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International Stocks and ETFs: Where To Focus For 2021

Investing part of your portfolio outside of your home country and into international stocks is an important part of diversification.

It helps you avoid geopolitical risk associated with having all your funds in just one country, minimizes the impact of localized economic bubbles, and allows you to take advantage of areas of growth and value across the world.

The Benefits of Global Exposure

Equity performance tends to be cyclical around the world.

Some regions outperform others over a decade, only for the trend to reverse during the next decade:

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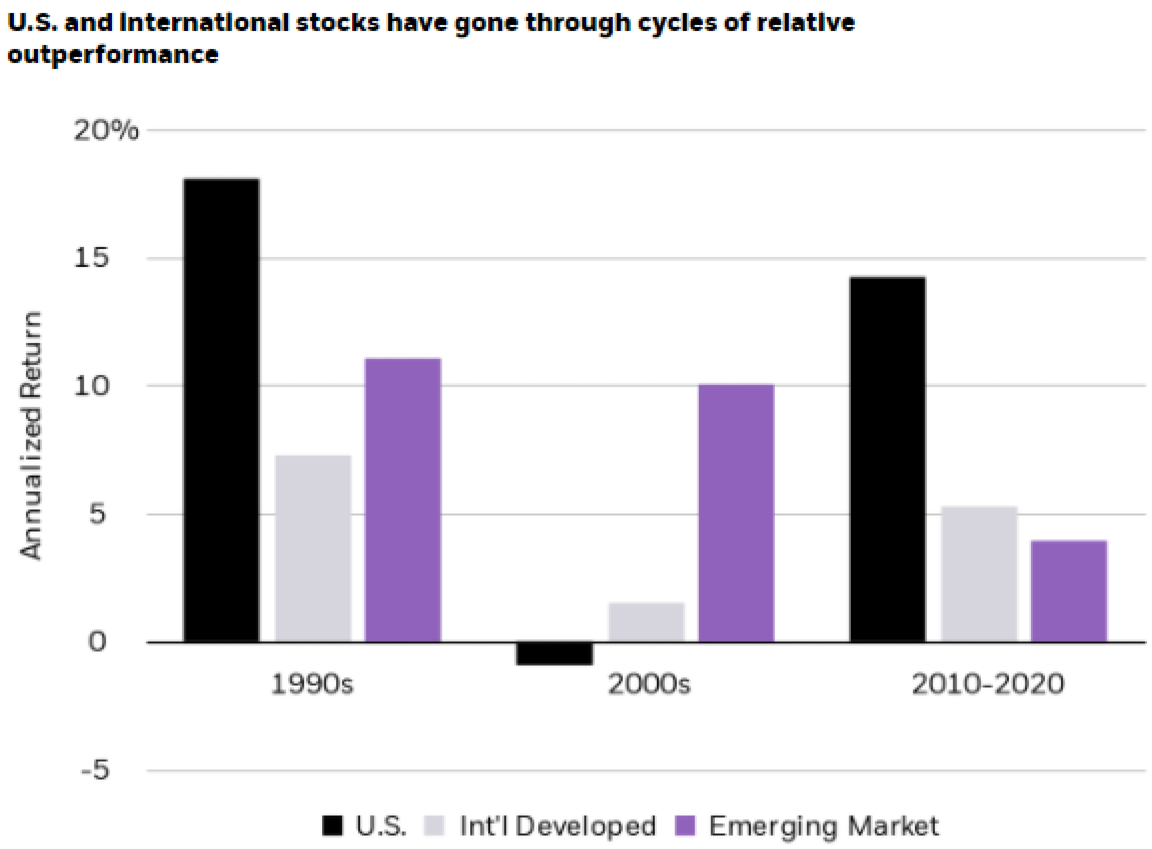

Chart Source: iShares

This often has less to do with actual economic performance of those regions, and more to do with changes in valuation levels of their stocks. The benefit of having a globally diversified portfolio is that you can reduce overall volatility and increase returns. The outperformance of one region can make up for the underperformance of another region.

For more hands-on investors, you may even be able to modestly boost returns further by investing more heavily in undervalued areas. In other words, you can invest more heavily in areas that have underperformed recently, and that are trading at lower valuations.

For example, Meb Faber, the CFO of Cambria Investment management, calculated that if you had invested in the cheapest 25% of countries in terms of CAPE, you would have crushed the S&P 500 between 1993 and 2018 (orange line vs dark blue line):

