

Is the Time Right for International Equities?

by Robert A. Simms and Herve van Caloen

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Roiling U.S. markets have many investors nervously questioning whether domestic equities have reached full valuation. With the Dow and Nasdaq indices whipsawing like some deranged pinball game, the timing could hardly be better for financial planners to steer apprehensive investors toward quality international stocks, particularly European equities.

Concurrent events in domestic and international markets have combined to create an unusual investment opportunity. The United States is currently in the eighth year of its economic cycle. Stocks with P/E ratios of 25, 50 and even higher—unheard of just a few years ago—represent significant portions of both institutional and individual investor portfolios. It's unlikely U.S. equity markets can continue to rise much further. As Morgan Stanley senior VP Robert Rowe puts it, "The trees don't grow to the sky." When will investors conclude domestic stocks at

The authors of this article suggest that financial advisors consider international equities as an investment for their clients, especially in light of two trends: unprecedented highs for U.S. stock prices and the positive effects of European economic unification.

historic all-time high prices are overvalued? Ricocheting domestic stock prices seem to be telling us that the time may be at hand.

The majority of today's individual investors were not in the market in 1987, the last time the bottom dropped out. Where will these investors, most of whom have never experienced a dramatic slide in portfolio values, turn when domestic equities plunge? Some will doubtless turn to fixed-income vehicles, but while that solution may temporarily address safety concerns, paltry single-digit returns will be unsavory medicine for investors grown accustomed to double-digit multiples.

Overseas, particularly in Europe, a different scenario is unfolding. The unification of the European economies has triggered a movement toward American-style capitalism, as increasing economic deregulation nudges the Old Continent ever closer to a free market such as exists here in the States. Europe has, for the most part, created a free flow of people, capital, goods and services within its borders. Tariffs have been eliminated and non-tariff barriers are being removed as, one by one, all of the old defensive mechanisms crumble. This portends well for European

economies, as well as the equity offerings of quality European companies.

Interest rates are relatively low, reflecting low inflation, and are now set at the European level so the nominal cost of capital is the same for all member countries. Converging inflation rates, remarkably at the lowest level, are making real interest rates equal to all.

In unifying, European governments have let the Germans, with their conservative economic policies, set the tone. This has created an integrated union for the weaker governments to find the strength to put their fiscal houses in order. It's a ploy that has worked marvelously with positive ramifications for business. Companies headquartered in the areas that suffered from chronic inflation in the past are benefiting from lower interest rates. The cost of capital in Italy or Spain, for example, was historically much higher than in post-war Germany, giving companies there a substantial competitive disadvantage. They used to pay high nominal interest rates that reflected high inflation rates and included a larger risk premium, resulting in a higher real cost as well as nominal cost of capital. Today, with the euro, the playing field is level.

Deregulation and Privatization = Investment Opportunity

These achievements are impressive on their own, but the economic unification of Europe is embryonic. Deregulation and privatization of large sectors of the economy are forcing the deregulation of labor markets. The opening of borders has kick-started a round of tax cuts as countries are competing for investments. The abolition of capital gains taxes for corporate shareholdings in Germany will lead to the dismantling of the overwhelming power of German banks over the corporate sector. The trend toward ever more deregulation appears strong and, at least for the time being, irreversible.

The new competitive environment has brought substantial cost reductions. European companies have become leaner. Open borders and the elimination of currency risks have provided corporations with additional bargaining power. Manufacturing facilities can now be relocated to European Union (EU) countries that enjoy lower labor cost, lower corporate taxes or a more flexible working environment.

Corporate, income and capital gains taxes are being lowered in almost every country, even Germany. Once corporate tax rates abate in one country, it becomes inevitable for others to follow suit, thus setting in motion an accelerating trend. It is inevitable that the different EU countries, just like the states in the United States, try to outbid one another. Pity the poor stubborn French. They will have no alternative but to follow suit or risk massive investment outflows. It is not foolish to believe that Europeans may gradually move to a zero corporate tax rate as countries keep outbidding one another to attract business.

