CAPITAL MARKETS PERSPECTIVES

Global Is More Than an Asset Class. It's a Perspective.

The world is interconnected. Examples multiply daily—consumers benefit from the proliferation of global trade, investors prosper from the expansion in global capital flows, and businesses profit from an increasing ability to transact with customers around the globe. The integrated global marketplace for goods, services and ideas is evolving as never before and realigning the global economic landscape at a dramatic pace. As the relative importance of the U.S. and other developed economies shifts to make way for emerging economies to play an increasing role on the world economic stage, investors in the developed world, not to mention consumers and businesses, must adjust if they are to potentially capitalize on opportunities and manage risks.

Though our lives have become increasingly globalized, our approach to investing has not. As of August 2010, the world equity and world bond mutual fund asset categories represent only 16% of total mutual fund assets.[1] Many investors still think of non-U.S. markets as inherently more risky. Moreover, the industry's approach to portfolio management reinforces this "us vs. them" mentality by segmenting the asset allocation pie into slices reserved for the U.S., and slices for international developed or emerging markets allocations. Investors, however, can no longer count on geographical indices to diversify their portfolios. Case in point, the correlation between the S&P 500 Index[2] and the MSCI All Country World ex-U.S. Index,[3] which comprises developed foreign markets, has risen steadily over the past two decades, culminating in a near-perfect correlation during the height of the financial crisis. This rise in correlation should not be surprising, given that we live in a world where companies increasingly compete across borders, and where the location of a company's headquarters is rapidly becoming less important than the location of its markets.

In a globalized world, diversification is about finding good companies wherever they might be located, with diversified revenue streams and growth opportunities.

This development does not mean that there are less opportunities for diversification. In a globalized world, diversification is about finding good companies wherever they might be located, with diversified revenue streams and growth opportunities. Diversification is also about adding global fixed income, currency and other assets that better manage risk and help to protect investors' long-term purchasing power in an increasingly interconnected world. Of course, diversification does not guarantee profit nor protect against loss. It is time to rethink the way investors take advantage of the new opportunities presented to them and manage the emerging risks of a more integrated world. The world is evolving… and will not regress. Increasingly, it is time for investors to globalize their thinking.

In this paper, we will present the ongoing evolution in the global economy and analyze the implications for the global equity and global fixed income markets.

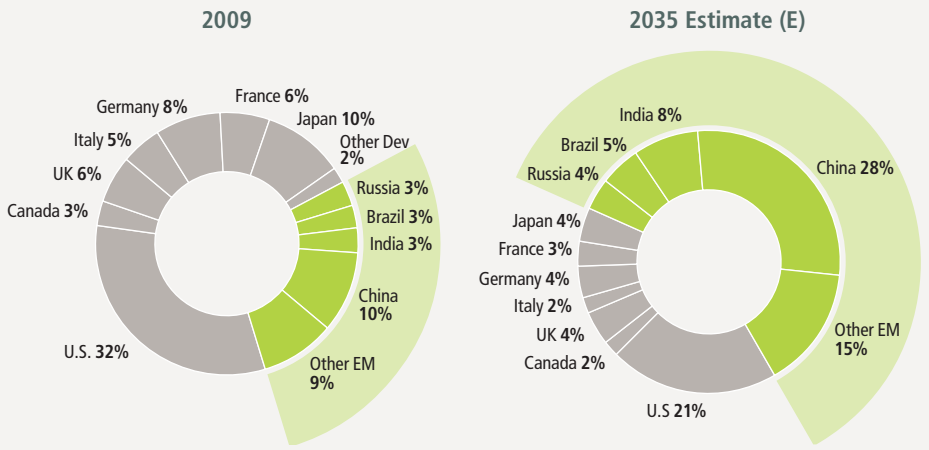
The world is evolving as never before

Today, the U.S., Japan and Germany represent half of the world's total output with U.S. shoppers alone consuming approximately one-fifth of the world's value of goods and services.[4] But the fact is that the developed world faces aging populations, disinflationary forces and untenable government debt positions. Declining labor forces in much of Europe and Japan increasingly strain the working populations of these countries to provide for their dependents that are increasingly living well beyond retirement age. Public debt levels in the U.S. and Europe are likely to equal 100% of total output by the end of this decade, and the debt burden already exceeds that in Japan.

