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INTERNATIONAL EQUITY INVESTMENTS FOR U.S. INSTITUTIONS

Speaker: BARRY MAURICE GILLMAN

MR. BARRY M. GILLMAN: I have spent the bulk of my career in global Investments. The other way to look at it is I haven't spent very much of my career in actuarial work, which means if you get beyond complicated actuarial questions, I'm going to have to plead ignorance.

I'd like to give you a broad-brush overview of the world of international investing, which is becoming, I think, more and more of a hot topic, both with institutional and, indeed, individual investors out of the United States. I will then take a look at some of the more specific questions and problems that arise to see if this is really something that is suitable for yourselves, or in some cases for your clients.

Let's start by taking a look at the big picture. The focus is on international equity. And I'd be happy, again, to respond to questions about fixed income, real estate, and other aspects of international investing, but I'm really looking at the equity side here.

The idea behind the first few charts in my presentation actually came from my nine-year-old son. He came home from school one day very recently and said, "Dad, you tell me about what you do all day, and you must be kidding, right?" I said, "Well, no, I wasn't, but what is on your mind?" And he said, "Well, you're always telling me about the equity markets in Japan and in Europe and how you make so much money in Japanese equities." And, he said, "You are kidding, right?" And I said, "Well, no." He said, "All this about taking my allowance each week and putting it in Japanese equity or something, I'm not sure about this anymore." I said, "Well, OK, what gave rise to this?" And he said, "Well, we had geography in school. The teacher showed us Japan on the map and it's tiny. You're putting my money there and it's so little."

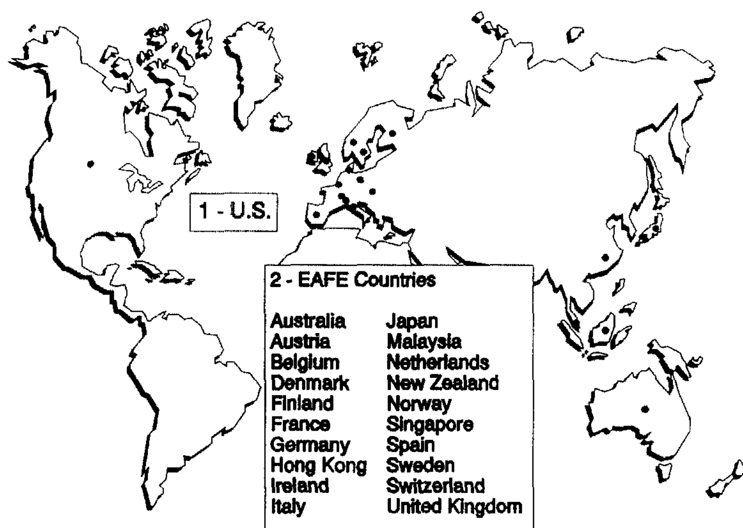
And that gave me the thought to take a look when people actually talk about international investing. In terms of the world map, what do we actually mean? Well, what I've done in Chart 1 is show the major investment markets around the world. So you see *The Wall Street Journal* or other publications talk about U.S. money, the wall of money moving overseas, but where is this wall of money actually going?

On the left-hand side is the U.S. Other areas represent the major developing markets around the world. And I think my son's point is reasonably well taken; relative to the world's land mass they are small. There is western Europe. In the Far East is Japan, accompanied by a lot of dots around the Pacific rim, and on the bottom right-hand side is Australia. Japan and the U.K. represent about two-thirds of the market capitalization of equity markets outside the United States. So my point here is that market capitalization and available opportunities are not really linked to the size of the particular countries involved.

There are other ways to look at the world's map if the countries have been plotted by their economic size. What happens when you change the world's map for this type of demography? Although the U.S. still represents a big chunk on the left-hand side of the picture, now Japan is amplified, given the size of the Japanese economy. The central part of the world's map is dominated by western Europe; France, Germany,

the U.K., and even Italy and Spain. The rest of those big land masses start to shrink down to very modest sizes. Africa is a little dot down at the bottom, with South America at the bottom left-hand side. We hear so much about the growth of all these Pacific economies yet China becomes very modest in size, even with the recent growth. The former Soviet Union also shrinks down. So, again, the world economic map looks a little different from the world's land map.

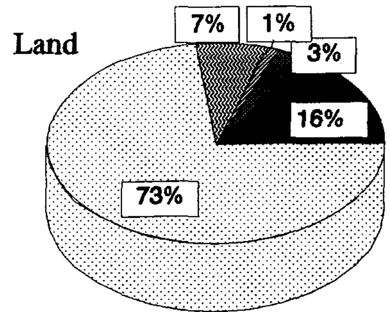
CHART 1
What in the World Is Out There?
Major Investment Markets

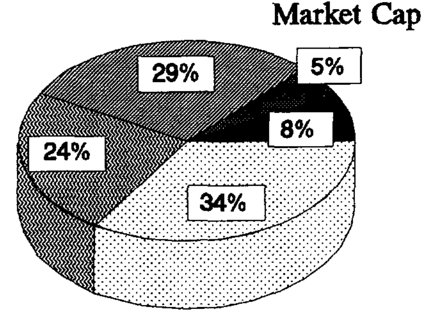


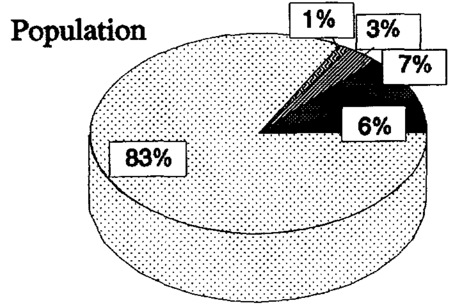
Put some facts and figures onto that. Starting on the top left-hand side of Chart 2, again, going back to the land mass, what are we talking about when we talk about going outside the U.S. in terms of the available countries? North America represents about 16% of the world's land mass. The developed markets of Europe, Australia, and the Far East (collectively known as the EAFE markets) represent 11% of the world's land mass. The rest of the world, nearly three quarters of the land mass, is virgin territory, unknown territory.

