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iShares Market Perspectives

The Case for CASSH
Smaller, Developed Countries That Offer Hidden Value

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Executive Summary

There is a growing consensus among investors that developed markets are stuck in a slow growth regime, defined by excessive debt, structural deficits, high unemployment, and deteriorating demographics. This is certainly true for Europe and Japan, and arguably for the United States as well.

However, not all developed markets fit into this slow growth purgatory. This narrative ignores significant differences in economic fundamentals. Interestingly, it is the smaller, developed countries that appear most healthy. Many of these countries are less burdened by debt and structural deficits and, for the most part, enjoy better growth prospects. Specifically, we would argue that Canada, Australia, Singapore, Switzerland, and Hong Kong — or CASSH — appear fundamentally stronger than most of the large, developed countries.

While better growth prospects and lower debt are no guarantees of higher returns, at the very least strong fundamentals do suggest that these markets should trade at higher multiples to their larger counterparts. This view is further supported by the fact that most of the smaller, developed countries also contain corporate sectors that are, on average, at least as profitable as those in the United States, Europe, and Japan. Despite these advantages, we do not believe that these fundamentals are fully reflected in the equity prices in these countries. This suggests that there may be an investment opportunity for those investors willing to overweight a basket of the smaller, developed nations.

An overweight to smaller, developed markets may also be justified on the basis of their currencies. Imbalances in many of the larger, developed countries may ultimately manifest in long-term depreciation of the dollar, euro, and yen. For the most part, we believe that countries like Canada and Singapore in particular are well situated to benefit from this trend, and can provide additional diversification for investors.

"The cool thing about being famous is traveling. I have always wanted to travel across seas, like to Canada and stuff."
Britney Spears

Small, but Solvent

While some are by nature explorers and seek out the exotic, most of us prefer the familiar. This same bias also informs our investment decisions. Regardless of where an investor lives, the vast majority, either consciously or unconsciously, adopts a home-country bias, i.e., a permanent overweight to one's home country.

However, investing internationally makes sense for a range of reasons. Including additional countries and regions in a portfolio can create more diversification, help reduce risk and boost returns over the long term. Our bias may be toward our home country, but it should be global. Of course that still begs the question of where to focus one's attention and find the areas that represent the best opportunity. In last month's Market Perspectives ("Are Emerging Markets the New Defensives?"), we took a look at emerging markets. In this issue, we focus on the developed world.

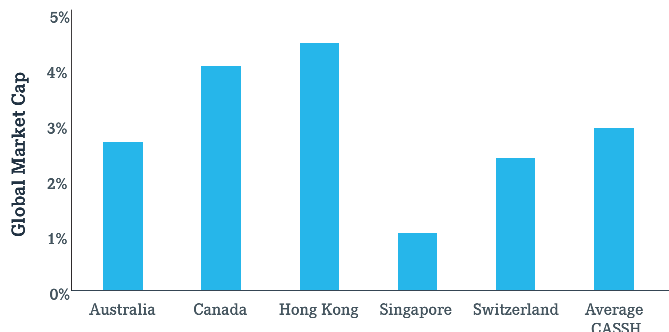
With more markets to follow than time to follow them, we all tend to focus on the larger investment opportunities. As a result, assets that represent a smaller portion of an investment universe are often given less attention. We believe that this dynamic is playing out today in equity markets. Investors may be paying insufficient attention to the smaller, developed countries, which exist mostly outside of the dollar, euro, and yen blocks.

Over the past year, investor attention has correctly been drawn to a host of structural problems in developed markets. From fiscal profligacy to deteriorating demographics, the developed world seems to be mired in a prolonged period of slow growth, if not an outright secular decline. However, while we share many of these concerns, it is probably too broad of a brush to use to paint all developed markets. In particular, many of the smaller countries actually look quite different — at least when it comes to deficits, debt, and growth — from the larger countries that most investors consider when thinking about developed markets.

In an effort to highlight some of the opportunities in these smaller, developed markets, we sifted through the MSCI World Index to identify those countries whose fundamentals — particularly as they apply to economic growth — are sufficiently different from their larger counterparts to merit investor focus. In order to keep the list to a manageable level, we applied a somewhat arbitrary cut-off. The countries listed in Chart 1 all represent at least 1% of global market capitalization. This screen was meant to ensure that it was practical to invest in these markets. Next, we looked for markets that were not denominated in dollars, euros, or yen (we made an exception for Hong Kong, whose currency is linked to the dollar). Finally, we eliminated any countries with large fiscal deficits or debt (this is why the United Kingdom did not make the cut). The resulting list included: Canada, Australia, Singapore, Switzerland, and Hong Kong. For the sake of brevity, and at the risk of introducing yet another acronym into the financial lexicon, we have dubbed these the CASSH countries.

