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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENT

INCREASING STRATEGIC EQUITY ALLOCATIONS TO ASIA

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Increasing Strategic Equity Allocations to Asia

Western investors seem sold on the long-term investment opportunities offered by Asia—and they should be. For the most part, Asian markets are underdeveloped and will broaden and deepen as the major Asian economies of China and India continue to expand at faster rates than those of the United States and Europe, benefiting all Asian markets.[1]

However, this is not just a growth story. The best investment opportunity in Asia today is not China or India, but Japan, which is primarily a value story (on which see our October 2005 Global Market Comment: *Japan: Still Time To Get In?*). Japan also represents one of the best ways to play China, which is a difficult and perilous market to play directly.

To date, most western investors have made only cautious forays into Asia, with toe-in-the-water investments in this or that public equity manager or private investment partnership. This has some merit as a means of keeping Asia on one's radar screen, but does not constitute a viable long-term Asia investment strategy.

For U.S. investors in particular, the first step in developing such a strategy is to stop thinking of the world in bilateral terms: the United States and the rest. Equity portfolios should be structured with either a global core complemented by satellite investments in regional markets, or with equal allocations to North America, Europe, and Asia (and perhaps a separate Emerging Markets allocation). This constitutes an implicit underweighting of the United States, a neutral weighting of Europe, and an overweighting of Asia, which we would regard as strategically appropriate.[2] In theory, this strategy should be implemented across both public and private investments. However, investors with meaningful allocations to non-marketable alternatives would face great difficulties in investing two-thirds of their portfolio outside the United States. Until more and better venture capital and private equity opportunities become available across the globe, even investors embracing a global equity strategy will likely continue to have portfolios with a significant western bias once alternatives are taken into account.

Why do we advocate such an approach, and how would an equity portfolio structured along these lines differ from prevailing institutional constructs?

First, it should be noted that a global equity portfolio allocated across countries according to their comparative market capitalization is relatively inefficient, since current market capitalization is unrelated to the prospective risks, returns, and correlations among markets—which are the data one needs to construct an "optimal" allocation. Since Asia's largest equity market is Japan, whose returns have been relatively uncorrelated to those of the U.S. and European markets (the correlations among which have been much higher), an increased allocation to Asia—at the expense of the U.S. and/or European markets—should

[1] See our forthcoming research report, *Investing in Asia*, for a more in-depth discussion.
[2] In the input assumptions we have developed for our long-term asset allocation and shortfall risk models, we assume the same prospective return for each major developed market or region. This is because these are designed as long-term "equilibrium" assumptions that deliberately eschew any short-term view of the relative prospects of the various equity markets.

therefore have better risk-return characteristics than would a portfolio allocated according to market capitalization alone (assuming the same relative correlations in the future as in the past). (See Tables A through E.)

Although the correlations of returns among all developed markets were much higher in the period 1998-2004 than had been the case during the preceding decade, correlations have declined in the past year or so, most noticeably in the case of the correlations of Japan's returns with those of the U.S. and European markets. On the one hand, the dramatic globalization of capital flows argues for higher correlations among markets, as investors become less parochial and more global in their equity allocations. On the other hand, the significant rise and continued increase in intra-Asian trade (which now accounts for 42% of all Asian trade), suggests that, viewed as a regional bloc, Asia is becoming economically more self-sufficient, less dependent on the West. This in turn suggests that Asian equity markets may prove better insulated in the future against economic contraction in the United States or Europe than has been the case in the past.

With the exception of Japan, Asian equity markets are relatively small and concentrated. For example, the largest 20 companies (by market capitalization) have averaged 57.9% of the MSCI Pacific ex Japan Index since 1998 (compared to 38.2% in the United States), while financials, the single largest sector, has constituted 47.1% of the index, on average (compared to 18.0% in the United States). However, there is also greater diversity across Asian markets than within the United States or across European markets. This simply reflects the very different composition of constituent economies, from those that are highly leveraged to global information technology, like Taiwan, to those with substantial natural resources, like Malaysia. This intra-regional diversity helps mitigate the risks inherent in relatively small, undiversified individual markets. In addition, a global equity portfolio, equally weighted in the United States, Europe, and Asia, would be less concentrated than a portfolio invested 70% in U.S. and 30% in global ex U.S. equities.

