



# Good Investing Knows No Borders: The Case for Investing in Non-US Markets

By

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## Introduction

Financial and economic events have caused many investors to pause and question whether the reward delivered by equities is worth the risk, particularly non-US stocks with the additional currency exposure. However, it would be unwise to dismiss an important source of global capital that provides a wide range of opportunities not readily available in other asset classes. A myopic perspective, based on last year's performance, overlooks incredibly profitable cycles that have benefited from the dynamics of a global economy. Often the best performance came out of protracted bear markets of varying severity. Clearly, the situation is more acute compared to previous downturns and will require massive de-leveraging in some countries. This process will take time. In the interim, markets will likely remain under pressure, more volatile, and better suited to stock picking. It could also be a time to exploit anomalies that typically arise from the indiscriminate selling of high quality companies across the world.

Any statements of opinion constitute only current opinions of The Boston Company Asset Management, LLC (TBCAM), which are subject to change and which TBCAM does not undertake to update. Due to, among other things, the volatile nature of the markets and the investment areas discussed herein, they may only be suitable for certain investors.

## A Broad Playing Field Outside the US

International markets provide comprehensive exposure to many of the world's growth drivers. Though some are as, if not more, challenged than the US right now, many boast healthier banking systems, lower consumer debt, favorable demographics, and interesting valuations.

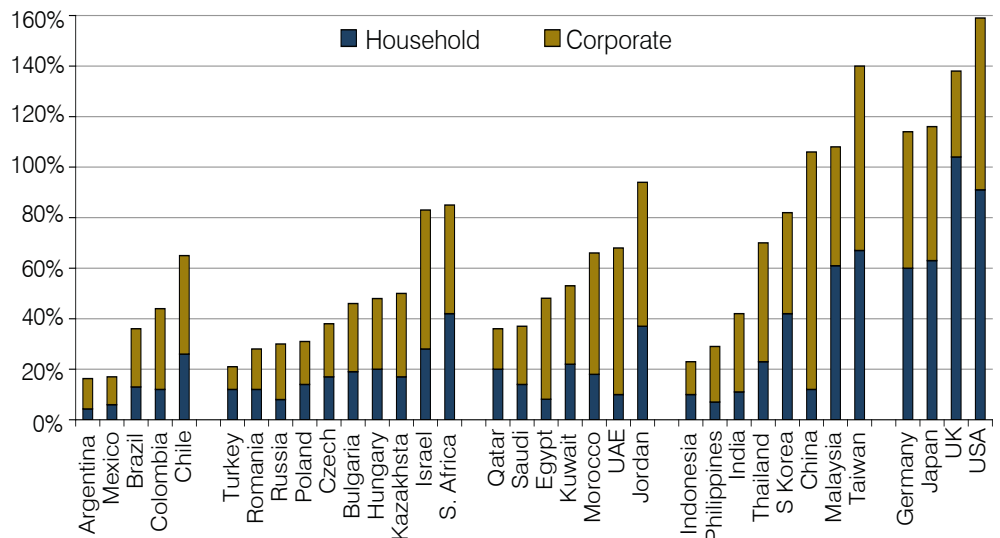
### Emerging Markets

Emerging markets are more of a victim than an architect of the current financial malaise. Although not entirely untarnished, as in Eastern Europe's case, most emerging markets have evolved from previous crises with a sharper focus on fiscal austerity, productivity, and industrial reforms. Several years of robust export activity has created an abundance of capital that can be invested via the public sector, which will likely serve to balance the present weakness in external demand. At the same time, a change in leadership is taking hold, with emerging markets contributing more to GDP expansion than developed nations.

The strength of the banking systems in many emerging markets is derived from low loan-to-deposit ratios, conservative provisions, and minimal exposure to the toxic assets plaguing developed market financials. In addition, lower inflation is prompting interest rate cuts, even among countries that are running current account deficits, such as South Africa and Turkey.

