Global Investing - a whole world of opportunity

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For equity managers prepared to look beyond traditional stock markets and take positions outside of the constraints of benchmarks, there are huge opportunities to create value for investors by investing globally. This is of obvious interest to investment advisers but they should be aware of a range of common misconceptions about how fund managers construct international equity portfolios. As globalisation continues apace and the opportunity set for world equity managers expands, it is important for advisors to understand these myths to prevent misconceptions clouding their judgement when selecting managers on behalf of their investors.

Myth 1: Benchmarks are a good starting point for active equity investors

Whilst benchmarks can communicate information about past performance, they can't tell investors anything about the prospects or worth of companies, sectors or markets. They certainly don't reflect world productivity. Companies from the USA and Canada dominate the MSCI World Index, representing just over 50% of it's value, but the two countries are only responsible for 32% of world GDP. The opposite is true of Emerging Asia, which represents just under 4% of the index, but is responsible for about 10% of the world's GDP1.

At its simplest, a benchmark-hugging strategy means buying more of an index's largest companies, less of its smaller companies, and steering clear of non-index companies. But biggest isn't necessarily best. Investors don't know whether shares in an index's biggest companies will outperform in the long run, but they can be fairly confident that shares in good quality companies should. Following capitalisation weight benchmarks implies overweighting stocks that have traded well in the past. Why buy the largest companies simply to mirror an index, at the expense of other, higher quality companies? When it comes to portfolio construction, perhaps advisors should be looking for fund managers that choose to be benchmark aware rather than benchmark driven and, using first-hand research, concentrate on finding high calibre companies with appreciable long term prospects. Confidence in their research is what enables skilled managers to take decisive positions against a benchmark.

Following completion of company research, too many managers decide they don't favour the subject business but take a position anyway because that company is in the index. An alternative view is that the key risk is not divergence from a benchmark, but investing in companies that do not deliver positive returns. Benchmarks can create a fear culture for investment managers, even though in recent times a strategy constrained to a World equity index may have underperformed. For instance, an MSCI index-driven global equity strategy means considerable exposure to the United States, which has been a serial underperformer since 2002. 50.5% of the MSCI AC World Index weight is in the US and Canada but the US returned just 1.2% in 2006 against 25.9% in Latin America and 16.3% in Emerging Markets. As chart 1 illustrates, the 5 year return from the US is flat and heavily lagging other geographic areas.

Stock markets discount – Historic regional returns for MSCI series to end Dec 06, in Sterling

	2006	2005	2004	2003	2002	5Y	10Y
World	5.8	23.0	7.5	20.3	-27.3	4.1	6.6
USA	1.2	18.2	3.2	16.1	-30.1	0.0	6.9
UK	14.6	20.1	11.5	18.8	-23.4	6.9	7.3
Europe ex UK	19.6	24.5	14.1	29.2	-27.6	9.7	10.3
Japan	-6.7	40.5	8.1	22.4	-18.7	7.1	0.9
AC Asia Pacific ex Japan	16.8	35.3	14.7	33.7	-14.2	15.8	4.6
Emerging Markets	16.3	50.5	17.4	40.5	-15.0	19.7	7.9
Latin America	25.9	68.2	30.2	56.2	-29.9	24.7	15.6

Source: Aberdeen Asset Management, Lipper, MSCI

Myth 2: Diversification is about having a large number of portfolio stocks

Harry Markowitz2, the developer of portfolio theory, demonstrated that by combining individual risky assets into a portfolio it is possible to derive a portfolio with a lower combined risk level than any of the individual assets in it, depending on the correlation in return of the chosen assets. Since Markowitz's published findings, the benefits of portfolio diversification have been well documented. Research by Solnik (1974)3 showed that beyond 20-25 holdings, the reduction in risk from adding extra securities to a portfolio becomes very small. Holding as few as 10 to 15 holdings instead of one, may diversify away, on average, 90% of non-market risk. Market risk remains as the impact of macroeconomic factors that affect all risky assets is not eliminated.

Solnik also demonstrated the benefits of global diversification with further research finding that by combining 40 US and European stocks, the risk to a US investor was roughly halved versus holding a US only portfolio with the same stock count. This theme is backed by others such as Reilly & Brown4. It therefore follows that simply having a large number of stocks in a portfolio isn't necessary to ensure that the portfolio is diversified. It's far more important to invest across a wide range of countries, sectors and companies to capture diversification of returns through constructing a portfolio of non-correlated assets from lowly correlated stock markets.

