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Going Global with ETFs

Here are some choice exchange-traded funds that can boost your international exposure—without hefty costs

by Marc Hogan

International stocks are widely expected to outperform their U.S. counterparts for a sixth straight year in 2007 (see BusinessWeek.com, 11/17/06, "World Won't Sniffle if U.S. Sneezes"). Even after such a lengthy winning streak, now might be as good a time as any to follow the experts' advice and make sure your portfolio has proper international exposure, pegged by some analysts at 20% of total holdings. Exchange-traded funds, or ETFs, can be a smart, low-cost route to a globally diversified portfolio.

International stocks might seem like one area where market expertise should give the pros an upper hand, but the numbers tend to disagree. The S&P/Citigroup (C) PMI World index outperformed 58% of actively managed global funds last year, while the S&P/Citigroup PMI World ex U.S. index outpaced 50.5% of international funds. The S&P/IFCI composite also led 75% of actively managed emerging-markets funds.

Like index funds, ETFs are baskets of securities that seek to track a benchmark, but they also trade intraday, like stocks. Many pros like them for their low prices and typical tax-efficiency (see BusinessWeek.com, 6/22/06, "Spread Your Bets in ETFs").

Still, it's important to remember to use international ETFs with caution. The markets they invest in can be volatile. Also, unlike mutual funds, ETFs incur brokerage fees with each trade, so they're probably not a good fit for investors planning to make frequent trades or monthly deposits.

Caveats aside, ETFs might be a convenient way to get exposure to foreign stocks. This *Five for the Money* offers tips to help investors find international ETFs that could be a solid addition to their portfolios.

1. COVER THE BASICS.
Globally minded ETF investors might want to make their first stop the iShares MSCI EAFE Index (EFA), some financial advisers say. This fund tracks a widely used benchmark for foreign developed-market stocks, with exposure to companies in Europe, Australia, and Asia. The $37.1 billion portfolio counts the likes of BP (BP), HSBC (HBC), and Toyota (TM) among its more than 800 holdings.

The iShares MSCI EAFE Index ETF's broad diversification can make it a quick, one-stop way to up your overseas exposure. "I consider it to be the S&P 500 equivalent of international markets," says Georgia Bruggeman, founder of Holliston (Mass.)-based Meridian Financial Advisors. "This is the first place to invest, and should be part of the foundation for everyone's portfolio," she adds.

The fund boasts an average annualized return of 14.38% over the five years ended Dec. 29, slightly ahead of its style peers, according to Standard & Poor's. Paul Winter, principal at Salt Lake City-based Five Seasons Financial Planning, also likes the ETF's low 0.35% expense ratio and its tax-efficient track record. "It has never paid a capital-gains distribution," Winter notes, and that's a fact investors are bound to appreciate, come Apr. 15.

2. TAP INTO EMERGING MARKETS.

After a strong multiyear run, stocks in emerging markets have hit a few roadblocks so far in 2007. Thai stocks fell after the new coup-installed government announced it would limit foreign investment, and Venezuela's move to nationalize some privately held industries raised a fresh set of worries. While it's tough to get the timing right, emerging-market exposure can still be a smart addition to a portfolio over the long run.

The $10.8 billion Vanguard Emerging Markets Stocks Vipers (VWO) ETF posted a 29.53% return last year, slightly below its peer average, according to S&P. The fund is cheap compared to its peers, with an expense ratio of just 0.3%. The iShares MSCI Emerging Markets Index (EEM), which tracks the same benchmark, carries expenses of 0.77%.

Either ETF can look cheap compared to a number of their traditional counterparts. "Some actively managed emerging market funds have extremely high expense ratios," says Eve Kaplan, a Berkeley Heights (N.J.)-based financial planner. "The ETFs are a good cost-effective alternative for some investors."

Particularly after emerging markets' recent strength, investors should remember that these stocks can be highly volatile. "People tend to buy them when they're hot, like right now, and then dump them the moment they start disappointing," says Morningstar (MORN) ETF analyst Dan Culloton.

3. TAKE A REGIONAL VIEW.

Still, some investors have reservations about how the major international indexes are composed. Whether your quibble is with MSCI Emerging Markets index's inclusion of Russia or the MSCI EAFE index's weighting to Europe, ETF providers also offer region-specific funds for more neatly calibrated exposure. Be careful, though, because simplicity is probably a better bet for most typical investors.

The $25.9 billion Vanguard European Stock ETF (VGK) and $12.3 billion Vanguard Pacific Stock ETF (VPL) provide low-cost ways to fine-tune exposure to Europe, Asia, and Pacific nations such as Australia and Japan. "I really love Vanguard's offerings because they allow me to slice and dice the international markets better than the EAFE index," says Michael Dubis, president of Michael A. Dubis Financial Planning in Madison,Wisc. Both Vanguard portfolios carry low expense ratios of 0.18%.

4. HEAD TO THE COUNTRY.

Nevertheless, certain investors might not want to limit their asset-allocation strategy to the regional level. With ETFs, they don't have to. A growing number of country-specific ETFs allow investors tweak their stock exposure on a country-by-country basis.

David John Marotta, president of Charlottesville (Va.)-based Marotta Asset Management, says he invests in ETFs for the 10 countries recognized each by the Heritage Foundation for having the most economic freedom. These include iShares Hong Kong (EWH), iShares Singapore (EWS), and iShares United Kingdom (EWU), among others. Each of these funds carries an expense ratio of 0.54%.

However, analysts and financial advisers frequently caution against average investors trying to beat the pros by dabbling in country-specific ETFs. "The right way to use ETFs for international exposure in a portfolio is to shun the single country funds," says James Sonneborn, wealth manager at RegentAtlantic Capital in Chatham, N.J. Instead, Sonneborn recommends a simple international portfolio component based on the more broadly diversified foreign ETFs.

5. CONSIDER REAL ESTATE.

As ETFs continue to proliferate, one emerging segment is international real estate. State Street Global Advisors recently rolled out its SPDR Dow Jones Wilshire International Real Estate (RWX) ETF. Just introduced last month, the fund tracks the Dow Jones Wilshire ex-U.S. Real Estate Securities index.

While investors should probably wait for it to build up a track record, some financial planners say the fund could be a savvy play for additional overseas diversification. RWX carries a 0.6% expense ratio, and its underlying benchmark boasts five-year average annualized returns of 29.19%. "I'm not putting it in any client portfolios yet," says Dubis, who likes the product but is taking a wait-and-see approach. "People have to be very careful."

As the world of ETFs keeps getting bigger, these funds remain an inexpensive choice for investors trying to keep up with the fast-changing global economy. With luck and some careful decisions, the added foreign flavor could lead to some appetizing returns for investors.

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