2014 Sir John Templeton Investment Roundtable
London May 14

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THE PARTICIPANTS

Moderator

Dr. Rory Knight, Chairman, Oxford Metrica. Trustee, John Templeton Foundation

Investment Managers

Jenni Chamberlain, Chief Investment Officer, Altree Capital
Cheah Cheng Hye, Chairman & Chief Investment Officer, Value Partners Limited
Peter Doyle, Co-Founder & Senior Portfolio Manager, Horizon Kinetics
Bill Kanko, Founder & President, Black Creek Investment Management
Michael Landau, Horizon Kinetics
Michael Lindsell, Director, Lindsell Train
Scott Phillips, Founder & President, Lauren Templeton Capital Management
William W. Priest, Chief Executive Officer, Epoch Investments
Lewis A. Sanders, Chief Executive Officer, Sanders Capital
Dr. John Schott, Principal, Steinberg Global Asset Management
Daniel Strickberger, Co-Managing Partner, DSM Capital Partners

Templeton Foundation Members, Committee Members & Trustees

Heather Dill, Committee Member & Trustee
Handly Templeton, Committee Member & Trustee
Dr. John M. Templeton, Jr., Chairman & President
Dr. Josephine Templeton, Trustee
Rebecca M. Templeton, Committee Member
Dr. Gail Zimmerman, Committee Member

Templeton Foundations

Dawn Bryant, General Counsel, John Templeton Foundation
Jinde Guo, Senior Managing Director, Investments, John Templeton Foundation
Valerie Martin, Chief Financial Officer, John Templeton Foundation
Nathan Newport, Investment Analyst, John Templeton Foundation
Betty Roberts, President & Chief Executive Officer, First Trust Bank Limited
Udayan Roy, Financial Controller, First Trust Bank Limited
Douglas W. Scott, Chief Administrative Officer, John Templeton Foundation

Templeton Foundation Guests

Mark Deal, Associate, Dechert LLP
Arthur R.G. Solmssen, Jr., Partner, Dechert LLP

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FOREWORD

Trouble is Opportunity

I am pleased to present the report of the proceedings of the 2014 Sir John Templeton Investment Roundtable.

The Roundtable is a private forum held annually at which an invited group of investment managers from around the world meet with the trustees and officers of the various Templeton Foundations to exchange views on the prospects for the world markets and the evolution in their investment thinking. The views expressed in the Roundtable, it should be emphasised, do not necessarily reflect the views of the John Templeton Foundations, their trustees, officers or employees.

The salient points emerging from the 2014 Roundtable are:

China - the risk is not the economy

I must thank the keynote speaker, Andy Rothman, in particular for his insightful talk and the participants for a stimulating discussion. Contrary to mainstream commentaries, the mood about China was particularly upbeat. He saw little risk in the economy, housing or the financial sector in China. The real concern in his view lies in the realms of society, politics and the lack of the rule of law. Shadow banking concerns, real estate bubbles and the lack of a consumer class are myths created by a superficial analysis of the aggregate data on China. Nevertheless - and perplexingly - Chinese stocks continue to under-perform overall economic growth.

Africa rising…

The demographics of Africa alone make a highly attractive case for long-term value investment. Although fraught with risk, the youth and the take-up of technology reveals a continent bristling with opportunity. The convergence of mobile technology and banking is likely to be the catalyst to an unconventional rise in the prospects for Africa.

A discernable if patchy and uncertain global recovery

In aggregate, global activity has strengthened over the last twelve months, and this trend is broadly expected to continue throughout 2014 and 2015. The engine for the recovery undoubtedly has been the larger economies, with emerging markets continuing to lag. Recent market volatility seems rooted in concerns about the fragility of the emerging economies.

Presently, three risks attend the world economy: emerging market risks as mentioned, broader geopolitical threats, and the spectre of deflation, particularly in Europe. The nascent recovery could all too easily be hampered by over-zealous central bankers and financial regulators.

However the overall view of the meeting was by no means pessimistic. True to the Templetonian philosophy, participants identified a host of opportunities around the world. Sir John always viewed the larger horizon with optimism, even in the worst of times. "Trouble is Opportunity" read the sign on his desk and he practised the principle. 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 individual imaginations.

Dr Rory Knight, Moderator

Dr Rory Knight is Chairman of Oxford Metrica and he serves as a trustee of the John Templeton Foundation. He was previously Dean of Templeton College, Oxford University's business college.

KEYNOTE SPEECH. WHY DOES THE WEST WANT CHINA TO FAIL?

Over the last two decades, the Chinese Communist Party has consistently delivered impressive economic performance. GDP growth may have slowed but still remains over 7%. Urban income growth, driving 9% consumption growth, has been the strongest in any major market. The wealth gap between rich and poor may have widened, but migrant workers' wages continue to rise by over 10% a year. Household debt is low and inflation modest. Private firms now account for 80% of urban employment and two-thirds of fixed-asset investment. Chinese citizens enjoy far more personal freedom - though admittedly not political rights - than ever.

Despite this, Western pundits predict China's economy is on the verge of collapse. Andy Rothman, Investment Strategist at Matthews International Capital Management, who has twenty years' experience as a resident and State Department economist and financial analyst in China, asks why and what the implications are for investors.

One of the problems in looking at China is there is just too much information - quite a contrast with thirty years ago. This leads to various misconceptions, and what I want to focus on is the key misunderstandings which make it harder to understand what is actually happening in China and make intelligent investment decisions there.

