International Equity Review
2012

Oxford METRICA

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FOREWORD

I am delighted to introduce the inaugural edition of International Equity Review which we intend to be an annual briefing for all interested in investing in the international equity markets. Our approach is to provide a general overview and summary of the global economy in combination with a number of focussed themes on which we wish to offer an informed opinion. Our coverage does not purport to be exhaustive and we avoid making predictions or recommendations for specific investments.

We begin with an overview of the global economy and summary review of the IMF's recent forecasts in their World Economic Outlook. This is especially relevant as their forecasts were adjusted slightly downwards. The section covers growth, fiscal matters and foreign reserves.

Since there are a number of factors, especially the European crisis, weighing rather heavily on the equity markets we discuss these in the next section. We argue that although the current crisis in Europe is daunting it would be a mistake to write Europe off. There will be "diamonds in the dust" for the discerning investor.

The aforegoing sections provide the background for another theme we explore on appropriate investment styles in the context of the current market conditions. We advocate a 'super-focussed' approach which invests in the minimum number of equities ranked by potential. We also suggest more rigorous scrutiny of investment manager performance.

The final theme is the scale of cash tied up in the balance sheets of the Global 100 by market capitalisation. This phenomenon is unprecedented and reflects the poor state of the international financial system.

In summary, our outlook for international equities is generally cautious with specific isolated areas of value opportunity.

Dr Rory Knight
Chairman

Dr Rory Knight is Chairman of Oxford Metrica.
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THE POLITICAL ECONOMIC LANDSCAPE

2011 has been characterised as an eventful year in the Global Political Economy. The so-called Arab Spring in the early part of the year has resulted in considerable and continuing disruption in the Middle East and north Africa. Syria is immersed in a bloody civil war and the military activity in Afghanistan continues with no end in sight. The recent change in the North Korean leadership and the tensions in Iran add further to the political risk in the world economy. The political uncertainties are not encouraging for a slowing global economy.

We are in the midst of a potentially disruptive change in leadership in many countries, with recent elections in Russia, France and Greece. The latter two seem to signal a popular resistance to austerity plans. The US presidential election has implications for the world economy as do the German elections next year for the European economy. These political changes may not contribute to stability as the need for resolute political leadership in the world's richest economies may be sacrificed for short term political capital. This is of particular concern in Europe where the prospect of the fragmentation of the Euro is now a more likely risk.

It is our opinion that a critical requirement for positive aggregate growth in the global economy is a strong revival in the consumer confidence of the "top billion" - the citizens of the three largest economies; the EU, US and Japan. Simply put, growth will only return when the "top billion" start spending again. The response of the political elite in the three largest economies is difficult to predict.

The US is likely to be well-disciplined in an election year. The commitment to a period of low interest rates by Ben Bernanke, the chairman of the Federal Reserve, is encouraging. The risks are that the leaders will wish to avoid the difficult decisions with respect to government debt and deficit. The Bowles Simpson commission report on Fiscal responsibility has not been embraced. The contest is between entitlements and austerity. In order to stimulate growth, politicians must resist the temptation to increase deficits and /or increase taxes. In Europe, the picture is much less settled. The political process in each member state of the Eurozone does not necessarily focus minds in the same way and the temptation to curry favour with the electorate at home at the expense of avoiding hard decisions in Brussels is now a significant risk. The election results in France and Greece illustrate how politicians are likely to resist austerity and risk financial stability for short term political popularity, as de Tocqueville predicted.

In addition, given the perilous state of the international financial system and the faltering growth in many national economies, it is not surprising that both consumer and investor confidence are precarious.

The year ahead for equities is likely to be flat in aggregate, accompanied by significant volatility with patches of superior performance.

Growth Prospects

Aside from the concerns of political reticence that contribute to uncertainty, the two major forces in the global economy are currently, fiscal consolidation and deleveraging. Namely, cutting government spending and reducing bank debt, respectively.

The problem is that neither of these factors stimulates short term growth. However, desirable frugal government and conservative banking are for longer term stability, reducing government spending and reducing credit will not stimulate consumers to spend. The risk of too vigorous an adherence to these twin paths is deflation and yet applying too little adjustment will result in continued financial risk. The chances are high that politicians will select a set of policy options that will not work.

As we write this in May 2012, the IMF has recently released its updated forecasts for growth in GDP for the world economy[1]. Figure 1 shows aggregate GDP growth rates continuing to decline with a discernible gap between what is described as emerging and advanced economies. Although growth is expected to slow over the next two years, at least the rate of growth is positive.

Figure 1 IMF aggregate growth forecasts[2]

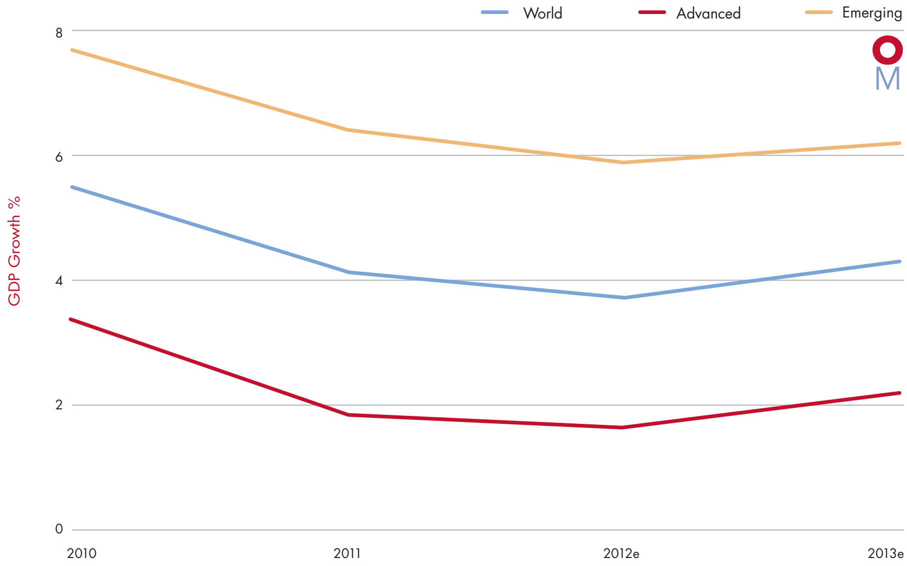
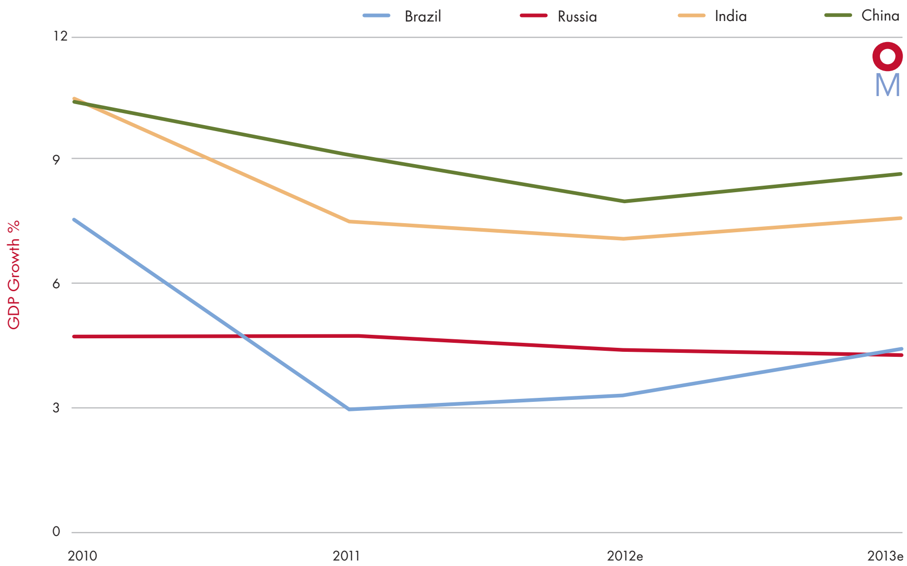


Figure 2 focuses on the BRIC countries where China is expected to have a soft-landing, meaning that despite the expected growth rate being lower than historic levels the rate will stay above 7.5%. Rates of growth for China below this level are considered precipitous and thus the term hard-landing. Brazil is expected to continue with the slower growth experienced in 2011.

