ABSTRACT

As the line between domestic and international equities continues to blur, a case can be made to implement public equity allocations through global mandates. This paper will examine the potential benefits and risks of global equity mandates, as well as the historical data comparing the global equity investment approach to the more traditional domestic/international split. We will also discuss the implementation process and the importance of selecting suitable managers.

INTRODUCTION

For years, consultants and institutional investors have taken more narrowly focused approaches to asset allocation and manager implementation. This is beneficial if the increased specialization increases a manager's ability to add value. If this is not the case, or is no longer the case, the benefits of "increased specialization" become the negative effects of "overly constrained."

The key to maximizing efficiency is figuring out which constraints are useful, and which are unnecessary. Further complicating this decision is the fact that appropriate constraints can change over time and may depend on the skill set of a particular manager. This paper will attempt to explain why this dynamic may be changing in public equities, and why the past benefits of specializing in domestic or international equities may now act as unnecessary constraints that limit the ability of some managers to add value.

INTERNATIONAL DIVERSIFICATION

Historically, there has been a demonstrable diversification benefit to complementing a domestic portfolio with international stocks, but this benefit has materially declined over the past decade, as is illustrated by the following chart. There are a number of plausible explanations for the increasing correlation among world equity markets, ranging from the globalization of trade to the opening of capital accounts (i.e., countries allowing increased levels of foreign investment.)

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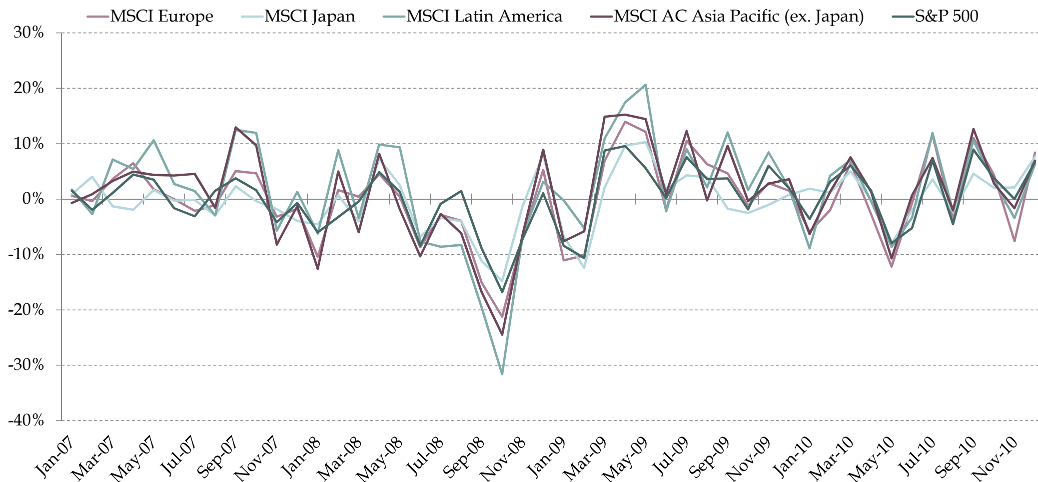
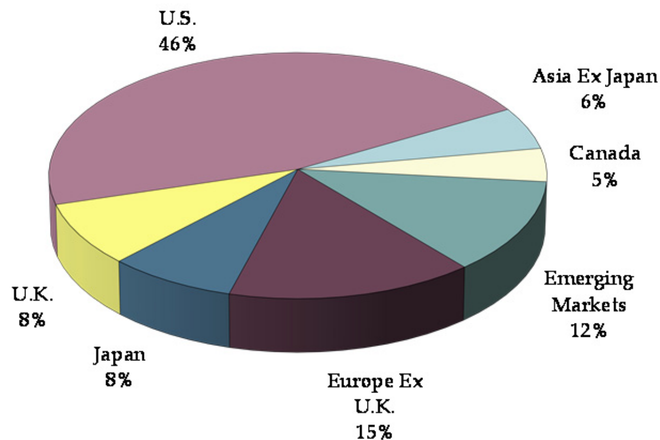
Furthermore, the benefit of international diversification for U.S. investors decreased when it was most needed. Negative economic shocks tend to drive correlations across asset classes up, particularly in regional equity markets. The most obvious example is the Global Financial Crisis, when the already increasing correlations among global equities spiked even higher (see the following chart).

