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Global equities: A core investment strategy in an integrated world

Whitepaper

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Executive summary

Investing globally allows investors to take advantage of long-term structural shifts which have brought about the integration of economic activities across borders and through markets. As the driving forces of globalisation, the liberalisation of trade and technological advances have played a crucial role in generating a dynamic market of opportunities spanning thousands of companies across different geographies, sectors and market capitalisation.

The principles of sound investment in a diversified portfolio of global stocks are consistent with a regional approach. The focus should be on strong companies with sound fundamentals, good management, a strong balance sheet and an attractive valuation. However, research shows that investors across the globe continually under-allocate to global equities. What investors tend to have is a home-country bias, focusing investments on domestic markets instead.

In this paper, we consider:

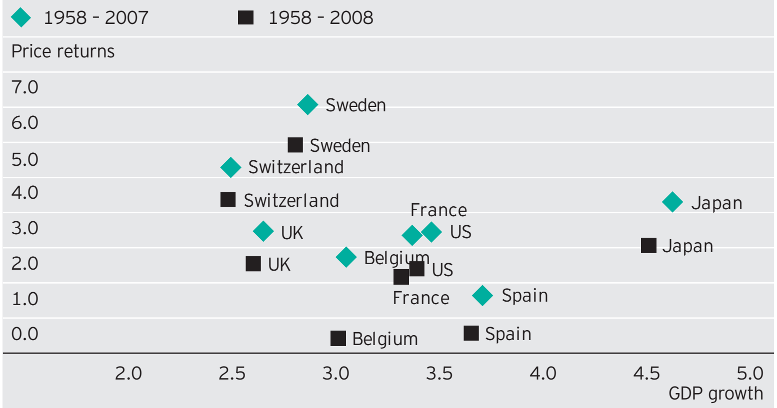
i: The irresistible rise of globalisation
ii: The benefits of global equity investing

In our view, seeking the best investment ideas from anywhere in the world opens up investment horizons, giving investors the scope to invest free from restrictions imposed by geographic boundaries. We believe it is more appropriate to focus on company valuations and an individual company's ability to grow revenues and margins, rather than a country's ability to grow its economy, as a means of generating outperformance over the longer term. And at a time of heightened geopolitical risk which has led to high levels of market volatility, global equities can be shown to reduce portfolio risk and the magnitude of one-off losses as well as making returns more consistent.

The irresistible rise of globalisation

The shifting balance of power in the global economy has had far-reaching consequences. This change is not just an emerging markets story and nor is it a new one – markets continually evolve over time. Although the term 'emerging markets' dates back only to the early 1980s, during much of the 19th century the US would have been regarded as a classic emerging market. The changes we are witnessing today underline the resurgence of China and India in the global market. We are seeing an economic and industrial catch-up that is bringing profound changes to the global financial landscape. The disparity between GDP growth in the emerging world and the developed world illustrates this point. This has led us to consider the relevance and impact of economic growth on equity returns. On a country basis it is apparent that, in the long term, there is no tangible relationship between economic growth and stock market returns. Figure 1 plots stock returns versus GDP growth for eight developed markets between 1958 and 2008 and shows negative correlation. By changing the period by only one year to 1958-2007, though the results change, the observed correlation is still negative. This challenges the assumptions that GDP growth translates into stockmarket performance. Equally, a country's stockmarket performance does not automatically reflect its local economy.

Figure 1.
Real GDP growth vs. real stock price return in selected countries



Source: MSCI Barra, IMF, OECD. May 2010. Growth rates are annualised.

Yet the changing trend in GDP growth rates is not without impact. For much of the 20th century, the US was the undisputed economic heavyweight with key relationships in the world market defined as such. But with the emergence of China and India on to the world stage, these relationships have started to alter, with implications for how companies face the opportunities and exploit the possibilities offered by the global marketplace.

A history of trade liberalisation

In recent decades, the world's economies have developed ever-closer links in trade and production, coinciding with developing countries making greater forays into the global market. Yet international trade is not a recent phenomenon – it has been present over the course of history. As early as 206 BC the Silk Road was a series of trade routes that crisscrossed Asia, linking it to Southern Europe and North Africa. The routes enabled the transportation of goods and the spread of knowledge and ideas and laid the foundations for the modern world of global commerce and industry.

