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GLOBAL MARKET COMMENTARY

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The importance of geographic revenue mix has increased in recent years as growth prospects for emerging and developed markets have diverged. For European and U.S. companies positioned to capitalize on this growth, it may provide a silver lining despite slowing domestic demand.

Many investors are interested in profiting from the growth divergence between developed and emerging markets. As a result, some are increasing their focus on where companies earn their revenues and profits, looking beyond their domicile or primary exchange listing. U.S. corporate earnings are increasingly not generated just from domestic sales, and it has long been the case that U.K. earnings are not just home grown. This may help explain why earnings for large-cap companies in Europe and the United States have held up relatively well year-to-date despite weak domestic economic data. Many of the firms that have beaten earnings expectations thus far in 2010 have done so with the help of significant foreign revenues; for example, the two U.S. sectors most exposed to foreign revenues, technology and industrials, saw 73% and 68%, respectively, of their constituent companies beat expectations during the second quarter, according to BofA Merrill Lynch.

This commentary discusses where European and U.S. companies earn their revenues and profits, and evaluates the investment implications for investors seeking to benefit from investing in Western companies that generate much of their revenue overseas.

Why This Should Be Important

As growth prospects between developed and emerging markets diverge,[1] European and U.S. companies with revenue exposure to more rapidly growing regions should be better positioned for earnings growth than those focused on domestic sales. This is not just because foreign sales may grow faster, but also because these sales can be more profitable than domestic equivalents. Using U.S. firms as an example, nonfinancial firms in the S&P 500 earned pre-tax margins in 2009 of around 14% on foreign sales, twice the margin earned on domestic equivalents; this helps explain why the share of profits earned by these companies from abroad has doubled in just the past 15 years.[2] One explanation is that companies such as technology and energy firms that sell to foreign markets earn higher margins, on average, than companies in domestic-focused sectors such as retail.

The importance of sales from foreign markets is also underscored by how well they have weathered the recent recession. While revenues for the S&P 500 (ex financials) fell by 4% between 2007 and 2009, sales to Brazil, Russia, India, and China (the BRICs) actually increased by 10%, according to

[1] For example, GDP growth in emerging markets in 2010 is expected to be 6.9%, approximately 300% of the level of GDP growth in developed economies.

[2] "Steady History of U.S. Corporate Profits (EBIT) Share of GDP," Bank of America Merrill Lynch, August 16, 2010.

Goldman Sachs. To illustrate this trend, the geographic revenue data for a selection of European and U.S. mega caps are shown in Exhibit 1. For the majority of companies, revenues from emerging markets have increased in recent years at faster rates than domestic sales.

Aside from revenue and profit growth, holding equities with diversified revenue streams should help insulate an investor when economic downturns occur in specific markets. For example, a basket of stocks with large sales to Asia and Latin America will help soften the blow of domestically oriented stocks when U.S. growth slows. This benefit will be reduced in the event of a global downturn, but the probability that any eventual recovery will be uneven across regions still helps support the rationale.

Geographic Revenue Mix

Exhibit 2 illustrates the geographic revenue mix for European and U.S. companies, using analyst estimates of companies in the S&P 500 and MSCI Europe indices. European companies, on average, earn 35% of their revenues outside Europe, with Dutch (48%) and Swiss (46%) firms earning nearly half of their revenue outside the region. U.K. companies earn over 42% of their revenue outside developed Europe. Given the size of the U.S. market, it may be unsurprising that the S&P 500 trails these other markets, earning just 30% of its revenue abroad. Focusing specifically on emerging markets exposure, Spanish and Swedish companies have the most exposure, particularly for financial and telecommunications firms. Differentiating the United Kingdom from other markets, several of its energy and materials stocks are only active in emerging markets and have no U.K. or other European revenue.[3] In contrast, only one company in the S&P 500 has no U.S. revenue, according to Golman Sachs research.

The fact that large-cap companies tend to earn more revenue from abroad than small caps may come as little surprise given the economies of scale in some industries (Exhibit 3). In the United Kingdom, the FTSE® 100 earns just 19% of its revenue domestically, while the comparable figure for the FTSE® 250 is 49%.[4] In Europe, mega caps earn 36% of their revenues outside the region, while the comparable number for small cap companies is 19%. In the United States, this discrepancy is similar, with the largest S&P 500 companies earning 42% of their revenue outside the United States, while the smallest earn 23%.

In addition to the link between market capitalization and revenue mix, clear industry biases emerge when analyzing foreign revenues. Across all regions, information technology, energy, industrial, and materials firms are the leaders in terms of international revenues; in Europe and the United Kingdom, health care is also a strong foreign earner (Exhibit 4). The sector analysis also helps to explain some of the differences in revenue mix between various equity indices. The FTSE® 100, the most international index, has a large concentration of basic resources and oil & gas firms.