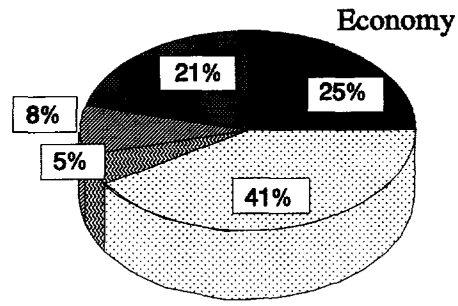
It becomes even more pronounced when we look at population, with 83% of the world's population living outside those developed markets. Or to put it another way, 94% live outside the United States and, again, 11% are in those EAFE markets. Things start to gain a little more perspective when we move around that chart and look at the economy and the market cap.

CHART 2
World Breakdown









In terms of the economies, the U.S. and Canada still represent 25% of the world's economy. The next biggest chunk of 21% is west Europe. Japan and the Pacific have 13%, with 41% represented by the balance of the world.

Now, the economic figure numbers are a little more fuzzy than the land mass and the population, depending on how one actually goes about calculating the size of the economy. The general context of the figures, I think, is reasonable. But it's only when we get around to the market capitalization that we see that in the global investment world the U.S. and Canada still represent 34% of the world's market cap. Or to put it another way, at the moment, about two-thirds of the world's stock markets are outside North America. And that's a figure that has been growing during the past 20 or 30 years with some ups and downs. The other two major blocks of stock markets are in Western Europe and Japan. The other Pacific EAFE markets represent a modest 5%, and all the rest of the world's stock markets combined represent only 8% of the world's market cap. And that probably is, an overestimate, given that some of these are really very thin, tightly held markets and maybe shouldn't be classified as "markets" at all.

Well, it's all very well to look at markets. Does that mean we have to invest in them? One of the topics I'd like to address is whether these are areas that one should be investing in. The first thing we want to look at is the valuation and the growth of other economic opportunities. We've tried to look at the regions or major countries around the world and rank them in some sort of order, depending on where the investment attraction lies. And this is, I have to admit, purely subjective from our point of view, in terms of where the areas are that have the best combination of value and growth. This ignores other factors such as liquidity in the markets -- you can you actually put a lot of money in there? We've ordered these by relative attractiveness.

Investment Attractions Rated
Valuation and Growth Factors Only

- Pacific Rim*
- China
- South and west Europe*
- East and central Europe
- Japan*
- Latin America
- Australasia*
- "Germanic" Europe*
- Indian Subcontinent
- Mid-East/North Africa
- South Africa
- North America
- UK*
- Central Africa
- Russia/Satellites

*includes EAFE markets

Up at the top is the Pacific rim. Given all the publicity we've seen in the press recently about the Pacific, that probably shouldn't come as a total surprise to anybody. And in Pacific rim, I'm including countries like Korea, Thailand, Hong Kong, Singapore, and Malaysia; several Asian dragons and other related countries. China ranks high, as does south and west Europe. I've grouped together France, Spain, Italy, Portugal, and Greece here. Then we move on to east and central Europe, which is the convenient name I've given to the grouping of the former Soviet satellites that seem to be likely to make it. They would be Poland, Hungary, and the Czech Republic. Then we have Japan, Latin America, Australia, and New Zealand. Germanic Europe – Germany, the Netherlands, Belgium, Austria, and Switzerland – countries anchored to the deutsche mark. And then down into more emerging markets; close to the bottom are North America and the U.K. At the bottom is central Africa and the rest of the former Soviet Union.

Now, again, these are our subjective judgments. If you are looking at markets around the world for opportunities, this is how we would come up with a long-term ranking. And, again, I'm not trying to time short-term investments. I'm looking at a five- to ten-year horizon, rather than jumping in with a three- to six-month view.

As practical people we have to say that it's not just the prices, the valuation, and the growth factors; there are other factors to be considered as well. When you plug those into the equation, you get a slightly different ranking. Specifically, of the factors that we add now, number one is liquidity. If the market is very small and you can't put sizeable institutional funds in there, you have to downgrade it. Liquidity is probably the most significant factor in the emerging markets in the sense of being able to put institutional money in there.

Investment Attractions Rated
Valuation and Growth, Plus Stability, Liquidity and Regulatory Factors

- South and West Europe*
- Pacific Rim*
- Japan*
- "Germanic" Europe*
- Australasia*
- North America
- UK*
- China
- East central Europe
- Indian Subcontinent
- Latin America
- Mid-East/North Africa
- South Africa
- Central Africa
- Russia/Satellites

*includes EAFE markets

Another one that we think is very significant is regulatory factors. Now that is not so much the regulations that you have to comply with when you're in a country but

primarily, can you put money in? Just as important, if you put money in, can you take it out again? There's a cadre of countries, fortunately a shrinking number, in the international investment business that should have been named the roach motel countries. You can check your money in, but you can't check it out again. And those countries will to be avoided over time. Fortunately, the number is shrinking as the governments in those countries figure out that it is not the biggest incentive in the world for a flood of foreign capital if people can put their money in but can't take it out. But there are still some outgoing restrictions that remain in place for now.

