

WHITE PAPER NO. 42



Global Investing: An Idea

Whose Time Has Come?



GREYCOURT

White Paper No. 42 – *Global Investing: An Idea Whose Time Has Come?*

“The world is round.”
- Eratosthenes (225 B.C.)

“The world is flat.”
- Indicopleustes (550 A.D.)

“The world is round.”
- Galileo Galilei (1610)

“The world is flat.”
- Thomas Friedman (2005)

If by “global investing” we mean looking for the best stocks on a global basis, regardless of where the company is domesticated, then global investing is a very rare phenomenon. American investors,¹ even experienced investors, tend overwhelmingly to manifest a very large home country bias. Today, for example, US stocks represent less than half the capitalization value of the MSCI World Index, yet even most professionally designed US portfolios have non-US equity exposures in the 10% to 25% range, including emerging markets. Are investors really intending to make such a huge bet against foreign stocks? Probably not. But if not, why the low exposure to international equities?

In this paper we propose to investigate the case for global investing, to examine why it is that so many American investors underweight foreign stocks, and to suggest a sensible middle ground between true global investing and the current home country bias that infects most portfolios.

Why Go Global?

The arguments for global investing are reasonably familiar to everyone – they proceed from the undoubted rapid integration of the world’s economies and financial markets since

¹ Americans are hardly alone. Almost all investors, even those residing in very small countries, exhibit strong biases in favor of their own domestic securities or those of nearby countries (e.g., Euroland).

the collapse of the Soviet Union (and with it, collectivist economic ideas) – but perhaps they bear repeating briefly. Here are the main points.

The world has become a very small place

Today we can email someone half way around the world, call² him to let him know we need a quick response, conduct final discussions through instant messaging, text message over a final comment, then fax³ over the signed contract, all as simply as doing business with the fellow down the street. And when the initial prototype is ready for review our supplier in Bangalore can “FedEx” it to us and we’ll have it the next morning. Instantaneous communications push the idea of global investing in many ways large and small, but the main thrust of modern telecommunications is that our fear of things “foreign” dies out quickly in the glare of familiarity and habit.

Everyone’s a capitalist

For those of us who were already in mid-career when the Soviet Union collapsed in 1989, it seemed as though one day half the economies in the world were centrally managed and the next day none of them were. That’s an exaggeration, of course – witness Cuba, Venezuela, most of the Middle East and sub-Saharan Africa, and even China to a larger extent than its boosters want to acknowledge.⁴ But it is certainly true that the demise of the Soviet Union caused – if only by example – most of the world to turn to free market

² As recently as the 1970s (yes, we consider that “recent”), international calls were extraordinarily difficult to make (remember trunk operators?), and even in the 1980s overseas calls were breathtakingly expensive.

³ The fax was among the first technologies to enable global “instant” communications, but it was soon displaced by email. However, there is still a role for the fax (faxing a signed agreement, for example). Hewlett Packard, expecting the fax machine to go the way of the dodo bird, got out of the business. But later, noticing that everyone still needed to fax things occasionally, HP got back in.

⁴ Paul Larson, the editor of *Morningstar StockInvestor*, spent a month in China in early 2007 (Morningstar has an office in Shenzhen). In speaking of China’s disadvantages, the first and most important was the top-down economic management imposed on the country by China’s Communist party. “The largest of these [imperfections] is imperfect capital allocation. While China has indeed moved to a market economy, with such a strong central government that remains majority shareholder in many companies there are still forces other than pure market forces meaningfully at work. * * * It’s far better than the Soviet style of communism that bankrupted that country, but there is still a ways to go before capital is freely and efficiently flowing.” “What Every Would-Be Investor Should Know about China,” Paul A. Larson, 07-09-07, available at news.morningstar.com/articlenet.

economies of one kind or another. As a result, the world is a more stable, more friendly,⁵ more understandable, and more investable place than it ever was before.