Advisers have often sought fund managers with portfolios containing a large spread of stocks, with the goal of protecting against risk. If you diversify away all the non-market risk you will be left with market risk and therefore market return. The intention of an active fund manager is to accept non-market risk and aspire to above market return as reward. In this case the main risk to the investor is that of investing in a poor company or one that is overpriced, therefore accepting the additional non-market risk but not gaining the reward due in a higher than market return. One of the most effective ways of protecting against this risk is to fully understand the business model of the asset you purchase and get to know and trust the management of the company you invest in. This is an important aspect to scrutinize when considering manager selection.

It may seem obvious, but investment managers should pick stocks because they expect them to rise in value, whilst also monitoring the risk and diversification of the overall portfolio. If a manager has a strong positive conviction about a company, he or she should therefore be prepared to take a meaningful position in it, of at least 2% to 4% of the portfolio. Otherwise, expected rises in that stock will provide minimal contribution to portfolio performance.

Myth 3: Economic factors should dictate investment strategies

While a thorough awareness of global economies is invaluable to any investment manager, there are strong arguments for portfolio construction to follow a bottom-up approach. A simple study5 comparing quarterly economic real GDP returns with stock market returns over the last 3 years in 23 countries showed a correlation of between -0.21 and 0.23 (average 0.03) implying a weak short term relationship between GDP growth and stock market return. There are companies with positive prospects based in countries with badly performing economies, and vice versa which implies that a portfolio's regional profile should be derived from comparative analysis between global companies.

China is one example, where whilst the macro story continues to be strong, with 11.9% growth in second quarter 2007 GDP, a plethora of problems persist at the company level. Few Chinese companies appear to be run for profit, many are still state-backed, and accountability to minority shareholders remains unsatisfactory. Meanwhile, the overstretched valuations of the country's mainland stock markets, are not justified by fundamentals. The Shanghai A share market trades on a P/E of 36.6x while the Shenzhen A shares trade on 44.0x 6. The best Chinese companies are listed in Hong Kong – and what's more, many are available at more attractive valuations than their mainland-listed peers. The Hang Seng China Index (including Red Chip and H shares) trades on a P/E of 21.3x 6. Additionally companies listed in Hong Kong are subject to greater regulatory controls and are generally more liquid.

Equally, when macro factors look downbeat, investors often overreact. For example, despite its lacklustre economic performance of recent years, Japan offers plenty of value opportunities that should unfold as the economy emerges from its slumber. Financials with sound asset-backing such as Bank of Kyoto and Orix have been available recently at attractive valuations.

Economic boundaries are less clear as many companies now operate globally with multiple sources of revenue, providing an extra layer of diversification for the investor. Increasing globalisation demands careful scrutiny of where individual companies are active in business and advisers should also beware of assuming their investors have exposure to certain markets when they do not. Well known sportswear company Adidas may be based in Germany and quoted on the country's stock exchange but only 42% of its sales were generated in Europe in 2006 and interestingly 39% of their employees were located in the Americas and Asia. Similarly, Westfield and Rio Tinto's earnings in Australia were just 50% and 44% respectively in 2006.

Myth 4: Thematic investment is the future

Identifying pet themes and buying exposure to them is not necessarily an efficient way of boosting performance. Those who focus on themes are often not alone, with the consequence that it's easy to overpay for shares. For example, with climate change high on the political agenda these days, alternative energy companies are much in favour. Unarguably, there are attractive propositions in the sector, such as Spain's Gamesa, which supplies renewable energy industries, and German wind turbines provider Nordex. However, the relatively small market capitalisation of such companies, coupled with theme-driven strong demand for their shares, means valuations are often stretched.

Sector or country themes should be derived only from where an investment manager finds value. If a portfolio has a relatively high weight in telecommunications for example, this may not be because of any top-down positive view of this sector, it could simply be because a manager continues to find value there. In this case, around eighteen months ago a number of telecommunications companies with strong free cashflow started to look attractive on price/earnings ratios. The UK's Vodafone was one example which fell to an all time low valuation driven by short-term investor pessimism about the sector.

