

C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENT: BENEFITS OF GLOBAL EQUITY INVESTING

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An Insular View of the World? The Benefits of Global Equity Investing

U.K.-based investors embraced the opportunity to invest in overseas equities following the removal of Exchange Controls in 1979, with U.K. charities holding non-U.K. equity allocations of 25% on average by 1986, accounting for nearly a third of their equity allocation. Today, their non-U.K. equity exposure remains about the same and seems poised to decline as some investors are growing weary of high global equity correlations and outperformance of U.K. equities in recent years. (See Table A.) However, investors with global equity allocations should take solace in the other compelling reasons to invest beyond national borders.

Don't Despair the High Correlations

Given that correlations of U.K. equities with U.S. and continental European equities are high today (approximately 0.80), diversification of country-specific risks is clearly not the most persuasive argument for investing in equities outside of the United Kingdom. However, correlations among these regions (represented by MSCI indexes) are unstable, ranging from -0.1 to 0.8. Correlations have been higher in recent years, but have remained unstable, ranging from 0.5 to 0.8 since 1986. (See Table B.) Although globalization may have contributed to the synchronization of business cycles and forged closer links among developed equity markets, there is no fundamental economic reason to believe that correlations will remain so high. In fact, correlations have been as high as 0.6 to 0.8 as recently as the mid-1990s when globalization trends were already in full force. From this historical perspective, it is reasonable to assume that correlations could fall in the future.

Limited Opportunity Set

One of the most compelling reasons for U.K. investors to invest globally is that U.K.-only mandates forego opportunities in other markets. Given that U.K. equities account for only 10.4% of the market cap of the FTSE World Index, investors who eschew non-U.K. equities sacrifice the opportunity set presented by 89.6% of developed markets shares (see Table C). With the average U.K. charity allocating an average of 30% of their equities outside the United Kingdom, it is clear that most institutions significantly underweight their overseas exposure. In general, we find that investors around the globe tend to have a local or regional market bias.

Structural Bets — Be Aware

Stock Concentration

Other developed equity markets not only represent a larger opportunity set, but, given the relative concentration of the U.K. equity market, they also provide a means for diversifying company-specific risks. Based on MSCI indexes, the market capitalisation of the ten largest securities represents 56.5% of the U.K. market compared to just 27.8% of the U.S. and 25.8% of Europe ex U.K. Similarly the market cap of the 50 largest securities represents 87.9% of the U.K. market compared to 61.9% for the U.S. and 65.1% for Europe ex U.K. (see Table D). Similarly, the FTSE All-Share Index is highly concentrated, with the FTSE 100 and FTSE 250 accounting for 96.8% of the FTSE All-Share, which contained 725 stocks at the end of February 2002.

Some of this high level of concentration has been due to big overseas acquisitions by U.K. companies and acquisition of big U.K. companies by overseas companies in recent years. For example, soon after BP purchased Amoco, its market cap grew from about 3.5% to 7.5% of the FTSE All-Share, while Vodafone's mergers with AirTouch and Mannesmann increased its market cap from about 2.5% to 12% of the index. At the same time, companies have also been delisted from the index. For example, in November 1999 Orange disappeared (temporarily) from the FTSE All-Share because it was bought by Mannesman, removing £20.7 billion in market cap from the index. Similarly, in May 2000, NTL bought Cable and Wireless Communication, removing a further £13.3 billion in market cap.

Sector Concentration

U.K. sector concentration is also high relative to that of other developed markets regions. For example, the three largest sectors in the FTSE U.K. Index account for 67.1% of the index, compared to only 53.5% of the world index, 58.5% of the U.S. index, 54.0% of the Europe ex U.K. index, and 51.7% of the Pacific index as of the end of February 2002.