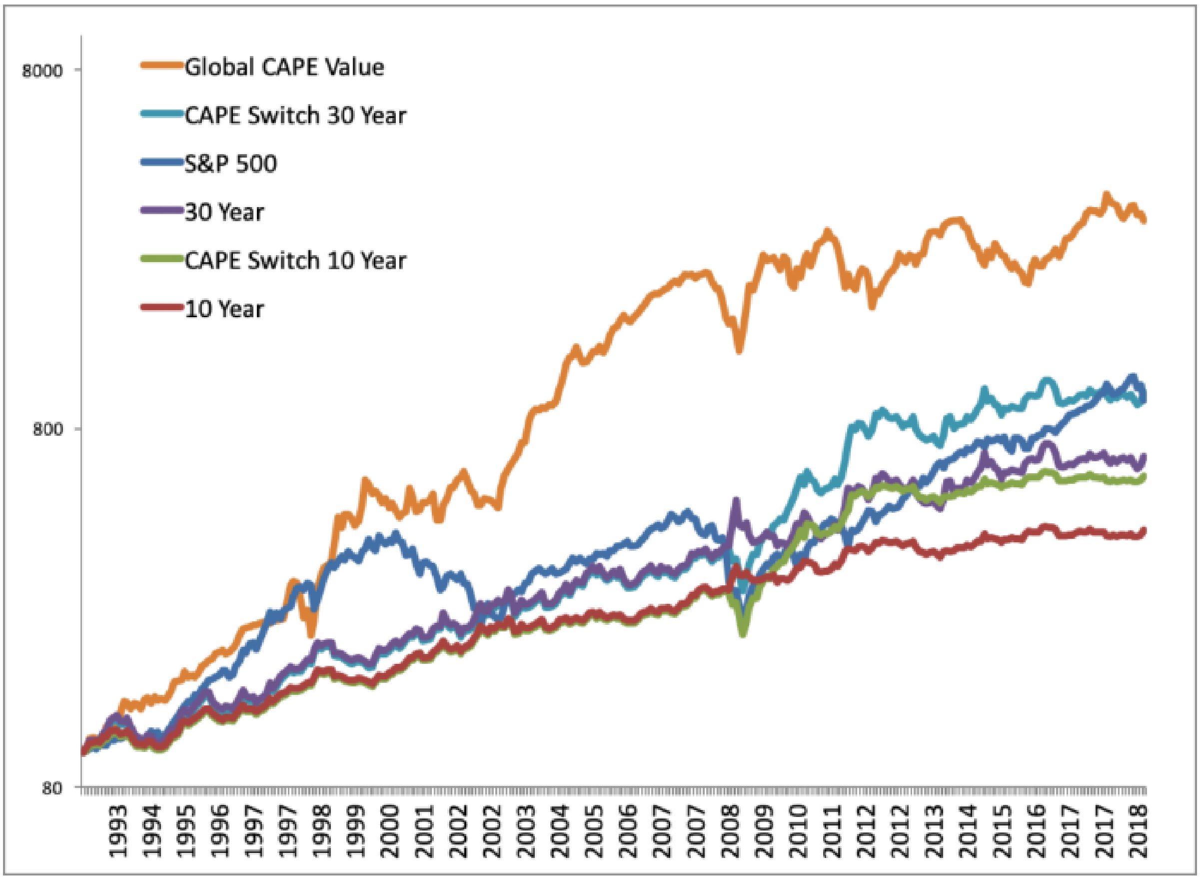

Chart Source: Meb Faber

That chart is logarithmic so the visual difference is smaller than it really is. Investing in the S&P 500 would have returned 962% from 1993 to 2018. Investing in the cheapest 25% of countries based on CAPE ratios would have returned 3,052%, or more than three times as much.

Discussion: Market-Cap Weighting

Many investors don't look carefully at the international index funds that they select. They pick a single well-known fund like the Vanguard Total International Stock fund or the MSCI EAFE index and assume it covers their basis.

The problem is, a lot of those common broad international funds are heavily concentrated into just a few countries, and Japan alone makes up 18-25% of their portfolio. This can have a dramatically negative affect over decades.

This is because most international index funds are weighted by market capitalization.

What this means is that instead of being equally distributed among the companies in their investing scope, they put more money into the biggest ones. Some people think this is the best approach, while others prefer an equal weighted index.

But while weighting by market capitalization makes decent sense on a domestic basis, it makes less sense when applied internationally. When international indices weight themselves by market capitalization with no other factors, it results in a huge concentration into just two or three countries. This is because they are not just weighted by the market capitalization of each company, but also by the market capitalization of each *country*.

This means that slow-growing and mature countries like Japan and Europe dominate just about every international index.

Japan, as good as the country is, is not particularly investor-friendly, with low growth and low dividends. And now the country faces population shrinkage.

Despite all this, I'm not necessarily even forecasting that Japan won't do well. That's not the core point.

I don't mind having Japan in my portfolio, but would I want Japan as a full 18-25% of my international holdings? Of course not.

Is there any particular reason why investors' money should be 3x more concentrated in Japan than Canada? Or 6x more concentrated in Japan than South Korea? Or 11x more concentrated in Japan than Brazil? Just because Japan's stock market is the biggest

There's no compelling reason for international stock funds to be weighted strictly by the stock market size of each country. It makes far more sense to broaden and diversify more evenly, so that you're not so heavily tied to the fate of just one country. Especially a shrinking country.

For international stock funds, there's no compelling reason that market capitalization weighting is the best way to go. I certainly don't want most of *my* international stocks concentrated into Japan and Europe; I'd rather have broader exposure.

Broader Diversification

- If you invest all your foreign holdings into something like the Vanguard International Stock Index (VEU), you'll be 18% in Japan.
- If you invest in the Vanguard Developed Stock Index (VEA), you'll be 22% in Japan.
- If you stick to the popular MSCI EAFE index and all the funds that track it, it'll be more like 25% in Japan.

In addition, you'll be heavily invested in continental Europe (France, Germany, Italy, Spain, etc) which shares interconnected geopolitical risks.

There are a couple easy and passive ways to spread out your exposure, though.

Idea #1) Add a Dividend Metric

When you add another metric to the equation besides pure market capitalization, it change which countries dominate the index. Adding a dividend metric often reduces or eliminates Japan from the running.

