

# Is International Investing Dead?...Long Live International Investing

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# Is International Investing Dead?...

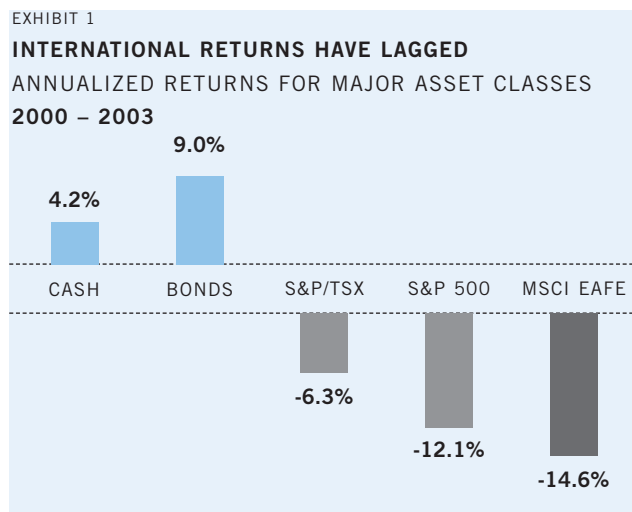
## Long Live International Investing

Newspaper articles and academic papers have recently questioned the benefits of international investing.<sup>1</sup> 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 it appears that “the king is dead,” and why we may soon be exclaiming, “long live the king” again.

### Recent Capital Market History Is Not Pretty

Over the past 10 years, the correlation between international and Canadian equities has dramatically increased. For example, on the basis of 3-year monthly returns, the correlation between international and Canadian equities was 0.34 in 1990, grew to 0.56 in 1995 and reached 0.70 in 2002.

**Exhibit 1** displays major asset class returns for 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.



### A Synchronized Global Bear Market

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

- The bursting of the global TMT bubble;
- Corporate scandals;
- Oil price shock; and
- Geo-political uncertainty

### We've Seen This All Before

Bear markets are a natural part of stock market cycles. **Exhibit 2** illustrates the bear and bull market cycles for the Canadian market over the past 30 years. Though bear markets can hurt, we can take comfort in knowing that every bear market eventually gives rise to a bull market. The challenge facing most investors is finding the patience – and even stamina – to see the bottom of the cycle to its end. By June 1970, for example, the market had compressed by almost 24%. If you were investing at the time, would you have foreseen the market's rise by almost 82% over the next 3 years?

EXHIBIT 2  
**BULL MARKETS BORN FROM BEAR MARKETS**  
CANADIAN BEAR & BULL MARKETS SINCE 1969

BEAR MARKETS			BULL MARKETS		
Date	Period Cumulative Return	Annualized Return	Date	Period Cumulative Return	Annualized Return
05/69–06/70	-23.7%	-21.8%	06/70–10/73	81.9%	19.7%
10/73–11/74	-33.1%	-31.0%	11/74–04/81	266.0%	22.4%
04/81–06/82	-37.2%	-32.6%	06/82–08/87	252.6%	28.1%
08/87–11/87	-25.5%	-25.4%	11/87–04/98	247.3%	12.7%
04/98–09/98	-26.2%	-26.2%	09/98–08/00	105.8%	45.7%
08/00–12/02	-38.9%	-17.6%	?	?	?

The author would like to thank Irshaad Ahmad of Mercer Investment Consulting for his insightful comments, which benefitted this article. All calculations are in Canadian dollars unless stated otherwise.

<sup>1</sup> Ernest M. Ankrum discusses this perspective in more detail in Global Diversification Is (Still) Good For Your Clients, from Investment Counseling for Private Clients IV, AIMR Publications 2002, Pages 12-18

