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14th January 2013

Eastern promise

Tweet of the week

"We're a £ trillion in debt and Andy Burnham's issuing statements about Frosties. #SpareMe #LabourWasters"

- Marcher Lord @MarcherLord1

"An investment operation," wrote Benjamin Graham and David Dodd in 1934's 'Security Analysis', "is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative." So congratulations are due to the Federal Reserve, the Bank of England and the European Central Bank. Having slashed policy rates (and therefore by natural extension cash deposit rates) to all-time lows, typically well below inflation (however defined), these bodies have managed to turn just about every investor in the world into a speculator. Legions of savers have felt compelled to play the stock market just to keep their capital above water. Having forced reluctant punters into uncertain waters, will the central banks ensure that these bathers aren't swamped ? Can they even ? Should they ?

Investing and morality make for uncomfortable bedfellows. But having crossed the ethical rubicon by bailing out bad banks, central banks are compounding the moral hazard by coercing investors into risk markets whether they want to be there or not. And today, all markets are risk markets. And risk markets are riskier markets when their valuations are higher as opposed to lower. This observation has been routinely ignored by bull market commentators, invariably selling equity product, gleefully advising investors to buy into a rally powered less by fundamentals than by simple price momentum. Ben Graham, for one, would be disagreeing with them:

"The one principle that applies to nearly all these so-called "technical approaches" is that one should buy because a stock or the market has gone up and one should sell because it has declined. This is the exact opposite of sound business sense everywhere else, and it is most unlikely that it can lead to lasting success in Wall Street. In our own stock-market experience and observation, extending over 50 years, we have not known a single person who has consistently or lastingly made money by thus "following the market." We do not hesitate to declare that this approach is as fallacious as it is popular."

We have no problem per se with equity investing. Equities typically comprise roughly a quarter of our client portfolios (admittedly this is likely to be significantly lower than most of our competitors – but then we're not stockbrokers, and we can conceive of attractive assets outside the well-trodden arena of the listed markets). But we do have a problem with valuation, namely with paying up simply to own the market. Happily, there are stock market opportunities out there with deep value characteristics. Perhaps surprisingly, many of those opportunities are in the part of the world already popular with equity market investors: Asia.

Asia, its economies, markets and "fundamentals", probably needs little by way of introduction, but just to recap:

- The region represents almost 70% of the global population, with a share of total income that is now rising rapidly;

- The anticipated rise of the Asian 'middle class' is expected to dominate the next two decades, with a relevant population rising from 500 million to some 3 billion;

- Asian personal consumption has grown by 5-10% per annum over the last five years (years which have simultaneously seen the west enter a profound slump, with a malign combination of Eurozone indebtedness, sagging growth, and widespread austerity programmes);

- Among the industries benefiting from this growth in domestic consumption are food and beverages, clothes, autos, insurance and transport.

We specifically like the secular theme of Asian domestic consumption because we can see the extent to which the western economies have gone spectacularly ex-growth – so Asian exporters to the west hold very little appeal for us.

Greg Fisher, fund manager of the just launched Halley Asian Prosperity Fund, suggests that to do well out of Asia, an investor is required to do two things:

1) Ignore the indices and conventional benchmarks;

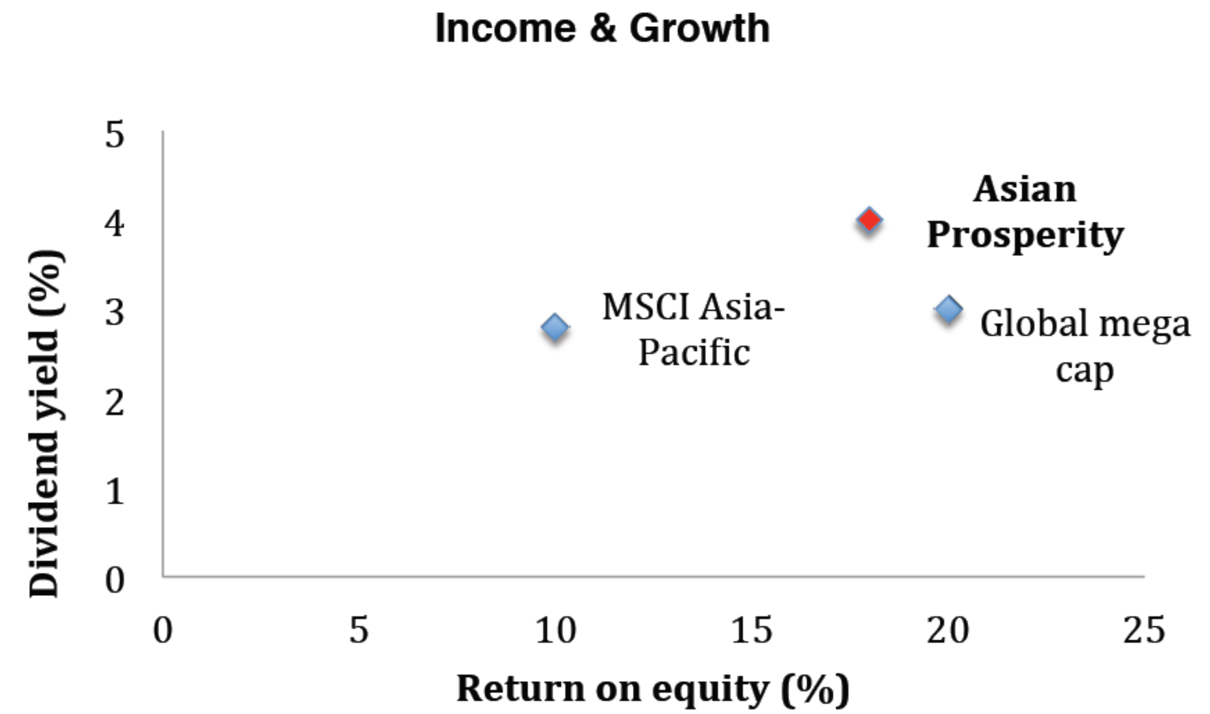
2) Adopt the classic value investing principles of Ben Graham, and focus on metrics like low price / earnings ratios, reliable earnings, and rising dividends.