When I first went to China there were no private companies. Private enterprise back then was a farmer who would come in from the countryside and put a plastic sheet down on the sidewalk and had a couple of vegetables for sale. Today in China, 80% of people in the cities work for private companies. The picture of China run by people in Mao suits in state-owned enterprises and government companies is very outdated. It has become a very entrepreneurial economy and in many ways like the US. According to the US census, two-thirds of US companies have no payroll. 60% of US firms have annual revenues of less than half a million dollars. They comprise just one individual running his or her own business. We're a nation of shop keepers, and basically China has become that as well.

The point I'm making is that this is an economy driven by the same kind of small firms we're comfortable and experienced with in the US. This has a huge impact on how the Communist Party deals with economic policy and personal freedom because you can't have a nation of entrepreneurs if their freedom is tightly controlled.

The big change started in the mid-1990s when the government decided to move from a command economy towards a market economy. It laid off 46 million state sector workers in six years – the equivalent of laying off 30% of the entire US labour force! This didn't result in massive upheaval because it did two other things at the same time. It allowed private firms to start and it gave away all of the urban housing stock to the people who lived there. This represented the biggest one-time transfer of wealth in the history of the world. China went from basically zero urban home-ownership to 85% of families in cities now owning their own home. Most of them live in a house that they got from their government or company or sold it to a developer who generally tore down the whole block of flats and used the money to buy another one. That's one of the reasons why there is so much money in China to buy apartments.

The second big misunderstanding concerns the role of trade in China. When you go to a store in the US it looks as if everything has come from China, and basically it has. But Chinese exports are much more important to us than to the Chinese themselves. Chinese exports are equal to about 24% of Chinese GDP. If you subtract the value of the imported goods that go into creating those items, they are equal to only about 2% or 3% of GDP.

Andy Rothman is an investment strategist at Matthews International Capital Management.

In terms of net contribution to China's growth, exports have been zero to slightly negative in recent years. China is no longer an economy driven by exports. The only place where exports are important in China is in terms of jobs. A disproportionate share of low skill and low wage jobs involve assembling what you buy in Walmart or the Apple store but, relative to the whole Chinese economy, exports are really insignificant. Politicians bang on about the excessive strength of the Chinese currency. But if you ask US companies doing business in China to tell you the problems they have there, the exchange rate will not be on that list, which is borne out by the annual surveys by US chambers of commerce in China and by the US China Business Council.

If exports are not that important to China's economy, the question has to be: what are they doing with all their production? 90% of what Chinese factories produce stays in China, and this tells you that China is the best consumption story in the world. This may surprise people who have heard that China has a very weak consumption story. It is true that the consumption share of Chinese GDP is very low, about 30%, whereas in the US it is over 60%. But the reason for that is not that consumption is weak but that China has been investing so much for so many years. They are building massive public infrastructure projects in China: the equivalent of the Eisenhower highways, the TVA, the EPA - in a couple of decades pretty much every public works project you can recall in the US over the past 100 years. That squeezes the share of the economy left for consumption but, by any other metric, China is the best consumer market in the world.

Consumption growth in China has been about 9% annually but only 1.5% in the US. We get excited when US retail sales grow by 3%, but in China they are growing at double digit pace. Pick any product from instant noodles to shoes, SUVs or computers, and China offers the best market in the world. If you own shares in any large S&P 500 company, the Chinese part of its business has probably enjoyed the highest margins and been the fastest growing part. And if not, you should ask why. Because the popular misconception is that China is a weak consumption economy, people are afraid to invest in the consumer stocks, but those are actually where some of the best opportunities exist, and where funds are – or should be - generally geared.

One of the reasons we suffer from these misconceptions is that China's stock market is misaligned with the economy. If you look at the listed universe in China, it includes very few companies and is dominated by the old state firms and by capital-intensive sectors, banks and the insurance companies. The privately-owned firms and consumer companies are just not well-represented. I get questions all the time in the US asking, why don't Chinese buy things? In fact, if you look at US exports to China, the growth rate has been phenomenal. While overall US exports rose by 100% between 2000 and 2013, US exports to China rose by more than 600%. Since it joined the WTO, China has gone from being the tenth to the third largest market for US goods - everything from soy beans to aircraft and machinery. So China has created a lot of jobs in the US as well.

The next thing I want to talk about is volatility. You've undoubtedly read in the papers about protests in China or, shockingly, that a company has recently failed or missed a coupon payment. A lot of people in the media are interpreting this as the end for China. But China is a country of over a billion people with millions of companies in China only two or three of which have recently gone bust! In fact, China's economic volatility reflects a fundamental structural change: the economy is now really being run by private entrepreneurs, and private entrepreneurs fail every day. Until recently, the Communist Party was afraid to let them fail, so local officials would bail them out. Now, finally, the Communist Party has realised that if they're going to have a privately-driven economy they need to have 'creative destruction'

and, gradually, they are allowing companies to fail. This is actually great news: we should be embracing China's new economic volatility. It shows the Chinese government is taking the nation further down the path to a market-oriented economy. Chinese junk bonds may occasionally fail, but that is not the end of the world and is in fact a good sign.

