

Does Globalization Allow You to Invest Abroad While Staying at Home?

Diversification is the mantra of investing, and globalization is the watchword of large corporations around the world, especially in developed markets. What happens when we put these two together? Are large US-based firms more 'global' today than a decade ago? Can investors gain significant exposure to overseas markets by owning a portfolio of large US-listed companies?

Although globalization is a long-running phenomenon, common wisdom holds that its pace has accelerated over the past decade. Our previous work has suggested that globalization has had wide-ranging effects on how companies do business, ranging from sourcing and sales to marketing, management and internal culture.

We were surprised to find that globalization has not had much impact on a basic corporate measure: sales. In terms of revenues, the largest US corporates are no more 'global' today than they were a decade ago. The 50 largest US corporates were already quite global by the mid-1990s, with non-US sales accounting for nearly 40% of total sales. After a sharp dip during the emerging markets crises and US technology bubble of the late 1990s, foreign sales are only now regaining their earlier importance. What does appear to have changed is the regional breakdown: Europe's importance has declined, while Asia's is rising.

We also find that a strategy of 'investing abroad while staying at home'—by investing in the 50 largest US-based firms over the past decade—would have produced lower returns and higher volatility than investing in either the S&P500 or a world index. For investors, this means that true global diversification still requires investing offshore.

We do expect to see the impact of globalization become more visible at the

corporate level over time. Companies in mature markets are increasingly looking to faster-growing economies for growth, and many businesses are becoming truly global through both mergers and organic growth. A decade from now, investing in the largest US firms may be a solid way to gain both exposure to globalization and portfolio diversification.

Home Bias Is Sticky

How can investors best gain exposure to globalization? 'Investing abroad while staying at home', through domestic-listed multinationals, may offer a form of 'safe diversification'. Investing in domestic

continued on page 2

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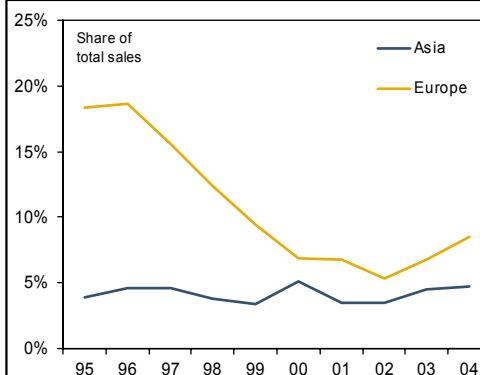
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Share of Sales to Europe Has Fallen Since 1995; Asian Share Is Edging Up



Source: Datastream, GS calculations

Does Globalization Allow You to Invest Abroad While Staying at Home?

continued from page 1

companies means that custody and settlement issues are resolved; foreign exchange risk is borne (or hedged) by the corporate rather than by the individual investor; and accounting and transparency standards are more familiar. Investing at home should also be cheaper, not least because investors would already be buying these stocks to gain exposure to the domestic market.

Studies show that US firms became more 'global' from the mid-1980s until the mid-1990s, as more firms opened or expanded international operations and multinationals derived a greater share of their sales from outside the US. But evidence on the degree of diversification in returns that this provided was scarce. And the data in these studies generally stop around the mid-1990s.

The Global Landscape Has Changed, the Data Has Not (Much)

Have the largest US firms significantly increased their foreign exposure over the past decade?

Globalization has taken root over the past decade in such profound ways that we had expected the answer to be 'yes'. But this story does not clearly emerge from the aggregate corporate data. In fact, the impact of globalization in the corporate data is so limited that it reminds us of the late-1990s joke (or what passes for one in economic circles) about the impact of technology on productivity—you see it everywhere but in the productivity statistics.

Data limitations are partly to blame for this, since US firms report a regional breakdown only of revenues, not of earnings. For some firms, revenues figures and earnings figures may be comparable, but for most, this will only capture a slice of the impact of globalization.

Data on US firms' foreign revenues show no clear upturn in global exposure over the past decade. We have looked at the 50 largest companies in the S&P500 as a proxy for the 'largest and most global' firms. Analyzing the data for 1995-2004, we find that:

Foreign Sales Have Not Risen Over the Decade

- At the simplest level, looking at North American revenues compared with 'other' revenues, the share of overseas sales in 2004 was not significantly different from its 1995 level. Both on an aggregate basis and a market cap-weighted basis, foreign sales account for nearly 40% of total sales among our Top 50 firms.
- Foreign sales as a share of the total fell significantly in the late 1990s. The trough corresponds with both the emerging markets crises, which would likely have dampened sales overseas, and with the technology and telecom bubble in the US, which inflated the market capitalization of these (largely domestic) companies. Other sectoral changes in the composition of the Top 50, including financial stocks' growing share of the total market capitalization, may have played a role in the fall in foreign sales.

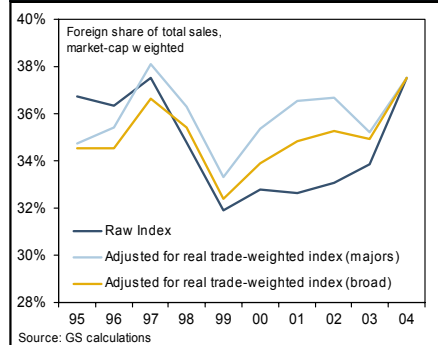
- The share of foreign sales has moved up sharply in the past two years. Though it is too early to call a trend, this coincides with robust economic growth across much of the world outside the US and suggests that this share may continue to rise if the BRICs and Japan perform as strongly as we forecast.

