DRAWING ON AMERICAN EXPERIENCE

How have U.S. investors fared with their allocations to international equity?

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Although most investors are still underweight in foreign equities, cross-border investment has skyrocketed over the past decade. Have U.S. investors' foreign equity portfolios performed well? While the performance literature on U.S. investors' domestic portfolios is vast and spans several decades, little is known about the skill with which American investors venture abroad. There are many reasons to suspect that investors might perform poorly in foreign markets—for example, they might be at an information disadvantage. However, perhaps surprisingly, we find that, compared to global benchmarks, U.S. investors' foreign equity portfolios earned substantially higher Sharpe ratios. This performance is particularly evident since 1990 and occurs in both emerging and developed markets.

We investigate three non-mutually exclusive reasons for the strong unconditional performance: trading strategy, private information, and preferences for two types of foreign firms—well-governed and cross-listed—that have alleviated information asymmetries. To conduct this analysis, we first form data on the monthly positions of U.S. investors in 40 non-U.S. markets for the period from 1976 through 2001.

Within each country, we assume that U.S. investors hold the market, so our paper is about country picking, not stock picking. Past work suggests that information asymmetries can result in momentum trading which ultimately hampers performance; in contrast, we find that U.S. investors abstained from momentum trading and instead were "contrarian when selling," meaning they sold past winners.

Our conditional performance tests provide no evidence that the superior (unconditional) performance owed to private information, suggesting that the successful exploitation of publicly available information also played a role. U.S. investors did indeed beat the MSCI benchmark, but our conditional returns-based and conditional weight-based models provide no indication that they moved into markets just prior to positive abnormal returns (or out of markets before negative abnormal returns). Finally, the documented preference for cross-listed and well-governed foreign firms, which performed well over our sample, appears to have served U.S. investors well, as governance and cross-listed portfolios outperformed both the MSCI and U.S. investors.

Mean and Standard Deviation of Monthly Excess Returns (in %, 1990-2001)

	Mean	Std. Dev.
U.S. Investors' Foreign Portfolios	0.13	(4.4)
MSCI	-0.11	(4.8)
Governance	0.24	(4.3)
Cross-Listed	0.28	(4.3)

Our results have clear implications for international investment. It is well known that foreign securities have only a small weight in investors' portfolios, but it is not known whether this weight is inordinately small, in part because we have not had a clear picture of the returns investors earn on their foreign portfolios. If investors are at a severe informational disadvantage when they venture abroad, the optimal weight on foreign securities would be far smaller than implied by standard metrics.

One interpretation of the skill exhibited by U.S. investors that we document is that information asymmetries are not severe: if investors are at a substantial disadvantage when they venture abroad, it would be unlikely that U.S. investors could reallocate across foreign markets in a manner that would produce superior portfolio performance—even in an unconditional sense—over a full decade. Another competing interpretation, for which we find some supporting evidence, is that information asymmetries may well be severe and U.S. investors performed well precisely by investing in the types of firms (cross-listed or well-governed) that have alleviated barriers to international investors. ■