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Do Countries Matter Anymore?

At first glance, the title of this report may appear to be ridiculous. Of course countries still matter. For better or worse, they make the laws under which we all live, they make important decisions about economic and social policy, and they still command people's allegiances and emotions. Even though we read about globalization almost every day in the business press and see books with titles like *One World, Ready or Not*, we all know that national governments are not about to go out of business any time soon.

Accordingly, anyone investing internationally has to pay close attention to political trends in other countries that may affect the value of their investments. We have always paid close attention to politics and other "top-down" macroeconomic factors because political changes overseas can have big impacts on variables like tax rates, interest rates, or currency exchange rates. All of these variables can and do affect the value of our international holdings, so we do the best we can to anticipate changes and position our portfolios accordingly.

Since we do a considerable amount of top-down research, we are frequently asked which countries' stock markets are most attractive and which should be avoided. Those are perfectly sensible questions that have historically dominated discussions of global investment strategy. Not surprisingly, we prefer to invest in countries that have reasonable equity valuations, good growth prospects and investor-friendly economic policies and government regulations.

That said, the importance of country decisions in international investing began to fade in the 1990s and may well fade further as time goes on. Instead, the importance of other decisions is growing, such as selecting the right global sectors and industries and the right companies within those sectors and industries.

The Role of Globalization

The main reason for the fading importance of country decisions is the very progress of globalization itself. Just 30 years ago, international investing was considered to be an extremely exotic pursuit. At that time, few individual or institutional investors in the U.S. had any direct foreign stock holdings and relatively few brokerage firms or investment banks engaged in any meaningful cross-border transactions. There were still international flows of capital, but such money flows were mainly concentrated in commercial banks that helped finance export and import businesses.

Not surprisingly, equity markets at that time often tended to be out of step with one another, since the markets were dominated by institutions and individuals with a strong "home bias" in their investment decisions. With a few notable exceptions, most companies then focused on doing business in their domestic or regional markets and most investors paid more attention to local economic trends rather than global trends. On occasion, a global shock like the oil shock of 1970s would shake up all markets at the same time. In general, however, statistical studies (which were rare) showed that international markets were only weakly correlated with one another.

Since those days, changes in global capital markets and the way that corporations conduct their

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business have been dramatic and sweeping. Most countries have fully opened their capital markets, leading to explosive growth in cross-border capital flows. Major investment banks and brokerage firms have gone global in their research and trading, while non-financial companies have expanded their operations around the world, creating intense competitive pressures in the process.

One of the most striking indicators of this process of globalization is the extent of foreign direct investment within the rich industrial nations. As shown in Chart 1, cross-border mergers and acquisitions have shown dramatic growth over the past decade, with the total volume of deals topping $1.2 trillion in 2000. Despite turbulent equity markets last year, cross-border M&A activity grew by 50% from 1999 and was up nearly 10-fold from the early 1990s. Moreover, cross-border deals represented 41% of all M&A in 2000, compared to only 24% five years earlier.

This frenzy of cross-border activity suggests that any tendency for major companies' shares to be priced simply on the basis of local market factors is now ancient history. Institutional investors and investment bankers alike are increasingly pricing firms according to standardized accounting information and common global metrics. Even small and mid-sized firms are continually being evaluated as potential takeover candidates destined to play a role in some mega-firm's global growth strategy.

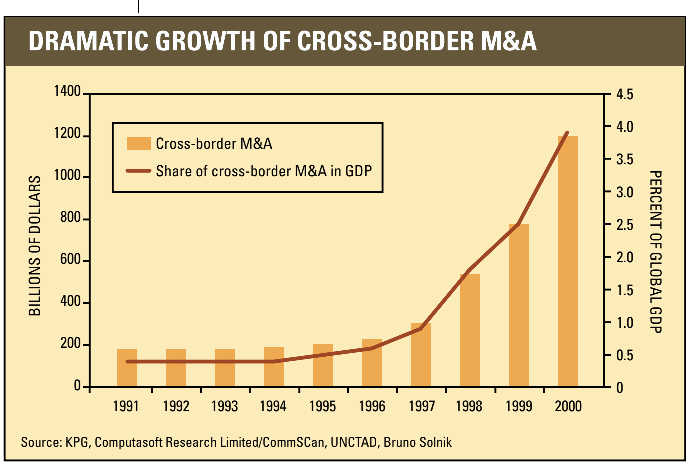

Chart 1. Cross-border M&A activity has boomed in the past decade, creating increasingly tight linkages between equity market pricing practices around the world.

