Geography and investing have been intertwined for a very long time. But their relationship has changed, and investment professionals may need to make some adjustments in response.

Investors traditionally have used a company's locale as a proxy for where the company operates. In today's integrated global economy, however, a company's domicile often has little bearing on where it generates its revenues and indicates almost nothing about its prospects. Unfortunately, many investors may be undermining their results by making important asset allocation decisions using this outdated metric.

Consider these examples: Burberry is based in the United Kingdom but generates 75 percent of its sales outside its home market. Sun Pharma is domiciled in India but generates 44 percent of its revenues selling some 200 generic drugs in the United States. Is Burberry really a British firm? Should Sun Pharma be considered an emerging markets company?

**Developed-Market Indexes are Showing Their Age**

Because indexes—and funds based on them—are composed of individual stocks, the problem persists even when one looks at a large pool of securities. For example, most investors think of the Standard & Poor's 500 Composite Index as a U.S. index because all its constituent companies are domiciled in the United States. However, those 500 U.S.-based companies generate 39 percent of their revenue outside the United States.

The domicile versus revenue disparity is even sharper for the FTSE 100: A full 77 percent of the revenues generated by its companies come from outside the United Kingdom. Or take the MSCI All Country World Index, the broadest global equity index, comprising nearly 2,500 companies. Emerging markets represent only 11 percent of the MSCI ACWI by market capitalization, but they account for a whopping 34 percent by economic exposure. The United States accounts for 49 percent of the index but only 28 percent of revenue.

All this means that investors in portfolios modeled on the S&P 500 or FTSE 100 might not be getting the exposures they are seeking. In each case, investors who rely on one of these geography-based indexes may inadvertently distort their portfolios and may not be accurately pursuing their original objectives.

A look at the MSCI All Country World Index shows that economies are highly integrated, with companies deriving a large portion of their revenue from outside their regions of domicile (see figure 1). The Capital organization helped create what are known now as the MSCI indexes in the late 1960s, using data gathered while doing global research on individual companies. (The indexes are now published by MSCI Inc.) At that time, only 18 countries were available for investing and nearly 90 percent of the opportunities were contained within five of them. Where a company received its mail served as a good proxy for where it did business.

**Globalization Has Transformed How Companies Do Business**

Since those days, globalization has transformed the economic world. Developments that include free trade agreements, formation of the European Union and its common currency, economic reforms, and the...
rise of a middle class in Asia, Latin America, and parts of Africa have enabled companies to compete for customers, labor, capital, and natural resources on a global basis. Average tariffs have declined from 26 percent in 1986 to 8 percent in 2010. Exports as a percentage of gross domestic product (GDP) have grown to almost one-third of global economic activity, up from 20 percent in 1994 and 15 percent in 1973. Country and regional economies are more closely linked than at any time in history.

Despite these sweeping changes, until recently we haven’t had a viable alternative to use as a foundation for asset allocation and portfolio construction. However, we’ve now reached a tipping point where revenues can and should be used as the more accurate proxy for where a company generates its sales.

Although it’s not a perfect measure, revenue offers many advantages in terms of determining a company’s true economic exposure. Few companies disclose where they source profits, but most break down revenues by region or country in their financial statements. Moreover, unlike profits or assets, the definition of and the accounting standards on the composition of revenue are more consistent around the world, making comparisons easier.

Tools to measure economic exposure by country and region are becoming more widely available. For example, MSCI has begun to systematically construct and provide data series based on economic exposure. We believe MSCI offers the best-constructed dataset currently available to analyze portfolios and market indexes based on economic exposure, and we are using the MSCI data series to analyze our portfolios.

**Investment Themes Are Better Articulated by the Revenue Methodology**

Evaluating companies and portfolios in terms of economic exposure—an approach we call The New Geography of Investing)—can help investors identify opportunities they might not spot with a domicile-based process. For example, if you want to benefit from growth in the U.S. housing market, is it better to invest in a domestic company that may be seeking to expand overseas or in a Hong Kong tool maker that currently generates 73 percent of its sales in the United States? Similarly, to participate in an economic recovery in Europe, should you look at companies based there?

