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Why Invest in US Equities?

Executive Summary

We believe the potential opportunity cost for non-US investors of ignoring markets outside their own, particularly the US market, is high. Investors who are overly exposed to their own domestic market are at risk of missing major investment themes and a source of potential outperformance. In addition, their portfolios will not be fully diversified. The advantages of investing outside one's home country or region may include:

- A better strategic asset allocation. Investing more broadly in geographic terms can provide an opportunity to improve the risk-adjusted performance of a portfolio. Home-country bias leads investors to invest disproportionately in familiar markets, frequently leading to an inefficient allocation.
- Better opportunities. The remarkable size and liquidity of the US market provide excellent opportunities for diversification in terms of themes, sectors and trends that may not exist in narrower equity markets. In addition, the global nature of many US businesses means that investing in US equities can in some cases serve as a proxy for global investment. Finally, the US economy is a global leader in technological innovation and competitiveness.
- Economic resilience. The US economy in particular has in the past seen sustained and robust levels of productivity growth, fuelled by the steady regeneration of the human capital base through a continuous stream of highly skilled immigrants from every part of the world. The US also inspires the largest inflows of foreign direct investment (FDI).

Having said this, there are also risks. These include currency and regulatory risks, while the maturity of the US market means that in some cases the most promising (yet risky) growth opportunities are in overseas markets. Other risks include political upheaval, the relative lack of information in some cases, and the potential lack (particularly in emerging markets) of strict financial and accounting controls and standards.

The recession that began in 2008 is another challenge. However, many economists believe that the US is likely to be the first country to emerge from the downturn because of its flexible markets and extraordinarily aggressive fiscal rescue package. Moreover, the US economy has demonstrated remarkable resilience in recovering from economic and political setbacks. Among the factors that account for this remarkable resilience are an innovative and entrepreneurial culture, strong productivity growth and favourable demographics.

In our belief, there is a broad spectrum of highly compelling reasons why investors should fully diversify their portfolios, which includes having significant exposure to US equities. In this report, we look at each in turn.

The fallacy of 'Home-Country' bias

Our research suggests that investors frequently overweight their exposure to their home (domestic) market, limiting their diversification potential. For example, Europeans concentrate their holdings in European stocks, despite the fact that the US equity market accounts for nearly 50% of a representative world index[1], Japan nearly 12%, the UK nine percent, France five percent, Germany four percent and so on. Investors frequently do not diversify their portfolios fully. This can be due to regulatory requirements imposed by their own governments, but is commonly also a function of familiarity.

However, the feeling of familiarity can distort perceptions of risk: investors often perceive foreign equities to be significantly more risky than domestic equities, regardless of the evidence. At the same time, domestic stocks are judged over-optimistically in terms of expected risk and return. If investors were to allocate assets based on modern portfolio theory[2], their exposure to domestic equities would tend to be lower and their allocation to US equities significantly higher.

More on risk and return

International diversification has historically allowed investors in all countries to lower the total risk of a portfolio, while offering additional profit potential. Studies show the evidence for this is consistent and extensive. Diversification increases as investments which are less than perfectly correlated are added to a portfolio.

Correlations are dynamic and complex

The concept of asset correlation emerged from an obscure place in Modern Portfolio Theory to provide analytical support for investment allocation decisions. By successfully combining pairs of low-correlating asset classes or investments, it should theoretically be possible to temper the volatility of returns and enhance risk-adjusted performance.

For example, a decade ago, the correlation between the S&P 500 Index and the MSCI EAFE Index (which excludes US equities) was 0.31, suggesting an opportunity to gain risk-adjusted return by diversifying among US and foreign equities. Then, the correlation between these benchmarks started to increase steadily, reaching an all-time high of 0.87 in July 2007. This led some to question the potential benefits that global diversification might bring to the risk-adjusted performance of a portfolio.

However, this data was based on five-year, historic look-back periods of rolling monthly returns. Using the shorter and more time-sensitive two-year look-back period produces a very different conclusion, in that the correlation between US and foreign stocks peaked at 0.93 in March 2005 and had declined to 0.62 by June 2007. A more dynamic time frame suggests that the diversification benefit of combining US and foreign equities has, in fact, staged a quiet comeback.[3]

[1] MSCI World equity index, data as at 31 December, 2008. Source: Wilshire Atlas.
[2] See e.g. Harry M. Markowitz, "Portfolio Selection" Journal of Finance, vol.7, no.1 (March 1952), pp. 77-91.
[3] Source: FactSet.

