2012 Sir John Templeton Investment Roundtable
London May 16

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FOREWORD

Trouble is Opportunity

I am pleased to present the proceedings of the 2012 Sir John Templeton Investment Roundtable. The roundtable is a forum held annually wherein 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 world markets. 2012 is an auspicious year for Sir John's legacy being the 100th anniversary of his birth and the 25th anniversary of the founding of the John Templeton Foundation.

We live in difficult times, when the shadow of sovereign debt and low growth hangs over the West; when the Eurozone itself may implode; when the promise of China, to which many look, seems to be flickering; a time of potential social unrest and of a deeper loss of faith in the ability of free market capitalism to meet humanity's needs adequately and equitably.

When one considers the West's loss of competiveness relative to its younger and more energetic rivals, one is reminded of the famous leader in the London *Times* over a century ago during another Royal Diamond Jubilee, that of Queen Victoria:

> 'We are finding ourselves somewhat less secure of our position than we could desire, and somewhat less abreast of the problems of the age than we ought to be, considering the initial advantages we secured … others have learned our lessons, and bettered our instructions while we have been too easily content to rely on the methods which were effective a generation ago …'

But if some see the present as the worst of times, others view it 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. In the contrarian spirit of Sir John Templeton, the asset managers whose views are sampled in this report, highlight - the pervasive gloom notwithstanding - a swathe of opportunities in these fields.
I hope you enjoy reading these proceedings and I thank all 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.

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THE LEGACY OF SIR JOHN TEMPLETON

In his memo of 2005 that predicted the coming financial storm – only discovered after his death – Sir John Templeton commented that we are living in extraordinary and demanding times. But from early on in his career, when he had to take on as many as three jobs to support himself and his family, John Templeton had become a great apostle of the blessings of adversity and especially of how to overcome it if only one could summon up sufficient imagination and will.

The larger horizon for Sir John was always optimism. 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. He considered the *mind* and clarity of thought to be great blessings. Passivity of thought and fatalism he deplored as pervasive flaws in human beings. This outlook is reflected in one of the central goals of the Foundation, which it will pursue throughout coming centuries: to help people themselves become positive agents - in their imaginations and in their sense of issues and of how to resolve them.

Consequently, Sir John constantly resisted encroachments on individual liberty - whether by people's own sense of their limitations or by governments and ideologies, agreeing with Thomas Jefferson's maxim that it can almost be guaranteed that government will grow and grow and liberty decline'. He shunned fashionable ideologies imposed by an intellectual elite and instead put his trust in down-to-earth common sense logic.

He would therefore be appalled for instance today by the attacks on genetically modified foods, which offer so much potential to feed and health of humanity; by the spiralling costs of higher education in America, which he saw as a self-perpetuating phenomenon, fed by unlimited government largesse, which would eventually lead to the closure of almost a third of colleges given the alternative of low-cost online courses; and by the focus, despite their unsupportable costs, on renewable energy sources above all other available possibilities. What might it mean not just for small businesses but the advance of society generally if energy costs could be cut by as a much as a third?

Sir John trusted in the limitless blessings life could offer but always believed that blessings had to have substance behind them – the substance of hard work, effort and thrift. His own 'adventure with thrift' began when he married my mother and they determined to save half their income, however small at that time and invest it wisely. Sir John dearly loved a bargain, to buy cheap and sell dear - which was why he never invested in industries and countries wholesale but selectively and why his fund almost became a special nation, if you will, all of its own.

But Sir John Templeton's motive was never solely profit for its own sake but the spiritual dimension, those laws of the spirit which he considered to be as immutable as the laws of gravity: love, gratitude and integrity and striving in the service of others and of society. It is in the light of his legacy and his belief in spiritual values that I request you in this meeting today not simply to explore the opportunities opened up by business and finance but also to take some time to pause and ponder what role character and virtue should play in your own activities and in the world of finance generally.

Dr. John M. Templeton, Jr., Chairman & President, John Templeton Foundation

THE WORLD ECONOMY: STORM CLOUDS AHEAD

The two major forces currently in the global economy are fiscal consolidation and bank de-leveraging, said Dr Knight. Austerity or stimulus: which forms the best basis for growth? Which will win out: deflation from world-wide deleveraging or hyperinflation from excess liquidity.