- A significant slice of the largest US firms are still almost entirely domestic. On average over the decade, nearly 20% of the Top 50 derive 90% or more of their revenues from North America. The most domestic-oriented firms are concentrated in the financials and telecoms sectors.

- Technology firms have risen in the rankings and now dominate the list of companies with the greatest exposure to both Europe and Asia. Natural resources firms are also strongly represented in the list of the most global firms. Financial services are an interesting story: though many are entirely US-focused, others show a high and growing share of foreign revenues.

continued on page 3

Share of Foreign Sales Falls, Then Rises, Whether Hedged or Not



Does Globalization Allow You to Invest Abroad While Staying at Home?

continued from page 2

FX Matters, But Not Much

- Currency may explain some of the fluctuations in foreign sales over the past decade. But we do not think FX is a major factor. The reported numbers effectively show foreign revenues on an unhedged basis. In the chart on the previous page, adjusting for the Dollar's movements against the major currencies effectively shows the revenues on a fully hedged basis. We do not have data on actual corporate hedging, but the reality is likely to be somewhere in the middle.
- Adjusting for exchange rate movements over the past decade softens the magnitude of the falloff in foreign sales during the late 1990s; it also shows a stronger recovery since. But the underlying story is still much the same.

Europe Is an Old Story, Asia an Emerging One

- US firms' aggregate exposure to Europe has actually fallen rather than risen over the past decade. Diversification into Europe generally predates the mid-1990s 'take-off' of globalization, but Europe's share of total sales fell significantly at the height of the bubble (and after).
- Although European sales have regained some ground, the recovery has been muted. This is perhaps not surprising given that the European economic recovery remains anemic; changes in the sectoral composition of the Top 50 may also have played a role.
- There is some promising evidence of the impact of globalization from Asia, which is becoming an

increasingly important destination for large US firms. The share of firms deriving a quarter or more of their revenues from Asia has nearly tripled, from a mere 4% in 1995 to 11% in 2004. Nearly one-quarter of the Top 50 derive 10% or more of their revenues from Asia. Most are tech companies.

Uneven Returns, High Volatility

Investing in a Top 50 basket is not the ideal way to achieve international diversification. Investing only in the Top 50 over the past decade would have left investors worse off than had they invested in either the full S&P500 or the world equity market—and with higher volatility.

Since 1995, the average annual return for the Top 50 has been lower than

continued on page 4

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Does Globalization Allow You to Invest Abroad While Staying at Home?

continued from page 3

that of the full S&P500 (9.8% for the Top 50 compared with 12.3% for the S&P). It has also been slightly lower than the average annual return for the world index (10.2%). Only in two years of the past ten (2001 and 2003) has our Top 50 basket posted a performance between that of the S&P and the world—the sort of return we would expect if the Top 50 did work as a proxy for the world.

The volatility of the Top 50 has also been higher than either the S&P500 or the world (16.2% vs. 15.1% and 14.2%, respectively). This is an important downside to the strategy of diversifying by investing via a Top 50 basket, since risk-reduction is one of the key goals of diversification!

It is interesting to note that the volatility of the Top 50 has fallen compared with the S&P in recent years. While this may be due to a period of historically low stock volatility, we see it as a possible sign of convergence in returns between large global corporations and the world index as a whole.

There are other reasons why investing in the Top 50 might provide lower returns and higher volatility than either the full S&P500 or the world index. Size is a major issue, given that large-cap stocks outperformed in the late 1990s and have underperformed in recent years. Size bias may well matter more than foreign exposure for relative returns and volatility. The degree to which the Top 50 are diversified (by sector) also matters.

Our point is not to argue that foreign exposure is responsible for the differences in performance—but rather to note that investing in just the Top 50 is far from the most effective way to achieve international diversification. For that, investors still need to look overseas.

Globalization Suggests That ‘Not Yet’ Will Give Way to ‘Yes’

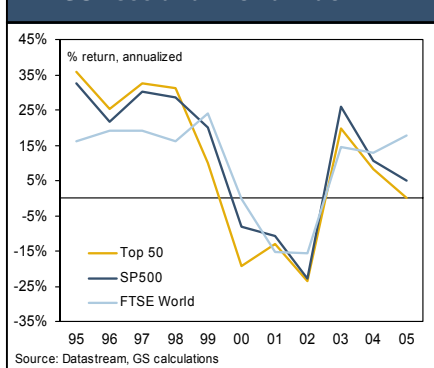
Just as the impact of technology did finally appear in the productivity statistics, so too is globalization likely to have a greater impact on corporate performance and equity returns in the future.

As we have discussed before, the world economy is undergoing an unparalleled process of integration. The rising importance of the developing world is likely to offset softer growth in the developed world in the decades ahead, boosting global trend growth. Developing economies also provide enormous growth opportunities for companies in saturated, slower-growing markets. We forecast that incremental demand—the annual increase in GDP in US Dollar terms—will be nearly as large in the BRICs (Brazil, Russia, India and China) as in the major developed economies by 2010.

With the Top 50 US-based firms deriving nearly 40% of their revenues from outside the US, global diversification is not a new story. The interesting story lies ahead, as US-based firms move into the BRICs and other large developing economies. China and India are the focus of investor and corporate attention, but for most firms these markets are currently just a small percentage of sales. If these economies grow as we predict, this could change rapidly in the future.

Continued globalization should change the composition of the largest US-listed firms, allowing them to resemble the global market more closely. Investing abroad while staying at home may be a hope for the future, but it is likely to become more possible in the years ahead. ■

Top 50 Return Generally Lags Both S&P500 and World Index ...



... But Volatility Is Generally Higher

