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INTERNATIONAL INVESTING

Let me begin with the admission that, as is so often the case, the sentiments I express here on the subject of international investing appear not to be shared by the majority of my colleagues in the securities industry. In fact, based upon my own sampling of the literature, I conclude that, in this instance, the minority group of which I am a part is very small indeed. I shall state my position, nevertheless.

MYTHS

The case for the ownership of foreign securities, on the face of it, is a tempting one for two reasons: First, over certain periods of time, some, or many, foreign securities markets may outperform the U. S. market and so, at such times, it might be especially desirable to be participating in them. Second, investment in foreign securities permits broader diversification. The world's various securities markets are not well correlated with each other, and so investment in them might help reduce overall portfolio volatility without necessarily reducing the portfolio's overall potential for gain.

One obvious shortcoming to the first of these two arguments is that it presumes the portfolio manager to be adept, not only at timing the U. S. market, but at timing foreign markets as well. Given that the funds available to any portfolio are finite, in order to increase investments in foreign securities markets, it is necessary to decrease one's investments in domestic markets. Presumably the international investor will do this when he believes that a foreign securities market will rise more or fall less than the U. S. market; and he may disinvest in a foreign market and increase his positions in U. S. securities when he believes the U. S. market will outperform that foreign market.

It is, however, widely recognized that portfolio managers do not succeed in timing even the U. S. market. The proof is abundant and irrefutable that those investors who practice active asset allocation, i.e., vary the proportions of their portfolios that they have committed to equities, depending upon their assessments of the outlook for that market, do less well than those who maintain a maximum commitment to equities 100% of the time.

If portfolio managers cannot effect successful market timing when working with U. S. equities alone, I am at a loss for a basis for believing they are capable of juggling many international markets simultaneously and achieving any higher order of success.

As to the argument that international diversification decreases overall portfolio volatility, the jury is out. On the one hand, though the correlation among the world's stock markets may be increasing, there is still admittedly a high degree of countercyclicality among them. However, international

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investing introduces a new source of portfolio volatility that is not present in an all-domestic portfolio - namely that caused by fluctuations in foreign exchange rates.

In fact, foreign investing adds a whole third dimension to the "total return" concept of investing. In addition to current income (dividends and interest) and capital appreciation (or depreciation), we must now take into account changes in the value of our investments resulting solely from changes in foreign exchange rates.

Currency exchange rate shifts play a big role in determining the performance of a foreign security. What is more, the interaction of individual stock performance in its own domestic market and its performance when measured in the investor's currency can be extremely complex. For example, to anticipate that a particular foreign currency will appreciate and then to invest in a company in that currency which is an exporter may be self-defeating since the currency appreciation should adversely affect that company's exports. Therefore, what one gains on currency he may lose in earnings. In the shorter term, the effect on the value of a foreign security to a U. S. investor by changes in relative foreign exchange rates can easily overwhelm the effects on the value of that security of changes in either the foreign company itself or of changes in the foreign stock market where the stock is traded. This added currency risk is so great, it has been persuasively argued, that it offsets any risk reduction provided by the added diversification into the foreign markets. An international portfolio, then, may provide no less risk than a purely domestic portfolio.

DIFFICULTIES

There are a number of difficulties associated with trading in foreign securities, but I would like here to focus only on those associated with evaluation.

The first, and probably biggest of these difficulties concerns the wide disparities in the techniques of accounting. There are generally considered to be five different accounting models used in the world today: (1) The American model, developed over the course of the century, emphasizes maximum disclosure in accordance with generally accepted accounting practices which are directed primarily toward protecting the equity investor or common stock "shareholder." (2) The British model, which provides considerably less disclosure and detail than the American model, has as its primary aim to protect "creditors." (3) The Northern European model, which is more lax than either the American or British models, makes its prime emphasis protection of "management."

There are four variations of the Northern European model: (a) The German variant, motivated by tax regulations, allows undervaluation via hidden assets, understatement of profits, and minimal disclosure. (b) The Scandinavian variant, where the government directs an understatement of profits by permitting that a large number of reserves be set up, increases reported expenses and transforms equity into debt. (c) The Swiss variant, which permits huge hidden reserves, excessive

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depreciation charges, and very large bad debt reserves, also keeps reported profits down. (d) The Dutch variant permits very minimal disclosure.

(4) The Mediterranean model used by France, Italy, Belgium, and Spain, is a tax-oriented accounting model which requires that financial statements conform to the tax code. Companies there resort to every conceivable loophole to keep profits low and avoid taxation which, in turn, produces ultraconservative earnings reports. Companies provide excessive provisions for contingencies, unjustified inventory write-downs, and extraordinarily high depreciation charges. Whenever possible, these financial reports try to avoid or at least minimize disclosure. Such reports are voluminous, but they do not disclose very much information that is useful to analysts. (Initially, one might think that such conservatism and profit understatement are good. The purpose of accounting, however, is to be accurate and realistic. When conservatism is carried to such an extreme as to render financial statements expositions of fiction, companies cannot be evaluated objectively either by any absolute criteria or by any relative criteria, one company to another.) (5) The last model is the Soviet which does not appear to have much relevance to security evaluation at all.