Scenarios at the macro level range from bleak to catastrophic, said one analyst. We are swimming in uncharted waters. Both consolidation and stimulus will be needed to navigate successfully between the Scylla of deflation and the Charybdis of hyperinflation. Emerging from the crisis could prove a very protracted process – four to six years or longer. Markets are generally efficient at pricing disruption, but nothing on the scale of current uncertainty and disruption has ever been experienced. Minus GDP growth of 2% over the next two years is a distinct possibility - which in turn has grave implications for lending and the corporate sector.

Another experienced investor and commentator on market behaviour endorsed this. There is a great deal of denial at the moment. The confidence that we have recovered from the crisis of 2008 is misplaced. The process of purging the excesses of the 1980s and 1990s which began in the early 2000s continues to accelerate. Artificial liquidity from the Fed has propped up markets, but at some point interest rates will have to be raised, and then the consequences could be grave.

If both long-term debt and current liabilities are both taken into account, agreed one investment manager, the totals are alarming. Can we fairly expect future generations to shoulder them? We can do something to reduce cash flows, but at some point there will have to be consideration of major restructuring – or accept hyperinflation. Deflation is generally seen as the big threat, but hyperinflation for all its downsides could at least reduce debt.

Equity markets are still behind the curve, many participants felt. In 2008 political concerns and the need to stabilise the banking sector trumped shareholder interests. Currencies have been - and are being - manipulated (see next section). It is uncertain, once reality bites, whether shareholders will keep their nerve.

Other managers were more upbeat. Equity markets were the one area that had not been artificially propped up, said one manager: 'They have taken everything on the chin'. He pointed to parallels in previous crises. "Go back to the Asian Financial Crisis, to Mexico in 1994, to Russia in 1998 or Argentina in 2001. They dropped some 90% against the $ at the very bottom, but markets only fell by around 47% - 50%. Today, Greece is down 90%, so the outlook is by no means entirely bleak.' He highlighted Apple, with its market cap of $570 billion far in excess of the Madrid stock exchange $430 billion: 'If you can own Apple, you can forget about Spain!'

Whatever their differences, participants agreed that, however black the storm clouds, there are always bottom-up opportunities. The key question, though, is when to jump in. The managers' consensus was that we have not yet reached the bottom and that prices have still some way to fall.

Asia bounced back from its 1998 financial crisis. Austerity and fiscal consolidation seemed to have worked there: what lessons could the West learn?

In reality the Asian Financial Crisis was at heart political and social. The key was structural reform – which can only happen when politicians can mobilise a social consensus. And Asia at that point was lucky: the West

was not in crisis and Alan Greenspan was pursuing expansionary policies at the Fed. Today is different and could turn out really seriously. The political and social solution will be much harder to achieve in Western societies given the shortness of electoral cycles and the volatility of electorates and their unwillingness to accept cuts.

Unrest is on the rise around the world, from the streets of Athens to the Occupy Wall Street movement, said Dr Knight. Does this betoken a deeper loss of faith in capitalism?

Confidence is eroding at several levels, commented one analyst. People have lost faith in governments and politicians. There is also a distrust in business, that started in the mid-90s with the Enron scandal and was fuelled by the 2008 financial crisis. People feel their savings and investments have been put at risk by reckless risk-taking: 'I do not see that confidence coming back any time soon until the folly, and that mind-set that caused that folly, is felt to have been purged out of the system'. At the same time there is denial of – and resistance to – any reductions in the standard of living. Lastly, there is a loss of confidence in currencies - and there are precedents in history to show where that can lead. There is no mystery why the gold standard was instituted and eventually why it failed, paralleled today in the European common currency bloc and its yawning disparities. Confidence has departed at many levels, and it is going to take a long time to restore it.

People feel they cannot trust their governments to be prudent and do the right thing by them, said Dr Templeton. Similarly, retirees have put their trust in fixed income funds – perhaps mistakenly. The spectre of hyperinflation looms, as in the Weimar Republic, and we all know where that led politically. If there had been an opinion survey of approval of the Bundstag in 1932 it might have shown a drop of 135. Strikingly, today's polls indicate a 15% drop of confidence in the US Congress. The public clearly sees an incompetence and lack of accountability in Congress - and that is something fraught with peril.

There has been a commodity boom in recent years: will this continue? asked Dr Knight. 'Fracking' is getting a lot of attention. Does it herald a new era of cheap energy? But from an energy supply standpoint what are the implications of the Iran/Israel standoff?

