

The Probability to Outperform

Scouring a large universe of international stocks to find the ones with best chances to outperform, is indeed a difficult task. Joshua Byrne, the manager of the Putnam International Equity Fund, relies on a long-term view, a disciplined process, a team of 20 sector analysts, and a blend between quantitative and fundamental analysis to find multiple points of confirmation that the stocks in his portfolio have all it takes to outperform.

Q: How would you describe your investment philosophy?

A: Our investment philosophy has remained the same for nearly 20 years. It is based on the belief that each company we invest in has an intrinsic value and its share price will fluctuate around that fair value, creating buying and selling opportunities.

I believe that our competitive advantage is our ability to estimate the fair values of the individual securities along with the key variables driving that value. Those variables might be the growth rate, or the amount of capital needed to finance the growth, or the company's ability to expand its margins through operating leverage, market share, or innovation. We focus on understanding those critical variables, which is crucial for building conviction and identifying potentially mis-priced assets in the marketplace. It is also important to note that we approach buying the stock as if we were buying the entire company.

This is an international fund and we're looking at all the non-U.S. markets with a focus on the developed markets in particular. Our benchmark is MSCI EAFE, which includes most developed countries in the larger international universe.

Q: What is your valuation approach and why do you believe in it?

A: A primary valuation tool is discounted cash flow analysis, which we do on every

single company we invest in. One of the reasons for choosing discounted cash flow analysis is that it represents a common language. Allowing us to cross compare investment opportunities despite all the non-cash accounting differentials in each individual country.

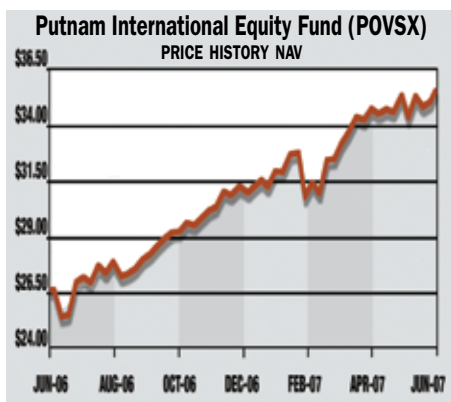
Also, since each stock is a financial asset, the discounted cash flow analysis allows you to derive the value of the underlying company. If you are investing in bonds, you consider the expected dividend stream and its worth relative to the opportunity cost of investing in another asset. If you are looking at a rental property, you would look at the yield and the potential price appreciation of the underlying asset. So we use discounted cash flow analysis because we want to know the underlying worth of the asset.

With the discounted cash flow analysis, you can take a longer-term view and take advantage of the mis-pricing opportunities. Because the short-term view often prevails in the market, many investors are looking at the most recent piece of information. For example, the sales and the margins of an automotive company may go up today. As we know, automotive manufacturers go through model cycles, and sales pick up when a new model is rolled out. If sales accelerate and top line growth leads to margin expansion, people might be willing to pay more for that stock. But a competitor might be coming out with



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“We want a portfolio where every name has the probability to outperform, with no name overwhelming the performance. That means that we do not like to take a make or break bet on any one stock. The fund reflects a broadly diversified portfolio of our best investment ideas.”



a better product six months later, which cannot be captured in static multiples like the price-to-earnings ratio or the price-to-book ratio.

Overall, we take a longer-term and holistic view and focus on trying to understand the critical variables that allow us to analyze how short-term events affect the underlying worth of the company, and potentially, if future returns may not be recognized by the current static multiples.

Q: Do you establish a hurdle rate for the return on invested capital?

A: Yes, we have a required rate of return for every company, above which an investment makes sense and below which it does not. This is largely determined by where the company does the business. In Japan, for instance, a company can borrow in yen and its hurdle rate is going to be lower in nominal terms than for a company that's doing business in the United States. So you have to look at companies in the appropriate currency, and then apply a rate to that investment. We also look at their capital structures and their ability to generate cash before applying an appropriate risk premium. For multi-national companies, we blend the hurdle rate for the different businesses and geographical areas.

Q: Would you walk us through your investment process?

