2010 Sir John Templeton Investment Roundtable

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JOHN TEMPLETON FOUNDATION
SUPPORTING SCIENCE ~ INVESTING IN THE BIG QUESTIONS

Oxford METRICA

‘Those who cannot remember the past are condemned to repeat it.’

George Santayana, 1905

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‘Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.’

Sir John Templeton, 1994

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Moderator: Dr Rory Knight, Chairman, Oxford Metrica

FOREWORD

I am delighted to present the proceedings of the 2010 Sir John Templeton Investment Round Table. This forum is an annual event hosted by the John Templeton Foundation, where a select group of leading investment managers from around the world meet with the trustees and officers of the various Templeton foundations to discuss and exchange views on the prospects for world markets.

The common element among participants is their identification with a Templetonian investment philosophy. All have derived inspiration from Sir John's approach, many indeed having worked directly with Sir John.

This paper reports on a wide-ranging discussion over more than four hours. This presentation is organized around the five key areas that emerged:

1. *The World Economic Outlook*. The discussion covers areas such as sovereign debt, where concerns about several European countries are aired; inflation, considered by many to be an inevitable consequence of a high level of government debt; the real likelihood of a "double dip" recession rather than a smooth recovery; commodities, the boom is expected to continue; currencies, which provoked interesting discussion especially on the future of the euro.
2. *Market Prospects*. The discussion ranges over the valuations and medium-term prospects for the markets. Some asset classes are considered undervalued; A number of brighter prospects are identified. Japan is singled out as an opportunity albeit anomalous.
3. *China*. Many views are expressed on China's future and role in the world including the political developments, the likelihood of a currency revaluation, China's business regime and demographic issues. Taiwan is identified by a manager as a key opportunity.
4. *Emerging Markets*. These markets are generally viewed with optimism for growth by the discussants. Specific countries and regions discussed include Brazil, Russia and Asia.
5. *Investment Strategies in an Uncertain World*. The discussion concludes with a focus on specific investment strategies. Each manager identifies an investment opportunity and a potential risk in the foreseeable future.

Although many dark clouds were identified on the horizon, the mood of the group was one of optimism, no doubt inspired by Sir John's belief that "Trouble is opportunity".

I wish to thank all participants for a most productive exchange of ideas.

Dr Rory Knight, Moderator

Sovereign Debt & the Threat of Contagion

The primary catalyst that led to the market fallout in 2008, it is widely believed, is the secular debt bubble. The world's debt/GDP ratio hit an all-time high, well above the level of the 1930s. This could take years or decades to normalize and there is a considerable risk of contagion from country to country given the deeply entangled global financial system.

In the US and the UK, the excesses of the inflated real estate bubble have now been embraced by government, and this substitution has greatly increased the debt on the state balance sheet. Extended 'entitlement' programmes will also introduce further costs into government spending. Governments around the world also coordinated the greatest monetary and fiscal stimulus programme in history to lift the global economy out of deep recession. 'As these programmes run their course,' asked **Dr Knight**, 'is strong economic growth still feasible in the face of such forces?'

'In the **US** we have had the technology bubble, then the real estate bubble and now, it seems, the government debt bubble,' commented **Mark Holowesko**. 'How will it all unwind? From our point of view there's a clear risk. There's no way the US government can inflate its way out of its problems unless it rolls short-term debt into long-term debt. It will mean higher interest rates.' He pointed out that the situation would be further aggravated in the US in a year's time when some 25 – 30% of sovereign debt will fall due, with a further 25 – 30% due over the next one to three years.'

'[In terms of the sovereign debt overhang] the US government is just kicking a can down the road.'

Kyle Tomlin

Looking internationally, the situation is also worrying in the **EU**, which has the highest debt to GDP ratio of any region. With a ratio of 190%, **Greece**, although seen as the prime candidate to default, is actually relatively well placed compared to other so-called PIIGS countries especially **Spain, Ireland** and **Portugal**. In fact the **UK** has a far higher ratio than any of these countries, but its debt repayment schedule is relatively long-term. The situation elsewhere is more encouraging, members said. In **Eastern Europe** it ranges from 140% in **Hungary** right down to **Russia**, which has a ratio of 44% - very little of which incidentally is government debt. The **Asian** average is much lower: around 20%.

'The looming crisis is equal to that after WWII when 40% of the developed nations had to devalue or restructure.'

Kyle Tomlin

Is Inflation Inevitable?

Historically, excessive government debt ends in **inflation**. Will this be the outcome this time around? Round Table members thought it highly probable. Certainly investors sense it as a threat on the horizon: indeed one of the factors driving the recent rally in stocks may have been uneasiness about holding reserves in fixed income and cash. In the **US**, the current rate of inflation, said **Holowesko**, is under-reported and is actually in the range of 3-4% if real estate deflation, due to the mortgage market being kept artificially low by government activity, is stripped out of the statistics. It will only be in 2 – 3 years time that inflation really kicks in visibly in the US. At that point, commented **Kyle Tomlin**, the greater threat could be to **bonds** rather than stocks.