Exhibit 1

Credit/Gross Domestic Product: Advantage Emerging Markets

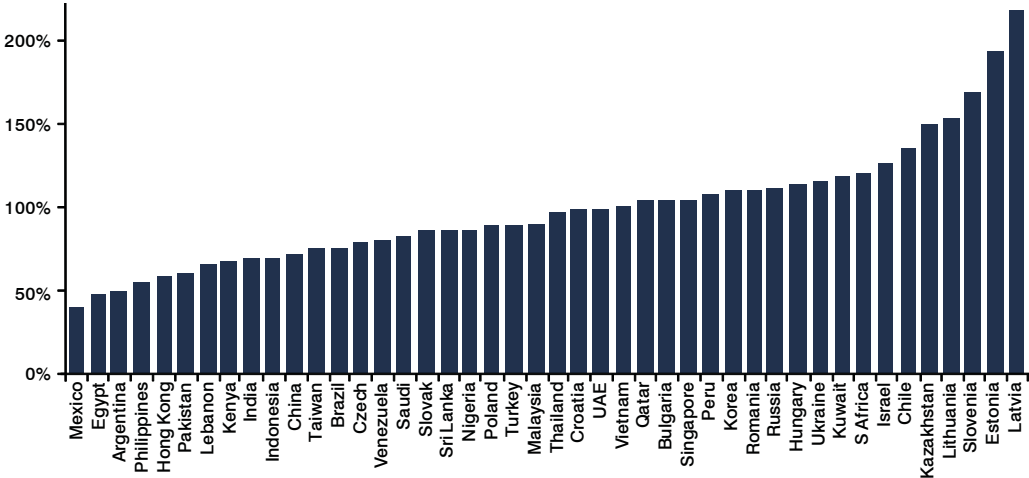


Source: IMF, Morgan Stanley Research, Data from 2006

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

Exhibit 2

Private Sector Lending/Deposit Ratio 2008 (%)



Source: Haver, CEIC, UBS estimates

Exhibit 3

A Change in Leadership

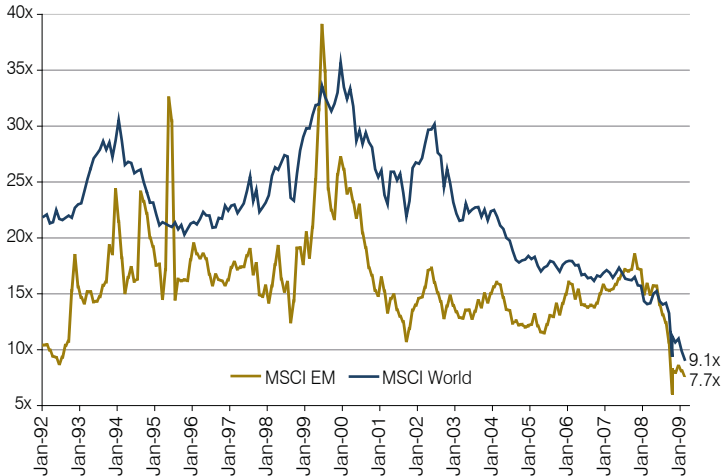
	US	Developed Europe	Developed Asia	Emerging Markets
2007	10%	34%	4%	50%
2008E	13%	19%	7%	61%
2009E	-60%	-29%	35%	252%
2010E	26%	-19%	-5%	91%

Source: IMF, Morgan Stanley Research. Estimates from Morgan Stanley Global Economics Team

Exhibit 4

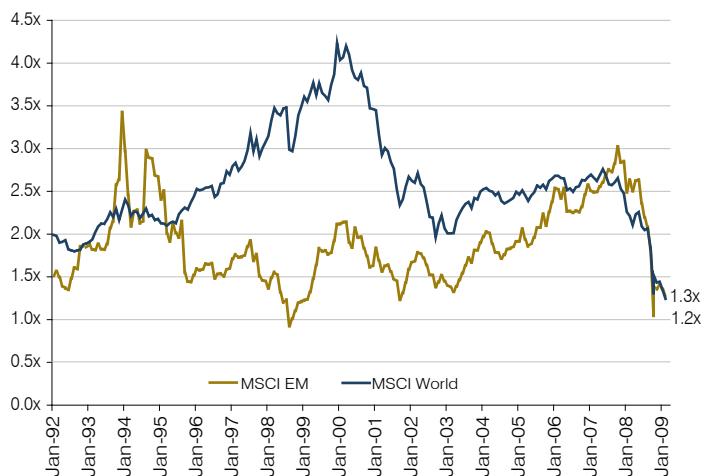
Emerging Markets are Attractively Valued