CHART 1

Percentage of Global Market Cap by Country



Source: Bloomberg 10/24/11.

Value vs. Fundamentals: What Drives Returns?

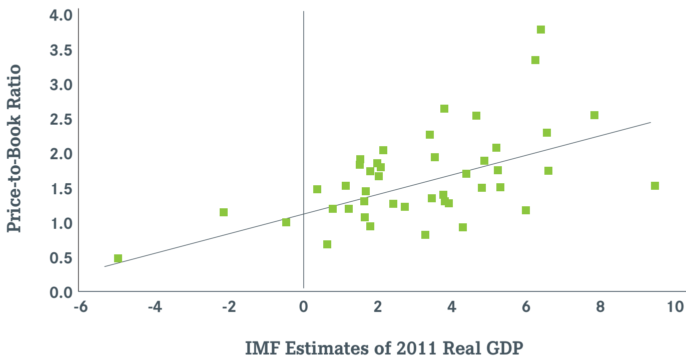
In thinking about these countries and the potential investment opportunity, it is useful to take a step back and consider an investment framework. How do you compare the merits of investing in a country like Australia relative to France or the United States?

While there are obviously many ways to frame the analysis, our own methodology revolves around comparing the fundamentals of a country to its valuation. The goal is to understand which countries look the most attractive based on factors that should drive performance: economic growth, corporate profitability, inflation, and solvency. We then compare those fundamentals to the current valuations of each country. The goal is to establish how the fundamentals are or are not reflected in each country's valuation. To the extent we find countries with good relative fundamentals that are trading on par or at a discount to their less attractive peers, we would overweight those countries. Conversely, if a country appears to have weak fundamentals yet still trades at a similar or more expensive valuation than its peers, we would underweight that country.

Our work suggests that this is a reasonable approach for country selection. Each of the factors enumerated above have historically had a significant correlation with valuation. By way of example, when you compare the values of countries today based on expected growth you find that the better the growth prospects, the higher the valuation. Based on this metric, you can explain roughly 30% of the variation in country valuations simply by measuring their expected growth rates (see Chart 2). As you would expect, the higher the expected growth, the greater premium investors place on that country.

CHART 2

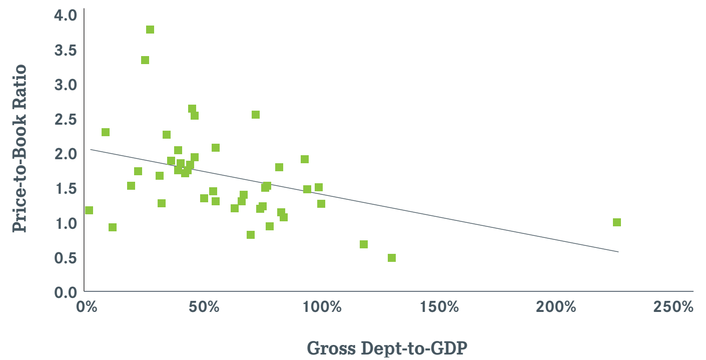
Economic Growth and Valuations



Source: Bloomberg 9/30/11.

CHART 3

Debt-to-GDP and Valuations



Source: Bloomberg 9/30/11.

We see a similar relationship when it comes to debt. Country valuations have a linear, although in this case inverse, relationship with gross debt as a percentage of GDP. This is fairly intuitive: the higher a country's debt level, the greater the risk, which should be reflected in the form of a higher discount rate and lower valuation. In this instance, debt-to-GDP explains roughly 20% of the variation in country price-to-book ratio (see Chart 3).

As a final example, this relationship between value and fundamentals is particularly strong when it comes to corporate profitability. A good anecdotal example of the importance of this relationship can be found in Japan.

For most of the past two decades, Japan has normally scored well on relative valuation, i.e., the market looks perpetually cheap. Yet, despite often trading below its book value, Japan has been a terrible market to buy and hold. Part of this can simply be attributed to two decades of lackluster growth and persistent deflation. However, there is a second reason that Japan has been the quintessential value trap: it is a serial destroyer of value (this is why the country always looks cheap on a price-to-book basis, but less so based on price-to-earnings). This is best evidenced by its low return on equity.

While Japan is an extreme example of why low profitability corresponds with a low valuation, it is illustrative of a broader point. Countries with profitable companies typically trade at a premium to those with a less profitable corporate sector. The relationship is sufficiently strong that it explains more than 35% of the difference in valuations between countries (see Chart 4).

While this is obviously a sparse list of factors, growth, profitability, and solvency explain a significant portion of the difference in relative valuation. Based on these three categories, we believe that the CASSH countries deserve to trade at a premium versus the larger, developed nations.

CHART 4

Return-on-Assets and Valuations

Source: Bloomberg 9/30/11.

