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WEEKEND INVESTOR

Four Reasons to Boost Your Foreign-Stock Exposure

Investors should consider adding to both emerging markets and developed foreign markets

Many foreign markets are cheaper than U.S. stocks based on valuation yardsticks. *PHOTO: REUTERS*

By JONATHAN CLEMENTS

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What goes down might come up.

Foreign stocks had a losing year in 2014—but they could juice your portfolio's performance if U.S. stocks falter, as many folks now fear. Here are four reasons I'm inclined to up my allocation to both emerging markets and developed foreign markets.

U.S. stocks have outperformed foreign shares over the past five, 10 and 20 years, and the margin of victory has been huge.

If you had invested $1,000 in early 1995, you would have more than $6,300 today if you had bought the Russell 3000 index, which offers broad exposure to the U.S. market—but less than $2,800 if you had invested in MSCI's EAFE (Europe, Australasia and Far East) index, based on data through January. That lackluster performance might scare off some investors, but it should intrigue anyone looking for a bargain.

U.S. stocks now account for more than half of global stock-market capitalization.

"Obviously, the U.S. is not half of the global economy," says William Bernstein, author of the book "The Investor's Manifesto" and an investment adviser. "That just doesn't make sense."

The dollar has soared in the currency markets, hurting U.S. holders of foreign investments, because those investments are worth less when converted back into dollars.

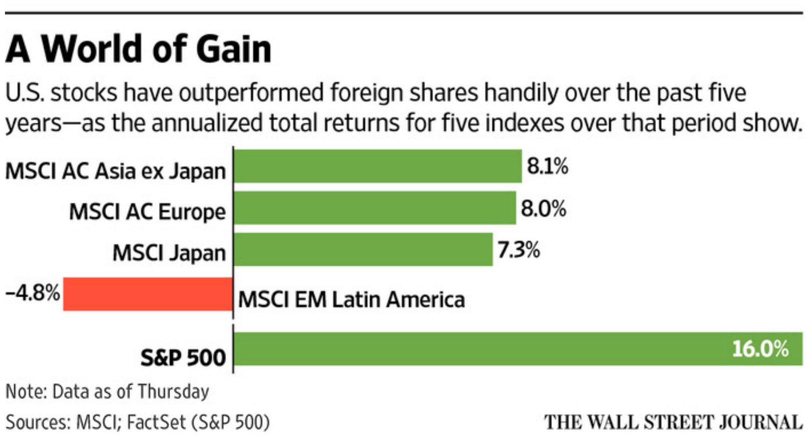
I have no idea what will happen next to the dollar. But I'm a lot happier investing overseas at today's exchange rates, with the dollar worth so much more overseas, than at those that prevailed six months ago.

Most important, many foreign markets are cheaper than U.S. stocks based on market yardsticks such as price/earnings ratios, dividend yields and price-to-book value.

Those lower valuations aren't surprising: Emerging markets involve greater risk, while there are big concerns about economic growth in Europe and Japan. "To buy low, you have to be willing to tolerate bad news," Mr. Bernstein warns.

Foreign markets' cheaper valuations don't guarantee higher returns, especially over the short term. Even over 10 years, valuations—as reflected in P/E ratios—drive only 35% or 40% of returns. "That means 60% to 65% is not dependent on valuations," says Vanguard Group's Francis Kinniry, a principal in the firm's investment-strategy group. "Yes, valuations are helpful, but I think people overplay it."

Mr. Bernstein suggests boosting foreign stocks to five percentage points above your target portfolio weighting. For instance, if you typically keep 20% of your stock portfolio in foreign stocks, you might go for 25%.



No doubt that will strike some folks as frighteningly large. But in recent decades, investment experts have favored a higher and higher foreign-stock allocation, in part because it has become so much cheaper to invest overseas. To date, of course, a larger allocation hasn't helped returns.

In the 1980s, I remember experts talking about stashing 10% of a stock portfolio abroad, maybe 20% if you were aggressive. By the 1990s, strategists seemed more willing to suggest that investors put 30% abroad.

Now, some folks think you should replicate the global stock market's weightings. Consider the Vanguard Total World Stock Index Fund , which tracks the FTSE Global All Cap Index. As of Jan. 31, the fund had 52% of its assets in the U.S., 39% in developed foreign markets and 9% in emerging markets.

Would it be wise to invest that much in foreign stocks? Consider two issues: your portfolio's risk and your future spending.

Because foreign stocks don't move in lock step with U.S. shares, you can reduce a stock portfolio's overall price gyrations by adding foreign shares. Vanguard's Mr. Kinniry says you get much of this risk reduction with a 20% foreign-stock allocation, though you can reduce risk further by going as high as 40%.

At 40%, however, you may have a mismatch between your investments—which would be heavily denominated in foreign currencies—and your future spending, which would be mostly in dollars. This is less of a worry if you are many years from retirement and spending down your nest egg.

It also may be less of a concern if you have a substantial sum in U.S. bonds.

Suppose your portfolio is evenly split between stocks and bonds. All your bonds are dollar-denominated, while 30% of your stock portfolio is invested abroad. Do the math and you find that 15% of your portfolio is directly exposed to currency swings, which doesn't seem too risky.

Looking to bolster your foreign-stock exposure? I would favor low-cost index funds that offer broad market exposure. Check out exchange-traded index funds such as and which both charge annual fees of 0.14%, or $14 per $10,000 invested, or the Vanguard Total International Stock Index Fund , a mutual fund with different share classes that have $3,000 and $10,000 minimums. Those two share classes levy annual fees of 0.22% and 0.14%, respectively.

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