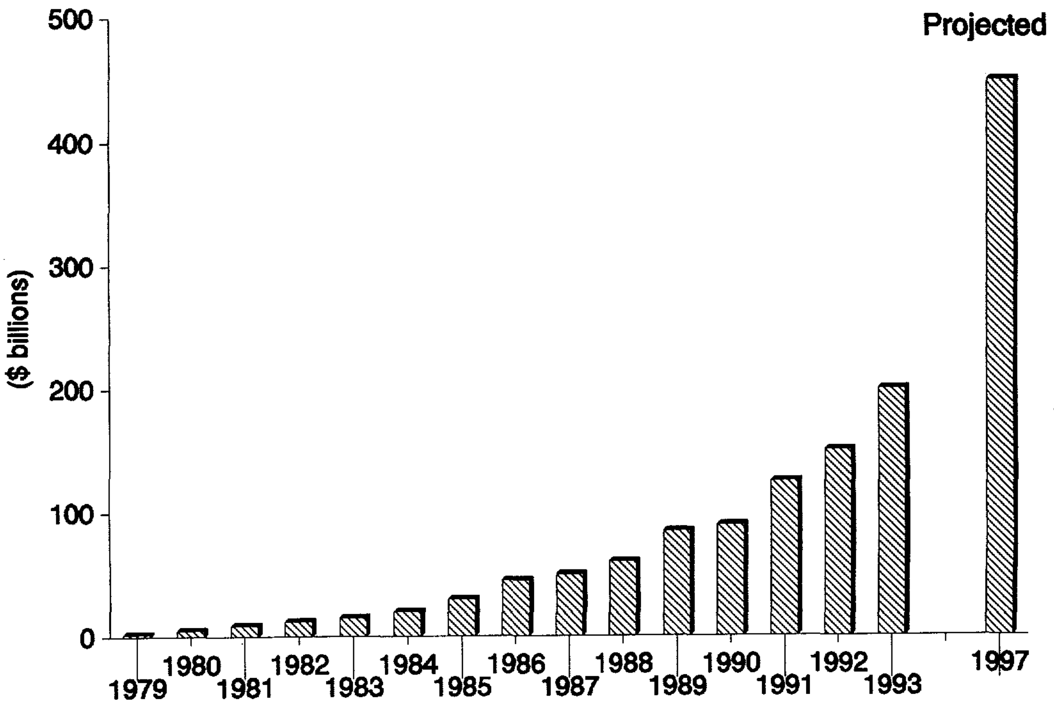
And the final factor that we plugged in is "stability." I'm not talking about market stability, but the general stability of the political and economic system in that particular country. You don't really want to start moving substantial funds into a country and find that the whole financial structure is either dramatically changed or totally absent after a coup, a revolution, or a war. When you plug all of these factors in you find that now the emerging markets move down the list and the developed markets move back up the list nearer the top.

There are two conclusions. First, as of right now, the emerging markets represent a large part of the world land mass and population. But, in terms of stock markets, it still is largely off limits to U.S. institutional investors. By off limits, I mean that it's impractical to invest large sums of money in many of the emerging markets around the world. On the other hand, the second conclusion is that the developed markets have a good risk-return profile. When you take into account regulation, liquidity, and stability, they represent an attractive opportunity relative to the North American markets. That has been the case for many years, and it is still the case now.

Let me switch slightly and take a look at what has been going on in the international investment business in the United States. The statistics in Chart 3 represent the growth in U.S. tax-exempt assets going overseas since 1979. This is primarily pension funds and related institutional investors; it does not include mutual fund assets or insurance company assets. Insurance company assets are relatively small in terms of overseas investments for reasons you may be familiar with. But the big money that's gone overseas is on the pension fund side.

In 1979, less than a billion dollars of U.S. pension fund assets were invested in the overseas markets. The industry has now grown to more than $200 billion in total exposure to the international markets. That still represents far less than 5% of total pension fund assets, but it's been growing steadily, both in absolute terms and as a percentage, during the last 20 years. These figures are supplied by Intersec Research in Connecticut. I noted a few characteristics as I followed their projections over the last 15 years. First, they have always forecasted increasing projections, and they've always been right, in terms of expectations. Second, every year they publish a five-year forward projection. The five-year forward projection this year is that by 1997, more than $400 billion of U.S. pension fund money will be in the international markets. Every year after their projection, most people in the industry say "that seems to be a little high." But, when you go back over the records, every projection has been exceeded in actuality. So the projected growth is expected to continue at least for the next five years, and possibly at a slower rate after that.

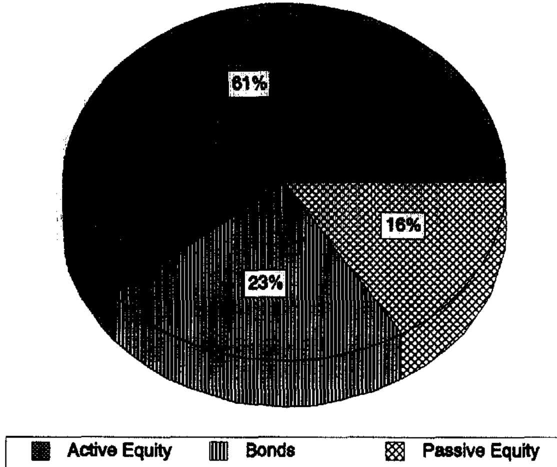
CHART 3
Growth in the U.S. Tax-Exempt Assets Abroad



Source: Intersec Research Corp., Stamford, CT.