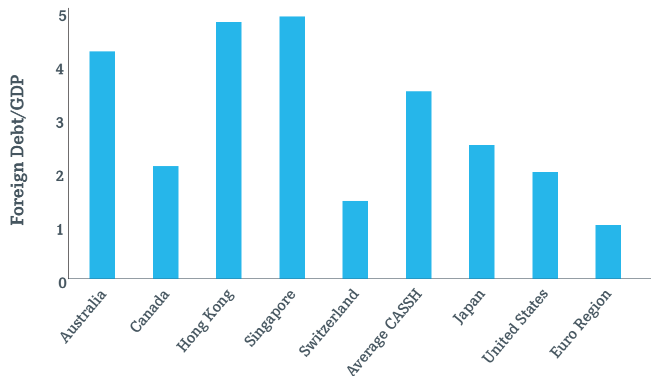
Growth: Small and Nimble

By the end of third quarter 2011, even the most optimistic investor had to agree that most developed countries were facing a prolonged period of slow growth. This is consistent with historical precedent; typically, recessions induced by credit bubbles are characterized by slow, anemic recoveries. While some of the smaller countries also participated in last decade's credit splurge, by and large, they exited the bubble with stronger banking systems and intact sovereign balance sheets. As a result, the CASSH countries generally held up better in 2011 and are also likely to grow faster next year (see Chart 5).

While overall global growth is likely to remain muted in 2012, on a relative basis the CASSH countries are likely to expand significantly faster than the larger, developed countries. Not surprisingly, the Asian countries — Hong Kong and Singapore — are expected to lead, with growth approaching 5%. Not far behind is Australia, which is expected to continue to benefit from the secular increase in commodity

CHART 5

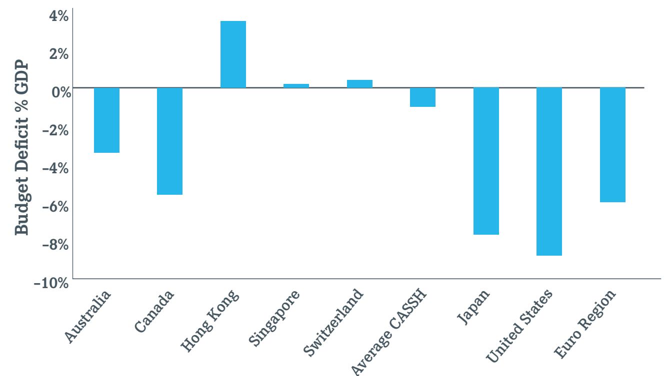
Real GDP Estimates 2012



Source: Bloomberg 9/30/11.

CHART 6

Budget Deficit as % GDP



Source: Bloomberg 9/30/11.

demand from China. In all, the CASSH countries are expected to grow by roughly 3.5% in real terms in 2012. In comparison, the United States, Japan, and the euro zone are expected to grow less than 2% (interestingly, economists are expecting Japan to outgrow Europe and the United States next year, indicating just how poor the prospects for the United States and Europe have become).

While forecasts are obviously subject to error, there are several fundamental reasons why the CASSH countries should demonstrate faster growth in 2012. One key reason is that these countries are less likely to be hampered by large deficits like those that plaque the United States, large swaths of Europe, and Japan.

Consistent with the bursting of previous credit bubbles, fiscal conditions have deteriorated significantly in most developed countries. However, the situation is far worse in Europe, the United States, and Japan than it is in the rest of the world. While the exact reasons differ — bank guarantees in Europe, persistent deflation in Japan, and a narrow tax base and growing entitlements in the United States — all three regions are facing enormous fiscal strain. In the United States, the deficits in 2009-2011 were consistently around 9% of GDP, the highest levels seen since the immediate aftermath of World War II. Europe and Japan were only slightly better (see Chart 6).

In contrast, with the exception of Canada, deficits in the CASSH countries are much lower, with Hong Kong even running a significant surplus. On average, the CASSH countries had deficits in 2010 of less than 1% of GDP, versus 7.5% on average in the United States, the euro zone, and Japan. Even in the case of Australia and Canada, the situation does not look as severe as it appears at first glance. According to Bloomberg, while the Australian deficit is likely to come in at around 3% in 2011, it is expected to fall to a little over 1% in 2012. And, according to the Canadian Minister of Finance, Canada's deficit for 2012-2013 is projected to be cut by almost two-thirds from 2009-2010 levels. Beyond the next couple of years, the Canadian deficit is projected to continue to decline to $0.3 billion in 2014-2015, followed by an expected surplus of $4.2 billion in 2015-2016.[1]

Lower deficits in the CASSH countries convey several advantages and lower the risk of these economies tipping back into recession. First, lower deficits suggest more room for fiscal stimulus, should it become necessary. One of the reasons investors have become so pessimistic on the outlook for growth in the developed world is due to the perception that most of these countries are "out of bullets." In the presence of huge deficits, these countries lack the wherewithal to promote growth through fiscal means — either by increasing spending or by lowering taxes. This is much less of an issue in the CASSH countries.