However members felt inflation's scale and prevalence could well vary across regions. From now China can be expected to become a net exporter of inflation rather than deflation - but at relatively low levels and driven by increases in real incomes (see pages 9-11). Elsewhere, inflation in emerging market countries will see some increases as Western liquidity is pumped through these regions but not to any very marked degree. In **Brazil** the fight against inflation, which has preoccupied the government for a decade, is now bearing fruit. It is possible,

some members argued, that instead of outright inflation or deflation we may see segregated inflation and deflation: inflation in the sectors where demand is expected to be much greater than supply (commodities, healthcare, etc), and deflation in the sectors where the asset valuation was bloated on the back of excessive leverage (real estate, financial services, etc).

But Valuations Are Still Relatively Low

Valuations – for a variety of different reasons and for now – remain relatively low. As **Holowesko** pointed out, inflation rises have not yet been reflected in the US mortgage market or in bond prices. The growth in **Chinese** real estate valuations remains modest (see pages 10-12). Emerging market valuations are still at attractive levels, except in **Brazil** where they have risen, having been previously depressed by the long fight to squeeze inflation out of the system. **Russia** has traditionally traded at a big discount to emerging market countries – unjustifiably so, in the view of **Julian Mayo**. In **Japan**, valuations are still anomalously low, as they have been for many years (see page 9).

'All government debt ends in inflation.'

Nick Train

A Steady Boom in Commodities

Given the strong growth potential and urbanization in China and India, members thought a sustained commodities boom is likely in coming years, regardless of how Western economies perform. 'The commodity boom is still in its infancy,' **Julian Mayo** commented. 'The average income in **China** is $6,000 and in **India** less than $3,000. The point is that with reasonable economic policies, these countries can grow at 8 -10% annually and still remain middle-income countries. However, if you look at per capita consumption of various industrial commodities and compare it with **Korea's** thirty yeas ago and **Japan's** forty years ago, you realise the sheer scale of numbers in these countries is significantly higher. If you look at where the world has come from in the last few years we have gone from a situation where it was dominated by a very small proportion of the world's population to a situation where a much larger population with a younger demographic profile has become engaged in the process. So it is fair to say demand for industrial and agricultural commodities is going to grow very strongly for many years to come.'

'The bond markets hope the equity markets will be hit – and vice versa.'

Sandy Nairn

Currencies: Will the Euro Survive?

Fears about the future of the **euro** have plunged global stock markets into chaos, with investors panicked by the possibility that **Greece**, followed by other eurozone members, may default on their debts and that the eurozone itself may break up. The global recession has disclosed serious structural problems within the European economy, most notably the lack of fiscal discipline in some peripheral countries, which had run large deficits, financed by cheap debt. Three outcomes seem possible: firstly, that the markets are convinced that the weaker economies can push through the necessary austerity programmes and closer fiscal and budgetary coordination will ensure that future spending is under close monitoring; secondly, that Greece, unable to solve its program and has to abandon the euro; or, finally and most gravely, that, like falling dominos, defaults in peripheral countries trigger further failures and precipitate a severe banking crisis, plunging Europe back into recession and creating financial turbulence worldwide.

Several members including **Jayne Sutcliffe** expressed the view that the second option was likely – and that it might on balance not be a bad thing. 'If the weaker countries left, I doubt the euro would be a weak currency', **Sandy Nairn** agreed, stressing the need for credit lending to be balanced stating that while. 'Sometimes,' said Julian Mayo, 'you need a particular event to shake Europeans up.'

From the investment angle, Kyle Tomlin was cautious: 'At the currencies level we are avoiding ones tied to the debt bubble like the euro. We are most concerned about that. It is likely that the eurozone will have to devalue the currency. Our favourite currencies at the moment are Canadian, Australian and Singapore dollars.' Contrasting the sovereign debt situation in Western Europe with Russia and Eastern Europe, he added: 'The eurozone contain countries which are immeasurably worse investment opportunities than some countries not in that zone.' Nervousness about currencies and concerns to safeguard them is not, however, limited to the developed economies, members agreed, but is a worldwide phenomenon, witness recent political and fiscal moves in **Brazil**. Not surprisingly, members highlighted the continuing investment interest in traditionally 'safe' commodities like **gold**, reflected in its current trading price of $1,200 per ounce.

'[A Chinese view is that] democracy creates inflation. Politics is at the heart of what we must consider.'

Cheah Cheng Hye

Opportunities

- The break-up or reduction of the eurozone
- Countries with low debt/GDP ratios such as emerging markets and Russia
- Current relatively low valuations in emerging markets (ex-Brazil) and in Asia and Japan
- Among currencies, Canadian, Australian and Singapore dollars
- A continuing steady boom in future in commodities, including gold.

'Populism can give rise to short-term, stop-gap measures. But it is too early to write off democracy.'

Julian Mayo

Recovery or Double-Dip?

The overhang of massive sovereign debt and current account deficits – together ushering in the prospect of inflation - and the uncertainties surrounding the euro provided a sombre backdrop for the Round Table's deliberations on market prospects. According to certain data sources, the P/E ratio of US small-cap stocks have hit an all-time high versus US large-cap stocks, but is this trend sustainable? Several members expressed gloom about the strength of the recent bounce-back in the stock markets. 'If you look at the underlying characteristics, you have to conclude there is the risk of the dip happening again,' said **Ana Kolar**. 'Everyone is assuming that this has been a phenomenal recovery and we are going to go straight up from the out-performance in small caps through big consumer names and financials. But the signs are that this is not going to be a regular recovery.'