In contrast, the structural headwinds in the developed world are among the tailwinds for emerging market economies. Demographics in developing nations are generally favorable, rising prices enable many of these countries to pursue countercyclical monetary policies, and debt levels are generally improving, particularly given expected long-term growth rates. Emerging economies are poised to grow four times faster than developed economies over the

Emerging Economies Will Claim a Larger Role on the Global Stage

GDP constant U.S.$ percentage of world GDP



Source of chart data: World Bank, OECD, Goldman Sachs Global ECS Research, as of 2/26/10.

next 20 years and economists forecast that by 2035, the output of the world's emerging economies will have surpassed that of the developed world. Within a generation, it is expected China will be the largest global economy, and five of the top 10 economies will be in the emerging world.[5]

Emerging market tailwinds

Demographics only tell part of the story

Population statistics for the emerging markets are staggering—87% of the world's population lives in the emerging world and virtually all of the increase in global population will be in developing countries—but countries with higher levels of population growth do not necessarily see more economic growth.[6] Historically, the age structure of the population is much more important. Large working-age populations with relatively few dependents are often a "demographic gift" or window of opportunity for economies, resulting in healthy bursts of economic output.[7] Baby Boomers in the U.S. during the 1980s are a prime example of this phenomenon. The current demographic make-up in countries like Brazil and India is perhaps even more compelling than the baby boom in the U.S. For example, of Brazil's nearly 200 million citizens, 43% are between the ages of 25 and 54, with only 14% over the age of 54. India is still in its adolescent phase, but with nearly 600 million of its 1.2 billion citizens under the age of 24, a large percentage of the population is poised to enter the workforce over the next two decades. Perhaps more importantly, only 11% of India's population is over the age of 54, growing to only 17% by 2030.[8]

Reducing barriers to entry

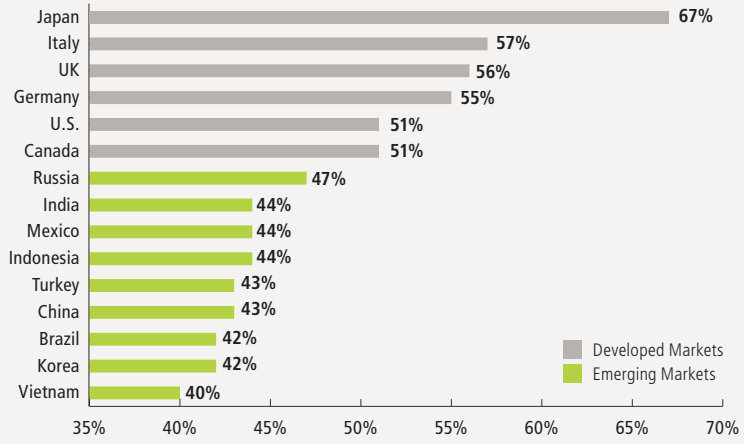
Demographics only tell part of the story. Despite so-called "demographic gifts," economic results are by no means assured and are dependent on the further fostering of competitive markets and sound monetary and fiscal policies. Countries around the world recognize what is at stake. In order to foster domestic opportunities for their citizens and attract foreign capital, governments are increasingly paying attention to the laws, regulations and institutional arrangements that shape daily economic activity. These include rules that increase the predictability of transactions by clarifying investors' rights, lowering the costs for businesses to enter the marketplace and reducing red tape. Reforms are ongoing.

Emerging economies are poised to grow four times faster than developed economies over the next 20 years.