In addition, deficits in the large, developed countries are likely to act as a drag on growth in other ways. Large deficits represent consumption over savings. Today's savings — whether from individuals, corporations, or the government — fund investment in future productive capacity. When budget deficits rise, all else being equal, national savings go down. If savings drop, there is less to invest. With fewer savings, countries accumulate fewer assets. With less of an asset base, national income suffers as there are fewer productive assets to generate future income.

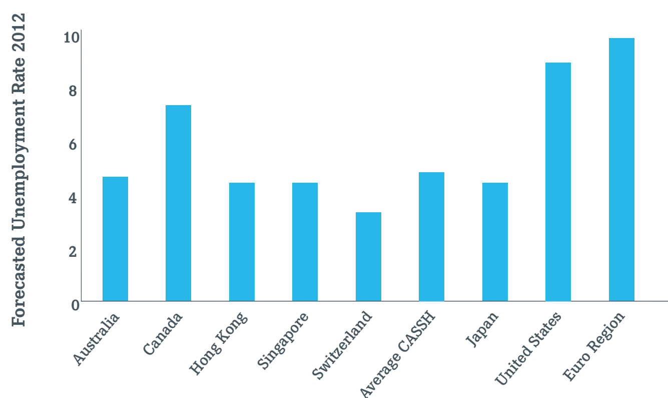
Another side effect of the bursting of a credit bubble has typically been high unemployment. In their seminal book, *This Time Is Different*, Carmen Reinhart and Kenneth Rogoff [2] highlight the impact of bursting credit bubbles on labor markets. Their research suggests that typically a bursting credit bubble will have a "deep and prolonged" impact on unemployment. On average, a modern financial crisis has caused

[1] *The Next Phase of Canada's Economic Action Plan: A Low-Tax Plan for Jobs and Growth*. Tabled in the House of Commons by the Honourable James M. Flaherty, Minister of Finance, June 6, 2011.

[2] Reinhart, Carmen, and Kenneth Rogoff. *This Time Is Different: Eight Centuries of Financial Folly*. Princeton, NJ: Princeton University Press, 2009.

CHART 7

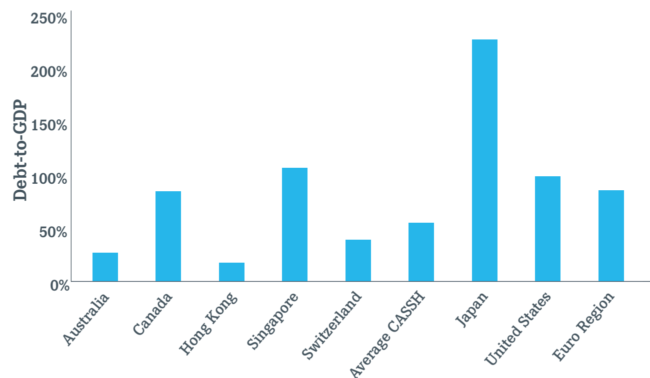
Unemployment



Source: Bloomberg 9/30/11.

CHART 8

Gross Public Debt to GDP



Source: Bloomberg 10/31/11.

the unemployment rate to rise for more than four years and by 7 percentage points.

The United States and Europe appear to be following the trajectory described by Reinhart and Rogoff. While unemployment remains low in Japan, structurally high unemployment is a problem for much of Europe, and it is a growing problem in the United States (see Chart 7). If this credit bubble follows the same pattern as previous ones, this could be the case for the foreseeable future. If so, high unemployment is likely to be particularly problematic in the United States. With the US consumer still comprising roughly 70% of the economy, a slow recovery in the labor market — with a likely accompanying stagnation in real wages — does not bode well for consumption or growth in 2012. In contrast to the United States and Europe, unemployment in the CASSH countries is modest. The average unemployment rate in the five CASSH countries is currently less than 5%.

Faster economic growth does not guarantee higher equity returns. Historical relationships between growth and stock returns have generally been weak. But as demonstrated, faster growing countries generally trade at higher valuations. All else being equal, slow growth in the larger, developed countries suggests that their equity markets should trade at a discount to their faster growing peers.

Solvency: Less Debt, More Sustainable Obligations

Economic growth affects equity valuations as faster economic growth typically translates into faster earnings growth. In contrast, debt levels drive valuations through their impact on the discount rate. Higher debt levels are indicative of greater risk, and as such should command a higher discount rate or lower valuation.