It's harder and harder to tell a US company from a foreign company

Coca-Cola is headquartered in Atlanta, but it gets far more than half its revenue, and even more of its profits, from non-US operations. Is Coke an American or foreign company? When Lenovo acquired IBM's personal computer business, it was headquartered in Beijing. Lenovo is incorporated in Hong Kong and its stock is listed there. But its CEO is based in Singapore, its Chairman is based in Raleigh, N.C., its CFO is in Hong Kong, its human resources head is in Seattle and global marketing is managed out of India.⁶ Dow Chemical is an American company, but the CEO is Australian, the recently departed CFO is Brazilian, the incoming CFO is a Canadian of Hungarian descent who grew up in Switzerland, and the four key division heads are from Italy, Netherlands, Argentina and the U.S.⁷ An increasing number of US companies have decided to reincorporate in an offshore jurisdiction to escape what they view as non-competitive US regulatory practices.⁸ Foreign or domestic? Indeed, there seems to be an increasing push for one worldwide accounting standard, making domicile distinctions not just increasingly irrelevant but almost prehistoric.⁹ Finally, many companies in the US and elsewhere, regardless of where their sales and profits come from, have integrated their design, manufacturing and distribution

⁵ If it weren't for a small but determined group of mainly Middle Eastern and South Asian terrorists, it's hard to imagine what we would have to worry about these days.

⁶ "Why Multiple Headquarters Multiply," Phred Dvorak, *Wall Street Journal*, November 19, 2007, page B1.

⁷ "What's Wrong with the Traditional Approach to Global Investing?" Jan M. Inscho, *Capital Guardian Viewpoints*, June 2006.

⁸ Until very recently, these offshore companies weren't eligible to be included in the Russell 1000 Index of large cap US stocks. Effective June 2007, however, Russell created a new category of firms called BDIs (Benefit Driven Incorporations) that are really US firms but have reincorporated elsewhere. Those firms are now included in the R1000.

⁹ "Transparent, Translucent, or Transient: Where Have IFRS Left Us?" Sir David Tweedie, publication of the 2006 CFA Institute Annual Conference, Zurich (21-24 May 2006). Here is Sir David, who is chair of the International Accounting Standards Board in London, on the impact of international accounting standards: "Our job at the IASB is to provide the tools needed to make sound investment decisions and to make the markets more transparent. In theory, we are setting out to do something very simple: Come up with a single set of high-quality global accounting standards. Once we have done that, it will not matter whether a transaction takes place in Boston or Brisbane or Beijing or Brussels: the accounting will be the same." Ibid.

processes worldwide. And these are not just the global multinationals, but so-called “platform” companies everywhere.¹⁰

Many foreign economies seem to be better managed than the US economy

In the bad old days international investing in general, and emerging markets investing in particular, was only for investors with very strong stomachs. Many foreign economies were abysmally managed, local juridical systems were highly suspect, and currencies were widely manipulated. But today, having apparently learned their lessons, a remarkable number of foreign economies are well-managed and robust, evidencing smaller budget deficits, lower trade deficits, and even more stable currencies, than in the US.¹¹

Foreign companies are now as well-managed as American companies

The world is a very competitive place, and foreign companies that may once have sought senior corporate executives only from among the *nomenklatura*¹² have long since wised up. Cultural differences still exist in the corporate world, but it would be very difficult to say with assurance that the US has any sort of decided advantage in the quality of our corporate leadership – if only because American management practices have been so widely emulated.

Foreign markets have improved substantially

Given that we are talking about the buying and selling of securities, the efficiency, honesty, cost, transparency, liquidity, and legal protections of foreign stock markets is obviously of central importance. And here the news is mostly good. No foreign bourse can rival the

¹⁰ A “platform company” is one that handles high value-added activities (design, engineering, management, marketing) in the US but outsources to a low-cost foreign country low value-added activities such as manufacturing.

¹¹ Note that this is unlikely to change any time soon. Managing an economy as large as that of the US, while also serving as the world’s policeman and the main target for dissatisfied lunatics everywhere, ensures that America be forced to carry out policies, and to incur massive costs, that other countries can avoid.