Although Asia's *emerging* equity markets[3] make up only 3.3% of the world market (by capitalization), they make up 10.5% of global GDP (Table G). With China and India hurtling along at full throttle, the entire region is likely to continue expanding more dynamically than the more mature economies of the West, and this growth should be reflected in rapid broadening and deepening of the equity markets. Despite their small size, therefore, we would favor including the emerging Asian equity markets in any pan-Asian portfolio, since their underlying economies constitute one-third of the region's GDP.

Table F indicates differences in region and country weightings among various global equity portfolio allocations. In the MSCI All Country World Index, which is float adjusted and capitalization weighted, North America constitutes 52.3% of the total index (U.S., 48.8% and Canada, 3.1%). Europe constitutes 29.1% (United Kingdom, 10.5% and Europe ex U.K., 18.6%), and Asia Pacific, 16.7% (Japan, 10.1% and Asia Pacific ex Japan, 6.6%). Obviously, a portfolio equally weighted among the three regions looks very different. The European weightings rise slightly, since Europe as a whole is now 33.3% of the total rather than 29.1%, but the Asian weightings increase dramatically, with weights in Japan and Asia Pacific ex Japan doubling, to 20.1% and 13.2%, respectively.

[3] China, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Taiwan, and Thailand.

Surprisingly, these major shifts in country allocations do not result in commensurate changes in economic sector weightings (Table F). For example, if we assume that the average U.S. institutional investor's equity portfolio is 70% invested in U.S. equities and 30% invested in global ex U.S. equities, the largest sector weighting would be financials, at 23.0%, with additional double-digit exposures in information technology (13.3%), health care (11.2%), consumer discretionary (11.6%), and industrials (10.3%). If the portfolio were allocated equally to the United States, Europe, and Asia, however, the exposure to financials would rise to 25.0%; information technology would drop to 11.1%; health care would also drop, to 8.9%; while consumer discretionary would rise to 12.3%. These are not immaterial changes, but they pale by comparison with the shift in country weightings. The increased exposure to the financial sector, already by far the largest, is not particularly desirable; on the other hand, the financial exposure of the U.S. portfolio is probably understated, since finance has in fact become the main business of several major U.S. companies listed as industrials (e.g., Ford, GE, GM). In addition, finance is the cutting edge of developing market growth.

Finally, Table F also shows what effect such changes would have on the exposure to different capitalization sectors. A 70% U.S./30% global ex U.S. portfolio is 78.4% invested in large-cap equities (defined as capitalization of >$10 billion), 19.2% invested in mid-cap equities (capitalization between $2 billion and $10 billion), and 2.4% invested in small-cap equities (capitalization of <$2 billion). In the MSCI All Country World Index, there is less large cap (74.3%), and more mid and small cap (21.6% and 4.1%, respectively). This shift is even more pronounced in a portfolio weighted equally across regions: the large-cap exposure is now 70.2% of the total, the mid cap 24.1%, and the small cap 5.8%. There is no particular reason to regard these shifts in capitalization exposure as inherently good or bad—and it is perhaps worth noting that investors employing active managers in their U.S. equity portfolios almost invariably end up with larger allocations to mid- and small-cap stocks than is reflected in the market indices.

A last word about implementation: larger allocations to Europe and Asia means greater scope for alpha from active management. The most efficient markets—that is, those markets where active managers struggle the most to add value (and fail, on average, to do so)—are the United States and the United Kingdom. Next most efficient is Pacific ex Japan (surprisingly) and Europe ex U.K., but managers have shown much greater ability to add value in the Japanese market.

In a 1992 paper, *Global Asset Allocation* (which our readers no doubt remember well!), we wrote: "The **idea** of global investing is not new, but for years acceptance has been provisional—yes, but not yet."

In 2005, we are saying: yes, and now.

Table A

CORRELATION MATRIX:
DEVELOPED ASIA WITH MAJOR DEVELOPED WESTERN INDICES

March 1, 1971 - October 31, 2005

Local Currency

	MSCI Pacific	MSCI Pacific ex JP	MSCI Japan	MSCI Hong Kong	MSCI Singapore	MSCI Australia	S&P 500	Nasdaq	MSCI U.K.	MSCI Europe ex U.K.
MSCI Pacific	1.00									
MSCI Pacific ex JP	0.52	1.00								
MSCI Japan	0.97	0.35	1.00							
MSCI Hong Kong	0.41	0.80	0.27	1.00						
MSCI Singapore	0.46	0.71	0.35	0.53	1.00					
MSCI Australia	0.41	0.79	0.28	0.34	0.43	1.00				
S&P 500	0.44	0.57	0.36	0.38	0.49	0.53	1.00			
Nasdaq	0.41	0.54	0.33	0.35	0.45	0.49	0.84	1.00		
MSCI U.K.	0.40	0.54	0.32	0.38	0.50	0.47	0.60	0.51	1.00	
MSCI Europe ex U.K.	0.50	0.52	0.43	0.36	0.40	0.48	0.64	0.60	0.60	1.00