Today, even more than growth, most measures of solvency favor higher valuations in the smaller, developed countries. As previously discussed, credit bubbles exert a lingering influence over a country's economic path. Not only do credit bubbles lead to higher unemployment, they also blow a hole in the sovereign's balance sheet. Analysis by Reinhart and Rogoff indicates that, on average, government debt rises by 86% in the three years following a bank crisis. According to data from Bloomberg, during the most recent financial crisis, publicly traded debt in the United States jumped from $5.3 trillion in second quarter 2008 to $9.8 trillion in second quarter 2011, an increase of 84%.

In contrast, many of the smaller, developed countries have seen a much milder increase in debt. Thanks in part to stronger banking systems, their respective bailouts have been considerably smaller than those in Europe or the United States (see Chart 8). As a result, gross debt-to-GDP averages around 50% in the CASSH countries, versus 225% in Japan, nearly 100% in the United States, and roughly 85% in Europe (despite all the handwringing over Europe, in aggregate, its debt is lower than US debt, and for the 17 members of the currency union, it is actually a bit lower still at around 80%).

It is also worth noting that, to some extent, the numbers for the CASSH countries arguably look better than the headline statistic suggests. This is because the average debt-to-GDP ratio for the CASSH countries is inflated by Singapore, which has a headline debt-to-GDP of 105%. However, Singapore's debt consists largely of Singapore Government Securities (SGS) issued to assist the Central Provident Fund (CPF), Singapore's retirement system. Special issues of SGS are held by CPF, and are non-tradable. The government of Singapore has not borrowed to finance debt expenditures since the 1980s.[3] Singapore's external debt is a miniscule $21 billion.

[3] http://www.indexmundi.com/singapore/public_debt.html, accessed 10/20/2011.

The better fiscal position of the CASSH countries is reflected in BlackRock's Sovereign Risk Index, a proprietary index that measures the riskiness of sovereign debt. While there is no rating for Singapore and Hong Kong, the other CASSH countries rank in the top 10 globally: Switzerland is ranked third, Canada fifth and Australia eighth. In contrast, none of the large European countries, the United States, or Japan make the list of the top-10 safest countries for sovereign debt (of the three, Japan is last at 34th, one notch below Turkey).

Finally, there is one additional point to make on the role of debt and solvency in valuations. When considering a country's long-term solvency and the appropriate discount rate to use, it is important to consider not just the explicit liabilities but also the implicit liabilities. This is one reason why Germany is currently trading at such a significant discount to other markets, despite the fact that is has a relatively pristine balance sheet. Investors are less concerned about Germany's debt level than about its contingent liabilities, i.e., the extent to which Germany might be forced to fund further bailouts for the weaker members of the euro zone.

In a similar manner, investors also worry about the unfunded liabilities a country owes to its own citizens. This is a particular concern in the United States, where various estimates of unfunded pension and healthcare costs run into the tens of trillions of dollars. While most of the CASSH countries face similar demographic challenges, it is interesting that, for the most part, the CASSH countries appear to at least have more sustainable pension systems.

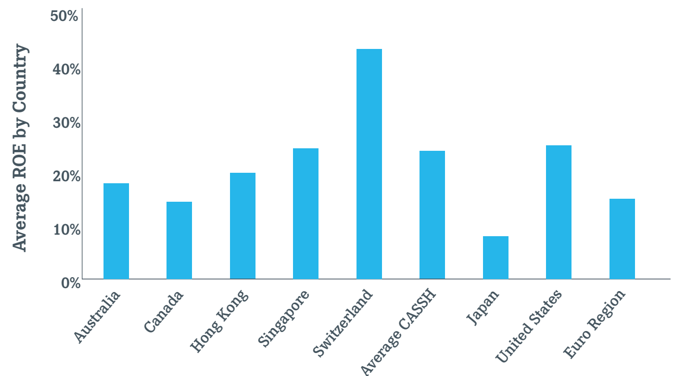
For example, Australia has revamped its retirement system so as to minimize the unfunded liability. Known as the superannuation retirement system, the scheme has a compulsory element whereby employers are required to pay an additional amount of employees' salaries and wages (currently 9%) into a fund. Funds can be accessed when the employee meets conditions of release. After a decade of compulsory contributions, Australian workers have more than $1.2 trillion (USD), more money invested in managed funds per capita than any other economy.[4]

In Canada, the system does not look quite as solid as Australia, but it does appear to be better funded than the United States. The Canadian Pension Plan (CPP) is a contributory earnings-related social insurance program. It forms one of the two major components of Canada's public retirement income system, the other being the Old Age Security (OAS). The CPP mandates that all employed Canadians, who are 18 or older, contribute a prescribed portion of their earnings income to a nationally administered pension plan. CPP is funded on a "steady state" basis: its current contribution rate is set so that it will remain constant for the next 75 years. In other words, assets held in the CPP are by themselves insufficient to pay for all future benefits accrued to date, but sufficient to prevent contributions from rising further.[5] In this respect, Canada compares favorably with the United States, where at some point in the next few decades (depending upon your actuarial assumptions) Social Security assets will no longer be sufficient to pay promised benefit levels.

