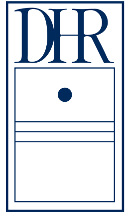
Perspective

May 2012 *By Davis Riemer*



DHR Investment Counsel, Ltd.
The Fine Art of Wealth Management

This Perspective has one subject - the international investment component of DHR portfolios. In the many meetings we have conducted in 2012, the most frequently asked question has been: "How much money is invested in Greece?" – usually followed by: "What should we do?" In those meetings, we could not offer either the detail or the comprehensiveness we can employ here. So in this setting, we not only directly answer that question of "how much?", but we also address the broader question of "what should we do?". As I thought through my approach to the matter, each level of the subject led me back up a ladder to a prior question. As a result, following the chart presentation, you will find a "top to bottom" discussion of what we do about the risk and why. One cannot make the risk go away. In fact, we contend that one cannot even completely avoid the financial consequences of it, regardless of one's investment actions. However, we believe that DHR's disciplined approach offers excellent strategy and a sound prescription for actions that make sense. Nevertheless, if you want the bottom without the top (the numbers without all the words) you may just focus on the charts.

Part of the answer to the question of exposure appears in Chart #1 (What's At Risk?) displaying the regional investment of the mutual funds that comprise the great majority of our clients' international investments. "Greater Europe" includes Western Continental Europe, Eastern Europe, Scandinavia and the United Kingdom. The "Eurozone" includes the seventeen countries that have adopted the Euro for their currency. With their penchant for abbreviations, American financial professionals have come up with a rather crude term for the most troubled nations (Portugal, Italy, Ireland, Greece and Spain) – "PIIGS."

What's At Risk? (1)

Percentage Invested by Each Mutual Fund in Region Shown

Fund Name	Greater Europe	Eurozone	PIIGS
DFA Internation Core Equity	54.69	24.25	5.92
DFA International Value	52.61	27.08	4.94
Tweedy, Browne Global Value	71.57	33.84	2.62
First Eagle Overseas	33.78	24.32	2.56
DFA International Vector Equity	53.74	23.46	6.43
DFA International Small Cap Value	48.72	20.23	5.27
Vanguard Emerging Mkts Stock Index	9.66	0.00	0.00
DFA Emerging Markets Core Equity	7.75	0.11	0.00
DFA International Real Estate	32.44	16.91	0.26

Chart #1 displays mutual fund investment and Chart #2 estimates portfolio investment. Since our clients' portfolios vary by size and amount of equity investment, in order to help each client estimate the amount of their money "at risk," we provide the following chart and procedure. We have tested this chart as an estimation tool. When we compared the specific amounts in a handful of actual portfolios to the use of the chart, the chart worked very well. We trust Charts 1 and 2 provide some comfort regarding concerns about international investment.

Whats' At Risk? (2)

Estimating Various Dollar Exposures of European Investment in DHR Portfolios			
Assume a "60/40" portfolio with 60% invested in equity		**Portfolio Percent**	**Portfolio Dollars**
Portfolio	**All Portfolio Assets**	**100%**	**$1,000,000**
All Equity	**60% of Portfolio Assets**	**60%**	**600,000**
All International Equity	**40% of "All Equity"**	**24%**	**240,000**
Greater Europe Equity	**55% of "All International Equity"**	**13%**	**130,000**
Eurozone Equity	**44% of "Greater Europe Equity"**	**5%**	**50,000**
Equity Investment in PIIGS	**24% of "Eurozone Equity"**	**1%**	**10,000**

With an understanding of "how much?" we must then answer "what should we do?" and "why?". Those questions go both to the nature of DHR's discipline and also to the heart of our investment strategies. When markets are "just fine," rising in price and facing sunny days ahead, few worry about such strategies. However, we now face darker concerns and consequential risks which are unique in our experience. Even given the character of the risk, we have confidence in our decisions and strategies, which we discuss below. DHR portfolios have investments in stocks, bonds, real estate and cash. This Perspective addresses only stock markets, but the principles apply also to bond, cash and real estate markets. For our purpose here, the principles from one market meet our needs.

