MARKET INSIGHTS

A world of opportunity:

Allocating to international equities

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Foreword

The traditional advice given to many long-term investors is to have roughly 20% of their stock exposure allocated to international stocks. This counsel has been offered despite the fact that the U.S. represents less than half of the world's stock market capitalization and that the global economy has outpaced the U.S. in growth every year over the past decade.

The principle rationale for this low allocation to international has been the risk reduction advantages of having assets denominated in U.S. dollars for investors whose liabilities are also denominated in dollars. But are investors paying too much in the form of forgone return and diversification for this one advantage?

In addition, if international stocks should be a bigger slice of the average investor's portfolio, how should this allocation be divided across regions and investment styles to take best advantage of a rebounding global economy, while respecting the risk tolerance of investors?

In this paper, we examine the case for a greater allocation to international investments based on relative economic growth, relative exchange rates, relative valuation and the current positioning of U.S. investors. Later, we introduce a methodology for identifying an optimal weight to international equities and propose three different model portfolios built around developed markets equities, emerging markets equities and international REITs. Finally, in an appendix, we examine the major objections made by investors to increasing international investing and how valid these may or may not be.

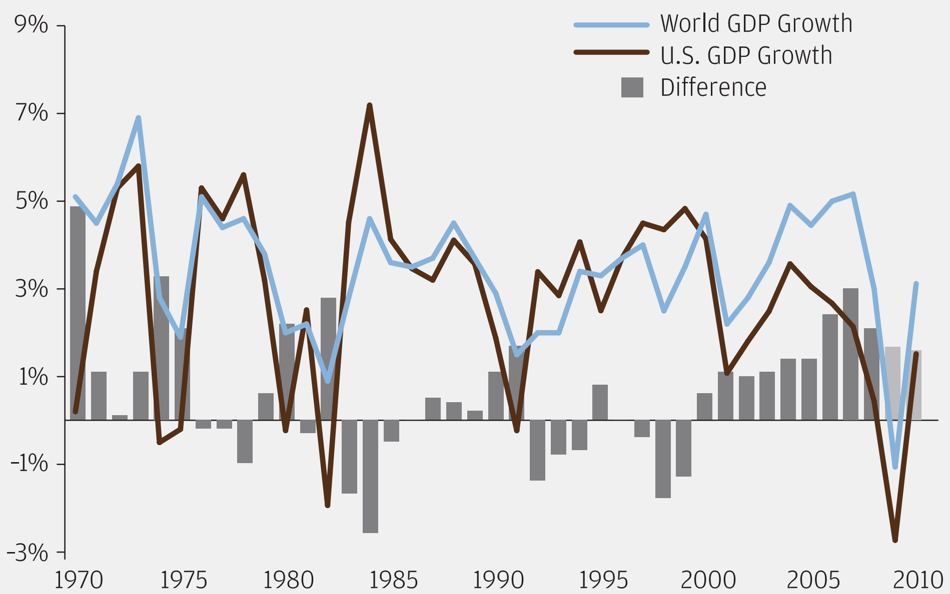
A world of opportunity:
Allocating to international equities

The case for a higher allocation to international equities

In recent years, judging by flows into international equity mutual funds, U.S. investors have clearly heard the message that they need more global exposure in their portfolios. One would like to think that this was due to a growing understanding of the opportunities available in international investing. More likely it's because, for seven out of the last eight years, both the MSCI EAFE index and the MSCI Emerging Markets index have beaten the S&P 500 in total return. Whatever the reason, U.S. investors have raised their weightings to non-U.S. stocks over the last decade. But should investors consider increasing international allocations further?

We believe, in many cases, the answer is yes for four main reasons:

CHART 1: World GDP Growth vs. U.S. GDP Growth 1970–2010
IMF sees the world continuing to outpace the U.S. in growth in 2010



Source: J.P. Morgan Asset Management, IMF. Data as of October 1, 2009 as provided by the International Monetary Fund. 2009 and 2010 data are estimates as provided by the IMF.

1. The rest of the world is likely to grow faster than the United States.
2. The U.S. dollar could fall over the next few years.
3. International stocks remain relatively cheap compared to U.S. stocks.
4. Many investors still have relatively low international allocations.

Falling behind the world in growth

For most of the past 40 years, the U.S. and international economies grew at about the same pace. The rest of the world saw faster growth at the start of the 1970s, 1980s and 1990s, and the U.S. generally outpaced the rest of the globe in the second half of each decade. But overall it was close to a tie – from 1970 to 1999, according to the IMF, the U.S. saw average real GDP growth of 3.2%, while the world economy grew by 3.5%[1].

However, starting in 2000, the rest of the world moved into the lead and, in 2009, appears to have beaten the U.S. in GDP growth for the 10th consecutive year. Indeed, over the past decade, the rest of the world has outpaced the U.S. in growth by a margin of more than two to one.

This higher rate of growth partly reflects a very tough decade for the United States. The collapse of the tech bubble, the contested election of 2000, the trauma of 9/11, the disruption of the Iraq

[1]Assuming "purchasing power parity" exchange rates.

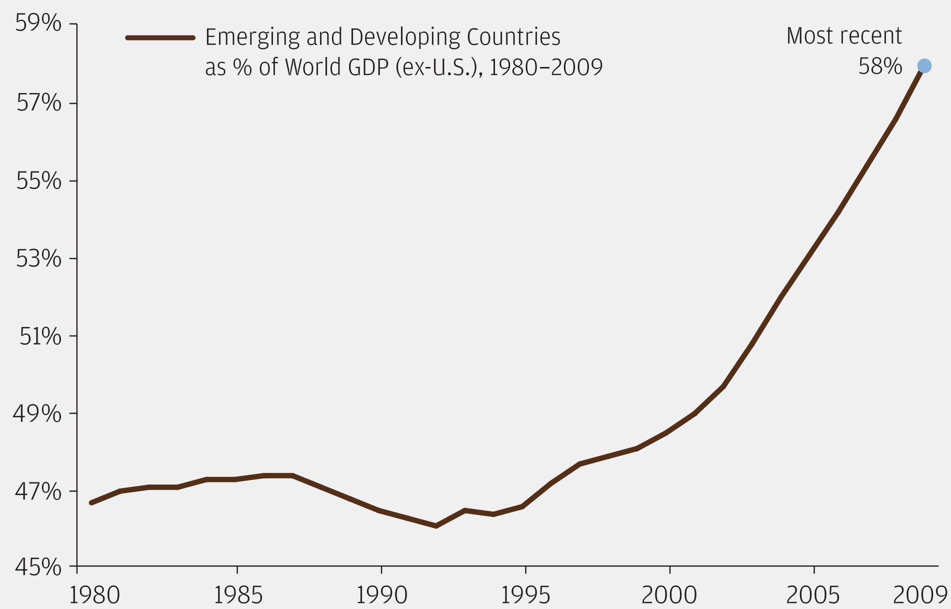
war, the destruction of Hurricane Katrina, a housing bubble, an oil bubble and the financial crisis of 2008–2009, for the most part, impacted the U.S. more than the rest of the world.

