What Are the Unique Risks Associated with Foreign Investments?

In our last two articles we asked **why aren't you investing offshore** and wondered about a coming **European economic boom**. But if you are thinking of putting your money to work outside of the USA, what are the unique risks associated with foreign investments and how can you avoid them? *Investopedia* writes about the **three biggest risks** that international investors face. These are transaction costs, currency risks and liquidity risks.

The Cost of Investing Offshore

> *Likely the biggest barriers to investing in international markets are the transaction costs. Although we live in a relatively globalized and connected world, transactions costs can still vary greatly depending on which foreign market you are investing in. Brokerage commissions are almost always higher in international markets compared to domestic rates. In addition, on top of the higher brokerage commissions, there are frequently additional charges that are piled on top that are specific to the local market, which can include stamp duties, levies, taxes, clearing fees and exchange fees.*

Currency Fluctuations and Worse

> *When investing directly in a foreign market (and not through ADRs), you have to exchange your domestic currency (USD for U.S. investors) into a foreign currency at the current exchange rate in order to purchase the foreign stock. If you then hold the foreign stock for a year and sell it, you will have to convert the foreign currency back into USD at the prevailing exchange rate one year later. It is the uncertainty of what the future exchange rate will be that scares many investors. Also, since a significant part of your foreign stock return will be affected by the currency return, investors investing internationally should eliminate this risk.*

Buying stocks as ADR's is a simple solution for someone who wants to invest only in foreign stocks. Otherwise you need to know how to use the Forex market to hedge your currency risk. Because currency futures, options and forwards are relatively complex for beginners an alternative might be to use a currency ETF. Of course the worst risk is if a country goes bankrupt, its currency becomes worthless and assets get frozen.

Liquidity Issues

> *Another risk inherent in foreign markets, especially in emerging markets, is liquidity risk. Liquidity risk is the risk of not being able to sell your stock quickly enough once a*

sell order is entered. There are some common ways to evaluate the liquidity of an asset before purchase. One method is to simply observe the bid-ask spread of the asset over time. Illiquid assets will have wider bid-ask spread relative to other assets. Narrower spreads and high volume typically point to higher liquidity.

Sovereignty Risk

This one is our own take on foreign investment risk. If you owned assets in Libya before Gadhafi took over in the 1970's you lost everything. The same thing happened in Cuba with Castro and to a degree in Venezuela first with Chavez and now Maduro. Unique risks associated with foreign investments can include having a strongman take over and nationalize all private assets. Make sure you have a clear sense of how stable the country is before investing there.

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