

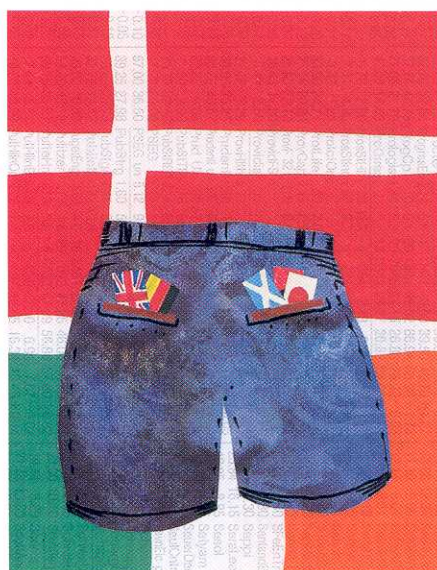
The Well-Traveled Portfolio

Limit your portfolio to nearly all domestic stocks, and you may limit your returns right along with it. Here's why

Philip Bullen

IN THE 1990S, INTERNATIONAL INVESTING lost almost all appeal for investors as U.S. equities enjoyed a spectacular run. A combination of rising price-to-earnings ratios, relatively good earnings, falling interest rates, and the promise of new technologies kept dollars, both from home and abroad, flowing to U.S. markets. Investors who bothered to look for overseas opportunities noted that U.S. markets outperformed international markets, as defined by the Morgan Stanley Capital International Europe, Australasia, Far East (MSCI EAFE) Index. In addition, there seemed to be increased correlation between the performance of U.S. and overseas markets. The result? The diversification benefits that international investing supposedly offered were not as noticeable. Investors questioned the validity of owning international stocks at all.

Ironically, international investments outperformed U.S. investments for most of the '60s, '70s, and '80s, as defined by the Standard & Poor's 500 stock index and the MSCI EAFE Index. Of course, the stellar U.S. market performance of the '90s is now a memory. And since 2000, domestic equities have underperformed international equities, market volatility has been higher in the United States, and correlations between domestic and foreign markets have softened. As a



result, the diversification benefits of international equities have again become apparent. Unfortunately, most investors did not have—and still do not have—enough exposure to international equities to reap these benefits.

Although foreign investments, especially those in emerging markets, may offer greater returns, they also present greater risks, including political and economic uncertainties of foreign countries and currency fluctuations. Still, the arguments for adding a larger mix of

foreign stocks to a portfolio are many—and convincing.

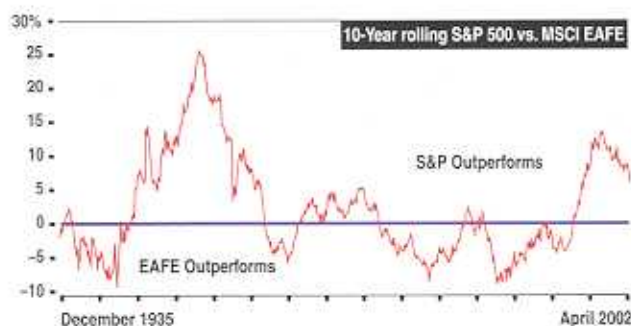
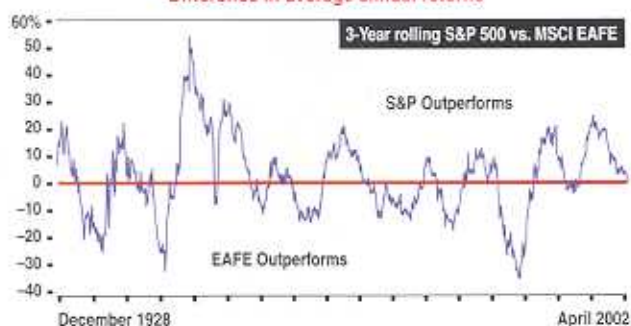
■ **Foreign markets have outperformed the U.S. equity market in the past, and the pattern of that performance is cyclical** “Clairvoyant analysts have no need for diversification.” Those famous words by Harry Markowitz, Nobel laureate and father of modern portfolio theory, get to the heart of why investors should consider increasing exposure to international equities. No performance of any asset class can be definitively anticipated because performance is cyclical. Figure 1 (see page 20) demonstrates this cyclicity by tracking the historical performance of U.S. stocks, as measured by the S&P 500 versus the performance of international equities, as measured by the MSCI EAFE Index. The charts show the rolling three- and 10-year performance of international stocks versus U.S. stocks.

