An Alternative Investment Methodology

Is Caterpillar a US company or a Latin American one, or a European one, or an Asian one? Is Santander Spanish, British, or Latin American? Is Alstom French, or Nestle Swiss, or HSBC British, or Chinese? Are any of the large listed Swiss companies Swiss?

When we say equities are cheap and bonds expensive, to which companies do we refer? Should we compare the equity valuations of large caps with the bond yields of high yield issuers? Could the cheap equity issuers have even cheaper bonds?

The world fears peripheral European banks. How then should an investor regard the securities of the German operations of a Spanish bank? Or the securities of the Swiss operations of a US investment bank? How much did the holder of Lehman International UK bonds get in recovery, 9 cents or a dollar and change?

Established investment methodology has always puzzled me. The modus operandi involves having a top down macro view, from which the regional and country allocations are made. A macro analysis of the relative attractiveness of equities and bonds are made, sometimes before, sometimes after the regional and country allocations are established. Bottom up stock picks are then made to populate the asset allocation. In an increasingly globalized world, this approach appears less relevant. Companies are more global than ever before. They do business and thus derive their revenues from various regions and countries and they fund themselves sometimes locally and sometimes globally, making their commercial prospects the result of complex interactions not captured by traditional methods of asset allocation.

Instead, companies should be analyzed from the bottom up by assessing the revenues from each region and country, and their costs and financing, in the same manner, from where they originate. Top down macro analysis can direct the search for opportunities but should not determine the asset allocation directly. Once the fundamentals of a company or business have been estimated, the value of the firm needs to be distributed across its corporate and capital structure. Each security is therefore valued on fundamentals. Then the hard work begins.

Asset prices and markets are driven by fundamentals not through a mechanical couple but through an elastic or viscous couple. Having a fundamental valuation of each asset is necessary but not sufficient. Market technicals and psychology need to be considered in the investment decision. For each market, an intimate understanding of all the major market participants, their motivations and capabilities, needs to be obtained and factored into the investment decision. Market participants are motivated by their economics, agency compensation, cultural peculiarities, regulation, et al. Their capabilities will involve their sources, costs, availability and stability of funding.

The result of all this analysis is the efficient portfolio. Asset allocation between equities and bonds, between regions or countries, is a consequence of the process, not the root of it.