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S&P 500 Versus EAFE

A historic perspective of the relationship between domestic and developed international markets can be gained by examining the relative performance of the S&P 500 Index and the Morgan Stanley EAFE (Europe, Australia and the Far East) Index. For the years 1994–1998, the average annual return of the EAFE was about 10 percent, which lagged behind the S&P 500 at 23 percent. But in previous years, such as during the 1980s, the EAFE outperformed the S&P 500 by an average of 5.5 percent a year (+21.8 percent to +16.3 percent). In 1999, the performance pendulum swung back toward the EAFE, which surged ahead of the S&P 500, 27 to 21 percent. So although the United States has beaten the EAFE in seven out of the last nine years, investment life is cyclical. And as noted by Morgan Stanley's Barton Biggs in a recent newsletter, there is a “performance ebb and flow between the United States and EAFE that is almost biblical: Seven fat years seem to be followed by an equal number of lean years.”

Dick Vartanian, chief investment strategist at New York's Republic National Bank, suggests that when comparing the EAFE and the S&P 500, it's important to recognize that the two indices are measured differently. “Investors who look only at the indices might get a distorted picture,” says Vartanian. “There is a significant difference between the performance of a market index and that of a typical stock.”

The performance concentration of the S&P 500 is among the top 25 to 40 stocks, referred to as the *two-tier effect*. Performance may broaden from time to time, but fundamentally it remains concentrated among the largest issues. However, the performance of the EAFE more closely reflects the market as a whole. So when comparing the EAFE and S&P 500 indices for 1999, the EAFE performance edge—27.11 percent to 21.04 percent—was actually better than it appeared because of the significant difference in performance between indices and actual portfolios. As Mr. Vartanian notes, “That difference makes it easy for investors to be thrown off.”

Those of us who invest in and closely monitor the international markets believe the EAFE will outperform the S&P 500 over at least the next three to five years. A Morgan Stanley Dean Witter study pre-

TABLE 1

S&P Index + EAFE = MSCI World Index

| | United States | Europe | Japan | United Kingdom |
|--------------------------------|--------------------|--------------------|--------------------|-------------------|
| 1998 GDP in \$ billions | 8,457 (42%) | 5,961 (32%) | 2,794 (19%) | 1,209 (6%) |

Percentages represent the percentage of developed market
 *EAFE includes Australia, Hong Kong and Singapore (6%)

dicts a mammoth flow of funds into European equity investment over the next decade, as much as \$13 trillion, equal to 1.5 times Europe's current stock market capitalization.

Momentum Shift

There are three fundamental elements supporting the quantum performance shift between domestic and international markets: valuation, economic cycles and shifting flow of funds.

Valuation. Based on quantitative valuation measurements done by our organization—price/earnings and price/book ratios, return on equity and earnings growth rates—the developed international (EAFE index) markets are currently undervalued compared with the S&P 500. Also, prospects appear good that the “developing” emerging markets will eventually be added to the EAFE index.

Economic cycles. The major developed markets—Europe, Japan and United States—are in distinct stages of their economic and stock market cycles. The economic recovery in the Pacific is now verified and the markets are responding appropriately. Japan, representing 16 percent of the world gross domestic product

(GDP) and 25 percent of its savings, saw its national index soar 51.40 percent during 1999, despite a slightly negative third quarter. The Hong Kong national index realized a similar gain of 55.24 percent for the year. Overall, the world index for 1999 without the United States was 20.95 percent compared with 15.82 percent when the United States was included.

The U.S. economy, which appears fully mature, could slow with reduced profitability if deflationary pressures increase and if the Fed triggers additional interest rate hikes.

Flow of funds. There is a shift into equities that is in its embryonic stage in Europe. The Continent has seen its cities bombed and economies ravaged by two world wars in the last 100 years. Much of it has been living under the shadow of communism for decades. Europeans have invested most of their assets in gold and bonds; what remains is likely to be found stashed under mattresses. New lower interest rates, the privatization of state assets and pension reform are giving birth to a new equity culture on the Continent where levels of equity ownership are a fraction of what they are in the United States and United Kingdom. Equity ownership in Japan remains at historic lows.

The U.S. bull market has been sustained by “Goldilocks” conditions: stable

economic growth, subdued inflation, declining interest rates and rising earnings. Baby boomers, who represent the substantial earners and savers in the economy, have pushed the U.S. market to unprecedented valuations. Their investment vehicles have been mutual funds, 401(k) and Roth IRA plans. But the baby boomer bulge is due to begin subsiding in 2005, and with the U.S. equity market approaching or already at full valuation, an accelerating shift of investment assets out of domestic stocks and into international equities appears inevitable. The question for financial planners and their investor clients should be when, not if, they should reallocate assets.

