How Much to Invest Abroad?

Individual investors may reap diversification benefits by investing internationally.

The level of benefit is based on many factors – cross-country correlations, major industries, domestic companies that operate globally, etc. Over time, global diversification benefits have fallen. However, investing outside your home country is still worthwhile.

The question then, how much should you invest abroad?

This question was asked of a panel in The Wall Street Journal. Some good responses. I will comment on a few and include my own view of the world.

My Thoughts (Since No One Asked)

The global market is 100%. Your domestic market is a piece of the pie. The U.S. is the largest financial market with about 33% (plus or minus – you actually may see some claim it as high as 46%, but that is too high) of global market capitalization. Canada has only about 4% of the global market share.

Some experts recommend investing in line with relative global weightings. So roughly 33% in U.S. equities, 4% Canada, etc. Fine by me. An easy way to do this is to simply purchase a global equity fund. For example, the Vanguard Total World Stock ETF (VT) or iShares MSCI All Country World Index (ACWI) ETF (ACWI).

Both are extremely inexpensive and do an excellent job of replicating the global equity markets in reasonable weightings. I use "reasonable" as global equity funds tend to overweight U.S. equities. In this case, both Vanguard and iShares invest about 48% in U.S. equities. The higher weighting in funds versus actual real world weightings has to do with investable assets and a slight U.S. bias. Not a huge issue if you are looking for one single fund to invest in. Canada's weighting sits at its proper 4%.

Some experts recommend home country bias when investing. If you live in Canada, instead of 4%, you might want to invest between 10 and 20% in Canadian equities.

Why? Your life is tied to your domestic financial markets. If you live in Canada, you are paid salary in Canadian dollars (CAD). Your debt is in CAD. Interest rates, inflation, unemployment, are all tied to Canadian-centric events. What goes on in Canada impacts Canadians disproportionately to world events. As a result, you may want to have greater exposure to Canadian equity markets.

I might add that some experts make the exact counter-arguement. That you should underweight your home market because of all the other impacts.

Me? I do not mind using either relative global weightings or home country bias. I think you need to consider other factors (what is your home market, debt load, other investments, cash flow requirements, etc.) before choosing one or the other. For many individuals who do not want currency and interest rate impact, a home country bias may be preferable. For younger investors, relative global weightings may prove better.

So what do the experts from The Wall Street Journal say? And bear in mind these folks are speaking as U.S. based investors. What might make sense for Americans may not be optimal for Aussies, Channel Islanders, or Malaysians.

Gus Sauter: Keep a Home Country Bias

> *In my view, investors should have a home-country bias because they face risks that are peculiar to their home country.*

> *So, an investor should invest a significant portion in their home country, but invest enough internationally to take advantage of diversification.*

Gus does not provide a suggestion for Aussies. But at 3% global weighting, a home country bias would probably put Australian equities at 10 to 20%. But some would say that more like 30 to 50% is suitable. Too high for me, but just letting you know.

As an aside, I have heard Gus speak a couple of times. Sharp guy.

Manisha Thakor: Don't Think About Where a Company is Based

> *As the consumer class around the globe continues to blossom, growth rates in emerging markets continue to eclipse those at home.*

Good advice. You need to consider the prospects for your home market versus foreign markets.

Also the region in which you live. If you live in Argentina, what goes on in Chile has more significance in your home market than what is happening in Germany. Conversely, Poles need to monitor the German market very closely given physical proximity and trade partnerships.

> *So the real question I think is: What is a non-U.S. investment?*
>
> *To date, corporate domicile has typically been the litmus test for the categorization of an investment as domestic or international. Going forward, I think it's important to pay attention to the source of revenue and profit generation*

So, so true.

Is Apple an American company? Much of its manufacturing is in China. Its customers surround the globe.

Is Nestle a Swiss company? Is Samsung only South Korean? HSBC solely British? Obviously not. These companies operate globally and derive much of their revenue outside their domestic markets. Yet if you look at each country's main indices, Nestle, Samsung, and HSBC dominate the domestic weightings.

As an aside, you can actually create an internationally diversified portfolio by strategically choosing domestic companies.

