

RESEARCH PAPER

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Global investing in the new world

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The global equity benchmark excludes many opportunities as the industrial advantage shifts to the so-called emerging economies. This paper challenges the conventional belief that history is the best guide to determine the optimal composition of the international equities component of a portfolio. It examines why it makes sense to structure an investment portfolio that emphasises global themes and relationships, as opposed to geographic regions. It looks at how a thematic approach to investing identifies the major secular, cyclical and structural influences on the world's stock markets, and how consistency, risk control and diversification are managed.

Emerging equity markets have posted stellar returns in recent times (56% in 2003, 26% in 2004, and 35% in 2005). This, coupled with the economic growth being witnessed in China and India, has many in the financial community acknowledging that one of the greatest influences and opportunities for portfolio construction over the coming years will be the emergence of the BRIC economies – Brazil, Russia, India and China. It comes as no surprise to see these types of funds being launched. However, such funds serve only to demonstrate that the financial community remains under the powerful influence of benchmarks. Despite the work published on the shortcomings of Modern Portfolio Theory, many strategic asset allocations are still based on historical relationships between asset classes. As Dick (2006) pointed out, the Markowitz model is simply an observation between two points in time. It is not a dynamic model that can be used to predict from a real world starting point.

However, many investors and fund managers ignore this by continuing to invest in a benchmark fashion around the MSCI World Index, the commonly accepted global share benchmark. This benchmark is also most commonly relied upon for determining strategic asset allocations and composition of international equities exposures within a diversified portfolio. This is a flawed starting premise. As Goetzmann and Jorion (1998) noted, markets have emerged, submerged and re-emerged over history. For example, Argentina had a larger market capitalisation than the UK in the 1920s, and all but disappeared by the 1930s. In addition, the MSCI World Index has constituents from just 26 developed countries and currently excludes dynamic economies such as China, India, Malaysia, South Korea, Taiwan, Brazil, Mexico, Turkey, Hungary, Poland and Russia. Given China's stock market is already the world's eighth largest (albeit its investable share market is considerably smaller), such biases raise concerns. Finally, the MSCI World Index constituents are not based on economic rationality. At the peak of the 2000 tech boom, the country weighting of Germany was less than the weighting of Microsoft. Russian company, Gazprom, which controls roughly

30% of the world's known natural gas reserves and which was recently in the top five companies in the world by market capitalisation, is not in the MSCI Index. Countries such as South Korea and Taiwan are not included in the index, while countries such as South Africa or Israel are included. The importance of Russia is acknowledged globally by inclusion in G8 economic summits, but the MSCI World Index does not include Russia.

The case for emerging markets

Should investors then make a strategic allocation to emerging markets, using the MSCI Emerging Markets Index as a basis for determining what the optimal allocation should be?

Over the last two decades, emerging markets have been viewed as a high risk way to attempt to add alpha to global portfolios. Figure 1 (overpage) highlights that, over the ten years to June 2006, adding an exposure to emerging markets on an index-weighted basis reduced portfolio return and increased volatility. It was a commonly held view that, at best, emerging markets should be invested in on an ad-hoc cyclical basis to capture global funds flow as these markets become beneficiaries of herd behaviour.

Such a conclusion comes as no surprise when looking at more detailed work on index composition. In particular Harvey (1998) discussed the three main problems of viewing emerging market allocations on this basis. Firstly, emerging market return data is highly non-normal, which poses a problem for a theory which assumes normality. Secondly, risk parameters change over time and allowances must be made for this nonstationarity. Thirdly, these markets, at least for part of the sample, are not integrated into world capital markets. Of all these problems, it is arguably the third that is the key issue, as financial market integration is critical for the capital asset pricing model to work.