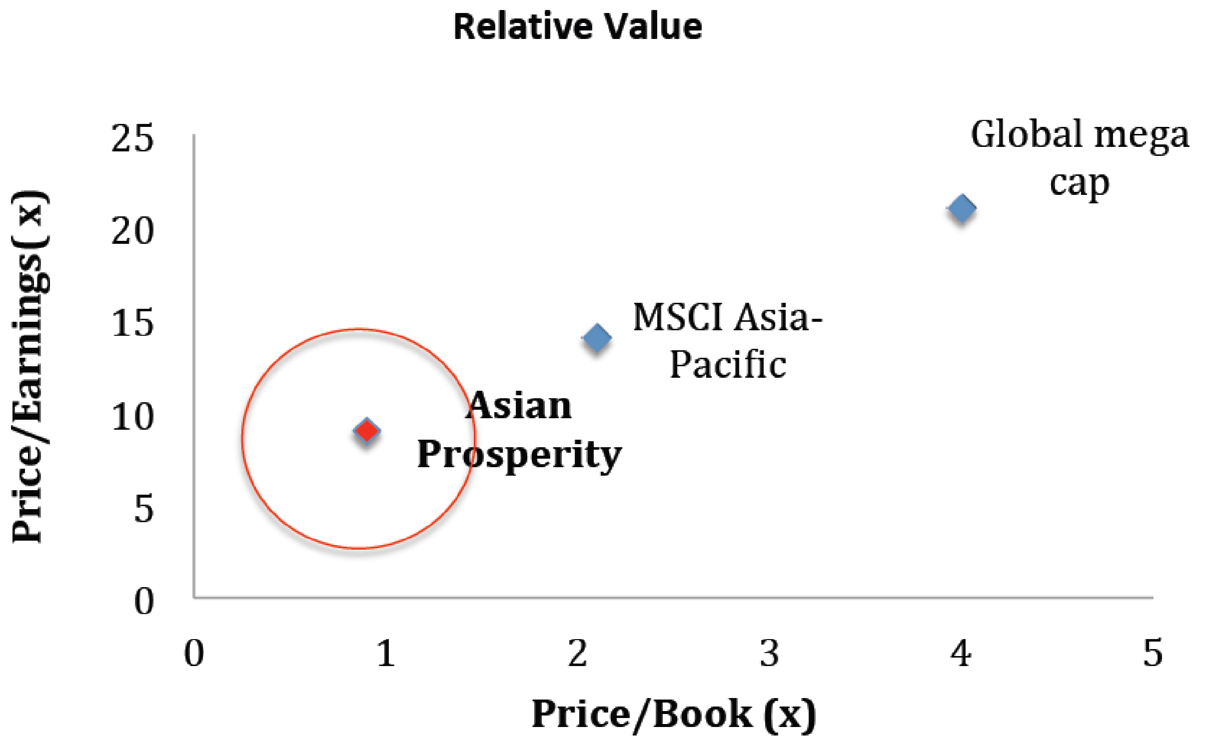
The conventional benchmarks, as always, are problematic. As Greg points out, the MSCI Asia ex-Japan index, for example, has over 70% by value allocated to China, Hong Kong, Taiwan and South Korea. The index "tends to be dominated by inefficient state-controlled Chinese corporations, not run for shareholder profit, the 'old' model of Asian companies, low margin exporters to the west, and expensive technology stocks." Apart from that it's ok.

Another problem with MSCI Asia ex-Japan is that today, most Asian equity funds use this index as a benchmark and therefore overlook Japan entirely. Japan is not without its own issues (with its 'old Asia' exporters, a cult of stuffing shareholders, and with some distressed financials), but it also has mid-cap companies neither selling to the US or Europe, nor selling 100% into the domestic market, but growing in Asia.

To Greg's thinking, Asian equity funds also suffer from the problem of size. Portfolios have a tendency to be dominated "by over-researched large caps where it is very difficult for a manager to have an edge, but also where, because of higher valuations, there is little margin of safety should company earnings disappoint."

A further characteristic of Greg's fund that appeals to us lies in the realm of currency. To the extent that Asian currencies will in many cases appreciate relative to the US dollar and European currencies, Asian Prosperity Fund will benefit from unhedged exposure to those Asian currencies. And whether in terms of ROE or price / book, Asian Prosperity will be run, again, according to classic Graham & Dodd deep value principles:





(Source: Samarang LLP)

In short, in its disdain for conventional indices, and in its commitment to Ben Graham value investing principles, meaningful yield, and potential for currency appreciation, Asian Prosperity Fund looks quite a bit like an equity equivalent to our preferred bond fund, the Wealthy Nations Bond Fund (which last year generated a return of 20.6% in its Singapore Dollar share class). More information on Greg and the fund can be found via http://www.samarangcapital.com. In the interests of complete transparency, we are investors in the fund.

So it is possible to resolve hideously warped markets with the quest for attractive equity investments at sensible valuations. But it necessitates conviction investing, a respect for traditional investment principles, and a healthy disregard for the benchmarks that will snare many less discerning investors (and their advisers). And in the words of Wayne Gretzky, don't skate to where the puck has been, but to where it's going. The puck is going to Asia – we have no doubt about this secular trend whatever. And cushioned with the buffer of a heavily defensive equity thesis, we're very happy to follow it there.

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14th January 2013.

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