

GAM Investment Meeting Notes

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Pacific Equity

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- The economic data we have been tracking, which includes loans, exports and electricity numbers, has been much softer than anticipated. Our expectation that the first quarter would mark the trough of economic activity is now unlikely to become reality, as soft data extended into the second quarter. This has been more or less corroborated by the corporate meetings we have been having over the past three to four weeks, where most company management reported that they have not seen any noticeable pick-up in economic activity during the second quarter. Given the soft data, we expect to see second-quarter GDP growth come in below 8%.
- To a certain degree this weaker economic environment has been driven by the European financial crisis, which has meant that export numbers have been softer than expected, with the main culprit being exports to Europe. Elsewhere, our corporate meetings have highlighted – especially among the smaller, privately owned companies – that balance sheet strength has continued to deteriorate, working capital and financing needs have continued to rise and receivables risk remains a concern.
- We have been reducing our small cap allocation, in response to the challenges this sector continues to face. We have also been reducing our exposure to Hong Kong diversified financials, such as the monopoly stock exchange. This has mainly been driven by the view that volatility is likely to remain elevated given that we are no longer close to resolving any of the macroeconomic issues the world is facing. We therefore feel more comfortable with a lower financials exposure and prefer to diversify our portfolios towards defensive, growth-orientated, large-cap companies that can deliver a solid 5% dividend yield, such as some of the energy and gaming companies.
- The flip side, however, has to be that since the economic slowdown in China was very much policy-induced, we are hopeful that policymakers may look to relieve the pressures on the economy. We have had three reserve requirement ratio cuts but this is probably a bit too little too late. The scale of policy stimulus will not be as extensive as we saw in 2008/2009 as policymakers are still dealing with the aftermath of the significant build-up in credit four years ago. Political uncertainties may delay the necessary policy loosening. But we are hopeful that we could see further reserve rate requirement cuts to support the economy, such as those actioned over the weekend.
- Retail sales are still growing at about 14–15% and electricity generation is around 4%. Loan disbursement is tracking below expectations, despite the fact that, seasonally, the second quarter should be a robust period for loans extension. The underlying data is therefore suggesting that the economy is slowing. The market has become more focused on the delta – the rate of

change – and there has not been any noticeable pick-up in economic activity.

- Despite the overall headwinds affecting the economy, there are still some interesting and attractive businesses on offer, especially in light of the recent sell-off in the market. The portfolios are positioned in areas that we think will continue to do well and where there are hard catalysts that should drive these businesses, such as investment in upstream oil and gas companies like China National Offshore Oil Corporation (CNOOC). Last year CNOOC suffered an oil spill at its main oil production site in Bohai Bay. This appears to be resolved now and we should see production normalising. The company has also had a number of successes in identifying new oil reserves in the area.
- The market expects a decline in oil production, but we think data will prove positive and may surprise on the upside. Although the oil price has pulled back, we think the combination of an elevated oil price, together with a resumption in production, should lead to an improvement in earnings. Similarly, in terms of natural gas, the government is committed to supporting the development of the sector, and therefore we have positioned the portfolios in companies that can benefit from these positive government tailwinds.
- We have an underweight position in the consumer sector. Since the summer of last year, consumption slowed to almost a standstill, especially in the low-end sectors of the market, such as speciality retailers, apparel retailers, women's shoe wear, department stores and some supermarkets. This trend persisted into the first couple of months of this year. We find that the Chinese consumer is becoming much more discerning in their purchasing. There has been no slowdown in some of the high-end stocks such as LVMH. In fashion wear, Inditex has been less affected by the slowdown, although Esprit and Ports Design have suffered due to a more stock-specific problem, whereby they have the wrong product offering for the Chinese market.
- Elsewhere, in the autos sector, companies such as BMW continue to report record car sales. Generally, where there has been a slowdown versus continued strength, it has been very stock-specific. However, in capital goods for example, with the housing market accounting for 13–14% of GDP and the government wishing for restraint in housing prices, it is inevitable that excavation equipment and heavy machinery have continued to see a marked slowdown in demand and no appreciable recovery in the second quarter of the year.

Emerging Market Equity

Tim Love, Investment Director, GAM Star Emerging Equity

- GAM Star Emerging Equity, which launched in March of this year, closed down 0.9% in April in US dollar terms, outperforming the iShares MSCI Emerging Markets ETF, which lost 1.7%, as well as the MSCI Emerging Markets index, which lost 1.2%. Commodity currencies came under pressure in April, triggering the market decline, and key emerging markets began to roll over quite

aggressively. Energy, materials, industrials and utilities all fell as a result.

- We held telecoms, autos and consumer discretionary names overweight to the benchmark during April, which aided our performance. Samsung, Uni-President and Hyundai Motor Company were among the best performers for us during the month, while oil plays, Brazilian banks and Brazilian homebuilders detracted.
- Most investors seem to be overweight in stocks that are high-yielding or growth-focused. In my view, this has left many with distorted portfolios. In the first quarter of the year, most of the inflows into risk-on assets, including emerging market equities, were primarily executed through ETFs. When this trade unwinds, it will be remarkably quick and strongly linked to the carry trade and to risk-off political dynamics. I would therefore caution that investors who now increase their exposure to these risk-on asset classes may be exposing themselves to two or three standard deviations over-owned or over-valued plays in consumer growth or consumer staple areas. In the event of a positive policy response, these over-crowded, alpha-generative, high-growth, high-yield areas might actually see declines. Those that are the least crowded and currently stand at three standard deviations cheap – such as deep cyclicals – could rally modestly, and in this event, the performance differential to the index would be extremely large.
- We are overweight utilities, consumer staples and consumer growth stocks and are slightly underweight materials and energy. Performance of these areas will depend to a large degree on policy response. We seek to protect against this uncertainty by identifying consumer growth plays that are laggards in countries such as Qatar, Malaysia and Mexico. Brazilian housing plays are an example of this type of investment. However, it is difficult to put much risk budget to work on calls of this type, given the current environment.
- In terms of valuations, emerging market equities remain cheap compared both with their historical averages and with emerging market bonds. The asset class is on a price-to-earnings ratio of less than 10x, with a return on equity of more than 20%, a price-to-book ratio of 1.4 and yields of 3.5%. However, this will not necessarily manifest itself in a risk-on bounce unless there is some currency-led confirmation of a policy response. The market is extremely skittish, given the macroeconomic problems in Europe and elsewhere. All the history of defaults in emerging markets indicate that it is better to default in an orderly way, rather than wait until the markets do it for you in a disorderly way. It is extremely difficult to run aggressive calls in emerging markets at the moment, despite their cheapness on a fundamental and technical basis, since the region will inevitably be affected by the tailwinds of the issues facing Europe.
- While we have some defensive plays in our portfolio, we are not looking to add to them significantly because, as and when policy response is positive, they are likely to suffer – and

disproportionately so. In our view, it is almost as dangerous to be in deep defensive plays as it is to be in under-owned, out-of-favour cyclical names.

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