FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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Why I'm Selling Foreign Stock ETFs

One of the most common mistakes that investors make is investing all (or nearly all) of their portfolio in securities issued by companies based in their own country, which is known as *home country bias*. This is understandable, as people tend to cling to what they know.

There are at least two problems with this. First, even at its current eye-watering valuation (third most expensive in the world), the U.S. stock market comprises less than 60% of the global market capitalization, which means that there are many opportunities outside the U.S. Second, international securities provide a powerful diversification benefit to a U.S. investor since foreign companies have a significantly lower correlation to the U.S. (especially smaller companies), and their operations and securities are denominated in a foreign currency.

As mentioned above, a third current problem is that due to their rich valuations, in general, U.S. stocks have a very low expected return compared with stocks from nearly every other country.

A good general investment strategy is to buy the stocks of the ten cheapest stock markets and avoid the stocks of the ten most expensive. But you also need to take taxes into account, even if your entire portfolio is in tax-deferred or tax-free accounts. Let me explain.

First, the vast majority of countries withhold taxes on dividends paid by companies based in their country, even if you own the stock in a tax-deferred or tax-free account. Usually the tax rate is significant (especially for countries in Western Europe) and can be as high as 35% (Switzerland).

If you hold such stocks in a taxable account, you can claim the U.S. Foreign Tax Credit on your income tax return and receive a dollar for dollar tax credit for taxes that those foreign governments withheld on dividends paid by your foreign stocks (assuming that the country has a tax treaty with the U.S.).

There are a few major countries that do not withhold any tax on dividends. If part of your portfolio is in a taxable account and part is in tax-deferred and/or tax-free accounts, you want to hold such stocks in your non-taxable accounts and save your taxable accounts for countries where the withholding tax rate is significant.

The vast majority of investors who have exposure to foreign stocks obtain it by using an international mutual fund or ETF, in both taxable and non-taxable accounts. The majority of most investors' portfolios are in non-taxable accounts, so when they invest that money in an international stock fund, they cannot claim the U.S. Foreign Tax Credit on taxes withheld from those foreign stocks.

This can cost you many thousands of dollars per year. What's that, you say? The IRS never told you about this? Hmm, that's weird.

So for many years, I used single-country stock ETFs as a way to obtain exposure to foreign stocks so I could use the (usually quite scarce) money in taxable accounts for high-tax countries and the money in non-taxable accounts for everything else.

However, there are several disadvantages to single-country stock ETFs. First, most of them are heavily invested in sleepy, highly regulated industries with a low return on invested capital that I normally avoid (e.g., banks, utilities, etc.).

Second, virtually all of these funds are weighted by market capitalization, which creates two problems: (1) In smaller countries, just a few stocks can dominate the country's stock market, so if you invest say 2% of your portfolio in a single-country ETF, half of that may end up in just two or three stocks from that country. And (2) market cap-weighted funds tend to buy high and sell low even though they don't mean to.

Further, foreign stock funds have annual expense ratios (which subtracts from your return) that can be significant (often over 0.5%, sometimes even over 1%).

Finally, most single-country ETFs are managed by iShares, which is owned by Blackrock, which is run by Larry Fink, who is the poster boy for ESG investing. Fink has made it very clear that when it comes to evaluating management performance and voting proxies, Blackrock will use ESG criteria. The E (environmental) and S (social) part of ESG actually destroy shareholder value, so the funds that it manages are doomed to underperformance at best and failure at worst. It's just a matter of time.

On the investment battlefield, mutual funds and ETFs are like a howitzer, or (for a large index fund like one based on the S&P 500 index) an artillery battalion. They're too crude of a weapon. Capital is scarce and precious, so as an investment advisor, I need something more precise, like a sniper rifle.

That's why in recent months and years, I have been gradually unwinding positions in foreign stock ETFs and replacing them with ADRs (American Depositary Receipts), which are basically individual foreign stocks that trade on U.S. stock exchanges and are denominated in U.S. dollars.

I have access to a wealth of information about these foreign stocks, so I can quickly assess their value, profitability, financial strength, growth, etc. However, there is not as much information available about them as there is for U.S. stocks. For example, I have not been able to find any information about insider ownership, insider transactions, or the percentage of shares that have been sold short by short sellers.

That incomplete data is one reason why many U.S. investors shun them. But that shunning also creates opportunity, because there are a lot fewer fishermen in that fishing hole.

The competition for investment returns has never been more fierce, or the expected returns (for an investor in U.S. stocks) so low. You need to take advantage of every possible edge, including targeting individual foreign stocks that have the highest expected return, increasing your portfolio's diversification, and reducing your taxes and expenses.

Mark my words: In the years ahead, a portfolio that is invested only in U.S. stocks via a market cap-weighted fund will have a very low return.

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