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JOHN TEMPLETON FOUNDATION
SUPPORTING SCIENCE~INVESTING IN THE BIG QUESTIONS

Oxford METRICA

CONTENTS

FOREWORD

A world of trouble, a world of opportunity

I am pleased to present the proceedings of the 2011 Sir John Templeton Investment Roundtable. The roundtable is a forum held annually wherein a select 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.

The managers share an identification with the Templetonian investment philosophy. All have derived inspiration from Sir John's investment approach – many indeed having worked directly with Sir John.

This paper commences with the opening remarks of Dr John Templeton Jr. on Sir John's investment and ethical legacy and proceeds to report on a wide ranging discussion over more than four hours. The paper is organized around the five key themes that emerged.

1 *The World Economy:* The discussion covered issues such as inflation, currencies and commodities. The general view is that inflation remains a major threat to recovery worldwide, the US dollar is likely to lose purchasing power and in the mid-term the commodities boom will continue.

2 *Asia:* Key countries discussed were; China, where the hard versus soft landing dilemma dominated; Japan, generally seen as a major opportunity for investment in the re-build and India, on which some concerns were expressed although all agreed there is much growth to come.

3 *Emerging Markets:* The discussions revealed a consensual optimism in the investment prospects for emerging markets. In particular Brazil and Korea (although recently reclassified) were singled out as undervalued. The case was put forward for Turkey's inclusion in the BRICs to be restyled BRICTs.

4 *Old World, New World; Europe & Russia:* Discussion on the Greek crisis raised concern for contagion while Scandinavia was identified as a success. Russia emerged as a favoured prospect.

5 *The Investment Outlook:* Although there was some discussion about investment psychology and the likelihood of another crisis, the trouble is opportunity theme espoused by Sir John was much in evidence. Each manager identified their top contrarian investment idea, what they saw as the largest investment threats and they revealed their most promising performer.

The mood was generally optimistic for investment prospects in the year ahead.

I hope you enjoy reading these proceedings and I thank all participants for a most productive exchange of ideas.

Dr Rory Knight
Moderator

ROUNDTABLE PARTICIPANTS

Moderator
Dr Rory Knight, Chairman, Oxford Metrica

Investment Managers
James Anderson, Partner, Baillie Gifford
Scott Cobb, Head of Europe and Principal, Longleaf Partners
Stefan Herz, Head of Eastern Europe and Latam, Charlemagne Capital
Cheah Cheng Hye, Chairman & Chief Investment Officer, Value Partners
Paul Matthews, Managing Director, Matthews International Capital Management
Julian Mayo, Co-Chief Investment Officer, Charlemagne Capital
Dr. Jane Siebels, Founder & Chief Executive Officer, Green Cay Asset Management
Dr. John Schott, Principal, Steinberg Global Asset Management Ltd.
Raymond Tam, Director & Head of Sales, Value Partners
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Jill Sideman, Finance Committee Member, John Templeton Foundation

What drove Sir John Templeton to establish a foundation in perpetuity? asked *John M Templeton, Jr.* Sir John had summed up his reasons as follows: 'If we ask one big question, we may find when we have the answer that we need to ask three more big questions.' This desire of his always to lay a longer and longer platform of reflection continues to be embodied in this Roundtable.

'If we ask one big question, we may find when we have the answer that we need to ask three more big questions'
Sir John Templeton

What sort of man was John Templeton? He had a very versatile and nimble mind and was a natural communicator ('People need to be told why they should invest in my mutual funds'). He never talked about the very next opportunity or – what the media always wanted to find out – hot stock tips. We live today in the midst of unprecedented turbulence, but even in earlier, relatively placid times his team could never rely on markets that were totally stable and static. 'Trouble is opportunity' read the sign which he kept on his desk. Instead, Sir John grounded everything in fundamental principles. Above all, as an investor he stressed the virtue of patience. He disapproved strongly of people going into stock shops and buying and selling quickly in order to make a fast buck. It was not, he maintained, good either for their character or their bottom line.

Two other of his characteristics are perhaps less appreciated. He was an optimist about rationality, the power of mind and mental control. He was also an outspoken contrarian and had an abiding sense of realism, summed up in his encapsulation of his financial and personal mission as one of 'sceptical stewardship'.

'Trouble is opportunity'
Sir John Templeton

His contrarian streak came across especially clearly at two points in his life. In 1973, on the very eve of the oil crisis when it was thought stocks would continue to shoot up forever, some undercurrent in his mind impelled him to get out equities and put four-fifths of his investments into fixed income stocks. In 2005, three years before his death he predicted in a memo only found among his papers the financial chaos that was to envelop us in 2008. 'It would,' he wrote, 'be longer and deeper than any other crisis – and this was from a man who had lived through the Great Depression.

