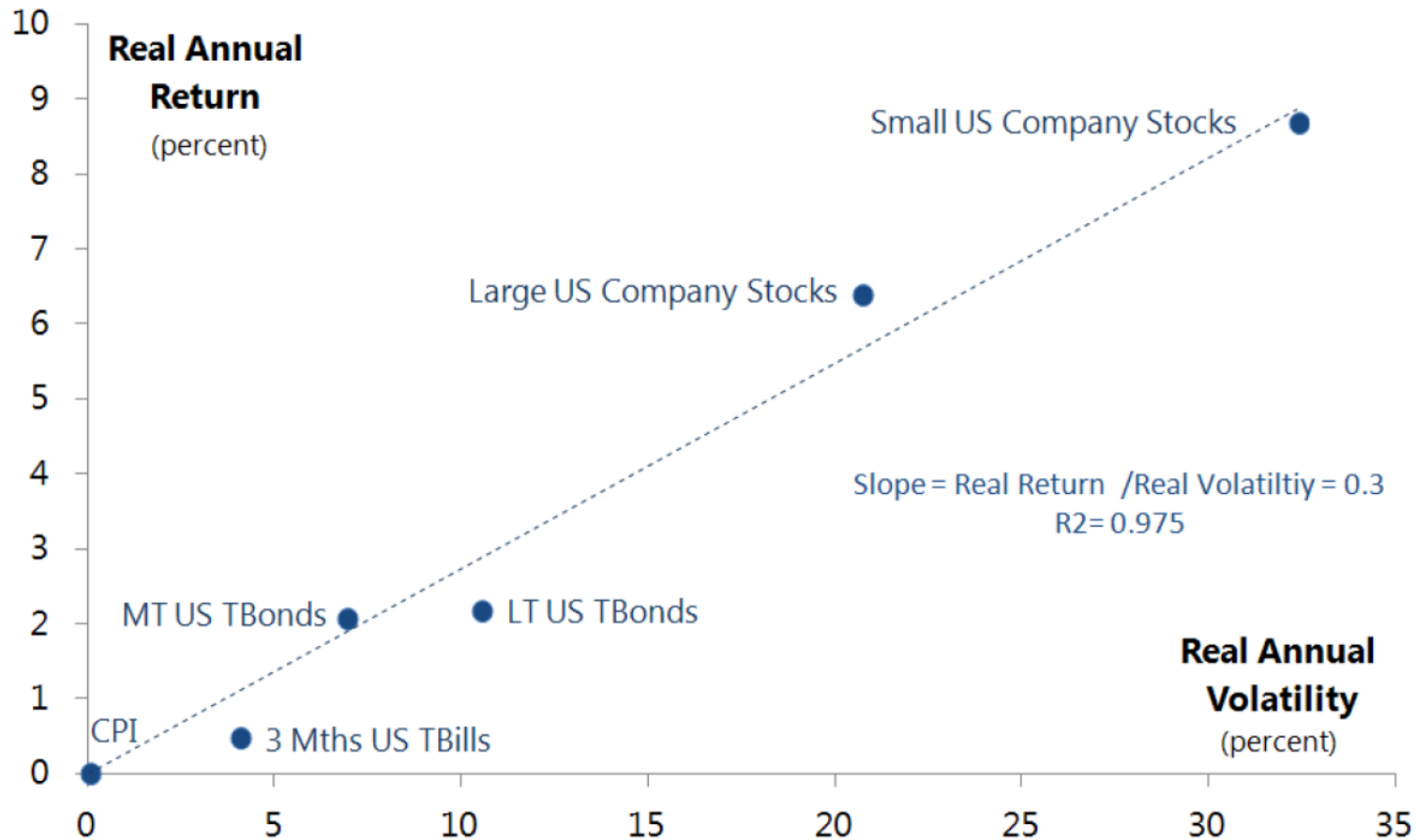

Gavekal Investor Conference Call

September 2014

Getting value for risk

Annual real returns vs. volatilities across US asset classes, 1926-2011



Sources: Ibbotson Associates, Bloomberg

Financial markets are a global information system **on risks.**

Over long-enough periods of time, asset classes typically return circa 30% real of their annual volatility.

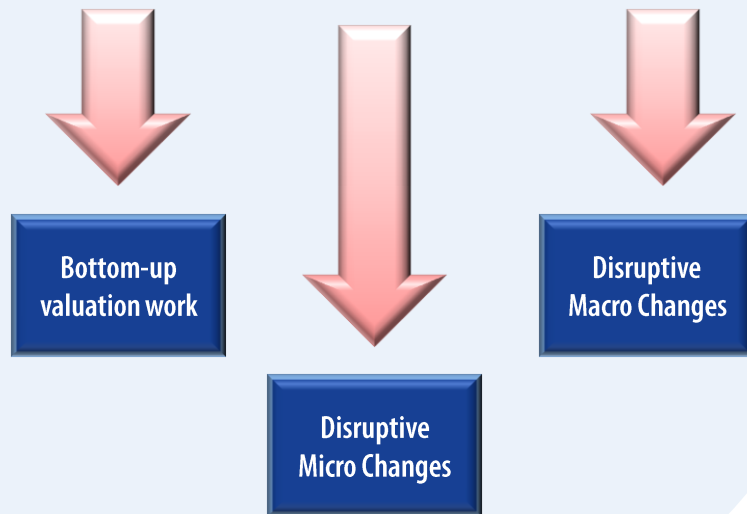
Equities are the riskiest assets to own, but the most rewarding over the very long term.

