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THE GURU'S CORNER

## Curb your enthusiasm

### Commentary: International equity funds warrant caution

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**NEW YORK (S&F) -- To read the news, placing investments abroad would seem to be a no-brainer -- but investors should tread carefully.**

Every day brings new headlines about our country's worsening trade deficit and budget deficits, on our dependence on foreign lenders to finance these and the resultant weakness of the U.S. Dollar, which is making new lows every day.

Meanwhile, the average international equity mutual fund is up 12.8 percent in 2004 through Wednesday, according to the Lipper International Index -- handily outpacing the 7.8 percent return of Vanguard's S&P 500 (VFINX: [news](#), [chart](#), [profile](#)) index fund.

#### Over the long term, international stocks match our own

From 1971 to 1989, international stocks (as benchmarked by the Morgan-Stanley EAFE Index) significantly outperformed the S&P 500 in U.S. dollar terms. However, from 1989 to 2002 the S&P 500 was much stronger. Since 2002 international stocks have regained the advantage. Over the entire period, the returns of both have been very close, with the S&P 500 slightly more profitable and slightly less volatile.

#### Diversification into foreign stocks disappoints

Holding a hypothetical portfolio of half EAFE and half S&P 500, rebalanced annually, since 1971 returned 0.1 percent per year less than the S&P 500 alone (in U.S. dollars, total returns). Drawdown in the diversified portfolio was slightly worse than for the S&P 500 alone, although by the academic risk measure (standard deviation of monthly returns) the diversified portfolio was slightly less volatile.

Given the absence of economical index funds tracking the EAFE during most of this period, the actual costs to an investor of diversifying internationally would probably have outweighed the modest benefits. Rather, the greatest potential benefit from investing in foreign stocks appears to depend on having a successful asset allocation strategy that identifies periods when foreign stocks are likely to outperform our own.

#### Weak U.S. Dollar helps international funds in 2003 and 2004

Most mutual funds that invest abroad do not attempt to hedge their exposure to foreign currency risk. As a result, even if a foreign stock market stays flat in terms of its local currency, investors from the U.S. can profit if the dollar falls.

From January, 2002 through the present, the U.S. dollar has lost 30 percent of its value, representing a rate of decline of more than 12 percent a year. During this period the average international equity mutual fund has gained almost 29 percent, while the S&P 500 index (total return) is up 10.3 percent.

The implication is that international equity mutual funds have benefited mightily from the weakness in the dollar -- far more than from strength in the world's major stock markets. A bet on continued strength in the foreign sector implicitly assumes that the dollar will not rebound significantly from current levels.

#### Dollar Index is near all-time lows

The chart below shows that the U.S. dollar is now near its lowest levels ever since currencies began to float against each other. The dollar bottomed out at similar levels in 1978, 1980, 1987, 1991, 1992 and 1995. The all time U.S. dollar low in 1992 was just 5 percent below current levels.



One factor that does bode poorly for the dollar is record trade deficits relative to total domestic production (GDP). On the other hand, inflation and federal budget deficits were worse in the past than is now the case. As a result, it is far from certain that the dollar ought to fall much further.

Bottom line: The history of the U.S. dollar index suggests that the U.S. dollar has more room to recover than to fall further, making it risky to hold international equity funds.

Of course past results do not predict any future level of safety or profitability.

Recommendation: Investors have not been rewarded over the long term by holding international equity funds in a fixed portfolio allocation. With the U.S. dollar near record lows, there is a good chance that this will continue to be the case. Long term investors should stick to U.S. stocks.

However, active asset allocators can bet on continued leadership by international stocks through the iShares MSCI EAFE Index fund ([EFA: news, chart, profile](#)), which has done a good job tracking the EAFE Index since inception in 2001. I recommend using a 10 percent buy stop in the U.S. dollar index as a signal to sell EAFE and return to U.S. stocks.

*Marvin Appel holds an academic doctorate in statistics. He applies his background in computer research and mathematical modeling to create asset allocation strategies for the Systems and Forecasts newsletter. Appel does not currently hold positions in EFA for himself or his clients, but may take such positions in the future. The recommendations here have not been formally back tested. ([systemsandforecasts.com](#))*

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