Finding Opportunities in Asia

Over the last 15 years, Asian economies have lead global growth and significantly increased their importance as a share of global GDP and output. China's economy increased in size by over 14 times from 1990 to 2010; India's economy grew five times in size in the same period.[1] The mega growth these and certain other Asian economies experienced in the past will be nearly impossible to achieve going forward; instead these economies are transitioning to a "new normal" where growth has slowed, but will likely be less volatile and more sustainable. Even though growth has been meaningfully reduced, relative to other regions in the world, Asia still remains the global growth engine, as demonstrated by the table on the next page. The Economist Intelligence Unit predicts that in the next two years (2017), China will be the world's largest economy. Goldman Sachs predicts that in the next 15 years (2030), India will become the third largest economy in the world. Looking even further out in the future, analysts predict that by 2050, Asia will account for over 50% of global output.[1] Another factor which makes Asia a strategically important region is the population dynamics of China and India, the world's most populous nations. China (1.36 billion people) and India (1.25 billion people) represent about 37% of the world's population. The next most populous country, the US, is a distant third, with only 0.32 billion people.[1] China's population is set to expand: in 2013 and 2014, a total of 29 out of 31 provinces loosened the one-child policy by allowing families to have a second child. China will also benefit from their new powerful consumer class, which we discussed in the Thinking Man #10.

In this note, we discuss our current exposure to Asia, where we believe we can find value, and finally, how we propose clients to invest in the region.

Limited Portfolio Exposure to Asia in Client Portfolios

Despite the large and increasing importance of Asia, our clients typically have a limited direct exposure to securities in the region, with our average client portfolio having less than a 5% allocation. Many of our portfolios do have more exposure to Asia, but indirectly. We have historically mainly obtained exposure to Asia by investing in multinational companies with significant focus in the area (for example, a US based company whose strategy is focused on growing sales by capturing the Chinese consumer). This is partially due to our investment philosophy which puts a high value on corporate governance and shareholder interests: both of which have not always been consistently strong points for Asian companies.

The Thinking Man's Approach

February 2015 | Series #27
Ilina Dutt | Research Analyst

While Asia has experienced a slow down over the last few years, it remains the region with the highest GDP growth; is taking market share of global output and will benefit from strong population dynamics. Our client portfolios have low direct exposure to the region, and as we are looking for opportunities for potentially higher growth investments, our BigSur Investment Committee has been scouring for potential investment opportunities in Asia. In this month's note, we discuss these opportunities as well as our criteria for selecting a manager in the space.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

ideas@bigsurpartners.com

JPMorgan 2015 Expected Real Annual GDP Growth	
United States	3.2%
Latin America	0.9%
Asia/Pacific	**4.9%**
China	**7.2%**
India	**6.0%**
Euro Area	1.5%

However, we are looking to meaningfully add to our exposure to Asia, given its increasingly important role in economic and financial markets, and higher growth profile relative to US and Europe. The BigSur Investment Committee has been looking for a "pure play"; a good vehicle in order to more directly access this asset class and better capture the opportunity set in Asia.

Finding Value in Asia: Private Companies

When evaluating ways to invest in Asia, we first take China as an example. When you look at the onshore Chinese stock market, about 90% of market value of the stocks are state-owned enterprises, or "old world" economies, such as steel or manufacturing. However, if you look at the GDP growth in China, about two-thirds of this has been driven by privately owned enterprises, particularly those in the service-based industries. Additionally, 80% of the job creation can be attributed to these private companies.[1] The Chinese government has recognized the significance of these private companies, and has started to implement reforms in order to accommodate their growth. For example, in July 2014, for the first time in history, the Chinese Banking Regulatory Commission approved three private banks funded with private capital.[2] The government is also opening the market to non-government enterprises in an increasing number of areas including: railways, telecom and petroleum. All of this should benefit these private companies, allowing them to play a larger role in China's economy. Finally, the China lifted its 14 month freeze on IPOs in January 2014. There were several successful IPOs out of China, most notably Alibaba, which in September 2014 was the world's largest ever IPO. These conditions all benefit private companies, which are normally hard to access for investment. The way we propose for our clients to gain exposure to such companies is through private equity managers who provide capital to these local Chinese enterprises.

A further positive force for investments in China are the potential for valuations to increase of their state-owned enterprises (SOEs). In addition to reforming private companies, China aims to increase efficiency of SOEs by choosing which industries and sectors would be most suited and profitable to be state-owned and also introducing the concept of "mixed ownership"- converting some of these strictly state-owned companies into partial state and partial private sector owned companies. One manager believes that these reforms could potentially increase valuations of these SOEs from anywhere between 5-8x over the next decade, which will help expand private equity valuations.