Sir John Templeton saw with a sad but firm realism what human nature was capable of when unfettered by little or no moral restraint. Even in normal times he told investors to expect more and more inflation, which he saw as a direct consequence of politicians' zero capacity to stop spending. Were he still alive he would identify a pervasive moral rootlessness, a moral collapse running across many nations and an inability to be true stewards of their countries finances and well-being that is even clearer today than in 2008.

'Above all, as an investor John Templeton stressed patience'

So what would Sir John be doing today? He would be treading the supermarket aisles to find out from housewives the true rate of inflation and to the owners of small businesses about the cash flow, credit and debt problems they were suffering. He made a point of talking to potential investors and to the managers of the companies in which he was thinking of investing – a practice perpetuated in this Roundtable.

His 'advisory' of 2005 remains intensely relevant today. Sir John would undoubtedly advise us to root ourselves in the centre of what really lasts and endures. He would go back to what he propounded as a teacher in the 1920s – the virtues of diligence, prudence, thrift and 'sceptical stewardship' – teachings that remain centred and true even in the worst of times.

'He saw with a sad but firm realism what human nature was capable of'

Happy days, it would seem, are here again – especially if you take a global view. Last year the world economy grew by 5%, its trade by 12.4% and growth in China and India topped 10%. For his part *James Anderson* painted a glowing future: 'The world is a better and more exciting place than ever. The underlying forces – emulation and technological progress – will get stronger and stronger.'

'The perspective on the world is too often set by the declining powers. The world is enormously exciting and enormously well-placed'
James Anderson

But is everything so rosy? *Jane Siebels* voiced some underlying fears: 'Other things are coming to a head. With the end of QE2, the troubled euro and higher inflation figures coming out of China we have all the makings of a perfect storm.' Investment managers' doubts swirled around main three areas: inflation fuelled largely by sovereign debt; related currency weaknesses and instability; and commodities pressures and looming resource and energy limits.

Inflation: Is the Tiger out of the Cage?

Chinese premier Wen (Jiabao) has said 'Inflation is like a tiger: once set free it is hard to get back into its cage'. Is the current surge in inflation, asked *Dr Knight*, structural and therefore endemic? In the last year it has been evident across markets, participants reported, especially in the emerging economies, currently ranging from around 10% in Russia to 7.5% and 6% in India and Brazil respectively.

Fuelling the surge in inflation has been China, which in a reversal of its previous role is now a net exporter of inflation to the rest of the world. In coming months, said *Cheah Cheng Hye*, Chinese inflation is likely to rise from 4.5% to 6% before probably subsiding (see also page 8). Inflation in China, he added, feels a lot higher than the official numbers. 'Officially it is 4.5% currently, but the authorities keep playing around with the formula for calculating inflation, so it is hard to get a precise picture.

'With the end of QE2, the troubled euro and higher inflation figures coming out of China we have all the makings of a perfect storm'
Jane Siebels

Julian Mayo made the point that a large proportion of their emerging economies' inflation is in fact imported from China and the West. However there is a deep and widespread determination on the part of central banks in those countries not to revert to the bad old days of hyperinflation. *Jane Siebels* also sounded a relatively upbeat note, commenting that in Japan inflation could actually be beneficial, with the rebuild, in kick-starting growth.

Currencies: Has the Dollar Had Its Day?

Many participants, when polled by *Dr Templeton*, felt that the USA's S&P rating would be downgraded in due course, negatively affecting US interest rates and, in turn, growth. Although US GDP is back at levels not seen since the beginning of 2008, there still worrying signs. The US recently breached the $14.3 trillion debt ceiling set by Congress and has yet to come up with a plan to tackle its annual budget deficit. US consumer confidence and manufacturing output are still in the doldrums, and US house prices still remain almost 40% below their market height. *Kyle Tomlin* drew attention to the fact that in the last three years the US has had to print over $1.2 trillion of new money to buy back bad mortgage debt. He predicted that the dollar would continue to lose its purchasing power in the foreseeable future.

In this regard *Cheah Cheng Hye* commented that in academic and political circles in Asia there is growing doubt whether the US model really works well and this might make global economies less willing to accept the US dollar as an international and reserve currency. The transition could prove highly disruptive.

What then are the best methods, asked *Dr Knight*, to protect purchasing power in the light of a weakening US dollar? *Tomlin* recommended concentrating on high quality large cap US exporters, and on equities in countries with healthy currencies – China, Hong Kong, Taiwan, Korea and, to a lesser extent, India. Participants saw little prospect of the euro becoming a global reserve currency given its present troubles (see also page 12).

'The US no longer enjoys the moral, political and cultural leadership it did for many decades after WWII'
Cheah Cheng Hye

The suggestion has been made that the IMF should see to it that a basket of currencies takes the role of reserve currency. However, *Paul Matthews* was of the strong opinion that the world is years away from any viable alternative to the US$ as a global reserve currency, especially in the shape of any kind of Asian regional currency.

