

## Asset Returns

November 30, 2006	10	20			
YTD	2005	2004	Year	Year	
<b>Domestic stocks</b>					
Large	14.1	4.8	10.7	10.7	13.2
Large Value	19.3	6.9	16.1	11.9	13.6
Large Growth	8.5	5.1	6.1	9.6	12.6
Small	17.8	4.5	18.2	10.7	11.8
Small Value	22.1	4.4	22.1	14.4	14.1
Small Growth	13.4	4.0	14.1	7.4	9.5
Micro Cap	14.3	5.7	18.4	15.4	14.5
<b>International stocks</b>					
Large	22.3	13.3	19.0	7.9	12.2
Large Value	25.8	14.4	24.9	10.2	14.5
Large Growth	18.6	13.6	16.5	5.6	10.0
Small	20.5	22.0	30.9	11.5	-
Small Value	23.8	23.2	34.8	12.5	-
Emerg. Mkts.	24.5	32.6	24.6	11.3	-
EM Small	31.1	25.8	28.9	-	-
EM Value	33.2	30.8	39.5	-	-
<b>Sectors</b>					
U.S. REITs	38.7	8.9	30.2	16.7	12.3
Energy	21.4	40.2	33.9	16.8	14.9
<b>Bonds</b>					
Short Term	4.3	2.3	0.9	4.3	4.6
Five Year	3.6	1.7	2.9	6.2	7.5
Long Bond	4.0	6.6	7.1	7.9	10.3
Total Market	4.8	2.4	4.3	6.2	8.0
<b>Other</b>					
Inflation	-	3.4	3.3	2.5	3.0
Comm. RE	-	14.5	16.1	11.8	8.0
Residential RE	-	8.3	13.5	6.6	5.5
Hedge Funds	-	2.7	2.7	9.9	-
Commodities	-	18.9	12.5	5.6	5.9

**SOURCES:**

Large Cap data is based on S&P 500 returns.  
 Large Value and Growth returns are based on Russell 1000 Value and Growth data.  
 Small Cap, Small Value & Small Growth are based on Russell 2000, R2000 Value and R2000 Growth data.  
 Micro Cap returns are based on the CRSP 9-10 index of the smallest publicly traded stocks.  
 Int'l Large, Large Value and Large Growth are based on MSCI's EAFE Indexes.  
 International Small & Small Value returns are based on small company data in developed markets from DFA.  
 Emerging Markets data is from MSCI's Emerging Market.  
 Emerging Market Value and Small Cap data is based on Indexes maintained by DFA.  
 REITs are based on the Wilshire REIT index.  
 Energy data is from S&P's energy index.  
 Short term bonds are represented by Lehman's index.  
 Five year bonds are five year treasury returns and long term bonds are 20 year treasuries.  
 Total Bond market is the Lehman Aggregate Index.  
 Other data comes from the Federal Reserve, National Association of Realtors, HFRI & the CRB.

**PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS. INVESTMENT OBJECTIVES, RISKS, CHARGES, EXPENSES AND OTHER IMPORTANT INFORMATION ABOUT A FUND ARE CONTAINED IN THE PROSPECTUS; READ AND CONSIDER IT CAREFULLY BEFORE INVESTING. PROSPECTUSES ARE AVAILABLE ON COMPANY WEBSITES OR FROM TSI.**

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## International Investing (Part 1)