For instance, Mexico has taken steps to allow businesses to pay taxes online and has streamlined electronic business registration for start-ups. Similarly, India has eased the process of closing a business by strengthening their bankruptcy laws. Egypt has removed an onerous pre-approval process

Part of the Story Is Demographics

Dependency Ratios: People outside working age population as a percentage of working age population (2020E)



Source of chart data: United Nations, as of 9/30/10.

for construction permits. In fact, over 90% of the countries of the Middle East, North Africa, Eastern Europe and Central Asia, and a total of 59 nations around the world, took steps in 2009 to make it easier to do business in their countries.[9]

The emerging markets are no longer simply the western world's outpost for cheap labor, but rather a hotbed of research and development and business innovations.

Widespread structural reforms have fostered better environments for individuals to accumulate skills and for firms to accumulate capital. Historically, societies that successfully curtail corruption, cut through bureaucratic red tape, and allow private businesses to flourish, generally produce much more output per worker. Over the last five years, such reforms have allowed productivity gains in the emerging world to accelerate, while those in the developed world have slowed. To suggest that there are still vast improvements to be made is an understatement. In many economies, the state-owned enterprise still rules, government bureaucracy still undermines, and crony capitalism still prevails. Nonetheless, progress over the past decade in the private sector has been significant. The emerging markets are no longer simply the western world's outpost for cheap labor, but rather a hotbed of research and development and business innovations. Many companies domiciled in the emerging world are world class—as innovative, productive and profitable as any in the western world.

The emerging consumer

As the private sector comes to the fore and companies produce more goods and services with the same or with less effort, profits increase. Businesses use such profits to invest in the innovations and advancements that grow economies and benefit societies as a whole. Of course, those gains are not distributed equally throughout societies, and much has been made of growing income inequality in many parts of the world. Wages, however, are generally improving in the emerging world as thriving industries drive large agrarian populations into the higher paying industrial and service sector jobs in the cities. Consequently, the citizens of the emerging market countries are moving out of poverty at a spectacular rate. While it took over 100 years in the United States to raise real per-capita GDP from $1,000 to $2,000 (real 2000 USD)—a wealth level that is often viewed as being above poverty levels, the citizens of countries like Vietnam, India, China and Indonesia have accomplished the same feat in less than 20 years. This revolution takes on greater importance when you consider that Vietnam, India, China and Indonesia currently represent roughly 40% of the world's population.[10]

Emerging middle class

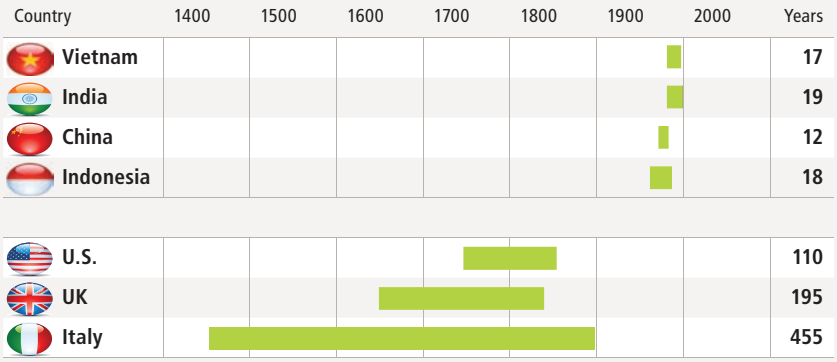
The story is not just about the movement of millions of people worldwide out of poverty. It is also about the growing middle class. According to the World Bank, there are now over 100 million households in the so-called BRICs—Brazil, Russia, India, China—with real household income over $10,000, up more than four-fold from the mid-1990s. The rapidly growing ranks of middle-class consumers (generally defined in the emerging world as earning over $6,000 annually) spans much of the emerging world and currently includes over one billion people, and they're spending a total of $6.9 trillion annually. Like the upward economic migration that took place in the United States in the early part of the last century, this growth is set to expand exponentially over the next two decades. The forecasts now show that the developed economies are expected to show little growth in the size of their middle classes, while consumer classes in emerging economies are in the early stages of rapid expansion. Keep in mind also that the income level required in emerging economies to have a "middle class" lifestyle is much lower than here in the U.S. New cars in India, for example, cost as little as $2,000.

