ASIA INSIGHT

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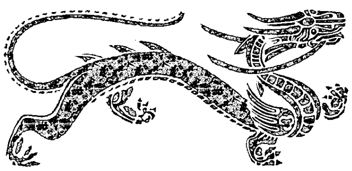

The Game Plan

as of 7/31/08

To China, hosting the Olympics fulfills the dream of a nation. The Chinese have held great expectations for the Games and believed that it would showcase the best of China. As we watched Beijing prepare itself for the Olympics, we noted the changes that the country has undergone and the impact of change that the Olympics will likely bring for China.

In the years leading up to the Olympics, we saw China's economy evolve, and many of these changes were accelerated in the last thirty years. The economic reform of the late 1970s strove to reduce central planning and introduce market-oriented policies to China. With these reforms, the country took an active role in privatizing government-owned assets and promoted private enterprises. Today, the private sector—a sector that had little presence three decades ago—contributes as much as 80% to China's economy. The development of China's stock markets and its accession into the WTO are further examples of its continued commitments to economic openness.

While China's extravagant US$42 billion Olympic budget is telling of its economic strength, it has been a source of controversy. Some have balked at such a large investment, saying it could have been better spent on improvements to health care and social programs, and to help China's tens of millions of rural poor. Others speculate that the large amount of pre-Olympic spending may result in a significant slowdown in China's economy after the event. Some commentators point to the slowdowns following the Olympics in Sydney in 2000 and Seoul in 1988 as a warning.

Costs for Hoopla

Justification both for and against Beijing's spending can be made. But it is important to also note that much of Beijing's Olympic budget—that has gone to plant trees and improve traffic—should endure even beyond the Games. Economically however, the likelihood of a sharp post-Olympic slowdown in China seems small. China's total Olympic budget, from 2003 to 2007, stands about 1% of its total investment spending over the same period. Further, the economic contribution of the capital city of Beijing to the country as a whole stands around 4% of gross domestic product. This implies that should there be a slowdown in Beijing, it is likely to have only a minimal impact to China's overall economy. By comparison, both Sydney and Seoul were much larger economic contributors to their countries, contributing a respective 25% and 28% of their nation's GDP. This closer economic relationship led to a larger impact on the macro economies when slowdowns were noted in the Olympic host cities.

Questions about the sustainability of tourism and consumption following the Olympics have also been raised. Beijing tourism authorities expect around 500,000 Olympic tourists—estimated at roughly a quarter of all foreign visitors to China for the month of August. For the full year however, Olympic visitors are estimated to account for less than 5% of total foreign visitors in 2008. With respect to consumption, a common measure is the aggregate of retail sales across the nation and Beijing accounts for no more than 5% of this national figure. Both these figures indicate a small effect on China's overall tourism and consumption.

With stricter visa restrictions, fewer tourists have been allowed into China and as a result, hotels have recorded lower-than-expected occupancy rates. Some of China's domestic travel, the largest portion of China's tourism industry, has also slowed due to heightened security at airports and the inconvenience of traveling during a busy time. China's tourism may actually benefit when tightened Olympics-related security measures are removed following the event.

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The risks today for China's economy revolve less around its Olympic spending, and have more to do with issues such as an overheating economy and inflation. In coping with its growing problem of inflation, the Chinese government has been known to rein in the economy through raising banks' reserve ratio requirements and interest rates, establishing lending quotas and implementing prohibitive policies on certain sectors to slow growth. We have noted in the past that government overreaction in economic matters can pose risks for investors.

As discussed above, the Olympics may not make a large impact on China's economy. What the Olympics have done for China, however, is arguably something less tangible in nature. The constant media attention has cast a spotlight—or, some may say, glare—on some controversial issues, including China's human rights record and its environmental policies. When the global Olympics torch relay began earlier this year, China's public relations efforts started heading downhill. In one widely publicized attack in France, a pro-Tibet demonstrator tried to grab the torch from Chinese Paralympic fencer, Jin Jing. The incident outraged many Chinese who voiced their disapproval in chat rooms and blogs across the Internet. What did not garner much media attention, however, is that many Chinese have been unprepared for the backlash against their country. Many felt the Olympics would bring only welcomed publicity to China, and were shocked to see the unfolding of anti-China sentiment in other parts of the world. These very revelations have emphasized that China has not made enough progress regarding human rights. Just like the extensive structural development within Beijing for the Olympics, the focus and common measure of advancement for the average Chinese has typically been infrastructure development, which has in some ways resulted in the lack of freer ideological developments.