Frank Holmes: Anticipate Before You Participate

> *when you combine non-U.S. stocks, U.S. stocks, real-estate securities and commodity-linked securities, the resulting portfolio historically outpaced any individual asset class with less volatility.*
>
> *understand the typical price movements of an asset class before you invest.*

Not quite sure what Frank's point is here. Whenever you prepare a portfolio you must consider historic returns and volatility (i.e., risk). That really is the whole point of diversification. Adding non-correlated assets to try and enhance overall portfolio returns while maintaining the risk level. Or reducing portfolio risk while maintaining the existing expected return levels.

Charles Rotblut: No Crystal Ball? Then Best Diversify

> *unless a person has a working crystal ball, it is impossible to predict where one should invest right now to maximize returns for the next 10 years. By mixing domestic equities with foreign equities, an investor increases the odds of being allocated to the right geographic region at the right*

> *time.*

Diversification spreads out the risks. Unless you are certain of the future, hedge your bets.

> *by diversifying internationally, an investor's wealth won't solely be dependent on the strength or weakness of the U.S. dollar.*

This is a two-edged sword. If your cash needs (living income, debt repayment, etc.) are in your home currency, investments in foreign currency denominated assets might be risky. But if you do not have these concerns, owning assets in a different currency may add value.

The Other Experts

Mostly dross. But you can see that there is no consensus on how much to invest outside your domestic market.

If you have a decent risk appetite and long time horizon, look to higher levels of non-domestic equities. Especially in emergent (and smaller) markets.

If you have substantial liability exposure to your domestic currency or you require income flows in local currency, then focus on a significant home bias.

Emerging Market

Diversification

What do you think of when your hear the term, “emerging markets”?

What type of companies and industries exist in emerging equity markets?

I have no idea what you may think. But in case you do not know …

Emerging Markets May Mirror Developed Markets

In “iShares: Challenging Investor Assumptions About Emerging Markets”, ETF Trends compares portfolio holdings between emerging and developed markets.

> *But what’s so surprising to me is that over this 18 year period, how similar the sector weightings between these two types of markets has become.*

I like BlackRock and iShares. But if the article’s author is truly surprised by this similarity, I may need to rethink my view on BlackRock. That aside, realize that there are likely similarities between industries in equity market indices, whether they are emergent or not.

> *While investors often associate the emerging world with resources, these days, emerging markets are just as likely to be associated with banks. Financials make up 28% of the MSCI Emerging Markets Index, compared with a 22% combined share of energy and materials and, interestingly, a 21% financials share in developed markets.*

Mirrored Industries, But Still Local Flavour

True. And worth keeping in mind when seeking diversification through different asset classes and markets. But I would add though that this is not 100% accurate.

You need to look at local population, proximity to other markets, natural resource base, availability of labour, etc., as these items greatly impact what goes on in any one country. Country (and industry, company) specific factors influence local companies to a great extent.

Compare Switzerland to Canada. Both developed markets. Lots of natural resources in Canada, so you would expect related industries to dominate major indices. Lots of milk producing cows in Switzerland, hence Nestle as a major company. Not all developed markets are homogeneous.

Or compare the emerging markets of Brazil to Poland. Yes, Brazil is considered (for now) an emerging market. Country specific factors impact major industries. If we break down the major industry exposures, we see financials (Brazil 28% versus Poland 45%), energy (B 16%, P 14%), consumer staples (B 15%, P 4%), materials (B 15%, P 16%), and utilities (B 7%, P 8%). In some industries, extremely close percentages. In others, significant variance. Depending on which emerging markets you invest in, you may discover high similarity or you may find low. Part of your research into which funds you want should consider this point.

Even if companies operate in the same industries, there will be some significant differences in results based on local factors.

A bank operating in Poland may have a relatively low correlation with a bank in Brazil. There are common factors that inherently keep correlations high (global economy a big one). But there are local factors (customer base, local economy, government, trading partners, etc.) that reduce correlations. The greater the difference in local specific factors, the lower the correlations (and the better the diversification).

I would expect correlations between Brazilian and Argentine banks to be higher as compared to Brazilian and Polish banks. Owning a Brazilian, Polish, and Vietnamese bank will provide better diversification than three Canadian banks.