Chart 4 shows how the assets break down. The bulk is in the international equity market. Sixty-one percent of the total at the end of 1992, was in active equity mandates in which managers were hired to beat the EAFE index. Another 23% was indexed, again usually to that index. The balance of 16% was fixed income. Those numbers have remained fairly steady as a proportion during the past five or six years. Ten years ago almost all the money invested internationally was active international equity. The fixed income and the passive side grew fairly rapidly in the late 1980s, and it looks like they have stabilized around these properties.

CHART 4
U.S. Tax-Exempt Assets Abroad
1992 Breakdown



Source: Intersec Research Corp., Stamford, CT.

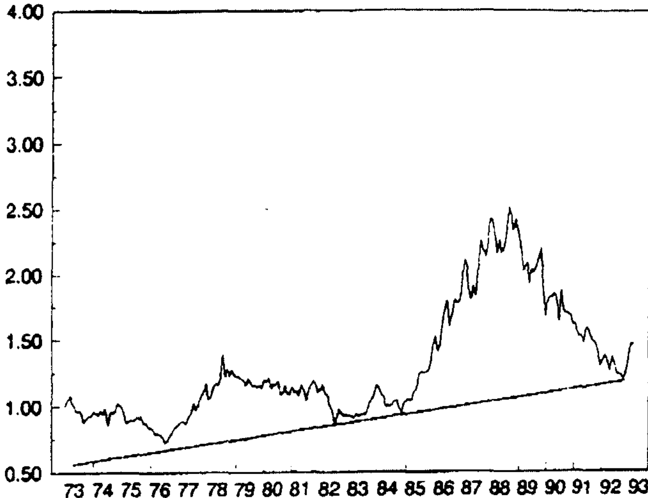
With all that money going international how has it actually done during that period? Chart 5 represents the relative of the international index, the EAFE index, against the Standard and Poor's (S&P) 500. Going back 20 years, you can see the trend line. It represents approximately the incremental rate of economic growth of the international economies relative to the U.S. economy during that period. The contention is that fast economic growth should produce better equity performance over time.

These markets are relatively volatile. When you look at that relative from the mid-1980s when the index was barely above 1, it moved up to more than 2.5 in the late 1980s and came zooming back down again by the end of 1992. So these are volatile markets relative to the U.S. But the underlying upward trend has been fairly steady over the years. On a long-term basis, it looks like the recent relative performance may have bounced off that trend and is once again moving up.

For those of you who follow the international markets, the reason why we had that tremendous surge in the mid to late 1980s, followed by the relative fall in the early 1990s, relates to the Japanese equity market. By 1988 it represented close to two-thirds of the international market capitalization outside the United States. It has now

shrunk back to under 50%, so it's had a major boom/bust again, which you may have followed in the financial press. Right now it looks like it's on a recovery track.

CHART 5
International Equity Index versus S&P



1973 = 100
Morgan Stanley EAFE index relative to S&P 500: price indices only

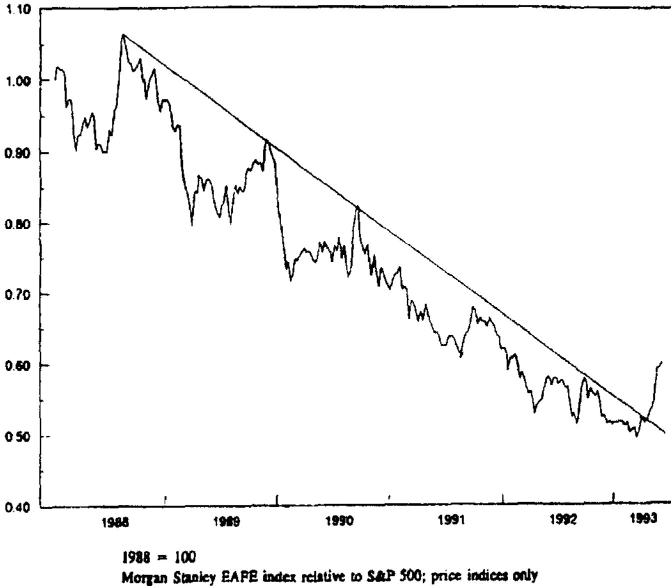
If we magnify the right-hand side of that chart, to get a recent five-year perspective, you can see in Chart 6 what for many practitioners was a really painful period. Anybody who put his or her first dollar of money out of the U.S. market into the international market in 1988 or 1989 suffered horrendous relative performance during that period. About 50% in terms of relative differential was lost by the early part of 1993. However, it looks like we've now broken through that downtrend that I've drawn in on that chart.

Has international investing done what clients hoped? To take a look at long-term performance, the two things that we generally test for are increased returns over time and whether it is a good diversifies of U.S. equity portfolios. I'm using ten years as a good benchmark here as "long term," although one can obviously take longer periods than that. All of us know you can pick the starting and ending points of a period, and you can prove whatever you want, especially when you have a volatile series. Rather than pick a specific ten-year period, we took the 15 ten-year rolling periods covering available data, 1968-92, and looked at every ten-year period of the 15 ten-year periods ending during that era.