Steps toward Change

However, mountains cannot be moved overnight, and we do not expect to see any major changes soon to some of China's more controversial policies. We expect, however, that the Olympics are serving as a catalyst to China's eventual improvements of these policies. For example, in an attempt to make room for peaceful dissent, China has set aside space in three Beijing parks as designated protest areas during the Olympics. It has also relaxed media reporting rules, including a change in policy to allow broadcast reporters to send live satellite feeds outside of game venues. Though some may decry these actions as merely token gestures designed to pre-empt any denigration over their policies during the Games, there will come a time when China will realize that "staging" improved conditions for its general population will not be enough to appease the crowd. What is also important to note is that conventional Western thinking may not always work in the East, particularly in a nation as large as China. One may argue that the expectation of China to fully westernize is unrealistic and may do more harm than good for its stability.

The world watched in awe as China left its mark with the opening ceremony of the 29th Olympics Games. Imageries of the country's developments resounded throughout the program and we see how far China has come. One program that highlighted a dazzling display of 2,008 drummers beating in perfect unison not only emphasized the country's sense of collectivism, but it was also a sobering reminder of the might of a superpower on the rise. The delicate balance between China's self-proclaimed "peaceful rise" and competitiveness in the global arena is something that the authoritarian government should seek to maintain.

As China has opened itself up to the world's greatest sporting event, it has also opened itself up for criticism that we hope will spark encouraging change. The backlash against China regarding human rights has at least brought such issues closer to many average Chinese. The country's struggles with other areas, such as air pollution and security, likewise may have the Olympics to credit as a catalyst for change. As the athletes hope to find success before a world audience, up-and-coming Chinese corporate entities are also hoping to compete on a global stage. Indeed, China faces some challenging issues, but we are convinced that its long-term economic fundamentals remain solid, the domestic consumption growth story remains unchanged and an atmosphere of improved friendly engagement and mutual understanding is already taking shape.

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ASSESSING ASSET ALLOCATION

Asset allocation is a subject so broad, it is hard to separate the wood from the trees. We would argue that there are three key questions regarding asset allocation that have generated much research and some controversy over the last decade: first of all, how much and where should an investor allocate money outside the traditional asset classes of equities and fixed income? Second: within equities, how and how much should one allocate outside the U.S.? Third: what is the optimal way of weighting companies in an index? Is this by market capitalization, or by some combination of other characteristics of those companies?

While it is certainly presumptuous for us to weigh in, given the experience and qualifications of those leading the debate over asset allocation, some of the recent commentary on designating allocations abroad has piqued our interest in terms of where Asia fits in a portfolio.

The difficult issue for an investor considering exposure overseas is determining a neutral reference point. In other words, if I decide to have a 40% equity exposure outside the U.S., is that overweight or underweight, and if so, against what? While institutional investment outside the U.S. began in the mid to late 1970s, the average retail investor headed overseas in two major waves: first in the late 1980s, then again during this decade. In both instances, it was a combination of market performance (assisted in both cases by dollar weakness) and socio-economic events that awakened the average American investor to the world

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at large. The first wave was triggered by a dominant Asian manufacturer, Japan, and the fall of the Berlin Wall. The second by another new dominant Asian manufacturer, China, and the global commodity boom. The weak currency added to the sense of relative economic decline, and today, this is reinforced by the notion that America will finally be eclipsed by China as the world's largest economy sometime this century.

In his recent book, “When Markets Collide,” author Mohamed El-Erian describes a multilateral economic future in which domestic demand in emerging markets is a counterbalance to U.S. growth. His recommendation is that U.S. investors be exposed to a “globally diversified” set of stocks, with only one third to half in the U.S.

If you agree with his economic and asset allocation views (we certainly concur about strong domestic demand in Asia), then what does “globally diversified” actually mean?