However, even in the absence of these shocks, the U.S. would have found it hard to keep pace. The most important trend in the global economy in recent decades is a confluence of political and technological forces that have ramped up economic growth in many developing economies to what appears to be a significantly higher path than their developed counterparts.

As recently as 25 years ago, the phrase "developing economy" was an uncomfortable euphemism, masking a more depressing struggle against poverty and starvation. Developing countries were seen as economic and political wastelands. Since then, however, the steady march of China toward free-market capitalism, the collapse of the Soviet empire and the emergence of more stable democracies in Latin America have broadened and strengthened the ranks of the developing economies. Growing international capital flows and a revolution in information technology hastened the movement of manufacturing jobs from the developed world to the developing world. Large numbers of service sector jobs have also fled to lower wage destinations.

From the 1980s to 2000, emerging and developing countries accounted for less than 50% of GDP outside of the U.S. They now represent almost 60%. These countries will likely continue to see significant productivity gains as agrarian societies, with near-zero output per worker, transition their labor forces to modern industries. While productivity growth will eventually slow in these nations as worker efficiency approaches levels in the developed world, it should still remain faster than in the U.S. for years and maybe decades to come. Given that these nations now represent a majority of output produced by the global economy outside of the U.S., it may be decades before the U.S. can again hope to match the world in economic growth in any consistent way.

CHART 2:
Emerging and Developing Economies Growing Share of Output



Source: IMF World Economic Outlook Database, J.P. Morgan Asset Management. October 2009.
Note: "Emerging and Developing" countries include all countries except for the following 33 countries defined as "Advanced" by the IMF: AU, AT, BE, CA, CY, CZ, DK, FI, FR, DE, GR, HK, IS, IE, IL, IT, JP, KR, LU, MT, NL, NZ, NO, PT, SG, SK, SI, ES, SE, CH, TW, UK, US. Calculated using purchasing power parity exchange rates.

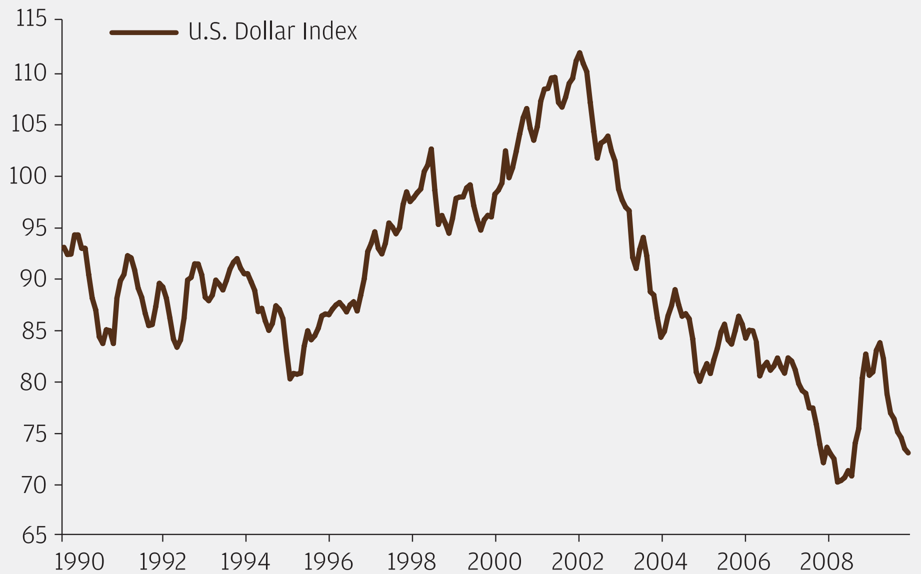
The potential for a continued dollar decline

International stocks could also continue to benefit from a falling dollar. It is one of the simplest relationships in finance: All other things being equal, if the dollar falls 10% overnight, your international stocks will be worth 10% more in the morning.

This has been a very powerful force in the last decade. Indeed, from the end of 2001 to mid-December 2009, measured in U.S. dollars, the total return MSCI EAFE index beat the S&P 500 by a cumulative 59%. Over 89% of the total outperformance was due to the falling dollar.

So where does the dollar go from here? Over the past two years, investors worldwide have treated the dollar as something of a safe-haven currency, getting into the dollar in times of increased financial stress and getting out as financial stresses ebbed. As the world's financial system gradually returns to normal, the dollar may resume its downward drift (although moreso relative to emerging and developing economy currencies than the Euro or the Yen). Moreover, the long-term trend for the dollar may still be one of weakness against most currencies for a number of reasons.

CHART 3: U.S. Dollar—Decline Interrupted
Nominal trade weighted exchange index: major currencies



Source: EcoWin, Federal Reserve, J.P. Morgan Asset Management. Data are as of 11/30/09.

First, as noted earlier, the rest of the world continues to outpace the U.S. in economic growth. International capital flows are attracted to fast-growing areas, boosting the demand for their currencies and reducing the demand for the currencies of slower-growing economies.

Second, the U.S. is still running a huge current account trade deficit as shown in Chart 4. It is certainly smaller today than at the end of 2005, when it amounted to 6.5% of GDP. Since then, the lagged impact of a falling dollar and faster overseas growth have cut it to just 3.0% of GDP. However, this still amounts to over $430 billion annualized, and with U.S. imports now rising rapidly, further improvement in the trade deficit may take some time. U.S. importers have to buy foreign goods with U.S. dollars and our persistent trade deficit creates an excess supply of dollars that puts downward pressure on our currency.

Third, the Federal Reserve continues to maintain a very easy monetary policy. This is facilitating a "dollar carry trade," whereby investors can borrow money at virtually zero percent interest rates in the United States and use it to buy foreign assets denominated in foreign currencies. As long as the dollar drifts down, investors can profit on both the returns on the foreign assets and on the movement in the exchange rate. In addition, the very actions of the trade itself, borrowing dollars and then selling them to buy foreign currency, tend to put downward pressure on the dollar.

