Seven Things Expats Need to Know About Investing

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Investing is a full-time profession for many people. Countless books have been written on the hows and whys of making smart investment decisions. If you are an expatriate, you must also consider the role that different currencies and tax jurisdictions play in your portfolio. These issues are complex, and our goal today is to simply introduce you to some of the concepts behind successful investing, as well as to provide you with additional resources and book recommendations to help you design an investment strategy that will work for you.

1. The Difference Between Speculating and Investing

In popular media, speculating is often confused with investing, but there is an important difference between the two. Speculating involves betting on the direction of short-term price movements, while investing is purchasing assets that generate an economic return over time. Betting on the short run (also called market timing) is generally a losing proposition—you may occasionally get lucky, but luck is not an investment strategy, and you'll probably lose over the long run. This is because short-term returns driven by market greed and fear are inherently unpredictable. On the other hand, long-term investment returns are ultimately driven by the cash flows generated by the underlying businesses. Having a calculated, well-thought-out, long-term investment strategy is much more likely to work for you than trying to time the market and hoping to get lucky.

2. Risk, Return, and the Relationship Between Them

Return is generally defined as how much you've made on an investment, and it is measured in percentage terms versus the original cost of the investment. At a basic level, we often think of risk as the possibility that a given investment will lose money. In the investment world, risk is often defined as deviation from the return that was expected. Risk is often measured in terms of annual volatility or standard deviation from the mean, but both risk and return can be measured in either the short or long term.

The important points to remember when it comes to investing are:

1. It is really the long-term return and risk taken that should concern you.
2. There is a link between the amount of risk taken and the expected return of an investment.

Generally, you have to take on more risk (in this case, greater annual volatility in the price of your investments) in order to get a chance (not a guarantee) of a higher long-term return.

3. Diversification—Not Putting All Your Eggs in One Basket

Diversifying means spreading investment risk among many investments. Holding a couple of concentrated positions in individual stocks, even market favorites like Google or Apple, rarely makes sense. The risk of something going wrong when you own just a couple of stocks is simply higher than can be justified by those stocks' potential return.

A better strategy is to purchase the entire asset class (in this case, U.S. large-cap growth stocks). While some of the companies in an asset class may experience real difficulty, overall a broadly defined asset class will not. Instead, the value of the asset class can be expected to appreciate over the long run, corresponding with the aggregate growth of the underlying companies in that particular asset class.

In today's world, buying an asset class is easy to do—you can purchase an index mutual fund or exchange-traded fund (ETF) that tracks the entire asset class. That way, you get the overall growth of the asset class combined with diversification benefits, but at a far lower cost than you could do on your own.

4. Asset Allocation—The Driver of Long-Run Returns

Allocating your savings between a defined mix of different asset classes is called "asset allocation," and numerous studies have shown that it is asset allocation (as opposed to market timing) that is the major driver behind the long-run return of a portfolio. The greater proportion of volatile asset classes (equities and alternatives) that you include in your portfolio, the greater your chance at a higher return over the long run. But to have a shot at the greater long-run returns, you'll have to put up with volatility. Remember that while diversification will reduce your risk of loss, it doesn't guarantee that your portfolio won't experience a down year.

5. Investment Returns—What to Expect

The following table is intended to give you some realistic expectations of what kind of long-term returns investment portfolios at different levels of risk (in this case, short-term volatility) might generate, as well as what types of short-term or single-year losses you might have to put up with on the way to achieving those returns. As this table shows, if you were to look back after 40 years of investing, the path to the end result would have been volatile. This is shown in the columns "Worst 1-Year Return" and "Range of Annual Returns Expected (2/3 of the Time)." However, if you look at the value of your investments at the end of the period and compare the average percent returns achieved, you would find that you'd done well as compared with keeping your savings on fixed deposit.

Investment Portfolio Returns (1972–2015, in U.S. Dollars)

Broad Asset Allocation		Value of $10,000 After 40 Years	Worst 1-Year Return	Avg. Annual Return		Range of Annual Returns Expected (2/3 of the Time)
Equity: Fixed Income	Short-Term Volatility			Total	Real	
Cash	Very Low	$71,646	0.0% (2013)	4.9%	0.9%	1.4%–8.4%
35% : 65%	Low	$238,213	-6.9% (2008)	8.0%	4.0%	1.0%–15.1%
45% : 55%	Moderate	$273,023	-12.1% (2008)	8.4%	4.4%	0.0%–16.8%
55% : 45%	Moderate	$310,428	-17.2% (2008)	8.7%	4.7%	-1.1%–18.6%
65% : 35%	High	$359,508	-22.0% (2008)	9.1%	5.1%	-2.4%–20.6%

Source: Ibbotson & Associates, MGP

Notes: Both equity and fixed income are globally diversified among several sub-asset classes. Returns are pretax, exclude fund fees, and assume annual rebalancing. Real return excludes average inflation of 4.05% per year during the period. Expected Range of Returns corresponds to one standard deviation from the Total Return, or the range that occurred within two out of every three years.

6. Passive vs. Active Funds—Why Minimizing Fund Fees Matters

To get exposure to a certain asset class, you can choose a passively managed fund, such as an index mutual fund or an ETF. Alternatively, you can choose a mutual fund with an active fund manager. In most cases, buying passively managed funds is preferable. This is because, in general, most active managers don’t outperform their passively managed fund peers in a single year, let alone consistently over the many years you’ll plan to invest. While there are exceptions, it generally just doesn’t make sense to purchase an actively managed fund, which may have a front or back load fee and running costs of 1.75–3% or higher each year. All this can equate to giving up a substantial portion (more than half) of the real rate of return that you might otherwise have expected to receive over time.

7. The Importance of Rebalancing

When the markets get rough, you may be tempted to bail on your investment portfolio and move to cash or fixed deposit. Conversely, when markets are booming, you may also feel enticed to put all of your holdings into the hot asset classes. In fact, that’s exactly what market greed and fear will be telling you to do.

As tough as it may be, when your portfolio’s asset allocation percentage holdings have moved substantially away from your targets (or perhaps once a year), you’ll want to rebalance your portfolio back to the original weightings. This may require you to sell what has outperformed and purchase what has underperformed, or it may be done by adding new cash savings. Rebalancing may sound easy, but it can be difficult in practice since it goes against what most market players will be doing. However, over the long run, rebalancing ensures that you buy low and sell high, one of the basic principles to successful investing.

Additional Resources

Hopefully, this post has taught you useful concepts to help you succeed in investing. As we mentioned in the introduction, there's a lot more to this topic, and we encourage anyone interested in the subject to consider reading the following excellent books:

- *The Investor's Manifesto: Preparing for Prosperity, Armageddon, and Everything in Between*
  by William J. Bernstein
- *A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing (10th edition)*
  by Burton Malkiel
- *Investing in an Uncertain Economy For Dummies®*
  by Sheryl Garrett (with three chapters contributed by Creveling & Creveling)

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