¹² For those of our readers whose names may not be on the list, “nomenklatura” (literally, names on a list) originally referred specifically to the Soviet practice of maintaining a list of names – members of the Communist Party – to whom all the plum jobs in Soviet society were to be meted out. The Soviet Union is long gone, of course, but the word has survived and now refers generally to the practice of any society that limits advancement largely to a small, arbitrarily selected group of people: graduates of the public schools in Britain before Thatcher, graduates of the “écoles supérieures” in France through the end of the Twentieth Century, the “1,000 families” in Mexico, and so on.

New York Stock Exchange in these metrics,¹³ but many come close and all have improved – and continue to improve. Even in the emerging countries stock markets are fairer and more rational than ever before, and in the developed economies there is now little to complain of.¹⁴

Chindia really, really matters

In the old days, outside the US there was Europe and a few emerging economies. Europe was mired in a socialist quagmire and the emerging economies were mainly good places to go to lose lots of money. Today, though, Europe has made great strides and, as noted above, many emerging countries could teach the US a thing or two about managing an economy. But the real story is one that didn't even exist a decade ago: China and India, gigantic and hugely productive societies that are not merely emerging from long backwardness but are (each) capable of replacing the US as the world's largest economy.¹⁵ We could debate endlessly the pros and cons of investing directly in China and India, but refusing even to consider investing in the companies that are powering their growth seems pure pigheadedness.

The world is growing faster than the US

The US economy, despite its gargantuan size, often seems to have the vibrancy, the resilience and a variety of growth characteristics that make it look more like an emerging market than like, say, Western Europe. But on the whole the non-Western world is growing much faster than we are, and with that sort of growth comes many and varied opportunities for investors.

Domestic-focused investing carries with it serious opportunity costs

As noted at the beginning of this paper, roughly 60% of global equity market capitalization lies outside the US. Ignoring more than half the opportunity set in a game as competitive as that of investing simply makes no sense. In addition, of course, stock valuations outside

¹³ The NYSE was organized under a buttonwood tree in 1792, but the London Stock Market was formed even earlier, in 1773, by stockbrokers who had been conducting business informally for years in local coffeehouses.

¹⁴ In some countries – Germany and Japan, for example – traditional ownership structures, such as cross-holdings and widespread bank ownership, mean that public floats can be considerably smaller than they would otherwise be.

¹⁵ Though not any time soon. China's economy is a fraction of that of the US and India's is even smaller. Moreover, while we are all amazed by the sheer scale of the populations in China and India, it's useful to keep size in perspective. For example, the populations of China and India are roughly four times that of the US. But the US is *five* times the size of the UK or France.

the US are often more attractive than those in the US. And while investors normally attempt to access these valuations by changing their US/non-US allocation, some commentators point out that that is a clumsy approach by comparison with the “real time asset allocation”¹⁶ available to global investors.

Why Stay Home?

It’s frankly difficult to find sensible arguments for a home country bias. Most of the reasons investors overweight US stocks have to do with fear, discomfort, lack of experience, and inertia. The one argument for a home country bias that we hear from investors we (otherwise) respect goes something like this: I am domiciled in the US and must discharge my liabilities in US dollars. Therefore, a portfolio overweight in US dollar-denominated assets makes sense for me.

Well, maybe. But this argument doesn’t carry as much water as might seem to be the case. For one thing, outside the marketable equity portion of most investors’ portfolios almost *all* assets are US-dollar denominated (fixed income, private equity and real estate, for example¹⁷), thus reducing the need to focus on dollar-denominated equities. For another, diversifying into non-dollar-denominated assets adds only a small amount of short-term volatility to our returns (currency fluctuations tend to even out over time), while adding a very large amount of diversification.¹⁸ Thus, our net risk is probably reduced.

Given all the arguments favoring a global approach to equity investing, and the paucity of arguments against it, why shouldn’t we simply accept “global equities” as an asset class that should replace “domestic equities” and “international equities” in our asset allocation strategies? The answer, it turns out, is that global investing is a great idea in theory, but its advantages begin to dissipate along the potholed road of actual practice.

¹⁶ The phrase is Inscho’s, *op. cit.*, note 6.