However, we don't believe the dollar will plunge dramatically from its level of late 2009. Many other developed countries have been through the same financial crisis and the same recession, and are emerging with the same degree of government indebtedness as the United States. In addition, while some developing economies such as China and India did much better, none of them wants to see their currency soar against the dollar, thus risking pricing their exports out of crucial American consumer markets. Having said this, however, on balance we believe the dollar will fall over the next few years, amplifying the return on international stocks.

Good value in overseas stocks

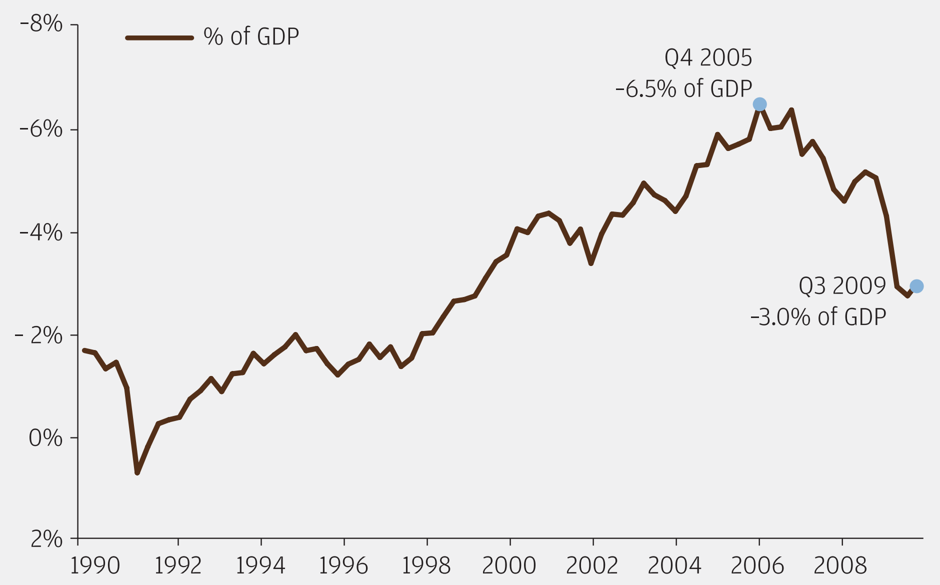
Finally, it appears that international stocks remain a relatively good value. Chart 5 shows composite valuation indices for MSCI U.S. and MSCI EAFE, respectively. These indices are geometrically weighted averages of four key valuation measures: price to forward earnings, price to book, price to cash flow and dividend yield.

By these measures, even after a strong rally in 2009, the MSCI EAFE index remains 24% cheaper than it has been on average since 1988. Moreover, it also remains cheap relative to U.S. stocks. For investors looking to build long-term, strategic exposure to international equities, current price levels still appear to be an attractive entry point.

If anything, these valuation measures probably understate the attractiveness of both U.S. and international stocks. Earnings, cash flow, book value and dividends should all rise rapidly with the recovery of the global economy. Moreover, for U.S. investors, prevailing low interest rates and low tax rates on dividends and capital gains enhance the attractiveness of both domestic and international stocks.

CHART 4: Current Account Deficit

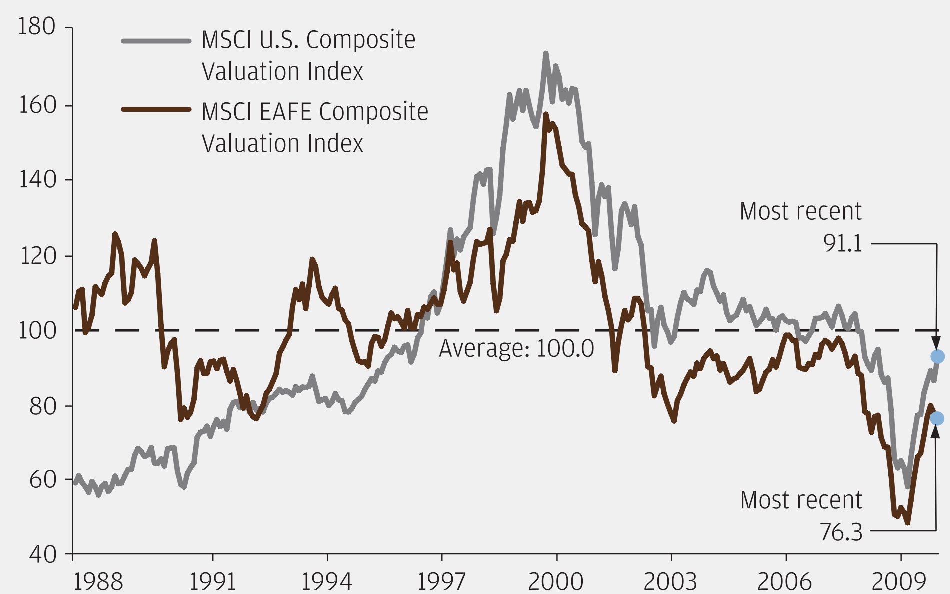
Current Account Balance, % of GDP



Source: J.P. Morgan Asset Management, BEA. Data are as of 9/30/09 and are reported quarterly.

CHART 5: U.S. and EAFE Valuations

Composite Valuation Index



Source: Thomson Datastream, J.P. Morgan Asset Management Global Multi Asset Group. Data up to November 2009. The composite valuation indices are geometrically weighted indices of four metrics (forward price to earnings, price to book, price to cash flow and dividend yield) for MSCI U.S. and MSCI EAFE, rebased to their 1988–2008 averages.

A continued expansion could boost both inflation and interest rates somewhat but should still leave them below their average levels of recent decades. In addition, the Obama administration's proposed 20% tax on dividends and capital gains for households earning over $250,000 per year would still result in a more stock-friendly tax environment than existed prior to 2003. The reality is that, in absolute terms, both U.S. and international stocks appear cheap and, in relative terms, international stocks look cheaper.

