2013 Sir John Templeton Investment Roundtable
London May 23

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FOREWORD

Trouble is Opportunity

The Sir John Templeton Roundtable is a private forum held annually where an invited group of investment managers from around the world meet to exchange views on the prospects for world markets. These are summarised in this report. It should be stressed, however, that the views contained in it do not necessarily reflect the views of any of the John Templeton Foundations, their trustees, officers or employees.

Overall, the group concluded that, whilst there appear to be signs of an economic turnaround in certain regions, a three-speed recovery is in evidence, with Europe generally lagging the US, which in turn lags the emerging markets. Although this has encouraged equity markets, there is still considerable volatility and risk attending international investing. It may be instructive, therefore, to reflect on aspects of Sir John's investment philosophy.

We never live in normal times

Even in earlier, relatively placid times Sir John's team could never rely on markets that were totally stable and static. But the larger horizon for Sir John was always optimism. 'Trouble is opportunity' read the sign which he kept on his desk. He consistently focused on the future and believed that the opportunities before us were limitless and only constrained by the breadth and flexibility of our imaginations. If some see today's conditions as difficult, others view them as one of the best of times for adventurous and imaginative investors. Technology continues to advance apace. A huge new middle class is on the rise across the emerging economies, armed with new energies and ideas and hungry for consumer goods and a better standard of life. There is a swathe of new opportunities in these fields.

Equally, if there is opportunity in trouble, there is also trouble in opportunity

In the pursuit of yield across the globe lie many risks and unforeseen pitfalls. In tackling today's opportunities and the risks Sir John would undoubtedly advise us to root ourselves in the centre of what really lasts and endures. He believed strongly as an investor in what he called 'the high expectancy virtues' – reliability, thrift and diligence. He often said his success was based on no more than picking bargains but this did not take account of the long weekends he spent probing the depths of company reports.

Sir John grounded everything in fundamental principles

He stressed the virtue of patience. Were he alive today he would go back to what he propounded as a teacher in the 1920s – the virtues of prudence and 'sceptical stewardship' – teachings that remain centred and true in the best as well as worst of times.

I thank Jim O'Neill for his stimulating presentation and all the participants for a most productive exchange of ideas.

Dr Rory Knight
Moderator

Dr Rory Knight is Chairman of Oxford Metrica. He was previously Dean of Templeton College, Oxford University's business College.

KEYNOTE SPEECH: THE NEW "NEW NORMAL"

Jim O'Neill, the man who gave the world 'BRICs' looks at global prospects now

Ever since I dreamt up the BRIC acronym I have believed – controversially – that the world is stronger than most people in financial services or business realise. But it is a very different world to the one in which my generation grew up, driven not by the so-called developed world but a multiplicity of places, among which China looms largest. China is by far the dominant economic force in this generation. But it is not the only place that matters in the emerging world: there are three other letters in the BRIC acronym.

Assuming that China grows at 7.5% annually this decade, and that the US and Europe get back to trend (2.5% and 1.5% respectively) that suggests a stronger rate of global growth than in the three decades in which I've worked. In that time world GDP growth has been 3.3%–3.5%. Economists assume that the world economy's growth will always be around that figure, because that's what it's always been. (One reason, incidentally, that economics is regarded as 'the miserable science' is that economists believe that what has happened will continue to happen!) But if you accept my assumptions the world could actually grow in this decade by around 4%. This means the equities rally around the world is firmly justified, and not simply the product of central bank liquidity.

China: New Winners, New Losers

China's economy is now $8.2 trillion, more than half that of the US. When I joined Goldman Sachs eighteen years ago, it was $350 billion. When I dreamt up the BRIC acronym, it reached $1 trillion. So the scale of China's change and influence is pretty unparalleled in history. Let me quote some eye-catching statistics. In 2011 alone China's GDP increased by $1.37 trillion. China is creating another Greece every 12.5 weeks – and a good Greece at that.China is now the same size as the other BRICs put together.

In my three decades in financial services China has grown by about 10% year-on-year but in future it will probably grow only 7.5%. One of the main reasons is that the Chinese themselves want slower growth. We have moved into an era when Chinese policy-makers are stressing the quality of growth as opposed to its quantity. The party's leaders have realised that if they keep to the path of maximum growth, it will bring increasingly fewer benefits and probably only to the elite. As China becomes more diverse and unequal that could spark serious disruption and threaten the Communist Party's dominance.

The winners and losers will be very different in future. Could it be that the rise of China among the BRIC countries has contributed in some very complex way to parts of the developed world growing by less than their trend, or what we thought was their trend? Or, as China slows, as it pretty clearly is doing, could it be the case, that with some luck some parts of the developed world will actually start doing a bit better than everybody thinks. It's something I once didn't even think was possible but I now think is not impossible. Not least because of the important relationship between economic growth and commodity prices, especially for those that are major importers of them.