Some Considerations

Exposure to foreign markets experiencing faster growth rates may make a stock relatively more attractive, but may not be enough to compensate for other weaknesses, such as underperforming domestic operations or declining profit margins. In industries such as energy and technology, which have large percentages of revenue from abroad, many firms have higher margins. Companies in

[3] "Screen Time: Sterling & Stocks," Bank of America Merrill Lynch, March 12, 2010.

[4] "Strategy Matters," Goldman Sachs, January 15, 2010.

these sectors may be able to protect margin pressures through control over resources, proprietary technologies, and other competitive advantages. For other industries, the potential to increase sales and profits may be more constrained, particularly where local competitors are able to offer similar products and marketing strategies.

The benefits of foreign revenue exposure can also be offset by high country risk factors, which could limit the upside potential for a stock, despite quickly growing sales and/or margins. This is especially true in Europe, where country correlations have risen in 2010 given sovereign debt and other macro concerns. For example, managers that focus on revenue mix might add Spanish stocks, which by various estimates generate between 17% and 30% of their revenue from emerging markets. However, sovereign debt concerns about Spain and the resulting elevated correlations between these stocks and their domestic index might offset any potential benefits during periods when macro considerations dominate.

These dynamics are illustrated in Exhibit 5, which highlights sector and industry correlations for different European equities across a representative mix of industries, as well as return data. Stocks from peripheral European countries have had higher country than industry correlations year-to-date, while stocks from "core" European countries have typically demonstrated the opposite dynamic. For example, most Italian and Spanish stocks across various industries have had extremely elevated correlations to their domestic indices year-to-date (though the trailing three-year figures are lower), despite the fact that in many cases, these companies are less reliant on domestic revenue than their peers in core Europe. One possible explanation is that the domestic indices for these companies are more concentrated than those of other European peers; for example, just five companies contribute 80% of the MSCI Spain's market capitalization. Companies that are domiciled in geographies affected by macro concerns can see correlations to domestic indices spike and performance suffer, even if they have extremely attractive foreign revenue mixes. While these concerns are important, they should not persist indefinitely. In fact, the country effect could provide longer-term buying opportunities, assuming that pessimism about countries brings down valuations of fundamentally strong companies that benefit from significant sales to other faster growth regions.

Looking at country risks from a different angle, a successful geographic revenue mix strategy will not just focus on foreign sales or profits, but specifically on companies with the highest exposure to the faster growth markets like emerging markets. This type of information is not readily available, as companies are not obliged by reporting standards to comment on geographic revenue mix. Often, when revenue mix information is provided, it is not broken down into specific countries or even markets. For example, while investors would love to target S&P 500 technology firms with high percentages of sales to emerging markets, they might have to guess whether this is reflected in sales to "the Americas outside the U.S." or "Asia excluding Japan." Such data can be very difficult to gather, and as a result, opinions can diverge on a company's exposure to sales from a particular country or region. For example, sell-side estimates for German corporate revenue earned from emerging markets range from 5% to 23%, suggesting that this type of investment theme is best executed by active managers that have the access and skill to gather information that is not routinely disclosed by companies.

As with any investment strategy, investors looking to increase exposure to companies with more international revenues should ensure that they are not doing so at premium valuations, which will inhibit the likelihood of seeing future performance versus companies more reliant on domestic revenues. Constructing comparable sets of exporter-oriented versus domestically focused firms is difficult due to disclosure, industry bias, and other issues. However, several indices created by investment banks to track the relative performance and valuation between these groups of stocks have demonstrated that, historically, there has been ample opportunity to buy companies with larger percentages of sales to foreign markets at a similar or even discounted valuation to those that are more domestically focused. For example, the Goldman Sachs index of European companies with high percentages of sales to BRIC countries currently trades at a similar valuation to the index of companies with more domestic sales (Exhibit 6).

Revenue Mix and Foreign Exchange Rates

Investors should be cautious in making assumptions about expected performance of globally oriented companies based on exchange-rate movements. The impact on many companies with diversified sales mixes of foreign exchange movements is often ambiguous. Complicating factors include the denomination of *costs* and revenues, as well as the timing and extent of hedging activity. One example is the impact of US$ appreciation versus Asian currencies for American manufacturers. Companies with Asian factories may benefit on the cost side, but these benefits may be partially offset by sales back into the Asian region. Another example would be sterling depreciation for a British financial or oil company with large international activities. Many of these firms keep their accounts in U.S. dollars, mitigating any currency impacts. Given that dividends are often paid in U.S. dollars, this could be of the most importance to U.K. investors.[5] Conversely, a mining firm that keeps accounts in sterling but sells goods in U.S. dollars to Asian accounts could benefit from a weakening pound. In other words, investors are right to try to target faster growth areas for revenues, but trying to express a view on currencies via equities is more difficult.

