



# PERSPECTIVES

A REPORT FOR CLIENTS OF TD PRIVATE CLIENT GROUP - PRIVATE INVESTMENT COUNSEL

## International Equities and Your Portfolio - The View from London

**Editor's Note** -- Few segments of the investment world have been as controversial in recent years as international stock markets, those outside North America. To find out what lies ahead, we recently spoke with TD Asset Management Limited's new international equity team in London, England.

**Investment Outlook (Outlook):** International stock markets have been dismal in recent years, generating negative returns and losses for investors, until very recently. What have been the major causes of these poor results?

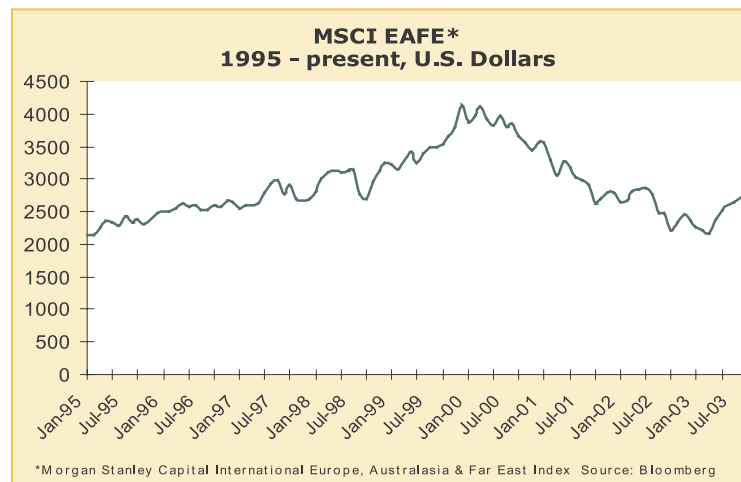
**London:** Returns in world equity markets have indeed been miserable since 2000 for Canadian investors: World markets generally peaked in early 2000 and have since fallen 37% in U.S. dollars. Specifically, Japan has fallen 47% and Europe 38%. The more recent Canadian dollar strength has compounded the fall in international markets when converted to Canadian dollars and has slowed the recovery this year.

of Japan, while not raising interest rates as quickly as it should have in the late 1980s, was again too slow to lower interest rates in the 1990s. In addition, the Japanese government helped prop up "zombie companies" that should have gone bankrupt and so excess capacity was kept in place, reducing the profitability of all.

In non-Japan Asia, market returns have been down modestly since 2000 (about 6% overall in U.S. dollars), as Asia experienced a severe contraction in 1997 and never fully participated in the run up of the technology and telecom stocks. Asian markets slid in 2001 as U.S. imports, particularly of electronic products such as computers and semiconductors, collapsed.

**Outlook:** That tells us why investors have lost money but doesn't necessarily make them feel better. Remind us why we should employ international equities at all, if they've been such poor performers of late.

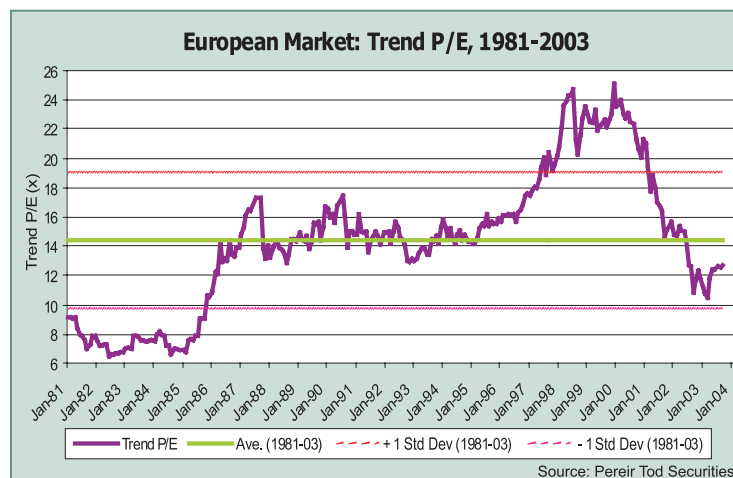
**London:** There are three reasons why investors should be interested in international equities now. First, the declines from the peak have been so enormous that valuations are now attractive. For example, in Europe, markets have gone from trading at their highest valuations in 20 years in 2000 (24x earnings) to close to their lowest (now 13-14x forward earnings). Dividend yields in Europe are at 3% and compare very favourably to bond yields. In Japan, it is now possible to buy good companies like Canon at 18x earnings when earnings are expected to grow by 40% this year. In Asia, many stocks with good growth like Samsung are trading at around 10x earnings. Remember that bear markets create opportunities!



**Outlook:** What were the key factors at work in each of the regions?

**London:** In Europe, the consumer has been weak due to high unemployment. As in North America, capital spending in Europe has been weak as the overcapacity, particularly in the telecom area, is absorbed. Furthermore, the European Central Bank's (ECB) unwillingness to cut rates as aggressively as the Fed has probably delayed economic recovery.

