Russell Investments

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Identifying “Country of Risk” in the Wave of Globalization

As technology advances and societies evolve, globalization is reshaping local cultures and melding global financial markets. Giant corporations, like Coca-Cola and Nestle, are taking advantage of this globalization wave by manufacturing products in various countries, sharing resources and operations across national borders and, most importantly, serving customers worldwide. While globalization has strengthened these companies’ competitive positions against those of their locally focused rivals, it has also complicated country risk assessment for investors who own their equities.

As we set out to illustrate that, as N. Carter noted in 1987, “Country risk assessment is an art and not a science,”[1] we first ask the question, “Why is country still important to investors?” Then we briefly explain some practical challenges a portfolio manager would face in managing a global portfolio. Finally, we carefully study several individual companies’ different country profiles and show how complicated country classification can become.

Why is country still important to investors?

The evolution of global capital markets allows investors to invest in companies with significant potential no matter where they are located. Recent Russell research has shown that sector effect is becoming more important than country effect in explaining short term stock returns.[2] While “going global” is the unquestioned trend for future investment styles, today’s investors currently still face conceptual barriers and practical challenges in trading and managing assets outside their home countries.

Before entering into a foreign country’s equity market, investors need to have basic knowledge about the country’s macroeconomies, including the country’s GDP, sovereign

[1] “Country Risk Assessment,” Carter, N. (1987). In International Finance and Investment, Bankers Books Ltd., London; p. 429.

[2] Xin Yan, Ph.D. FRM. 2009. “Going global: A changing view of country, sector, size and style.” Russell Research, 2009. Available on request.

debt rating, overall openness of its capital market, corporate governance, and currency valuation. These macro factors usually have little day-to-day impact on a stock's trading activities. However, they reflect and influence market participants' views of a country's overall economic status. Substantial movements in these macro factors could mirror or trigger huge speculation regarding the future of the country, thus indirectly affecting stock prices of companies domiciled in that country. Of course, these new dynamics also bring in tremendous opportunities for potential excess returns to investors and have become a key investment strategy for asset owners to achieve incremental returns with respect to their foreign holdings. It is also worth noting that these macroeconomic risks are not company-specific. In other words, it's reasonable to assume that country risk exposures are universal to all companies residing in the same country. For evaluation of an individual stock, country risks need to be considered on top of the company-specific analysis.

Practice challenges for international managers

Technically speaking, international equity managers' jobs are more challenging than those of their domestic peers. They not only need to understand and evaluate company-specific factors, but also country-level factors and associated risks. "Country risk" to them is a much broader concept than just macroeconomics. Many details need to be learned quickly, such as working with the local exchange platforms, currency exchange rules, trading regulations and so on. Some countries have a special set of regulations for non-domestic investors. It is critical for a manager to understand exactly where the opportunity set is. Take ownership restriction, for example. It is very common for a country to impose foreign ownership limits (FOLs) on listed companies in sensitive public sectors such as aerospace, defense, telecommunications, broadcasting and mining. For instance, in Japan, foreigners can not hold more than 25% of a broadcasting company's outstanding shares. Foreign ownership restrictions can be company-specific, too. In Ireland, Ryanair protects its ownership by shutting the door to all non-EU investors, and non-Canadian investors cannot hold more than 49% of Canadian Oil Sands Trust units. FOLs are also prevailing in emerging countries. To list a few: Non-Gulf-Council-Corporation (GCC) investors are not allowed to own more than 49% of the equities of any public company in Qatar; a non-Chinese-national individual is not allowed to invest in the Chinese A-share market, and so on.

Managing a stock portfolio efficiently in many foreign markets at the same time also requires the portfolio manager to work long hours and deal with trading activities in different time zones. An international stock portfolio is usually also a multi-currency portfolio. As a result, some foreign-exchange knowledge and, possibly, hedging strategy would be helpful in portfolio management as well. In summary, a successful manager should be experienced with various individual markets and should also know how to coordinate these country blocks into a working global portfolio.

Companies' country profiles

Russell's global equity universe contains securities listed on more than 75 stock exchanges worldwide. Among the 40,000-plus publicly traded companies, three major country profiles can be identified on the basis of company characteristics:

1) Traditional local companies residing and operating in a single country;
2) Global corporations with diversified business units and client groups in multiple geographic locations; and
3) Benefit-driven companies with divergent country characteristics in their incorporations, domiciles and stock listings.

We estimated that within our global equity universe, more than 95% of the names belong to the first two categories. In other words, the firms can be described as being either truly local or truly global. For these companies, their three home-country indicators [3] (HCIs) are highly consistent. As a result, both groups of companies can be classified to their respective countries of incorporation.

It is the third group of companies that is of most interest to our study. Unlike a diversified global enterprise with broad economies of scale, a benefit-driven company's client base is usually concentrated in a single market. To take advantage of various benefits, such as lower legal, tax and labor costs or better market liquidity, a company might deliberately choose a country where the legal system or business environment is most friendly. As a result, these companies usually have blended and disconnected country profiles, featuring diverged HCIs. For example, Baidu.com, the largest Internet search engine firm in China, is a Caymanian-incorporated company. Yet its only publicly listed stock trades on NASDAQ in the form of an American depositary share (ADS), while the underlying Chinese shares are unlisted in China. Thus three countries are linked via legal and tax laws (country of incorporation), assets and revenue (country of domicile) and stock trading (country of primary listing). This creates tremendous complications for market practitioners who are accustomed to classifying a company in a single country.