Employing that traditional metric would lead you to Europe’s largest company by market capitalization, Swiss-based Nestlé, even though Nestlé derives 70 percent of its revenue outside Europe, 40 percent of it from the emerging markets. Looking instead through an economic exposure lens could identify a U.S.-headquartered employment agency, Manpower Group, which generates 64 percent of its sales from Europe. Or it might take you to Priceline.com, which generates more than 60 percent of its business in Europe through its subsidiary Booking.com.

Understanding economic exposure may enable investors to identify companies that are benefiting from the rapid growth of the middle class in developing economies, or the development of new technologies and healthcare solutions, regardless of where the companies are domiciled. Conversely, it also can help investors rethink their exposures to certain economies or regions that might be facing specific challenges.

**Are Traditional Country and Sector Funds Still Appropriate?**

Aspects of the domicile approach remain useful in some instances, e.g., certain emerging markets where macroeconomic policies and foreign investor sentiment play important roles. The old geography has its place, and we do not anticipate that investors will discard entirely portfolio analysis by country of domicile. However, we also believe the new geography of investing has broad implications for the investment industry. For example, are traditional country funds or sector funds still appropriate, or does it make more sense to invest based on broad mandates that are defined by investment objective or investment themes rather than by domicile?

Recognizing that globalization has changed the way investors should evaluate companies is important, but it is just a start. Measuring the economic exposure of specific companies and overall portfolios—using revenues as a proxy—should be part of a broader tool kit for plan sponsors, advisors, and other investors who build and analyze investment programs. It will help them better understand the opportunities and risks embedded in portfolios and build investment programs that are more truly aligned with participants’ objectives.

In the traditional approach, plan sponsors and advisors typically allocate to many asset class segments (see figure 2). We suggest a new geography approach where domicile and style boxes are less important (see figure 3). We believe that broad geographic mandates are more powerful and domicile becomes less relevant. Broad-based mandates allow advisors and investors to focus on investment objectives as the building blocks of an asset allocation program.
Thinking Outside the Box

It may be helpful for us in the investment management industry to begin thinking outside the traditional asset allocation framework defined by country of domicile and style boxes, because these parameters are becoming increasingly less relevant in a globalized world economy. Broad mandates such as global equity—or those defined by objectives such as capital appreciation or dividend growth—provide a superior framework for defining portfolios and as the building blocks of an asset allocation program.

Ultimately, investors are not really seeking a U.S. fund, or exposure to European companies, or to emerging markets. They are seeking to finance their retirements, send their kids to college, or achieve other personal goals. The new geography of investing can help all of us in the investment industry move toward objective-based investing, and therefore toward the reason people are hiring us in the first place.

The traditional approach to asset allocation recommends that assets be split by style—core, growth, and value. But we recommend a global approach, with assets allocated by investment objective. The proportion of assets allocated to each objective shifts as a client’s needs change. For example, during the accumulation phase, capital appreciation is a large part of how assets are allocated; in retirement the capital appreciation bucket is smaller and the income and preservation buckets are larger.

Key Takeaways

- Think globally: Reconsider geographic screens used to define mandates. Instead, start by defining a client’s or shareholder’s objectives.
- Are there any investment themes you are trying to capture and what is the best way to capture them? Is it the growth of the middle class or the revival of the housing sector? What sort of portfolios can do that?
- Consider flexible mandates, whether it be global total markets or global small cap, as an unconstrained approach that may allow you to take advantage of growth regardless of where it originates.
- Be careful of tactical country- or region-specific shifts. An investment in a country-specific index may not give you the exposure to the country or region that you are looking for.
- Develop a complementary revenue-based approach for portfolio analysis to better understand a portfolio’s real exposures and risks.
- Consolidate and simplify your asset allocation strategy.

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