It’s the Fourth of July … a hot summer day in a sleepy town somewhere in the heart of America. The picnic table is piled high with hot dogs and burgers. The cooler is stocked with beverages. The kids finish their second round of chocolate milk and take off for another run around the yard. You snap a picture to capture the moment and then call your significant other, who’s on the way to the store in the family car, to mention you’re out of aspirin.

Sounds as American as apple pie, right? Only now let’s think about the companies that could be part of this Fourth of July scenario. Some of the products (for example, the beverages, camera, mobile phone, car and medicine) could actually be domiciled overseas.

The world is getting bigger and bigger – and yet, from an investor’s point of view, it’s never seemed so small.

How does one gain access to global markets? One answer is investing in international funds. Just like domestic equity funds, international funds can invest up and down the market cap and across various styles.

Perhaps the best gauge of the world’s overall equity market is the MSCI All Country World Index. This is a weighted index that includes 45 countries (24 developed and 21 emerging markets). It’s important to note that the relative weights of the countries in this index have changed in the last several years. The United States made up more than half (52.5%) of the global stock market at the end of 2003. By March 31, 2011, this weighting shrunk to just 43%, with well over half (57%) of the global market now consisting of non-U.S. countries. International developed countries currently make up 43%, with the remaining 14% in emerging market nations. Thus, with an ever-changing global market, it may be a good time to reassess international exposure in DC plans.

Home-country bias
For the typical investor, however, adjusting domestic and international allocations isn’t always an easy task. Investors (and this applies to all countries, not just to the U.S.) tend to suffer from “home country bias.” This is the tendency to invest predominately in domestic markets, and it arises from uncertainty about – and fear of – investing in foreign countries. Plan sponsors can help alleviate this fear by focusing on educating participants on the potential risks and rewards that come with international investing.

Risks and rewards of international investing
International funds typically have higher risk/reward profiles. On a holistic level, exposure to international markets can reduce overall portfolio risk and dampen volatility through greater diversification and lower correlations among investments. International investing can open up a “world” of opportunities, giving people access to economies that are oftentimes growing at a faster pace (as measured by gross domestic product) than their domestic counterparts. These funds also have access to companies that the average investor cannot own. Furthermore, as of March 31, 2011, countries such as France, Germany, Japan, the United Kingdom, Switzerland and Australia, as well as many Emerging Markets countries, appear more attractively priced than many U.S. companies, based on common valuation metrics such as price-to-earnings, price-to-book and dividend yield.

Yet investing in international markets does not come without risks. Revolution in the Middle East, earthquakes in Japan and New Zealand and debt crises in Greece, Ireland and Spain can all have profound effects on the prices of international companies. Fluctuations in currencies can also impact fund returns. Additionally, political and operational risks are important factors when considering the risks inherent in international investing. Finally, when thinking about international exposure, it should be noted that some U.S. multinationals (these companies can make up large parts of domestic funds) derive significant revenues outside of the U.S. For example, U.S. companies such as 3M and Wrigley get 60% of their revenues from international sales.

As the world’s investable market changes, it’s important to consider the case for international investing. It is necessary to weigh both the risks and rewards and to educate participants on behavioral tendencies, such as a home country bias, that may hinder participation in international markets.

1 MSCI
2 MSCI, FactSet, J.P. Morgan Asset Management
3 Investing in American Companies with International Exposure, Linden Arden, Yahoo Finance

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