International stock allocations—still underweight

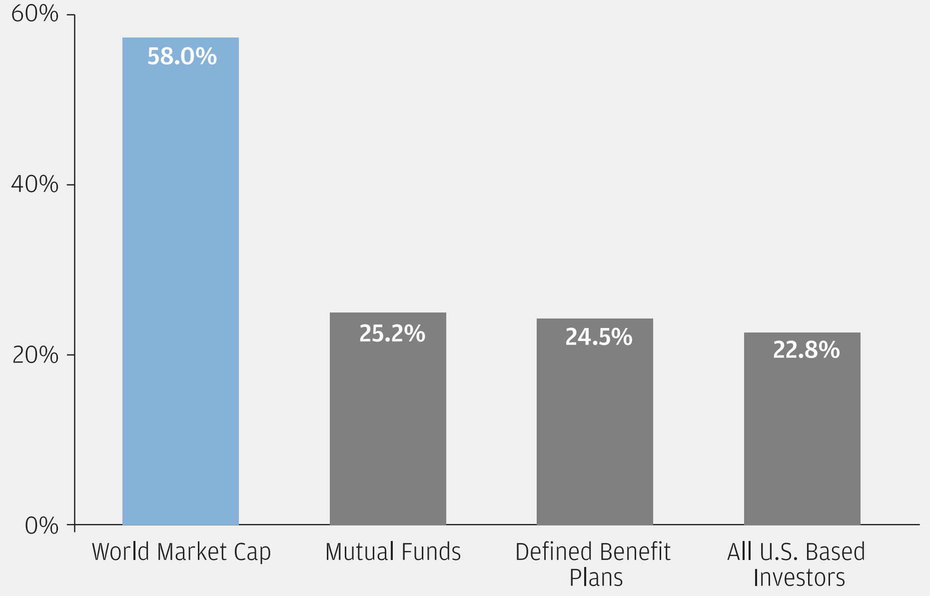
Over the last two decades, both institutional and individual investors have increased their exposure to foreign equities. In 1995, the median allocation to non-U.S. stocks for U.S. pension plans was zero. By the end of the third quarter 2009, it had grown to 25%[2]. The average allocation for all U.S. investors at the end of the third quarter of 2009 was just under 23%[3], suggesting that the international allocation for individual investors remains close to 20% of total equity exposure.

By contrast, the Capital Asset Pricing Model (CAPM), developed in the 1960s by William Sharp and John Lintner[4], suggests that a normal portfolio for an individual investor would include international stocks in proportion to their share of total world stock market capitalization. At the end of the third quarter of 2009, this would have meant a 58% allocation to international stocks.

However, few analysts would suggest that 58% is the right number for the average investor. First, CAPM, in general, has not proven to be a very good model of actual market behavior, with many anomalies being noted in the data over the years.

Moreover, even if CAPM was a good description of U.S. equity markets, domestic investors putting money into international markets must consider the extra volatility in international stocks due to their denomination in foreign currencies. Another consideration is the extra information costs entailed in investing overseas. Because of these factors, we believe it makes sense to hold a lower allocation to international equities than implied by a strict interpretation of CAPM. But how much lower?

CHART 6: U.S. Investor Allocations to International Equity
% of Total Equity Allocation by Type of Investor



Source: MSCI All Country World Index (world market cap) as of 11/30/09, Investment Company Institute (mutual funds) as of 8/31/09, Federal Reserve (all U.S. based investors) as of 12/10/09, Wilshire Associates (defined benefit plans) as of 9/30/09. J.P. Morgan Asset Management.

[2]Wilshire Associates TUCS database. [3]Flow of Funds Statistics, table L213, Federal Reserve Board. [4]Sharpe, William F. (1964). Capital asset prices: A theory of market equilibrium under conditions of risk, *Journal of Finance*, 19 (3) 425–442 and Lintner, John (1965). The valuation of risk assets and the selection of risky investments in stock portfolios and capital budgets, *Review of Economics and Statistics*, 47 (1), 13–37.

Designing an international equity allocation

We believe that investors should not only think about increasing their allocation to international equities but also consider more carefully how to allocate money within international equities as an asset class. In other words, we need to stop thinking about international as just a slice of an investment pie and start thinking about it as a whole pie with slices of its own. In the next sections of this paper, we examine an optimal weight to international equities and recommend three different model portfolios appropriate for a conservative, moderate and aggressive investor.

Framework for finding an appropriate international equity weight

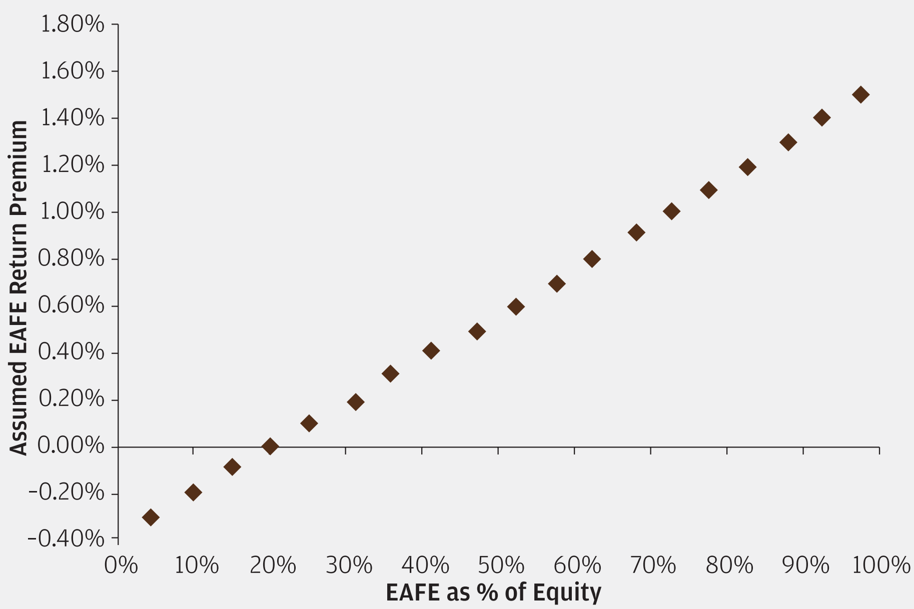
A portfolio optimization model is probably the best way to address the question of how much to allocate to international equities. However, this requires estimating volatility, correlation and future returns for each asset class. Each year, J.P. Morgan Asset Management generates long-term estimates for each of these factors across asset classes. We consider factors such as current valuations, expected earnings growth, dividend yields, inflation rates, interest rates and credit spreads to estimate future returns. While it is unlikely that our estimates will match actual results, this process provides investors with a relative ranking of risk and return to help evaluate which markets are likely to outperform others.

With these inputs as a guide, we modeled a portfolio of traditional building blocks for U.S. investors: U.S. Large Cap, U.S. Small Cap, Developed International Equities and U.S. Core Bonds[5]. For the sake of simplicity, we excluded other extended asset classes, including emerging markets equities and international REITs, but will discuss their role later in the paper. Based on our Capital Market Assumptions, we calculate that the optimal level of exposure to developed international markets (EAFE) is 21.4% of a traditional 60% equity / 40% fixed income portfolio. In other words, 21.4% of the total portfolio would be in international stocks, or about 35% of the equity allocation.

