

MyConsultant

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Global shares: Themes for 2011



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Recently we undertook two global research trips which covered three continents and 16 cities, ranging from Singapore, Hong Kong and Chennai, to Amsterdam, Edinburgh and Memphis. During these trips we conducted 100 onsite manager visits with incumbent and prospective managers. This involved meeting portfolio managers, analysts, Chief Investment Officers and CEOs.

One pleasing aspect to note is that the team and processes of the investment managers managing your money are still intact and working very well. This is stating the obvious (because if they weren't, we would walk away from the manager). The other observation is that whilst there are macro uncertainties, managers continue to see good stock opportunities.

We thought it worth sharing with you the insights we gleaned and how our Global Shares strategies are positioned relative to the following key themes for 2011:

1. Corporate re-leveraging
2. A stock-pickers' market, and
3. Effectively exploiting emerging markets.

Theme 1: Corporate re-leveraging

The GFC has not only impacted many people around the world in an unprecedented manner, it still has many lingering effects. Consumers, for one, have been holding on to their money. According to the US Department of Commerce, we've seen the US savings rate rise from roughly 2% in 2007 to more than 6% today. If people aren't spending, company sales will suffer, and so will the unemployment rate – a vicious cycle as risk aversion cramps growth.

Likewise, companies have also become loath to spend. More than half the companies in the US are spending less than it would cost to simply replace their plant and equipment as it wears out.¹ Eventually, though, companies worldwide will have to spend as the pent-up demand for new capital outlays grows.

Banks are also hoarding cash. As part of their stimulatory policy actions, the US Federal Reserve has injected substantial amounts of cash into US banks.

Exhibit 1 shows that excess reserves held by US banks deposited with the US Federal Reserve now stands at more than a trillion dollars, up from virtually zero held for decades.

¹ Alliance Bernstein, company reports & Empirical Research

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This is an unprecedented development and an indication of how much cash is sitting on the sidelines in banks. To be sure, all this idle cash represents an opportunity, but not until the banks feel secure enough to lend widely again.

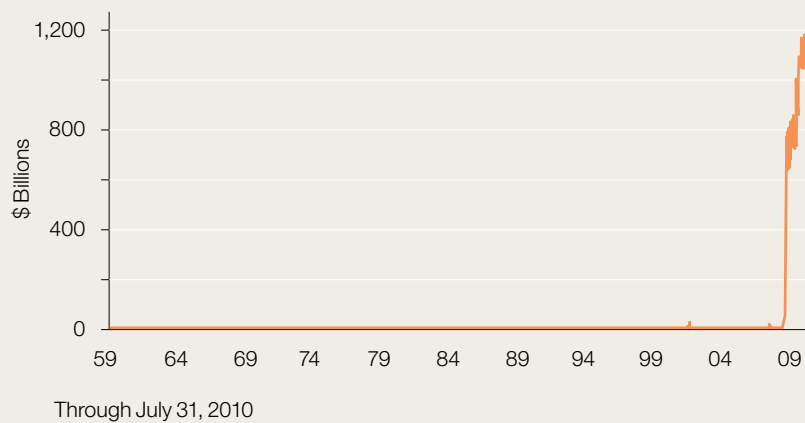
In the corporate arena current profitability is close to historically high levels as per **Exhibit 2**. In every region of the globe, corporations are generating more cash than over the past two decades – lots more. After a period when capital spending declined precipitously, there are early signs of increased capital investment by businesses. It's difficult to predict whether this trend will continue in the immediate future. But if it does, it could be a powerful force in boosting economic recovery.

In the last few months we have seen the start of a corporate re-leveraging cycle that could be an enduring theme for global equity markets over the next couple of years. With the global economic recovery showing signs of greater sustainability, the expectation is for corporate management teams to increasingly gain the confidence to deploy capital and re-lever balance sheets by increasing capex, returning cash to shareholders and engaging in mergers and acquisitions.

As **Exhibit 3** shows, cash levels on balance sheets are high (both in total dollar terms, as well as relative to assets and market capitalisation). With the cost of debt low relative to the cost of equity, and with high cash levels putting downward pressure on return on equity (RoE), firms will be incentivised to boost leverage to improve profitability.

