June 25, 2007

GLOBALIZATION

The patterns of global commerce are constantly evolving, and by now it should be obvious that the current era of U.S. and European industrial dominance is coming to an end. To historians this should come as no surprise, as we are simply moving to the next phase of a very long-term and seemingly inevitable global cycle of shifting industrial and economic leadership. As industrial nations mature, wages, benefits, and living standards rise. In addition, greater prosperity typically leads to a higher sense of social responsibility, resulting in increased spending on factors such as safety, workers' benefits, and environmental stewardship. In total, relative competitiveness falls which then opens the door to lower-cost providers.

According to Peter Kennedy's book *The Rise and Fall of the Great Powers*, in 1750 China and India accounted for 58% of global industrial activity. But by the turn of the twentieth century a major shift had taken place, as Europe and North America together then totaled 87% of such activity. Now, the focus is returning to greater Asia, as China and India once again emerge as major industrial powers. Naturally, this raises a number of questions. What is the current state of globalization? How will it evolve from here? Where does the U.S. fit into this process? And, most importantly, how can investors prosper from it? As such, we thought this would be an opportune time to put forth our thoughts on the process of globalization and how we plan to take greater advantage of it in our role as fiduciaries of U.S.-domiciled investment accounts.

A More Integrated World

Merriam-Webster very efficiently defines globalization as the "development of an increasingly integrated global economy marked especially by free trade, free flow of capital, and the tapping of cheaper foreign labor markets." This process has been ongoing for centuries and has become more robust with each significant development in international transportation, communication, and financial infrastructure: from oxcarts to sailing ships to airplanes, from the telegraph to the Internet, and from barter to wire transfers. Each step in the process has allowed for further specialization of production, and therefore a greater variety of available goods and services and a lower cost of consumption.

However, the ability to communicate instantly around the world or to transport goods cheaply and quickly is only part of the reason why globalization is now proceeding so rapidly. Just as important has been the current state of near uniformity in the fundamental economic structure of the family of nations. In other words, with only a few holdouts,

BTR CAPITAL MANAGEMENT, INC.
BALANCED TOTAL RETURN INVESTMENT MANAGEMENT
550 Kearny Street, Suite 510, San Francisco CA 94108 - (415) 989-0100 - FAX (415) 989-0123

basically the entire world is functioning within a capitalistic economic framework. The fall of the Iron Curtain in 1989 effectively introduced several hundred million producers and consumers into capitalist society. And while there is no such obvious date or event to point to in the case of China, India, and other developing nations, realism seems to have long since set in, such that free market-oriented reforms have led to booming commerce among well over two billion additional global economic participants.

In an ironic twist, the holdouts against capitalism aren't always who one would expect. Sure, there's North Korea, Cuba, and now Venezuela, but BCA Research of Montreal cites a survey wherein only 36% of French people said they believe that free markets constitute the best economic system. For Chinese people it was 74%. Amusing anecdote aside, it is no surprise that, nominally communist or not, China has been the biggest driving force behind the current wave of globalization.

<u>Why China?</u>

The reason is fairly simple. When you're a country of more than a billion people, of whom the vast majority are still engaged in subsistence farming, your level of economic development has almost nowhere to go but up. Subsistence farming is the most basic and least efficient form of economic activity. It's a tough way to make a living, characterized by grueling manual labor and reliance on uncontrollable events. Unsurprisingly, as GaveKal Research points out, this way of life leads to extremely conservative financial management (i.e., high savings and low consumption). In comparison to subsistence farming, the higher productivity and lower volatility of industrial manufacturing is a huge improvement.

Climbing the next step up the ladder of economic development requires, among other things, a willingness to open a nation's doors to foreign trade and investment. And since China's government decided that open doors were a better option than open rebellion among its people, it was happy to become the world's factory. Chinese companies could do many jobs just as well, and for a lot less money than, say, American or German ones. When the barriers to this kind of job transference were lowered through open trade, economic activity entered a virtuous upward spiral. Tens of millions of rural Chinese workers have moved to the cities, where they are now engaged in comparatively more reliable factory jobs. In the process, these workers have not only become more productive, which has boosted economic growth, but are now also more willing to invest and spend, which should give an added positive jolt to overall economic activity.