Compelling Reasons to Invest in US Equities

1. The largest economy and equity market in the world

The US is the world's largest economy and is its core. The second-largest economy, Japan, is only a third the size. This is reflected in the US equity market, which comprises nearly half of the MSCI World Index[4]. With a market capitalisation of US$19.9 tn[5] as at end-2007, the US equity market is the largest-ever single concentration of wealth. The US market capitalisation is 5.2 times the size of the UK; 4.5 times the size of Japan; 9.5 times the size of Germany and 17.2 times the size of Hong Kong[6].

Additionally, of the top 20 companies in the Forbes Global 2000 list 2008, nine have headquarters in the United States; three in the UK and France respectively; two in the Netherlands; and one in each of Germany, Russia and Japan. Of the top 100 companies in the world, 29 have headquarters in the United States[7].

The size of the US economy and equity markets, and the prevalence of large, successful companies, gives investors a greater selection of investment opportunities. A bigger market also tends to lead to increased competition between companies, and greater efficiency. This wealth of companies also means that the US equity market tends to be diversified internally, unlike many smaller countries where a few large companies frequently dominate the national index.

Exhibit 1

World number of listed companies

Luxembourg	34	Italy	301
Portugal	47	Singapore	472
Ireland	60	Germany	658
Austria	102	France	707
Netherlands	122	Hong Kong	1029
Finland	130	Australia	1913
New Zealand	154	United Kingdom	2588
Belgium	163	Spain	3498
Denmark	198	Canada	3881
Norway	208	Japan	3884
Switzerland	257	United States	5130
Sweden	272	Developed markets	26251
Greece	292	World	51322

Source: Standard and Poors Global Stock Markets Factbook 2008, p. 349.

[4]Data as at 31 December, 2008. Source: Wilshire Atlas.
[5]Source: Standard & Poors Global Stock Markets Factbook 2008, p. 23
[6]Source: Standard & Poors Global Stock Markets Factbook 2008, p. 23
[7]Source: The Global 2000 – Forbes.com

2. A highly diversified market with a wealth of investment themes

We mentioned earlier the potential benefits that international diversification brings to the total risk of a portfolio; we believe the same argument pertains to diversification by sector. With 5,130[8] listed US domestic companies at the end of 2007, significantly more than any other country in the world (see Exhibit 1), the US equity market offers unsurpassed opportunities for diversification by company, industry and sector. Compared to many smaller, narrower stock markets, which are often highly concentrated and dominated by a small number of sectors or industries, not only does the US stock market offer opportunities for broad diversification, it offers non-US investors a wide choice of investment themes, sectors and trends that may be unavailable in their home markets.

3. Improved liquidity

The US equity market is one of the most liquid stock markets in the world. In 2007, shares traded in the US were valued at US$ 42.6 tn[9], 4.1 times the value of shares traded in London that year and 6.6 times the value of shares traded in Tokyo. This means that the performance-limiting issues that can often be associated with building stock positions – and subsequently reducing them – in some stock markets, are less likely to occur in the US market.

4. Investing in US Companies may serve as a proxy for global investing

The operations of many US businesses are global in nature and, as such, offer investors significant international exposure. While blue chips like Microsoft, General Electric and Coca-Cola operate in nearly all international markets, many large US companies derive a large proportion of their revenues from outside the US – particularly consumer cyclical, technology and energy companies. In fact, according to estimates by Standard & Poor's, at the end of 2007 companies in the S&P 500 Index derived nearly 50% of their sales outside the US – a rise from 30% in 2001[10].

Investing in US multinationals can, therefore, serve as a proxy for global investing by providing investors with exposure to economies throughout the world. Moreover, given the global operations of many US companies, periods of US dollar weakness, rather than being a source of concern, actually boost the profits of US companies, as they translate foreign earnings into the dollar.

5. An allocation to US equities can potentially offer an improved risk/return result

A comparison of long-term risk/return distributions for representative market indices shows that, historically, an allocation to US equities has improved the investment outcome (Exhibit 2, page 5). For example, in the 15-year period January 1994 to December 2008, the MSCI EAFE index[11] returned 3.88% with a standard deviation of 17.87%, while the S&P 500 index returned 6.46% with a standard deviation of 16.77%. For non-US investors, an allocation of 80% to the EAFE index and 20% to the S&P 500 resulted in a higher return for a somewhat reduced level of risk (standard deviation) than investing entirely in non-US shares. A similar pattern was seen for the 20-year period January 1989 to December 2008.