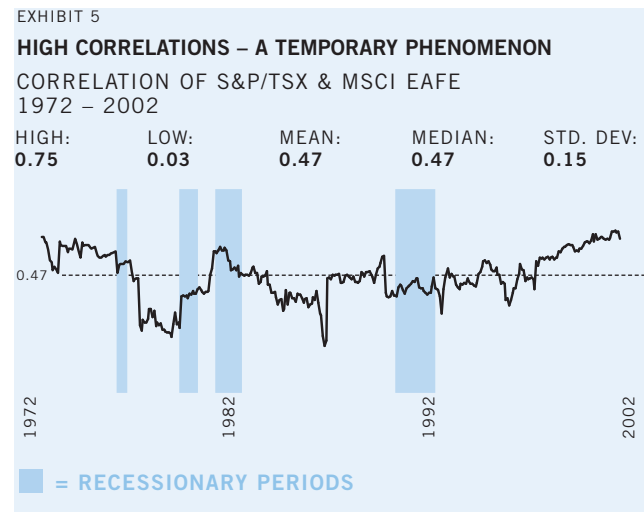
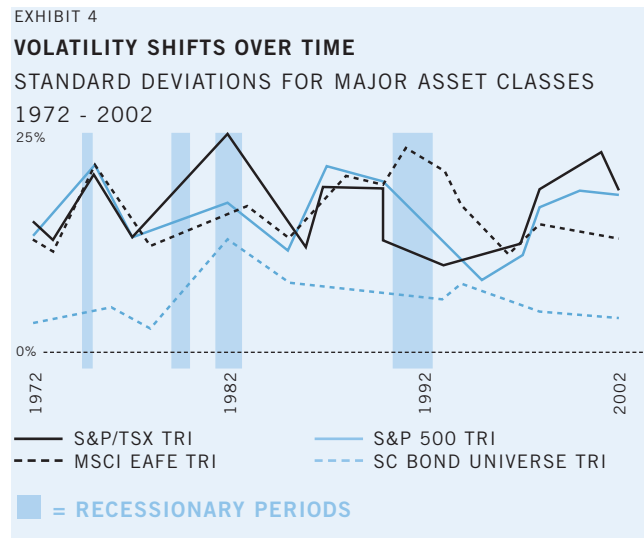
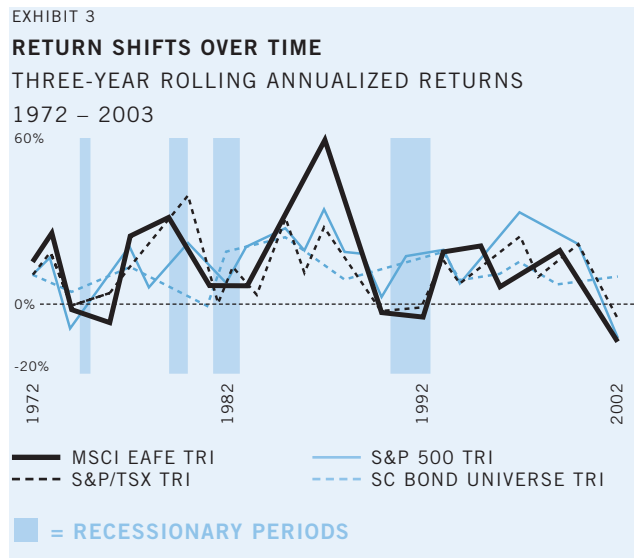


## Returning to the Basic Principles

Asset allocation is a three dimensional recipe where the key ingredients are expected returns, risk and correlations. **Exhibits 3, 4 and 5** display time series charts measuring the expected returns, risk and correlations of various equity asset classes over rolling three-year periods. Some important observations are as follows:

- Returns, risk and correlations are all time-varying, making assumptions about these variables so treacherous.<sup>2</sup>
- Volatility appears to shift over time through low, moderate and high volatility *regimes*.<sup>3</sup>
- While the correlation between Canadian and international equities has varied over time, its recent high water mark is more a result of the data point selected as opposed to representing a specific trend. As the saying goes, “statistics don’t lie, but know your statistician”.

What is clear from the data is that, 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.<sup>5</sup>



### Regime Shifts Are Difficult to Forecast

The time series data clearly illustrates that market behaviour changes over time as markets transition from one regime to another. These regime shifts are extremely difficult to anticipate especially if you think back that it was not too long ago where the most popular investment books had titles such as *Dow 36,000*, *Dow 100,000* and *Electronic Day Trading Made Easy*.

<sup>2</sup> For example: Harry S. Marmar, “Optimal International Asset Allocations Under Different Economic Environments: A Canadian Perspective,” *Financial Analysts Journal* (November-December 1991): Pages 85-92; Bruno Solnik, “The Economic Significance of the Predictability of International Asset Returns” (October 1990/91), HEC School of Management; Antii Ilmanen, “Time-Varying Expected Returns in International Bond Markets,” *The Journal of Finance* (June 1995)

<sup>3</sup> The pioneering work on regime shifts was by S.D. Hamilton, “A New Approach to the Economic Analysis of *Time-stationary Time Series* and the Business Cycle”, *Econometrica* 57, pages 357-384, 1989