To investors thinking in a "top down way," the "top" is "the world." Today, more so than even one generation ago, the world is like a spider's web. Every place leads to every place else and what happens in one spot causes ripples to the others. Today's investor can neither get out of the world, nor ignore the interconnectedness of its many parts. For better or worse – and it is both – we are in it. Stop and reflect on the paucity of our life were all things foreign to be excluded. Foreign nations bring us goods, services, products, ideas, people, and markets. (Including the enjoyment of travel. And good investments.) But with those benefits also come problems – old, new and unexpected problems. Where will they begin? How will they affect us? One can speculate about the answers, but we cannot know the answers and DHR does not want to speculate with clients' investment capital.

Today's uncertainty is great, but despite the uncertainty, we must decide. What kind of decisions should one make in such an environment? If we cannot identify the source of future trouble and cannot estimate the extent of its consequences, we should avoid concentrating our resources in one or only a few places. In a word - we should diversify. This is nothing new, but the point is always worth making. *When faced with uncertainty in investing - diversify*. Even if we invest all our capital in our own country, and even at that in a diversified way, we neither shield our capital from the world's risks nor capture the world's opportunities. Failing to "capture the world's opportunities" includes the opportunity costs of not being in the right place, when good results occur elsewhere. Good events for investors are not confined to our country.

When we consider how to diversify investment capital across the world, we can learn by examining a comparison to the same purpose in our country alone. To invest in the U.S. stock market in the most diversified way, one would buy shares of every publicly traded company. To do so in the way most supported by efficiency theory, one would apportion the dollars of investment in exactly the same proportion as each whole company bears to the entire market. After doing that, one cannot diversify further. Compared to the whole-market-capitalization-weighted method, other methods can only concentrate.

In fact, one can do the same thing in the world's stock markets. An investor can apportion capital in exactly the same proportions as each country - and within them, each company - bears to the entire global market. This is not only a theoretical possibility; it is also investable, in Vanguard index funds, exactly as described. Since this is the broadest investable form of diversification, DHR believes it must be the starting premise of portfolio construction. From that starting premise, all variations, because they concentrate, must be justified. As our clients know, DHR does use variations and therefore does concentrate – by country, by capitalization and in value. Our methods of doing so are consistent with logic, reason and experience. We set them out here.

The "starting premise," called "naïve" portfolio construction, places capital according to the relative size of each national market compared to the global market. Therefore, it calls for approximately 40% of the investment capital in the U.S., 43% in other developed nations, 16% in developing (emerging market) nations, and a trace in "frontier" markets. With this approach, one would own the entire list of the world's publicly traded companies. However, most of one's capital (over 90%) would be in large companies. Both of the dominant styles of classification - value and growth – would be represented. However, over 75% would be invested in growth stocks. Those "weights" to large capitalization and growth styles do not result from judgmental selection or preference. They reflect the aggregate of investment decisions of all the world's investors. They result inevitably from the allocation of capital by share volume and share price. That is "the top" for us as investors – investment in all the world's securities, in an entire-market, capitalization-weighted scheme. DHR alters that plan in three ways – by country, capitalization and value.

Let's look at country first. Compared to the "naïve" scheme of allocating capital among countries, what about selecting countries based on favorable (or unfavorable) economic fundamentals? The world offers investors dozens of countries and thousands of companies in which to invest, in addition to the thousands available in the U.S. Whether we invest only domestically or also internationally, we have the same problem: from all available choices, how can we select (buy or hold) those whose values (prices) will increase and deselect (avoid or sell) those whose values will decline? Furthermore, since prices neither increase nor decline indefinitely, how can we know when they will change, in which direction and to what degree? Do financial statement fundamentals tell us the answer? Do the financial fundamentals of a country tell us the answer?