Opinions were divided. One manager felt risks had been priced into the market and major geopolitical risks actually calming down. Others were less sanguine, pointing out that a third of the world's oil passes through the Hormuz Strait and, if that were to be closed, the consequences would be serious. Oil could spike at $200 per barrel. 'We are looking hard at oil and energy names outside the Middle East,' one investment manager responded. 'There are natural resources in Canada that increasingly can be exploited. Geopolitical risks are always tough: the key is making money.'

THE USA: WILL THE DEBT BOMB EXPLODE?

Senator Coburn's book The Debt Bomb argues persuasively that America's debt bomb could explode, said Dr Knight. Could there be dire consequences for the US and world economy? Also, the Federal Reserve has actively expanded its balance sheet through a variety of programmes. Could there be unintended consequences?

US debt has ballooned from $11 trillion in 2011 to over $15 trillion, it was reported, and over the last three years there has been a 45% increase in overall US debt. The current deficit is $1.5 billion, approximately 10% of GDP. Historically, oil-rich and other foreign nations financed America's debt. More recently there has been a 'peer bid' in the markets to fund it, but if that falls away, the US is potentially heading for a major collision.

The Fed's extension of its programme of purchases, especially its shift from shorter to much longer dated bonds, is worrying, participants felt. It now holds over $1 trillion of mortgage-backed securities and more than $1 trillion of treasuries dated longer than five years. A rise in interest rates could theoretically wipe out the Fed's balances and the odd situation could arise where the Fed itself was in negative equity.

The US Monetary Committee is projecting 3% inflation, but that could creep up, and the inflationary wash-out should greatly concern investors. The government is striving to hold mortgage rates down through successive QE programmes in order to calm the mortgage market, but the mortgage rate remains stubbornly high. The real underlying issue perpetuating the problem is unsustainable unemployment and social structure costs. Further QE to ease unemployment may paradoxically be adding to the strains at this point.

Taxes could be raised to recapitalise the Fed but that would be difficult. A more likely scenario is continuing fiscal sloppiness and devaluation. With the marginal cost of printing dollars zero, no Gold Standard to fall back on and foreign governments holding substantial assets, a potential trap is waiting to be sprung.

A more politicised Fed?

Since 2008 there has been no systematic approach to bail-outs, commented one manager. They have been allocated piecemeal on a political basis - something never seen before. The Fed has always fought deflation – admittedly an evil – but deflation can actually, as in China, bring more people into the workforce. To counteract that by creating monetary inflation, by leveraging up, which benefits the turbo-borrowers, creates serious problems. People are much more averse to trade freely because the underlying picture is opaque.

Are we witnessing a blurring between Executive and Fed? Asked Dr Templeton. He cited the elimination of food and fuel costs from the CPI. Certainly more regulation is being assumed by the Fed, replied a manager, and that is more open to political manoeuvring. But in reality the Fed itself is having to compensate for a lack of leadership and decision-making in Congress.

How are US banking, equity and housing markets actually doing five years after their peaks?

The US appears further along the path of recovery than Europe. It has been much more aggressive in buying since 2008. Its banking sector looks relatively healthier at this stage. The weighted leverage rate for US banks is 11 compared to 15 in Europe. But the situation remains fragile.

There is also greater regulatory repression. Given their $200 billion previous losses, banks are being forced to maintain greater reserves. It is very difficult to get the approvals to start a new bank at present in the US. More generally, banks seem more concerned about funding federal debt than lending to business and as a result are starving the private sector. The private sector is responding appropriately. Companies are building up to $2 trillion in excess cash. This almost represents the emergence of a free market banking system detached from 'the government morass'.

And the outlook for US small businesses?

Half the US economy and employment comes from small businesses, said John Templeton. Yet it is the most threatened and crumbling sector. Overall costs per employee have risen to $6,000, $8,000 for medium-sized businesses, and $10,000 for small businesses.

EUROPE: DIAMONDS IN THE DUST

Is a 'Grexit' likely? asked Dr Knight. What could be the fall-out?

A Greek exit from the eurozone is highly likely, most participants thought. The key question is not 'if' but 'when' and especially 'how' - whether its exit would have a domino effect on other weaker euro economies like Italy, Spain, Portugal and Ireland. Only one manager – admittedly one closely involved in European markets – felt otherwise. Europe's problems are part, he said, of a larger cocktail of problems, arising from the US expansion of home ownership, loose monetary and deregulation policies and the 'monsters' spawned by globally integrated financial markets. Germany, he believed, will go a long way to protect the euro, even accepting its historical nightmare of a higher rate of inflation. But, even so, he was dubious about the long-term financial and investment prospects for Europe.

