

Thematic Investment Strategies

A New and Sustainable Approach To International Investing

The creation of the World Trade Organization, a unified Europe and the elimination of countless trade barriers have changed the way business is conducted. Companies in developed countries now must compete on a global basis. Sony sells more televisions in Europe and the rest of Asia than it does in Japan. Nokia phones are available near the Eiffel Tower, the Empire State Building and Red Square.

As barriers have fallen, the factors that most affect how companies are valued have also changed. The performance of the currency and the stock market in a company's native country historically were often overriding factors affecting the company's stock price. Today, where a company is headquartered is far less important than its ability to respond to rapidly changing global markets.

International investing is likewise changing as the world's economy globalizes. Successful investors will be able to identify companies that can capitalize on broad changes sweeping across countries. Investment strategies whose success relies primarily on country selection will become obsolete.

Thematic Investing

New Ways of Looking at International Investing

Thematic investing is an innovative strategy utilized by only a handful of money managers that takes advantage of the increasing globalization of markets. It relies on a blend of macro-economic and traditional fundamental analysis to target companies that will most benefit from the technological, structural and regulatory changes reshaping the world economy.

The first part of a thematic investment process is a top-down analysis that examines broad structural changes currently disrupting industries and economies. These changes range from the deregulation of industries, such as telecommunications and transportation, to demographic changes and technology developments. Different forces sometimes overlap in how they impact industries and economies and each major factor is often accompanied by micro factors. The goal is to understand how the confluence of these forces will change the basis for competing in certain markets and industries.

Thematic Investment Process

- ▶ Identify changes that will fundamentally alter the structure of economies and industries
- ▶ Analyze and understand the implication of these changes
- ▶ Develop investment themes that target industries most positively affected by the changes
- ▶ Identify companies in those industries best positioned to capitalize on the changes
- ▶ Build a portfolio of those companies with stock prices that do not yet reflect their potential

Case Study: WPP Group PLC

PART 1

Broad Structural Change

Introduction of Competition to Previously Closed Markets for Consumer Goods

The reduction of trade barriers, improvements in technology and better access to information is giving consumers more choices and the ability to better compare alternatives when purchasing a wide variety of products. One implication of this change is that consumer product companies that have historically dominated closed local markets such as Germany, France and Japan now face increasing competition for their core client bases.

Investment Themes

Filters Used to Narrow Universe of Possible Investments

Once a structural change and its implications have been identified, each of the trends and factors and how they interact are analyzed. The goal of this stage is to develop investment themes that summarize the new economic environment in the different markets and industries. A theme in essence acts as a filter, narrowing the universe of possible investments down to a manageable number of stocks that can be closely examined.

Fundamental Analysis

The Final Filter for Building a Portfolio

The final part of a thematic investment process is designed to identify companies that are best positioned to benefit from macro-economic changes. It employs fundamental analysis and considers factors such as stock price, management quality and vision, brand name and business strategy.

This stage has a two-part goal. First, it seeks to identify organizations with market position, experience and strategy that will allow them to capitalize on the broad macro-economic changes and substantially grow earnings. Second, it seeks out those companies with stock prices that do not yet reflect this potential for accelerated earnings growth.

Case Study: WPP Group PLC

PART 2

Investment Theme

Branding & Promotion

Expanded competition is forcing many consumer goods companies, for the first time, to focus on the importance of brand name in their home markets. At the same time foreign companies trying to penetrate these markets also need to develop brand recognition with consumers. But building and maintaining brand recognition in a competitive environment can be very costly and requires large investments in a variety of activities. A broad investment theme emerging from these changes is to look for industries most likely to benefit from these large potential expenditures.

A group of companies well positioned to benefit from this race to build and maintain brand names are advertising agencies. If they follow strategies similar to those in the U.S. market, large consumer goods companies will conduct broad television and radio advertising campaigns in Europe and Asia that will cost hundreds of millions of dollars.

The enormous size of these advertising campaigns creates an outstanding opportunity for many ad agencies because their compensation is based on a percentage of the total dollars spent on clients' advertising campaigns. As a result, ad agencies need only capture a few major new accounts to substantially increase their profits.

PART 3

Fundamental Analysis

In early 1998, WPP Group was an advertising agency particularly well positioned to capitalize on the race to build brand names in many European and Asian countries. It had transformed itself during the mid-1990s from a British firm focusing almost exclusively on the United Kingdom into one of the world's largest communications groups. It now has more than 300 of the Fortune Global 500 companies as clients. Its 33,000 employees work out of 950 offices in 92 countries.¹

WPP has also recently acquired two prominent U.S.-based marketing firms, B/W/R Public Relations, the country's largest independent entertainment public relations firm, and Feinstein Kean Partners, a leading biotechnology marketing firm.² WPP has done an excellent job of assimilating its acquisitions into the company mold, yet allowing them to continue to operate in an entrepreneurial fashion.