Myth 5: Emerging market companies are risky

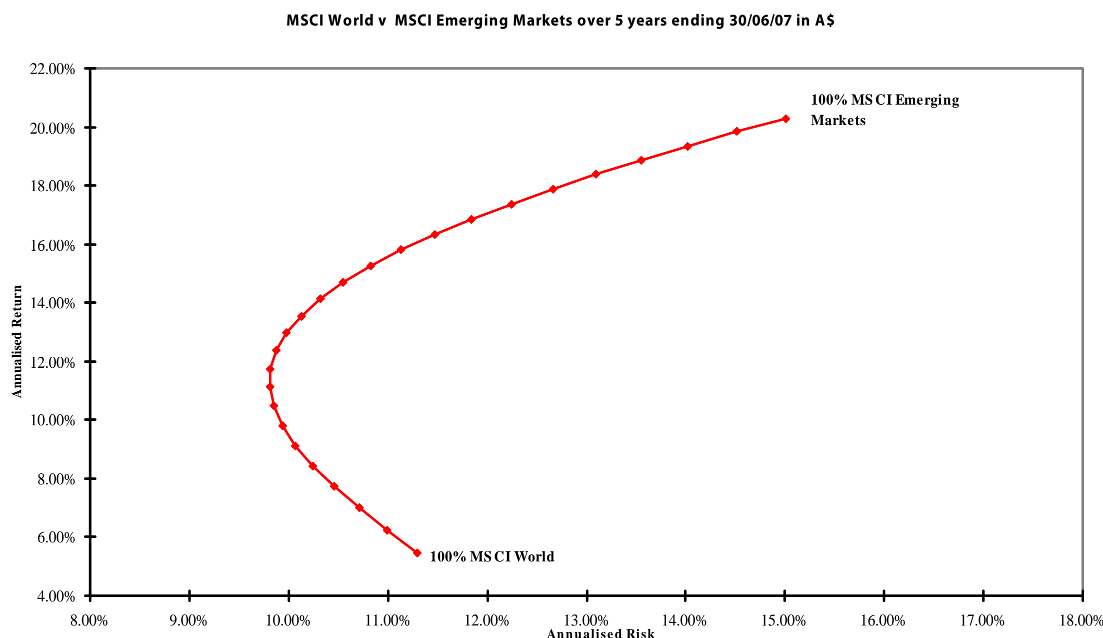
Undoubtedly, the recent strong performance of emerging markets, delivering a 20.3% annual return for five years to June 07 in A$, has diverted attention from the pitfalls of investing in them, such as volatility caused by political instability. Furthermore, the recent rush of poor IPO's and the surge in China's mainland markets are obvious symptoms of over-exuberance.

However, emerging economies are actually in increasingly good shape, and their fast growth rates have been much-vaunted. Importantly for global equity managers and their investors, the quality of companies based in these economies has risen dramatically - corporate governance, disclosure and transparency have all significantly improved. Company management are now far more concerned with the needs of the shareholder and are committed to growing profits rather than solely increasing sales. In addition, companies have worked hard to restructure balance sheets, reduce debt and focus on core skills. The evidence of surplus cash being paid out is also encouraging as are higher dividend yields such as 2.7% in Brazil and 3.7% in Thailand.

No wonder then, that the conventional wisdom about investing in emerging market equities – namely, that these companies are riskier and less shareholder friendly than developed ones – is being challenged. Recent data7 shows that MSCI Emerging Market volatility is at its lowest in the past 20 years and approximately half what it was during the turbulent period surrounding the turn of the century.

Indeed the inclusion of emerging market companies can actually reduce risk in a global portfolio through diversification. Chart 3 demonstrates the impact of increasing a portfolios weight to emerging markets. In theory an investor who increased their exposure to the MSCI Emerging Markets Index to 55% over the last 5 years would have enjoyed the same risk exposure as an investor with 100% in the MSCI World and yet would have been rewarded by an increase in return of approximately 10% per annum.

MSCI World v MSCI Emerging Markets over 5 years ending 30/06/07 in A$



Source: Aberdeen Asset Management, MSCI

Of course, there are still many large constituents of emerging market indices that may fail quality criteria tests in thorough fund management houses and yet would still appear in the portfolio of a passively-managed emerging markets fund. But it's also worth remembering that in recent years, scandals involving Worldcom, Enron and Parmalat have shown that poor governance is not just a problem in emerging markets.