Another issue that is getting a lot of attention at present is the property market. If you open the *FT* or the *Wall Street Journal*, they will tell you that the Chinese property market is a bubble which is about to burst. I am actually quite bullish about China's real estate market. Let me explain why and give you a few statistics. One of the misconceptions people have is that everybody buying property in China is a speculator or an investor. The reason is that if people like us know people in China, they tend to be pretty well-off and probably have several apartments, which is where well-off people put their money in China. But only 10% of all new house-buyers in China are investors and 90% are owner-occupiers.

Even more importantly, a lot of these transactions are in cash. 20% of Chinese new home-buyers are paid for entirely in cash. That is a pretty good indication that, while affordability for the average Chinese person may remain difficult, affordability for the people for whom the builders are actually building is actually not a problem. If you are an owner-occupier and you want to buy a new home with a mortgage in China, the minimum cash-down payment required is 30%. Think about the difference between this structure and what went wrong in the US: no no-doc loans, no ninja loans, no balloon ARMs - all plain vanilla 20 or 30 year loans with a minimum of 30% cash down! The level of cash equity and the amount of skin held by Chinese homeowners in the game is the opposite of what it was in the United States before the Crash. That means that even if house prices in China were to fall by a third, hardly anyone would go under.

Admittedly, house prices in China have risen unbelievable fast. On average, new prices have gone up nationally by 9% a year for the last eight years. That sounds insane until you compare it to income growth. Over that same period, average nominal income went up by 12% annually. It's crazy but it's not insane. Another important distinction between China and the US is that they have learned from us: there are basically no mortgage-backed securities market in China, no asset-backed securities, no CDOs or CLOs. Consequently, the kind of contagion we saw in the US isn't possible because there is almost no secondary securitisation. If a mortgage or a trust product goes bad, the spillover effect is quite limited.

That takes me to the other issue terrifying people: shadow banking. I would argue that in China there is not a single shadow bank. Let me explain. I have talked about how entrepreneurial the Chinese economy and Chinese society has become and how 80% of the people now work for private companies. But the financial sector is still completely controlled by the Party. That accounts for most of the credit picture. The other part, the one that gets a lot of attention, comprises the trust companies. But there are only about 69 of them, and most of them are also owned and operated by the Communist Party. 90% of the assets under management in these scary trust industries are under Party control. That doesn't mean they're good, but they are hardly shadow institutions if they are run by the Party. They are not allowed to have any leverage. They are highly regulated by the same regulator that regulates the banks, and the Party backs them up. That doesn't mean there won't be problems and failures and blow-ups. Inevitably there will be - this is high risk stuff. But it's not really like shadow banking in the US: lightly regulated, highly leveraged, with no recourse to a central bank. There is nothing like that in China.

So far I've talked about non-problems. Let me conclude by telling you what I think are the real problems. The biggest risks in China have nothing to do with economics or finance. The probability of a housing market or financial

sector melt-down in the next five to ten years is very low because the Party has so many resources at its disposal and is not afraid to step in and act. There's effectively no moral hazard in China. No, what I worry about is the political and social and legal dimensions. There is a huge disconnect getting bigger and bigger every year between the changes in Chinese society and economy and the political, legal and social structures. Everybody's got their own business, their own car and house, their own intellectual property and money and savings. The savings rate in China's families is about 25%. Chinese household bank accounts contain altogether the equivalent of almost $8 trillion. So Chinese families hold in their bank accounts a sum greater than the combined GDPs of Russia, Brazil and India, and their corporate accounts are even bigger. But there is no rule of law. There is no fair and transparent legal system.

To an optimist like me, it's actually quite amazing that China has been able to achieve what it has without the rule of law. There are rules but if, say, I have a dispute with you and your cousin is good friends with the Party secretary who appointed the judge, I'm in trouble. And this is going to be an increasing problem as the economy is driven more and more by private enterprise, and recessions - real recessions - become inevitable. When that happens, tensions will mount and conflicts will have to be resolved. In those circumstances, whom can we trust? This is a huge problem in China: the absence of any institutions that Chinese people can trust. They don't trust the government about food safety or about environmental or occupational safety. They don't trust the courts. This is a massive institutional and societal problem that is going to take a really long time to resolve. You cannot create the rule of law and set up institutions overnight. Yet I see very little sign that the government is moving in that direction. And, combined with all of that, is the absence of a free media.

You notice I haven't said anything about democracy. For me, democracy comes at the bottom of the list. If we look at countries like Russia, we can see that having an electoral process but not having sound institutions and the rule of law is a waste of time. Chinese people are not clamouring for the right to vote for the head of the Communist Party. Eventually they'll get there. They are paying more taxes, and they'll want to be able to have their say in how that money is spent. But really what they need first are institutions. For example, you're paying taxes in Shanghai but local budgets are a state secret, and so you have no idea how the city is spending your tax money. That's got to change but as yet I don't see much conversation about, or progress towards, that in China.

Finally, I return to my question: why does the West seem to want China to fail? I'm troubled by the schizophrenic change in public discourse about China. Fifteen years ago, everything that you read about China was: it's just great, it's taking over the world. If you only could go to China, teach your kids Chinese, move your company to China, you'd be rich. Of course, it wasn't true then and now we hear from everyone that China is collapsing. Every quarter, we are told by the *FT* and the *Wall Street Journal* that China's GDP growth rate is the slowest since the Qing Dynasty. Of course China is growing more slowly - it's gotten so big. Is it really news that growth is only 7.3% instead of 7.5%? We need to consider how big the base has become. Today's growth is calculated on a base three times greater than when it was running at 10% ten years ago. Even with a lower growth rate, China's economy is growing 200% faster than when the growth rate was higher. China is not going to collapse when GDP growth drops - as it will - to 5 or 6% by the end of this decade.

