Volume 6 //

Acuity

The greatest wealth is **your peace of mind**...

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Going global -
can we do it by staying at home?

“Globalisation is an irreversible process, not an option”

Kofi Annan, former UN Secretary General

‘Globalisation’ – the buzz word of the past decade

It is almost impossible these days to turn on the news or open a newspaper without seeing yet another journalistic piece either about globalisation or the inexorable rise of China and other emerging economies and the transfer of economic power from West to East.

The question that many investors rightly ask themselves and their advisors is: how should we position our portfolios to take advantage of these trends?

The answer is a little more complex than simply relying on the global nature of many companies listed on the London Stock Exchange or allocating a material part of the portfolio to emerging markets – or a ‘BRIC’ (Brazil, Russia, India and China) fund.

This volume of Acuity seeks to explore some of the issues that surround the global diversification decision and how it can be satisfactorily resolved.

As ever in investing, there are no absolute right or wrong answers, but there are better solutions, which lie in decisions based on sensible magnitude and direction, rather than spurious accuracy. Robust portfolios are likely to encompass material exposure to companies listed and operating outside an investor’s home market, with material, yet controlled, allocations to emerging markets. Their extra return comes with extra risks.

Learning to live with a global portfolio and avoiding regret is an important part of a successful investment experience.

Three questions to get you started

A recent paper on globalisation[1] posed three simple questions with thought-provoking answers. They are worth repeating at the start of this brief insight into ‘home bias’ – the phenomenon (and puzzle) as to why investors, both individual and institutional, tend to have a far higher allocation to equities listed on their home markets, than to international markets. Investment theory and logic would suggest that home bias is neither entirely rational nor optimal. The questions posed were as follows:

Q1: What is the largest bank in the world, by market capitalisation (i.e. the value of its shares)?
Answer: ICBC of China.

Q2: Where is General Electric’s largest research & development facility located?
Answer: Bangalore, India.

Q3: How many of the top return-generating companies over the past three years were in the US?
Answer: one in the top 201.

Ever more global – a few interesting insights

The rate of globalisation has been dramatic over the past three decades, driven by free trade organisations such as NAFTA and the World Trade Organisation, lower tariffs on imported goods around the world, the global expansion of the supply chains and operations of multi-national companies, and the internet. Take McDonalds for example: twenty five years ago, the Big Mac was available in 6,000 restaurants in the US and 1,000 overseas. Today there are now more than 18,000 franchised outlets worldwide representing more than 50% of the corporation's profits. In fact, global trade has risen since 1970 from under 20% of global GDP to around 60% of GDP. Commercial shipping capacity doubled from 1980 to 2010[2].

Distinguishing between developed and emerging markets is not easy

Spurious accuracy is a danger in many fields – including investing. The use of pie charts in illustrating broad asset allocations (i.e. the mix of investments) is a common and forgivable example. Take for example the pie-chart on the left in Figure 1, which shows an equity portfolio divided into three 'clean' parts: a UK equity allocation, an allocation to non-UK (international) developed market equities, and a smaller allocation to emerging markets. It all looks neat and tidy, and helps to tell a basic story. In reality though, where does developed market equity end and emerging markets begin, and vice versa?

Take, for example, the FTSE 100 index (the top 100 listed UK companies by capitalisation). Around 70% of its constituent companies' earnings come from overseas, of which an absolute 20% comes from emerging markets. Standard Chartered Bank (sponsors of Liverpool Football Club, which has a very large following in Asia) derives most of its revenues from the emerging markets. Vodafone is another example of a company where the majority of its revenues are generated outside the UK. In the US, constituent companies of the S&P 500 Index derive in excess of 40% of earnings from outside the US, like McDonalds. In fact, over 21,000 multi-nationals operate in the emerging markets[3] and approximately 70% of world equity market capitalisation is dominated by them[4].

The same situation applies in reverse. Samsung Electronics, a Korean company, is one the largest stock in the MSCI Emerging Markets Index, and generates somewhere in the region of 40 percent of its revenues from Europe and the Americas[5]. The web of cross-border corporate earnings is extremely complex.