Endorsing this, one investor predicted a future for Europe ranging from 'recession to outright depression'. 80% of European credit is channelled through some 50 large banks. Collectively, they could see between $2.5 and $4 trillion stripped from their balance sheets. We might suffer minus GDP growth of 2% over the next two years. There could be a swathe of asset sales in reaction to falls in share values and bank deleveraging. We are living in a time when 'the banks can take down the sovereigns, and the sovereigns the banks'. Europe should look to its balance sheets and ability to self-fund during a period of major discontinuity.

The ECB with its LTROs, said another participant, is in even worse shape than the Fed, despite US property-related risks. It has extended a large amount of credit to banks to fund the 'pro-sovereigns'. 'There is a 25% "haircut" in prospect relating to pro-sovereign debt. It is my understanding the ECB no longer has any real equity, and I doubt the German taxpayer will stand behind it.'

Given Europe's loss of competitiveness and the burden of its welfare systems - heavier than anywhere else in the world - even the manager who trusted in the euro's survival saw only one way out: 'If the currency is to hold together, the only way to resolve the issue is to do what Germany did; net nil or even declining wages and deep cuts in living standards. This problem may stay with us for the next decade or even longer.'

This inevitably poses the question: are European equities therefore a complete value trap?

'Would Sir John, even with his eye for a bargain, be "bottom-fishing" in Europe at this point? asked a participant. Probably not, he concluded. 'Volatility is the stock-picker's friend, but we are not yet at the point of maximum pessimism that has to be reached. That said, there is no question that we will be in Europe in perpetuity. There will be some fantastic buying opportunities, but they will be emerge gradually and we will have to space out our buying.'

On banks, a contrarian note was added by one European investment manager. At 20% of the total market, the European banking sector is still way too large, he said, and there will inevitably be casualties. But on a stock-by-stock basis the situation continues to evolve and not entirely negatively. Despite notoriously inefficient Italian banks, a virtually bankrupt Spanish banking sector and high price German banks, there are still opportunities, especially among Swiss banks like UBS with its strong wealth and asset management franchises.

Other long-term European opportunities identified by participants included:

- European multinationals, especially those trading in dollars
- Companies with high dividend yields and cash flows
- European commodities, 'despite their current slaughter on the markets'

CHINA: AN ATTACK OF ASIAN FLU?

Chinese equities have underperformed for several years and growth has fallen to 7.5%, said Dr Knight. What is the outlook, especially in the face of European recession?

The story in China is no longer just one of growth but of a change in direction, said a China-based investment manager. China is embarking on a restructuring that will make it less export-dependent and more self-sustaining and consumer-led. In pursuit of the so-called 'harmonious society there will be greater investment in health, education, welfare and the environment. 'The system has swung from extreme socialism to extreme capitalism, and is now reverting to something more sensible.' This change will bring new opportunities and new winners. Not all held this view. Inflation being the latest Chinese export.

Others were less sanguine. Fixed asset investment in China has fallen from 50% to 30%, pointed out a manager familiar with Asian markets, consumption rising conversely. Much future investment is having to be brought forward to fill this 'investment bucket'. Interest rates will have to be liberalised if the renminbi floats: '8% - 10% growth in perpetuity is certainly not going to happen.' Another emerging market investor highlighted the dangers of inflation, pointing out that Chinese labour costs have risen by some 400% over the past decade.

Is China deeper in debt than thought? asked Dr Knight. He drew attention to the debt lurking outside the central government and state banks, not just at local and provincial levels but in the shadow banking system. The China-based manager argued the debt is internal - 'Chinese people owe Chinese people - and therefore containable. Others questioned this: with total debt some 200% of GDP, a Chinese bank recap like that of the early 2000s might be on the horizon. Given Chinese banks' $ trillion balance sheets, foreigners might look very hard before leaping in.

Two other key issues were also raised by Dr Knight: corruption and the 'housing bubble'. One participant recounted how one leading Chinese businessman routinely sets aside 20 million renminbi for purposes of bribing officials. In addition, several notorious frauds by Chinese have recently come to light on international stock exchanges. The China-based investment manager pointed out, however, that a recent *Wall Street Journal* survey had shown corruption only a minor concern to most Chinese – way behind issues like healthcare and employment. Another manager who dealt in China disagreed: 'If you have intelligence and energy but no integrity,' he warned, 'you have some very dangerous people … the way to play it is dull, safe and cheap'.