So what is the answer? I guess the reason the media portrays China so negatively is the same reason why, when if you go home tonight and watch the news, the top five stories inevitably will involve an accident, a murder or a fire. It is simply that bad news sells.

QUESTIONS AND DISCUSSION

Where is the reform programme heading?

'Its first and overriding commitment', the speaker said, 'is to continue to improve the environment for private enterprise, the second important one is to reform China's household registration system. China effectively has its own apartheid system. You can pretty much go wherever you can find a job. But the 230 million migrants to the cities still have rural registration and are discriminated against in social and health service provision and pension rights. The party is going to allow equal access to services, which is a good sign that the Communist Party is thinking ahead'.

Could ideology still raise its head?

There is an old saying, "In the short-run, politics determines economics but, in the long-run, economics determines politics". Is the Communist Party terrified that economics could now be playing a disproportionate role?

'You never hear an ideological component in a debate', said Rothman. 'A fundamental decision was taken in the mid-1990s. After Tiananmen, the Party realised that if they had to bring the tanks out again, they would not win. And that led to massive, irreversible change - probably the first time in history a one-party authoritarian regime has voluntarily given up power over the economy. As a result, they've given up power over people's lives. Today, you can pretty much do anything you want in China as long as the Party doesn't think you threaten their right to rule'.

Should we mind the gap?

Referring to Thomas Piketty's recent controversial book on inequality, Dr Knight asked about differentials in China. The gap between rich and poor has risen significantly in China, Rothman accepted, but it is, he said, a consequence of fast growth. 'I am less worried about inequality in China than in the US because at the bottom end of the scale wages have been rising by more than 10% annually for over a decade. Contrast that with the US where people at the same end of the scale probably have a lower standard of living than ten years ago and a lot more household debt. There's still a big divide in China, however, between city and country. In the cities, home-ownership is predominantly based on 60-year leases that theoretically can be renewed when properties are sold. In the country, tenure is still very tenuous and corruption is a huge problem. Technically, there are rules to protect farmers' rights but these are constantly infringed'.

Is a housing meltdown likely?

'A great deal of construction sales in China take place in three or four cities, where the most recent data shows the sharpest decline in new housing starts in many years', commented a participant. 'And this market accounts for over 10% of Chinese GDP. Is high inventory a cause for concern?'.

'I am concerned', Rothman replied, 'especially in the smaller cities where developers have been very aggressive. But I don't think high inventory is going to cause a crash in the property market. As soon as sales pick up, inventory levels will fall. Every few years, people smell price cuts and hold off. Which is what happened a few years ago when home sales slowed down and developers cut prices'.

'Oversupply may be a function of the structural defects of the Chinese system for allocating capital', added a Chinese investment manager. 'A lot of banks controlled by the Party have been over-lending to well-connected property developers and local governments who have vested interests in land sales.

I don't think that's going to lead to the kind of crisis we saw in Spain or Iceland but it may put pressure on economic growth because of the spillover effect on the construction industry'.

Are non-performing loans (NPLs) a worry?

'When the global financial crisis hit, China implemented the biggest Keynesian stimulus ever known to man', said Rothman. 'They brought forward years of planned infrastructure which they funded through the banking system. The stimulus was successful in preventing social instability, and they started winding it back down. After nine consecutive years when annual investment growth was 25%, it's been growing more slowly over the last four years. This year, fixed asset investment growth is going to be about 18%. Manufacturing investment has stabilised because the sector is built out.

'But the economy is still digesting this massive stimulus. The projects are largely done, but the local governments haven't paid off the loans. All they're doing is paying the current interest. The situation isn't sustainable but it also doesn't worry me because at some point the government will simply pay off its own banks.

'You have to bear in mind that the majority of loans outstanding in the Chinese banking system are loans from a Party-controlled bank to a Party-controlled state enterprise or local government. They're an internal loan within the Party, and that's why we've never yet seen a default by a local government or a state enterprise on one of these loans. Now, though, an increasing share of lending is going to private companies and households, and in consequence the level of NPLs will rise. The Party view is: it's risky but it's what we want'.

The fall in 'credit potency'

The return per unit of GDP in terms of credit expansion has been falling, commented a participant. 'It used to be one-to-one, now it is perhaps as much as one-to-four. What are the implications?'.

The Chinese government's view', said Rothman, 'is that today we've a lot of money. We're not borrowing abroad. Commodity prices and construction costs are a lot lower than they'll be ten years from now. It's easier to grab people's land now than down the road. So let's build while we can. We're investing in public infrastructure, and we're not worried about the IRR on giving people clean drinking water and a sewer system, building a subway to deal with traffic congestion or putting scrubbers on power plants. The IRR is the return to society over the whole lifetime of that project.

'One of the best ways to understand the investment boom in China is to make a trip to India, where insufficient infrastructure has been a major contributor to high poverty and illiteracy, and low mobility and GDP growth. When the investment boom in China began twenty years ago, there was no infrastructure. Now infrastructure is reasonably in place, so further incremental increases are inevitably generating smaller returns. But, over time, it will pay dividends. Keep in mind the scale of China. The US has nine cities with a million or more people, China has over 100. The process is not as scary as some people think because this is investment for the long term – not unlike Sir John's investment philosophy'.

