International Equities- Get Your Passport Ready

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Non-US equities account for more than half of the global equity markets, yet many investors have little to no exposure, even to the developed international markets. For a number of reasons, a well-diversified portfolio should include exposure to both developed and emerging markets. Reasons to consider the foreign markets include: added diversification, the potential for higher growth rates, and a chance to uncover attractive investment opportunities.

Diversification. When considering diversification, most often we think of investing in different asset classes such as stocks, bonds, commodities, real estate etc. Exposure to different countries and currencies can also diversify, as many times they do not move in synch with the US markets. Companies operating overseas may have a unique product set or a completely different customer base that will potentially respond differently to market forces. Diversification benefits are not as good as they used to be. Performance has become more correlated, particularly across the developed markets, due to global expansion, advances in communication and technology, and increases in money flows across borders.

Many investors avoid the stocks of foreign companies because they consider them to be too risky. An investor's risk profile should be considered when determining how much exposure to have, but often the diversification gained by adding an international component can reduce the overall risk of a portfolio. Or the risk of a portfolio will stay constant, but the returns will be higher given that same level of risk. No doubt there can be large swings in performance, particularly in the emerging markets, so an investor should understand that this volatility will exist.

Higher growth rates are anticipated from economies abroad. In addition there may be growth opportunities overseas not present in the US due to any number of economic factors. Exposure to different geographies, including the emerging markets, can help to boost returns if included as a piece of a well diversified portfolio.

Missed opportunities. International stocks are increasingly becoming a larger part of the investment universe. By allocating some portion of your investments overseas, you increase the likelihood of uncovering undervalued assets. It increases the chances of being in the right region at the right time. Investing solely in US based companies ignores three quarters of the world economy and more than half of all equities.

As is the case with any investment, determining how much exposure or the appropriate allocation is step one. International equity has two components: the developed markets and the emerging markets. Growth is generally expected to be higher in emerging markets, but they will face bumps in the road and most certainly greater volatility. Exposure to both the developed and emerging markets is recommended, but it's best to assess tolerance for this volatility when setting

the allocation. Above all, balanced exposure across business sectors is still a priority. Sector allocations should be appropriately weighted across both US and internationally owned companies in the portfolio.

International Indices. MSCI, Inc. publishes widely used indices that track different regions of the international markets and indices that represent the market as a whole. They have developed specific criteria to classify a geographic region as developed or emerging. MSCI reviews the list of countries each year for potential changes. The developed markets are countries that are most advanced and meet specific criteria for a strong economy, a liquid market, openness to foreign capital, ease of capital inflows and outflows, and a sustainable operational framework. Developed markets currently include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, New Zealand, Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, UK, and the US. Emerging markets are underdeveloped or developing economies that can be experiencing rapid growth. Emerging markets include: Africa, Eastern Europe, Latin America, Russia, the Middle East and Asia (excluding Japan, Hong Kong and Singapore).

Even if a portfolio holds only US domiciled companies, there can be some exposure to the international markets. Coca Cola, Exxon and GE for example have large scale operations abroad. Overseas expansion can be a major source of revenue and a primary driver of growth for a US company. Furthermore, factors that affect foreign companies will also have a similar impact on the overseas operations of US companies. So even if it appears a portfolio has zero international exposure, most likely it is exposed in some way. This should also be considered when establishing the international equity allocation.

How to Invest: For most investors the simplest way to invest internationally is to purchase foreign stocks that trade on the NYSE in the form of an American Depository Receipt or ADR, or by purchasing an international mutual fund or ETF. These options provide liquidity and offer the ability to transact in US dollars on US exchanges.

Higher costs. Expect to incur higher costs with any of these investments. Mutual funds, even lower cost index funds, tend to carry a higher expense ratio on any international fund due to higher transaction costs incurred by the fund. ADRs offers the convenience of purchasing single stocks and receiving dividends in US currency, so an investor does not have to make a foreign currency transaction. This comes with a small added ADR fee. Sometimes there will be foreign taxes assessed. Finally, certain countries impose withholding taxes on dividends if you elect to receive the dividend in cash. This can be avoided in most cases by electing to receive the dividend in the form of additional shares of the company's stock.

It may be a good time to review and potentially add international exposure to a portfolio as the markets have sold off this year and in general valuations are lower.