In every ten-year period, 15 times out of 15, the aggregate return for a portfolio that was 20% internationally diversified, (i.e., 80% domestic, 20% international equity) exceeded the return of a purely domestic portfolio. And the average excess return was somewhere in the region of 1% during that period. For all 15 rolling periods, the

volatility of the diversified portfolio was less than the volatility of the pure U.S. portfolio. Again, the volatility was reduced by about 1% or so during each period. Now, looking forward, can we take those as guarantees?

CHART 6
International Equity Index versus S&P



1988 = 100
Morgan Stanley EAFE index relative to S&P 500; price indices only

Obviously not. I would be confident making the statement that it's likely that the volatility reduction will persist during any given ten-year period going forward because that is a consequence of the low correlation between the markets, which I expect to continue. With more caution I'd say that, if we're right in our perception of how these markets are likely to behave in terms of value and growth, there's a high probability that in most ten-year rolling periods, the international equity markets should produce a higher return than the domestic. There's no guarantee of that as we move forward. But certainly it's worked in the past.

Of course, not everything is rosy; there are problems to deal with for any asset class. I'd like to run quickly through some of the issues that will be faced by anybody moving into the international investing field. First is the asset/liability mismatch. There's been active debate within the profession on this. The basic issue is for any institutional plan whose liabilities are purely dollar denominated, is it prudent to invest in assets that are non-dollar denominated? My contention always has been that once you move away from a pure fixed-income portfolio and which looks to immunize liabilities, then whether you look at U.S. equities, at real estate, at international equities, or at any other asset class in which you're no longer tied to a fixed monetary stream, then you're looking at volatility and a potential mismatch within that asset class. That's the appropriate test to apply in my view, not whether the assets are dollar denominated, yen denominated, or deutsche mark denominated.

If you're concerned about the currency mismatch, it is possible to run an international portfolio that is currency hedged back into the U.S. dollar. You have no foreign currency exposure, but you do have the underlying market exposure.

Regarding insurance company constraints: as a subsidiary of Prudential, we're familiar with the constraints that apply under New York and New Jersey regulations. I'm less familiar with those that apply in other states. But, in general, our experience has been that there are two types of constraints that have held back insurance company general-account assets from going international. One is the regulatory constraints. That means in most states it will be hard for most insurance companies to put more than 3-5% of their general-account assets in international markets. That varies from state to state, and it also includes any capital one might have in overseas subsidiaries that are carrying on business abroad, so it's really an even tighter constraint than it seems.

This is an explanation as to why it's been the pension fund industry rather than the insurance industry that has driven the bulk of institutional assets overseas, and that may continue to be the case. The other constraint includes capital availabilities: this affects our company in terms of general-account assets, and may affect others as well. As capital becomes more constrained in terms of its uses and applications, that puts a restriction on the amount of general-account assets you may wish to have invested overseas.

One practical note is that, in the pension industry, it's a rule of thumb that if you don't get near to 10% international, you're not getting appropriate diversification. Look at all the effort and work that you put into investing your money internationally: certainly it costs more in terms of management time and effort, as well as dollars, to manage an international program. If you're constrained to 3-5%, it may be an otherwise valid decision that it just isn't worth the effort in terms of the management time and other costs.

Costs are higher for an international program. The two primary areas of cost are management costs and transaction costs. I break down management costs into two areas. The actual management fee could be a fee charged by a manager or it could be the cost of you running the assets. Either way, I would say a rule of thumb is to figure about double the cost of managing an equivalent pool of domestic assets. There are custody costs, for safe-keeping overseas. Again, it is probably at least double domestic costs. Right now, about 10-15 basis points for a moderately sized international portfolio, by which I mean anywhere in the region of $25-100 million, is a good approximation as to what the custody cost would likely be.

Transaction costs in terms of commission are higher than in the U.S. market; although the differential has been coming down. The good news on costs generally is that costs in the international area have been coming down relative to domestic. The bad news is that they're still significantly higher. So overall, I would say if you have estimated a little less than double the cost to run an international portfolio than to run an equivalent domestic portfolio, you're probably in the right ballpark.

The question often arises, if you get past the asset/liability mismatch, is currency a positive or a negative? There's a contention out there that if you wait long enough,

currency really doesn't matter, it will all come out in the wash and what really matters is the movement of the underlying markets. So, if you look back over the last 20 years or so, which is the period since currencies started to float – what do we learn from history.

As I said, the general perception is if you wait long enough, currencies will have no impact. But 20 years is not long enough to wash out the currency effect. During the last 20 years, the depreciation in the U.S. dollar against the major international currencies has added just about 1.5% a year to international equity returns, which is a significant number. It's not always one way. The worst period, when the dollar strengthened in 1980-84, took away more than 7% annually from international returns, a fairly significant amount. So that 1.5% compound return over the 20-year period has included a significant adverse period.

The conclusion we reach is that unless you believe that the U.S. dollar is systematically going to be the strongest currency among the major currencies around the world, currency is more likely to be a long-term reward for international investors rather than a major long-term risk. On the other hand, there are going to be periods in which it presents a significant, material, short-term risk. That is something that can be managed and should be managed. But currency risk is not a reason for backing away from international assets, whether they be equity or fixed income.

Now we're going to the manager risk. In general, when you're looking at your U.S. managers, whether it's yourself or outside managers, there's a perception that managers are the market. It's very hard for the average manager to beat the market by a significant amount, but it's also true that it's unlikely that the average manager will underperform the market by a large amount in any quarter. In other words, because institutional investors in the United States tend to be the market, the market's return tends to be fairly closely correlated with the average manager's. This is not true internationally. International managers as a group are a relatively small part of the assets in the global markets. And as such, quarter by quarter, there is a much higher chance that the average manager will be far away from the index that you may be used to seeing in any given quarter. In fact, the international merge risk is approximately double that of domestic merge risk.