Another example is Japan, where the private sector is also looking to undergo meaningful business and industry restructuring. One manager sees a good opportunity in small and medium enterprises (SMEs) that are facing declining profits and market share in the domestic market, and are now, more than ever, very willing to have private equity firms invest and help them expand their business abroad (particularly to China) and to improve their competitiveness. Many of these companies also

[1] Stephen S. Roach, Yale Jackson Institute for Global Affairs, "Get Ready for the Next China" BCA Investment Conference, September 16, 2014

[2] These three private banks are: Tianjin Jincheng Bank; Qianhai Weizhong Bank; Wenzhou Minshang Bank

call themselves "undermanaged" and are seeking private equity funds to improve their operations and margins. This comes at a time when many of the large global private equity players have exited the Japanese market (including: Merrill Lynch, Unitas and Vestar). This manager also sees entry valuations of these deals as low and attractive, especially when considering the valuations of the public equity market: while multiples have decreased in Japanese public equity markets since the peak cycle in Asia (January 2007), private equity multiples are at a much deeper discount. For example, the manager told us, at the height of valuations in private equity in Japan, they were paying a 18.1 entry multiple to get into deals: in 2014, that number for similar deals was 5.2 (representing a 70% discount). The public markets, on the other hand, were trading at PE multiple of 26.8 in 2007, and in 2014 at 18.2 PE multiple (representing only a 30% discount).[1]

Private Equity Environment in Asia

Capital invested in Asia private equity has grown over the last two years (in 2014, there was about $80 billion invested), but has still not reached its 2007 peak ($97 billion).[2] Private equity is still "underdeveloped" in Asia, whereas flows continue to saturate the US private equity market: in 2014, US private equity funds raised six times more capital than Asian private equity funds (US: $266.2 billion, Asia: $44.2 billion).[3] Private equity in many Asian countries is still in a nascent stage, with a small but growing number of local firms that are not easy to access. Some of the 'major' US and global firms may be active in the largest deals, but they often do not have a significant-enough local presence and/or are too large to access some of the more interesting deals and managers in the SME sector.

Conclusion: Importance of Manager Selection

Given that we believe private companies are the appropriate play in Asia for our clients, we have been vetting private equity managers in Asia. Below are some of the key characteristics we have used for our evaluation.

> *Boots on the ground:* A strong local presence is important for us when selecting an international manager, and in emerging countries, we feel it is extremely important. We like firms to have analysts who have local knowledge, understand local corporate culture, government, consumer habits, etc.
>
> *"Network effect":* a local presence is not only important to understand the investments. It is also important to develop a network and access top tier partners. As we mentioned earlier, shareholder rights may not be as protected in Asia. Instead, there is a large emphasis placed on trust and reputation. Thus, it is very important to work with a group that has an established and well-respected local presence, a strong network, with the aim of selecting companies and deals in which we can feel confident.

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[1] Asia Alternatives Management LLC, "Asia Alternatives' Asia Private Equity Market Perspectives," December 2014
[2] Asia Venture Capital Journal, "Asia Private Equity and Venture Capital Review 2014," December 2014
[3] Cambridge Associates, "Asset Class Views," January 2015

Knowledge of the different markets in Asia: Asia, similar to Latin America, cannot be categorized as one story. Therefore, it is very important that a manager understand all the intricacies of each country's economy and opportunity set. For example, one top tier manager told us their views on India: capital markets are overstocked (the Bombay stock exchange has over 5,000 listed companies, making it the exchange with the most companies listed in the world) and thus, private equity is generally competing with public equity.[1] This manager found that in most deals they look at, investors are paying public market valuations and are not being compensated with enough of an illiquidity premium. This manager chooses to only invest in early stage technology companies in India which are aiming to become globally significant, because that's where they believe investors can earn the best risk-adjusted returns. India's publicly traded equity markets is an area we see potential value; we are researching this further, and may be writing a follow up Thinking Man on that opportunity.

Co-investment opportunities: Private equity funds can offer additional return potential when there is an opportunity to co-invest alongside a manager in direct deals. Some managers may have limited capital or restrictions on how much they can allocate to a single investment in a certain company. At times, these companies are looking for additional funds, and if a manager has high conviction in the company, they may offer their fund investors the opportunity to participate in a co-investment in the company. These direct co-investments have the potential to enhance returns and are very difficult opportunities to access.