¹⁷ We acknowledge that non-dollar denominated products in these areas are sprouting like kudzu, but we consider that fact to be a sure sign of a market bottom for the US dollar.

¹⁸ We mean diversification both in the sense of different return streams and in the sense that the US is not an isolated archipelago: we are affected positively and negatively by other economies, and hence the question of what a dollar will buy, even domestically, isn’t really a local issue at all, but a global one.

Global Investing in the Real World

Or, maybe, real investing in a global world. Let's take a look at just a few of the more serious challenges faced by an investor who wishes to adopt a global investing approach.

Is “global equities” an asset class?

When thoughtful investors design portfolio strategies, they begin with the concept of an “asset class.” By mixing and matching different asset classes in a sensible way – that is, taking advantage of less-than-perfect correlations among the asset classes – they are able to build portfolios which optimize return per unit of risk. We don't wish to get bogged down in the debate over what constitutes an “asset class,”¹⁹ but for portfolio construction purposes it is generally useful to divide investment assets into smaller, rather than larger, categories.²⁰ For example, using as building blocks for a portfolio such categories as US large cap stocks and US small cap stocks²¹ makes more sense than trying to design a portfolio around one huge asset class called “US equities.” By using the finer definitions we can tailor the portfolio to our needs much more carefully, and we are also likely to end up with a better-diversified portfolio.

Extending this thought to “global equities,” we would make the same comment: the term is too broad, too encompassing, to be of much use in the design of investment portfolios. It incorporates all the domestic asset classes mentioned above, as well as non-US large cap equities, non-US small cap equities, and emerging markets equities. If we simply turn all the securities over to one global equities manager, what chance is there that that manager will create an efficient portfolio for us? The answer, of course, is “little to none.”²²

¹⁹ For what it's worth, here is Frank Russell Co.'s view about the characteristics that define an asset class: “1. Securities included in the class should be more conceptually similar to each other than to securities excluded from the class. 2. Returns of securities included in the class should be more highly correlated with each other than with returns of securities outside the class. 3. The asset class in aggregate should represent a material fraction of the investment opportunity set. 4. Price and composition data should be readily available. 5. It should be possible to invest useful amounts in the asset class passively, at the quoted prices. 6. All defined asset classes should sum to an approximation of the entire investment opportunity set.” “Hedge Funds – A New Asset Class or Just a Change in Perspective?” George Oberhofer, AIMA Newsletter, December 2001.

²⁰ Of course, whether or not “global equities” is or isn't an asset class is hardly a perfect objection to the use of global equities in a portfolio. For example, most observers would deny that hedge funds constitute an “asset class,” and yet many astute investors (Yale, for example) have allocations to something called “absolute return,” i.e., hedge funds.

²¹ Many advisors would advocate even finer distinctions, including mid-cap and micro-cap stocks.

²² Here is the text one global manager inserts into every shareholder letter, immediately after the country/industry allocations table: “As we note in this and prior letters, there is no attempt to

Of course, one argument for investing globally is that correlations among world markets have become so high that the former usefulness of asset class distinctions like US and EAFE no longer matter. Certainly it is true that correlations between the S&P and EAFE have risen from roughly 0.40 in the early 1980s to roughly 0.80 in the first decade of the twenty-first century, driven by the collapse of the sponsor of socialism in 1989. But US/non-US correlations have always followed long, cyclical patterns, and it is not yet clear that today's high correlations represent a whole new paradigm. For example, the correlation today between the S&P 500 and the MSCI Emerging Markets Free Index is also very high²³ – roughly 0.75. Does anyone expect that high correlation to persist long-term?²⁴ And in very recent periods (2003 -2006), S&P/EAFE correlations have dropped back to 0.65, driven by currency fluctuations.

Is it possible to succeed as a global equity manager?