Trailing Price to Earnings



Source: MSCI, FactSet. Data as of February 20, 2009

Trailing Price to Book

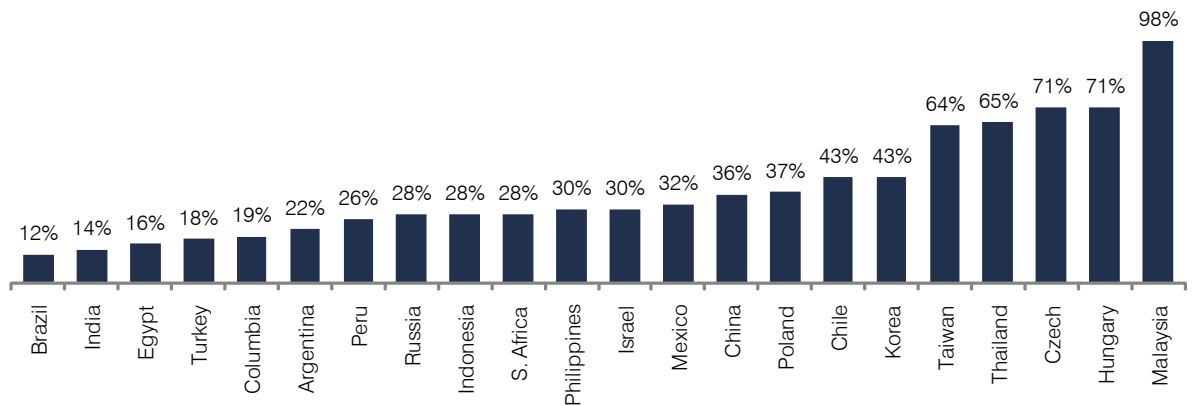


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A popular misconception about many emerging markets is that they are heavily reliant on exports to developed markets. Exports are more broadly diversified across markets, with a large portion intra-emerging, as illustrated in Exhibit 6, providing a measure of safety as developed markets ratchet down spending. Emerging markets are also home to a wide range of market-share leaders in consumer electronics, commodities, and generic pharmaceuticals, for example.

Exhibit 5

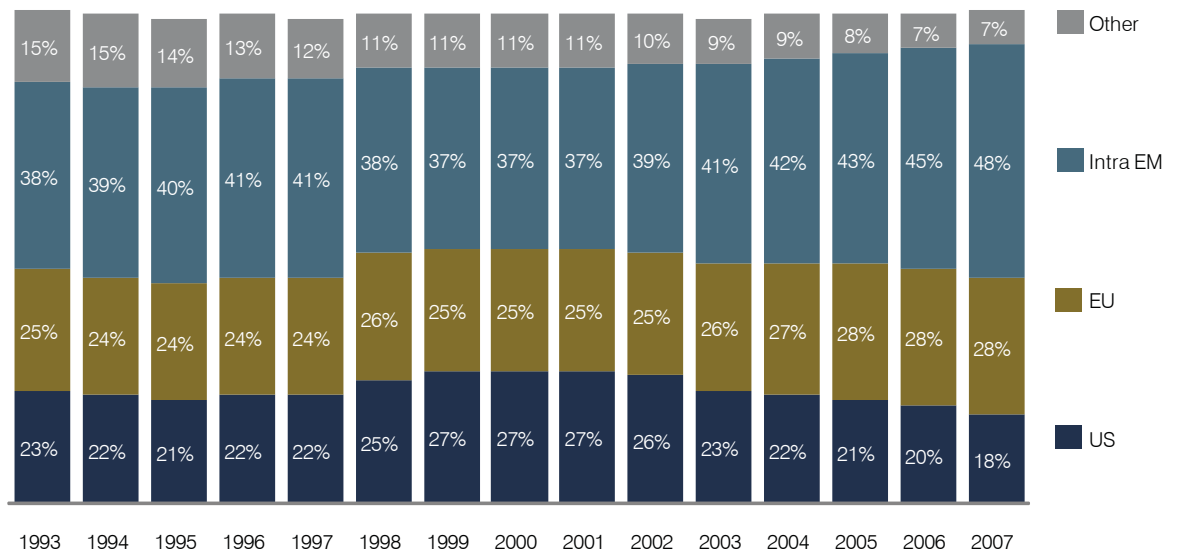
Exports as a Percent of GDP  
(Last Twelve Months Ending November 2008)