Energy accounts for 16% of Brazil and 15% of Poland equity markets. Very similar percentages in industry allocation. Petrobras makes up a large portion of the Brazilian component. PKN Orlen a large portion of Polish energy. If you go to the links, both are indeed energy companies. But Petrobras is the 7th largest energy company in the world and operates in 25 countries. It is renowned for deep water oil exploration. Whereas PKN Orlen specializes in refining crude oil. Both energy, but different emphasis. That provides diversification benefits.

Yes, there can be similar industries and percent composition between developed and emergent markets (as well as between developed markets or emerging markets). But the local situation and circumstances will lower asset correlations to some extent. Which means you can still get diversification benefits from investing in emerging markets.

Increased Globalization Increases Correlations

Okay, let's rein in the "diversify with emerging markets" horse a little.

Twenty years ago, investing in emerging markets provided strong diversification with domestic market investment portfolios. That was the investing mantra.

With each passing year, the world seems to get smaller. Domestic companies in developed markets increasingly operate in emerging and frontier markets. Emerging markets, especially larger ones like Brazil, Russian, India, and China (known collectively as BRICs), have extensive trade relationships with developed nations. This results in ever increasing correlations as the differences between developed and emergent continues to blur.

You can still get enhanced portfolio diversification by investing in emerging markets. Just realize that the benefits are decreasing over time. And that individual portfolio holdings within an emerging market index may be quite similar in nature and ratio as in your home developed market index.

It is beneficial to include emerging market equities in one's portfolio. But do not blindly assume that simply including them will bring positive results. Consider the components of the emerging market index. How they relates to your domestic equity holdings, as well as how they correlate to other emerging and non-domestic developed markets you wish to invest in.

Brazil, An Emerging Market

Or an emerged market?

In our initial look at emerging markets, we saw that Brazil is included.

And if we look at its overall market characteristics, Brazil probably should be classified as an emerging economy. But in other aspects, perhaps not.

Consider today's slightly funny example.

Emerging Does Not Always Mean Small

Often emerging markets have relatively small economies. Malaysia, Peru, Thailand come to mind. And frontier markets such as Romania, Tunisia, and the Ukraine.

But an emerging market is not necessarily small.

In 2011, [Brazil passed the UK to become the world’s sixth largest economy]. Not what one likely associates with an emerging market economy. Adding further insult to the UK and its fully developed market, is the expectation that two other emerging markets, Russia and India, will surpass the UK as well over the next decade.

And we cannot ignore China. Its emerging market is already the world’s second largest economy. Including China, four of the world’s top 10 economies are from emerging market nations.

With four of the top 10 global economies, these emerging market countries exceed many other developed nations. Australia, Canada, Spain, and other developed markets rank below the top 10.

When assessing investments, do not automatically equate emerging markets with small economies.

But huge economies being considered as emerging is not the funny part.

Foreign Aid

The funny part relates to foreign aid.

Although managing a smaller economy than Brazil, the [UK still provides them with foreign aid]. Not something that makes many Brits happy. And up until this year, the UK was financially assisting China and Russia as well.

Again, the Brits are not alone. As a Canadian taxpayer, I am [helping fund several countries with larger economies] than Canada’s. Including all four of the emerging markets in the world’s top 10 economies.

A list that Canada does not make. Perhaps because we finance the development of other countries, instead of our own (yes, I realize other factors are also involved in foreign aid)?

Pretty funny stuff.

[Diversify With Emerging Markets]

[Emerging market investments] can add value to one's portfolio.

On the one hand, emerging market assets provide potential diversification benefits that help lower overall portfolio risk.

At the same time, emerging markets offer potentially higher returns than investments in developed markets. This helps enhance overall portfolio expected returns.

Lower portfolio risk, higher expected returns, count me in!

Well, like any investment, there are always a few strings attached.

The advantages of diversification into global markets today are less than they were 20 years ago. This is due to factors including: the ever increasing level of globalization, closer economic ties between countries, and improved information flows for investors.

Today we will take a look at the risk reducing benefits in adding emerging market assets to one's portfolio. And the issues to watch out for.

