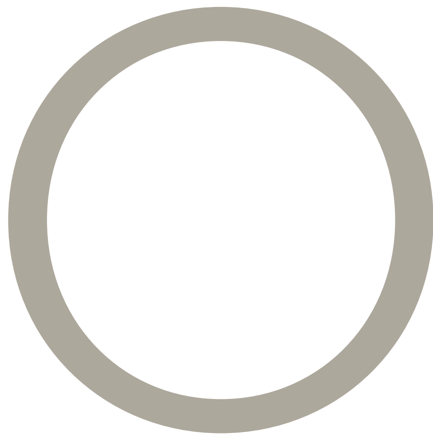

SIR JOHN TEMPLETON INVESTMENT ROUNDTABLE 2018

London | 17th May

JOHN TEMPLETON FOUNDATION | OXFORD METRICA

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THE PARTICIPANTS

MODERATOR
Dr Rory Knight, *Chairman*, Oxford Metrica; *Trustee*, John Templeton Foundation

INVESTMENT MANAGERS
Mark Baribeau, *Managing Director*, Jennison Associates
James Bullock, *Portfolio Manager*, Lindsell Train
C.T. Fitzpatrick, *Founder*, Vulcan Value Partners
Mason Hawkins, *Chairman*, Southeastern Asset Management & Longleaf Partners
James Hunt, *Portfolio Manager*, Tocqueville Asset Management
Bill Kanko, *President*, Black Creek Investment Management
Pinaki Kar, *Portfolio Manager*, DSM Capital Partners
Jun Oh, *Partner*, Wellington Management
Hugh Sergeant, *Partner*, River and Mercantile Asset Management
Amit Wadhwaney, *Partner*, Moerus Capital Management

TEMPLETON FOUNDATION MEMBERS, COMMITTEE MEMBERS & TRUSTEES
Dr John Schott, *Committee Member*
Jennifer Simpson, *Chairman*, John Templeton Foundation
Dr Josephine Templeton, *Member*
Handly Templeton, *Committee Member*
Rebecca M. Templeton, *Trustee*, John Templeton Foundation
Dr Gail Zimmerman, *Trustee*, John Templeton Foundation

TEMPLETON FOUNDATIONS
Tadd Albury, *Financial Controller*, First Trust Bank
Dawn Bryant, *General Counsel*, John Templeton Foundation
Heather Dill, *President*, John Templeton Foundation
Udayan Roy, *President and Chief Executive Officer*, First Trust Bank
Dr Andrew Serazin, *President*, Templeton World Charity Foundation

GUESTS
Mark Deal, *Associate*, Dechert
Thomas Johnson, *Partner*, Dechert
Jane Siebels, *Committee Member*, First Trust Bank

FOREWORD

TROUBLE IS OPPORTUNITY

I am pleased to present the proceedings of the 2018 Sir John Templeton Investment Roundtable, the annual forum in which investment managers from around the world, invited by the Templeton Foundations, debate the threats and opportunities in financial markets.

China, the world's newest superpower, dominated this year's Roundtable as in previous years. In his keynote address, 'The Positive Surprises Keep Coming', Dato' Seri Cheah Cheng-Hye marshalled an impressive array of evidence to illustrate China's continuing rise and its investment opportunities as well as the US-China tensions it has sparked and- speaking with striking candour- the social and spiritual cracks underlying China's material success. The subsequent discussion went on to probe the actual day-to-day reality of China's 'state capitalist' model, the limits to the control it exerts and the changing complexities of Chinese share dealing.

Later, participants focused on Brexit, that 'elephant in the room', on the threats of proxy wars and 'oilmageddon' in the Middle East and on the prospects for the Korean peninsula. It then examined the roots of the New Isolationism, the trade wars it might bring, the spectres of inflation and sovereign debt and the extent to which we can trust central banks to lead us out of the maze.

More positively, attendees touched on current and future investment opportunities: regions like the Eurozone where, unlike the US, the economic cycle had not yet peaked as well as countries now turning the corner like India and Brazil. They then discussed the implications of the unstoppable impact of the high-tech juggernaut before finally weighing the prospects for the investment industry itself – all in line with Sir John Templeton's dictum that 'trouble is opportunity'.

I am certain you will find much of interest and value in their deliberations. The views expressed at the Roundtable discussions do not necessarily reflect the views of the Templeton Foundations, their trustees, officers or employees. I would like to thank all the participants, colleagues and in particular Dato' Seri Cheah Cheng-Hye for his keynote address.

Dr Rory Knight
Moderator

Dr Rory Knight is Chairman of Oxford Metrica and he serves as a trustee of the John Templeton Foundation.
He was previously Dean of Templeton College, Oxford University's business college.

KEYNOTE ADDRESS BY DATO' SERI CHEAH CHENG-HYE

Dato' Seri CHEAH Cheng-Hye is Chairman and Co-Chief Investment Officer of Value Partners Group. He is in charge of the Group's fund management and investment research and he sets the Group's overall business and portfolio strategy. In 2007, he led Value Partners to a successful listing in Hong Kong, making it the first asset management company listed in the city. He has over 30 years of investment experience and is considered a leading practitioner of value investing in Asia. Prior to founding Value Partners, he worked at Morgan Grenfell Group in Hong Kong and had a stint as a financial journalist.

Dato' Seri CHEAH currently serves as an Independent Non-executive Director of Hong Kong Exchanges and Clearing Limited since April 2017. He has been a member of the Hong Kong SAR Government's Financial Services Development Council ("FSDC") since 2015, following a two-year term as a member of the New Business Committee of FSDC since 2013. In addition, he has been a member of The Hong Kong University of Science and Technology ("HKUST") Business School Advisory Council since June 2011. He is also Deputy Chairman of The Malaysian Chamber of Commerce (Hong Kong and Macau).