For example, if you put 50% of your international holdings into the Vanguard International Stock Index ETF (VXUS), and 50% into the Vanguard International Dividend Appreciation Stock Index ETF (VIGI), your exposure will look more like this:

	100% Vanguard Total Intl Stock	100% Vanguard Intl Div Appreciation	50/50 Split of Both
Japan	18.3%	8.9%	**13.6%**
United Kingdom	13.0%	5.9%	**9.5%**
Canada	7.1%	16.7%	**11.9%**
France	6.1%	9.8%	**8.0%**
Germany	5.9%	2.8%	**4.4%**
Switzerland	5.7%	11.1%	**8.4%**
Australia	5.2%	4.7%	**5.0%**
China	4.9%	7.3%	**6.1%**
South Korea	3.4%	1.6%	**2.5%**
Taiwan	3.2%	0.0%	**1.6%**
Hong Kong	2.7%	5.6%	**4.2%**
India	2.1%	10.2%	**6.2%**
Denmark	1.1%	3.2%	**2.2%**

Click on the image for a bigger view.

That approach helps to move some assets out of Japan and spread them around a bit, especially into Canada and India.

Idea #2) Split Developed and Emerging Markets

Developed countries tend to have the biggest stock markets, and thus larger market capitalization. They totally dominate the allocation percentages of market cap-weighted index funds and ETFs.

But, most global growth is coming from emerging markets.

Over the next couple decades, several emerging markets will be the biggest economies in the world:

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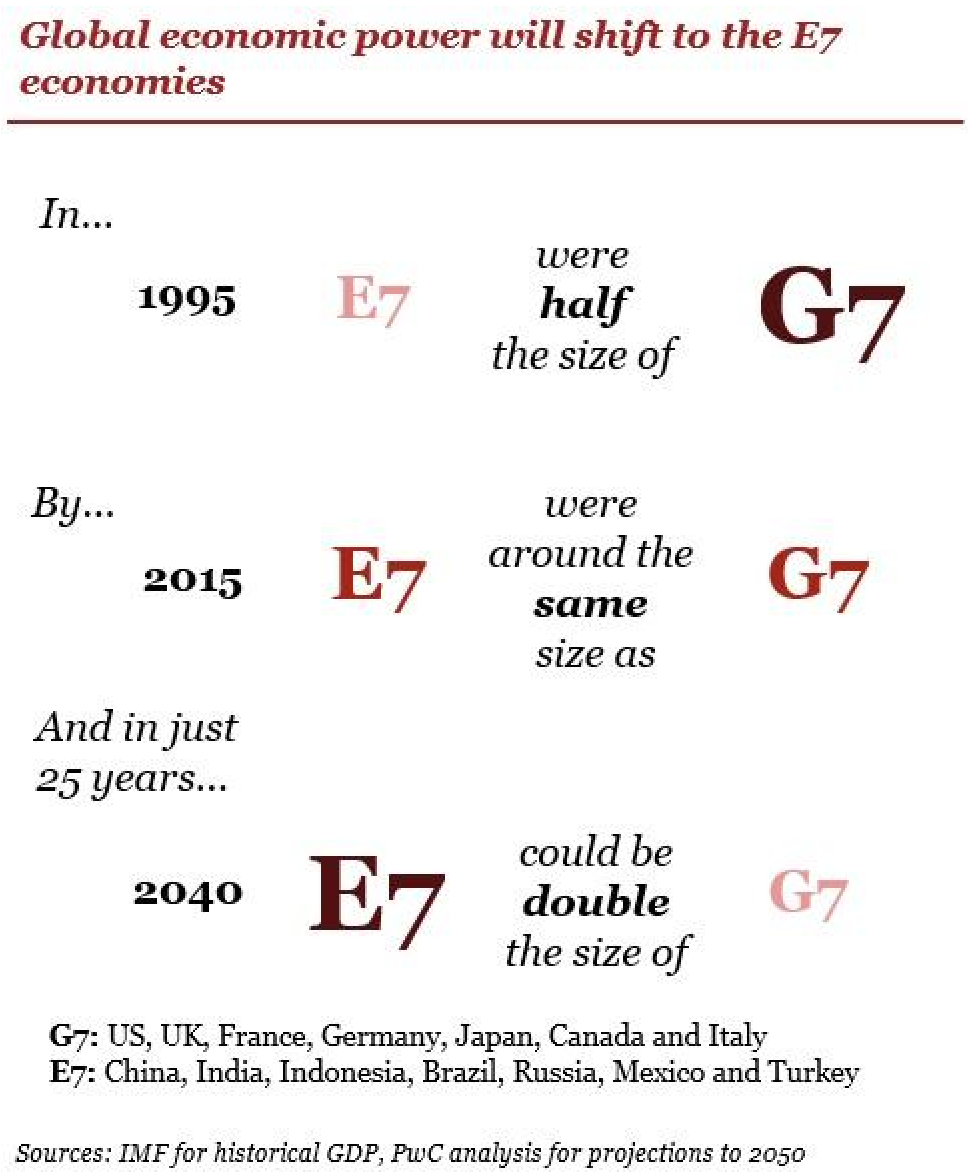

Chart Source: PwC Global

Already, most global growth is coming from emerging markets:

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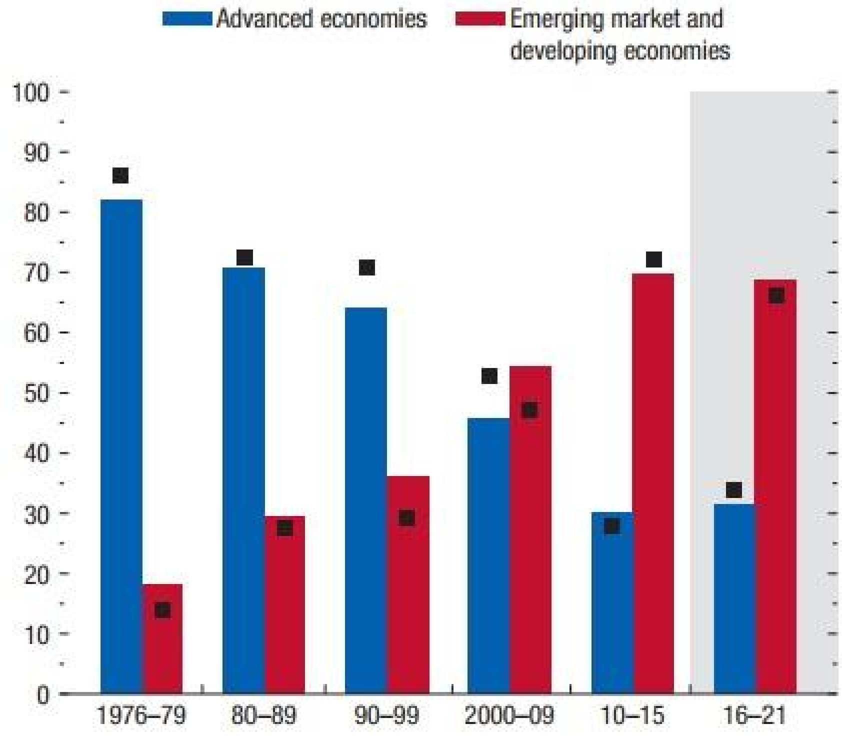
Figure 2.1. Contribution to Global Output and Consumption Growth
(Percent)

Emerging market and developing economy growth prospects are increasingly relevant for the global economy.



Source: IMF staff calculations.
Note: Weighted averages are calculated using market exchange rates. Colored bars show percentage of contribution to output growth; black squares show percentage of contribution to consumption growth.

Chart Source: IMF World Economic Outlook

Despite this, due to weighting by market capitalization, the Vanguard FTSE All-World Index ETF (VEU), which represents the world besides the United States, and indices just like it, have only about a quarter of their assets in emerging markets and three-quarters of their assets in developed international markets.

In fact, the Vanguard Total World Stock Index ETF (VT), which includes the United States and all major countries and represents literally the entire world by market capitalization, has less than 12% of its assets in emerging markets.

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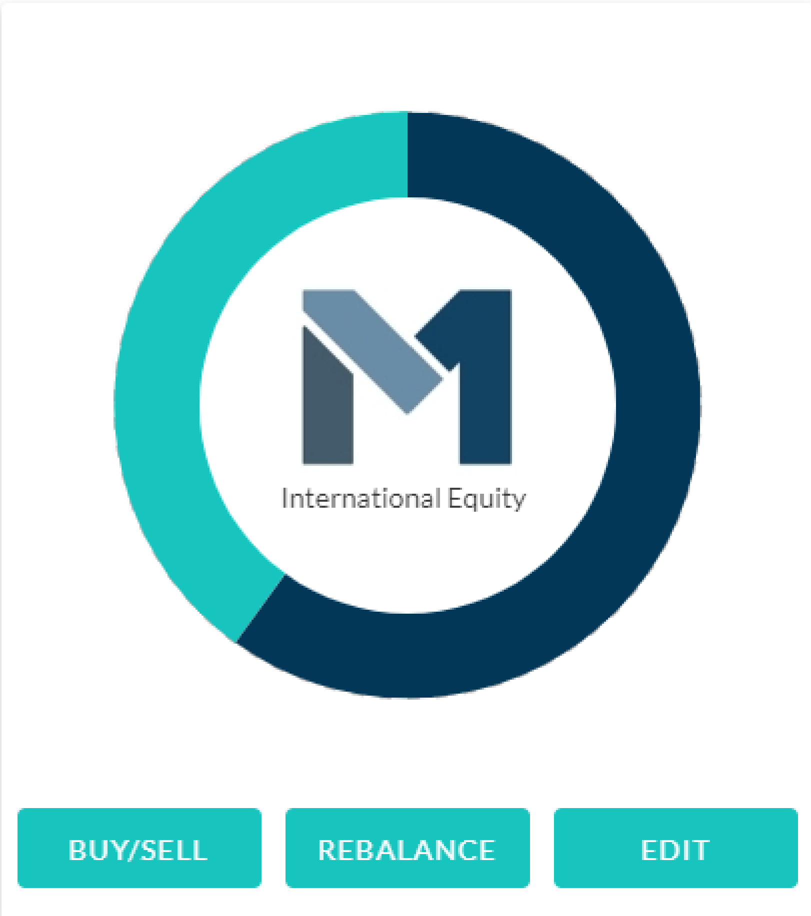
For this reason, I like to split my emerging markets exposure and developed foreign exposure into separate allocations, and then weight the emerging exposure more heavily. Emerging markets are more volatile, but that's where most forward GDP growth is coming from.