Advice for Investors

We think attention to geographic revenue mix is important, and we suspect that we will hear much more about it in the years to come. However, whether investors need to do anything to their portfolios to capitalize on this theme depends on several factors. Some investors may already have in their portfolios significant exposure to companies with a large percentage of foreign revenues. There are several reasons for this, one of which is portfolio tilt. For example, our recommendation to invest in quality equities given their defensive characteristics would overlap with a focus on large-cap multinationals. Many large-cap U.S. portfolios have heavy weightings of blue-chip exporters like Apple, Exxon Mobil, IBM, and Procter & Gamble. In fact, the main difference between a U.S. mega-cap exchange-traded fund and a basket of the largest exporters in the S&P 500 (by market capitalization) would only be a handful of financial and telecommunications firms (Exhibit 7).

A second and related reason why little action may be required is that some investors may already employ active managers that use a revenue screen as part of their investment process. We are aware of numerous European managers that have focused on this theme for a long time given slower rates of domestic growth. However, many U.S. portfolio managers also consider revenue mix for

[5] For the FTSE® 100, 49% of the dividend is paid in U.S. dollars, according to Deutsche Bank.

various reasons, including the acknowledgement that economic growth will be slower in the United States than in some foreign markets, as well as the fact that if the majority of a company's revenue is earned abroad, this drives the investment thesis and thus must be thoroughly understood.

Finally, while we are aware of only a limited number of funds that offer this as a main investment thesis, sizing allocations that are dedicated exclusively to this strategy should be done carefully. Artificially limiting the universe of stocks from which a fund manager can choose could limit performance (e.g., if domestic-oriented stocks were trading at much cheaper valuations than exporters). However, having observed the holdings and track records of some of these managers, it does appear that at least some funds are unconstrained and will rotate into more domestic-focused stocks when valuations are compelling, easing this concern.

In conclusion, we think revenue mix is an interesting lens through which to view stocks, and certainly something that investors may wish to question their managers about. During times of market turmoil, such as late 2008/early 2009, it also may be the case that valuations for exporters become very compelling relative to domestic champions, and thus is a filter that investors may want to ensure managers are considering. At a higher level, understanding revenue mix may also help ease concerns about current macro risks, or at least help explain why earnings for large-cap companies in Europe and the United States have held up relatively well year-to-date despite weak domestic economic data. Revenue mix and international operations can also explain some of the dichotomy between robust corporate profits at large multinationals and moribund domestic labor markets since, in addition to revenues, many of the expenses (including labor) for these firms are also incurred abroad. Investors that are tempted to reduce their equity exposures to a particular country may want to think twice before selling upon the next release of a disappointing piece of macroeconomic data. ■

Exhibit 1

Selected Large-Cap U.S. and European Companies' Domestic & Foreign Revenue

	% Change in Revenue				Foreign Revenue as a % of Total Revenue		
	2007–08		2008–09		2007	2008	2009
Company	Domestic	Foreign	Domestic	Foreign			
Apple Inc.	42.3	67.7	6.9	24.0	40.3	44.3	48.0
Chevron Corp.	23.2	24.5	-37.0	-34.2	56.1	56.4	57.5
Cisco Systems, Inc.	8.9	16.2	-12.4	-11.6	47.1	48.7	49.0
Intel Corp.	-9.2	-0.6	-3.3	-7.1	84.3	85.5	85.0
Johnson & Johnson	-0.4	9.7	-4.4	-1.4	46.9	49.3	50.1
JPMorgan Chase & Co.	-0.4	9.7	52.0	41.6	27.0	25.9	24.5
Kraft Foods Inc.	4.6	30.5	-0.4	-6.6	47.6	53.1	51.5
McDonald's Corp.	2.2	3.8	-1.7	-4.2	65.3	65.7	65.1
Merck & Co., Inc.	-9.0	10.2	7.7	24.3	39.3	43.9	47.5
Pfizer Inc.	-11.9	10.4	6.6	1.3	52.2	57.8	56.5
Anglo American plc	-2.2	14.6	-25.8	-24.9	60.0	63.7	64.0
AstraZeneca plc	6.9	4.3	-4.8	10.4	69.2	68.6	71.7
BAE Systems	-8.5	23.7	22.5	22.2	77.8	82.6	82.5
GlaxoSmithKline plc	16.6	2.2	18.5	15.4	71.0	68.2	67.6
LVMH Moët Hennessy • Louis Vuitton S.A.	7.1	2.7	-8.6	4.0	63.0	62.0	65.0
Rolls-Royce Group plc	25.9	20.1	11.3	16.6	64.2	63.1	64.2
SABMiller plc	28.5	11.2	16.7	-22.2	78.1	75.5	67.3
Siemens AG	4.4	5.8	-11.7	-7.2	79.4	79.6	80.4
Telefónica S.A.	0.7	3.8	-5.4	-0.2	63.4	64.0	65.3
Unilever	-6.0	1.5	-4.5	-1.5	90.6	91.3	91.5