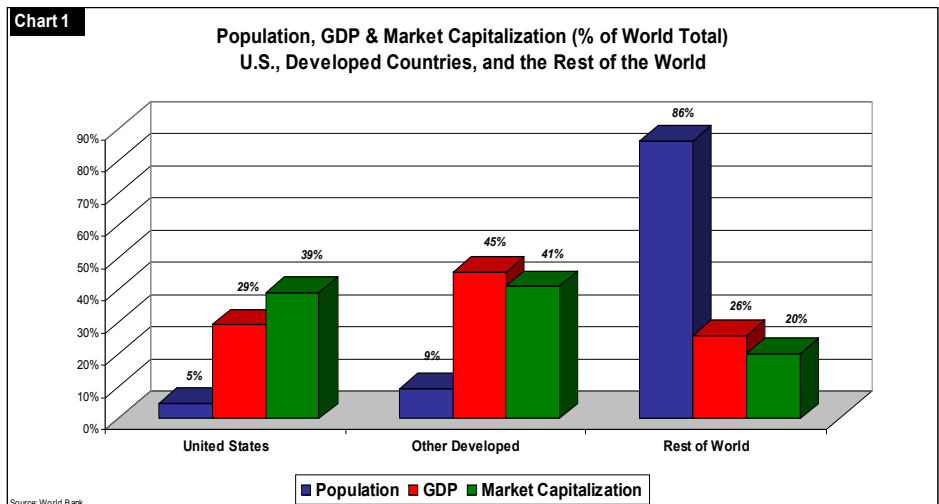
International investing represents an opportunity to diversify an investment portfolio beyond domestic holdings. Modern Portfolio Theory holds that diversification should improve portfolio risk and return characteristics if long term returns, correlations and volatility are considered properly. Additionally, international investments have delivered strong returns in recent years (see table of Asset Returns.) The case for international exposure seems simple, however, there are numerous uncertainties and potential risks associated with international investing. Over the next two newsletters, I'm going to discuss the international economic opportunity, some of the risks associated with international investing and the investment characteristics of developed and emerging markets.

### Economic Opportunity – Diversification & Growth

The U.S. has 296 million people and the world has 6.4 billion, as of the end of 2005<sup>1</sup>. We represent only 5% of all the people on earth. However, our GDP of \$13 trillion is 29% of world GDP and our equity market capitalization of \$17 trillion is 39% of the world's equity markets<sup>2</sup>. Chart 1 summarizes these figures for the United States, other developed countries (using World Bank definitions) and the rest of the world.

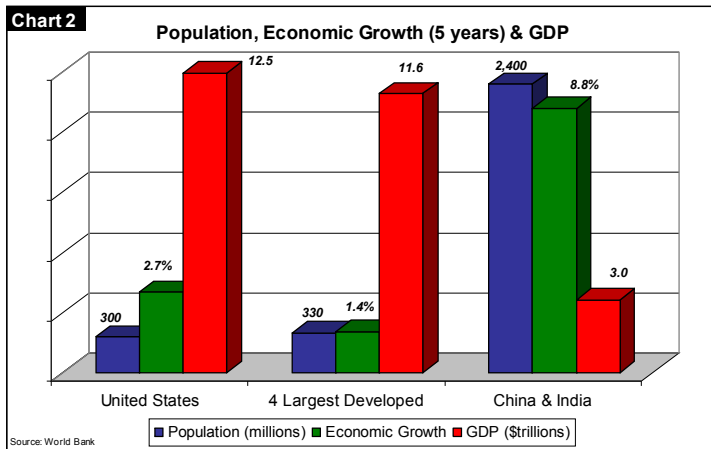
The chart shows the U.S. is not the center of the economic world. The U.S. does have the largest economy and the largest equity market, but other developed nations have markets equal to ours and the developing world has markets equal to roughly 1/2 of our market. As a result, 60% of the world equity opportunity is outside the U.S. Since the world's economies are not perfectly correlated, these markets represent an opportunity to diversify cyclical economic factors. Additionally, economic growth has been stronger in developing nations in recent years, than in the developed world.

When reviewing growth statistics, it's helpful to look at the countries that roll into the title "developed" or "developing." Consequently, I summarized the population, GDP, and growth numbers for the four largest developed countries outside the U.S. (Japan, Germany, France, & United Kingdom) and the two largest developing countries (China & India.) in Chart 2. Together, the 4 developed countries have a population and GDP close to those of the U.S. China and India have a combined population 8 times larger than U.S. and a GDP 1/4 the U.S. This represents a 30 to 1 difference in per capita



gross domestic product. In other words, U.S. citizens produce 30 times the value of goods and services as their Chinese or Indian counterparts. However, those countries have grown at 3 times the rate of the U.S. over the last five years. The growth represents a closing of the gap in productivity.