Figure 2 IMF growth forecasts for BRIC economies

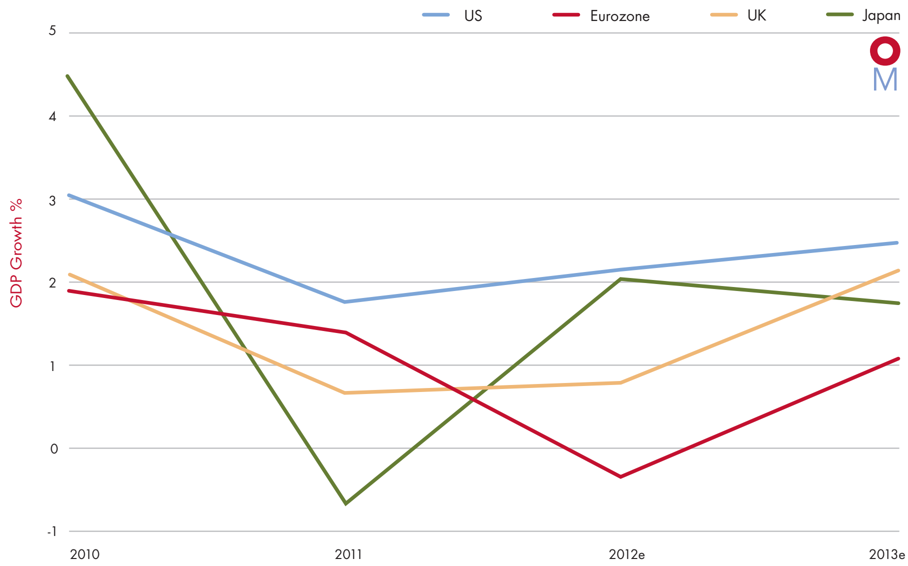


The picture for the advanced economies shown in Figure 3 is rather more bleak with Europe expected to shrink in real terms.

1 Figures 1 to 12 are based on data from the IMF World Economic Outlook, April 2012

2 2012e indicates a forecast

Figure 3 IMF growth forecasts for advanced economies



In the light of current market uncertainties, the rate of shrinkage may be greater than the IMF forecasts for Europe. Equally, the forecasts for the UK and Japanese economies appear somewhat optimistic. Our view is that consumer confidence of the "top billion" is being dampened by the lack of clarity among politicians within the Eurozone.

The consensus is that world growth will be decelerating and relatively flat. However, the downside risk is significant with the IMF's more pessimistic but reasonably likely estimates for real GDP growth at -3%. This assumes a relatively optimistic view on inflation.

Inflation Expectations

Whilst the last two decades have been largely inflation free, the spectre of high inflation is a distinct possibility. Inflation prospects are very diverse across economies.

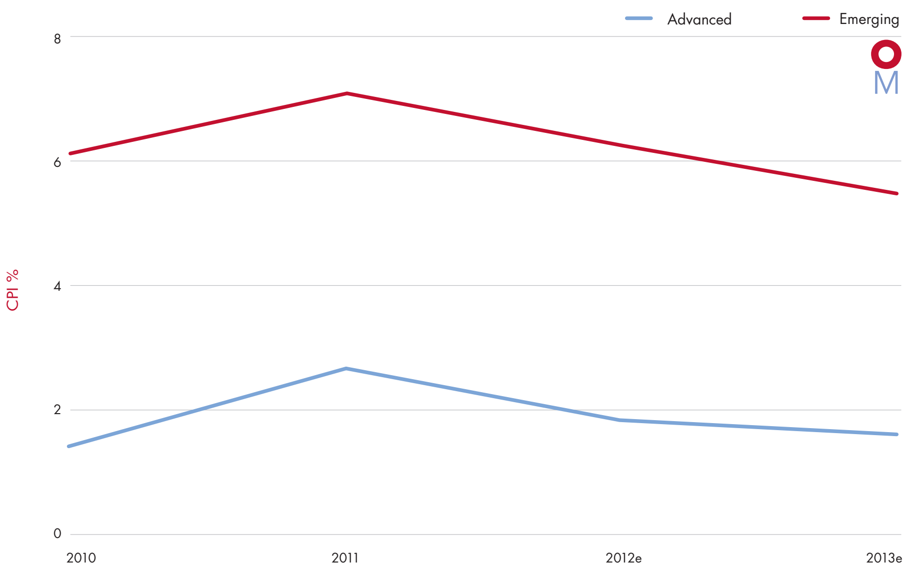
The emerging economies are likely to experience a greater level of inflation than the advanced economies. Indeed a concern is that the Chinese economy might overheat and the prospect of real estate bubbles has been raised. Similarly India is likely to inflate. In particular there is inflation risk in Latin America where the larger economies are operating at full capacity.

The BRIC country that we feel faces the largest challenge in this regard is India. The deficits in absolute terms are massive and in relative terms to GDP significantly larger than any of the other BRIC countries. The IMF are working on the assumption that there will be little improvement and that India will have a deficit to GDP ratio twice as bad as the second worst BRIC, Russia. There are a number of implications; Firstly, it means that India will be unable to reduce its debt reasonably in the next few years and secondly, the Rupiah will be under much pressure. The Rupiah is currently at an all time low against the dollar. Little wonder the Indian government is minded to tax transactions retroactively.

The diversity in inflation expectations across economies, particularly the divide between the advanced and emerging economies, carries significant implications for exchange rate volatility.

Investors based in advanced economies are likely to face high forward rates in hedging currency risks. Emerging currencies are likely to be volatile. All are subject to the possibility of commodity price shocks which attend the world markets.

Figure 4 IMF inflation forecasts



Fiscal Matters

Deficits

The outlook for reducing government deficits is not good - austerity if followed should reduce deficits in the coming years but the aggregate position will be persistent deficit spending albeit at a slowing rate, through to the end of next year, see figures 5 through 7.

It is clear in figure 5 that deficits haunt both advanced and emerging economies and they are unlikely to disappear very soon even with planned austerity. Deficits are less conspicuous in the emerging economies than the advanced, although the position is not uniform across the BRIC economies. Figure 6 illustrates this expected diversity among BRICs and highlights that India is expected to experience continued deficit spending of nearly 8% of GDP. This emerging lack of uniformity across BRICs is one of the reasons that the whole construct of the BRIC grouping is being questioned and may become redundant. This non-uniformity theme continues with respect to government debt as will be discussed below.

