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International Investments Key to Fixed Income Diversification

Investing internationally wasn’t easy when John Kvale of J.K. Financial Inc. began to incorporate such instruments into client portfolios “at least 15 years ago.”

“There weren’t a lot of choices, and you really had to work [at it],” he said, except for “a few old stalwarts in the industry–Mobius, Templeton.”

But it was worth it, Kvale said, perhaps even more then than now, when markets were far less linked and what affected one didn’t necessarily affect all.

“Diversification internationally probably helped more 15 years ago than today, because markets are more correlated,” he said.

Still, Kvale said, “We feel strongly that international investments are the core of every client portfolio. We constantly preach diversification and international investments are at the core of diversification.”

New clients, however, usually have to be convinced of the wisdom of moving beyond the borders of the U.S., particularly when it comes to fixed income instruments. Kvale said new clients often do not have any international diversification in their fixed income investments, although most do in their equities. However, he said, “Our mantra is, fixed income needs to be diversified just as equities are.”

Long term, he said he looks to emerging markets, although he knows they’re somewhat out of favor.

“From our standpoint, emerging markets are maybe like the U.S. was 70, 80 years ago,” he said. “The volatility can be great and allocation needs to be made accordingly.”

The normal level of allocation he uses at his firm is “maybe 30% of equities in international, and of that maybe 5, 10% in emerging markets. We understand that those emerging markets are like small caps. Developed international [markets are] like large companies here, and tend to react like that. Emerging markets are like small companies here, but can be even more volatile.”

He professes to being a realist about international diversification, understanding such a strategy won’t fix everything in a portfolio, and said he works to make his clients understand that, too.

“We adhere pretty strictly to asset allocation and diversification,” he said. “That comes with positives and negatives. When you have a year like last year, where domestic markets just went crazy through price-to-earnings expansion and international mostly all trailed heavily, in the spirit of diversification you’re not going to get the total return of a portfolio that a client may see in the Dow or S&P, particularly in small cap.

“The way we get ahead of that is to try to make sure we constantly remind everyone that diversification is a double-edged sword. It can hurt you in a time when that [PE expansion] happens.”

The flip side of that, he said, is that when things are going better and performance is enhanced, clients are pleased because they think that getting that enhanced performance is what advisors are supposed to be doing, rather than making sure the portfolio is always protected through diversification.

However, he said, “everybody needs to realize that [international diversification] is not a magic bullet. If we have a crisis like 2007, 2008, 2009, the correlation [affects] everyone, and everything’s going to drop. How do you combat that? Just because you have international diversification, equity is still equity and will act like equity. [It’s all] highly correlated. Make sure your total allocation between fixed income and equity is appropriate.”

Everybody has a home bias, he said, to the extent that “most people can’t even tell you what the German DAX is.”

That bias can be harder to conquer when it comes to fixed income, but Kvale said it's no less important on that side of a portfolio and he said makes sure his clients know that, explaining to them that the bonds of developed countries exhibit behaviors similar to large-company bonds in the U.S. while bonds of smaller, emerging-market countries are more like those of small companies.

He relies on ETFs and index mutual funds for international diversification, and does not use ADRs, international REITs or other vehicles. Because of the potential for changes in interest rates, and because of the large inflow of money into fixed income markets over the past five years, he said that he's more comfortable with ETFs in highly liquid areas and relatively large portfolios, for both equity and fixed income.

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