International markets: How much of the world should investors see in their portfolios?

International investments have the capacity to play a significant role in a diversified portfolio, but there are unique factors to consider.

The United States makes up approximately half of the world's equity markets and about 40% of the global fixed income market. That means, of course, fully half of the global markets are made up of non-U.S. investments. With international markets showing signs of increasing returns, investors are wondering what role foreign investments should play in their portfolios.

WAYS TO OWN INTERNATIONAL

Access to the international markets has come a long way in the past 20 years. Through vehicles such as individual stocks, mutual funds and exchange-traded funds, investors can access a variety of international equity markets. These include established economies such as those in Europe and Japan, large developing economies such as India and Brazil, and smaller emerging markets such as Malaysia and South Africa.

International bond investing is similar to domestic investing, with the bonds issued by foreign governments. As with equities, governmental fixed income markets range from established economies such as the United Kingdom, Japan and Germany, to emerging markets such as Brazil and Russia. International bonds can be issued in U.S. dollars, which presents no currency risk for U.S. investors, or local currencies, which carry additional sources of risk and return relative to their value against the dollar.

RISK AND RETURN SOURCES

Much like investing in U.S. entities, international investments can earn money through income – dividends for stocks or interest for bonds – as well as an increase in value of the investment. Unlike U.S. investments, however, international investments might bring exchange rates into play. Most foreign securities are bought and sold in the local currency.

For example, an investor buying stock in Japan first will need to exchange U.S. dollars for Japanese yen. And there is no guarantee the exchange rate will benefit the investor.

Consider the following hypothetical investment:

HOW EXCHANGE RATES CAN AFFECT TOTAL RETURN

Buy scenario: A U.S. investor purchases stock in Japan selling for 1,000 yen per share.

Exchange rate:
120 yen/dollar

Cost per share in dollars:
1,000 yen per share ÷
120 yen per dollar = **$8.33**

One year later: The stock sells for 1,200 yen per share, a 20% increase in value, but the value of the yen weakens.

Exchange rate:
125 yen/dollar

Cost per share in dollars:
1,200 yen per share ÷
125 yen per dollar = **$9.60**

Total return:
15.2%

Other sources of risk and return include earnings growth and dividends – just as in the U.S. markets – political uncertainty, disinflation, commodities and more. Many of today's news headlines deal with political issues such as Brexit, the common term for the United Kingdom's withdrawal from the European Union; economic recovery efforts in Greece; Russia's political and military influence; elections in France and Germany; and debt loads in Italy.

DIVERSIFICATION HOLDS THE KEY

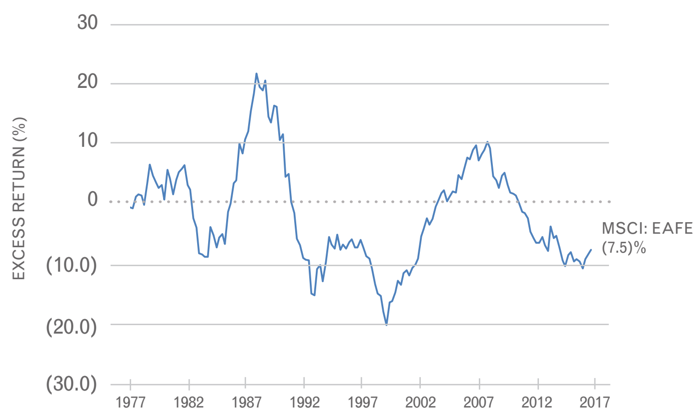
For the five-year period ending with 2016, U.S. equities had an annualized return of 14.7%, as measured by the S&P 500 index. By comparison, international equities returned 6.3%, as measured by the MSCI EAFE index. Knowing that, why would anyone want to own stocks that have given less than half the return of domestic stocks?

For that answer, it's better to look ahead, not back.

No one knows if the U.S. stock market will continue to lead the world for the next five years, as it has for the past five, but these things tend to go in cycles over time. As the chart below shows, periods of decline in the international markets over the past 40 years were typically followed by sharp upswings. International equity has shown improvement in 2017, with the MSCI EAFE index returning 12.6% through May 18, 2017, including a 5% contribution from the dollar. The MSCI EAFE Emerging Markets index returned 15.2% through May 18, 2017, including 3.5% from the dollar. It seems likely that company valuations and earnings growth will drive foreign markets higher and, hopefully, provide investors with an additional source of return.

ROLLING 20 QUARTER EXCESS RETURN RELATIVE TO S&P 500 SINCE INCEPTION OF MSCI:EAFE

ENDED MARCH 31, 2017



SOURCE: CALLAN

Diversification is a critical element of any portfolio, and part of that is diversifying away from one country into the world's many markets, currencies and opportunities. As for how much of a portfolio should be diversified into international investments, the Asset Management Services Investment Committee considers a normal holding to be 25% of a portfolio's equity. Others use 33%, while institutions seem to let the world's equity balance be their guide with a 50/50 mix. ■

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Past performance is not a guarantee of future results. Indexes are not available for direct investment. Any investor who attempts to mimic the performance of an index would incur fees and expenses, which would reduce returns. Asset allocation and diversification do not ensure a profit or protect against a loss.

There is no assurance that any investment strategy will be successful or that any securities transaction, holdings, sectors or allocations discussed will be profitable.

It is important to review the investment objectives, risk tolerance, tax objectives, time horizon, and liquidity needs before choosing an investment style or manager. All investments carry a certain degree of risk and no one particular investment style or manager is suitable for all types of investors. This should not be considered forward looking, and are not guarantees of future performance of any investment.

- Fixed-income securities (or "bonds") are exposed to various risks including but not limited to credit (risk of default or principal and interest payments), market and liquidity, interest rate, reinvestment, legislative (changes to the tax code), and call risks.
- There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices generally rise. Short-term bonds with maturities of three years or less will generally have lower yields than long term bonds which are more susceptible to interest rate risk.
- International investing involves special risks, including currency fluctuations, different financial accounting standards, and possible political and economic instability.
- Investing in emerging markets can be riskier than investing in well-established foreign markets. Emerging and developing markets may be less liquid and more volatile because they tend to reflect economic structures that are generally less diverse and mature and political systems that may be less stable than those in more developed countries.
- Investing in small-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. Stocks of smaller or newer or mid-sized companies may be more likely to realize more substantial growth as well as suffer more significant losses than larger or more established issuers.

INDEX DEFINITIONS:

MSCI EAFE: A free float-adjusted market capitalization index that is designed to measure securities exhibiting overall growth style characteristics across Developed Markets countries around the world that are included in the MSCI EAFE Index. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend. With 558 constituents, the index targets 50% coverage of the free float-adjusted market capitalization of the MSCI EAFE Index.

MSCI Emerging Markets: A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of December 31, 2010, the MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

Standard & Poor's 500 (S&P 500): Representing approximately 75% of the investable US equity market, the S&P 500 measures changes in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested.

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INTERNATIONAL HEADQUARTERS: THE RAYMOND JAMES FINANCIAL CENTER
880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716 // 800.248.8863

AMS17-1086expires 7/31/18 17-AMS-1453 JK/KF 5/17