International economies offer diversification outside the United States, both from developed and developing nations. Additionally, developing nations have shown higher growth in recent years and should grow faster in the future as their economies expand to meet the needs of their citizens.



## International Investing Risks

Although, international investments offer the benefits of diversification and the potential for higher returns, there are unique risks associated with foreign exposure. I'll limit my discussion to market history, political stability, transparency, and exchange rate volatility. These factors impact our ability to understand long term return and volatility drivers and make effective allocation decisions.

**Market stability & history** – In the United States, we've had a continually functioning equity market that goes back to the 1800's. There is readily available data from Ibbotson<sup>3</sup> that reports equity and bond returns back to the mid 20's. We can use this data to research asset classes, returns, volatility and correlations. However, the same depth of data is not available for most international markets. For example, as recently as 60 years ago, the 2 largest developed countries outside the U.S. were devastated (Germany & Japan.) Their markets were non-existent and their political systems were going through complete transformations. Consequently, broad-based international index data only goes back to the early 1970s.

There is even less data for developing markets. The first equity index tracking this group was started in 1988 (less than 20 years ago.) We've only had 3 presidents over that entire period. Additionally, the largest country in the emerging market world (China) was recently a Communist nation that didn't allow private property ownership. India (the second largest developing country) restricted foreign investment and is still early in the process of capital markets liberalization. International markets generally, and emerging markets specifically, just don't have the same depth of historic data as is available for the U.S. market.

In addition to a lack of market history, the international markets (especially emerging markets) can be very unstable

when compared to the U.S. As recently as 1998, emerging markets experienced a near melt-down when Russia defaulted on its bonds and the Asian Tigers had serious trouble. The MSCI Emerging Market Index dropped 56% from 8/97 to 8/98. Devaluations in countries like Mexico and Argentina severely impacted the dollar value of local currency investments as recently as 10 years ago. It's possible for some emerging markets to decline almost 100% in dollar terms.

**Political Stability** – Politics is a concern in the emerging markets, because much of their growth depends on a commitment from top leaders to economic liberalization. World Bank statistics show a clear link between the ease of doing business and economic strength<sup>1</sup>. Free market reforms in large countries like India and China must be sustained if those countries expect to maintain their high levels of growth. However, these countries are experiencing significant demographic changes that could lead to political problems.

**Transparency** – Imagine two investments; the first in a company that provides full financial information in a format you can easily understand and the second in a company that provides only partial financial information that is often incomplete or inaccurate. Where would you invest? What if I told you the second company was growing 3 times faster than the first? Would that change your mind? In the U.S. we have well established financial reporting rules and relatively transparent investment markets. Although, the same is true in other developed countries, their accounting regulations and market disclosures can be substantially different from ours. In developing countries, the situation can be dramatically different. Reporting standards, market information and regulation can be cloudy. For example, who takes the roles of FASB (accounting), NYSE (market making), SEC (mutual fund regulation), and the NASD (investment regulation) in China, the Communist Party?

**Exchange rates** – In the U.S. we invest with dollars and all of our expenses and income are usually in dollars. When the dollar changes in value relative to other currencies, dollar denominated investment in those markets also change value. The Euro is near all-time highs vs. the dollar. The climb to this position has fueled overseas returns for U.S. investors. However, it also works the other direction as it did in the 1990's when weak foreign currency added to lack-luster international returns for an entire decade.

## Summary

There is substantial economic opportunity outside the United States and capitalizing on that opportunity can help investors diversify their investment portfolio and possibly boost investment returns. However, there are risks to overseas investing and the markets can be relatively immature. Next month, I'll look at the historic data for developed and emerging markets and quantify the benefits and risks associated with their inclusion in an asset allocation strategy.

*Gabe Thornhill*

1. *World Bank website*, [www.worldbank.com](http://www.worldbank.com); the World Bank's website has extensive data on the economies around the world
2. *Financial Planning*, Carpenter & Veres, December 2006
3. *Stocks, Bonds, Bill and Inflation Yearbook*, published annually by Ibbotson, available on Morningstar's website: [www.morningstar.com](http://www.morningstar.com)