

# KEYSTONE FINANCIAL PLANNING ELECTRONIC NEWSLETTER

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## **Go worldwide for best diversification**

The average American investor seems to have myopia about investing outside of the United States. That is a shame because diversification is the key to a successful portfolio, and foreign stocks and bonds offer tremendous diversification benefits.

Back in 2000—the last full year where more stock mutual fund shares were purchased than sold—domestic stock funds had net inflows of over \$24 billion from investors, show statistics gathered by the Investment Company Institute, a mutual fund trade association. International stock funds, meanwhile, gathered less than \$2 billion in new money. Last year, when bond funds were popular, international bond funds took in only \$400 million in new money, while domestic bond funds saw \$23 billion in net inflows. This shows that U.S. investors are giving disproportionate attention to domestic investments. Yet American investment assets—including stocks, bonds, money market instruments and investment real estate—only account for about half of the investable assets available throughout the world, show statistics gathered by Brinson Advisors, a subsidiary of the UBS Group.

A recent study of major world stock markets over a 150-year time period showed that there were diversification benefits to investing globally. The study by three professors at Yale University also showed that diversification varied in different time periods. In periods when there was a high degree of economic and financial integration worldwide—such as at the end of the 19th century and currently—international investors needed to put more money into new and developing markets in order to achieve maximum diversification.

Investors have two general choices for international investing: Developed countries, including those in Western Europe and Japan, and developing countries, such as those in Eastern Europe, Asia, South and Central America, and Africa. Investors should consider using both groups because each offers different diversification effects.

Buying individual international stocks is even more inefficient than buying individual domestic stocks. The costs of buying international stocks are higher and the logistics are more complex. Investors who try to solve this by buying American Depository Receipts—essentially foreign stocks traded on U.S. exchanges—get the least diversification effect.

Mutual funds that hold wide varieties of foreign stocks are probably the best bet. Numerous academic studies also show that passively managed international funds—those that buy a representative sample of each foreign market and don't make timing or selection judgments among stocks—beat the average actively-managed fund.

Investors should consider putting more of their equity investment in international stocks. Putting just 5% or 10% of a stock portfolio in foreign stocks is probably not enough. Most investors should consider investing between 20% and 50% of their equity portfolio in foreign stocks. They should also consider investing a small portion of their fixed income portfolio in international bonds.

There is a drawback to international diversification: the investor's portfolio will probably have different results than the commonly followed domestic stock indexes. Investors who diversify internationally should be prepared to suffer through periods when their portfolios lag behind the Dow Jones Industrial Average or the S&P 500 Stock Index. Such underperformance probably will be erased over the long-term, but can last for several years as it did in the late 1990s, causing pain for some diversified investors.

### **Low expenses are a key to mutual fund success**

It costs money to run a mutual fund and investors should gravitate toward funds that cost less than average to operate. Mutual funds as a class of investments are excellent low-cost instruments for most investors. But their low-cost average obscures those funds whose operating costs are significantly higher than average.

Operational costs detract from a fund's net return. A fund that earns 10% in one year and had operating expenses equal to 1% of assets will distribute a 9% gain to shareholders. Another fund that also earns 10% but has operating expenses of 2.5% will only distribute 7.5% to shareholders. Mutual fund expenses include everything from the cost of advertising and the cost of trading investments held by the fund to the cost of stuffing envelopes with quarterly statements for shareholders.

Costs are one of the few predictable performance variables when shopping for a fund. Investors should compare the costs of funds they are considering to appropriate benchmarks. A survey of costs from 1998 through 2002 using Morningstar Inc. data showed the large U.S. growth stock funds cost 1.18% of assets to operate while large value stock funds cost 1.04%. Here are other benchmarks to use when evaluating mutual fund costs: Small U.S. value, 1.22%; small U.S. growth, 1.39%; mid-cap U.S. value, 1.22%; mid-cap U.S. growth, 1.27%; large international value, 1.15%; large international growth, 1.47%; high quality domestic intermediate term bond, 0.84%.

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