While financial statement disclosure for foreign companies has improved in recent years, both quantitatively and qualitatively, several major areas of disharmony still exist, particularly in methods of consolidation, currency translation, and asset valuation.

A major problem relates to how subsidiaries and joint ventures are dealt with in the accounting statements. The United States and the United Kingdom use "consolidated" accounting, lumping all subsidiaries into one set of statements, thereby permitting a more accurate evaluation of the enterprise as a whole. Every country has different conventions as to whether or not companies consolidate, when they consolidate, and how they consolidate the financial statements of their subsidiaries.

Japan provides an interesting variation of the consolidation problem. In that country, a corporate phenomenon known as reciprocal ownership considerably complicates the evaluation process. It is widespread practice in Japan for corporations to hold large positions in the common stocks of each other. In fact, over 70% of all the outstanding shares of Japanese companies are owned by other Japanese companies.

Each company includes, in its own earnings, only the dividends it receives, and none of the undistributed profits of the companies whose stocks it owns. This results in a gross understatement of earnings which, incidentally, explains why Japanese companies have appeared to sell at such high price-earnings ratios.

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In fact, it can be mathematically demonstrated that, if two companies, neither of which pays any dividend (and Japanese companies pay out very little in dividends anyway), each owns 70% of the other, the true price-earnings ratio will be only 30% of the price-earnings ratio computed in the conventional manner, i.e., a P/E which appears to be 50-to-1, in reality, is only 15-to-1.

Considerable confusion concerns currency translations and reporting in preparing accounting statements. At least four different major currency translation methods are practiced throughout the world, and sometimes all four are practiced simultaneously in the same country.

Asset valuation methods and the use of replacement or historical cost accounting are other areas of non-uniformity among nations.

As a result of all the foregoing international accounting differences, all of the standard operating and financial ratios, including price-earnings and price-to-book ratios, are distorted and so it is utterly invalid to compare these ratios across national boundaries.

From a macroscopic point of view, too, good information about economic and monetary developments in foreign countries is less readily available. Often there are very few timely economic reports published by foreign governments, nor is information about impending policy changes made public.

There is a propensity among investors who sense the nature and magnitude of the problems with investing in foreign securities to presume that these problems may be effectively overcome by investing via investment trusts - either closed-end or open-end (mutual funds) - that invest in foreign securities. The point, however, is that the foregoing problems are horrendous, even for the most talented and experienced of security analysts and portfolio managers. Moreover, these problems utterly preclude the possibility of anybody's assessing either the values or the potentials of foreign securities with anywhere near the degree of reliability that one might hope to achieve in making similar assessments of domestic securities. The simple fact is, the science of accounting and the policies of public disclosure are nowhere near as advanced in any other country on Earth as they are in the United States.

A SOLUTION

It may come as a surprise to my reader, at this point, to discover that, the foregoing discussion notwithstanding, rather than discouraging international investing, I enthusiastically support it. I merely propose that one go about it in a somewhat different way than that advocated by those promoting individual foreign issues and/or investment companies dedicated to investing in foreign securities.

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Probably that aspect of the argument I hear for investing in foreign securities that I find most troublesome is the implication that, when the securities in a particular foreign exchange perform particularly well, it is because that particular exchange bestows some merit to the securities traded on it. There are times when securities traded on the American Stock Exchange outperform those listed on the New York Stock Exchange. It does not, however, follow that it was necessary to own securities listed on the American Stock Exchange during this period to have achieved the results achieved on that exchange. A bit of examination will reveal that it was because speculative securities, natural resource issues, or maybe energy stocks, were outperforming the pack, and that these were more heavily weighted on the American Stock Exchange, that the AMEX was outperforming the Big Board. If one owned speculative stocks, natural resource stocks, or energy stocks that were on the New York Stock Exchange, one did just as well.

More recently, the NASDAQ has been outperforming the New York Stock Exchange Index. That is because technology stocks have been doing especially well, and technology stocks are weighted more heavily in the NASDAQ index than in the NYSE Index. It does not following that one needs to have been invested on NASDAQ to have participated in the rise in technology stocks. It means, merely, that he needs to have owned technology stocks, irrespective of whether they were traded on NASDAQ or the NYSE.

Similarly, one does not need to be invested in foreign "securities" to participate in whatever degree of performance is achieved in those foreign markets. One needs only to be invested in the foreign "economies" or foreign "industries" which are producing the above-average performance in the foreign securities markets. This is a much easier task and one fraught with far fewer hazards.

It is usually surprising to investors to learn the great extent to which most successful U. S. companies themselves invest overseas. In other words, it is by no means necessary to purchase the shares of a foreign company domiciled in a foreign country and/or traded on a foreign exchange to enjoy all of any benefits available in foreign investing. Many industries may have matured in the U. S. but still have great potentials for growth overseas. Our U. S. corporate managers are in no way oblivious to such developments, and investors may be sure that U. S. corporations explore such foreign investment opportunities in depth, on a global scope, and on an ongoing basis.