<u>The Danger of Protectionism</u>

Of course, on the other side of the equation there has to be a willingness on the part of the developed economies to not invoke protectionist policies. After all, a lot of those jobs now held by Chinese, Mexicans, or Poles were lost by Americans, Brits, and Germans. The established industrial nations have a choice. They can either erect barriers in an effort to maintain their existing employment structure and standard of living, or they can adjust to the new situation by being flexible and creative. Any move toward protectionism by such nations would have the effect of inhibiting world trade, global growth, and inevitably their own domestic growth and prosperity. This is why we find the ongoing protectionist rumblings in Congress so disturbing.

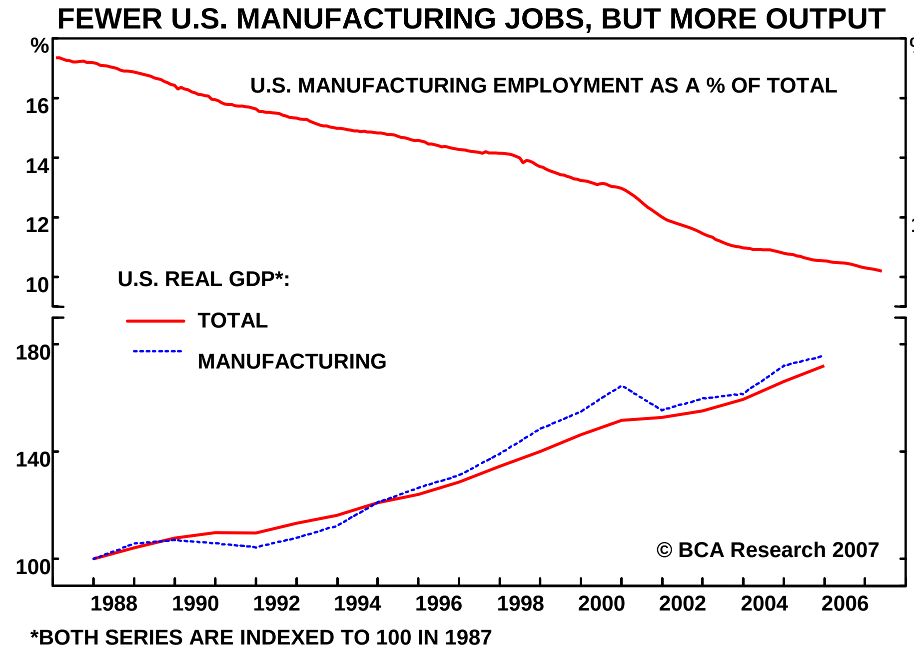
America's Gain

Like it or not, our economy has changed, with massive improvements in computing and communications technologies, as well as open access to enormous sources of inexpensive labor. In the evolving global economy, there is now greater capacity to manufacture almost everything. Thus, it has become the low-cost producer who wins. Fortunately for America and the other developed nations, globalization hasn't meant that the formerly high-cost producers are now the net losers, although they have had to alter their ways of doing business. With lower trade barriers, U.S. and European companies can now design and market their products and services to a wider audience of consumers, while the process of manufacturing or providing a service can be outsourced to where it can be done most cost effectively.

This period of globalization has also witnessed positive developments in the sophistication and efficiency of the domestic side of developed-nation economies. Job growth has resulted even within what might have been considered mature industries. And while many factory jobs have been lost, and the resulting dislocation painful for those directly affected, overall employment has grown significantly in the past generation. Here are a few facts from the Bureau of Labor Statistics to put globalization's impact on the U.S. worker in perspective: In 1977 there were 18.2 million U.S. factory workers. In 2007 that total had dropped to 14 million. During the same 30-year stretch, however, the number of professional, education, healthcare, and business services workers rose from 12.7 million to 36.2 million.

Those are pretty good numbers. Sure, many politicians complain about the quality of the jobs that have been created in recent years. But if we look at the long-term trend, it's clear that economic growth since the early 1980s has been strong, and many of the jobs created have been of high quality. After all, it "strains credulity" to claim that the 23 million new professional, education, healthcare, and business services workers are in reality just driving taxis, serving fast food, or stocking shelves at Wal-Mart.

So clearly, the loss of factory jobs thus far has not hurt the U.S. workforce as a whole. Perhaps even more surprising is the fact that U.S. industrial production has continued to grow. As the chart below shows, manufacturing GDP growth since the late 1980s has exceeded total GDP growth, despite the loss of jobs.



