



BROWN ADVISORY

# Investment Perspectives

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## Scary Movies

Never has it been so important to have a global perspective with regard to investing. As the world becomes a smaller place, events beyond our borders have a greater impact than ever on domestic investments. Moreover, international markets offer some compelling investment opportunities following their recent corrections. The developed markets represent good value, but require discrimination in stock and sector selection since overall growth is modest. On the other hand, emerging markets – with the economic winds at their backs – are attractive on a long-term basis, although volatile.

*Navigating Our World* (acronym: *NOW*) is the name we've given to our biennial client conference, which took place on May 20. The title seemed particularly apt this year, since the conference occurred just as the financial crisis in Greece and the European Union was reaching a crescendo. The sharp reaction of world markets in recent weeks only underscores the need for a thoughtful approach to "navigation." Thus, a world view is critical to making good investment decisions.

Having a global perspective adds value to the investment process in two ways. First, it expands the range of investment opportunities available for making money or mitigating risk, or both. Second, because of the linkage of world markets, a global view helps us better understand the risks of investing in any particular one. As a leading venture capitalist said at his firm's recent annual meeting, "If you don't know what's going on in

BRIC countries, then you make bad deals in North America." Let's start with the second issue and then circle back to investment opportunities that we see abroad.

### *Spooky Markets*

The problems in Greece have obviously spooked world markets, justifiably so as it's hard to see how the country will successfully emerge from its crisis. The IMF and EU rescue program of approximately \$125 billion appears to be enough to address the country's near-term liquidity issues, but long-term solvency will depend on its ability to comply with the terms of the program and grow its way out of debt. Neither seems likely. The IMF program requires fiscal retrenchment equivalent to 11% of GDP over the next three years, in addition to the 5% already initiated by the government. This is a tremendous burden on an economy that grows slowly under the best of circumstances, and its public sector workers will need to bear much of the load since they account for the largest share of government spending. The culture of entitlement, shadow economies and corruption will be hard to break. Even at full compliance with the terms of the package, the country's gross debt will reach about 150% of GDP by 2012, and interest payments will be a huge drain on resources since well over half of the debt is held by foreigners. The *Bank Credit Analyst* points out that 58% of the time results in IMF programs have fallen short of projections, so the odds of compliance are not good. Devaluation of the currency, enabled only by withdrawal from the EU, remains a reasonable prospect.

On the surface, it's hard to fathom that financial



distress in a country as small as Greece could wreak such havoc on world markets, but such is the nature of connectivity. For perspective, the economy of Greece represents only 2% of the European Union's GDP. Even with gross government indebtedness reaching an alarming 120% of GDP, its public debt adds up to only about 5% of the EU's total. The risk on which most investors focus in this regard is the European banks, which hold much of this debt. According to *The Bank Credit Analyst*, European banks have nearly \$700 billion of exposure to the sovereign debt of Greece, Italy, Spain and Portugal. If, as a result of restructuring, the banks wrote off 20% of this amount on their balance sheets, they would take a 13% hit to their equity. The European Central Bank recently estimated that EU banks would need to write off close to \$150 billion in both public and private loans this year, but that part of this total would be offset by gains in other securities. In fact, European banks absorbed similar write-offs in 2009 and still earned a profit.

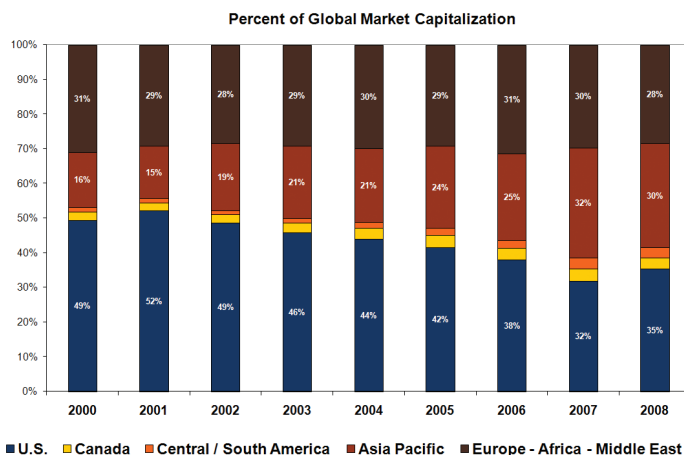
### Seen This Movie

We feel like we've seen this movie before, and fairly recently. Greece, in a sense, is the Bear Stearns of today's financial crunch. Although seemingly small and isolated, its linkage to banks and to other sovereigns gives rise to the fear of contagion. Similarly, the European Financial Stabilization Mechanism, the huge rescue package designed to get ahead of the problem by providing liquidity, reminds us of TARP. It should be remembered, however, that the sub-prime problems that precipitated the 2008 financial meltdown were far more massive than today's sovereign issues. Then, a large number of European as well as U.S. financial institutions held toxic mortgage paper, while today the sovereign debt of Greece, Portugal, Italy and Spain is concentrated in German and French banks. In addition, the write-offs required to accurately reflect mortgage losses were far greater than what is likely to be needed in the case of sovereign debt.