The rise in wealth levels and growing demand in the emerging markets, in our opinion, will potentially represent the greatest investment opportunities in a lifetime.

Emerging market consumers are increasingly moving beyond the bare essentials. Rising wealth and thriving cities mean growing demand for the "finer" things. Global Insight estimates that within the next six years, demand from the emerging market consumer will represent more than 50% of the total demand for luxury goods,

40% of World's Population Is Rapidly Leaving Poverty Behind

Number of years for major economies to raise wealth levels from U.S.$1,000 to $2,000 per capita (real 2000 USD)



Source of chart data: OECD (Maddison, 2006), Goldman Sachs Research, as of 12/31/09.

growing to 56% by the end of the decade.[11] Such trends are unprecedented in world history. Companies with exposure to this phenomenon have the wind at their back. For example, LVMH, the world's largest luxury conglomerate, generated over one-third of its Q1 2010 revenue outside of the developed world, with 28% emanating from Asia (ex-Japan). It is perhaps no surprise that LVMH's highest inventory-turnover store is on the Champs Elysees. Their second highest is located in Beijing. This is just one anecdotal example of the growing might of the emerging consumer. The rise in wealth levels and growing demand in the emerging markets, in our opinion, will potentially represent the greatest investment opportunities in a lifetime.

Equity investing in a globalized world

Astute investors realize that fundamental changes in the global economy will create winners and losers. But the answer to capitalizing on the shift is more complex than simply "buy emerging markets." In fact, history suggests that there is not a strong correlation between GDP growth and market performance. While growth can create an environment in which home countries can thrive, many other factors drive performance—investment and capital deployment decisions, regulatory and tax regimes, and cost structure, to name a few. Winning companies, and winning investments, are those that find ways to capitalize on the shifting landscape. The winners will be those companies with diverse growth prospects and sustainable competitive advantages including: intellectual property, access to growing markets, respected brands and high free cash flow.

Don't forget about the U.S.

Many American companies have embraced emerging markets opportunities as key drivers of their future growth. For example, the companies in the Dow Jones Industrial Average collectively generate nearly 50% of their revenues from outside the U.S.[12]

For example, a company like Procter & Gamble (P&G), by revenue the world's largest producer of household and personal products, has tailored development, marketing and distribution to cater to consumer tastes, budgets and cultural norms around the world. P&G's goods currently reach four billion people worldwide. P&G has created items, such as low water-volume detergent and low income feminine protection products, specifically for developing nations, and has recently extended its multi-billion global toothpaste brand, Crest, which already has over 50% market share in China, to India.

Another example is Wal-Mart, the most ubiquitous name in retailing and the world's largest retailer by a considerable margin, with annual sales in excess of $400 billion. Wal-Mart is already very well positioned in Brazil, China and Mexico, and while its international sales currently represent "only" slightly more than 25% of its annual sales, the company's international sales growth is handily outperforming its U.S. sales.[13]

The companies in the Dow Jones Industrial Average collectively generate nearly 50% of their revenues from outside the U.S.[12]

Nonetheless, U.S.-centric investors are missing out on a much larger opportunity set. Of the actively traded companies with a market capitalization of over $1 billion, two-thirds are headquartered outside of the U.S. Similarly, the U.S. represents "only" 155 of the top 500 global companies by sales. While this is a much larger share than any other country can claim, the slice represents only 31% of the top 500 companies globally.[14] The Fortune Global 500 is evolving. For the first time in more than a decade, a non-American firm, energy giant Royal Dutch Shell, topped the list. The U.S., with seven of the top 20 companies, is still well represented, but the number of American companies featured in the Fortune 500 list fell to its lowest ever, while more Chinese firms have appeared than ever before. Thirty-seven Chinese companies made the list (two in the top 20), up from only six in 1998.