If the long-term returns are there, that shouldn't be a major problem, but it's something to be aware of. And, as a practicing international investment manager, I know the pain that it sometimes causes boards of trustees, committees, etc., when they take a look at their international program and we tell them we have missed the market by 5% this quarter or 10% this year. The fact that the average manager may have done even worse is not really a great consolation; that is one of the facts of international management. And the reason is that the investable universe that most managers deem attractive doesn't correspond very closely with the investable universe as defined by the market cap outside the United States.

So, let me summarize, and then I'll be very happy to take questions. First, there are sizeable opportunities outside North America, and most of those are concentrated in that small group, in terms of land mass, of the developed countries: Western Europe, the Pacific Rim, Japan. International investment, particularly equity investment, is no

longer a little alternative asset class, certainly as far as the pension fund industry or the mutual fund industry is concerned.

Ten years ago I was making presentations in which we were listed along with other alternative asset classes – oil and gas, venture capital, and real estate – in a footnote somewhere. Now international equities are here to stay; they are part of the long-term investment scene for U.S. institutions.

There are costs, there are constraints; they are manageable, they're not a reason to avoid the asset class. I would say, though, for an insurance company's general account, there's a real limitation, in general, on the amount of assets one can invest internationally. In the past, the diversification benefits and the long-term performance have been there. In the future, the diversification is still likely to be there. The long-term benefits are more arguable. But I would say from a practitioner's point of view, this is probably the best time, for at least five, or six years, to be looking at moving international relative to domestic equity assets. And so right now we have a window of opportunity as far as international equity is concerned as we move back through the cycle.

MR. RICHARD Q. WENDT: When you were referring to your first chart on the allocation of all the international investments, I was thinking of the impact of multinational companies and whether there is a growth or diminishment of multinationals. For instance, I read just recently that Coca Cola has 80% of its sales outside the United States. And to a certain extent, you could say, therefore, that although it's headquartered in Atlanta, perhaps it has many characteristics of an international company. On the other hand, although we think of Honda as a Japanese company, it is building cars in Ohio, and the United States is a major market for the Honda Corporation. And then in the future, we have the North American Free Trade Act (NAFTA) coming, which may lead to some of the United States corporations putting their plants and facilities in Mexico or elsewhere in North America. Does that confuse some of the issues? If you're buying Coca Cola, are you buying U.S. stock? Or if you're buying Honda, are you buying Japanese stock? How do you take that into account if you do?

MR. GILLMAN: The NAFTA issue is a separate topic. But the role of multinationals is a very valid point. Multinationals are generally exposed to a number of different economies around the world, so it's in their interest to maximize their business and their profits. And, in fact, the U.S. multinationals pioneered international investing decades before the institutional investors moved overseas. Now, when buying the Coca Colas or the Phillip Morrises in the U.S. market, are you getting international diversification? The answer is no. You are in terms of their profit base; but in portfolio terms you aren't. Regarding those statistics that I mentioned about the performance of the international market to the domestic, the Coca Colas and the Phillip Morrises are in the domestic part. The Hondas, the Royal Dutch Shells, and the Unilevers are in the international part.

In practice, I found that the best measure of whether you're getting the diversification is the main center of trading for a particular stock. It is not that relevant as to whether you're seeing Coca Cola with 80% of its sales abroad or Honda with 50% of its sales in the United States. What is relevant is where these companies have

traded, because that's how they act as stocks. Certainly, when you look in a broader sense in terms of the economy, yes a certain percentage of U.S. corporate profits come from overseas and in the aggregate, but that is true also of the British, the Dutch, and the Japanese. I can name Japanese companies other than Honda that have the bulk of their businesses outside Japan. It may not be in the United States, it may be in Hong Kong, it may be in Australia; so one has to deal with the complication worldwide that it's not a nice, neat, easy parcel.

Probably the best way to illustrate this is with Sony. Sony is a Japanese company that is familiar to most U.S. investors, both institutional and individual. Back in the 1960s and 1970s, 40% or more of Sony was owned by U.S. investors. In the late 1960s and during the 1970s, it traded like a Wall Street stock. If you ran correlations of Sony during that period against Tokyo's market and against the Dow, it correlated much more strongly with the U.S. stock market than with Tokyo's stock market. In the mid-1970s, most U.S. holders of Sony sold out. And, in fact, by, I would say, the mid-1980s, Sony's U.S. ownership was down well under 10%. It then traded like a Japanese stock. Recently, there's been a move up in U.S. ownership, and Sony is starting to correlate more strongly with Wall Street again.

So it's a valid point about the economic spread of investments in terms of the global multinationals. But the answer really is, if you're looking at the international markets, you're looking at stocks that are headquartered outside the United States and that trade outside the United States. But the globalization does continue. And as more stocks list on different markets around the world, if indeed the center of trading does tend to move into the U.S., they become more like U.S. stocks. Again, there are companies that I can think of that were foreign stocks five years ago and that are now genuinely U.S. stocks. And the reason for this may be simple. The straw that broke the trader's back was that the chairman decided he liked living in the U.S. more than he liked living in London or wherever, and that was the final move that brought it in as a U.S. company.