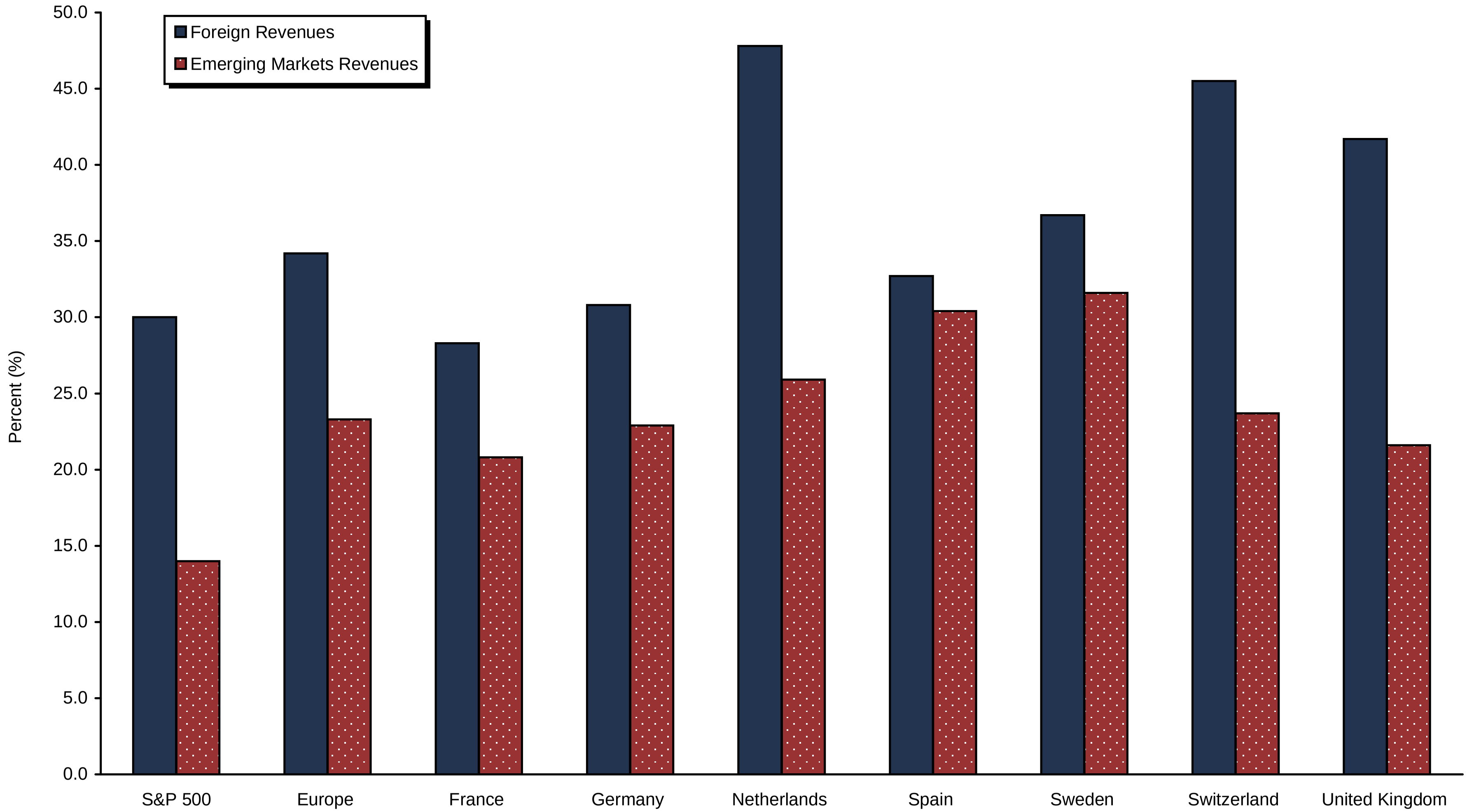
Sources: Selected companies' annual reports.

Notes: Domestic revenues refer to revenues of each company's home country and/or Europe as a region in local currency except for Anglo American plc, AstraZeneca plc, and SABMiller plc, which are in U.S. dollars. Anglo American plc, AstraZeneca plc, GlaxoSmithKline plc, LVMH Moët Hennessy • Louis Vuitton S.A., Rolls Royce Motor Cars Limited, and SABMiller plc domestic revenues include Europe. Unilever domestic revenues include the Netherlands and the United Kingdom.