Sector Bets Relative to World Markets

Limiting equity exposure to U.K. companies also results in taking significant sector bets relative to global developed markets (see Table E).¹ For example, the general industries sector represents just 1.3% of the FTSE U.K. Index, compared to an 8.9% weight in the FTSE World Index. In order to invest in the general industries sector in a meaningful way, a U.K.-only investor would need to take on significant

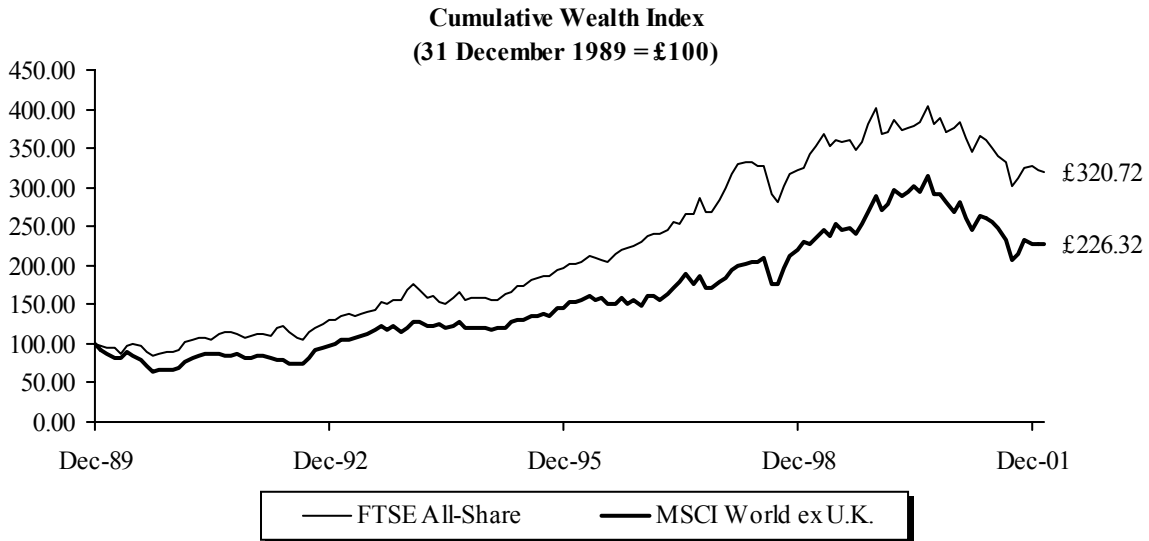
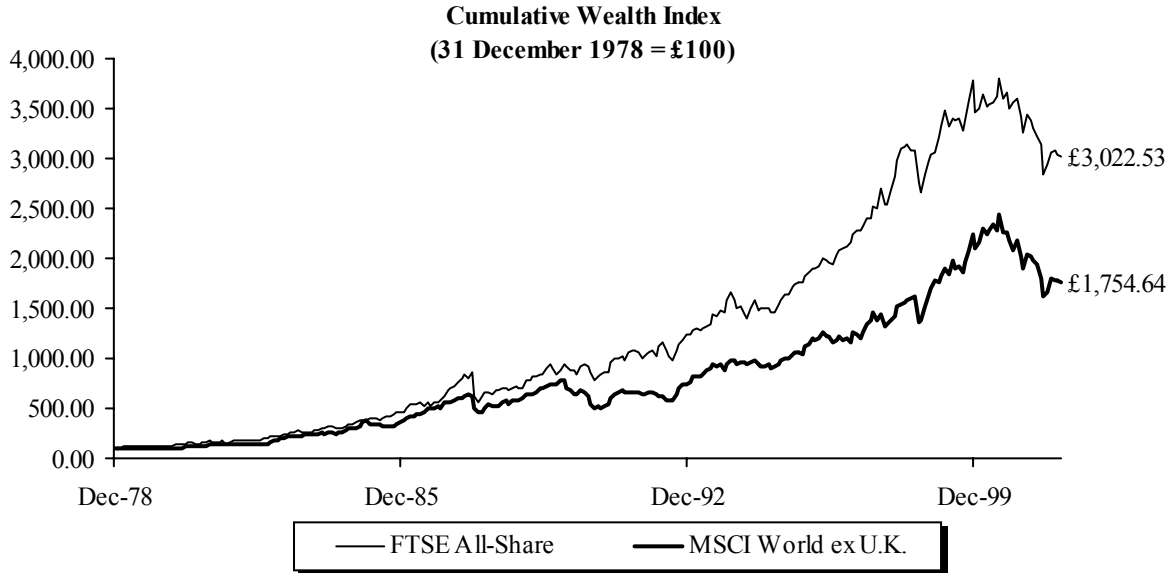
¹ This is not an issue that confronts U.K. investors only, of course. All indexes present their own set of confines, and overcoming these structural limits is a compelling reason to invest globally.