Company fundamentals are available in the U.S. market. They are published, then deeply analyzed and interpreted. Most professional investors use fundamental analysis to some extent when they make portfolio selection decisions. One might expect that, by selecting only favorable fundamentals, an investor would do well. Also, timing indicators are published regularly by a number of gurus, some selling subscriptions for high prices. One might expect that, using timing indicators from sources previously demonstrated to have been "correct" in their forecasts, an investor would do well. Yet, when one examines the actively managed portfolios in the U.S. market, one finds that success - i.e. performance exceeding that of the market - occurs no more often than by statistical chance and appears also to be randomly distributed across all participants. So, neither actively managed selection of individual securities nor market timing works reliably to a greater extent than chance.

1. **Focus on long-term objectives.**
2. **Use bonds and cash to temper fluctuation.**
3. **Diversify globally and invest in all markets.**
4. **Emphasize value and small cap.**
5. **Rebalance but neither exit nor concentrate in markets.**
6. **Remain invested to risk tolerance.**

Why should portfolio selection techniques relying on fundamental analysis or timing succeed in international markets when they fail in the U.S.? (They do not.) Why, if we consider each country in the world as an individual investment opportunity, should we expect the results of selection or timing among them to differ from those in the U.S. market? (We should not, although it is somewhat more complicated.) Should we believe that timing strategies for various countries' national markets will generate long-term investment performance greater than the global market itself? One is tempted to answer "yes," because the condition of different countries is so disparate. Over short periods, the matter can seem obvious; for example, markets in Europe have certainly not fared as well as markets in the U.S since the beginning of 2008.

Nevertheless, we see such disparity in the historical record, even if recent, and our concern lies with the future. Forecasting future outcomes is no easier for a country's financial markets than it is for individual securities. *The foremost cause of a change in the price of a stock is the emergence of new information*. Every investor wants to be first to get new information. Recently, some investment companies have found ways to learn of and "get in front" of large institutional trades by as little as a few thousandths of a second and thus "front-run" the trades, taking profit faster than the mind can comprehend. New information can spread across the world almost instantaneously. Thousands of investors examine it continuously on a "24/7" basis. At any moment, they can invest (or dis-invest) anywhere in the world. This increases the efficiency in markets. Efficient investment markets do not consistently or reliably reward selection of individual issues or market timing. *DHR believes that a global, stay-invested strategy has a higher probability of success over the course of time than does any strategy based on selection or timing*.

Having set aside both fundamental analysis and timing to select countries, we return to the question of country allocation. DHR recommends that 60% of clients' equity capital be invested in the U.S., although our country holds 40% of global equity. Our allocation reflects the desire to manage two types of risk, one of which lies in characteristics of investment markets and one in investor psychology.

When deciding to put capital at risk, it is important to bear in mind some of the characteristics of financial markets. Compared to those of the rest of the world, the United States stock market is the largest, most heavily researched, most efficient, best understood, most liquid, and best supported by law of all stock markets in the world. Those characteristics reduce risk and support a domestic investor putting a majority of capital in the U.S.

In addition, investor psychology also matters in decisions about country allocation. DHR believes that, as the degree of an investor's discipline over time increases, the probability of long-term investment success rises. However, discipline can be made easier or more difficult by the risks one chooses to accept. For example, most investors experience "phase risk," discussion of which appears in both investment and psychology journals. That means that an investor can be made uncomfortable by the decline in value of one's own portfolio if other portfolios are rising. Despite knowing that all portfolios go through cycles, the psychology of feeling alone can challenge one's discipline. The problem with phase risk lies in its tendency to cause an investor to sell out of a portfolio when it is down. The tendency to sell at market troughs is one of the greatest impediments to long-term investment success. Therefore, the discipline adopted by an investor should be one that reduces phase risk to a tolerable extent.

Placing 60% of equity investment capital in the U.S. means DHR cannot invest according to the "naïve" model of portfolio construction. Furthermore, we do not attempt to time market cycles to make decisions about entering and exiting the stock markets of various nations. Therefore, we must find different ways to allocate our investment capital across the globe than by using either the "naïve" diversification scheme or market timing strategies.

