



# Who Needs a Global Investment Portfolio?

**H**opefully, you're not bent on world domination. If you expected to casually thumb through an imperialist manifesto, you've been led astray by the title of this book. *Own the World* has nothing to do with conquering the world—unless you're referring to the world of global investing. But even if you were hoping to overthrow a government or two, you'd be well served to read on. Maybe you'll find expanding the horizons of your investment portfolio is just as satisfying as expanding your empire. As you'll learn, it's easier, cheaper, and involves significantly less bloodshed. All you need to do is embrace the myriad opportunities to manage risk and enhance performance offered by investing globally. No shady arms deals or knowledge of military tactics required.

Global investing can involve just about any type of asset. Italian cars, French wine, Greek sculptures, Australian bonds, Canadian

commodities, Hong Kong real estate—all legitimate options. But “legitimate” doesn’t mean appropriate. It’d be cool to sink some dough into a classic Ferrari Testarossa. But a fender bender puts a serious dent in your retirement plans. When it comes to investing, most folks should stick primarily to stocks, bonds, and cash. They’re sufficiently liquid, have reasonable transaction costs, and involve measurable risks. That doesn’t mean a Picasso can’t provide a decent return, but few investors have the means, know-how, or appropriate facilities to make *Garçon à la Pipe* viable. If you want to sprinkle in a few more exotic investments, do so with caution. Stocks, bonds, and cash should comprise the core of most investment portfolios.

## **THE MOST IMPORTANT QUESTION**

Stocks, bonds, or cash. But how much of each? A simple question, but vital. In fact, the answer will likely impact your returns more than any other decision. It’s true. The asset class you choose is more important than anything you can learn about global investing. But even a perfect asset allocation will fall flat if you’re not investing correctly. Just buying a few stocks isn’t the right way to play the stock market. And owning a corporate bond or two isn’t a good fixed income strategy. *Diversification* and *risk control* are essential components of any well-constructed portfolio. This book’s aim is to show why global is the best way to invest, but it can’t determine which asset allocation is most appropriate for you. Why? Because that decision requires a thorough analysis of your personal circumstances—namely your investment objectives, cash flow needs, and time horizon. But there are really only three major investing goals for the vast majority of people. Most want their portfolios to:

1. Grow over time.
2. Provide income.
3. Do some combination of numbers 1 and 2.

The appropriate allocation for each goal will depend on a number of considerations. But generally, if you want more growth, and have a long time horizon, hold more stocks. If you require more income, you may need some bonds or even cash. Or maybe not—depends on how much cash flow you need and your time horizon. But most folks requiring income still need some stocks.

What about risk tolerance? Shouldn't risk tolerance factor into this decision? Not without first defining *risk*. As covered in Chapter 3, *investment risk* usually means *volatility*. But there's also the risk you won't meet your investing goals. The fact investing in stocks makes some people uneasy doesn't change the fact stocks almost always have superior long-term returns.<sup>1</sup> As you'll read, investing globally can help mitigate some, but not all, of the volatility associated with stocks while still capturing stocks' growth potential. For most, stomaching the volatility inherent in stocks gives them the best chance of achieving their growth objectives. So unless stock market volatility is affecting the proper functioning of some of your vital organs, don't let nervousness about short-term market volatility get in the way of achieving your long-term goals. Besides, stocks might not be as risky as you think.

### **Stocks Are Safer**

Many investors mistakenly think bonds and cash are "safe" because, near-term, they can be less volatile than stocks. If they need income, folks believe they should own few stocks if any at all. But this is usually very wrong.

Why? Stocks pretty much always outperform bonds and cash over any significantly long time period. If you look at 20-year periods throughout history, stocks trounce bonds almost every time. It isn't just US stocks; it's true of stocks in most countries. Table 1.1 compares returns on stocks versus government bonds for various countries over 20-year periods from 1926 through 2007 (i.e. 1926–1946, 1927–1947, etc. UK data starts in 1932). As you can see, stocks outperform bonds far more often than not.

**Table 1.1 Stocks vs. Bonds**

Country	Frequency of Stocks	Average 20-Year Return	
	Outperforming Bonds	Stocks	Bonds
US	98.4%	924.9%	243.5%
UK	100.0%	1,302.1%	432.2%
Japan	82.3%	3,066.0%	284.7%
Germany	77.4%	481.7%	196.7%

Source: Global Financial Data.

