Should investors give foreign stocks another look?

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The dramatic surge in U.S. stocks this year has overshadowed significant weakness in most global equity markets. In fact, with the exception of Japan, almost every major foreign market has lagged the United States, and many former powerhouses such as Brazil, Russia and China are negative for the year.

So does investing in foreign stocks still make sense? It does, and the recent weakness in these markets provides a great opportunity for investors to add to their portfolios on the cheap.

Global investing makes sense for several reasons. Perhaps most importantly, it provides diversification and helps reduce overall portfolio volatility.

That doesn't mean U.S. and foreign markets move independently from each other; they don't. But their performance diverges enough (they generally move in the same direction between 45% and 85% of the time depending on the market environment) that having exposure to both tends to add stability and increase overall returns.

Further, with the possible exception of Japan and several developed European countries, most foreign economies are poised to grow at least as fast as the United States economy in the next several years. And some areas, such as Eastern Europe, India and the Pacific Rim, likely will grow much faster. In fact, the International Monetary Fund recently forecast global economic growth would hit 3.3 percent this year – substantially higher than the United States, which is expected to grow by only 1.9 percent.

Many foreign firms also have dividend yields far exceeding U.S. companies. For example, the Vanguard FTSE Europe Fund (VGK) currently pays a 3.47 percent dividend, while the Vanguard FTSE Emerging Markets Fund (VWO) yields 2.47 percent. Compare that to the S&P 500's 2.10 percent yield, and it's easy to see how overseas investments can play a role even in conservative, income-oriented portfolios.

Finally, for much of the past 10 years, foreign stocks have significantly outperformed U.S. counterparts. For example, the MSCI EAFE Index, companies located in developed markets such as Japan, Germany and the United Kingdom, has averaged a 10.19 percent annual return for 10 years, while the MSCI Emerging Markets Index, comprised of stocks from China, India, Brazil and other developing nations, has returned 17.41 percent on average. Both indices have far outpaced the U.S. market during this period.

Foreign stocks are cheap

For the first time in many years, most foreign stocks are cheaper than their U.S. counterparts. This is particularly true for stocks in many high-growth areas such as China, Korea, Russia and Brazil.

For example, the price/earnings ratio for U.S. stocks in the S&P 500 Index is currently 17.94 based on trailing 12-month earnings, and the Russell 2000 Index — a broader mix of U.S. stocks that includes many small- and medium-capitalization companies — has a price/earnings ratio of 33.09. Both are well above their historical averages. Compare that to both VGK and VWO, with price/earnings ratios near 11.

This is a sharp reversal from a few years ago when valuations in both U.S. and foreign markets were roughly the same. In fact, for much of the past 10 years, foreign stocks — particularly those in rapidly growing nations such as China, India and Brazil — have sported much higher price/earnings ratios than U.S. stocks.

How to invest overseas

Perhaps the least-complicated way for U.S. investors to gain foreign exposure is to buy one of the more than 2,100 U.S. mutual funds that invest overseas. If you decide to invest in international mutual funds, keep in mind an important distinction — "foreign" funds invest exclusively outside the United States, while "global" or "world" funds generally invest in both U.S. and foreign securities.

But mutual funds are only the beginning. Investors also can buy ownership interests in foreign stocks such as Toyota, Nokia and Novartis directly on U.S. exchanges. These securities, called American Depository Receipts, are issued by U.S. depositary banks and represent one or more shares of a foreign stock.

Possible pitfalls

Investing overseas isn't without risk. First, currency fluctuations can have a significant impact on investment returns. For example, in 1997, the MSCI EAFE Index gained 13.82 percent when measured in local currencies, but only returned 2.06 percent to U.S. investors due to a rising U.S. dollar. Conversely, a falling U.S. dollar adds to overseas returns, such as in 1994 when a 1.78 percent loss in the MSCI EAFE Index turned into an 8 percent gain for U.S investors.

Political instability also can be a problem, particularly when investing in emerging markets such as Latin America, Africa and the Middle East. When you compound this with the lack of liquidity in many of these markets, it can make for a bumpy ride if you aren't careful.

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