Myth 6: Global equity portfolios have outperformed due to overweight positions in emerging markets

International managers who have performed strongly of late have found themselves being criticised for being overweight emerging markets, perhaps because commentators have viewed these markets as risky. However, investing in emerging economy companies should not be about allocating assets based on past index performance or on a top-down asset allocation theme. Out-performance can be generated by disregarding the MSCI World benchmark in portfolio construction, and investing across sectors and regions in healthy companies, wherever they are based.

The simple fact is that given the enormous improvements in emerging market companies that are being documented, global equity managers are increasingly comparing emerging market stocks with those in developed regions. They are finding impressive companies that reward their shareholders well, trading at more attractive valuations than their developed market counterparts.

The energy sector provides a convenient example. Analysis8 has shown that a company such as Petrobras in Brazil is not only cheaper on a price earnings basis than the likes of the UK's BP, but also has a strong production growth and reserve life and high level of dividend yield – as illustrated in Fig 2 below:

Comparative research example – Energy sector

Company	Region	P/E 07	P/E 08	P/E 09	P/B	Dividend yield	Dividend growth (5yr) %
Exxon Mobil	**USA**	**11.4x**	**11.9x**	**11.6x**	**3.6x**	**1.8%**	**6.8%**
Chevron Texaco	USA	9.9x	9.3x	8.9x	2.2x	3.0%	9.0%
EOG Resources	USA	14.4x	12.3x	9.8x	2.9x	0.5%	24.6%
Total	Europe ex UK	9.0x	9.1x	9.1x	2.8x	3.8%	16.1%
ENI	**Europe ex UK**	**8.9x**	**9.2x**	**9.6x**	**2.3x**	**5.5%**	**24.2%**
BP	UK	10.4x	10.0x	9.6x	2.3x	4.1%	6.4%
Petrochina	**Asia**	**10.5x**	**10.4x**	**9.7x**	**3.0x**	**4.1%**	**21.1%**
Petrobras	**Latin America**	**5.9x**	**5.8x**	**7.8x**	**1.8x**	**4.8%**	**18.3%**

Source: Aberdeen Asset Management, Bloomberg Mar 07

Fund managers can, on behalf of their investors, of course tap into emerging market growth via multi-national companies based in the US or elsewhere in developed markets, which are now deriving more of their earnings growth from upcoming overseas regions. But why pay extortionate multiples for a partial exposure to emerging market growth through these companies, when it is possible to invest in emerging market companies of equal or better calibre at more attractive valuations and with more potential for excess returns?

Myth 7: Anyone can invest in emerging markets

Global managers have been tempted by high returns to increase their exposure to emerging markets but do they possess the necessary experience, skills and resources to do so. It's important not to simply follow the herd, and the main risk to the investor is still that of investing in a badly managed company.

This is particularly true when investing in emerging market equities. While many companies have improved in leaps and bounds, there are still plenty of exceptions. For instance, state-backed or part-family-owned businesses often don't treat shareholders fairly, and instead of focusing on bottom-line profitability, many mis-managed companies still concentrate on simply growing market share. There are also downright dishonest companies.

Poor companies can of course be found throughout the world, but careful stock-picking using first-hand research minimizes the risk of investing in them. Well-resourced, experienced emerging market equity managers with the skills to analyse company accounts are better placed to sort the good companies from the bad and secure sought-after alpha for clients, of obvious interest to financial advisors.

Myth 8: Volatility is your enemy

There will always be peaks and troughs in equity markets, but ironically this very volatility can provide opportunities for global equity managers with an eye for the long term. Far from being an enemy, short-term volatility can allow investment managers to top-slice on highs and top-up on dips, backed by confidence in their convictions.

Profits can be locked in when a stock begins to exceed an estimate of fair value. Likewise, when share prices dip on weak earnings forecasts or negative short-term news flow, fund managers can use this as an opportunity to top up, provided they are confident in a company's long-term outlook. For instance, Intel recently reached ten year lows as mediocre earnings figures depressed its valuation. This gave an opportunity to buy a company whose robust asset backing and branding remain. In situations like this, meetings with company management would give fund managers the confidence to believe that restructuring should turn the company around.

Following the introduction of a new stock name into a portfolio, volatility in the stock price provides the opportunity to add to that position later at attractive valuations. Consequently, fund managers may be quite happy if a stock in which they hold confidence is weak in the short term, because it provides the opportunity to add to positions.

Myth 9: Active management is about high turnover

Active equity portfolio management is not necessarily about high stock turnover. Some fund managers argue that active management is more about running a portfolio with a substantial variation from its benchmark.