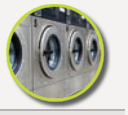
Emerging market companies have come of age

Emerging market companies are increasingly moving up the value chain. They are experimenting with new production and distribution models, and creating economies of scale that allow them to provide products and services to the world's rapidly growing consumer class more cheaply than their Western competitors. These are world class competitors and investments. According to Boston Consulting Group,

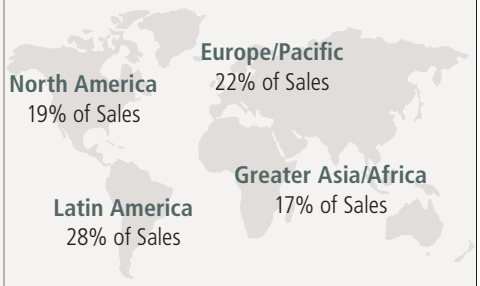
Case Studies: Personal Care

Procter & Gamble

China	Addressing common oral health issues
India	Reaching more laundry consumers
Africa	Providing female hygiene & education



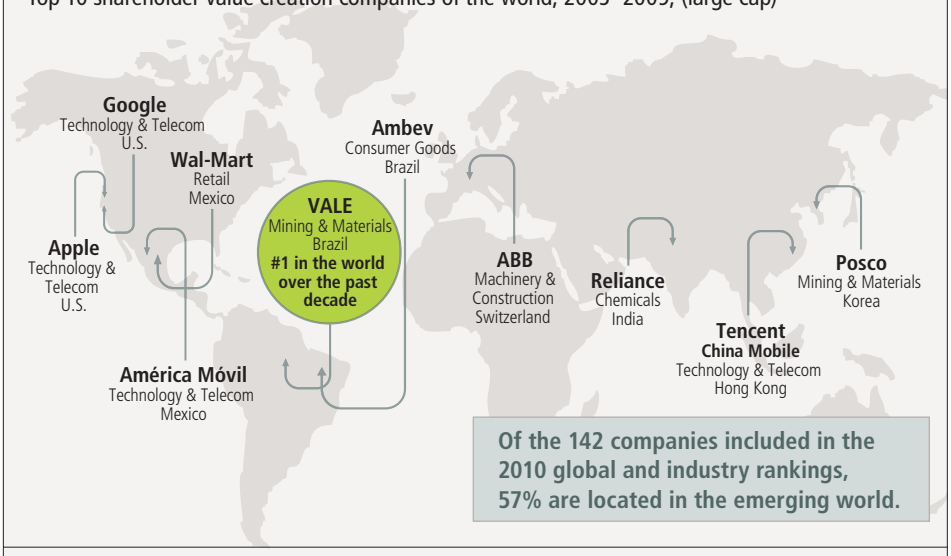
Colgate Palmolive



Source of data: Procter & Gamble and Colgate Palmolive 2009 Annual Reports.
The mention of specific companies does not constitute a recommendation on behalf of any Fund or OppenheimerFunds, Inc.

Many Top Shareholder Value Creation Companies Are Domiciled in Emerging Markets

Top 10 shareholder value creation companies of the world, 2005–2009, (large cap)



Source of chart data: Boston Consulting Group. **Past performance does not guarantee future results.** The mention of specific companies does not constitute a recommendation on behalf of any Fund or OppenheimerFunds, Inc.

eight of the top 10 companies in terms of shareholder value creation over the past five years were domiciled outside of the U.S. In fact, of the 142 companies included in the 2010 global and industry rankings, 57% are located in the emerging world. Brazil's Vale ranked number one over the past decade.

At the beginning of this century, 80% of the top quartile companies in return of capital by sector were headquartered in the developed world. Less than a decade later, nearly 50% of these industry leaders were in the emerging world.

Industry Leaders in the Emerging World

Infosys is an information technology and consulting company headquartered in Bangalore, India, with revenues of over $4.8 billion. The company has offices in 33 countries and development centers in India, China, Australia, UK, Canada and Japan and has over 110,000 employees. Infosys designs and delivers technology-enabled business solutions to Global 2000 companies. Examples extend from providing virtualization software to Schlumberger geologists searching for oil to leveraging marketing optimization technologies for Autonomy Interwoven, the leader in web-content management. The company partners with top technology firms around the world including Hewlett-Packard and IBM, and has recently announced a three-year deal to manage Microsoft's internal IT services worldwide including management of applications, devices and databases in 450 locations across 104 countries.