In August 2016, Dato' Seri CHEAH was conferred Darjah Gemilang Pangkuan Negeri ("DGPN"), one of the highest civil honours granted by the state of Penang in Malaysia to recognize exceptional individuals. The DGPN award comes with the title of "Dato' Seri". In 2013, he was conferred Darjah Setia Pangkuan Negeri ("DSPN") with the title of "Dato'" and was named an Honorary Fellow of the Hong Kong University of Science and Technology.

CHINA - THE POSITIVE SURPRISES KEEP COMING

Like Sir John Templeton, who invested in the potential of surprises not yet priced into markets, I, too, am a contrarian investor. China, I believe, will present the world with surprise after surprise, the vast majority of them highly positive and these in turn will open up truly significant opportunities.

It will be one of the minority of developing countries that succeeds in breaking out of the middle-income bracket, that notorious swamp where so many developing countries remain stuck. Those that have broken out from it like Korea are a small minority. By contrast, many of the rest like Latin America, stay stuck at that stage without any chance of light at the end of the tunnel.

Today, China is an upper middle-income country. However, according to Morgan Stanley, by 2027 China will decisively cross the income threshold for a developed country: $12,476.00 per capita income - not bad going for a nation which in the post-war era was at starvation level. Of course, you have to set things in perspective. US annual per capita income is some $60,000. But it is still a major achievement and it presents a wealth of investment implications given China's potential, with its size and growth, to become the leading developed country.

Current Chinese growth is stronger than was expected. It is expected to be 6% this year and 6.5% next year. A recent survey suggests that by 2027 China will be the biggest economy on the planet followed by the US, India, Japan, Indonesia, Russia and Germany. Every four years the Chinese economy is growing by an amount equal to the entire gross domestic product of the UK. Just picture that – a new UK every four years! These are plain statistics, but the evidence really hits you when you're there and notice the expensive BMWs and Porsches on the road. From a financial or investment point of view that is good. But success also brings its problems, some of them unanticipated.

BAY WATCH

One development largely overlooked by the Western media is China's Greater Bay Area. In June I will be among the guests travelling along the world's longest sea bridge connecting Hong Kong with Zhuhai and Macau. 55 kilometers long, it will cut traveling time between Hong Kong and Zhuhai from three hours to 30 minutes. It's an amazing structure supported by artificial islands facing the South China Sea but it is only one of the major projects in what is fast becoming China's huge new Bay Area combining Hong Kong, Macau, Shenzhen, Guangzhou, and Zhuhai and some eleven other cities in a massive metropolitan area. Right now the area contains 67 million people and in itself an economy the size of Russia or Australia. Within the next five years or so it will have an economy bigger than Germany's in 2015.

Another engine driving Chinese growth is urbanization. China's current urbanization rate is still quite low. Compared to developed countries where the urbanization rate for the population can be 80% to 90%, in China it is still below 60%. But the wave of migration to the cities is continuing apace and represents another positive in terms of economic growth, generating huge demand for infrastructure, appliances and indeed all sorts of goods and services.

FROM SUPPLY CHAIN TO DEMAND CHAIN

China is not only now the world's factory – the dominant player in the supply chain. As the world's second largest consumer market, bigger than the entire consumer market of a major country like Germany or Britain, it is also a leader in the global demand chain. Only one consumer goods and services market is bigger than China and that's the US. But whereas the US is a mature market that took two or three generations to get to this point, in China it happened almost overnight. It's staggering to witness.

For example, the Chinese company Midea is today one of the world's largest producers of white goods. Their brand is everywhere. Just recently they just took over one of the top three robotic manufacturers in Germany called Kuka. The German government almost blocked the deal, but finally decided not to. Midea also uses the Toshiba brand for refrigerators and air conditioners and various other products. I can remember visiting Midea in the 1990s. Its factory was in Zhuhai. It was making air conditioners and its brand was much despised. Originally a state-owned enterprise, through a series of transactions, too complicated to describe, it went through a management buy-out and is now an A-share listed company in China

Now China is moving from goods into services. The government is aiming to create a so-called "Beautiful China," with clean air, better quality growth, less wastage, a move away from financial repression, an enhanced rule of law and a better quality of life generally. Those companies that are able especially to offer healthcare, education, travel stand to make a lot of money. People are way past the 'buy a car, buy a refrigerator' level. Very fascinating to observe, this phenomenon is rousing some jealousy in Hong Kong, which formerly was, of course, far richer than the mainland. Big shots from Hong Kong used to go into mainland China and throw their weight and money about. Not so much anymore.

China now represents a huge consumer market. The biggest market in the world for General Motors, iPhone and Apple is not their home country, the US, but mainland China. There are now some 750 million internet users in China, all demanding digital services, payments, information and social media. To meet these demands giant companies have emerged as world-class competitors. The secret of the global success of companies like Tencent, Alibaba and Baidu is not that they are particularly innovative, but that they have a huge customer base. Chinese are addicted to their smartphones. It's the new Chinese opium.

In online streaming, communications and payment systems China is outstripping the world. They have leapfrogged Western checkbooks and even credit cards. Most young Chinese wouldn't even know what a checkbook is! The advent of e-commerce is having a vast impact. Shopping malls in China are increasingly not selling goods because there simply isn't the demand there. Instead they are switching to selling services such as facials or whatever.

THE GOAL: TO DOMINATE THE VALUE CHAIN

There is another chain that is even more important than even the demand chain. It is the value chain. If you are successful in the value chain you own the brand, the intellectual property, the design and the industry standards. In this chain there's only one real superpower at present: the USA, followed by Japan and Germany and to some extent the UK. The real reason the US feels threatened by China is that China, having advanced from the supply chain in the 1990s to the demand chain currently, now aims to move into the value chain. The value chain represents the final frontier, the last battle. Who captures it will be the next dominant superpower.

A YOUNG OLD COUNTRY

China has traditionally been seen as an ancient civilization but among the major developed countries, China is the youngest. The current government and society in China dates only from 1949 when the Communist Party took over after having defeated the Kuomintang, the Nationalist Party, in the civil war. The United States likes to think of itself as a young country but it is, in fact, quite old. Its system of government dates back to 1786. China, being a young country, knows only one thing: that change is good.