Monthly Returns of Regional Equity Markets
2007 - 2010



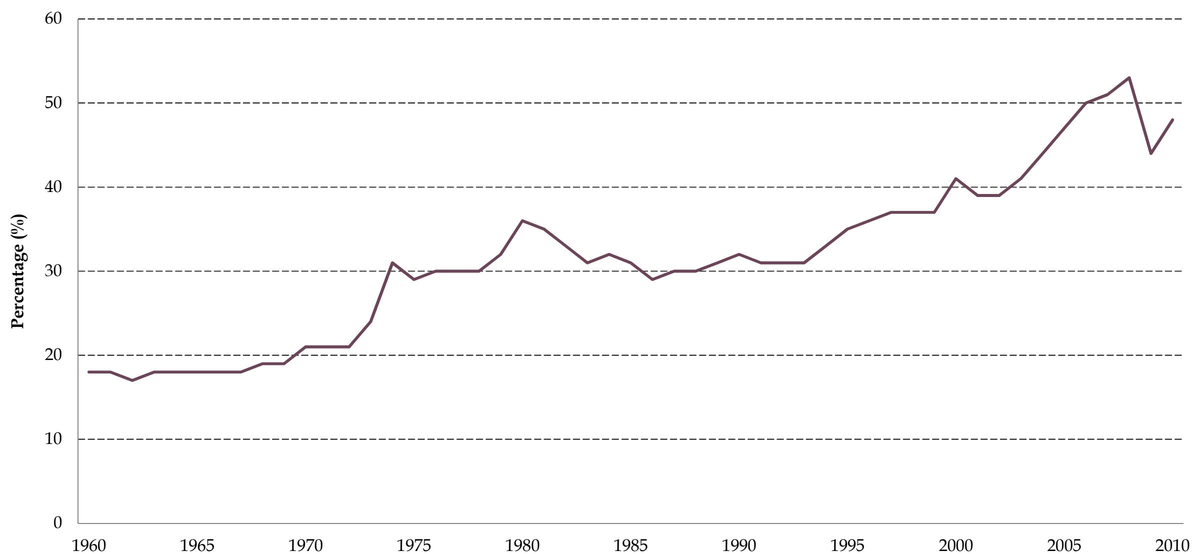
If the diversification benefits of investing overseas are no longer compelling, one potential reaction would be to question the value of investing in international equities at all. Doing so, however, would severely constrain a plan sponsor's opportunity set as it would eliminate over half of the world's public companies from consideration (see the following chart).

MSCI All Country World Index
Regional Weights as of June 2012



IT'S A GLOBAL WORLD

As trade and commerce have become more globalized, many companies have become "domestic" or "international" by domicile only. For example, roughly 46% of the revenues of companies in the S&P 500 came from overseas in 2010[1]. Similarly, 44% of European company profits came from outside Europe[2]. If regional barriers have collapsed in the business world, perhaps they should recede in the investment world. If domestic and international companies are direct competitors for customers, should they not be viewed as direct competitors for investors' capital?



OVERLY CONSTRAINED?

While the result of holding separate domestic and international equity strategies is effectively a global portfolio, it may be less efficient than an approach that allows portfolio managers to invest in the best companies across the globe. Regionally constrained managers may invest in lower conviction ideas to build diversified portfolios, even though more attractive stocks may be available outside of their region. A narrowly-focused manager may lack the broader perspective needed to realize that some investments are not truly "world class" companies or are not attractively valued relative to stocks elsewhere.