Julian Mayo, while also not identifying any alternative to the US$ as global reserve currency, pointed out in connection with the burgeoning interregional trade flows between the world's emerging markets that the largest emerging economies are increasingly pricing commodities and other goods and services in their own currencies. Thus if a Chinese company is buying from a Brazilian one it will buy in reals without recourse to the US$ as a unit of account.

'The joy of America is the extraordinary process of innovation coming out of the West Coast'
James Anderson

Commodities & Resources: Boom and Future Famine?

Is the commodities boom sustainable? asked *Dr Knight*. The price of potash a commodity consumed in large quantities by India and China, has effectively doubled, for instance, since the last Roundtable meeting. What threats and opportunities do commodities pose for investors?

Julian Mayo predicted a Hobbesian competition for resources which would result not merely in relative but an absolute decline in Western living standards over the next generation. Others felt convergence more likely. *James Anderson* was markedly more optimistic, trusting in technological innovation's ability to come up with alternative solutions.

However concerns were raised about the mixed signals sent by volatile capital markets to commodity producers and innovators. *Cheah Cheng Hye* returned repeatedly to looming resource limits, especially those in foodstuffs, energy and especially water facing China. Strategies are being pursued by the authorities to overcome these, including the import of resources and the outsourcing of basic agricultural activities to Africa and South America. He predicted a continuing emergence of regional blocs and cross-border alliances – strategies of 'guns and gold' whereby resources are exchanged for military and other aid.

'Malthus was wrong. We can expect as much technological innovation in the 50 years as in the past 15,000'
James Anderson

Regarding energy, *Cheah* suggested the possibility of China (now the world's largest energy user, consuming 20% of the world's output) accessing Siberian resources despite the distances involved. Renewables, solar energy and new technologies such as thermo-electrostatic vibration were also receiving increasing attention in China but, as elsewhere, would demand substantial state subsidy before becoming viable. Coal for all its environmental downsides looks remaining like the mainstay in China for the foreseeable future.

But what future for nuclear power, asked *Dr Templeton*, expressing his bemusement at Germany's decision to shut its nuclear plants. Surely, China would not limit itself to relying solely on renewable sources of energy? Elsewhere, the position is more positive: in South America, said *Mayo,* there is little problem given its availability of natural and hydroelectric resources. Even in Japan a nuclear future should not be ruled out despite the disasters unleashed by the tsunami. The government had not yet declared its hand, and one option might be to construct a range more modern, safer sounder plants on the Western, and less seismically active, shore of the island.

'Germany seems to have lost its mind and its political courage shutting down its nuclear plants. I can't imagine the Chinese putting themselves into that kind of limitation box'
Dr Templeton

Where then are the commodity investment opportunities? *Paul Matthews,* endorsed an indirect strategy. Rather than investing in primary producers directly he advised focusing on those companies which had done well over the long-term because of - or despite - the commodity cycle.

Opportunities

- Companies that have done well over the long-term commodity cycle
- High quality large cap US exporters
- Equities in countries with healthy currencies – China, Hong Kong, Taiwan, Korea and, to a lesser extent, India

China: A Hard Landing Ahead?

Is the Chinese economy, asked *Dr Knight,* headed for a 'hard landing' (defined as growth falling to 7% or less)? Capital expenditure in China has reached unprecedented levels. It is the major source of growth and now constitutes over 50% of GDP. Some argue there will be an inevitable overshoot, and growth will be significantly disrupted.

'When your average human being consumes as much electricity as the US our planet will be wiped out.'
Cheah Cheng Hye

'China suffers from a phenomenon of currency suppression,' said *Cheah Cheng Hye*, 'a system of forced saving that operates at low cost by giving very poor returns to the Chinese people. Throughout the history of the PRC there have been very few opportunities for people to invest their savings except banks which pay very miserable interest rates, typically below the rate of inflation. Chinese people are not allowed to put their money to work overseas.'

Poor returns on capital are one of the factors driving the massive increase in buying gold in China (which this year passed India as the biggest international purchaser of gold. Since 2003 some 6-8% of every fund *Cheah* runs is in gold. Participants, incidentally, reported increased buying of silver and of gold (now spiking at over $1,500 an ounce) as a hedge against inflation.

'However one of the secrets why China is able to withstand so many crises,' continued *Cheah* lies in the way the government can easily turn the tap on and off to control the economy, using savings as a fiscal an investment resource and only giving back a small excess to the people. The government would therefore not be well served by any free floating internationalization of the *renminbi*.

'The Chinese government is very aware they need the support of the people to continue to enjoy the right to rule the country'
Cheah Cheng Hye

'Prevailing market wisdom, *Cheah* continued, is that the Chinese government has overdone its tightening measures. Several months ago they began to restrict the money supply and imposed price controls in order to discourage property buyers and speculators and slow down consumption. However the speed with which growth has slowed has frightened Beijing, and the general feeling is that the government will do a u-turn and start loosening controls again.