Could it be that U.S. manufacturing operations are simply more productive because the jobs that remain here are the ones where we enjoy a competitive advantage? The whole point of globalization is that labor and capital are allowed to combine in the most efficient and profitable ways and places. The U.S. entrepreneurial culture is alive and well, and we remain the global leader in numerous endeavors such as technological and agricultural innovation, filmed entertainment, and healthcare research. Besides, let's remember that the entire economy can't really be outsourced. One may be happy with a Chinese-built TV, or tolerate dealing with the occasional customer-service rep in India, but surely our doctors, teachers, auto mechanics, restaurants, shops, etc. will remain local.

So How Do Investors Benefit?

It has long been clear to BTR that, from an investment point of view, foreign exposure is highly important. And the importance of that exposure will only increase in the future, because although so much has already happened in terms of globalization, we are still in the early days. Millions of Chinese and other emerging nations' citizens remain underemployed. For instance, nearly 60% of the Chinese population is still rural, as opposed to 20% in South Korea where the process of industrialization started much earlier. The corresponding number for India is closer to 70%. Barring truly foolish moves by political leaders, the current phase of global economic expansion is a decades-long phenomenon. Consider that real estate privatization was only established in China in 1998. With both the legal and financial ability (due to the relative reliability of factory work versus subsistence farming) to buy a property, millions of Chinese will settle down in a home they own, and presumably commence the other spending that goes along with it. This is how it happened in Japan, Taiwan, and South Korea, and how it will happen in

Vietnam, Brazil, and other countries. As the standard of living in those nations rises, other, hungrier populations will rise up and start to take some of their jobs. And so, the evolution will continue.

Of course, there is more than one way for us to achieve foreign investment exposure, thereby benefiting from global growth. The most obvious way is to purchase foreign stocks directly, as long as local accounting practices do not prevent us from achieving a sufficient comfort level with the financial statements. Hopefully, global economic integration will lead to more unified accounting standards and a greater number of companies, such as Novartis or Honda, being listed on multiple major stock exchanges. Or, we can simply buy exposure to broad markets through country- or region-specific closed-end or exchange-traded funds. And let's not forget that investors can also achieve *stealth* foreign exposure through what are basically domestic household names.

Few may be surprised to learn that Coca-Cola generates 71% of its revenue outside the U.S., as it is widely known to be one of the most valuable brand names in the world. But it is not alone. It is out there selling alongside ExxonMobil (76% of revenues outside the U.S.), Avon Products (75%), Nike (63%), IBM (62%), Procter & Gamble (55%), and Caterpillar (52%). In fact, Merrill Lynch calculates that S&P 500 companies earned 48% of their profits outside the U.S. in 2006, up from 38% just four years earlier. And, it is the international markets that are keeping earnings growth strong for large-cap American companies. Statistics from Thomson Financial and Morgan Stanley show that in the first quarter of 2007, S&P 500 companies with more than 25% of revenues from abroad had twice the earnings growth of the rest.

Conclusion

Globalization clearly has its benefits, such as falling prices for consumer and capital goods. Unfortunately, those benefits can sometimes come at a steep cost, as anyone who has lost a job to outsourcing will attest. The fact is, however, that globalization is a well-entrenched process. Employers, employees, and nations who accept that fact will motivate themselves to adapt successfully. America as a whole has done so, as our 4.5% unemployment rate attests. We at BTR believe that globalization is one of the most reliable investment trends going forward, and that the stock prices of U.S. and international companies with meaningful exposure to that trend will benefit. As such, our intention is to continue the process of growing the globalization exposure in BTR's client accounts.

The Stock Market — A Brief Update

While volatility has been rising, the stock market continues to exhibit a strong underlying upward trend. Yet there are numerous reasons to expect a retrenchment in coming months, including the fact that firming global economic growth has led to higher interest rates and rising inflationary expectations. One should also note that a correction seems overdue. The stock market's advance since 2002 has been the second longest period in modern stock market history without even so much as a ten percent pullback.

How deep could a correction be? How long could it last? While no one can know for sure, the operational word in our opinion is "correction," as in a pullback within an ongoing uptrend. We continue to be positive on the longer-term stock market outlook. Liquidity is abundant, valuations are reasonable, and looking forward, the fundamental environment is quite positive. If a correction does begin, there is likely to be a flurry of negative commentary. That is normal during declining markets, and rising pessimism is one of the factors that helps bring declines to an end.

As always, we continue our effort to take advantage of periods of volatility. Recently, we have pared some unwanted or fully-priced positions. The important thing for us going forward is to make sure that we are invested in what we want to own for the longer pull.

Bottom line, we remain optimistic about the U.S. stock market and, as indicated in this edition of our *Investment Strategy Update*, the longer-term global investment outlook as well.

- 6 -