One central tenet underlies all investing; risk and return are positively related. Where we see return in excess of market return, then we will also find above-market risk. With respect to certain kinds, but not all risks, we can say that risk leads to the opportunity to achieve return. In stock market research, three "dimensions" of investment have been identified as controlling, for purposes of assessing portfolio investment performance. First: the market chosen for investment; Second: the size of the companies in the portfolio; Third: the nature of the portfolio companies' financial statements relative to "value." (Value can be measured in several ways.) The risk of a "small company investment portfolio" exceeds the risk of the general market, as does the risk of a "value" portfolio. Correspondingly, the returns achieved by portfolios of small and value companies exceed the general market return. One can significantly reduce portfolio risk and achieve the premium return with proper diversification.

In 1957, Rolf Banz identified the small cap premium. In 1992, Fama and French identified the value premium. ("Premium" means extra return over market return). Both premia have been successfully tied to the underlying tenet of the relationship of risk and return; they meet the test of theory. Both premia have been exhaustively researched and tested in the domestic market and those findings have been repeated in the international markets. They meet the test of empirical evidence. Were these findings only in the U.S. market but not in international markets, one would question whether they were manifestations of actual risk or simply anomalies of the domestic market. However, the findings do appear in foreign markets, both developed and emerging, so we can conclude that they are indeed dimensions of risk and therefore of expected return. We have repeatedly seen that the investment premium for the risk of both small cap and value styles has been significant and can be captured.

DHR does not use market timing and does not speculate about which nations will generate higher (or lower) returns in the near or intermediate-term future. Additionally, DHR does not invest in individual countries other than our own and does not select stocks of individual companies. Using passively managed, broadly diversified asset-class funds, we do seek to increase diversification with international investment and, by doing so, we greatly increase the opportunity set for investing in the value and small cap asset classes. When investing in a risky asset class, diversification reduces the risk of capital loss and the fluctuation of the portfolio as a whole, but does not reduce the opportunity for return. In fact, proper diversification can actually increase return. The math of it has led some market thinkers to say "diversification is the only free lunch in investing." If we can have available to us twice the number of value stocks and twice the number of small cap stocks for investment, it surely makes sense to take advantage of that opportunity.

ective

Even so, one might ask: "Why not just avoid Greece?" But, why should we only lock the barn door after the horse has escaped? Shouldn't we also think preventively? If so, then shouldn't we also exclude Spain and Italy, who have the same troubles but where our investment is larger? And Portugal, whose economic challenges resemble those of Spain and Italy? If we exclude Greece, Italy, Spain, and Portugal because of their economic fundamentals, then because it has the same issues, we should probably also exclude Ireland. If those nations' difficulties cause the Euro to collapse, what then would become of the European economic zone and markets? Should we exclude Europe – Greater Europe – from our portfolios? You can see that this train of reasoning is a slippery slope of incrementally changing financial data, at the bottom of which sits one's "risk-free" mattress. The task of successfully managing it (i.e. correctly forecasting the incremental changes) exceeds the skills of the best of us. The lucky achieve good results – for a while.

In addition, two other reasons argue against trying to do something about eliminating investment in troubled nations. One is timing and the other is cost. Timing strategies can succeed, but they do not do so reliably, in large part because there is no surer way to miss a rebound in prices than by exiting an investment in a period of low returns. Research in portfolio investment has repeatedly demonstrated that holding through volatility offers a higher probability of long term success than does any timing strategy. Regarding cost: The amount we have invested in the highly troubled European nations is relatively small, so excising those nations from a portfolio is extremely difficult and expensive. In order to construct a global portfolio without including those nations, one would have to assemble many funds, each investing in a single country, until one had the desired result. Then, one would have to buy and sell according to timing indicators. The transaction costs attendant to building and rebalancing that portfolio would be prohibitive.

While investing globally means we will always have trouble a-brewing in our portfolios, it also means that we are protected from the consequences in the most rational way and that we have intelligently captured all the world's investment opportunities for positive return.