Investors will, of course, have difficulty timing these swings in performance because there is substantial volatility in the three-year returns. Nevertheless, there are many periods in which investors frequently were better off investing

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FIGURE 1

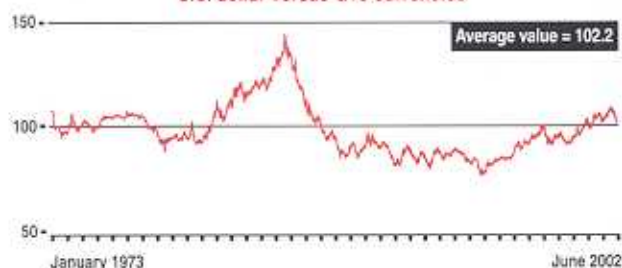
Difference in average annual returns



SOURCE: FMR Corp., Global Financial Data, 12/01.

FIGURE 2

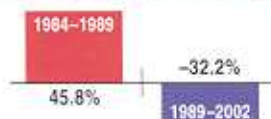
U.S. dollar versus G10 currencies



SOURCE: FMR Corp., Global Financial Data, 6/02.

FIGURE 3

Gain and loss in MSCI EAFE returns for U.S. investors attributable to movement in dollar's exchange rate



SOURCE: FMR Corp., Factset, 6/02.

FIGURE 4

Rolling three-year correlation and average absolute difference in return between U.S. and international markets

Low < 0.3	11.8%
High > 0.7	13.4%

SOURCE: FMR Corp.

in international stocks than in U.S. stocks. Indeed, during the three-year periods, international stocks outperformed U.S. stocks roughly 44 percent of the time. During the rolling 10-year periods, international stocks outperformed more frequently after 1975, albeit by a smaller margin than when U.S. stocks outperformed during the '90s.

In short, there have been many extended periods in which international stocks outperformed U.S. stocks—most notably, from the mid-'20s to the mid-'40s and from the early '70s to the mid-'90s (based on rolling 10-year performance). In some cases, the periods represent an investment lifetime.

■ **Currency trends can boost the returns of international stocks** U.S. investors in international markets may benefit from the impact currency fluctuations have on foreign stock returns expressed in U.S. dollars. In fact, the strength or weakness of the U.S. dollar versus other currencies is a key factor in determining how well U.S. stocks perform relative to international stocks (see figure 2, left).

The latest sustained period of time when international markets outperformed the U.S. market occurred in the mid- to late '80s, when the dollar was generally weakening compared with other investments. Specifically, from 1984 to 1989, international markets outperformed U.S. markets by more than 200 percent on a cumulative basis. Of this performance difference, 45.8 percent was attributed to the strength of other currencies against the dollar (see figure 3 left).

On the other hand, the exceptional performance of U.S. stocks versus that of international stocks in the mid- to late '90s corresponded with—and was partially caused by—a dollar that rose 45.8 percent against G10 currencies from 1984 to 1989. From 1989 to 2002, the dollar detracted 32.2 percent from the performance of international markets. Although the dollar weakened over the past year, it was still above its 30-year average versus other currencies as of April 30, 2003.

■ **In seven out of 10 industry sectors, the best-performing stocks during the decade ending in 2002 were those of overseas companies** And the companies that led each of those seven sectors were from seven different countries. In fact, investors who put money only in the U.S. equity markets miss out on roughly 45 percent of the world's total market capitalization and access to roughly 75 percent of the stock universe as defined by the Morgan Stanley Capital International World Index, as of year-end 2002.

Clearly, investing in international markets increases opportunities. Contrary to many Americans' assumptions, some of the largest and most successful companies in the world are not domiciled in the United States. That in itself argues loudly for the value of diversifying holdings across an array of countries, industries, and stocks. Investors who limit their investable universe exclusively to the United

States stand to narrow their opportunities for success, without gaining any advantages in return.