In reality, the asset allocation pie-chart should probably be represented by the chart on the right. Sensible investing works in orders of magnitude, not to two decimal places!

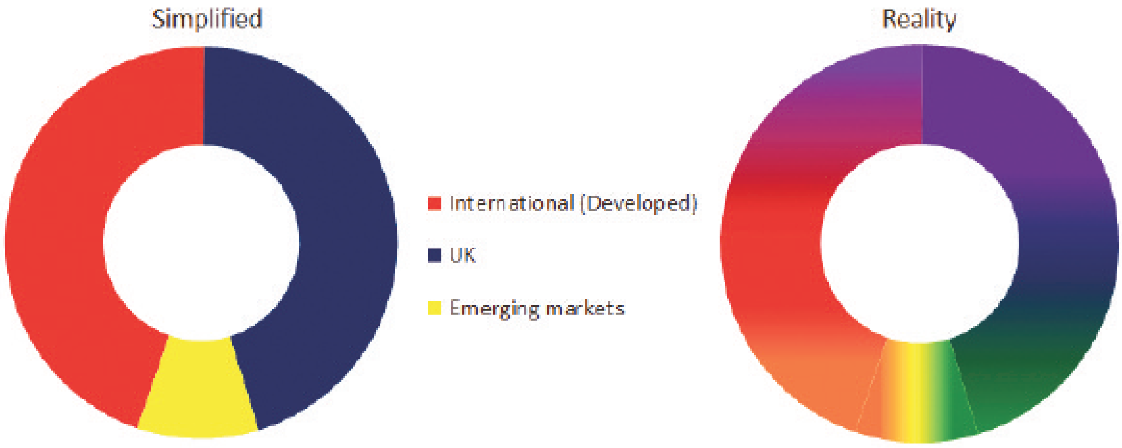

Figure 1: Where do developed markets end and emerging markets begin?

It is tempting to think that perhaps one could be sufficiently globally diversified by staying at home, safely investing in familiar companies like HSBC - the Hong Kong & Shanghai Banking Corporation to give it its full name. While that may be feasible, particularly if the home market is large and diverse enough such as the US, the solution is likely to be sub-optimal.

Arriving at a better globally diversified solution

Thirty or forty years ago, most investors had little choice but to employ a stockbroker to manage any investable wealth. Portfolios were made up of predominantly UK listed companies, such as Grand Metropolitan Hotels, British Leyland, Lucas Industries and Portland Cement, many of which operated largely in the domestic economy, while a few - such as ICI and British Petroleum - provided broader international exposure. Owning stocks like Whampoa Docks, listed in Hong Kong, provided some eastern spice.

Investors today have almost too many choices. Without due care, portfolios can end up containing risks that are ill-understood and potentially injurious to wealth. Taking advantage of globalisation needs to be undertaken within a risk-controlled framework, based on deep insight and a good dose of common sense.

What does investment theory suggest we should do?

Modern Portfolio Theory, the foundation stone of sensible investing, suggests that diversification - placing eggs in multiple baskets - can and should help to deliver a better relationship between the risk taken and the return received. On that basis, investors should consider spreading their equity eggs into baskets outside of their home market.

The paradox, as investors strive for diversification, is that globalisation appears to have increased the correlation between markets. During the credit crisis all equity markets fell together (although high quality bonds did a sterling job). Yet to dismiss diversification as a useful tool risks throwing the baby out with the bath water. For long-term investors, well spread portfolios have the likelihood, although not the guarantee, that they will deliver a better investment journey. Remember that the Japanese stock market languishes at around 25% of its highpoint of almost 20 years ago. The risk of owning the UK market alone is therefore evident. Diversification by market is the only tool to protect against such an outcome.

Perhaps as importantly, one of the principal aims of our investment programme is to capture the wealth creation delivered by the dynamism of global capitalism. Remember that in 2010, the global economy actually grew by around 5%[6], after inflation, despite the sluggish, after-inflation growth of Western economies. In order to capture this wealth creation potential, over time, investors must own global capitalism in a far broader manner than is on offer by simply investing in FTSE companies, despite their overseas earnings exposure. The UK represents less than 10% of global market capitalisation, as Figure 2 illustrates.

