A BOTTOM-UP SEARCH FOR GROWTH IN THE INTERNATIONAL MARKETS

FUND FACTS

NEUBERGER BERMAN INTERNATIONAL FUND—(NBISX)

CATEGORY:
International

PERFORMANCE: (thru 6/30/00)

Compound Annual Return (%)	Fund	Category
1 Year	33.6	25.6
3 Years	13.1	10.4
5 Years	16.4	12.9

RISK: (relative to category)
Above Average

TOTAL ASSETS: (as of 6/30/00)
$200 million

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It isn't only the U.S. markets that have displayed a split personality in recent years. Overseas, certain markets have performed spectacularly, while others have produced only lackluster returns. And like the U.S., foreign market differentiation has been split primarily along sector, rather than regional, lines. Not surprisingly, international mutual funds that have focused on sector growth opportunities have fared quite well.

One international fund that has produced high relative returns over the last five years is the Neuberger Berman International Fund. Over the last year, the fund was among the top 20% of all international stocks funds, and it has consistently outperformed its peers over the last one year, three years and five years. The fund currently has about $200 million in total assets.

In early July, Maria Crawford Scott discussed the management of the fund with portfolio manager Benjamin Segal.

What is the investment philosophy of the fund?

The Neuberger Berman International Fund is an equity fund that invests in companies that either do the majority of their business overseas or whose stocks are quoted overseas. Our philosophy is to grow our mutual fund holders' wealth over the long term through capital appreciation of the shares of companies with strong earnings growth.

What is the international benchmark you compare yourselves to, and how closely does the fund match it?

Our primary benchmark is the Morgan Stanley Capital International EAFE [Europe/Australasia/Far East] index, which is an index of developed markets overseas. However, we do have the discretion to invest in emerging markets, so we also monitor the MSCI World index, which includes emerging markets.

We are very much bottom-up investors. We find high-quality companies, whether they are in Japan, Latin America, or Europe, and we familiarize ourselves with the company, its products, its industry, its management and its financial track record. We are stock pickers and financial analysts; we're not economists, so we're not making a bet on which economy is going to go up or down. From a risk management perspective, we keep a very close eye on where we're invested relative to the EAFE benchmark. But what tends to happen is that we may find a shortage of companies we like in Germany and at the same time find tremendous opportunities in Singapore, which causes us to be underweighted in Germany and overweighted in Singapore. Of course, that's a strong indication that there's a lot of growth in Singapore, and that in the long term, earnings will compound faster and the currency will strengthen because the economy's so strong. But we are analyzing at the company level, and we feel very comfortable doing so because we believe that the economic and business fundamentals are interlinked.

What do you look for in a stock?

We set both buy targets for prospective stocks and sell targets for our holdings, and we're looking for a minimum 50% return over three years—roughly 15% every year. Most of that appreciation will be based on the earnings growth of the company, but the other area where the appreciation can come from is in terms of a change in multiple, such as an improving price-earnings ratio. So, we do have some stocks in the portfolio that the

market views as out-of-favor.

When you set your price targets, do you project both earnings growth and future multiples?

Yes, absolutely. You have to be careful because you often see multiples reverting to their long-term means over time. So, if a stock is trading at 60 times earnings now and has a 15% earnings growth rate, we won't get our 50% return in three years' time if the multiple contracts to 40 times earnings. In fact, we would have lost significant value, and it's not much consolation that the earnings are still growing at 15%. With growth companies, you've got to be very comfortable that the stock can hold its valuation, or you've got to have sufficient margin for error—for instance, a 30% annual earnings growth rate, so you'll still get your 50% over three years' capital appreciation even if the multiple is cut in half.

How do you project price-earnings multiples several years down the road?

We base it on historic multiples, as well as our assessment of how mature the business is. As businesses and industries mature, the multiple contracts towards the long-term mean, which has been around 15 times earnings. But some companies and industries mature faster than others, and that's where our qualitative judgment comes in—determining how long we believe a premium multiple will be retained by a given growth stock, compared to other companies that may lose their premium ratings over a short period of time. We spend a lot of time on the road traveling and visiting the companies, and assessing these situations individually.

We invested in a company called Diageo, which is the world's largest premium drinks company. It has very strong brands—Guinness and Johnnie Walker whiskey, for instance—and they've got very high profit margins. But investors haven't paid any attention to the fact that the stock was trading at 12 to 13 times earnings. We invested in that company because we think that it can get back to its historic premium to the market of 18 times earnings—and that's 50% upside even if the company doesn't generate any earnings growth whatsoever.

We primarily invest in growth companies, not value, but Diageo is a great example of how sometimes the market misjudges growth. There actually is a fundamental growth characteristic to that company. It's not growing at 80% a year like some of these high technology names, but it is growing. Right now it is suffering from a bargain basement valuation, which is unfortunate for the company, but is a great opportunity for investors like us.

Does your growth bias cause you to be overweighted in certain industry sectors?

We are overweighted in technology. For instance, in information technology, we're at 27% compared to 13% for the EAFE index, which is ridiculously low, given that it is about 25% of the U.S. market. So, we're double-weighted in technology relative to the international index, and a lot of people ask us if we are nervous about the risk of being so heavily overweighted.