Emerging Markets May Diversify Portfolio To Reduce Overall Risk

As we saw in our look at diversification, asset correlations (i.e., connection between the assets) impact overall portfolio risk.

By adding assets with low or negative correlations to an existing portfolio, it reduces portfolio risk to some extent.

How Much Diversification Depends on Amount Added and the Inter-Asset Correlation

The exact amount depends on the amount of new asset being added. Obviously, if you add stock worth $1000 to a portfolio with a total value of $1 million, its impact will be smaller than if the entire portfolio was worth $2000.

The amount of risk reduction also is impacted by the inter-asset correlation. The lower the correlation between portfolio assets, the lower the overall portfolio risk.

Developed Markets May Have Close Economic Ties and High Correlations

Often emerging market assets have lower correlations with developed countries than do developed countries between themselves.

For example, Canada and the U.S. are closely related in many economic areas. If the U.S. economy suffers, there will be a significant impact on Canada. The same close relationship exists between European Union countries like France and Germany.

Developed nations tend to have similar markets, trading relationships, rule of law, consumers that enjoy similar products, etc. As such, systematic risk factors that impact one developed country can have an impact on all. The closer the relationship between two countries, the higher the inter-country correlation.

As the economic ties begin to fade, correlations between the countries fall.

Emerging Markets May Have Less Economic Ties to Developed Markets

With emerging market countries, often the connection between a specific country (e.g., Morocco) and your home country (e.g., Canada) is small. So you can get diversification benefits by adding emerging market assets to your investment portfolio.

The lack of connection between an emerging market and your home country may be due to a variety of factors. Proximity, lack of trade treaties, disposable income in the emergent market, resources, can all weaken ties (and correlations) between your country and the emerging market. For diversification purposes, this is good.

But Not Always

Even though one country is labelled an emerging market, its unique relationship with a second country determines its correlation.

Not simply whether one is developed and the other emergent.

This is a crucial point to remember.

You Must Always Compare The Specific Countries

Distance and economic development are often keys to correlations between countries.

The correlation between Mexico and the U.S. is higher than between the U.S. and Germany simply because of physical proximity and the resulting ties and trade. The same holds true between Germany and the Poland. But the relative correlations between Germany and Mexico or the U.S. and Poland will be smaller due to distance and lack of common borders.

Also, some large economies (e.g., Brazil, China, India, Russia) are included as emerging markets. Although considered emerging markets, these countries have close economic ties to many developed nations.

For example, China holds a huge amount of U.S. debt. And the U.S. is a big importer of Chinese made goods. Even though the two countries are physically far apart, their economic ties lead to a higher correlation than might otherwise expected.

So, in many instances, adding an emerging market investment to your portfolio will reduce your overall portfolio risk. But do not blindly assume that emerging market assets have lower correlations than other international assets. You need to dig a little deeper to see the specific relationship between the markets. Sometimes, the benefits will not be there.

The World Continues to Shrink

As the world continues to become smaller through increased globalization and information flow, diversification benefits have fallen.

Just look around you to see this is true. Not that many years ago, foreign automobiles in the U.S. were relatively rare. Today, Japanese, Korean, German, and others are the norm.

Consider Starbucks. Almost impossible to believe, but prior to 1996 there were no Starbucks outlets outside the U.S. It was only in 1998 that Starbucks opened a store in the United Kingdom. 13 years later, I cannot walk more than a block in downtown London without stumbling across a mermaid like sea siren. Today Starbucks operates in 57 countries with over 17,000 stores. And approximately 1000 of those are in the U.K.

Also, new free-trade agreements (FTAs) continue to develop that serve to enhance economic ties. In 2011, Canada completed a FTA with Colombia, concluded negotiations on a FTA with Honduras, tabled legislation on FTAs with Panama and Jordan, and continues to negotiate on a FTA with India. That Stephen

Harper has been a busy fellow.

Complicating things further is that the German car driven by the Australian may have been built in the USA or South Africa. That Apple iPod bought by a Swiss person was made in China. And the American is getting his assistance from JPMorgan Chase or AT&T via a call centre employee in the Philippines.

As more and more companies shift resources to take advantage of lower cost jurisdictions, they increase their operations in emerging markets. This increases ties as well as correlations.