A similar result is seen in the long-term data combining investments in Emerging Markets and the US index. An investment solely in the MSCI Emerging Markets index over the same 15-year period resulted in a return of 2.75% with standard deviation of 27.45%, while a 50 to 80% allocation to the S&P 500 index resulted in higher returns for reduced risk. On a 20-year basis, an allocation to the S&P 500 index served to reduce risk for a similar return. While in the short term, US markets may underperform non-US or Emerging market indices, the longer-term data shows the historical benefits of an allocation to the US.

[8]Source: Standard & Poors Global Stock Markets Factbook 2008, p. 349
[9]Source: Standard & Poors Global Stock Markets Factbook 2008, p. 27
[10]Source, Standard and Poors, quoted in the Financial Times, February 5 2009, page 33
[11]The MSCI EAFE index is an index of foreign shares from the perspective of a North American investor – covering Europe, Australasia, and the Far East. Data in these examples derive from Zephyr StyleADVISOR

Exhibit 2

	15 year (Jan 94-Dec 08)		20-year (Jan 89-Dec 08)	
	Annual Return (%)	**Standard Deviation**	**Annual Return (%)**	**Standard Deviation**
S&P 500	6.46	16.77	8.43	15.72
MSCI EAFE	3.88	17.87	3.49	18.23
MSCI EM	2.73	27.45	10.12	27.66
50% EAFE 50%S&P 500	5.35	16.66	6.19	16.09
80% EAFE 20% S&P 500	4.51	17.23	4.63	17.18
50% EM 50% S&P 500	5.58	20.38	10.27	19.95
80% EM 20% S&P 500	4.13	24.34	10.44	24.33

Source: Zephyr StyleADVISOR. Index combinations are hypothetical illustrations, representative of typical investor portfolio allocations. Indices were rebalanced annually, and dividends were reinvested.

6. An environment that promotes innovation and entrepreneurship

It is not surprising that many of the world's most dynamic, internationally competitive and profitable companies are to be found in the US. The culture is equity-oriented, pro-business, creative and probably one of the most entrepreneurial in the world. A well-educated workforce and an open economy foster a culture that is highly innovative and encourages entrepreneurs to take chances by developing new companies and investing in new technology.

INSEAD's Global Innovation Rankings and Report 2008-2009[12] ranks the US as the global leader in innovation. To quote the report, "This comes partly as no surprise, as the US with a legacy of over 100 years in innovation, has been consistent in taking the leader's slot."

Similarly, the yearly IMD World Competitiveness Yearbook 2008[13] lists the US as the world's most competitive economy, as it has been every year since overtaking Japan in 1994. IMD note that "The US, because of its openness, resilience and entrepreneurship, always seems to find the means to reinvent itself in ways that Japan (and much of Europe) often lacks."

7. A robust economic advantage

Over the years, we believe the US economy has proven to be one of the most resilient economies in the world, recovering rapidly from economic and political setbacks. Among the factors that account for this, in addition to an innovative and entrepreneurial culture, are strong productivity growth and constant regeneration of the human capital base through immigration and population growth.

Over the longer term, economic growth is boosted by rising productivity levels. Even in the shorter term, productivity growth affects key variables such as employment, the rate of inflation and the growth rate of output. A major economic development in the United States, over the past decade, has been a sustained rise in labour productivity, or output per hour.

From the early 1970s through to 1995, productivity growth in the US non-farm business sector was about 1.5 per cent per year. This was disappointing relative both to US historical experience – between 1948 and 1973, output per hour of work grew at an impressive rate of nearly 3 per cent per year, on average – and when compared to other industrial economies. However, according to Federal Reserve Chairman, Ben Bernanke[14], since 1995 productivity has increased at an annual rate of about 2.5 percent. To quote remarks he made to Harvard University in June 2008, *"Productivity growth revived inthe mid-1990s… illustrating once again the resilience of the American economy."*

[12]Confederation of Indian Industry & INSEAD,"Global Innovation Index 2008-2009" 2009 INSEAD

[13]The IMD World Competitiveness Yearbook ranks 55 countries on the basis of 331 criteria. The US is followed closely by Singapore, but this is a much smaller economy.

[14]See Board of Governors of the Federal Reserve System, Chairman Ben S. Bernanke,"Remarks on Class Day 2008", At Harvard University Cambridge, Massachusetts and Speech Before Leadership South Carolina, Greenville, South Carolina, August 31, 2006.

Bernanke ascribes the pickup in productivity growth over the period to private-sector initiative, combined with constructive government policy - through support of basic research and the promotions of economic competition - and monetary policy.

The US economy sports a further advantage in its favourable immigration trends. The country has benefited strongly from the successive waves of highly skilled immigrants from every part of the world. This phenomenon has resulted in the continuous regeneration of the US human capital base in an unprecedented way.