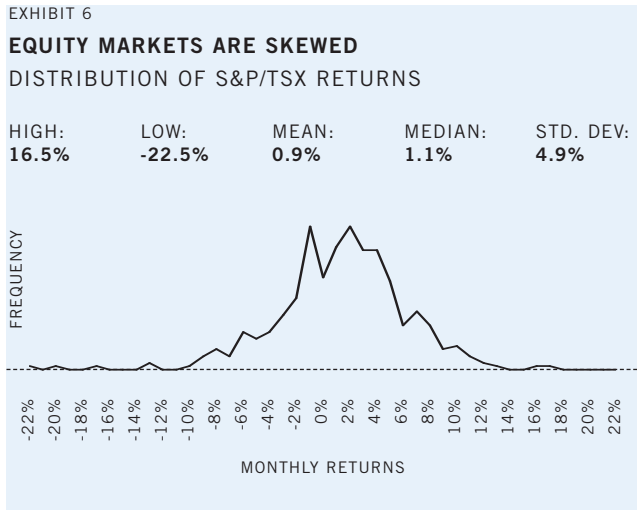
<sup>4</sup> While recent research has found that correlations increase in bear markets it has also found that international diversification is still valuable – see “International Asset Allocation with Regime Shifts”, by Andrew Ang and Geert Bekaert, *The Review of Financial Studies*, Fall 2002, Volume 15, No. 4, pages 1137-1187

<sup>5</sup> Recent empirical research suggests that “regime switching” models provide a more appropriate methodology for testing correlation breakdowns. “...regime switching models provide a data coherent method that can capture many salient features of asset returns such as GARCH effects, skewness, conditional leptokurtosis and most importantly, regime switches”, page 42 from “Correlation Jumps” by Wai Mun Fong, in *Journal of Applied Finance*, Volume 13, No 1, pages 29-45



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What makes regime shifts so difficult to forecast is that asset class returns are not normally distributed; the returns are better described as being “lumpy” or having outliers, i.e., suffering from skewness.<sup>6</sup> **Exhibit 6** displays the distribution for Canadian equity returns with associated outliers.<sup>7</sup>



Perhaps another way to examine the challenge of predicting regime shifts is displayed in **Exhibit 7**. Over 30 years of capital market history, 3 or 4 different economic regimes can be clearly identified depending on how one interprets the period 1972 – 1993.

**EXHIBIT 7**  
**INTERPRETING REGIME SHIFTS**  
 ECONOMIC REGIME SHIFTS SINCE 1956

	Total Experience (1956-1995)	Low Inflation Low Real Rates (1956-1964)	Boom/Bust Inflation Cycle (1972-1993)	Galloping Inflation (1973-1982)	Current Environment Declining Inflation High Real Int. Rates (1983-1995)
<b>INFLATION</b>	4.6%	1.8%	6.4%	9.4%	3.4%
<b>CASH</b>	2.6%	1.8%	3.0%	0.8%	5.4%
<b>BONDS</b>	3.7%	2.5%	4.9%	-0.8%	8.5%
<b>CANADIAN STOCKS</b>	5.8%	8.3%	5.7%	2.0%	7.5%
<b>U.S. STOCKS</b>	7.7%	10.5%	7.3%	1.0%	13.4%
<b>CANADIAN STOCKS</b>	-	-	10.0%	1.6%	15.0%

Cash: ScotiaMcLeod 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; International Stocks: MSCI EAFE TRI

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

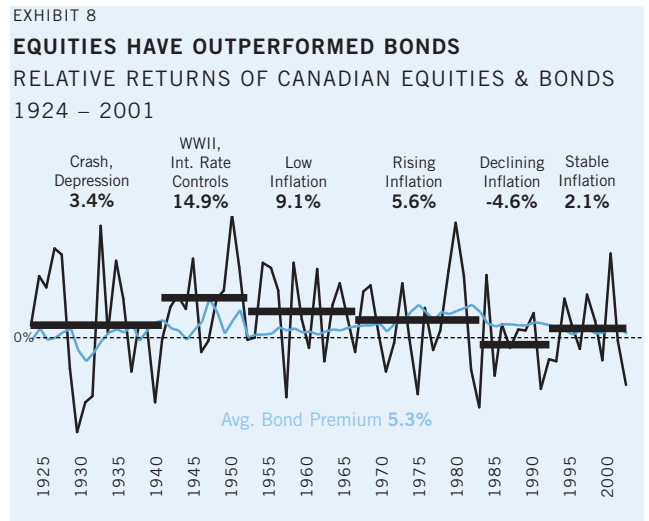
**So What's a Poor Soul To Do?**

Successful asset allocation decisions are strategic in nature and based on the following long term 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 and that the spreads between asset classes should reflect where interest rates are today and one's view on productivity growth and inflation.