As corporations take a truly global approach to their business, it makes less and less sense for investors to continue to categorize companies based primarily on the national location of the corporation's headquarters. Does it really matter to the company's economics whether DaimlerChrysler is considered a German company or a U.S. company? Should investors expect the global cellphone giant Nokia to move in lockstep with the Finnish stock market (or vice versa)? Should electronics giant Sony's share price move in lockstep with Japan's equity market, when its operations and sales efforts are spread around the world?

Consider also the impact of one of the most visible signs of globalization in recent years, namely the development of a common currency in Europe. In the past, when each country in Europe had its own currency and rather independent monetary and fiscal policies, it was common for many investors and fund managers to make "country bets" within Europe, emphasizing stocks in countries that were well positioned from a business cycle standpoint. Thus, even as recently as five to 10 years ago, most investment strategists in Europe couched their recommendations in terms such as "overweighting Germany and underweighting Italy."

Fast-forward to the 21st century with the last vestiges of independent currencies scheduled to disappear in 2002 when euro notes and coins finally replace local currencies such as French francs and Italian lira. With Europe's monetary policy now dominated by the European Central Bank, and most European companies thinking about their businesses in pan-European and global terms, country allocation strategies in Europe are going out of style rapidly. Investors in the "United States of Europe" are now naturally focusing on selecting the right sectors and the right companies within those sectors. Think about it: when is the last time you heard a U.S. investment strategist recommend "overweighting Illinois and underweighting Indiana?"

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This is not to say that country issues have gone away completely for investors in Europe. The British pound is still in its own orbit, as are some Scandinavian currencies. Tax and regulatory issues remain important as well. However, the trend is clear: European investors are likely to continue changing their investment focus toward pan-European or global investing, reflecting the global focus that most businesses are taking toward their operations.

Curiously, many institutional and individual investors have been relatively timid about adjusting their portfolios to the changing global landscape. In many countries, foreign stocks are still regarded as a separate asset class, justified primarily because of their risk diversification benefits. This means effectively that many equity portfolios have a strong "nationalistic" or home market bias, which can also bias investors' portfolios toward a few big stocks or sectors that dominate one country's market (think Nortel).

As noted by international finance expert Bruno Solnik, a key issue for investors is as follows: "If corporations take a truly global approach to their business, why do investors and investment firms continue to remain provincial and structure their global efforts around the old question: what percentage to allocate to foreign stocks?"

Where Do Country Effects Still Matter?

Not only has the importance of country decisions begun to fade in importance within Europe, but they have also faded between Europe and the United States. As Chart 2 shows, the correlation between monthly returns on the U.S. and European stock indexes in recent years has been relatively high – approximately 0.71 (1.0 is perfect positive correlation, -1.0 is perfect negative correlation). As a point of comparison, the correlation between the closely linked Canadian and U.S. markets is 0.80.

In theory, the higher the correlation, the less diversification benefit there is from investing in the other country. In practice, however, such correlations can change dramatically over time. And there can still be substantial benefits to international diversification simply by creating an expanded choice of companies in which to invest.

Where do country effects still seem to matter the most? Based on recent data, we would single out Japan and the emerging markets. As Chart 3 shows, both Japan and the emerging markets have had lower correlations with the U.S. market in recent years. The reason is simple: for much of the period, Japan's market went down or sideways while the U.S. market went up. Ditto for the emerging markets.

