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Countries don't matter?

Tim Farrelly | farrelly's | 15 February 2016

For a number of years, many fund managers have maintained that country and regional analysis are no basis for making asset allocation decisions. Where a company is listed makes no difference, they say – it's the economic exposures that count. If you want exposure to China, buying US-listed companies that operate in China is much the same as buying Chinese stocks directly.

It's not hard to see where this one is going. The events of the past year have clearly shown that where a company is listed really does make a difference. Over the year to September 2015, Chinese companies listed on the Chinese mainland exchanges were up 25.8%. Over the same period, Chinese companies listed in Hong Kong fell by 4.8%. From September 2014 to June 2015, mainland stocks were up over 100% while Hong Kong-listed stocks were up just over 40%. (Source: MSCI China A Shares and China H Shares Indices, in US dollar terms).

So very, very different returns. Was this driven by fundamentals? Not a bit.

On the mainland, Chinese businesses were trading at around 30 times earnings, while back in Hong Kong, investors could buy shares in Chinese businesses at around 11 times earnings. They are not separately listed, but it is very unlikely that the Chinese businesses of US-listed companies ever had increases or valuations remotely like either of these.

So, in June 2015, were Chinese businesses expensive? It depended entirely on where they were listed. From time to time, investment markets go mad. Sometimes, the madness is localised, as in this example and in the example of Japan in 1990. Ssometimes, it is global, as was the case during the tech boom.

To identify and help investors avoid investing in seriously overpriced markets, we find using countries as the unit of analysis very helpful. It certainly is obviously applicable in identifying where, for whatever reason, investors in a particular market seem to have lost their minds. It also helpful where the problem is global and it is an industry that is overvalued. During the tech boom, the US market was clearly massively overvalued compared to Australia and New Zealand. Australian tech stocks were equally overvalued, but they made up a much smaller part of the index. The problem was industry based, but a country-based analytical approach still provided the right answers.

None of this is to talk down the usefulness of industry- and stocks-based analysis. Rather, it is to say that country-based analysis continues to provide a very useful framework for identifying bubbles.

To say otherwise is nuts. And you can clearly see it’s nuts.

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