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GLOBAL INVESTING

Prospering in a Changing World Economy

BY APRIL W. KLIMLEY

Early in 1994, a group of opinion leaders from business and government met in Washington to discuss global investment trends at a private symposium sponsored by Merrill Lynch and Forbes. This report is based on the symposium discussion.

▲ From left to right: Launny Steffens, Executive V.P., Private Client Group, Merrill Lynch; Robert Rubin, Assistant to the President for Economic Policy; Bert C. Roberts Jr., Chairman and CEO, MCI Communications Corp.; The Right Honorable Baroness Thatcher, O.M., F.R.S.; Paul Craig Roberts, Distinguished Fellow at the Cato Institute; Jim Rogers, Host of CNBC's "Your Portfolio"; Arthur Zeikel, President, Merrill Lynch Asset Management Inc.; Malcolm S. Forbes Jr., President and Editor-in-Chief, Forbes.

THE STAKES ARE CHANGING FOR THE GLOBAL INVESTOR

For many American investors, 1993 was a turning point. It was the first time many had invested overseas on their own behalf, and returns of 50% or more in the Pacific Rim and Latin America left them wanting more.

"Resistance broke down in 1993," says Arthur Zeikel, president of Merrill Lynch Asset Management. "The international mutual fund flows became a deluge." The reason, according to Zeikel, was "a recognition of the investment opportunities created by the global trend toward democracy." In addition, says Zeikel, "People realized these markets offer greater opportunity along with the greater risk."

This increased sophistication prevented panic among investors when overheated emerging markets faltered and the dollar fluctuated in the first half of 1994. Asset flows into international funds slowed but didn't stop dead. Investors seemed to be focusing instead on their long-range objective: to increase their international holdings gradually over time. That objective makes sense, considering the minimal global holdings of most American investors.

AMERICANS ARE UNDERINVESTED ABROAD

"The typical U.S. investor is missing out on the enormous opportunity to invest in international stock," observes Launny Steffens, executive vice president, Private Client Group, Merrill Lynch. Given the changes in world capital markets over the last 20 years, this limited exposure probably does not make sense.

Since 1970, the U.S. portion of total world capital markets has dropped from 66% to 37% in 1993. During that same period, nondollar stock markets have frequently outperformed their U.S. counterparts. Yet until last year, most Americans were not participating in that worldwide growth through their investment portfolios. Instead, many people balked at global investing.

The average American investor has only around 4% of his or her portfolio invested in international securities, according to data from the Securities Industry Association. Many people have even less.

Steffens thinks investors would be better off patterning their asset allocations much closer to total world capitalizations. "If you looked at world markets and you wanted to index your holdings, you'd have about 40% in the U.S. markets and put around 60% everywhere else," he explains.

Merrill Lynch's own clients have substantially larger global holdings than the average U.S. investor. But even this isn't really enough, according to Steffens. "I would be very happy to get our clients up to around 25%," he says. "But of course, it's going to vary. Some years, maybe it should be 40%, and some years, 15%. I think the whole process of global asset allocation is going to be one of the most critical things that people should be concerned about in the next two decades."

PARTICIPATING IN WORLD GROWTH

Given the roller-coaster nature of the early part of the year, 1994 seems to be a good time to reassess global asset allocation and develop a more selective investment approach, concentrating on long-term growth rather than market-timing opportunities.

"There has been an explosion of wealth creation in many parts of the world," observes Zeikel. "The underlying conditions are the reason it makes sense

to participate in what is going on. From China to India, countries are moving toward free enterprise."

Of course, opportunity varies region by region, country by country. And some regions and countries come with greater risk — liquidity, political or currency risk. Some markets that promise high growth rates are very risky because of their small size and the dominance of a limited number of primary stock issues.

Argentina is a good example of this. The top ten stocks accounted for 65.7% of the market's capitalization at the end of 1993. A major move by only one or two issues can affect the entire market. And the total size of the market itself is modest — only $44 billion, compared to the $89 billion capitalization of a single American company like General Electric.

Currency risks are another factor to consider. When a local currency declines against the dollar, it can wipe out all securities gains. However, if the currency strengthens, an investor may benefit from securities denominated in that currency, even without a price gain in the securities themselves.

Most fund managers carefully analyze the currency outlook when making decisions about where to invest. Historically, currency shifts tend to balance out over time. Often, proper asset allocation calls are more important than currency factors.

Despite these risks, it is clear that global diversification has multiple advantages for many investors. It allows investors to participate in many rapidly growing non-U.S. economies. This year, given the actions of the Federal Reserve, it looks as if U.S. economic growth will be approximately 3.5%, while the emerging markets of Asia and Latin America are expected to have growth of 5% or better.

▲ Arthur Zeikel, President, Merrill Lynch Asset Management
"There has been an explosion of wealth creation in many parts of the world."

Stronger economic growth has often led to strong stock market performance. Since 1970, the U.S. equity market has only been among the top four best performing developed markets five times.

MAKING THE MOST OF THE GLOBAL ADVANTAGE

The most compelling reason to go global is also one of the oldest principles of investing: diversification. There has been a "global advantage," or positive risk/return tradeoff, when you diversify into nondollar equities.

Adding these investments to a domestic portfolio can increase returns over time and may actually lower risk. One reason for this is the independent movements of various equity markets. For example, when the U.S. market soars, the Japanese market may dip and vice versa.

