

**BEACON POINTE**

**A D V I S O R S**

**BEACON POINTE RESEARCH**

**THE CASE FOR INTERNATIONAL INVESTMENTS  
MAY 2003**

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### Executive Summary – The Case for International Investments

Beacon Pointe research indicates that international investment certainly has a place in every investor's portfolio despite the controversies surrounding the very tenet of international investments.

The case of international diversification has been embroiled in controversy due to several reasons:

- Fading diversification benefits due to increasing globalization
- US multinationals provide international exposure
- Currency volatility enhances risk
- US markets have outperformed international markets despite recent downturn
- Emerging markets, in general, perform poorly
- Management, custodial, trading, and taxation costs impact returns

In the investment world, investing based on recent market events can be very much like driving a car with your eyes locked on rear view mirror. Investors are likely to miss out on the potential outperformance of international equity markets as other forces combine to offset the negative perceptions of international investments. These forces include:

- Weakening dollar
- Flight of capital away from U.S.
- Recovery in the emerging markets
- Reversion to the mean of stock market performances
- Fundamentally cheap valuations in the international equity markets, especially in the emerging markets

***Beacon Pointe believes that these factors combine to make investments in markets outside the U.S. more attractive than have been in recent times, notwithstanding some of the stated advantages such as diversification and better returns not realized.***

### The Case for International Investments

#### Globalization and International Exposure

“There is always a disposition in people’s minds to think that existing conditions will be permanent.”

- Charles H. Dow  
1901

Stock performance of foreign companies mimic international stock markets.

In recent times, the economy has become increasingly global, and some investors have made the case that investing in U.S. multinational companies should provide them international exposure.

Although it sounds logical, it is difficult to make this case valid because each country’s capital markets reflect its economy, and individual companies tend to track their home markets. Regardless of how ubiquitous the U.S. multinational companies may be, their stock performances will not mimic companies that are located in these international markets, thus precluding the investor from reaping benefits from international stock market performance.

In addition, even when foreign business accounts for more than 50% of the revenues for US multinational, the stock prices of these companies are set by US investors reacting to the stock prices and bonds of US markets.

From an economic standpoint, despite globalization, Bernstein Research<sup>1</sup>, based on various sources such as Bloomberg and MSCI, shows that the world economies remain driven by local factors such as domestic interest rates, industrial production, trade balances, unemployment, corporate profitability, and so on.

#### Currency Volatility

Hedging can offset currency fluctuation while allowing the investor to benefit from currency movements.

Volatility in foreign currencies can help or detract from stock performances for international companies. Returns are boosted when foreign currencies rise against the dollar and fall when they decline against the dollar. Over the long term currency fluctuations do tend to cancel out.

Fidelity research has shown that the relative value has a major effect on returns of international markets vs. U.S. markets. The latest sustained period of time when international markets outperformed the U.S. markets occurred in 1984-1989, when international markets outperformed the U.S. markets by over 200% on a cumulative basis.

Hedging may be one solution to offset the currency fluctuations. For instance, if investors believe that the foreign currency is undervalued and therefore poised to rise, then he or she can reduce the hedge in order to benefit from the performance boost through the translation of the currency into dollars. On the contrary, if investors believe the foreign currency is overvalued and therefore poised to decline versus the dollar, then he or she can increase the hedge. Thus, hedging can reduce the volatility in currency fluctuation while retaining the ability to profit from currency movements.

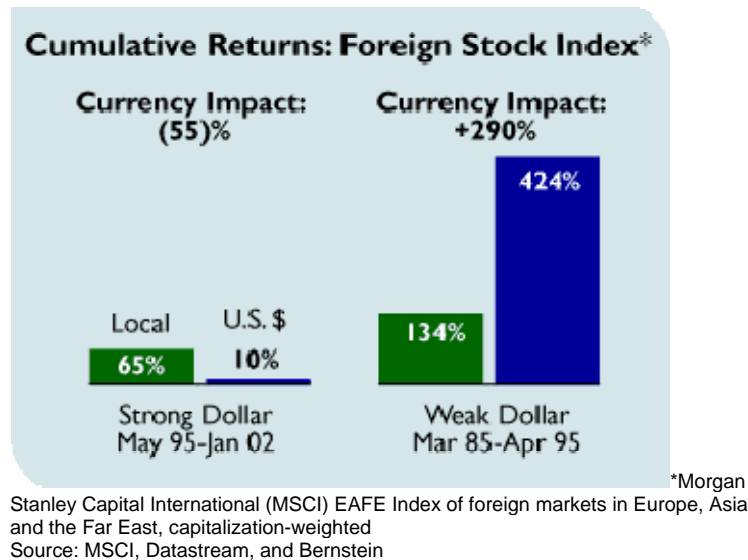
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<sup>1</sup> Bernstein – Top 10 Reasons Not to Invest Abroad. [http://www.bernstein.com/research/stocks/stocks\\_topten.htm](http://www.bernstein.com/research/stocks/stocks_topten.htm)

Although currency exchange declines may make purchases cheaper in foreign markets for U.S. products, there are two more important implications of a decline in the purchasing power of the US dollar:

- Competitiveness of U.S. companies would improve in global markets
- It would enhance the returns of investors who have some part of their investments in the global markets.