China went through a traumatic experience, the Cultural Revolution. People look back not with nostalgia, but dread. They can only look forward. You see this by comparing Hong Kong with mainland China. Hong Kong is scared of change. They are proud of their legacy as a territory of the United Kingdom. Almost nothing can be changed in Hong Kong now. It is deadlocked. But in China, people talk constantly about change, as though it were a great blessing. They're going to make mistakes, sure, but they will get it right more often than wrong. They have lifted half a billion people out of poverty since 1979 and are rightly proud of this incredible achievement.

But stability and consistency are good too. It may go against the grain of liberal democratic thinking, but personally I believe that the recent controversial decision to remove the term limits for the Chinese president Xi Jinping is actually good for the investor. It provides an ingredient that is increasingly conspicuous by its absence in the world today, which is strong, stable and predictable leadership.

THE BEST OF FRENEMIES?

America's position is conflicted. It wants China to provide a big consumer market, but does not want China to move up the value chain. But these two developments are two sides of the same coin. How can China develop as a consumer market if it doesn't have the capacity to move up the value chain? I think the medium to long-term prospect is going to be one of friction and continuing conflict, as the US as the incumbent superpower tries to slow down or even obstruct the rise of a potential new superpower.

It's going to be difficult. The Chinese people won't be willing to compromise. Much of the discussion in the Chinese internet media these days is about how the country must become much more self-sufficient and not a hostage to vital components from the US. Kissinger was recently quoted that this period is like the period before World War I: incumbent superpower versus rising superpower. People are even envisaging scenarios like a new Cold War or a new technological war between the United States and China, with Europe caught somewhere in between. Maybe, hopefully, they are wrong.

Most problematic at the moment is the trade relationship between China and the United States. The media is hypnotised by America's $375 billion trade deficit with China. But you need to look at the trading relationship in total, not only the merchandise trade between two countries captured by customs figures. America has immense business interests in the form of subsidiaries in mainland China, not only iPhone but General Motors (GMC), Ford, Kentucky Fried Chicken, Starbucks, Caterpillar, and, of course, Boeing. A recent Deutsche Bank study calculated that, taking into account subsidiary sales, the deficit is less than 10% of the official figure. Another way of looking at things involves 'intermediate goods': the huge amounts of components from Japan, Korea, Taiwan and other countries that go into products sold by China to America. America's trade deficit with China would be roughly 35% lower than the official figure if you take this category into account. So, if you look at the overall picture, the trade relationship between the two countries is actually reasonably well-balanced.

I think the Trump administration is, in fact, well aware of this. And there's too much at stake for American companies which is why I'm confident that US business interests will push back against the tariffs. China, in its turn, needs a solution and is willing to bend over backwards to compromise.
There will probably be a truce or a temporary compromise of some sort, but not a permanent solution. Because the real fight isn't about trade, but the battle to dominate the value chain. That will be very difficult to resolve because the Chinese will not give way on that. They feel they have the right to be world-class. They don't intend to be laundry men forever.

COULD IT ALL GO WRONG?

Lastly, I want to turn to what could go wrong with my basically rosy scenario from an investment perspective. It is often pointed out that China's long-term demographics do not look good. Like many countries around the world, it faces an aging population. But the picture is not quite as grim as often thought because of China's education dividend. Each year the country is producing roughly 7.5 million college graduates - the pay-off from putting huge resources into education over the last ten years. In addition, Chinese workers on average now have nine years of schooling compared to eight in 2010. That extra year is already having a significant impact. Another factor offsetting the negative impact of an aging population is that China is now a global leader in the use of robotics in its factories.

Another problem often raised is China's potential debt crisis. China, undoubtedly, built up debt very quickly after 2008. In fact, many Chinese leaders think they did the world a great service after the financial crisis of 2008 when Wen Jiabao ordered a stimulus in the shape of massive reflation. Not a lot of people thank China for that. But it came at a cost. There has been an alarming increase in Chinese debt to the point where it is slightly over 270% of GDP. So why are people like me relatively relaxed about it and don't subscribe to the view of some of the well-known short sellers you see on CNBC or Bloomberg? Because, when you really analyse the situation, you'll find it's nowhere as bad as you might think.

For one thing debt is concentrated in state-owned enterprises (SOEs) and in local governments. And the lenders are state-owned banks. So in a way the Communist Party is lending to the Communist Party. And it is all domestic debt. China doesn't owe anything to foreign countries. In fact, on a net basis, China is a creditor to the rest of the world. China's credit position to the world is equivalent to 15% of GDP. More importantly, the area that should really interest investors is the main engine of the Chinese economy: the private sector. Over 70% of employment is now in the private sector. The banks have never favoured this sector, so it's not hugely leveraged. Capacity utilisation bottomed out in 2016 and has been improving since, so profits are actually doing well. Chinese debt looks superficially dangerous, but when you tunnel down, it looks much more manageable.

China also has one of the world's biggest savings pools, one that is largely trapped in the country because of government capital controls. That is changing, but for the time being the Chinese banks can take their funding for granted because the depositors have nowhere to put their money apart from bank deposits or real estate, where the opportunities incidentally are also quite tight: one apartment per family or person, depending on the city.

It amounts to financial repression. At the moment that is positive in that it helps China fund its debt mountain. But it's also negative in the longer run if the country is to become an advanced economy. In response President Xi Jinping has announced a program to gradually deregulate, open up markets and enhance the rule of law and enhance ownership rights in China. It may have the unintended effect of making Chinese debt more dangerous because people will have more ways

to part with their money and banks will not be able to take discounting for granted. But China has to do it. I have witnessed huge amounts of wasted capital in China: money being lent to people who can't use it properly because it's so abundant and so cheap; because it's their money and they have nowhere else to put it.

In the last couple of years, the priority has been cleaning up the financial sector before introducing more deregulation. There were a lot of irregular practices such as shadow banking and unauthorised wealth management products and other irregular financial practices in the Chinese capital markets. If they can successfully solve this, there is not much to stop China from achieving its goal of becoming a fully developed country by 2027.