Between 1994 and 2004, growth in the US exceeded that in the eurozone by one percentage point. Superior US productivity accounts for part of the difference but the balance can be explained in terms of faster population growth in the US. Looking ahead, the trends continue to look very encouraging. While the EU and Japan face the challenge of declining populations, US population projections by the Pew Research Centre[16] show, on the basis of current trends, the US population increasing from 296 million in 2005 to 438 million in 2050 – with 82% of the increase coming from immigrants arriving between 2005 and 2050 and their US-born descendants. Interestingly, in spite of these strong immigration trends, the evidence shows that there is room for more. The Proudfoot Consultancy's 2008 Global Productivity Survey shows that in the US, 31% of managers cite staff shortages and an insufficient labour pool as the main barrier to increasing productivity[17].

Finally, the US economy also benefits from strong foreign direct investment flows. In 2008, UNCTAD[18] estimates that global foreign direct investment (FDI) inflows will have fallen by 21% to US$1.4 trillion and are expected to fall further in 2009. Global economic recession has hit FDI flows as well as the patterns of FDI location. Even so, preliminary estimates by UNCTAD show the US still to be the single country with the largest FDI inflows: US$220 billion, equivalent to 26.2% of all FDI inflows into developed economies and 15.2% of World FDI inflows (including developing economies).

"US Bucks Slowdown in Global Productivity" – The Conference Board

The latest annual Productivity Brief from The Conference Board[15], the global business membership and research organisation, shows that, "Despite a slowdown in world productivity in 2008, output per hour worked in the United States increased slightly by 1.7 percent, up from 1.5 percent in 2007…The most recent productivity advances have been realized, however, through rapid layoffs, suggesting that the productivity of remaining workers and firms is actually strengthening."

Commenting on Europe, The Conference Board writes, "Europe suffered a dramatic slowdown in productivity growth, with many European firms slow to reduce headcount in response to falling output. Productivity growth across the 27-member European Union fell from 1.3 percent in 2007 to just 0.2 percent in 2008 and is expected to come to a complete halt in 2009."

Potential challenges

While the reasons to invest in the US are compelling, it is worth being wary of several potential challenges. First, non-US investors are exposed to movements in the US dollar, which adds an additional layer of return (positive or negative) to any investment. The US currency is affected not only by capital flows to and from the US, but by fiscal and monetary policy, and economic data. Inflation, for example, plays a major role in the economic outlook, and thereby dollar strength. This could be a risk because the US Federal Reserve is somewhat less hawkish on inflation than the ECB or other central banks. In fact, for non-US investors, investing in the US adds a new level of economic uncertainty and unfamiliarity that may require more research and attention. That said, investors have the ability to hedge currency movements, or can choose funds that do this for them, isolating share price movements.

[15]The Conference Board, Press Release/News, Jan 22 2009, "U.S. Bucks Slowdown in Global Productivity Says the Conference Board"
[16]US Population Projections: 2005-2050, by Jeffrey S. Passel and D'Vera Cohn, Pew Research Center, February 11, 2008
[17]Proudfoot Consulting Global Productivity Report 2008, page 7.
[18]UNCTAD (United Nations Conference On Trade and Development) Press Release, 19/01/09

Another consideration is the global reach of US businesses. Many US companies see their most promising growth in overseas markets, including emerging markets. While investing in US companies can serve as a proxy for global investing and provides strong diversification benefits, it might be preferable for some investors to invest more directly.

Finally, there are several regulatory risks in the US which could fundamentally change the business model of companies investors have targeted. Legislation such as Sarbanes-Oxley is widely seen to have reduced the US's competitive edge by introducing an overly complex regulatory environment. Litigation risk in the US is high, while protectionism is a spectre that regularly rears its head in difficult economic environments. There is also a risk that because of likely financial market reforms in the wake of the credit crisis, lending costs could increase, hitting corporate profitability and growth.

In spite of these considerations, we believe the case for investing in the US is strong. The US government is making an all-out effort to revive the economy and, while challenging conditions persist, a recovery may come in the US even earlier than elsewhere.

Encouraging trends

Against a background of the most serious recession for decades, the US Federal Reserve responded quickly by cutting interest rates nine times over 15 months, and by beginning a programme of quantitative easing. This was followed by the Obama administration's massive $787 bn fiscal stimulus package, designed to create jobs and pull the economy out of recession. When combined with the financial sector rescue plan, TARP (Troubled Assets Relief Program) and a housing programme of foreclosure relief, it is evident the US has done more to stimulate its economy than any other country.

