Do World Markets Still Serve as a Hedge?

By MARY ROWLAND

One of the many arguments for investing abroad is that stock markets in different parts of the world tend to hit their peaks and valleys at different times because of varying economic conditions. It follows, then, that an American can hedge against a decline here by having money in Europe, the Pacific Rim, Latin America or elsewhere.

The market crash of October 1987 seemed to turn that theory on its head. When the Dow Jones industrial average dropped 508 points in one day, stock markets around the world fell. Once again, in the first and second quarters of this year, the stock market slump in the United States stretched to most parts of the world.

Not surprisingly, these worldwide downdrafts have prompted researchers to look again at the relation between United States and foreign markets and to ask whether investing abroad actually does provide a cushion against bear markets here.

Some financial advisers believe the benefits of diversification abroad have been blunted. "International markets have become more correlated with the U.S. market, particularly in down markets," Peter L. Bernstein, a consultant in New York, said.

The two countries that have historically been most out of step with the United States, Mr. Bernstein says, are Japan and Italy. Those two stock markets have certainly done very well this year. At the end of June, the Japanese market was up 34.41 percent in dollar terms, and the Dow was down 3.44 percent. The Italian market was up 21.12 percent, and most of Europe was down about 4 percent.

A number of studies have looked for a long-term trend of more correlation between domestic and foreign markets as the economy moves from one of many nations to a global economy. Correlation measures whether investments move together or against each other.

"Perfect positive correlation of 100 percent means that two things always move in lockstep," said Campbell R. Harvey, associate professor of finance at the Fuqua School of Business at Duke University. "Perfect negative correlation means that two things move lockstep in opposite directions." Investors look for negative correlation because it provides a hedge and reduces the volatility of a portfolio.

Most researchers say they can find no long-term trend toward increased correlation among world markets. "We recently did some work on the correlation of the monthly returns on the index of U.S. and foreign markets," said Christian Wignall, chief investment officer of G. T. Global funds in San Francisco, which manages $20 billion in assets. "We wanted to find out if the correlation has risen or fallen over the past 24 years. The answer is very clearly no."

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Mr. Wignall and others concede, however, that the correlation varies over time. "Our view is that in short-term periods of global stress or trauma, it is not unlikely that global markets will behave like the U.S.," said George Murnaghan, vice president of Rowe Price-Fleming International, which manages international funds for T. Rowe Price, the mutual fund company based in Baltimore.

Some studies support that point, indicating that the correlation is much greater when markets are volatile, which is precisely when investors would like to see a low correlation. Professor Harvey, who teaches global asset allocation and portfolio management, and Claude Erb and Tadas Viskanta, both of the First National Bank of Chicago, found in a recent study that the correlations between two stock markets are greater in bear markets. Their study looked at the Group of Seven nations: the United States, Britain, France, Germany, Italy, Japan and Canada.

Even when the 1987 market crash is excluded, the point holds true, Mr. Harvey said. In fact, the correlation in down markets is nearly double the correlation in up markets, the study found. For example, the correlation between the United States and German markets when both are rising is only 9 percent. But the correlation when both are falling is 52 percent.

"What we've found is that in down markets, the correlation is much higher, which works against you," Mr. Harvey said. This is exactly the opposite of what an investor wants from diversification. Ideally, when the United States market declines, other markets would rise.

Still, most advisers say that international investing provides an important opportunity to diversify. "You still have to be exposed to global markets whether it is an up or a down cycle," Mr. Bernstein said. "There are many opportunities you will miss if you do not have the exposure."

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And, over the long term, putting international stocks in a portfolio will both increase returns and reduce volatility. "When you put somewhere between 30 to 40 percent of a U.S. portfolio in international stocks, you both increase the rate of return and decrease volatility," said Mark Holowesko, director of global equity research for the Templeton Funds in Nassau, the Bahamas.

There are other reasons to invest abroad, too. Particularly now, the best values may be outside the United States. "The feeling among most money managers is that U.S. markets are still overvalued and that the values today lie abroad," said Neal Litvack, executive vice president of marketing at Fidelity Investments.

Furthermore, even though many markets moved in tandem during the first half of the year, the exceptions were notable. "Japan represents 40 percent of the world market outside the U.S.," and its major index is up more than 30 percent, Mr. Wignall said. "That's pretty effective diversification."

Finally, the emerging markets do not yet move in sync with the American stock market, the professionals said. That may be little consolation to investors whose domestic holdings have dipped this year and whose emerging markets holdings have plummeted. Still, "the correlation here is zero or negative," Mr. Harvey said, based on a separate study he conducted of emerging markets and the United States market. "These markets provide a good hedge against the U.S. market."