Exhibit 2

Revenues by Region

2009

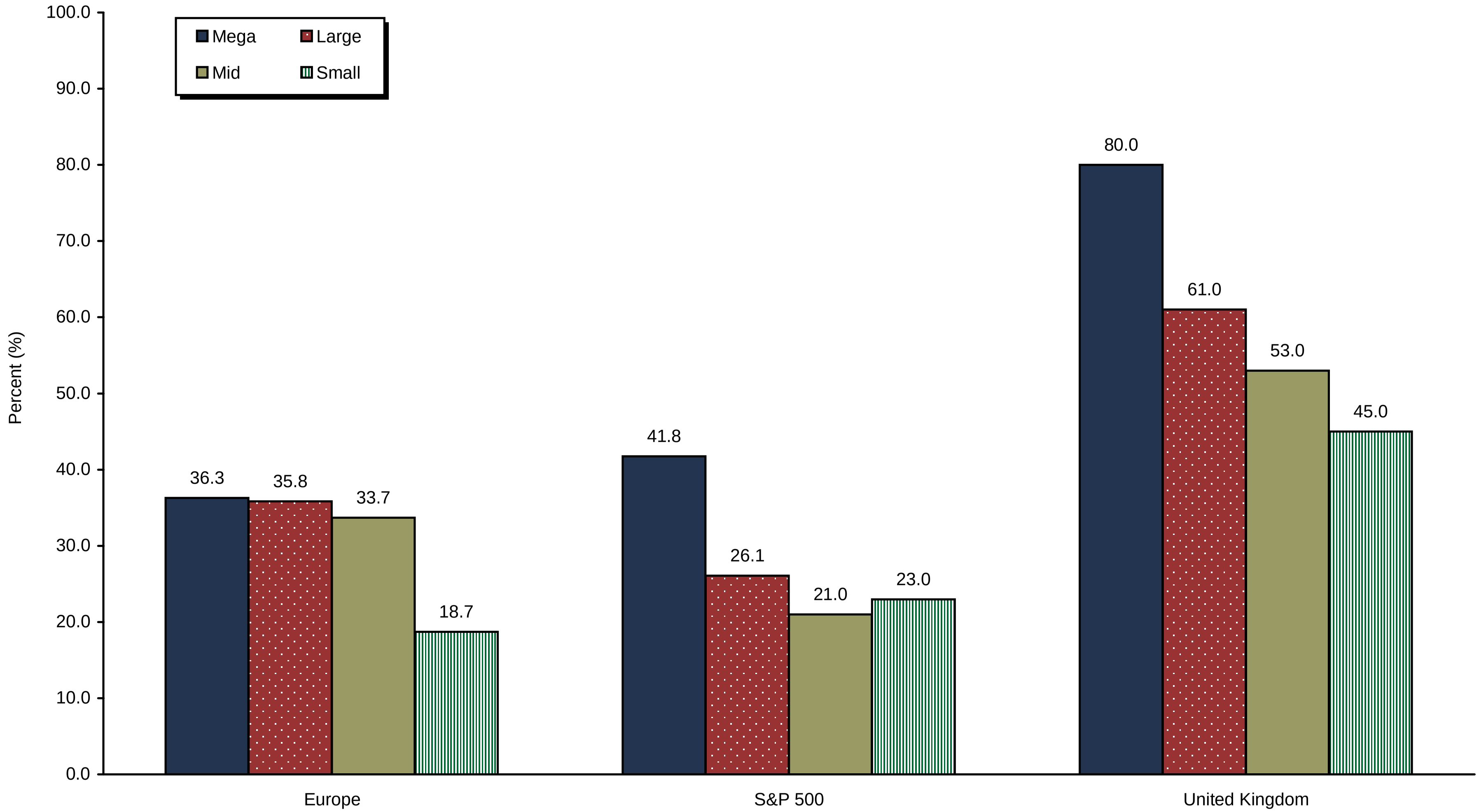


Sources: Company 10-K filings, FactSet Research Systems, Goldman Sachs Global ECS Research, Morgan Stanley Research, and Standard & Poor's.
Notes: S&P 500 foreign revenues data represent Goldman Sachs breakdowns, and S&P 500 emerging markets revenues are based on Cambridge Associates' analysis. All other regions represent Morgan Stanley estimates.