Benefit-driven companies select individual countries for inclusion in their company profiles for different purposes. We analyzed a variety of country profiles of such companies in our global equity universe and decomposed the overall company risk exposure to its legal/tax risk, financial risk and business risk. The following country risk indicators (CRIs) were created to help global investors identify the most influential single risk basket for such companies.

- Legal/ tax risk: Country of Incorporation
- Financial risk – assets: Country where most of the company assets are located
- Financial risk – income: Country where most of the sales/revenue are generated
- Business risk – management and operations: Country of company's headquarters

Using CRIs to classify a benefit-driven company

Unlike a global firm with diversified consumer groups and collaborative business units in multiple locations, a benefit-driven company features diverged HCIs with few or no business interactions among the countries. For instance, a company may reside in a country where labor costs are low and there is great client potential. However, that particular market might not maximize the company's tax savings, or the local stock market might not be the most attractive for the company's initial capital raising. Provided substantial incentives, a company might seek to register outside its country of domicile. For instance, by incorporating in a "tax haven," the company might significantly reduce its tax payments in its country of domicile.[4]

For security analysts and index providers, divergence in a company's legal and financial risks causes conflict in assigning a stock to a single country. As previously mentioned,

[3] Russell defines three Home-Country Indicators in its Global Index construction methodology: Country of Incorporation, Country of company's primary headquarters and Country of company's primary stock exchange.

[4] The term "tax haven" refers to "an area where a composite tax structure was established deliberately to take advantage of, and exploit, a worldwide demand for opportunities to engage in tax avoidance" (definition provided by Geoffrey Colin Powell and adopted by The Economist and others). The issues surrounding such deliberate tax avoidance is well recognized and discussed by various governmental organizations, including OECD, G20, IMF and the U.S. National Bureau of Economic Research. While some country names are commonly observed in "likely-to-be" lists, none of these organizations was able to provide a straightforward list of country/region of "tax havens."

country of incorporation ties into the entity's legal and tax risk, and the location of its assets, revenue and business operations link to its financial and business risk. All three types of risk, when exaggerated, can be critical to a company's equity performance. Thus for these companies, the challenge is rather how to pick the country that best relates to the company from the investors' point of view.

There are a handful of well-known benefit-driven companies whose primary stock listing is in one country but whose incorporation is overseas. For these companies, stock performance is less correlated with the macroeconomic conditions of the country where they incorporated. An example is Garmin, which is headquartered and incorporated in the Cayman Islands but listed on NASDAQ, who raises the bulk of its capital in the U.S. It also generates almost all its revenue in the U.S. and in Europe. Obviously its overall risk lies outside its country of incorporation.

For a company with diverged HCIs, the primary location of its assets or revenue seems to drive investors' perception of which country it belongs to. This is also true of companies that incorporate in the U.S. but whose primary assets or sources of revenue are located elsewhere. In almost all cases, the primary location of the company's assets or revenue is the best match to meet investors' expectations. SOHU.com is a Chinese company that has 100% of its revenue-generating activities and assets in China but trades in and is headquartered the U.S. In this case, China would seem to be a more appropriate "country of risk."

Data limitations and possible solutions

Although the primary location of assets and revenue is the strongest country indicator for benefit-driven companies, the geographic asset/revenue breakdown is not always available for each and every public firm. As of today, this data is not a requirement under IFRS standards, nor is it stringently suggested in any other well-known financial reporting standards. Even when companies voluntarily provide the data, the format for presentation of geographic breakdowns is not standardized. Breakdowns by country, region and a mixture of both are observed across our global equity universe. Absence of the assets/revenue location data or otherwise insufficiently detailed information brings more challenges to allocate benefit-driven companies. In such cases, we recommend using "country of headquarters" as a supplemental source, assuming their business risks share the same geographic profiles as their financials.

Physical headquarters address is often more accessible from a company's filings. However, this method of discovery is not flawless. As globalization proceeds, fewer and fewer companies detail their financials to the country level anymore, especially in continental Europe. Sometimes, the exact addresses of their corporate headquarters do not show the full spectrum of places where their primary business risks reside.

Conclusion

Since 1984, Russell has consistently maintained its objective and rules-based standard for index construction. However, when it comes to classifying a company in a single country, we have discovered that the “one company/one country” concept creates complications in today’s new environment, with its increasingly integrated markets. The conventional incorporation-driven country classification methodology has sometimes led to unreasonable outcomes.

Globalization allows companies to have their legal entities incorporated in one country, employees and factories situated in another, and product sales conducted in yet a different market. In many cases, incorporation – or any other single risk factor – is not alone sufficient to identify a company’s accurate country risk profiles. In this paper, we recognize that the issue does not apply to the majority of the companies in our global equity universe. Their home country indicators (HCIs) continue to point to the same country, which is thus undeniably also their country of risk.

There are however limited numbers of “benefit-driven” corporations whose HCIs do not match. To help identify such a company’s true country of risk, we created a new set of risk indicators, called country risk indicators (CRIs), which correspond to the company’s legal/tax, financial and business risks, respectively. After examining different styles of company profiles, we found the geographic distribution of a company’s assets or revenue to be a strong variable that effectively brings benefit-driven companies into their correct (from an investor’s perspective) country baskets, when appropriate data is available. When data is not available, Russell uses business risk or headquarters as the country of risk.

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