It is important to recognize that the output of the optimization process is highly sensitive to the assumptions one makes about the future. We assume, for example, that the annual return on the EAFE index beats that on the S&P 500 by 25 basis points over the next 10–15 years. In Chart 7 to the right, we show how the optimal mix of international equities can vary depending on the degree to which EAFE is expected to underperform or outperform the S&P. The y-axis shows the

CHART 7: EAFE Excess Return Assumptions

Impact on Strategic Asset Allocation



Source: Barclays, Standard and Poor's, MSCI and J.P. Morgan Asset Management. Results based on J.P. Morgan Capital Markets Assumptions, forecasted returns, volatility and correlations. Optimal EAFE weights as part of a total portfolio comprised of S&P 500, MSCI EAFE and Barclays Aggregate Index, where Barclays Aggregate represents 40% of the total portfolio.

[5]U.S. Large Cap represented by S&P 500 Index, U.S. Small Cap by Russell 2000 Index, Developed International by MSCI EAFE Index and U.S. Core Bond by Barclays Aggregate Index.

excess return of EAFE to the S&P. The x-axis shows the optimal EAFE content as a percentage of equities for that excess return assumption.

The dot on the lower left shows us that if EAFE was projected to lag the S&P 500 by 30 bps, the optimal amount of EAFE as a percentage of equities would be about 3% of total equities. If the EAFE and the S&P were assumed to generate exactly the same return (zero on y-axis) the optimal weight to EAFE in an equity portfolio would be 20%. If you expect EAFE to outperform the S&P by 1% over the next 10 years, you would hold about 75% of your equities in EAFE.

Over the past 10 years, the correlation between the S&P 500 and EAFE has been unusually high (0.89) compared to previous periods. If you assume the correlation will fall, the diversification benefits associated with owning EAFE would increase, boosting the optimal allocation to EAFE.

While holding 35% of your equities in non-U.S. equities is more than investors do today, it is significantly below the 58% weight derived from a market capitalization weighted index such as MSCI ACWI. The cap-weighted approach generates too much currency risk and significantly increases the volatility of the equity portion of the portfolio.

It is possible to hedge currency exposure, but for retail investors this is not practical. A handful of mutual funds fully hedge their currency exposure, but the vast majority do not. If an investor has the view that the U.S. dollar is likely to weaken going forward, holding a higher allocation to EAFE is one way to implement that perspective in a portfolio.

Suggested model portfolios

The investment opportunity set outside the U.S. is, of course, much wider than just the developed markets equities represented by EAFE. An approach that embraces other non-U.S. asset classes will result in a more efficient total portfolio, while also enabling the creation of different portfolios for different risk tolerances. The following is an overview of the international opportunity set.

Large cap, large cap value and large cap growth—These are the most prevalent categories in non-U.S. investing and they deserve a core role in most investor portfolios. Pay careful attention to the emerging markets content in these portfolios. Some international equity managers may hold no emerging markets while others can hold more than 25%; we estimate the average is 7.5%. Investors must measure this exposure when building their total international pie.

Generally speaking, most Core managers do not take big style bets and run lower tracking error than managers in the Large Value and Large Growth universe. Style-based investment processes aim to add value by focusing on a narrower subset of the total developed international equity universe and usually have high alpha targets for a market cycle. Over most cycles, the Value universe has generated lower beta than EAFE and has held up better in their markets. In the 2007–2009 market, the opposite was true; greater exposure to Financials contributed to significant Value underperformance. Going forward, we expect that Value managers will likely provide some downside cushion compared to Core or Growth managers.

Emerging markets—We expect that emerging markets equity markets will outperform developed markets over the intermediate to long run. Emerging economies may experience fewer major macroeconomic crises going forward, assuming a continuation of the relatively prudent policies of the last 10 years (i.e., high foreign reserves, fiscal discipline and current account surpluses). Even with this, emerging market equities should continue to be more volatile than their developed brethren and we expect that long-term strategic buyers will, at times, second guess the wisdom of their investment. However, despite the challenge of short-term pain, we advocate a significantly higher weight to emerging markets than most investors hold today.

It is difficult to find data on the dedicated emerging markets holdings of institutional investors in the U.S., but we estimate that the median weight in U.S. pension plans is zero or in the low single digits. Another component to the bull argument for emerging market stocks is that these investors, and global investors in general, will increasingly deploy their capital into these markets from a relatively low level today.

As a note of caution, we would suggest that investors closely monitor relative valuation between emerging market equities and developed market equities. In the past, emerging markets have traded in a wide range to developed markets, at times trading at a large discount and other times at a slight premium. If emerging markets trade at a significant premium to developed markets, we would advocate trimming the position.

International REITs—International REITs offer good diversification to equity markets, in part because their performance tends to track local property markets. Other benefits include the fact that the geography of international REITs is focused on the Asia-Pacific region, which works as a complement to the Euro-centric EAFE index. In addition, International REITs tend to have significantly lower beta than EAFE, attractive dividend yields relative to both EAFE and U.S. REITs and historically have had low volatility.

International small cap—Small cap international companies are not widely covered by the buy- or sell-side research community, so there may be a good opportunity to add value through security selection. Small cap stocks also tend to be more domestically focused compared to their EAFE counterparts.

In the following models, we did not include this asset class due to implementation difficulties. Capacity is limited due to low liquidity in many markets, and it can be difficult to find open mutual funds. Those funds that are open often have a limited track record to investigate. Although a handful of ETFs have been introduced over the last few years, the tracking error has, in many cases, been quite high compared to ETFs that track broader benchmarks.

Three model portfolios

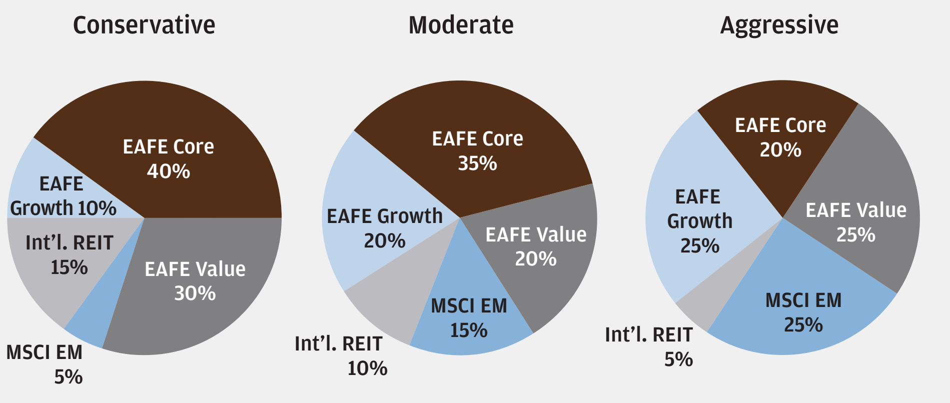
Below we share our view of different possible international model portfolios, or "pies," that may be appropriate for a Conservative, Moderate and Aggressive investor. Each allocation illustrated is meant to show the investor's overall allocation to international equities.