Protect yourself

'I'm interested in what you said about the lack of the rule of law', commented Dr Knight. 'Most of the Chinese companies that are listed on the New York Stock Exchange are actually Cayman Island holding companies with operating contracts back to businesses in China. Should investors be worried

about those arrangements?'. 'Basically you've got no protection', replied Rothman. 'With variable interest enterprises (VIEs) if you tried to get your money back, you'd have no hope. But that doesn't necessarily mean you shouldn't invest. You have to know the risks, what the government's interests are and whether they are aligned with yours. 'This is a giant country being asked to observe Western laws on patents and copyright that could impoverish them', said a participant. 'So why wouldn't they copy everything we do?'. 'It's changing', Rothman replied. The turning point came several years ago when, for the first time, the majority of intellectual property rights law cases were filed by Chinese companies against other Chinese companies. All of a sudden, the light went on in the Party. Protection is still lousy, but it has improved dramatically because the Communist Party has realised that it needs the rule of law and intellectual property rights if people who own their own businesses and, in consequence, the economy, are to thrive. If you talk to foreign companies in China now, they'll tell you that while there's still a long way to go, things have improved, and they are investing on that basis. Look at GE's massive innovation centre in Shanghai and Microsoft's big software development centre in Beijing'.

A tough market to crack?

'It is a risky, complicated environment', Rothman continued. 'Basically, it's still, "buyer beware". You really need to look at an actively managed fund. If you just invested in the index or an ETF in China, you'd be doomed to lose. Our portfolio managers do over 2,000 company visits in China every year. There is somebody there all the time on the ground because we need really to get to know the companies'.

The Chinese investment manager agreed. 'Since 1979, China has delivered or over-delivered on the macro side, but its stock market has been one of the worst performers in recent years. We are not making the kind of money that we should in the world's fastest growing economy. So to outperform you really have to be very careful.

'We are living through one of the most exciting chapters in Chinese history. When you're in the middle of something, you don't necessarily see it clearly. It could be a case of "two steps forward, one step back", so familiar in the broad sweep of Chinese history. However, the new reform programme may well close the circle by finally allowing the private sector a dominant role, deregulating the economy, improving corporate governance and accountability, and transforming China into a much more free enterprise society'.

But still a dangerous dragon?

China is increasingly flexing its military muscle internationally, Dr Templeton noted. It is in dispute with Japan over the Senkaku/Diaoyu islands, and has unilaterally extended its claims over waters patrolled by the US Seventh Fleet since WWII. The White House's response has been low-key. What sort of message does this send to Western allies in the region? Dr Knight added that a new book, *Strategic Reassurance: US-China Relations in the 21st Century,* argued that the relationship would be of a long-term Cold War nature and requires careful management. 'Given China's size, it's inevitable that it's building up military power', Rothman replied. 'China is saying: we're a superpower and going to act like other superpowers do. Recent incidents of aggression are not accidental, and that inevitably means that the relationship with the US is going to be more tense. I don't think the Party wants to take conflict to the next level, but accidents can happen. The key is to build up confidence between the militaries and have open channels of communication. There is an opportunity for the US and China to play this the right way. We need to take steps to try to help China shape its strategic and political future just as we've done to help them transform their economic future'.

A MORE UNPREDICTABLE WORLD?

The threat of Russian and Chinese expansionism

'As well as China's new territorial aggressiveness', said Dr Knight, 'we have seen Russian land grabs and sabre-rattling in the Ukraine. What does this portend for financial markets?'.

'My primary concern is that the Chinese stock market should reflect macro-economic growth', the Chinese manager said, 'and for that you need peace not war. As for the Ukraine, most Chinese', he said, 'would see this as an opportunity for closer alignment with Russia, allowing China wider access to Russia's wealth of natural resources and so fuel its continuing economic growth'. He predicted (as indeed was announced immediately after the Roundtable) that the two nations would sign a major natural gas supply agreement.

'Putin is attempting to reconstruct the old Soviet Union', one participant commented, 'but he is confusing territory with real power – technology and knowledge. Russia trails other economies by any metric that matters. It is a country of home-grown technology, and its aggressiveness will shut down any chance of acquiring technology from the West'. Oil revenues, he pointed out, constitute 50% of the Russian economy and it is, therefore, utterly dependent on sustained high oil prices, which cannot be guaranteed. As to investment prospects in Russia, another participant saw little opportunity at present. 'At 2.5x earnings, Gazprom is the world's cheapest gas stock but who really owns it?'. Not just the essential transparency but 'feet on the ground' are in short supply. While the current situation may prove a temporary hiatus, and isolated short-term opportunities may arise, 'it will take time before an effective investment strategy evolves for Russia'.

A new barrier: the Piketty Fence?

Dr Knight alluded to the new book by Thomas Piketty, which controversially argues in essence that, since capital returns exceed economic growth, increasing inequality is inevitable. 'Is inequality capitalism's "Achilles heel" and what are the implications of the policies put forward to solve this problem?'.