Regarding the NAFTA issue, again, the same things apply in terms of Canada, the U.S., and Mexico. The NAFTA issue opens up a broader range of issues, because we get into the trading blocs around the world. And thinking back to that economic map of the world, you have North and South America. NAFTA ultimately may extend, if it does pass, to link up with the South American Free Trade Zone that is currently being built. So there is the Americas trading bloc, the European trading bloc, which has still never come to fruition in the way that the Europeans had hoped, and then there are the emerging Japanese and Chinese regional trading blocs in the Far East. That should not, in terms of impact on international investment, slow things down; in fact, it may well increase the pace. Because, intuitively, if these trading blocs act as they're meant to, which is to promote growth within them as opposed to keeping everybody else out, then that should be good for corporate profits for all concerned.

MR. YUAN CHANG: I wonder if you would comment a little bit more on the globalization of economic forces. I think you made the comment that in the next ten years, perhaps the correlation of the markets will not change – there's no reason why it should change. Maybe it will change over a longer term. What might that longer term be?

MR. GILLMAN: There are two separate issues here, and one is the globalization of the world's economy. And, from that perspective, I do believe that there will be a continuation of these trends. I believe in free trade and I think that, whether NAFTA passes or not, ultimately the economic forces are fairly strong toward globalization of trade. And, again, that should be beneficial for all these economies. It will make it difficult to keep the markets compartmentalized, the Japanese stock market away from the U.K. stock market away from the U.S. stock market.

In practice when we're looking at a U.S. institution that wants to put equity money overseas, the question you've raised is the time horizon. Do we expect the correlations among the different markets to increase soon, so that we get less diversification because of this globalization trend.

My view is that that's unlikely to happen in a five- to ten-year time horizon. The Japanese economy has already globalized. Not necessarily with the U.S., but in terms of its role in Southeast Asia. The Japanese market, as an example, has correlated a lot less strongly with the U.S. and other markets in the last five years than one would expect if the trend toward globalization was going as you suggest. As long as the markets in individual countries are still dominated by investors in that country, then the globalization of economies has a very modest impact. Again, using Japan as an example, the biggest international market, foreign investors controlled about 15-20% of the trading volume in Japan in the early to mid-1980s. Right now, that is probably down to under 5%. The Japanese market correlates very poorly with the United States as a result, and that's at the same time as the Japanese economy has become more globalized.

FROM THE FLOOR: You seem to be uniquely qualified to comment on a pet idea that I have, that the situation of the U.S. is now very similar to the situation of Great Britain after the Napoleonic wars. And I think of even more similarities when I observe that Russia is now ruled by a pro-Western regime for the first time since 1815. How did the British investors do after the Napoleonic wars, and can we learn anything from that era?

MR. GILLMAN: In terms of how British investors did after a major trauma like that, I don't have the statistics on that. But the period of the 1800s into the 1900s was an era when the British and the Dutch were major international investors. In other words, they moved away from their domestic markets that had become mature. They moved into the emerging markets in a big way in that century. And the emerging markets then were not the same emerging markets that exist today. Emerging markets to the 19th century European were such esoteric places as the United States. I'd also bring out the point that 30 years ago Japan was an emerging market, and people who moved in there early did very, very well.

So I think the lesson to be learned is that the world doesn't stand still. Just because the developed markets represent the biggest opportunity in the international markets right now, one shouldn't ignore the emerging markets.

I recently saw a list that showed a "typical" international portfolio. On it were such things as investments in Columbia, Venezuela, emerging Africa, and little bits of the Far East. And the footnote on it said this was a 1902 portfolio. Whether we're

looking at the opportunities in Russia, the opportunities in South America, or at the developed markets, the point is, it's not a good idea to ignore those markets entirely, because somewhere out there are the great opportunities of the 21st century. But besides the emerging markets and their liquidity problems, you also have to face the fact that there are probably some submerging markets on the list. As a reasonably prudent investor, it may make sense to have some exposure to some of these economies, but I wouldn't go overboard, in the sense of trying to put the bulk of international assets into unproven situations. My rule of thumb, for what it's worth, is that I would not invest anywhere I wouldn't go and visit.

FROM THE FLOOR: Barry, particularly in the last five years, there have been a number of articles written and discussion topics even at Society of Actuaries' meetings on international investing, and it's really become one of the items that is in vogue in this country of late. My presumption is that, if this meeting were in London, it wouldn't necessarily be a hot topic, that the European markets have looked at international or global investing as the way to go for a longer period of time. Maybe I'm wrong, but that's the sense I have. In any event, if you were giving this talk to a British group in London, how would you recommend a portfolio configuration that would presumably optimize return given volatility? I assume it wouldn't be 80% U.S. investments and 20% for the rest of the world.

MR. GILLMAN: It would be 80% U.K. investments.

FROM THE FLOOR: Well. Would it be 80-20 U.K., or how would it likely be configured?

MR. GILLMAN: The concept is basically the same. The constraints are a little different. When basing out of the U.K. or any other European country, you have to remember that the domestic market is a much smaller percentage of the world's market caps than when basing out of the U.S. That's one of the reasons why many investors in these countries, have internationalized to a greater degree than the U.S. The domestic opportunity set is small, even if "domestic" includes all of Europe. Having said that, I think maybe people give too much credence to the internationalization, the sophistication of other investment centers. Having lived in the U.S. now for 15 years, I've always sensed a certain defensiveness by the U.S. financial community. "All these internationalists have been doing this for years and years, they must be streets ahead of us." Well, the answer is, they really aren't. Having grown up in the financial community in London in the 1970s, I was continually amazed as an internationalist in that context at the high proportion of the investment community in the U.K. that was focused on the U.K. only. It didn't want to accept the idea or it was uncomfortable with the idea of investing internationally, whether it was in the U.S. or in Japan. If you go to Switzerland, for example, as opposed to London, you still find that the proportion that's invested outside Europe is relatively small, because they don't feel comfortable with the volatility in the Far East. They're more comfortable with Germanic Europe and maybe the U.K.

