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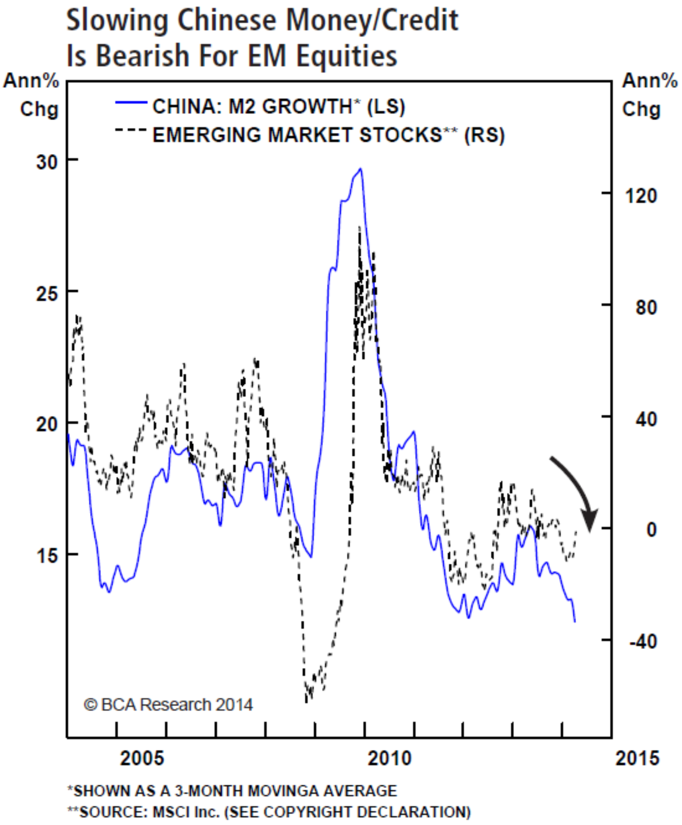
Monthly Investment Commentary – April 2014

Market Outlook

I attended the IMF semi-annual meeting in Washington last week, and it is clear that global growth is slowing down. China has just announced 7.4% first quarter growth, but nominal GDP has fallen further (more than 2%), as deflationary pressures increase. Most forecasters have been wrong-footed by this global trend, which is impacting commodity prices as well as company revenues and earnings. I do not expect that share prices will make any progress between now and October; and, indeed, we could have a sharper correction after such a strong performance in 2013. The emerging markets, as the chart below demonstrates, are still beholden to the outlook for China's economy, and its demand for raw materials and imports.



Source : BCA Research

The next big change will be declining property prices in China and Hong Kong and, perhaps, elsewhere. Of the major emerging markets, only India holds promise with the probable election of Narendra Modi as a pro-business prime minister. Indonesia also has promise, with a change of administration coming this year. All in all, it is a classic "sell in May and go away year" and we believe that bonds may be a better bet for the next six months.

Colombia

I also made a 3-day trip to visit our major holdings in Colombia 2 weeks ago, which was enlightening. Here is a country of nearly 50 million people, of whom more than half are under 30 years old, and where there has been a tremendous recovery since the violence and terrorism of the long civil war ended a decade ago. There are some excellent companies in Medellin and in Bogota, including the two major oil companies, Ecopetrol and Pacific Rubiales, which are run by the Venezuelan expatriates and have vastly expanding oil production. The most impressive retail company is Exito, a supermarket chain with the French Casino Group as its 54% shareholder, but which has an excellent focus on both the high-end consumer and also the popular market (the average income in Colombia is still only US$300 per month, between US$5,000 and US$10,000 per annum). One additional factor supporting local share prices is the rapid build-up of national pension funds, on the exact model of Chile (which was consistently outperformed).

Reflections on 40 Years in the Investment Business

It is just over 40 years since I started my career as a banking trainee in London in February, 1974 - a time of general gloom and despondency. UK inflation was about 20%; gold had begun to move up from US$35 an ounce in 1971 to over US$100 in 1974; and the debasement of paper money, in my 40-year career, has been continuous, as reflected, for example, in London property and in gold, which is today at about US$1,300.

In 1975 I was inspired by the British referendum, which voted decisively to stay in the European Union and I went to work on the Paris bourse, which taught me much about market psychology. Warren Buffet describes his neurotic partner, Mr. Market, as being either euphoric or deeply despondent. This was certainly true of French investors in those days, buying gold mining shares but deeply despondent about the Communist influence on their economy. Today it is difficult for any young analyst or investment manager to have the experience of a physical trading floor, although market psychology doesn't change. Michael Lewis' new book, Flash Boys, gives an extraordinary insight into the new technology underlying markets.

