

## Should Your Mutual Fund Strategy Go International?

For investors watching their calendar year returns, 2006 was the fifth consecutive year that returns of domestic stocks trailed international equities.<sup>1</sup> While recent returns should not dictate how a long-term investor allocates a portfolio, those relying solely on domestic stock funds may want to consider adding an international fund.

### Reasons for Going International

Foreign stock and bond markets can potentially move independently from the U.S. financial markets — for example, when domestic stock prices are falling, other markets may be posting gains. For this reason, U.S. investors may reduce overall portfolio risk by combining domestic funds with international funds. If one declines in value in the short term, the other may increase or hold steady, which in turn may reduce a portfolio's overall volatility. In addition, including international investments in a portfolio provides greater exposure to the world's largest companies: In 2006, four of the 10 largest firms — Royal Dutch Shell, BP, DaimlerChrysler and Toyota Motor — were based outside the United States.<sup>2</sup>

**Options for Investors** If you and your financial advisor decide that international investing is for you, there are several options to consider.

Investing directly in foreign stocks poses several challenges for investors. Industry and company research may not be readily available, it may be difficult to compare accounting standards of foreign companies with those in the United States, and investors may need to commit substantial funds to build a diversified portfolio.

Mutual funds, in contrast, offer professional management and, depending on the fund's objective, immediate diversification among companies in many different countries or industries. In selecting individual securities, portfolio managers may draw on the investment firm's proprietary in-house research as well as analysis conducted by independent firms. Portfolio managers may also meet regularly with the management of companies that they invest in, as well as the firm's customers and suppliers, in order to gather information about the company's business prospects and assess the strength of its management team.

Global funds invest in foreign and domestic markets, while international funds invest only in developed foreign markets. Some funds invest only in a single country or region of the world. Emerging market funds focus on invest-

ments in smaller, less-developed countries.<sup>3</sup> Funds may also be defined by investment style, such as index, growth, or value.

### Approaches to Asset Allocation

Some diversified international mutual funds seek to invest in a variety of national markets using the Morgan Stanley Capital International EAFE index as a benchmark. Country weightings may reflect those of the EAFE index, which are based on each country's total market capitalization.

By the same token, other funds seek to enhance diversification by allocating assets among different industry groups around the world rather than just targeting individual countries: for example, investing in pharmaceutical companies in different countries. Their rationale for this approach is based on recent price movements of domestic and international equities: Since the 1970s, returns from both of these broad categories have increasingly moved in tandem, potentially justifying the need to diversify across industry groups that have not exhibited this trend.<sup>4</sup> Keep in mind that this is just one approach and it may not be right for every investor.

### Approaches to Asset Allocation

Earnings and capital gains on international investments are subject to income taxes assessed by foreign governments as well as U.S. income taxes. If you invest in international funds, you will receive a statement showing the amount of foreign taxes

paid on your shares. The United States has tax treaties with many individual countries, which may allow you to claim a credit on your U.S. tax return for taxes paid abroad.

### A Word About Risk

Virtually all investments carry a degree of risk and international funds are no exception. By themselves, international funds historically have experienced more volatility than domestic stock funds. In addition, international funds carry greater currency risk and political risk than their domestic counterparts. Yet despite these potential shorter-term issues, a modest allocation to international investments may bring the opportunity to share in the longer-term benefits that come with a global economy. Your financial advisor can help you determine whether international investing is appropriate given your situation and overall goals.

*This article is not intended to provide specific investment or tax advice for any individual. Consult me, your financial advisor, or your tax advisor with questions.*

<sup>1</sup>*Sources: Standard and Poor's; Morgan Stanley. Returns of domestic stocks are represented by the total return of the S&P 500, international stocks by the Morgan Stanley Capital International EAFE Index. Investors in international securities are sometimes subject to less liquidity compared with investors in domestic securities. Past performance does not guarantee future results and investors cannot invest directly in any index.*

<sup>2</sup>*Source: Fortune.com.*

<sup>3</sup>*Emerging markets are normally more volatile than the markets of more developed foreign nations, and therefore, you should consider this increased market risk carefully before investing.*

<sup>4</sup>*Source: Fortune, March 31, 2005.*