Source: Morgan Stanley Research

Exhibit 6

Exports as a Percent of GDP  
(Regional: 1993-2007)



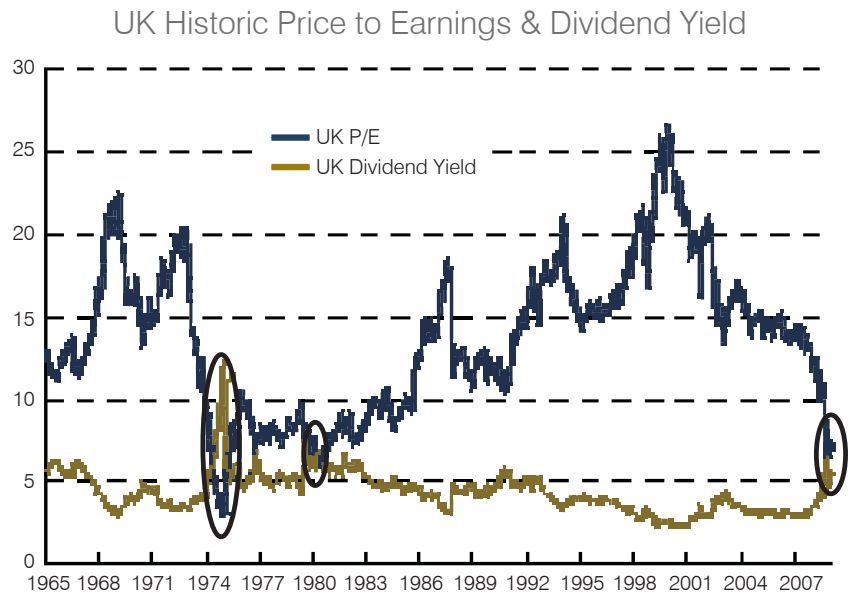
Source: Morgan Stanley Research

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## The United Kingdom and Continental Europe

In developed markets, the case for investing is more complex, but should not be entirely dismissed. Several companies have solid capital structures, an ability to make business investments despite the downturn, and a likelihood of capturing market share from weaker competitors. Of course, each region is different. The UK is dealing with a serious recession on par with the US, one that will require a shift from borrowing to savings and a sizeable real estate correction. Monetary and government officials have acted quickly by slashing rates to 0.50%, nationalizing or partly nationalizing struggling banks, and arranging a stimulus package. On the positive side, the UK homeowner will see a windfall of disposable income as most mortgages are variable rate. This will accelerate the savings/debt reversal and could lead to early stabilization of the consumer sector.