Figure 5 IMF government deficit forecasts

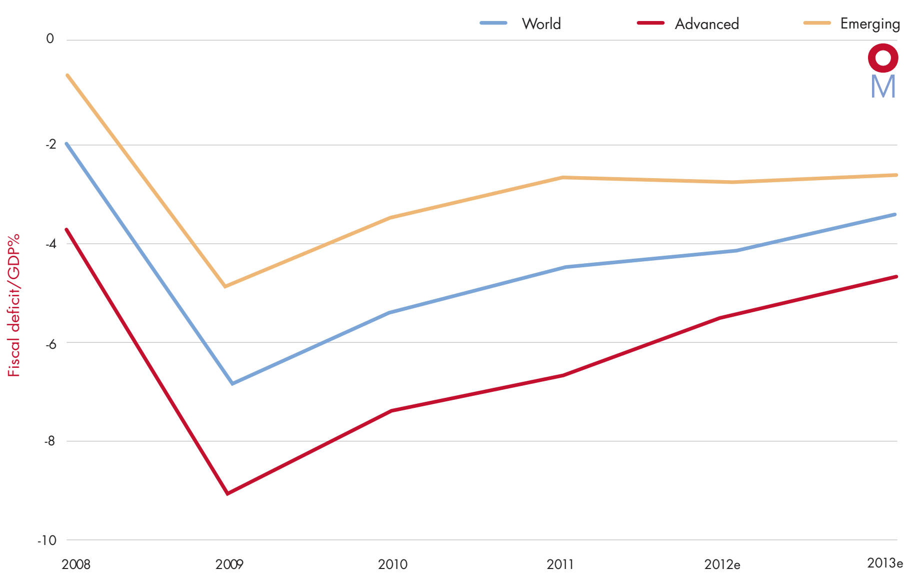


Figure 6 IMF government deficit forecasts for BRICs

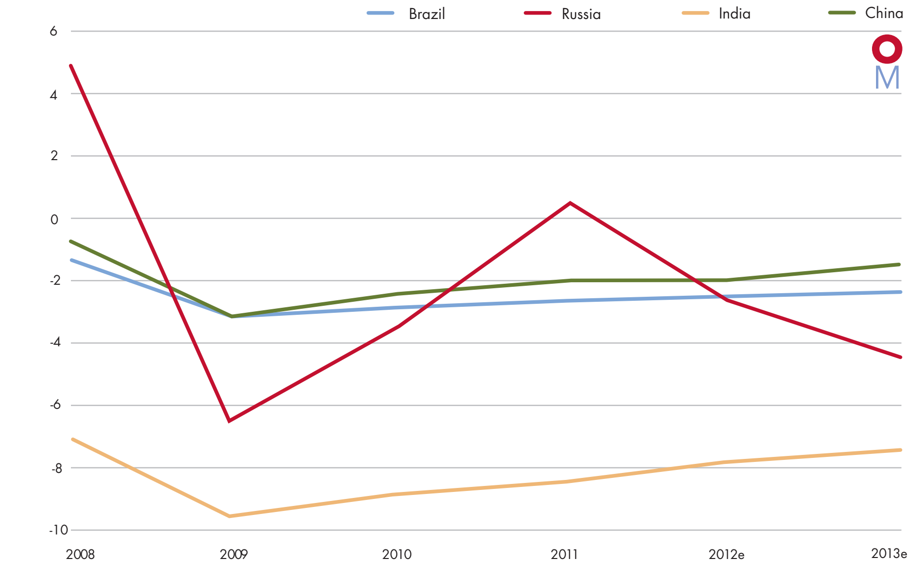


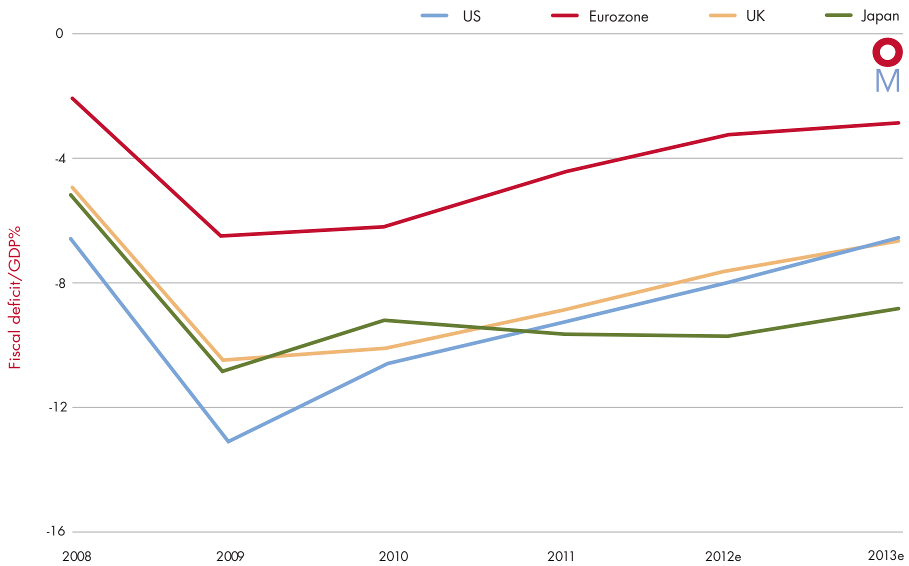
Figure 7 shows how much worse the fiscal deficits are in the advanced economies and the IMF forecasts that they will improve only slightly over the next two years. The United States and the United Kingdom are expected to reduce their deficits from current levels of around 8% to just over 6% of GDP. Japan is forecast to have a continuing deficit of close to 9% two years hence.

That makes the IMF outlook for overall deficits in Euroland look very optimistic; predicted to be around 3% on average. This of course masks some very much larger deficits in the Mediterranean members of the Euro being offset by their more fiscally frugal northern neighbours.

Debt

This outlook for deficits implies that government debt is going to rise across the advanced economies for the foreseeable future.

Figure 7 IMF government deficit forecasts for advanced economies



Government debt levels will therefore continue to be of considerable concern in the advanced economies where the average debt level is more than 100% of GDP and expected to grow.

Figure 8 IMF forecasts for government debt

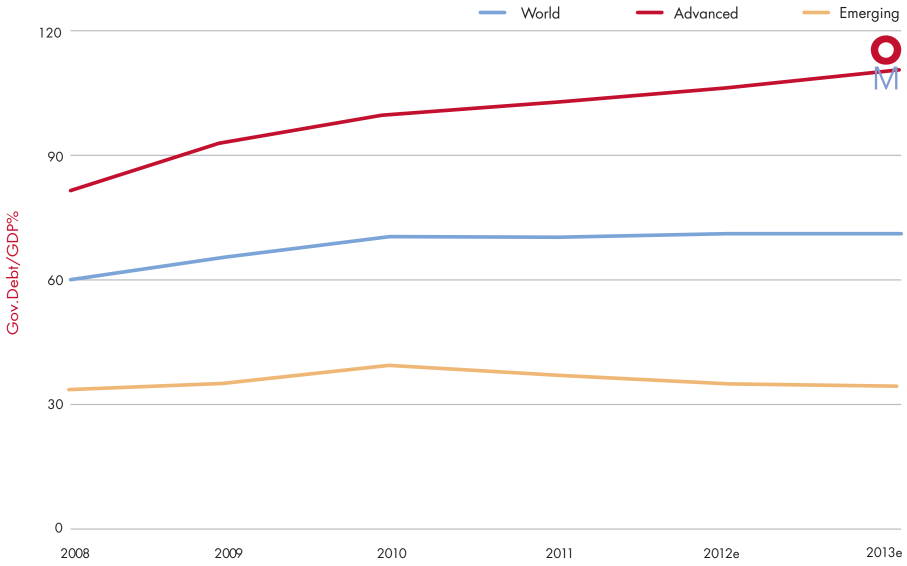
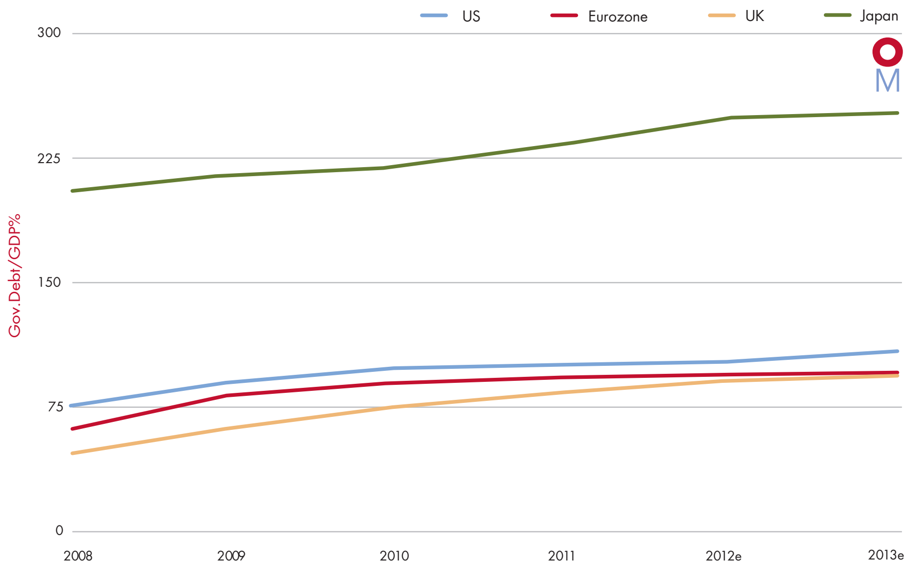


