

Global Diversification Could Shield Clients' Portfolios from Drops

Now could be the time for international equities

Can the economic cycle, steaming into its eighth year, continue much longer? With S&P 500 P/E ratios

hovering at 27 times 1999 earnings, U.S. equity markets appear to be fully valued.

When the inevitable economic reversal comes, will you be able to shield your clients' portfolios from precipitous drops? A good place to look may be international equities. The Morgan Stanley EAFE index promises to outperform the S&P 500 over the next three to five years. Here's why:

- EAFE markets are undervalued relative to the S&P 500, based on our quantitative valuation measurements of P/E and price-to-book ratios, return on equity, and price-to-earnings growth rates.

- Different stages of the economic cycle exist in European, Japanese, and U.S. markets. High unemployment notwithstanding, the economy in Europe promises to improve steadily, thanks to the European Monetary Union, a stable interest rate environment, the Kosovo resolution, and increased corporate restructuring. Japan—16% of the world's GDP and 25% of the world's savings—will recover once reforms are adopted. Conversely, the U.S. economy appears fully mature and

imperiled by potentially higher interest rates.

- A shift in European assets into equities from gold, bonds, and hidden cash, caused by lower interest rates, the privatization of state assets, and pension reform. Equity ownership in Japan has shrunk to historic lows as a result of the seven-year bear market and should rebound.

- The support for the domestic bull market has come from the "Goldilocks" environment: stable economic growth; subdued inflation; declining interest rates; and rising earnings. Baby boomer investment in mutual funds and retirement plans has fueled the market's unprecedented valuations. But boomers' impact will wane in 2005, when they start to reach retirement age and become savers instead of spenders.

Once these events reshape the markets, a stampede to EAFE stocks will follow. Now is the time to diversify client portfolios into international equities, not only to reduce risk but also to enhance long-term performance.

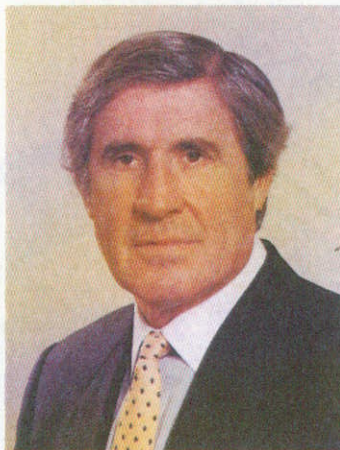
Most economists expect accelerating economic growth outside the U.S. to slow to about 3% in 1999 from 3.4% in 1998, but higher interest rates would slow that rate even more. A revitalized Europe could easily exceed the U.S. growth rate by 1% annually over the next five years. Japan appears poised for recovery, and much of Asia outside Japan should return to its higher historic growth rate of 7% to 8% annually. A stabilized Latin America should see yearly growth reaccelerate to 3% to 4%.

Another factor is global corporate restructuring, as the practices of cutting staff and wages and spinning off or shut-

ting down non-core businesses spread to continental Europe and Asia, enhancing profits.

The creation of the EMU—unifying 400 million people with an aggregate economy of \$6.3 trillion vs. 300 million people and \$8 trillion for the U.S.—will intensify competition and consolidation.

International investing can involve unexpected twists. The best way to mitigate their effects is the use of ADRs. Their advantages include quotation and dividend payment in U.S. dollars; avoidance of global custody charges associated with holding foreign shares; annual reports typically available in English; transaction settlement in three days; easy registration and delivery to investors; and conversion into underlying securities by investors. ADRs are often marginable, and they frequently have listed options. ☎



By Robert A. Simms

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