> '2008 was an unfortunate year, but it might be remembered for the wrong reasons.'
>
> Nick Train

Kyle Tomlin endorsed this view: 'The reason that we do not think that this is a normal recovery is because of sovereign debt. Overall, the debt to GDP ratio is the highest in history. It seems that we have all these short-term bullish forces right now but at some point in time bearish forces are going to enforce their will and make it much more difficult for a normal recovery. I don't see how we can be in a second bull market until we have addressed the debt issue. And how is that going to occur: by higher taxes, printing money or by the inefficient allocation of assets and capital?' The great fear is, of course, a retreat away from free and open capital markets into protectionism, or if not protectionism, unnecessary intervention and the imposition of heavy-handed regulation and restrictive capital controls.

> 'It is estimated there will soon be over 50 billion minutes of Skype chat out of 400 billion international telephone calls in total.''
>
> Nick Train

Brighter Prospects

Members, however, stressed that we should heed Sir John's advice that 'the time of maximum pessimism is the best time to buy'. Many members struck a strongly positive note, highlighting a range of market and technological prospects over the longer-term, especially in the light of fundamental changes in what **Dr Knight** called 'the ecology of information'.

'The appetite that consumers have around the world for entertainment and information seems insatiable,' said **Nick Train**. 'Just at the start of this year we had the extraordinary phenomenon of ***Avatar***, the biggest grossing movie of all time. In December **Nintendo** had the biggest ever sales of gaming products. And look at the outstanding successes of **Apple**.' The opportunities offered by tech stocks, especially in **Asia**, and particularly **Taiwan**, were also highlighted by other members.

The continuing pace of globalisation - unslackening despite the downturn - was also welcomed. 'Obviously 2008 was an unfortunate year, but it might be remembered for the wrong reasons,' **Train** commented. 'Apart from the near-collapse of the global financial system two specific transactions seemed in particular to illustrate how industries are responding to the way the world is today: the Mars–Wrigley merger and a massive deal in the beverage industry, the InBev and Anheuser-***Busch*** merger. Then in the last six months we have had Kraft's take-over of Cadbury and Heineken's deal in Latin America with Femsa. There seems to be an unbroken trend in seeking to establish a global footprint and present a genuinely global range of brands in products and services.'

Not all members welcomed these developments wholeheartedly. **Jayne Sutcliffe,** while outlining her own role in carving out broader global roles for banks from emerging economies, regretted the worldwide absence of emerging

country brands with a distinctive identity and thought this lack itself offered an opportunity.

But new entrants empowered by new technology also bring with them disruption as well as opportunity. Train cited the explosive impact of *Skype*, the 30% owned subsidiary of eBay, on world telephony. In less than five years *Skype* has gone from nowhere to 20% of all cross-border telephony. It worries us to see how profit margins can be exploded by an entrant in that way.' Among the highest profile victims currently of new technology are of course newspapers, as the internet cuts into their revenues and provides an alternative – and free - information source. But the doom-mongers are being premature, Train argued: 'Consumers' appetite for news and information and for editorials under the masthead of a trusted newspaper brand – that still seems like a big opportunity.' Specifically, he saw opportunities in the development of familiar and trusted newspaper presences online.

'Purveying news via the medium of dead trees does seem a declining business proposition.'

Nick Train

In addition, the Round Table identified a range of strong, attractive opportunities in the emerging market countries (see pages 12-14). In evaluating these opportunities an effective management team is the key, said Sutcliffe. 'It doesn't guarantee a good company but in our experience you will not find a good corporate without good management running it.' Just as important as good management are attitudes, Round Table members agreed – both among managers and investors. If confidence is vital - and arrogance and complacency conversely damaging - to entrepreneurs, investors too need to maintain a due sense of their own limitations. Hubris, as the events of the past two years have shown, can be financially lethal.

'The digital business might go the way of railways in the nineteenth century when you had huge top-line growth and zero profitability.'

Julian Mayo

Opportunities

- Entertainment and digital infotainment products
- Online newspaper sites
- International telecommunications and internet telephony
- FMCGs with global footprints such as Unilever or seeking to achieve them through merger
- By contrast, the possibilities of developing distinctive regional brands.
- Underpriced Japan stocks (see below)

'The downside is a blanding out of goods and services. Everywhere you go in the world you can see the same products and can buy the same things.'

Jayne Sutcliffe

Japan: Anomaly – and Opportunity

'Japanese capital markets are odd but they have been odd for a long time,' commented Nick Train. 'And they are cheap as well as being odd, with the Nikkei down some 75% from its all-time highs. Dividends are the bedrock measure: what return you get from a stock without putting capital at risk. We are interested in finding that "sweet spot" that combines an above-average dividend yield with a high quality company. Altogether we find that our stocks give us a 15% premium relative to the world index. In the UK we struggle to get a 5% premium yield relative to the market average. But the average dividend yield for our Japan-only account is 70% higher than the market average. This seems to be sending out a signal that, for some reason, higher quality businesses are relatively undervalued in Japan.

If in addition you make cross-border comparisons in industries like pharmaceuticals and consumer branded goods, then leading Japanese corporations – although maybe without the strong management disciplines of some of their global competitors - seem to be valued at enormous discounts. The Kao Corporation, a business we like, has a free cash flow yield of 10% and look at P&G and Colgate, it's 5%. Some of the Japanese pharmaceuticals are traded at less than one times revenues, with 30% of the market cap in cash.