So the starting point of any serious long-term investor should be to **wonder how to beat the returns offered by equity markets?**

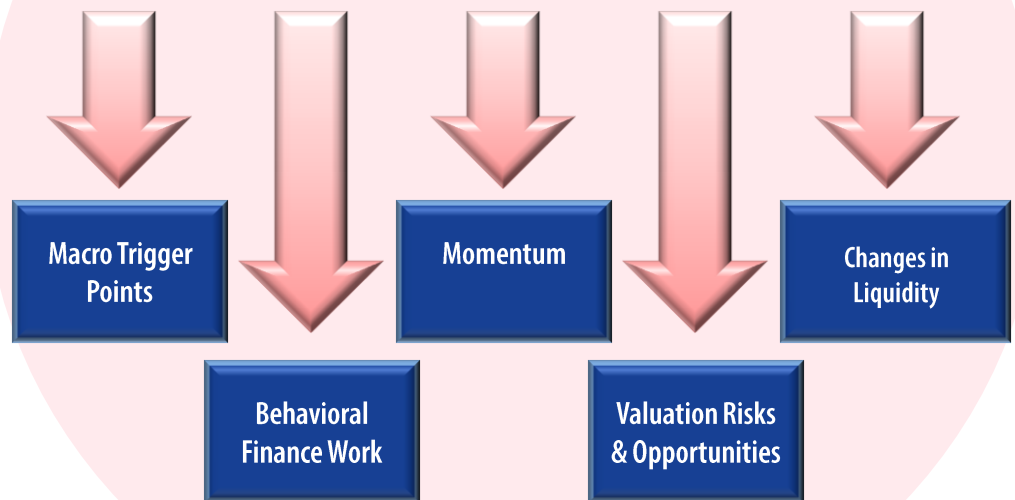
Beating the long-term returns offered by equities

There are two ways to beat the long-term returns offered by equity markets:
by **identifying market inefficiencies** or by **identifying periods of market dislocations and avoiding equity market draw-downs**

