

**INTERNATIONAL EQUITY:
THE TOP TEN QUESTIONS OF
INSTITUTIONAL INVESTORS**

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**INVESTMENT STRATEGY AND
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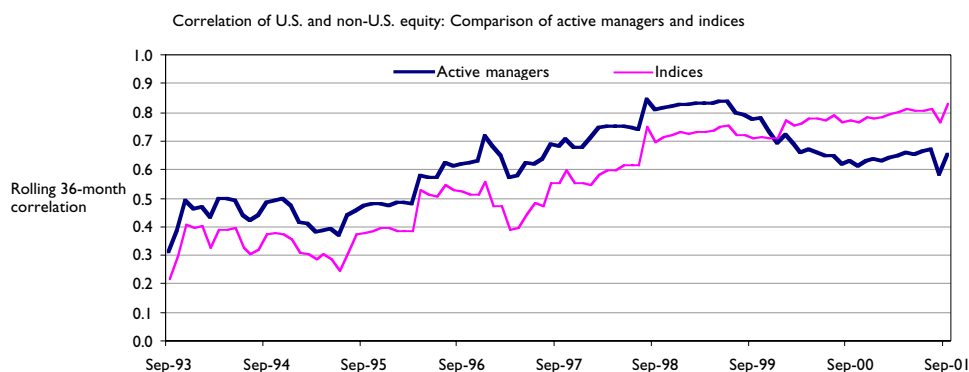
SUMMARY

In the first quarter of 2002, Putnam Institutional Management hosted a series of round-table discussions with investors in cities across the United States. The topic: the role of international equity in institutional portfolios.

We talked with dozens of plan sponsors in these meetings. What follows is a compilation of the questions most frequently asked, along with responses based on our recent research on international equity.

1. Given the high correlation between U.S. and international equities, should I continue to hold international stocks for diversification?

Yes. The correlation numbers most commonly quoted are for broad market indices such as the S&P 500 and MSCI EAFE, which can be misleading. The returns of top-quartile active U.S. and international managers were highly correlated in the mid to late 1990s but have dropped to much lower levels in recent years.



2. Can't I use American Depositary Receipts (ADRs) to replicate the international equity market?

ADRs can be used effectively to provide international exposure, particularly when they are used in a portfolio that is benchmarked to a broad international equity index such as MSCI EAFE. Investors should keep in mind, however, that the universe of ADRs is considerably smaller than that of the MSCI EAFE Index and has different capitalization and sector profiles. For example, the ADR universe has a large-capitalization bias relative to the Index and has a lighter weighting of “Old Economy” industrials and utilities. For this reason, a portfolio that relies on ADRs rather than locally issued shares for international exposure may exhibit a higher level of tracking error than a more risk-averse investor would desire. The table below summarizes the sector differences between the MSCI Index and a portfolio made up solely of ADRs.

Sector weights: Availability of MSCI EAFE stocks through ADRs

	Weight of local stocks in		
	EAFE Weight (Local)	EAFE that also have ADR's	% Available if buying ADR's
Consumer Discretionary	13.81	9.77	71%
Consumer Staples	8.26	6.14	74%
Energy	8.41	6.30	75%
Financials	25.02	17.46	70%
Health Care	10.19	7.13	70%
Industrials	9.59	4.48	47%
Information Technology	7.25	4.79	66%
Materials	5.90	3.98	67%
Telecommunication Services	7.11	6.15	86%
Utilities	4.46	2.75	62%
Total	100.00	68.95	
Number of Securities	1021	408	
% of Securities			40.0%

Holdings Data As Of 4/11/02
Provisional MSCI EAFE
Source: FactSet

3. *Can't I get the same exposure to the international markets through U.S. multinational corporations?*

No. U.S. multinationals are imperfect representatives of local markets. Owning local securities gives a U.S. plan exposure to tax regimes, political risks, regulations, and legal systems that provide opportunities for excess return generation and diversification. Also, multinationals have a large-capitalization bias and are more closely correlated to large-cap U.S. stocks, further limiting diversification.