The big commodity winners of the past decade will no longer be the big winners in this decade. Fifteen years ago a lot of people around the world rather smartly but somewhat simplistically believed you just had to buy Australian dollars because they were liquid and uncomplicated. But it's not as simple as that. The commodities Australia is strong in – coal, iron ore – are not going to be the big winners from the new China – which means the Australian dollar will lose much of its strength. The same will be true of many other hard commodity producers. The winners will be countries that provide the growing Chinese middle class with what they really want – not so much the lavish

Dr Jim O'Neill formerly Chairman of Goldman Sachs Asset Management luxuries of the past but what I call 'luxury-lite' items that satisfy basic middle class consumer aspirations in food, health care and lifestyle.

China, maybe without realising it, is stepping out of its role as low cost exporter to the world. But you can't go from full-speed one way to the other without consequences. Industries, especially in coastal regions specialising in low value-added exports, are going to have problems – which may underlie the social disruption recently in those cities. Suddenly life there doesn't seem so hunky-dory as in the past.

The BRICs are now Eight

But there are other places in the emerging world just as exciting as China. When I joined Goldman Sachs Asset Management three years ago the phrase 'emerging markets' struck me as ridiculous. How can you call South Korea an emerging market? It's an insult. I decided to find a new way to view any so-called emerging economy that represents more than 1% of global GDP. There are now eight: the four original BRICs plus South Korea, Indonesia, Mexico and Turkey. These eight, I believe, will contribute $16 trillion (half from China) to global GDP over the next decade – about twice as much as that of the US and Europe together. So, China is actually a lot more important to the world than whether Ben Bernanke pulls the plug on the QE express, certainly a lot more important than what happens in Greece.

The financial media often emphasise that emerging market equities underperform developed markets. That is true if you look at the standard indices but below that lid it is not at all the case. The heavyweights in the indices, China, Brazil and Russia, have performed disappointingly. However several emerging stock markets do exceptionally well – Turkey, Indonesia, the Philippines and parts of Africa. Ever since I dreamt up the BRICs acronym I have tried to drum home two things: a lot of these places shouldn't be seen as emerging markets, and, secondly, they shouldn't be thought of as one. I have failed miserably because the media loves to lump them together – which is patently ridiculous.

India: Reagans in the Wings?

Being 'Mr. BRIC', I spend a lot of time caught up in the never-ending argument about China versus India. I always say it's a bit like comparing Manchester United with Manchester City. That's a bit unfair to India, which has a lot of very exciting things going for it, but for people to see it rivalling China is pretty ridiculous. Since 2010 China's GDP has increased by $2.3 trillion – more than India's total GDP.

But if it ever got things right, India could be the most interesting place in the world. India's labor market dynamics are unparalleled in any of the world's other large countries. Between now and 2035 the increase in India's working population could be as big as the US's working population today. If that happened, India's working population amazingly would equal China's and the USA's put together. So if Indian policy-makers ever discovered the religion of economic reform, India could be a major story. Unfortunately Indian policy-makers don't seem to get that religion.

It is often said: 'India does really well despite its government'. Is there something about India's being the world's biggest democracy that stops policy-makers being able to boost development like China? It's too complex an issue to unravel here, but the next election in India will undoubtedly be interesting. There are people not in government who want to be in government who are setting themselves up as the Ronald Reagans of India. Whether they can get into government, form an effective coalition and actually do the things they say remains to be seen. But if they did, it would be hugely exciting. We will see if they ever reach that Promised Land.

Africa: Playing Leapfrog

What is unrolling in Africa is not just a commodity story, even though the commodity rally has given many countries there a development platform. There are two other quite simple but substantive factors. One is the happy coming together of modern technologies, particularly the internet and mobile telephony. This is allowing nations to leapfrog stages of development in previously undreamt of ways. Secondly – and this is something widely underestimated - even though many of them suffer as very young democracies with dreadful problems of corruption, new leaders are emerging, educated in the West, who are trying to implement better standards of governance, and this will give these countries a big boost in the race to catch up with the rest of us.

South Korea: Never Waste a Crisis

South Korea is arguably the most interesting country to develop in my lifetime. Today South Korea's per capita GDP approaches that of a G8 country. It is the only country in the world of a population of 40 million that has managed to do that in my lifetime. Once South Korea's per capita GDP was in the same league as African countries. So when I meet African policy-makers and they ask how to reach the Promised Land, my blunt answer is: get on a plane to Seoul and see if you can translate what they've done to your own society. In forecasting BRIC growth to 2050, I and my colleagues at Goldman Sachs made a number of assumptions based on some 18 different indicators that we believed were critical to sustainable growth and productivity. Called the Growth Environment Index, it covers 180 countries. South Korea comes second after Singapore and above any G8 country. It does particularly well in technology, education and, increasingly governance – South Korea may not be the best for corporate governance but it has learned the lessons from 1998. Never let a crisis go to waste!

Brazil; Playing the Blame Game

To be honest I have contradictory thoughts about Brazil. When I first dreamt up the BRICs acronym, a lot of Brazilians thought I was crazy even to include it because Lula had just been elected. In the next three years Brazilian growth was as weak as today. Then it accelerated sharply. Commodity producers' growth slides round a trend – except that trend has been rather violent in Brazil's case. They had a classic 'Dutch disease' problem because the Brazilian *real* touched insane valuation levels. Despite the fact that the *real* has now fallen, it is still overvalued. That plus the fact that commodity prices are falling is a problem. And Dilma Rousseff is a Lula da Silva without the charisma. You could say Brazil's trying to do a China when China's no longer doing a China. They think 'How do we get 10% growth? Oh yeah, use the state investment bank'. But even the Chinese have decided they can't do that anymore.