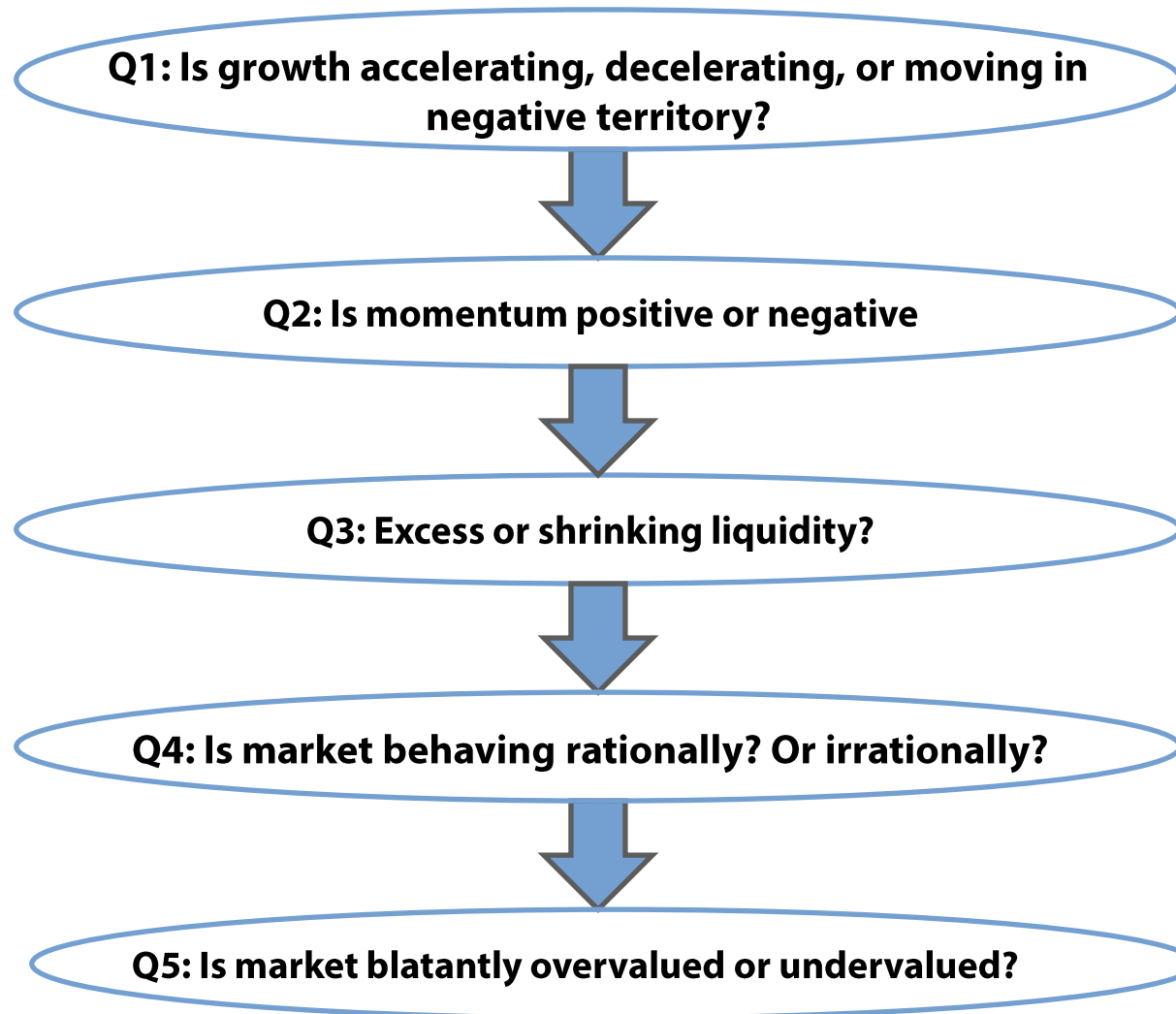
Identifying Market Inefficiencies



Identifying Market Dislocations



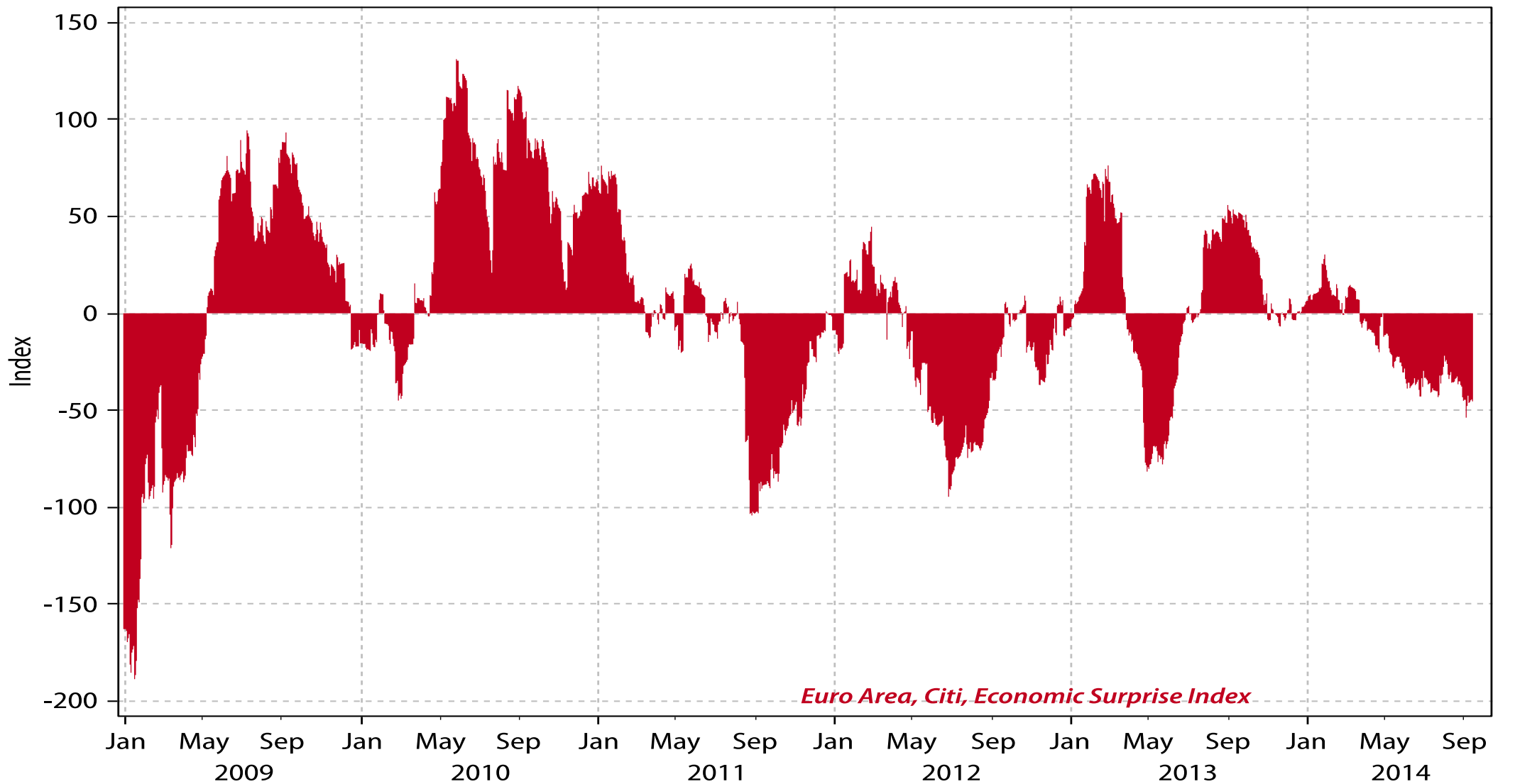
Identifying possible market dislocations, country by country



1- Where might growth disappoint?

Euroland is the one part of the world which continues to underwhelm

Euro Area, Citi, Economic Surprise Index

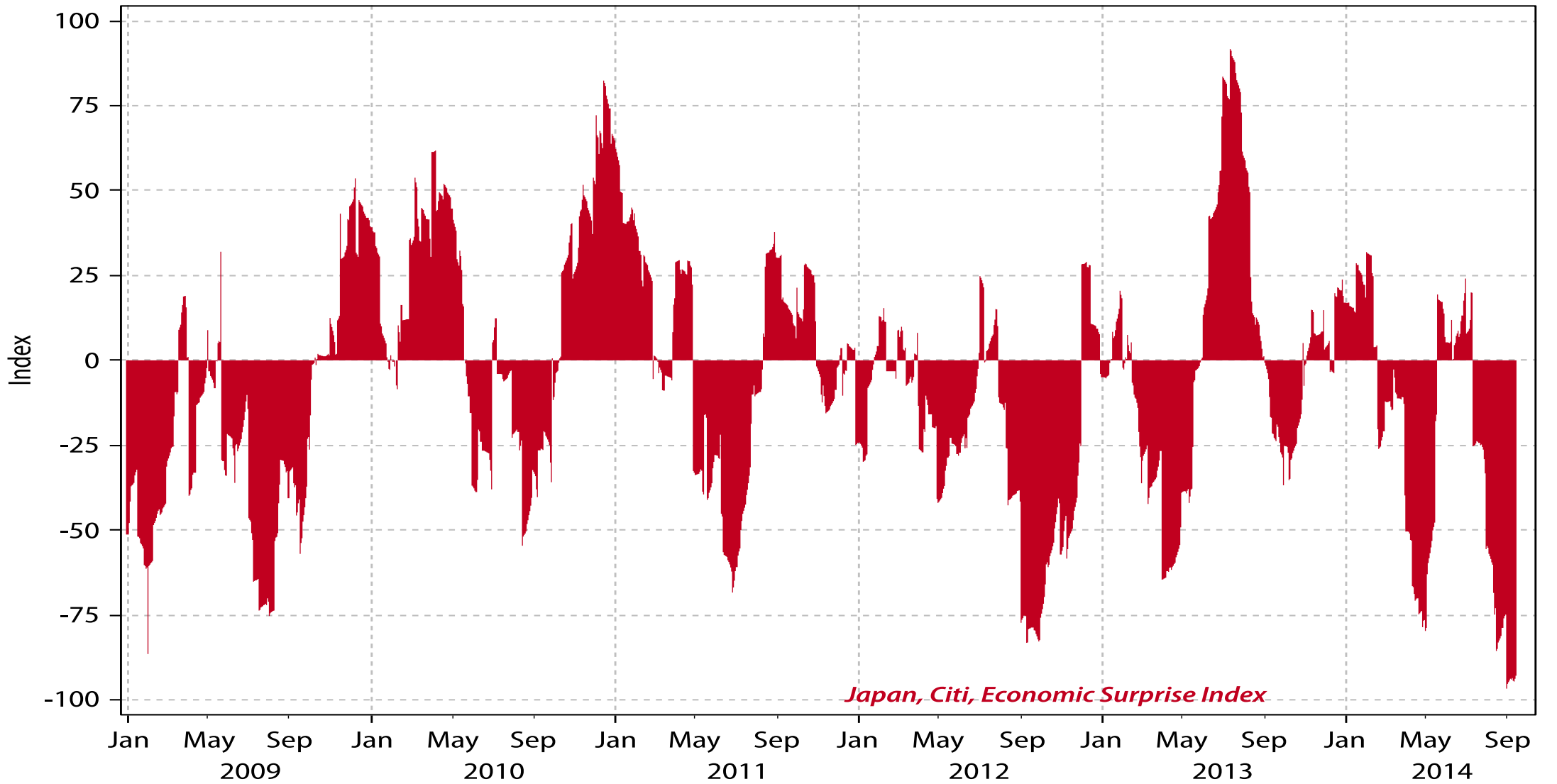


Euro Area, Citi, Economic Surprise Index

Gavekal Data/Macrobond

Along with Japan (if anyone still cares?)