Investors therefore face a dilemma. The current benchmark starts from a premise that excludes much of the emerging economies yet, if we are to include these them within portfolios, we are largely forced towards a naïve extrapolation of history to measure expected

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In addition, there is a growing body of research that explains indices were created to measure price movements in the markets, and were never intended to become investment supports. As a result, most market indices do not appear to be suitable to serve as benchmarks. This research has the potential to re-invigorate the active versus passive investing debate, which is far beyond the scope of this paper. However, such work does serve to highlight that many approach investment with potentially flawed paradigms.

If we return to Goetzmann's assertion that many emerging markets are in fact re-emerging markets, it is then appropriate to look at when these markets began to re-emerge. Many commentators point to the fall of the Berlin Wall in 1989 and the collapse of the old USSR as key events. The major benefit was the obvious lifting of the Iron Curtain and the liberation of millions of individuals across Eastern Europe and Asia who were then able to pursue a capitalist way of life. The lesser recognised beneficiary was China. If the Berlin Wall had not fallen, perhaps Russia would have remained a communist economy and perhaps China would not have recognised that communism, which had served it well during the essential years of reconstruction post 1949, was not the solution going forward. Perhaps China would still be embracing old communist style economic planning rather than its current style of government which is essentially a one party militarist but capitalist state. The key to empowerment of the individual through capitalism is the right to have title or leasehold to property established through the rule of law. This is now the case throughout most of the old Soviet Union and is growing rapidly in China today. It is the foundation of a new consumer society that is steadily becoming wealthier, albeit from a low base – a tide that is unlikely to be turned.

This has forced a major change on the global economy. We are witnessing a new industrial revolution. The trickle-down wealth effects have allowed rural workers in countries like India and China to move on a massive scale to urban areas where manufacturing jobs

are being created. Capital is attracted to the cheapest labour and India, China and other emerging economies have been massive beneficiaries of this. Wages will rise eventually but they will continue to remain competitive globally. This is not a one to two year phenomenon. It is likely to continue for another two decades.

Like the last industrial revolution in the 19th century, this new industrial revolution has forever changed the investment fundamentals for companies. Those not able to take advantage of the arbitrage for global labour are threatened. Many of the developed world's companies are under attack from companies in the emerging economies and are fighting for survival. The attack of industrial advantage has already shifted in many industries to companies in emerging economies. Figure 2 shows industries across three areas: emerging markets, contested industries and developed markets. Those industries listed under emerging markets have already fallen to companies domiciled in emerging countries. These companies are gaining margin and market share from their developed market peers.

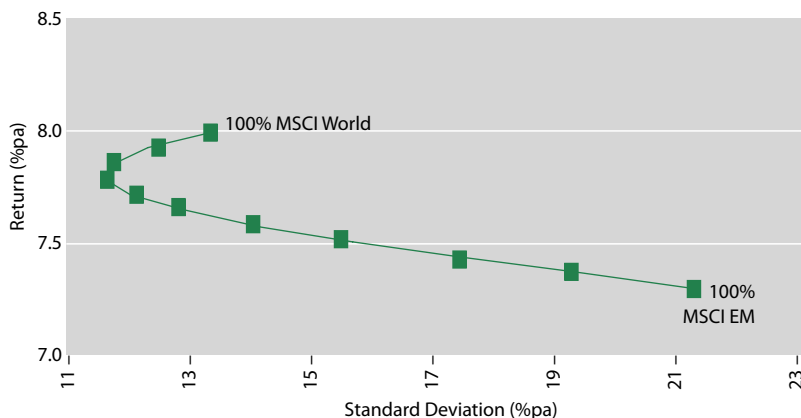
Chemicals and metals and mining – Saudi Arabia has announced initiatives in both areas, building petro-chemical plants and an aluminium smelter in the desert. The primary attraction is basically free feedstock for the petro-chemical plant and very cheap electricity produced from natural gas that will benefit the smelter. The power cost for producing aluminium is typically about 40% of production costs. As they will have the lowest costs, both projects will cause a shift down in the global cost curve for petro-chemicals and aluminium. Hence when they come on stream in 2007 and 2008, they will have implications for established chemical companies such as Dow Chemical and BASF and aluminium producers such as Alumina and Alcoa.