Sources: Morgan Stanley Capital International, Standard & Poor's, Thomson Datastream, and *The Wall Street Journal*. MSCI data provided "as is" without any express or implied warranties.

Note: Nasdaq data are price returns.

Table B

CORRELATION MATRIX:
EMERGING ASIA WITH MAJOR DEVELOPED WESTERN INDICES

January 1, 1988 - October 31, 2005

Local Currency

	MSCI EM Asia	MSCI China	MSCI India	MSCI Indonesia	MSCI Korea	MSCI Malaysia	MSCI Pakistan	MSCI Philippines	MSCI Taiwan	MSCI Thailand	S&P 500	Nasdaq	MSCI U.K.	MSCI Europe ex U.K.
MSCI EM Asia	1.00													
MSCI China	0.63	1.00												
MSCI India	0.52	0.23	1.00											
MSCI Indonesia	0.36	0.20	0.23	1.00										
MSCI Korea	0.54	0.27	0.25	0.28	1.00									
MSCI Malaysia	0.77	0.50	0.25	0.32	0.33	1.00								
MSCI Pakistan	0.32	0.11	0.35	0.16	0.11	0.21	1.00							
MSCI Philippines	0.63	0.47	0.17	0.37	0.24	0.54	0.14	1.00						
MSCI Taiwan	0.53	0.47	0.33	0.08	0.28	0.37	0.18	0.36	1.00					
MSCI Thailand	0.72	0.43	0.16	0.35	0.46	0.54	0.25	0.57	0.36	1.00				
S&P 500	0.54	0.43	0.25	0.23	0.35	0.38	0.07	0.38	0.27	0.42	1.00			
Nasdaq	0.53	0.34	0.42	0.21	0.36	0.34	0.18	0.29	0.27	0.36	0.80	1.00		
MSCI U.K.	0.52	0.31	0.19	0.21	0.38	0.38	0.06	0.35	0.26	0.40	0.73	0.55	1.00	
MSCI Europe ex U.K.	0.55	0.23	0.30	0.32	0.31	0.38	0.11	0.36	0.37	0.37	0.72	0.64	0.76	1.00

Sources: Morgan Stanley Capital International, Standard & Poor's, Thomson Datastream, and *The Wall Street Journal*. MSCI data provided "as is" without any express or implied warranties.

Notes: Nasdaq data are price returns. Data for MSCI China and MSCI Pakistan indices start on January 1, 1993. Data for MSCI India Index start on January 1, 1994.

