GAM Investment Meeting Notes

For accredited, professional, institutional and/or qualified persons only

31 August 2011

Japan

Ben Williams, Senior Investment Manager, GAM Star Japan Equity, GAM Japan Equity, GAM Japan Equity Hedge

- From our perspective, after looking at Japan for the past decade or so, we were encouraged by Bernanke's Jackson Hole speech – in particular by his comments that politicians must be aware that fiscal policy may also be required. Ever since the US debt ceiling debacle we have been concerned that politicians would try and push through very austere fiscal policies, particularly in the US on the back of the tea party activist movement.
- On the corporate side, Tachihi Enterprises, a real estate company based in Tokyo, was bought out by management. Shares were trading at around JPY 4,000 – below book value, yet with significant real estate on the balance sheet – and the management offered a large premium at JPY 6,300. We have seen a pick-up in share buy-backs recently, and this particular deal indicates there is some corporate activity taking place in Japan if price levels are attractive.
- Another interesting announcement was Toshiba, Sony and Hitachi agreeing to merge their small and mid-sized LCD display businesses to create Japan Display. Hitachi and Sony each had 6% global market share and Toshiba 9%. The new company should have around 22% global market share, which would leapfrog competitors Samsung and Sharp. One of the problems in the technology sector in Japan has been the large number of companies competing for market share. This has pressured margins because of inefficient R&D (due to lack of scale) on the one hand and pricing pressure on the other. This is only a small deal and we would like to see similar deals in mobile handsets, telecom equipment and semiconductors, to name a few. However, it is an encouraging start.

Pacific

Michael Lai, Investment Director, GAM Asia Equity, GAM Asia Equity Hedge, GAM Star Asian Equity, GAM Star Asia-Pacific Equity, GAM Asia-Pacific Equity, GAM Star China Equity, GAM Greater China Equity Hedge

- We anticipate that the decline in consumer and business confidence will eventually be reflected in economic activity. We therefore expect to see a patch of softer economic data releases ahead, including from Asia. It is inevitable that Asian growth will suffer as consumers hold back and corporates delay spending for a period. Markets are pricing this in and we saw a significant drop in August. The uncertainty over the economic outlook could unsettle share prices for a while longer.
- The corporate earnings season was reasonably good. However, the key issue that has become obvious now for a number of companies – and one that has worried us for a while – is rising cost pressures, such as higher material and labour costs. By and large, Asian corporates remain remarkably robust, but in certain areas we are seeing a noticeable pick-up in cost pressures that affect margins. The companies that we speak to tell us that a major concern for them is rising wages impacting their bottom line. This is different from the developed world, as inflation in Asia remains elevated while it is subdued elsewhere.
- Inflation will also remain a key variable in China, and – contrary to what many had believed in past months – we do not see the pressure declining in the second half of this year. This means that we are not likely to see an easing in monetary policy. Other economies that do not have a fixed exchange rate regime have more flexibility. We should see a continued appreciation of Asian currencies to offset these inflationary pressures.
- In our portfolios we continue to prefer the ASEAN economies relative to India and China. The export-oriented economies of Korea and Taiwan have borne the brunt of the sell-off, which we think was somewhat exaggerated. Last week we took the opportunity to buy some Korean stocks at these low levels, and they have rebounded between 10% and 20% from their mid-August lows. These moves illustrate the amount of irrational selling in these markets.
- Looking ahead, the softer economic outlook is clearly not helpful for share prices and will provide a significant headwind. Nevertheless, we remain reasonably constructive over the longer term, especially from a bottom-up perspective.
- Year-to-date, GAM Star Asian Equity has lagged its benchmark despite our reduced exposure to cyclical sectors, such as technology (from around 24% to 15%) and financials. Within technology, we reduced our hardware positions, which have subsequently struggled. This included our holdings in DRAM memory chip manufacturers, including Taiwan Semiconductor Manufacturing in Taiwan as well as Samsung Electronics and Hynix Semiconductors in Korea, which were all affected by investors de-risking. We still have positions in the latter two. However, the software and internet-related stocks such as NHN, Interpark, NC Soft and Tencent, have performed relatively well for us.
- With regards to financials, Chinese banks have shown a lacklustre performance for the past three years. The stocks that we hold, such as China Citic Bank, however, are trading at the bottom range of their valuations and we had expected them to have limited downside potential. However, they have acted as a drag on portfolio performance. The same is true for Chongqing Rural, which had an IPO late last year and has declined 35% year-to-date. For the time being we are still reluctant to build up our exposure to technology or financials given the prevailing macro backdrop.
- We have been underweight supposedly defensive utilities and telecoms, which are both industries that are subject to regulatory price pressures. In several countries across the region power companies, for example, were not allowed to