Japan, Citi, Economic Surprise Index

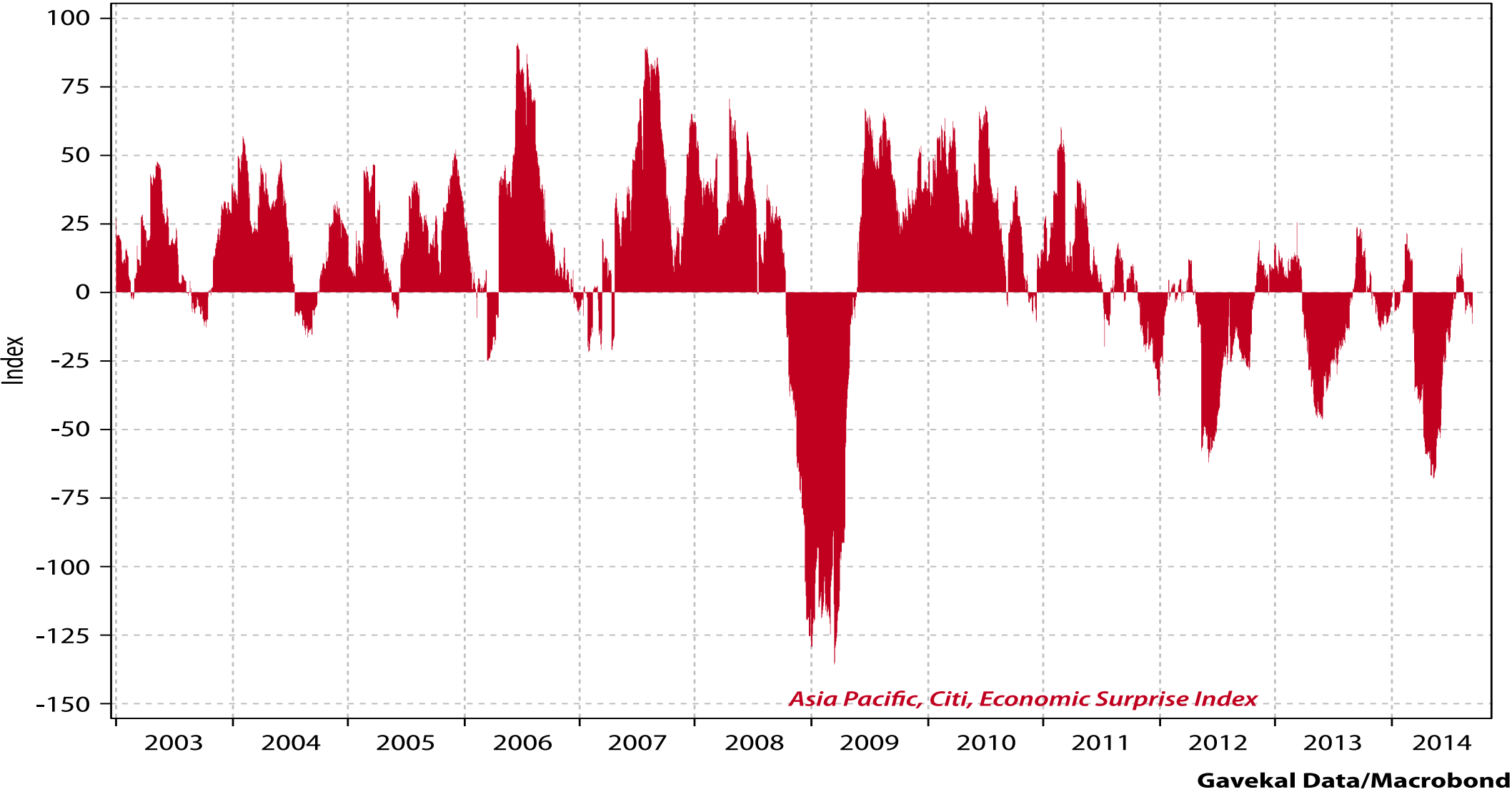


Japan, Citi, Economic Surprise Index

Gavekal Data/Macrobond

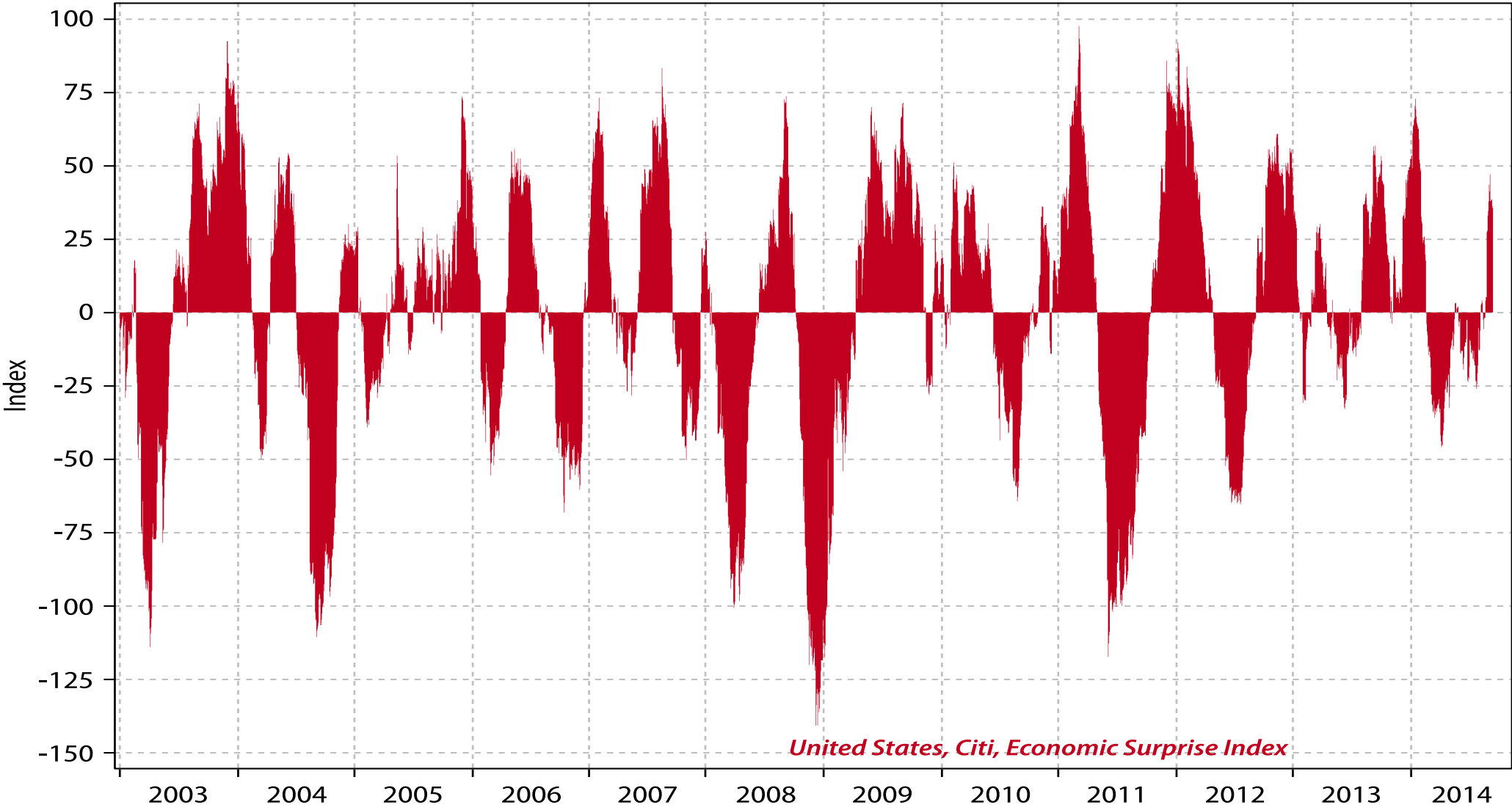
Asia has had no 'upside surprise' since 2011 but economies seem to be on track