tracking error. Other significant sector bets relative to global developed markets equities include an overweight of 10.9 percentage points to the resources sector and an underweight of 11.2 percentage points to the information technology sector. These varying figures show that the sectoral exposure of U.K.-only investors can differ considerably relative to those in other developed markets. This is not an issue that confronts U.K. investors only, of course. All indexes present their own set of confines, and overcoming these structural limits is a compelling reason to invest globally. U.K.-only investors should be aware of these implicit bets and ensure that they remain comfortable with the degree of concentration at both the sector and total index levels.

In short, investors who limit their equity exposure to the United Kingdom give up 90% of the available opportunity set, hold relatively concentrated equity portfolios unless they take on significant tracking error, and make significant sector bets (with concentrated sector allocations) relative to the global economy. Investing in global equities not only represents a greater opportunity set for U.K. investors, but also provides the potential to reduce volatility associated with the high concentration found in domestic indexes. Why invest globally? Indeed, the question should be: Why *not* invest globally?

Table A

CUMULATIVE WEALTH OF THE FTSE ALL-SHARE AND MSCI WORLD EX U.K.



	<u>Total Return (%)</u>			<u>Average Annual Compound Return (%)</u>	
	<u>One Month</u>	<u>Three Months</u>	<u>One Year</u>	<u>Three Years</u>	<u>Five Years</u>
FTSE All-Share	-0.81	-1.40	-11.76	-2.06	5.89
MSCI World ex U.K.	-1.01	-2.60	-13.03	-0.14	7.14