'This will be a signal for people to start buying equities again in China. Chinese markets have been among some of the worst performing in the world in the last eighteen months, with the result that shares have seldom been so cheap, currently trading at less than ten times earnings. That may be good news for equities but bad for inflation.'

China's current five-year plan covering 2011 to 2016 is the most important for many decades, said *Cheah*, and aims to transform China's economy from one of export-led growth to one based on domestic consumption. Stocks relating to the domestic Chinese market therefore attractive, apparently more so than real estate, a market which is generally considered to have become overheated. However he took the contrararian view that Chinese property offers a sound investment prospect. With increasing urbanization and rising living standards and an excess of savings there will continue to be growing demand for residential property. The fact that buyers have to make 30-40% down payments will reduce the likelihood of negative equity.

Infrastructure is also a booming sector, especially transport and - China's unstoppable love affair with the car notwithstanding - rapid transit. But with commissions mostly going to local companies he had found investing in concrete producers and suppliers more rewarding. Banking stocks appear much less attractive given the underlying uncertainties and lack of transparency shrouding Chinese banks - a view shared by *Paul Matthews*. In contrast, the position of Hong Kong banks is much stronger, said *Matthews*, on the basis of the large *renbinmi* reserves they attract as an outlet from the mainland.

'There's been no compelling catalyst to move in a big way into Japan, and we've been burnt many times over the past few years. We're looking hard but we haven't yet made a major move'
Paul Matthews

Looking ahead, a range of serious challenges confronts China, however. One, already mentioned, is resources. Others are more social, political and cultural. Henry Kissinger's recent book, *On China*, states that the Chinese government, having freed the economy, will inevitably lose control of the state. Will China successfully contain its enormous pressures in future? One highlighted by *Cheah*, is the potential instability created by the high unemployment rate - now approaching 25% - among current Chinese college graduates due to a mismatch between academic provision and vocational requirements.

'China has been so far outside history and normal expectations Optimistic projections seem always to be borne out,' said *Cheah*. 'But the skeptical human being in all of us always asks the question: "Will it always really be OK?"

'One of the ways our fund managers have tried to find good prospects has been to try to identify Japanese companies that were looking at emerging markets – not necessarily because that was a good asset strategy in itself but because it was a way to identify switched-on Japanese managers'

Paul Matthews

Japan: At the Tipping Point?

'Japan has been through a catastrophic time: will the rebuild bring it out of the economic doldrums?' asked *Dr Knight*. 'If so, which sectors offer the greatest rewards and what are the most effective ways to identify prospects?'

'The concern we have,' reported Kyle Tomlin, 'is the Japanese government debt to GDP ratio which, at 225%, is the highest in the world. If Japanese bonds were to yield the same as US treasuries, Japan would consume 100% of its revenues.' His other concern is Japan's ageing demographic, the oldest in all developed markets.

'So the question is: are valuations so compelling that it is time to dip into the markets? Japanese equities have fallen 75% in the last twenty years – the lowest in their history and among the lowest in developed nations. Large cap Japanese companies have cash yields of over 20% and their debt levels have been coming down for some time now. Although they're currently not as attractive as US corporations from a valuations perspective, we think if there is pressure on the Yen there could be a tipping point approaching, with people going from net savers to net consumers, and we're thinking of moving in, focusing on exporting companies.'

'We think there's a tipping point approaching in Japan'

Kyle Tomlin

John Templeton raised the problem of interlocking ownership in Japan, especially between banks. The vast majority of shares – 85% - is organizationally owned, Tomlin agreed, and there remain significant problems of transparency. *Scott Cobb* highlighted Japanese managers' failure to focus on shareholder value and best use of capital on the basis of his experience of the insurance sector. Underlying this are deep-seated cultural attitudes. However there signs of change among the younger generation. The question is: how quickly can they move up and take the helm?

India: Still Playing Catch-Up?

India continues to grow impressively, but, said *James Anderson:* 'India troubles me. It still has many of the traditional problems of emerging economies. Parts of the economy are doing well, notably the service sector, but it hasn't yet undergone the agricultural revolution that China did. It was an agricultural revolution, not an industrial revolution, that kick-started China back in the 1970s.' Others pointed out that efficiency has increased in many cities, not just front-line places like Bangalore, and there are beginning to be infrastructure opportunities in ports, roads and airports. India is like China thirty years ago but is still very far behind. But there lies the opportunity.

'India has adopted some of the West's worst features such as celebrity culture, corruption and an obsession with politics and tomorrow's headlines'

James Anderson

Opportunities

- Chinese domestic consumables, real estate and concrete
- Cheap Japanese stocks
- Emerging market-oriented Japanese companies
- Indian infrastructure

The last year has seen a recovery in Western stock markets with some of the shine correspondingly taken off emerging markets, said *Dr Knight*. Have the usual problems of emerging markets disappeared? And what are the implications, in terms of investors' asset allocation decisions?