But many U.S. investors shy away from international stocks because they have limited knowledge of specific foreign companies. Certainly, no investor should put money into a company he or she knows little about. Yet as consumers, U.S. investors fill their homes with products manufactured by non-American companies. In fact, often the same companies they have avoided as investments make some of the best products in the world.

■ **Based on overall returns in the equity markets, the United States has been the top-performing region only twice in the past 15 years** This is all the more surprising given the great bull market the United States enjoyed during most of those years. And just as the overall historical performance of EAFE versus the S&P 500 has been cyclical, regional performance tends also to be cyclical. A region that's in favor one year tends to fall out of favor the next. Hence, an investor is best served by a diversified exposure across regions.

Changing economic conditions in many countries provide additional arguments for investors to include international equities. Many foreign economies continue to move toward deregulation and privatization—an environment that the United States has enjoyed for many years. With those changes comes the potential for stronger foreign-equities markets. In Europe and Asia, pension reforms mean that government-sponsored programs are giving way to privately sponsored programs. This should increase demand for equities in these regions. The continued integration of the European Union and its resulting growth as a more competitive economic force could also provide tremendous opportunities for returns.



periods (for instance, one or two quarters) while performing quite similarly the rest of the period. Also, assets can move in lockstep, with one outperforming the other only by small increments over short periods. But over the years, those small increments can accumulate into rather large differences in returns. Such differences have the potential to provide the diversification necessary to construct more efficient portfolios.

■ **Foreign markets have attractive valuations** Valuations and growth prospects in international markets provide further evidence that investors should consider increasing their allocations to international stocks. Two key stock-valuation measures, price-to-earnings (P/E) ratios and price-to-cash flow (P/CF) ratios, suggest that today overseas stocks are relatively inexpensive. P/E ratios are significantly lower in Europe, parts of Asia, and emerging markets than they are in the United States. In fact, the P/E ratios of stocks in Europe and the Asia Pacific excluding Japan are 19.4 and 19.0 respectively, approximately 30 percent lower than those of U.S. stocks. The P/E ratios for emerging-market stocks were about half that of U.S. equities.

The P/CF ratio also suggests that overseas stocks are relatively inexpensive. The average P/CF ratios for European, Japanese, and emerging-market stocks were 31 percent, 23 percent, and 40 percent lower

There have been blocks of time in which investors may have been better off owning a significant amount of international equities

Skeptics argue against international investing by pointing to recent increased correlation between the performances of U.S. markets and international markets. Causes cited include increased globalization, frictionless flow of funds across borders, and other factors. Perhaps more to the point and counter to conventional wisdom, higher correlations between U.S. and overseas equities do not necessarily imply similar returns. Analysis of the rolling three-year correlations between international and U.S. stocks since 1970 shows that in periods when correlations were highest (greater than 0.7), the absolute return difference between the two asset classes was, on average, 13.4 percent. When the correlation was lowest (less than 0.3), the absolute return difference was 11.8 percent. The obvious conclusion: Even in times of high correlations, there can be very meaningful differences in returns between assets (see figure 4, page 20).

Why does this happen? In a given three-year period, one asset can dramatically outperform another over short time

than the average U.S. P/CF ratio. An analysis of the price-to-sales (P/S) ratio confirms this conclusion.

Valuations describe the relative prices of stocks, but they don't provide much detail regarding the quality of the asset itself. Higher valuations, for example, might be justified by more reliable past earnings or higher expected future earnings. For each measure of earnings growth for the past five years, the United States was the second-lowest of five world regions. While emerging markets, Europe, and Asia Pacific averaged double-digit earnings-per-share (EPS) growth during the same period, U.S. EPS grew at about 8 percent.

As individual investors await recovery from a protracted bear market in the United States, there's no better time to recognize the value of non-U.S. stocks, reexamine their stock allocations, and begin including international equities in their investment mix. There is a big world past the borders of this country—a world that holds vast opportunities for advisers and investors who choose to expand their horizons. **WM**