So being an active manager doesn't necessarily mean trading for short-term gain, it is about holding on to stocks in which there is strong confidence in the long-term prospects, providing their outlook and valuations remain satisfactory.

Global equity portfolios can be run with turnover of between 25% and 30% a year, and much of this activity consists of using short-term volatility to top up or top slice positions. With a long term view stocks will be held for three to four years, and perhaps longer.

Doing nothing, can be and should be, a valid active decision. Some managers feel compelled to change holdings simply to be seen to be 'adding value', in the process increasing trading costs for investors and potentially realising additional capital gains.

Myth 10: The aim is to have all stocks performing strongly

Of course, it would be ideal if all the stocks in a portfolio perpetually rose in value. But in reality, some sectors or stocks will outperform others. In the long term, investment managers with confidence in the future of their chosen stocks shouldn't be too concerned if those stocks under-perform from time to time, because periods of weakness offer the opportunity to build up positions.

A diversified, non-correlated portfolio is the best way to maintain long-term performance. If all stocks in a portfolio perform strongly at the same time, it's likely that those stocks are not diversified but closely correlated.

A healthy, diversified, portfolio will therefore contain laggards which will provide the next leg of the growth story, thereby maintaining and prolonging strong performance.

Summary - Investing on a truly global basis

Globalisation has made traditional benchmarks less relevant as company earnings become more diversified. The challenge for financial planners is to find investment managers that have the confidence to move away from benchmarks and invest in an unconstrained way on a truly global basis. At Aberdeen, we believe that shares in quality companies should outperform in the medium to long term, regardless of market capitalisation, sector or origin. Well-resourced, experienced emerging market equity managers, like Aberdeen, with the skills to analyse company accounts allow comparison of emerging market stocks with those in developed regions, giving vast opportunities to add value through global investing. Aberdeen run high conviction portfolios that are benchmark aware not driven and with experience across markets allowing full advantage to be taken from the flexibility and opportunity provided by a global universe. We are excited by the improving quality of companies in emerging markets and invite financial planners to embrace the opportunities opened up by viewing markets from a global perspective, in line with the way that management operate their companies.

The challenge for advisers and researchers is to ensure that their international active managers are utilising the full opportunity set of globally listed companies. Active managers should not be imposing artificial constraints around portfolio construction that effectively turn them into 'closet benchmark huggers'.

Index managers have a valuable role in portfolio construction, and are remunerated accordingly. Active managers charging active fees should not be managing relative to the benchmark, or should at least be open about the constraints to which they have subscribed. Are they managing investors' risk, or their own risk of underperforming?

Advisers and researchers should therefore ask their 'active' managers

1. What is your tracking error?
2. Do you manage risk relative to the benchmark or at a company level?
3. If you have 50% invested in the US is this because you believe the companies you hold offer the best potential returns for investors – or is this an enforced position due to your own self imposed constraints?
4. How do you treat diversification?
5. On what basis do you allocate to emerging markets – is it based on market capitalisation or do you conduct your own fundamental research of the companies?
6. What experience, knowledge and resources do you possess to put you in a position to allocate to emerging markets?
7. What is your portfolio turnover?

Ideally advisers should seek truly active international managers who use the full opportunity set afforded them. However where this is not possible advisers could consider the use of specialist regional equity managers to tilt their overall exposure to markets and companies under represented in traditional benchmarks.

1 Source: Deutsche Bank, IMF, MSCI, 31 Dec 05

2 Source: Portfolio Selection –Efficient Diversification of Investments, Markowitz, John Wiley & Sons 1959.

3 Source: Introduction to Stock Exchange Investment, Rutterford, MacMillan, 1994.

4 Source: Investment Analysis and Portfolio Management, Reilly & Brown, South Western, 2003.

5 Source: Aberdeen Asset Management, internal research comparing quarterly Factset Economic Real GDP local data and MSCI Country Index local data for 23 countries for the period Sept 2007 to March 2007.

6 Source: Bloomberg, consensus estimates 07. Data as at 26 July 2007

7 Source: Aberdeen Asset Management, internal research looking at volatility of MSCI Emerging Markets Index as defined by an annualised standard deviation in returns over rolling 3 year periods for 20 years to 31 Dec 2006.

8 Source: Aberdeen Asset Management, internal research.