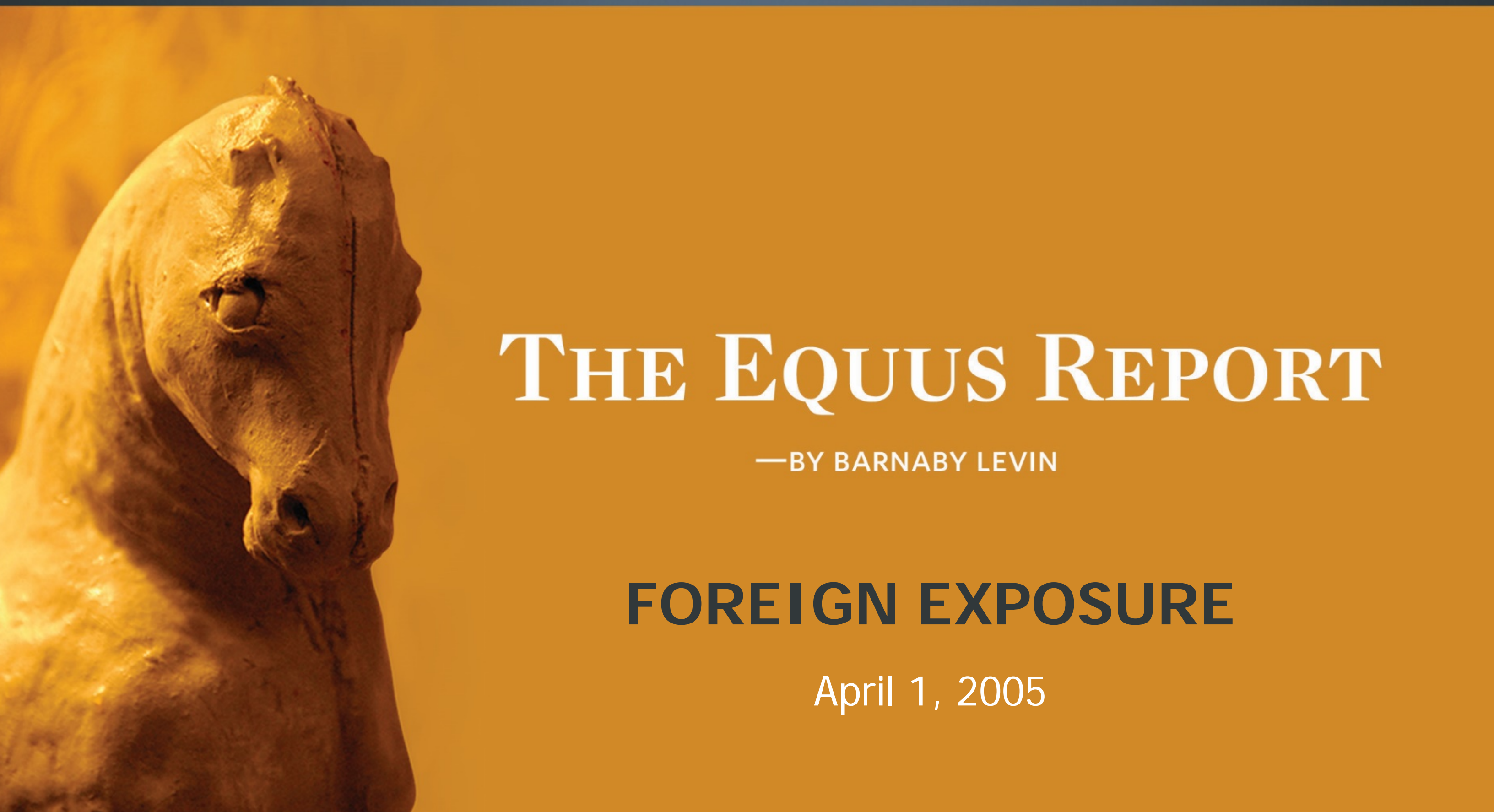

THE EQUUS REPORT

—BY BARNABY LEVIN

FOREIGN EXPOSURE

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Foreign Exposure

For several years, I have been steadily increasing our foreign exposure in the “Core” strategy.

One reason for this is valuation. Foreign companies like Sony or Cemex have tended to trade at lower multiples than their American counterparts on a price-to-earnings or price-to-sales basis.

Another reason is dominance. Given my bias toward choosing the number one- or two-company in any given sector, it behooves to me to “follow the leader”[1] wherever they’re based on a global basis.

Part of the reason for moving more money offshore is in recognition of the fact that we live in a global and, as Tom Friedman says,[2] ever-“flatter” marketplace. In my articles, “Creative Destruction” and “Is the U.S. Losing Its Competitive Edge?” I have demonstrated how, in my opinion, globalization and the internet have changed the competitive landscape, removing most of the significant barriers to entry and, as a result, spelled the end of “Fortress America.”

Finally, in recognition of our country’s increasing budget deficit and weakened dollar, it simply seems logical that a greater portion of the companies we choose should generate revenues in regions and currencies other than that of our own economy.

In 2004, for example, General Electric earned 41% of its $150 Billion in revenues offshore and in their annual report, said that they expect “as much as 60% of their revenue growth from developing countries over the next decade.”[3] In fact they said that, given the faster growth rates of developing nations, this is the only way multi-national companies can grow “in a slow-growth, more volatile world.”

So, I have been increasing our overseas exposure by adding more foreign companies and by choosing domestic companies that are more aggressively pursuing international strategies. But I also wanted to add more direct exposure to these emerging markets myself through the use of exchange-traded index shares.