Regarding the housing bubble, the China-based investment manager again accentuated the positive. The boom in property ownership reflects a genuine demand for better housing on the part of the Chinese people. The overall figures are 'healthy': a third of purchases are paid in cash and 40% down payments are required. However another manager pointed out that the Chinese house price to income ratio is close to 7 – and is 14 and 18 respectively in Beijing and Shanghai. At the height of Japan's property bubble the ratio was 8. 'Fortunately the government has done the right thing and clamped down, and by now most of the risks have been priced into the markets – which is why the Shanghai Index has been in bear territory for the last three years.'

Overall, though, the China-based investment manager struck a bullish note: 'The way to make money in China is much simpler than all these macroeconomic ideas: it is to make money out of stupid people. The Chinese market is immature and emotional, poorly-informed and momentum-driven. The key is consistency, knowledge and research.' He cited two opportunities in financial services in particular: firstly, supplying microfinance in the $5,000 -$15,000 range to the start-ups and SMEs which, with state blessing, are

rapidly becoming the backbone of the Chinese economy. With a default rate of only 0.4% these were an excellent bet. Secondly, as capital controls ease, more and more Chinese families will be looking to invest abroad. Providing them with financial advice will be a potentially large and lucrative market.

Finally, Dr Knight asked: whither the renminbi? It is probably too weak at its present fixed level. There is also the larger question: many argue the world's financial ills flow from having the dollar as a reserve currency given weak US fiscal discipline and a profligate consumption and debt. Could the renminbi replace it, and how disruptive could the transition prove?

The China-based manager predicted a gradual and orderly upward rise in the value of the renminbi as Chinese surpluses were recycled internationally and capital controls eased. He saw little prospect, though, of the renminbi's becoming the world's reserve currency in the immediate to medium term, and even less scope for the euro in this role, given its present troubles, or the dollar's replacement by some notional - and difficult to agree - basket of currencies. 'For all its drawbacks, the dollar is still the strongest force in the financial glue factory.'

JAPAN: DEAD MEN WALKING OR WAKING?

Dr Knight pointed out Tepco has lost 95% of its value; Sony 35%. With a market cap of $29 billion, Hitachi is said to have $8 billion in potential redundancy liabilities and $25 billion in pension liabilities. Does Japan offer real value?

'Whenever I think about investing in Japan, I lie down,' said one investment manager. My basic problem with Japan is that I don't believe Japanese companies are really on my side. I don't think there is real sense of fiduciary responsibility to shareholders embedded in the system … Now there is a school of thought that believes that you can invest spectacularly in companies that are run by "second generation" entrepreneurs – people trained in western business schools and who have a more Western orientation, but I am happy to let others take the lead on that.'

Other managers were more positive. 'Japan,' one said, 'has a group of companies that continue to operate at the highest level. In any market of thousands of stocks you are going to find a few diamonds – which is what as an investor I like. There are a lot of dead highly leveraged companies that could come alive if interest rates resulted in anything like a realistic market price'. He cited USS, a Japanese used car company that has just raised its dividends and earnings per share for the twelfth year in a row; also those 'historical black boxes, Japanese trading companies that trade at cheap multiples and are actually a very inexpensive way to play China'.

Another Asian investor endorsed this: 'There are pockets in Japan that combine cheap valuation with global competitiveness: trading companies, as already mentioned; automobiles; Mitsubishi; the world's largest manufacturer of medical equipment; robotics, and semi-conductors - in both of which sectors Japanese companies are "category killers". It is hugely significant that when supplies were interrupted after the tsunami a several manufacturing sectors in the West almost ground to halt.

Olympus lost around 80% of its value as a result of a corruption scandal: what are the implications? asked Dr Knight

Lack of transparency may be one obstacle, investors thought, but they discounted corruption as a major factor. Olympus was a case of out-and-out bribery. It should be seen in proportion; it represented nothing on the scale of Enron and its impact was dwarfed by the tsunami.

BRIGHTER HORIZONS: THE EMERGING ECONOMIES

Inflation is also on the rise in the emerging markets, said Dr Knight. In the BRICs it currently ranges from around 10% in Russia to 5% in China, with India and Brazil at 7.5% and 6% respectively. From Argentina to Vietnam rates are even higher. Is this phenomenon transient? How will it affect their stock markets? Where are the opportunities?

