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summaries

SIGMA INVESTMENT COUNSELORS

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International Investing…Why Bother?

Investors can be a fickle lot, tending to chase investments that are hot at the moment and shying away from investments that are underperforming. This is clearly the case with international equities which have underperformed US-based indices for the past several years. In light of the slowing growth in India and China, looming fiscal problems in Europe, etc., it is easy to understand why investors are asking "why bother?" when it comes to investing overseas. However, with history as a guide, we know this period of underperformance is likely to be short-lived. International exposure offers investors the benefit of portfolio diversification, which can reduce the volatility of a portfolio without sacrificing return.

A 2011 study published in the Financial Analyst Journal (FAJ) presented evidence as to why "International Diversification Works (Eventually)". The study was done by Clifford Asness, Roni Israelov, and John Lieu and was the winner of the Graham and Dodd Award for Best Article. In the most recent CFA Magazine, Susan Trammell, CFA digested the article and revived the conversation among investors.

The basic summary of the study states "over holding periods of increasing lengths, single-country equity portfolios' worst cases are far more painful than the worst performance of a globally diversified portfolio and become increasingly painful over time." Again, as in most investing truisms, the data shows investors need to focus on the long-term, big picture, and not just on a few quarters performance.

The data from the FAJ study shows that markets are increasingly correlated during downturns. As an example in this most recent bear market, the US developed international and emerging markets were all down between 40% and 60% from their highs to their lows. The study shows that despite this increased correlation during downturns, these crashes tend to be short lived. Over long time periods, equity markets based in different countries have not declined at the same time. Their underlying economic growth is more of a factor than short-lived panics. According to the study, the global economic performance is not enough to explain most of the long-term market returns - country specific economic performance is a bigger factor.

Interestingly, the internationally diversified portfolio outperformed from every countries perspective in the study, not just the United States. It did not matter if you were an investor in England, Japan, Mexico, or anywhere else across the globe, a globally diversified portfolio over the last fifty years provided better protection than holding investments based in one country.

According to the study, and if history is any guide to the future, an investor who holds a single-country

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portfolio for long enough should expect to experience a five-year period in which real wealth will decline by 57%. A global portfolio's worst expected five-year return would be a negative 39%. By diversifying internationally, investors can maintain the same expected return as that of a local portfolio but substantially reduce potential worst case events.

In the long run, according to the data, international diversification does protect investors and not at the cost of performance. International equity investments are a part of our core holdings and we believe should have a place in any portfolio with a long time horizon.

International Benchmark Change

While we are on the topic of international investing, we also wanted to bring to your attention a change being implemented within our international ETF investments. Over the next few months, Sigma's two most widely used international ETFs, the Vanguard MSCI EAFE (Ticker: VEA) and Vanguard MSCI Emerging Markets (Ticker: VWO) will be migrating to new benchmarks. These changes are being implemented by Vanguard, not Sigma, so it is up to us to determine whether we want to accept the changes or migrate to different funds for international exposure.

Because the ETFs that we use are passively managed baskets of stocks without a team of managers actively buying and selling within the portfolio, they are built to closely reflect a pre-determined benchmark or index. Targeting a passive benchmark is often a great way for investors to get broadly diversified investment exposure at the lowest possible cost. Both of the aforementioned funds are known for being among the least expensive international investments in the world. VEA currently costs 0.12% per year for an investor to own, while VWO comes in at 0.20%. While a portion of these fees go to Vanguard for administering the funds, the balance goes to the index provider (MSCI in this case) for maintaining quality, investable benchmarks.

While Vanguard's international ETFs have historically been managed to reflect MSCI indices for benchmarking purposes, Vanguard has recently decided to move both VEA and VWO to benchmarks that are maintained by FTSE. FTSE is a direct competitor to MSCI and maintains more than 120,000 real-time indices worldwide. So why is Vanguard making the change? Vanguard felt that they could get a comparable service from a different firm at a more competitive price. Vanguard is well-known for being ruthless when it comes to driving the cost of investing continually lower and this case will be no different.

While lowering the cost of investment is almost always a good thing, we wanted to be certain that the change from MSCI to FTSE indices would not bring about a material deviation in investment exposure for our clients. After analyzing the potential tax impact along with the anticipated changes in country and sector exposure, which are all expected to be minimal, we believe that Vanguard's international benchmark changes are in fact in the best interest of our clients.

Marisa A. Lenhard, CFA, CFP®

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Improvements to Sigma Reports

In an effort to continuously upgrade our client service levels, we are in the process of implementing a new client reporting software. There will be no changes to reports that are sent out for the period ending September 30, 2012. However, after this quarter, client reports from Sigma Investment Counselors will have a new look and feel. We think the new format is a nice improvement, and look forward to hearing your feedback!

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives

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