> 'Over the last 150 years you've had a relatively small part of the world driving the world'
>
> Julian Mayo

Julian Mayo thought the longer-term prognosis continued to be very attractive. 'At present we are seeing the flipside of quantitative easing in the US. People are going where their money is looser and the momentum of economic growth is felt to be more favourable. Is the West's dominance going to continue? I don't think so. The emerging markets have gone back at the moment to being slightly at a discount compared to the developed markets but we are still seeing company earnings growth in the 15-20% range in emerging markets. The underlying fundamentals are strong and the variations reasonable. It is a matter of patience and valuations – looking at companies where you expect the most growth in the next five years and where the market has mis-valued assets.'

Brazil: Business as Usual?

Stefan Herz agreed, especially with reference to Brazil: 'I don't see any real constraints on growth over the coming years. Domestic consumption growth and a growing middle class are not just a China story, he continued but also a growth driver in markets such as Brazil. Brazil is reducing its reliance on exports and trade. Only about 10% of its GDP derives from exports and only half of that commodities.

On the political front how is Dilma Rousseff doing, *Dr Knight* asked, in the eyes of international investors? 'With various corruption charges there's been a lot more political noise coming out of Brazil in recent months,' *Herz* replied, 'but broadly speaking it's "business as usual", and that's not surprising in that Rousseff is Lula da Silva's chosen successor.'

> 'Should the BRICs rather be called the BRICTs and include Turkey?'
>
> Dr Knight

'But is the currency too strong and the *real* likely to devalue?' *Dr Knight* pressed him, 'Could we see indexation return?' 'It is really more a matter of the dollar's strength than the *real*'s weakness, said *Herz*. However one aspect that slightly worries me: the unorthodox monetary policies being adopted at the moment, the so-called macro-prudential measures whereby you attempt to control consumer spending by fixing bank reserve requirements and by raising interest rates but perhaps not at the rate you should be to control inflation. It's really an experiment where the ultimate outcome is still rather uncertain.'

More positively, he highlighted the increasing role being played by intra-emerging market trade flows, for instance between Brazil and China. 'This will change the global trade landscape,' *Herz* said, 'and reduce the reliance on developed markets for some of the strongest emerging market countries It's not just a matter of the Russians and the Brazilians selling commodities to the Indians and the Chinese but individual companies trading with one another across emerging markets.

Korea – An Increasing Interregional Player

'One of the companies we've invested in over the last three years is a Korean company, Kia Motors, which goes to Africa and Brazil as well as China,' said *Julian Mayo*. 'A few years ago about a quarter of Korea's trade was with other emerging markets; now it is about half and that is set to continue. Our view is that this is a long-term trend.'

> 'At present in the emerging markets we are seeing the flipside of quantitative easing in the US'
>
> Stefan Herz

'The Matthews Fund is weighted heavily in Korea, a market currently enjoying a favourable growth/PE ratio,' commented *Dr Knight*. 'What are the sectors or stocks which you might expect to outperform over the upcoming year?' Agreeing that Korean stocks are among the cheapest, *Paul Matthews* singled out telecoms as particularly attractive.

BRICs or BRICTs?

Dr Knight raised the role of the so-called BRICs: should they rather not be called the BRICTs and include Turkey, also an increasingly important emerging market player? Are the ratings agencies once more behind the curve again in not yet granting an investment grade to Turkey? Will it benefit from the turmoil in the Middle East, becoming an even more important strategic partner for the West? Participants agreed it deserves increasing focus and not only because of its strategic position but pointed to the difficulty of identifying specific prospects given Turkey remains a relatively inefficient investment market.

> 'There is one aspect that slightly worries me: the unorthodox monetary policies being adopted by Brazil … It's really an experiment where the ultimate outcome is still rather uncertain.'
>
> Stefan Herz

In the Wake of the Arab Spring

Is the Arab Spring, asked *Dr Knight*, opportunity or threat? Will the Arab Spring continue to gather momentum and even have a broader copy-cat impact throughout Africa? Specifically, what is the investment outlook for Egypt, the virtues of certain of whose companies were extolled at the last meeting?

Participants were guardedly positive but expressed concerns over the continuing social unrest, fuelled not least, as already mentioned with regard to China, by widespread unemployment among young male graduates. In addition, Islamic fundamentalism continued to be a source of major concern. *John Templeton*, however, pointed out that, in the case of Egypt, the Moslem Brotherhood does not enjoy broad support among the population, the majority of whom do not wish to see the Brotherhood gain greater control.

How Best to Open the Door?

Dr Knight commented that the beneficiaries of growth in emerging markets are not restricted to local companies in these markets. Is there opportunity to gain exposure to emerging market growth at better prices through developed market global companies?

Scott Cobb described how one of the companies in which he had invested, domiciled in southern Europe but with the bulk of its assets outside its legacy markets, had largely been able to side-step the crisis in developed markets thanks to its 'very enviable' positions in Africa and Latin America. 'We think there is considerable value in this company and look to invest for further profit in it.'

