David Peebles and Albert Sebastian, portfolio managers, The USAA International Fund

An Eclectic Approach to Investing in The Full Spectrum of Foreign Stocks

This month's mutual funds column focuses on single-country and regional closed-end funds, which allow you to construct your own international portfolio.

The more traditional route overseas, however, is with a mutual fund that invests internationally, with the portfolio manager making decisions regarding regional and country weightings, as well as individual stock selection decisions.

There are plenty of international funds to choose from, but many are relative newcomers, with only short records by which to judge performance. One fund with a longer track record (it was formed in 1988) and that has performed among the top 25% of international funds over the last five years, is the USAA International Fund. Over the last five years (for periods ending June 30, 1997), the fund returned 15.3%, compared to 12.2% for the average international stock and 13.1% for the Morgan Stanley EAFE index; over the last three years it returned 14.9%, compared to 11.7% for the average and 9.4% for the EAFE index; and over the last year it returned 21.8%, compared to 16.6% for the average international fund and 13.1% for the EAFE index. Currently, the fund has about $654 million in total assets.

The fund is managed by a team of three managers, each responsible for specific regions of the world. In early September, two members of the team, portfolio managers David Peebles and Albert Sebastian, discussed the management of the fund with Maria Crawford Scott.

What is the basic investment objective of the fund?

David Peebles: The investment objective is growth and income—actually much closer to growth—and it is carried out by investing in international stocks.

What do you consider to be an international stock—do you mean non-U.S. based?

David Peebles: The way we look at it, it is generally anything that's not a U.S. stock, but we've run into some turmoil because of the mergers. If a company is 90% in the U.K. and is domiciled in the U.S., is that an international stock or not? Typically we say that if the majority of the business is overseas, and in most cases, incorporated overseas, we consider it to be an international stock.

The fund has an unusual management in the sense that you've got three different people managing different aspects of the fund. Could you explain that just a little bit?

David Peebles: We started off with one manager and then we hired two analysts. As they became more proficient in certain areas, we decided that it was better to have them managing those particular areas, and it's worked out very well for us to have three different equal portfolio managers. I handle the U.K., Canada and Australia, Al [Sebastian] handles Europe, and Travis Selmier handles the emerging markets and Japan.

Albert Sebastian: What we do is have the three of us get together and decide on an overall strategy, and from that we allocate a certain percentage to each region. Then the portfolio manager responsible for that region decides how the money will be invested.

The allocation is based on a lot of top-down factors, earnings per share growth for the market in those regions, valuations, and the flow of funds, particularly in the emerging markets. We also try to get a feel for how we're positioning ourselves relative to our competitors.

In terms of country allocations, that would be a decision of the manager responsible for that region?

David Peebles: Yes. For instance, in Europe, Al will come in and talk about Europe in general. He may mention specific countries, but it's more or less a conversation about Europe in general. As a group we decide that we want X percent in Europe, and then it's Al's decision as to which countries and which companies the fund will go into.

How much do those regional allocations change over time?

David Peebles: We really don't make big changes. I guess the biggest change that we've made has been in Japan, where a few years ago we were as high as around 30%, and now we're down closer to 13%. More typically, the moves would be similar to our recent change in the emerging markets, where we had been around 25% and we reduced it to 21%.

The USAA International Fund is part of the USAA family of funds, 9800 Fredericksburg Rd., San Antonio, Texas 78284-8916, (800) 531-8448.

What regions does the term "emerging markets" encompass?

David Peebles: Travis breaks it down into Southeast Asia, Northeast Asia, the Indian subcontinent, Latin America including Mexico, South Africa, the Mediterranean, Central Eastern Europe, and Russia.

Do you use similar approaches to investing in each of your regions?

Albert Sebastian: In Europe, we tend to be more bottom-up driven. We do a lot of company analysis, a lot of industry analysis, and we focus on the fundamentals. We also do more cross-border analysis, so the weightings for the individual countries tend to be determined by where we find the best opportunities and value in stocks.

In contrast, the approach to emerging markets is more top-down, focusing on the specifics of the country and its dynamics.

Why the difference?

Albert Sebastian: Europe is becoming much more of an integrated economy, which lends itself more to cross-border analysis, comparing certain companies in one country to similar companies in another country.

David Peebles: That's not to say that there is no bottom-up analysis in the emerging markets. For instance, Travis Selmier, the manager responsible for emerging markets, would first decide that Mexico is very attractive, and then he would look at Mexican companies on a bottom-up basis to find the best stock.

As an example, in looking at Telekom Malaysia, we probably would not be that concerned about what the Singapore telephone companies sell for, because the Singapore market sells at a much higher price-earnings ratio, and maybe the Malaysian telephone firm is a slower growth company. So there's a much bigger distinction there than there would be between two telecoms in Europe.

What drives the stock selection process?

Albert Sebastian: We really don't have a particular style anywhere in the fund—we're not growth-oriented, we're not value-oriented. We have an eclectic approach. I would say, though, that in the developed markets, we always use some sort of valuation check. If we buy a growth stock, we try to determine how much we're paying for that growth. And we do try to identify value in stocks, and we try to look for a catalyst for that value to be realized. But we're not only buying stocks with low price-earnings ratios or low price-to-book-value ratios.

How do you determine "value"?

Albert Sebastian: How we determine value depends upon the stock. An example would be Akzo Nobel, based in the Netherlands, and one of our biggest positions. It's both a chemical company and a pharmaceutical company, and when you break the company apart and look at the individual components of the company—the chemical businesses and the pharmaceutical businesses—it's selling significantly below its break-up value. So, from a valuation perspective, we like that company—we feel it's undervalued. Now, what is going to cause that value to be realized in the marketplace is, number one, a change in management philosophy at the company, and, number two, several new drugs that are going to hit the market that we feel are going to be very successful. We feel the stock will be revalued upward as more analysts become focused on the pharmaceutical business of the company.