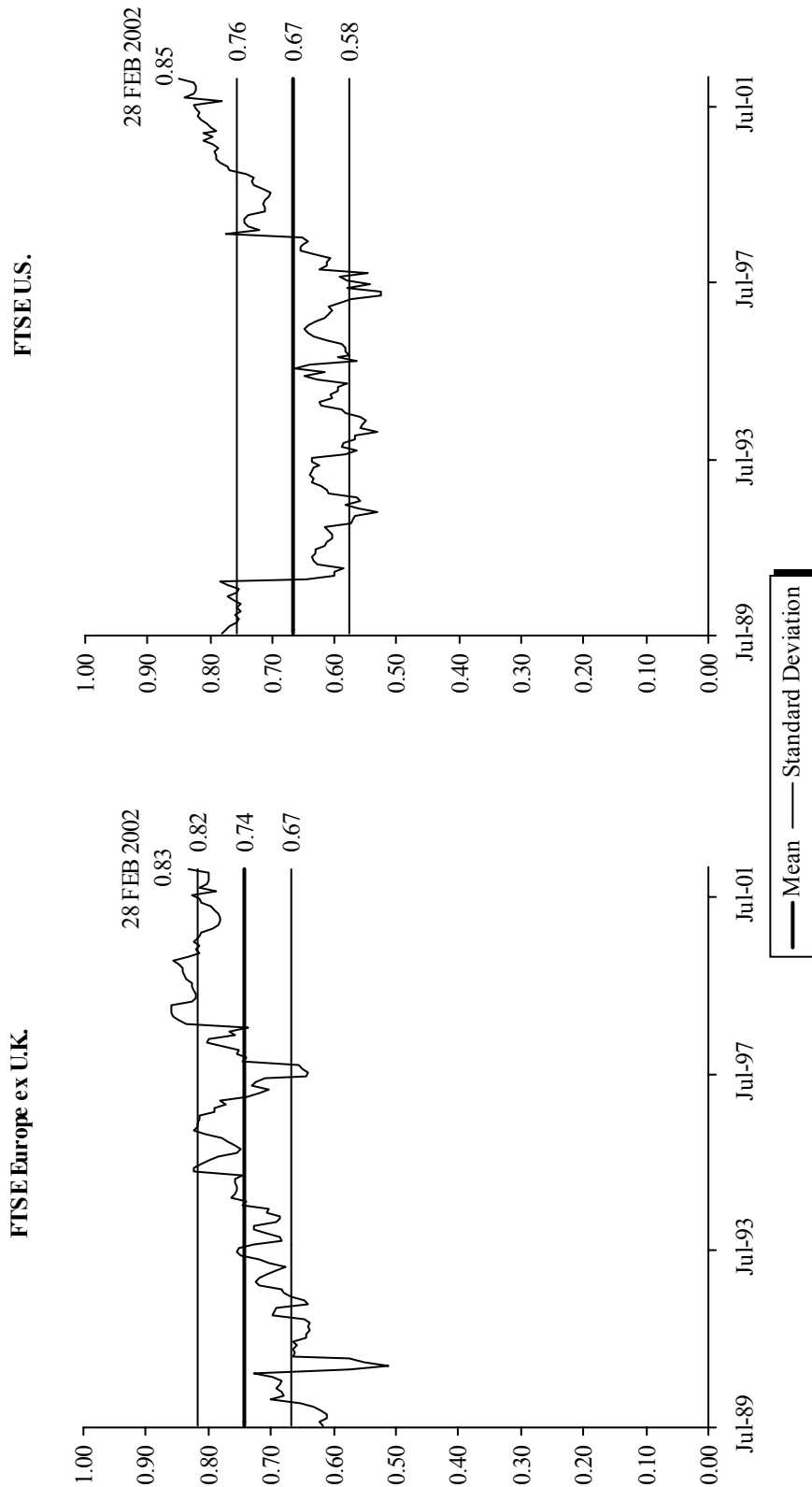
Source: Datastream International. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: Data are as of 28 February 2002.

Table B

CORRELATION ANALYSIS OF FTSE ALL-SHARE WITH FTSE EUROPE EX U.K. AND FTSE U.S.

31 August 1986 - 28 February 2002



Source: Datastream International.

Note: Data in the graph represent rolling 36-month correlations.