But my answer to that is "No." Being based here in New York, we can see the future of technology. We would feel very comfortable with that 27% technology weighting if we were a standard, passive U.S. index fund. And we think that, over time, that 13% technology weighting in EAFE is more likely to go to 27%, rather than the other way around. Those are growing companies and we're overweighted in that sector.

We're correspondingly underweighted in financials, which are 22% of EAFE.

Does an overweighting in technology bring you to certain countries, so that your country composition varies from the index?

Absolutely. For instance, if one is enthusiastic about mobile telecommunications, that leads you to Ericsson and Nokia, the two largest mobile companies, which are based next door to each other—one in Sweden and one in Finland. Finland is a country with about four million people, and Nokia represents something like 7% of GDP for that country. It is almost double-digits in terms of its contribution to the country's tax base and employment. And there are a lot of companies that are suppliers to Nokia, either in terms of components or software.

If one is looking for a country that will be trying to quickly catch up in technology, you've got China, which has a huge market; Japan, which is still inefficient in many ways; and Indonesia, which is a huge country. All these countries have to play technological catch-up with the U.S., and they are looking to Singapore companies to advise them.

We see a compelling investment thesis in Singapore because they are the best-educated, cleverest, most technologically-savvy Asians. It's a symbiotic relationship, with Singapore as both the technological and financial center in one spot for the whole of Southeast Asia, which has a population even greater than that of the U.S. Our Singapore investments are, in effect, investing in the whole area, but in the highest quality, most profitable portions of the growth there—you get the growth characteristics without the risk.

What about your commitment to Japan?

We're reducing our weightings in Japan. We started the fund in 1994 and we went through the first four or five years being substantially underweighted in Japan. In the beginning of last year, we began to see some changes going on in Japan—we saw new companies springing up, taking business from the old cozy big bank trading group

companies. At that time, we managed to pick our stocks quite well and we became modestly overweighted just through appreciation. But since the beginning of this year, we've become a lot more cautious. I think the change in government doesn't signal any real change of mentality, and the country is going to be slow to adopt the economic reforms that are really needed to get the economy driving again. Having said that, there are a number of companies that compete on an equal footing with American companies, and we still favor the small, more nimble competitors challenging old business.

One of your holdings is a Malaysian iShare (formerly known as WEBS), an index-traded fund sold on the American Stock Exchange. That's really more of a play on the country rather than an individual company. Do you plan on using those instruments for other countries as well?

Malaysia is a unique case. Investors became reluctant to invest in it because the country introduced capital controls, which meant that once you invested in the country you had to wait at least a year before you could withdraw your money. We felt that was an unreasonable risk for our mutual fund owners, but we wanted exposure to that market because we thought it was unfairly beaten up and it represented a good value. So we went with the WEBS. That was a particular case, and it was so unusual it is unlikely to occur again.

Do you tend to own the larger-cap companies within an industry or country, or will you invest in smaller caps?

A bit of both. We take a barbell approach. We own a number of the largest companies—Vodaphone, Nokia and BP Amoco are the three largest companies in the EAFE index, and we are shareholders in all three. That's not because we like buying large caps, but they're just very, very good at what they do. But we also own a number of companies at the smaller end of the spectrum. Some of the smaller companies are challenging the old ways of doing business by launching new products, by finding a new niche or new service. And our fund is still relatively small, so we have the opportunity to invest and have meaningful positions in companies that are really quite small. In the mid-cap companies, we're underweighted because we find those companies have neither the scale of the big boys nor the nimbleness or responsiveness of the small companies.

What would prompt you to sell a stock?

As a company reaches the price target we have set, we start scaling out. Or if the fundamentals on which the valuation is calculated are fundamentally undermined, we would sell. Of course, we are constantly reevaluating our price targets. We've continually moved up the price target for Nokia because they have done so well, and that's why we've held the stock for so long. For other companies that have seen their business fundamentally undermined, we would move the price target down, and that would trigger a sale.

The past several years, the markets in the U.S. have had a split personality. Has that spilled over into the foreign markets as well?

Absolutely. In the international arena last year, for instance, Japan was up 30+% in dollar terms and Singapore was up 65%, while Europe was up in only single digits. Within Europe, Finland was up 80%, while the U.K. and Portugal were very weak. Basically, there was a very strong differentiation in markets, and investors were very discriminating between good companies and bad companies. This year, there hasn't been any change in that, and in fact it's probably been accentuated by the European union. Investors are focusing more and more on individual company performance—they're not saying 'I want to invest in Germany,' or 'I want to get out of Italy.' They're saying 'I want to buy a good company, and I don't care if it's in Italy or Germany, I just want to find a good company.' It's a strong business ethic that is spreading across the world, and we think that is what's going to drive international equities going forward.

What is your outlook internationally?

The potential in international markets is just tremendous. The international markets right now are so much cheaper than the U.S. markets, even in technology. Of course, some technology companies are going to be more expensive than their U.S. peers because they have better products. But given a similar company in a similar business, I think you'll find it much less expensive internationally.

Coupled with that, you're seeing a substantial change in the mindset of international companies. They're becoming more business-oriented, managing for value. Returns on equity in the U.S. are pushing 20%, while internationally they are more like 10%, so there is a tremendous potential to leverage internationally to high levels of profitablility.

Taken altogether—low valuations and all these secular drivers, it has got to be great for international investing. And adding the diversification benefits, I think there's a compelling reason to be invested internationally. ◆