[4] Wikipedia, accessed 10/20/2011

CHART 9

Return-on-Equity (ROE)



Source: Bloomberg 10/31/11.

Whether based on explicit debt or unfunded liabilities, the CASSH countries, on average, appear less of a credit risk than the large, developed countries. While the United States is likely to continue to benefit from its status as the issuer of the reserve currency, the Standard and Poor's downgrade of the US credit rating last summer illustrated that its sovereign balance sheet is not what it used to be. Similar to the story on growth, more manageable debt levels in the CASSH countries do not necessarily imply higher returns, but less sovereign risk should be rewarded with a higher multiple.

Profitability: CASSH Countries are Competitive

The third component that has typically driven valuations is profitability, measured by either return on equity (ROE) or return on assets (ROA). As with solvency, ROE and ROA are both relevant when comparing a country's current valuation with its history and also for marking comparisons between countries.

From the above analysis, it is clear that CASSH countries are likely to grow faster and are, on average, in better fiscal condition than their larger peers. It is also true that they are as profitable as the larger, developed countries, if not more so. ROE in the CASSH countries runs from a high of nearly 43% in the case of Switzerland to a low of 14.5% for Canada (note that Switzerland's astounding ROE is partly a function of the fact that a large part of the Swiss market cap is concentrated in pharmaceuticals and consumer staples, two sectors that have

[5] Ibid

particularly high ROE). The average for all five countries is 24%, which compares favorably with the global average of around 20% (see Chart 9).

While it is true that the CASSH average ROE is slightly lower than that of the United States, it is much higher than either Europe or Japan. In aggregate, the three major developed regions have an average ROE of around 16%. Even if you exclude Japan, the average ROE for Europe and the United States is still only 20%. Even more than growth or solvency, the CASSH countries arguably deserve a higher multiple considering the competitiveness of their respective corporate sectors.

Valuation: Smaller is Cheaper

So far, we've established that the CASSH countries are, on average, likely to grow faster, benefit from a stronger fiscal position, and are generally more profitable than the larger, developed nations. In isolation, all that simply suggests is that these countries should trade at a premium compared to other developed countries. To the extent that the premium is too large, investors might still be better off overweighting the United States, Europe, or Japan. However, to the extent that better fundamentals are not being rewarded with a higher P/E ratio, we would argue that this represents a potential opportunity. Under this scenario, our assumption is that valuations in the CASSH countries should converge with the averages for the larger countries, and in the process provide better relative returns.

Today, despite better fundamentals, the smaller, developed countries trade at virtually the same P/E ratio as their larger counterparts. As of early November, the CASSH countries had an average P/E ratio of 10.7x based on next year's earnings. Of the five countries, Singapore was the cheapest based on current earnings, with a P/E ratio of just 8x, while Hong Kong looked the cheapest based on next year's earnings, at 9x (see Chart 10).

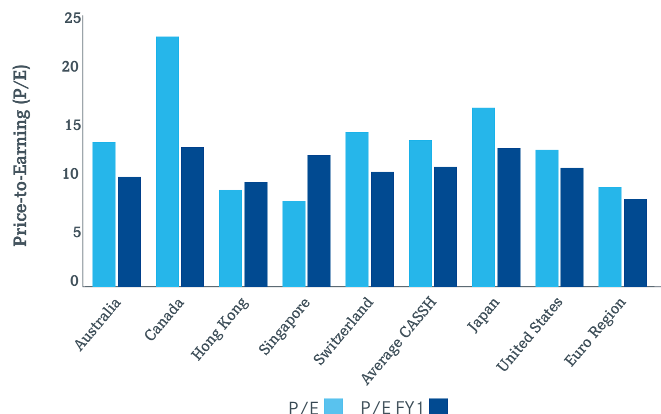
These numbers are on par with the average for the United States, Europe, and Japan. Of the three regions, Europe is easily the cheapest, trading for under 10x earnings and barely 8x next year's earnings. However, on average, the large, developed countries trade for approximately 10.7x next year's earnings, identical to the CASSH countries. Despite considerably worse fundamentals, the larger, developed nations offer no discount. To the extent that the discount is not evident in today's prices, we believe investors have a better alternative in overweighting CASSH equity markets, getting better fundamentals for a similar price.

What About the Currencies?

While the equity markets of the CASSH countries may look reasonable to cheap compared to the United States, Europe, and Japan, this leaves open the question of their currencies. A dollar-, euro-, or yen-based investor will be assuming significant currency risk by investing in the CASSH countries (Hong Kong being the possible exception). Does the expected return on the currency side of the trade change the risk-reward of investing in the CASSH countries' equity markets?