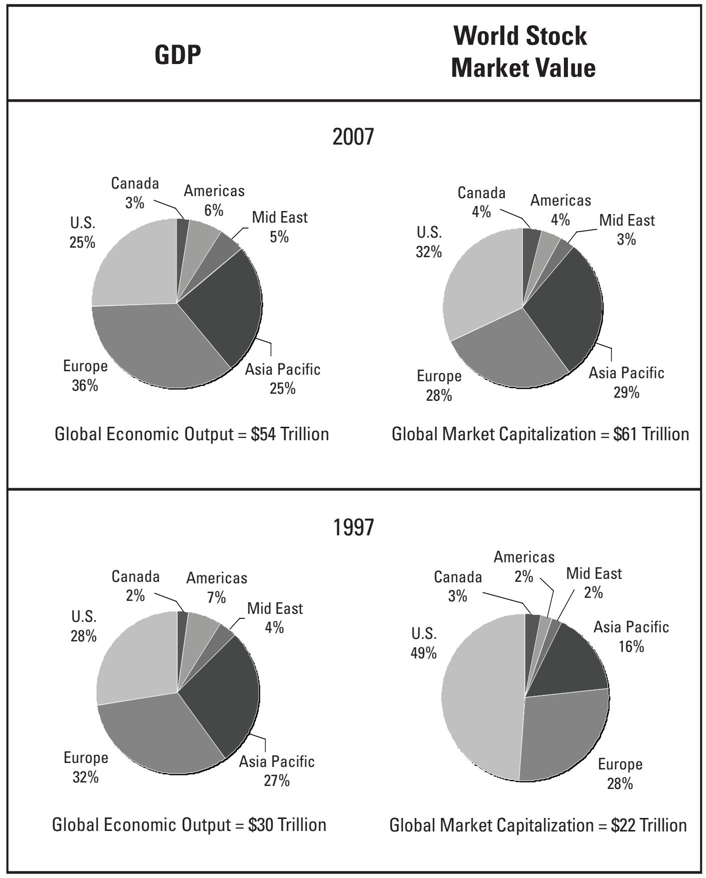
The most obvious approach would be to start with an established benchmark as a frame of reference, but that itself can be misleading. Some argue that the U.S. accounts for more than 40% of world stock market value. But it doesn't. It accounted for 42% of the MSCI World Index at the end of last year. However, as the chart to the right shows, the U.S. accounts for only about 32% of the world stock market value. Why the difference? Investability. Index providers focus on creating benchmarks that are representative and investable, not all-encompassing. For example, China’s domestic A share market and most small companies are excluded from standard global benchmarks.

Total stock market value could be a good neutral frame of reference, except for the risk that bedevils capitalization-weighted construction; you potentially overweight overvalued markets (e.g. Japan accounted for one third of the world's market value in 1990). Now we certainly don't intend to wade into the fundamental vs. market-cap weighting debate. Instead, we suggest an alternative—economic size. But even here you can debate weightings based on purchasing power exchange rate vs. current exchange rate. However, the charts here show some of the potential advantage of a GDP approach. The weightings are not affected by valuation, so you would have had a higher exposure to Asia when valuations were low during the Asian Financial Crisis at the end of 1997. Using this approach would have underweighted Japan relative to a market weighting back at its peak in 1990.

Given the amazing growth of Asia in the last decade, some readers may be surprised to see that the region represents a smaller proportion of the world economy today. Such is the effect of the stagnation of Japan, formerly Asia’s largest economy by far. In addition, the data does not use purchasing power parity, so arguably it understates the actual economic relevance of China and India.

The bottom line in this analysis is there is no absolute right answer. So where is the average investor today? It is clear from our discussions with advisors and clients that there are more ways of implementing a globally diversified portfolio than there are days in a year. To focus on an average would likely hold only marginal value. Instead, we will make very few broad assumptions and review that against our chosen benchmarks, total stock market value and total GDP. If you have 35% of your assets outside the U.S., and you invested 25% in international funds and 10% in emerging market funds, you will likely have anywhere from 5% to 15% in Asia-Pacific, depending on your specific selections. So you have about half our reference weightings.

all data as of 7/31/08



Source: International Monetary Fund; World Federation of Exchanges members; figures are in U.S. dollars

Thus, our contention is that many U.S. investors are underweight the Asia region, especially if you assume that Asia’s high relative economic growth will continue, pushing it to an even larger part of the world's markets and GDP in 10 years time.

Of course, astute readers will have noticed the real mismatch here is the overweight of the U.S. and underweight of Asia. Why not just add a lot more emerging markets? You could, but we think this economic separation of the world makes less sense today, and other schemes (allocation by region or broad international exposures supplemented by regional allocation) are equally valid. But we can get more into that next month.

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