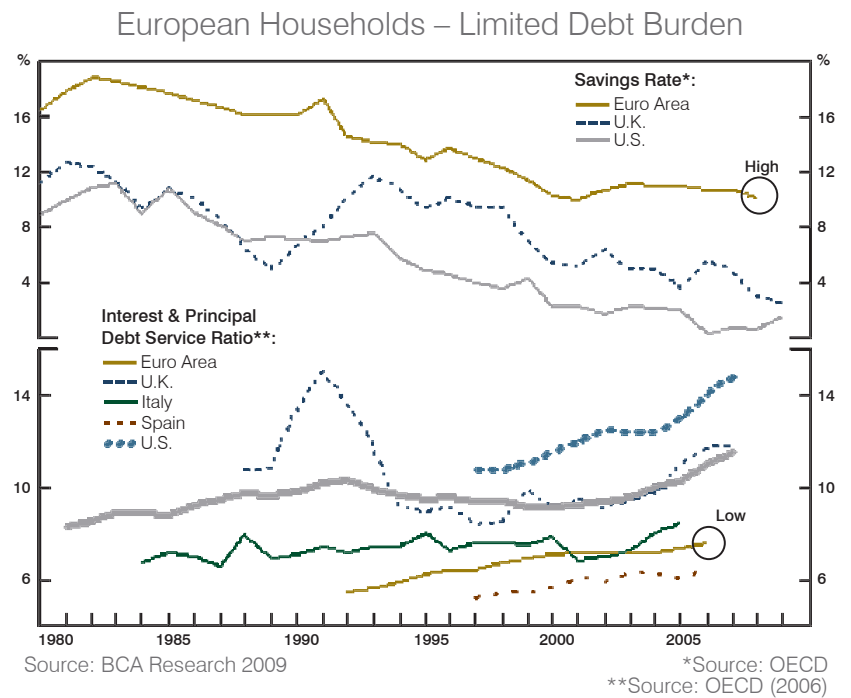
Exhibit 7



Source: DataStream

Conversely Europe, the largest market outside the US, offers a different story. Most countries on the Continent are not overly leveraged, excluding the banking sector, nor have they experienced a massive property boom that required a swift correction, Spain notwithstanding. Only 20% of Europeans have a mortgage, the personal savings rate is a healthy 10%, and assets are held in relatively safe time deposits and insurance products.

Exhibit 8



However, many countries have reaped the benefits of an enlarged Eurozone with the addition of the CEE countries. That trend is notably reversing with German industrial production down 20% year-over-year in January. European governments have been slower than their UK and US counterparts to coordinate an aggressive stimulus package. A debate about whether it should be arranged on the national or regional level has created the typical inertia associated with many Eurozone initiatives. However, Europe also has comparatively more generous safety nets than the US, making it less necessary to shore up these benefits as unemployment accelerated. With inflation rapidly falling, and a potential reprieve on the common currency's fiscal austerity measures, a wide range of stimulus

measures have now been launched, including Value Added Tax (VAT) reductions and rebates on auto purchases. Overall, this has been one of the worst bear markets on record in Europe, and while we can not rule out further downside, the magnitude should be limited and tempered by periodic rallies.

Exhibit 9

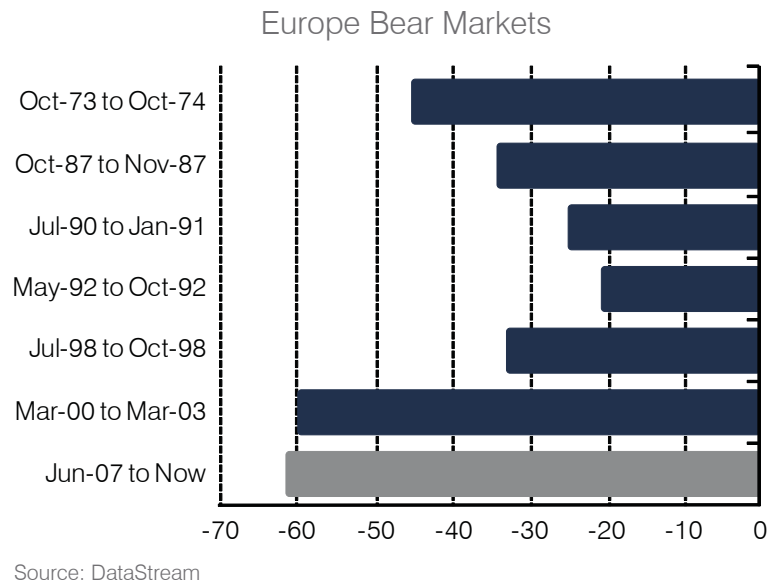
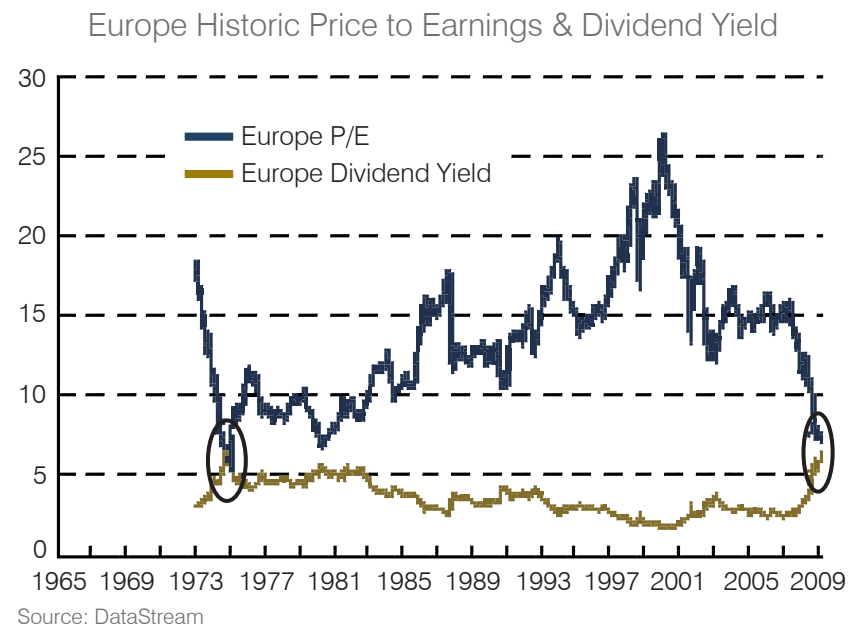