CHART 10

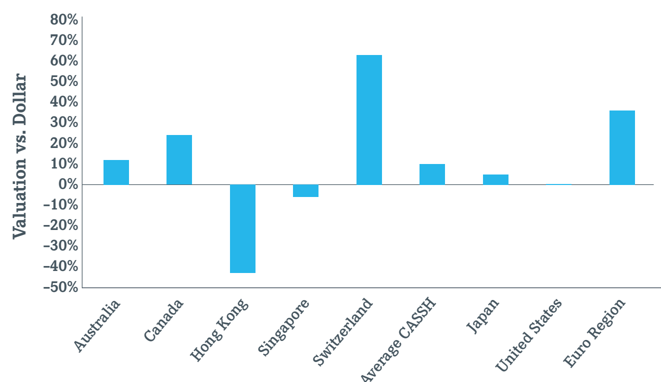
Valuations



Source: Bloomberg 11/01/11.

CHART 11

The Economist Big Mac Index



Source: *The Economist*, http://www.economist.com/blogs/dailychart/2011/07/big-mac-index

A long-term currency forecast is notoriously difficult, but as a sanity check we used one of the simpler metrics of currency value to assess how over- or under- valued the CASSH currencies may be relative to the US dollar. For this exercise, we selected purchasing power parity (PPP) as a reasonable metric to compare the CASSH countries' valuations relative to the dollar.

The notion of purchasing power parity is relatively straightforward. A basket of goods — preferably goods that are consistent in quality — should cost the same in different countries once you adjust for exchange rates. Based on this definition, it is possible to compare different currencies to see how well they hold to this relationship.

One of the longer-lived PPP indices is the famed "Big Mac" index, published by *The Economist*. While originally a somewhat tongue-in-cheek take on this theory, the Big Mac index accommodates the spirit of PPP quite well: a Big Mac is a consistent item that should cost the same in dollars regardless of the location.

Based on this index, Switzerland looks like the biggest currency risk, with a 63% overvaluation against the dollar, while Hong Kong appears roughly 40% undervalued. In all, the CASSH countries appear roughly 10% overvalued versus the US dollar. This is an improvement versus the yen and euro, which are overvalued versus the dollar by 5% and 36%, respectively (see Chart 11).

For US dollar-based investors, the CASSH basket appears more reasonably priced versus the dollar than a combination of the euro and yen (it should be noted that while the Hong Kong dollar appears undervalued versus the US dollar, the Hong Kong dollar is currently pegged to the dollar through a currency board. Therefore, a formal revaluation would be necessary to realize any undervaluation).

Another reason that investors may benefit from — or at least not be hurt by — the exposure to the CASSH block currencies is the fact that, as noted above, the United States, Europe, and Japan are all distinguished by relatively large deficits and arguably unsustainable debt-to-GDP ratios. The danger in these deficits is that these countries could seek to manage their obligations not through fiscal reform but by monetizing the debt, i.e., allowing their central banks to purchase the debt directly and in the process dramatically increasing the supply of money. Should any of the larger, developed countries choose this route; the effect is likely to be a significant debasement of their currency versus countries that maintain a more conventional monetary policy. While we are not suggesting that any of the large, developed countries view monetization as a debt management tool, investors cannot ignore the possibility. The fact remains that excessive debt levels in the United States, Europe, and Japan introduce a risk of debt monetization that is largely absent from the CASSH countries.

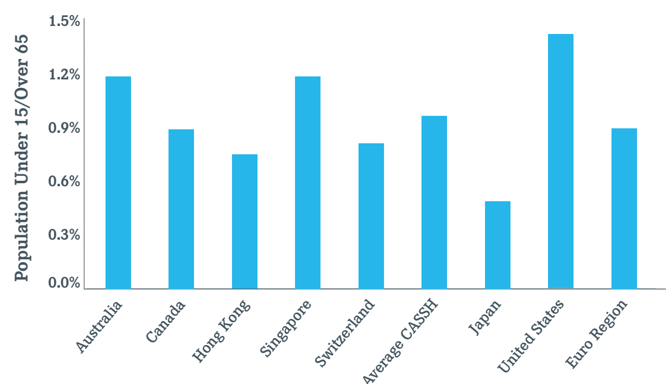
Cautionary Notes

We have focused the body of this analysis on the ways in which the CASSH countries differ — primarily in a positive way — from the larger, developed countries. While the CASSH countries enjoy several advantages, there are other ways in which they face some of the same challenges as the rest of the developed world.

One area in which the CASSH countries look depressingly similar is demographics. Along with other developed countries, most of the CASSH nations will face aging populations over the next several decades. This graying of the developed world will hurt these countries in a number of ways. As has been well documented, a large working age population relative to retirees is a significant tailwind for growth.