Conservative—This portfolio is constructed with a lower beta than the EAFE index. The vast majority of the assets are held in Large Cap developed markets, with a tilt toward value-oriented strategies to mitigate downside risk. Emerging markets exposure is approximately 11%, with 6% coming from stocks held by EAFE managers (assumes 7.5% average weight) and 5% to a dedicated emerging markets manager. International REITs are incorporated at a 15% allocation to further dampen downside risk and boost diversification.

Moderate—Most investors would probably fall into the moderate category. This model is fairly evenly divided between Large Cap Core, Value and Growth strategies. Emerging markets composition is greater than most investors hold today – about 20%[6] of the total international pie. If an investor allocated 35% to the international pie within a 60/40 portfolio, emerging markets would constitute about 4.5% of the total portfolio. We believe this is an appropriate allocation that balances performance with short-term risks. The 10% weight in international REITs enhances diversification and helps offset the downside risk of the emerging markets exposure.

Aggressive—Although we have reservations about a market capitalization-based approach[7] to the overall international weight within a portfolio (due to excessive foreign exchange risks), aggressive investors and/or those with very long time horizons should consider taking a market cap approach to their emerging markets exposure within equities. Within the aggressive international model, we recommend a 30%[6] weight. This higher weight also increases the beta and the volatility of the total portfolio. Over intermediate to long-term time horizons, we expect that this added exposure to emerging markets will result in considerably higher returns. However, this approach will likely underperform developed markets from time to time, possibly by a significant margin.

CHART 8:
Example International Allocations



Source: MSCI, Global Property Research, J.P. Morgan Asset Management. Data is most recent as of 12/14/09. U.S. bonds represented by Barclays Aggregate Index. U.S. equity represented by S&P 500 Index.

In addition to taking a more aggressive approach to the allocation to different international markets (beta), this model also looks for a greater contribution from active management (alpha) by taking bigger weights in Value and Growth managers, whom we predict will generate higher expected alpha/tracking error most of the time. A small weight to international REITs bolsters diversification.

[6] This allocation assumes a 5% exposure to emerging markets through EAFE managers and the rest through dedicated emerging markets exposure.

[7] Asset allocation weights correspond to the market value of all international stock as a percent of the total market value of all stocks globally.

Conclusion

Following a decade of disappointment, and particularly after the traumatic financial crisis of 2007–2009, many investors are taking a very conservative approach to investing. We believe that for many, a more balanced approach is appropriate. This is a world of uncertainty, but it is also a world of opportunity.

In particular, we believe that international stocks still offer a compelling long-term opportunity, even after a decade of outperformance. In this new decade, the world is still set to beat the U.S. in growth, reflecting the strength and increasing importance of emerging and developing economies. In addition, the dollar may continue to drift down on average and international stocks, by a variety of measures, seem cheap in both absolute terms and relative to the United States. We also believe, even after a decade in which flows into international stocks outpaced flows into U.S. stocks, U.S. investors in general, and particularly individual investors, remain underallocated to international stocks.

Finally, we believe that international equity investing doesn't just deserve to be a bigger slice of the average portfolio, but should be treated as an investment pie of its own, allowing investors to exploit the diversity of international investing opportunities. These include investing across sub-categories such as Growth, Value and Core, emerging markets and international REITs, which can provide both the diversification benefits and return potential that are the hallmark of a long-term commitment to international equity investing.

Appendix

Examining the reasons for *not* investing internationally

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If, despite a significant rise in foreign investing in recent decades, many investors are still underexposed to international equities, a natural question is, "Why?" Procrastination and an unwillingness to explore less familiar investment strategies may be part of the answer, but there are a number of more logical arguments made. In this section, we explore the reasons often given for not investing in international equities.

Reason #1: ***Correlations between U.S. and international stocks have risen over time and head toward 1.0 at times of stress, severely reducing the diversification benefits of holding international stocks.***

The rationale for diversifying in the first place is to reduce the volatility of portfolio returns for a given level of risk. International stocks have always been seen as a way to diversify a portfolio because, in addition to a good long-term return potential, they would, at least some of the time, go up when U.S. stocks went down and vice versa. In other words, they weren't perfectly correlated to U.S. stocks – and because of this, they could help reduce overall portfolio volatility without sacrificing return.

However, as shown in Chart 9, the correlation between U.S. stocks and the MSCI EAFE index of international stocks *has* risen over time and tends to jump at times of market stress. Even with this, however, international equities can offer important diversification benefits for three reasons.

First, over time, the volatility of international stock returns has tended to drift down relative to U.S. stocks. So even if we have lost some ability to reduce portfolio volatility through diversification, we have gained some back because international stocks are less volatile themselves than in the past.

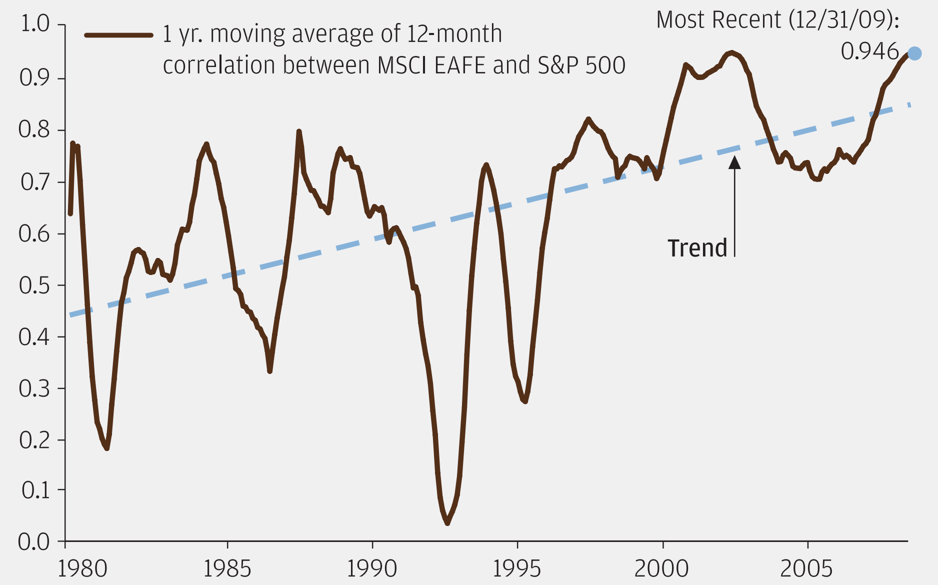
Second, emerging markets have, over time, become a more important part of the global opportunity set and are less correlated with domestic markets than the MSCI EAFE index. So even if the correlation between the S&P 500 and the MSCI EAFE has increased over time, by moving more of a portfolio's international assets into emerging markets, good long-term diversification can be maintained by including more international.

