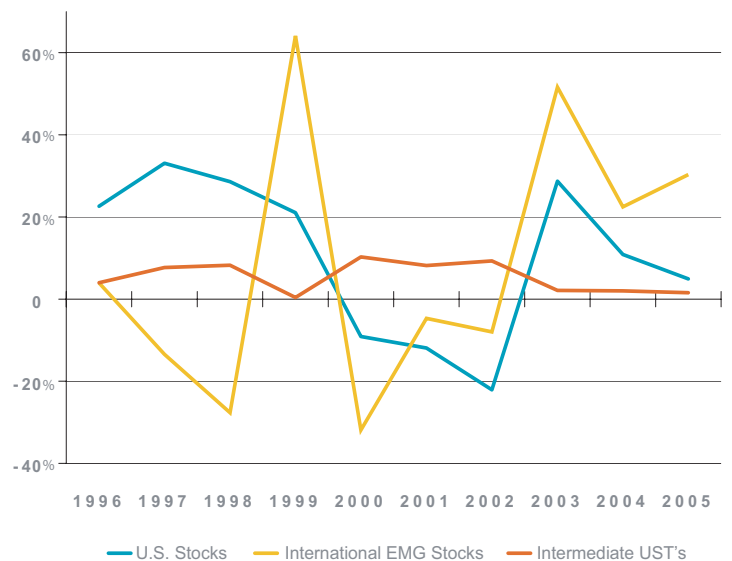
For the purposes of this article, we define international investing as buying and selling stock of companies located overseas whose business is done predominantly in currencies other than the U.S. dollar. We also include the purchase and sale of debt issued by international companies or countries and denominated in the local currency.

#### REASONS TO INVEST ABROAD

##### Diversification benefits

As an investor you want to make sure you have a well-diversified portfolio — one that has a variety of asset classes that do not perform in lock step with each other. In statistical terms, it means you want to have assets that are not highly correlated to one another. In Exhibit 1, you will see the rates of return for U.S. stocks, U.S. bonds and international emerging stocks from 1996 to 2005. The chart simply illustrates how various asset classes can perform differently from each other over various time periods.

Exhibit 1 - Asset Class Returns 1996-2005



Source: S&P 500, Lehman, Morgan Stanley

Having your entire portfolio in one asset class (i.e. U.S. stocks) is just another type of a concentrated portfolio. By investing in a number of different asset classes, you can reduce your portfolio's exposure to market risk or the systemic risk of any one asset class.

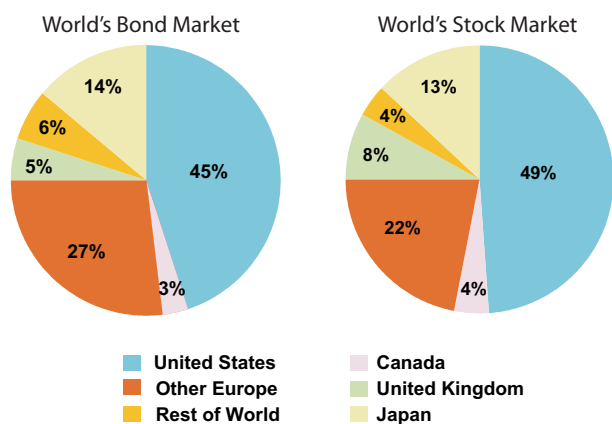
Allocating a portion of your portfolio to international securities provides you with a variety of companies, countries, and currencies, which then results in a well-diversified portfolio. This protects against having all your assets going up or down at the same time, thereby reducing the volatility of the portfolio. Although diversification is no guarantee against loss, it is a prudent strategy to adopt.

You may hear some people down playing the benefits of international investing because the correlations between domestic and international securities have increased over the years. While it is true that the diversification benefit has diminished somewhat because of the higher correlations seen in recent history, it has not diminished to the point where international investing adds no value. Despite higher correlations between U.S. and international securities, diversification is necessary. This is because investors do not know what the future will bring with respect to returns and volatility of various asset classes. If you knew what the future held you would not need to diversify your holdings. You would only need to own one asset — the one that was going to make you the most money. Unfortunately, that isn't the way it works!

**Attractive investment opportunities lie outside the U.S.**

Beginning in 1985, the total market capitalization of all non-U.S. stocks began to surpass the total of all U.S. stocks. Exhibit 2 below illustrates that at the end of 2005, more than 50% of the world's stock and bond market capitalizations were non-U.S.