Theoretically, if a manager is talented, the larger the opportunity set the better his returns should be. But the opportunity set for global equities is so vast that very, very few investment organizations can possibly amass the resources required to succeed with the strategy.²⁵ Moreover, the firms that do possess those resources tend to be the kind of organizations (i.e., very large ones) in which stockpicking talent has not traditionally blossomed.²⁶ As a result, many firms that offer global equity products stick to index or

allocate the portfolio assets among countries (or sectors) based upon an overarching macroeconomic view or index-related considerations." Shareholder Letter, Third Avenue Global Value Fund, LP. See www.thirdavenuefunds.com/taf/documents/shareholderletters.

²³ One reason for the close correlations, and one possible catalyst for diverging correlations in the future, is the glut of liquidity that has dominated investor sentiment since 2002. Here is David Darst, Chief Investment Strategist at Morgan Stanley Global Wealth: "What's behind [the increase in correlations] is the global river of liquidity that's flowing in full spate. It's liquidity, it's unanimity of opinion, it's a little bit of lack of discrimination between risky and not-so-risky assets." Quoted in "Global Stocks In Step, Sending Managers to Arbitrage," Daniel Hauck and Alexis Xydias, Bloomberg.com (4/5/07).

²⁴ For an argument that international diversification depends increasingly on emerging markets exposure, see "Long-Term Global Market Correlations," William N. Goetzmann, Lingfeng Li, and K. Geert Rouwenhorst, *Journal of Business*, vol. 78, no. 1 (January 2005).

²⁵ Morningstar considers most global managers to be so incompetent that it refuses even to follow the vast majority of them. "Our Favorite World-Allocation Funds," Gregg Wolper, 07-31-07, available at news.morningstar.com/FundAnalystPicks.

²⁶ Exceptions in the past, though perhaps not in the future, would include AllianceBernstein, Capital Guardian and Templeton. As an example of the scale on which a global manager operates, here is a recent snapshot of the assets under management at the Capital Group of Companies: Capital Guardian Trust Company (\$170 billion); Capital International (\$150 billion); Capital

enhanced index products, rather than attempt active management in so vast a sector. Thus prospective global investors must ask themselves these questions:

Do I only want an indexed approach, and if so why not get it by, say, mixing the Russell 1000, Russell 3000, MSCI EAFE, and MSCI Emerging Markets Indices, which allows me to specify my asset allocation strategy?

Do I really want to be a captive client of a very small handful of mega-firms that have the resources (at least theoretically) to invest on a global basis?

Since global equity portfolios (other than enhanced index portfolios) tend to hold only a tiny subset of the entire MSCI World Index,²⁷ am I willing to live with the very large tracking error these portfolios are likely to generate?

We might also keep in mind that for decades the name of the game in beating the MSCI EAFE was getting the Japan bet right – Japan represented so much of the EAFE that over-weighting Japan when it underperformed, or under-weighting Japan when it outperformed, was death to a manager’s performance. Consider how much more true this is of the decision to over- or under-weight the US.

Can a global manager outperform in the US portion of its portfolio?

Research has overwhelmingly suggested that even highly diligent managers in the US large cap sector will have difficulty outperforming the index net of their fees and other costs. If this is the case, then what possible reason is there to believe that a global manager – distracted by the need to evaluate thousands of securities across dozens of countries – can outperform in the US large cap sector? Isn’t it more likely, in fact, that a manager preoccupied with picking stocks all over the world will be even less likely to outperform in the highly efficient US market? And won’t this undercut the rationale for “going global?”

Are we confusing global investing with a Bull Market?

Call us cynics, but we wonder how much interest there would be in global investing if foreign stocks hadn’t consistently outperformed domestic stocks since the turn of the century. Certainly, American investors have rapidly ratcheted up their foreign stock exposure in recent years, though not, we suspect, for reasons we would find persuasive. If

Research and Management Company/American Funds (\$940 billion); Total = @ \$1.3 trillion. During calendar year 2005, Capital Guardian’s analysts visited more than 10,000 companies.

²⁷ The MSCI All-Country World Index includes more than 2,000 companies located in 49 countries.

it happens that domestic stocks outperform foreign stocks over the next market cycle, will interest in global investing wane? We hope not, but we suspect so.

Does Chindia really, really matter as much as we think?