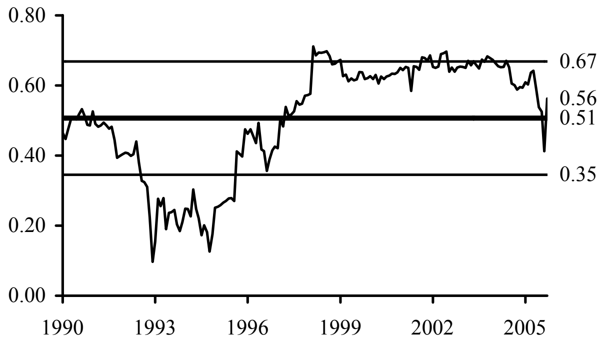
Table C

36-MONTH ROLLING CORRELATIONS OF MSCI ALL COUNTRY ASIA PACIFIC WITH MAJOR WESTERN EQUITY INDICES

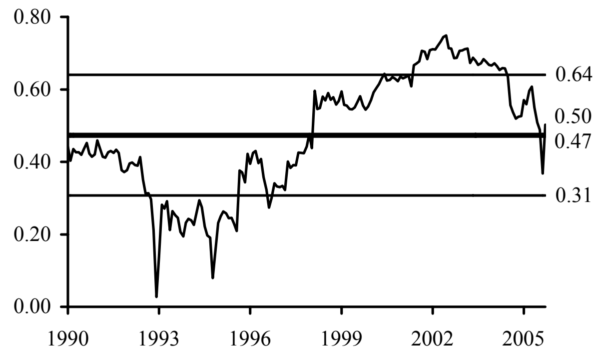
January 1, 1988 - October 31, 2005

Local Currency

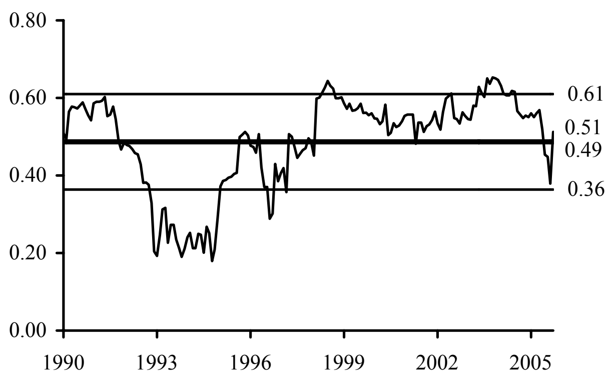
MSCI AC Asia Pacific and S&P 500



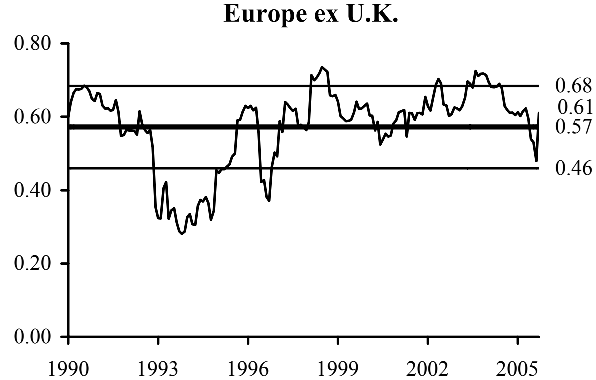
MSCI AC Asia Pacific and Nasdaq



MSCI AC Asia Pacific and MSCI U.K.



MSCI AC Asia Pacific and MSCI Europe ex U.K.



Mean
One Standard Deviation

Sources: Morgan Stanley Capital International, Standard & Poor's, Thomson Datastream, and *The Wall Street Journal.* MSCI data provided "as is" without any express or implied warranties.

Note: Nasdaq data are price returns.