The valuations just stand out compared to other developed capital markets. I don't know that we're able to point to the catalyst that could release the value, but what I do know is that the Nikkei isn't at 40,000 any longer, it isn't at 14,000 any longer, it's been down to 8,000 and now it's back up to 10,000. That seems like an opportunity to us.'

Paul Matthews agreed: 'If you look at world market valuations, there have been few periods in recent history when as many markets are on roughly the same multiples as they are today. Almost everywhere you look around the globe, they are 15 times earnings – and there are very few outliers like Japan. Most investors in Asia within the last twenty years have had to live with a strange concept which is referred to as "Asia ex-Japan", and we have done that simply because twenty years ago Japan was 90% of the index and we all felt that Japan was overvalued and that opportunities were spread throughout the region.

Now I am not saying that we should all rush out and buy Japan today, but we should accept that Asia includes Japan. We have to look not only at Japanese companies but our regional exposure overall and to include Japan when we think about the growth in domestic consumption in Asia, because Japan is by far the richest economy in Asia and has the strongest household expenditure.'

'Japanese capital markets are odd but they have been odd for a long time. And they are cheap as well as being odd'

Nick Train

'The valuations just stand out compared to other developed capital markets.'

Nick Train

Currently, China is underreporting its inflation rate, which in reality is running at some 4%, said **Cheah Cheng Hye**. This will eventually turn China from an exporter of deflation to one of inflation – but on a relatively mild scale in comparison to the long-term impact of Western governments' own sovereign debts and fiscal deficits. The rise in Chinese property prices has largely been driven by, and kept pace with, rises in incomes and there are no strong grounds to expect China will not be able to continue to stimulate domestic consumption while restraining inflation. There are, however, some signs of Chinese government anxiety over a possible real estate bubble, and it is already taking steps such as limiting property ownership to one house per family. China is not only a managed economy but in general a well managed one, and we should not underestimate the Chinese government's ability to curb or kill a bubble before it gets out of hand.

'Never underestimate the Chinese government's ability to curb or kill a bubble before it gets out of hand.'

Cheah Cheng Hye

As to the dangers of overinvestment by Western companies, the Round Table concluded that, while there is some evidence of overcapacity in plant and machinery, in general there is very little evidence generally of overinvestment. There have been instances of questionable lending by banks, and **Andrew Foster** for one commented that he had difficulty believing in the credibility of the larger Chinese banks. The fundamental long-term challenge for China will be to move away from an export-led economic model to one based on sustainable domestic consumption, and so far it is making good headway in this direction. Currently, China's domestic market for consumer goods is increasing by some 20% each year.

Longer-term, **Cheah Cheng Hye** also predicted an increasing trend away from banks and companies geared to exporting goods to 'service and infrastructure'. The emphasis will gradually shift to healthcare, education and social services and also from the inland to the coastal provinces - all as part of China's drive to achieve a more harmonious and balanced economy and society. The Chinese authorities are trying to identify places to put its reserves and balances to work effectively but, said **Cheah**, 'you can only cross so many bridges at one time in China'. **Robert Horrocks** reflected whether this shift could itself help accelerate China's liberalization agenda: previously the Chinese have regarded themselves as employees of the state, in the future they may increasingly see themselves as consumers of first-class services provided by the state. 'I wonder if that doesn't change the relationship between the two and actually might provoke China to experiment with more of the types of new political structures we've seen already'.

'There is a growing feeling in China after the financial crisis that Western governments don't have the ability to deal with their own economic problems in the way China does.'

Jayne Sutcliffe

Will China Revalue Its Currency?

In urging China to review its fixed currency exchange rate and revalue the RMB upwards, Western governments such as the US 'should be careful what they wish for', warned **Paul Matthews**. China's fixed exchange rate structure has been a source of great stability during a period of unparalleled global turbulence. Its abandonment could usher in a period of dangerous volatility. **Cheah Cheng Hye** agreed, pointing out that China's neighbors are increasingly using the RMB as a currency for transactions. Rather than a revaluation of the RMB, he anticipated the adoption of a 'managed float' system based on a gradual and continuously adjusted revaluation against a basket of China's major trading partner currencies. This, in his view, will probably result in 3-5% appreciation of the RMB overall.

Business Unfriendly Regime?

Are the recent Rio Tinto prosecutions and the withdrawal of Google over internet censorship signs of a worsening climate for Western businesses and investors in China? Overall, members thought not and that the Google affair was an 'outlier' and the prosecutions a specific, isolated case. An increasing range of foreign enterprises are continuing to do business in China on a quite straightforward and satisfactory basis. More business information is becoming available, and China has now built up a fairly substantial body of commercial law. Western businesses and individuals can institute legal proceedings – which was certainly not the case over twenty years ago.

We should never forget, however, said **Mark Holowesko** that free trade in China is still its own version of free trade and that China has in reserve lots of ways of limiting the activities and growth of foreign companies if it so chooses. There is still a lot of excess cash in the Chinese system that has not yet priced itself in. Transparency and freedom of information remain major issues. Both **Paul Matthews** and **Robert Horrocks** stressed that if China is to transform itself into a world-class, technologically innovative economy, the open exchange of information will be vital.