But There Are Exceptions

In general, the world is shrinking, which means a trend towards higher correlations between countries. But sometimes circumstances arise that reduce the current connections.

Greece is intimately connected to the European Union through the Euro. If it leaves the Euro, as may happen, the correlation between Greece and other Euro countries will fall. Probably not much given the physical proximity of European countries, but it will decrease to some degree.

Or look at the current situations in Egypt and Pakistan. The U.S. has had close military and economic assistance ties to each country. But as political circumstances change in both countries, there is a strong probability that ties between these nations and the U.S. will decrease.

Changing correlations is not necessarily a one-way street.

Conclusion

Including emerging market assets in one's portfolio can provide diversification benefits by reducing overall portfolio risk.

But it is not the slam-dunk that it was 15 or 20 years ago.

You need to examine any emerging market in direct comparison to your home region. Australians will have closer economic ties to China, Indonesia, and the Philippines than a Brit.

And a specific emerging market may have a higher correlation to your existing portfolio than some developed markets. Japan has closer ties to China than it does to Sweden.

Finally, never forget that the world is fluid. As global events change, so too can correlations.

When considering adding emerging market assets in your existing portfolio, do your homework.

Make certain that the potential asset actually provides a diversification benefit by reducing overall portfolio risk.

And once it is in the portfolio, monitor world events to ensure that it continues to provide these benefits over time.

Next up, a look at how emerging market assets can enhance portfolio returns.

What are Emerging Markets?

Emerging markets are popular investments for many investors.

Why?

Emerging market investments may aid in reducing portfolio risk through enhanced diversification. At the same time, there is also the potential for higher returns in less developed markets.

Today we look at what constitutes an emerging market.

Emerging markets are often seen as high flying investments in uncontrolled regulatory environments. Growth oriented assets with high price to earnings ratios. Located in far flung corners of the world, a long distance from your developed and well regulated domestic market.

But this is not necessarily true in all cases.

What is an Emerging Market?

Per Investopedia, an emerging market economy:

> *is defined as an economy with low to middle per capita income. Such countries constitute approximately 80% of the global population, and represent about 20% of the world's economies.*
>
> *… countries that fall into this category, varying from very big to very small, are usually considered emerging because of their developments and reforms.*
>
> *… are characterized as transitional, meaning they are in the process of moving from a closed economy to an open market economy while building accountability within the system.*
>
> *Because their markets are in transition and hence not stable, emerging markets offer an opportunity to investors who are looking to add some risk to their portfolios.*

That is the financial world's agreement on what constitutes an emerging market. Countries with lower per capita income and wealth. However, the size of the country's economy can be big or small, which may surprise some investors.

The key aspect is that the country is in a financial transition. Moving from an unregulated, disorganized system towards one with better oversight, transparency, and rule of law. Things that give investors some confidence and therefore begin to attract domestic and foreign investment.

However, because the shift to full development is not complete and there is some probability of regression, investing in emerging markets is riskier than investing in a developed market. And with greater risk, there is the expectation of higher returns.

This, plus diversification benefits, is a major reason why investors take a chance on emerging markets.

Who are the Emerging Market Countries?

Anyone that meets the criteria above. You can make your own determination.

But in many financial instruments, an emerging market country is more closely defined. And some of the inclusions may not appear to many readers as emerging markets.

For example, the MSCI Emerging Markets Index currently includes only 21 countries in their index. As at May 30, 2011, the index only included:

> *Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.*

Brazil, China, India, and Russia have substantial economies, yet they are still considered emerging markets. That said, these countries are also often segregated into their own fund, known as BRICs.

Frontier Markets

And where are countries such as Kenya, Lebanon, and the Ukraine? Are they not also emerging markets?

Yes. But they tend not to be included in emerging market indices or funds. Instead they are classified as “frontier markets”, reflecting even less development.

As at May 30, 2011, the MSCI Frontier Markets Index includes 25 countries, with a few more under consideration.

