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FINDING GROWTH IN ASIA

After returning from a 10-day research trip in May, Rob Lutts believes the case for emerging markets is still quite strong.

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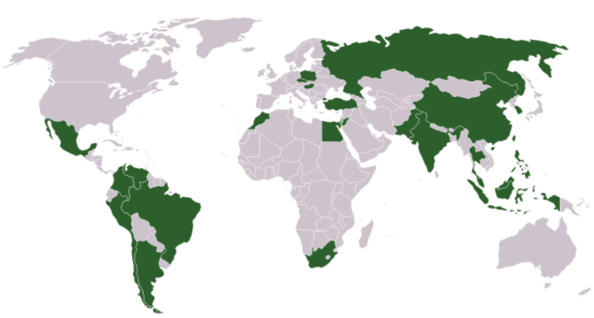
INTRODUCTION

Succeeding in today's challenging financial markets requires thinking outside the box. This is nothing new for our firm, as we have been looking for growth on a global basis since 2002. My first trip to China in 2002 opened my eyes to a vibrant and healthy economy that was growing at four times the rate of growth of the United States economy. Investing in the emerging markets puts the "wind at your back" and has the potential to produce much better than average returns. After returning from a 10-day research trip to Singapore and Vietnam in early May, I believe that the case for emerging markets is quite strong; and, after meeting with enthusiastic entrepreneurs in Southeast Asia, I believe the economic environment in China and Southeast Asia continues to be very healthy.

THE EMERGING MARKETS

A growing middle class is the primary driver of new growth in the region. Banking services, education, health care, transportation, food products, and infrastructure all should experience above-average growth. We believe most investors are underexposed to this area of the equity markets. Our favorite emerging markets include China, Brazil, India and Singapore. In the frontier class we favor up-and-coming Vietnam. It has a young and educated population that is eager to join the ranks of more affluent populations. A more favorable regulatory system and a pro-free-markets initiative will help Vietnam become one of the faster-growing economies in Asia. We believe it is an ideal time to boost exposure to this region, and that the emerging markets are poised to lead the global equity markets in the coming decade. As I met with leaders of education companies, financial firms and internet search engines one common theme was emphasized by all companies: a high level of expectation about personal growth. In meeting with the executives and managers of these companies it is quite evident that they place a very high emphasis on education and personal growth. They expect to move forward and as a result the companies have a very healthy expectation for development and growth.



The following provides some statistics which support our conclusions:

1.) **Economic growth is driven by investment and consumption**. The emerging markets now have a base of 1.7 billion consumers with incomes in the $5,000 - $20,000 range. This is the sweet spot for consumption. We expect the emerging markets are beginning a very large surge in consumption from within their economies, which will drive high economic growth.

2.) **Valuations are now extraordinarily attractive**. Due to the global economic crisis, all equities have been reduced in value. Earlier this year the emerging markets were very attractively priced. Today they are priced about average P/E ratio (price/earnings ratio) over the past seven years. Today's emerging markets trade at about 15 times next year's estimate of earning. **Superior growth rates, better financial health, a stronger banking system than the West, and moderating inflation are all reasons why the discounted prices in these emerging markets will not last.** We expect a revaluation (mark-up to current valuations) to begin soon. We believe five years from now many emerging markets (possibly China) will trade at premium valuations to developed markets.

3.) **Mortgage penetration –** underutilized leverage is present now in emerging economies. Leverage will eventually be tapped and will catapult growth.

4.) From a top-down perspective, the **emerging markets present an extraordinary situation.** Emerging markets have:

    1.) 80% of the world's population,

    2.) 75% of the land mass,

    3.) 66% of Foreign Exchange Reserve,

    4.) 50% of GDP (PP adjusted), and

    5.) **Only 10% of World Market Capitalization**

    We anticipate Emerging Markets' world capitalization will rise dramatically in the coming decade.

5.) **Special Drivers**: A low-cost work force that is highly educated and motivated. Other reasons for the region to do well include economic incentives and low taxes and other infrastructure costs.

Mortgage Loans as a % of GDP	
USA	80%
UK	87%
China	11%
India	5%
Vietnam	2%

VIETNAM: THE NEW FRONTIER

Vietnam entered the global financial community with the launch of its stock market only nine years ago. This market, although small (estimated market value of 300 largest listed companies is only about $12 billion), is expected to continue a relatively high level of growth in GDP of 5-7% once the global economy recovers. There are many reasons to be optimistic about the prospects of economic growth in Vietnam.