SABMiller, in South Africa, is, after In-Bev, the world's second-largest brewing company measured by revenues, with operations in 75 countries on six continents and over 70,000 employees. The company was founded in 1895 as South African Breweries (SAB) and purchased the Miller Brewing Company in 2002. The company produces over 200 different beverage brands with many customized for local tastes. As of March 31, 2010, the company generated over 50% of its earnings in places like Latin America (31%) and South Africa (22%), with 14% of its earnings generated in North America.

Even as western companies reeled from the 2008 recession, emerging market companies went on a shopping spree, pursuing growth through mergers and acquisitions. There were 102 deals in the second half of 2009 involving companies domiciled in the emerging world buying companies domiciled in the developed world, up from 78 deals in the first half of 2009.[15] India dominated such deals up until 2008, with China, which recorded 50 acquisitions in 2009, now leading the way. The total number of deals instigated by buyers in the developed economies is still greater but has been in decline since mid-2007. The more high profile deals include the sale of GE Plastics to the Saudi Basic Industries Corporation, the purchase of Jaguar Cars by India's Tata Group, the sale of Godiva Chocolatier to Turkey's Ulker Group and the purchase of Burger King by 3G Capital, a New York investment firm backed by Brazilian investors.

Fixed income investing in a globalized world

Diversification is also about adding global fixed income and currency exposure to help manage long-term equity risk and protect long-term purchasing power. In the fixed income markets, the U.S. experienced a 30-year bull market in bonds that began with former Fed Chairman Paul Volcker declaring war on inflation, as the Fed ratcheted up short-term interest rates to curb credit and curtail the then-ongoing wage/price spiral. U.S. interest rates are unlikely to spike in the near term with the economy grinding along slowly and the Federal Reserve Board signaling that it will provide ongoing policy accommodations. For fixed income investors, this situation creates two problems. First, investors relying on income find it increasingly difficult to generate cash flow to support lifestyle needs. And second, the low yield environment offers little protection against eventual interest rate increases, and corresponding bond price declines.

A new threat to U.S. consumers' lifestyles is the relative cost of imported goods in U.S. dollar terms. Except for a sharp drop in 2008, the price of imported goods has been rising steadily for the past decade. Part of the reason is a rise in production costs as commodities and labor prices grind higher. But another reason is a weaker U.S. dollar, which erodes purchasing power for U.S. consumers. This weakness is likely to persist as money flows out of the higher leverage, slower growth countries of the world into those economies generating true economic value. Historically, there is a tight correlation between prices of goods imported into the U.S. and the value of a basket of emerging market bonds denominated in local currencies. Investments in foreign debt markets may allow investors to hedge against a declining U.S. dollar and subsequent import price increases, while potentially generating yields in excess of those offered by U.S. Treasuries.

Historically, there is a tight correlation between prices of goods imported into the U.S. and the value of a basket of emerging market bonds denominated in local currencies.

Structural reforms in emerging markets

Despite deteriorating public finances in many developed economies, bond yields in select countries of the developing world remain high relative to those issued by many countries of the developed world. Investors have long memories and the high inflation rates and fiscal profligacy of emerging market economies during the second half of the twentieth century still haunt. Nonetheless, many emerging economies have several key attributes working in their favor. Their increasingly independent central banks have resisted currency appreciation by accumulating foreign reserves, which played a defensive role during the financial crisis. The governments have been running counter-cyclical monetary policies, currently raising interest rates to stabilize growth rates and fight inflation. Thanks to long and painful periods of debt restructuring following the excesses of the 1980s and 1990s, many governments in the emerging world have strong fiscal positions. Their strong fiscal positions mean that they have been able to increase spending when necessary without assuming an unsustainable debt burden.

Developed countries are in an altogether different position. As growth slows and populations age, the picture is likely to worsen for many developed market countries, even calling into question the creditworthiness of sovereign debt (like the countries of peripheral Europe). Expect higher taxes and scaled-back government spending in many corners of the developed world. With the exception of India, the picture is much better on the emerging market side.