## How to Win in Vegas

Not only do stocks usually outperform bonds over the long-term, they do so by a wide margin. In America, stocks' average 20-year return since 1926 beats bonds almost four to one! I hate investing-gambling analogies because there's a huge difference between the two—at least when investing correctly. But imagine walking into Caesar's Palace, and in addition to normal slot machines, blackjack, and craps tables, they offer a game paying four times your money 98 percent of the time. If that game existed, you'd play until the pit boss had to hock his watch, his home, and his first-born child. Stocks' historical long-term returns mean stocks should comprise a significant portion (if not the bulk) of most investment portfolios—unless you have a very short time horizon or zero desire for growth (i.e., probably not you). And as demonstrated in this book, if it makes sense to own stocks, it makes sense to invest globally—always. Ergo, it makes sense for virtually all investors to make global stocks a meaningful part of their portfolios.

## “HOME, SWEET HOME” BIAS

Many US investors invest solely in domestic stocks. Stock ownership is the American way! Often, our preference for US stocks begins at an early age. Maybe your grandparents gave you a few stock certificates as a kid, hoping you'd become a young tycoon. But no matter when they start, most folks begin with well-known US companies.

Stocks like Coca-Cola, General Electric, General Motors, or Procter & Gamble may have comprised your fledgling portfolio instead of Toyota, British Petroleum, or Nokia.

And why shouldn't most investors' first inkling be to invest only in the US? For a long time, sticking with US stocks was probably very rational. For much of modern history, hurdles to foreign investing were relatively high—particularly for individual investors. But the investing world is changing rapidly, and the majority of these hurdles have toppled like the Berlin Wall, making foreign investing easier than ever.

### **Where Has Global Investing Been?**

You may have heard investing outside the US is difficult, time consuming, and requires special skills and experience attainable only by hacking through foreign jungles with a machete. Some of that may have been true in the past, but global investing has changed dramatically in recent years. Today, foreign investing is barely more difficult than investing in US companies.

Many mature markets have been open to foreign investors for years—make that centuries. The Dutch East India Company first tapped investment dollars by listing shares on the Amsterdam Stock Exchange in 1602. But equity market liberalization in many places is relatively new. Capital markets in many countries are still developing, and some countries place significant restrictions on foreign investing. But even investing in countries welcoming foreign investors has involved a number of challenges.

**Getting the 411.** Getting your hands on information about foreign markets was difficult. Since the first ticker tape machines tapped out stock prices in the late nineteenth century, information about stocks listed on US exchanges has been relatively easy to obtain. But foreign stocks were a different story. Pricing information wasn't timely. Accounting standards weren't uniform. Press releases and earnings announcements often weren't translated into English. Foreign news

sources weren't readily available. As a result, getting up-to-date, accurate information about foreign markets meant speaking a dozen different languages and even traveling the globe looking for investing opportunities.

**Border Patrol.** There were also few vehicles enabling US investors to easily invest abroad. In 1990, only 122 mutual funds deemed "global" or "international" (more on that dreaded word shortly) were available in the US.<sup>2</sup> Exchange-traded funds (ETFs) didn't even exist in the US until the mid-1990s. And buying foreign shares not traded on US exchanges usually required establishing accounts with foreign brokerage firms which could be onerous and costly. Some institutional investors weren't even allowed to invest overseas because they perceived foreign investing as not only risky, but unpatriotic!

### **Global Markets Are Now Open for Business**

The current environment is much different. Most countries have realized the benefits of opening their markets to foreign investors. Foreign companies benefit because availing themselves to the large pool of global capital can reduce the cost of raising money. If more investors are interested in investing in a firm, it can usually raise money at more favorable terms. Additionally, global investors often provide technology and expertise to firms that need them. These realizations led many formerly closed markets to embrace global investors with open arms.

We now have better access to information about foreign economies, markets, and companies, thanks largely to the Internet. For those with a modicum of computer savvy, information on foreign countries and stocks is a mouse click away. Foreign firms provide financial information, annual reports, press releases, and a host of other relevant information right on their websites. If you prefer the ink and pulp medium of newspapers, you can have any number of foreign newspapers delivered to your door. As an added bonus for those who don't speak Farsi, these are usually translated into English. Foreign executives are wise to the fact that the more people who can read about their firms, the more foreign investors they're likely to attract.