Exhibit 1: Risk aversion is causing banks to hold cash

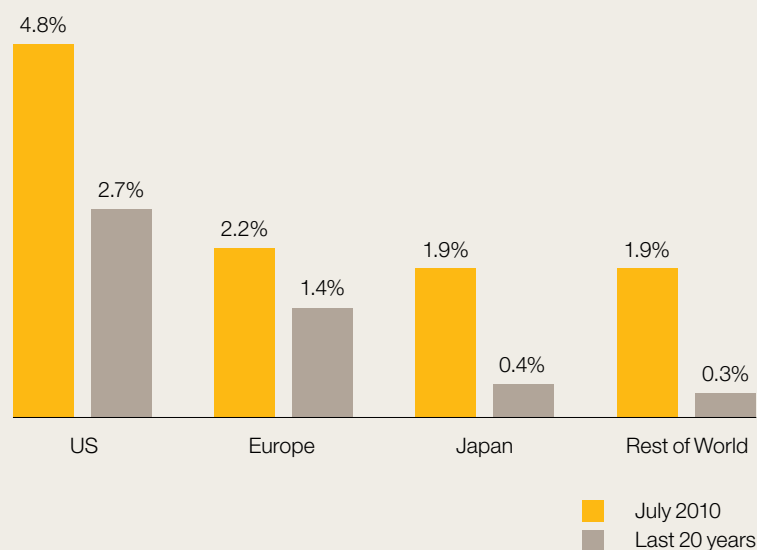
Excess reserves at Fed



Source: Alliance Capital

Exhibit 2: Corporate cash flow margins are very high

Free cash as a percentage of sales as of July 2010



Source: Alliance Capital

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It seems most companies are reluctant to utilise this excess cash via increasing dividends. It is expected that companies will either acquire or merge; or return cash to shareholders via share buybacks. It is worth noting that mergers and acquisitions don't necessarily work well, and shareholders in the acquiring company often lose out. So, in trying to play this theme, one has to do so selectively: either by buying cheap companies that may be taken over (e.g. the types of stocks that DFA or Tweedy, Browne own), or by backing high quality management that have a proven track record of making prudent acquisitions and not destroying value (e.g. the types of stocks that Walter Scott own).

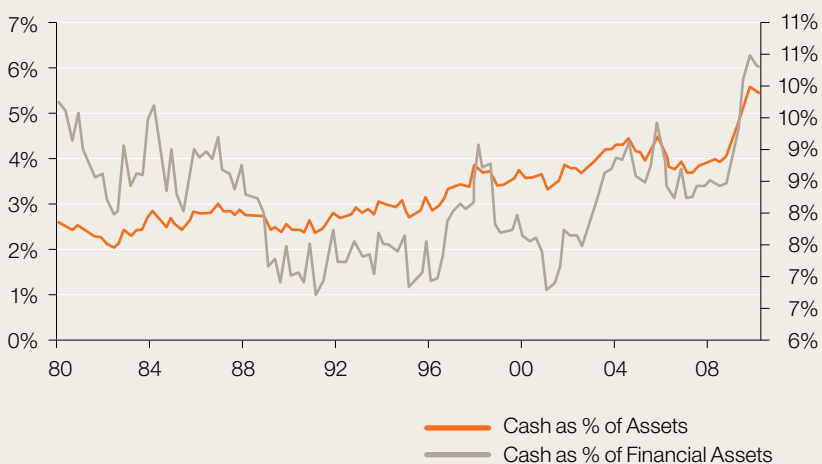
How corporations use their excess cash will be a key determinant of how earnings, equity markets and the broader economy fare over 2011.

Theme 2: A stock-pickers' market

The strong rebound in earnings growth was the key driver for market returns in 2010. Indeed the 36% bounce in global earnings has accounted for all of the market gains, while PE multiples (on a forward and trailing basis) contracted (thereby neutralising the growth in earnings). As shown in **Exhibit 4**, it is quite normal for earnings growth and changes in multiples to move in opposite directions, particularly in years of large swings in earnings.