To illustrate this concept in a hypothetical example, imagine that a domestic equity manager is analyzing banks for potential inclusion in a portfolio. To diversify, the manager buys four U.S. banks. In this case, however, the fourth most attractive bank in the U.S. is only the 40th most attractive bank in the world. Because the manager is constrained to only U.S. securities,

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1 Source: Standard & Poor's.
2 Source: Citigroup.

the 40th best bank finds its way into the portfolio, in the process bypassing numbers 5 through 39, representing a potential opportunity cost.

AN ALTERNATIVE APPROACH

Global equity mandates remove the barriers of regional constraints and, ideally, allow investors to benefit from the best investment opportunities regardless of a company's country of domicile. This allows for a more efficient and timely flow of capital to the best investment opportunities, be they in specific companies, sectors, or regions. With regional mandates, a plan sponsor's ability to exploit investment opportunities in a timely fashion may be somewhat constrained. Moving capital from the domestic equity market to international markets, for example, must be done at the asset class level, as opposed to targeting specific companies. Furthermore, many plan sponsors have a governance and decision-making structure that may result in an implementation lag that offsets the benefits of identifying the opportunity.

The potential benefits of a global equity mandate can only be realized if managers can be identified with the experience, skills, and resources necessary to analyze and compare companies across the globe. Fortunately, advancements in the availability of information in recent years have arguably made it less important for portfolio managers to have "on the ground" presences in each country in which they invest. This has significantly increased the number of investment teams with the ability to execute global equity portfolios, and it has provided broader opportunity sets for investors seeking to implement global mandates.

In examining broad manager universe performance, there is some statistical evidence that the added freedom provided in a global equity mandate improved returns. As of June 30, 2012, the median manager in the eVestment Alliance Global Large Cap universe produced a greater excess return over the respective benchmark than the median manager in either the Foreign Large Cap or U.S. Large Cap universes over the past ten years (see the following table).[3] The top and bottom quartile manager returns are also superior for global equity managers, when compared to their international and domestic counterparts. Furthermore, the spread between the top and bottom quartiles is significantly larger for the Global Large Cap universe, suggesting that global mandates provide active managers with the opportunity (although not the certainty) to add more value.

10 Year Excess Returns by Manager Universe[4]

	Global Large Cap	Foreign Large Cap	U.S. Large Cap
25th Percentile	3.9%	2.0%	2.1%
Median	1.7	1.1	1.1
75th Percentile	0.5	0.2	0.2
# of funds	95	131	774

[3] Source: eVestment Alliance. Excess returns are presented before fees. The Global Large Cap universe returns are benchmarked to the MSCI World index, the Foreign Large Cap returns to the MSCI EAFE index, and the U.S. Large Cap returns to the S&P 500.

[4] Source: eVestment Alliance, gross of fees, as of June 30, 2012.

As discussed further in the Appendix, a similar pattern holds over different time periods, and for different manager databases. While analysis of any peer group contains survivorship bias and other data issues, a peer universe of nearly 100 global equity managers with ten years of performance history is relatively robust. Furthermore, comparing across peer groups within the same database may serve to normalize any data integrity issues.

OTHER CONSIDERATIONS

Any analysis of excess returns must consider the benchmark. For global equities, the most widely-used benchmarks are the MSCI World index and the MSCI All Country World index (ACWI). The main difference is that the former encompasses developed markets only, while the latter also includes emerging markets. Thus, a given manager's propensity to invest in emerging markets should be the main determinant of which benchmark is used. While historical positioning can be a valuable guide, it is also instructive to get a clear sense of the manager's true investable universe. For example, a manager may have historically held a low weighting to emerging market stocks due to risk or valuation concerns, but that allocation may rise significantly if those concerns subside. As a reference, the MSCI ACWI index included approximately 12% emerging market stocks as of June 30, 2012.

Manager fees must also be considered. In the eVestment Alliance database, the separate account fees for a $50 million mandate are very similar for the Global Large Cap peer universe and for the International Large Cap universe. In fact, the top quartile, median, and bottom quartile fees are identical (see the following table).