Figure 9 sets out the forecast for government debt in the advanced economies. European debt is not as bad as the position in the United States. However, the government debt to GDP has reached dangerous levels in Japan where government debt now represents more than 2 years worth of GDP and this is expected to grow substantially in the next two years. The Euroland debt levels are manageable on average. However, in some economies, levels are much higher, notably in Greece where Government Debt to GDP is now over 200%, although this is likely to fall through default either within or outwith the Eurozone.

Our view is that Greece will leave the monetary union and default on its loans. The European effort will then be on the banks that will inevitably suffer the losses. We are therefore not sanguine on the near term prospects for most European banks, although much of this has been impounded into prices and there are specific opportunities in this sector.

Figure 9 IMF government debt forecasts for advanced economies

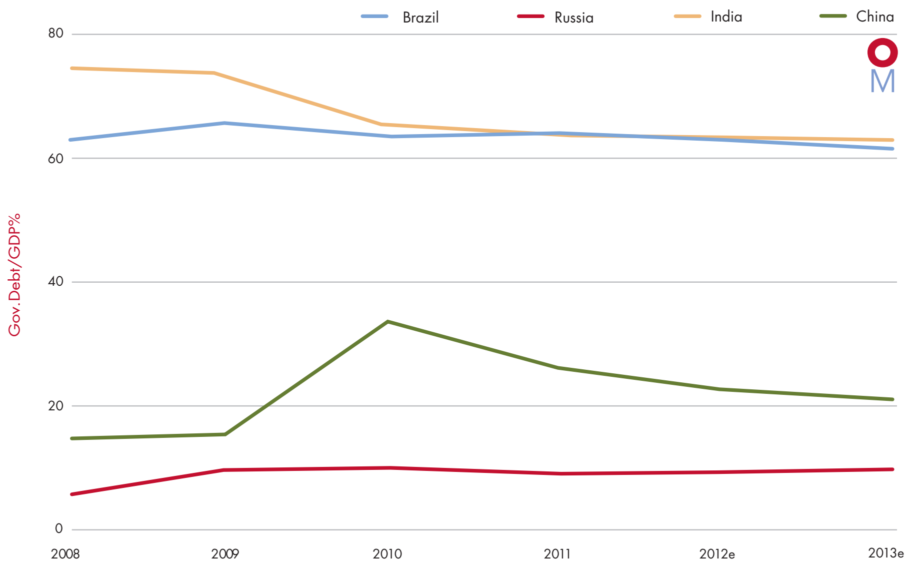


It is obvious that if Euroland was fiscally integrated, the debt levels would be manageable. The problems derive inter alia from the lack of fiscal integration. The fixed exchange rate mechanism across Euroland is causing grotesque distortions and the lack of flexibility in a fixed exchange rate regime combined with the lack of fiscal integration or enforceable rules on fiscal matters is an unfortunate mixture when the business cycle slows.

If the rest of Euroland cannot be convinced that the cost of keeping Greece in is less than the cost of departure, Greece might have to leave. If Greek citizens believe the cost of the austerity package in staying exceeds the cost of the exit they might leave, albeit reluctantly.

The persistence of excessive government debt in most advanced economies has major implications for the top billion in that it represents an end to the Keynesian experiment of government expenditure for growth which is now exhausted. The need to reduce deficits constrained by borrowing capacity means governments can no longer spend more. This leaves only the monetary option as the way forward for growth. The top billion must start spending; for this, they need confidence and access to credit and increased liquidity. The excessive regulation of banks and the political allocation of credit, as witnessed in the selective bail out of banks and the TARP arrangements, are a dangerous game in our opinion.

Figure 10 IMF government debt forecasts for BRICs

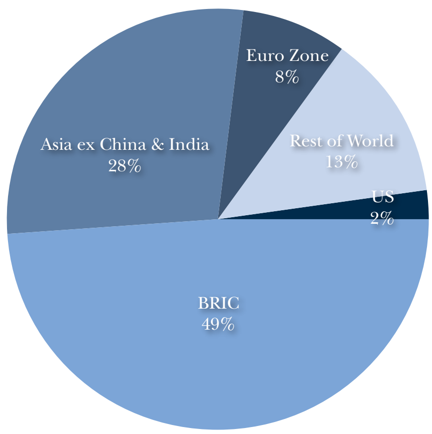


In the emerging markets government debt levels are currently averaging around 40% of GDP and are expected to reduce slightly to around 35%.
Among the BRIC countries Brazil and India governments are developing the debt habit, with government debt at over 60% of GDP which is double the average for emerging markets as a whole including themselves, however substantially lower than the advanced economies. Debt levels are much more manageable in China and Russia (see Figure 10).

China is often mistakenly cited as the engine of global economic growth. The source of global growth is top billion consumption which has driven the wheels that are Chinese production over the last decade. This debt-fuelled consumption has provided China with a substantial trade surplus and enormous foreign reserves. It is now a major creditor nation. The redistribution of foreign reserves to the emerging world and specifically Asia has significant implications for the global political economy. We shall now examine foreign reserves.

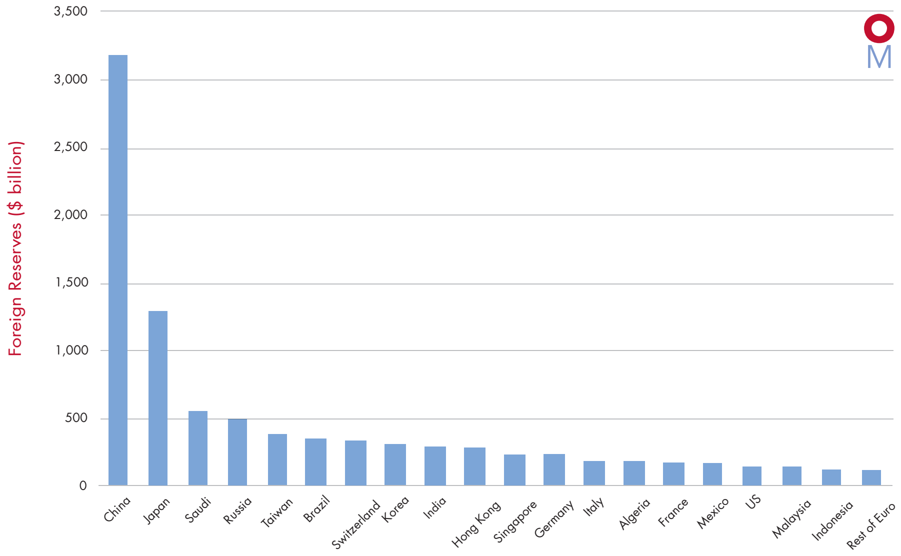
Foreign Reserves

The continued funding of top billion consumption with debt has provided China with the lion's share of foreign reserves. The assets held abroad by a country's citizens represent in aggregate the extent to which cumulatively the creditor nations have developed trading surpluses with debtor nations. The new creditor nations are the BRIC countries and the rest of the emerging economies. Figure 11 shows the magnitude of this for the leading 20 countries and regions.



