International Portfolio Investment

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Executive Summary

The focus of this paper is to analyze the feasibility of international portfolio diversification for a potential US investor with a moderate risk aversion. The first section includes the benefits of international portfolio investment with a special emphasis on the diversification aspect. The changes in correlations over different periods are discussed and the investments time horizon importance is stressed. The second section presents the additional costs incurred by maintaining an internationally diversified portfolio, including the risks and constraints involved. The conclusion contains a set of recommendations for a potential investor interested in internationally diversifying his portfolio.

Benefits of International Portfolio Investment

Investing internationally provides not only increased stability to a portfolio, but also potential higher yields with less risk. By investing in foreign securities, investors can participate in the growth of other countries and diversify the risk of a potential bearish US market[1]. Nevertheless, it is important to notice that on the long run international benchmark returns exceeding U.S. equity market returns is not the most important benefit of international investing. Actually, over the last 30 years, the Morgan Stanley Capital Index Europe, Asia, Far East (MSCI EAFE) has outperformed the S&P 500 by an insignificant amount (a little over 1% on average) [1]. Furthermore, a strong U.S. dollar and weaker foreign currencies undermined the returns to MSCI EAFE for U.S.-based investors, as illustrated in Figure 1 [2].
The most obvious advantage of international investing is the ability to reduce portfolio volatility (see Figure 2). The actual benefit derived from international diversification is a function of return correlation and volatility. If markets exhibit highly positive correlation, there is little one can do to diversify market risk. Correlations between various stock market returns globally are significantly lower than between various sectors in the same market [3]. It is important to realize that correlations are not stable over different time periods (see Table 1) and maintaining an international portfolio requires constant adjustment as the investment frontier keeps changing for different periods (see figures 2 through 8).
The increased pace of globalization has made international investments more accessible to general investors. Emerging markets in particular have begun to offer attractive investment alternatives as they become more and more accessible and they offer higher returns. Less than perfect correlations between national economies are also adding the advantage of decreasing risk by diversification. Nevertheless, the downside of globalization is that it leads to increased international trade and therefore increased correlation between countries' economies (see Table 2). Yet, investing internationally, especially if done so with a long time horizon in mind, is undoubtedly beneficial to investors.
Holding a well-diversified portfolio of leading global companies based in the United States is not sufficient. Companies with significant foreign currency revenue or expenses are concentrated in distinct industries and it is difficult to rebalance the sector exposure within an individual company [1].

International Diversification Costs

Even though these advantages appear attractive, the risks and constraints for international portfolio investment must not be overlooked since they might influence the investment decision considerably.

[1] 1977, 1984, and 1987 are just some examples of years when the U.S. market was bearish, while foreign markets were bullish, providing a counter balance for diversified U.S. investors

International financial investments are subject to currency risks and political risk [4], as well as a set of constraints such as taxation, foreign exchange controls, capital market regulations, transaction costs and required familiarity with foreign markets [3].
While it might look attractive to the investor to purchase some foreign stocks for his portfolio, this might not be feasible after all additional cost and risk are considered. The performance improvement as a result of international portfolio investment must be measured only after allowing for these risks. Political uncertainty, lack of company information, lack of liquidity, trading and custodial difficulties, confidentiality and insider trading problems, higher transactions costs compared with developed countries are all part of the additional difficulties involved when investing internationally.
International investment risks tend to be intensified in countries from the emerging markets in the Pacific Rim, Asia, Latin America, and former Eastern Bloc. Nevertheless, emerging markets, as a group, have much lower volatility than the individual markets because of low correlations between these markets. But even investing in emerging markets as a group no longer provides the degree of diversification that it previously did, as it becomes obvious that there has been a significant increase in the correlation between emerging markets and more developed markets, including the United States (see Table 2).

Conclusion

The most important step to be taken before making investment decisions is determining the degree of risk each particular investor is willing to take. Nevertheless, regardless of the amount of risk aversion involved, international diversification can provide undeniable benefits in the context of increasing globalization.
Even if investing in foreign securities is getting easier, there still exist significant barriers and complexities to this strategy such as transactions costs and lack of information. In the face of these obstacles it might be most sensible for the private investor to consider investing in international mutual funds - thus, a maximum of diversification can be exploited at low transactions cost and management fees.
Although the risks involved with foreign investments cannot be completely eliminated, there are ways of reducing those risks, such as blending international stocks into a U.S. portfolio and investing for the long term. It is important to realize that foreign investments should be made with a long-term strategy in mind. The investment time horizon is a key element in taking this decision. International stocks can be volatile – especially in the short-term – therefore, rather than buying international stocks to provide a possible short-term boost, they should be part of a long-term investment plan.
Out of the wide range of international investment opportunities, emerging economies have historically been characterized by high average returns and large volatility [5]. Nevertheless considering the low correlation with developed country returns inclusion of these markets in a portfolio will significantly reduce portfolio volatility and increase expected returns.

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