Meanwhile, the Japanese equity and real estate market has been unwinding massive overvaluations for over a decade. Since its peak in December 1989, the Japanese equity market has declined 63% in Japanese yen to the end of September, 2003. The Bank



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The second reason to like international equities now is that they give investors the opportunity to access growth in other parts of the world, particularly Asia. Economic growth in China and the rest of Asia is likely to exceed growth in North America by a considerable amount over the next few years.

For example, GDP growth in China is expected to be around 8% in 2003. While it is difficult to invest directly in China, it is possible to invest in companies in Asia, Japan and Europe that benefit from growth there. For example, Rio Tinto, the U.K.-based mining company, is making a lot of money exporting iron ore from Australia to China.

- ✓ We favour Japan and the rest of Asia as China's growth is more beneficial to Japan and Asia than to Europe.
- ✓ Within Asia, there is an overweight to Hong Kong, Korea and Taiwan and underweight to Singapore that is less influenced by Chinese imports.

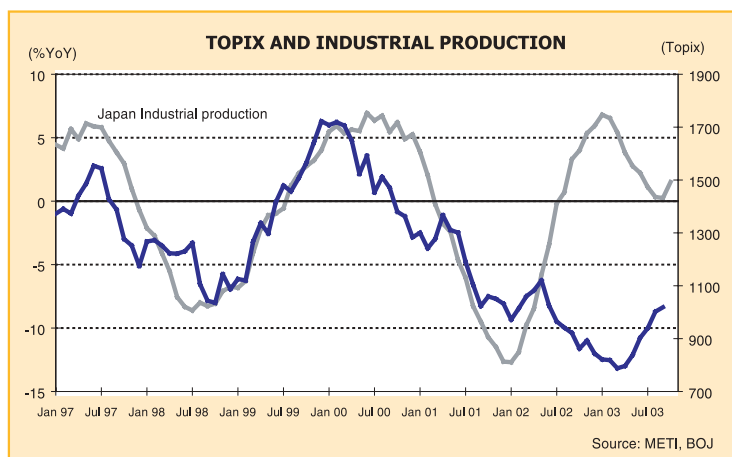
The third reason that investors may want to consider allocating part of their portfolio to international equities is that geographic diversification should decrease risk. The stock markets in Europe, Japan and Asia are not perfectly correlated with the stock markets of North America, as there are different economic and profit growth expectations for these areas. This means that if the North American stock markets hit a bit of a rough patch, international markets may provide better performance as we expect a solid profit rebound.

**Outlook: How would you describe the approach employed by your team in evaluating potential investments?**

We assess the investment merits of individual stocks, sectors, countries and currencies in an integrated process. Regional allocations are managed according to sectors on the basis of investment themes, rather than a country by country allocation. We believe that we can add more value through stock selection, and focus on companies with above-average long-term sustainable growth rates, where the growth is not reflected in the price of the securities. In our portfolios, there is an emphasis on global leaders – those companies that can sustain earnings and cash flow growth from their leading and growing market share. We analyze the financial strength and stability of each company we consider for investment, along with an assessment of free cash flow – which is important for an increasing stream of dividends to shareholders, an important component of return in the long run.

**Outlook: Let's do some globe trotting. Can you describe the prospects region by region?**

**London:** While the European economy has been sluggish and France is now officially in recession, there are some forward-looking indices which are starting to point to recovery in late 2003 or early 2004. German business confidence has increased for several consecutive months, the euro-area manufacturing sector is showing signs of troughing, and there are indications that the euro-area services sector is expanding. Sustained weakness in the euro and/or implementation of reforms recently proposed in Germany would make us more positive on the prospects for faster growth in 2004, while renewed strength in the euro might cause us to become more cautious. Overall, Europe's recovery is likely to be fragile and lag the U.S. and Japan.



Japan's nominal GDP growth will likely remain negative in 2003 and narrow to zero in 2004, but real GDP growth is likely to be 1.8% in 2003 and 1.4% in 2004. Recent economic releases have all been ahead of estimates, including industrial production. Personal consumption is increasing as employment conditions are on the mend as long-term growth areas such as health care and services generate jobs. Corporate capital expenditures are likely to remain firm on the back of recovering cash flow and profitability, and the export sector is benefiting from China's expanding demand.

Resurgent electronics demand would be a huge positive for Asia. With the investment cycle in the U.S. and Japan, along with expanding demand from China, we expect electronics demand to pick up over the coming months. With sustained buoyant demand from China reinforced by cyclical recovery in the U.S. and Japan, we expect firming export growth across Asia.