Another example is a U.K. stock, Corporate Services Group, where we feel that the stock is undervalued relative to its earnings growth. In that instance, we just look at the stock, its price-earnings ratio, and how rapidly the company can grow in the industry it's in. So, those are two different stocks, and we look at them differently.

What about industry diversification? Do you pay much attention to industry groups?

David Peebles: The decision regarding the industries we invest in is really based more on our bottom-up approach. We tally up the amounts we have invested in each industry, but we don't pay a lot of attention to any particular industry. For instance, the telephone industry is our largest industry holding, and it is large because maybe we've got a telephone company in Europe, and maybe we have one in Canada, and then maybe we buy one in Japan, so it just happens to work out that way. But each manager views the telephone industry in his region differently. In the emerging markets, we would be buying a telephone company because of the infrastructure changes, whereas in developed countries, it may be more for valuation reasons. Keep in mind, too, that our largest industry, telephones, is only 6.3% of the fund—we are spread very thin in industries.

Japan obviously is a developed country, but do you view it differently than, say, Europe?

David Peebles: Japan is really kind of a world of its own. It has less of a correlation to the U.S. than any of the other countries, so the cycle is different, and the recovery is much slower at this particular time.

Your outlook for Japan does not appear to be very optimistic, based on your low 13% exposure.

David Peebles: And we probably would've been lower in percentage, except that it's such a big market that you can't afford to bet too heavily against it. But the economy is not growing nearly as fast as most people thought, we don't see the restructuring we would like to see, and consumer spending is not there. So, in general, we still don't see any reason to rush into that market. Valuations, from

the standpoint of historical Japanese valuations, are probably pretty cheap, but if you look at them versus Europe, they're still very expensive.

Within Europe, which countries are you more heavily weighted in now?

David Peebles: We've increased our weighting recently in the U.K., we've got a big exposure in the Netherlands, in France, and in Switzerland.

We're very much underweighted in Germany. We feel the valuation isn't as good in Germany, partly because the political situation is not very good there. In some countries, the political situation isn't very good but it is reflected in the share price, like in France recently. And that's a question of the direction. Is the political situation getting better or worse in France? I'd say it's getting better, because France, after the elections, couldn't get any worse, and you're in a situation where the market corrected significantly due to the elections. Is it better or worse in Germany? I'd say it's getting worse.

What about Canada? You seem to have a fair amount there as well.

David Peebles: We like Canada because of the natural resources, primarily energy. We look at the energy stocks throughout the world outside the U.S. and we found the Canadian energy stocks as attractive, if not more attractive, than any other area.

Is Australia similar, at least in terms of attractive natural resources?

David Peebles: Right now it is—we have one energy stock and two natural resources stocks in Australia. But that is not what we have traditionally done there. We have more traditionally been in special situations.

In the emerging markets, I noticed that you had some holdings in Russia.

David Peebles: We do have some in Russia, although they are not very large; we have about 2% there. We have several holdings, including several utilities, and we recently sold RAO Gazprom, which actually has the largest gas reserves of any company in the world. These are more liquid Russian names, and they're very standout companies selling at very low price-earnings ratios. They've been very successful, and Russia has been one of the top-performing markets this year.

How do you view the problems with some of the Asian tigers—Malaysia and Thailand, for instance?

David Peebles: We don't have much money in either of those areas. In Malaysia, we had sold our entire position prior to the last few legs down in the market. Once we felt that the market had fully discounted the controls put in by the government, and we no longer believed that they could maintain the controls that they had put on, we started back in, but we just couldn't get anything bought in time. So, we have one Malaysian stock, but we have less than a tenth of 1%. In Thailand, it was a similar situation. We had sold out dramatically before the trouble started, and we continued to sell on down. In Indonesia, we have six-tenths of 1%, but it's spread over five or six different companies. So, in Southeast Asia, our target is to be about 5%, but that has been scaled back to below 4%.

Do you hedge currencies?

David Peebles: No, we don't do any currency hedging. We will buy and sell currencies, but only to meet our settlements in the securities we buy. We're not too sure that anybody can hedge currencies very successfully over long time periods, and we can spend our time more profitably looking at companies. Also, we do take currencies into consideration in terms of our country weightings and the different types of companies we buy. For instance, to a certain extent, you can hedge your position if the company you buy does business in the U.S.

What would cause you to sell a stock?

David Peebles: A couple of things. One would be if it moves in price such that it's no longer a value, and the event that we bought it for has been recognized by the market. Another reason may be that the reason we bought the stock just isn't working out.

Albert Sebastian: We try to be disciplined about this. We buy a stock for a particular reason, and if those reasons change, then the stock is sold.

Do you see international markets over time performing similarly to the U.S. markets in terms of long-term rates of return?

David Peebles: My opinion would be that the mature markets are going to perform over the long term basically in line with the U.S. markets, and with the growth in the emerging markets, the balance may tip in favor of international stocks.

You've had a great long-term track record. What do you attribute that to, country selection or stock selection?

David Peebles: I think that it's been mostly stock selection. We spend a great deal of time looking at countries and we like to think we can do a good job there, but I think it comes down to, in our case, stock selection.

Also, we don't like to make real big bets. We do make some bets, but we're not going to be 30% in Japan one day and 10% a week later. We make gradual moves and even though we'd like to be in the top 10% [of mutual fund performers], we think that if you always shoot to be in the top 10%, you're probably going to have very volatile performance.