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Americans boosting investments in foreign markets despite high risks

Amid a plunge in many overseas stock markets prompted by the Dubai debt crisis, there's mounting concern that investors are rushing overseas too aggressively.

The electronic stock board of a Hong Kong bank shows how Asian markets tumbled as fears mounted over Dubai's massive debt problems. (Vincent Yu, Associated Press / November 27, 2009)

Manny Mashhoud has done well investing in U.S. stocks for two decades, but the Glendale insurance executive fears that the country's economy could be restrained for several years by high unemployment and the lingering trauma of the recession.

So he's sharply boosting his investments in overseas markets and is even setting up a brokerage account so he can buy and sell stocks directly on foreign exchanges.

"The advantages of the foreign markets substantially outweigh what we have here," Mashhoud said.

Sharing that sentiment, many Americans -- though still raw from the 17-month bear market that ended in March -- are pouring money into mutual funds that buy foreign stocks, especially in emerging markets such as China and India.

The shift, applauded by many financial advisors, has paid off this year. But there's mounting concern that investors are rushing overseas too aggressively.

As a plunge Thursday and Friday in many overseas stock markets shows, international investing poses a whole new level of risk. The latest tumble came in reaction to a sudden debt crisis in the Middle East emirate of Dubai.

Some experts warn that the growing love affair with overseas assets could end badly.

"It's a scary trend," said Chris McIsaac, an executive at mutual fund group Vanguard. "We've seen bubbles before in different sectors of the market and we all know what happens to bubbles."

In Dubai, part of the United Arab Emirates, state-owned conglomerate Dubai World on Wednesday asked for a delay in repaying some of its $60 billion in debt, sending shivers through investors who feared that it could set off a wave of falling dominoes in the way the collapse last fall of Lehman Bros. did.

Over the next two days, key stock indexes sank more than 6% in Hong Kong, more than 5% in Shanghai and South Korea and more than 3% in Japan and India.

On Wall Street, which was closed Thursday for Thanksgiving, the pain wasn't as severe. On Friday the Dow Jones industrial average slumped 154.48 points, or 1.5%, to 10,309.92.

Even before the global financial crisis and recession, U.S. investors were increasing their ownership of foreign stocks. Such a move was something that many financial professionals had long advised.

The move abroad generally makes sense, financial advisors say, because many international economies -- especially ones that are still industrializing -- are expected to grow far more rapidly than the U.S. economy.

This year, individual U.S. investors, still jittery about the stock market overall, have yanked a net $4.1 billion from mutual funds specializing in U.S. stocks. At the same time, however, they shoveled almost $21 billion into risky emerging-market funds.

Meanwhile, an index of emerging-market stocks has nearly doubled from its March low, compared with a 57% gain for the Dow.

The rush overseas has been so strong that Vanguard took the unusual step last month of cautioning investors against plowing too much into its emerging-market fund.

Still, financial firms are rolling out new products as demand for them grows.

Fidelity Investments, which just increased its recommended international exposure for a typical investor to 30% of one's overall portfolio from 20%, launched a program last month for individuals to directly buy securities online in foreign markets, something once reserved for financial professionals.

The program, which also permits the buying and selling of foreign currencies, is geared toward savvy investors who know what they're doing, said Jim Burton, head of Fidelity's retail brokerage.

"This is not for everybody," Burton said. "It's for investors who are prepared to put in the time required to do their homework."

Still, critics worry about the harm that investors could do to their portfolios.

Foreign stocks, especially in emerging markets, are notoriously volatile. Information about companies that issue shares can be hard to come by. Currency fluctuations can magnify the effect of stock-price moves on a portfolio that is measured in dollars. Past booms have been followed by knee-capping busts. Tellingly, the markets that have significantly outperformed U.S. stocks this year also lost much more ground during the bear market.

"It's extraordinarily risky," said Victoria Collins, senior managing director at First Foundation Advisors in Irvine. "People assume they have more knowledge than they actually do. That has always worked out badly for investors in the past."

In what may be an even scarier trend, individual investors also have made a dash into currency trading -- also known as foreign exchange, or forex for short -- in the wake of this decade's long slide in the value of the dollar, a decline that was reversed by the financial crisis but resumed with a vengeance early this year.

Individual investors traded an average of $125 billion a day in foreign currencies in July, August and September, up from $100 billion last year and only $10 billion in 2001, according to Aite Group, a research firm.

With such trades, an investor might, for example, buy euros or Japanese yen or Indian rupees in exchange for U.S. dollars.

Although the value of a currency moves relatively slowly compared with stocks, foreign-exchange markets allow investors to put little money down to execute a trade. That built-in leverage can multiply their gains and losses by a factor of 100 or more.

"You could have $2,000 in your account and be trading hundreds of thousands of dollars a day," said Sang Lee, managing partner at Aite.

It's now even possible to trade currencies without making the decisions yourself.

At 2-year-old online trading site Zulutrade Inc., investors monitor the performance of other traders, identify the ones who might do well and set up programs that will automatically mimic their future trades.

Some investors have made big profits on Zulutrade, said Leon Yohai, the firm's chief executive.

One person turned $5,000 into $60,000 in four months, withdrew all the profit and again turned the original $5,000 into $60,000 in another four months, he said.

But others get wiped out, Yohai acknowledged. People who notch profits early on get greedy, he said, and trade ever-larger sums. A handful of wrong moves can be devastating.

"If you follow the directions we give them -- which are for dummies -- they do well," Yohai said. "If they don't follow the directions, or you pick the wrong guy [to mimic], they might lose money."

Despite the risks, the potential for strong gains overseas is drawing investors.

Mashhoud, the Glendale insurance executive, has traded currencies for several years through a broker and is now preparing to trade foreign stocks online.

"In the next two years an investor can do substantially better in the foreign markets than they can here in the U.S. market," he said.

At 46, Mashhoud is aware of the dangers, he said, adding that foreign stocks would make up only a small portion of his portfolio.

"It is risky, absolutely," he said. "It's not for the faint of heart. You better know what you're doing."

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