

Visit **Benefits and Pensions Monitor** magazine online at: <http://www.bpmmagazine.com>

---

## **Taking A Fresh Look At International Equity**

By: Chris Lees

February and March – two months, two milestones.

Jazz enthusiasts might be disappointed that the last reference refers to **investment** milestones rather than Miles Davis' classic album, but we believe **plan sponsors** should be aware of these important developments which, in our view, suggest the time might be ripe to increase the amount of international equity exposure in your scheme.

February's milestone was a change in the level of correlation between the U.S. equity market and international equity markets. Correlation is measured on a scale of one, where the markets move in perfect unison, to minus one, where the markets move in opposite directions.

Between 2003 and 2005 the correlation between the U.S. equity market and international developed markets was very close at 0.93, based on monthly movements in the S&P 500 Index and the MSCI EAFE indices. Portfolio theory suggests that investing abroad should help to diversify a portfolio. That isn't what a correlation of 0.93 says.

In February, we finally had concrete evidence that this was changing. During the two-year period ending February, the level of correlation between the S&P 500 Index and Morgan Stanley's EAFE indices dropped to just 0.63. That's still a reasonably high level, suggesting that 63 per cent of developments in the U.S. market are echoed in markets around the world. However, look at it the other way and it also says that 37 per cent is accounted for by local factors.

That's a welcome degree of portfolio diversification, and if you believe the arguments about Asia and Europe 'de-coupling' from the U.S. economy going forward, it's likely to become more significant over time. For plan sponsors who were deterred from looking outside the U.S. market for investment opportunities, the world just got a whole lot bigger.

March's milestone was potentially historic. March 29, possibly for the first time since World War I, the market capitalization of Europe passed the U.S.

### **Certain Assumptions**

Fans of the U.S. market might feel reassured that certain assumptions need to be made for this statement to be true. One assumption is that many of the Eastern European markets, as well as Russia, must be included in 'Europe' to make up the numbers. The second assumption is that because national governments still hold large stakes in many of the floated companies on the European Equity Market, if they were removed, the market would decrease in size.

That being said, a very important shift must be noted. For many years the U.S. market was far and away the largest equity market, with the rest of the world trailing behind. That the value put on public companies in Europe, however calculated, has come anywhere close to the total capitalization of the U.S. equity market demonstrates that the European markets must have done a great deal of catching up.

So that brings us to where we are today; an environment where investment prospects for the international equity markets are significantly more attractive than the prospects for the domestic U.S. equity market.

Economically, the level of growth available in Europe and Asia is rising, in contrast to flat or falling growth in the U.S., and corporate profits are moving in the same direction. Secular trends in both Europe and Asia are highly supportive of equity markets, in our view,

with changing corporate culture and rising levels of share buy-backs and merger and acquisition activity making for an attractive environment for stock selection.

### **Currencies Strengthen**

Finally, as anyone who has traveled to Europe or Asia in recent months will be only too aware, international currencies such as the Euro, Sterling, and most Asian currencies have strengthened against the U.S. dollar. That might make for an expensive holiday, but a rise in the value of international currencies can help to boost international equity investment returns in U.S. dollar terms. Again, in our view, this isn't a short-term phenomenon.

One theme, is a shift in the financial 'centre of gravity' to Europe and Asia. Did you know that both the London and the Hong Kong Stock Exchanges handled a higher value of IPOs last year than the New York Stock Exchange? Our client portfolios reflect this shift, with their strategic focus on European and Asian financial growth stocks.

International equity markets have passed two major milestones in recent months and we believe the time is right for plan sponsors to review their overseas equity exposure in light of these developments.

Chris Lees is an investment manager responsible for EAFE and global equity portfolios with Baring Asset Management.