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A Modern Rationale for International Equity Investing

By Egor Rybakov, CFA, Associate Equity Portfolio Manager
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The benefits of international investing have been questioned recently because of the rising correlations between markets in various countries. However, as pointed out by Bruno Solnik (Professor of Finance and Economics at the HEC School of Management in Paris) in AIMR's September 2002 conference proceedings, "Correlations do not tell the whole story. Benefits from diversification can still be gained by investing non-domestically. In constructing portfolios, investors need to evaluate the rising importance of industry factors over the country factors when selecting securities. And above all, investors need to consider company factors, such as where the company does business and how much business is done there, not just where the company is headquartered."

The last two decades have witnessed steady growth in international investing by American institutions and individuals alike. Research conducted by the D.C.-based Investment Company Institute (ICI) recently demonstrated that in the year 2001, 34% of all U.S. households that invested in mutual funds diversified their portfolios internationally by owning either a global or an international mutual fund. (Source: ICI's 2001 *Profile of Mutual Fund Shareholders*). And International Monetary Fund (IMF) data suggest that foreign equity ownership rose from 2.7% of total U.S. personal assets during the 1991-1995 period to almost 5% during the 1996-2000 period.

Traditional arguments for international investing rest on academic studies, which show that foreign assets added to domestic portfolios raise the Markowitz mean-variance efficient frontier above that of a portfolio with only domestic holdings. In other words, global diversification provides higher returns for a given level of risk or lower risk for a given level of return. While this had been a perfect case 25 to 30 years ago, rising correlations of cross-country returns over the last decade have made the benefits of global diversification less obvious. We do, in fact, agree that investment strategies based solely on country selections proved less effective in recent years. However, Thornburg continues to emphasize the benefits of global stock selection based on company-specific criteria.

Economic developments in recent decades were supported by a few important trends, including fading nationalistic economies and extension of economic collaborations on a global level. Global competition resulted in a more efficient allocation of resources and led to the creation of a broad variety of less expensive products and services. Today, even those investors restricted to the U.S. capital markets cannot afford to ignore the foreign competitive landscape. In automobile manufacturing, for example, the U.S. competitive environment has been permanently altered by counterparts in Japan, Europe and Korea. An analysis of the wireless handset market would be incomplete without considering Nokia, Ericsson and Samsung Electronics. And the U.S. consumer electronics market would be deficient without products from Sony, Toshiba, Samsung, Mitsubishi and Sharp. An average personal computer sold in the U.S. is almost all made of foreign (mostly Asian) components. Even analysts' predictions of U.S. computer shipments are closely linked to motherboard, memory module and flat panel display shipments from Asia. Many unique foreign companies, which now dominate a significant part of the world and U.S. consumer and industrial markets, are available to U.S. investors only through investing internationally.

Worldwide economic integration has not only eliminated many regional barriers to entry, but has also contributed to the formation of a global corporate mindset. Many companies expand overseas in pursuit of design and engineering talent, lower manufacturing costs, economies of scale, and even more importantly, new consumers. Cross-border mergers & acquisitions grew from 0.5% of global Gross Domestic Product in 1991 to approximately 4% at the end of 2000. This trend is reflected in Thornburg International Value Fund portfolio holdings as well. One of our former holdings, U.K.-based medical products manufacturer Smith and Nephew, attempted to acquire its Swiss competitor, Centerpulse. Another holding, British Petroleum, created a joint venture with Russian firms TNK and Sidanco to develop oil reserves in Siberia. OTP Bank, one of the leading Hungarian banks and also a recent holding of TGVAX, has been establishing its position in Central Eastern Europe through acquiring local banks outside of Hungary, including recent acquisitions in Slovenia and Bulgaria. Adding foreign revenues not only enhances corporate growth over the long term, but also gives companies the benefits of global diversification on the corporate level. A trend toward decreasing reliance on a specific geographical area, combined with faster growth prospects, should command higher valuations for these companies in the future.

Another important trend that became especially evident during the last decade is the increasing focus on consumers in emerging countries. Statistics suggest that the U.S., which hosts only 3% of the worldwide population, accounts for 17% of world consumption. Rising per-capita incomes and standards of living in China, India and the countries of Eastern Europe create enormous markets for products such as automobiles, consumer and household electronics, wireless communication, and financial services. In many instances, local companies are better suited to satisfy local demands due to their knowledge of domestic business trends and established reputations. One of our current holdings, Gedeon Richter, is a prime example of such a beneficiary. Gedeon Richter is a Hungarian generic pharmaceutical company that sells the majority of its products in the countries of Central and Eastern Europe. A combination of an aging population and growing healthcare spending, combined with Richter's solid reputation among local consumers, represents an attractive growth opportunity. Another holding, Mobile Telesystems, provides wireless services in Russia and other territories of the former Soviet Union. The company operates one of the largest and most reliable wireless networks in Russia, which has allowed it to capture the most profitable local corporate and private customers. Low wireless penetration in its regions of operations, combined with a low-cost network and aggressive expansion strategy, position Mobile Telesystems for profitable growth. Another recent addition, China Life Insurance Company, offers individual life, group life and accident and health insurance together with asset management services in China. It has the most recognized life insurance brand, largest distribution network and biggest customer base in China's life insurance market. A low rate of life insurance penetration in China, combined with rising income levels, an aging population and recent reform of the social welfare system (which has shifted the burden of welfare from the government to private industry) also represents an appealing growth opportunity.

Steady development of foreign economies has been reflected in the distribution of world market capitalization, which shifted from 66%/34% for the U.S./Rest of the World (R.O.W.) in 1970 to 48%/52% U.S./R.O.W in 2003. While it is generally more difficult to analyze a foreign company, recent improvements in accounting, disclosure and corporate governance have led to the creation of more efficient foreign markets and have made foreign financial analysis more accurate. Development of the aforementioned "global corporate mindset" has in part resulted in improving managerial practices within many foreign companies, including the adoption of international accounting standards, which have simplified cross-country comparisons. In addition, recent corporate scandals in the U.S. involving Enron, WorldCom, Qwest Communications and HealthSouth, demonstrated that even U.S. markets, long deemed the most transparent and efficient of all, are not immune to mischief. Admittedly, traditional concerns about currency risks remain. However, these concerns can be effectively mitigated (where risks are perceived) through currency hedges. In addition to currency hedges executed by investors, many companies hedge foreign exposure on the corporate level, thus leaving investors with smaller "net" currency exposure.

Many recent trends have been indicative of improving conditions in the area of international investing. While it may take international markets decades to reach the same levels of efficiency as U.S. markets, recent developments suggest movement in the right direction. International diversification, though it might look less obvious nowadays, continues to create a proposition of enhanced returns for domestic investors. A company-specific approach appears to make the most sense. Increasing flows of improved financial information, combined with cross-country analysis of industry competition, should increase the probability for successful international investing today.

Sources: "Cross Industry, Cross Country Allocation." Financial Analyst Journal, #6, vol.58, Nov-Dec 2002; "Global Consideration for Portfolio Construction," by Bruno Solnik; "Twenty Years of International Equity Investing," Richard O. Michand, Gary L. Bergstrom, Ronald D. Frahure, Brian K. Wolahan; Journal of Portfolio Management, vol #26, Fall 1996.