Asia Pacific, Citi, Economic Surprise Index



US maintains strong positive momentum

United States, Citi, Economic Surprise Index



United States, Citi, Economic Surprise Index

Gavekal Data/Macrobond

The European slowdown: how much of a risk for markets?

As we see it, the most significant development on the global growth landscape over the past couple of quarters has to be the renewed weakness of the Eurozone economies. This is all the more worrying since the rest of the world economy appears to remain on the post-Lehman recovery path.

The markets have moved accordingly and European growth assets have performed miserably, while EMU bond yields keep making new lows. Looking forward, we can think of three separate scenarios for Europe:

1. **Slow deflation** - Through a combination of a resilient global growth, a more active ECB and a renewed turn towards pro-growth fiscal policies, European data recovers. Implicit in this scenario is a weaker euro, which would also help boost corporate profits and trade, and make euro-denominated financial assets more attractive to foreign investors.
2. **Japanization** - EMU growth continues to be lackluster, but no cataclysmic event materializes. Europe becomes a source of capital, as opposed to a destination for capital. European assets may not fall in absolute terms, but are very likely to underperform their peers. Essentially, Europe becomes the new Japan. The impact on global asset markets is marginal.
3. **Euro crisis 2.0** – The widening structural productivity gap between northern and southern Europe can no longer be papered over and the viability of the euro once more comes into question. Under this scenario, Europe's weakness should be sold. Moreover, in contrast to the second scenario, this outcome would naturally have spillover effects for global asset markets.

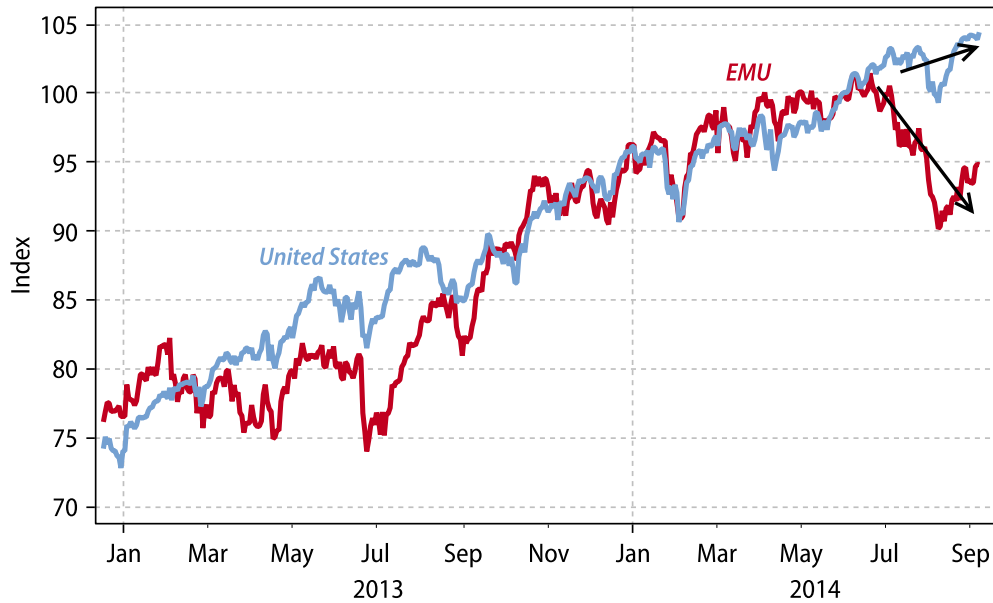
As of right now, the market seems to increasingly be positioning itself for the second scenario, hereby implying that Europe will be a source, rather than a destination for capital. But that a negative impact on ex-EMU assets should be limited?

