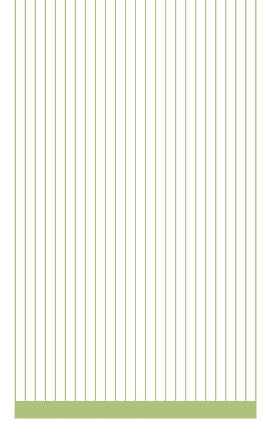


Five Myths of International Investing

While many investors have taken advantage of the six-year rally in U.S. stocks, they may have overlooked attractive opportunities overseas. Despite the recent struggles of some international markets, there are powerful reasons to look outside the U.S. for equity exposure, such as enhanced diversification, the potential for better risk-adjusted returns, and more. And though a full recovery in markets abroad may take some time, their near-term prospects seem to be brightening. For instance, Japan outperformed the U.S. in 2015. The outlook for most developed international markets has improved, and leading economic indicators for more than half of emerging markets have risen in recent months.

Nevertheless, many investor portfolios remain underexposed to international stocks, often due to misperceptions about the asset class. So here are Fidelity's responses to five common "myths" investors have about investing in international stocks.

MYTH 1: International investing is too risky.
Reality: In combination with U.S. stocks, international exposure can actually lower risk in an equity portfolio. Over the past 65 years, a globally balanced hypothetical portfolio of 70% U.S./30% international equities has produced better risk-adjusted returns (Sharpe ratio)[1] and lower volatility (standard deviation) than an all-U.S. portfolio (Exhibit 1, left). The 70/30 relationship has fared worse over the past decade or so (Exhibit 1, right), but we believe it may revert to its historical norms given the cyclicality of U.S. and international stock market performance.

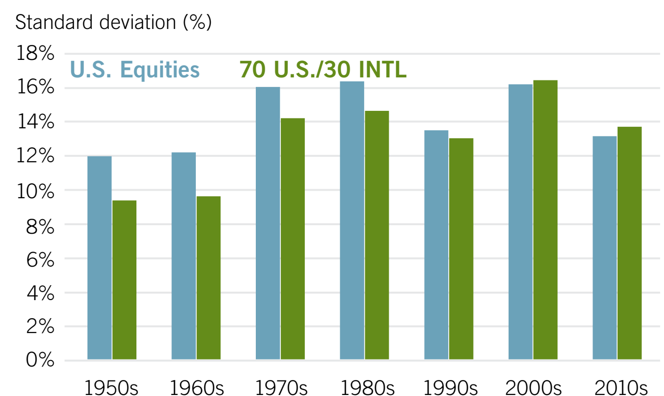
1 See last page for Glossary of Terms.

MYTH 2: U.S. stocks usually outperform foreign stocks.
Reality: Historically, the performance of international and U.S. stocks is cyclical: One typically outperforms the other for several years before the cycle rotates (Exhibit 2, left). Recent performance has favored U.S. stocks, but given the cyclical nature of these asset classes, foreign stocks will eventually take the lead again. Timing these rotations is difficult, though, so investors who are underexposed to international could miss significant gains when the market corrects. Note also that all of the world's best-performing stock markets have

Exhibit 1 Foreign exposure can lower portfolio risk over the long term, though it's been less supportive recently.

1950 to 2015	S&P 500	International Portfolio	Globally Balanced Portfolio 70% U.S. / 30% International
Annualized Returns	11.2%	9.4%	10.9%
Standard Deviation	14.4%	15.2%	13.2%
Sharpe Ratio	0.51	0.37	0.54

Volatility by Decade



Hypothetical "globally balanced portfolio" is rebalanced annually in 70% U.S. and 30% foreign stocks. U.S. equities: S&P 500 Total Return Index; International equities: GFD World x-US Return Index (1950-70), MSCI EAFE (1970-87), and MSCI ACWI ex-US Index (1987-present). Source: Bloomberg Finance L.P., Fidelity Investments (AART), as of Dec 31, 2015. Past performance is no guarantee of future results.

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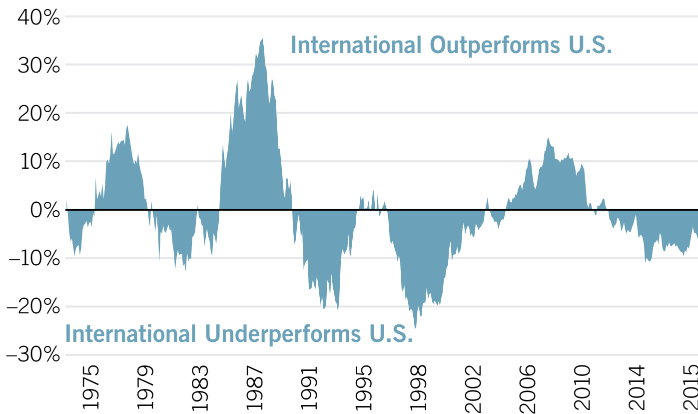
Exhibit 2 Even when the cycle of performance favors the U.S., foreign markets can still offer higher returns.