Two years later, I moved to an "emerging market" - that is Brazil - and spent some time learning how to make bank loans to coffee and soybean farmers in the south. We learned very early on that credit-worthiness and also judgment of character were key tests of both borrowers and of investment criteria. I also learned how important it was to understand the local language and culture in order to invest intelligently; and this helped me a great deal when I moved a few years later to Asia. My training on Wall Street in 1979, first as an oil analyst and then as a young emerging market manager, was also invaluable. There is no substitute for the competitive excellence that Wall Street produces, but I was already conscious that Asia would be the great opportunity in the investment world of the next generation, and so I started to learn Japanese. Ironically, I was hired to set up a research department by Barings in Hong Kong in the spring of 1982, so I was lucky enough to be in the right place at the right time for the opening up of the Asian markets. After taking over as managing director of the investment company of Indosuez in Hong Kong, I was fortunate to be able to launch the first country fund for Thailand in 1987 with the support of George Soros, who was our major investor. This success was followed by Indonesia, Philippines, India and China.

So when we launched Lloyd George Management in January 1992, I decided that our focus should be on China and India as the two major capital markets, which had yet to catch up with the size of their economies. I published The East-West Pendulum in the year after the Tiananmen event since I saw that there was a 500-year change in the global balance of power because of China's renaissance. Also (in the shorter-term) the smart Chinese money -- that is, the Hong Kong and Taiwan investors -- were actively building and investing in China. The following year in 1993 we opened our office in Bombay, and this, too, was fortunate timing, although it took almost 10 years before India really paid off for us in a major way.

It was, I believe, Winston Churchill who said, "The best prophet of the future is the past"; and one consistent thread of my career has been the need to read and study history and to understand the cultural background of the countries in which we are investing. "Political risk" and whether a country treats its foreign investors fairly and equitably is very often a function of a its history. We can also study the credit history of the country in terms of defaults to see whether the current investment grade is deserved. In respect of the current trend towards emerging markets and, even more, frontier markets, it will be as well for us to take into account these historical factors as well as currency risk before making longer-term investments. There is no doubt from my recent visits to Africa, to Vietnam, to Colombia and elsewhere that there are great opportunities in the catch-up phase of the consumers in these regions. It is probably too early to say whether these will be good long-term investments. I can only say that I have observed the most intelligent investors, such as Li Ka Shing, moving his capital from China and the Asian countries towards the Anglo-Saxon safe jurisdictions, such as the UK, Canada, Australia, and, to a lesser extent, the USA.

A final comment on the investment world in 2014, as opposed to 1974, or even 1994, is that it is a much less innocent world today. We have, of course, the Internet; but, more importantly, we have the aftermath of 9/11, the financial crisis of 2008, and the Madoff and other scandals. The due diligence, compliance and AML (anti money laundering) required for our business today is 10 times what it was a decade or two ago. The trust element has, it seems, disappeared. Where we could win business and perform well in specialized areas is now much more difficult in terms of competition and compliance, which makes life for smaller fund managers very difficult indeed. Nevertheless, the need for smart, intuitive stock pickers, with a good grasp of the political and economic changes in the world, remains the key factor.

Another major change for our industry has been index funds, and exchange traded funds (ETFs). Eighty percent of the new capital going into India today is in the form of ETFs, which makes it very difficult for active stock-picking funds to compete because of the higher expense ratios. I have long felt that, in Asia, index funds look "in the rear-view mirror." The large index components, in terms of countries and companies, are those that have been successful in the past. Japan in 1990 was 40% of the world's index. Within 10 years it had fallen 7%. China went from zero to nearly 20% of the emerging market universe. Many companies which hardly registered on the radar screen in the 1990s -- Apple, Google, Samsung, and others -- have risen to be very large cap weights; and others -- such as Blackberry or Nokia -- have fallen to a fraction of their former value. Indices are always following rather than leading. The role of active investment managers must be to anticipate and identify change and to try to spot the future winners among small cap stocks. I believe that our role is increasingly in finding shares beneath the radar, both small-cap and micro-cap stocks, and also private equity. My recent experience in Myanmar, where the Yangon stock exchange is likely to open in 2015, has illustrated this in that we have found many new and interesting companies which were not yet researched or even audited for public listing. Once again, it is local knowledge and intensive research which will reward investors; and this will include private equity as well as listed shares in these new markets.

It has been a privilege for me to write this monthly commentary, and I hope that our clients and investors have appreciated a different perspective. I wish you all a Happy Easter, Passover, Songkran, Tomb Sweeping Day, or just summer/spring break!

R. Lloyd George

Robert Lloyd George
April 18, 2014