What is Freedom Investing?

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Freedom Investing: Investing in Economically Free Countries

> ### Would you rather put your money in companies founded in North Korea or in South Korea?

This is the opening thought experiment posed by Megan Russell of Marotta Wealth Management. The difference between the two is obvious. Do you want your money sitting in a state-controlled environment like North Korea or in a more economically free country like South Korea? It's important to understand global investments and how they fit into your overall investment portfolio.

About Megan

You can listen to Megan Russell and I chat about Freedom investing on a recent episode of my podcast. We explore Marotta Wealth Management's ideology and strategy with regard to Freedom Investing. Megan is no stranger to the topic. On her blog, Marotta on Money, she has spent years exploring this topic and has an admirable history of openly sharing her strategy and results. Megan has done a lot of first-hand research in this area and shares her expertise on the show and in what follows.

What is Freedom Investing?

The simple thought experiment above was meant to give you pause for thought. What does it mean to invest in an economically free environment? For starters, companies without state control can pursue profits, hire and fire employees, and innovate without fear of retribution. Freedom to explore opportunities is not a given around the globe. It makes sense to avoid companies operating under a regime that can change the rules at a moment's notice, potentially wiping out your gains.

How do you go about determining which countries are "economically free?" Luckily, you don't have to figure it out on your own. The Heritage Foundation has developed an Index of Economic Freedom. Countries are evaluated on a number of criteria including, but not limited to, labor and monetary freedom, government spending, and tax burden. The list is updated yearly and offers results on a scale from 0-100 which allows you to take a deeper dive into the component parts.

In terms of strategy, the idea is to invest your money into countries where the operating environment is on the high end of the economic freedom scale and avoid those countries that fall on the low end. It makes intuitive sense that the local laws and culture will greatly impact the success of a company, but what do the numbers say?

How does Freedom Investing Perform IRL (in real life)?

Megan and the Marotta on Wealth blog offer insightful details about the specifics of Freedom Investing. You can read a variety of articles on their website that include backtesting and refining results if you want to immerse yourself in the details. I'll give you some tips for implementing the strategy a bit further along in this article but let's first explore just how much of a difference it could make.

Megan found in her backtest of their current strategy that "basically the average advantage of freedom investing is a 2% annual advantage" over the MSCI EAFE index.

In "A 25-Year Review of Freedom Investing", Megan explains how compared to the EAFE, "on average Freedom Investing has a 1-year advantage of 2.093%, 5-year advantage of 1.995%, 7-year advantage of 2.314%, 10-year advantage of 2.400%, 15-year advantage of 2.392%, and 20-year advantage of 2.073% over the EAFE Index."

The MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia, and the Far East, excluding the U.S. and Canada. It covers approximately 85% of the free float-adjusted market capitalization in each country.

This is a good benchmark for comparison because the Freedom Investing strategy is investing in developed markets outside the US.

As is always the case with factors, in the backtests of results over varying lengths of time sometimes Freedom does better and sometimes not, but, Megan writes, "of the 293 measured 1-year periods, Freedom Investing lost to the EAFE Index in 96 of them" while "of the 185 measured 10-year time periods, Freedom Investing lost to the EAFE Index in 0 of them."

While 2% may not sound like much, let's take a closer look. Say that you invest $10,000 and assume the EAFE Index gets a 6% annual return and Freedom Investing returns 8% per year. After 1 year, you are obviously **ahead** by only $200 ($10,800 in Freedom versus $10,600 in EAFE). By year two Freedom Investing is ahead by $428 and in year three that's $686. But compounding continues its yearly march and after 20 years the Freedom Investing account has outgrown the EAFE account by $14,538 or 45%! That's 45% more money by investing in countries that are freer.

A Note About Risk

Does this investment strategy come with more risk? We typically measure risk by the standard deviation of returns, or volatility, which is how much the portfolio goes up and down. This is a terrible way of measuring your risk, but it's the industry standard for portfolios. By that measure, looking backward with actual results, it turns out that Freedom investing had a superior risk-adjusted return. You can read more about this in Megan's "Risk-Return Analysis of Freedom Investing."

Where does Freedom Investing Fit Into Your Portfolio?

As mentioned above, this strategy is to invest in developed countries with greater degrees of economic freedom and not include those with heavy restrictions. The US is near the top of the economic freedom index (currently 20), and that's essentially where the line is drawn: those above the US are freer and those below should not be included in your portfolio. However, not all of those 20 countries have large enough markets to warrant investment and there are some other nuances to take into consideration (listen to the podcast for more discussion on this topic).

Since these are developed countries outside the US, it makes sense to think about this portion of your portfolio as the International (not including Emerging Markets), or the ex-US developed countries.

What About Emerging Markets?

Notably, there are two countries that are more free than the US, large enough to warrant investment but lie within the FTSE emerging markets, rather than developed markets: Taiwan and Chile. There's no technical definition of what is an emerging or developed country but generally, developed countries have more advanced economies and mature markets. And most importantly for us, companies that maintain market indices define which countries are part of which index. Since emerging markets have their own risk/reward and different labor forces at play, it makes sense to separate them from developed markets.

You might feel confident replacing your developed market (index) investments with the freedom investing strategy discussed here since it includes approximately 10 different countries. This keeps your international investments well diversified. On the other hand, since emerging market indices generally include 20+ countries, only investing in Taiwan and Chile may not be diversified enough.

How Do I Implement Freedom Investing?

So, how do you actually put this strategy to work within **your** portfolio? Aside from the obvious: compiling research and determining what works best for your situation, you should also consider the following (in order from most to least complicated):

1. Make a list of the investable, free countries from the Heritage Foundation. Look at the market-cap-weight from FTSE for those countries and divide your investment into country-specific funds (see below for a list of funds).

2. Same as #1, but just equal-weight the countries (i.e. 10% into each of 10 country-specific funds).
3. Decide on a handful of free countries and put some investment into each**.**
4. **Get someone else to do this for you!** Give me a call or check out Marotta Wealth Management,

Bottom Line: Investing in Free Countries Makes Sense

What I love about Freedom Investing is that the strategy makes intuitive sense and the backtesting results support the concept. Furthermore, it feels good to put your money in business owners that are allowed to operate with freedom and own the rewards. Investing in countries that allow businesses more freedom to operate is a win-win-win.

I want to extend my sincerest gratitude to Megan and her firm for openly providing so much information about this Freedom Investing strategy and beta testing results for many years. I'm not a fan of complicated investing. Freedom investing is a strategy I use because it's simple to understand and easy to execute as a buy-and-hold investment.

To read more about Marotta Wealth Management's latest updates on their Freedom Investing strategy, you can browse their articles on the topic here. If you have any questions or comments, please feel free to reach out!

List of Funds

The following is the list of country-specific funds Megan's team uses in their implementation:

- Australia: FLAU
- Canada: FLCA
- Hong Kong: FLHK
- Switzerland: FLSW
- United Kingdom: FLGB
- Denmark: EDEN

- Finland: EFNL
- Ireland: EIRL
- Netherlands: EWN
- New Zealand: ENZL
- Singapore: EWS
- Taiwan: FLTW
- Chile: ECH

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