His company currently runs a $20 million global portfolio with the bulk of its assets and value in emerging markets, particularly Brazil. While denying that either larger macroeconomic trends or close bottom-up analysis had led them to markets like Brazil and admitting 'they still remain a challenge, he concluded 'it makes sense to find companies that are cheap and overlooked as a result of the recent recovery in Western markets.'

Raymond Tam highlighted an interesting related trend: the increasing investment in emerging markets by major Western pension funds, of which incidentally a 1% allocation by these funds is equivalent to 10% of the total market cap of the Morgan Stanley Emerging Market Strategy Index. Pressed by *Dr Templeton* whether these funds included state employee schemes threatened by bankruptcy and whether their investments were directed towards equities or fixed income, *Tam* replied that interest had previously centred on equities but agreed that in the last six months the funds had become more conservative in outlook.

> 'People look at countries like Brazil and think it's all about commodities and petrol and oil but it's not. It's not just a matter of the Russians and the Brazilians selling commodities to the Indians and the Chinese'
>
> Stefan Herz

Opportunities

- Domestic consumption and non-commodity markets in Brazil
- Interregional emerging market trade
- Korean telecoms
- Turkey, and 'Arab Spring' opportunities in countries such as Egypt
- European companies with emerging market holdings

Greece: Sick Man of Europe

Greece's debt has now stands at 350 billion euros, a staggering sum amounting to 150% of Greece's annual economy (and predicted to top 170% in 2012) and requiring annual interest payments of more than 20% of its GDP simply to be serviced. Commercial banks, which currently hold 27% of Greek debt, are bracing themselves for losses in the region of 30 billion euros, whatever further bail-outs are agreed in 2011. Greece may be tiny (only 2.5%) in relation to the total Eurozone but its knock-on effects could be severe. Which brings us to the crisp question, said *Dr Knight*: can the euro survive?

'The last time Greece mattered was 2,500 years ago'
James Anderson

James Anderson, for one, was unphased and in no doubt at all of the long-term survival, indeed success, of the Eurozone. His contrarian view was that: 'The capital markets – and particularly London, which is the epitome of these markets – are peculiarly Europhobic and have been consistently wrong in their judgements throughout my entire career. The crisis in the European community – whether we agree about its existence or not – is a means to further integration rather than anything else. Over the past eighteen months the judgement of the Germans has been that they cannot walk away from the euro. If the Germans have taken that decision that is what ultimately matters. So I think the euro will survive and, yes, personally I'm in favour of that.'

Northern Renaissance

One of the reasons for Anderson's optimism has been 'the economic near miracle' taking place in the northern Eurozone. 'Fifteen years ago,' *Anderson* continued, 'most of Scandinavia was a disaster in the eyes of most people and thought to be going bankrupt. We are now in a position where the economies of Sweden and Finland - despite Nokia - are booming, with 5% growth and their government deficits structurally gone.

'Over the past eighteen months the judgement of the Germans has been that they cannot walk away from the euro. If the Germans have taken that decision, that is what ultimately matters'
James Anderson

'What is more interesting is that this is also happening in Germany now. It has taken them fifteen years to get over reunification but Germany has now built a society and an economy that can continue to grow at 3 – 4% per annum. I find it amazing to go to Berlin. They simply do not recognize the picture of the world that is put out by the *FT* or the *Wall Street Journal* or lots of hedge funds. They've priced themselves into world markets, and they have a happy well-educated society without any of the inequalities that so bedevil Britain and America.'

Southern Lights

Is the Euro crisis, asked Dr Knight, creating opportunities in Europe? 'I veer between optimism and pessimism,' replied *Scott Cobb*. 'We are trying to position our portfolio so that if the worst happens in Europe and the euro collapses we still have that margin of safety. Regarding the collapse of the euro we – like James Anderson - take a contrarian view. There are lots of tragic places like southern Europe. But you also have some big companies that, while tainted by macro-economic troubles, have the bulk of their assets outside the Eurozone. You can find real opportunities in Spain and Italy in these kinds of companies *(see also previous section*).

Russia's Commodity Wealth – Both Curse and Blessing

Commodity wealth in Russia is both curse and blessing, said *Stefan Herz*. 'A curse in that it is well as holding back the long-overdue reforms in law, transparency, etc, that are needed it has helped prevent the country building up its industrial base and developing a middle class as in other emerging markets. On the other hand the blessing is that Russia's commodity wealth is so substantial that it is likely to continue for many more years to come and during that time enable a process of reform.

'Germans simply do not recognize the picture of the world that is put out by the FT or the Wall Street Journal or lots of hedge funds'
James Anderson

'I was in Moscow last month and met with representatives of Rosnef. It has at present 22 billion barrels of oil reserves but conservative estimates put potential reserves at 350 billion barrels - or ten times the current figure! I think that gives you some sense of the extraordinary commodity wealth there is in Russia to underpin reform. Reform, I believe, is on the agenda and likely to continue and accelerate.