Generally, participants were optimistic about the emerging Asian economies, seeing them as reasonably well insulated and unlikely to be knocked off-course by a downturn in the West: Europe accounts for as little as some 6% of the foreign trade in some countries there, much of it channeled through China. The rise of the emerging market consumer they saw as a powerful and irreversible long-term trend.

'Traditionally,' said an investor, 'emerging markets have been seen as troublesome, and investors have looked to the West for income growth. However they are now beginning to look for dividend and fixed income opportunities in the Asia-Pacific region. We ourselves started a fund that was $100 million three years ago and now totals almost $3 billion!'

Korea: 'The Germany of the East'

'Korea is just a tremendous story,' one manager commented. 'Sir John always liked countries with a strong work ethic, and I think that is why Korea – unlike Greece - has worked out so well.' The Korean economy has been extremely agile and their leading companies have out-competed the Japanese in many fields. The extraordinary level of education and internet penetration means that Korea with a population of only 48 million is extremely competitive. As an example, Naver, a local search portal, rivals Google in size. Similarly local social media companies are thriving on a global scale locally.

Dr Knight pointed out that the KOSPI (the larger Korean exchange) is extremely concentrated and dominated by a small number of names. There could be interesting buying opportunities outside these big names. Tensions with the North are a concern but even these may turn into opportunities in the next decade.

Other areas of opportunity include Thailand, Indonesia and the Philippines. Over the past two years there has been a lot more political stability in Thailand, and the cost of capital in Indonesia and the Philippines has come down markedly. 10-year government bonds used to be in double digits but are now 6 -7%. Mid-sized caps and brands are starting to develop. These are extremely populous nations that are actually very big spenders. We think of Japan, China and Korea as the big spenders, but these countries also have consumption levels at 50 – 60% of GDP.

Indonesia is the world's second biggest exporter of coal, cocoa and tin and in addition has large reserves of nickel and other vital minerals. The World Bank forecasts Indonesia's GDP growth, already more than 6% a year, could be more than 10% by 2020. Cushioned by $100 billion of foreign reserves, Indonesia has a fiscal deficit of only 1% and a very healthy debt-to-GDP ratio of 26%. Annual per capita income has grown to $3,500, and estimates set the population in the middle class at between 15% and 40%. Unlike China, Indonesia has a young population and its economy is already strongly driven by consumption.

In Indonesia FDI soared 20% to $19.3 billion last year. Many international companies are already well established there, but there remain substantial opportunities in retailing, medical products, financial services, education, waste management, energy renewables and aviation. That said, issues remain. A number of attempts to broach Indonesian markets or trade its commodities

internationally have had their fingers burnt, such as Churchill Mining and the London-registered Bumi plc. Elsewhere, Burma may also prove an attractive long-term bet if the pace of its policies of liberalization accelerate and rewarded by corresponding reductions in sanctions.

India: Problems Are Opportunities

India has its problems, said an Indian manager. It has a current account deficit based on external financing. The economy grew at its lowest rate – 5.3% - between January and March, a significant slowdown from the 9.2% of a year ago. Inflation is stubbornly high, and agriculture and manufacturing have slowed or fallen back. Developments, though, such as India's recently introduced retrospective tax on international mergers are retrograde and hopefully do not herald a return to bad old ways and a reversal of the market liberalizations that have delivered so much. Developments like these are reflected in the rupee, which is at an all-time low.

'The situation in India is very volatile,' the Indian manager commented. 'But it has amazing long-term potential if the infrastructure gets properly developed and you identify the right investment opportunities. Electrical machinery is one area of strength, commodities are less so, given their lower consumption there relative to China. When sentiment is negative it is a good time to buying into India, but all the same we are currently holding our fire until stocks come down further.'

South America

Argentina, its recent high GDP growth rates notwithstanding, is something of a problem case. Under the presidency of Cristina Fernández it is pursuing both politically confrontational and economically unorthodox and illiberal policies, as evidenced in the Repsol affair, and the external funding options still open to Argentina still remain limited in the wake of its 2001 debt default.

