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Global investing from the comfort of home

Mitigating Risk

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Markets around the world have been improving and have recovered more than half the losses of the 2007-2009 bear market. With this improved performance over the past 21 months, investors have been gaining confidence to return to the markets. However, the biggest mistake many investors make is to chase after the hottest sectors.

Investing for the long term requires balancing the objective for growth with the desire to protect one's hard earned money. Too many people choose an investment based solely on past performance without regard to the risk being taken. The severe losses the markets experienced in 2008 and early 2009 are fresh in many investors' minds. However, many investors today are pouring money into emerging market funds without understanding the risks. There is a better way to invest.

It is true that the fastest-growing economies around the world are the emerging markets of Asia and Latin America. Also, the market performance of the emerging markets has beaten the performance of the developed markets of the United States and Europe by a wide margin during the past decade. However, outperforming sectors often become the underperformers going forward.

In the 1990s, technology and telecommunications companies were the market leaders. Money poured into the stocks of tech and telecom companies. The decision to invest in that sector was based on past outperformance rather than valuation. Many individuals invested very late in the decade just in time for major losses shortly after the turn of the decade. A similar flow of money is being directed toward emerging markets funds today, which again may be a very untimely decision for many.

Rather than invest directly in the markets of Asia and Latin America, investors may be better off investing in leading multinational companies that trade at much more attractive valuations.

For example, Procter & Gamble, the world's biggest maker of consumer products, plans to accelerate its efforts in developing markets, including Brazil and India. P&G generates 34 percent of its business in the emerging markets. Wal-Mart recently announced a planned acquisition in South Africa to further expand its emerging markets business. Currently a quarter of the company's sales are outside the United States and international sales are the fastest-growing part of the business. IBM, which serves clients in 170 countries, generates almost 20 percent of its business from emerging markets.

These American companies have a long track record of effectively allocating capital to the markets that are able to generate the greatest rate of return. Each has a long-term history of paying regular dividends and raising those dividends annually.

During the 1990s, these same companies invested in technology to improve their operations and to increase their workers' productivity. It turned out to be a mistake to invest directly in the tech and telecom sector at the end of that decade. Instead, it made more sense to invest in the companies that were taking advantage of technology advances to improve their profitability. The same may be true of the emerging markets today. The companies investing strategically in the fast-growing emerging markets may be a better opportunity than investing directly in that sector.

Tax-efficient investment

With an extension of tax rates on current income, capital gains and dividend income for the next two years, the benefits of dividend-paying stocks has increased. Over the past 100 years, almost half of the total return of the markets has come from dividends. Dividend income and long-term capital gains will continue to be taxed at a maximum rate of 15 percent. Investors in the lower tax brackets will pay no tax on dividend income and long-term capital gains. For 2011, the lower tax brackets include individuals with taxable income up to $34,500 and married couples with taxable income up to $69,000. There is no more tax-efficient investment than dividend stocks for these taxpayers.

Long-term investors who want to participate in the market but are not comfortable with the additional risks involved with investing directly in the emerging markets may be well-served by focusing on companies that have operations throughout the globe, that have a long history of paying regular dividends and raising those dividends and have a strong management team. There are many great American companies to choose from. Additionally, for at least the next two years, the dividends earned will be taxed at favorable rates. NHBR

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