

March 2006 Commentary

International Investments – Why and How Much?

"The past is a foreign country; they do things differently there." L. P. Hartley

Over the last four years international investments have outperformed domestic investments. In fact, it appears that international investors couldn't have gone wrong. According to the Wall Street Journal, over the last three years every single foreign fund tracked by researcher Morningstar -- 1,057 -- has outperformed the S&P 500. This sounds compelling, but will the results be as good for international funds over the next few years?

First, let's take a step back and ask the basic question: "Why international?"

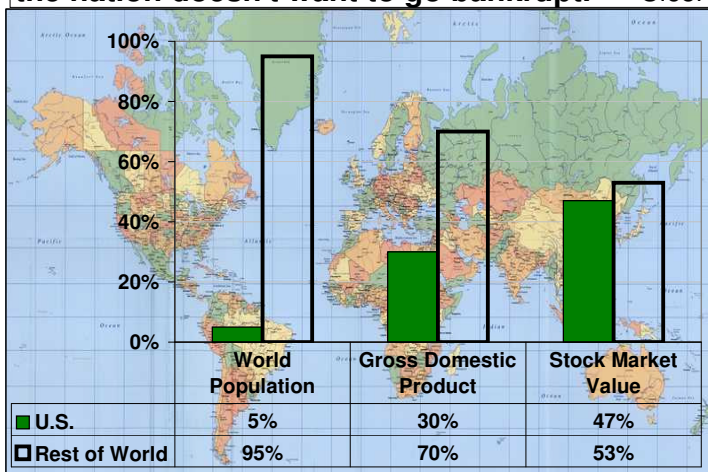
The United States certainly has an important place in the investment world. The U.S. accounts for only 5% of the world's population, but has 30% of the world's economy and nearly 50% of the world's total stock market value. Certainly, with a stock market this large, most U.S. investors could simply ignore opportunities to invest abroad. But if they did, they would be arbitrarily reducing their opportunity set by ignoring the other half of the world's equity market. This would be analogous to a U.S. investor taking the U.S. stock market, randomly dividing it in two and saying "I'm only going to invest in this subset of companies."

On the other hand, an investor could ask "What makes an investment international?" This is actually a difficult question to answer. Many companies that we might think of as domestic perhaps ought to be classified as international, as they have significant operations around the globe. For example, U.S. blue-chip companies like Coca-Cola, Procter & Gamble, Pfizer, Intel, Exxon Mobil, 3M and Citigroup all have 50% or more of their business outside the U.S. If a company does more business outside the U.S. than inside, does that make it an "international" stock? Moreover, Procter & Gamble produces about 25% of its sales in developing (or emerging) markets – does this make the company an "emerging markets" stock?

Just as a border between two countries is usually an imaginary line, the distinction between whether a company is domestic or foreign is also somewhat arbitrary. Traditionally the determining factor of whether a company is classified as an international stock is where the company is headquartered. However, increasingly the investment world is becoming one global marketplace and the distinction of where a company is domiciled is less important. Companies that are based in Europe or Asia may do more business in the U.S. than a similar American company might. For example, Teva Pharmaceutical, an Israeli based company, has almost 60% of its revenue generated from U.S. sales. Does that make it a domestic company? Nokia, a company based in Finland, only has 1% of its sales in its home country while its largest market, at about 12% of sales, is in the United States.

In our view it makes more sense to look at where companies source their revenues than where they are headquartered to determine how "international" they are. Using this measure, many investors find that their portfolios of domestic stocks often contain significant (and a surprising level of) international exposure.

"The national budget must be balanced. The public debt must be reduced; the arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced, if the nation doesn't want to go bankrupt." Cicero (55 BC)



World's Largest Stock Markets	Total Market Cap	Percent of Total
United States	14208 \$US billion	46.5%
Japan	3429 \$US billion	11.2%
United Kingdom	2904 \$US billion	9.5%
France	1143 \$US billion	3.7%
Canada	1105 \$US billion	3.6%
Germany	873 \$US billion	2.9%
Switzerland	831 \$US billion	2.7%
Australia	666 \$US billion	2.2%
Italy	517 \$US billion	1.7%
Spain	480 \$US billion	1.6%
Total Developed World	28607 \$US billion	93.7%
China	175 \$US billion	0.6%
India	142 \$US billion	0.5%
Total Emerging Markets	1920 \$US billion	6.3%
Total World	30527 \$US billion	100.0%

How much international investments should an investor have in a portfolio?

In our view there is not a magic percentage of an equity portfolio that should be allocated to international investments. Whatever the desired percentage is, we recommend that investors set a target weight and rebalance back to the target periodically. And, whatever the asset class, it is even more important not to be seduced by strong short-term results and be tempted to increase exposure to an allocation after a period of strong results. Equally, it is as important not to be scared away from investing in an area following recent underperformance (for example, avoiding international stocks following a foreign markets crisis or negative currency swings).

Lately, much of the interest in stocks appears to be heading overseas. International equity funds, a sector that represents only 15% of total assets among all stock mutual funds, captured about 80% of the inflows into stock funds so far this year, according to AMG Data Services of Arcata, Calif. Perhaps many investors are disappointed with the results from the U.S. market and are looking elsewhere for returns. Then again, many investors - who aren't aware of how much international exposure they had in their domestic portfolios - are likely chasing the strong performance results seen in international markets in recent years. The table below shows the returns of various developed markets over the last twenty years. In recent years, the U.S. market has underperformed many other markets. In our view, the underperformance of the U.S. market may provide an opportunity to get international exposure at attractive valuations via global companies trading in the United States.

