Buffalo Mutual Funds

International Investing: Less Than Meets the Eye

A Whitepaper Discussing the Benefits and Failures of International Investing.

July 2001
Summary and Conclusion

Keep five to ten percent of your portfolio in gold as a hedge against inflation. Invest internationally to enhance returns and provide diversification.

Some things get repeated often enough that you begin to believe them. For as long as most investors can remember, one of the guiding lights of the financial advisory community has been to allocate a portion of your assets to international securities — stocks and/or mutual funds. While that advice may have been well intentioned, the results of the past 30 years suggest most investors would have been far better off had their dollars never left the shores of the United States.

The reasons for investing overseas include the potential for higher returns and portfolio diversification1. Part of the expectation for higher returns from international investments is associated with the higher economic growth rates of other countries, especially in Asia and Latin America. The growth rates for many foreign economies exceed that of the United States. Driven by higher population growth and the expectation of rapid improvements in productivity, the regions outside the United States would appear to have greater potential for yielding higher growth, and hence strong equity returns.

It's hard to argue with the population growth numbers. China’s population currently is increasing by about 10 million people per year, India adds nearly 17 million people per year, whereas the United States is growing by only about 2.5 million people per year. Productivity improvements, another source of rapid economic growth, should be greater in most other countries. And the United States is a mature economy. Adding more computers, phone lines, and highways is not going to meaningfully increase the productivity of American workers.

However, many countries are just beginning to put in place infrastructure that most Americans take for granted. Less than 2 percent of Indonesian households have a computer, and the penetration of wireless phones in India is only 1 percent. Or, contrast the United States, where there is roughly one automobile for every man, woman and child, with China, where there are nearly 100 people for each vehicle. You can see how the bullish case for international investing starts to build. The rest of the world will have a tremendous appetite for new cars, computers, restaurants, wireless phones and energy.

1 For a good starting point on international investing, see www.sec.gov/pdf/ininvest.pdf.
Those companies that are best able to satisfy the expected huge overseas demand will make fortunes. For some pundits, the important decision to be made revolves around picking the right international mutual fund or stock.

But there’s more to the argument for international investing than just the prospect for greater returns. Diversification is the second reason for spreading your assets overseas. The imperfect correlation of returns between investments in different countries lowers the overall volatility of your total portfolio. For example, the health of the Japanese and Mexican economies depends on different variables, which explains why your Japanese holdings may be down during the same year that your Mexican investments are up, resulting in a less volatile portfolio.

How have the owners of foreign stocks and international mutual funds fared?

**Many Unhappy Returns**

Measured in U.S. dollars, the returns on international stocks over the past 31 years (1970-2001) have lagged those in the United States, on average, by about 1.5 percent per year. One thousand dollars invested in both the S&P 500 and the Morgan Stanley International EAFE Index at the end of 1969, and held through the end of 2000, would have grown to $36,456 and $24,029, respectively. While the 1990s were difficult years, most of this 31-year period was absolutely spectacular for those who invested in the Japanese economy. This period also saw the emergence of the Asian tiger economies of South Korea, Indonesia, Malaysia and Thailand; the fall of communism; the collapse of the Berlin Wall; and the introduction of a common European currency.

The 1970s and 1980s also included an overall weakening of the U.S. dollar ($1 bought 300 yen in 1970, but only 100 yen as the year 2000 came to a close), which also helped to boost international returns when measured in U.S. dollars. This environment has been a very strong one for international markets, yet foreign returns lagged behind those of the United States.

The following table summarizes the returns of the S&P 500, the Morgan Stanley EAFE Index and the results of mutual funds that invest only in international stocks as tracked by Morningstar, Inc.
Increasing Correlation

A second reason for investing internationally is the benefit of diversification. Intuitively, spreading your investments across more than one country makes a lot of sense. While the United States may be experiencing economic weakness, another country’s economy may be strengthening. Hence, while one of your investments is falling, the other may be rising: that’s the beauty of diversification and is how it can lead to lower portfolio volatility.

