TAM ASSET MANAGEMENT REVIEW

Facts & figures on global investment strategies

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The Value of International Markets In Your Portfolio

International investing is getting a lot of attention these days—and for good reason. Despite the record highs set by the U.S. stock market it ranks dead last in performance this year compared to fifteen other markets tracked by *The Wall Street Journal*. Japan, the market most of Wall Street wrote off as *marketsona non grata* (excuse my Spanish), is the big winner—up 50% so far this year.

That's the good news. The bad news is a lot of investors jumped in only after the foreign markets had already made big moves. (Market timing, pure and simple, is a fool's game).

International markets should be part of a balanced portfolio not because these markets have been hot recently, but because this kind of diversification can actually increase returns and lower risk. The key is in the *correlation* of markets, or how one market moves in relation to another.

Correlation analysis is itself foreign to most people. But money managers have been using it in another form for years. Managers usually build stock portfolios that include individual stocks and industries that tend to move in different directions at different times. The idea is to develop a *portfolio* that *appreciates* over time, but with less volatility than the stocks individually.

The flaw in this approach is that the performance of the stock market as a whole is by far the most important determinant of portfolio returns (see Chart 1). Therefore, these managers, although well-intended, are subjecting the portfolio to much greater risk than necessary by being under-diversified. Furthermore, since few of these managers have expertise outside of U.S. stocks, the diversification benefits of foreign stocks is lost.

An example of market correlation is shown below. Both markets A and B produced a 10% annual return over four years, but they took different routes to get there. By combining the markets 50/50 you would have received the same overall return, but with fewer bumps along the way.

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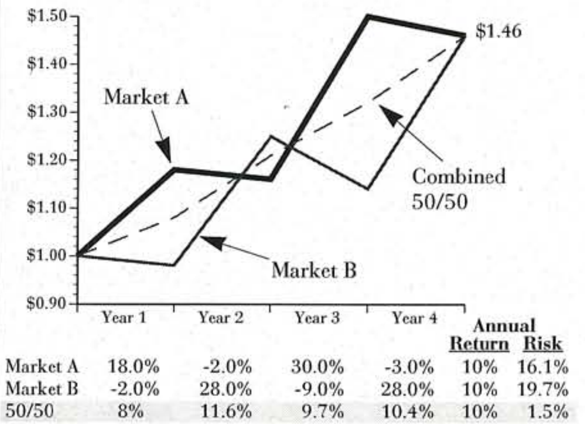
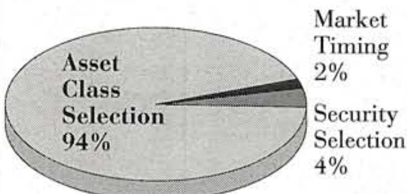
Chart 2: Correlation Example



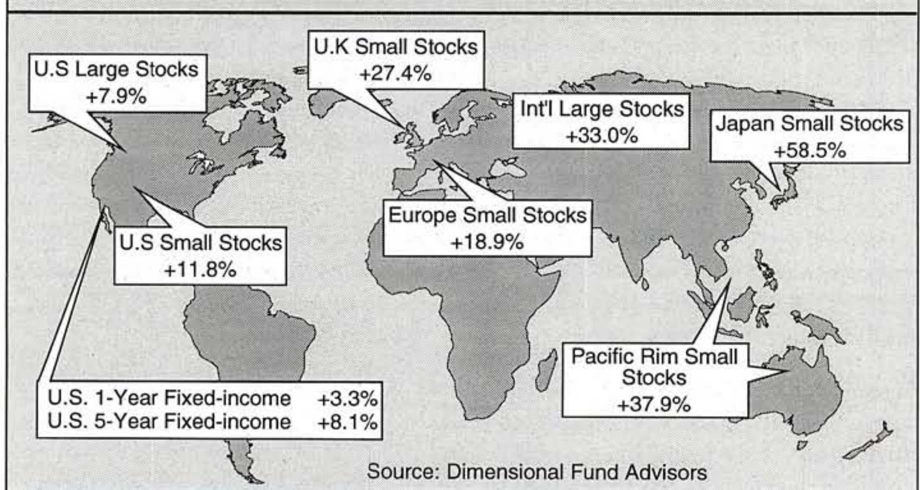
	Year 1	Year 2	Year 3	Year 4	Annual Return	Risk
Market A	18.0%	-2.0%	30.0%	-3.0%	10%	16.1%
Market B	-2.0%	28.0%	-9.0%	28.0%	10%	19.7%
50/50	8%	11.6%	9.7%	10.4%	10%	1.5%