*Currency effects on stock returns can be paramount*



**Chart 1<sup>2</sup>**

The chart above, published in a recent Bernstein article, illustrates the impact on returns for U.S. investors investing in foreign markets. A strong dollar in May, 95-Jan, 02 caused returns from the international markets to be negatively impacted by 55%, while a weak dollar from Mar 85-Apr 95 was impacted positively for US investors to the extent of 290%.

Currency fluctuations can have huge impact on returns for U.S. investors

The question some investors may have is what might cause the decline of the U.S. dollar. To answer this, one must examine the trends in the current account deficit. From the chart below, we can see the current deficit, as a percentage of GDP, has reached 5% which implies an additional \$40 billion a month floating in the international markets. In the late 90s, with the U.S. economy and financial markets faring strongly relative to the rest of the world, this was not an issue as these dollars found their way back to the U.S. However, with a weak economy and a prolonged bear market, these additional dollars are being sold off and converted to some other currencies causing an erosion in the value of the dollar.

The value of the dollar in recent times has declined 14% against a basket of foreign currencies. In light of further erosion in the value of the dollar, US investors can get higher returns by investing a part of their investments in foreign markets.

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<sup>2</sup> Adapted from Bernstein article: February Performance and Strategy Update, Marc D. Stern, Mar 13, 2003

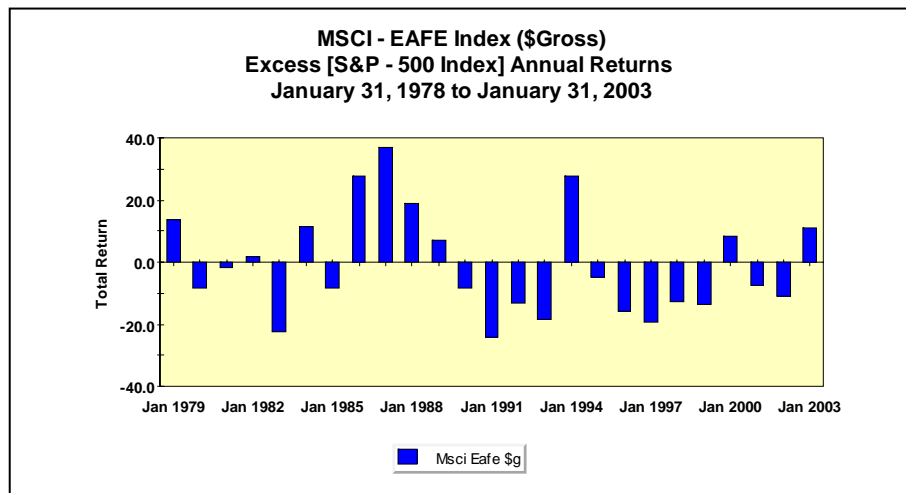
**Outperformance of U.S Stock Market**

International stock performance in recent times has been woeful in comparison to the U.S. stock performance and was most pronounced in the 1990s when a raging bull market in the U.S. contributed to the significant divergence. This has led to investors to put more money in the U.S. markets than in the international markets. But, as Charles Dow observed back in 1901, this tendency to extrapolate current trends into the future indefinitely will prove to be costly, as factors such as mean reversion may come into play to mitigate this divergence in stock performances. The following charts indicate the underperformance of international and emerging stocks underperformance in recent times.