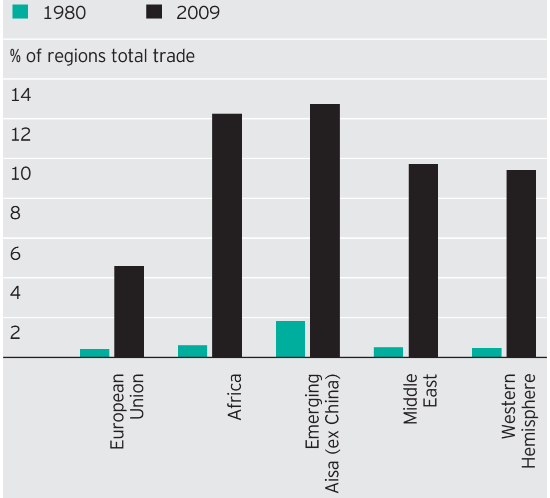
For over two thousand years, the integration of economies and societies around the world was a process that had evolved slowly, with the expansion of world trade as the linchpin. However, the advent of trade liberalisation after World War II is one of the most important stages in the modern history of globalisation and it brought about some of the most rapid change. In the summer of 1944, delegates from 44 countries met in Bretton Woods, New Hampshire, as they formulated their strategy for post-war reconstruction.

The Bretton Woods conference established a rules-based system of international finance. The end of World War II spurred efforts to correct trade restrictions which had been imposed between the two world wars. The resulting multilateral trade agreements and other forms of international economic cooperation led to the General Agreement on Tariffs and Trade (GATT) in 1947 and laid the foundations for the World Trade Organisation, with the remit of liberalising trade and dealing with the rules of trade between nations at a global level. Through the elimination or reduction of trade barriers, such as import tariffs, world trade among developed countries grew rapidly in the post-war years, helping restore confidence in the world economy, boosting world output and raising the standard of living.

For some, the end of the Cold War with the fall of the Berlin Wall in 1989 marked the embrace of open markets and global capitalisation. Yet for others, 1978 was the defining moment in recent history[1]. The opening of China to the outside world through a policy of reform initiated by Deng Xiaoping brought China back into the mainstream of international politics and economics. Time magazine even made Deng its 'Man of the Year' in 1978, remarking that some of the reforms he was advocating 'sometimes look surprisingly like a capitalist road'. A year earlier, Deng himself had declared that: "To get rich is glorious." Economic progress has since been rapid.

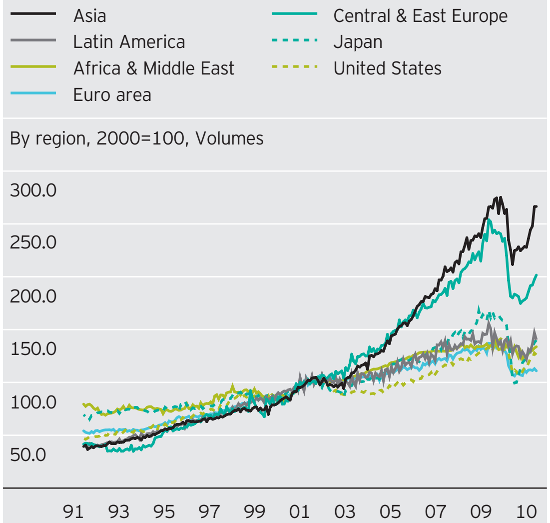
According to the IMF[2], the opening up of China has meant increasing links with the rest of the world, as reflected in its rising share in world trade, global markets for selected goods and capital flows. China's share in world trade has increased nearly tenfold over the past three decades, to about 9%, while its share in world GDP has risen to 13% from less than 3% (source: IMF, World Economic Outlook, Dec 2010). The increase in China's share of world trade is particularly significant in certain markets. China now accounts for nearly one-tenth of global demand for commodities and more than one-tenth of world exports of medium- and high-technology manufactured goods. China's rising share in world trade over the past three decades is underpinned by a rise in its share of external trade with every major region (see Figure 2).

Figure 2.
Surging trade
China is an increasingly important trading partner with all regions



Source: IMF; Direction of Trade Statistics; Financial Times, December 2010.

Figure 3.
World export trends, 1900-2010



Source: CPB Netherlands Bureau for Economic Policy Analysis (www.cpb.nl), OECD, May 2010.

Thirteen years after the opening of China, India became the last major world power to join the ranks of globalising nations. On the eve of presenting the new budget in 1991, India's then Finance Minister Manmohan Singh quoted the French novelist Victor Hugo, proclaiming that: "No power on earth can stop an idea whose time has come". Over the next few years, the government pushed through a collection of market-based reforms. Businesses were opened up to the private sector, laws on foreign investment were liberalised, the stockmarket was opened up for foreign investment and capital began to flow into the country.