Chart 1: The Determinants of Portfolio Returns



Source: Brinson, Hood, and Beerbower, "Determinants of Portfolio Performance", Financial Analysts Journal, July-Aug 1986

Asset Class Returns Year-to-Date: 8/31/93



Source: Dimensional Fund Advisors

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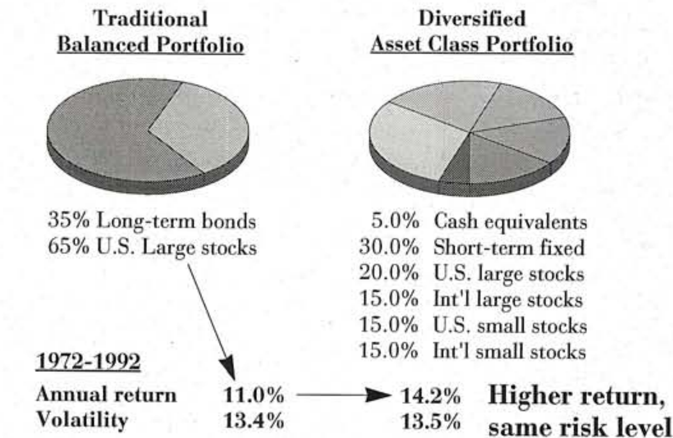
The Value of International Markets (cont.)

Why should volatility be an issue if you end up in the same place anyway? Because: (1) you never know when you need to jump off and (2) you are less likely to stay for the whole ride if things get too bumpy.

In the real world, rather than keeping the return constant and decreasing the volatility, a long-term investor might opt to boost the performance while keeping the volatility constant. The illustration below shows how this is done by shortening fixed-income maturities and adding additional stock classes.

The Benefit of Efficient Diversification



Details of the market indices and mutual funds used in this illustration can be obtained upon request. Past performance is no guarantee of future returns.

If you combine markets that move in different directions, won't you end up with 0% return?

If you combine a market that grows at 10% per year with a market that *loses* 10% per year, you will get nowhere fast. But why would you include a market that hasn't shown meaningful growth over time?

A stock manager selects 30 or 40 stocks that he believes will appreciate in line with past trends or future projections. The problem is the movement of individual stock prices has proven to be random. Therefore, predicting future returns for individual stocks is useless—over the long-term the average portfolio will only return what the *market* returns minus trading costs. However, because of the lack of diversification, the risk is very high that this portfolio will underperform the market and incur higher volatility.

To benefit from efficient diversification, investors should limit their portfolios to a combination of short-term bonds and low-correlating growth markets.

Why use international index funds?

This topic will be covered in a future newsletter, but consider for now these points: (1) the international funds TAM uses for portfolios contain almost 4,000 different stocks; (2) most international funds own less than 100 stocks, and (3) would you be comfortable with some guy in Chicago picking the "best" 100 foreign stocks from 15 different countries?

Are The Salad Days For Active Management Over ?

When a limited number of stockbrokers began offering the services of independent money managers in the early 80's they were, for the most part, moving small retirement plans and high net worth individuals out of the hands of incompetent bank trust officers. These brokers were helping to improve portfolio returns by focusing attention on performance and they were compensated by the commissions on the trades placed by the manager. Investors who listened benefited generally by better management and higher overall stock exposure during one of the greatest bull markets in history.

Ironically, a new breed of stockbroker is now attempting to steer the focus away from performance and toward "service" as the true measure of their value. Does this sound just a bit like the trust officers of old?

What happened? Did independent managers suddenly become as incompetent as their trust department brethren? Did brokers start recommending inferior managers by mistake? Not necessarily. What happened is that because of the proliferation of wrap accounts, the brokers' focus on performance has backfired—to the surprise and frustration of clients and brokers alike. We have known for quiet some time that the average investment manager cannot consistently "beat the market". We also know that it is virtually impossible to predict the few who will. So moving investors away from consistently bad management to average management, while an improvement, was only a good first step.

Like Dorothy in the Wizard of Oz, the answer to our dilemma has always been there*—well at least since the mid-1950's. It's just that Wall Street has chosen to ignore it. However, a combination of events—the growth of wrap account business, the popularity of mutual funds, the awarding of the 1990 Nobel Prize in economic sciences to three Americans, and the revision of the Prudent Investor Rule in 1990—is forcing advisors, if not brokers, to rethink there role with clients. So far the focus of brokers has only shifted to better "service". But at 3% a year and at a level of quality only their mothers could appreciate, these brokers are once again selling their customers a bill of goods.

*Broad, efficient asset class investing, of course. For a complete history of the evolution of modern investment concepts, read Peter L. Berstein's *Capital Ideas.*