WHEN IS AN OIL STOCK NOT AN OIL STOCK?

Country of domicile can have a greater effect than sector.

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Large parts of the fund management industry believe that employing a top-down strategy—particularly a strategy based on forecasting returns between geographic areas of the world—is too difficult to do and doesn't add much value. Towards the end of the 1990s, most investment managers became increasingly disillusioned with using top-down strategies to run European equity portfolios. Largely as the result of the technology, media and telecommunications (TMT) bubble bursting, they dropped country level analysis altogether, with many becoming pure bottom-up managers.

Using principal component analysis, I examined 21 European equity markets over two distinct time periods: the five years to the end of 1999, and the subsequent five years. The objective of my analysis was to look for the relative strength of the country effect in these two periods.

THE COUNTRY EFFECT IS ALIVE

The consensus would expect the country effect to have withered since the introduction of the euro and the economic reforms that accompanied it; actually, the opposite has actually been true. The country affect has reasserted itself and other analysis would suggest that, in Europe, country and sector effect are currently on par in terms of importance.

The European analogy is applicable to global equity portfolios. At the end of 2004, according to Intersec's EAFE equity universe, nearly two-thirds of investment managers employed a bottom-up-only approach. Of the remaining third, very few probably employ any sort of explicit geographical strategy when analyzing global investments.

I am not suggesting that a geographic strategy will add more alpha than bottom-up stock picking or global sector analysis, but I do believe geographical analysis is largely ignored today because many managers gave up on it during the TMT bubble. The law of active management states that the larger the independent opportunity set the better our chance of adding value, so why unnecessarily constrain that opportunity set?

What has many managers stymied is how to successfully combine a top-down strategy while investing in the appropriate stocks. This begs the question: when is an oil stock not an oil stock? An example will best illustrate how to approach this problem.

PONDERING PETROBRAS

Petrobras is a Brazilian oil company. From the perspective of a Brazilian investment manager running a local portfolio, it behaves as he would expect versus his universe of investments—that is to say, as an oil stock would. However, this is not true for an investment manager running an international equity portfolio with the latitude to invest in Brazilian equities. Thus, one cannot directly compare Petrobras with other oil firms such as British Petroleum or Exxon Mobil; although they are of course all impacted by the movement of oil prices, the largest effect on the price of Petrobras is the fact that it is a Brazilian stock. While it might be categorized as an oil stock, if the international portfolio manager decides he wants to buy Petrobras he will first have to review his expectations for those factors driving the Brazilian equity market. Alternatively, when the international portfolio manager is looking to invest in BP or Exxon, the country effect on each company's share price will be dwarfed by developments in the energy markets.

> **"IN EUROPE, COUNTRY AND SECTOR EFFECT ARE CURRENTLY ON PAR IN TERMS OF IMPORTANCE."**

Stocks are largely driven by a different balance of similar factors. If we assume these factors can be largely categorized as geography-, sector- and company-specific, we get some way towards understanding how to combine top-down fundamental analysis with individual stock picking. ■