Exhibit 3

Foreign Revenues by Cap Size

2009

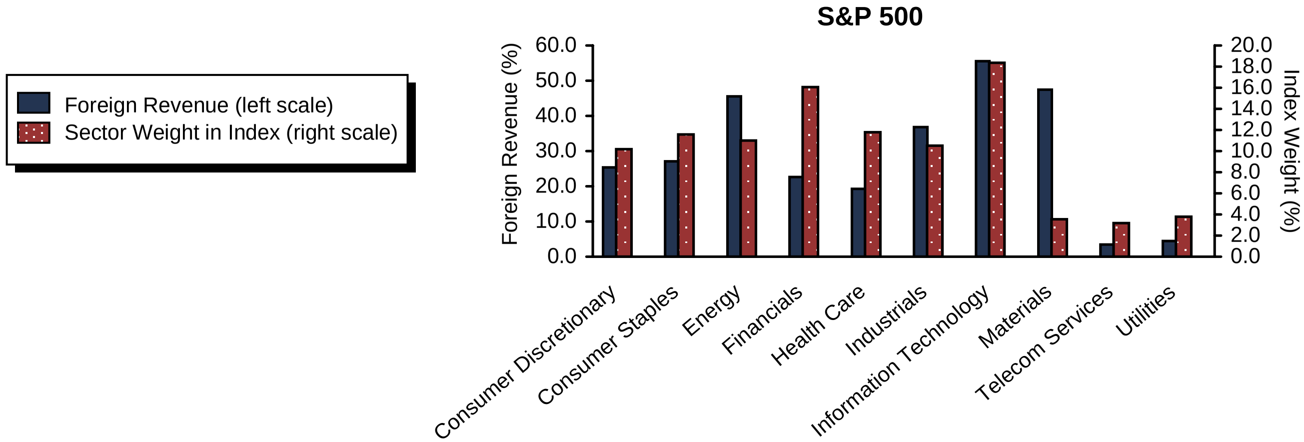


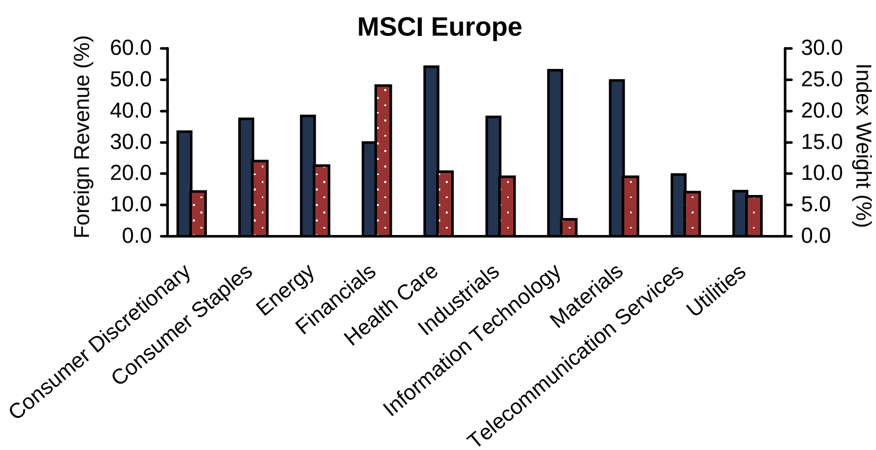
Sources: BofA Merrill Lynch, Goldman, Sachs & Co., Morgan Stanley Research, and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Notes: Data for Europe and the United Kingdom represent the MSCI Europe and MSCI U.K. indices, respectively. Size groups determined by allocating 40% of total market capitalization to mega caps, the following 30% to large caps, the next 15% to mid caps, and the remainder to small caps.

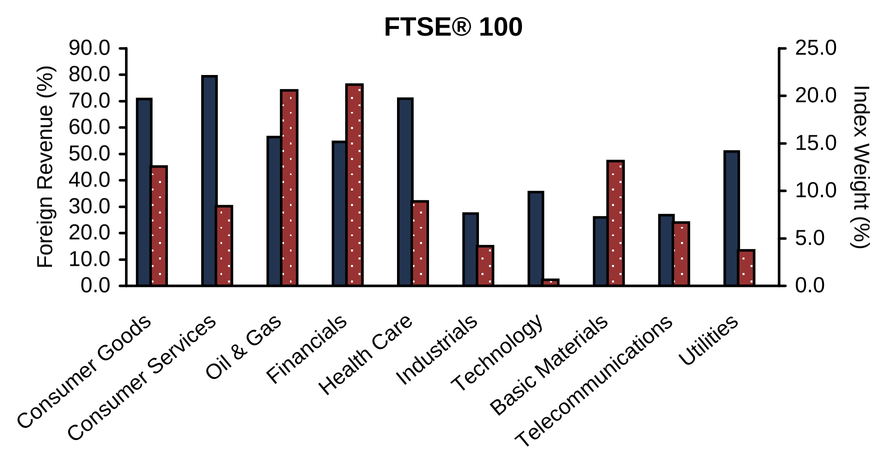
Exhibit 4

Revenues by Sector

2009







Sources: BofA Merrill Lynch, FactSet Research Systems, Goldman, Sachs & Co., Morgan Stanley Research, and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

Notes: S&P 500 and MSCI Europe sectors are based on the GICS classification, while the FTSE® 100 sectors are based on the ICB™ classification. The ICB™ classification includes consumer goods, consumer services, and oil & gas, which differ from the GICS-defined consumer discretionary, consumer staples, and energy sectors. Foreign revenues for the FTSE® 100 represent revenues outside of Europe. For the FTSE® 100 sector revenues, data represent the average of foreign revenue percentages for the companies within each sector.