But perhaps the biggest risk to China's development lies in changing attitudes in the US. The US seems to be turning its back on globalism and many of the Western democracies are also being swept along in the same wave of populist thinking. This could create a breakdown in the global economic system that we have enjoyed since the 1990s.

CRACKS IN THE MATERIALIST SURFACE?

Another challenge concerns social stability. In the West, political institutions, power transitions and the rule of law can be taken for granted. Not so in developing countries. China is a vast country with a difficult history and some serious emerging problems - the gap between rich and poor, the environment and the financial repression already mentioned. With access to the internet people are more aware than ever that they are not getting a good deal from the Chinese capital market while a few fat cats are doing very well indeed.

The Chinese man in the street feels he is breaking his back in the hope that, given the poor welfare system, he will get better housing, medical care and education for his kids. But it's really not a very satisfactory long-term situation. Social stability in China can be fragile in times of stress. It's a big country with lots of different groupings and the Chinese people, by nature a bit uncivil and rebellious, are not easy to manage. There is a lot to improve, in terms of civil behaviour. There's always this underlying, inescapable sense of tension that somehow, somewhere, something or other will break down and chaos will erupt.

People are scrambling for solutions. Some even long for the good old days of Chairman Mao, when the country was very poor, but very simple and when everyone was more or less the same. Another response in the major cities is a quiet, but powerful tide of interest in Christianity, Buddhism and other religions. I know it's surprising, but it's true, especially among young people. They sense that something is missing in the equation. More prosperity, yes, bigger cars, yes, more appliances, yes - but it is not enough. Spiritually the country is searching for a more meaningful answer. Do all societies go through that in this stage as they develop? Perhaps. And what are the investment implications? Unfortunately, I have to confess I do not have any answers to those questions.

KEYNOTE SPEECH DISCUSSION

THE COMMUNIST PARTY: DEAD HAND OR HELPING HAND?

'Will the government try to increase control over investors by means of technology?' asked a participant. 'On the face of it, the party is going to continue to fight to maintain control, Cheah replied. China now is only one of five Communist countries in the world although in fact it practices what amounts to a kind of state capitalism. Surveys show 80% support for President Xi Jinping. In everyday life people are surprisingly free. The individual Chinese man or woman enjoys more freedom today than at any time in the history of China, so long as they don't get involved in politics and oppose the Communist Party. That said, the party's official view is that the Western model is failing and that with big data and supercomputers and the internet, it will be possible for communism to be practiced more efficiently. But I don't know if they really believe in what they're saying. In ten years China will probably find a path to a more hybrid kind of system between Western liberal democracy and communism.'

THE FUTURE'S BRIGHT

'I believe that we are entering a golden period of opportunity,' stated Cheah, 'offering with the greatest opportunities ever seen in the history of the asset management industry in China. The same conditions that in the 1950s in the US allowed giant brands like Capital Group, Templeton and Fidelity to emerge now exist in China. China has no way forward except to follow deregulation, opening up its markets, enhancing the rule of law, protection of ownership rights and liberalization. Financial repression is on its last legs because otherwise the lid will come off and there will be huge capital flight from Chinese households looking for a better return.'

'There is evidence of the changes in my own company. In November, we were granted our first PFM licence, which means we are now able to fundraise under our own brand in China from institutional investors. Previously, we had to go through the Big Five banks which charge excessive fees. We have been told we may get a full asset management licence by 2020. We were also given a private equity licence in Shenzhen, using which we will open our first office in mainland China. Our biggest fund may soon get a Mutual Fund Recognition (MFR) licence allowing it to be sold directly to the Chinese public. I feel the new mood is a development of historical importance in human history. I live in a state of constant intellectual excitement as I travel the country. It's a turning point for the world, for better or worse.'

PUBLIC OR PRIVATE?

'The good news is that private enterprise is leaping ahead,' said Cheah. 'As recently as 2000 90% of listed Chinese companies were state-owned; now the figure is 50% and by 2020 likely to be 25%. These companies are under more pressure to perform. Their ROE is higher and efficiency greater. In the old state-owned enterprises (SOEs) managements generally fail to maximise profits. In fact, I know of some Hong Kong fund managers who actually invest in SOEs because of their underutilised potential. Personally, I have no hang-up whether companies are state-owned or not except that we are value-oriented and SOEs tend to be cautious and play by the book.'

'Does the state still exert influence over non-SOEs?' asked a participant. 'It is a factor,' Cheah admitted, citing PetroChina which imports gas at prices guaranteed to lose money because the Chinese government signed agreements with source countries at levels favourable to them. In consequence PetroChina's shares underperformed. 'We find that same pattern across the board where loyalty to country is more important than the interests of individual shareholders. So you have to be flexible and prepared to put a discount on that factor.'

GOING GREEN?

Participants asked about opportunities to invest in companies working to protect China's environment – a pressing concern. 'Quite a number are popular in China and accessible to foreign investors,' said Cheah, 'such as the hydro-electricity company Yangtze Power which has a huge market cap. There are also smaller companies specialising in various environmentally friendly things like green energy or electric cars or the wind power guys. But they are so well-discovered that I focus on the more innovative companies that, for example, specialise in smart meters to monitor water consumption intelligently.'

WEIGHTING THE SCALE

Participants voiced concerns about corporate governance, especially minority discounts and variable voting rights. 'Governance has greatly improved,' replied Cheah. 'It was very bad in the 1990s, but is now actually above average for emerging markets, partly because penalties are very harsh. In fact, rather than dishonesty, I'm more worried about inefficiency and lack of competence.'

'As to variable voting rights, Hong Kong now licenses shares where the founder has five times more votes than other shareholders. I'm conflicted regarding this because apart from being a professional fund manager, I'm also on the Board of Hong Kong Exchange which recently turned down the opportunity for one of the biggest listings in the history of the world, refusing to let it have variable voting rights: Alibaba. In response Alibaba went off to New York in 2015.'

