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Global Asset Management

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Looking back over this last decade, performance has been very much driven by the emergence of China on the world stage. While we owned a small number of Chinese companies, above-average growth where it occurred came primarily from global companies whose products were in great demand to fuel Asian economic growth – think iron ore, technology and to some degree oil.

This decade will be different. It will be imperative to own companies that directly serve the Chinese domestic economy, as well as those global companies that benefit from strong demand trends emanating from Chinese economic growth.

Relative growth rates between the West and China have shifted dramatically. Last decade, it was thought that China was growing at 8-10% a year, and the U.S. was growing at 4-5% per annum. Thus the growth opportunity in China was 2X that of the United States.

Post the financial bubble, growth in the West will be on the order of 1-2% at best, while growth in China should remain on trend at 8-10%. Thus the relative core growth ratio has risen to 5X that of the West.

As an example, we have been buying shares in a high-end Chinese retailer whose same- store sales grew 25% last year and whose total sales grew 34%. We also own a U.S. discount retailer that just reported 7% overall sales growth and 3% same-store sales, and we were delighted by these results given the current economy. Note the relative growth rate of the two companies. It is a powerful message.

We looked in our files and our first client communications regarding China were in 1991 when we wrote about its emergence on the world stage. In late 2003, we made our first steps of investing in a package of Chinese companies as a portfolio strategy. Returns were OK, not brilliant, but we learned a great deal. There is not just one Chinese stock market; it actually is broken down in many ways. We think of domestic consumption companies versus export companies. We think of Shanghai vs. Hong Kong companies. We think of Chinese-owned technology stocks vs. U.S.-listed Chinese technology stocks. Each of these has different secular characteristics and involves different groups of buyers and sellers.

As we have previously pointed out, total consumption in China is about 35% of its GDP. This compares to 72% of GDP in the U.S. in the 2nd quarter, the result of years of encouragement by government. As an economy, the U.S. now has to rebalance to a lower consumption of 65% or less of GDP. In China, conversely, the government needs to increase consumption as a percent of GDP. It could take years to get consumption in China up to 50%. But already China is the largest consumer of automobiles in the world at 16 million units per annum. Even conservative estimates point to annual sales of 25 to 30 million automobiles a number of years out. Demographics as well as growth in personal income make these projections appear realistic. Actually, retail sales and industrial production in China have trended upward at 14% per annum for the last two decades, and while the

rate of growth could taper off some, the fundamentals suggest the maintenance of a substantial level of growth.

As a consequence, you can expect that we will continue to add positions to portfolios from a list of Chinese companies we have been following; the majority of them focus on the consumer, but the list also includes manufacturing and technology companies.

You might ask, if China is such an engine of growth, why is it that year-to-date the Shanghai SE Composite is down 18% while the S&P 500 is down only 2%? The reason is that while our Federal Reserve has done everything in its power to provide liquidity to fight deflation, in China the Central Bank is acting counter-cyclically. It is in a classic stage you should recognize from the U.S. in the 1960's or 1970's. The Central Bank is restraining the growth of credit, fearing rising inflation, rising real estate prices and too rapid growth. Thus, there is a controlled slowdown occurring and growth near term is moderating. We doubt the Chinese stock market is out of the woods, but the reality is that while broad sections of the Chinese market and economy are being affected near term by credit restraint, substantial areas of the economy are growing in their own special sphere. Even so, we advise against throwing caution to the wind. It is more likely that the slowdown will persist as we go into the winter. Certainly the export markets are at risk. The Chinese Central Bank has been tightening credit since September of last year. Our view is that this is a time to be positioning at deliberate speed for the next substantial bull market.

Asia and China are not without geopolitical risks and their own property bubble. Given the emergence of China on the world stage as now the second-largest world economy after the U.S. but ahead of Japan, we sense a buildup of kinetic energy. This is a country with an unusually strong balance sheet and a high savings rate. It can weather a storm. In contrast, Europe, Japan and the United States all have balance sheet issues that will restrain growth for years to come. In the West, only quite unusual growth companies can beat those odds.

The objective here is to highlight the reality that over this coming decade, the shifts in economic ascendency that we have experienced are not the end of the story but only the beginning of an investment roadmap. The probable source of sizable capital gain for portfolios this decade will flow from Asia and China and out into the world in a more dominant way. We will be part of that.

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