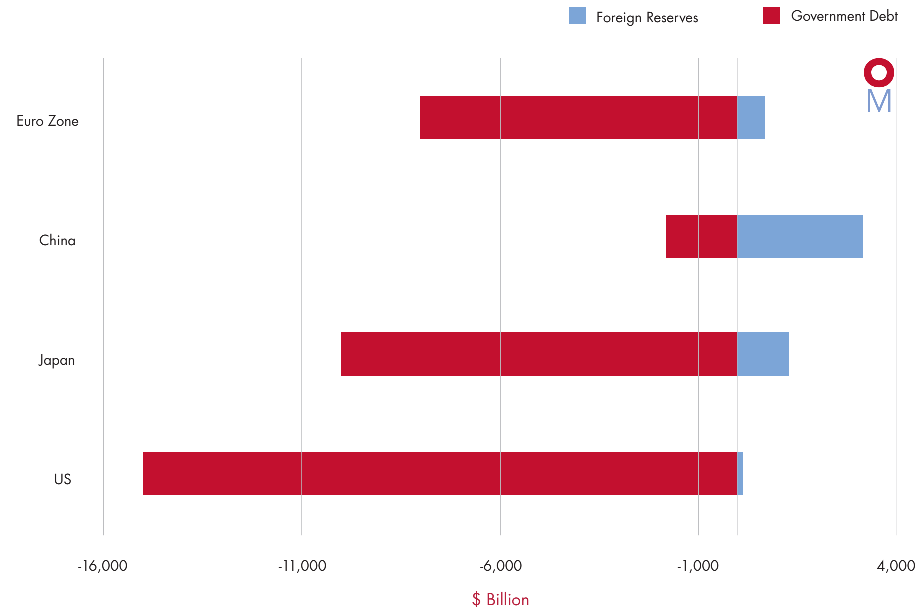
This diagram illustrates the asymmetry of foreign reserve holdings across regions. The BRIC countries hold 49%, BRIC plus the rest of Asia hold 77% with the Eurozone and the US holding 8% and 2% respectively. (IMF World Economic Outlook, January 2012)

Figure 11 Top 20 foreign reserves



The Chinese domination with $3.2 trillion is evident. Interestingly, Japan comes in second with $1.3 trillion, less than half of the Chinese reserves. The Chinese lead is all the greater when one considers how much larger is Japan's debt burden (see figure 12).

Figure 12 Foreign reserves and government debt



In order to describe the extent of the asymmetry among regions, consider the diagram in the margin which organises the foreign reserve data by regional groupings. The BRIC group holds just less than 50% of all foreign reserves, while BRIC and Asia hold around 77%. The Eurozone and $ are hold less than 10% combined.

Currencies

Since the strength of a country's balance sheet is an important factor determining the stability of its currency, foreign reserve holdings strengthen and government debt weakens a currency, Figure 12 presents a stark message; the $ and Renminbi should probably not be pegged. The United States foreign reserves are a paltry $120bn in comparison to the $3.2 trillion held by China, without any adjustment for the size of these economies. The difference is exacerbated by the massive debt, held by the US government which was $15 trillion

(December 2011) and currently more than $16 trillion, as against the more conservative $1.3 trillion held by China. China thus has net reserves (foreign reserves less government debt) of nearly $2 trillion which would rank the largest even against all other countries' gross reserves. The US net debt position is now a little under $16 trillion, more than its annual GDP.

Although an endowment of massive reserves provides considerable support to a currency, it does not mean that investors are not exposed to significant currency volatility.

In the light of the data presented above, the idea is often expounded that the US dollar is at risk of being replaced by the Renminbi as the world's reserve currency. Although BRIC inter trade is growing, it is a minor part of world trade. Even if the most optimistic expectations are realised, inter BRIC trade is unlikely to exceed 10% of world trade over the next decade. In our view, the $ is a weak world reserve currency. However, the Renminbi is not remotely ready to replace it. The fixing of the Renminbi value to the $ undervalues the Renminbi which may help exports but it creates many distortions in the Chinese economy which ill suits a world reserve currency.

The Global Outlook

This section aimed to provide a brief description of the state of the world economy and its prospects for growth in the next year. The picture is somewhat depressing and exacerbated by the considerable uncertainty surrounding the European Union's abillty to act decisively over the burgeoning financial crisis.

Coupled with ambivalence in an election year in the US we believe that the world economy is unlikely to enjoy a recovery in the next twelve months. The dual fixed rate exchange rate regimes in the form of the Euro and the $/Renminbi peg will create problems in the year ahead.

Fortunately, much of this bad news has been impounded into equity prices and we believe that aggregate equity markets will have a lack-lustre performance with above average volatility and increasing correlation across markets. There will be patches of excellent performance and patches of spectacularly poor performance with an increase in corporate bankruptcies across the world notably in the financial sector. However, it is in these troubled sectors that the best value is still to be found.

FACTORS WEIGHING ON INVESTORS' MINDS AND EQUITY MARKETS

There are a number of factors that are weighing heavily on equity markets and which are chiefly responsible for the recently observed behaviour of equity prices. These are the so-called "bogey men" of the markets that are currently receiving extensive coverage in the media and from other commentators. We provide a brief coverage of these as a background to the next sub section on the characteristics of global equities.

Greece exits the Eurozone

As we write, the probability of an exit, orderly or otherwise, by Greece is increasing.The consequences are significant for the creditor banks. German, French and British banks will be most impacted if the Greek government defaults on its sovereign debt, or reissues in "New Drachmas" at a significant devaluation. Current political rhetoric is intended to exaggerate the cost of an exit in the form of political and financial contagion. The first is much less important for equities than the second. The so-called firewalls should contain the financial fall out, although the political attention will be concentrated on the weakening banks. The main problem is that the exit and attendant default by Greece will expose the weakness of bank balance sheets across Europe. Many politicians are in denial on this subject.

There is no doubt that as a first time event, the exit will result in an increase in uncertainty in the short term which will see a significant fall off in equity prices. Some of this has been impounded into prices as reflected in the recent reductions. The Greeks have two options; leave and default now or remain in the Eurozone and default later. Paradoxically the former, albeit a short term set back, is better for a more timely recovery and it will force the central bankers to act more promptly. It is likely to be welcomed in Greece as the benefits of a significantly devalued currency are reaped. However, further austerity there is unavoidable, and further social unrest may ensue which will further disturb equity markets. The likelihood of this event is significant enough to avoid investing in European banks, even though they look deceptively cheap.

There are two major consequences that have received less attention. Firstly, the risk of Spain enduring a financial crisis on the same scale as Greece and secondly the failure of a major northern European bank.

The disruption created by the crisis in Greece would pale in comparison to the distress of a similar crisis in Spain. Apart from the far reaching financial consequences, the social unrest would be considerable. Spain is the most likely to experience such a fate, and recent severe unemployment and bank panics augur poorly. The recent problems at Bankia, a major Spanish bank, may be the harbinger of further problems.