For example, in a M1 Finance portfolio, you can overweight emerging markets:



Slices

Name	Actual / Target
VWO Vanguard FTSE Emergi...	59.8% 60%
VEA Vanguard FTSE Develo...	40.1% 40%

Each month, I add money to my M1 Finance account, so if emerging markets dip, my allocation buys the dip and brings the allocation back to where I want it. If developed markets dip, my allocation buys that dip instead.

If I was investing in a pure market-cap weighted index like VEU, then when emerging markets go down, I would have less exposure to them than before. However, as a value investor, I want to increase my weighting towards assets that recently underformed, because that's what tends to offer better returns going forward.

That's value investing at its finest, and is why I invest with M1 Finance as one of my accounts.

It doesn't hurt that, right now, emerging markets are cheaper than stocks in the United States or the developed world.

International Stock ETFs for 2021

Choosing the right international stock ETF is a combination of the following:

- Which countries you want exposure to, and in what proportions
- What market-caps you want to include (large, medium, small)
- Any additional metrics you want (growth, dividends, etc)
- Expense ratio: the lower the better, all else being equal

Most large international index funds and ETFs are based on one of two sets of indices:

- The Morgan Stanley Capital International (MSCI) indices
- The Financial Times Stock Exchange (FTSE) indices

Both of them allow a fund to passively track a market at a low cost. But although the MSCI and FTSE indices are similar, they're not exactly the same. For example, one of the biggest differences between the two right now is that MSCI considers South Korea to be an emerging market, while FTSE has considered it to be a developed market since 2009.

BlackRock, the largest asset manager in the world, which owns the massive iShares brand of ETFs, tends to use MSCI for its international index funds. Vanguard, on the other hand, tends to use FTSE indices for its funds.

Below, I'll highlight some of the funds that I believe offer the best international exposure at the lowest rates.

Best Broad International Stock ETFs

ETF Name	Expense	Top Countries
Vanguard Total Intl Stock (VXUS)	0.11%	Japan, UK, Canada
iShares Core MSCI Total Intl Stock (IXUS)	0.11%	Japan, UK, China
Schwab Intl Equity (SCHF)	0.06%	Japan, UK, France

The Vanguard VXUS ETF follows the FTSE Global All Cap ex US Index, which includes developed and emerging markets.

The iShares one follows the MSCI ACWI ex US Investable Market Index, which also includes developed and emerging markets.

The Schwab one follows the FTSE Developed ex US Index, and doesn't have emerging markets, so to be balanced you might want to get emerging market exposure from another fund. The cool thing about this ETF is that in addition to beating Vanguard on price (!), you get commission-free trading of it inside a Schwab account. This is one reason why I list Charles Schwab as one of my recommended brokerages on my resources page.

Best Emerging Market ETFs

ETF Name	Expense	Top Countries
Vanguard FTSE Emerging Markets (VWO)	0.14%	China, Taiwan, India
iShares Core MSCI Emerging Markets (IEMG)	0.15%	China, S. Korea, Taiwan
Schwab Emerging Markets Equity (SCHE)	0.13%	China, Taiwan, India

My only complaint with many emerging markets ETFs is that nearly a third of the value is typically invested in China, and another huge chunk is split into Taiwan, India, and in some cases South Korea.

You can buy single-country ETFs from iShares alongside your emerging market ETF, like their Brazil ETF or their Russia ETF, if you want to broaden your emerging market exposure into countries that don't have a big weighting in the index.

Best International Dividend ETFs

ETF Name	Expense	Top Countries
Vanguard Intl Dividend Appreciation (VIGI)	0.25%	Switzerland, Canada, Japan
Vanguard Intl High Dividend Yield (VYMI)	0.32%	UK, Switzerland, Australia
iShares Intl Select Dividend (IDV)	0.50%	UK, Australia, France

The Vanguard International Dividend Appreciation ETF focuses on companies with fast dividend growth, and the yield is rather low at under 2%.

The Vanguard International High Dividend Yield ETF has different geographic exposure, and has an average yield of about 3%.

The iShares International Select Dividend ETF follows the Dow Jones EPAC Select Dividend Index (not a FTSE or MSCI index for a change). It has a 4%+ yield, and gives a portfolio exposure to the UK and Australia.

The Benefits of Single-Country ETFs

Another way to spread out your international exposure is to strategically invest in a small number of single-country ETFs along with your core broad international ETFs.

For example, let's say I want to have emerging markets exposure, but am not thrilled about the fact that China represents a full third of most emerging markets index funds, like the iShares Core MSCI Emerging Markets Index. To solve this, I would invest in that index, but then also pick a small number of single-country ETFs, like maybe a Brazil ETF, a Thailand ETF, and a Russia ETF.

That way, I spread my emerging market exposure out more evenly.

iShares has the largest selection of single-country ETFs, and are great picks. The meaningful downside is that they have relatively high expense ratios, sometimes over 0.60%, and so it's important to use them wisely.

Frankin Templeton "LibertyShares" also offers a large range of single-country ETFs. While they don't have quite as large a selection as iShares, and their funds don't have as much liquidity, their expense ratios are way lower, typically 0.19% or below.

My Favorite Way to Invest Globally

In addition to owning international stocks through some of the above-mentioned index funds and ETFs, one of my main vehicles for global investing for eight years now is by owning Brookfield Asset Management and Brookfield Infrastructure Partners.

Brookfield Asset Management (ticker: BAM)

Brookfield Asset Management started in 1899 as a Canadian company that began developing electrical infrastructure in Brazil (or Brasil as it's spelled in Portuguese). It was originally called "Brascan" as the combination of Brasil and Canada.