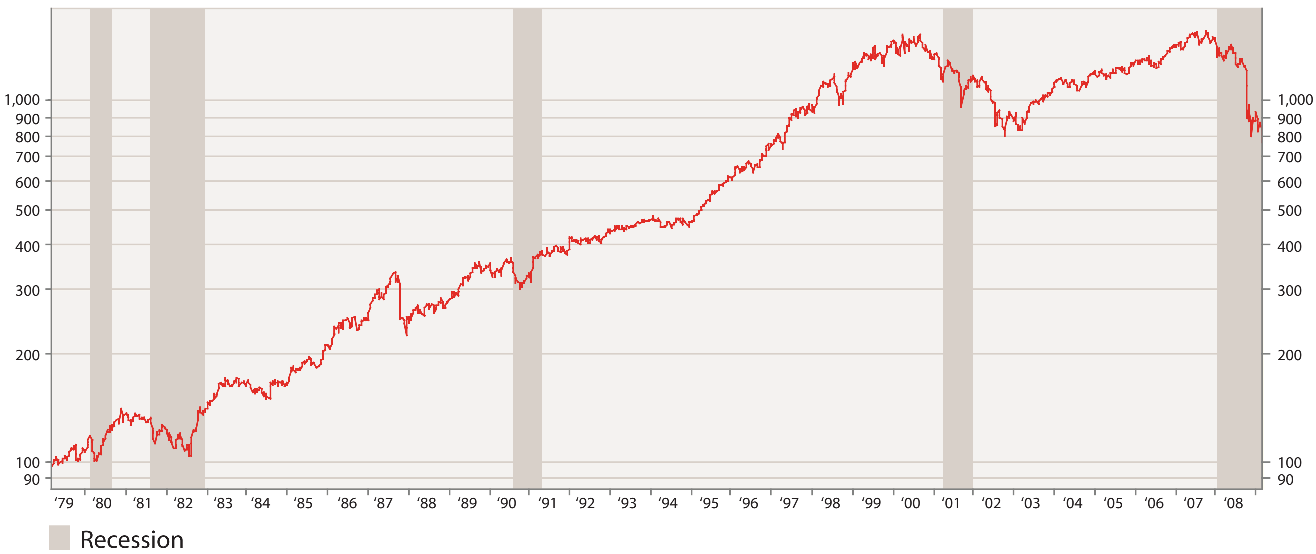
Because of this, many believe the US could be the first economy to emerge from the current recession, and its stock markets the first to recover. On the FIFO (first in, first out) principle, as the first to enter recession, many economists now expect signs of recovery perhaps by late 2009. This argument is supported by the US' flexible markets, and the fact that most companies are able to more quickly downsize workforces and cost bases than in many other advanced countries.

Stock markets may anticipate recovery

In general terms, stock markets have historically anticipated economic recovery, and turned up before the economy has. Exhibit 3 of the S&P 500 index from 1979 to the present time, illustrates that, in all of the four previous recessions since 1979 (marked with vertical bars), the US stock market has started to recover a few months in advance of the recovery in the real economy (in 2001, the market recovered before the end of the recession).

Exhibit 3

S&P 500 Price Index – 1979 to Present



Source: Factset, weekly index closing price (dividends/capital gains not included). Data covers period Feb 1979 to Feb 2009.

US Equities Still Most Favoured

A further encouraging sign for US equities is that asset allocators still favour the US – in fact it is the only region where they are 'net overweight'. Exhibit 4 illustrates, the region that fund managers would most like to overweight (net) on a 12-month view is the US:

Moreover, according to the survey, fund managers regard the outlook for corporate profits and the quality of earnings as most favourable in the US.

Exhibit 4

On a 12 m view, which region would you most like to overweight/underweight?

% of fund managers interviewed saying:		Dec 08	Nov 08	Oct 08
Most like to Overweight	**US**	53	53	45
	Eurozone	4	4	8
	UK	3	5	1
	Japan	10	18	16
	Global Emerging Markets	19	14	24
Most like to Underweight	**US**	11	11	16
	Eurozone	26	25	27
	UK	16	18	16
	Japan	14	10	14
	Global Emerging Markets	24	27	21
Net	**US**	42	42	29
	Eurozone	-22	-22	-19
	UK	-14	-13	-15
	Japan	-4	9	2
	Global Emerging Markets	-5	-13	3

Source: Merrill Lynch, Global Fund Manager Survey, 17 December 2008. Table 33.

Conclusion

The US equity market is one of the most sophisticated equity markets in the world. It is also the largest market in the world, offering remarkable opportunities for diversification in terms of themes, trends and sectors that may not be available to non-US equity investors. Therefore we believe the opportunity cost of not having a portfolio allocation to US equities is high.

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