Dexia, the Belgian bank, was an early casualty of the Greek crisis. It had too great an exposure to Greek sovereign debt which along with other factors required it to be bailed out by the government. If a similar event is experienced by one of the larger brand-name banks in Germany or France, the shock waves for equities would be great. Although the respective governments and the EU would no doubt bail out affected banks in such circumstances, the loss of confidence in the European banking system would take some considerable time to recover. Again, this would caution against the European banking sector and the Euro.

The American "debt bomb"

Books have been written and countless commentators have described the US at a "tipping point" with respect to its levels of debt.

Most agree that it is not in China's best interest to sell off its holdings and it is unlikely to do so voluntarily. However, China has its own stability problems. At the moment it benefits greatly from the distorting peg with the dollar; its dollar holdings are in effect shorting the Renminbi to help trade. This is under considerable pressure. A collapse in the dollar would cause a significant disruption to world equity markets. If the US government defaulted on its debt, further volatility, mainly downward, in equity prices would follow.

This likelihood would induce one to diversify away from US dollar denominated assets. ADRs may provide useful hedging against the dollar for US based investors. The dollar is not a strong currency but in comparison to the woes of the euro it is holding up. However, the Renminbi is the Achilles Heel.

China has a hard landing

If China's growth rate decelerates to below the IMF forecast say to as low as 6% or 7%, it will be an indicator of deeper problems in "top billion" consumption and in the Chinese economy. There is a lot to go wrong and we are extremely cautious on the outlook for China. Our worry is that a dramatic deceleration in China will cause global equities to falter.

There is a potential real estate bubble in China financed through debt. This point is obfuscated by claims that mortgages require 40% deposits. This is true, but the deposits are chiefly funded in the underground lending network, which is reputed to be $1.3 trillion. As pointed out earlier, China is shorting its own currency to keep the Renminbi artificially low through the peg to the dollar, and finally inflation is likely to be higher than reported. In the past few years capital investment has been a significant part of GDP growth. This investment has largely been in projects that are unlikely to generate much return. They have been in such ventures as nearly 200 airports and motorways to nowhere, nice to have but do not produce returns, and there is little capacity to continue such a rate of investment. The Chinese stock market has been among the worst performers for the last two years. Couple this with a number of high profile frauds in listings abroad with dubious corporate structures, and the risks are high. It is little wonder the Chinese IPO market has stalled.

Commodity shocks and diminishing safe havens

The signs from Iran are not encouraging; the closure of the Strait of Hormuz would cause such a shock. It is estimated that 17 million barrels of oil pass through the strait per day. This represents 35% of sea borne oil and 20% of total world trade. Apart from the effect of political concerns on equity prices, the likely impact on inflation expectations would likely reduce world equity prices by somewhere between 10% & 15% in our estimation. Should this occur, the usual safe havens would not be adequate. There may be some refuge in gold if one acted quickly and the Swiss Franc is unlikely to hold up as in past crises. The recent announcements from the Swiss National Bank (The central bank in Switzerland) confirm this with a mention of the introduction of capital controls.

Well-intentioned government regulation slows growth

In the last year there have been over 14,000 new financial regulations world wide, this is more than 60 per day[3]. This imposes a monumental burden of compliance on financial institutions. Ideas such as the proposed Tobin tax would be bound to have a negative impact on equity markets. We do not expect there to be much support internationally for this tax which has been popular to attack bankers and clamp down on executive compensation. Unfortunately the combined effect of these initiatives would be an unintended impediment to growth which would dampen equity markets further.

NEW APPROACHES TO GLOBAL EQUITY INVESTMENT

This section reflects on the suitability of various equity investment approaches for the next two years given the current market conditions and likely prospects. The view is considered of both the professional fund manager and the trustee of endowments (and similar entities) that delegate to these managers.

Investment philosophy

Most investment managers have an implicit set of guiding principles for their investment approach. It is not always sensible to be too rigid in the application of these principles as market conditions often dictate a more pragmatic response. Nevertheless, if a manager has been appointed on the basis of their stated management style a potential moral hazard problem arises between manager and client if there is a dramatic drift, especially if the shift is not disclosed.

The current state and prospects for global equity markets impose a rudely pragmatic intervention into any investment philosophy which gives rise to a matter of some importance for professional investment managers and their clients.

The locus of investment policy making is crucial. If the policy locus is at the manager level, as in a fully discretionary mandate, it is reasonable to allow market realities to dominate investment principles. Although if selected on the basis of their stated management style such a drift in approach may be unwelcome, particularly if performance suffers.

[3] See Financial Times 8 December 2011

However, if the policy locus resides at the level of the trustees and managers are explicitly required to avoid style shift, the situation is equally fraught since major market changes would require a massive reallocation across managers with the appropriate styles for the prevailing conditions. This is likely to be disruptive. In most cases and market conditions an accommodation occurs; managers adapt slightly to market conditions and their appointees do not abandon their investment principles for the ever-changing swings in market sentiment.

We argue that current market conditions will test the tolerance levels of trustees and the convictions of managers. Good *ex post* performance will however resolve most of the issues raised.

Nevertheless, we contend that trustees need at such a time to revisit precisely why each manager has been chosen. If they have been selected on the basis of past performance and or a particular investment style it may be time for a review, as past performance is likely to be a poor guide and some strategies may be ill suited to the current conditions.

Although these are not normal times for global equities, reports of their demise are exaggerated. We recommend a strong dose of market pragmatism for the three aspects of investing – policy, management and performance evaluation – over the next two years.

Current characteristics of global equities

Increasing volatility

The increase in volatility of stock prices over the last 4 years is likely to continue. This has been exacerbated by an increase in magnitude of the changes in bilateral exchange rates, which results in prices in any international investor's numeraire currency being even more volatile. This holds even if the currency element is hedged. Rolling hedged returns typically are as volatile as unhedged returns because forward exchange rates are as volatile as spot exchange rates.

Directionless markets

Our view is that equities in aggregate will fluctuate at a higher volatility around a low and possibly negative average, showing no significant return. A return to a bull market is possible in early 2013, however bouncing along at present to slightly lower levels is likely. On a more positive note it will be observed below that we detect pockets of value and the best managers will be able to generate good returns, despite the general malaise in the global economy outlined above.

Increasing convergence

There has been a trend to convergence in equity returns across the world markets. This results in the observable increase in co-movement of equity markets, more formally the pairwise correlation coefficients between markets are increasing. The causes are not independent and include an increased interdependence among countries as globalisation expands; a convergence of investor expectations and strategies that becomes self-fulfilling (or in a formal sense these expectations are realised); a convergence of trading on country equity markets. This occurs through dual listings and depositary receipt programmes. The dominance of global macro events also contributes to this observed convergence (see below).

Equities are cheap

At least they appear to be cheap in comparison to historic metrics and bond prices. It is evident that Price Earnings (P/E) ratios are higher than they have ever been in the last three years in most markets. Cash flow yields are similarly strong and in the financial sector Price to Book (P/B) ratios are at an all time high. The dividend yields on many equities exceed the yield on bonds. This may reflect the fact that bonds are unusually expensive. It is true that much money left equity markets in the last few years and it is assumed that large amounts of cash are on the sidelines in other securities and commodities. $500 billion is reputedly in cash or near cash in private equity funds. It will be seen in the next section of this briefing that some $5 trillion is held in cash and near cash by the Global 100 equities. This does not mitigate against the risks that over shadow the world economy.

Macro factors dominate

Equity prices have become dominated by global macro factors discussed earlier in the briefing. This raises issues for investment management and some believe it makes bottom up investing difficult. While this may be true, we argue below that value investing is most suitable to current conditions. These characteristics conspire to test the skills of most investment managers and we would suggest that many investment styles are ill-suited to these conditions.