Brazil's finance minister, Mantega, I believe, was the first to come up with the phrase, 'currency wars', thus shifting the blame from the shoulders of the politicians themselves. But the *real*'s strength sprang from the conflict between Brazil's fiscal policy and its tight monetary policy, a classic cause of currency strength. And what does 'currency wars' mean anyway? Does it really mean we're going to fight each other because of currency valuations? Currency issues are blown out of all proportion. I've wasted a lot of my career on so-called currency modelling. It's about as futile as forecasting oil prices. Ten years ago the *renminbi* was significantly undervalued but now may even be slightly over-valued. It is very easy for Washington politicians to blame their woes on the *renminbi* but I don't think that holds water.

Japan: End of the 'Happy Depression'

Let me jump from that to Japan and the *yen*. There's a huge difference between weakening a currency to revive a domestic economy and doing so to increase export share. The aim of Japanese policy is to revive the domestic economy, and if it succeeds the world will have to live with that. For countries whose industries compete with Japan it may be an issue and I can imagine there have been some interesting phone calls between senior people at Samsung and Tokyo and Washington! But after all Washington presided over a weak dollar for most of my professional career.

At the risk of sounding like an academic economist, there is a big difference between nominal and real currency decline. If the *yen*'s decline is part of Japan ending deflation, that is very different from a decline where Japan still has deflation. My view is that dollar/yen equilibrium hovers around 110. If Japan had had inflation at 2% for the past 20 years, that figure would be about 150. So that apparently big difference of 40 shouldn't matter too much to other countries if it only reflects a different level of inflation in Japan.

Japan has been in a 'happy depression' for the past twenty years. But the happy part of that is ending. They have to do something or Japan is going to be a disaster. Lest we forget, Japan is still the third largest economy in the world. So if Japan revives for the first time in twenty years, that will be a really good thing for other Asian exporting countries. The growth of domestic demand in a country is much more important for other countries' exports than the level of its currency.

The USA: Changing Places?

The 'new normal' is newer than we think. More than ever Europeans should fight the temptation to write America off. Yes, there are huge problems in Washington, but bizarrely the two parties are so idealistically apart, that they end up having to compromise, which stops both sides doing anything too dangerous. Two factors cyclically benefit the US right now. One is the housing market recovery. House prices compared to personal income are back to where they were at the start of the 1990s. The second is the astonishing development in shale energy, which is giving US manufacturing an edge it has not had in my professional career. Given these two huge advantages, it is quite possible the US economy will grow by trend this decade.

One way of thinking about this decade is that the US and China will swap places a bit. At the start of the crisis China was too much like China and the US too much like the US. As we recover, America has got to be more like the old China and China has got to be more like the old America. China has to consume more and produce less and America has to consume less and produce more. Early signs are encouraging. The US deficit, which was 6.5% of GDP before the crisis is today about 3%. China's surplus, which was 10%, is about 3%. Together, these suggest progress. Also, the weakening ratio of Chinese industrial production compared to retail spending is also moving in the right direction.

The Eurozone: A Most Unnecessary Crisis

The Eurozone crisis is the most unnecessary I've seen in my working life. Crises generally occur because of balance of payment problems. If the Eurozone were a genuine United States of Europe there wouldn't be a crisis because ironically overall it has a balance of payments that is close to being balanced. No, the cause of crisis is that monetary union was created for political, not economic, reasons. And at some point European voters have to decide whether they really want a true economic and monetary union. It's as simple and as complicated as that.

Which means that the German election is of enormous importance. Not the election itself, because all the main German parties believe in EMU, but because of the past. The EU was put together by a generation desperate to ensure WWII would never recur. It was a brilliant achievement but carried out in the belief of a static world framework. But the world isn't static. If world trade carries on as it's been doing, Germany will soon export twice as much to China as to France. Whether the EMU is robust enough to deal with that is questionable. It means some of these big things that the politicians keep talking about endlessly are going to have to be done. After the German election they cannot fool around talking about banking union anymore, they will have to do it and also create some kind of central fiscal authority. But of course that will be extremely difficult because seventeen democratically elected countries will want to have their say.

London: BRIC Capital of the World

The UK is suffering what I call 'a Facebook crisis'. True, we undoubtedly have serious problems, but our leaders – possibly because of the demands of the Coalition – insist on making things worse. Living in a 24/7 world of social media, policy-makers love to act by the minute not the principle, heaping blame for our woes onto each financial institution and onto the City collectively.

Yes, some of the things financial services did were bad. But our policy-makers delude themselves if they think the roots of the crisis lie in the City. The cause was the US housing crisis – the fact that the US had zero savings but kept on dreaming up schemes to attract money from around the world to allow 300 million people to own a house even though they couldn't afford it. They had a regulatory environment that supported and indirectly encouraged financial institutions to dream up crazy instruments.

Financial institutions exist to transmit savings from the places where there's too much to places where there's too little. How they get transmitted through financial instruments has obviously changed dramatically. It is the job of policy-makers and regulators to keep watch and ensure it is done in the broad interest.

