

Dive in to foreign stocks

BY CHRISTINE BENZ

Imported goods are so ubiquitous in our lives that we hardly give them a second thought. As I sit in my home office, I'm clacking away on my laptop from a U.S. company and talking on a cell phone from a U.S. maker. But I'm not far from a Korean-made TV and there can be little doubt that the plate I ate my lunch on was made in China.

Just as most imported goods are no longer remotely exotic, investors are becoming increasingly comfortable with foreign stocks in their portfolios, too. To make good decisions about your foreign-stock holdings, it's important to give some consideration to the amount of initial research and ongoing oversight you're willing to dedicate to your portfolio, how much volatility you're willing to tolerate and whether you want to shoot for market-beating performance or are comfortable holding an index basket of foreign stocks (and the low costs that come along with such a strategy).

Thinking through your choices can help you arrive at the right answer.

WILL YOU INVEST IN INDIVIDUAL STOCKS OR FUNDS?

As with investing in U.S. stocks, your first decision when investing in foreign stocks is whether you will invest in individual stocks or in some type of managed product — a mutual fund, index fund or exchange-traded fund. And as with U.S. investing, it's perfectly reasonable to do both: invest directly in individual foreign stocks — especially blue chips such as American depositary receipts (ADRs), where trading costs are apt to be low and disclosure high — while employing funds to obtain exposure to less liquid parts of the international stock market. Here are the pros and cons of each tack.

Individual stocks

Why: Investors in individual stocks have the opportunity to generate strong, even market-beating returns by concentrating their investments in a well-researched basket of individual stocks. Individual-stock investors also can avoid the management fees that accompany mutual funds and ETFs. But if they venture beyond American depositary receipts, which allow them to buy stakes in foreign companies trading on a U.S. exchange, their transaction costs are apt to be higher than what they would pay for U.S. blue chips. Bid-ask spreads also may be large when purchasing securities on foreign exchanges, further increasing trading costs. Of course, such costs also are borne by funds, and in fact, foreign-stock fund expenses generally are higher than is the case with U.S. stock funds. But as larger entities, funds may be more readily able to benefit from economies of scale than individual-stock investors can.

Why not: Investors in individual stocks may have more concentrated portfolios than what they would be able to obtain through a fund, and therefore, their portfolios' volatility could be higher. If they venture beyond blue-chip multinationals, whose shares are listed on U.S. exchanges, individual-stock investors may find it difficult to thoroughly research prospective holdings: Different countries take varying approaches to shareholder disclosures. Costs also may be higher.

If you go this route for all or part of your foreign-stock exposure: Morningstar's philosophy for investing in stocks transcends geography. As with investing in the U.S. market, we believe that foreign-stock investors improve their chances of success if they focus on high-quality companies with sustainable competitive advantages, or moats, and aim to pay a reasonable price for them. Investors can use the screening tools on Morningstar.com to identify companies that fit the bill.

Funds

Why: Whereas the investor in individual foreign stocks may have a difficult time researching and building a portfolio that's well diversified by geography, company size, style and sector, an investor in a well-diversified fund gets instant diversification. The fund investor also can rely on professional managers to do the heavy lifting on researching companies and navigating varying disclosure regimes.

Why not: Professional management entails costs, and foreign-stock funds typically charge even more for their services than U.S. stock funds do. That can cut into the returns investors earn on their foreign-stock holdings. Funds also can foist unwanted capital gains on their shareholders, whereas individual-stock investors exert a higher level of control over capital gains realization. The taxes that foreign companies levy on their dividends also can end up denting some investors' returns, even though investors receive a tax credit for them.

If you go this route for all or part of your foreign-stock exposure: Start with Morningstar Medalist funds to winnow down the universe to a more manageable group; our analysts believe these funds will outperform their peers in the future. You'll find them on Morningstar.com.

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INVESTMENTS



QUESTIONS TO ASK WHEN INVESTING IN U.S. EQUITIES

Finding the right stocks, mutual funds and exchange-traded funds requires some introspection. How much ongoing oversight are you willing to provide for your holdings? Do you get rattled when the market goes down? Are you compelled by data showing that the typical fund manager doesn't beat the market, or do you believe that a well-chosen basket of individual stocks or actively managed funds has the potential to earn market-beating returns? Answering those questions can go a long way toward helping you identify investments that you can live with for many years.

If you're aiming to fill out the U.S. stock portion of your portfolio, carefully consider the following choices:

CHOICE 1: Will you invest in individual stocks or funds?

As an investor in U.S. stocks, your first decision is whether you'll buy individual stocks or some type of a managed product — a mutual fund, index fund or exchange-traded fund — that invests in U.S. stocks. Note that many investors successfully do both. It's not uncommon for individuals to invest the bulk of their portfolios in funds while reserving a smaller portfolio for investing in individual equities. Here are the pros and cons of investing in individual stocks and mutual funds.

Individual stocks

Why: The ability to generate strong, even market-beating returns is the key reason to consider investing in individual stocks. By concentrating your investments in companies that you've researched thoroughly and determined to have strong fundamentals, you have the opportunity to out-earn the return you'd earn in a mutual fund with a more diffuse portfolio. Individual stock investors also can avoid the management fees that accompany mutual funds and ETFs and exert greater control over their tax costs.