Exhibit 10



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## Japan

At first glance Japan appears locked in a never ending cycle of deflation, flat local demand, and paltry shareholder returns. Yet, Japan has been dealing with these issues for almost two decades, and now trades below 1990 levels on a normalized basis. Many investors avoided Japan during its “lost decade” and therefore missed periods of strong performance. Japan’s banking system is much healthier than in the US or Europe (its one challenge being local market exposure) and corporate balance sheets are flush with cash. The Central Bank has been quicker to act on troubling economic signals this time around, and the government will likely expand its ability to buy local shares. This should provide temporary relief to the Japanese market, particularly bank shares; however a sustainable recovery will require global stability. That said, one should not overlook the global leadership of many Japanese companies, especially the auto manufacturers that are already gaining market share. Although we loathe waving the restructuring flag yet again, the economic climate is such that Japanese companies with poor returns on equity will be forced to address shareholder return by improving balance sheet management, rationalizing capacity, and moving more production offshore.

### Exhibit 11

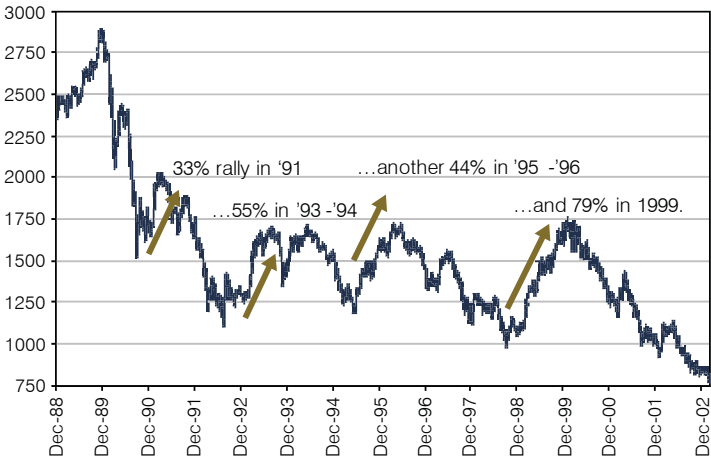
#### Bear Market Rallies in Japan

Start	End	Duration (MM)	%	% in USD
Mar-90	May-90	2	20%	13%
Sep-90	Mar-91	6	35%	44%
Aug-91	Oct-91	2	18%	22%
Aug-92	Jun-93	10	50%	78%
Jun-95	Jun-96	12	57%	23%
Jan-97	Jun-97	5	20%	19%
Oct-98	Apr-00	18	62%	110%
Mar-01	May-01	2	23%	18%
Feb-02	May-02	3	29%	35%
<b>Average</b>		<b>7</b>	<b>35%</b>	<b>40%</b>

Source: DataStream, Credit Suisse Research

Exhibit 12

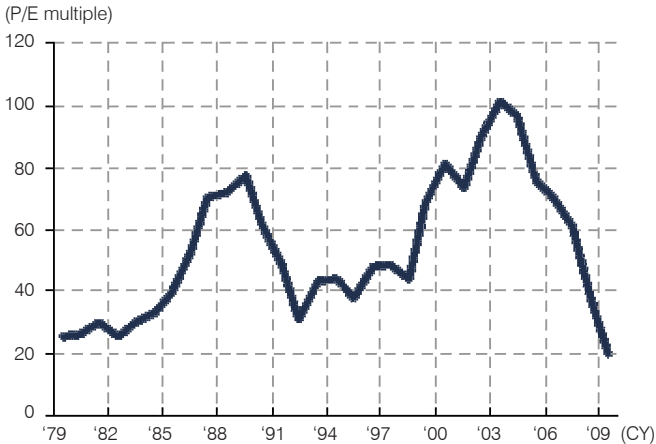
Investors Could Have Played Bear Market Rallies in Japan: Topix 1998-2003