> *Argentina, Bahrain, Bangladesh, Bulgaria, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Kazakhstan, Mauritius, Nigeria, Oman, Pakistan, Qatar, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Ukraine, United Arab Emirates, and Vietnam. The MSCI Saudi Arabia Index is currently not included in the MSCI Frontier Markets Index but is part of the MSCI Gulf Cooperation Council (GCC) Countries Index. The MSCI Bosnia Herzegovina Index, the MSCI Botswana Index, the MSCI Ghana Index, the MSCI Jamaica Index, MSCI Trinidad & Tobago and the MSCI Zimbabwe Index are currently stand-alone country indices and are not included in the MSCI Frontier Markets Index. The addition of these country indices to the MSCI Frontier Markets Index is under consideration.*

Know What You Are Investing In

A wide range of countries are considered emerging markets.

In some cases, the term “emerging market” may not seem appropriate for some of these countries. India, Brazil, China, and Russia may come to mind. All have large economies and close ties to many developed nations.

And in some cases, countries that are really emerging markets are not classified as such. Argentina, Croatia, Estonia, Lithuania, the Ukraine, and Vietnam are emerging markets, but categorized as frontier markets. And countries such as Ghana, Jamaica, and Saudi Arabia are neither currently classified as emerging or frontier markets.

When assessing potential investments, do not assume that an emerging market investment falls under a common sense perspective. You need to dig a little deeper to really know what you are investing in.

That way, you will be able to build a more effective and efficient investment portfolio.

Next a look at the potential advantages of adding emerging market assets to your portfolio.

Should You Actively Invest?

It is highly questionable as to whether active management is appropriate for investors.

You can find studies that indicate active management can provide superior performance in certain circumstances. But more studies conclude that, over the long-term, active management does not outperform a passive approach.

What do I think?

I believe investors should generally stick with a passive approach to investing. However, I believe that there are times when it is beneficial to use active management. Today we will look at situations where I believe that active management can provide value.

Note that while I shall lay them out separately below, usually a specific investment resides in multiple boxes.

Niche Markets

I believe active management can be used in niche markets that require specialist knowledge.

In niche markets, the number of knowledgeable analysts is less than for stocks and bonds. The less competition in researching investments, the greater the probability that a true expert can find value amongst individual assets. Also, the less competition, the easier it is to differentiate the top experts from the mediocre and poor ones.

Fine art, collectibles, gems, and wine are a few examples of niche markets.

In areas such as these, I believe experts have a definite advantage over most other investors in the segment. Therefore, being an expert, or following their recommendations, may allow for outperformance of the niche market as a whole.

I also believe that expertise in specific fields can translate into active management success even in non-niche markets.

For example, if you are a heart surgeon, you may be able to assess developments in cardiovascular tools and related public companies better than most other investors. Similarly, if you work in the high-tech industry, you may have an advantage in determining which high-tech companies and products have better likelihoods of success.

Investing in market segments where you have better technical knowledge than others may give you an edge when trying to select individual investments.

Inefficient Markets

A tenet of passive investing is a belief in markets being highly efficient.

An efficient market is one where securities' prices reflect all relevant information. If true, then it is not possible to use active management techniques (individual security analysis and selection, market timing, etc.) to "beat the market". A passive strategy of trying to only match the market return is the only investing option.

However, some markets may not be fully efficient. In these markets, active management may outperform passive.

Niche markets are often inefficient.

Do all investors have access to the same information concerning a new artist? Do all investors possess the same skill to assess the quality of diamonds and rubies? Probably not.

Securities markets may be less efficient in developing countries.

Some countries may not have stringent insider trading regulations. Some countries may not have comprehensive reporting requirements for companies. Some countries may be more corrupt than others. Without proper rules and governance, certain individuals may possess corporate information that other investors do not receive. This can lead to inefficient markets and allow the investors with the information to prosper.

Companies that do not trade on established markets may suffer from inefficiencies as well. Shares that trade “over-the-counter” (OTC) tend to have less consistent publicly available information for investors to assess. Compounding this is that OTC stocks often have a limited corporate history in which to examine.

Investors with preferential access to information on investments or possessing specialized knowledge concerning an inefficient market, may succeed utilizing active strategies.

Ignored Markets

Because of perceived inefficiencies in some developing markets, analysts and investors may avoid following and investing in these markets.