India's trade restrictions had previously been among the most severe in the world, but the decline in tariffs was followed by a substantial increase in trade flows. The ratio of total trade to GDP increased from a base of 13% in the 1980s, to nearly 19% of GDP in 1999/2000[3] and to 35% in 2005[4]. India's economic growth is now among the fastest in the world. It is projected to grow by 8.75 percent in real terms in 2010/11, moderating to about 8 percent the following year[5].

India weathered the recent global financial crisis well, and since mid-2009 domestic demand has powered a strong recovery. Domestic demand is key to the future prospects of India and China and other emerging economies. It is difficult to conceive that these countries can continue to grow by taking export market share from other (developed) countries. The only sustainable way for them to grow will be via domestic demand that ultimately expands the global market for US and other developed country exports.

Trade and development today
Indeed, while the recent recession was associated with the worst decline in trade in recent history[6], it did not reverse the fundamental shift to a more globalised world economy (see Figure 3).

Productivity growth is at the heart of economic progress. The World Bank reported that per capita real income grew more than three times faster for developing countries which lowered trade barriers (5.0% per year) than those which didn't (1.4% per year) in the 1990s. The benefits of openness and lower trade costs apply to firms and shareholders alike too. According to the OECD[7], trade drives the reallocation of resources towards more productive firms, leading to their expansion and the contraction or exit of relatively unproductive competitors from the market. The research also shows that increased competitive pressures induce changes at managerial and organisational levels, which in turn boost within-firm productivity.

In the global market, greater imports offer consumers a wider variety of goods at lower prices, while providing strong incentives for domestic industries to remain competitive. Exports, often a source of economic growth for developing nations, stimulate job creation as industries sell beyond their borders. More generally, trade enhances national competitiveness by driving workers to focus on those areas where they, and their country, have a competitive advantage.

Capital flows have always played a prominent role in the growth of global trade. In the last few decades, the liberalisation and deregulation of global trade have contributed to a strong surge in Foreign Direct Investment (FDI) flows, with important consequences for the development of technological know-how and the geographical pattern of industrialisation[8].

Trade liberalisation has also brought about multinational cooperation. According to author Thomas L. Friedman[9], this is becoming one of the most powerful drivers of the global economy today.

Take, for example, the Apple iPad 2, unveiled in the UK in March 2011. To build the second generation iPad, well over 100 companies from countries including Japan, Taiwan, Korea, and the US, produced components which were then assembled in China by a Taiwanese company called Hon Hai (whose trade name is Foxconn). The camera lens, for example, was made by three Taiwanese companies: Asia Optical, Largan, and Genius; the memory by Korea-listed multinational conglomerate Samsung; and the high frequency devices by Murata in Japan. The production involved suppliers from around the world collaborating for their mutual benefit. More broadly, whether used for domestic production, consumption or re-export, imports can give firms access to new technologies and critical inputs at competitive prices, making it possible for these firms to become more competitive.

In our view, it is important to move beyond the emerging markets versus developed markets debate, as it is clear that there are high and low growth countries and high and low growth industries globally. Citigroup[11] has identified its Global Growth Generators, or 3G – the countries that over the next 5, 10, 20 and 40 years are expected to deliver high growth and profitable investment opportunities, wherever they may exist. Global Growth Generators are not exclusively countries either, they could be companies too, such as the Global Growth Companies (GGC) of the World Economic Forum (WEF), created in 2007. The purpose of this initiative is to "identify those players that in addition to showing consistently high growth rates, through their new technologies and innovative business models, act as disruptors of traditional industries. GGC members come both from fast-growing emerging markets and from established economies." As of April 2011, 300 companies from over 60 countries had been admitted to the GGC Community. A typical GGC has consistent annual growth rates exceeding industry and regional averages by 15%; minimum turnover between US$ 100 million and US$ 5 billion, depending on the industry; demonstrated growth potential; capacity and intent to build a global business; and exemplary executive leadership.