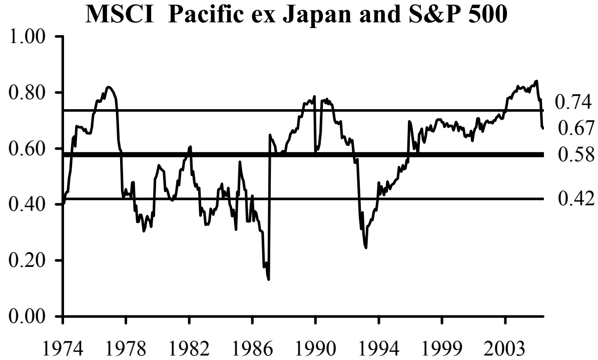
Table D

36-MONTH ROLLING CORRELATIONS OF
MSCI PACIFIC EX JAPAN WITH MAJOR WESTERN EQUITY INDICES

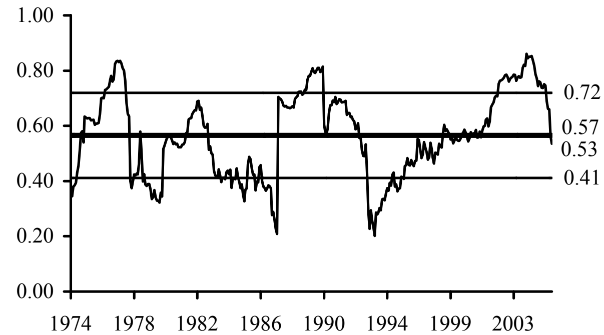
March 1, 1971 - October 31, 2005

Local Currency

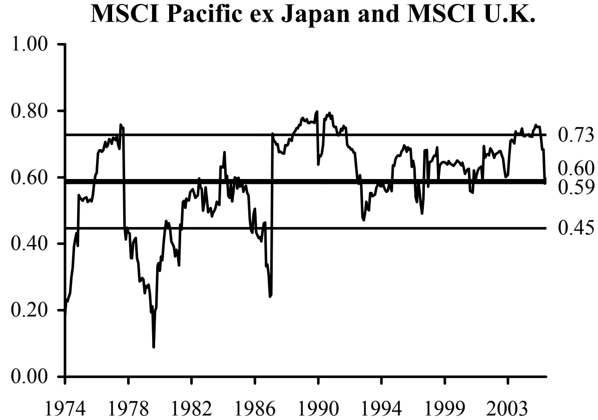
MSCI Pacific ex Japan and S&P 500



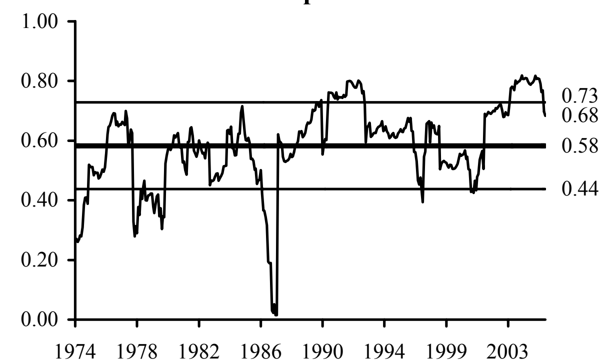
MSCI Pacific ex Japan and Nasdaq



MSCI Pacific ex Japan and MSCI U.K.



MSCI Pacific ex Japan and MSCI Europe ex U.K.



Mean
One Standard Deviation

Sources: Morgan Stanley Capital International, Standard & Poor's, Thomson Datastream, and *The Wall Street Journal.* MSCI data provided "as is" without any express or implied warranties.

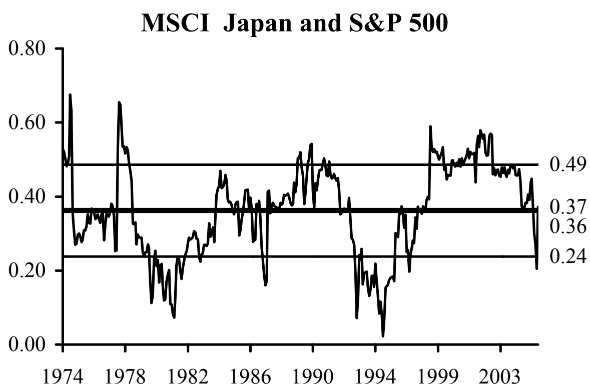
Note: Nasdaq data are price returns.

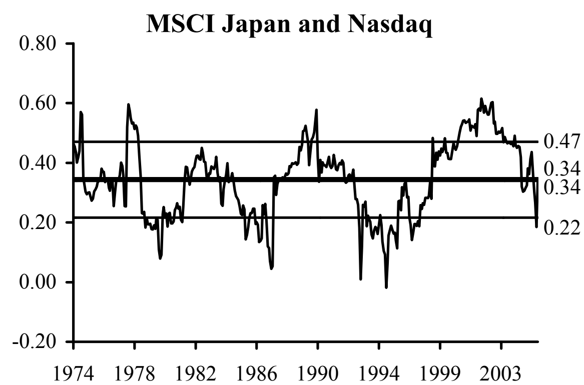
Table E

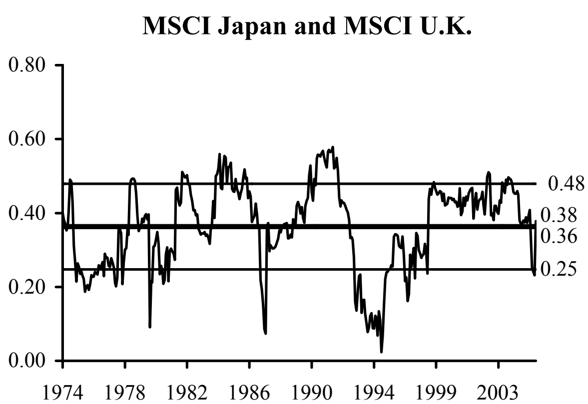
36-MONTH ROLLING CORRELATIONS OF MSCI JAPAN WITH MAJOR DEVELOPED WESTERN EQUITY INDICES

