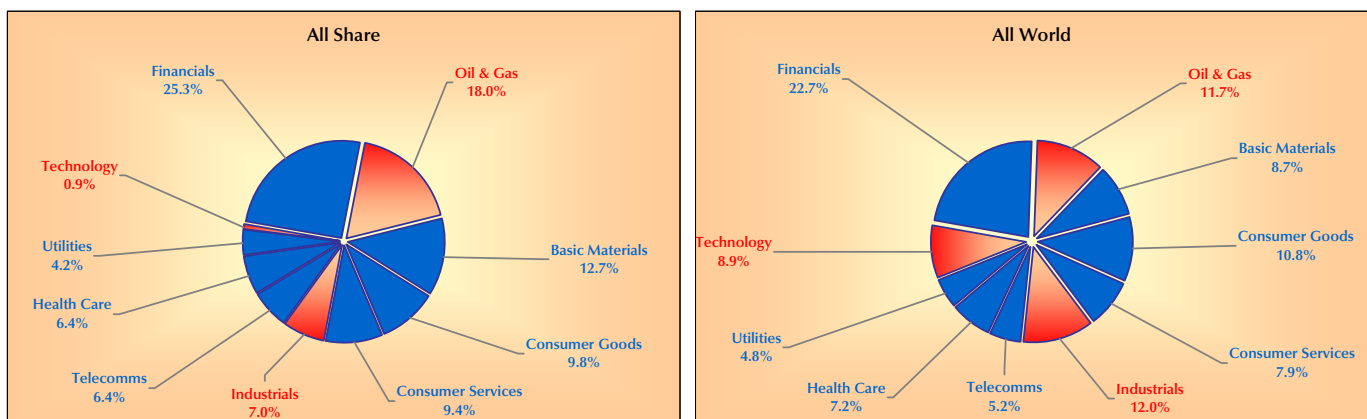


Diversify With a Global Wealth Weighted Index

Diversification is the most appropriate response to uncertainty according to Ben Graham, the originator of 'value investing' in the 1930's. But what do we mean by diversification? It is the spread of investment over a variety of enterprises. The analogy in manufacturing is to implement a marketing strategy that requires producing a variety of different goods or services as a safeguard against the effect of a fall in demand for one particular product.

For UK pension funds diversification means broadening the scope of their investments as much as possible. In the equity asset class they should expand into global equities in order to capture a wider range of opportunities and at the same time spread their risk more evenly by avoiding the particular concentration in the All-Share. For example, while the Technology industry comprises just 0.9% of the All Share, it makes up 8.9% of the All World FTSE index which includes 50 countries. The charts below illustrate that a much better balance in industry allocation, and therefore better diversification, can be achieved by investing in the All World stock market than in the UK market.



Another way to look at diversification is to focus on companies. In the UK market the top twenty-five companies by market capitalization make up 62% of the FTSE All Share. This differs significantly with the top twenty-five companies in the All World index which make up only 15% of the market capitalization.

In addition to better diversification than UK equities, global portfolios offer a better absolute return.

Absolute 10 year return (% p.a.)

US: S&P 500	1.75%
Japan: Topix	1.97%
UK: FTSE All Share	3.53%
FTSE Developed World	3.63%
FTSE All World	4.20%
FTSE Emerging Markets	11.41%

The decision to diversify with global equities raises the question: *how do I choose my regional and industry equity allocation?* We believe the answer lies in the wealth measures of a company, rather than its market capitalization. This is because share prices are random and volatile in the short term, occasionally forcing the investor tracking these prices to misallocate capital. For example, in 1988

Japan’s weight in the All World rose to nearly 43% at a time when North America was 30%. Similarly, during the dotcom bubble in 1999-2000, the Technology industry was 24% of the world market before falling in 2001 to 11%.

Re-weighting market indices using the three primary measures of company wealth (net profit, cash flow and shareholders’ equity) removes the distortion created when investors herd in one direction. This results in a more stable view of the equity market in the long run. The current regional allocation of the global equity market using the wealth weighted strategy is shown in the table below.

	Wealth weight	FTSE weight	Active weight
EUROPE EX UK	24.25%	21.16%	3.09%
JAPAN	9.56%	8.18%	1.38%
UK	10.36%	9.03%	1.33%
DEVELOPED ASIA EX JAPAN	4.89%	5.47%	-0.58%
EMERGING MARKETS	10.14%	11.93%	-1.79%
NORTH AMERICA	40.80%	44.22%	-3.42%

GWA’s wealth weighted strategy adds value in the long term. Over the last 10 years it has added 1.45% per annum (p.a.) to the absolute return of the FTSE All Share and 2.63% p.a. to the FTSE Developed World index. Wealth weighting the Emerging Markets index added a substantial return of 4.38% p.a. to the return of the FTSE Emerging Market index over the last 7 years. When added to the absolute return, the GWA Emerging Market index has delivered an outstanding 25.27% p.a. over this period.

Wealth Weighted portfolios are indexed by FTSE and implemented by Legal & General, State Street Global Advisors, Mitsubishi UFJ, Sumitomo Trust, AP3 and the Teachers Retirement System of Georgia among others. Because it is an active strategy offered in what is traditionally seen as a passive investment medium, it is very low cost.

Including a wealth weighted global market index in core portfolios offers better diversification, broad coverage and superior returns in the long run.