Participants questioned both Piketty's data and his analysis. The relative fall of the standard of living among the working population in the West they saw as a recent phenomenon driven by three overriding factors: globalisation, information technologies and QE. Globalisation has unleashed a tsunami of new labour, and the reach and speed of information-based technologies had exploded exponentially. As a result, 'returns for labour have collapsed while those based on capital and technology have gone through the roof'. In the resulting destabilisation, a 'winner-take-all' has become the new norm across many industries. Exacerbating inequality has been QE which, by artificially repressing interest rates, has boosted the returns on capital. 'Essentially', a participant observed, 'we have robbed Grandma to save Goldman'. A Paris-based manager argued from his experience that the seductive allure of a wealth tax as proposed by Piketty should be vigorously resisted. As a result of high taxes, France is suffering a mass exodus of capital and innovative talent – the seed corn of tomorrow's jobs and industries.

QE and the dangers of deflation

'Equity markets are riding high at the moment', Dr Knight said, 'but is there a risk in the developed economies from lower than expected inflation?'. An extensive debate ensued. The view of one participant was that 'the overriding concern of policy-makers and central banks has been to avoid deflation and keep us out of a 1930s-type depression. But the danger of deflation has been deflected. In fact, I'm not sure that a little bit of deflation is necessarily bad. If you look back at previous centuries, deflation has often been the norm'.

An end to US primacy?

'Our firm is quite bullish about the prospects for US growth', said one American manager. 'Recovery is taking off and, uniquely, it has not been driven by the housing market. QE has accomplished its mission, and the private sector is in the process of a self-reinforcing cycle of expansion. Paradoxically, though, we in capital markets are vulnerable, and growth will bring in its wake higher interest rates, which inevitably will impact on valuations'.

But, looking more widely, Dr Knight asked: 'Is the US retreating into neo-isolationism - a grim prospect for Europe?'. Shrinking American power is inevitable, many participants thought, given its falling economic dominance, deficit problems and current political inertia. 'The US is in the process of downsizing after the Bush years', commented one manager. American neo-isolationism is especially worrying, participants thought, especially given that, as one observed, 'the EU has neither political nor military power. The West still enjoys moral force but lacks the physical force to back it up'. The end result might be that countries increasingly pull apart and pursue their individual self-interest.

The roots of American enfeeblement run deep, said Dr Templeton, and spring from a malign combination of several factors. One is falling educational attainment and proficiency. He pointed to surveys in which some years ago the UK and US were ranked 10th and 11th respectively in the world. In the most recent survey, out of 38 countries, their positions had fallen to 26th and 34th. Nearly half of freshmen fail to graduate from high school and, of those who go on to college, a further half drop out before the end of their first year. He cited the case of a manufacturer of roadside signs who, unable to find adequately skilled employees in the US, was obliged to look to China to find the requisite skills.

Other factors include profligacy and reckless over-borrowing. 'Sir John consistently warned his investors not to borrow in order to invest heavily'. More fundamentally, Dr Templeton detected a loss of faith in the spirit of free enterprise that had contributed so much to create the prosperity of Britain and America. 'Since Adam Smith, it has been accepted that free trade drives economies, but now we see an ever-increasing tax burden falling on small businesses - the heart (54%) of the US economy. This stranglehold on burgeoning enterprises imperils not just the economy but the principle of democracy itself'. 'Democracy has great virtues', a manager added, 'but politicians often do not act as statesmen. They tell the public what it wants to hear, not what it should hear'.

Japan: the sun also rises … or not

'How is Mr Abe doing?' Dr Knight asked a manager close to Japanese markets. 'The government has intervened without precedent in the bond market – at a level even double that of American QE', he replied. 'In fact, Japanese QE started long before America's, and its long-term achievement is questionable in that nominal wages have fallen 20% in the last twenty years. The current round has resulted in the yen weakening, the stock market rising, and corporate profits growing. But Japan is saddled by debt, and the new consumption tax is an added burden. It is unclear that the momentum will be maintained, and markets have stalled. Paradoxically, QE has postponed the restructuring and deregulation needed. Companies have been able to defer hard decisions by issuing new equity and bolstering balance sheets. That, I think, is a retrograde step. I'm not sure momentum can be maintained unless Mr Abe comes up with new measures – which is what the markets are looking for'.

Emerging markets: maybe tomorrow …

'Is this the year emerging markets' recent lack-lustre performance turns round?', Dr Knight asked. Participants thought investors should hold back for two or three

years but highlighted three exceptional opportunities: the emerging middle-class consumer, and specific opportunities in Brazil and Africa. Regarding the first, one participant cited the startling statistic that Unilever, active in 170 countries across the world, sells its products to a third of the global population – 2 billion consumers, with a further billion able to afford them within ten years.

Brazil: not just commodities

'You can't find anyone who'll get behind Brazil right now', a participant observed, 'with good reason. They had a nice growth trajectory when China was heavily consuming Brazilian commodities. GDP was still growing at 7.5% after the Crash. Then things fell apart, and growth since has been anaemic. Brazil has grave problems of unrest, corruption and income inequality plus an awful tax system - including a 58% payroll tax putting a brake on new hires. But there are opportunities. São Paulo's stock market, for instance, is the world's cheapest, trading at a 40% discount to other exchanges. Controlling 90% of Brazilian shares, and with a dividend ratio of 80% and yields of 5-6%, it is actively buying back shares and has huge long-term potential. Currently, only 0.35% of Brazil's population owns shares (compared to 53% in the US) and there are only 346 listed companies (as opposed to 4,500 in the US). One pitfall might be this autumn's elections'.