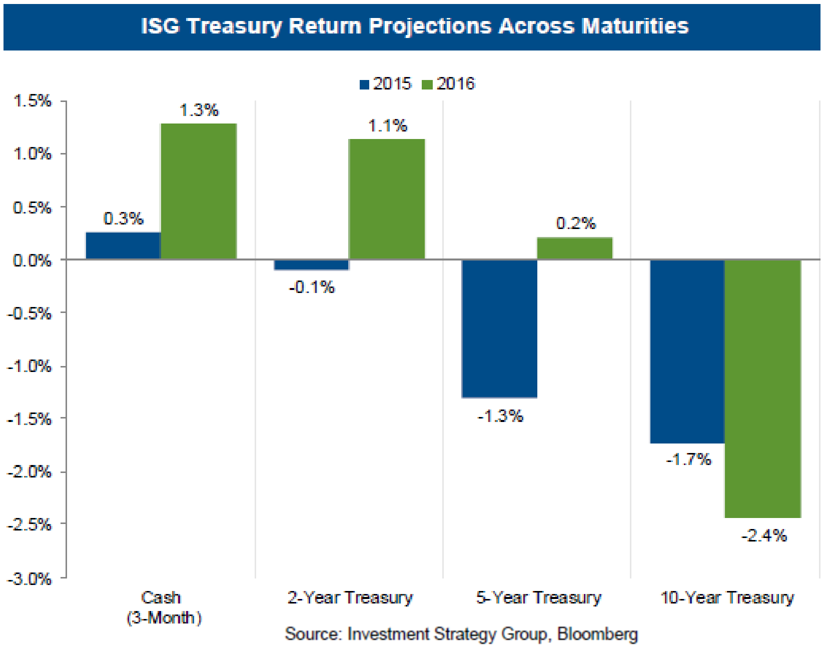
Manager track record, team experience, and investor base: As with all of our investments, we consider the manager's qualifications and track record of performance as key factors in our decision making. We like managers who have been specializing in their market for years, and who have earned a reputation of being a top manager in their space. Given our goal of introducing clients to "institutional caliber" managers, it is also important for us to understand who the other investors in a fund would be, and if they represent "smart money."

We have identified a manager who we believe fits many of these characteristics and will be a well suited vehicle for those clients looking for exposure to Asia. We will be following up with more details and information on the specific opportunity.

[1] Bombay Stock Exchange, "Introduction", http://www.bseindia.com/static/about/introduction, Date accessed: February 4, 2015

- Clients may arguably view cash having an "opportunity cost." In our view, the other "low risk" asset- investment grade fixed income- offers limited value. 10 year government yields in developed countries at these low levels have a potential for negative returns for 2015. As value investors, rather than invest a large allocation to investment grade fixed income, we prefer cash to have the portfolio flexibility to take advantage of the opportunities as they present themselves (especially to buy high quality assets at a good entry point for the long-term).

Chart 1: Expectations of Negative Treasury Returns



- We put high grade investment bonds at an underweight as 10 year yields in developed countries are extremely low: US at 1.8%, UK at 1.5%, Germany at 0.4% and Japan at 0.2%. Over 1/3 a of the government bond markets have 10 year nominal yields of less 0.5% while 5 year nominal rates in Germany and Japan are negative!

- Chart 1 on the previous page demonstrates these views by the Goldman Sach's Investment Strategy Group's projections for return across Treasury maturities in 2015 and 2016 vs. cash

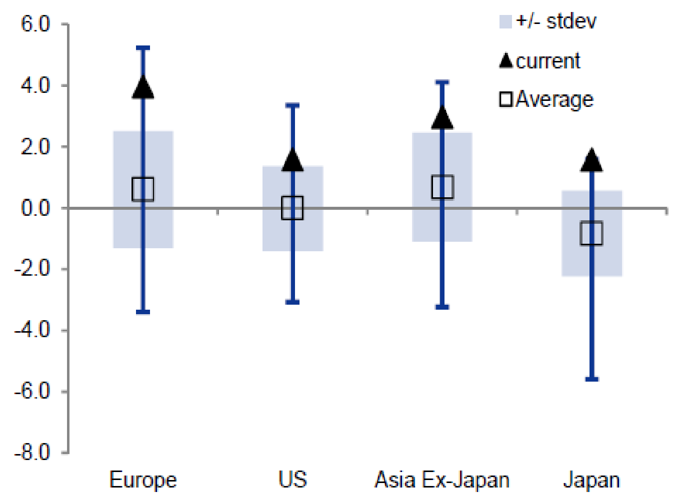
Key Point #3: Equities should outperform fixed income in 2015, even though the performance of a traditional balanced portfolio will be modest, around 4-5%.