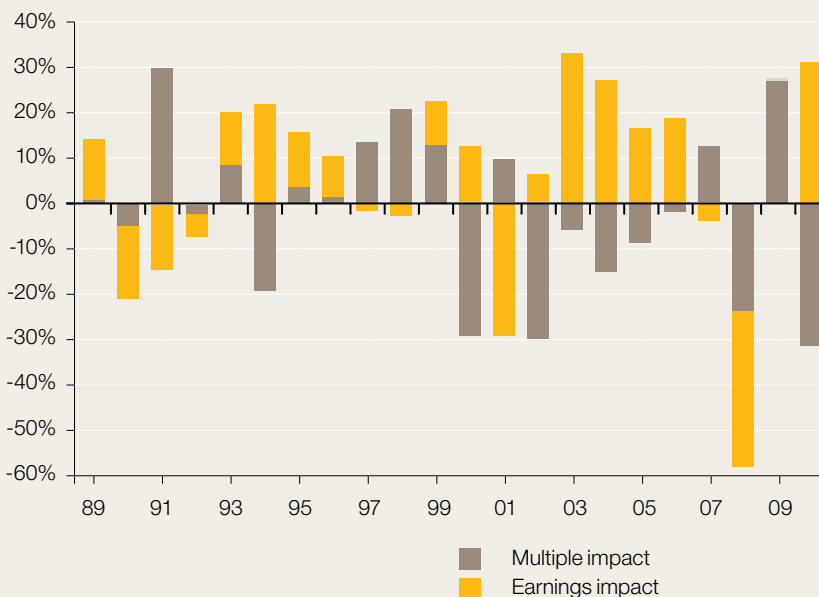
Indeed, global earnings growth is expected to slow (the cyclical rebound is over) to around 8-10%.

Exhibit 3: Cash as a percentage of assets for US non-financial corporate business



Source: UBS

Exhibit 4: Market return drivers: Multiples compared to earnings for the MSCI World



Source: UBS

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And there is debate around whether analyst expectations for 2011 appear too high. The unknown is what is going to happen to multiples. Should valuations not change through 2011 (they seem fair at today's levels), then the market return will be driven entirely by the 8-10% earnings growth. This will be an acceptable outcome for investors and in line with historical long-term equity market returns. It is worth noting that it is very difficult to predict what markets will do in the short-term, because it will be influenced by market sentiment which is often not truly reflective of fundamentals.

It is therefore those companies that are able to grow their earnings sustainably that should be rewarded the most.

Currently our strategy in aggregate has a bias that would benefit from this theme.

Another perspective is the sector correlations of the market. The early stage of a bull market is when most stocks go up together – as evidenced in 2009. However, as time progresses, those companies with superior operational and financial performance tend to separate themselves from the rest of the herd and perform better – correlations tend to fall. This wasn't the case in 2010 as macro factors tended to dominate and sector correlations actually increased.

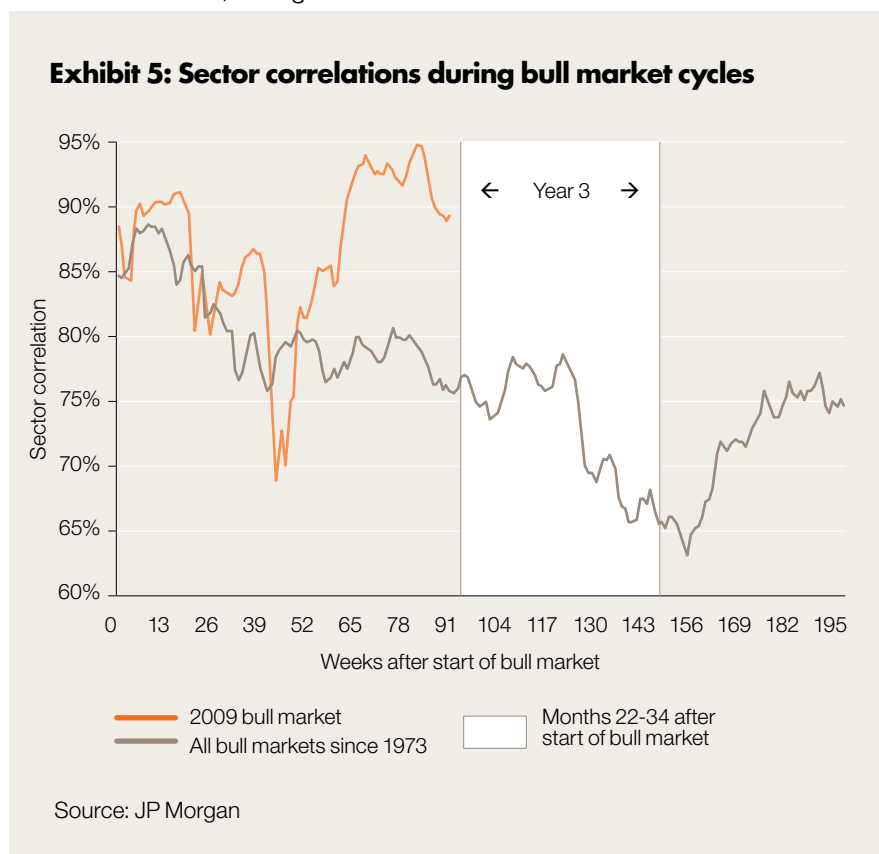
Exhibit 5 shows the average sector correlations through previous bull markets compared to the 2009 bull market. As can be seen, sector correlations typically decline to cycle lows during the third year of a bull