Why not: Because their portfolios are apt to be less diversified, individual-stock investors may have to deal with higher volatility than mutual fund investors. Selecting and monitoring individual stocks also requires more initial research and ongoing oversight than buying and holding mutual funds. And while investors in individual equities can avoid fund-management fees, they will have to pay transaction costs to buy and sell, which can cut into their returns.

If you go this route for all or part of your U.S. stock exposure: Morningstar believes that stock investors greatly improve their chances of success if they focus on two key tasks: finding high-quality businesses with sustainable competitive advantages, or "moats," and paying a reasonable (or better yet, low) price for them.

Mutual funds

Why: Buying a diversified U.S. equity mutual fund gives you instant exposure to a broad cross-section of companies. You'll also gain access to professional management and analysts: Even if you opt for an index fund, the

mechanics of managing the fund will be overseen by a professional manager and traders. Outsourcing the management and trading of individual stocks frees you up for other tasks, such as setting and monitoring your portfolio's overall asset allocation. As an owner of a fund, you'll also be able to obtain institutional-level (read: lower) trading costs.

Why not: Professional management isn't free. You'll pay for the fund-management personnel — its managers, analysts and traders — and you'll also pay your share of operating costs to cover everything from the fund's website to shareholder reports. It also is worth noting that professional management doesn't guarantee better results than what you might be able to achieve with your own hand-selected basket of individual stocks. A fund's portfolio performance also may be affected by investor dollars flowing into and out of the fund; for example, a big influx of assets could cause the fund to have more cash than usual, or sizable redemptions could force the manager to sell shares he or she would rather hang onto. Mutual funds, especially actively managed ones, also may foist unwanted

capital gains distributions on their shareholders, a problem that you can avoid by buying and holding individual stocks. (Equity investors can, however, reduce the problem of unwanted capital gains distributions by buying broad-market index funds and especially exchange-traded funds.)

If you go this route for all or part of your U.S. exposure: Start with Morningstar Medalist funds to winnow down the universe to a more manageable group; our analysts believe these funds will outperform their peers in the future.

CHOICE 2: Will you buy an index fund or go with an actively managed fund?

If you've decided to invest in a mutual fund for your U.S. stock exposure, your next decision is whether to buy an index fund that tracks a benchmark — rather than attempting to beat it — or a fund whose manager picks individual stocks in an effort to beat the benchmark. As with the decision about whether to buy individual stocks or a fund, the decision about whether to go with an active or index fund isn't black and white; it's possible to hold both. Here are the pros and cons associated with each strategy.

Index funds

Why: Index funds — sometimes called passively managed funds, in contrast to those run by active managers — give you broad exposure to a given market segment, often at very low cost. Index funds come in two main subtypes: traditional index mutual funds and exchange-traded funds. Exchange-traded funds (ETFs) are similar to traditional mutual funds except that investors can trade them throughout the day, just as they can with individual stocks. Thanks to their cost advantage relative to actively managed funds, as well as the fact that their trading costs are very low, broad-market index funds generally have beaten the typical active fund over long periods of time. With a passively managed fund, you don't have to worry much about management or strategy changes, because what you hold is dictated by what's in the index. Broad-market equity index funds also tend to have good tax efficiency, meaning that they make few capital gains distributions on a year-to-year basis.

Why not: You'll never beat the market or mitigate overall market losses with index funds. You'll simply capture market returns (or losses) minus the fund's fees. Because index funds always will stay fully invested and allow their winners to appreciate, they frequently perform well when the market is going up. On the flip side, because index funds are required to stay fully invested and mirror the index's holdings at all times, their managers won't have the opportunity to raise cash or retreat from overvalued securities if they think the market is pricey.

In practice, broad-market index funds make few changes to their portfolios, and when they do, it's usually around the margins. But index funds focused on a specific slice of the market, such as small-cap or value stocks, may make changes.

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MORNINGSTAR PICKS: DOMESTIC EQUITY FUNDS

By focusing on large-company stocks, these funds are great cornerstones for an equity portfolio. Find more at Morningstar.com.

AMG Yacktman Service (YACKX): Managers Stephen Yacktman and Jason Subotky look for high-quality companies. They tend to hold stocks for a long time, resulting in low turnover, and maintain heavy positions in individual stocks and sectors.

Dodge & Cox Stock (DODGX): Management seeks a decisive value approach, focusing on large companies that look cheap on a range of valuation measures. They hold on through tough times, which means those who invest in this fund must be patient: some out-of-favor names can remain that way for a while.

Fidelity 500 Index (FUSVX): Rock-bottom costs and a great record of closely tracking its index make this fund a top choice for exposure to the S&P 500 index.

Fidelity Spartan Total Market Index (FSTVX): This low-cost index fund offers comprehensive coverage of the U.S. stock market. This fund covers nearly the entire U.S. stock market, holding around 3,500 stocks.

Harbor Capital Appreciation (HACAX): Manager Sig Segalas and his team at Jennison favor growth stocks; specifically, they look for fundamentally sound companies with long-term competitive advantages that are growing faster than the S&P 500.

Oakmark (OAKMX): Manager Bill Nygren focuses on companies with strong fundamentals — including financial health, business-growth potential, and management's talent for capital allocation — whose prices appear attractive in absolute, not relative, terms.