[1] Source: Hoover’s Handbook
[2] “The World is Flat: A Brief History of the Twenty-First Century,” Thomas L. Friedman

Starting about a year and a half ago, in an effort to balance the inherent risk of more unpredictable, less regulated markets like that of China, I began investing in a core group of countries from South America to Asia Pacific, with demographics that are nearly the opposite of our own. The countries that I was and remain most interested in to begin with are those with younger populations. These countries are only now beginning to enter their "Spending Cycle" and, because of this – in conjunction with improved education; standards of living; and increased opportunities brought about by a flood of foreign investment – they are just beginning to enter a meaningful and arguably more sustainable consumption phase that has the potential to drive dramatic GDP growth for many years to come. At the same time, through broad geographic diversification, I am also seeking to reduce the risk of the periodic upheavals that are bound to occur in any young and transitioning culture.[4]

With regard to economics, "when you tally up global output measured in a single currency, emerging market countries already account for 19% of the world's production, with China alone at 4%. When measured by units of output, the ratio for emerging markets rises to 31% while, on its' own, China accounts for 13%."[5] Clearly, there is a divergence. But the fact that this divergence is taking place at a time when emerging economies are growing faster than those of their more developed brethren is an indication that this gap is only likely to widen.

Last year, China attracted a record $60 billion from foreign investors and, in January, received another $4 billion as the government allowed 3,563 foreign companies to build stores and factories.[6] According to the National Bureau of Statistics in Beijing, their 2004 GDP, now valued at $1.649 trillion, grew 9.5%[7] There are estimates that, over the next twenty year, China will become "the largest consumer and consumer-finance market" in the world.[8]

Because the demographics driving this growth are unlikely to change for many years – and given the likelihood that these countries will continue to promote policies that are not only in their own best interest, but also favor these high rates of growth – new companies will continue to form as a result of direct investment; their domestic listings will expand; and odds are that, over time, their markets will rise just as ours has done over the last three decades. I suggest that, for decades to come, a select group of these developing nations will continue to exhibit robust growth and that we must respond by increasing our exposure to their markets today.

[3] "GE Pins Hopes On Emerging Markets," Kathryn Kranhold, The Wall Street Journal, March 2, 2005
[4] *There are additional risks associated with international investing. International investing may not be for everyone*
[5] "Investing in Emerging Markets," David Kotok, Cumberland Advisors, December 6, 2004
[6] "Foreign Investment in China Rose 10.7% in January," Xiao Yu, Bloomberg News, February 19, 2005
[7] "China 2004 GDP Rises 9.5%," Dow Jones Newswires, February 28, 2005
[8] "GE Pins Hopes on Emerging Markets," Kathryn Kranhold, The Wall Street Journal, March 2, 2005

It is not that the US is in "decline" – although, as I have said, I believe that this may happen soon enough.[9] But, as a proportion of the global economy, our role is already beginning to diminish.

As Geoffrey Colvin says, "Economic growth is an uncomplicated idea. Just think of it as labor-force growth times productivity growth (and) as American's Baby Boomers retire, our labor- force growth is going to slow"[10] at the very time when emerging market productivity, though starting from a relatively low base, is accelerating overall.

Yet productivity is on the rise, not only in emerging markets, but also in Europe. Over the past five years, I have purposely avoided any significant exposure to continental Europe, given its entrenched socialism, aging population and Herculean task, not only of integrating East and West Germany, but multiple countries, each with different cultures and objectives, under this loose framework fondly referred to as the European "Union." Five years after the introduction of the Euro, the region's economy is still lagging that of the U.S. for the 11th year in 12.[11] But as David Kotok of Cumberland Advisors points out, there are forces underway that may once again make Europe a more formidable competitor.[12] According to him:

1. Capitalism is a rising phenomenon and the 35-hour workweek is headed back to 40. Given the threat of production moving to a new eastern EU member from an older one, the "old" countries are beginning to work more and with less wage pressure.
2. Capital expenditures are increasing, especially in the "accession" countries like Turkey.
3. Corporate tax rates are falling. In nearly every EU country, the corporate tax rate is now less than or equal to that of the U.S. and, after combining our 35% federal rate with that of states like California and New Jersey, even Germany at 40% is competitive.
4. In 2007, ten new countries will join the EU. And this "borderless" bloc of twenty-five countries promises a vastly improved range of products and productivity.
5. While ostensibly moving toward greater transparency and openness within and among its member states, the EU retains its protectionist bias toward the rest of the world and it continues to create barriers-to-entry for us in their drive toward self-sufficiency.

We may wonder – given the ongoing sluggishness of the European economies – about the Euro's recent strength. It may be partly due to some of the above. At the same time, central

[9] "Is the U.S. Losing its competitive Edge?" February 1, 2004; "Risicare," April 16, 2003
[10] "Value Driven: The U.S. is in decline – and that's a good thing," Geoffrey Colvin, Fortune, February 21, 20005
[11] "Europe to Lag Global Growth on Costs, Population." John Fraher and Christian Baugaertel, Bloomberg News, July 12, 2004
[12] "Report from Rome," David Kotok, Cumberland Advisors, February 24, 2005

banks all over the world are finally realizing the need to diversify their over-dependence on our currency, and the wisdom of making sure their foreign currency holdings more accurately reflect their own domestic balance of trade. Whatever the reason, central banks are shifting reserves away from the dollar [13] and a recent statement by South Korea about their intent to increase investments in other currencies should sound a siren. South Korea – with more than $200 billion in U.S. reserves – is the fourth largest holder of US debt in the world after Japan, China and Taiwan.

Like a child whose universe expands in stages from home to school to country the older he or she gets, so must our investment perspective evolve as the world's economic horizon grows ever "flatter," creating a single playing field that will ultimately know no boundaries. This, in the end, is why we must think – and act – globally.

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[13] "Central banks shift reserves away from the US," Chris Giles, Financial Times, January 24, 2005