Africa: getting connected

'Africa is an extraordinary continent', Dr Knight commented. 'It contains 15% of the world's population, with a median age of 25 compared to the global average of 35, and technology is making unprecedented inroads there'. At a recent Milken Conference, the actor, Matt Damon, who is involved in various African initiatives, had joked that Africa now has more cell phones than toilets! A manager versed in African markets agreed, 'a mobile is no longer a luxury in Africa: it's a necessity'.

True, the continent has crippling problems of ethnic and religious division, she continued, staggering income inequalities and severe problems of graduate unemployment, especially in the nations on its northern littoral. 'A further bugbear is the 'Big Man Syndrome': leaders who benefit their own tribes or interest groups at the expense of the rest of their populations. But the instability in Libya, Egypt and Nigeria should not blind us to the opportunities. In contrast recently to the BRICs, Africa's story has been one of increasing productivity and growth. African growth has been some 8% overall. The continent has suffered less from the fall-out of the Crash than other regions. Lower interest rates have enabled it to attract international capital, despite the danger of overburdening themselves with foreign debt. There is also increasing domestic investment, both within and between countries, especially by South Africa.

'Nowhere is the emerging middle-class consumer more on the rise than in Africa. The most lucrative opportunities, though, are not to be found among the multinational subsidiaries but among small companies with strong local links and managements. Nestlé Nigeria trades at 34x earnings whereas the United Africa Company, an old Lever Brothers-founded firm, trades at 12x'. She added that the companies she cited are publically traded.

'Technology is transforming African lives', she added. It is re-writing the story of banking in Africa. She highlighted the tie-up between Vodafone and Kenya's Equity Bank, which has taken advantage of mobiles and internet technology to facilitate money transfers and saving. 'In a rural area, instead of sticking your money in a mattress or having to walk miles to the nearest bank, you can now go to the local mom-and-pop store and do your transactions there. This not only cuts bank costs and side-steps the need to build extensive networks of branches, but creates client histories enabling banks to understand spending patterns and tailor services to clients' needs'.

THE INVESTMENT LANDSCAPE: FOLLOWING IN THE FOOTSTEPS OF SIR JOHN

'Growth in the big S&P companies – the Proctor & Gambles, the Krafts, the IBMs and the Fords - has been very anaemic: only 1% or 1.5%', a manager commented. 'They've cut their expenses dramatically with the result that operating margins are at an all-time low but, even with today's low interest rates, their P/E multiples remain pretty high. In these companies, it is hard to see where strong returns are going to be generated. To get these, you need to look off the beaten track, especially at owner-operator companies. If you look at the companies that went out after the Crash and bought distressed assets, it was the owner-operators. Investing in these companies you get the best, most aligned managements, the best access to information, the lowest costs and the best returns on capital. And in many cases they trade at a massive discount to the S&P'. Some of these owner-operators, another participant added, can be found among large consumer staples companies. 'They may not be household names but they are driven by multi-billionaires who have the money and guts to go out in a crisis and buy great assets'.

Owner-operators apart, other large staples or long-life consumer franchises might rather be seen as 'dead money': safe investments that offered reliable substitutes for treasuries themselves no longer so trustworthy, given high government debt levels. To achieve higher returns, investors might look to other alternatives: not necessarily the 'extreme cult stocks', a manager said, like Amazon, Twitter and Red Hat which, despite their healthy low double-digit growth overall, have unattractively high P/Es of around 18/19x and low top-line income growth, but companies that enjoy more modest growth like MasterCard or Visa.

One participant, though, was more upbeat about large companies. He cited educational publishers such as Reed Elsevier with long-established markets and now able to take advantage of new digital technologies to deliver their content. Another large publisher, Pearson, he added, enjoys access to a $50 billion educational market worldwide, operating across all four educational tiers. Two years ago, it derived half its revenues from digital formats; that figure has now risen to 70%.

Other promising fields mentioned by managers included aquaculture – commercial fish farming to meet growing global needs for food. 'As consumption rises, people consume more fish', said a manager whose firm has an interest in this area, 'and this demand is not only on the rise in developing economies but, given increasing health awareness, in the developed economies too'. He went on to mention other counter-intuitive opportunities, for instance taking advantage of forced asset sales in China from over-extended property developers. He cited Toronto-based Brookfield Asset Management (also, incidentally, one of last year's Roundtable stock picks) which bought land in the centre of Shanghai at a 50% discount on its 2007 price. Chinese life insurers are another promising area, which are now permitted to invest up to 30% of their assets in stocks. China Life, for example, has been unfreezing asset chunks worth up to $100 million for such acquisitions.

The Chinese manager also saw underperforming or over-extended assets in China as an opportunity. Recently, conscious of underperformance in Southeast Asia, the region in which his firm specialises, his office conducted an analysis of the correlation between underperformance and metrics such as earnings per share, dividend yields and P/E multiples, and found the 'per point' measure key. Clients might have to be persuaded of the benefits of a long-term contrarian approach, he added, but it brings rewards 'in extremely volatile markets like China'.

Across the board, managers paid tribute to the continuing merits of Sir John Templeton's investment approach: contrarian, value-based, long-term, and both opportunistic and careful. Such strategies had proved their worth in the course of his career and continue to do so in today's ever-more unpredictable and fast moving world.