Finally, with the mortgage experience fresh in their minds, central bankers are better able to cope with liquidity and solvency issues.

Still, the markets remain on edge as investors assess the damage. In our view, the main issue is the impact of widespread fiscal restraint and de-leveraging on the prospects for growth in worldwide GDP. The U.S. recovery remains tentative as consumers attempt to pay down debt and the government addresses record deficits. China is constraining credit in an effort to control inflation, although growth remains quite strong. At the margin, the EU's problems mean greater headwinds for global growth. As we've stated before, this combination of circumstances means the recovery process will be a slow one, and the risks along the way will be higher than we've typically experienced in recovery precisely because of the leverage involved.

figure 1. The Incredible Shrinking Share



Source: World Federation of Exchanges



So how should one be positioned in an international context? To some extent, investing in U.S. equities provides exposure to international markets. The average S&P 500 company generates about 45% of its revenue abroad, and Brown Advisory's large-cap portfolios have somewhat greater exposure. Many of our small-cap companies, too, have successfully developed non-U.S. business. Over the long term, however, it's important to keep in mind that the U.S. represents a shrinking minority of investment opportunities on a worldwide basis.

If, on a strategic basis, non-U.S. stocks should occupy a greater proportion of balanced portfolios than 10 or 20 years ago, the recent financial turmoil provides an opportunity to participate sooner rather than later. As noted, we've seen a version of the crisis before, and although it was scary, it had a happy outcome for investors. We believe the new movie will end the same way. The flight to quality has been huge, as the yield on 10-year Treasury bonds declined from about 4% in early April to 3.1% in June. Mounting fears have created a compelling set of circumstances:

- Relative to the U.S., international equities have lower valuations and higher historical earnings growth, as indicated in the table below.

- Compared to their historical averages, international stocks (using MSCI EAFE as a proxy) are close to a 20-year low in terms of price to earnings and price to book value.
- The recent surge in the dollar may present an opportunity for incremental gains in international stocks. Once the EU's problems are sorted out, the euro should eventually recover at least some of its recent losses, and the Chinese renminbi is likely to be gradually revalued based on recent announcements. Both developments would add to local market returns when measured in dollars.

For these reasons, we think now is a good time to review one's asset allocation as between U.S. and international equities to make sure that the international piece makes sense in light of one's individual risk and return objectives. Accordingly, we've significantly increased the range of our international investment options in recent years. Starting with our long-standing "core" international portfolio, we've added exposure in emerging markets, small-cap stocks and hedged investments.

**figure 2. International Markets: Higher Earnings Growth At Lower Valuations**

	MSCI EAFE Total	EAFE Small-Cap	MSCI Emerging Markets	S&P 500
Historical 3-yr EPS Growth	11.4%	12.6%	16.2%	10.6%
Price/Earnings	14.3x	15.4x	16.5x	18.0x
Price/Cash Flow	6.2x	4.2x	7.2x	11.0x
Price/Book	2.1x	1.2x	2.1x	2.2x
Yield	3.0%	2.7%	2.0%	2.0%

Source: Factset; data as of 12/31/2009



## *Offense and Defense*

In considering asset allocation, it's also useful to divide the world into two broad categories: developed and emerging. Since 1990, the population of North America and Europe – representing most of the developed world – has grown only slightly and today numbers about a billion people, a level that it will barely exceed over the next 40 years. Meanwhile, the rest of the world (Asia, Latin America and Africa) has grown from just over four billion in 1990 to almost six billion today, and it is projected to reach nearly eight billion by 2050. Similarly, in economic terms, the U.S. and other developed nations occupy the bottom half of a listing by GDP growth while the emerging markets rank mostly in the top half. In the stock market, the percentage of global market capitalization represented by U.S. companies fell from 49% to 35% between 2000 and 2008, a loss exactly offset by the gain in the Asia Pacific region, while the rest of the world – principally Europe and Latin America – essentially stayed the same. Broken down differently, these trends would show rapid expansion in the emerging markets and contraction in the developed ones over the period.

In today's world, we think of the emerging markets as "offense" and the developed markets as "defense." As we've noted, the developed world is struggling with heavy debt loads that make it difficult to stimulate fiscally, so governments must use expansive monetary policy in an effort to grow their way out of the recession. With so much slack, deflation looms as a threat to the weak recovery. Although the U.S. is certainly better off than Europe or Japan, it shares some of these characteristics. To be sure, there are pockets of growth (witness parts of technology, health care and selected consumer sectors), and valuations are reasonable, so there is opportunity. But successful investing in this world requires discrimination.

On the offensive side of the ledger, the emerging markets have the advantage of favorable demographics and strong sovereign balance sheets, giving them more policy options for managing growth. Inflation, not deflation, is a major concern. The rapid growth of many emerging markets, like that of U.S. technology in the 1990s, gives rise to greater volatility, so investors need a long time horizon – and a strong heart. The "right" mix of offense and defense will therefore vary considerably from one investor to the next, but both should have a role, in our view.

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