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A Perspective on International Funds

International funds have become quite popular in recent years. Some advisors recommend that investors hold 30 percent or more of their investments in international funds. While reasons exist to include international funds, in order to prevent surprises, investors must understand the inherent uncertainty these funds introduce. In particular, the lack of extensive market data for international markets, as mentioned above, is a concern that frequently is not given enough consideration.

One of the main ideas in favor of international funds is that they tend to perform somewhat independently of US investments, so they add diversification to a portfolio. At times when US stocks have been down, international funds have been up, and vice versa. Holding assets that behave oppositely offers beneficial protection for the portfolio against market swings. Furthermore, international funds have tended to have higher returns than domestic funds over their short existence.

Unfortunately, the lack of historical data for international funds introduces an unpalatable amount of potential forecasting error. Even when systems adjust for limited historical data to minimize bias, as with Guideway's software, a certain degree of forecast error always occurs with any estimation. The size of the error depends greatly upon the number of years of historical returns. The more data, the smaller the forecasting errors tend to be. Again, think of the baseball analogy. For this reason, we believe that in order to comprehend the level of uncertainty in a portfolio, sticking to boring domestic stock and bond funds is best.

In the late 1990s, we conducted a casual experiment using a newly formed sector fund with five years of history. This fund had been on an upward tear since its inception a few years prior, with returns averaging 20-something percent per year and little volatility. At that point, the best statistical forecast showed a 99% chance the fund would return over 15% per year after inflation. The implication was that with only a few thousand dollars, almost anyone could be fabulously wealthy and retire with very little uncertainty. This result was obviously incorrect.

The problem was not with the statistical analysis. It was perfectly correct. The catch was that, with any statistical analysis, the estimates are correct on average. If instead the projections were based upon many different funds with 5 years of history and different starting years, the projections would be correct overall, but not necessarily correct in any single example. With short histories, and therefore little data, projections and risk estimates tend to be disturbingly inaccurate from case to case. When a very large number of historical years of data is available, the projections and risk estimates would be very accurate.

The primary philosophy at Guideway is to utilize high quality, low cost domestic index funds with extensive historical records that improve forecast accuracy. Rather than trying to maximize returns, what matters is optimizing the probability of achieving a financial goal while also minimizing the risk of failure. With almost 90 years of recorded history, domestic index funds offer a much more predictable picture than international funds, which are typically less than 20 years old. Furthermore, almost 50% of the revenue of the S&P 500 arises from other countries since numerous American companies sell into international markets. Therefore, we believe that a portfolio does not necessarily need to include international funds. A successful retirement depends upon having a reliable, unbiased long-term plan, not one that is skewed and over-inflated. Staying with domestic stock and bond funds enables improved forecast accuracy.

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