'In Brazil commodity wealth has been channeled into the economy, in Russia into private bank accounts'
Stefan Herz

Cultural Deficits

John Templeton, however, mentioned the obstacles of continuing deference and passivity in Russian culture - points *Herz* accepted were valid. 'If you compare Brazil and Russia both have greatly benefited from their commodity resources but whereas in Brazil commodity wealth has largely been channeled back into the economy, in Russia it has all too often been channeled into private bank accounts and not found its way back out again into the broader economy. But, again, I think that is beginning to break down, and from an investor's point of view we tend to mark up the more transparent companies and reward those companies that care more about minority shareholders and punish those that fall into the categories you mentioned. I think as an investor you can find tremendous opportunities in that market. But you tend to have to pay much higher multiples.'

Gazprom & Yukos: Different but Similar

'A good example of what I'm talking about is Gazprom,' Herz continued. 'We all know that Russia is one of the cheapest economies in terms of average multiples. The reason that Gazprom is cheap is that is trading on two times earnings. Gazprom does not care about minority investors. It is the ATM or cash-point for the Russian government. We as minority investors will never see the cash from Gazprom.'

'Gazprom is the ATM for the Russian government'
Stefan Herz

In answer to a question from *Kyle Tomlin* as to whether Lukoil had the same value structure as Gazprom, Herz replied that 'Lukoil has an interesting story in that it is trying to diversify out of Russia. There is a lot of value in Lukoil, but it is not based on their Russian business but the licences that have off the coast of Africa and in the southwest African basin. Lukoil is playing an aggressive game of diversification outside Russia. So I would agree with you that it does not fall into the same value set as Gazprom, but Lukoil does share the same problems if you compare multiples in the developed markets and its shortfall in transparency.'

'When I go to Brazil, I'm always welcomed by companies and they actually want to talk to me. When I go Russia I'm merely tolerated most of the time.'
Stefan Herz

Opportunities

- Northern Eurozone countries, especially Germany, Sweden and Finland and, to a degree, France
- Companies in the southern Eurozone with assets in developing markets
- Russian companies – where more transparent

Is Another Crash Inevitable? An Experiment in Speculator Psychology

Will there be another market crash next year? Dr Knight put this question to Dr John Schott, an expert in market psychology as well as investment. For an answer Dr Schott turned to the findings of Vernon Smith who won the Nobel Prize in Economics in 2002 for their work confirming 'what all practitioners know': that markets are not at all efficient.

Smith believed that people, no matter how sophisticated, make cognitive errors that lead them to value shares incorrectly and judge wrongly when buying and selling, and designed a computer simulation to test this hypothesis. Participants with a range of expertise and experience were allotted stock that the players could trade between themselves but which they were definitely informed would only be worth a maximum of $2 after 20 days. After each of the 20 one-day sessions they were paid dividends ranging from nothing to 20c. Thus, the absolute maximum value any player could gain at the end of the game would be $12 ($2+50cx20).

Trading began slowly but from sessions 4 to 17 soared as high as $40. Bells also rang at random, making announcements affecting the value of the shares. These led everyone to believe that the market would collapse on day 18, so players felt secure in the belief that they could trade as high as they liked and sell on day 17. In fact the market collapsed unexpectedly on day 16 and players lost severely.

The striking thing was that players did not learn their lesson. When the experiment was repeated a month later, the same behaviour reappeared, though in slightly more subdued form. When the possibility of options trading and greater liquidity (each player was allocated additional funds of $120), volatility in share values became even more pronounced. However, when the experiment was repeated a third time players learnt their lesson and traded sensibly.

Smith christened the phenomenon 'Bubble Junior': the tendency of investors to engage in irrational behaviour even after a first major crash, and it is borne out by the historical record. In 80% of crashes – even as severe as the Great Depression - a 'Bubble Junior' emerges.

What makes people to act in this irrational way? Schott put it down to a mixture of greed, competitiveness and the excitement, both physical and mental experienced during a bull run. 'Purely on psychological grounds I would say there is an 80% chance of a market crash happening in the near future similar to that we have just experienced. It will probably be less severe, although this cannot be guaranteed.

'No less a figure than Warren Buffet believes the second crash will, if anything, be worse, since the first did not plumb the same depths as in other depressions. We are still in Buffet's view in a process of deleveraging that is - as we are now witnessing in Europe - overtaking sovereign states. Within the next 24 months the US will follow the same path or pay the penalty of hyperinflation. The only factor likely to delay this would be the US election cycle which typically sees administrations giving a boost to the economy in the third and fourth years.'

Of course this scenario is not set in stone – there exists the power to exert rational control that Sir John rated so highly (*see page 5*). But the prospect should nonetheless weigh heavily on the minds of all prudent investors as they feel their way out of the crash of 2008.