market. It is noteworthy that the current bull market hasn't followed the typical path with correlations increasing in 2010.

Despite the recent positive correlation in stock returns, the fundamentals of the underlying companies have been less correlated. We believe return correlations have been high because investors have been much more focused on macro factors in driving their investment decisions than the fundamentals and attractiveness of individual stocks. In effect, investors have been treating equities as a singular asset class instead of a broad collection of individual stocks and companies, each with its own unique risk-return trade-off. Because of this macro focus, during 2010

stocks tended to advance and retreat in unison based on the latest release of a piece of macroeconomic news. And since this news has been very mixed, it has resulted in a market psychology that quickly shifts from optimism to pessimism and back again, affecting nearly all stocks together regardless of their unique characteristics. This is not a normal market environment. Should or if these macro anxieties subside, unique company characteristics will once again distinguish the winners from the losers, creating an environment where stock-pickers should be rewarded.

The equity market's limited differentiation between companies



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with structural rapid growth and their peers has become particularly pronounced since the financial crisis. Despite the widening gap between high and low-growth companies, the premium that equity markets award for faster growth has declined substantially in recent years.

Exhibit 6A shows the evolution of valuation multiples (EV/EBITDA) for top-quintile growth companies relative to their sector averages. Not only have the multiples for fast growing companies been declining in absolute terms, but the gap in valuation between growth leaders and the sector average has also narrowed to the lowest point in a decade.

As **Exhibit 6B** shows, the valuation gap between high and low growth companies has been converging when the earnings and operational performance of the companies have been diverging. This is unusual and isn't expected to last.

Another way of capturing this is to look at the dispersion of price/earnings ratios as shown in **Exhibit 7**. This has been trending down for two decades and is at near all time lows. The globalisation of information and technology, coupled with the re-rating of Emerging Markets and the de-rating of Japan, means the valuation differential is now minimal. The market, relative to its history, is ascribing similar valuation multiples to stocks, irrespective of the growth opportunities embedded in the stocks.

The implication of this for our Global Shares strategy is that we are able to buy companies with higher growth prospects without having to pay up for this growth. It is therefore not surprising that our strategy has developed a growth bias as our managers are trying to exploit this

Exhibit 6A: Valuation of high-growth stocks has been decreasing steadily...