Brazil's economy, by contrast, is in comparatively rude health in the midst of the world financial crisis. The government deficit and debt are low, the currency is having to be reined in by various government policies. A strengthening real is of course not good for exports but a nice boost for overseas investors. It is a commodity-based economy with three companies in the world's top 100 companies by market capitalisation, one being Itau Unibanco. The economy is diversifying with financial services an example of its sophistication. It has developed strong trading links globally and especially with China. Any concerns about the transition to the new president Dilma Rousseff have now dissipated. Confidence is high and above average performance can be expected.

Russia & Eastern Europe

The recent swapping of roles by Putin and Medvedev ushers in a new phase of political certainty if unpopular to some. Russia has more unrealised potential than Brazil. Its vast natural resource wealth provides the backbone to the economy. A relatively unregulated market, it has a population that has embraced free market principles with more enthusiasm than is fashionable even in the US. Corporate governance standards and financial reporting while improving have some further room to improve before meeting world standards. Nevertheless, its geographical reach represents a competitive advantage yet to be exploited. Investment in Russia is not without risk but the overall picture remains optimistic.

While the other ex-Eastern Bloc states lag behind, Poland along with some of the Baltics has emerged as the most vibrant and agile of the ex-communist countries, Poland now has an annual GDP growth of over 5%. The Polish plumbers and artisans have now by and large departed from the West and are enjoying the fruits of their own booming economy!

BLACK SWANS AND UGLY DUCKLINGS: THE INVESTMENT OUTLOOK

What are the threats and the unexpected events that could throw investment and recovery off course? asked Dr Knight. And where are the big opportunities?

Participants highlighted a wide range of concerns:

- Violent and unpredictable swings in public opinion and major social unrest imposing populist political views and short-term solutions that avoid addressing the real problems – in the worst case scenario 'a blow-out over Europe'

- The opportunities and dangers in China as already described. A hard landing in China, involving a combination of inflation, debt and economic slowdown could involve significant economic and, in turn, major social and political disruption

- However another investment manager put forward a contrarian view: China might open up its capital account with result that the renbinmi, instead of going up, sank dramatically in value. This would turn China into even more of a political powerhouse. 'That is one scenario almost no-one is positioned for.'

- He also raised the spectre, not of inflation, but deflation. 'The general history of European markets has been one of inflation. It is something everyone in this generation has grown up with but the monetary transmission is not working - we're not getting any inflation despite all the monkeying around that has gone on. But in fact what happens when governments default is massive deflation, and I don't know anyone who has a portfolio positioned for deflation.'

- Another contrarian possibility he raised was that oil prices, instead of rising, plunged from, say, $100 a barrel to as low as $40. 'That scenario would make many energy projects around the world no longer viable and concentrate power in handful of producers. These three factors in combination could make a huge difference to valuations and investment opportunities.'

- One of the great strengths of the Templeton Fund, said another asset manager, had been its long-term strategies. 'My greatest fear is that short-termism will creep into incentive structures – which it already has – and results in some perverse behaviour with regard to corporate governance and both business and asset management. An increasing share of the market is dominated by short-termism or by passive managers who do not believe that they can beat the market. Managers need to take a long-term view'

- In this context there was some discussion of exchange traded funds (ETFs) which have attracted a lot of attention from the media and investors alike. They have risen in volume from $10 billion in 1997/8 to $1.2 trillion today. These are having a damaging impact on the markets in two ways, said one asset manager. Firstly, they focus on very liquid securities and thus results in a lot of volatility. Secondly, inefficiencies are created if there is too much indexing. Managers are trying to squeeze everybody into the middle, into risk-free models such as ETFs. 'If you index everything entirely, it becomes a sort of socialistic structure –almost a politburo in the shape of the index.'

- Over-regulation, which imposes an excessive burden on start-ups and small businesses, and confiscatory policies on the part of governments was repeatedly mentioned. It is a world-wide phenomenon, commented

one manager, and has been reflected in the rise of the socialist parties in France and Greece. 'Sir John was always keenly aware of the dangers of envy and of governments taking over responsibilities from individuals, and he made a point of avoiding countries with high ex-corporation taxes.'

- War and plagues were identified as further possible threats. Other threats, said the Indian investment manager, are rising food prices and also the income disparities both between, and within, societies worldwide. The latter are now wider than at any time since the 1920s and 1930s, a period that saw the rise of political extremism in the form of fascism and communism. The biggest antidote, he thought, is the rise of female literacy in emerging market countries. That more than anything, in his view, is the factor that will transform them socially and in turn, economically.