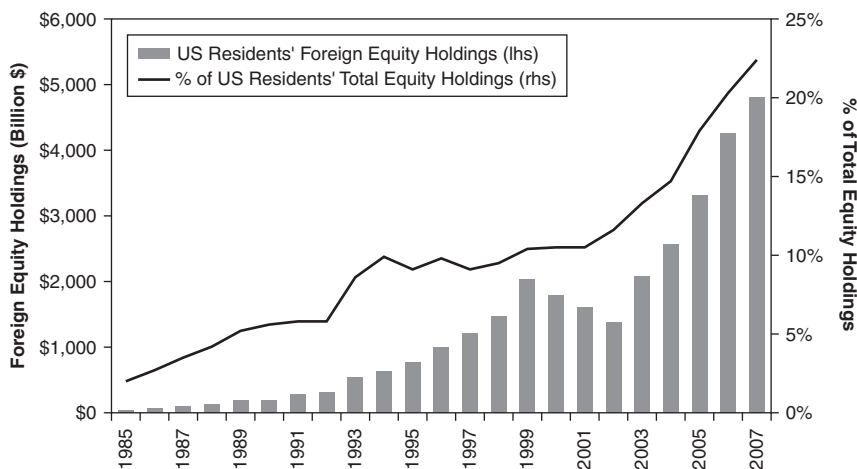
There are also more ways to invest abroad than ever. There are now thousands of foreign investments easily available to US investors. Chapter 7 looks at some of these in greater detail. And global exchanges are integrating at a rapid pace, so investors have much greater access to investments on exchanges around the world. In 2006, the NYSE Group, operator of the New York Stock Exchange, merged with Euronext N.V., one of Europe's largest exchanges, to form NYSE Euronext. In 2007, the London Stock Exchange merged with the Borsa Italiana S.p.A., Italy's primary exchange. In 2008, the NASDAQ Exchange merged with OMX AB, which operates exchanges in Nordic and Baltic countries, to form the NASDAQ OMX Group. Incidentally, Borse Dubai, operator of the two main exchanges in the United Arab Emirates, holds significant stakes in both the NASDAQ OMX Group and the London Stock Exchange. These are just a few examples of the wave of mergers and partnerships among global exchanges. All this integration means investors can more easily buy and sell stocks in far-off lands.

### **We Still Don't Get It**

Despite the increased ease of foreign investing, US investors remain woefully underexposed to foreign stocks, as shown in Figure 1.1, which illustrates US investors' total foreign equity ownership.

US investors in aggregate have over \$21 trillion invested in stocks,<sup>3</sup> but only \$4.8 trillion, or 22 percent, is allocated to foreign stocks.<sup>4</sup> This is a significant increase from just a few years ago, but still far from reflecting the composition of global equity markets.

A more detailed description of the global landscape is forthcoming in Chapter 4, but the value of US stocks comprises less than 50 percent of all tradable stocks in the world. Less than half—that's it! Don't put away your red, white, and blue "We're #1" foam finger just yet. The next biggest market, currently Britain, is less than one quarter the size of the US. In fact, you'd have to combine all the stocks in the next 10 largest countries to equal the market capitalization of the US.<sup>5</sup> We're not only number one—we're number one by a huge margin.



**Figure 1.1 US Investors' Foreign Allocation**

Source: US Department of the Treasury.

As such, US stocks should play a prominent role in both US and non-US investors' portfolios. But the optimal mix of foreign and domestic stocks should be driven by the market capitalizations of the countries making up the world. In other words, if America is 45 percent of the world stock market value, Britain 11 percent, and Djibouti 0.00003 percent, you should generally hold about 45 percent US stocks, 11 percent UK, and 0.00003 percent Djibouti (that is, if you find a Djibouti stock—if not, you can easily skip Djibouti).

You needn't rigidly adhere to this mix. If you're not so optimistic about US stocks, you might put less than 45 percent in the US. Or, if you think the US will do great, you might own more than 45 percent here. Later chapters will show that a number of different strategies or factors might cause you to include more or less of certain countries. But the relative sizes of stock markets in each country should serve as a starting point.

Believe it or not, foreign investors need global diversification even more than we do in the US. As an American, half of your portfolio in your home country is still a sizable portion. But imagine a British investor trying to properly diversify globally. A Brit would invest only 10 percent or so of his portfolio at home. And the UK is the second

largest market! Investors in smaller markets need to send even greater portions of their portfolios abroad. It might seem difficult, but it's the right thing to do.