2- the market momentum reflects economic realities

European assets have reacted to the shift in EMU growth outlook

US vs EMU stock markets

Using MSCI in US\$



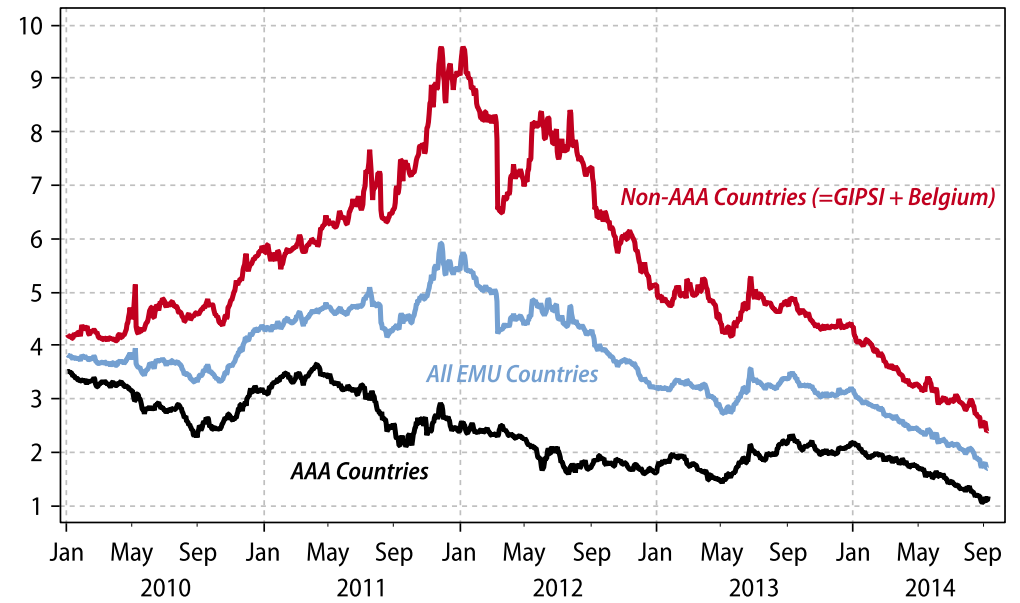
Gavekal Data/Macrobond

During 2013 and for the first six months of 2014, US and European equity markets were virtually joined at the hip. During that period, the US MSCI rose by 35%, the EMU MSCI was up 31% and the correlation between the indices was 94%.

However, since then the story has been very different. The US market has kept creeping higher, up by another 4%, while the EMU market has collapsed, shedding close to -7% and the correlation has broken down completely.

EMU bond yields are plumbing new depths

EMU debt-weighted averages of 10Y bond yields



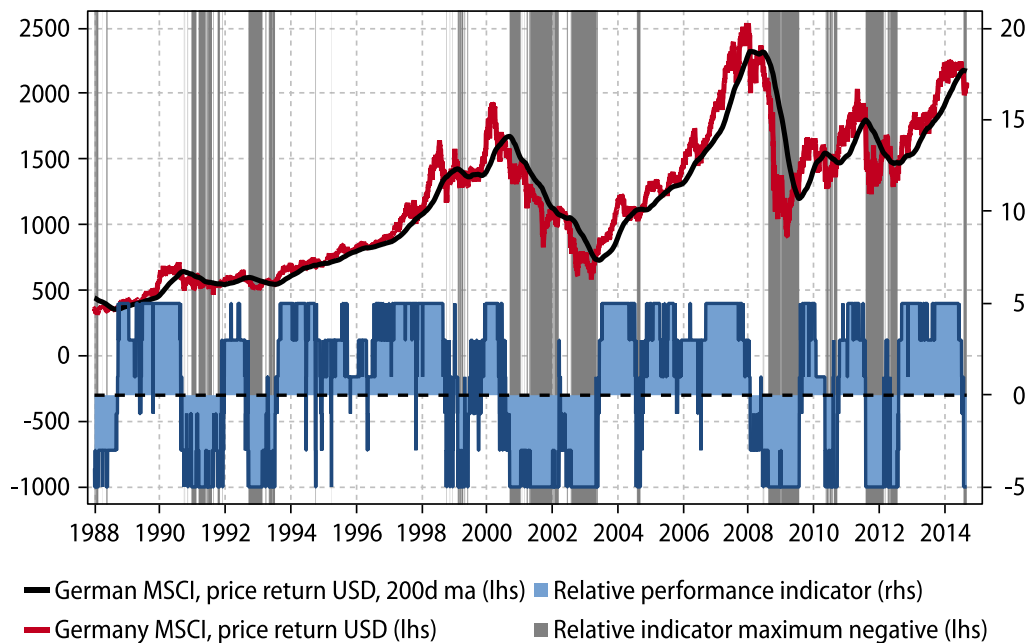
Gavekal Data/Macrobond

On the flipside, European bond markets have done very well, as illustrated by the chart above.

This all indicates that investors have been ramping down their expectations on EMU economic growth significantly. The question is, has the adjustment been made already, or is this the start of a longer trend? And what is the implication for the rest of the world? Ultimately, that depends on what scenario one believes will play out in Europe.

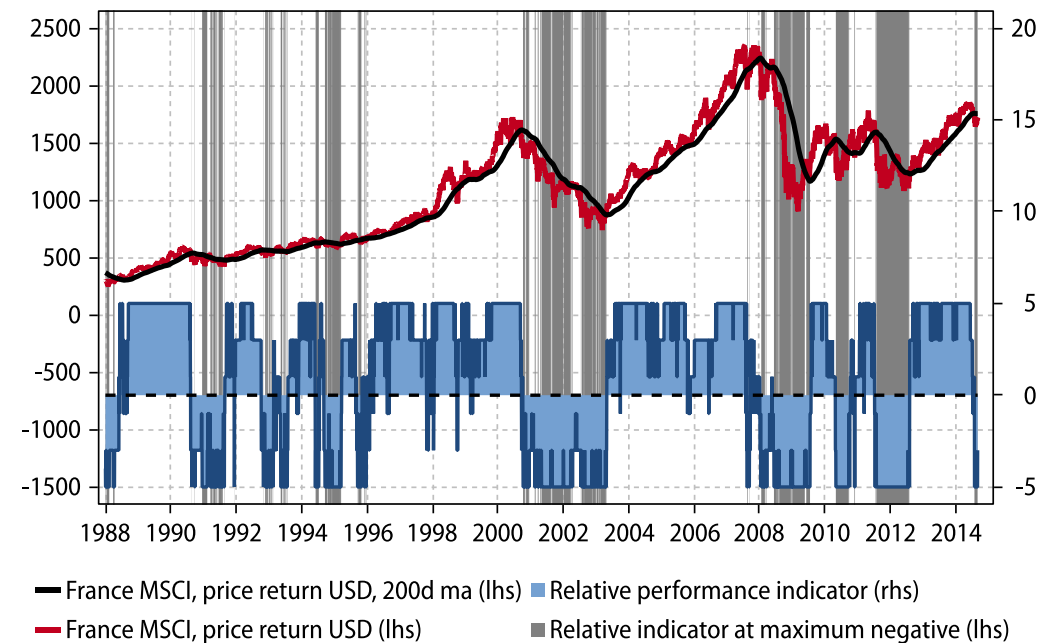
Extremely poor momentum on European stock markets

German equities & the relative performance indicator



Gavekal Data/Macrobond

France equities & the relative performance indicator



Gavekal Data/Macrobond

When it comes to stock markets, one of the things we look at is relative performance.