The Roundtable concluded that – despite the encouraging if gradual recovery in the West – the investment outlook remains uncertain. US treasuries, having reached a peak, offer only poor yields. Inflation and commodity pressures are on the rise in developed and developing economies alike. Established

> 'My definition of stupidity is where the value of a company is assumed to reside in its next set of quarterly earnings. If that is the case, China is probably the most stupid market at the moment'
>
> Paul Matthews

> 'In the short run the market is a voting machine, in the long run a weighing machine'
>
> Benjamin Graham

> 'Increasingly I find I must pay attention to the political and economic and sometimes even the religious or historical context of the investment'
>
> Cheah Cheng Hye

global currencies in the West are weak and troubled and are few signs of a replacement coming from the East. Above all, the spectre of a second crash – 'Bubble Junior' – lurks on the near horizon.

Sir John would be jumping up and down at this point because there are so many opportunities to snap up'
Jane Siebels

Go against the Flow: Trouble Is Opportunity

Despite all the worrying trends, said *Jane Siebels* however, 'Sir John would be jumping up and down at this point because there are so many bargains to snap up.' This contrarian and (in the best sense) opportunistic approach came to the fore repeatedly in participants' contributions throughout the meeting. (*A range of their ideas are summarized in the following table.*)

Cheah Cheng Hye in particular extolled the benefits of going against the flow: 'The common sense view is that when you want to invest your money you should try to find a country whose economic growth is very strong and that by choosing the right market you can make your money grow. With China I have found this to be true but not as true as you might think. According to the Morgan Stanley Index if you had put money into China in 1993 you would still be in negative territory despite all the tremendous growth in the country in the last seventeen years.

'So you can be in the right country and lose money – and you can be in the wrong country and make it. I have found a new way to make money: choose the market with the maximum number of stupid investors off whom you can make money. So there are two ways to make money: either economic growth or the stupidity of other investors, and the second way is easier for the seasoned professional investor. My position is that of a bottom-up investor. We look at ratios and returns on equity, p/e, etc, and we find bargains. Then, on the assumption that other investors are stupid not to have picked them up, I scoop them up myself.'

'You can be in the right country and lose money – and you can be in the wrong country and make it'
Cheah Cheng Hye

Go Both Micro & Macro

Jane Siebels looked back on her time working with Sir John Templeton: 'He used to say, instead of getting bogged down trying to figure out what is going to happen with inflation and currencies you should just concentrate on stocks. The only thing that matters is price of the company – and that is what I think we should all be thinking about: companies. If we are moving into a world of inflation we should be looking companies that are price makers, not price seekers. They should be leaders in their fields and they have to have a strategic competitive advantage that is sustainable over the long term.'

'There are two ways to make money: economic growth or the stupidity of other investors'
Cheah Cheng Hye

At the same time *Cheah Cheng Hye* argued for a broader angle of consideration: 'From the investment perspective what makes the picture interesting is that increasingly you have to look at social, political and other non-financial issues in terms of assessing the attractiveness or otherwise of investments. In the old days when I first started I mostly concentrated on financial analysis but increasingly I find I must pay attention to the political and economic and sometimes even the religious or historical context of the investment I'm making to figure out whether I should proceed or not.'

'The only thing that matters is price of the company'
Sir John Templeton

What came across crystal clear from the range of contributions from investment managers in the course of the meeting was that, in order to get the best investment returns in today's complex, interrelated world both are needed and that to succeed a finely judged admixture of the two approaches - top-down and bottom-up - is essential.

'We should be looking companies that are price makers, not price seekers'
Jane Siebels

OPPORTUNITIES, THREATS & PROMISING PERFORMERS

Dr Knight invited the participating investment managers to put forward their top contrarian investment opportunity ideas, what they saw as the biggest investment threats and to identify specific promising performers.

Participant	Best Opportunity	Greatest Threat	Most Promising Performer
Kyle Tomlin	Small and medium-sized Hong Kong and Chinese apparel and consumer goods companies	Sovereign debt in the developed countries especially Europe	Volkswagen
Jane Siebels	Bargains created by 'Bubble Junior'	Deflation from snowballing deleveraging in developed markets	Singapore-based organic food and branded protein company serving China
Julian Mayo	Chinese property	Western complacency	FP RO: a Romanian restitution fund
Stefan Herz	Consumer stocks	Western sovereign debt crisis and consequent inflation	Eldorado, the largest Russian retailer
Scott Cobb	Spanish equities operating in South American markets	Collapse of the euro and consequent currency instability	–
Cheah Cheng Hye	Uranium stocks	The threat to Hong Kong Golf Club memberships from 'Bubble Junior'!	Sime Derby, a Malaysian multinational with interests in plantations, property, and motors, etc
James Anderson	'Virtual deflation' – genuine deflation driven by economic and technological progress	Us – the financial community and the malign effects of greed and poor risk models	Amazon
Paul Matthews	Japanese pharmaceuticals	A hard Chinese landing and a bubble in parts of the Chinese real estate market	–
John Schott	–	Western oil dependence	–

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