A Time of Opportunity

Despite these fears, participants felt the investment industry is in a tremendously exciting phase. Investment is the art of the specific, and current conditions offer unique opportunities for the bottom-up investor. The widespread emphasis on macro risks and indexing, with investors trying to by-pass risk rather than pick promising stocks, opens up considerable room to exploit market inefficiencies.

'The most exciting thing – whether it is in Japan or Mexico or somewhere else – is to find the next new idea, the out-of-favour idea. Where it is listed is less important than what it can do, where the clients could be, where the business and earnings could come from. So it is good to be as global as possible and to have as many opportunities to consider as you can.'

Dr Templeton mentioned the habit of giving children gold coins to mark their birthdays and other celebrations as investments for the future: what 'gold coins' would those taking part in this meeting give their children today? Participants came up with a range of suggestions and investment opportunities.

- Gold itself is a valuable hedge, said one manager. The key question is: what proportion of assets should it account for? He himself routinely put 10% of his money into gold and advised any client with more than $7 million to invest to do likewise. The result is that gold had cumulatively come to represent some 25% of the holdings within his network – which he felt was probably too high a figure.

- Equities, not bonds, would be the future, many managers agreed. Bonds have been seen as the safe option in recent times. That is no longer necessarily going to be the case for the next five to ten years, given and possible government defaults resulting from their massive sovereign debts and political instability. This will create major problems for banks and insurance companies needing to generate a steady flow of returns for their investors.

- Managers welcomed the opportunities in shale deposits and in 'fracking' technologies, which look to transform the energy scene. Already the US now has the lowest gas prices among developed economies. Shale gas may not yet be a significant commodity globally but, as LPG becomes more widespread, it will be.

- Several managers emphasised that the US had regained some of its position as an agricultural and manufacturing exporter, partly reflecting cheaper energy prices and partly as a result of static or falling domestic labour costs compared to China where they had risen markedly. The

Midwest in particular had benefited from this trend – although several managers thought this upswing might now have peaked. In contrast, the view was expressed that the Toronto exchange which had done well of late is now over-priced and set for a fall.

- The depressed subprime property market offers another area of opportunity, said one manager. As with Japanese ports in 1989 there is a lot of liquidity there. However he warned that the opportunities have now begun to contract. 'The various account parties involved have become much more sophisticated, having written - and had to pay out on - a lot of insurance policies. They are now very wary if you come at them with an out-of-the-box idea. One said; "We are not in the business of selling cheap lottery tickets anymore."

- But, all participants agreed, opportunities glitter brightest in developing markets. As already described new middle-class consumers are emerging worldwide. Bling, according to one manager, could be the next big thing: 'These new aspirational consumers are not ashamed to appear rich. They attach no stigma to it and are ready purchasers of luxury goods like Cartier jewellery and watches.

- Should things take a turn for the worse in the West, other appropriate responses, managers thought, might be to invest in diversified multinationals like Unilever, with strong footprints in emerging economies and to steer clear of countries with a lot of capital requirements and identify companies with good capitalization that were equipped to survive in a hyperinflationary environment. Currencies too are of considerable concern.

Investors as Contributors to the Real Economy

In response to Dr Templeton's introductory question about the role of character and values in investment management, a participant pointed out that Sir John had always made a sharp distinction between what he called 'hedonistic greed' and the more altruistic and service-oriented drive to succeed of the entrepreneur and small businessperson. Another investment manager echoed this: 'I would encourage everyone in our industry to view themselves as professional service providers rather than simply asset accumulators. I see some major challenges ahead in our in our field. We need a change of attitude away from short-term gain towards providing services to the real economy that help real people by creating real jobs and industries.'

Another participant developed this point: 'One of the least understood things in the USA but less so in Europe and Asia is that people, especially retirees, are going to outlive their returns, given advances in life expectancy. The downside of the low interest rates and policies being pursued at the Fed is that savers are being seriously disadvantaged. Any asset managers who can come up with a solution to the pensions deficit will be performing a very valuable social role.'

And On the Bright Side …

Today, bankers and financiers are viewed with suspicion, if not outright condemnation – wrongly and unfairly. Their efforts over recent decades have helped lift billions out of poverty, ignorance and disease. The participants at this meeting reaffirmed the overriding social value of investment and wealth creation and its ability to create real industries and real jobs and to sustain savers in old age. 'One may not be proud today to say one is a banker or an asset manager,' commented one participant, 'but I hope one day to be so again.' Given the optimism informing this report, it is a hope certain to be fulfilled.

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