'It was a major blow. Alibaba's trading volume is equivalent to 15% of the entire trading volume of the Hong Kong Stock Exchange. Hong Kong also saw that Ant Financial and Xiaomi and several pre-profit, biotech and medical companies were about to flee to New York for listing. The compromise that has been agreed is that Hong Kong will allow variable voting rights, but only under strict criteria. You've got to have a certain size, history and track record and only individuals are allowed to have the more powerful voting rights. If that individual sells or dies or whatever, that right is extinguished. For now companies will not have superpower voting rights. It's a thorny issue on which I don't have a clear position myself.'

IN THE THROES OF CHANGE

'Chinese stocks fall into various categories,' he continued, 'some in Hong Kong and New York and a few in London and Singapore. On the Chinese mainland itself they're called A-shares. It's a huge market. Something like 3,500 companies listed on mainland China. It is the world's largest equity market after New York and it's very much a domestic market, dominated by retail Chinese investors. There are 100 million retail accounts and investors treat the market like a casino, a crazy short-term market where people buy small companies whose price can jump or fall very quickly.'

'Most also have substantial holdings in Chinese banks. Here, long-term value institutional investors like us enjoy certain advantages. The big Chinese banks like us on that account. These banks generally trade below book value and are not allowed to fail. So we've been buying these banks and made a lot of money recently when the banking sector was re-rated.'

'Out of the blue the Chinese government recently announced that they want companies to go back to China for listing in Shanghai or Shenzhen in the shape of Chinese Depositary Receipts (CDRs). Hong Kong felt under pressure because now, not only is New York a rival, but also potentially Shanghai. It's a very tense and complex game where everyone's afraid someone else is stealing their bread

and butter. At present most of our assets are listed in Hong Kong and we only use the Hong Kong Stock Exchange's Stock Connect Program to buy in China. However, we anticipate moving far more money to China in future. We have been told by the Chinese banks that give us mandates, whose typical size is $200 million to $500 million, that they want the investments to be in the shape of A-shares.'

'Chinese shares have not been easily accessible to foreign investors. Foreign ownership to this day is only 2%. However, MSCI is about to admit some of the more important A-shares into its Index, so making them better known internationally. Based on experience in Korea and Taiwan, Chinese domestic A-shares will continue to increase in numbers and importance and they could become an important part of our investment universe, especially if you are MSCI benchmark-conscious.'

A NEW CENTRE OF GRAVITY?

Dr Knight pointed out Tencent took a different route. As well as being traded in Hong Kong it has a very active American Depository Receipts (ADR) programme. 'Will the advent of the Chinese equivalent, the CDRs, detract from the ADR programme?' he asked. 'It's possible', Cheah thought but added: 'The Chinese requirement is not as threatening as at first thought because only companies with a minimum market cap of $100 billion will be invited to issue CDRs and only about five or six companies meet that criteria.'

'So is China poised to take the super power mantle from the US?' asked Dr Knight. Cheah thought not. 'Personally, I think China has to solve its own issues with its identity as a civilized country first. We are eagerly awaiting the next generation of Chinese who will be much more multi-dimensional, in terms of attitudes, not only respecting China, but also the rest of the world. A narrow approach focusing solely on China's interests is not fit to fill any vacuum left by the US. I favour continuing financial leadership by the US. It may not be perfect, but it's predictable.'

POLITICAL AND ECONOMIC CHALLENGES

BREXIT: THE ETERNAL ELEPHANT

'Brexit remains the elephant in the room,' commented Dr Knight. 'When we last discussed Brexit a lot of people thought it wasn't going to happen, but it did. To what extent has it been reflected in prices and built into your prognosis?'
'In the wake of the referendum our view was that UK equities should be avoided,' commented one manager. 'The UK economy had been growing ahead of most other developed world markets. A combination of strong growth, relatively unconvincing valuations and clearly a high degree of political uncertainty made us quite cautious.'

'Fast forward and that caution has become so standard that it has created significant opportunities. Valuations have now become very attractive, with the UK trading between 20% and 40% below its long-term average. Economic growth has significantly moderated and that has been built into expectations. But investors round the world remain very negative in terms of their view on the UK domestic market. These factors incline us – in line with John Templeton's contrarian approach - to favour the UK equity market.'

'The final outcome of Brexit I would not care to speculate on. A key question remains whether the United Kingdom stands apart or commits to some form of customs union with the Eurozone. But the situation is much clearer than two years ago. Many developed countries have become more inward looking, particularly over the sensitive issue of immigration, but I think that has peaked in the UK.'

'Does the value of sterling play into your point about cheapness,' asked Dr Knight, 'or represent another layer of risk? It was $1.50, went down to $1.20 and is now about $1.35. Do you think it might next year get back to $1.50?'
'Not that far,' the manager replied, 'but it will trend more positively. Sterling is still relatively volatile, but on balance it is cheap and that inclines us to be supportive of sterling investments.'

KOREA: GOING TALKIES

Dr Knight moved the discussion to the Korean peninsula. 'With the Winter Olympics and the two countries under the same flag it was looking very optimistic. A summit may or may not be now on the cards. Last year Henry Kissinger in a talk said something that struck me very forcibly: "If Korea does not get fixed within 18 months, we will have massive problems." We're now at that point, so I have two questions: if the summit works out, will the North become the new frontier market and if it doesn't work, what are the risks?'
'It's important to define "work out",' replied an experienced investor. 'The US wants denuclearisation but I don't think that's on the table. The North Koreans won't be willing to give that up. What North Korea would really like is to get a lot of money from South Korea or the US. The last time they had a summit Dae Jung Kim, who won the Nobel Peace Prize, sent over half a billion dollars in cash to bring it about. And they probably think that given the mercurial nature of Trump this might be their best chance to get a good deal.
But regardless of what happens, it's good that the parties are at least talking and looking beyond the summit, there's no doubt the South Korean equity market will continue to represent tremendous value. Korea is the cheapest market in Asia, trading at close to twice the book value and four to five times earnings. If you look at what has happened over the last twelve months, Korea has had a president impeached for corruption followed by a president with a mandate for reform. He wants to break up the power of dominant groups and I think they have got the message. We will see more corporate reforms and better shareholder returns. So, regardless of what happens with North Korea, there is a tremendous case for re-rating the Korean market.'