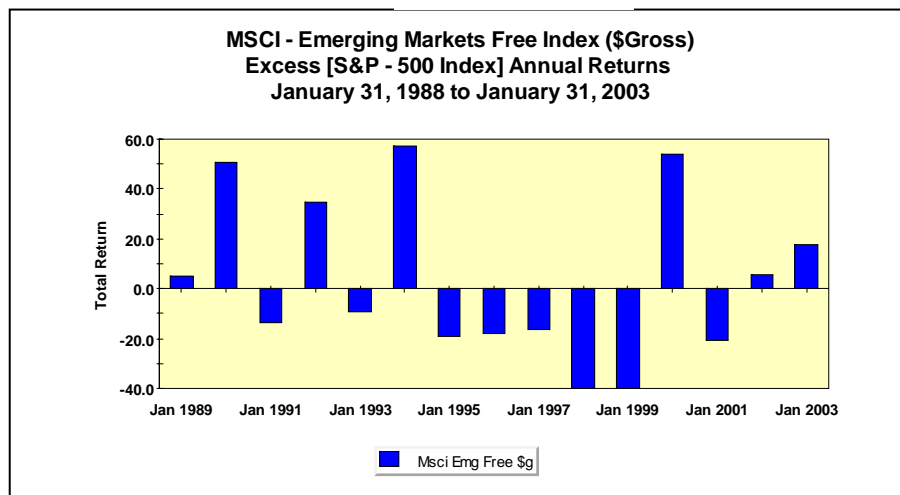
As illustrated below in Chart 2, EAFE (Europe, Australia, and Far East) markets have underperformed the US market in 11 out of the last 15 years. For the emerging markets, in six out of the last ten years, the U.S. markets have outperformed the international markets in spite of the economies higher growth rate in the emerging markets (see Chart 3).

EAFE markets have underperformed the U.S. stock markets in 11 out of 15 years.

**Chart 2**



**Chart 3**

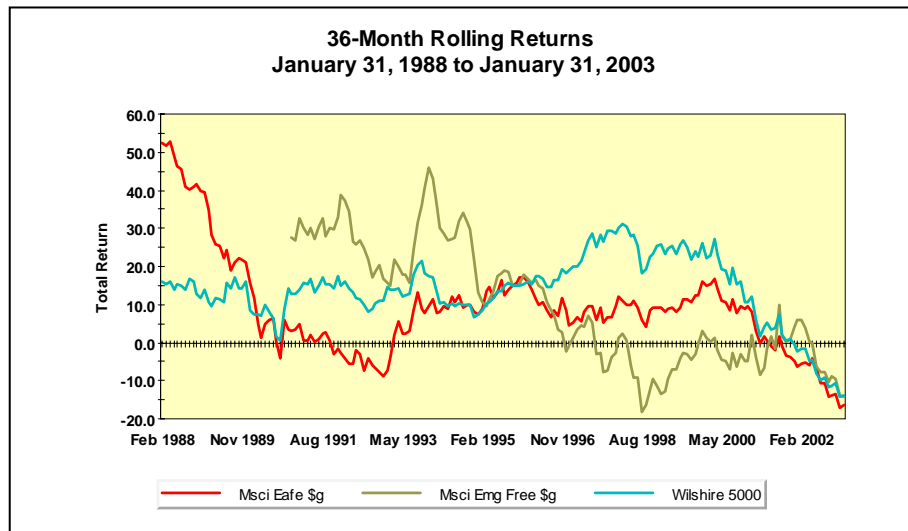


Emerging markets have underperformed the U.S. stock markets in six out of ten years.

Recent underperformance should not be construed as a predictor of future underperformance.

Even on a 3-year rolling basis (Chart 4), we can observe the lack of predictability of returns amongst the three asset classes, and as a result, strengthens the case for diversification using international stocks. Recent underperformance of international markets should not be construed as a predictor of future underperformance.

**Chart 4**



**Emerging Markets Are Bad Performers?**

Since the 1980s emerging markets have outperformed US markets 50% of the time.

When you look at recent performers, that viewpoint may be valid. However, if you look at long-term returns as shown in Chart 4, emerging markets have outperformed the U.S. markets about 50% of the time. In fact, in 1993, emerging markets returned a whopping 75% and investors were as enthusiastic then as they are downcast now.

Factors favoring investments in emerging markets include cheap valuations, positive demographics, high savings rates, rising income per capita, and change in cultural attitude.

Going back to the famous quote related to extrapolation by Charles Dow made more than a century ago, it would be a mistake to take a totally negative view of the emerging markets and not include it in your asset allocation. When you consider that countries in the emerging markets represent over 25% of the economic output, it becomes difficult to ignore them.

Other factors that are in favor of investments in emerging markets include inexpensive valuations, positive demographics, high savings rates, rising income per capita, and change in cultural attitudes.

On various valuation parameters such as price to earnings (P/E), price to book value (P/BV), price to sales (P/S), and price to cash flow (P/CF), emerging markets have historically cheap valuations providing potential boost to investments with low downside risks.

On a P/E basis, historical discount of international markets with respect to U.S. markets has been at 15%. Currently, it stands at 35%. Similar discounts have been observed for other valuation parameters.