STOCK SELECTIONS

Dr Knight invited managers to identify stocks that they judged particularly promising in the coming year. As last year, this year's 26 selections are extraordinarily diverse, spanning holding companies and conglomerates, independent owner-operators and public companies; and sectors that range from retail, construction and property development, hospitality and leisure services to agribusiness and steel production. Particularly notable, are the numbers of organisations pioneering drug development on the frontiers of medicine and biotechnology; companies specialising in digital and internet-mediated products; media, publishing and communications groups; and energy providers.

These included (with ticker symbols and corporate status in brackets, followed by brief descriptions):

- Alexion (ALXN). Alexion Pharmaceuticals is the developer and distributor of *Soliris*, a drug used to treat rare disorders such as atypical hemolytic uremic syndrome and paroxysmal nocturnal hemoglobinuria.

- Arcelor Mittal (MT; ADR). Arcelor SA is a multinational steel manufacturing corporation headquartered in Luxembourg and formed in 2006 from the takeover of Arcelor by Mittal Steel.

- Arcos Dorados (ARCO). Arcos Dorados is an Argentinian company engaged in the operation of McDonald's franchisees, serving over 4 million customers in Latin America through the operations of 1,840 McDonald's-branded restaurants in twenty Latin American countries.

- Biogen (BIIB). Biogen Idec Inc is one of the world's leading biotech companies. Its core capabilities include drug discovery, R&D and manufacturing and a global commercial infrastructure.

- BM&F Bovespa (BVMF). BM&F Bovespa (BVMF) is a stock exchange based in São Paulo, Brazil, with a recently-quoted capitalisation of $1.22 trillion, making it the 13th largest stock exchange in the world.

- Carnival (CUK; ADR). Carnival Corporation & PLC is an American multinational cruise corporation and the world's largest cruise ship operator.

- Celgene (CELG). Celgene Corporation is a global bio-pharmaceutical company engaged in the discovery, development and commercialisation of therapies to treat cancer and immune-inflammatory diseases, focusing on areas such as intracellular signalling pathways, immunomodulation and therapeutic applications of cell therapies.

- Chesapeake Energy (CHK). Chesapeake Energy is an Oklahoma-based oil and gas company and the second largest US natural gas producer.

- China Yuchai International (CYD). China Yuchai International (CYI) is a holding company based in Bermuda and listed on the NYSE, whose businesses include engine manufacturing, hospitality and property.

- Citrix Systems (CTXS). Citrix Systems Inc is an American multinational software company providing servers, applications and desktop virtualisation and networking, software as a service and cloud computing technologies, including Xen open source products.

- Eland Oil & Gas (AIM; ELA). Eland Oil and Gas PLC is a Nigerian oil and natural gas upstream exploration and production company listed on AIM, with its operational offices in Abuja and Aberdeen.

- Icahn Enterprise (IEP). Icahn Enterprises LP is a diversified holding company headquartered in New York and controlled by billionaire investor Carl Icahn.

- Kennedy Wilson (KW). Kennedy-Wilson Holdings is a vertically-integrated real estate investment and services company, offering property and asset management, brokerage and auction services, and construction and trust management.

- Liberty Media (LMCA). Liberty Media Corporation is an American mass media company controlled by its chairman John C. Malone who owns the majority of its shares.

- MagicJack (CALL). MagicJack is a computer peripheral that plugs into computers and routers and, in combination with the related YMAX Corporation, provides internet-based services allowing users to make unlimited North American telephone calls.

- Nintendo (NTDOY; ADR). Nintendo Co Ltd is a Japanese consumer electronics multinational. Nintendo is, by revenue, the world's largest video game company.

- Pearson (PSON; ADR). The world's largest education company and book publisher.

- PetroChina (PTR; ADR). A listed arm of the state-owned China National Petroleum Corporation, PetroChina is China's biggest oil producer.

- Samsung Electronics (005930:KS; GDR). This globally-established Korean brand manufactures and distributes an innovative range of consumer and industrial electronic products worldwide, such as semiconductors, personal computers, peripherals, monitors, televisions and home appliances including air conditioners and microwave ovens. It also produces internet access network systems and telecommunications equipment, including mobile telephones.

- Scangroup (SCAN; KN). This leading advertising and communications services consultancy is headquartered in Nairobi and provides its services throughout East, Central and Southern Africa. It has subsidiaries in Tanzania and Uganda as well as media-buying operations in eleven other countries across Africa.

- Sears Holdings (SHLD). An American multinational founded in 2005 by the merger of Sears and Kmart.

- Shanghai Pharmaceuticals (SHPMY; ADR). A manufacturer, wholesaler and retailer of bio-pharmaceuticals, chemical and Chinese traditional medicines and healthcare products.

- Swatch (SWGAY; ADR). Swatch and its subsidiary Montres Flik Flak design, manufacture and distribute the Swatch and Flik Flak wristwatch brands.

- Transcorp (TRANSCORP; Lagos). Transnational Corporation is a diversified conglomerate with strategic investments and core interests in the hospitality, agribusiness and energy sectors.

- United Health (UNH). Number 17 on Fortune Magazine's top 500 US companies, United Health is a diversified health care company in Minnetonka, Minnesota.

- Wienerberger (WIE). The world's largest producer of bricks and the top roof tile producer in Europe, with 230 plants in 30 countries.

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