MuhlenkampMethods
For the Intelligent Investor

Answers to questions you may not even know you have.

Foreign Investing

Adapted from a presentation delivered at the December 2002 Muhlenkamp & Company Seminar. Just as many investors fail to take changes in inflation into account when evaluating investment choices, many also fail to take currency exchange rates into account when investing outside the United States. In this essay, Ron takes a sharp look at foreign investing by tracking not only foreign stock performance, but tracking currency exchange rates as well.

In 1995, we were told that we should be invested in foreign stocks because the table below tells us that for the prior 20 years if you had invested in the S&P 500 you would have done 14½% per year. If you had invested in the EAFE (which is Morgan Stanley's Europe, Australia, and Far East Index), you would have done roughly 16% per year. So people said that you've got to invest in foreign stocks.

Figure 8.13 Comparative Returns, Domestic and International Equities, 1975-94

Comparative Returns Domestic and International Equities

*Morgan Stanley International Europe-Australia-Far East Index

20 Years	Cumulative	Annualized
S&P 500	1,420%	14.19%
EAFE*	1,962%	16.05%

Year	S&P 500	EAFE*
1975	37.31	37.10
1976	23.99	3.74
1977	-7.19	19.42
1978	6.39	34.30
1979	18.65	6.18
1980	32.39	24.43
1981	-5.26	-1.03
1982	21.53	-0.86
1983	22.59	24.61
1984	6.3	7.86
1985	31.8	56.72
1986	18.67	69.94
1987	5.25	24.93
1988	16.61	28.59
1989	31.69	10.80
1990	-3.10	-23.20
1991	30.47	12.50
1992	7.62	-11.85
1993	10.08	32.94
1994	1.32	8.06

Note: The black bars on the right denote the years when the EAFE outperformed the S&P 500.
Source: Morgan Stanley International Europe-Australia-Far East Index

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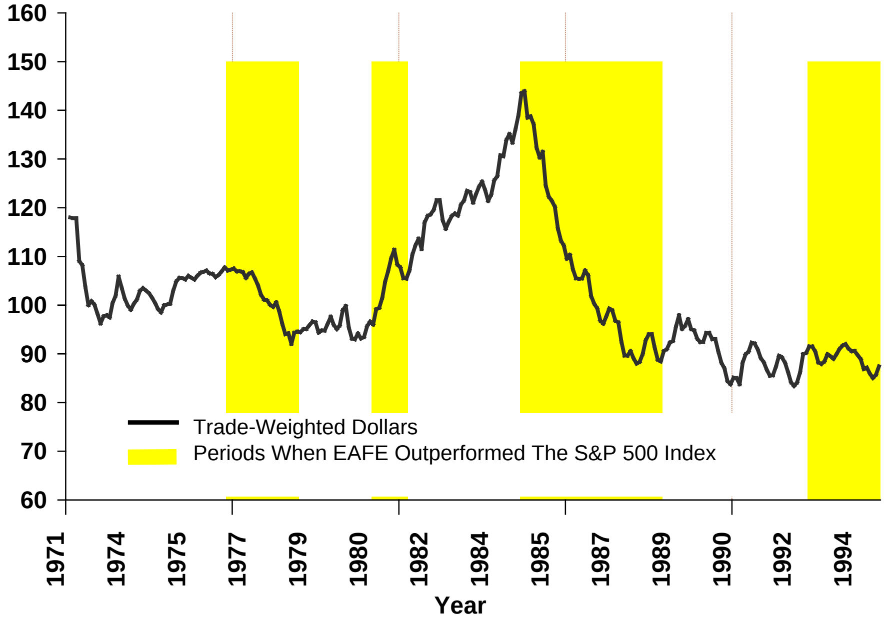
We know that when you invest outside the United States, part of your return is due to the performance of securities in the local currency and part is due to the change in the currency values relative to each other. We wondered what happened to the currency during the years when the EAFE outperformed the S&P 500. So we constructed a chart of the trade-weighted dollar for the period (see Figure 8.14).

Figure 8.14 Trade-Weighted Dollar, 1971-95



Source: Federal Reserve Bank of St. Louis

We found that in each of those periods when the EAFE outdid the S&P 500 by more than 2%, the dollar was going down, and these were the only times when the EAFE outdid the S&P 500. In early 1995, it looked to us like the dollar was below where it should be, so we concluded that it wasn't a good time to invest in foreign securities.

So what has happened to the EAFE since 1995? Let's look at the updated data in Figure 8.15.