Performance Considerations

The United States appears, after years of outpacing most other industrialized countries, ready to relinquish its leadership role in economic growth to Europe and the emerging markets. Europe could easily exceed the U.S. growth rate by one percent or more annually over the next half-decade. As European companies follow the lead of the United States and restructure, reducing staff and wages, and spinning off or shutting down non-core businesses, they are beginning to experience greater relative profit improvement and generate higher returns on invested capital.

Massive layoffs, on an even grander scale than what was experienced in the United States in the last two decades of the 20th century, have been implemented in corporate Europe, resulting in leaner companies. Workers, organized or not, have had to show more flexibility. Production costs and labor rigidities, which had driven costs to unsustainable levels in the past, are being remedied. Moreover, with open borders and the elimination of currency risks, corporations have gained bar-

The Role of ADRs

As the world's borders open up, companies are being forced to relocate their manufacturing facilities to the most attractive areas within the EU—that is, countries that offer reduced labor costs, lower corporate taxes or a more flexible working environment.

Production is moving to the most business-friendly areas and goods are then freely shipped to the rest of Europe. The United Kingdom, Ireland and Spain have thus experienced large direct investments. On the other hand, Germany, which happens to have the highest level of corporate taxes in the Union and the highest labor cost in the world, has experienced large net outflows of direct investments in the last decade. Increasing outflows of capital into Germany's neighboring countries' production facilities are not being matched by foreign direct investments in Germany.

There is little enthusiasm among corporations to set up production facilities in Germany. Why bother since the German market can be accessed from Ireland or the United Kingdom with little additional transportation cost?

There are other enormous economic considerations that support the case for global portfolio diversification. Ninety-four percent of the world's population resides outside the United States. Consider China, with over a billion people, \$150 billion in hard reserves and seven to eight percent annual growth. China has a GDP of \$903 billion and is expected to represent 25 percent of the world GDP by the year 2025. Non-U.S. markets now account for about half of the total world market capitalization. In addition, recent trends and history suggest that their share of world market capitalization is likely to grow (see Table 1 on page 100).

In light of all these factors, does it make sense for financial planners to advise their investor clients to restrict their portfolios to fully valued U.S. equities at the highest prices in history? The international markets are diverse and enormous, containing nine of the world's ten largest real estate companies; eight of the ten largest in automobiles, insurance, metals, and gas and electric; and seven of the largest banking and beverage companies. Should these great companies be overlooked merely because they are based overseas?

Yes, investing outside the United States involves risk, but those risks and any potential surprises can be minimized using ADRs.

- ADRs facilitate proxy voting.
- ADRs are often marginable; ordinary shares are not.
- ADRs often have listed options.
- ADRs are convertible into the underlying security at the investor's request.
- ADRs versus ordinary shares, can easily be registered and delivered to investors.
- ADR annual reports, for the most part, are in English.
- ADRs avoid global currency changes associated with holding foreign shares.
- ADRs of U.S. securities are traded in the secondary market on the listed New York Stock Exchange.
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In advising clients on portfolio selection, financial planners might ask themselves an important question: Which is the greater risk: using ADRs to diversify client portfolios and access some of the largest, most successful companies the world, or limiting investment choices exclusively to a domestic market at its all-time historic high?

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gaining power. Thanks largely to the elimination of borders, manufacturing facilities are now being relocated to the most attractive areas within the EU—that is, countries that offer reduced labor costs, lower corporate taxes or a more flexible working environment.

In the past, it often made sense to set up small manufacturing facilities in various European countries to circumvent all kinds of tariffs and non-tariff barriers. Opening of the borders prompted a consolidation of these facilities. Today, companies' investment decisions are easier to

make. Production is moving to the most business-friendly areas and goods are then freely shipped to the rest of Europe. The United Kingdom, Ireland and Spain have thus experienced large direct investments. On the other hand, Germany, which happens to have the highest level of corporate taxes in the Union and the highest labor cost in the world, has experienced large net outflows of direct investments in the last decade. Increasing outflows of capital into Germany's neighboring countries' production facilities are not being matched by foreign direct investments in Germany. There is little enthusiasm among corporations to set up production facilities in Germany. Why bother since the German market can be accessed from Ireland or the United Kingdom with little additional transportation cost?

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