But, as the economies of other countries become more intertwined with that of the United States, the diversification achieved through the expected low correlation of inter-country returns has been waning. The reasons for the increased correlation of returns between the U.S. market and elsewhere seem clear. Increased globalization through the easing of trade barriers has been a major factor. Also, as companies mature in their own country, they find expansion through foreign operations as their best growth option. McDonald’s receives more than half of its revenue from outside the United States. Elan Corporation, an Irish pharmaceutical company, receives nearly 75 percent of its revenue from the United States. Sony, the large Japanese electronics conglomerate, gets more than two-thirds of its revenue from outside Japan.

Mergers and acquisitions also have played a role in increasing the correlation of inter-country returns. Remember Chrysler, Amoco and Best Foods (you may remember them better for such products as Hellman’s mayonnaise and Skippy peanut butter). Over the...
past few years, these companies became acquisitions for Daimler (Germany), British Petroleum (United Kingdom) and Unilever (The Netherlands), respectively.

Other factors contributing to increased correlation include the widespread use of the U.S. dollar in international commerce and the growing worldwide dependence on certain countries for critical technological expertise. For example, Japan in consumer electronics, Finland in wireless phones and the United States in aerospace and software.

The accompanying graph shows the correlation coefficient\(^2\) between the S&P 500 and the Morgan Stanley EAFE Index using a three-year moving window of monthly index return data. Note that the correlation coefficient between international and domestic stocks has increased from 0.5 in the early ‘90s to more than 0.8 at the end of 2000. As the correlation between U.S. and foreign stocks strengthens (as this graph of correlation shows it has), the case for diversifying your portfolio by adding foreign stocks or mutual funds to your holdings weakens.

If you want additional proof of the lack of diversification benefit from holding foreign securities, look at 1987. The U.S. market collapsed during October of that year. Studies and analyses since then have widely described the market collapse in the United States as the result of program trading and the use of portfolio insurance strategies. As the following table shows, diversification across countries didn’t help investors when they needed it most.

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<tr>
<td>United States (S&amp;P 500)</td>
<td>-21.8%</td>
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<tr>
<td>United Kingdom (FTSI 100)</td>
<td>-26.0%</td>
</tr>
<tr>
<td>France (CAC-40)</td>
<td>-22.9%</td>
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<tr>
<td>Germany (DAX 30)</td>
<td>-21.5%</td>
</tr>
<tr>
<td>Japan (Nikkei 225)</td>
<td>-12.5%</td>
</tr>
<tr>
<td>Hong Kong (Hang Seng)</td>
<td>-43.2%</td>
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\(^2\) The correlation coefficient measures the degree to which two variables move together. A coefficient of 1.0 implies perfect association of movement between the returns of the S&P 500 and the EAFE Index. A correlation of 0 implies no correlation of returns.
The Longer Run

We used 31 years of data in our analysis because 1970 marks the inception date of the widely used Morgan Stanley EAFE index. Data on the U.S. stock market is readily available going back much further in time. Ibbotson Associates has compiled very detailed and reliable U.S. stock market return data from 1926.

Why is similar data on foreign markets so hard to come by? Because the United States is essentially the only market in the world that has not been overrun by an invading army, closed for years at a time, experienced runaway inflation (the kind where the government occasionally tells you to simply add a zero to all bill denominations), or been permanently closed by a dictator wearing green fatigues.

A very frustrating way to lose your money in the United States has been to own stock in a company that has disappointing earnings. Owning a company located in the eastern part of Germany at the end of World War II was an even more frustrating way to lose your money. Even if your country was one of the victors of war, your stock ownership was not safe — Renault and Air France fell under French government control shortly after World War II.