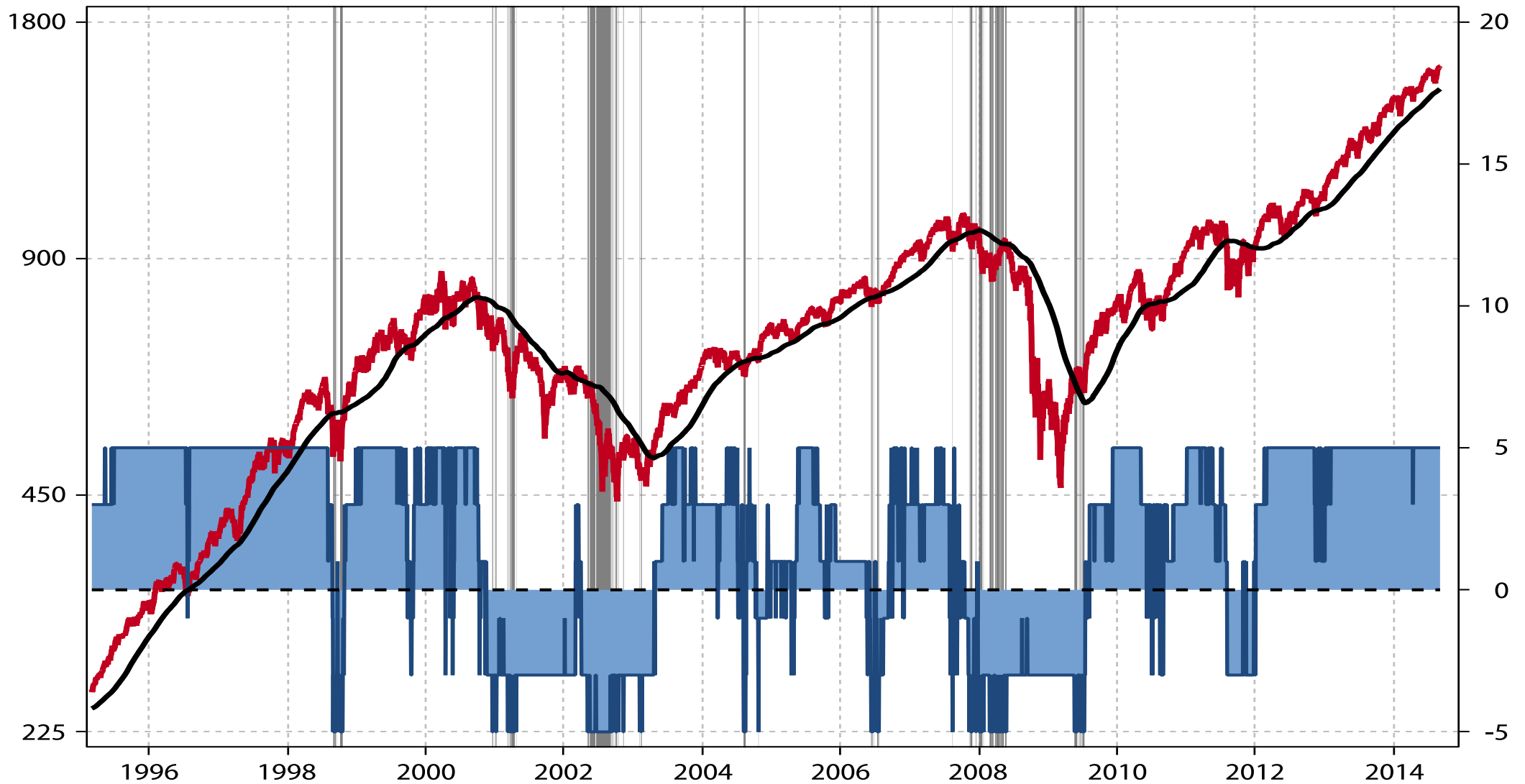
To that end, we have built a battery of indicators that look how local stock markets have performed against 1) their own long-term average, 2) the world MSCI, 3) gold prices, 4) US short rates, and 5) the long end of the German bond market.

Today, our relative performance indicators for the big European markets are near a maximum negative of -5.

The last three times this happened and stayed there, the stock markets went down -33%, -50%, and -33%. Obviously, this is not terrifically encouraging and suggests that investors have severely ramped down their expectations for growth in Europe.

Aside from Europe, momentum is either very positive

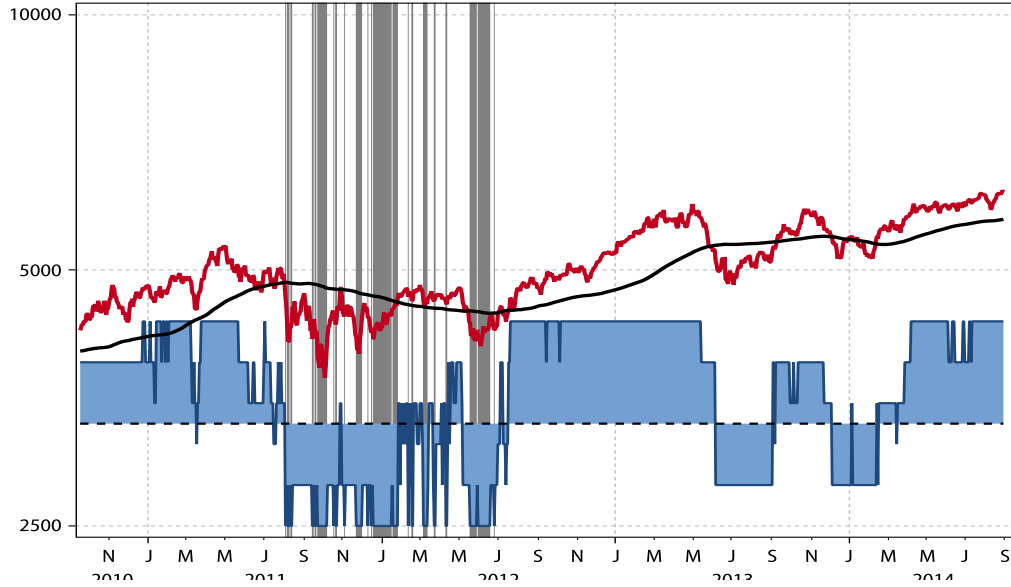
USA equities & the relative performance indicator