If investors around the world were properly diversified, US investors would only own about 45 percent of US stocks and non-US investors would own the rest. Yet we collectively own far more. So not only do we own too many US stocks, but foreigners own too few! A preference for stocks in our home country isn't a trait exclusive to US investors. Investors in most countries usually keep more of their portfolios at home than they should. This is commonly referred to as *home bias*.

It's a universal truth—biases are bad in investing, and a home bias is no exception. Any investment decision based on your political leanings, sports teams, favorite color, or astrological sign will undoubtedly cause you to overlook great investment options elsewhere. Do yourself a favor: Keep biases far, far away from your investment portfolio. They can cost you. So what causes this home bias?

### Definition

#### Home Bias

*Home bias* is the tendency for investors to favor stocks in their home countries. A US investor owning mostly US stocks has a home bias toward the US. Same with a French investor owning mostly French stocks, a Portuguese investor owning mostly Portuguese stocks, an Aussie favoring Australian stocks, and so on.

## Dreaming of Far Away Places

Many factors shape our preference for domestic stocks. One of the most fundamental factors is our perception of foreign countries. When many investors think about things foreign, investing isn't their focus. What do you think of when your mind wanders to foreign environs? Is it that trip to Europe you took after college, lugging your backpack from hostel to hostel, soaking up the culture all the while trying to figure out how to order a Big Mac in German? Or is

it your honeymoon in Tahiti, sipping fruity cocktails on the beach, concerned only about the adequacy of your sunscreen's SPF? Unless you travel abroad regularly for work, your perception is probably that foreign lands are romantic and leisurely. On trips overseas, we're trying to put the stresses of everyday life behind us and enjoy the relaxed side of life. Worries about sales figures, paradigm shifts, out-of-the-box thinking, and action items are reserved for the US of A.

Or you may have the opposite opinion of foreign countries. Often, our view of foreign lands is shaped by the snippets we see on TV or read about in the paper, and they can be less than glowing. As a result, you might see foreign countries as places where most drivers are on the wrong side of the road and the water isn't safe to drink.

Close your eyes and think of France. Do you see the Eiffel Tower and the Arc de Triomphe or the home of the world's largest utility? Does the UK make you think of Buckingham Palace or global banking behemoths financing infrastructure projects in emerging markets? Is South Korea a country in a continual standoff with its neighbor to the north or the domicile of one of the world's largest electronics companies? Truth is foreign countries can be vacation spots or nightly news fodder, but they're also homes to some of the world's best firms. Yet most Americans confine their search for investment options to our borders.

### **Ignore Mr. Wisdom**

Conventional wisdom is partly to blame. Conventional wisdom tells us somewhere between 10 and 20 percent of a US investor's portfolio should be allocated overseas because foreign is too "risky." This begs the question: Who is this Mr. Wisdom, and why is he qualified to advise you on your portfolio allocation? Wasn't it Mr. Wisdom who once said the earth was flat? Didn't Mr. Wisdom assure us humans couldn't fly?

Once again, Mr. Wisdom is leading us astray. Recommending a mere 10 percent to 20 percent allocation to foreign stocks is way out of line with global equity market make-up. Is Mr. Wisdom arbitrarily

excluding an entire hemisphere? Even a bias toward companies domiciled east of the Prime Meridian or north of the equator still wouldn't result in an 80/20 allocation. Frankly, we have little respect for Mr. Wisdom's advice, especially as it pertains to investing. And this recommendation by Mr. Wisdom is no exception.

### **We Like What We Know**

Home bias also results from investors' preference for investing in companies they know. Most US investors would rather own shares of General Electric, a well-known US industrial conglomerate, than shares of Siemens, a comparable German company. Many of us have seen and maybe even used a Caterpillar tractor, but few of us have even heard of Komatsu—a Japanese company and one of Caterpillar's main competitors. And that catchy Intel jingle warms our hearts while the thought of owning shares of Taiwan Semiconductor leaves us cold. Despite our affinity for familiar, home-grown companies, we all utilize products made by foreign companies on a daily basis—often without knowing it. (Chapter 2 covers some of the foreign goods and services many of us use every day.)

