

A Modern Rationale for International Equity Investing



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) demonstrated that in 2001, 34% of all U.S. households that invested in mutual funds diversified their portfo-

lios 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. The U.S. consumer electronics market would be deficient without products from Sony, Toshiba, Samsung, Mitsubishi and Sharp.

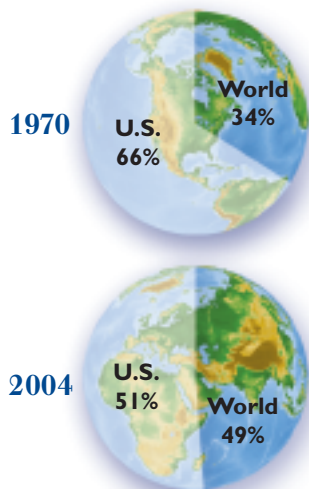
An average personal computer sold in the U.S. is almost all made of foreign (mostly Asian) components. Even analysts' predictions of U.S. computer shipments are closely linked to motherboard,

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. 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.

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Shift in U.S. and World Market Capitalization



Source: MSCI Blue Book

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.

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 (ROW) in 1970 to 51%/49% U.S./ROW in 2004 (see pie chart above). 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, 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.

The Thornburg International Value Fund takes advantage of this increased flow of information, employing a bottom-

up approach to bringing overseas opportunities home. Committed to hands-on, fundamental research, the team searches the globe for promising companies at a discount.

For additional information on Thornburg International Value Fund, please visit www.thornburg.com/fp



Sources:

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 Journal of Portfolio Management, Vol. 26, Fall 1996.

The views expressed by the Portfolio Managers reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change.

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