'There is an underlying view in Asia that eventually the Western economies will not support a global free trade system'

Cheah Cheng Hye

Regional & Political Instability: No Blip Yet on the Radar

Opinions of Round Table members were divided over possible consequences of conflicts in some of China's neighboring countries such as **Thailand** and **Korea**. **Andrew Foster** felt conflicts in Asia have the potential 'to roll the world over in a way they might not have done for decades'. In general, though, members concluded that the risk escalation of such conflicts is minimal. Specific fears were expressed, however, by **Paul Matthews** about rival drilling operations in the South China Sea where at least six nations are pursuing their claims. The relations between mainland China and **Taiwan** also remains a serious issue, with the Taiwanese still highly apprehensive of Chinese intentions. This has not, however impeded increasing economic integration between the two states (a high proportion of Taiwanese electronic components, for instance, are manufactured in China) which look set to give rise to some attractive commercial opportunities in the future (see below).

'The Chinese economy has been an enormous stabilizer in the world in the last two years and to a large extent that has been due to its fixed exchange rate …I can't think of a single Asian country in the last thirty years that has gone through [abandonment of fixed exchange rates] without extreme volatility. If China can avoid that it will be an extraordinary achievement.'

Paul Matthews

China: Last Bastion of Capitalism?

Other concerns related to China's instability were highlighted by some members - but in an entirely different and broader perspective: the West. Cheah Cheng Hye highlighted increasing Chinese concerns that in the wake of the financial crisis that Western governments simply do not have the mandates and power to manage their debts and deficits. Democratic answerability to volatile and short-sighted electorates is often seen as antithetical to the taking of firm measures and contrasted with the 'smack of firm government' in managed economies. Some Chinese see democracy as a luxury that is not for the East – and one that the West itself may be increasingly unable to afford. Until the meltdown, the American economic model was widely respected. That is now less the case, and many Chinese are now worried about the knock-on effects of further turbulence in Europe and America and about the fate of their massive reserves invested in the sovereign bonds of West countries. In their most extreme form, fears have been expressed that the West itself may lose faith in free trade and open markets.

A Grey Future: Facing up to an Ageing China

Finally **Cheah Cheng Hye** drew attention to a factor likely to play a significant role in China in coming decades: the fact that from 2015 China will begin to have an increasingly aging population. This demographic shift, which has its roots in the state's long-maintained one-child family policy, will have a major impact in China and beyond. The motor driving the Chinese and increasingly

the world economy – a large supply of young, energetic, disciplined and motivated labour force – will begin to dry up unless policies are radically revised. 'This is something that will eventually affect the world, not right now but certainly in years to come,' said Cheah.

> 'A year ago I looked out of my office window and saw very few Chinese containers coming into the Bay area but today it has almost gone back to the levels of two years ago. It has been a remarkable achievement that, despite the fear that China could not sustain its growth in the face of the downturn, yet it did.'
>
> Paul Matthews

Opportunities

- Taiwan: due to the political difficulties and the decline of its stock market from the peak in 1990, the Taiwanese companies are often overlooked, said Cheah Cheng Hye. This year saw the signing of a cross-Straits agreement between Taiwan and China that could open up significant commercial opportunities.
- Stocks: On the mainland stock exchanges, B-shares trade in US and Hong Kong dollars and trade at a 40% discount to their A-share counterparts, which are traded only in RMB. The A-shares are traded at a 30% premium to their counterpart H shares in Hong Kong, and the B-shares at a 10% to 15% discount to their H-shares. This historical legacy, B-shares, should eventually disappear, and the three classes of shares will converge. Simultaneously – and despite the recent Chinese share-dealing scandal in Singapore and the halt imposed on the so-called 'Through Train' program which allows Mainland Chinese to invest in Hong Kong market, plans are under way to allow foreign companies to list on Shanghai stock exchange, and therefore Chinese local investors will be able to buy foreign companies with RMB. Given that China maintains a closed capital account, the impact of these developments will be limited, and trading in foreign company shares conducted at a premium or discount, said Paul Matthews. Nevertheless these developments will open up significant arbitrage opportunities as well as a conduit for Chinese surpluses in the form of individuals' savings to be made available to and provide a boost to world share markets.
- Longer-term, meeting the needs for products and services generated by the growth in Chinese domestic consumption and the increasing shift to improved social, education and healthcare systems identified above.

> 'The challenge for China is to move away from an export-led business model to one based on sustainable domestic consumption.'
>
> Cheah Cheng Hye

> 'China will have to become a better innovator, a country that generates new ideas, and that will be harder to do in an environment where you can't have a free exchange of information.'
>
> Robert Horrocks

The general view of the Round Table was that emerging economies are areas of enormous - and as of yet still only narrowly tapped - potential. Jane Siebels in particular commented on the powerful sense of excitement and motivation she encountered in firms in emerging market countries, contrasting it with the caution she saw in developed economies. Emerging markets account for 85% of the world's population, 50% of the world economy in PPP terms and yet only constitute 13-14% of the world's asset portfolio. Increasingly, they should not be an optional part of asset portfolios but a key component. We are in the early stages of a major shift in economic power from the developed to the developing economies, whose implications we have yet to fully comprehend. That said, there remain major issues of concern such as protectionism and fears in the wake of the financial crisis that these economies could reverse the free market reforms on which many of them had embarked.