'Any specific comments on Samsung?' asked Dr Knight.
'If you look at what Samsung has done,' said the manager, 'it's phenomenal. Samsung Electronics accounts for about 30% of Korea's total market cap. In 2012 Samsung's dividend ratio was about 10%. The company has bought back $10 to $20 billion of stock in the past five years. They have promised over the next three years to give back 50% of their total free cash flow in dividends and buybacks.'

'So, if you're a Korean company competing with Samsung, the brand leader with the best technology, what are you going to do? Would any foreign investor invest in a small one or two billion-dollar Korean company unless that company was a materials or auto company with really high growth prospects and a business model better than Samsung's? That could really shake up the whole corporate culture. I think we'll see something similar to what happened in Japan after Abe was elected in 2012, with corporate dividends and buyback increasing year after year.'

'Where do you see pressure for change coming from?'a participant asked.
'The same source – a combination of government and market. In response, the fund management companies are adopting stewardship codes and the government through the efforts of the national supervisory council, is forcing the chaebol groups to break up or clarify their structures. When the president said, "We expect the Hyundai Motor Group in twelve months to clean up their structure", within a couple months they took action. Even companies or chaebol groups not in the top ten are adopting more transparent structures. In countries and societies like Japan and Korea, which tends to be conformist, once you get some amount of momentum, then everybody jumps on the bandwagon.'

Dr Knight put the contrary view: 'Korea is the economic phenomenon of our lifetime. The chaebol structure has served it well. Who says Anglo-American corporate governance structure is the best way to develop an economy? Is there a danger Korea will go too fast in dismantling a system that has served it well?'

'Just because chaebols served their purpose in the past does not mean they will in future,' the speaker replied. 'If you look at the chaebols, which is better off now than they were ten years ago? Very few. I would say only Samsung has actually improved. So, I think it's time for Korea's whole economic structure to move on.'

'Has the activist investor movement had an impact in Korea?' asked Dr Knight.
'I wouldn't exactly say that I'm an activist, but I do engage with managements to try to influence their behaviour,' said the speaker. 'In Asia you often have young management teams that haven't gone through multiple economic cycles and can consequently make poor decisions. Secondly, there are a lot of family-owned businesses who view shareholders as second-class citizens. So there's scope for beneficial intervention. But you have to tread carefully. If you go to a Japanese company as a foreign shareholder buying 10% of a company which has 80% of its market cap in cash and say, "I want you to pay a billion dollars in special dividends starting next month", the response will be: "It took us 40 years to get that cash pile. What right do you have, after buying our shares only last week, to demand half of that?" And there's some point to that. But all the same, there's got to be progress.'

OILMAGGEDON?

'What are the investment implications of the US withdrawing from the Iran Treaty?' asked Dr Knight. 'Might it spark a proxy war between Iran and Israel and what would be the consequences?'
'We've already had what amounts to a proxy war in the Middle East, in Syria and now in Iraq,' an attendee remarked. 'New conflicts could well impact on oil prices. We're at the end of a period when production has been subdued. There's also been a belief in the ability of US producers to increase production at a low

marginal cost. But global demand is growing. Venezuela's production has dropped dramatically. So there's a potential threat. A contrarian Templetonian take might be that supply and demand get massively out of kilter very quickly and the price goes through the roof. The implications of that would be very serious both for producers and service companies and for users.'

WHAT'S DRIVING AMERICA FIRST?

'There are three great forces in the world right now that markets and societies are struggling to come to terms with,' a speaker stated. 'The first is the China-US imbalances already discussed. The second is the impact of Middle Eastern migration, primarily to Europe and, linked to that, the rise of terrorism as an international weapon. That has had significant psychological impact. The Western democracies have shifted from a position of progressive inclusiveness to one geared towards achieving greater security. That lies in part behind Trump's rise in popularity. But we've seen the same with Brexit and in Germany and Hungary.'

'The third factor is the New Left, an intellectual force far more far-reaching than often appreciated. Starting in the 1920s with Antonio Gramsci in Italy who had a different view about how communism should evolve in the West, his writings influenced the Frankfurt School of Philosophy after World War II and the kind of New Left thinking that gained legitimacy in universities. That in turn led to the emergence of political correctness. What we are now seeing is a reaction to that by the rest of society, especially in the United States but also worldwide.'

'Personally, I think Trump's less unpredictable than he seems. The best way to understand him is to read his Art of the Deal where he makes clear how he operates: beginning with extreme demands and trying to put the opponent in a position in which he has to make concessions. While he's undoubtedly very impulsive and narcissistic, there's a kind of business approach behind what he's doing, one that in the United States has reinvigorated the engine of the economy. Whether that will hold true for in the rest of world or not, I do not know.'

TRADE WARS ON THE HORIZON?

'Doesn't President Trump have a point calling out trade practices in Europe and China?' enquired Dr Knight. 'Is a full-on trade war on the cards? What would be the effects?' 'Of all the risks around the world, a trade war is one of the most serious,' said a manager. 'Oil might go up, but in a few years it's going to be dirt cheap because of electrification of vehicles. But trade is another matter altogether because it impacts the profit stream of the many companies that trade with China. Who cares much about steel? It won't matter to China because it has so much excess capacity. What really matters to the international community is the quietly effective pressure they can exert in other areas. Take something as simple as cosmetics. Korea used to have a booming cosmetics business in China, but then anti-defence missile systems were deployed in South Korea which China didn't like. Two years later stocks of Korean cosmetics companies are now nowhere near their 2016 highs whereas French and US companies like L'Oréal and Estée Lauder are near 52-week highs. China can put enormous indirect pressure on Western goods and services. Fortunately, there are lots of vested interests in the west. These and their lobbyists can make their position pretty clear. Given what we've seen so far, the best hope is a truce. Hope's not a good strategy, but we've got to hang onto it.'