Oil and gas – most of the easily winnable oil has been won from developed countries. Today, companies must be in areas such as offshore Brazil, the Gulf of Mexico, the Caspian Sea, Western Africa, Russia and Sakhalin. BP recognised this when it bought Russian company TNK, realising it could not replace reserves as fast as they were being depleted. Other developed world companies (for example, Chevron) have also realised this and purchased positions in Russian companies.

Generic pharmaceuticals – this sector has been the domain of the emerging countries for some time now and is dominated by companies such as India's Dr Reddys and Ranbaxy Laboratories and Teva Pharmaceuticals from Israel.

DRAM/Microchips – Taiwanese companies now dominate the DRAM/microchip industry segment and are winning market share from developed market companies based on price. This has threatened the existence of some developed world companies. At least one is now unable to fund research and development from cashflow.

Figure 1: Effect of Emerging Markets in a portfolio – 10-year risk and return



Notes: MSCI World Accumulation and MSCI Emerging Market (Free) Accumulation indices at 30 June 2006 in Australian dollars. Source: MSCI, Deutsche Asset Management

Personal computers – personal computers ceased to be the domain of the developed world when IBM sold its PC business to Chinese company Lenovo.

The contested industries are still in a state of flux. Some such as the automobile industry will fall to the cheaper labour and scale advantages that will inevitably accrue to China and perhaps India. Financials, leisure and telecommunications are still being contested but are also likely to fall to emerging economies because of labour cost advantages. Over the next five years, Deutsche Asset Management expects to see up to five Chinese banks with a market capitalisation of up to \$US100 billion as they follow their local client companies' moves outside China, and are thus able to expand business opportunities.

The consumer electronics industry has seen a war between Sony and South Korean company Samsung over the last few years. That battle has been won by Samsung. It now appears to be outspending Sony and has an R&D product road map extending out almost a decade. After Google, Samsung is probably the fastest created, globally recognisable brand name in history.

Software, although still controlled by major western companies, is now being outsourced to countries such as India and will be an interesting contest in the future as the companies in the emerging economies continue to build critical mass.

Those industries under the developed world heading will continue to be dominated by the developed world for some time to come. There are only four. Retail will remain a local industry for some time to come – it is difficult to shop in Shanghai or Mumbai on line from Sydney or Melbourne. Luxury brands (Rolex, Tiffany, Cartier and Ferrari and the like) have in some cases taken many decades to build their brand and it is extremely difficult to build new brands with the same cache. Biotechnology is also likely to remain in the domain of developed markets for some time as work opportunities for ambitious talented graduates tend to be centred around major universities in California, Boston, Oxford, Cambridge and Munich, which have produced profitable products and are able to pay staff well. Over the long term, capital goods are also likely to fall to emerging market companies but not for a few years. This is because companies such as Caterpillar and Komatsu have long-term relationships with major resource companies such as Anglo, BHP Billiton and Rio Tinto. Talks with senior management at these companies reveal that safety issues are of paramount importance, as well as long-term contracts extending out for many years covering warranty and speedy parts replacement. It appears unlikely that the major mining companies are about to deal in a large way with “The Shanghai Shovel Company” or its equivalent for a few more years yet. However, this industry is under threat longer term.

The attack of industrial advantage is here to stay and developed world companies are and will continue to be impacted. To construct a portfolio around the

MSCI World Index which excludes so many of these future opportunities is not only naïve but dangerous. Yet, as noted earlier, making a strategic allocation or “carve out allocation” to such markets poses problems.

Thematic investing – capturing truly global returns

Approaching international equity investing not from a benchmark perspective, but more from an economic perspective enables the development of themes playing out in the world's markets and affecting companies globally. A truly global approach allows a manager to take advantage of the full range of opportunities. Indeed, markets are starting to come to the same conclusion. Figure 3 shows the risk and return over the five-years to June 2006 of portfolios invested in a mix of MSCI World and MSCI Emerging Market (Free) indices. There are a large range of portfolios for which an emerging markets exposure would have increased returns and lowered volatility.