- While we expect the equity markets to have a lower returns for 2015 than average returns since 2009 (which have been around 20% annually), we still see stocks as attractive relative to bonds.

- Dividend yields remain high relative to bond yields, as demonstrated by Chart 2. The black arrows represent the current premium dividend yields offer to real government bond yields, ranging from 2-4%. In all cases, this premium is at the high end of the range and above the averages of the last few years.
- Dividend pay-outs and share repurchase programs have increased steadily in the last 5 years and will continue to do so in 2015.
- While popular measures of stock-market valuations like the P/E ratios or the cyclically adjusted P/E ratios are above the historical average, they are far below the all-time peaks; but relative valuations when we compare them with bond yields are still attractive
- The technical factors of investor and regulator complacency are not present – the market still continues to climb a "wall of worry"
- The last 6 times the S&P500 produced negative annual returns (including dividends) the US economy was in or near recession. Low gasoline prices, strong auto sales and potential for more housing construction should keep the US economy afloat.

Chart 2: Dividend Yields of Stocks Higher Than Real Bond Yields

Exhibit 23: Dividend yields are high vs. real bond yields
Dividend yields minus 10-year real government bond yields. We use 5-year average inflation as a proxy for inflation expectations. The distribution uses data from 1990 except for Asia ex-Japan where it is from 1995



Source: Datastream, Haver, Goldman Sachs Global Investment Research.

Key Point #4: We maintain our investment thesis held for over 5 years that the US is the best neighborhood and offers better risk-adjusted returns than Japan and Europe (both of which are marred in deflation) as well as Emerging Markets.

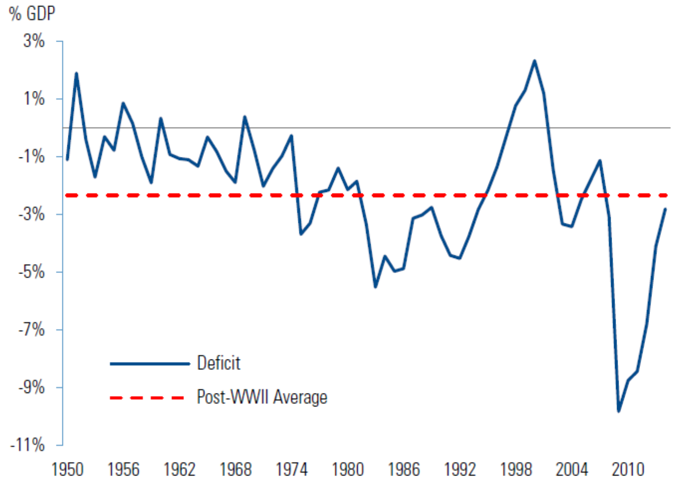
Within our equity allocation, we continue our long standing position of a US overweight, as the US boasts a stronger economy, better profit outlook, less fiscal drag and falling bond yields.

- An accelerating US economy is a notable exception in a world where growth is expected to be below the long term trend for most countries: many analysts predict the US to be a leader in GDP growth in 2015 with expectations between 2-3% growth.

- The health of US economy is stronger: the federal budget deficit which plagued the economic a couple years ago have been meaningfully reduced, and is now at the average level since World War II (as demonstrated by Chart 3). Leverage at both the consumer and corporate level have been sharply reduced in the US versus other parts of the world.

Chart 3: US Federal Budget

The US federal deficit has narrowed to a post-crisis low in fiscal year 2014.