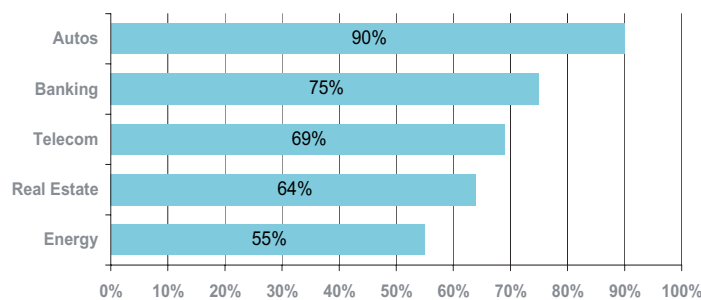
**Exhibit 2 - World's Stock & Bond Market Capitalizations Ending 12/31/05**



Source: Lehman, Financial Insights

Another important reason investors need to invest abroad is that the evolution of the global economy continues to reduce the dominance of American companies. This same point is true at an industry level.

**Exhibit 3 - Non-U.S. Share of Various Industries**



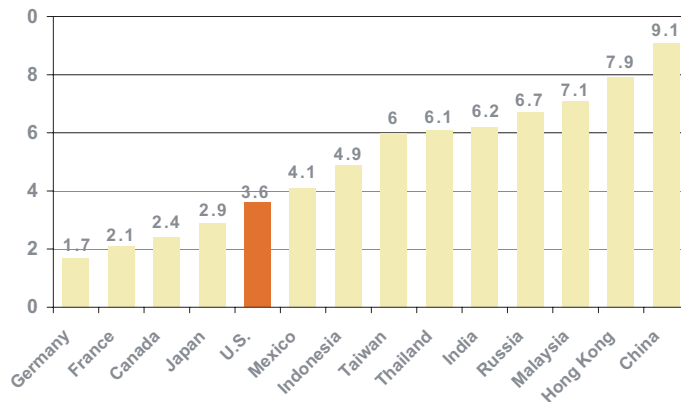
Source: Bernstein

In many industries, the greatest share of investment opportunities (based on market share) lies outside the U.S. By looking at Exhibit 3 above, you can see examples of that. For instance, 90% of the world's automobile industry is held by non-U.S. companies. It is no longer adequate to get international exposure in your portfolio by simply investing in U.S. multi-national companies. By including international stocks and bonds in your portfolio, you are greatly increasing your opportunity set and, in turn, your opportunities for attractive returns.

**Growth prospects are plentiful outside of the U.S.**

There are many countries in the world growing their economies at very fast rates. Exhibit 4 graphs the 2005 real GDP growth rates of various countries around the world.

**Exhibit 4 - GDP Growth Rates**



Source: 2005 CIA World Fact Book

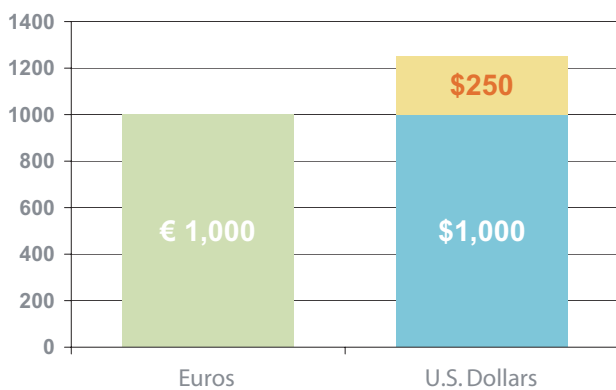
Notice the U.S. in red with a real GDP growth rate of 3.6%. Notice, too, that there are many countries around the world that are growing at much faster rates than the U.S. There are some emerging nations that have economic growth equal to two or three times that of the U.S. This economic growth often leads to compelling investment opportunities. As an example, strong commodity prices have helped countries that are big exporters of raw materials. The resulting inflow of capital creates new wealth, supports economic growth and leads to new return opportunities. As an investor, you want to capture some of that upside in your portfolio.

Another attractive attribute of investing overseas is that international interest rates are relatively low. This enables international companies to more easily finance growth and restructure balance sheets. Many of these companies are not fully valued and these catalysts can lead to stock price appreciation.

**Allows an investor to profit from a changing U.S. dollar**

Most currencies do not have a fixed value. They float relative to other currencies in the world. When thinking about international securities, it is important to know that international stocks and bonds trade and pay interest and dividends in their local currency. If that local currency becomes stronger relative to the U.S. dollar, your foreign earnings translate into more U.S. dollars, thereby improving your overall return on investment. This point is illustrated below.