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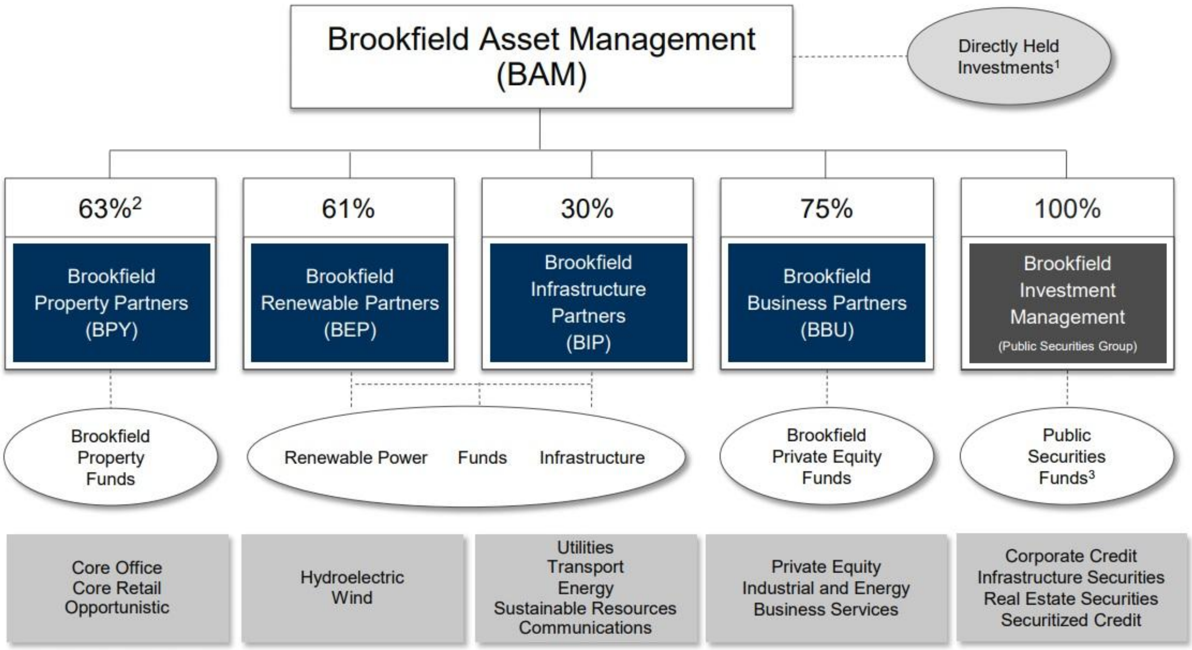
Now, almost 120 years later, they've expanded into a global manager of real estate and infrastructure, and operate closed-end and private equity funds to allow institutional investors to invest alongside them. They have also spun off four publicly-traded partnerships that individual investors can purchase units of.



Source: Brookfield Asset Management Corporate Profile

Click the image for a larger view.

Most of their assets consist of real estate, infrastructure, and renewable energy. The management team uses a contrarian investing strategy, meaning they buy attractive assets at a significant bargain from troubled businesses and turn them around.

When the global financial crisis struck in 2008 and over-leveraged companies started failing, BAM swooped in and purchased assets from those struggling companies, including a lot of assets in Europe, and refinanced those assets with less debt and lower interest rates due to their own investment-grade structure, and those assets became incredibly profitable as the global economy recovered.

During the 2014-2017 severe Brazil recession, Brookfield once again swooped in and made big investments in Brazil, including buying assets from struggling companies.

By fixing the financing, restructuring the companies they buy, and often replacing management of those companies and bringing in experts from their own team, Brookfield plays an important role in keeping critical assets up and running worldwide.

Occasionally, they sell assets to other companies once they are running at optimal performance, so that they can recycle that capital into buying troubled assets at a value once again, for superior returns. For example, after owning Chilean electricity transmission assets for many years, the company sold these fully-valued assets this past year after having achieved an incredible rate of return during their holding period.

The management team consists of a bunch of chartered accountants, and they use discounted cash flow analysis for valuation of various assets.

The company has achieved 16% annual returns over the last 20 years due to this smart investment strategy and disciplined focus on fundamentals.

Although they are a company with less than $50 billion in market capitalization, they currently have over $350 billion in assets under management.

They make money in two main ways:

- Direct investments in global real estate and infrastructure
- Investment fees for managing funds for other investors to buy in

By operating highly profitable closed-end funds, private equity, and publicly traded partnerships, and investing their own capital and their investors' capital into them, they expand their scale and operate profitable assets around the world.

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Brookfield Infrastructure Partners (ticker: BIP)

My preferred investing vehicle in the Brookfield umbrella of investments is Brookfield Infrastructure Partners.

The partnership was spun off from BAM in 2008 with them continuing to have the controlling stake, and I took a large position back in 2010 when the global economy was still struggling with the aftermath of the financial crisis, which was my first Brookfield investment. Back then, it was trading at an $11 split-adjusted unit price, and was paying a nearly 7% distribution yield.

They bought assets from struggling companies, and at this point, they owned timberland, ports, and a variety of utility assets. The timberland and ports in particular weren't doing so well due to the lack of global need for wood (for new housing) and the reduced global trade levels in the aftermath of the recession. But that's exactly why it was a great investment- the company itself was very well-capitalized, and they bought assets at a major discount so that they would profit during a recovery.

