Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

An Eye Offshore

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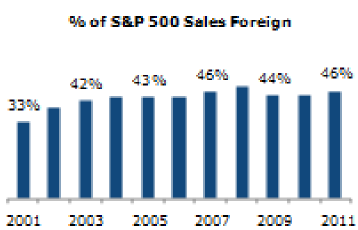
Daily investment headlines are rife with news and opinions about what is happening in Europe or China. Fifteen years ago U.S. investors paid little attention to what was transpiring 'Across the Pond' or in the 'Middle Kingdom'. Most had little overseas investment and domestic stocks were largely considered tied to the domestic economy. The world has certainly changed. Not only are portfolios more geographically diversified, but U.S. traded company earnings have gone global. It is estimated that less than 25% of S&P 500 sales in 1990 came from outside our borders, compared to Standard and Poors' current estimate of more than 45% of sales originating offshore in 2011. Companies still do not have a standard or requirement on reporting geographic sales, so this is still only an estimate from available data but the trend is clear. U.S. companies' international sales have become a significant part of their business model.



With this evolution, fundamental analysis of companies has also become a global exercise that only starts with understanding how much of a company's sales come from which geographic regions. Analysis now has to include questions like;

1. What region are they depending on for growth?
2. Are their competitors new or old?
3. Is geography an advantage or disadvantage?
3. Are these economies accelerating/ decelerating and why?
4. Are costs denominated in U.S. dollars or the sales currency?
5. Are currency fluctuations hedged?

While it once was sufficient to understand the dynamics of the U.S. economy, now it is necessary to analyze trends in major markets like Europe and Asia. Many companies with little opportunity for domestic sales growth are looking to emerging markets for growth. Fiscal and monetary policy in Brazil takes on more importance, as does the IFO business sentiment index in Germany. It becomes more critical to understand the impact of the mass migration from the farm to the city of a population four times our size—does it fill an empty apartment block or is it a sign of impending doom? The morning economic news feed has grown to include 'what was reported last night' in addition to 'what is going to be reported' in the U.S. today.

Earnings reports have become more complex. It is common for companies to discuss acceleration or deceleration in Asia or Latin America because that is where their growth is occurring. They often talk about the FX effect on earnings. The net change in sales denominated in a different currency is a combination of the change in volume times the change in the sales currency relative to the USD. The detail of an earnings report can tell a different story than the headline.

Competitive analysis has also evolved. A weaker U.S. dollar means a product produced in the U.S. is cheaper for a foreign buyer and vice versa. But consumer behavior and tastes are also different in a foreign market. So a judgment must be applied to how well a U.S. strategy will adapt to a new environment. Competitors in Europe or Australia can be different than those in the U.S. Analysts need to understand the competition that a company like Kraft has from not only General Mills or Kellog, but also Nestle, Unilever, and Indofoods. The basic competitive analysis has not changed but it has more moving parts.

Cost analysis is also more multi-faceted. Whether a company produces products in the U.S. or some other country for distribution overseas has a big impact on margins and reported earnings. Input prices for power, wages, and commodities delivered in Indonesia are very different from Indiana. We have already mentioned currency impacts for reporting, but longer term companies have to decide where the best place to locate production is and currency plays a large role in that decision. Wage growth does as well. The Yuan exchange rate is a frequent political target. But little attention is paid to the wage and input inflation occurring in China, which has a much bigger impact on costs than appreciation in the currency. If you add these inputs to Yuan appreciation it is becoming a more difficult decision for companies to locate in China. There is also something to be said for moving production closer to a growing group of consumers in Asia and Latin America. Production denominated in the same currency as sales also serves as a hedge to help maintain margins. The more spread out sales become, the more production considerations come into play, which leads to greater moving parts in cost analysis.

In the U.S., 'globalization' tends to be associated with outsourcing production for products sold in the U.S. However, many of our companies are globalizing in many other ways by tapping into new sources of revenue. As investment professionals, our scope of understanding and analysis is growing with the companies we invest in.