Forcing British banks to have more capital so they are not so vulnerable shouldn't be confused with destroying the City – which our policy-makers have been flirting with. The UK actually runs a quite modest current account deficit of 2-3% of GDP but if we did not have a huge invisible surplus it would be 5-8% with dire domestic consequences. The City has contributed some two-thirds of the UK's invisible surplus over the last thirty years.

Also, there is a huge, huge difference between what UK banks do for the British economy and what London does as the home of international companies. I have just left Goldman Sachs, the so-called 'Vampire Squid'. It employs 5,000 people in London, many from around the world. (Incidentally, as a northerner I would never have got a look in if American meritocracy hadn't changed the City's culture!) And the tangential benefits stretch beyond that. A vibrant services sector depends on those people in finance.

London enjoys three outstanding advantages. It is the only major service centre awake at the same time as Beijing, Mumbai, Moscow, Rio, Sao Paulo, etc. Secondly, everybody wants to conduct themselves business-wise in English.

Thirdly, there have been major infrastructure improvements. If we did not have the Channel Tunnel, there wouldn't be 300,000 French people living in London today. Yes, London is not the UK – indeed I often think it should have different economic policies to the rest of the UK! – but it is the BRIC capital of the world. It is to the world what Hong Kong has been to China. And that is something which benefits the whole UK. End of sermon – except that I would add that with the big drop of the pound in the past five years, UK manufacturing at last also has a chance, if only gradually, to start mending its fortunes.

'Trouble is opportunity' Sir John's said. That is something relevant to both emerged and emerging markets today. If there is one thing I've learned in my thirty-two years in the market it is that opportunities and value emerge when things are at their worst – though not all can exploit them!

THE FUTURE: MORAL COMPASS OR COMPULSION?

Dr Knight began by focusing on broader political trends. Following the financial crisis, are we now facing a decade of over-regulation and how will this impact international investment?

'Politicians and regulators are certainly going to be looking in the rear view mirror for the foreseeable future,' commented one investment manager. 'They will probably go too far down that road and to some extent end up stifling competition and the free flow of capital and trade.' Other managers agreed that regulations have grown too complex and costly. One reported that there are now five times as many hurdles to cross in starting a new investment business as in 2000. The US tax code was singled out for stinging criticism, now so complex in one manager's experience that not even the IRS fully grasps it. And the demonisation of business is not just at a political level, a participant commented but widespread throughout the media: 'Film villains used to be robbers and terrorists, now they are businessmen!'

However the general view was that, burdensome though the layers of regulation now are, managers can grin and bear them. More importantly, though, they felt we are in danger of losing sight of the fact that regulation should be positive in its aims, encouraging transparency and creating a level playing field. Especially in Europe, managers are encountering an anti-financial industry attitude. One had found the regulatory tangle so dense that it actively discourages new entrants into the telecommunications field and shelters inefficient incumbents.

'But could it be that the politicians are right?' asked another manager. Savonarola in his calls for a bonfire of the vanities could not have been more fiery. 'We in financial services have done an appalling job,' said the manager. 'We have put the world into a serious financial crisis because of the way we have operated. Untrammeled finance without adequate regulation is not a good recipe for a happy, successful, balanced society … We all run ridiculously profitable businesses but we have done a very poor job … We have allowed people who are renters of shares to boast about performance over short-term periods of time.'

He went on to attack the dominance of the City, comparing it unfavourably with the more socially responsible, owner-operated cultures in northern Europe and Scandinavia. Businesses there not only made a more positive contribution to society but in the long run were far more profitable. He concluded: 'I don't believe Sir John was in the investment business solely to make money out of it.'

Speaking as a long-time advisor to Sir John, Dr Knight responded that Sir John himself would have put the emphasis on personal integrity, role models and education rather than regulation. Heather Dill, Sir John's grand-daughter, echoed this, saying that while she sensed 'a weakening of our whole moral fabric', Sir John would have stressed cooperation, charity and transparency – virtues to which she would add diligence and an attitude of service to others rather than of entitlement. Endorsing this, an American manager pointed out that the wealthy in the US today are 'uncommonly generous compared to other countries and times', thus dispersing wealth and countering the accretion of moneyed dynasties.

Is the answer a robust corporate responsibility division? All agreed that handing over responsibility is not the answer. In fact, argued another manager, it is the trammeling of free markets and the failure to push home 'the principle of moral hazard' that has contributed to the malaise. 'When you have failed businesses bailed out at vast cost to taxpayers, the ultimate force of the market is not allowed to be brought to bear.' 'The free market system is not perfect,' concluded one investment manager, 'but we have yet to find a better one,'.

Equity prices have surged 15% to April, commented Dr Knight. Is the rise sustainable or simply a product of central banks' liquidity measures?

'Sir John used to say the most famous words in the English language were "It's different this time",' recalled a veteran colleague. 'But if he were here he might say it really is different this time. 'There is a separation in market psychology at the moment. The professional investor is showing signs of becoming too greedy and ignoring danger signals while the individual investor, especially in Europe, remains extremely risk-averse.'