**Exhibit 5 - Purchased Stock Forecast**



Suppose an investor, Mrs. Jones, is interested in purchasing shares of XYZ company which is located in Europe and trades in euros. Mrs. Jones decides to purchase \$1,000 worth of XYZ and at the time of purchase the euro and the dollar are equal to each other. A \$1,000 investment in XYZ will cost Mrs. Jones 1000 euros. For simplicity's sake, let us assume that Mrs. Jones holds the stock for one year and that the stock price does not increase during that year. When Mrs. Jones sells XYZ stock one year later, she receives back her original investment of 1000 euros. When she exchanges the euros into dollars Mrs. Jones expects to receive back her original \$1000, but to her surprise she receives \$1,250. Mrs. Jones discovers that even though the stock price did not increase, her investment in XYZ still generated a profit of \$250 because the euro had strengthened versus the U.S. dollar during the year.

At Fiduciary, we feel the U.S. dollar will continue to weaken relative to other major currencies for quite some time. Exchange rates, just like everything else in the world, are driven by supply and demand. If there are too many dollars in the world relative to the demand, the dollar will weaken. Three supply and demand drivers that continue to plague the U.S. dollar are interest rate differentials around the world, our country's trade deficit and our federal budget deficit.

Interest rates vary around the world. Investors often purchase bonds from the country that offers them the highest interest rate. Before these purchases are made, the investor must first buy the appropriate currency leading to an increase in demand for that currency which, in turn, can lead to an appreciation of that currency. This type of phenomenon has occurred in the U.S. over the last few years and is one reason the dollar has not depreciated more. With the Federal Reserve near the end of its tightening cycle and other central banks like the Bank of Japan and the European Central Bank at the beginning of theirs, it is likely that the interest rates offered by the U.S. will become less attractive over the next several years. This could lead to less demand for U.S. Treasury securities and therefore our dollar. This could eventually lead to a further depreciation of our currency.

The enormous trade deficit in the U.S. means that, as a country, we are buying more goods and services from foreigners than we are selling to them. As a result, the world has an overabundance of U.S. dollars or too much supply. Countries with large trade deficits will sometimes reach a point where they cannot attract enough new foreign investment to offset the imbalance. This can also lead to a currency's depreciation.

A large federal budget deficit, similar to the one the U.S. has, is an indicator that a country is not fiscally responsible. This is not a trait which attracts foreign investment unless interest rates rise significantly.

## RISKS TO INVESTING ABROAD

U.S. investors are familiar with the issues surrounding investing domestically. These all hold true for international investing as well, but there are a few important additional points.

**Political, economic and social instabilities** do occur, and it is difficult to understand how these will affect the capital markets. Often, turmoil in any of these areas causes price volatility in both the bond and stock markets.

**Fluctuations in currency exchange rates** can detract from an investment's overall return and add additional risk to the portfolio.

**Less publicly available information exists** for international companies both in terms of general information and accounting information. This makes a thorough analysis of an international security less likely and more difficult.

**International investing comes at a higher cost.** International data collection, research, and accounting systems are all more costly and this gets passed on to the investor via higher management fees.

Because of these issues, a long-term commitment to this asset class helps smooth out the inevitable bumps.

## WAYS TO INVEST

An investor can buy international shares directly via the foreign exchange they trade on. Instead of purchasing a stock from the NYSE, for example, one could purchase shares from the London Exchange. There are also many international funds available to investors. At Fiduciary, we spend quite a lot of time analyzing various funds to ensure we are selecting the very best ones for our clients. Some of the criteria we look for when selecting funds are compelling risk/return characteristics, excellent risk management, tax efficiency and, of course, competitive pricing. Lastly, if an investor were interested in investing in a particular country or region, there are funds designed to do just that.

## CONCLUSION

We want to reiterate two important points. First, adding international stocks and bonds to a well-balanced portfolio increases the opportunity for greater return while reducing volatility thereby improving the risk/return characteristics of a portfolio. Second, we live in a very big world and there are a lot of great investment opportunities overseas. As a U.S. investor you want to capture some of those opportunities — not ignore them.

The *Perspective* is a Fiduciary Trust publication in which its professionals share their best thinking on timely wealth management topics. This commentary was authored by Mary Elizabeth R. Drake, CFA, Vice President and Investment Officer. She also serves as a member of Fiduciary Trust Company's Investment Committee.

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