Exhibit 5

Company Performance, Revenues and Correlations

As of September 30, 2010

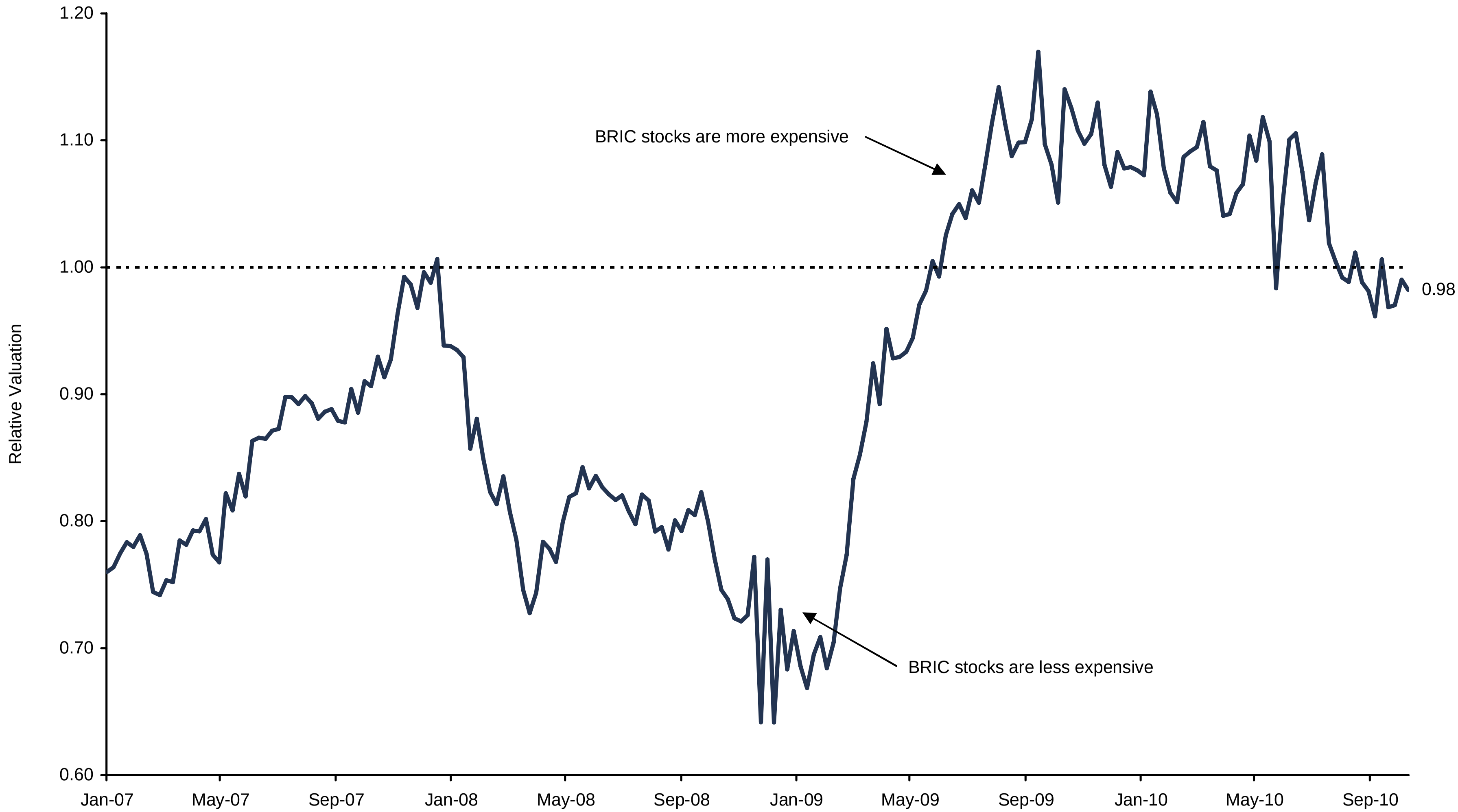
			Performance		Correlations			
		Revenue from	Stock	Domestic Index	Versus Domestic Index		Versus Sector	
	Country	Abroad	YTD Return	YTD Return	YTD	Trailing 3 Yrs	YTD	Trailing 3 Yrs
Financials								
BNP Paribas S.A.	France	55%	-6.7%	-3.3%	0.90	0.67	0.98	0.76
ING Groep N.V.	Netherlands	82%	10.3%	2.7%	0.78	0.82	0.88	0.92
Lloyds Banking Group plc	U.K.	0%	46.2%	2.2%	0.84	0.65	0.92	0.83
Banco Bilbao Vizcaya Argentaria	Spain	63%	-24.0%	-12.8%	0.97	0.94	0.87	0.88
Unicredit S.p.A.	Italy	51%	-16.3%	-11.0%	0.94	0.92	0.88	0.92
MSCI Europe - Financials		--	-6.2%	--	--	--	--	--
Telecoms								
BT Group plc	U.K.	17%	3.7%	2.2%	0.19	0.53	0.25	0.61
France Télécom S.A.	France	47%	-9.1%	-3.3%	0.65	0.38	0.83	0.60
Telefónica S.A.	Spain	64%	-6.9%	-12.8%	0.94	0.69	0.93	0.84
Telecom Italia S.p.A.	Italy	28%	-5.8%	-11.0%	0.43	0.41	0.68	0.79
Deutsche Telekom AG	Germany	53%	-2.7%	1.8%	0.63	0.34	0.82	0.55
MSCI Europe - Telecom		--	0.5%	--	--	--	--	--
Energy								
BG Group plc	U.K.	79%	-0.3%	2.2%	0.56	0.48	0.67	0.60
Royal Dutch Shell plc	U.K./Netherlands	--	2.5%	2.2%	0.77	0.72	0.82	0.92
Repsol YPF, S.A.	Spain	52%	0.9%	-12.8%	0.95	0.78	0.75	0.66
Total S.A.	France	76%	-16.0%	-3.3%	0.98	0.66	0.81	0.90
MSCI Europe - Energy		--	-9.5%	--	--	--	--	--
Utilities								
Centrica plc	U.K.	32%	15.1%	2.2%	0.30	0.31	0.44	0.41
Iberdrola, S.A.	Spain	54%	-12.1%	-12.8%	0.86	0.79	0.94	0.79
Enel S.p.A.	Italy	39%	-3.4%	-11.0%	0.80	0.86	0.93	0.83
Électricité de France S.A.	France	47%	-23.9%	-3.3%	0.78	0.78	0.88	0.83
E.ON AG	Germany	42%	-25.4%	1.8%	0.69	0.86	0.87	0.92
MSCI Europe - Utilities		--	-12.6%	--	--	--	--	--