In some countries there are legal constraints on certain, investors and in others such as the U.K., its a conceptual constraint. The people do not feel comfortable having more than a certain percentage outside their home country. And it has nothing to do with the risk-return study or the asset-allocation studies where the numbers show up.

If the foreign market is small, the comfort level tends to be higher. I would say the U.K. is typically in the region of a 25-30% maximum comfort level in terms of overseas assets. But you see the same pressures at a U.K. board meeting or at a trustees' meeting as you would see here. And you get the same questions raised on patriotism, currency, and risk that you would here. Those countries are nearer a "mature" level of exposure. The funds flow here in the U.S. is still moving up the curve toward that comfort level, which I would guess is going to end up somewhere in the region of 15-20%.

FROM THE FLOOR: Do you foresee the ultimate development or perhaps acceptance of a purely global equity benchmark? We now look at returns generally in this country in the context of a domestic market return, such as the S&P 500, or we look at international investments versus EAFE. Do you foresee the development of a return index that would presumably look at a market-cap-weighted or some purely global benchmark that, if used to measure returns, might bring more of a market-weighted portfolio mix into portfolios?

MR. GILLMAN: I think some have already moved in that direction. The idea of global investing, that instead of having a U.S. portfolio and an international portfolio, you really should think totally globally, is a great concept. It's been a good theory put forth for the 15 years that I've been working with U.S. institutions, but it's never actually come to reality, with a few exceptions. I suspect that for the foreseeable future we're still in a business that will separate the domestic from the international, and it will be a rare fund that goes truly global.

I think that "comfort level" has something to do with it. It's almost like stepping off into the unknown, having had a domestic benchmark, certainly with a domestic liability structure, for all one's history to say, "Well, this is a nice global concept; we'll go with it in the future." If you go to the world's market cap in an equity portfolio you're going from zero in Japan as your neutral weighing to an index that then has almost a third of the world's market cap in Japan, that's a big jump for most people. It may be something that occurs gradually, but I would not expect it to happen before the end of the century.

MR. ANTHONY J. ZEPPETELLA: Once you decide to invest internationally, in international equity markets, I know the decision to be made is kind of deciding between active management and indexing of some sort. One of your charts gave some information on that, and I have a question on its interpretation. You show that the international equity managers differed from the index returns by about 4%. Was that a standard deviation, or is it a 4% excess average return?

MR. GILLMAN: That calculation is very straightforward. I took every quarter of the last 20 years, the difference between the average manager and the index, and just took the absolute value as I totaled it out, and I took the average.

MR. ZEPPETELLA: Could you comment on the indexing of international investments versus active management? Is there any information on comparative returns?

MR. GILLMAN: Again, following on from that variability, one of the characteristics of indexing versus active management internationally is that most managers tend not to be close to the index. If you're measuring against an index for any given period, they either look extremely smart or extremely stupid. The EAFE index tends to be at the top of the first quartile or at the bottom of the fourth quartile in a number of periods.

Does that mean that we in the international investment community generally just blank out and act very, very dumb for years at a time, then suddenly smarten up? No, it's a characteristic of the market.

What it does do though is suggest to the bulk of our clients, the plan-sponsor community, that after two or three years in which active managers have underperformed the index as a group, we had better switch to being passive. In fact, in the 1970s to the mid-1980s, more often than not, the international management community beat the index by a handy margin. It was considered an easy index to beat.

It was an easy index to beat, to get a little technical for a minute, because Japan represented at that time, about a third of the index. About a third of the Japanese market was literally not tradable. Some big banks never traded but represented a big chunk of the market cap of the index. These stocks underperformed. Everything else was going up, but they never did anything. You couldn't own them, so you didn't own them, therefore you beat the index. Everything else you did was kind of peripheral. Nobody noticed that for about 15 years. Most of the clients accept what the managers tell them. We're smart guys, we beat the index.

Suddenly there was a period of time, I think it was from 1984 to 1987, when everybody got dumb. What happened was that these banks that nobody could own and that were a big chunk of the index doubled. Nobody owned them, you couldn't get into them, you lost ground to the index, and suddenly everybody was dumb.

And by the end of that period right before the crash, which also dropped active managers in general behind the index again, the client community was saying, "Well, these guys were so smart in the 1970s and early 1980s and they're all dumb now; we're going to have to index because that's the only way to keep up with the market." And that was also getting close to the Japanese market peak. If you were indexing, two-thirds of your assets were going into the Japanese stocks. At least from that perspective you could own the Japanese bank stocks by then, after they had gone up dramatically.

Then there was about a four-year period in which international managers in general beat the index again. And so we went through a period in which indexing went from zero to about 25% of international assets by the late 1980s. It then stabilized as people started to move back more toward active management.

The moral of this story is very clear. You don't make those active/passive decisions, in my view, on the basis of whether the active managers have beaten the index recently. The validity of indexing internationally is that if you have really big funds to go international, and liquidity is a real problem, then indexing makes sense. But you have to choose your index very carefully, and it should not necessarily be the standard international index.