INVESTING/Francis Flaherty

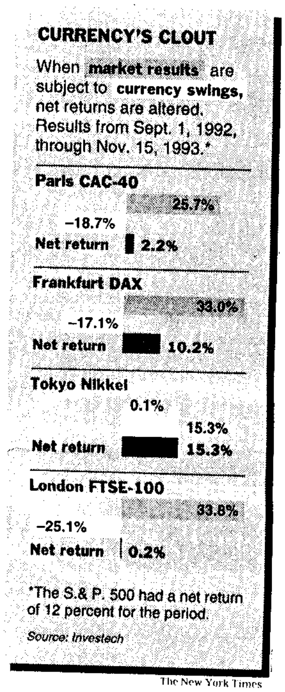
Beware the Odd Twists In Foreign Investments

As more and more Americans invest abroad, there is something they should know: Kansas it's not.

Foreign markets are not as odd as Oz, of course. But in seeking profits from free trade agreements or Communism's eclipse, investors will encounter issues they need not worry about at home.

Currency is one. "Currency fluctuations increase the volatility of international stocks," said George D. Kinder, a financial adviser in Cambridge, Mass. "Take a foreign stock that may range between a 20 percent loss and a 20 percent gain. If the likely currency fluctuation is 5 percent either way, then the stock really has a 25 percent range on both sides."

This currency twist can enhance — or derail — stock performance. For the year ended in August, Tokyo's Nikkei index rose 16 percent, and the yen gained 21 percent against the dollar, yielding a combined 40 percent gain for American investors. But the London market's 32 percent jump in the period turned into just a tiny hop for Americans. The reason: the dollar rose 24 percent against the pound.



The New York Times

Many people ignore currency swings, but now may be the time to pay attention, said James B. Stack of Investech Research in Whitefish, Mont. With America's rebounding interest rates and low inflation, he said, "it's tough to see the dollar going anywhere but up against European currency over the next 12 to 18 months." However buoyant the European markets, such a swing might deep-six an American's profits.

Hedges can tame the currency risk, but they may not work, warned Brian S. Mattes, a vice president of the Vanguard Group of mutual funds. He suggested holding for the long term and diversifying.

"Economy correlations" is something else Auntie Em did not worry about, but international investors should. The markets of some countries move in tandem, some in opposite ways, and some follow no pattern. Generally, the larger economies have positive correlations with one another and zero to slightly negative correlations with emerging markets like India, Thailand and Greece.

By taking a stake in economies that are only loosely related, investors can lower their risk. With a position in emerging markets, for instance, an investor gets a hedge against trouble in his American portfolio. Campbell R. Harvey, an associate professor of finance at Duke University, is high on emerging markets anyway, but the hedging role heightens their value.

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Even a stock mix in closely connected economies can soften market declines. When the United States market dropped about 20 years ago, Mr. Kinder said, an American investor could have cut his losses by a third if he had placed 25 percent of his portfolio in Japan and 25 percent in Canada. One reason: Canada's oil reserves cushioned the stock market there from "oil shocks."

Some conditions in foreign markets — lackadaisical regulation, great price swings, political instability — might cause a commotion in Topeka. Domestic investors who blanch at news of a mere corporate reorganization may want to stay home upon hearing Mr. Kinder's worries. "I'm heavily invested in Asia and excited," he said, "but the growing military in China concerns me a little."

Such risks add an exclamation point to that standard investment rule: Diversify! "People will read that Argentina's doing real well and invest a lot there," Professor Harvey said. But one-country investors "can lose their shirts," he warned. "Invest in a basket of countries."

Diversify in other ways, too. Select mutual funds that focus on different industries and different size companies, and that practice different investment philosophies.

"Find funds that hedge," Mr. Kinder said. "Use small-cap funds to enhance the rate of return, and use value funds to minimize price swings."

As in all money matters, the most important question is: How much? What part of a portfolio should be foreign? "The conventional wisdom was 10 to 20 percent," Mr. Kinder said. "But that range is moving up," to 20 percent to 25 percent, he said.

Whatever the recommendation, Americans are homebody investors. Sophisticated pension funds invest only 5 percent to 10 percent in foreign equities, and individuals far less.

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Thinking more globally than most, Professor Harvey uses world stock value as a guide. For instance, with emerging markets representing $900 billion — or nearly 10 percent — of the world's $10 trillion in stock, he recommends giving them 6 percent to 20 percent of a portfolio.

This world-equity idea may explain past investment patterns. "International investment was an afterthought for Americans 20 years ago — and with good reason," Professor Harvey said. "The U.S. share of world capitalization was peaking then at about two-thirds."

If world stock is the guide, what would a portfolio look like today? At September's end, the United States had 37 percent of world equity, Japan and the rest of Asia 35 percent and Europe most of the balance.