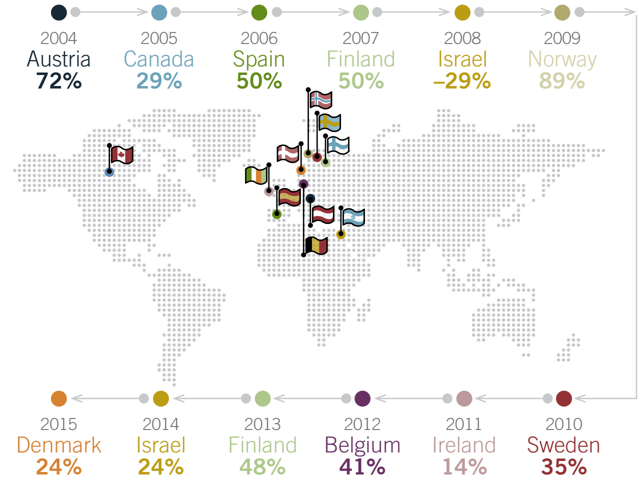


Exhibit 2 (left): MSCI EAFE Index vs. S&P 500 Total Return Index. Source: FactSet, as of Dec. 31, 2015. Exhibit 2 (right): Source: FactSet, MSCI country indexes, as of Dec. 31, 2015. Past performance is no guarantee of future results.

been located outside the U.S. during the past 12 years (Exhibit 2, above right), and the top-performing stock in nine out of 10 market sectors during the past decade belonged to international companies.[2] This illustrates the value of maintaining international exposure in any market environment.

2 *FactSet, as of Dec. 31, 2015.*

MYTH 3: U.S. multinationals provide adequate international diversification.

Reality: Over the years, many large U.S. companies with operations overseas have experienced periods when their stock prices have been highly correlated to the performance of the S&P 500. High correlations indicate that investment returns are moving in tandem and typically signal lower diversification. The correlations between major U.S.-based multinationals and the S&P 500 have declined in recent years, but this doesn't necessarily make them good replacements for international stocks in a U.S. investor's portfolio. Exhibit 3 compares the average correlations of several U.S. multinationals in different sectors to their international counterparts with U.S.-listed shares. The international stocks shown here have offered lower correlations to the S&P 500 over the past three years, which typically signals better diversification benefits. And while U.S. multinationals may provide some exposure to foreign markets, they still offer only a fraction of the currency diversification that can be achieved by investing directly in overseas markets.

Exhibit 3 International stocks can provide more diversification benefits than U.S. multinationals.

THREE-YEAR RETURN CORRELATION WITH THE S&P 500, 2013 TO 2015			
Financials	**Telecom**	**Consumer Staples**	**Technology**
Citigroup (U.S.): **0.76**	Verizon (U.S.): **0.67**	Procter & Gamble (U.S.): **0.64**	Apple (U.S.): **0.46**
Lloyds Banking (U.K.): **0.34**	Deutsche Telekom (Germany): **0.16**	Unilever (U.K.): **0.17**	Samsung (Korea): **0.22**

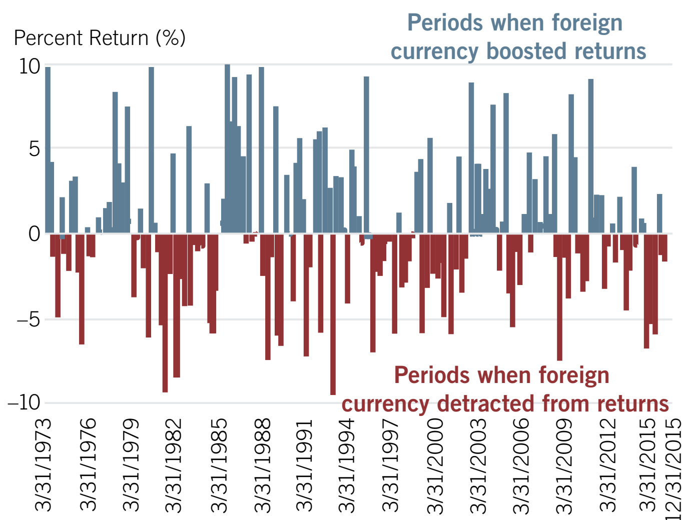
Source: Morningstar, as of Dec. 31, 2015. Company names shown here are for illustrative purposes only and not a recommendation or an offer or solicitation to buy or sell any securities.

MYTH 4: Investors should hedge their currency exposure.

Reality: Currency hedging involves holding a stock denominated in a foreign currency and an equal but opposite position in the currency itself. This is intended to prevent currency fluctuations from hurting the stock price. While it sounds good in theory, the effort and expense involved might not be worth it. Timing currency calls is very difficult, even for professional investors. And currency tends to be a relatively

small component of returns. Historically, earnings growth and price-to-earnings ratios have been far bigger drivers of performance. Most important, currency hedging does not pay off over time. Since 1973, currency hedging has detracted from returns in 50% of quarters, and helped in 50% of quarters (Exhibit 4). And during that same period, the unhedged MSCI EAFE Index has actually beaten the local-currency-denominated (hedged) EAFE by 1.09% on an annualized basis.