I continued to hold for years as the units tripled in price and paid high distributions. It became such a big part of my portfolio that I decided to sell my stake, and used part of the money to buy BAM and invested into a couple other companies. Then, in 2017, while still holding BAM, I invested in BIP once again for the long-haul as well because I want that direct infrastructure exposure once more.

A 2017 report by the worldwide management consulting firm McKinsey & Company found that the world needs $69 trillion in infrastructure spending through 2035. It has been a chronic area of under-investment:

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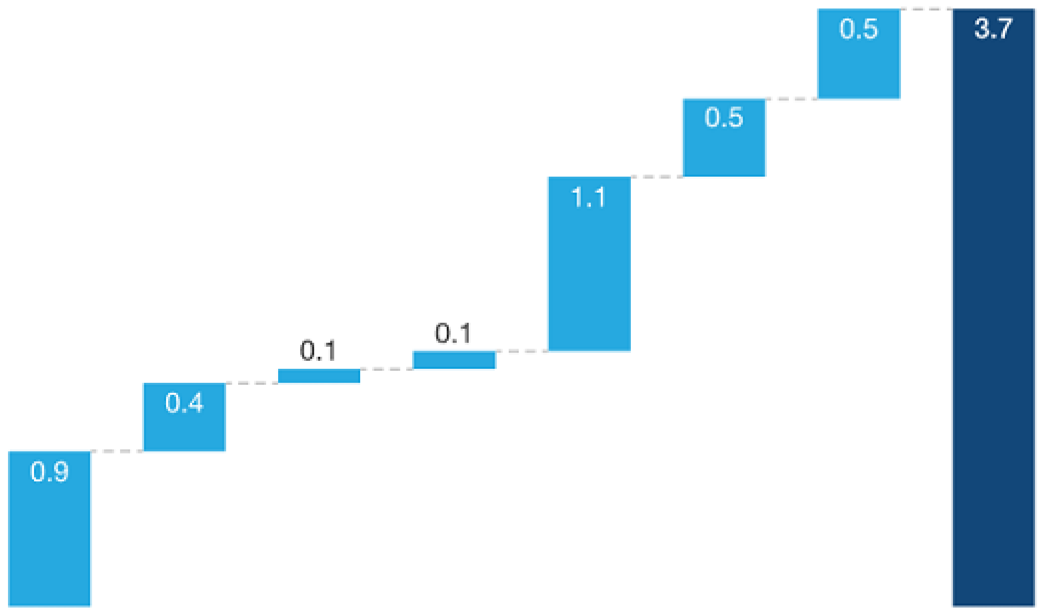
The world needs to invest $3.7 trillion in economic infrastructure annually through 2035 to keep pace with projected growth.

Average annual need, 2017–35, $ trillion, constant 2017 dollars



	Roads	Rail	Ports	Airports	Power	Water	Telecom	Total
Annual spending, % of GDP	1.0	0.4	0.1	0.1	1.3	0.5	0.6	4.1
Aggregate spending, 2017–35, $ trillion	18.0	7.9	1.6	2.1	20.2	9.1	10.4	69.4

Note: Figures may not sum, because of rounding.

Source: GWI; IHS Global Insight; ITF; national statistics; McKinsey Global Institute analysis