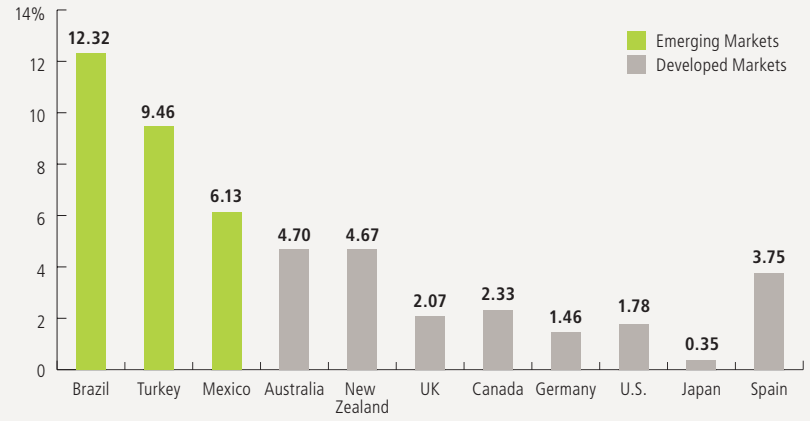
Will the long-term drop in U.S. inflation and the ensuing secular bull market in U.S. debt be echoed in countries like Brazil? The lessons of the past have seemingly been learned. The days of governments using their central banks for little more than their own personal piggybanks are a thing of the past. Brazil's independent central bank has earned its stripes over the past eight years by raising short-term interest rates to combat inflation. The results have been reminiscent of the successes of the U.S. Fed in the early 1980s, as Brazil's consumer price index has declined from nearly 18% year-over-year to 4.39% year-over-year at the end of October 2010.[16] Real yields in Brazil remain elevated as the country continues to prove its inflation-fighting credentials and as pension costs and social spending remain high. This lag between policy advances and bond market skepticism creates opportunities for investors to not only capture high real yields, but to also take advantage of potential currency appreciation as global capital flows to higher growth/higher yielding countries of the world. Brazil is simply one example. Other emerging countries are following a similar path.

Conclusion

Traditional ways of thinking about portfolio construction and diversification are outdated, and simply won't do for the markets we face today. Borders and other artificial divides can't—and won't—impede truly great opportunities, and this is welcome news for investors willing to globalize their thinking.

Time to Look Globally for Yield and Total Returns?

5-year sovereign bond yields as of 9/30/10



Source of chart data: Bloomberg, 9/30/10. Yields listed are that of each country's "on-the-run" (most recently issued) 5-yr government bond except for Brazil's, which was interpolated using 4- and 7-yr "on-the-run" bonds.

What does this all mean for investors?

Equities

For years, it has been standard practice to build an equity portfolio according to the style boxes familiar throughout the asset management industry. The core of such a portfolio typically includes core allocations to large-cap domestic stocks, divided into growth, value and/or blend categories. Smaller allocations to mid- and small-cap stocks (again, divided into growth, value and/or blend categories) often round out the domestic component, to which an international allocation—usually heavily weighted toward large-cap developed-market stocks—is appended.

A newer approach to asset allocation aims to more fully reflect the globalized nature of today's financial markets from the outset. It starts with a "global core" holding—generally shares of large companies headquartered across developed markets. The idea is to gain comprehensive exposure to the world's prime corporate movers, and evaluate companies against their competitors worldwide (not simply within regions), when searching for the most attractive investment opportunities.

Broadly diversified global portfolios will, by definition, include emerging markets exposure. Given the economic, political and regulatory risks associated with doing business in the emerging markets, maintaining separate strategic exposure to this segment is consequently advisable.

Borders and any other artificial divides can't—and won't—impede truly great opportunities, and this is welcome news for investors willing to globalize their thinking.

