PRIVATE ASSET MANAGEMENT, INC.
WEALTH STRATEGY ADVISORS
PARADIGM

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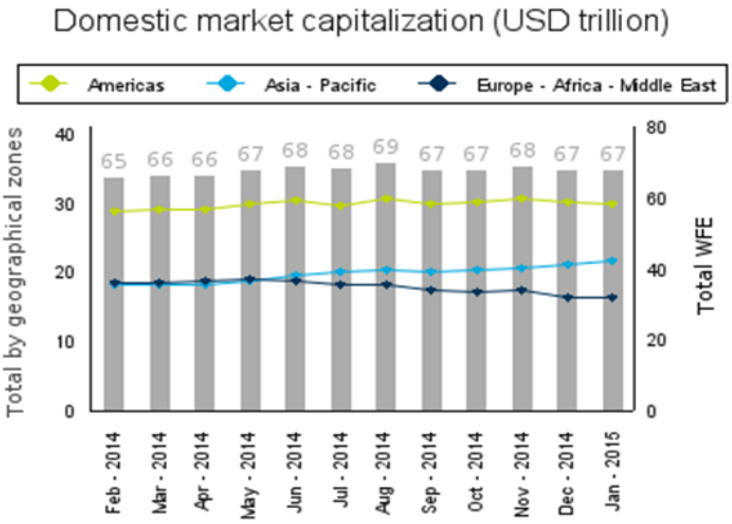
Foreign stocks can provide benefits as part of a diversified portfolio. This month, we will review the size of the world stock market and the logic for including foreign stocks in a diversified portfolio.

Size of world stock market.

According to the World Federation of Exchanges, the January 2015 value of all stock exchanges was $67 trillion, as shown by the gray bars and right axis in the table below. Using the left axis, this table also illustrates how the total value is distributed by region: Americas, $29 trillion; Asia-Pacific, $22 trillion; Europe-Africa-Middle East, $16 trillion.

The U.S. stock market makes up $26 trillion of the Americas total, with Canada, Brazil, and Mexico making up most of the remainder. This means that the U.S. is roughly 39% of the world stock market, up from 37% a year ago.



Past logic for including foreign stocks.

Twenty or thirty years ago, the logic for investing overseas had four main factors for improving risk-adjusted returns: low correlation of price movements between the various stock markets, access to different companies, the potential for higher growth, and a hedge against the dollar. The relevance of these factors still exists, but the magnitude of their importance appears to be declining.

First, world markets are more intertwined now than in the past. This increases the correlation of how prices move, thus muting the benefit of adding foreign stocks to a portfolio.

Second, companies are becoming more global, which reduces the impact of investing in various countries. Morningstar, an investment research firm, estimates that companies in the S&P 500 now earn 40% of their profits from outside the U.S. Although no exact numbers exist, foreign earnings twenty to thirty years ago for the S&P 500 were probably in the 20-25% range.

Third, for the developed world, the U.S. growth rate stacks up well versus Western Europe and Japan. Investing overseas for higher growth and returns, especially the last five years, has not been rewarded.

Fourth, the hedge against the dollar can work both ways. At the end of 2013, a declining dollar over the previous decade had helped ten-year returns by 0.5% per year when foreign returns were translated back into U.S. dollars. However, at the end of 2014, ten-year returns had been hurt by 0.9% due to the rise in the dollar.

Future potential for including foreign stocks.

Although diminished from ten to twenty years ago, the relevance of the four factors for including foreign stocks still provides enough value to include them in a diversified portfolio. An overriding conclusion, however, is that investing in foreign stocks is a long-term strategy. Often it can take five to ten years for foreign stocks to reveal their value in a portfolio. If one is not committed for the long term, it is possible to eliminate foreign stocks at an inopportune time.

Economic cycles and market movements still vary by region. In the past ten years, the annual returns for foreign and domestic markets have varied four times by more than ten percentage points. Buying what is most attractive plus adjusting the overall equity exposure between U.S. and foreign markets can still add value.

Although companies are global, the exposure to different industries varies by region. Technology may be more prevalent in one market, such as the U.S., while resource-based companies may be more prevalent in another market, such as Australia.

Growth and returns do not correlate perfectly. By most measures, the U.S. economy is well positioned compared to the rest of the developed world. However, the U.S. market is more expensive when measured by price-earnings ratios. This means that returns in other markets could match or exceed U.S. returns over the next five years because their stocks are currently more attractive. As we constantly remind you, valuation matters.

Finally, foreign markets still allow investors to hedge against a falling dollar. This ability will not change in the future.

We believe foreign stocks will continue to provide benefits in a diversified portfolio. The benefits may not be as great as in the past. However, the benefits appear to outweigh placing all of your equity assets solely in the U.S. market.

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