Separate Account Fees by Manager Universe[5]

	Global Large Cap	Foreign Large Cap	U.S. Large Cap
25th Percentile	0.62%	0.62%	0.52%
Median	0.70	0.70	0.58
75th Percentile	0.75	0.75	0.65
# of funds	185	147	953

As expected, both are materially higher than the fee that would be charged by a comparable U.S. Large Cap manager. Broad generalizations of management fees are difficult to make, however, as they require various assumptions and, in this case, use only the managers' reported fee schedule (i.e., they do not assume any negotiation of fees). Custody costs are also higher for global and foreign mandates than they are for domestic mandates.

POTENTIAL RISKS

A move towards global equity mandates is not without risks. For one, investors cede what has historically been a major asset allocation decision (i.e., the domestic versus international equity weighting) to the underlying global equity managers. If investors exclusively use global managers, they can no longer deliberately overweight the United States or

[5] Source: eVestment Alliance, as of June 30, 2012.

underweight Europe, for example. But increased globalization has rendered the ability to overweight or underweight regional economies much less precise. Overweighting "the United States' economy" and overweighting "U.S.-based companies" have different meanings today. Still, investors who want to maintain dedicated exposure to a certain region can combine global and regional managers.

Manager research takes on heightened importance when moving towards global equity mandates. Some managers have launched global equity strategies in recent years to respond to increasing client demand. Many managers who run global equity portfolios are, in fact, poorly equipped to do so. Many global equity strategies today are the result of a domestic equity manager or international equity manager looking to expand their opportunity set and/or their client base. Unfortunately, the skills and experience that allowed them to be successful within their original opportunity set may not translate to the rest of the world. Furthermore, broadening the investable universe without adding resources may dilute a manager's research efforts.

Some managers have created global equity strategies by simply combining existing domestic and international portfolios. While the result is technically a global strategy, this approach fails to utilize the added freedom that a truly integrated global effort would provide. As both portfolios are essentially built in isolation, there is no real added benefit to combining them. Finally, just as the broader opportunity set enables skilled managers to add more value, it also allows sub-par managers to detract more value. For example, due to the breadth of their opportunity set, global equity managers are more likely to be significantly underweight in certain areas of the market (e.g., European small cap stocks). Ultimately, the skill of the manager involved will determine whether these underweight areas prove to be helpful or harmful.

CONCLUSION

Global equity mandates remove the barriers of regional constraints and, ideally, allow investors to benefit from the best investment opportunities in the global stock market. They promote a more timely flow of funds to the most attractive investment opportunities wherever they occur in the world. The historical performance for global equity managers supports the thesis that they have been able to more successfully exploit their investment universe than have domestic or foreign-only equity managers.

Increased globalization has made global equity mandates more relevant, and the speed and flow of information around the world has made their execution more feasible. Managers with the ability to manage a truly global portfolio do exist, but the added degrees of freedom require a heightened level of scrutiny from a due diligence perspective. Assuming a suitable manager can be identified, and the plan sponsor is comfortable delegating certain strategic decisions, global equity mandates can be a valuable part of a public equity allocation.

APPENDIX

In this appendix we seek to provide a more robust analysis of the performance of global equity managers vs. their domestic and international peers. Since any one observation in time may be subject to endpoint bias, we examined several trailing periods. In addition, we looked at multiple databases to determine if a bias in any one database was providing a skewed picture of the data. We used the Global Large Cap, Foreign Large Cap, and U.S. Large Cap manager universes within the eVestment Alliance and Morningstar Direct databases.

The following table examines three separate, but over-lapping, trailing ten-year periods using the Morningstar Direct databases. The data supports the results presented earlier in this paper, namely, that global equity managers have historically produced superior excess returns relative to their domestic and foreign-only counterparts.