Global small-cap stocks also offer unique potential advantages in a portfolio, especially in the "global core" context. The small-cap market is generally less efficient and less liquid than the large- and mid-cap segments, and small-cap returns are often driven more by company-specific characteristics than global industry or style factors. It is critical for global small-cap managers to possess local, company-specific knowledge spread over a vast number of small-cap stocks across countries and regions. Analyst coverage of small-cap stocks is far less comprehensive, in every region, than for stocks of larger companies. This discrepancy may impede price discovery among market participants, leading to greater volatility and lower correlations with large-cap developed market stocks. As with an emerging market allocation, exposure to global small caps is therefore likely to help diversify a portfolio and improve its efficient frontier.

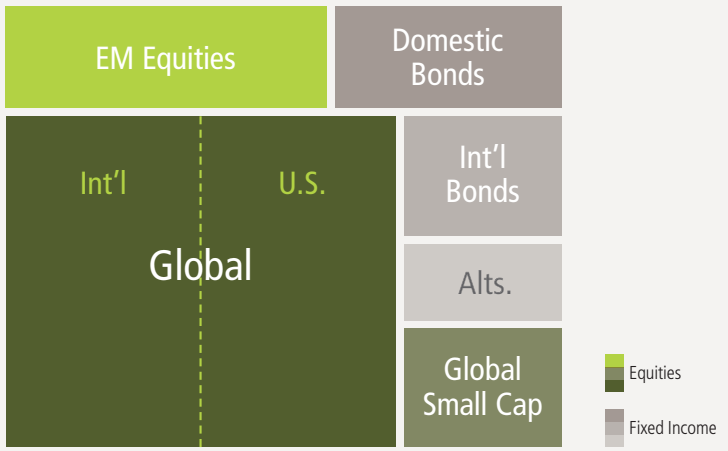
Fixed income

Global bond mandates enable a favorable position, including exposure to incremental yields and value in foreign currencies. Similar to equity investing, the partitioning of the fixed income opportunity set into domestic/international is artificial; most investors are already overexposed to the U.S. Treasury and agency markets. As such, we recommend building global bond portfolios by adding international fixed income mandates to the mix.

Alternatives

Alternative investments, such as commodities, can provide diversification benefits to a broad global portfolio and often serve as a hedge against geopolitical risks and inflation. Alternative investing entails a level of expertise and should be viewed as its own investment mandate.

Globalize Your Portfolio



Guidelines above may be appropriate for an investor generally, subject to factors specific to each individual. A financial advisor should always be consulted. Diversification does not guarantee profit or protect against loss.

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1. Source of data: Investment Company Institute, as of August 31, 2010.
2. The S&P 500 Index is a broad-based measure of domestic stock market performance that includes the reinvestment of dividends. The index is unmanaged and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any fund. **Past performance does not guarantee future results.**
3. The MSCI All Country World ex-U.S. Index (ACWI) is a free-float-adjusted, market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The index is unmanaged, includes the reinvestment of dividends and cannot be purchased directly by investors. **Past performance does not guarantee future results.**
4. Source of data: World Bank, as of December 31, 2009.
5. Source of data: Organisation for Economic Co-operation and Development.
6. Source of data: United Nations Population Division, as of December 31, 2009.
7. Source of data: Nancy Birdsall, Allen Kelley, Steven Sinding, "Population Matters: Demographic Change, Economic Growth, and Poverty in the Developing World."
8. Source of data: United Nations Population Division, as of December 31, 2009.
9. Source of data: The World Bank Group, "Doing Business 2010: Reforming Through Difficult Times."
10. Source of data: Organisation for Economic Co-operation and Development.
11. Source of data: Global Insight Estimates, December 2009. Luxury market is defined as womenswear, menswear, leather goods, shoes, watches, jewelry, perfumes and cosmetics.
12. Source of data: Bloomberg, as of December 31, 2009.
13. Source of data: Bloomberg, as of September 30, 2009.
14. Source of data: Bloomberg, OppenheimerFunds Research, as of May 31, 2010.
15. Source of data: KPMG, "Developed World Trails Emerging Economies on Cross-Border M&A," August 3, 2010.
16. Source of data: Bloomberg, as of October 31, 2010.

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