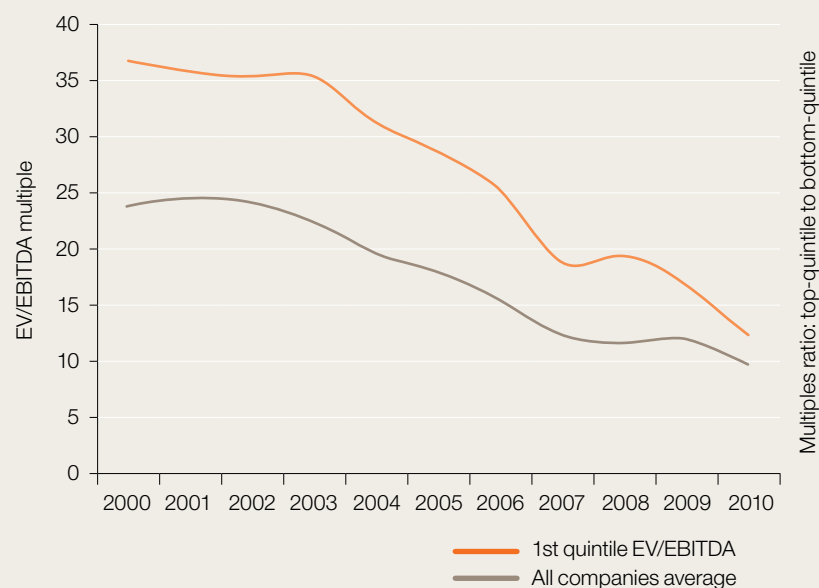
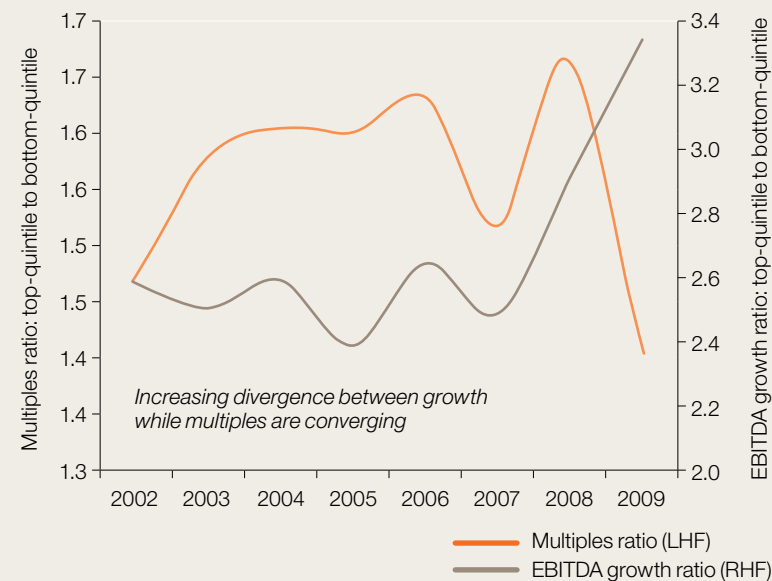


Exhibit 6B: ...resulting in low multiples for growth leaders



Source: Goldman Sachs

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opportunity. Usually we expect the strategy to exhibit no deliberate bias, but with the valuation dispersion at close to a two decade low, our view is that this is appropriate.

Theme 3: Effectively exploiting emerging markets

As described in the previous *My Consultant*, successful investment in emerging markets is more than just buying stocks listed in these markets.

To put this into context, in ten years the developing world's middle class will spend about \$20 trillion annually, almost triple their current consumption rate of roughly \$7 trillion and double the current US consumption rate of \$10 trillion.² US large cap companies are leading the race to capture these fast growing sources of revenue, an edge they are likely to maintain, or grow, given the advantages of operational scale that they enjoy.

Put another way, viewing the US stockmarket as purely a play on the US is no longer valid. **Exhibit 8** shows the extent to which US companies capture their revenues from outside the US (note this is not how much comes from emerging markets, rather how much comes from outside the US). The larger cap US names already derive a significant portion of their revenues from outside the US and this is growing.

Further, between 1995 and 2009 pre-tax margins on foreign business for companies in the S&P 500 grew

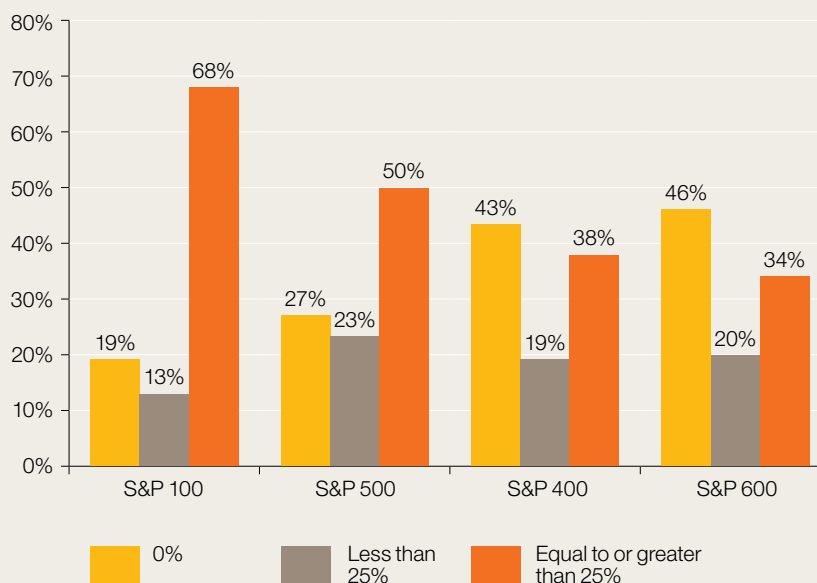
² 'Growth and competitiveness in the United States: The role of its multinational companies.' McKinsey Global Institute. June, 2010

Exhibit 7: Dispersion of global shares PEs



Source: Merrill Lynch

Exhibit 8: International revenue for US companies as a percentage of total revenue



Source: Legg Mason

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significantly in absolute terms as well as compared to pre-tax margins on domestic business as shown in **Exhibit 9**.