'Emerging market countries account for 85% of the world's population, 50% of the world economy (in PPP terms) and yet only constitute 13-14% of the world's asset portfolio. If this disparity is so obvious, why haven't emerging markets been taken up to a greater extent by investors?'

Rory Knight

Going Cheap? Emerging Market Valuations

Julian Mayo pointed out that, in contrast to the 100 times p/e ratio at the peak of the Taiwanese market in 1990, emerging market stocks in aggregate have been trading at a much more reasonable level over the last twenty years. At the moment, they are trading at 11.5 times forward p/e. There is little evidence that emerging market stocks as a group are overpriced.

A Shared World

Mayo commented that ever since the Asian financial crisis in the late 1990s, a large number of emerging corporations have been applying a prudent and disciplined approach in managing growth and balance sheet. Historically, companies in emerging markets paid lower dividends than developed ones. However the current dividend yield for emerging markets is largely on a par with developed markets and price/earnings ratios roughly comparable. Part of the reason lies in the globally interconnected pattern of shareholding today and the fact that foreign shareholders play a much more active role in emerging markets. Foreign shareholders, for instance, now hold significant holdings in companies like Samsung. Foreign investors are helping support, if not drive, the agenda on improving corporate governance and returns on capital.

'There is an increasing view among the people we speak to that emerging markets are no longer an option but a necessity. But the big asset consultants, the big asset managers and the asset retailers are still at the early stages of a major shift in asset allocation.

Julian Mayo

Emerging Market Returns & GDPs: Why Not in Synch?

Nick Train raised the issue of the lack of correlation historically between GDP growth in emerging economies and their stock market returns. Part of the reason, members thought, was the traditional tendency of companies in these economies to retain capital and invest it domestically and all too often wastefully. Arrogance, complacency, and poor corporate governance were cited as other factors by Paul Matthews especially in Asia. Another reason for the anomaly is lack of public profile: many smaller yet very profitable companies simply remain private. In China, corporate earnings are shared by government, management, employees and investors. The wealth distributions among four parties often shifts in response to changing political needs to favour some of these competing constituencies.

Backsliding Away?

The big risk, said **Andrew Foster**, is that in the aftermath of the 2008 financial crisis and the resultant questioning of free market models, emerging economies will back away from, or even reverse, some of the market-opening reforms they have undertaken. This concern was acknowledged by the Round Table participants. Certain moves were cited which might have a negative effect on investment and reflect an increasingly protectionist agenda. In October **Brazil** introduced the *Imposto Sobre Operacoes Financeiras* (IOF), a transaction tax of 1.5%, followed by a measure imposing a further tax on ADRs. Designed to hold down the value of the *real*, this might, however, also serve to discourage foreign investment more generally. It was also pointed out that, in line with the recent example of Australia, several other resource-rich emerging market countries including Brazil and Nigeria have introduced new taxes on mining company earnings. Intended to protect their resources and in part to respond to the increasing exploitation by China, these measures again could well have a negative impact on foreign investment.

'I grew up when the capital gains tax in the UK was in the high 70% range, so the trend in the last twenty to thirty years has been very positive for us,' said **Paul Matthews**. 'We've just come through some of the lowest capital gains tax treatment that any of us have seen in decades in our country, and it is swinging the other way right now. The question is whether this is a cyclical change indicating that the overall environment for investment in the next twenty years will likely become much more adverse?'

'It has always struck me just how exciting emerging markets are. If I visit CEOs in the West, they are all so cautious and staid and you would not describe them at all as excited. I've always believed in human capital and that the real driver behind the world economy is motivation – and there is just tremendous motivation in emerging markets.'

Jane Siebels

South American Prospects

Brazil is probably the one major emerging market where valuations have risen most markedly. The reason, members said, may lie in the fact that previously prices were artificially depressed as a result of Brazil's decade-long fight to squeeze inflation out of its system. A few large Brazilian companies have low p/e ratios but this is not true of the mid-size companies, which have seen a notable increase in their share values. The battle against inflation has now largely been won, providing some justification at least for Brazil's higher multiples. However **Brazil**, like **China**, is very concerned with keeping its currency stable. If Mr. Lula's Workers Party under Dilma Rousseff is elected in October there is the possibility that the ***real*** might be devalued. Some believe the Mayor of Sao Paulo, Jose Serra of the PSBD may be a safer pair of hands for the economy. This is likely to be an issue of some concern to investors, especially as the Brazilian central bank is not separate from the government – which makes political interference more likely.

Investors continue to be very negative about companies in **Argentina** – and not necessarily correctly, commented **Jane Siebels**. They are still managing to do business, and one contrarian conclusion might be that the only way is up. If so, given that they are trading at only a quarter of their replacement value, there may be worthwhile investment opportunities among them.

'Go back only a decade, and you find emerging markets were consuming about 60% of their GDPs as opposed to 45% today, so I think the next big story will be the rise of domestic demand in developing markets.'