A: We believe that blending quantitative and fundamental tools allows us to build a higher degree of confidence in the names that are likely to outperform going forward. Our process starts with scoring every stock in our universe, which consists of more than 2,000 names, on a quantitative basis.

The universe is broken down by individual sectors and we use historic metrics to decide which names look attractive in terms of valuation, earnings quality, and potential catalyst metrics, such as price and earnings momentum. In that way we decide which names potentially might outperform or look attractive relative to the rest of their sector.

Then, our team of 20 dedicated analysts looks at the names on a fundamental basis. Through discounted cash flow analysis they evaluate the most attractive stocks in the sector from a valuation standpoint. This fundamental analysis is entirely forward looking because it's a projection of their future cash flows versus the amount of capital they have to invest to generate those cash flows, while the quantitative approach is primarily backward looking.

Q: What is the rationale behind combining the historic with the forward-looking view?

A: With over 2,000 stocks in our universe, we believe, this approach actually increases the probability we can identify a specific selected name that will outperform going forward, and that is our ultimate goal. We want a portfolio where every name has a reasonable probability of outperforming, with no name overwhelming the performance. That means that we wouldn't take a significant bet on any one of those stocks. In our process, every stock goes through a process examining the investment thesis and the probability it will outperform over time. The more points of confirmation we have, the more likely it is we are to select that name for the portfolio. So it's a series of probabilities.

Q: How is your research process organized?

A: We have analysts located in Boston, London and Tokyo, as well as emerging market analysts. They all have their sector expertise, which means that we have technology, healthcare, consumer, and financial analysts. Each of them has a fundamental framework and looks at factors that typically lead to outperformance within the specific sector. They score all the names they actively follow within their sector on their fundamental framework,

and then do more analysis on the most attractive names.

We actually have analysts managing about 10% of the portfolio through sector sleeves, and the analysts are incentivised and measured against their performance within their sector. They are motivated to own the performance of the portfolio and to make the same determination about the best risk-reward returns in their sector as a portfolio manager does for the overall portfolio.

The analysts present those names to the portfolio management group, where we discuss the critical variables, why the stock is mis-priced, where the potential upside surprise or downside risks could come from, and how that could affect the valuation. What we're looking for is a differentiated point of view from the consensus, the rationale behind that point of view, and the level of conviction.

For example, the reasons behind a better-than-expected performance of an auto company may include a platform-sharing agreement with another player, which enables it to lower the cost and to price the product competitively, or its sales and distribution network, its service network, etc. Another reason may be examining all the potential future outcomes and deciding that the market doesn't necessarily price correctly the alternative outcomes.

If everyone agrees that a company's new product will help them grow sales 6%, then the market factors 6% in future projections. But the product may be an unexpected hit, such as Nintendo, for instance. Two years ago the consensus opinion was that X-Box was going to be the leader, PlayStation 3 would be a close competitor, and Nintendo was dead in the water. Today X-Box and PlayStation 3 are having price cuts, while Nintendo is very successful. So two years ago, the Nintendo stock was not priced for success and it had very limited downside. The risk/reward in that case was very favorable, even if you couldn't be sure that the product was going to be a huge success.

Q: Could you give us examples of specific stock picks?

A: One example would be EFG Eurobank, the second biggest bank in Greece. It has about 500 branches in Greece, where the penetration of financial products is accelerating as per capita GDP goes up. Currently, the company has market capitalization of 12.5 billion euro and is trading at 12 times earnings. The stock scores very well on historic metrics because it's growing well in its home market.

More importantly, our fundamental analysis and insight led us to be even more positive because of the over 1,000 branches that the company has opened in Eastern Europe, including Romania and Bulgaria. So EFG Eurobank will be able to benefit from the improved GDP and personal wealth growth in those markets as well. Many other banks are starting to see Eastern Europe as a tremendous opportunity and the recent transactions show that banks have been paying an average of about \$9 million euro per branch.