This he ascribed to factors stretching far beyond finance. 'Together with the pain of 08/09 there has been a drop of trust in the system. Traditional US voters have lost faith in both parties, while previously disenfranchised groups now feel empowered under the Obama regime. Sir John always maintained that sovereign debt would be paid for by inflation. This time we might see not just inflation but even over time the collapse of the dollar as an international currency and, as a more remote possibilty, a depression that might trigger a right- or left-wing dictatorship.'

Other managers confessed they sensed a 'chilling calm' in current markets. 'It is a very dangerous period,' said one. 'The absence of volatility gives a misleading impression of stability.[1] The rise in markets is largely a product of low interest rates and central banks' liquidity measures. 'Admitting to nervousness about the wind-down of the 'great monetary experiment of QE', one manager added, 'We are in uncharted territory. It could end up in very high inflation or depression. We are coming to a point where even the markets would like to see QE easing off. Also, US interest rates are being kept artificially low. If markets forced a rise it might be no bad thing.'

Are we witnessing a three-speed recovery, asked Dr Knight, with emerging markets leading the pack, followed by the US and Europe lagging behind?

'Foreign eyes like mine,' said a Chinese investment manager, 'see disturbing signs of crisis in Western civilization. The doctrine of free trade which has done so much to advance the cause of mankind no longer enjoys the same support from Western electorates. They simply see it benefiting a thin layer of rich people. Meanwhile countries like China are embracing former Western doctrines with open arms. Moreover, the global system is "wobbly" in that US government policies are not benefiting domestic consumers but rather driving growth in Asia.' An American manager agreed that US government actions had to an extent been counter-productive: 'We have a liberal government that doesn't know what it is doing in that it is pouring too much money into the system and acquiring financial assets that does not benefit the people they need and want to help.'

However other managers were far more bullish, going so far as to predict an American renaissance. 'An awful lot of attention is being paid to the government actions but not to the dramatic changes taking place below them at the corporate level,' said one. The recovery and current corporate values are sustainable, he argued. 'Prices have risen but, even net of tax and debt, the multiples with regard to underlying enterprise values are nowhere near as bad as often claimed and in line with long-term levels.'

'I've just come back from a visit to the southern states,' added another. 'The dynamism there is very noticeable. The housing market is up 10% and property companies are reporting 50% more people coming through their doors. And the rebound isn't just in housing. The transformation in the US petrochemical industries with developments like shale oil is startling and feeding through strongly into lower

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[1] *As of 23 May, 2013.*

energy costs for consumers and businesses. Central banks have done a good job in stimulating the economy when others couldn't or wouldn't. Today's correction apart, the eighteen-month rebound in equities has shown fear is not a driver. Together, they have created a dynamism that will drag up the whole of the world.'

Do recent corporate transactions tell us anything about investment opportunities? asked Dr Knight.

A surge in M&A activity is likely in the near future, said a manager, given the volume of excess capacity among companies, their lack of organic growth and relatively low earnings coupled with their ability to borrow capital 'incredibly cheaply'. To date, we have not seen much of this, another manager commented, the big exception being consumer goods and franchises, for instance Warren Buffett's acquisition of Heinz and the recent Findus/Unilever buy-back at a striking 36 times P/E. 'Call it irrational exuberance if you like but these guys know a lot more about consumer franchises than we do and just how unique and valuable cash flows are with the rise of the emerging market middle-class consumer.' Media companies have also experienced a wave of take-overs, reflecting the need to acquire quality content and capitalise on the proliferation of platforms and new dish and transmission technologies.

Dr Knight commented that Michael Milken had recently observed that there are several trillion dollars currently languishing in fixed-income securities earning less than 1% interest. Does this imply there is a tsunami of capital on the brink of being unleashed from bonds into equities?

'Sir John was actually quite active in the area of bonds,' one manager recalled who had worked closely with him. 'But I think that, were he here, he would be shorting bonds for the foreseeable future'. Managers pointed to three great ice caps of pent-up cash – the balance sheets of banks and companies and in individuals' fixed-income investments. Probably sooner than later, managers felt, they would be unfrozen to the benefit of equities. However one manager commented that the boost to equities might not be totally positive, given that 'a lot of equity investment has itself been in the form of 'bond boxes'. The key issue is whether investors who had trusted in traditionally safe assets might be badly hit; also, how far the continuing recovery in equities might be damaged by a take-off in inflation and corresponding interest rate rises.

Dr Knight asked whether the fall in the price of gold indicated inflation fears had receded. Is the rise in gold never driven by fears of inflation but rather a combination of speculation and loose monetary policy?

There has been a switch from reliance on 'hide-money' investments such as gold or Swiss francs into other financial assets, managers agreed. There has always been a disconnect between the price of gold in Asia and that in financial markets, observed a Hong Kong-based investment manager. The gold market in Asia has always been physical, and at present there is a shortage of actual gold in Asian marketplaces, even though the price in Europe is quite low. Outside Asia, managers agreed the price of gold looks set to continue to fall – that is, unless inflation starts to rocket. Nevertheless, Dr Knight commented, there is a floor gold is unlikely to fall through. A price of $1,300 an ounce would mean most of the world's gold mines would be unprofitable and have to go out of business.