McKinsey&Company

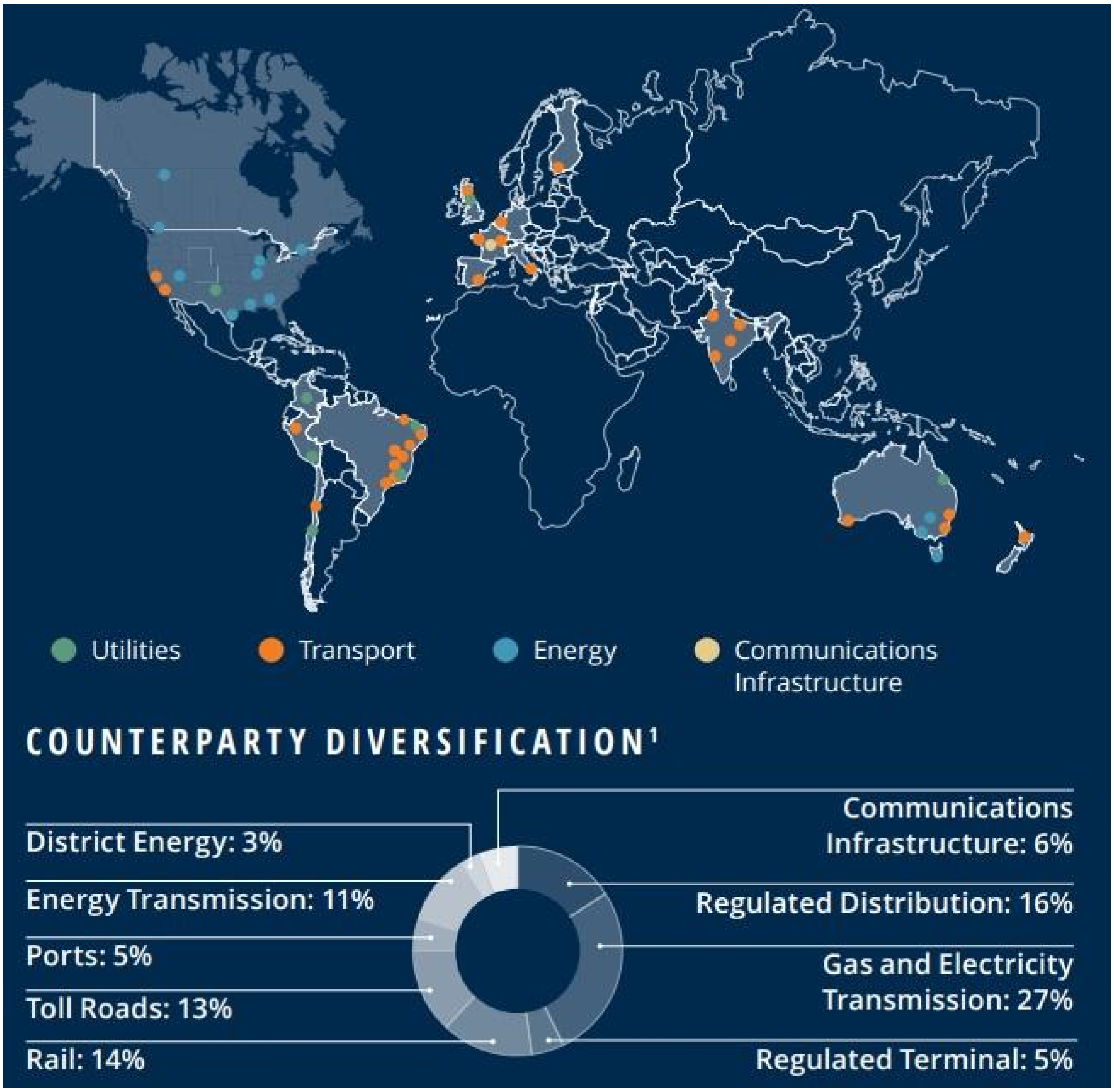
Source: McKinsey Global Institute

As per the report:

> *Investment will continue to shift to emerging markets; nearly two-thirds of global infrastructure investment*

in the period to 2035 is required in emerging economies

Here is BIP's map of operations:



Source: *[Brookfield Infrastructure Partners Fact Sheet]*

They own:

- Natural gas pipelines, electricity transmission, and toll roads in South America
- Freight rail, shipping ports, and logistics assets in Australia
- Telecommunications towers in Europe and India
- And various other utilities throughout Europe and North America

The reason I like investing in Brookfield is that it's like buying curated emerging market exposure. They combine the well-capitalized and stable organization of a business headquartered in Toronto and New York with infrastructure assets in both developed and emerging economies that they routinely buy at a discount.

Most of their cash flows are contracted for the long-term, and they build inflation-hedges into most of their contracts. These assets are long-lived cashflow-producing machines, and they pay out 50-70% of their cash to unitholders in the form of distributions while investing the remaining amount into growth.

And not much economic/volume growth is needed to produce great returns:

Source: Brookfield Infastructure Partners Investor Factsheet

The partnership currently offers a 4% distribution yield, and expects to grow that distribution at 5-9% per year going forward, which translates into 9-13% annualized returns.

In the past, they've beaten their estimates.

Normally it's not a good idea to to put publicly traded partnerships in a Roth IRA, but Brookfield's partnerships are an exception.

Unlike most Master Limited Partnerships, they are not particularly tax-efficient, their taxes are confusing due to their global nature, and they most likely will not generate UBTI unless they use their revolving credit facility, which they don't plan on doing. That makes them fairly safe for a Roth, and even preferred for one.

You can read my full analysis of Brookfield Infrastructure Partners here.

Final Thoughts

International stocks have broadly under-performed U.S. equities over the last decade. Emerging markets in particular are cheap.

At the current time, with U.S. stocks highly valued, there are some great opportunities globally.

But investors might want to take a look at their international exposure and see if they are more concentrated into just a few countries than they thought they were. Broad international index funds and ETFs tend to be highly concentrated into the slowest-growing economies with the largest existing market caps, which historically cripples returns.

- First, consider splitting your international exposure into a normal index fund and a dividend-focused index fund, because that combination will spread your geographic exposure out more evenly.
- Second, consider splitting your developed international exposure from your emerging market exposure. Emerging markets represent the bulk of forward growth but only a small fraction of current market capitalization, and are therefore under-weighted in most global index funds.
- Third, be aware that the cheapest markets tend to outperform over time. Right now, that's Russia, Poland, South Korea, China, Singapore, and Turkey, Italy, and Israel.

- Fourth, realize that you can use single-country ETFs to broaden your international exposure, or concentrate more heavily into countries you're bullish on.
- Fifth, consider Brookfield Asset Management (BAM) and Brookfield Infrastructure Partners (BIP) as well-managed ways to get curated global and emerging market exposure.

I like to own a few different low-cost global index funds to balance out my international exposure, and invest in Brookfield for curated value-oriented emerging market infrastructure exposure as well.

Currently, emerging markets are cheaper than other stock markets around the world based the price to earnings ratio, the price to book ratio, and a variety of other metrics, even though on average they also have higher GDP growth than the developed world. They've dramatically underpeformed U.S. equities over the last decade.

If we look back further, to the 2000-2010 decade, we can see that emerging markets greatly outperformed.

While it's not impossible, I would be greatly surprised if emerging markets do not give investors good returns over the next decade compared to last decade. It's better to buy emerging markets when they are historically undervalued than to buy U.S. stocks when they are historically overvalued.