Another participant chipped in: 'Trump may be a narcissist but as a TV show host he's aware of the need to maintain ratings. Trump needs to get votes. There's a mid-term elections coming up and he doesn't have any big wins yet. Look at where the people who supported him stand: farmers - the U-turn on the TTP and the fight with Mexico have hurt them and the fight with China even

more; factory workers - closed factories were going to reopen, new factories were to be built and the new Tax Act would repatriate construction. Well, that hasn't happened. So something's got to give before the next election. Deals are going to have to be cut. The U-turn on ZTE was a straw in the wind.'

INFLATION: NO LONGER ON THE BACKBURNER?

'Could we change gear and think about economics,' said Dr Knight. 'Is inflation looming again as an issue?'

'It's an increasing threat,' one participant declared. 'If you look at asset classes round the world since the crisis, because of low interest rates, we've had inflation in prices. However, we haven't really seen it yet in the real economy. In the US inflation is close to 2.5%, in the UK around 2.5% and the rest of Europe under 1%. I'm worried about inflation in China, especially since its currency has been largely pegged to the free-floating dollar. China has published an inflation figure below 1%, but I'm dubious about that. For the last half dozen years the companies we're in contact with have experienced labour inflation of up to 7%.'

'So, inflation is ticking up. We're at an inflection point following nine years of bull markets that benefited from repressed interest rates. We're now at a point where rates are starting to change and, because rates have been so low, you could see massive volatility in stock prices. As rates start to rise and expectations change, values can whip around a lot.'

'Inflation will probably return,' agreed another manager, 'but there could even be a kind of solution in that. Warren Buffett says, "Don't worry about debt because the US can repay it without hitting any kind of bump in the road." I wonder. He also has the funny idea that government should eliminate all taxes and there'd be an unimaginably huge economic boom. And each year the Treasury should just print money equal to 4% of GDP and that would control spending. The only trouble is that the next year after that you'd have to have to print 5%, then 6% and so on.'

'There's one interesting view,' added another participant, 'that the correlation between interest rates and asset price inflation isn't well established; that if you're a long-term equity owner with companies generating real cash flows, you will be able to access real cash flows into the future and therefore interest rates and inflation don't necessarily matter. The corollary is that if you invest in really high-quality companies with a great pedigree and pricing power, you have the ability to price ahead of inflation and protect your owners from it. This suggests building interest rates into the discount rate to value equities may not even be needed.'

CAN WE TRUST THE BANKERS?

Dr Knight asked: 'Is there a risk of missteps by central banks? This month a senior figure in the New York Federal Reserve went on record that there's no way the Fed can reduce its balance sheet from the $4.4 trillion to the $800 billion in 2008. What would be the consequences of central banks getting things even slightly wrong?'

'Certainly there's no way that the United States could ever repay its debt,' a participant agreed. 'If there was another 2008, with an incumbent Trump, would we apply 1930s-type actions? Would the US simply cut the dividends that it pays on bonds? I doubt it. On the other hand I didn't think Trump could win and I didn't think Brexit had a ghost of a chance. So, like Sir John always said, you cannot predict the future.

INVESTMENT OPPORTUNITIES

RIDE THE CYCLES

'We believe everything has a cycle - good and bad,' said a speaker. 'The global financial crisis created big profitability, dislocations and opportunities to buy into US equities when profits were depressed and valuations attractive.'

'Fast forward and the cycle is clearly very mature. In the US profitability is significantly higher than of any pre-crisis peaks and the valuations on those high levels of profitability are also high. The global benchmark is dominated by the US equity market, so we're cautious about that element of the global benchmark. But there are lots of opportunities elsewhere where the cycle is less mature. If you look round the rest of the world, a lot of regions fit that criterion. The Eurozone has only been in a bull market for eighteen months and there's a big valuation gap between European and US assets. We also take a positive view of the Asia Pacific region including Japan and Korea.'

'One further observation about the interest-rate cycle that has profound implications for stock picking round the world: interest rates have fallen for some thirty years and bond yields trended downwards given the policies adopted after the crisis. It has created a bubble in sovereign debt. The proxies for that debt were companies that had cash-flow characteristics similar to bonds. As bond yields bottom out and trend outwards, that will undermine those businesses, some of those bond proxy-type stocks, strengthening the case for traditional value investing which has been struggling. That's an opportunity we're hoping to exploit.'

INDIA: THE NEXT CHINA?

'India has enormous potential in scale and capabilities,' commented Dr Knight. 'What are the specific opportunities?'
In response a participant highlighted India's private banks, some of which have been strong performers in both their liabilities and assets. He added that in the wake of the recent clean-up that trend will continue. Other opportunities can be found in in automobile and consumer companies, although some valuations there are quite high.

'India could be the next China in financial systems and digital and mobile payments,' stated another speaker. 'Although it's not as easy to do business as in China, PayTM is probably going to be the leading player there. 40% of it is owned by Ant Financial so it will benefit from Alibaba's technology. In the consumer field Amazon's fighting Flipkart in India, but it's too early to tell who will win. But the roadmap's clear: not bricks-and-mortar, but digital.'

BRAZIL: GETTING IT TOGETHER

'What about Brazil,' asked Dr Knight, 'an area the Roundtable has rather neglected of late.''Brazil has just been through a recession like it hasn't experienced in thirty years: some seven quarters of downturn and with one in four Brazilians unemployed. The reason was that Brazil had tied itself to China's star, especially in iron ore and soya exports. Other problems included corruption and money laundering. These impacted on the National Development Bank (BNDS), but the outcome might be positive. BNDS had crowded out private banks and they have now been able to enter the field. Petrobras, another big source of finance, has also been cleaned up. So things are looking up. The growth rate has picked up, as have retail sales. There's another bright spot: Brazil now benefits from some very competent central bank governors who are getting to grips with inflation. Rates are down to about 2.7% - an amazingly low number for Brazil. The Selic (Sistema Especial de Liquidação e Custodia) rate is now about 6.5%. The elephant in the room here is the forthcoming election which may bring a return to the bad old ways. The odds are that the upturn will continue.'