And what prospects for other commodities?

In contrast to gold, other commodities are on a predictable upward curve, given growing demand and increasing labour costs and regulation, reported one manager familiar with commodity sources in emerging markets. As an example she cited one copper mine in Chile where forty separate licences were now required before drilling was undertaken. Looking ahead, commodity prices would continue to crest, though not detrimentally so, and eventually top out at a new level of equilibrium.

Japan – The Sun Finally Rising?

Japan has recently stolen the investment limelight from China, Dr Knight commented. Performance appears to have benefited from the new 'Abenomics' – Prime Minister Abe's blend of a lower yen and monetary and fiscal loosening. But is the upswing sustainable? Might we be on the verge of a ten-year Japanese renaissance?

Overall, participants' views were positive – in some cases enthusiastically so. After several botched attempts to kick-start the Japanese economy in recent years they felt this one might succeed. Already they detected a sense of early optimism among consumers that could unleash a pent-up surge of spending. Heavily regulated companies with low margins and strong balance sheets could see their profitability shoot up if Japanese business and society really put its back into the reforms.

However, participants pointed out several potential pitfalls. The drop in the yen has in part been a side-effect of Japan's higher energy import costs in the wake of the shut-down of its nuclear power plants. Were they to be restarted, a rising yen could once again dampen the competitiveness of exports. Also, Japanese banks have disproportionate holdings of government bonds. If inflation and interest rates took off and bond yields rose, that could seriously weaken their position.

Moreover, Japan has a rapidly ageing population and an increasing burden of social spending. With Japanese interest rates at their current 1% the country is already running a 25% deficit. Were they to rise to 3% or more, there could be trouble ahead. Also, the savings ratio in Japan is much lower than commonly realised – lower in fact even than that in the US, resulting in less money therefore either to drive consumption or cushion rising social costs.

But the overarching challenge, managers agreed, is removing the historic overhang of over-capacity and entrenched uncompetitiveness among Japanese corporations. Tackling this must be the essential 'third prong' in the reform programme.

One manager was pessimistic about the chances of success, dismissing Abenomics as 'the last desperate throw of the dice to bail out the old system', doomed to failure short of an influx of new blood in the shape of a wave of immigration. Others, though, were far more positive. Previous attempts at reform had foundered in part because of the rapid turn-over in governing administrations. This time Prime Minister Abe has both a larger and a longer window of opportunity. The Keidanren, Japan's CBI, had given him strong backing and with a 70% approval rating in his sails Abe is likely to carry Japan's Upper House in next month's elections, thus greatly strengthening his hand.

Dr Knight even pointed to a possible rise in shareholder activism in Japan in place of their traditional passivity. He drew attention to the recent letter sent by Daniel Loeb of Three Point (a 6.5% shareholder in Sony) to Sony's president calling on him to hive off the entertainment division in view of the group's $100 billion drop in value. Moreover, said another manager, Japan's tax take is relatively low and there is scope to increase it in order to cope with the problems of heavier social spending and a possible rise in the current account deficit.

An economic renaissance in Japan would certainly give a significant fillip to the global economy. But a revitalised and more sharply competitive Japanese industrial sector might also create losers abroad. One manager made the interesting point that, South Korea's car industry apart, these were unlikely to be among the new economies. Since Japan competes 'at the high end', for instance in its exports of machinery to China, its main rival is in fact Germany. It is there, the heartland of Europe's strongest economy, that damage from a reinvigorated Japan might be inflicted – adding further woes to the already troubled Eurozone.

China: The Giant Looks in a New Direction

With slowing growth and its new president Xi Jinping embarking on a ten-year term whose avowed aim is reform, what prospects, Dr Knight asked, for Asia's economic superpower?

The jury on reform in China is still out, said the Hong Kong-based manager. But there is, he said, widespread acceptance in Chinese society not just amongst its newly appointed rulers that the old model of export-led, hell-for-leather, beat-America-at-all-costs growth needs to move in a different direction. The old model is no longer sustainable given its impact on the environment and its entrenching of the rich-poor divide in China. There needs to be 'a shift from quantity to quality', with efforts directed towards services, health care, education and in meeting the consumer demands of China's growing middle classes. It would involve greater liberalisation, more privatisation and a lightening of the regulatory burden.

At present, he reported, some 1,500 approvals were needed before a start-up can be launched in China. The government has recently announced that it will cut this figure to 900 – a considerable if still a hefty total! However he identified several potential minefields, perhaps the most dangerous being the unsustainably large amount of paper that the government has allowed to be issued to underpin equity markets.

Dr Knight asked about China's shadow banking system. Has a potential financial bubble been created in peril of being pricked.

Parallels should not be drawn with the subprime crisis, the manager replied. Dangers are ring-fenced. Securitisation of loans in China is minimal, and loans-to-deposits and loans–to-collateral ratios in China are relatively quite low – about 50%. But it cannot be denied that China's shadow banking is yet one more aspect of the system of financial repression imposed in China. To date the government has offered very little incentive either to savers or to investors wishing to seek opportunities outside China. With a loosening of controls we could witness a surge of capital out of China in search of opportunities in foreign capital markets - and correspondingly rich pickings for financial advisors and asset managers.