Julian Mayo

Asian Economies: Arrived, Arriving or Not Yet on the Bus

The Round Table's moderator, **Dr Knight**, commented that anyone who still regards **South Korea** as an emerging market clearly cannot have been there recently. He raised the possibility of the Korean banking sector proceeding to emulate the country's manufacturers like Samsung and LG and develop a global presence. **North Korea** is of course run by a dying regime with no clear succession plans, said **Cheah Cheng Hye**. Yet, despite their current political instability, countries like **North Korea** and **Burma** are worth bearing in mind as future investment prospects. Burma, although one of the world's poorest countries with average annual per capita incomes according to estimates of only $500, has mineral resources as well as great agricultural potential. North Korea has a well-educated and highly literate population, is rich in minerals and iron ore

and has the benefit of a relatively pristine environment. Its workforce is well-disciplined and, in more than one sense, hungry. Investing is possible for non-US citizens, for instance, via Chinese banks, and already some South Korean and foreign interests have established a minor foothold.

Other Round Table members were more sceptical about opportunities in North Korea, pointing out that if a more open regime emerged or if there was unification, immediate needs would be for long-term investments in infrastructure, which would offer little immediate profit potential. **Cheah** responded that he was not recommending any immediate investments commitments, simply carrying out preliminary research and beginning to establish connections on the principle of 'wait and see'.

'The two things we look for in emerging markets are confidence and hunger – motivation in another word – but not complacency or arrogance. You don't want your CEOs to be little hunched men waiting humbly but you don't want arrogance like in Asia in the mid-1990s and Japan in the 1980s.'

Julian Mayo

Look to the New Frontier

Discussions of emerging markets tend to focus on Asia, Latin America, Russia and Eastern Europe to the exclusion of all else, said **Jayne Sutcliffe**. But as some countries like **Korea** are moving to the developed economy group, it is therefore becoming increasingly necessary to look for new comers. Some companies in the **Middle East** and **North Africa** are now becoming increasingly investable, said **Sutcliffe**, adding that her firm is particularly interested in prospects in **Egypt**.

'We have world economic power being taken by the emerging economies, and we still don't know what that means in the end, and the risk is that we do not adopt a humble approach.'

Jane Siebels

Opportunities

- Emerging market investment opportunities generally
- Undervalued Brazilian and Argentinian companies
- Looking way ahead, North Korea and Burma
- The Middle East, Egypt and North Africa

Uncertainties over markets, currencies, sovereign debt and deficits have led to a greater emphasis on liquidity – either in the form of cash or fixed income. The return on liquid assets is negligible, observed **Dr Knight**, but many institutions are holding up to 30 to 40% of their assets in liquid instruments. If inflation takes off, these investments will be at risk. What steps should investors take to safeguard their assets in future? What are the best alternatives to fixed income? And what investment methods should be implemented to successfully hedge inflation while also being mindful of a deflationary scenario.

'I guess the question we are all asking is what would Sir John do right now?

Kyle Tomlin

This is a major challenge, members all agreed. In the face of uncertainties a defensive strategy seems to be the most common response. Among the 'best of a bad bunch', current safe-play strategies range from sitting on cash (**Jayne Sutcliffe**) to maintaining a blend of cash and treasuries (**Mark Holowesko**) and index-linked government bonds (**Paul Matthews**). The possibility was put forward of investing in short-term emerging markets bonds in locally-denominated currencies, but it was accepted that this also involved exposure to significant currency risks. **Cheah Cheng Hye** put forward a somewhat different idea: a constantly monitored and adjusted basket of short-term fixed income instruments– an option with which he and a group of other investors had experimented.

'You know, when I first joined Sir John at the bank, I was a typical banker - you know, wanting to keep cash flow for expenses – and Sir John said, "No, I don't want you to keep anything in cash, unless it is expedient to do so." So his answer today might be just to spread the oil.'

Betty Roberts

'There's a lot of excess capacity," said **Holowesko**, but added that that pointed to opportunities given valuation levels. 'What is exciting if you look at companies around the world is that, free cash flows at the corporate level have increased dramatically. You could argue that the excess cash that has been generated by companies is still not reflected in their share prices. Maybe it's worse in Wall Street than in bond street at the moment but it still might be worth taking a run at the market. The point is the attractiveness of some equity valuations at present. The 10-year US government bond yield is currently 3.7% but you can buy fantastic companies with 7% free cash yield, 4 – 6% dividend yields, good balance sheets and strong businesses.'

'It may be worse in Wall Street than bond street at the moment but it still might be worth taking a run at the market.'

Mark Holowesko

'We don't look at it geographically,' he added. 'We do our work from a bottom-up perspective. We look at industries, companies and the teams running them and from a free cash perspective. **Pharmaceuticals** have all sorts of problems as a sector but the companies we're looking at will generate about 85% of their market cp in the next three or four years. We're also looking at undervalued **technology and IT** companies.' Price not growth is often the main consideration: 'Not one of our best investments was a company that has grown at most 2% a year. I think we paid about 2400 but we got back 50-something in dividends.'

Kyle Tomlin also struck a more positive note: 'If you count in the free cash flow from US corporations and savings from consumers in the US, the ratio of free cash to GDP is the highest in history and at the same time capital spending and depreciation is at the lowest levels, so if there is to be a significant pick-up – in Asia and the West as well – that would seem an area to invest capital.' He outlined his firm's careful 'sieveing' approach, applying, like Sir John, a series of different ratios to screen opportunities.