Figure 8.15 Comparative Returns, Domestic and International Equities, 1975-2006

Comparative Returns Domestic and International Equities

32 Years	Cumulative	Annualized
S&P 500	5,671%	13.45%
EAFE*	5,213%	13.15%

*Morgan Stanley International Europe-Australia-Far East Index

Year	S&P 500	EAFE*
1975	37.31	37.10
1976	23.99	3.74
1977	-7.19	19.42
1978	6.39	34.30
1979	18.65	6.18
1980	32.39	24.43
1981	-5.26	-1.03
1982	21.53	-0.86
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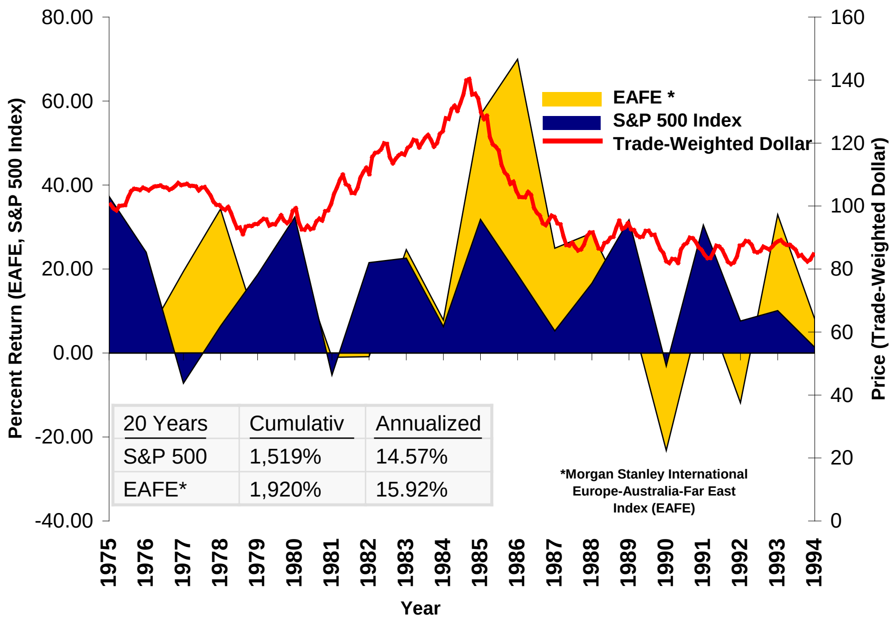
1989	31.69	10.80
1990	-3.10	-23.20
1991	30.47	12.50
1992	7.62	-11.85
1993	10.08	32.94
1994	1.32	8.06
1995	37.58	11.55
1996	22.96	6.36
1997	33.36	2.06
1998	28.58	20.27
1999	21.04	27.37
2000	-9.10	-13.96
2001	-11.89	-21.21
2002	-22.10	-15.66
2003	28.68	39.17
2004	10.88	20.70
2005	4.91	14.02
2006	15.79	26.86

Note: The black bars on the right denote the years when the EAFE outperformed the S&P 500.
Source: Morgan Stanley International Europe-Australia-Far East Index

For the period from 1995 to 2002, the EAFE underperformed the S&P 500 as the dollar continued to strengthen against other currencies. Investing in foreign stock in 1995 would not have been a wise choice.

Figure 8.16 plots the trade-weighted dollar, the S&P 500, and EAFE from 1975 to 2006 Any time you see the gray above the black, it's a period when the EAFE outperformed the S&P 500—and each of those is a period when the trade-weighted dollar is falling relative to other currencies. From 1995 to 2006, there have been two periods when the EAFE outdid the S&P 500.

Figure 8.16 Domestic and International Equities, Comparative Returns, 1975-2006



The lesson to learn is this. You can't just extrapolate the past to arrive at the future. You have to have some measure of value. This allows you to make a judgment as to whether recent price trends are sustainable or have overshot the mark, resulting in fundamental over- or undervaluation. Markets are partly valuation and partly trends and momentum. You want both working for you. Today (December 2002), it looks like the dollar is beginning to roll over. It looks like it is a little overpriced so, frankly, foreign stocks are looking interesting for the first time in a decade. So we are starting to do some work on them.

Any time you invest outside of the United States you take two additional risks. One is accounting risk (and with a little help from Enron, we're finding out that we have more accounting risk in the United States than we thought we did). The other is currency risk. Figure 8.16 shows us that when it comes to foreign investing, the currency is at least as important as an individual company's financial performance.

In roughly 1994 or 1995, Morgan Stanley came to town and talked about all these great companies they were going to bring public in India and China, and how we ought to invest in them and make a lot of money. What do I know about a company in India or China? What I concluded was that if they are going to bring all these companies public, the company that I know is going to make money is called Morgan Stanley. They get paid up front. So we bought Morgan Stanley, and it worked out rather well. Sometimes it helps to be a little simplistic.