The growth and influence of the Chinese and Indian societies has certainly been spectacular, and we can all be forgiven for being rather transfixed by it all. But we shouldn't make the mistake of projecting straight-line growth in these economies, we shouldn't over-estimate their impact (any more than we should ignore it), and we should remember that we've been here before.

On the subject of straight-line projections, we frequently read things like this: "Growth in the Chinese economy has averaged 14% per year and therefore China will control 50% of the global economy in fifty years." Possibly, of course, but highly unlikely. In the first place, the annual growth rates that are so casually bandied about really represent the growth rate of the large Chinese cities, not of the country as a whole. When you add in the (dismal) growth rate of the Chinese countryside you come up with a much lower number. Second, China is a totalitarian country, something we tend to forget or minimize. People are always suggesting that somehow the Chinese Communist Central Committee is really a bunch of closet capitalists who only nod in the direction of Communism because it keeps them in power. Nonsense. What is really happening is that the Central Committee recognizes that the best way to keep the huge Chinese population docile is to maintain a high growth rate, and that only by following largely capitalist policies can such a growth rate persist. Ultimately, though, China has to transition to a post-manufacturing economy (query whether the weird Chinese educational system is up to this task) and to a democratic form of governance, but it has no idea how to do either of these things. As David Brooks has written, "Perhaps it's simply impossible for a top-down, memorization-based elite to organize a flexible, innovative, information economy, no matter how brilliant its members are."²⁸

Finally, remember that we've been here before:

"[I]f we really want to observe a powerful economy in action, we need only look at the Soviet Union between 1917 and 1935. In barely a generation, Soviet-style communism transformed a backward, peasant, agrarian society into the second largest economy in the world, an economic triumph that seems unlikely to have been surpassed by any nation in history."²⁹

²⁸ "The Dictatorship of Talent," *New York Times*, December 4, 2007, p. A35.

²⁹ Gregory Curtis, *Creative Capital: Managing Private Wealth In a Complex World*, (iUniverse Press, 2004), p. 25.

We know what happened to the Soviet Union and most of its satellites. What would happen if the huge People's Liberation Army were to be disbanded tomorrow? Might China fragment into several autonomous regions or city-states, rather like the Soviet Union and Yugoslavia? It's useful to keep in mind that although China has existed as a cultural region for centuries, it has been held together as a nation-state only temporarily and by force of arms.³⁰ In any event, a non-democratizing China faces the reality that capitalism without a civil society is not Communism, but fascism.

India, of course, has the opposite problem. It's "the world's largest democracy," and a fractious one at that, deeply divided along ethnic, religious and caste lines and with a massive and growing population of desperately poor citizens who are barely being touched by the rapid progress of the educated elite. The only way we know of to move a society from undeveloped to developed is to install the necessary infrastructure – roads, power, basic manufacturing, and so on – exactly what the Soviet Union and China produced and exactly what India lacks. And without a command-and-control government like China's, India is unlikely to have the necessary infrastructure any time soon. China, like the USSR, kept its people impoverished for decades while it built the infrastructure it needed through brute force. But as a democracy, India can't follow suit. The global economy isn't interested in what India can produce in two decades, it's interested in what India can produce today – which, given its educated elite, means services. But as far as we know, a service economy won't carry India as far as it needs to go without vast improvements in its basic infrastructure.

Don't get us wrong – the growth in Chindia is real, and rapid improvement in living standards in the world's most populous countries is very much to be desired. The question is whether that growth, and the investment opportunities it makes possible, can possibly keep up with the current optimistic expectations.³¹

What about investing in multinationals?

Many investors argue that the main benefits of global investing, without many of the downsides, can be obtained by investing in global, multinational companies, regardless of

³⁰ Modern China has been an integrated nation only since the late 1920s, when it was unified by the Kuomintang under Chiang Kai-shek. The People's Republic of China was organized only in 1949.

