

IS International Investing DEAD?

Long live international investing.

BY HARRY S. MARMER

Newspaper articles and academic papers have recently questioned the benefits of international investing. International returns have not been attractive and, to make matters worse, correlations between international and domestic markets have been increasing. Is this a new secular trend? Is international investing dead? This article explains why currently it appears that “the king is dead,” but also why we will most likely exclaim “long live the king” again soon.

Over the past 10 years the correlation between international and Canadian equities has increased dramatically. For example, using three-year monthly returns, the correlation between international and Canadian equities touched 0.34 in 1990, 0.56 in 1995 and 0.70 in 2002.

Over the past three years, non-Canadian equity markets have substantially underperformed Canadian equities, making the case for investing outside of Canada look like a losing battle.

Global Synchronized Bear Market

While these performance results are not pretty, they should not be surprising given that we have been living through a global synchronized bear market that was caused by the following factors:

- The bursting of the global technology, media and telecommunications stock bubble;
- Corporate scandals;
- Oil price shock and geopolitical uncertainty

It’s important to remember that bear markets are a natural part of stock market cycles. They can hurt, but out of every bear market is eventually born a bull market. The difficulty most investors have is seeing through the bottom of the cycle. For example, if you were back in June 1970, after the market had compressed almost

24%, do you believe you would have foreseen the market’s rise by almost 82% over the next three years?

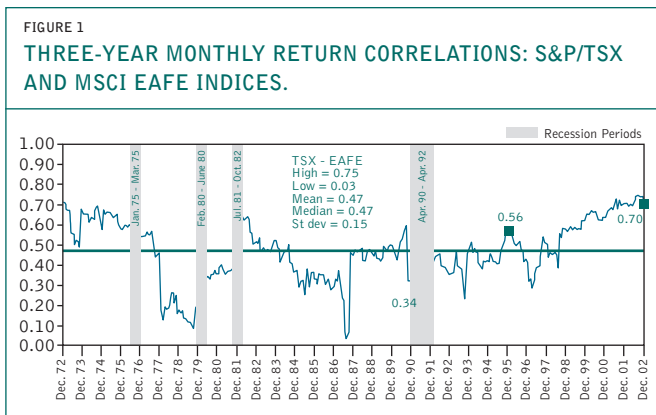
Asset allocation is a three-dimensional problem where the ingredients are expected returns, risk and correlations. Some important observations are as follows:

- Returns, risk and correlations are all time-varying, which makes assumptions about these variables treacherous;
- Volatility appears to shift over time through low, moderate and high volatility regimes,¹ and;
- The correlation between Canadian and international equities has indeed varied over time but its recent high water mark is more an artifact of “this statistician” selecting a data point as opposed to representing a specific trend—that is to say, statistics don’t lie but know your statistician.² (See Figure 1)

Over time, there have not been particular secular trends. Instead, the evidence suggests that the behavior of this correlation is “cyclical” or regime-like in nature.³

Shifts Are Difficult to Forecast

The behavior of markets changes over time, as they transition from one regime to another. These regime shifts



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TABLE 1
REGIME SHIFTS: VARIOUS ECONOMIC REGIMES 1956-1995

| Description ⁵ | Total Experience (1956-1995) | Low Inflation Low Real Int. Rates (1956-1964) | Boom/Bust Inflation Cycle (1972-1993) | Galloping Inflation (1973-1982) | Current Environment Declining Inflation High Real Interest Rates (1983-1995) |
|--------------------------|------------------------------|---|---------------------------------------|---------------------------------|--|
| Inflation | 4.6% | 1.8% | 6.4% | 9.4% | 3.4% |
| Cash | 2.6% | 1.8% | 3.0% | 0.8% | 5.4% |
| Bonds | 3.7% | 2.5% | 4.9% | -0.8% | 8.5% |
| Canadian Stocks | 5.8% | 8.3% | 5.7% | 2.0% | 7.5% |
| U.S. Stocks | 7.7% | 10.5% | 7.3% | 1.0% | 13.4% |
| International Stocks | — | — | 10.0% | 1.6% | 15.0% |

⁵ Cash: Scotia Mcleod Inc.; SMI 91-day T-Bill total return index (TRI)

Bonds: SMI Long-Term Bonds TRI

Canadian Stocks: TSE 300 TRI

U.S. Stocks: S&P 500 TRI in Canadian \$

International Stocks: MCSE EAFE TRI in Canadian \$

Source: *An Introduction to Real Return Bonds for the Institutional Investor*, by H. S. Marmar, B. McInerney, M. D. Heyer - March 1997

are extremely difficult to anticipate. For example, not too long ago the popular investment books had such titles as *Dow 36,000*, and *Electronic Day Trading Made Easy*.

