How Much Foreign Stock and Bond Exposure Do You Need?

- COMPASS' view on how much to allocate to foreign stocks and bonds follows what the article states is the "middle ground".
- COMPASS seeks the expanded opportunity set and diversification benefits offered by investing in foreign securities, but limits clients' exposure due to the higher risks inherent in investing overseas.

This is one of the central questions confronting investors putting together their portfolios, yet there seems to be no consensus. Some experts argue for highly globalized portfolios, with allocations to foreign and U.S. stocks and bonds mirroring their market values. But other experts believe that due to the extra costs and volatility that can accompany foreign stocks and bonds—and especially the foreign-currency swings that can occur when those market gains or losses are translated into U.S. dollars—less is more when it comes to foreign exposure. A related question is whether (and how) a portfolio's allocations to foreign and U.S. stocks and bonds should change over time.

Stock Allocations: Fully Global, U.S.-Centric, or Somewhere In-Between?

The issue of how much investors should stake in foreign stocks has been a contentious one for years. In the "less foreign is more" camp are experts who believe that because many U.S. blue chips are increasingly global in their reach, investors in them get exposure to foreign markets indirectly, while avoiding the extra costs and volatility associated with foreign stocks (foreign-currency swings in particular). At the other extreme are the "global market-cap agnostics"—those who suggest buying a basket of U.S. and foreign equities weighted according to their market values. The U.S./foreign allocations of global-market indexes have hovered around 50/50 for the past several years.

Meanwhile, most asset-allocation experts recommend a middle ground. Investors may not need to steer half of their portfolios to foreign stocks to obtain most of their diversification benefits. The rationale behind how much foreign exposure an investor may choose gets back to volatility. Because foreign stocks typically entail some currency risk as gains or losses are translated from foreign currencies to dollars, investors who want to reduce volatility may want to also reduce their foreign weightings accordingly.

Bonds: It's Complicated

Even though more than 50% of the world's fixed-income investments exist outside the United States, investing in foreign bonds has the potential to add cost and volatility to a U.S. investor's portfolio. Few asset-allocation experts are in favor of mirroring the global markets' allocation to U.S. and foreign bonds.

Because types of foreign-debt exposure vary so widely, one-size-fits-all recommendations are tricky. Investors could steer a larger share of their fixed-income portfolio to foreign sovereign bonds rather than corporate and/or local-currency-denominated debt.

The volatility issue can be addressed, at least in part, by hedging out the currency risk of the foreign bonds. That helps ensure that investors partake of foreign bonds' yields and any price changes, but not the currency-related impact when those returns are translated into dollars. However, hedging strategies entail costs, and in a low-returning asset class like bonds, those costs can take a big bite out of returns.

Past performance is no guarantee of future results. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses.

Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than the other asset classes. International bonds are not guaranteed. With international bonds the investor is a creditor of a foreign government or corporation. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.

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