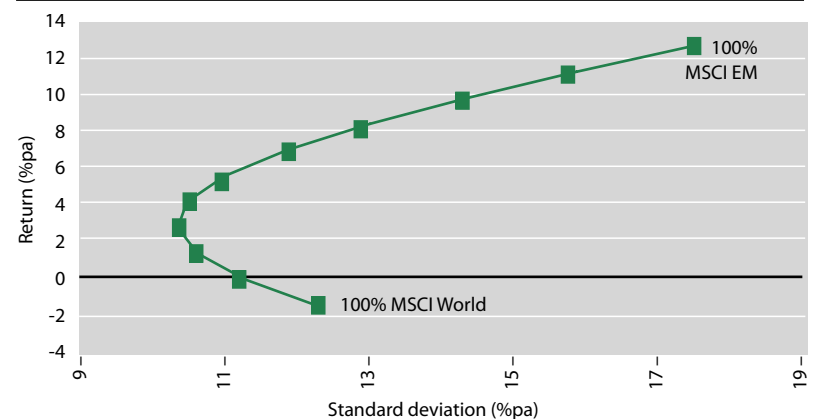
By viewing the world as one integrated global market, and analysing it as a single investable entity, no assumptions are made regarding appropriate country or sector allocation. Instead, global trends – or themes

Figure 2: Geographical attack of industrial advantage

EMERGING MARKETS	CONTESTED INDUSTRIES	DEVELOPED MARKETS
Cement	Automobiles	Capital goods
Chemicals	Consumer electronics	Luxury brands
Generic pharmaceuticals	Financials	Biotechnology
DRAM/Microchips	Leisure	Retail
IT services	Software	
Metals and mining	Telecommunications	
Oil and gas		
Steel		
Personal computers		

Source: Deutsche Asset Management

Figure 3: Effect of Emerging Markets in a portfolio – 5-year risk and return



Notes: MSCI World Accumulation and MSCI Emerging Market (Free) Accumulation indices at 30 June 2006 in Australian dollars. Source: MSCI, Deutsche Asset Management

– can be identified that can lead to those stocks most likely to deliver long-term outperformance. Employing rigorous top-down and bottom-up analysis, this thematic approach to investing identifies the major secular, cyclical and structural influences on the world's stock markets. Of course, a thematic approach is not the only way to invest globally, but it does provide a rational and logical framework for analysing the global opportunity set, and helps to identify groups of companies that benefit from the one constant all investors face – change. The thematic approach is designed to be forward looking and is not constrained by the historical dead weight of benchmark indices.

Conclusion

There are a number of conclusions to be drawn. Firstly, combining developed and emerging market portfolios in simple linear combinations is inefficient from the viewpoint of an investor who wishes to maximise risk-adjusted return. A far better approach is to consider the available universe of investable assets as one entity, and to construct a fully integrated portfolio that correctly rewards risk and generates superior return. A thematic approach allows themes to be viewed as market pervasive risk factors – factors not isolated to one part of the global market. This allows construction of a portfolio that satisfies more fully the conditions required to maximise wealth while controlling risk.

Secondly, it is interesting to note that the assumption of market capitalisation-based benchmarking has been rigorously challenged over the last few years with the introduction of fundamental indices and a number of global equity products that use sophisticated, quantitative techniques to exploit the resulting inefficiencies in these traditional benchmarks.

Finally, in its original form, the capital asset pricing model of Sharpe-Lintner made no assumptions about benchmarks. The premise of this work was to construct a framework with which an investor could build efficient portfolios. A market portfolio was defined to be all investable assets, not just a commonly used subset of assets. Going back to and applying the original theories of portfolio construction allows for construction of superior portfolios into the future. ■

ENDNOTES

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