

A Modern Rationale for International Equity Investing



The benefits of international investing have been questioned recently because of the rising correlations between markets in various countries. However, as pointed out by Bruno Solnik (Professor of Finance and Economics at the HEC School of Management in Paris), "Correlations do not tell the whole story. Benefits from diversification can still be gained by investing non-domestically. In constructing portfolios, investors need to evaluate the rising importance of industry factors over the country factors when selecting securities. And above all, investors need to consider company factors, such as where the company does business and how much business is done there, not just where the company is headquartered."

The last quarter century has witnessed steady growth in international investing by American institutions and individuals alike. Research conducted by the D.C.-based Investment Company Institute (ICI) demonstrated that in 2008, 43% of all U.S. households that invested in mutual funds diversified their portfolios internationally by

owning either a global or an international mutual fund. (Source: ICI's 2008 Profile of Mutual Fund Shareholders). And according to the Bureau of Economic Analysis, U.S. direct investment abroad via equity capital investment flows increased 172% in 2007 from the prior year.

Traditional arguments for international investing rest on academic studies, which show that foreign assets added to domestic portfolios raise the Markowitz mean-variance efficient frontier above that of a portfolio with only domestic holdings. In other words, global diversification provides higher returns for a given level of risk or lower risk for a given level of return. While this may have been the case 25 to 30 years ago, rising correlations of cross-country returns over the last decade have made the benefits of global diversification less obvious. We do, in fact, agree that investment strategies based solely on country selections proved less effective in recent years. However, Thornburg continues to emphasize the benefits of global stock selection based on company-specific criteria.

Economic developments in recent decades were supported by a few important trends, including fading nationalistic economies and extension of economic collaborations on a global level. Global competition has resulted in a more efficient allocation of resources, and has led to the creation of less expensive products and services. Today, even those investors restricted to the U.S. capital markets cannot afford to ignore the foreign competitive landscape. In automobile manufacturing, for example, the U.S. competitive environment has been permanently altered by counterparts in Japan and Korea. An analysis of the wireless handset market would be incomplete without considering Nokia, Ericsson and Samsung Electronics. The U.S. consumer electronics market would be deficient without products from Sony, Nintendo, Samsung, and Sharp.

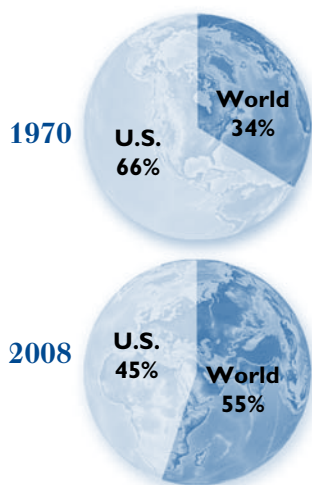
An average personal computer sold in the U.S. is almost entirely made of foreign (mostly Asian) components. Even analysts' predictions of U.S. computer shipments are closely linked to

chips, memory modules, and flat panel display shipments from Asia. Many unique foreign companies, which now dominate a significant part of the global consumer and industrial markets, are available to U.S. investors only by investing internationally.

Worldwide economic integration has not only eliminated many regional barriers to entry, but has also contributed to the formation of a global corporate mindset. Many companies expand overseas in pursuit of design and engineering talent, lower manufacturing costs, economies of scale, and even more importantly, new consumers. Cross-border mergers & acquisitions grew from 0.5% of global Gross Domestic Product in 1991 to approximately 4% at the end of 2000. Adding foreign revenues not only enhances corporate growth over the long term, but also gives companies the benefits of global diversification on the corporate level. A move toward decreasing reliance on a specific geographical area, combined with faster growth prospects, should command higher valuations for these companies in the future.

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Shift in U.S. and World Market Capitalization



Source: MSCI Barra

Another important trend that became especially evident during the last decade is the increasing focus on consumers in emerging countries. Rising per-capita incomes and standards of living in China, India, the Middle East and Latin America create enormous markets for products such as automobiles, consumer and household luxury goods,

wireless communication, and financial services. In many instances, local companies are better suited to satisfy local demands due to their knowledge of domestic business trends and established reputations.

Steady development of foreign economies has been reflected in the distribution of world market capitalization, which shifted from 66%/34% for the U.S./Rest of the World (ROW) in 1970 to 45%/55% U.S./ROW in 2008 (see pie charts). While it can be more difficult to analyze a foreign company, recent improvements in accounting, disclosure, and corporate governance have made foreign financial analysis more accurate. Development of the aforementioned “global corporate mindset” has in part resulted in improving managerial practices within many foreign companies, including the adoption of international accounting standards, which helps to simplify cross-country comparisons. In addition, corporate scandals in the U.S. involving Enron, WorldCom, Qwest Communications,

and more recently various financial institutions, demonstrated that even U.S. markets, long deemed the most transparent and efficient of all, are not immune to mischief.

Admittedly, traditional concerns about currency volatility and risks remain. However, these concerns can be effectively mitigated, if so desired, through currency hedges. In addition to currency hedges executed by investors, many companies hedge foreign exposure on the corporate level, thus leaving investors with more minimal currency exposure.

Many recent trends have been indicative of improving conditions in the area of international investing. While it may take international markets more time to reach the same levels of efficiency as the U.S., recent developments suggest movement in the right direction. International diversification, though it might not always be obvious, continues to create a proposition of enhanced returns for domestic inves-

tors. A company-specific approach appears to make the most sense. Increasing flows of improved financial information, combined with cross-country analysis of industry competition, should facilitate the investment process abroad.

The Thornburg International Value Fund takes advantage of this increased flow of information, employing a bottom-up approach to bringing overseas opportunities home. Committed to hands-on, fundamental research, the team searches the globe for promising companies at a discount to our estimates of their intrinsic value.

For additional information on Thornburg International Value Fund, please visit www.thornburg.com.



Sources:

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Securities mentioned should not be considered buy or sell recommendations. The views presented are subject to change.

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