CHART 12

Demographic Ratios



Source: Bloomberg 10/31/11

As the balance of the population approaches retirement, there is less growth in the work force, which is a drag on GDP. An aging population also hurts a country's finances to the extent it implies a higher dependency ratio, i.e., the number of individuals not in the work force relative to the number of working age individuals.

Within developed countries, the United States actually stands out as having one of the more favorable demographic profiles, thanks in part to steady immigration and relatively high fertility. On the opposite side of the spectrum, Japan is a demographic time bomb, with a population that is rapidly graying and too few young adults entering the workforce.

So how do the CASSH countries compare? While there is a fair amount of variation in the demographics, Australia and Singapore look alright, while Hong Kong's demographics are worse than Europe's. On average, however, the CASSH countries' demographics are in line with the rest of the developed world. The average ratio between those under 15 to those above 65 is 0.97, virtually identical to the average for the United States, Europe, and Japan (see Chart 12). In other words, in the absence of significant immigration, demographics in the CASSH countries are likely to be as large of a drag on growth as they will be for the rest of the developed world.

The second issue to be aware of with the CASSH countries is their overall debt levels. Thus far, we've focused on public sector debt. When taking into account private sector debt, the CASSH countries look less distinct. Australia, for example, has private sector debt equivalent to roughly 130% of GDP, while Switzerland's ratio is 175%. These levels compare favorably with the United States, where an overleveraged consumer has pushed private sector debt to over 200% of GDP, but they look less impressive relative to France and Germany, where private sector debt is a bit above 110% of GDP.[6]

[6] Source: Bloomberg

One final issue to be aware of: certain CASSH countries are home to large banking sectors. This is particularly true in Australia, Singapore, and most of all Switzerland. As a result, these countries have large bank assets relative to the size of their overall economies. For example, Switzerland has banking assets that equal more than370% of GDP.[7] While the banking systems in these countries appear sound, similarly large banking sectors were problematic in many countries — think Ireland — during the lead-up to the financial crisis. This introduces an additional risk — financial sector leverage — that investors need to remain aware of.

Conclusion

"*Facts do not cease to exist because they are ignored.*"
Aldous Huxley

The CASSH countries suffer from a number of disadvantages when it comes to investor mind share. First, they comprise a relatively small part of traditional global equity indices, such as the MSCI World or ACWI indices. Second, they are somewhat exotic, making it less likely that investors in large countries will allocate capital to relatively esoteric countries. Third, and this is particularly true in the case of Hong Kong and Singapore, investors might not even think of these as developed countries. Finally, and perhaps most importantly, the CASSH countries suffer by definition from the home-country bias. As these countries have a relatively small investor base — with the possible exception of Australia, which punches well above its weight —whatever benefit they derive from their domestic constituency is lost when compared to the much larger pools of money available in the United States, Europe, and Japan.

Arguably this has created an opportunity, for three reasons:

First, a combination of lower debt and less structural damage from the financial crisis suggests that these countries should, on average, grow faster than their larger peers. While this in itself does not guarantee outperformance, faster economic growth has historically correlated with faster earnings growth.

Second, these countries do not suffer from the same fiscal imbalances as the United States, Europe, and Japan. While they will be impacted by systemic risk along with the rest of the global economy, their idiosyncratic risk is lower, and should be rewarded with a lower discount rate and a higher multiple.

Finally, these countries all have profitable corporate sectors, which are capable of competing on a global stage.

Despite these advantages, investors can pay approximately the same price for a dollar of earnings in the CASSH countries as they would for the same cash flow in the United States, Europe, and Japan. To the extent investors are getting better fundamentals for the same price, we believe they should consider an overweight to these markets in their equity portfolios.

Nonetheless, there is some non-trivial risk that the sovereign debt issues in the United States, Europe, and Japan will ultimately be resolved partly through a depreciation of their currencies. Even in the United States, where the dollar appears undervalued, a cheaper dollar may prove the most politically expedient way to deal with the current fiscal imbalances. In this event, the diversification into these smaller countries may prove additive.

It is certainly true that the CASSH countries have their own challenges. As witnessed in 2008, a global recession or crisis will hit them as hard as, if not harder than, places like the United States which, despite all its travails, continues to enjoy safe-haven status. That said, over the long term, we believe that the catalyst for a future crisis is more likely to come from the United States, Europe, or Japan, than from any of the CASSH countries. As such, using these countries to mitigate any home-country bias seems like a prudent strategy, even if they are a bit harder to find.

[7] Ibid

The Case for CASSH?

Some Examples of Investing with Potential iShares Solutions

	Potential iShares Solutions	
Canada	iShares MSCI Canada Index Fund	EWC
Australia	iShares MSCI Australia Index Fund	EWA
Singapore	iShares MSCI Singapore Index Fund	EWS
Switzerland	iShares MSCI Switzerland Index Fund	EWL
Hong Kong	iShares MSCI Hong Kong Index Fund	EWH

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