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The Sound Investor Series #42

ETFs for the Internationally Inclined

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March 22, 2006

A reader wrote asking what Exchange-Traded Funds (ETFs) I recommend for international investing. While I'm not as enamored with international investing as many financial professionals are, here are my two cents.

Before getting to the heart of the subject, I want to suggest investors tread carefully. International markets and emerging markets in particular, are white hot. Recent performance has been excellent and money is pouring in. In my experience, this enthusiasm often occurs near a market top.

I am not recommending long-term investors alter their investment patterns, but speculators chasing performance should take notice. Just take a cautionary look at a long-term chart of the MSCI EEM index back to the early 1990s when emerging markets were rocketing skyward. Buyers in late 1993 and 1994, before the market fell sharply, had to wait 10 years to get back to even.

Now on to the main subject. Most ETFs are structured to follow stock market indexes and for international indexes, the most popular family is published by Morgan Stanley Capital International (MSCI).

MSCI's indexes were started in the late 1960s to help portfolio managers measure the performance of stocks around the world. It was less than 40 years ago but the international landscape was very different. Japan severely limited foreign investment and the UK, the largest developed market outside the U.S. had to be bailed out by the IMF in 1974. Today's "emerging markets" didn't exist.

MSCI currently calculates equity indexes for 50 countries around the world. It also groups the countries in various combinations to create additional indexes. For instance, the 50 countries are split into 23 "developed" and 27 "emerging" markets based on economic factors such as GDP per capita.

The MSCI World Index covers the all "developed" markets including the US and Canada. When the two North American countries are removed, the remaining 21 developed countries make up MSCI's most popular index – EAFE. EAFE stands for Europe, Australasia and Far East. Japan and the UK currently have the largest weights at about 25% each.

The iShares MSCI EAFE Index Fund (EFA) ETF follows this index of developed markets. With the increasing interest in international markets, the fund has grown to \$26 billion in assets, almost doubling since early 2005. Fund expenses seem reasonable at 0.35%, so for investors wanting general exposure to international markets, this fund is a good choice.

Moving over to “emerging” markets, investors can use the iShares MSCI Emerging Markets Index Fund (EEM) ETF to access the whole group. South Korea has the largest weighting in this index at 18%, followed by South Africa (13%), Taiwan (11%) and Brazil (10%). EEM assets have tripled in the past year to \$12 billion.

There are other ETFs in the international area, with many based on other publishers’ indexes such as S&P and Dow Jones. Most of these are good products, but are more appropriate for active investors. ETFs track 22 individual countries ranging from Japan (\$13 billion in assets) to Belgium (\$80 million). Some regional indexes have seen tremendous growth like iShares S&P Latin America 40 (ILF) where assets increased seven-fold in the past year to almost \$2 billion.

I don’t think ETFs are the best vehicle for investing in emerging markets. In many countries, the indexes do not adequately represent the underlying economy or the sectors where you want to be invested. For this reason, I recommend long-term investors use actively managed funds in these markets.

Investors should always be very careful when buying and selling ETFs, especially international ones. European markets are only open during our morning hours and Asian markets are completely shut during our business day. During calm periods, ETF bid/offer spreads have typically been reasonable, but in volatile markets, they are likely to widen, to an investor’s detriment.

To summarize, investors have a full menu of ETFs to choose from in the international arena. For long-term investors in developed markets I recommend using the EFA ETF. In the smaller emerging markets, I would discard the index approach and use an active fund manager.

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