GLOBAL INVESTING: NEW FORCES AT WORK

Corporations are no longer defined by borders—investors shouldn't be either.

JOHN REINSBERG

Deputy chairman, Lazard Asset Management.

The case for globalization is an old tale, with many forces at work making the world a much smaller place. Corporate governance is not unique to Wall Street but exists worldwide. The competition for labor, otherwise known as the 'talent war,' has gone global, evidenced by global outsourcing growing at a frenetic pace. China has become the world's new engine for growth—at least for now.

There are many global forces at work: the developed world now clearly has coordinated monetary cooperation; accounting standards are being harmonized on a global basis through the International Accounting Standards Board; labor can now move freely throughout many regions in the world, particularly within the EU; and companies now operate around the globe through borderless organizational structures. Nationalism and the home country investment bias is being replaced by a global investment landscape in which Dutch pension funds no longer focus only on Royal Dutch, Philips, and Unilever but rather have become pan-European investors.

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The global competition for capital has forced companies to play by new global rules, including governance. Liquidity in local stock markets continues to climb as a new 'equity culture' emerges around the world through pension reform.

The number of decisions that global investors have to make has diminished as the MSCI World index has migrated from a single country focus (23 countries) to more of a regional approach with only seven choices (Canada, U.S., Euro-denominated Europe, non-Euro-denominated Europe, UK, Japan and Pacific ex-Japan). Where and how a company does business has become more important than where it is domiciled. Country of domicile has little effect on business in multinational companies like Nokia (99% foreign sales), GlaxoSmithKline (92% foreign sales) or Colgate (72% foreign sales). In fact, a breakdown of the top 500 companies in the MSCI World index shows that 74% can be categorized as global companies competing around the world, with the remaining 26% being more locally focused.

Industry or sector influences have therefore become a much more important metric in determining investment results. Several academic studies provide empirical evidence of this premise. A study in the *Financial Analysts Journal* (Dec. 2002) on "Cross-Industry and Cross-Country Allocations" points out that an industry-relative forecast model outperforms a country-relative forecast model for the 10-year period ending June, 2001.

Another study published by AIMR in 2003 dealing with measurement of the "Performance of Alternative Perfect-Foresight Strategies" points out that the industry-tilted investment approach has become more dominant since 1999. The 10-year efficient frontier (ending in 2003), which searches for the optimal asset allocation between the S&P 500 and the MSCI EAFE index, finds the optimal trade-off between annualized return and risk exactly at the 50/50% mark.

Global investing's time has come. Everything is connected: the world has become a single economic unit and opportunity set. However, the system of global financial markets is not perfectly efficient, with many asymmetrical risk/reward opportunities to exploit. Understanding these connections and asymmetries is still founded in fundamental analysis and research. A portfolio constructed from the bottom up clearly has many investment asymmetry and risk advantages. ▮