raise their tariffs to combat rising inflation, despite a sharp rise in input costs. Both sectors were also shunned by many other market participants, and therefore outperformed on a relative basis during the sell-off, as other, more widely held stocks were sold down far more heavily.

- Elsewhere, we prefer industrials, consumer staples and consumer discretionary. In particular, we like oil refineries and petrochemicals. No new refining capacity has been added anywhere in the world over the past 10–15 years. At the same time, Asian economies continue to grow at healthy rates of 4–8% per year. This creates a favourable supply/demand outlook for refineries, giving them pricing power. However, despite these favourable characteristics, refineries are lumped together with other sectors in the category of high-beta cyclicals, making them vulnerable in times of market weakness. We took advantage of the lower prices and added to our favoured holdings, SK Innovation in Korea and Thai Oil in Thailand.

Long Only and Absolute Return Fixed Income

Tim Haywood, Investment Director, GAM Absolute Return Bond Fund, GAM Star Dynamic Global Bond

- Equities have bounced back more than credit in the past few days, which is an interesting situation, because if one believes that recession is really looming then one would not expect this to be the case. We have eased our equity hedge and bought credit, although overall our trading activity has been fairly limited.
- In developing our investment themes, we are looking at purchasing the upper end of the US high-yield debt market – which has fallen by about seven points and retraced two – hedged against an index such as the Russell 2000. We have been adding to our credit allocation, including a new purchase of Bank of America corporate bonds, one day before Warren Buffet unexpectedly but helpfully bought into the bank's equity.
- We have also been taking the opportunity to re-position new shorts in places like Australia, where the short end of the yield curve looks particularly rich. The US perhaps represents the other side of this equation, as bonds have the potential to rally further, particularly beyond five years. That said, the bigger picture shows that many government bonds are very expensive, and long term there appear to be two new chances for convergence. One is intra-European government bond convergence, which we last saw play out significantly back in the late 1990s. If Germany and Italy remain linked by the euro, then to buy Italian bonds and sell German ones will allow us to benefit one more time from a convergence that many thought would never be seen again. Second, the underlying strength in corporates is not being reflected in credit spreads, so they now seem particularly cheap, trading at the widest spread levels seen in 15 years with the single exception of the fourth quarter of 2008.
- In the GAM Absolute Return Bond Fund, we have kept our portfolio largely unchanged and benefited as markets began to rebound. We chose not to make significant ad-hoc changes to our portfolios on this occasion, but instead adopted the philosophy that we liked what we owned before the shift, and not much has become more attractive during the summer. We feel that the current market scenario reflects in part the situation we faced two and a half years ago where the fourth quarter of 2008 set up the opportunities for the second quarter of 2009.
- It seems that most citizens of Greece, Ireland, Portugal and Spain all want to remain in the euro, and therefore abide by the rules imposed. Of all the still-unlikely break-up scenarios, it seems more plausible that Germany may exit the euro, along with the Netherlands, Finland and Austria. If this did play out, it would be likely to create an instant recession in these countries. For this reason, such an outcome remains an unlikely scenario. The big decision we face is when to make a wholesale switch out of the government bonds that we own into cheap corporates on the basis that market pessimism is unwarranted.

Source: GAM