

# The right tools for the job



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## Global strategies are the key to adding value.

The first quarter of 2003 was a period of intense anxiety. Geopolitical concerns, terrorism fears, worries about a prolonged economic downturn, and questions about corporate accounting and governance all weighed on the minds of investors. Naturally,

this anxiety is manifested in how assets are priced in capital markets. In the United States, for example, the real yield on Treasury bills is negative; that is, investors are so risk-averse that they are willing to give up purchasing power for perceived capital safety. Nominal rates, currently at 1.2%, are less than one quarter of their 50-year average, 5.3%.

Real bond yields are less than half the average of the last 20 years. Inflation expectations are also modest—about 2%, as compared to 4% over the last 50 years—reflecting subdued expectations of demand and earnings growth.

Risk aversion is also reflected in corporate yield spreads. High-quality companies are selling at normal spreads to Treasuries, but lower-quality credits are trading at levels nearly two standard deviations above normal. Last autumn, when anxiety was at its peak, lower-quality spreads were at almost unprecedented levels above Treasuries.

In equity markets, while prices have fallen substantially since March 2000, stocks in developed markets are still not cheap in an absolute sense.

Emerging markets are the exception: they are, in fact, quite cheap. The forecast profitability for emerging markets is marginally higher than that for developed markets, and yet emerging markets companies are trading at a substantial discount to their developed market peers.

In absolute terms, equities are at more or less average valuations: neither compellingly cheap nor disturbingly expensive. But they are very cheap relative to bonds and cash, which are themselves quite expensive. The equity risk premium is at its highest level in a decade, leading to the expectation that equities will outperform fixed income around the world over the next year.

However, the returns expected for both asset classes are modest: about 4% to 5% for bonds, and about 9%

for equities. This leaves most pension plans short of their assumed liability growth, making it imperative that pension funds capture alpha from their managed assets.

How to approach this is not obvious because, unlike three years ago, there are no broad mispricings in the market to exploit. Growth and value look fairly valued in relation to each other. Small-cap stocks are trading at normal valuations relative to large-cap stocks. In fact, over the last twelve months, there has been no discernable style or sector difference to returns.

What are some solutions? First, expand the opportunity set. In other words, go global. Next, concentrate portfolios to their best ideas only. And last, actively manage currency exposure.

Why go global? Even though there are no broad mispricings in the market, there are still opportunities. The indiscriminate selling brought on by investor anxiety has led to interesting opportunities in the market. However, those opportunities vary by sector.

Why concentrate a portfolio into fewer holdings? In a world of high anxiety and low growth expectations, there is no force to drive the broad market. Alpha will be a function of stock picking, not of asset class, style or sector exposure. In order to maximize the benefit, stock selection should not be diluted by other constraints.

And why active currency management? Currency management can both reduce risk and enhance return. In that light, there is a strong case for avoiding exposure to the U.S. dollar. The U.S. is accumulating record current account deficits. The interest rate differential is negative between the U.S. and all the major regions except Japan. And while foreign investment in the U.S. is still maintaining the U.S. dollar at relatively high levels, any drop in those flows will cause the greenback to fall.

In summary, intense anxiety and loss-aversion have made fixed income assets expensive and increased the relative return expectations for equities. There are no broad class or style mispricings in the equity market: alpha will be a function of stock selection. Markets outside the United States—especially emerging markets—are cheaper and thus offer higher return potential. And currency diversification away from the U.S. dollar is desirable. ■