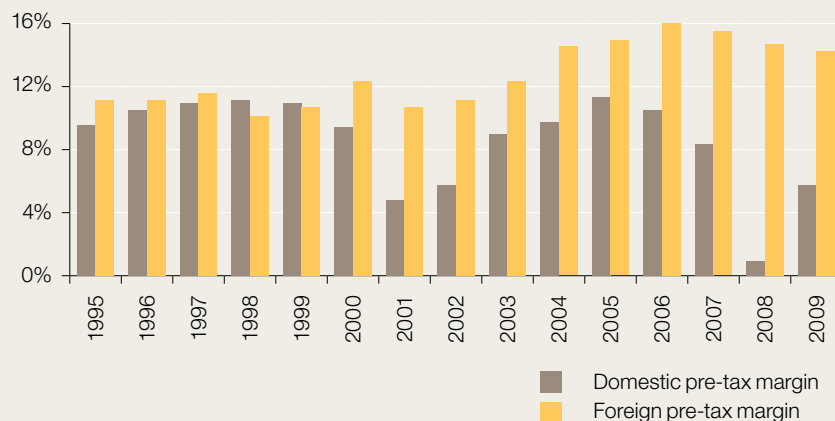
The point about revenues in the US coming from outside the US is applicable to tapping into emerging markets. Investing in emerging markets should be considered on a more holistic basis than just looking at where the stock is listed. A more useful perspective is to look at the extent to which the revenue of the portfolio is derived from emerging markets. For example, whilst Standard Chartered is listed on the UK stockmarket, it derives 90% of its revenues from emerging markets. Samsung, whilst listed in Korea (a country that is classified as an emerging market), derives only 15% of its revenues from Korea, with approximately 50% of its revenues flowing from the US and Europe.³

Domestic investors often view the Australian mining sector as a good way of getting exposure to the growth in emerging economies.

For example, BHP derives 49% of its revenues from emerging markets. There are other stocks that are not listed in the emerging markets that still derive a lot of their revenue from them. For example, Ivanhoe Mines in Canada generates 80% of revenues from emerging markets, Qualcomm (in the US) generates 66% and, ASML (in the Netherlands) generates 60%.

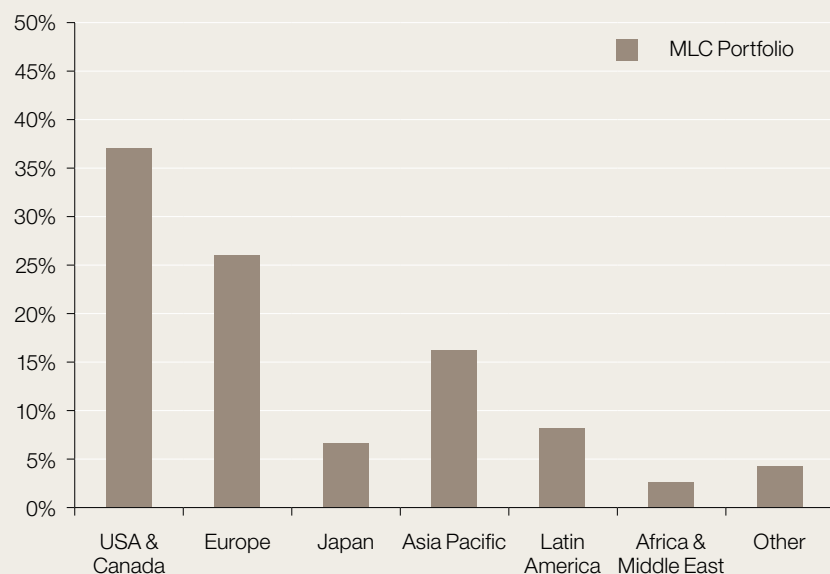
³ Source: Bloomberg, Samsung Annual Reports

Exhibit 9: S&P 500 domestic versus foreign pre-tax margin



Source: Legg Mason

Exhibit 10: Revenue distribution of the MLC Portfolio versus the Geographical Distribution of Index



Source: MLC managers



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Exhibit 10 shows the geographical distribution of the MLC Global Shares strategy by source of revenue (& not by listing). It shows that approximately 30% of the revenue of the portfolio is derived from emerging markets. This number compares to approximately 10% of the portfolio invested in stocks *listed* on emerging stockmarkets.