The benefits of global equity investing

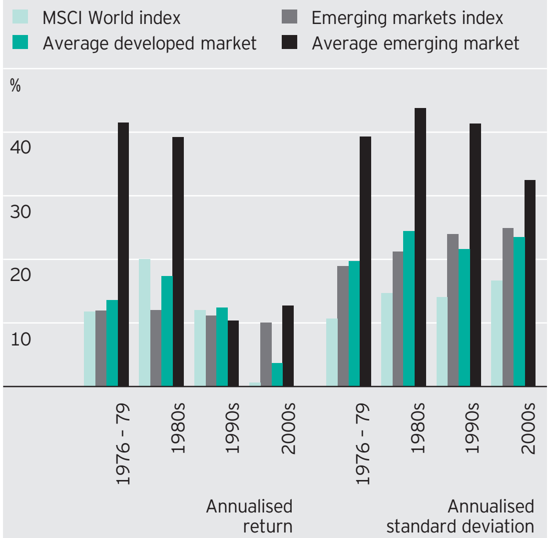
Globally equity investing has traditionally been structured around country asset allocation. This approach was supported by observations that the country factor is a major source of influence on stock-price behaviour. But for companies today, the opportunity set is a marketplace many times the size of any single economy, with a combination of mature and growing economies in which they can operate. In an integrated world economy, the corollary is that companies face global, not local competition. In such a world, we believe that companies which can survive, compete and prosper in an increasingly competitive global environment provide a compelling opportunity for investors. For these companies, movements in their share prices are more accurately reflected by global factors in relation to the geographical breakdown of their activities rather than where their headquarters are located or where their stock is traded. The US market, for example, is closely linked to emerging world growth with nearly a quarter of total US profits and about 30% of S&P 500 sales generated abroad[12].

In our view, some of the most attractive investment opportunities are companies which are not limited to their local market. For example, Spanish construction and engineering firm Obrascon Huarte Lain derives most of its earnings from concessions (toll roads etc) in Latin America, while Compass group, the leading provider of contract catering and support services in the UK and Ireland, derives 40% of its sales from North America, 26% from Europe, 17% from the UK, and another 17% from the rest of the world. Likewise, Chinese shoe retailer Daphne International offers exposure to Chinese consumption growth while German luxury car manufacturer Daimler is also experiencing high growth among Chinese consumers. According to the WTO[13], exporting firms across a number of countries are more productive than non-exporting firms. This is by and large a 'selection' effect, with the more productive firms choosing to become exporters, while less productive firms choose not to. A more level global playing field means that the old rules linking a company's nationality and its economic exposure no longer apply. Emerging market companies that trade internationally may be dependent on growth in the developed world. Similarly, multinationals in leading economies may be relying on growth in emerging countries.

The advantages of a globally diversified portfolio
Traditionally, emerging markets have been viewed as riskier than developed markets. The financial crisis, which originated in developed markets, has shifted perceptions, and the risk gap is now seen as smaller. Some have even claimed that developed markets are now riskier. However, between 1976 and 2009, the emerging markets index has been consistently more volatile than the MSCI World index. Although the gap has narrowed somewhat, even over the last decade, emerging market returns had an annualised standard deviation of 25%, compared to 17% for the MSCI World[14]. Holding a diversified portfolio of emerging market stocks is still appreciably riskier than a diversified portfolio of developed countries. See Figure 4 for how individual emerging markets are on average much riskier than individual developed markets, although their risk has fallen steadily since the 1980s.

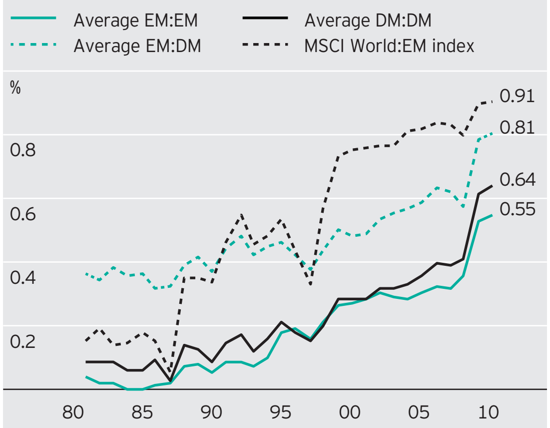
What really matters, in our view, is not the volatility of individual markets but a diversified portfolio of both developed and emerging markets. Diversification provides a strong motive for investing across both developed and emerging markets and for gaining cross-regional exposure to different economies and sectors. Single-country indices, are, in comparison, often dominated by one or two industries. The UK stockmarket, for example, is heavily weighted towards financials and energy with each sector comprising some 20% of the FTSE 100 index. At the other end of the scale, technology merely makes up a little over 1% of the FTSE 100, reflecting the narrow focus of the index. The

Figure 4.
Emerging market risk and return, 1976 – 2009



Source: MSCI Barra; S&P; Credit Suisse Global Investment Returns Yearbook 2010.

Figure 5.
Correlations between markets, 1976 – 2009



Source: MSCI Barra; S&P; Credit Suisse Global Investment Returns Yearbook 2010. Authors's analysis.

benefits of a diversified exposure are greatest when the correlations are low. Analysis shows that the correlations between developed and emerging market indices, as well as within separate baskets of developed markets and emerging markets, indicates scope for meaningful risk reduction (see Figure 5). We believe that the reduced volatility of a global equity strategy is of paramount importance in today's uncertain economic environment.