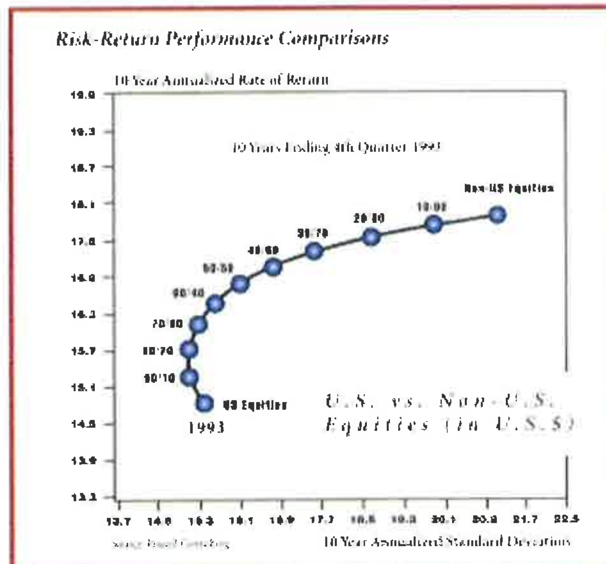
Institutional investors picked up on these principles years ago. That's what prompted them to begin investing globally. Most keep around 10% of their funds in foreign securities, and some far more.

▲ Launny Steffens, Executive Vice President, Private Client Group, Merrill Lynch
"The typical U.S. investor is missing out on the enormous opportunity to invest in international stock."

During the past decade, it has become much easier to invest abroad both for individual and institutional investors. This is because of the explosive growth of international mutual funds, which were the fastest-growing segment of the mutual fund industry last year. The number of non-U.S. companies listed on American exchanges through American Depositary Receipts (ADRs) also has increased substantially.

Given the complexity of international investing, most investors — institutional and individual alike — seek professional advice. This usually means finding a professional adviser who selects individual investment options or chooses a family of mutual funds that provides these options. The adviser also plays the role of a counterbalance during rapid market shifts, keeping the focus on long-term goals.

"There are a number of money management companies that have good solid, long-term track records offering managed portfolios in a variety of these areas of the world," Steffens points out. "These companies have created families of funds, so that you can easily achieve



This chart shows how adding non-U.S. equities to a portfolio can increase your rate of return. For example, 70/30 represents a 70% weight in U.S. equities and a 30% weight in non-U.S. equities.

global diversification. Your fund manager can put money in different regions, say, a European fund or one with Asian or Latin American issues, and then be able to diversify fund assets at relatively low cost."

When it comes to asset allocation, the general rule for global investing is basically the same as it is for domestic holdings: diversification. Investing in a regional basket of securities is less risky than investing in individual nondollar stocks. And the average investor may be surprised to learn that institutional investors prefer nondollar equities from highly industrialized countries; they only keep around 7% of their global holdings in the emerging markets that everyone likes to talk about.

The reason for this is simple. Smaller markets can be highly volatile, fizzling as fast as they mushroomed. That's what happened early this year to the Pacific Rim funds — the darlings of many 1993 investors. These funds accounted for 20 out of the 25 worst-performing funds in the first quarter of 1994.

HAVE A LONG-RANGE OBJECTIVE

The lesson here is that if you decide to invest internationally, you should think long-term. Too much concentration in one country or region means you'll run the risks inherent in "market-timing," the same risks you would encounter if you bought too much of one company's stock for your domestic portfolio.

Your objective should be to participate judiciously in worldwide growth. Fundamental economic forces are fueling positive conditions for growth in most parts of the globe. Eight-hundred-seventy million people in India or 1.2 billion in China create a strong foundation supporting the development of the stock markets in those countries.

These are countries moving toward more liberalized economies. And they are accompanied by many other countries in Eastern Europe, Latin America and elsewhere around the globe.

"If these conditions continue over the foreseeable time horizon, as I think they will," says Zeikel, "then I think individuals should have a certain portion of their assets devoted to participating in this real economic growth."

FOCUS ON EUROPE:

A Weak Recovery Creates Selective Opportunities

▲ The Right Honorable Baroness Thatcher, O.M., F.R.S.
"A nationalized industry is not efficient. Why should it be? It's got a treasury checkbook behind it."

If you missed the boat last year in the European stock markets, don't despair. Just invest more selectively. That's the consensus among the experts these days who see a turnaround developing on the Continent, despite recent jitters.

"In Europe, you have the beginning of a business recovery," observes Merrill Lynch's Arthur Zeikel. "This is opening up selective investment opportunities, despite longer-term structural problems."

Those fundamental, long-term problems remain very visible. They include high unemployment and an aging infrastructure. But signs of a recovery seem to be overshadowing them. Many European corporations with strong exports or foreign earnings reported surprisingly good results for late 1993.

That demand for European exports and services has been led by the U.S. In a certain sense, the U.S. economic recovery has acted like an engine, pulling Europe along behind it.

Of course, Great Britain started emerging from its slump last year. Germany and France appear to be recovering from what is their worst recession since World War II.

An increase in consumer spending is also helping this recovery along. Car sales of European auto makers are increasing, aided by certain government buying incentives and the rise of the yen that makes Japanese cars more expensive.

In the past year, the Bundesbank has been lowering German interest rates. If this keeps up, it will attract greater capital investment, since lower interest rates make equities more attractive, relative to bonds. European companies also are happy with the lower energy costs that resulted from the 1993 decline in oil prices and the fact that inflation is remaining at bay.

Behind these signs of recovery lie several other much more far-reaching changes. These have to do with the restructuring of European corporations. Executives have finally recognized they were pricing themselves out of the market. This was the result of the high cost of labor and expansive social programs that came from the protectionist and socialistic policies that prevailed in Europe after World War II. To counter this, many companies have adopted widespread corporate restructuring and cost-cutting programs along the lines of those undertaken a few years ago in the U.S.

A great deal also depends on government policies within a country. Paul Craig Roberts, distinguished fellow at the Cato Institute, takes the position that most governments have weak