Even in developed nations, some market segments may not be extensively covered by analysts. Analysts and investors do an excellent job of monitoring the large-cap stocks. But often nano or micro-cap companies are ignored.

The avoidance is nothing nefarious. Rather, information availability is better with larger companies, so they are easier to monitor and assess. Also, small companies typically have a limited number of shareholders as compared to larger companies. So there is less interest in the market for small companies.

For example, consider China Logistics Group (CHLO), an OTC stock. On October 27, 2010 it had a share price of USD 0.04, a market capitalization of USD 1.58 million, and 39.51 million shares outstanding.

Some investors may not invest in penny stocks either by choice or based on regulations or internal investment objectives. For example, in some jurisdictions funds may not be eligible to trade equities beneath certain price levels or that do not trade on authorized exchanges. As well, a fund prospectus will disclose the investment objectives and any constraints that may be imposed on investment options. As a result, some funds may not be able to invest in China Logistics, so their analysts do not cover the company.

Other investors or funds may avoid nano-cap companies on logistical grounds.

Consider the Fidelity Advisor Small Cap Growth T (FCTGX) mutual fund. It invests in small-cap stocks, so perhaps China Logistics is of potential interest. But if we look at the Fidelity fund, we see that it has assets under management of USD 1.5 billion. China Logistics only has a market-cap of USD 1.58 million. All it would take is for Fidelity to invest 0.1% of their assets into China Logistics and they would own every available share. And given restrictions on ownership levels in companies, Fidelity would not want to own 100% of China Logistics.

Imagine Fidelity investing in a slew of China Logistic size companies. Investing less than USD 0.5 million in company after company would be a logistics (no pun intended) nightmare for Fidelity. That would be 3000 companies to trade, monitor, and account for. Not the easiest, wisest, or most cost-effective proposition.

With less investors seeking opportunities in ignored markets, those that do may find active strategies successful.

Note that trading OTC shares can be a high-risk strategy. The lack of publicly available information, possible lack of corporate history, and potentially less rigorous regulatory oversight increase risk for these shares. Further, there are also liquidity issues with many of these companies which can impact one's ability to trade the stock. I suggest extreme caution should you ever decide to trade OTC stocks.

Long-Term Market Phases

Market timing can be a costly strategy for investors. It is not an easy thing to do and if you are late to either enter or exit a market as it changes direction, you can lose a fair bit of money. Please see my discussion on investment bubbles for problems with market timing.

And based on many studies, it does not seem to be a successful long-term strategy to pursue.

However, I do think that sophisticated and professional investors can take advantage of long term market phases to beat a benchmark over the short-term.

In prolonged bear markets, by moving portfolio assets into cash or defensive assets, a prudent investor may be able to protect the portfolio. When the market turns upwards again, the investor divests the safer assets and returns to the relevant asset class.

In lengthy bull markets, allocating capital into higher risk (with higher expected returns) assets or using leverage and derivatives may enhance the bull market impact on one's portfolio.

Of course, shifting assets around in one's portfolio requires incurring extra transaction costs.

It also may trigger premature taxable capital gains upon the sale of an investment that was sold due to market timing.

These costs, along with the cost of not timing the market swings correctly, can have a significant, and negative, impact on your performance. They are a major reason as to why active management suffers in comparison to a passive, and non-trading, approach.

Conclusion

These are the areas in which I think investors can successfully utilize active strategies to outperform a passive approach, at least in the short-term.

In each circumstance, specialized knowledge is necessary to take advantage of the situation.

If you possess expertise in certain fields, I suggest you incorporate that knowledge into your overall investment strategy.

If you do not possess the skills yourself, you can pay someone to provide the service for you. However, the greater the expertise required, the greater the management fee charged. And the greater the fees, the higher the returns needed to beat the passive benchmark. When outsourcing technical expertise, be sure that you are receiving value (in the form of superior performance) for the price you are paying. In most cases, you do not.

In each area above, investment options tend to be relatively high risk.

Before you invest, make certain you understand the risks associated with investing in niche markets, developing countries, OTC shares, and the like. Without the specialized knowledge of the market, your odds of success are rather low.

Next we will look at passive investing.