Asian Exports and Electronics Ratios		
	Exports % of GDP	Electronics % of exports
China	25	30.8
HK total	124	n.a.
HK domestic	10	22.9
India	11	2.3
Indonesia	34	13.9
Korea	34	37.1
Malaysia	98	55.9
Philippines	45	69.1
Singapore total	144	n.a.
Singapore domestic	77	47.8
Taiwan	46	45.1
Thailand	53	23.5

Source: Credit Lyonnais Securities Asia

**Outlook: Asia's two largest countries seem to be going in opposite directions. China is growing dramatically while Japan remains mired in a slump. How do you capitalize on China and are there signs of hope for Japan?**

**London:** China is becoming the world's factory, absorbing foreign direct investment and producing manufactured products. July exports (+31%) indicate the manufacturing sector is booming. The Chinese domestic economy is also booming as seen in the growth of imports (+35%) and domestic consumption. There are two investment opportunities in China - to buy companies exporting to China (e.g. Rio Tinto or Fanuc) or manufacturing there (e.g. Taiwan Semiconductor Manufacturing Co. for foundries or Johnson Electric for electric motors).

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China is both a threat and an opportunity for Japan, as Japan cannot compete with cheap Chinese labour. Japanese companies have to restructure and move their operations to China, as Yokogawa Electric (no.2 in the world in industrial instruments after Honeywell) is doing with their plan to shut 15 of their 18 domestic factories and move production to China. On the other hand, China represents 22% of Japan's exports and is the fastest area of growth by destination. China is a massive opportunity for many of Japan's manufacturing companies, especially in the capital goods sector, such as robot manufacturer Fanuc.

**Outlook:** *Can you identify any themes that recur throughout your portfolio and are reflected in stock selection?*

**London:** In Europe, we focus on companies that benefit from growth outside of Europe, as well as companies that are cutting costs through restructuring. Tesco is not only a leader in British food retailing but is also an Asian growth story. Tesco is now the largest grocer in Thailand and Korea, with a growing presence in Taiwan as well. Their Asian operations are now of a size that they are generating strong profit growth.

Standard Chartered Bank is U.K. based, but is another Asian growth story. The bank has rapidly growing operations in Hong Kong, India, Malaysia and Taiwan, which have led to earnings growth of 17% in the first half of 2003, much greater than its peer group.

ABN AMRO is a cost cutting story, reaping the benefits of rationalizing its Dutch branch network.

In Japan, we focus on global export leaders and domestic Japanese companies that are genuinely restructuring. Canon's estimated earnings growth of 40% this year reflects its burgeoning semiconductor business along with its digital still camera business, which is benefiting greatly from exports to China.

Nissan is a cost cutting story, with French management turning a money loser into a very profitable firm with a P/E ratio of 9.5x current earnings and 6x cash flow. Nissan also has one of the more progressive dividend policies in Japan.

In Asia, we focus on companies that benefit from outsourcing of manufacturing capability. Samsung has a low P/E of 9x forward earnings partly because it is a very large cap stock in a small country with restrictions on foreign ownership. It is a leader in semiconductors, cell handsets, flat panel displays and consumer goods, which are of high quality and gaining market share.

Fanuc is a leader in robotics and will benefit as auto production in China increases and robotics penetration of the Chinese auto industry rises from the current 10% to 90% over the coming decade.

**Outlook:** *We have seen some sharp fluctuations in currencies in the past few years -- U.S. dollar falling, euro recovering etc. What role do currencies play in your selections? Can you provide any examples of how currencies have influenced your decisions?*

**London:** While we typically do not hedge currencies, currency analysis does play an important role in our stock selection process. The strength of the euro is one of the factors that has caused us to be cautious on the prospects for economic growth in the region. This is a key reason why we are underweight the region relative to Japan and Asia. Within Europe, we are underweight Industrials and Consumer Discretionary (heavily weighted to autos), partly due to the view of a strengthening euro.

We are monitoring the appreciation of the yen. At current levels, we remain comfortable with our overweight position in Japan, and with our position in Japanese exporters. However, if the yen were to appreciate significantly from current levels, we would revisit these positions and likely reduce our exposure to exporters.

Asia is a dollar-related economic area and so manufacturing and exporting industries would be positively affected by a weak U.S. dollar. The strength of the Australian dollar is causing the economy there to slow. This has led us to underweight Australia and to underweight domestic stories within Australia (e.g. banks). We are positive on resource companies such as WMC Resources that should benefit from growth in Asia.

**Outlook:** *Overall, how would you sum up your outlook for international markets for the coming year?*

**London:** Valuation favours the international markets and they may spend some time in "catch-up" mode: European stocks trade at a collective price/earnings ratio discount of about 20% when compared to U.S. stocks, yet underlying profit growth over time is very similar.

Japanese corporate profits are expected to rise 12%, providing solid support for an advance in equities, as the benefits of restructuring are realized.

China is becoming the world's factory as it absorbs foreign direct investment and expands its manufacturing, while also boasting growing imports and domestic consumption. China's growth will benefit Japanese and Asian companies, as a source of demand and also offer lower costs for outsourced manufacturing.

**Outlook:** *Thanks very much for this update.*

**London:** Our pleasure. 

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