Sources: Deutsche Bank AG/London, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: All returns are in local currency. Domestic index for Royal Dutch Shell represents the MSCI U.K. Index. Revenues data are as of 2008.

Exhibit 6

Relative P/E Ratios of European Equities Oriented Toward Either BRICs or European Revenues

January 1, 2007 – October 11, 2010



Source: Goldman, Sachs & Co.

Notes: Graph represents the relative valuation (based on price-earnings ratios) between European stocks with high revenue exposure to Brazil, Russia, India, and China (the BRICs) and European stocks with high domestic revenue exposure. The median sales exposure of the BRICs basket to emerging markets was 24% (as of October 21, 2010). Data are weekly.

Exhibit 7

Top 30 S&P 500 Companies and Foreign Revenue Exposures

September 30, 2010

			Weight In	
Largest Companies in S&P 500	Index Weight	Non-U.S. Revenues (%)	Bridgeway BlueChip 35 Index (BRLIX)	WisdomTree Large Cap Dividend (DLN)
Exxon Mobil Corp.	3.02	70	2.64	3.76
Apple Inc.	2.53	48	3.98	--
Microsoft Corp.	1.80	43	2.58	1.89
General Electric Co.	1.69	54	2.75	2.26
Johnson & Johnson	1.66	50	2.75	2.64
Procter & Gamble Co.	1.65	61	2.82	2.54
International Business Machines Corp.	1.65	64	2.70	1.55
AT&T Inc.	1.64	5	2.77	5.12
Chevron Corp.	1.58	57	2.58	2.90
JPMorgan Chase & Co.	1.47	25	2.75	0.38
Berkshire Hathaway Inc. (Cl B)	1.38	11	3.21	--
Pfizer Inc.	1.35	56	2.58	2.48
The Coca-Cola Co.	1.31	65	2.71	1.98
Bank of America Corp.	1.27	20	2.84	0.16
Google Inc. (Cl A)	1.27	53	2.73	--
Wells Fargo & Co.	1.26	0	2.93	0.46
Cisco Systems, Inc.	1.20	50	2.58	--
Merck & Co., Inc.	1.10	57	2.78	2.33
Intel Corp.	1.03	85	2.62	1.72
Wal-Mart Stores, Inc.	1.03	25	2.65	2.14
PepsiCo Inc.	1.02	44	2.75	1.64
Oracle Corp.	1.01	58	2.66	0.57
Philip Morris International	1.00	100	--	2.58
Hewlett-Packard Co.	0.93	64	2.85	0.32
Citigroup Inc.	0.90	51	--	--
Verizon Communications Inc.	0.89	3	2.66	2.71
ConocoPhillips Co.	0.82	35	2.83	1.73
Schlumberger Ltd.	0.81	84	2.79	--
Abbott Laboratories	0.78	53	2.88	1.22
McDonald's Corp.	0.76	66	2.65	1.43
			78.04	46.51

Sources: Bloomberg L.P., Bridgeway Capital Management, Inc., FactSet Research Systems, Goldman, Sachs & Co., and WisdomTree Funds.
Note: BRLIX weights and non-U.S. revenue figures are as of June 30, 2010.