³¹ In this regard it is useful to keep in mind that many of the wildly optimistic views about Chindia can be traced back to financial firms with a vested interest in fanning the flames of investor enthusiasm. Before investing, it may be useful to consult more objective parties, such as Council on Foreign Relations Senior Fellow Walter Russell Mead, who suggests that estimates of the size of China's economy are preposterously wide of the mark: "China, it turns out, isn't a \$10-trillion economy on the brink of catching up with the United States. It is a \$6-trillion economy, less than half our size." "The Great Fall of China," *Los Angeles Times*, December 30, 2007.

where they are domesticated. But at the end of the day this turns out to be mainly a US domestic portfolio. Of the fifty stocks in the Dow Jones Global Titans 50 Index, for example, fully 28, representing 62% of the market capitalization, are US companies.³²

Moreover, many investors misapprehend the challenges associated with competing successfully on a global basis. A company that has a successful US domestic product can't simply design, produce and market that product exactly the same way in scores of other countries. Thomas Friedman and other contemporary "flat-worlders" point out that technology is technology is technology, regardless of national borders. True enough, but corporations don't mainly sell technology, they sell products and services based on technology. And to make those products and services of interest to different populations around the globe, the corporation has to customize them to local and regional needs and preferences. The German hausfrau may prefer a front-loading, small capacity, energy-efficient washing machine, while the Iowa homemaker wants a top-loading, high-capacity washer and energy-efficiency be damned. Trying to sell the wrong product to the wrong housewife is a recipe for failure. Global businesses themselves must think globally, but act locally.³³

Stockpicking in non-nonsynchronous markets

In the most developed stock markets, stock behavior tends to be nonsynchronous, that is, the complement of stocks traded on those markets don't tend all to move in the same direction. In the US, for example, in most weeks roughly 58% of the stocks move in the same direction. By contrast, in China more than 80% of the stocks move in the same direction.³⁴ In non-nonsynchronous markets, why pay an active management fee to a global manager when an ETF would be a lot less expensive?

Thinking non-monolithically

Although we have tended to talk in this paper – for simplification purposes – as though global equities consisted of only two sub-categories, US and non-US, in fact the world is vastly more complex than this. US equities includes large cap, mid-cap, small cap, microcap, hedge, venture capital, buyouts, and the large group of quasi-equity investments that includes mezzanine, distressed, turnarounds, etc. Non-US equities includes EAFE, emerging markets, global small cap, hedge, venture capital (in the UK and Israel), buyouts

³² The UK has nine companies, Switzerland four and Japan two. No other country has more than one. See "Dow Jones Global Titans 50 Index Statistics," April 30, 2007, at www.djindexes.com.

³³ See Pankaj Ghemawat, *Redefining Global Strategy* (Harvard Business School Press, 2007).

³⁴ "New Perspectives on Investing in Emerging Markets," Michael J. Schill, The Research Foundation of CFA Institute (2006).

(in Europe³⁵), etc. Accessing this vast and diverse opportunity set through a global equity manager, even among long-only asset classes, would be, to say the least, challenging.

Coupling versus decoupling

Traditionally, when the US got a cold, emerging markets caught pneumonia. More recently, it has been argued in many quarters that most emerging markets have “decoupled” from the US. The rationale suggests that as an outlet for emerging markets goods the US has been replaced by China, India and Japan, so that the US could, for example, fall deeply into recession without significantly affecting the emerging economies. There is something to all this, to be sure – if nothing else, many emerging countries have far sounder economies these days. But there is also less than meets the eye: the US remains far and away the world’s dominant economy and, even more, far, far and away the world’s dominant equity market. Most likely, if the US gets a cold the emerging markets will at least catch a bad case of the flu.³⁶

The Bottom Line:
Think Globally, Act Locally

Thinking globally

Beginning the equity allocation process by looking at global equity market capitalization makes all the sense in the “world.” Here is an exercise investors might try. Assume our investor has 35% of his entire portfolio in US large cap stocks, 5% in US small cap stocks, 15% in international stocks and 5% in emerging markets stocks. Of the 60% of the portfolio in equities, then, our investor has 40% (67% of the equity exposure) allocated to US and 20% (33%) allocated to non-US, compared to a market weighting of (roughly) 45% US and 55% non-US:

	<i>Investor’s Portfolio</i>	<i>Global Market Cap (rounded)</i>
US equities	67%	45%
Non-US equities	33%	55%

Now we might ask ourselves why we are so smart that we can make a huge, 22% bet against non-US stocks? What is it we know that gives us confidence to make such a sizable

³⁵ Many investors will be surprised to learn that management buyouts represent twice as high a percentage of GDP in the UK as in the US. (Source: Groupe LCF Rothschild)

³⁶ In the summer of 2007, when the credit crisis struck, the Dow fell 8% and the MSCI Emerging Markets Index dropped almost 18%. Decoupling?

bet? Would we do so elsewhere in our portfolio? If not, we should probably take steps to bring these two allocations closer together.³⁷

Acting globally

We have discussed above the challenges associated with using a global manager for our equity portfolio, but of course it's possible to do so, with these being the main choices:

Option #1 – Engage an active global equity manager. Here the main challenge is that there are so few firms that have the global resources required to demonstrate ongoing competence in such a challenging endeavor. Thus, if we adopt Option #1 we will be taking very substantial organizational risk – if our manager blows up or substantially underperforms, so will we – Big Time.

Option #2 – Engage a “core plus” global equity manager. Many large firms – global banks and investment banks in the main – offer so-called “core plus” strategies. These firms have decided that active management in this area is far too challenging, and so they manage global money by indexing most of the allocation and then “porting” return from a short-term bond portfolio into the indexed global equity portfolio. If all goes well, these managers will deliver the return on a global benchmark – the MSCI All Country World Index, for example – plus a few points of return from the bond portfolio. Of course, all does not always go well.

Option #3 – Engage a pure index manager. This is the simplest approach to a global equity exposure, but it means that roughly 60% of our overall investment portfolio cannot outperform.

Our skepticism of global equity management notwithstanding, we see no reason why adventurous investors shouldn't dip their toes in the global equity market by engaging one of the managers described above. A global manager would therefore be managing money alongside more traditional domestic and foreign managers, and this in itself presents complications in terms of maintaining our asset allocation strategy and in judging relative performance. But it's not impossible, and may be worth the trouble just to gain experience with a global manager.

³⁷ Note that we aren't advocating the notion that portfolios should always reflect market capitalizations exactly – therein lies madness. But we ought to start with global market caps and then examine valuations, rather than starting with a huge bet against market caps and then trying to think our way out of a position we never thought our way into.

Acting “locally”

By acting “locally” we mean implementing the globally designed portfolio in the traditional way: by engaging domestic and international specialist managers. Thus our globally-designed, locally-implemented portfolio might look something like this:³⁸

Long Equity Asset Allocation

	<i>Investor's Current Portfolio</i>	<i>Global Market Cap</i>	<i>Investor's New Portfolio</i>
US equities	67%	45%	45%
Non-US equities	33%	55%	55%

Portfolio Implementation (Long Equities)

	<i>Subtotal (% of Equity Alloc)</i>	<i>Total (% of Equity Alloc)</i>
US large cap passive	35%	
US small cap active value	4%	
US small cap active growth	6%	
<i>US total</i>		<i>45%</i>
EAFE active value	10%	
EAFE active growth	10%	
Non-US small cap	5%	
Emerging markets core	20%	
EM Asia ex-Japan	10%	
<i>Non-US total</i>		<i>55%</i>

If we were to inject a global equity manager into the portfolio, we would take that manager’s allocation out of the US large cap passive and EAFE active allocations, roughly equally.

Conclusion

Given the very fundamental change in the economic organization of the world that followed the collapse of the Soviet Union, and how rapidly those changes have evolved over the ensuing two decades, we agree wholeheartedly that a conceptually global

³⁸ We aren’t necessarily recommending this portfolio for anyone. We show it simply to indicate how a portfolio that is conceptually global might be implemented in a more traditional fashion.

approach to equity investing makes sense. We have argued, however, that implementing a global approach using global equity managers remains problematic and it is likely to remain so for many years to come. “Think globally, act locally” is likely to be the preferred strategy for most US-based and non-US based investors.

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