Conclusion

The MLC Global Shares strategy has developed a bias towards well run companies that are capable of growing their earnings even if the major western economies struggle to grow. This is particularly relevant as the initial rebound in earnings after the financial crisis was a function of a cyclical rebound in earnings, companies cost cutting and inventory restocking. However, going forward it is expected that earnings growth will be fairly muted, and the *distribution* of the earnings will be even more important. When one considers the macro risks that are embedded in the world today, our strategy is well positioned to capture the opportunities presented by the major themes confronting the 2011 investment landscape.

A summary of our incumbent Global Shares managers and their current positioning and views is given in the Appendix, together with a breakdown of regional and industry exposures.

Appendix:

MLC Global Shares Strategy: Manager summary & regional and industry exposures

Manager summary

Manager	Style/Role in strategy	Current positioning and views
Capital International (12.5%)	130 stock portfolio with a mid-large cap Growth At a Reasonable Price (GARP) bias, expected to provide through the cycle performance.	According to Capital International, consumer spending can be expected to increase as personal income rises, especially in the developing world. The strategy is invested in consumer companies which are well positioned to capture and meet this demand from growing middle-class populations. They also see a number of attractive opportunities in Information Technology companies which are benefiting from secular growth in the networking and internet space. Their investments in Financials remain concentrated in a smaller number of firms than those represented in the benchmark as they believe only a few of them have the financial strength and expertise to meet the challenges that lie ahead.
Carnegie (12.5%)	25-30 stock portfolio with a mid-large cap growth bias, which is expected to participate in major market rallies to capture potential upside.	In 2011 Carnegie anticipates that the outperformance of cyclical shares will fade and that market leadership will broaden and become more balanced. Heading into 2011, a more gradual increase in earnings and share prices will result in increased focus on stock-picking and less on macro economic data. Furthermore as the bull market matures they also anticipate that investment horizons will gradually lengthen. Carnegie has sold out of its positions in the Bank of America to focus on Telecoms, which they think have upside potential due to changes in the personal habits of smart-phone users.
Dimensional (12.5%)	500 stock portfolio with a small-mid cap deep value bias, which may provide volatile market relative performance.	Dimensional remains focused on small-cap, deep value portion of both developed and Emerging Markets. This segment of the market has had a volatile year, ending with a marginally positive return. The last quarter produced positive returns providing momentum going in to 2011 that the deep-value segment of the broader market may continue to provide positive returns as global growth expectations increase.
Harding Loevner (12.5%)	50 stock portfolio with a mid-large cap quality growth bias, which may provide volatile market relative performance.	Little has changed of Harding Loevner's belief that the environment offers headwinds for companies to achieve easy revenue and earnings growth, and those that can, will be highly prized by investors. However, its view on Emerging Markets has been tempered down amidst concerns of policy reaction to rising inflation. Purchases in the quarter have led to an increase in the weight to US listed companies while reducing those in the UK and Japan. The strategy maintains an underweight position (relative to the benchmark) to Emerging Markets listed companies.
Mondrian (12.5%)	90-100 stock portfolio with a large cap value (dividend) bias, which is expected to provide capital preservation during volatile market conditions.	Mondrian continues to focus the strategy on markets that offer the most attractive real returns, balanced with the risk profile of each market. As of 31 December 2010 it retained the above-market exposures to Spain, the UK and Italy, while keeping below-market exposure to Australia and Japan. On a sector basis they continue to find value in areas traditionally characterised as defensive: Telecoms, Health Care and Consumer Staples. Mondrian is less exposed to growth-oriented sectors such as Materials and Consumer Discretionary. Mondrian remains comfortable with their allocation to Emerging Markets.
Sands Capital (12.5%)	25-50 stock portfolio with a mid-large cap secular growth bias, which is expected to participate in major market rallies to capture potential upside.	Sands Capital has had a relatively quiet quarter with no sales from the strategy and the lone addition of Nike, the global sportswear company to the strategy. This is a reflection of its confidence in its strategy's companies over the last few quarters and their ability to perform well during 2011. Secular growth over a 3-5 year period remains the cornerstone of the strategy employed to identify the investment opportunities.