10-Year Excess Returns by the Median Manager[6]

	Global Large Cap	Foreign Large Cap	U.S. Large Cap
As of 12/31/11	2.7%	1.5%	0.8%
As of 12/31/10	3.4%	1.8%	1.4%
As of 12/31/09	3.5%	1.8%	2.5%
Average # of funds	257	144	912

While longer-term time periods are generally preferable when analyzing performance, there is a greater risk of survivorship bias impacting the data. In order to estimate how much bias may be present in the manager universe, we first examine the "drop-out" rate of managers. This rate (see the following table) measures the percentage of managers in existence at the beginning of the measurement period that subsequently dropped out of the universe.

"Drop-out" Rate by Manager Universe[7]

	Global Large Cap	Foreign Large Cap	U.S. Large Cap
As of 12/31/11	18%	26%	21%
As of 12/31/10	20%	30%	21%
As of 12/31/09	22%	31%	21%

Both intuition and past research[8] imply that the majority of managers who dropped out of a universe were underperforming. Hence, their exclusion upwardly biases the results relative to what an investor in the median fund would truly have received. Further, the greater the interquartile spread (i.e., the difference in return between outperforming and underperforming managers), the greater this survivor bias is likely to be. Hence, we make a simple calculation that multiplies the drop-out rate by the interquartile spread to arrive at a very rough estimate of survivor bias (see the following table). This basic calculation implies

[6] Source: Morningstar Direct, gross of fees.
[7] Source: Morningstar Direct.
[8] See "Mutual Fund Survivorship" by Cahart, et al (2001), and "Survivor Bias and Improper Measurement" by Barrett and Brodeski (2006).

that the global equity universe may have somewhat less survivor bias than the other two universes.

Estimate of Survivor Bias by Manager Universe[9]

Global Large Cap	Foreign Large Cap	U.S. Large Cap
0.6%	0.9%	0.7%

Another important factor that will impact the excess returns is the choice of benchmark for global and foreign equity strategies. The tables shown above reflect excess returns vs. benchmarks that include developed markets only (MSCI World for global and MSCI EAFE for foreign). As the performance of emerging markets has outpaced that of developed markets in recent years, many active managers have sought to beat their benchmarks by allocating a portion of their portfolios to emerging markets. While it is not possible to quantify the exact impact of this effect across the full range of managers, it is nonetheless a useful exercise to also compare the returns of the manager universe to benchmarks that include emerging markets.

The tables below show the same manager universe excess returns, with the benchmark for global equity managers changed from the MSCI World index to the MSCI All Country World index, and the benchmark for foreign equity managers changed from the MSCI EAFE index to the MSCI All Country World ex-US index.

10 Year Excess Returns by Manager Universe[10]
(Includes Emerging Markets in Non-US Benchmarks)

	Global Large Cap	Foreign Large Cap	U.S. Large Cap
25th Percentile	3.3	0.4	2.1
Median	1.1	-0.5	1.1
75th Percentile	-0.2	-1.4	0.2
# of funds	95	131	774

10-Year Excess Returns by the Median Manager[11]
(Includes Emerging Markets in Non-US Benchmarks)

	Global Large Cap	Foreign Large Cap	U.S. Large Cap
As of 12/31/11	2.1%	-0.2%	0.8%
As of 12/31/10	2.5%	-0.3%	1.4%
As of 12/31/09	2.8%	0.2%	2.5%

Even when including emerging markets in the benchmark, the median global equity manager has fared better than the median foreign equity manager over the trailing ten years,

[9] Source: Morningstar Direct.
[10] Source: eVestment Alliance as of 6/30/12, gross of fees.
[11] Source: Morningstar Direct, gross of fees.

while faring the same or better than the median domestic equity manager. For some added perspective, the emerging markets weighting in the MSCI All Country World index was 12% as of June 30, 2012. While it has certainly increased in recent years, this number likely exceeds the emerging markets allocation of many of the global managers shown above. Thus, the true excess return of global equity managers most likely lies between the excess returns versus the two benchmarks shown above (i.e., between 1% and 3%, before fees).

To reiterate, there are a number of potential data integrity issues when examining performance across hundreds of managers. However, the historical evidence implies that global equity managers have been able to use their added degrees of freedom to add more value than have their domestic or foreign equity peers.