Two 'black swans' were spotted circling over this generally benign Chinese landscape. One is the longer-term play-out of China's 'one child' policy. It has bred a generation of spoilt children who may prove far less diligent and industrious when today's hard-working generation retires. The second is the Senkaku/Diaoyu islands dispute between China and Japan. 'A local commander could provoke somebody,' said the Hong Kong-based manager, 'and loose off a gun, triggering a war. And it is a war that China might not win. If Japan lost, its system would probably survive. Not so China, such would be the rage and disappointment of the Chinese populace. Dr Knight added that at a private presentation he attended, arranged courtesy of Mark Holowesko, Henry Kissinger had highlighted the grave dangers contained in that very same flashpoint.

What role for the emerging economies in the new global order? Dr Knight asked. Will their benefits be diluted by convergence?

'If you are looking for outstanding growth, one American manager said, you've still got to look beyond Europe and the US to the emerging economies. His company was continuing to uncover 'tremendous opportunities' not only in Asia but also in South and Central America and even as far afield as Africa. However one manager long familiar with these markets added that, as one source of global disequilibrium – the US deficit – shrinks, it is likely to be replaced by another: 'the wind-down of quantitative easing'. The knock-on effects on emerging markets could be significant. We are going to see these countries running lower surpluses and deficits *vis-à-vis* the west. Country and company selection in these markets is therefore likely to become even more crucial (see next section).

MARKET PROSPECTS: REACHING BEYOND GREED AND FEAR

The corollary of Sir John's maxim 'trouble is opportunity', said Dr Knight is: 'Beware greed in a bull market and fear in a bear one'. Does Sir John's value approach represent the best strategy under present conditions? If so, what are the value opportunities and pitfalls?

'Emerging markets have always been great places for stock picking,' the manager continued. 'There have been strong performances in Mexico, Indonesia and more recently in Thailand. The Philippines has been the star over the last year. Hard on their heels are the 'frontier' economies, not just Vietnam, Qatar and Saudi but some of the former statelets of the Soviet Union and the poorer countries in Southeast Europe.'

But he cautioned that, performance-wise, emerging economies were a mixed bag and one likely to be even more mixed in future. 'You can get some cheap opportunities in Russia, Brazil and China but they are usually cheap for a reason. Conversely, the better quality opportunities are not as cheap as they were. Once Mexican wages were four or five times higher than in China. No longer. Similarly, the Philippines once the cheapest Asian stock market, is now among the most expensive. The risk is to become obsessed with growth and companies that are just "land-grabs", when what you want is what Sir John also looked for: companies with solid growth prospects that would compound their returns year-on and year-out.'

But even so if you look below the country level to that of individual stocks you can still find some very attractive businesses trading at low single or double digit P/E multiples. Examples he had invested in include a Macau-based LPG supplier bought at eight times P/E and now trading well above that and a Taiwanese contact lens manufacturer supplying the mainland Chinese market bought at a very low P/E and now trading at over 20.

In Japan, the rising tide of optimism has in one way had an adverse impact on investment. There are undoubtedly still value opportunities but the valuation discount of the past has to a degree been dissipated. It is true that deregulation has substantial potential for previously heavily regulated companies with low margins, strong balance sheets and unprofitable capital reserves, but even if such companies are at a discount to cash, it is often difficult to realise returns given the obstacles to take-overs in Japan.

As already noted, growth in China has slowed, and there is a sense that its traditionally attractive low-cost manufacturing exporters have lost some of their lustre given their mixed record and the mooted switch to supplying the growing middle-class domestic market with services and consumer goods. But one international investment manager felt impelled to protest: 'Is China manufacturing all that bad a prospect?' It is notable that of the managers' 20 stock picks (see below) 10 are Chinese or in some way closely linked to Chinese markets.

The Hong Kong-based investment manager made two observations. Firstly, a host of ill-informed investors are continuing to flood into Chinese markets. The canny investor can comfortably cream profit from the resultant market and pricing inefficencies. Secondly, 70% of enterprises are still state-owned and to that extent strongly driven by government policy. Whereas other Roundtable managers thought bargains should be sought among China's remaining non-state sector 30% he argued on the contrary that it is possible to thrive by riding and anticipating the winds of official thinking: 'You only need to stay about half a mile ahead of the policy curve to make a good living in China'.

He went on to highlight three areas of value opportunity. 'Given China's ambitions as a regional superpower, you won't go wrong investing in military-related enterprises. Also, while many of the China 'B' shares traded in New York are of dubious quality and many would like to see them out of that market altogether, they should not all be tarred with the same brush.' Finally, his third preferred asset class consisted of the small or medium-sized export companies based in the Pearl Delta: 'There is a feeling the the Chinese export market to the West has died. This is by no means the case. Westerners still want cheap shoes, toys and clothing, and China is still well placed to provide them'.

In the previous discussions the prospects identified had included selected emerging markets and companies; the potential corporate renaissance in the US and Japan; the scope for M&As, especially in media and consumer goods and franchises. Commodities had been viewed as a fair long-term bet, bonds and fixed-income investments and gold and other 'hide money' options were contra-indicated. Dr Knight now invited managers to identify two or three attractive stocks each and justify their choices.