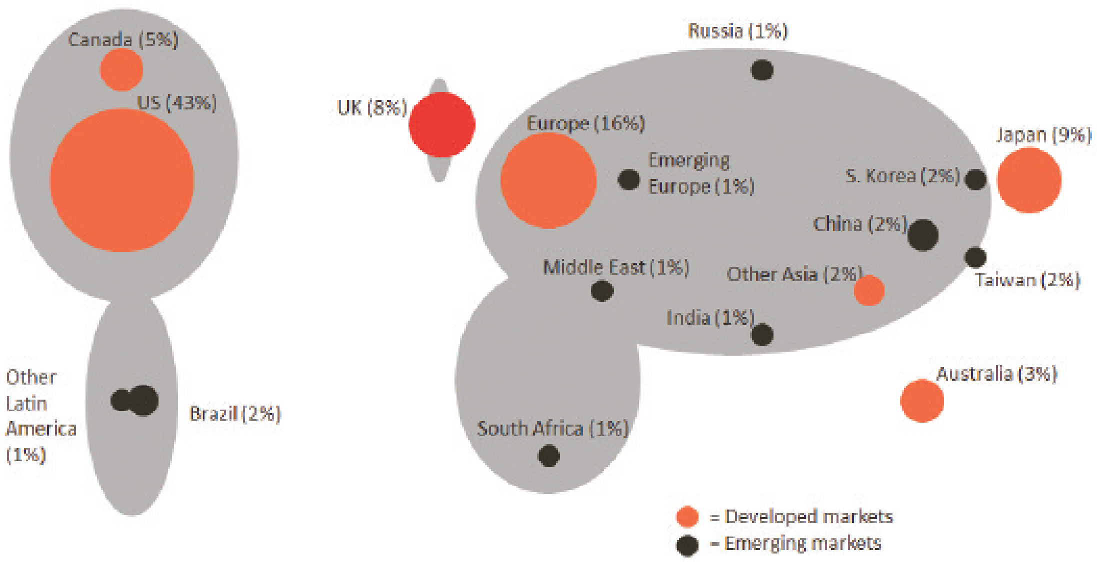

Figure 2: Global markets by capitalisation
Data source: MSCI. All rights reserved. Data at 31/12/2010

Diversification within developed markets (e.g. US, Germany, France, Japan etc.) is about risk reduction, not better returns. Over time the total cost of raising capital by companies in one market is expected to be broadly similar across all developed markets.

Companies in emerging markets, however, have a considerably higher total cost of raising capital. The flip side of the coin is that the expected return for providing capital (owning equities or bonds) is higher than that of developed markets. Many investors seem to forget that these risks are quite considerable and need to be taken in a controlled manner and in moderation; they include corruption, political instability, rule of law, freedom of the press, weak corporate governance and the sudden imposition of foreign exchange restrictions (remember Malaysia in 1997) to name a few.

What do the numbers tell us?

A piece of recent research[7] reviewed the benefits of the ownership of a global portfolio rather than a domestic portfolio, using market data from 1950 to 2009. It demonstrated that broad diversification made a material difference to wealth protection on the downside over 5 and 10 year time periods, across the majority of markets reviewed. The paper concluded that in the short-term, market panic and global contagion tend to result in markets falling together, but in the medium to long-term (which should concern investors more) the underlying basket of economic growth provides protection from one economy performing poorly.

What is happening in practice?

In practice, the realisation that global diversification of equity market exposure is beneficial over the medium to long-term has driven increasing allocations by both individual and institutional investors, although this still varies quite considerably by country[8], as Figure 3 illustrates.