**Exhibit 8** shows the excess returns of Canadian equities relative to bonds proving that capitalism eventually works. The excess returns for stocks have been positive in 5 out of 6 economic regimes. Only with the emergence of the disinflation regime where bond yields had hit record levels did capitalism appear to “fail”. Of course, this exhibit also reveals that the equity premium varies significantly over time.<sup>8</sup>



\*SCU used since 1955

<sup>6</sup> Research on financial returns having non-normal return distributions goes back to Benoit Mandelbrot, in “The Variation of Certain Speculative Rules,” Journal of Business, 1963

<sup>7</sup> This is discussed in more detail in Chapter 10, “Striving for Institutional Investment Success”, page 105, from Perspectives in Institutional Investment Management, by Harry S. Marmer, Rogers Publishing, 2002, Toronto

<sup>8</sup> Keith Ambachtsheer tackles this issue in “The ‘Post-Bubble Blue Decade’: Is All The Bad News Already in Stock Prices?,” The Ambachtsheer Letter, No 255, May 2003



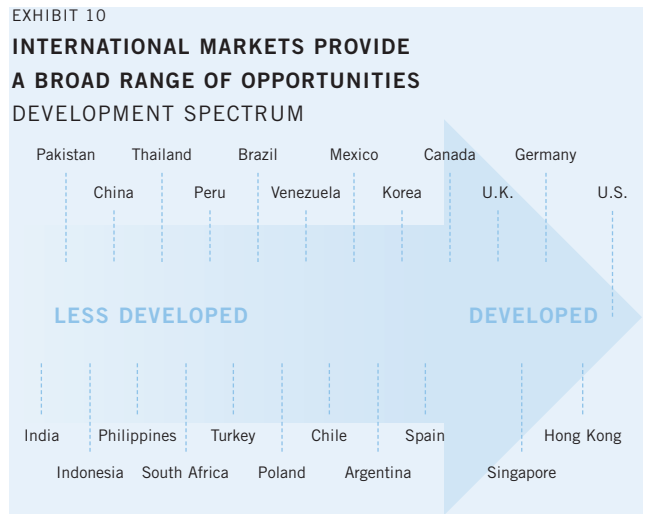
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**The Merits of International Investing Are Still There**

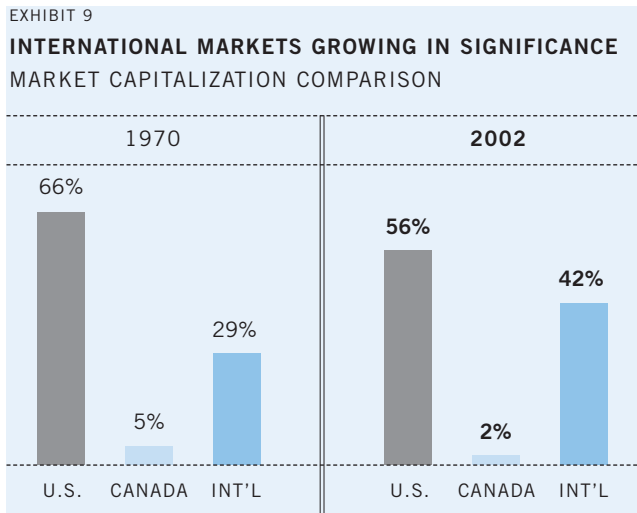
We do not believe that the high correlation between Canadian and international stocks is a permanent phenomenon. We believe that it is a symptom of this current regime shift where equity correlations have temporarily increased reflecting the global synchronized bear market regime.<sup>9</sup>

Hence, the principles of international investing still exist:

1. *International Markets Are a Significant Portion of the World* – **Exhibit 9** reflects the growing importance of international markets over the last 30 years. Although the Canadian market has shrunk to about 2% of the world’s market cap, international markets have become a significant portion of world markets. Today, international companies compose a much larger proportion of the opportunity set for investors than they did in 1970.<sup>10</sup>
2. *International Equities Offer Access to a Broader Spectrum of Economies* – **Exhibit 10** illustrates that international countries represent a broad spectrum of economic opportunities that provide additional diversification benefits.<sup>11</sup>



Source: World Bank (July 2001). World Development Indicators Database. Rankings based on 2000 GDP per capita data.