Finally, long-term investors are interested in *long-term* diversification and international equities still offer this benefit. It may be true that in a crisis whatever happens in the U.S. today is mirrored in Asia overnight and in Europe tomorrow morning, but as the time periods are stretched out, markets in Asia, Europe and the U.S. follow very different paths, reflecting very different economic paths.

Reason #2: *Investors get enough international exposure just by holding U.S. multi-nationals, such as Coca-Cola, IBM or GE.*

It is true that many large U.S. firms have very significant exposure to overseas economies. Indeed, in 2008, according to Standard and Poor's, of the 253 S&P 500 firms reporting sufficiently detailed information in foreign operations, almost 48% of sales came from outside the United States[8]. However, the reason you diversify internationally is not to increase your exposure to the rest of the world, but to decrease your exposure to the United States. Despite their global reach, Coca-Cola, IBM and GE are still very exposed to the United States. Indeed, the monthly returns on a capitalized weighted index of the 10 S&P 500 companies with the greatest foreign exposure has a correlation of 0.90 with the S&P 500 over the past two decades, but only 0.69 with the MSCI EAFE over the same period.

CHART 9:
Correlation Between S&P 500 and MSCI EAFE



Source: MSCI, Standard and Poor's, FactSet, J.P. Morgan Asset Management. Calculations are based on price only indices. Data reflects most recent as of 12/31/09.

Reason #3: *Foreign markets have less effective governance and disclosures than U.S. markets.*

In the past, the accounting standards used by companies differed greatly from one country to another, and this made the job of comparing companies around the world very difficult. Furthermore, certain countries, including the U.S., had more stringent disclosure standards than others. Over the last 10 years, however, a common accounting methodology, known as International Financial Reporting Standards (IFRS), has been adopted by more than 100 countries. Virtually every major developed and emerging market is now using, or will soon move to, IFRS, with the exception of Japan and China, whose governments are working with the International Accounting Standards Board to close the gap between their approaches and IFRS.

The U.S. had actually been the one big holdout to this trend of converging accounting standards. U.S. companies have historically reported their financial statements using U.S. Generally Accepted Accounting Principals (GAAP). In 2008, the SEC proposed a timeline for transitioning American companies from GAAP to IFRS by 2014. At the most basic level, IFRS and GAAP aren't all that different: sales are sales and expenses are expenses, although there are more significant differences at a more detailed level. However, the coming harmonization of accounting practices globally will remove the uncertainty surrounding how companies around the world keep score. So, while in the past it could have been argued that international firms operated with different and weaker accounting standards than the U.S., this is a much less valid criticism today and will be even less valid in the years to come.

[8] "Foreign Sales by U.S. Companies Continue to Rise," Standard and Poor's Press Release, July 14, 2009.

Reason #4: ***Most of the gains from international investing come from currency effects rather than the superior performance of international equities.***

Yes – over the past eight years, two-thirds of the outperformance of international stocks has come from a falling dollar rather than the outperformance of foreign stocks measured in local currencies. For larger institutional investors, this could imply the need for a foreign currency overlay strategy. However, for individual investors, it may make the most sense to buy currency exposure and foreign stock exposure in one place – namely international stocks. Moreover, it should be noted that there is a strong positive correlation between outperforming stock markets and rising currencies, so you probably don't want to be long a foreign stock market and short its currency.

Reason #5: ***Many investors prefer to invest domestically because they feel they have a better handle on what's going on here and don't have the expertise to compete with local investors in Shanghai or Frankfurt.***

It is a very natural human instinct to bet on the familiar rather than the unfamiliar. However, investors can't really afford to limit themselves to investments in which they have a deep understanding, whether domestic or international. They need the diversification and the potential returns. The answer is to hire fund managers who have a breadth of research to allow them to act as expert investors in foreign markets.

Reason #6: ***Isn't international more volatile than domestic investing?***

One of the main fears that investors have about investing internationally is that international stocks are riskier than U.S. stocks. To some extent, this is true. As shown in Chart 10, over the past 20 years, the standard deviation of monthly returns (measured in U.S. dollars) has been 4.34% for the S&P 500 and 5.05% for the MSCI EAFE index. This implies that roughly two-thirds of the time, the monthly return on the MSCI EAFE came within 5.05% percentage points of its mean return, about 16% higher than the volatility on the S&P 500. However, it is worth noting that much of this extra volatility was just currency movements – in local currency terms, the volatility numbers for the MSCI EAFE index are only 6% higher than for the S&P 500.

More important, adding a riskier asset

CHART 10:
Adding Emerging Markets to the Mix

	Index	Currency	Avg. Monthly Return %	Volatility of Returns %
RAW INDICES	S&P 500	USD	0.75	4.34
	MSCI EAFE	USD	0.49	5.05
	MSCI EAFE	Local	0.36	4.59
	MSCI EM	USD	1.10	7.02
	MSCI EM	Local	2.07	6.55
COMPOSITE INDICES	**65% S&P 500/ 35% EAFE**	**USD**	**0.66**	**4.27**
	65% S&P 500 / 25% EAFE / 10% EM	**USD**	**0.72**	**4.37**

Source: MSCI, Standard and Poor's, FactSet, J.P. Morgan Asset Management. Calculations based on monthly total return data. Data is most recent as of 12/31/09.

class to a portfolio may not make the overall portfolio much more risky, or even riskier at all, provided that the assets are not perfectly correlated. The whole secret to diversification is that provided one asset zigs while another zags, a combination of them may be less volatile than either individually. In Chart 10, a combination of 65% domestic stocks and 35% MSCI EAFE actually had less volatility than an S&P 500 portfolio on its own.

Adding emerging markets to the mix does increase the overall volatility of the portfolio slightly. However, even a portfolio of 65% S&P 500, 25% MSCI EAFE and 10% MSCI EM had a monthly return standard deviation of 4.37% over the past 20 years, which is insignificantly different from the 4.34% seen for the S&P 500 over the same period.