Their picks covered a wide range: publicly quoted companies, private and owner-operated ones, ADRs and Hong Kong-quoted and other offshore enterprises. From them a picture emerged of the changing architecture of the global economy. In it petrochemical, shale and energy transportation companies were prominent, especially in the Midwest, Canada and China and particularly if 'clean' in focus; also pharmaceuticals, healthcare and new gene and electronic technology companies; leisure, consumer goods, clothing, retailing and e-commerce enterprises; in addition, asset management firms, mainly outside the traditional financial centres and especially where ethical in record and management; above all, companies able to meet the demands of youthful and emerging markets globally, especially in Asia.

(Ticker symbols and corporate status are provided in brackets, followed by brief descriptions and manager comments where pertinent).

- American International Group (AIG), the US-based insurance multinational propped up by the Federal Reserve in 2008. 'AIG really has been fixed. It has good management now, the poorer assets have been sold off, and this year the overhang of government shares will probably also be sold. It sells at 60% to book and may even re-institute a dividend.'

- Alibaba (private), a Chinese e-commerce platform for small businesses. 'Still unquoted despite its $100 million market cap, Alibaba is one of the most interesting companies in the world'.

- Brambles (BMBLY; ADR), an Australian supplier of re-usable pallets, crates and containers and related logistical services that is 'making big inroads into mainland China'.

- Brookfield Asset Management (BAM), a Toronto-based firm handling a portfolio of $180 billion. 'A real owner-operated culture of which Sir John would have approved, it focuses like Berkshire Hathaway years ago on compounding returns long-term'.

- Chesapeake Energy (CHK), one of the largest US natural gas suppliers specialising in exploiting new fields including shale deposits. 'Chesapeake is likely to get sold in the next year or so. Its outside investors and new Board are putting the final lipstick on the pig, and a major will no doubt pay a hefty premium to get into its field'.

- China Vanke (CVKEY; ADR). Headquartered in Shenzhen, Guangdong, China Vanke is the largest residential real estate developer in China. It is engaged in developing, managing and selling properties across twenty cities in the Pearl River, the Yangtze River Deltas and the Bohai-Rim Region and also provides investment trading, consultancy and e-business services. Its largest shareholder is China Resources. In 1991 China Vanke was listed on the Shenzhen Stock Exchange. As of May 2013 China Vanke's market capitalisation is HK$165 billion.

- China Yuchai International (CYD). 'Still trading at low multiples, this is one of China's largest manufacturers of diesel engines and associated parts'.

- Capital Southwest Corporation (CSWC), a Dallas-based firm handling assets of $660 million. 'As a small cap in which it is difficult to get more than 500 shares at a time, it is ideally suited for the individual investor. Sir John would have loved it – a wonderful fifty-year record with management of terrific integrity and a company that is currently trading at a 50% discount to book'.

- Devon Energy Corporation (DVN), an Oklahoma-based Fortune 500 company specialising in identifying and exploiting 'second area' reserves. Given the high cost of energy replacement reserves and the opportunity to sell them well below stock market prices, this is a very attractive option'.

- Flowserve (FLS), a manufacturer of equipment for petrochemical companies. 'Its mangement has done well historically and is poised to benefit from current demands. A long-term prospect whose top line not yet visible but whose day is coming'.

- Inditex (INDEXY; ADR), a multinational Spanish clothing company. 'Supplying retailers across some eighty-six countries worldwide, this is a fascinating company'.

- Illumina (ILMN), a biotech specialising in genetic analysis and testing. 'Targeted recently but unsuccessfully for take-over by the pharmaceutical giant Roche, this San Diego-based outfit has the potential to contribute to the detection and treatment of a wide range of genetic diseases'.

- Mead Johnson Nutrition (MJN), a global producer of infant formula with a strong presence in China and other emerging markets. 'The joke is that more baby formula than drugs is now being smuggled from Hong Kong into China!'

- NewOcean Energy Holdings Ltd (342; HK), a Macau-based LPG supplier specialising in the provision of cleaner energy throughout southern China with a potential market of 100 million consumers in Guandong Province alone'.

- Nintendo (NTDOY; ADR), the highly successful computer games maker. 'If there is one name I have to pick, it's got to be Nintendo'. The Japanese electronics company, is the world's largest video game company by revenue.

- Novartis (NVS; ADR), the big pharma, 'poised to capitalise on ageing demographics and healthcare needs in both the developed and developing world'.

- Pacific Textiles Holdings Ltd (1382; HK), a Chinese Pearl River Delta-based manufacturer of fabrics and knitted textiles supplying a wide range of top brands and stores worldwide.

- Prince Frog (1259; HK), a fast-growing maker of children's and adults' care products and related animation media.

- Universal Display Corporation (PANL), a developer of energy-efficient organic light-emitting diodes (OLEDs) for screens and lighting. 'As more and more LED TVs come on the market, its future looks bright. The smart investors are already moving in.'

- Williams Pipeline (WMZ), a Tulsa-based oil and gas transporter. 'One of the biggest US players with a headstart in the market, it looks set to benefit from the huge US expansion in these fields'.

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