The simple calculation of 9 million euro per branch for 1,000 branches leads to market value of 9 billion euro, which compares to 12.5 billion euro market cap. That value of 9 billion euro isn't currently generating any net profit, but will be shortly because of all the investments in the infrastructure and the growth rate. Combined with the core earnings generated today, that reflects a earnings multiple of 5 to 6 for a company that is growing at 10% rate. That essentially is a discount that gives us a margin of safety.

Q: Could you highlight your portfolio construction process?

A: Through our process, we generate a score for every stock, and we can combine them based on the alpha opportunity versus the risk of owning that name. Our objective is to find those 80 to 90 names for which we have a high degree of confidence, and then we look at the right position size for every name.

About 70% to 80% of our portfolio is active share relative to the benchmark, which means that only 20% to 30% of our portfolio actually would be represented


in the benchmark. There are over 1,000 names in the EAFE index right now, and our portfolio is actively managed relative to the benchmark. So we're more focused on finding names for which we have a high level of conviction. These names may or may not be in the benchmark, but if they are, we make sure that we have an active position in them relative to the benchmark.

Since we are bottom-up stock pickers, we don't want large sector bets to overwhelm the stock specific risk. We don't have specific targets for the weights of stocks, sectors, countries, or region, but we don't want any name to be too large and we want every name to be able to contribute to performance. The goal is more than 70% of our risk to be stock-specific risk, and to have names with high probability to outperform. That increases the probability for the portfolio to outperform.

Q: What is your view on risk control?

A: We have a biweekly portfolio construction meeting and a dedicated team member who analyzes the portfolio construction between meetings to see where we're taking the most risk and to make sure that it matches the area where we have the most conviction, the most upside, and the biggest alpha opportunity. At the end of the day, we have to decide whether the amount of the opportunity is worth the individual risk. We also make sure that to not place large allocation to a stock or a sector that could overwhelm performance.

The stock-specific risk is mitigated through the detailed analysis. We have a risk metric for every name relative to the other names in similar sectors and countries. Overall, we estimate the incremental risk from adding to or subtracting from a position, as well as the amount of upside and the level of conviction we have in every name. We compare that score to our other opportunities, and this is how we make our buy/sell decisions.

This process results in a broadly diversified portfolio with risks dynamically managed to reflect where we have the greatest conviction. 

Putnam International Equity Fund

Symbol	POVSX
Website	www.putnam.com
Address	Putnam International Equity Fund 1 Post Office Square Boston, MA 02109
Tel. No.	617-760-1000
Inception	02/28/1991

PORTFOLIO

Total Net Assets*	\$7,321
Avg Mkt Cap (\$ Weighted) *	\$55,450
Average Price/Earnings Ratio	14.64
Average Price/Book Ratio	2.56
Turnover Ratio (06/2006)	83.10

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$500
Min Subsequent Investment	\$50

RISK (AGAINST S&P 500 INDEX - 3 YEARS)

Alpha	0.11
Beta	1.01
R-Squared	0.57
Ann. Std Deviation	9.78
Sharpe Ratio	2.11

RETURNS VS. MSCI EAFE INDEX

	POVSX	Index
1 Year (Cum.)	29.51%	27.00%
3 Year (Ann.)	22.79%	22.24%
5 Year (Ann.)	15.48%	17.73%
10 Year (Ann.)	10.81%	7.66%

RETURNS VS. LIPPER INTERNATIONAL LARGE CAP CORE AVG

	POVSX	Index
1 Year (Cum.)	29.51%	20.59%
3 Year (Ann.)	22.79%	11.68%
5 Year (Ann.)	15.48%	10.71%
10 Year (Ann.)	10.81%	7.13%

FEES AND EXPENSES

Max Sales Charge - Front	5.25%
Max Sales Charge - Deferred**	None
Max Redemption Fee	1.00%
Total Expense Ratio***	1.26%

PORTFOLIO MANAGER

Joshua Byrne	01/10/2000
Simon Davis	10/30/2000

*millions **a deferred sales charge of 1.00% on class A shares may be imposed on certain redemptions of shares bought without an initial sales charge
*** versus Lipper category average of 1.53%

Data through: 06/30/07

Source: Company Documents; Lipper

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