### **Bigger Isn't Always Better**

The aforementioned grand size of US equity markets may also inhibit foreign investment. If our skies are so spacious, our plains so fruited, and our stock markets so large, why even consider looking abroad? There are so many perfectly good stocks to choose from right here! Can't you build a perfectly good, well-diversified investment portfolio of US stocks?

Believe it or not, as great as America is, the best investment options aren't always in the US. Judging by size alone, some of the world's largest stocks in a number of sectors are located abroad. By market value, the largest energy, banking, and telecommunications companies are Chinese; the largest Materials company is Australian; and the largest food company is Swiss.<sup>6</sup> And the landscape continues evolving. Just five years ago, 8 of the 10 largest companies in the

**Table 1.2 Largest Global Stocks**

Company (2003)	Country	Company (2008)	Country
General Electric	US	PetroChina	China
Microsoft	US	ExxonMobil	US
Pfizer	US	General Electric	US
ExxonMobil	US	China Mobile	Hong Kong/China
Wal-Mart Stores	US	Gazprom	Russia
Citigroup	US	ICBC	China
Johnson & Johnson	US	Microsoft	US
Royal Dutch/Shell	Netherlands	Petrobras	Brazil
BP	UK	Royal Dutch Shell	Netherlands
IBM	US	Berkshire Hathaway	US

Source: Shlomo Z. Reifman, "The Global 2000," *Forbes*, July 21, 2003; Scott DeCarlo, "The World's Biggest Companies," *Forbes*, April 2, 2008.

world were US companies.<sup>7</sup> As of this writing, that number was down to four. Table 1.2 shows the 10 largest companies by market value in 2003 and 2008.

Obviously, being the biggest doesn't necessarily mean they're the best, but the changing make-up of the world's largest stocks is a clear indication foreign companies have become significant, if not dominant, players on the global stage.

### **Mythical Multinationals**

What about all those big US multinationals? Many US companies generate significant amounts of revenue overseas. In fact, as highlighted in the next chapter, some of the largest, best-known US corporations derive more sales outside the US than they do here at home. Doesn't investing in these companies give investors exposure to foreign markets?

Simply, no. Conditions where a firm is domiciled have major impacts on its stock performance. A US firm selling popsicles in Spain will benefit from a heat wave on the Iberian Peninsula. But that doesn't mean the stock will act like a Spanish stock. On the contrary, US multinationals tend to act more like US stocks than foreign stocks, even when doing significant business abroad (you'll see this illustrated in Chapter 3).

Domestic economic, market, and political conditions impact a nation's stocks no matter where they operate. For instance, changes in US capital gains tax rate don't discriminate between US-domiciled firms garnering profits primarily at home versus those operating significantly overseas. Similarly, the interest rate environment in the US impacts most US companies in one way or another. The same is true for every nation. Japanese multinationals act like Japanese stocks; Djibouti multinationals act like Djibouti stocks.

### **Global Investing Isn't as Scary as You Think**

Arguably the most significant contributor to home bias is the all-too-common perception foreign stocks are more risky than US stocks. Investors' impression of foreign markets is punctuated by periods of well-publicized turmoil: the Mexican peso devaluation of 1994; the Southeast Asian Financials Crisis of 1997; the Russian debt default of 1998. All headline grabbers, well-chronicled in investing lore, forever contributing to our fear of foreign markets just as the *Friday the 13<sup>th</sup>* movies make us sure a trip to summer camp will involve a masked madman emerging from the nearby woods.

What didn't make headlines is that from 1994 through 2007, Mexican stocks have provided average annualized returns of 16.1 percent (versus 11.2 percent for US stocks.)<sup>8</sup> Since Asia recovered from its financial crisis, stocks in many Southeast Asian countries have soared. In Thailand, the epicenter of the crisis, the Stock Exchange of Thailand Index has had 15.3 percent average annual returns.<sup>9</sup> Indonesia's Jakarta Index has returned 20.4 percent per year, and the Philippines Kuala Lumpur Index has climbed 12.7 percent annually. These all trump annual US returns of 1.7 percent per year over the same period. And the Russian stock market, still nascent at the time of the country's debt crisis, has been booming in recent years, providing investors with average annual returns of 50.1 percent since 1998.<sup>10</sup>

Those markets zigged while our markets zagged. Why? Because many conditions impacting stocks in one country or region are confined

to that specific area. A discussion of correlations among different countries and the impact on investment risk follows in Chapter 3, but for now, take my word for it—investing in both zigging and zagging markets is a good thing because it can actually reduce risk, which is exactly the opposite of what most investors believe.