Changing demographics will cause a shift, over time, in earning and spending power from developed markets to emerging markets.

High savings as a percent of GDP and declining nominal deposit rates portend increased spending in emerging markets.

Emerging markets are not suitable for all investors.

Back in December 2002, Beacon Pointe professionals performed a due diligence on AllianceBernstein for some of their value product offerings. We met with Mr. Giulio Martini, Director, Currency & Economic Research to discuss their international products and their perspective on international markets.

According to Mr. Martini, Bernstein Research shows that non-U.S. markets are now at attractive valuations relative to the U.S. stock market. The P/E of non-U.S. markets is 16.5x next year's earnings while the U.S. market is at 20x next year's earnings. On a price/cash flow basis, historically, non-U.S. stocks have been trading at a discount of 15% while the current discount is around 35%. This makes a compelling case for an increased exposure to international markets. Similar discounts have been observed on other valuation parameters such as P/BV and P/S.

The changing face of demographics makes for a strong case to consider international markets, particularly in the Asian markets (excl. Japan). Census estimates from United Nations, U.S. Census Bureau, and CLSA, suggest that there will be over 800 million people in the 30-49 year old range and a total of over one billion people in the 10-29 year old group. This compares to a total of a little over one billion people in the 0-9, and 50+ groups. This is in stark contrast to the aging problem faced in the developed countries that have had low birth rates and appear to be declining.

What this means is that the dependency ratio (defined as population of 0-14 year olds + population of 65+) / population of 15-64) will rise in developed world and decline in the Asian markets (excluding Japan). As such, there will be a shift over time in growth of earning power and consequently spending power from the developed world to the emerging markets. According to the Bank of Ireland, it is estimated that the number of people earning over \$5,000 per annum will rise from 226 million in 2001 to 541 million in 2010 assuming the GDP growth rates observed from 1986-1996. This is important because studies show that when incomes rise over \$5,000, 60% of each additional dollar earned is spent directly on discretionary items.

In a U.S. Roadshow by the Bank of Ireland, Ms. Jane Neill, Chief Investment Officer, said that the gross domestic savings, as a percentage of the GDP, is very high in many of the countries in the Asian markets including China, Hong Kong, and India with the average savings rate of 31% in 2001. Because of this huge savings pool, there is a significant amount of money waiting to be spent. With changing cultural attitudes, this appears likely to happen, as the people in these markets tend to be more materialistic.

Another factor likely to help the stocks of companies in these markets is the declining nominal deposit rates in Asia. For instance, in China, the 3-month deposit rate back in 1997 was 3.33% and as of Oct., 2002, it was 1.71%. The corresponding figures for India are 11.50% and 7.00%. Similar declines have been observed in other countries in Asia.

Caution, however is advised because many of the countries in these markets have woefully inadequate financial and legal structural integrity to protect your

investments, unlike that in developed markets. As a result, we advise no more than 5% of your portfolio be allocated to the emerging markets. High net worth and institutions can expect to add alpha to their existing portfolio if emerging markets are added to their portfolio mix.

### Management, Custodial, Trading, and Taxation Costs

Investments in international markets have traditionally been on the higher side relative to domestic stocks. However, in recent times due to the increasing globalization, these costs have come down and can be further mitigated by bucking against the trend in terms of trading – for example, buy when others are eager to sell and vice versa.

Increased competition in the investment world that caters to international investments, globalization, technology, and improved informational flow have all combined to reduce management, custodial, trading, and taxation costs and have made costs for international investments less onerous than they have been in the past.



### Conclusion

Many factors that have supported keeping the money in the U.S. for investors no longer appear to be valid, and it appears that investors in U.S. are better off by making some prudent investments in foreign markets.

Factors that have helped investors garner superior returns in the U.S. markets such as a strong economy, a strong dollar, and a strong bull markets have all but disappeared causing a flight of capital from the U.S. This, coupled with the huge current account deficit, has resulted in a decline in the value of the dollar.

Unfavorable demographics in the U.S., relative to some other parts of the world, is another factor that is making investments in the international markets such an enticing proposition for investors. Emerging markets appear to be most favorable in terms of demographics as the dependency ratio of the people in these countries account for a smaller proportion of the overall population. In addition, the spending power of the people in these countries is poised to be on the upswing making for an environment conducive to growth in the economy.

Considering all of the factors discussed in this article, we strongly believe that investors with some exposure to the international markets are likely to fare better than those solely invested in the U.S. markets. However, investments in these markets have risks that may not be suitable for all investors and would depend on the asset size. Please contact your Beacon Pointe consultant if you have any questions.