What makes regime shifts so difficult to forecast is the fact that asset class returns are not normally distributed but are better described as being “lumpy” or having outliers, that is, suffering from skewness.⁴

Perhaps another way to examine the challenge of predicting regime shifts is displayed in Table I. Three or four different economic regimes, can be identified between 1972 and 1993 depending on how one interprets the period. Of course, there could be other opinions on how to classify these regimes, which supports the sage saying: “history is almost forecastable from the future.”

Successful asset allocation decisions are strategic in nature and based on the following premises:

- Stocks outperform bonds
- Bonds outperform cash
- Correlations are relatively stable

The first two assumptions are based on the belief that, in the long term, capitalism works, while the spreads between asset classes should reflect where interest rates are today and one’s view on productivity growth and inflation.

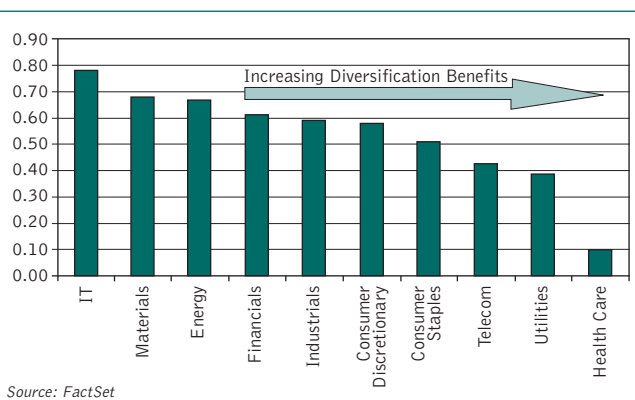
Generally speaking, the excess returns for stocks have been positive for five out of six economic regimes since 1924. Only in coming out of a disinflation regime where bond yields had hit new records did “capitalism appear to fail.”

We do not believe that the correlation between Canadian and international stocks has permanently increased to a significant degree but is instead an artifact of this temporary regime shift where equity correlations have increased reflecting the global synchronized bear market regime.

Hence, the principles for benefits of international investing are still there, including:

1. International markets have become a significant portion of world markets, while Canada has indeed shrunk over time. Today, international companies compose a larger proportion of the opportunity set for investors than they did in 1970, according to FactSet Research Systems.
2. International equities offer access to a broader spectrum of economies and opportunities that can provide for further diversification benefits (World Bank [July 16, 2001]).
3. Sector and country correlations still vary: From an

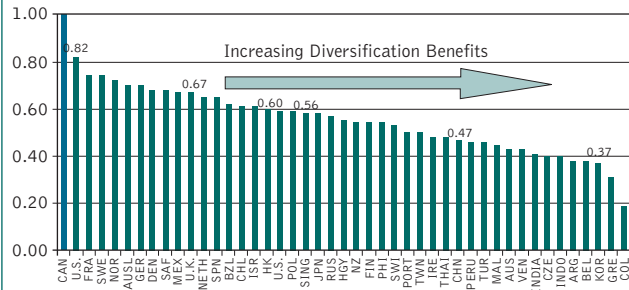
FIGURE 2
CORRELATION OF SECTORS: MSCI CANADA VS. MSCI EAFE



Source: FactSet

FIGURE 3

5-YEAR CORRELATION: MSCI CANADA VS. VARIOUS MSCI AC WORLD INDICES (ENDING JAN. 31, 2003)



Source: FactSet

investment manager perspective, international markets are thought of less from an EAFE perspective and more from a sector and country viewpoint. Figures 2 (see page 44) and 3 confirm that from a Canadian investor perspective there are a wide variety of diversification benefits available across sectors with correlations as low as 0.10, and countries with correlations of less than 0.20. (All calculations in Canadian dollars unless otherwise stated.)

In conclusion:

- The bear market will end if it hasn't already, and;
- Market volatility will stabilize, while;
- Correlations between equities will stabilize, and consequently;
- International investing will continue to provide superior returns adjusted for risk.

And recall the observations of Nobel Prize-winning economist Harry Markowitz: "Diversification is both observed and sensible; a rule of behavior which does not imply the superiority of diversification must be rejected both as a hypothesis and a maxim." ■

End Notes

1. See S.D. Hamilton, "A New Approach to the Economic Analysis of Timestationary Time Series and the Business Cycle", *Econometrica* 57, 1989.
2. See "International Asset Allocation with Regime Shifts", by Andrew Ang and Geert Bekaert, *The Review of Financial Studies*, Fall 2002, Volume 15, No. 4.
3. Recent empirical research suggests that "regime switching" models provide a more appropriate methodology for testing correlation breakdowns (Correlation Jumps by Wai Mun Fong, *Journal of Applied Finance*, Volume 13, No 1).
4. Research on financial returns having normal return distributions goes back to Benoit Mandelbrot, in "The Variation of Certain Speculative Rules," *Journal of Business*, 1963.

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