Another participant agreed that Brazil's prospects looked brighter. The political uncertainty there coupled with Argentina's could paradoxically create opportunities. But, he added, pension reform would also be essential.

THE HIGH TECH JUGGERNAUT

'Are tech companies like Amazon overvalued?' asked Dr Knight.

'Amazon's an unusual case,' a manager replied. 'There's a lot of variety in the sector including companies like SAP and more speculative companies like Snap. Some – generally the new shiny toys - are overvalued while others - the more boring ones – are undervalued.'

'Amazon has been the great disruptor in US retail,' Dr Knight commented. 'Could that sort of disruption open up opportunities elsewhere?'

'The disruption caused by Amazon is really staggering,' the manager agreed. '44 cents out of every dollar spent online last year in the US was through Amazon, up from 38 cents the year before. And online is 50% of all the US's incremental spend. It's truly a juggernaut and the competitive dynamic isn't slowing down. To stay in business as a retailer you have to invest in your e-commerce engine or, if you're a consumer products company, go direct. Those strategies are all very expensive and usually margin-dilutive. It's happening everywhere: Alibaba and JD in China and MercadoLibre in Latin America.'

'Once you get to that scale, you can start layering in other services. If you have a big data center, you can become a cloud computing company with huge profit margins to fund your growth in other new markets - social networks, communications, messaging, gaming, digital payments - all on the one platform. The only successful consumer companies will be very dynamic and proactive. But they're competing in an instant global market. If a hot yellow leather jacket comes down the runway in Milan, it will be on Instagram immediately or WeChat in China.'

THE INVESTMENT INDUSTRY: ITSELF A BAD BET?

'Will the investment industry suffer similar disruption?' asked Dr Knight. 'Will we still be having this seminar in ten years' time? Will there be new opportunities, for us as investment managers.'

Replying, one manager struck a positive note: 'The investment industry is all about preserving and creating wealth. As guardians of long-term opportunities, I think managers are well positioned because wealth creation will continue at an attractive pace and the best managers can add a significant amounts of "alpha". But how wealth creation is delivered will have to evolve. A major change from my perspective since I started 30 years ago is the instant availability of quality data for almost every listed company worldwide. Processes will be more quantitative. We will have to be more transparent and offer better value for money. There will be increasing pressure on profit margins which will have to be offset through scale and efficiencies.'

STOCK SELECTIONS

Dr Knight invited managers to identify stocks that they judged to be particularly promising in the coming year. As last year, this year's selections are extraordinarily diverse, by sector and geography. Sectors ranged from real estate, food and banks to leisure and hotels. There is a fairly even split among the Americas, Europe and Asia. Noticeably, all but one are traded on the NYSE & NASDAQ, either as shares or as depositary receipts. Three of the six ADRs are unsponsored (UADR).

STOCK	MARKET: SYMBOL	SECTOR: COUNTRY
BR PROPERTIES	BOVESPA: BRPR3 (ADR)	REAL ESTATE: BRAZIL
CENTURY LINK	NYSE: CTL	TELECOMMUNICATIONS: US
CJ CHEIL JEDANG	KRX: 097950	FOOD: KOREA
KERRY LOGISTICS	SEHK: 636 (UADR)	LOGISTICS: HONG KONG
NATIONAL OILWELL VARCO	NYSE: NOV	OIL: US
NETFLIX	NASDAQ: NFLX	LEISURE: US
NINTENDO	TSE: NTDOY (UADR)	LEISURE: JAPAN
NOVOCURE	NASDAQ: NVCR	MEDICAL DEVICES: US
REGENERON PHARMA	NASDAQ: REGN	PHARMACEUTICALS: US
SANTANDER MEXICO	BOVESPA: BSMXB (ADR)	BANKS: MEXICO
SHANGRI LA ASIA	SEHX: 0069 (ADR)	HOTELS: SINGAPORE
WILMAR INTERNATIONAL	SGX: F34 (UADR)	FOOD: SINGAPORE
WR GRACE	NYSE: GRA	CHEMICALS: US

TABLE 1. Stock selections

OXFORD METRICA CLIENTS

BANKING

BNY Mellon
Credit Suisse
Deutsche Bank
Invesco
Schroders
Templeton & Phillips
UBS

ENERGY & MINING

BP
De Beers
Exxon Mobil
Gazprom
Gold Fields
Royal Dutch Shell

FOOD

DongA One
General Mills
Nestlé

FOUNDATIONS

John Templeton Foundation
TWCF

HEALTH CARE

Baxter
Bristol-Myers Squibb
Johnson & Johnson
Merck Serono
Natura
Novartis
Novo Nordisk
Solvay

INDUSTRIAL

ABB
Aker Solutions
BAA
BAE Systems
General Electric
INI
Jardine Matheson
Kone

INSURANCE

AIG
Aviva
FM Global
If
ING Group
Munich Re
OIL
RSA
SCOR
Swiss Life
Swiss Re
Zurich Insurance Group

PROFESSIONAL SERVICES

Accenture
Aon
Ashurst
Blue Rubicon
Deloitte
Edelman
EY
Freehills
Hill & Knowlton
Ince & Co
KBC Peel Hunt
Kenyon International
Marsh
Ogilvy PR
OTC Markets Group
Porter Novelli
PriceWaterhouse Coopers

PUBLISHING

Reed Elsevier

RETAIL

Huhtamaki
Tesco

TECHNOLOGY

Cisco Systems
Green ICN
Hitachi
IBM
ICN Telecom
Infosys
Intel
KNTV
Oracle
Tencent
Xilinx

TRANSPORT

P&O Ferries

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