Figure 5 also shows that correlations between markets have gradually increased over time. Global equity markets have certainly become more integrated. This is most notable during periods of market turbulence when correlations tend to rise sharply as risk assets are more likely to fall together. This explains the recent jump following the credit crash and the subsequent rise in market volatility. Indeed, academic studies support the theory of rising market correlations. Bertoneche (1979)[15] found that correlations between global markets were below 0.20 in the 1970s. By the 1980s, Odier and Solnik (1993)[15] found many correlations to be around 0.50. Goetzman et al (2005)[15] substantiated these findings and concluded that diversification was enhanced by exposure to newer markets. See Figure 6 for historical individual country volatility compared to a diversified global portfolio.

Figure 6.
Benefits of Global Diversification: Lower Volatility

	Volatility (%)		Volatility (%)
Germany	32.4	Spain	22.2
Finland	30.4	Netherlands	21.9
Japan	29.9	Denmark	20.8
Italy	29.1	United States	20.4
Norway	27.5	United Kingdom	20.1
Belgium	23.7	Switzerland	19.9
France	23.6	New Zealand	19.8
Country average	**23.5**	Australia	18.2
Ireland	23.2	**World average**	**17.8**
Sweden	22.9	Canada	17.3
South Africa	22.6		

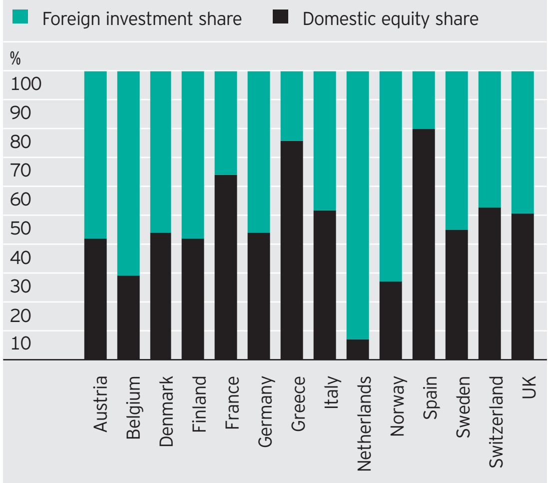
Standard Deviation: 1900 -2009.
Source: Elroy Dimson, Paul Marsh, Mike Stauton; Credit Suisse Global Investment Returns Sourcebook, 2010.

Beyond economic advances, a number of important factors in equity markets have increased the integration of global markets. The synchronisation of accounting practices and the tightening of regulations around foreign investment have encouraged global investing in recent years. Twenty four-hour trading platforms have become the norm, and companies with dual listings around the globe are growing in numbers: multinational companies like Nestlé and the New York Stock Exchange. Stock exchanges themselves are embarking on 'collaborations', reflecting the degree of opportunity within the global marketplace and the general direction of business practices today. Since February 2011, Deutsche Börse has been in talks to buy NYSE Euronext which would create the world's largest trading powerhouse. The London Stock Exchange also announced a merger with TMX Group, the operator of Canada's main exchanges.

In terms of accounting practices today, more than 110 countries around the world have adopted the International Financial Reporting Standards (IFRS), an established set of rules which provide a foundation for accounting standards around the globe. The broad adoption of IFRS has increased transparency and given investors greater confidence in buying international shares.

During the past decade, we have seen a sizeable shift in investor attitude towards a greater appetite for investing in companies with an international exposure[16]. Yet J.P. Morgan's study found that investors across the globe continually under-allocate to international equities, having an average exposure of only 51%. Investors with home-country biases risk missing out on the increasing opportunities for reduced risk and potentially higher returns offered by global equities. Investors have some way to go before they take full advantage of the benefits offered by a diversified portfolio of global equities (see Figure 7).

Figure 7.
Home bias – part of equity portfolio invested outside of resident's own country



Source: IMF, MSCI, J.P. Morgan Asset Management, February 2010.

In summary
The influence of country and regions has waned over the past decade while sector and security selection in particular, have increased in importance. In our view, there are clear diversification benefits from holding a broad spread of securities in a global portfolio. Diversifying globally by selecting best-in-class opportunities among individual stocks, regardless of geographic boundaries, potentially provides excess return in addition to diversification. The principles of sound investment are the same, whether investors have a global or regional portfolio. In our view the focus should be on strong companies with sound fundamentals, good management, a strong balance sheet and an attractive valuation. Seeking the best investment ideas from anywhere in the world opens up investment horizons and broadens peripheral thinking, giving investors the scope to invest in an unconstrained universe.

Important information