"Few people think more than two or three times a year; I have made an international reputation for myself by thinking once or twice a week." George Bernard Shaw

(A larger version of this table is available on our website - www.madisonadvisors.com - under the Client Resources tab)

Developed-Market Equity Returns

Annual Returns of Country Indices (1986 - 2005) - Ranked in order of performance (Best to Worst)

RANK	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
1	Japan 99.41%	Japan 43.03%	France 37.87%	Germany 46.26%	United Kingdom 10.29%	Hong Kong 49.52%	Hong Kong 32.29%	Hong Kong 116.70%	Japan 21.41%	Switzerland 44.12%	Hong Kong 33.08%	Switzerland 44.25%	France 41.54%	Japan 61.53%	Switzerland 5.085%	Australia 1.68%	Australia -1.34%	Germany 63.80%	Australia 30.34%	Canada 28.31%
2	France 78.35%	United Kingdom 35.09%	Australia 36.40%	France 36.15%	Hong Kong 9.17%	Australia 33.64%	Switzerland 17.23%	Switzerland 45.79%	Australia 5.40%	United States 37.14%	Canada 28.54%	United States 33.38%	United States 30.14%	Hong Kong 59.52%	Canada 5.34%	United States -12.39%	Japan -10.28%	Canada 54.60%	Hong Kong 24.98%	Japan 25.52%
3	Hong Kong 56.11%	Canada 13.91%	Japan 35.39%	United States 30.01%	United States -3.15%	United States 30.07%	United States 6.39%	Germany 35.64%	Germany 4.66%	Hong Kong 22.57%	United Kingdom 27.42%	Germany 24.57%	Germany 29.43%	Canada 53.74%	France 4.31%	United Kingdom -14.05%	Switzerland -10.31%	Australia 49.46%	Canada 22.20%	Switzerland 16.33%
4	Australia 42.28%	Australia 9.25%	Hong Kong 28.12%	Switzerland 26.21%	Switzerland -6.23%	France 17.83%	France 2.81%	Australia 35.17%	Switzerland 3.54%	United Kingdom 21.27%	United States 23.24%	United Kingdom 22.62%	Switzerland 23.53%	France 29.27%	Australia -9.95%	Hong Kong -18.61%	Canada -13.19%	France 40.22%	United Kingdom 19.57%	Australia 16.02%
5	Germany 35.29%	United States 2.91%	Germany 20.60%	Canada 24.30%	Germany -9.36%	United Kingdom 16.02%	United Kingdom -3.65%	Japan 25.48%	United States 1.13%	Canada 18.31%	France 21.20%	Canada 12.80%	United Kingdom 17.80%	United States 21.92%	United Kingdom -11.53%	Canada -20.43%	United Kingdom -15.23%	Hong Kong 38.10%	France 18.48%	Germany 9.92%
6	Switzerland 33.37%	Hong Kong -4.11%	Canada 17.07%	United Kingdom 21.67%	Canada -13.00%	Switzerland 15.77%	Germany -10.27%	United Kingdom 24.44%	United Kingdom -1.63%	Germany 16.41%	Australia 16.49%	France 11.94%	Australia 6.07%	Germany 20.04%	United States -12.84%	Switzerland -21.38%	Hong Kong -17.79%	Japan 35.91%	Germany 16.17%	France 9.88%
7	United Kingdom 26.95%	Switzerland -9.45%	United States 14.61%	Australia 9.30%	France 13.83%	Canada 11.08%	Australia 10.82%	France 20.91%	Canada -3.04%	France 14.12%	Germany 13.58%	Australia -10.44%	Japan 5.05%	Australia 17.62%	Hong Kong -14.74%	France -22.36%	France -21.18%	Switzerland 34.08%	Japan 15.86%	Hong Kong 8.40%
8	United States 16.28%	France -13.81%	Switzerland 6.18%	Hong Kong 8.39%	Australia -17.54%	Japan 8.92%	Canada -12.15%	Canada 17.58%	France 5.18%	Australia 11.19%	Switzerland 2.28%	Hong Kong -23.29%	Hong Kong -2.92%	United Kingdom 12.45%	Germany -15.59%	Germany -22.39%	United States -23.09%	United Kingdom 32.06%	Switzerland 14.96%	United Kingdom 7.35%
9	Canada 9.94%	Germany -24.75%	United Kingdom 5.95%	Japan 1.71%	Japan -36.10%	Germany 8.16%	Japan -21.45%	United States 9.15%	Hong Kong -28.90%	Japan 0.69%	Japan -15.50%	Japan 23.67%	Canada -6.14%	Switzerland -7.02%	Japan -28.16%	Japan -29.40%	Germany -33.18%	United States 28.41%	United States 10.14%	United States 5.14%

Index returns are for illustrative purposes only and do not represent actual performance. Index performance returns do not reflect any management fees, transactions costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Performance information shown is historical and is no guarantee of future results. See below for a description of each index listed above.

Source: Morgan Stanley Capital International (MSCI). Each country's return is represented by its respective MSCI country index.

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Madison Financial Advisors

Cincinnati - Washington, DC - Tel: (888) 943-4198 - www.madisonadvisors.com

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