While WPP is a dominant firm in its industry, its stock price languished until recently. Many investors viewed advertising agencies as cyclical in nature and failed to recognize WPP's potential for tremendous earnings growth. Thematic investors who recognized this potential benefited as the stock price rose 246% from January 1998 to November 1999, compared to 26.3% for the Small Cap EAFE Index.

Structural Change

Aging Populations and Unfunded Pension Systems

Many countries in Europe and Asia are facing potential crises because of their rapidly aging populations and a lack of privately funded pensions. These governments have promised their citizens pensions with benefits far more generous than those currently paid by the U.S. Social Security System to its participants. These countries, however, rely on “pay-as-you-go” pension systems that have no assets set aside to meet future pension obligations.

While many individuals are entitled to supplemental pensions from their employers, these projected benefits are substantially less than those provided by the government to retirees. As the number of retirees increases dramatically during the next 10 to 15 years, many of these governments will lack the financial resources to continue to pay the same level of retirement benefits.

Investment Theme

Individual Retirement Planning

This looming pension crisis has not gone unnoticed by citizens in many European and Asian countries. They recognize that they will need to individually finance a portion of their retirements if they hope to maintain their current standard of living. As more citizens of these countries assume responsibility for financing their retirements, the demand for a variety of services will likewise increase. An investment theme resulting from the looming pension crisis is to seek out industries that will be able to best provide the services needed by these consumers.

Fundamental Analysis

Industries such as investment management, brokerage, and insurance will directly benefit from the increased demand for individual pension planning in Europe. Skandia Insurance is Sweden's largest financial services and insurance company and is particularly well-positioned to capitalize on these changes. It transformed itself during the past five years from strictly an insurance company into a global asset management and financial services company. It has also developed the ability to distribute products to consumers throughout Europe and Asia with operations in 24 countries.⁴

Management has focused the company solely on savings-related businesses, and made a large investment in expanding its sales force in an attempt to capture even greater market share of retirees' business. A recent study by the Dow Jones Sustainability Group Index named Skandia the best large insurance company in the world, an award that was based upon the company's ability to focus on sustainable growth and increase shareholder value.⁵

Skandia's stock price didn't reflect its true value in early 1998 because the market failed to recognize its shift from an insurance company to a full-service financial services organization and its strong position to capture individual retirement planning business. Although it had an earnings growth rate much greater than most of its competitors, its PE ratio was relatively low.

Thematic investors recognized Skandia's potential and have benefited considerably as the stock price increased almost 161% from January 1998 to November 1999, while the EAFE Index increased only 39.5%.

Thematic Investment Strategies Are More Sustainable Than Many Traditional Approaches to International Investing

Unlike most traditional approaches to international investing, country selection (and thus currency) plays only a minor role in a thematic investment process. It instead seeks out companies that will benefit from broad structural changes that alter the competitive landscape across countries and industries.

This natural diversification and lack of dependence upon country selection for performance is a particular strength of thematic investment processes when compared with most traditional international investing strategies. As shown in the table below, the investment returns of individual countries are increasingly correlating with one another.

Monthly Correlation of Returns Between Countries Increasing³

	Germany		United Kingdom		Japan		Australia	
	10/93 - 9/96	10/96 - 9/99	10/93 - 9/96	10/96 - 9/99	10/93-9/96	10/96-9/99	10/93-9/96	10/96-9/99
Germany	—	—	0.51	0.61	0.05	0.30	0.42	0.59
U.K.	0.51	0.61	—	—	0.34	0.44	0.62	0.69
Japan	0.05	0.30	0.34	0.44	—	—	0.48	0.64
Australia	0.42	0.59	0.62	0.69	0.48	0.64	—	—

The correlation between German and British stocks increased from 0.51 during the period from October 1993 to September 1996 to 0.61 from October 1996 to September 1999. The correlation between Japan and Australia increased from 0.48 to 0.64 during the same time periods. What happens in England now has a greater impact on Germany. What happens in Germany now has a greater impact on Japan and the rest of the world.

Over the long term, the continued shift towards a global economy will likely mean that the correlation of investment returns between stock markets in different countries will further increase. As a result, the stock market and currency of a company's native country will have even less relevance to the performance of its stock price than they do today. Investment managers who continue to rely largely on country selection in their investment processes will have a difficult time adding value while international strategies that look across countries and currencies should be far more sustainable.

Summary

International investing has changed dramatically during the past decade. It has become more popular, more efficient and is considered an integral element of most asset allocation strategies. It has also become an area in which it is much more difficult to generate superior performance.

Most traditional international investment strategies rely on selecting countries with stock markets and currencies that will perform best over the next couple of years. As the world economy becomes increasingly global in nature, these strategies will rapidly become obsolete.

Thematic strategies, by comparison, are designed for our increasingly global and changing world. They capitalize on changes that cut across industries and countries and will only benefit from the continued globalization of the world's economy.

^{1,2}Source: WPP Website.

³Source: Standard & Poor's MicroPal; data based on the returns of Morgan Stanley indices that represent each country.

^{4,5}Source: Skandia Website.

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