Money Travels

As barriers fall and fear of foreign markets diminishes, small investors go global in the search for big returns.

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May 2 issue - The admonition not to put all your eggs in one basket dates to 17th-century Italy, but it's only starting to catch on in global investing. Sure, financial advisers have been warning clients to diversify for decades, and woe to those who didn't listen. Just ask all those former Enron employees who put all their money in company stock. In theory, however, spreading one's bets applies not only to stocks versus bonds and real estate but also to the United States versus Europe, Japan and emerging markets. For all the recent hype about globalization making the world a much smaller place, typical investors are only just starting to venture outside their home markets.

A big reason is simply that they can. Restrictions on the movement of capital have begun to fall, for one thing. The Internet has made it easier to track what is happening in remote places. Historically low interest rates have pushed profit-seekers to venture further afield. (U.S. Treasuries still pay nearly four points less than emerging-market bonds.) Emerging markets have become more transparent to welcome them.

Daytraders in their pajamas dabble in Thai baht and South African rand online. Chat rooms compare the merits of blue chips from Boston to Beijing to Budapest. U.S. workers direct retirement savings into emerging-market funds, and Britons are seeking sunny real estate in Africa. Even Germans, who typically felt safer with fixed-rate bonds or cash in the mattress, now hold half of their (still small) equity portfolios abroad. In its latest World Economic Outlook, released this month, the International Monetary Fund calculates that foreign portfolio holdings as a percentage of market capitalization have increased in many developed countries, including Canada, Japan, the United States, Britain and Germany (chart).

The birth of global investing—known by the technical term "decline in home bias"—has become a hot topic in the markets. The reason: Federal Reserve chairman Alan Greenspan has argued in recent speeches that the growing willingness of foreigners to invest in America is one reason not to worry excessively about U.S. deficits and the falling dollar. He measures the fall in home bias by comparing domestic savings with domestic investment; the difference is the broadest possible measure of a nation's trade and financial ties to the outside world. By this measure, home bias has slowly declined worldwide for the past two decades, falling slightly faster since 1995. A big exception is Japan, where individuals keep 99 percent of their assets at home, but even the Japanese are starting to shake off this provincialism (following story).

Much has been made of how foreign central banks are propping up the dollar by buying U.S. securities, but the flows of private investors are staggering, and merit closer attention as well. Mutual funds are a global $14 trillion industry, and pension funds total closer to $20 trillion worldwide. Since the 1970s, governments have chipped away at the restrictions on money flowing overseas. Don Cassidy, analyst with mutual-fund tracker Lipper Inc. in Denver, calculates that in 1980, just 5.3 percent of U.S. open-end stock funds were invested outside the 50 states. This February, that share hit a record 16.2 percent. While recent global market jitters may signal a retrenchment—money tends to fly home during downturns—the latest evidence is that investors are globalizing more aggressively than ever.

It's impossible to track all individual investment decisions worldwide, but a good proxy is choice in mutual funds. In the United States, says Financial Research Corp. of Boston, net flows into international equities in 2004 totaled a record $85 billion, compared with the industry's overall take of $228 billion. The falling dollar is a bonus: the MSCI Europe stock index was up a decent 9 percent in euros in 2004, but a heartier 21 percent in dollar terms. While the weak dollar makes U.S. real estate cheap for Europeans, plenty of Americans have snapped up property in France or Italy in recent years, in part as a currency hedge.

The vast bulk of global investing goes into stock and bond funds that span the world. Americans and Europeans tend to concentrate on each other. For the past decade, Western Europeans have consistently held 55 percent of their relatively small stock investments in Europe and about 10 percent in the United States. Yet last year their bet on the emerging European markets soared 70 percent, to 16.7 billion euros, calculates FERI Fund Management Information. Americans, meanwhile, began to buy heavily in Europe last year, after a three-year pullout.

More-exotic country-specific funds are catching on, too. Both Daiwa and Morgan Stanley offer a fund for Thailand. Others target Israel and Turkey. Investment into emerging-market equities hit an 11-year high of $38.5 billion last year, primarily in Asia, up from just $1.1 billion in 2002, reports the Institute of International Finance. Investors also bought $72.5 billion in emerging-market bonds, compared with $5.4 billion two years ago, favoring emerging Europe and Russia.

There is a long way to go before individuals follow the textbook advice on global diversification. In theory, because the value of U.S. stocks equals about 44 percent of the value of all stocks worldwide, investors (American or not) should put about 44 percent of their portfolios in the United States. They rarely do. American mutual funds hold about 90 percent of their total assets at home; retirement funds, about 82 percent. The world's most globalized individual investors come from small nations with open economies and with many famous domestic companies that actually list on foreign exchanges. Ben Phillips, managing director of mutual-fund analyst Cerulli Associates in Boston, includes in this group the Swiss, who invest 29 percent of their mutual-fund assets abroad, and the Singaporeans, who have pushed that figure up to 78 percent. Still, other small globalized nations don't fit the pattern: South Koreans keep 95 percent of their mutual-fund assets at home.

The subject of home bias first hit the radar in 1980 in a seminal paper by Martin Feldstein and Charles Horioka (one still cited by Greenspan) that found what was, at the time, a surprising correlation between national savings rates and national investment rates. In other words, investors were staying home. Why? There is still no consensus explanation. One line of research focuses on costs. Not until a 2000 paper by Maurice Obstfeld and Kenneth Rogoff did other economists really grasp the simple fact that moving money across borders, like shipping cars, costs money.

Another angle focuses on the role of information in making investment decisions. Richard Portes of the London Business School and Helene Rey of Princeton stud—ied bilateral equity flows among 14 countries and found a very strong correlation between where people invest and where they find it easy to place a phone call, find newspaper coverage or open a bank account. NYU Stern School of Business scholars agree information is important, but they say the key is not just access. It's that investors find it more cost-effective to build on small advantages they have at home, like knowledge of accounting rules.

Other analysts focus on irrational factors. A 1999 study found that in the United States, one out of every 10 companies in a fund is held because it is near the portfolio manager's hometown. Another concluded that private investors buy local companies simply because they feel familiar. Yet doing so does not lead to higher returns. University of Hannover finance professor Lukas Menkhoff recently asked German fund managers how they would ideally allocate money. Those who revealed a home bias justified it as a result of their superior knowledge of the market. Still, they were no better able to predict the Frankfurt market than outsiders.

In short, while it is eminently sensible to invest (as Warren Buffett says) in what you know, the truth is often that investors think they know a lot more about their home market than they really do. Certainly many Americans have learned that lesson by bitter recent experience, which helps explain why their tendency is increasingly to move money abroad. As a group, small investors may never reach the theoretical ideal of a globally balanced portfolio. But now, the bias is to run away from home.

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