Source: FactSet Research Systems, Inc. (MSCI Data)

<sup>9</sup> A recent paper (entitled “Evaluating Correlation Breakdown during Periods of Market Volatility” by Mico Loretan and William B. English, International Finance Discussion Papers, No. 658, February 2000) suggests that increases in correlations during volatile periods ‘reflects nothing more than time-varying sampling volatility’

<sup>10</sup> FactSet Research Systems, Inc. (MSCI data)

<sup>11</sup> World Bank (July 16, 2001) – World Development Indicators Database. Countries are ranked based on their 2000 GNP per capita figures



3. *Sector & Country Correlations Still Vary* – From an investment management perspective, international markets are regarded less from an EAFE perspective and more from a sector and country viewpoint. **Exhibits 11** and **12** confirm that international investing still offers Canadians a wide variety of diversification benefits available across sectors and countries with correlations as low as 0.10 and less than 0.20 respectively.

#### Long Live International Investing

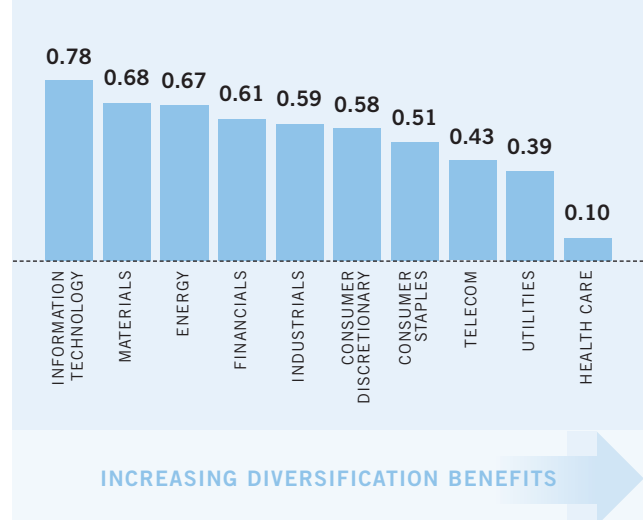
So, what does this mean to investors wondering about the future of international investing – or, more importantly, what will be the impact of international investing on their portfolios? When we review the history – long-, medium-, and short-term – of international investing, it is critical to ensure the perspective we take and the statistical models we apply are meaningful and accurate. Short-term bouts of market volatility and correlation jumps occur but the longer term facts are far more encouraging. When thoroughly examined, international investing has always delivered strong diversification benefits, broader opportunities and enhanced returns – and it continues to do so. Looking ahead, it appears international investing holds even more promise than ever before. As with its predecessors, the bear market is dying out and international investing will continue to provide superior risk-adjusted returns and benefit portfolios.

Nobel-laureate Harry Markowitz puts it succinctly:

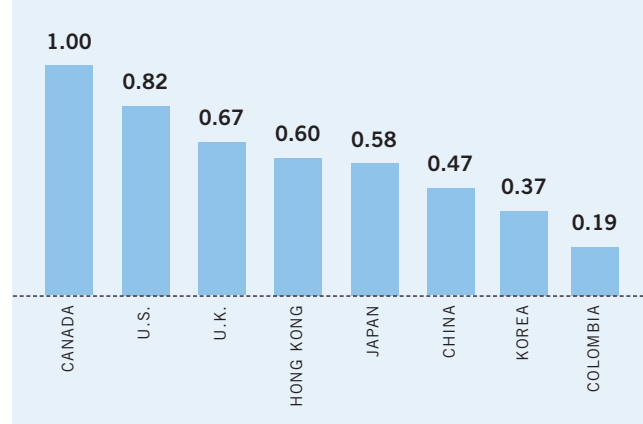
“Diversification is both observed and sensible; a rule of behavior which does not imply the superiority of diversification must be rejected both as a hypothesis and as a maxim”.<sup>12</sup>

EXHIBIT 11, 12

#### DIVERSIFICATION BENEFITS OF INTERNATIONAL SECTORS SECTORS CORRELATION OF MSCI CANADA & MSCI EAFE INDICES



#### DIVERSIFICATION BENEFITS OF INTERNATIONAL MARKETS 5 YEAR COUNTRY CORRELATIONS OF MSCI CANADA & VARIOUS MSCI AC WORLD INDICES



<sup>12</sup> Harry Markowitz: “Portfolio Selection” – The Founders of Modern Finance: Their Prize-winning Concepts and 1990 Nobel Lectures, Pg 13-28 The Research Foundation of The Institute of Chartered Financial Analysts

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