4. *Given the recent improvements to the MSCI EAFE Index, can my manager still outperform?*

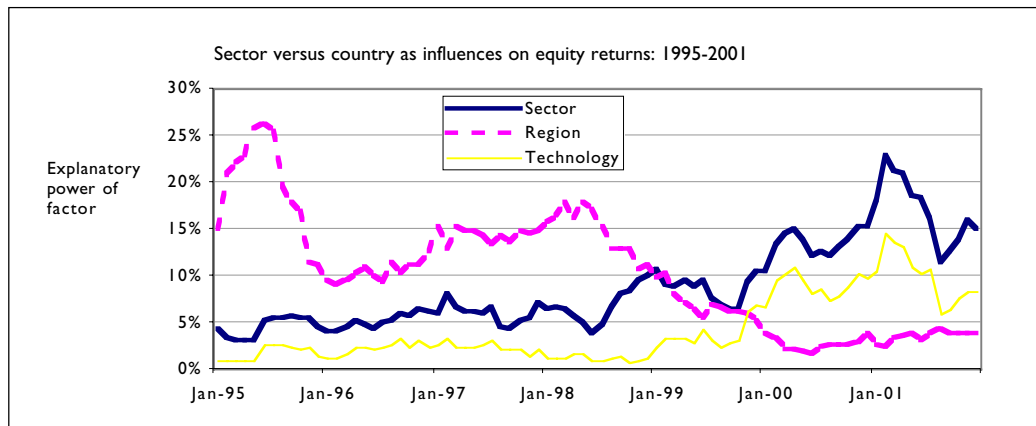
Yes. Our research suggests that opportunities for outperformance are likely to persist, although the magnitude of that outperformance is uncertain. First, active international managers still have a broad array of strategies at their disposal — sector, style, market capitalization, country, and currency as well as stock-specific factors — to improve diversification and generate excess return. Second, although the changes implemented by Morgan Stanley Capital International have improved the Index's coverage from a capitalization and free-float perspective, sector weightings have not been significantly altered.

Furthermore, past outperformance of most active international equity managers versus MSCI EAFE historically came from underweighting Japan, overweighting technology, media, and telecommunications stocks in late 1999, and/or placing well-timed bets on skyrocketing out-of-benchmark issues such as NTT DoCoMo. But even after stripping out these factors, half of all active managers beat the more comprehensive Salomon Smith Barney Primary Market Index Europe and Pacific.¹

¹ Our researchers found that half the universe of active international equity managers outpaced the SSB PMI EPAC Index over the period 1996–2001 (five-year rolling returns).

5. What factors drive the price behavior of international equities?

Regression analysis reveals that sector surpassed region as a driver of international equity returns in the years 1999–2001, a period in which the technology and telecom “bubble” inflated and then burst. More recently, the explanatory power of both sector and region has subsided while stock-specific factors have become more prominent. This trend highlights the importance of selecting international equity managers with excellent bottom-up stock-selection skills.



Source: Putnam Global Asset Allocation team

6. When will international equity returns become more competitive with U.S. equity markets?

As measured by the broad market indices, U.S. equity returns have significantly outperformed international markets in recent years. Yet over the same period, many active international managers have been able to deliver returns competitive with (and in some cases exceeding) those of U.S. markets.

7. How should I manage currency risk?

We recommend a 50% hedge ratio because the reduction in volatility gained from currency hedging is not linear. A 50% hedge ratio delivers three-quarters of the volatility reduction that would be achieved with a 100% hedge.²

8. Is style-based investing appropriate for international equity?

We recommend a core approach as the anchor for an international equity allocation. Although a growth and value manager may each seek to optimize the return and risk of their respective individual portfolios, there is no guarantee of an optimal blend of securities and risk exposures for

² “International Benchmarks: In Support of a 50% Hedge Ratio,” Steve Gorman and Edward Qian, The Journal of Investing, Summer 2000. To obtain a copy of this article, please contact your Putnam Account Manager.

the combined allocation. A core manager is in a much better position to measure and manage risk for the total portfolio. Skilled style-specific managers can, however, provide additional excess return when implemented as part of a satellite approach around the core allocation.

9. *Why not use a seamless global equity strategy?*

Seamless global investing is an intuitively appealing approach that presents some challenges in implementation and benchmarking. Effective implementation requires a broad and deep commitment to research that few firms can make; research coverage constraints could lead to a larger-capitalization bias. Also, while there are many skillful U.S. and international equity managers, few firms have successfully integrated the insights of both specialties into a combined portfolio.

The most widely accepted global equity benchmark, the MSCI World Index, is weighted approximately 50% U.S. stocks/50% non-U.S. stocks. This weighting may limit the appeal of MSCI World-benchmarked strategies for U.S. investors seeking diversification.

10. *At a total plan level, what allocation weight in international equity do you recommend?*

We recommend an allocation to international equity in the 10% to 20% range. The appropriate weight will depend on the plan's overall asset allocation as well as its risk and return objectives.

Putnam Institute is Putnam's educational program designed to provide our clients with insights and analysis on investing, capital markets, and industry trends.

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