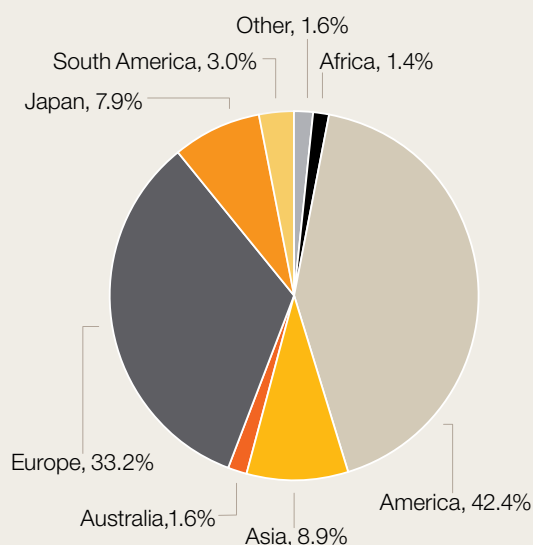
Appendix:

MLC Global Shares Strategy: Manager summary & regional and industry exposures

Manager	Style/Role in strategy	Current positioning and views
Tweedy, Browne (12.5%)	30-50 stock portfolio with a mid-large cap value bias, which is expected to provide capital preservation during volatile market conditions.	Tweedy, Browne is cautiously optimistic about the current valuations for the global share market. The strategy's P/E ratio is also at a discount to the forward multiple of the MSCI World Index. According to Tweedy, Browne, Benjamin Graham would have found these earnings yield comparisons to be favourable. With corporate cash levels near record highs and the economy continuing to improve, Tweedy, Browne is cautiously optimistic about equity market prospects in 2011 and beyond. There were no material changes to the strategy during the quarter. Tweedy, Browne added to and trimmed a number of existing positions, establishing one new position (Zurich Financial) and trading out of another (Home Depot).
Walter Scott (12.5%)	50 stock portfolio with a small-mid cap real return bias, which is expected to provide capital preservation during volatile market conditions.	Walter Scott's investment philosophy and process remains unchanged. However, it is more optimistic about the economic outlook than it was this time last year. Although it maintains consensus growth estimates are too ambitious, Walter Scott remains confident that companies in the strategy have the financial stability and the individual market strength and position to seize opportunities and create meaningful wealth over the long-term. There were no additions to the strategy over the quarter with one sale, Hutchison Whampoa, a level of activity well in line with its 'buy and hold' investment philosophy.

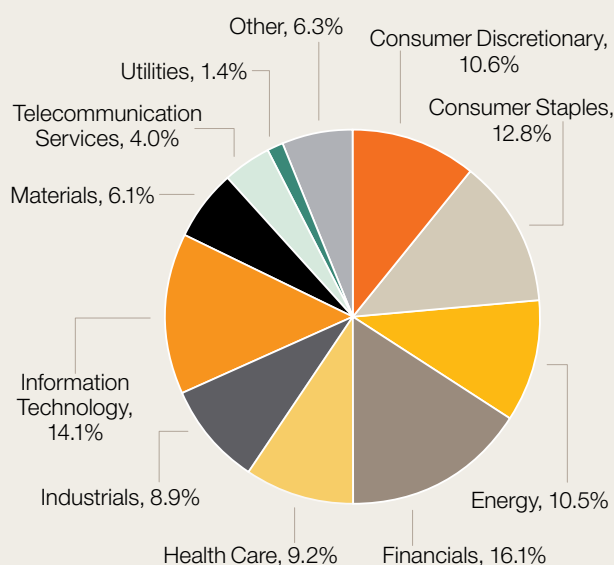
Regional and industry exposures

**Global Regional Exposure
MLC Global Shares Strategy**



Source: MLC Investment Management

**Industrial Exposure
MLC Global Shares Strategy**



Source: MLC Investment Management



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