'This whole internet thing is still at such an early stage. It's just changing the way consumers and businesses around the world deal with each other, and there are big, big opportunities.'

Nick Train

'We have an interest in **technology** and that lead us to companies in **Taiwan**, where there are some of the best and cheapest technology companies in the world. We looked at stock primers above 129, global stream equity of less than 100%. We then looked at only the 20% cheapest companies, screened them by capex and ended up with several candidates which have a median price to free cash flow of 5.2 times and a median price to book of 1.5 times. As you might expect, half of the stocks were technology stocks and a quarter of them were from Taiwan.'

Before closing the meeting **Dr Knight** thanked members and asked if they would go round the table and give their responses to two questions: what are your biggest investment ideas in the near and medium future and what are the biggest risks? Their answers are summarised below:

Participant	Investment Idea	Investment Risk
Cheah Cheng Hye	Taiwan and a selection of China Stocks	An ageing China
Andrew Foster	-	Chinese bank positions Over regulation
Robert Horrocks	-	Income disparities within countries
Rory Knight	Korean financial sector	Excessive regulation
Ana Kolar	-	An interrupted stock market recovery
Paul Matthews	Japan	Over-regulation and capital controls
Julian Mayo	Growth in emerging economy domestic demand	A double-dip recession 'Hubris'
Sandy Nairn	Intermediate goods producers in a future upturn	Over-regulation and capital controls
Jane Siebels	Argentinian companies	The euro
Jayne Sutcliffe	'New Frontier' emerging markets	Entitlement programmes
Kyle Tomlin	High relative value capex stocks	Inflation threats to bond markets
Nick Train	The internet Japan	Disruptive new industry entrants

THE SIR JOHN TEMPLETON ROUND TABLE & THE FINANCIAL CRISIS

The inserted memorandum - a financial last testament, if you will - written before his death by Sir John Templeton in June 2005 only came to light some three years later. Given the financial woes afflicting our financial system, its words show striking prescience.

Predicting financial chaos in many nations within five years, Sir John laid bare his concerns: 'I am now thinking that the dangers are more numerous and larger than ever before in my lifetime. Quite likely in the early months of 2005 the peak of prosperity is behind us. In the past century, protection could be obtained by keeping your net worth in cash or government bonds. Now the surplus capacities are so great, that most currencies and bonds are likely to continue losing their purchasing power. Mortgages and other forms of debt are now over tenfold greater now than ever before 1970, which can cause manifold increases in bankruptcy … Clearly, major corrections are likely in next few years … Over ten fold more persons hopelessly indebted leads to multiplying bankruptcies not only for them but for many businesses that extend credit without collateral. Voters are likely to enact rescue subsidies that transfer the debts to governments, such as Fannie Mae and Freddie Mac.'

'Sir John was a profoundly committed to sceptical stewardship,' commented Dr John Templeton Jr. at the close of the Round Table meeting. 'What is desperately lacking in the US and the rest of the Western world is what Sir John would have called "common sense logic". Sir John really hoped, because he was an optimist, that in sceptical stewardship there someday perhaps might be a framework to actually break the historical cycle of inevitable bubbles and all the psychological traps that draw people into bubbles.' In this connection Dr Templeton deplored the way many countries were allowing the growth in their entitlement programmes to outstrip that of their revenues.

'Sir John was a fervent believer in economic freedom,' continued Dr Templeton, 'who profoundly agreed with Milton Friedman's statement that "the only way that has been found to get a lot of people to cooperate voluntarily is through the free market". Drawing attention to ***New Threats to Freedom***, recently released by the Templeton Press, Dr Templeton added that 'Freedom and free enterprise are inextricably linked, and if you threaten one you threaten the other. And at the heart of freedom is the freedom to fail. Economic progress is driven by creativity and the related virtue of emulation. Creativity is another word for entrepreneurship. It is the ability to imagine possibilities that have yet to come into existence. Creativity demands the freedom to act. Wherever people are left free to exercise their capacities, the wealth of societies will grow. Where enterprise is hindered, liberty and prosperity suffer.'

But at the same time Sir John firmly believed, said Dr Templeton, in the moral obligations of business towards individuals and society as a whole. 'Every successful entrepreneur is a servant,' Sir John had stated said, adding that 'the market economy has a way of punishing the economic vice of pride. 'What should we accentuate,' Dr Templeton asked, 'smartness and mental agility or wisdom and integrity?' This belief in ethical values, moral obligation and social contribution – spirituality in its widest and its most active and practical sense – that informed Sir John Templeton's philanthropy and continues to inform that of the Templeton Foundation.

It was the need, in the face of the gravest financial crisis to overtake us for a century, for a combination of vision, intelligence, knowledge and common sense logic that helped provide the impetus for the establishment of the Sir John Templeton Investment Round Table in 2009. Now in its second year the Round Table is notable for its encouragement of a free and frank exchange of

views between the group of investment experts advising the Foundation and for its forward-looking focus. It plans to continue to hold annual meetings in future and to involve an even broader range of advisors, foundations and other interested parties. It is with this aim, and in the hope of exercising an effective and salutary influence, that the Templeton foundation makes available this report of the Round Table's 2010 meeting. 'At the Foundation we ask more and more about enduring impact, Dr Templeton concluded. '"Good enough" is no longer good enough. We are looking for things that are truly sustainable and transformative.'

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