1.) **Low- cost labor** has attracted foreign investors. Vietnam has consistently attracted high direct fixed investments. GE recently announced an investment of $61 million in a wind turbine assembly plant in Hai Phong.

2.) **Plans to continue liberalizing the economy** to allow for productivity growth and enhancements are continuing. Tourism industry and financial services industry are growing rapidly.

3.) **Vietnam's admission to the WTO in January 2007** is a key to transforming its bureaucratic governance. Vietnam has strengthened its diplomatic and economic relationships with its key trading partners.

4.) **The poverty rate** has declined from 58% in 1990 to under 25% in 2006.

5.) **Banking reform** – privatization of state-owned banks and strengthening of the independence of the Central Bank should help further development.

But like any other emerging market, of course, there will be challenges and risks. Some of these include:

1.) **Regulatory Problems** – Protection of local state-owned operations.

2.) **Contract Enforcement** – Legal system is far from adequate.

3.) **Corruption and Influence** – Improving but is still problematic.

4.) **Infrastructure Issues** – Roads, electricity, and transportation are all lacking. There is much opportunity to improve here.

Personal Observation of Economic Reality

Here are some of my personal observations while in Asia:

1.) Asia has slowed down like the rest of the world; however, **the Asian banking sector and property sector are in much stronger condition than the developed economies like the United States and the United Kingdom**. I met with the new CEO of the second-largest publicly traded bank in India and heard some very good news regarding lending and banking services in India. I believe the leading Chinese and India banks continue to remain quite profitable and growth rates in the coming decade could easily top 20% per year.

2.) **Debt levels in Asia are very attractive from an investor's point of view.** Today the United States has a mortgage to GDP ratio of about 80% (this means we are 80% leveraged). As a result of significant cultural differences, Asians seem to avoid debt and prefer to save before spending. This means these economies will be much more vibrant in a downturn. China has a mortgage to GDP ratio of only 11%, while India is a miniscule 5% and Vietnam is only 2%. There is plenty of room for these debt levels to rise in these economies. This means higher levels of growth can be achieved with the use of some financial leverage.

3.) **The spirit of entrepreneurship is alive and well.** After many trips to Asia, I have come to learn that it seems that a disproportionate share of Asian companies have the luxury of higher profit margins. This is true for some easy-to-understand reasons. First, the government taxation is much less in these economies. There is no large social services sector that requires high corporate taxation and corporations are viewed as a critical component of the countries' economic growth engine. Secondly, we know companies in Asia have much lower labor costs and lower infrastructure costs, which allows for much higher net margins. We find banks in India with double the margins of banks in USA and retail stores in China with 30% net margins (very rare in the developed economies).

4.) **Vietnam operates in the shadow of China, but is following in the footsteps of China and we believe will experience great growth in the coming years.** In Vietnam, the economic system is quite robust and we expect longer-term GDP growth in the 6-8 percent range. I met with a private media company in the television production business that was experiencing dramatic growth in the 35% area.

Rob Lutts meets with executives of TV Plus in Hanoi, Vietnam. (May 2009)

The women-run company was positioning to continue that level of growth for many years. The middle class in Vietnam is growing fast and therefore media growth is in a favorable position.

Summary

The world continues to become smaller and smaller as the emerging economies continue their journey to higher levels of income and consumption. During this transformation vast amounts of wealth will be created by many companies in the right position. We favor the areas in the emerging economies that are benefiting from the extraordinarily large middle class in the emerging markets. It is estimated that there are more than 1.4 billion people with incomes of $5,000 to $20,000 in the emerging economies (China, Brazil and India being the largest). We expect we are entering a period of time when a large surge of consumption from within these economies drives growth at a very high level. Think of the United States in the 1950s. We have positioned our clients to benefit from banking services, education, healthcare, transportation, retail, and infrastructure improvements. We believe most investors are not properly exposed to the growth opportunities we have uncovered. Many lack the confidence to have a longer-term perspective about these markets. We believe these up and coming countries are still at the beginning phases of growth. We expect many corrective phases of ten percent or more in the coming years, however we believe it is likely these markets will produce double the performance of the developed economies. Do not expect a smooth ride; rather, one that needs a longer-term perspective to be able to benefit from the longer-term growth of the region.