GRAYISSUE

Can a share be geographically undesirable?

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Investors looking to benefit from offshore diversification of their investment often intuitively choose to allocate capital to countries with rapidly growing economies, hoping that this will translate into high returns on their investment. However, research shows that stock market returns are, in fact, not correlated to a country's economic growth. Instead, returns are determined by current valuation levels and underlying growth prospects, and therefore may often be found in the countries with slower growing or struggling economies, usually overlooked by investors.

How relevant is country exposure?

Perhaps rather than trying to obtain a precise view on country exposure, the more relevant question is whether investors can use information on country exposure to determine the ability of a share, portfolio or index to outperform over time. We do not believe they can. The reality is that economic data such as GDP growth has little predictive power for equity returns – and this is why we are not proponents of the 'top down' approach to investing, which first looks at the broader economic picture.

In fact, while shares in countries with higher rates of economic growth tend to become overvalued as a result of higher investor expectations, often shares in countries with slower growth tend to be ignored by the crowd and thus offer better value for money. The graph illustrates this, showing that the countries that delivered the highest real equity returns were not the ones with the most impressive GDP growth rates.

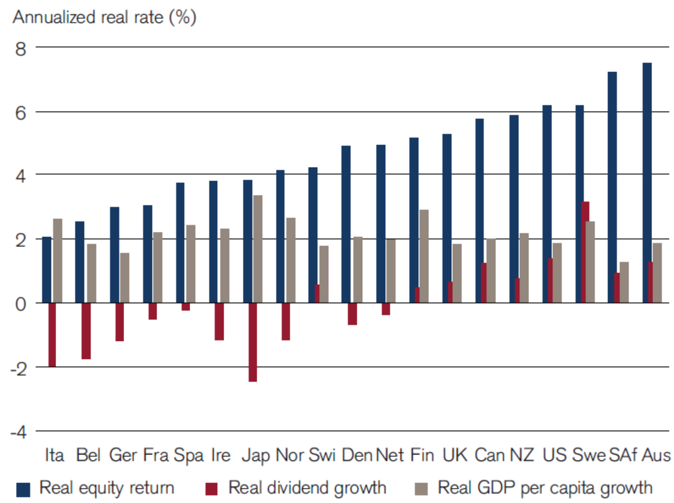
Look at South Africa over the past 12 years. Over this period, GDP has grown at a rate of 8.5% per year in nominal terms and roughly 2.7% in real terms. But 12 years ago, corporate earnings and the valuations on South African shares were so depressed that the market was able to generate fantastic returns in a modest economic growth environment.

The Japan question

Take Japan as the most topical example. We agree that the country faces enormous challenges in the years to come. To say nothing of the devastation caused by the 11 March earthquake and tsunami, Japan is struggling with an ageing population and a government debt burden that is one of the worst in the world at 200% of GDP, making it an unpopular investment choice.

Returns, dividends, and GDP growth, 1900–2009

Source: Dimson, Marsh, Staunton, Triumph of the Optimists; authors' updates



But that does not mean we cannot find compelling investment opportunities in the world's third-largest economy. In fact, analysts at our offshore partner Orbis have identified a number of individual Japanese companies that can do well despite the macroeconomic challenges the country faces.

Where is revenue generated?

Companies are not immune to local market dynamics. If sentiment towards a particular country changes, as has happened with Japan, in the short term it is typical to see most shares behave in a similar fashion. But in the long run, it is a company's ability to generate earnings and dividends that will ultimately determine its value. And this is increasingly influenced by what happens globally.

It is important to remember that a company's stock market listing is no longer a reliable indication of where it generates its revenue and profits. Thanks to the globalisation of economies and financial markets, it is not uncommon for global businesses to derive a substantial portion of their revenue and profits from outside their home market.

Ultimately, we believe that the price you pay – the valuation – plays a far more important role in determining returns than simply looking at country exposure.

Commentary by Chris du Toit, Allan Gray