In fact, I will bet that any U. S. corporate management trying to decide whether or not to market its product or set up operations in a foreign country will give the question far more study than will an international portfolio manager trying to decide if it should add a particular foreign security to its holdings. Furthermore, after such an investment is made by either, I will bet that the corporate manager will monitor and nurture his foreign investment with much more tender loving care than the portfolio manager will his investment.

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As you can see, I am not averse to investment in foreign countries. I just prefer to delegate the authority for making the specific foreign investment decisions to corporate managers rather than to portfolio managers.

Let me concede that investing in foreign economies via domestic companies does nothing to mitigate currency fluctuation risks. To whatever extent our domestic company is involved overseas, it will be vulnerable to changes in foreign exchange rates. Investing in foreign economies via domestic companies, however, will do much to avoid many of the other problems cited above that are unique to foreign security investing.

The big advantage to participating in foreign operations via a domestic company, as opposed to a foreign company, is the reasonable assurance we have that the accounting standards applied to the company's overseas operations will be consistent with the accounting standards applied to its domestic operations, and that these standards will be U. S. "generally accepted accounting principles." What is more, we can also rest assured that the standards applied to one domestic company's overseas operations are essentially the same as those applied to another domestic company's overseas operations.

It has always seemed to me that, just as important as buying an appropriate security for a portfolio at an appropriate time, is what one does with that security after it is bought. Subsequent decisions about holding or selling are every bit as critical as the initial one to buy. Whereas the information that leads us to buy a security may come as the result of a one-shot package of merchandising or of heightened public attention in the news media, the stream of information for effective monitoring needs to be readily available, on-going, useful, and reliable. As noted in the foregoing discussion, these latter conditions are far more apt to be met by a domestic company than they are by one domiciled overseas.

One additional annoyance, and often expense, that is avoided when one's foreign investing is done via domestic companies, as opposed to foreign securities or investment trusts holding foreign securities, is the foreign tax withheld on the dividends paid by foreign companies.

Most foreign countries withhold a certain percentage of the dividends paid to U. S. owners of their securities. These withheld amounts can be claimed as credits against U. S. taxes, but claiming the credits does require completion of a special tax form (IRS Form 1116) to accompany one's Form 1040. In an account such as an IRA, a pension or profit-sharing trust, or an endowment fund, where no U. S. taxes are paid anyway, the amounts withheld are irretrievably and forever foregone.

The majority of foreign countries have a 15% withholding (Australia, Britain, Canada, Denmark, France, Japan, The Netherlands, New Zealand, Norway, South Africa, and Sweden); several have a

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25% withholding (Belgium, Germany, Ireland, Israel, and Spain); while some range as high as 35% (Malaysia and Switzerland). To subject oneself voluntarily to incremental taxes of such magnitude, or even to the incremental paperwork needed to reclaim the amounts withheld, must require more investor fortitude than many can comfortably muster.

SOME NUMBERS

Even among those investors who advocate investing in foreign securities, there is no consensus as to how much of a portfolio should be dedicated to the group. The policy norm among U. S. pension plans, however, appears to call for at least a 5% commitment, with a number of plans moving toward 10%, and with a few as high as 15%.

In conjunction with this writing, I analyzed our own list of "Investment Suggestions." This is a list to include only companies that fulfill certain criteria including that they are of high-quality, that they are growth-oriented, and that they are domiciled in the United States. On the particular date of our sampling, there were 38 companies that made this "Buy" list. 27 (71%) of these companies reported deriving some portion of their sales from foreign operations. Assuming that those companies which did not provide a breakdown had no foreign sales whatever, the average percentage of total sales for the 38 companies was 25%. In other words, if one assembled a portfolio made up of equal positions in each of these 38 companies, one-quarter of all the sales of the companies in his portfolio would be derived from overseas sources.

If one wanted to put an even greater emphasis on foreign investing with an all-domestic company portfolio, and so confine himself only to those 27 companies reporting some foreign operations, the dependency of his portfolio upon overseas sales would rise to 36%. If one wanted to confine his portfolio to just that half of the list (19 of the 38 issues) with the greatest percentage of foreign sales, his portfolio dependency upon foreign sales would rise to 45%. If one confined his list to the top dozen issues, his foreign dependency would rise to 52%; and, if he confined his list to the top six issues, he would have a portfolio deriving 61% of total sales from overseas operations.

Of incidental interest, also, was the fact that, among those eighteen companies that reported their percentage of total profits as well as sales emanating from overseas sources, the average for sales was 41% and the average for profits was also 41%. A fair inference, I would think, from this observation is that American companies, at least collectively, are in fact achieving a reasonable balance in the pursuit of opportunities for profit both domestically and abroad.

In conclusion, it seems safe to say that a typical portfolio constructed to meet our own traditional quality and growth criteria is made up of companies which collectively already derive about one-quarter of their sales and profits from sources overseas - a figure even somewhat above the 5%-15% convention common among the nation's pension funds. Moreover, if an investor should want a still

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heavier (or lighter) foreign emphasis, the desire can be easily accommodated by employing the same screening criteria with the same universe of domestic companies, but by simply modifying the mix to emphasize (or de-emphasize) those companies with stronger foreign components.

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