## **WE'RE NOT ALONE OUT THERE**

As stated earlier, inadequate global diversification isn't a US-only trait. Quite the contrary. Investors in virtually every nation have home biases to varying degrees.

At one end of the spectrum are Chinese investors. In China, government capital controls prevent virtually all citizens from buying anything but Chinese stocks. Similarly, foreign investors have limited access to Chinese shares unless they're listed outside China's mainland exchanges. Chinese investors have a state-induced home bias.

On the other end of the spectrum are the citizens of Luxembourg. Why Luxembourg? First, who doesn't love to use the ethnonym "Luxembourger"? Second, Luxembourg's market packs a disproportionately large punch for its size in terms of the total value of shares traded there. The Luxembourg Stock Exchange (or Bourse de Luxembourg for those of you who *parlez-vous français*) has 261 firms with shares listed, but only 34 are actually Luxembourg-based.<sup>11</sup> A single firm—steel producer Arcelor Mittal—accounts for over 70 percent of the combined market value of those 34 issues. Add the next two largest, and these three make up about 90 percent of the total value of domestic, publicly traded Luxembourgian companies. Imagine the plight of the poor Luxembourger. She can either sink her entire nest egg into these few stocks or she can look abroad for investment options. The first path leaves her with a poorly diversified portfolio, heavily weighted to a single economic sector. The second provides her with tens of thousands of companies to choose from.

The choice seems simple. But like us Yankees, Luxembourgers express a degree of home bias as well. In fact, to varying degrees, investors in virtually every country have dedicated a larger proportion

of their investment dollars (or yen, pounds, or euros as the case may be) to stocks in their home countries than the composition of global equity markets would prescribe.

## GLOBAL ISN'T INTERNATIONAL

More and more investors and investment advisors are catching on to the benefits of global investing, but few get it right. There's a lot more to global investing than buying a few stocks with an *n̄* or *ü* in the name. Many even get the terminology wrong by equating "international" investing with "global" investing. By definition, if something is *international*, it involves multiple countries but not necessarily all countries. By contrast, *global* includes everything on the planet all the way down to the magma. So while an "international" portfolio might have a smattering of non-US investments, a "global" portfolio avails itself to investment options throughout the globe. As such, a true global approach requires a thorough analysis of the composition of global stock markets.

Once you know something about the countries, sectors, and industries that comprise global markets, you can use that information as a guide to building a global portfolio. The approach you take can be either *active* or *passive*.

### Definition

#### Active or Passive

Investors can be either *active* or *passive*. *Active* investors try to build portfolios that do better than the overall market by choosing investments they think will be better than average. Active investors might concentrate their portfolios in countries, sectors, or individual stocks they expect to outperform the broader market. Of course, things don't always work out the way active investors expect, often causing them to do worse than the market. By contrast, *passive* investors simply try to match the performance of the market. It's often difficult for passive investors to track the market perfectly, but they try to get as close as they can.

The passive approach is relatively easy. You simply construct a portfolio that tracks global markets as closely as possible (less fees, of course) and leave it alone. Go on vacation, take up a hobby. An occasional peek at your account statement and a few adjustments every once in a while are the extent of your required involvement. For the most part, the portfolio takes care of itself. In fact, you may not need to buy a single individual stock! The downside is you're likely to underperform global markets, year in and year out, thanks to fees—but not by much if you do it right.

If the active approach is your cup of tea, you're in for a little more work. Expanding your investment horizons overseas means expanding the number of factors you must consider. But in return, you'll have many more opportunities to add value and manage risk. Both of these strategies will be covered more in depth later in the book.



### The Global View

If you expected this book to tell you which countries are going to provide the best returns over the next several years, you're in for a disappointment. The investment world is a dynamic place. By the time this book is written, edited, and hits the bookstore shelves, the environment is likely to have changed. What this book does is give you the tools required to monitor and analyze global economies and markets yourself.

Global investing not only bestows innumerable benefits on your investment portfolio, it just might teach you a thing or two you didn't know about this wide world of ours. The journey is part of the reward, as they say. So read on, enjoy, and tread confidently into the world of global investing so you too can *Own the World*.