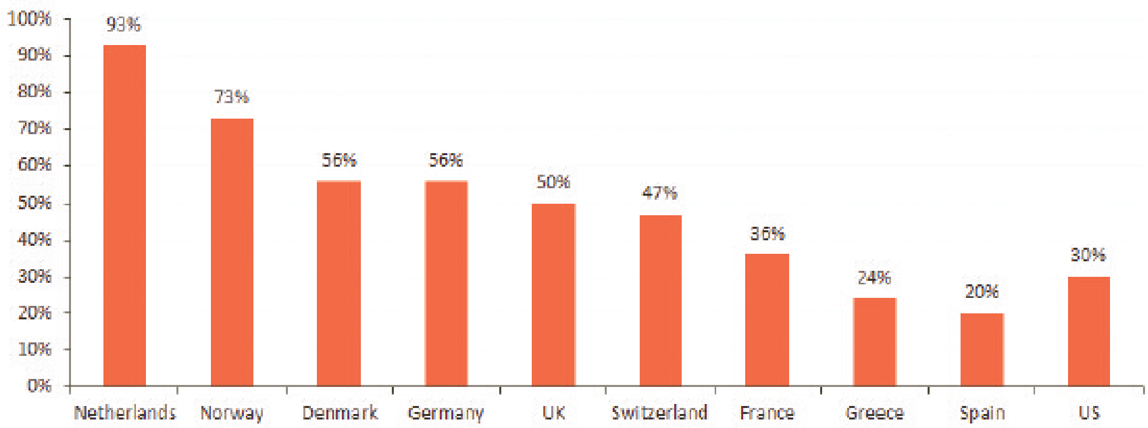

Figure 3: Home bias – percentage of portfolio invested internationally
Source: JP Morgan Asset Management (except US – Zweig, J., (2010) Placing Your Investing Chips in the Right Countries, WSJ)

Why does 'home bias' occur?

There are a number of suggested reasons why home bias occurs, such as avoiding non-domestic risks, the costs of investing overseas, information asymmetries - where investors know more about domestic stocks (or at least think they do), corporate governance differences and behavioural biases. It is likely that home bias is a mix of all of these to some extent, and will vary by investor.

On the behavioural side of the equation, some investors appear to have a distaste for, or fear of, foreign stocks[9]. Others tend to suffer regret when they own a portfolio that behaves differently from that of their home market[10]. Familiarity, patriotism and overconfidence, for example in names like Marks & Spencer or BP, sometimes makes investors feel that they are investing in something less risky, or with better prospects than an unknown name. In reality this is unlikely to be the case. Less sophisticated and experienced investors also seem to exhibit higher levels of home bias in their portfolios[11].

What does sensible diversification look like?

As ever in investing, the answer depends on investors' individual circumstances. However, a robust and eminently sensible solution comes from understanding and accommodating both the investment rationale and individual behavioural traits that make some investors feel more comfortable staying at home.

First, for a UK based investor, keeping a material allocation to the UK maintains the familiarity of well-known names, yet provides a level of 'going overseas by staying at home' diversification via UK-listed multi-nationals. It also minimises non-GBP currency exposure, although there is obviously still the unknown impact of currency on foreign earnings.

Second, making a material allocation to global companies listed outside the UK avoids the risk that the UK (or the home market of an investor not in the UK) performs poorly over the longer-term by providing a broader capture of the wealth creation potential of global capitalism. Returns from developed markets are expected to be broadly comparable over the longer-term, given the similar cost of capital.

It is interesting to note that by taking on non-GBP (or other home currency exposure), the risk of a global equity portfolio is largely unchanged, and the effect on returns is ambiguous – they may be higher or lower as a result[12], and over time should even out.

Third, a material, yet controlled, allocation to emerging markets provides exposure to this higher return opportunity, over and above that already inherent in the developed markets allocation.

Living with your portfolio and avoiding regret

It is important to make sure that you do not continually judge your robust, globally diversified portfolio against a home-based benchmark that is familiar to you, such as the 'Footsie' (FTSE 100). Torturing yourself over short-term market noise is a recipe for an unhappy investment experience. Try and remember the longer-term reasons why your portfolio is structured as it is and learn to take comfort in it robustness.

We hope that this paper has provided a little more insight to help do so.

End notes

1 Russell Investments (2010), Globalization, equity markets and the perils of home-country bias. Viewpoint (September, 2010)

2 Source: United Nations Conference on Trade and Development

3 United Nations World Investment Report, 2010

4 Brinson (2005), The Future of Investment Management, Financial Analysts Journal, found at www.ssrn.com.

5 Staverman, B., (2011) The Many Ways Into Emerging Markets. Bloomberg

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Other notes and risk warnings

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