Table C

FTSE WORLD COUNTRY ALLOCATIONS

As of 28 February 2002

	Index Weighting (%)		
	FTSE World <u>Index</u>	FTSE World ex U.S. <u>Index</u>	FTSE World ex U.K. <u>Index</u>
FTSE United Kingdom	10.4	24.3	---
FTSE Austria	0.1	0.1	0.1
FTSE Belgium	0.4	0.9	0.5
FTSE Denmark	0.3	0.7	0.3
FTSE Finland	0.7	1.7	0.8
FTSE France	3.9	9.2	4.4
FTSE Germany	2.9	6.7	3.2
FTSE Greece	0.2	0.4	0.2
FTSE Ireland	0.3	0.6	0.3
FTSE Italy	1.4	3.4	1.6
FTSE Netherlands	2.2	5.2	2.5
FTSE Norway	0.2	0.5	0.2
FTSE Portugal	0.2	0.4	0.2
FTSE Spain	1.2	2.9	1.4
FTSE Sweden	0.9	2.2	1.0
FTSE Switzerland	<u>2.8</u>	<u>6.5</u>	<u>3.1</u>
FTSE Europe ex U.K.	---	---	19.8
FTSE Europe	28.1	65.8	---
FTSE Australia	1.5	3.5	1.7
FTSE Hong Kong	0.9	2.1	1.0
FTSE Japan	7.4	17.4	8.3
FTSE Korea	0.6	1.4	0.7
FTSE New Zealand	0.1	0.1	0.1
FTSE Singapore	0.3	0.8	0.4
FTSE Taiwan	<u>0.4</u>	<u>1.0</u>	<u>0.5</u>
FTSE Asia Pacific	11.2	26.3	12.5
FTSE Brazil	0.4	0.9	0.4
FTSE Israel	0.1	0.2	0.1
FTSE Mexico	0.4	1.0	0.5
FTSE South Africa	0.3	0.7	0.3
FTSE Canada	2.1	5.0	2.4
FTSE United States	<u>57.3</u>	---	<u>63.9</u>
FTSE North America	59.4	5.0	66.3
FTSE World ex U.S.	---	100.0	---
FTSE World ex U.K.	---	---	100.0
FTSE World	100.0	---	---

Source: Datastream International.

Note: Figures may not total due to rounding.

Table D
MARKET DISTRIBUTION ANALYSIS FOR SELECTED INDEXES

<u>Date</u>	MSCI U.K.		MSCI U.S.		MSCI Europe ex U.K.	
	<u>Top 10</u>	<u>Top 50</u>	<u>Top 10</u>	<u>Top 50</u>	<u>Top 10</u>	<u>Top 50</u>
31/12/1995	32.32	78.04	20.94	53.95	21.74	55.72
31/12/1996	35.31	79.43	22.68	56.19	22.68	57.09
31/12/1997	40.43	83.51	22.14	56.87	22.68	58.80
31/12/1998	42.65	85.23	25.69	65.05	22.16	59.22
31/12/1999	52.80	86.51	30.64	69.13	27.43	66.62
31/12/2000	56.34	89.35	28.15	64.30	24.68	67.16
31/12/2001	57.15	87.74	28.12	61.89	25.32	66.19
28/02/2002	56.53	87.93	27.82	61.89	25.84	65.14

Source: Morgan Stanley Capital International, Inc. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: Data for Top 10 and Top 50 represent the percent of index accounted for in the largest 10 and 50 stocks ranked by market capitalisation.

Table E

SECTOR WEIGHTS FOR SELECTED INDEXES

Index Weight (%)	FTSE U.K. Economic Group Over- and (Under-) Weights Relative To:				
	<u>FTSE U.K.</u>	<u>FTSE World</u>	<u>FTSE U.S.</u>	<u>FTSE Europe ex U.K.</u>	<u>FTSE Pacific</u>
Resources	18.93	10.93	13.09	9.48	15.84
Basic Industries	1.84	(2.26)	(0.85)	(5.08)	(5.55)
General Industries	1.34	(7.60)	(7.52)	(7.02)	(17.08)
Cyclical Consumer Goods	0.17	(2.67)	(1.49)	(4.50)	(8.66)
Non-Cyclical Consumer Goods	22.16	3.00	(0.27)	5.36	14.93
Cyclical Services	12.04	0.35	(1.31)	5.31	0.27
Non-Cyclical Services	12.15	4.57	6.02	2.94	4.97
Utilities	4.39	1.07	1.41	2.12	(1.08)
Financials	25.98	3.80	6.53	(1.78)	4.48
Information Technology	1.02	(11.19)	(15.61)	(6.83)	(8.13)

Source: Datastream International.

Notes: Data may not total 100 percent due to rounding. Relative figures represent the difference between FTSE U.K. sector weights and the corresponding sector weights for the FTSE World, U.S., Europe ex U.K., and Pacific Index. Data in parentheses () indicate an underweight position while a positive figure indicates an overweight position. Data are as of 28 February 2002.