Exhibit 4 Historically, hedging currency has hurt returns about as often as it's helped them.



Quarterly returns of MSCI EAFE USD Index vs. MSCI EAFE Local Currency Index 1973-2015. Source: Morningstar, Fidelity Investments, as of Dec. 31, 2015. Past performance is no guarantee of future results.

MYTH 5: Index funds beat active funds in international.

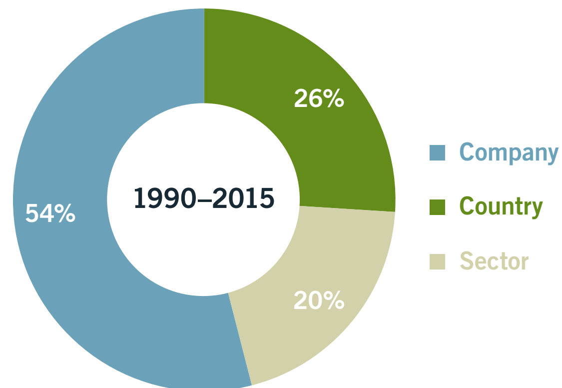
Reality: An index fund provides exposure to all available companies—good and bad—in a particular investment universe. By contrast, active managers backed by skilled research analysts have the ability to select (or avoid) specific companies they believe will beat (or lag) the index average. This is especially notable because company selection is the biggest driver of equity returns—twice as important as country or sector selection (Exhibit 5). The ability to pinpoint specific opportunities may explain why the average actively managed large-cap international fund has beaten its benchmark index by 0.86% annually, even after fees. In comparison, the average large-cap international index fund has trailed its benchmark by 0.32%.[3]

3 *Fidelity Investments, "U.S. Large-Cap Equity: Can Simple Filters Help Investors Find Better-Performing Actively Managed Funds?" May 2015.*

That's a difference of 1.18% per year in favor of active funds. And when you consider the power of compounding, it's clear that actively managed international funds may offer more growth potential than index funds alone.

Exhibit 5 Company selection is a bigger component of equity returns than country and sector combined

Average Source of Return for Global Stocks



Source: MSCI All Country World Index, Fidelity Investments, as of 8/31/15.

Investment implications

International exposure is an essential component of a balanced equity portfolio, and it's important not to let myths and misconceptions derail a sound asset allocation strategy. Given this, here are several important considerations about the six-year bull run in U.S. stocks: a) it won't last forever; b) investors may now have *too much* U.S. equity exposure, which increases portfolio risk; and c), we may be seeing the early signs of recovery in a number of markets abroad. For individual investors, now may be an ideal time to re-examine their stock allocations and add more international equities to their investment mix, especially actively managed strategies.

Investing in companies overseas comes with political, liquidity, and currency risks, all of which can create price inefficiencies within individual stocks. Capitalizing on these inefficiencies requires specialized local knowledge, careful research, and efficient trading. Active managers by definition can maneuver a portfolio to take advantage of these inefficiencies, and potentially produce greater excess return compared with their benchmarks and passive strategies.

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Fidelity's Investment Product Vice President Matthew Godfrey, Investment Product Directors Wilson St. Pierre and Cheri Kotlik, Asset Allocation Research Team Senior Analyst Jacob Weinstein, and Thought Leadership Vice President Matt Bennett contributed to this report.

Glossary of Terms

Standard deviation shows how much variation there is from the average (mean or expected value). A low standard deviation indicates that the data points tend to be very close to the mean, whereas a high standard deviation indicates that the data points are spread out over a large range of values. A higher standard deviation represents greater relative risk.

Sharpe ratio compares portfolio returns above the risk-free rate relative to overall portfolio volatility. A higher Sharpe ratio implies better risk-adjusted returns.

Correlation measures the interdependencies of two random variables that range in value from –1 to +1, indicating perfect negative correlation at –1, absence of correlation at 0, and perfect positive correlation at +1.

Price-to-earnings (P/E) ratio shows the relationship between a stock price and its company's earnings (or profits) per share of stock

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Past performance is no guarantee of future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

Investing involves risk, including risk of loss.

All indices are unmanaged. You cannot invest directly in an index. Stock markets, especially non-U.S. markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets. Risks are particularly significant for investments that focus on a single country or region.

Index definitions

The S&P 500® Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of The McGraw-Hill Companies, Inc., and has been licensed for use by Fidelity Distributors Corporation and its affiliates.

MSCI Europe, Australasia, Far East Index (EAFE) is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors in developed markets, excluding the U.S. & Canada.

MSCI All Country World Index (ACWI) is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors of developed and emerging markets.

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