Readers who think that looking back further than 30 years would help the case for international investments may have forgotten that the U.S. political and economic system weathered the Depression and World War II in far better fashion than the rest of the world. With assets of foreign companies being nationalized, expropriated and bombed, and with some countries experiencing bouts of daily inflation exceeding what Americans typically see in an entire year, it’s no wonder reliable and accurate data from foreign stock exchanges are hard to come by. If anything, the past 31 years would seem to be the exception for international markets, and having access to a longer period of data would serve to weaken the case for foreign stocks.
Who Benefits?

What companies benefit most from the growth of international markets? The opportunities are huge. Who will sell supplemental insurance to the aging Japanese population not reimbursed by Japan’s health insurance system? Who will be the largest beneficiary of the adoption of personal computers in India and Indonesia? As the standard of living grows in Russia, which restaurant will emerge to be the winner in feeding this country’s rapidly growing appetite? What consumer products will become household names in China, thus virtually assuring strong future growth?

You don’t have to search very far. AFLAC, based in Columbus, Ga., already insures one of every four Japanese and receives more than 80 percent of its revenue and profits from Japan. Intel, based in Santa Clara, Calif., is by far the largest producer of microprocessors for use in PCs, has virtually no foreign competition for processors (AMD is a distant second) and receives about 60 percent of its revenue from outside the United States. McDonald’s opened its first restaurant in Russia in 1990. Today it operates 63 Russian units, and the McDonald’s in Pushkin Square is the busiest McDonald’s restaurant in the world — out of nearly 29,000. McDonald’s receives more than 63 percent of sales from outside the United States. Developing brand awareness will be critical for winning over a
vast country with more than 1.2 billion people. Fortunately for Coca-Cola, it’s already the most recognized brand in China; the company receives more than 61 percent of its revenue from outside the United States.

Investing in U.S.-based companies that stand to be the beneficiary of the rest of the world’s growth yields several benefits. Unlike their foreign counterparts, U.S. companies must conform to U.S. accounting and auditing standards (we’ll take those standards over any elsewhere in the world), trade on U.S. exchanges (better developed rules, lower costs and superior liquidity), and generally face less political risk (nothing like waking up in the morning to see that one of your holdings was just nationalized by the government — a common occurrence in Europe over the past 50 years).

Our belief in which companies are likely to be the true beneficiaries of global growth is the basis for the strategy of the Buffalo USA Global fund, which invests solely in U.S.-based companies that receive at least 40 percent of their revenues or income from outside the United States. This strategy generally leads us to large U.S. companies with global distribution capabilities, possessing strong competitive advantage over foreign rivals. Most holdings fall in sectors where U.S. companies lead the world: in technology, consumer products and healthcare.

Old Beliefs Fade Slowly

Recommendations for investing in international markets, or directly in foreign stocks, will be with us forever. The primary reason for advocating such investments — aside from collecting higher fees — is the hope for strong returns, which is easy to understand. Admittedly, there is always a stock market in some country around the world that is outperforming the United States. Like watching a Roman candle on the Fourth of July, the meteoric rise of each fireball erases the memory of the previous burnout.

The return data suggest that investors are not being compensated for the additional risks of foreign investing. And, with the stock markets of the world increasingly clinging together like socks in the laundry, investors are left with less of the expected diversification benefits, and more of the country specific risk. Investors looking outside of the United States for their international investment ideas appear to have been looking too far from home.
References to specific securities should not be construed as recommendations by the Fund or Advisor.

For more information, including annual charges and expenses, please call for a prospectus, which should be read carefully before investing. Shareholders may call 1-800-49-BUFFALO (1-800-492-8332) and advisors should call 1-800-422-2454.

Data represented reflects past performance and is no guarantee of future results. Investment return and principal value will fluctuate, and redemption value may be more or less than original cost.

International investing involves special risks such as political instability and currency fluctuations.

For a listing of the top ten holdings of the funds, see the Fund Information section of the Buffalo Funds web site at www.buffalofunds.com or click on the following link: Fund Information