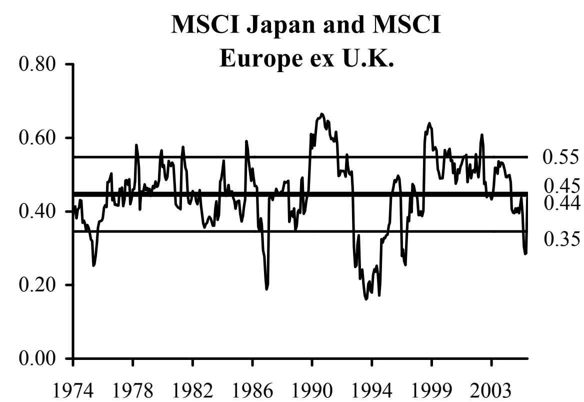
March 1, 1971 - October 31, 2005

Local Currency









Mean
One Standard Deviation

Sources: Morgan Stanley Capital International, Standard & Poor's, Thomson Datastream, and *The Wall Street Journal.* MSCI data provided "as is" without any express or implied warranties.

Note: Nasdaq data are price returns.

Table F

COMPARATIVE PORTFOLIO CHARACTERISTICS OF TRADITIONAL AND GLOBAL EQUITY PORTFOLIOS

As of October 31, 2005

	Percent of Portfolio (%)			
	Portfolio 1	**Portfolio 2**	**Portfolio 3**	**Portfolio 4**
	70% U.S. 30% AC World ex U.S.	AC World	50% U.S. 50% AC World ex U.S.	33.3% U.S. 33.3% AC Europe 33.3% AC Asia Pacific
Regional				
North America	72.06	52.32	53.43	33.33
United States	70.00	48.80	50.00	33.33
Canada	1.82	3.11	3.04	---
Other	0.24	0.41	0.40	---
Europe	17.08	29.14	28.46	33.33
United Kingdom	6.16	10.51	10.27	12.02
Europe ex U.K.	10.92	18.63	18.20	21.31
Asia Pacific	9.78	16.69	16.30	33.33
Japan	5.90	10.08	9.84	20.12
Asia Pacific ex Japan	3.88	6.61	6.46	13.21
Others	1.08	1.85	1.80	---
Total	100.00	100.00	100.00	100.00
Sector Allocations				
Consumer Discretionary	11.62	11.44	11.45	12.27
Consumer Staples	8.72	8.34	8.36	7.87
Energy	9.50	9.79	9.77	8.29
Financials	22.95	24.22	24.15	25.01
Health Care	11.19	9.95	10.02	8.86
Industrials	10.26	10.08	10.09	10.79
Information Technology	13.30	11.37	11.48	11.07
Materials	4.58	5.84	5.77	6.40
Telecommunication Services	4.08	4.90	4.85	5.07
Utilities	3.81	4.06	4.05	4.36
Total	100.00	100.00	100.00	100.00
Capitalization Distributions				
Large (>$10 Billion)	78.37	74.28	74.51	70.18
Mid Cap ($2 Billion - $10 Billion)	19.19	21.62	21.48	24.07
Small Cap (<$2 Billion)	2.44	4.10	4.00	5.75
Total	100.00	100.00	100.00	100.00
Portfolio Concentration				
Top 20 Stocks	21.19	16.45	16.64	15.01
Top 50 Stocks	33.76	28.23	28.45	26.48

Sources: Morgan Stanley Capital International and Factset. MSCI data provided "as is" without any express or implied warranties.

Table G

DEVELOPED AND EMERGING MARKETS COUNTRY ALLOCATIONS

October 31, 2005

U.S. Dollars

	Percent (%)	
	GDP	Market Capitalization
Developed & Emerging Markets		
All Country World	100.0	100.0
All Country Asia Pacific	25.1	16.7
All Country Asia Pacific ex Japan	13.1	6.6
Developed Markets		
Pacific	14.6	13.4
Pacific ex Japan	2.6	3.3
Australia	1.6	2.2
Hong Kong	0.4	0.7
New Zealand	0.3	0.1
Singapore	0.3	0.3
Japan	12.0	10.1
Emerging Markets		
EM Asia	10.5	3.3
China	4.3	0.5
India	1.8	0.3
Indonesia	0.7	0.1
Korea	1.8	1.1
Malaysia	0.3	0.2
Pakistan	0.2	0.0
Philippines	0.2	0.0
Taiwan	0.8	0.9
Thailand	0.4	0.1

Sources: Deutsche Bank, Morgan Stanley Capital International, and The World Bank. MSCI data provided "as is" without any express or implied warranties.

Notes: Market capitalization is float-adjusted. GDP data are as of 2004.