

JANA Asia Research Trip

June 2010

In the last three years, JANA has conducted 16 visits to the Asian subcontinent. Our global research program continues to expand as well with nine overseas research trips scheduled for 2010. The research yields significant benefits in terms of identification of new investment opportunities, insights which assist with our Strategic Asset Allocation views, and monitoring the investment managers of the funds we work for.



Our most recent trip to Asia, which took place during the first two weeks of May, was undertaken by Aidan Geysen and Gary Wilson. The trip comprised meetings in Singapore, Hong Kong, Shanghai and Tokyo, covering listed equity, private equity, absolute return and property, as well as meetings with a number of macro economists.

There were several outcomes we were looking to achieve from the trip:

- To test the case for having a more direct exposure to Asia;
- Understanding the relative valuations compared to other global equity markets;
- Exploring the political and economic risks with investors based in the region; and
- To gain insight as to how Australia is placed as a major trading partner, and the potential implications for domestic equities.

Some of the key findings from our trip were as follows:

1. China's Property Market

- The unanimous sentiment expressed by investors in the region was that "China" as a whole is not experiencing a property bubble. Housing prices have risen strongly in the tier 1 centres of Beijing, Shanghai and Shenzhen, but China is a very large market, and affordability remains high outside of these three cities. With the initiatives taken by the Government to cool the market, prices are likely to come off from their highs, though leverage remains low and this is considered by most observers unlikely to destabilise the market. As in Australia, the housing market underpins everything and the Government has no incentive to orchestrate a crash.
- There is a more significant concern looming within China, which relates to the significant amount of credit growth which has gone to fund local government development projects. The lending was released so quickly that there is little transparency as to the nature of the projects funded. The government through the banks is now trying to rectify the lack of transparency, and whilst the loans are interest only until the completion of the project, the potential for a bad debt problem exists a few years down the track.

2. The rise of domestic brands

- It has been a common view expressed by investors that one of the best ways to access China is through Western brands selling to the Chinese consumer. This argument has appeal, as you can invest with a company with high standards of accounting, domiciled in a stable regulatory environment, but with access to growth through the emerging consumer. We observed a marked shift on the strength of this theme from previous trips, whereby the rising prominence of domestic brands taking share from Western brands, was expressed by a number of managers. For example, companies such as sporting wear manufacturer, Li Ning, are taking share from the likes of Nike. Whilst the super luxury brands such as Louis Vuitton, Hermes and Gucci continue to dominate their niche, the next rung down are likely to find it harder, and this aspect bears monitoring through our global and emerging market managers.

JANA

JANA Investment Advisers Pty Limited.
JANA is a registered trademark.

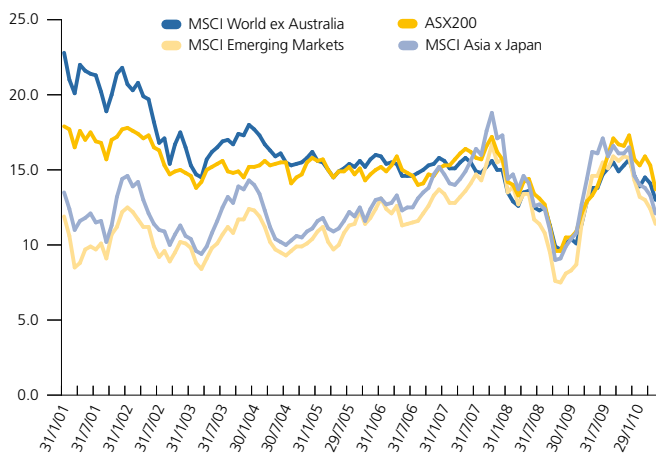
3. Japan – Short term gain, long term pain...?

- It is hard to find optimism within Japan's investment management fraternity, as the market has serially disappointed since the late 80's. The big change is that this time they are not alone, at least in the minds of investors based in Japan. The European economies are facing similar issues to Japan, with debt rising, austerity requirements hampering consumption, and unfavourable demographics all common elements with Japan. In addition, the management of monetary policy is made so much harder by virtue of the common currency. It was generally felt that Japan is in a pretty good spot at the current time with exports rebounding strongly as a result of global growth picking up, and expectations for strong earnings growth over the next 12 months. However, the longer term picture remains challenged with government Debt-to-GDP above 200% and rising, an aging population, and successive governments which have shown little promise or willingness to tackle the issues. The potential for a reduction in benefits and an increase in taxes is a course of action that would help to deal with these issues, though would obviously curb consumption in the near term.

4. Valuations

Trying to define the attractiveness of markets at present is difficult with relativities moving around quite substantially week to week. However, as the chart below shows, Asia ex-Japan is trading at a slight discount to other geographies.

1 Year Forward PE – Excluding Loss Markets



In addition, the markets are trading at a discount relative to the historic average, and the following fundamental drivers remain in place:

- Generally low government and consumer debt.

- Emerging Consumer – An important driver of growing consumption is having a legitimate social security/pension and healthcare system. These requirements are being addressed but will take 5-10 years before being bedded down. Consumption, as observed by retail spending, has been growing strongly, which is largely driven by the rising wealth effect, rather than a reduction in per capita savings. The migration from rural to urban areas in China is well in train and is a strong contributor to the rising wealth effect.
- The cyclical recovery in the global economy continues to benefit many parts of Asia, and there is anecdotal evidence that manufacturers in China are starting to experience labour shortages, given the sharp rebound in exports.
- Regulatory/Political Risks – The terrible situation affecting Thailand highlights the potential for instability, though these risks aren't unique to the developing world, with firebombs being thrown at banks in Greece an extreme example, but the Resource Tax in Australia, and reintroducing the ban on shorting financials in Germany are two other examples. China seems to receive the most focus when regulatory risk is discussed due to its significance to the world economy. Unfortunately, regulatory risk is always likely to be higher in China, given it is such a large country, and the government is trying to balance economic prosperity with social equality and as one economist put it, "the items on the wishlist are in conflict". A common comment made by investors in the region is that despite the unpredictability, if you look at the trend of regulatory change over the past 10 years, it has been a positive trend, however, there were a couple of examples used to highlight a recent trend of more regressive policy.

Conclusion

The insights gained from this trip were particularly valuable as a result of meeting with investment managers from a range of disciplines, as well as economists and strategists who are looking at the macro environment. In particular, we gained a number of insights about some of the longer term risks which require monitoring over the next few years.

More than in the past, it is worth asking the question whether a specific allocation to Asia has merit. Consumption in China appears well supported for the long term, and western brands aren't necessarily going to reap the benefits. Unlike the plethora of China bulls out there though, we are cognisant of the risks of investing in the region based on the assumption that stronger economic growth will automatically lead to value creation for shareholders. These risks need to be carefully weighed with the investment case, which is a debate we will be having over coming months and years.

Important Information

This research note is intended to provide general information only for wholesale clients and has been prepared by JANA Investment Advisers Pty Ltd ABN 97 006 717 568 (AFSL 230693) without taking into account any particular person's objectives, financial situation or needs. Investors should, before acting on this information, consider the appropriateness of this information having regard to their personal objectives, financial situation or needs.

JANA Investment Advisers Pty Ltd, Level 9, 530 Collins Street, Melbourne VIC 3000, Australia, is a member of the National Australia Bank Group of companies.