Investment styles ill-suited to current conditions

We contend that investment management styles ill-suited to current and prospective conditions are any form of the so called “top-down” styles. This includes asset allocations by country and sector; perhaps paradoxically, since most markets are being dominated by macro factors and political events. Our observation is based on the view that macro factors are asymmetrical in their impact, more likely negative than positive, or at best offsetting. Furthermore the increased convergence across markets noted above will largely dilute the power of diversification, which is the rationale for most asset allocation programmes. Similarly, passive management styles based on various indices and benchmarks are likely to underperform. We consider that this will not be an appropriate time for Beta investing and Alpha based approaches are likely to perform better.

Recommended investment styles

The view expressed above that the dominance of macro factors renders the so called “bottom-up” approaches redundant is true in so far as the poorer stock selectors will be denied the cover of a positive and stable market-wide return. We believe there is a strong argument to eschew diversification-based strategies and to migrate to a “super-focussed” approach. The term “super-focussed” refers to an approach which invests in the minimum number of equities ranked by potential. The number selected will depend on the confidence in the rankings and the amount available to invest. Empirical evidence suggests that when stocks are added at random to a portfolio the benefits of diversification are exhausted at between 15 and 20 stocks. This means that holding stocks in greater numbers is likely to be redundant.

We foresee that strategies which hold fewer stocks will tend to generate better returns than their large number counterparts. The Pareto rule or some variant is probably applicable, whereby 80% of a portfolio’s return is generated by 20% of the stocks.

We believe there are undervalued pockets of opportunity for the discerning investor and consequently value investors and ‘stock pickers” are the managers one would back in such markets. Good alpha based managers are likely to be the best performers in the mid term. Many of course will be exposed as mistakes will be hard to hide without the cover of large market-wide returns.

The maxim of the legendary investor Sir John Templeton, “Trouble is opportunity”, seems particular apposite to these conditions.

Measuring performance

Since managers that are selected on the basis of being value investors or stock selectors are there to discover undervalued stock, there seems little point in spending much time on their views of the global macro economy, particularly where they are focused on a specific market or region. The performance evaluation might focus more specifically on stocks held than portfolio performance. This enquiry might centre on why so many stocks are owned. Where this is the case, it may be characterised as managers hedging their own skills, although the size and weight of funds and any restrictions on the maximum percent of an equity to be held are factors that may lead to more stocks in the portfolio. A key question to ask is why so many stocks are held and why managers do not concentrate on their best ideas. Managers might be asked to explain why stocks have been selected with a high level of specificity.

Managers might be asked to account for the setting of target price levels for selling a holding and the expected holding period. The rate of share turnover might be reported. We are recommending a change to standard performance reporting models where the emphasis moves from the portfolio performance to the individual stock level. If the number of stocks is too numerous to make this feasible, there is probably cause for concern.

This change of emphasis means that benchmarking against a global index or regional or country indices would be less relevant. If a benchmark is to be used it needs to be tailor-made to suit the stock selection approach taken by the manager and may include a peer group of managers. Alternative metrics such as holding period and stock turnover, *inter alia*, might be helpful. In addition, currency effects would be isolated.

Manager meetings would need to focus on the disclosure of the full stock list and managers asked to account for why they hold these particular names. We are particularly sceptical of the "Risk On Risk Off" (RORO) for value investors and stock pickers as there is little justification for holding cash and non equities in a delegated account.

Some investment ideas

We close this commentary by offering a few investment ideas which seem logical in the light of the foregoing analysis. We are optimistic that there are many pockets of good value where essentially strong companies are undervalued and depressed by macro factors. These companies may thrive in the mid term, although searching them out may take more research than when a bull markets lifts all stocks. Here are a few we have noticed.

High dividend yield European stocks
European stocks that are currently trading on high dividend yields that have strong balance sheets are particularly attractive at moment. Many of these are enjoying high levels of free cash flow.

European & US multinationals (MNCs)
There is a set of MNCs that have a significant penetration into emerging markets, that is in excess of 30% of their sales are in these markets. These companies have attractive P/Es and dividend yields. Furthermore they represent a potentially more interesting alternative to investing in the underlying emerging market directly. The quality of corporate governance and financial reporting is likely to be better. Certain undesirable macro factors will be avoided and currency effects will be ameliorated. Although the sales of the MNC are not immune to currency fluctuations, they are not as disruptive as daily movements in currency markets to which an investment in a local firm would be. Furthermore the MNC is in a better position to manage the specific currency exposures it faces. Most importantly these MNCs are presently trading a discount to the emerging markets.

European financials
Despite the concerns we expressed earlier about the risk inherent in the European financial sector, it is very likely that the best performing stocks in the next 18 months will include some European financials, so too will the worst performing stocks. Thus selecting the winners is essential. There are some undervalued financials with strong balance sheets selling at P/B ratios at an all time low.

THE GLOBAL 100

This section provides an overview of the current state of some aspects of the Global 100, the world's largest companies ranked on market capitalisation. The full list is presented in the table on the next page.

Apple is by far the most valuable company in the world with a market capitalisation on this date of nearly $500 billion. This represents an amount larger than some country's stock exchange value for example the Madrid Stock Exchange with an aggregate value of approximately $430 billion.

It will be noted that China now has 3 companies in the top 10, Europe 1 and the US takes the other 6 positions. Banks have diminished in their domination of the rankings, with only 1 in the top 10, being the Industrial and Commercial Bank of China.

The diagram in the margin shows the distribution of the Global 100 by provenance. The US on 43 has less than half of the top 100 slots with the European Union on 21 at less than half of the US number. The BRIC countries are now on 15 of the top 100 places with China contributing 10 of these. Japan's contraction is reflected in the fact that it has no companies in the top 20 and only 4 in the Global 100.

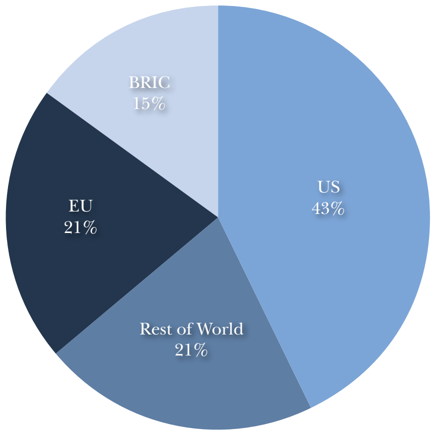
The most striking feature of the data presented on the Global 100 is the amount of cash (and near cash) being held by these corporations. All but one of these companies holds in excess of $1billion in cash on its balance sheet, the exception is SABMiller which has $954million. The average holding is $49 billion representing on average 41% of market capitalisation and 18% of the total assets on their balance sheets.

It is an unusual phenomenon that so much cash is held on corporate balance sheets. There was a market maxim that $1 on the balance sheet was valued at 50¢ in the market price, to illustrate that shareholders tend to be sceptical of managements that hoarde large amounts of surplus cash. The current scale of cash on corporate balance sheets is unprecedented, being a symptom of the poor state of the international financial system. It suggests that corporations are unusually cautious about their future access to funds.

Note the scale of this cash build up by referring to the total of column 4 in the appendix which indicates that the aggregate amount in cash is $4.9 trillion, of which $1.5 trillion is in industrial corporations and the balance in Banks. The amount in industrial corporations is only slightly less than the $2 trillion in free cash on Bank balance sheets. In order to adjust for size, columns 5 & 6 report cash balances as a percentage of market capitalisation and total assets respectively. On average cash represents a staggering 42% of market capitalisation weighted by value. This is affected by the very large percentages exhibited on bank balance sheets. This is due to the nature of the balance sheet of a financial institution which is required to hold a set of its assets in marketable securities so we instead focussed on actual cash held, or free cash. Adjusting for this by including only the free cash at Banks the average reduces to 30%, still a large percentage. Cash as a proportion of total assets averages 21%. The cash holdings of Apple in excess of $110 billion is larger than the market capitalisation of any company below 46 in the rankings and indeed the market capitalisation of some small countries. Since the IPO, Facebook has lost some 30% of its market capitalisation which would place it around the rank of 82.

