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Foreign Stocks Look Like Junk, Step Up To American Quality

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Investors in foreign-stock funds got hammered in 2011. Exchange-traded funds in developed countries shed 14% of their value on average. The MSCI EAFE Index ETF dropped 12.2%.

Brazil no refuge

Emerging-market ETFs got hit even harder: Brazil (down 26%), Russia (down 31%), India (down 37%) and China (down 20%).

Meanwhile, the S&P 500 produced a total return of 2%, including dividends. The S&P MidCap 400's total return was negative 2%.

This kind of breathtaking underperformance by foreign-stock ETFs was not what their boosters have been projecting.

In 2008, when many overseas stocks were near record highs, you'd hear talk of how America was going the way of Japan, perhaps even the Roman empire. Investment advisors would wave pie charts in our faces and insist that it was essential to move a goodly chunk of our portfolios into foreign stocks.

Doing so, they said, would increase our returns and reduce portfolio risk.

Those pie charts guys were wrong. Some are changing their minds. Those who are sticking to their guns are still wrong. Go ahead and sell those volatile foreign funds and use the proceeds to buy U.S. blue chips instead.

You can start with low-cost ETFs that track the S&P 500 and the S&P MidCap 400. Then, consider picking up the handful of stocks in top performing U.S. companies that derive much of their revenue from foreign countries. I recommend Apple, Chevron, Nike, McDonald's and Praxair.

First, let me explain why I've become such a naysayer on foreign-stock ETFs.

I know it sounds judicious to own shares in overseas companies. So much so that it has become financial dogma on Wall Street.

Just over a year ago The *American Association of Individual Investors Journal* published a feature promoting the idea that investors should put money into foreign funds because they don't "correlate" strongly to U.S. stocks and because "over the past 10 years more than 80% of the world's stock markets have outperformed the U.S. market."

Billionaire investor Ken Fisher recently sent out a marketing letter to investors saying that "foreign securities can improve the performance of your portfolio and help you decrease your level of risk."

My colleagues and I found the opposite is true. According to our analysis, foreign stock exchange–traded funds have been a poor hedge against swings in the U.S. stock market, and they've been sub-par performers over the past 15 years. Plus they charge much higher fees.

To perform our analysis, we used data from Morningstar. We sifted through the performance figures of foreign-country exchange-traded funds with significant assets that have been trading for at least 15 years.

The funds that met our criteria covered 15 countries, ranging from well-established economies like those of the U.K. and Germany to fast-growing up-and-comers like Mexico and Singapore. (You can see data on the 15 countries here in our table.)

ETF		15-Year Avg. Total Return	Assets (Millions)	Expense Ratio	Dividend Yield	Beta
Australia	EWA	11.9%	$2,570	0.53%	3.59%	1.15
Canada	EWC	10.6%	4,622	0.53%	1.35%	1.02
France	EWQ	6.9%	294	0.54%	1.68%	1.22
Germany	EWG	8.0%	2,513	0.53%	1.55%	1.27
Hong Kong	EWH	7.6%	1,356	0.53%	2.62%	0.85
Italy	EWI	5.0%	120	0.54%	2.75%	1.33
Japan	EWJ	1.3%	6,616	0.53%	0.58%	0.66
Malaysia	EWM	10.1%	847	0.53%	2.31%	0.68
Mexico	EWW	18.4%	987	0.53%	1.48%	1.18
Netherlands	EWN	4.2%	90	0.53%	2.04%	1.16
Singapore	EWS	8.1%	1,452	0.53%	2.88%	1.12
Spain	EWP	9.8%	158	0.53%	2.20%	1.29
Sweden	EWD	9.9%	269	0.53%	1.77%	1.23
Switzerland	EWL	6.4%	241	0.53%	0.34%	0.85
UK	EWU	5.7%	1,094	0.53%	2.83%	0.92
SP500	SPY	7.4%	81,233	0.10%	1.76%	1.00
SP400	MDY	11.1%	7,805	0.25%	1.14%	1.16

Sources: Morningstar, Winans International

Since 1997, the ETFs for these 15 countries have produced an average annualized total return (including dividends) of 8.4%. Admirers of foreign ETFs compare their performance to that of the S&P 500, which over the same period generated a lower average return, of 7%.

Alas, that's not a fair comparison, because the vast majority of the companies in the foreign-country ETFs are not large-cap stocks. They wouldn't stand a chance of getting into the S&P 500. A fairer benchmark is the S&P MidCap 400. That index has produced an annualized total return of 11% since 1997. An investor who split his investments evenly between the two indexes would have outperformed a foreign-stock investor soundly.

What about this idea that buying and holding foreign ETFs will reduce your investment risk? After all, that's what the pie-chart guys say you must do to protect yourself from wild swings in the U.S. dollar and America's other financial insecurities.

A good way to measure risk is to look at "beta." That's a measure of how a security moves relative to the ups and downs of the U.S. stock market. A security that tracks the U.S. market exactly has a beta of 1.00.

A security whose movement is more volatile than the U.S. stock market has beta greater than 1.00. If it is less volatile, its beta will be less than 1.00. Bigger betas—positive or negative—equal more risk.

Naturally, the beta of the major S&P 500 ETFs is 1.00. The beta of the S&P MidCap 400 funds is 1.16. The betas of the foreign ETFs we studied ranged from 0.66 (Japan) to 1.33 (Italy). The average for the group of 15 was 1.06—not significantly less risky than U.S. shares.

More important, in the bear-market years of 2000–02, 2008 and 2011, the ETFs in these 15 countries suffered an average annualized total return (including dividends) of negative 20.4%, worse than the 15.7% loss produced by the S&P 500 and the 8.6% loss of the S&P MidCap 400. So much for the hype about investor protection.

Now, not everything about foreign stocks is bad. If you want to invest in an overseas company, then by all means, buy its shares or its American depositary receipts. (I own ADRs of overseas companies like Novo Nordisk and Canadian National Railway.)

Foreign-stock ETFs can be good trading vehicles for active investors, myself included—a convenient way to place a short-term bet on a country whose stock market we are convinced will boom in the coming months.

If you're a fan of dividends—I am, certainly—might be pleased to learn that they tend to offer slightly higher yields. (The foreign ETFs we studied pay an average yield of 2%, versus 1.45% for the S& P 500 Index.)

Unfortunately, you'll face significantly higher fees to own them. The average expense ratio for a foreign-stock ETF is 53 cents per $100 of shares owned. That's twice as high as you'd pay owning an S&P 400 ETF and five times the cost of the most efficient S&P 500 funds.

So, since they're not significantly better performers or less risky over the long run, don't let your broker push you into buying and holding 10% or 20% of your wealth tied up in these overseas stock funds over the long run.

The fact is, if you own large-cap U.S. stocks, you're already heavily invested in the global economy. Standard & Poor's reports that 47% of the revenue that poured into the coffers of the S&P 500 in 2010 came from outside the U.S.

If you want to wager on overseas economies, pick up extra shares of a high-grade U.S. company that derived at least 50% of its revenue from outside the U.S. in 2010. Some of my favorites these days include Apple (58% of its sales came from outside the U.S.), Chevron (73%), Nike (50%), McDonald's (66%) and Praxair (61%).

And if you feel you're over-concentrated in large-cap U.S. shares, there are better ways to diversify. Buy a low-cost fund that tracks S&P's MidCap 400.

That index, which tracks 400 U.S. companies with market caps ranging from $500 million to $8.2 billion, has been beating virtually all foreign-stock ETFs for years.

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