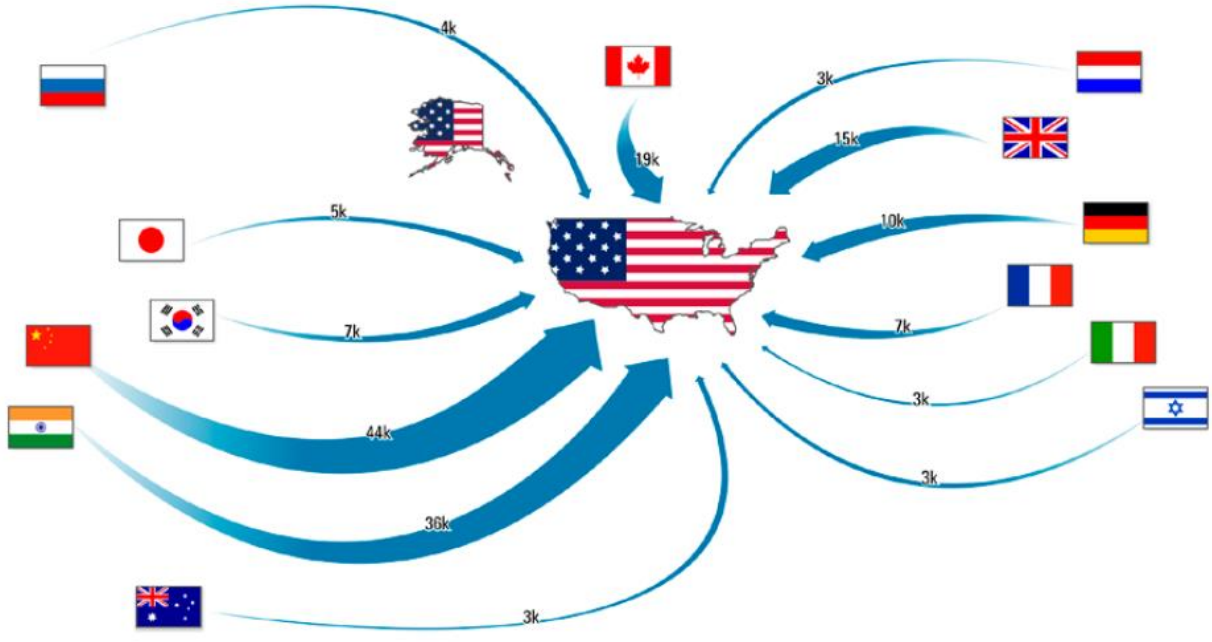
Data through FY 2014.
Source: Investment Strategy Group, Datastream.

- The US continues to show it is the winner in the "brain game." It remains the country which is able to attract the top talent from around the world. This is a key differentiator for the US in a world which increasingly puts values on human capital resources, intellectual property and innovation and puts less value on natural resources such as commodities. Goldman Sachs used data from the World Intellectual Property Organization to create an interesting chart showing the flow of highly skilled "inventor' immigration (Chart 4 below). The US was able to increase the inflow of this key demographic by 51% in the period of 2006-2010 (from the period 2001-2005). This is a way that the US can continue to keep its edge.

Key Point #5: We continue to believe our clients should hold more non-traditional asset classes where the illiquidity premium overly compensates for the extra risk.

- As discussed in previous Thinking Man notes, we are focused on finding non-traditional revenue producing assets that offer lower levels of liquidity and have an expected INTRINSIC return that well compensates the risk. Given our cautious views on fixed income, and lowered expectations of equity returns, we think investors must seriously consider allocating to non-traditional assets to position their portfolios for multigenerational wealth.
- We are looking for assets which offer intrinsic value with nominal returns of 8-11%. Some examples include: revenue producing core commercial real estate; opportunistic hard money lending (against high quality assets); private debt; infrastructure and other niche asset types. It is important to distinguish that we are not simply talking about any "alternative" product which is not an equity, bond or cash, (i.e. we are not looking to hold hedge funds which are liquid positions into illiquid funds). For more details on the type of non-traditional assets we are investing in, please see Thinking Man #22 published at the end of September.

Chart 4: Migration Flow of Inventors to the US



Data through 2010.
Note: Showing the number of inventors migrating to the United States between 2001 and 2010.
Source: Investment Strategy Group, Goldman Sachs Global Investment Research, World Intellectual Property Organization.

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Conclusions:

- 2015 will be the first post QE year and will see volatility across markets go back to more normal levels from depressed levels. This spikes in volatility should be taken advantage of by our clients. We continue to look closely monitor the markets for opportunities to deploy cash when there are spikes in volatility and sudden market corrections. We believe some strategies like "covered call writing" can be a defensive way to gain exposure to US equity markets.

- The goal is to strike a balance between growth and safety that allows our clients to "sleep well at night" during a potentially tumultuous 2015 without being tempted to act impulsively, while we aim to detect good entry points for long-term opportunities.

- 2015 will see a surge in "credit events": Credits with low fundamentals are being punished by the market. As one manager told us, the market may have "finally entered a phase of credit risk differentiation." The price breakdown in lower quality high yield signifies a shift in the fixed income markets, and many managers believe that if there is another fall in fixed income markets, these lower quality credits can continue to gap down.

- One of our focuses this year continues to be finding top tier, high quality non-traditional investments. We're identifying attractive themes and looking for the most efficient and appropriate vehicles to invest with. Some new ideas that we've been working on include diversified real estate in the US and Europe for distressed and value added opportunities; private companies in Asia; private and mezzanine debt in the US and Europe.

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