This overview of corporate balance sheets illustrates the extent to which liquidity is being held back by both banks and corporate clients reflecting their lack of confidence in the financial system. On the positive side it shows some balance sheet strength in the world's leading companies. This may be a manifestation of the well-known Keynesian liquidity trap and augurs negatively for the recovery. It is essential to economic recovery that the hoarding of cash abates.

Cash is defined as cash plus marketable securities. The average cash of $49 billion reported is greatly affected by the significant amount of marketable securites held by fiancial institutions. In order to remove this effect we note that the average for the Global 100 excluding financial institutions is still over $17 billion. All market prices are at the close of trading on 18 May 2012, except for Facebook which is reflected at the opening price for the IPO on 19 May 2012. All amounts are in $ millions unless otherwise stated.



This diagram shows the distribution of the number of companies in the Global 100 by market capitalisation on 18 May 2012, in US$.

Rank	Name	Market Capitalisation	Cash	Cash/ M.Cap	Cash/ Assets	Country
1	Apple	495,695	110,176	22%	73%	US
2	Exxon Mobil	383,025	18,670	5%	5%	US
3	Petrochina	271,060	9,777	4%	3%	China
4	Microsoft	249,674	59,529	24%	50%	US
5	IBM	228,263	12,335	5%	11%	US
6	I&C Bank of China	227,460	564,675	248%	22%	China
7	China Mobile	213,695	52,851	25%	35%	China
8	Wal Mart	209,754	6,550	3%	3%	US
9	Google	203,019	50,196	25%	65%	US
10	Royal Dutch Shell	201,964	15,024	7%	4%	Dutch/UK
11	General Electric	199,774	131,479	66%	19%	US
12	Berkshire Hathaway	198,800	176,928	89%	43%	US
13	Chevron	197,544	19,110	10%	9%	US
14	AT&T	195,179	2,442	1%	1%	US
15	Nestlé	189,835	8,509	4%	7%	Switzerland
16	Proctor & Gamble	175,257	3,991	2%	3%	US
17	Johnson & Johnson	174,532	33,847	19%	29%	US
18	Coca Cola	169,616	15,779	9%	19%	US
19	Pfizer	168,932	23,972	14%	13%	US
20	Wells Fargo	167,070	91,143	55%	7%	US
21	China Con. Bank	165,292	439,005	266%	23%	China
22	BHP Billiton	159,122	4,364	3%	4%	UK
23	HSBC	149,078	319,097	214%	12%	UK
24	Samsung	147,318	23,159	16%	17%	Korea
25	Philip Morris	144,982	3,576	2%	10%	US
26	Roche	142,050	12,024	8%	18%	Switzerland
27	Novartis	140,251	5,388	4%	5%	Switzerland
28	Ag. Bank of China	136,665	449,488	329%	24%	China
29	Intel	131,762	14,572	11%	20%	US
30	Toyota	131,697	35,585	27%	10%	Japan
31	Oracle	130,597	29,742	23%	40%	US
32	Vodafone	129,201	12,079	9%	5%	UK
33	JP Morgan Chase	129,160	410,895	318%	18%	US
34	Bank of China	123,277	496,687	403%	26%	China
35	Petrobras	122,666	35,069	29%	10%	Brazil
36	Ecopetrol	120,676	6,135	5%	12%	Colombia
37	BP	118,916	14,650	12%	5%	UK
38	Verizon	117,532	6,532	6%	3%	US
39	Merck	115,671	15,566	13%	15%	US
40	Anheuser Busch	112,015	5,423	5%	5%	US
41	Glaxosmithkline	111,828	9,337	8%	14%	UK
42	Gazprom	108,395	16,353	15%	5%	Russia
43	Ambev	108,294	4,618	4%	18%	Belgium
44	Pepsico	107,554	3,813	4%	5%	US
45	Facebook	104,000	3,910	4%	57%	US
46	Total	103,677	19,733	19%	9%	France
47	Amazon	98,377	5,715	6%	28%	US
48	Qualcomm	97,988	26,568	27%	64%	US
49	Abbott Labs	97,912	9,527	10%	15%	US
50	Unilever	96,396	6,398	7%	10%	Dutch/UK

51	Vale	94,700	4,944	5%	4%	Brazil
52	BAT	94,695	3,491	4%	8%	UK
53	America Movil	92,117	4,711	5%	7%	Mexico
54	China Petroleum	91,999	4,000	4%	2%	China
55	Sanofi	91,616	5,345	6%	4%	France
56	McDonalds	91,076	2,289	3%	7%	US
57	Cisco Systems	89,137	48,412	54%	53%	US
58	Rio Tinto	88,503	10,255	12%	9%	UK
59	Schlumberger	86,348	4,085	5%	7%	France
60	CNOOC	81,954	15,746	19%	26%	China
61	Eni	81,134	2,981	4%	2%	Italy
62	China Shenhua	79,544	10,309	13%	16%	China
63	Walt Disney	79,234	3,731	5%	5%	US
64	Novo Nordisk	78,788	2,384	3%	22%	Denmark
65	LVMH	78,707	2,985	4%	5%	France
66	Commonwealth Bank	78,083	28,354	36%	4%	Australia
67	Citigroup	77,438	26,505	34%	1%	US
68	Visa	77,340	4,653	6%	13%	US
69	SABIC	76,594	15,891	21%	17%	S.Arabia
70	Siemens	76,368	11,954	16%	9%	Germany
71	Comcast	76,250	2,207	3%	1%	US
72	Statoil	76,008	15,315	20%	11%	Norway
73	China Life Insurance	75,606	8,887	12%	4%	China
74	Bank of America	75,221	375,055	499%	17%	US
75	SAP	74,115	7,068	10%	21%	Germany
76	Volkswagen	73,505	35,564	48%	10%	Germany
77	RBC	73,425	23,044	31%	3%	Canada
78	TSMC	72,566	6,122	8%	22%	Taiwan
79	UPS	71,722	6,080	8%	17%	US
80	Home Depot	71,624	3,191	4%	7%	US
81	L'Oreal	70,854	2,141	3%	6%	France
82	NTT Docomo	70,040	10,814	15%	13%	Japan
83	TD Bank	68,960	15,810	23%	2%	Canada
84	Rosneft Oil	68,249	3,855	6%	3%	Russia
85	Kraft Foods	67,994	1,852	3%	2%	US
86	United Technologies	66,830	6,285	9%	10%	US
87	BASF	66,049	5,050	8%	6%	Germany
88	BG Group	66,037	3,496	5%	5%	UK
89	Conoco Phillips	64,733	4,215	7%	3%	US
90	Altria	64,382	4,156	6%	11%	US
91	American Express	64,048	27,082	42%	18%	US
92	Occidental Petroleum	63,806	3,760	6%	6%	US
93	Westpac Banking	62,328	20,340	33%	3%	Australia
94	SAB Miller	62,125	954	2%	3%	UK
95	Telefonica	61,382	10,721	17%	6%	Spain
96	Mistubishi	60,387	113,562	188%	4%	Japan
97	Diageo	60,367	1,794	3%	5%	UK
98	Itau Unibanco	58,709	126,505	215%	26%	Brazil
99	Honda Motor	58,565	15,092	26%	11%	Japan
100	3M	58,521	4,494	8%	14%	US
Total		11,932,278	4,929,527	41%	11%	

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