Source: Tokyo Stock Exchange, Morgan Stanley Research

Exhibit 13

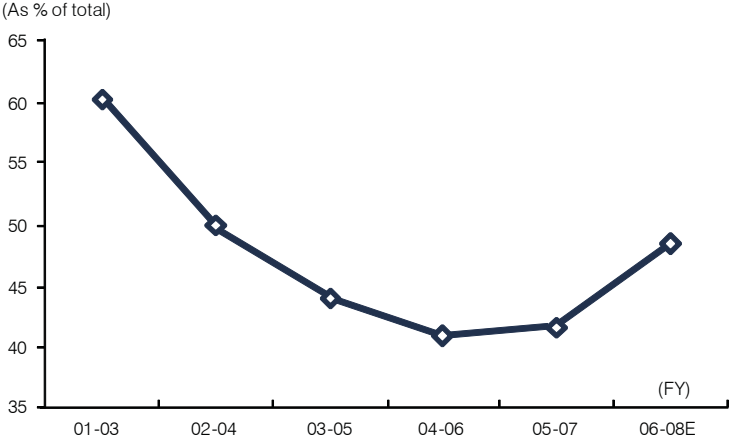
TOPIX Valuation: Based on 10-year Average Earnings



Source: Nomura

Exhibit 14

Companies Reporting Return on Equity of Less Than 8% for 3 Successive Years



Source: Nomura Note: Universe consists of TSE-1 listed companies.

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## The Value of Active Management

We believe there are many reasons for investors to look beyond the US today. Although the present environment is more challenging than it has been for several years, unsettled markets can also reap tremendous rewards. The key to success is to identify solid businesses that can stay on track and emerge as market leaders, a strategy best suited for active investing. For example, passive management does not evaluate capital structure and a company's ability to service and refinance its debt, an important consideration in a restrictive credit cycle. There are also off balance sheet commitments such as options held by minority shareholders and currency derivatives that can materially increase a company's financial commitments. Nor will an index strategy establish a company's sustainable margin, prospects for business investment, management skill, or competitive position. In a robust bull market, these issues may not have as much bearing on investment returns as they should, and normally will, under more volatile and even normal conditions. Given today's heightened level of economic uncertainty, active management may well be the more prudent choice for international investors.

## Author Biographies

### **D. Kirk Henry, CFA**

#### **Executive Vice President**

Kirk joined The Boston Company to spearhead the firm's Non-US Value Equity Group. He currently serves as the Director of Non-US Value Equities and Lead Portfolio Manager on the Non-US and Emerging Markets Value strategies. Kirk is also a member of The Boston Company's Executive Management Team.

Prior to joining The Boston Company, he was Executive Vice President at Cseh International & Associates, Inc. Previously, he was an International Portfolio Manager at Provident Capital Management, Inc. Kirk started his career as a Securities Analyst with First Chicago Investment Advisors and Sears Investment Management Company.

Kirk graduated with a BA in Human Biology from Stanford University. He received an MBA in Accounting and Finance from the University of Chicago. Kirk holds the Chartered Financial Analyst designation and is a member of CFA Institute and The Boston Security Analysts Society.

### **Andrea M. Clark, CFA**

#### **Vice President**

Andrea is a Portfolio Strategist and an Equity Research Analyst on The Boston Company's Non-US Value Equity investment team.

Prior to joining The Boston Company, Andrea was a Vice President with Standish Mellon Asset Management, where she was responsible for equity product management, development and positioning. Previous to that, Andrea was a Vice President of Institutional Product Management at Pioneer Investment Management, Inc. During her career, Andrea also worked for Putnam Investments in several business groups including Portfolio Analysis and Marketing.

Andrea received a BS and an MBA from Suffolk University. Andrea holds the Chartered Financial Analyst designation and is a member of the CFA Institute and the Boston Security Analysts Society.

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