Reason #7: *Aren't foreign countries less stable and more threatened by terrorism?*

In the immediate aftermath of 9/11, many Americans were fearful of investing abroad because of the perception of foreign terrorism and unstable governments. The gut reaction is quite understandable — almost all TV news stories about the rest of the world involve disaster or destruction. However, this fear of international political instability is probably misplaced for a number of reasons.

First, the truth is that the best money is made in boring places and the vast majority of international stock market assets are located in countries that are just as politically stable as the United States.

Second, the last few decades have actually seen a remarkable expansion of free enterprise around the world as China has moved away from communism, India has embraced a more free-market philosophy, the Soviet Union has collapsed, the Iron Curtain has fallen and Latin American governments have adopted both more democratic government and more responsible fiscal management.

Third, while 9/11 engendered fears about the rest of the world, the chilling truth is that if Al Qaeda ever got their hands on a weapon of mass destruction, they would likely use it against the United States or Israel. We are the main protagonists in the war on international terrorism and are thus probably more threatened than other countries such as Brazil, Germany or Australia, which are less likely to be targets. Fear of terrorism is a reason *to* invest abroad not a reason to avoid it.

Reason #8: *Shouldn't we be supporting the American economy by buying American securities?*

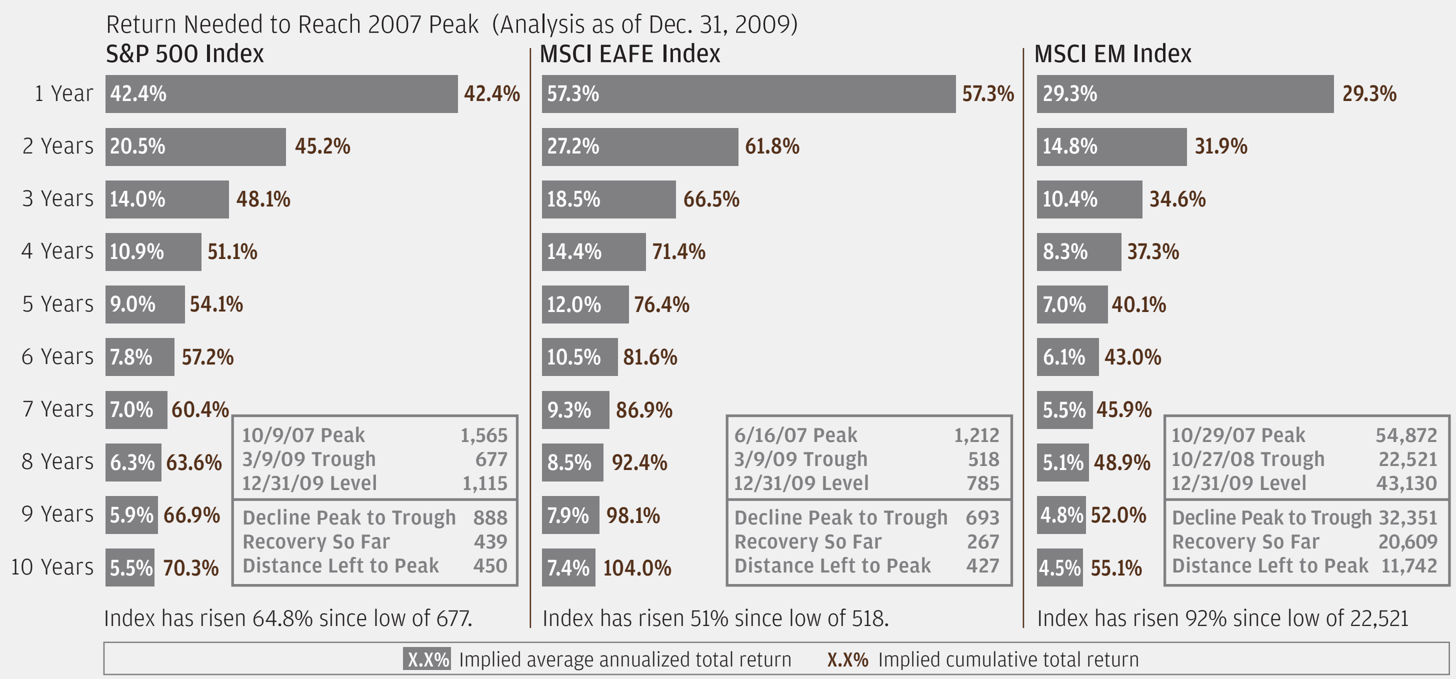
Some investors feel that it is unpatriotic to buy foreign securities as U.S. money should stay at home to support U.S. industry. If people feel that way, that is their right. However, it is worth noting that most foreign investors don't feel that way. In fact, year after year, as the United States runs a current account deficit, we also run a capital account surplus. While there is a net flow of American money going abroad to buy foreign goods, there is an equal and offsetting flow of foreign money coming to the United States to buy our stocks, our bonds, our real estate, our CDs and our mutual funds. So the question has to be asked: If the rest of the world has no patriotic qualms about investing in the United States, why should we be concerned about investing overseas?

Reason #9: *After a decade in which international outperformed, isn't it too late to be getting in?*

In the decade of the 2000s, it is true that international stocks outperformed U.S. stocks, S&P 500 with the MSCI EAFE logging a positive 17.0% return compared to a 9.1% loss for the S&P 500. However, most of the difference was currency – in local currency terms, the MSCI EAFE index actually provided a negative 6.3% return over 10 years. Thus, in local currency terms, there is no more exuberance built into international stock valuations than their domestic counterparts.

More to the point, as shown in Chart 11 below, by the end of 2009, while the S&P 500 had recovered just 49% of its bear market losses, the MSCI EAFE index had recovered only 39%, while the MSCI EM index had recovered 64%. Even if it took five years from the start of 2010 to get back to their old highs and assuming a continuation of 2009 dividend yields, these three indices would provide annual average U.S. dollar returns of 9.0%, 12.0% and 7.0%, respectively. Since March 2009, the stock market recovery train has been moving out of the station across the world. But after a brutal bear market, it is a very long train and a very long platform, and there is still time for global investors to get on board.

CHART 11:
What Stocks Would Have to Do to Get Back to Their Old Highs



Source: Standard & Poor's, MSCI, J.P. Morgan Asset Management. Implied values reflect the average geometric total returns required for the indices to reach their 2007 peaks over each stated time period. Data assume a continuation of 2009 dividend yields (S&P 500: 2.02%, MSCI EAFE: 2.95%, and MSCI EM: 2.05%).
Chart is for illustrative purposes only. Past performance does not guarantee future results.

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