Forgetting the statistics for a moment, this makes sense from a fundamental viewpoint as well. Japan suffered from abysmally poor economic policy and lack of political leadership in the 1990s, resulting in virtually no growth in the economy or corporate profitability. Emerging markets were beset by serial crises in Latin America, Asia and Russia. In contrast, the U.S. benefited from pro-growth economic policies and buoyant trends in corporate profits over the same period.

Opportunities in Japan and Emerging Markets?

The aftermath of these growth divergences has left equities in Japan and the emerging markets looking quite cheap relative to U.S. equities, suggesting opportunity for substantial outperformance

AVERAGE CORRELATION OF MONTHLY STOCK RETURNS

1995-2000

U.S. - Canada	0.80
U.S. - Europe	0.71
U.S. - Japan	0.51
U.S. - Emerging Markets	0.67

Source: DataStream

Chart 2. Correlations between the U.S. and the Canadian and European markets have been relatively high in recent years. But Japan has moved to a different rhythm.

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of those markets if there is a fundamental improvement in growth and profitability in coming years. Japan's recent decision to move to more aggressive monetary easing could be important in that regard. Likewise, aggressive easing by the Fed has historically been good news for emerging markets, which typically have benefited from subsequent improvements in global growth and capital flows. Accordingly, we now have roughly 20% of our global equity portfolios exposed to Japan and the emerging markets, up from next to nothing a few months ago.

Eventually, when Japan and the emerging markets get folded into the United States of Pan-Eurasia-America, the importance of country decisions for those markets will probably fade as well. But for the time being, we are putting continued emphasis on top-down country research for Japan and the emerging markets, while we have moved toward more bottom-up sector and company research for Europe and United States – which can increasingly be thought of as one large economic zone.

It is also worth noting that in a world of increased market correlations and globally integrated industries, it is harder for us as investment managers to give a simple answer to the question, "What countries are most attractive now?" For example, we currently have a relatively small exposure in Europe of about 10% of our global equity fund, compared to an exposure of around 65% in the U.S. market. That does not mean that we hate Europe compared to the United States. Instead, it indicates that when we drill down to the industry level we are finding more companies in the United States that seem likely to dominate their global industries. When valuations are comparable, which is the case currently, we will opt to invest in the global industry leaders.

In short, in an era of globalization, top-down country decisions will still matter, especially in areas like Japan and the emerging markets that still seem to move to their own rhythms. At the same time, we have oriented more of our research and asset allocation emphasis to understanding global sectors and industries.

And as we wrote in *Boomernomics* nearly three years ago, "We part company with some advisors by recommending a core position in global funds that include foreign market exposure." To be sure, country funds will still be important, but they can also leave investors with too many eggs in one sector or currency basket, or at the mercy of the fortunes of one or two big companies.

There may be no such thing as a free lunch. But in financial markets, we would argue that the closest thing to a free lunch is diversification. And the most robust type of diversification is global in scope.

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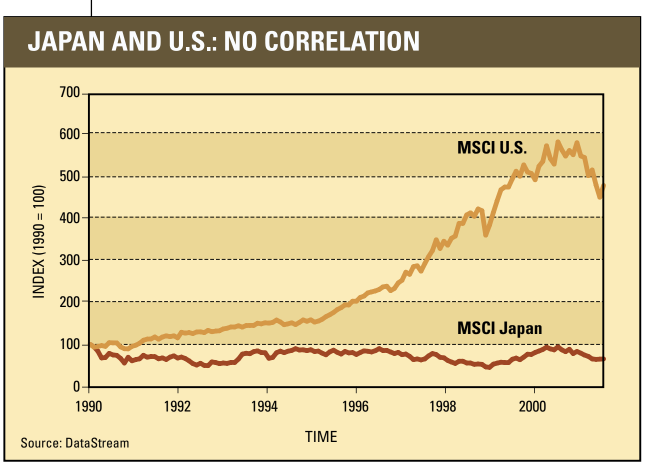

Chart 3. The low correlation between the U.S. and Japanese markets over the past decade is easy to understand: For much of the decade, the U.S. went up and Japan went down!