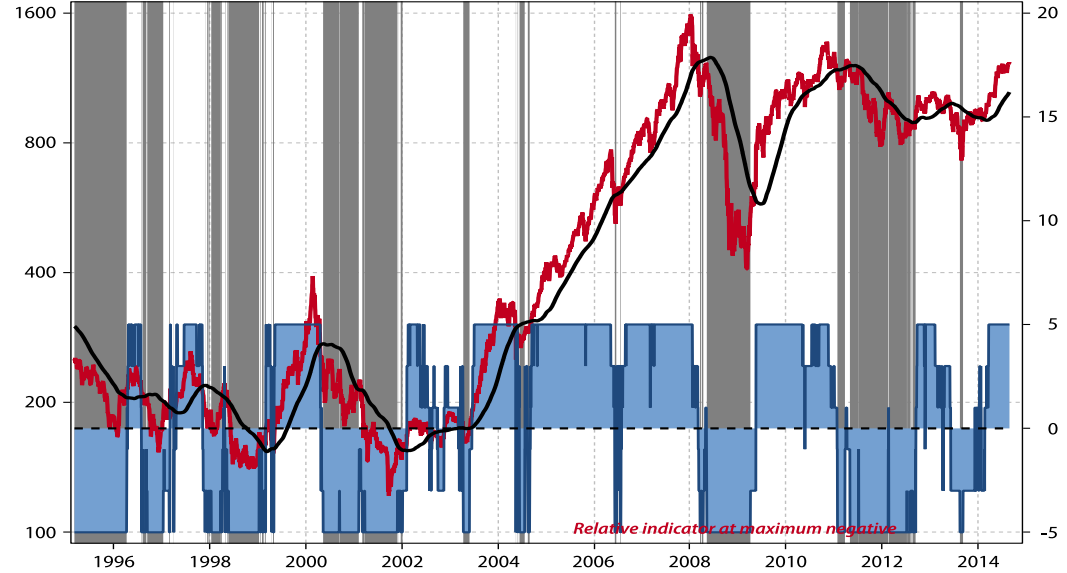
Gavekal Data/Macrobond

Asian markets in maximum positive readings

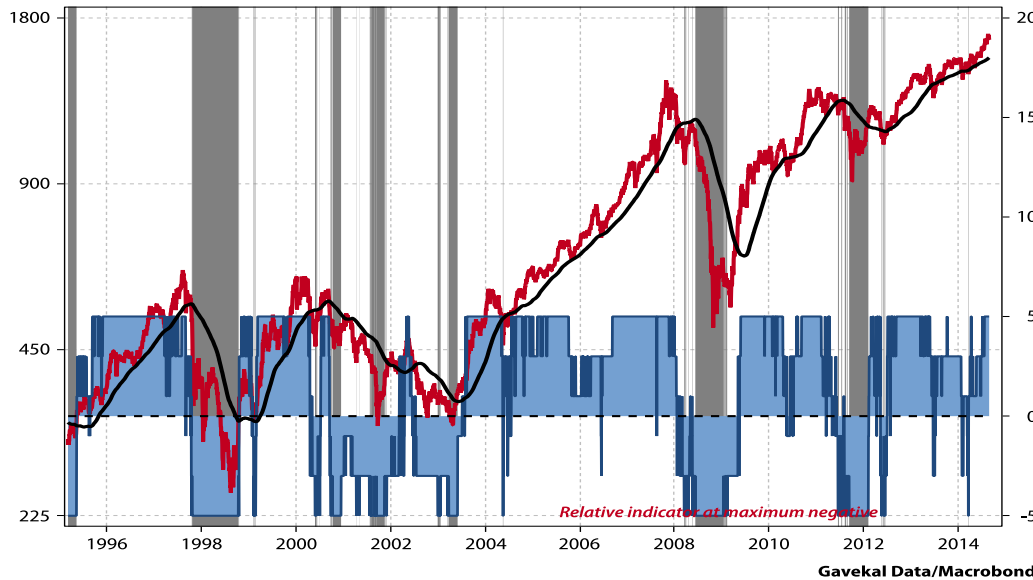
Australian equities & relative performance indicator



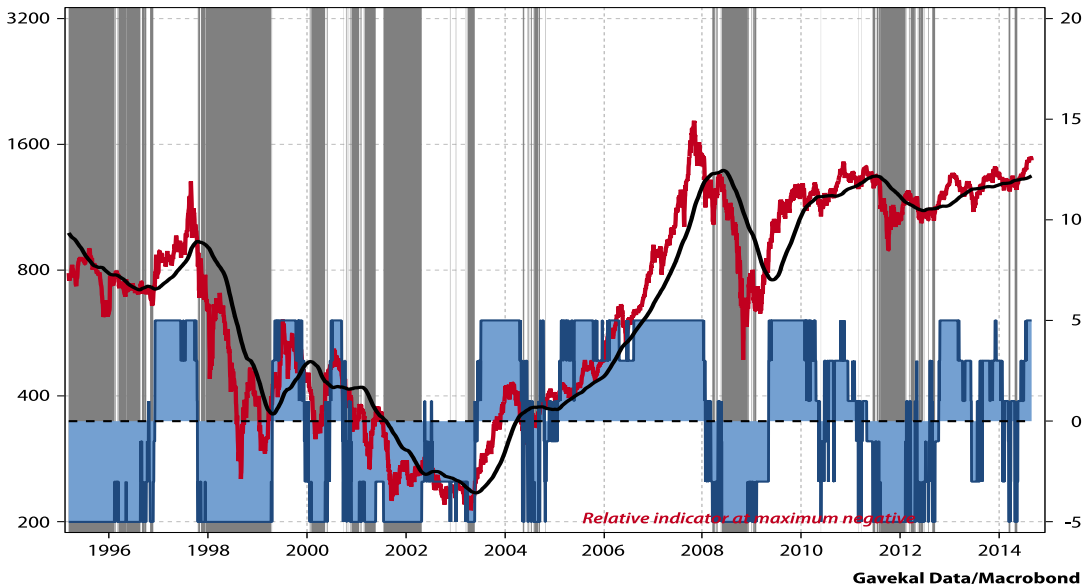
India equities & the relative performance indicator



HK equities & the relative performance indicator

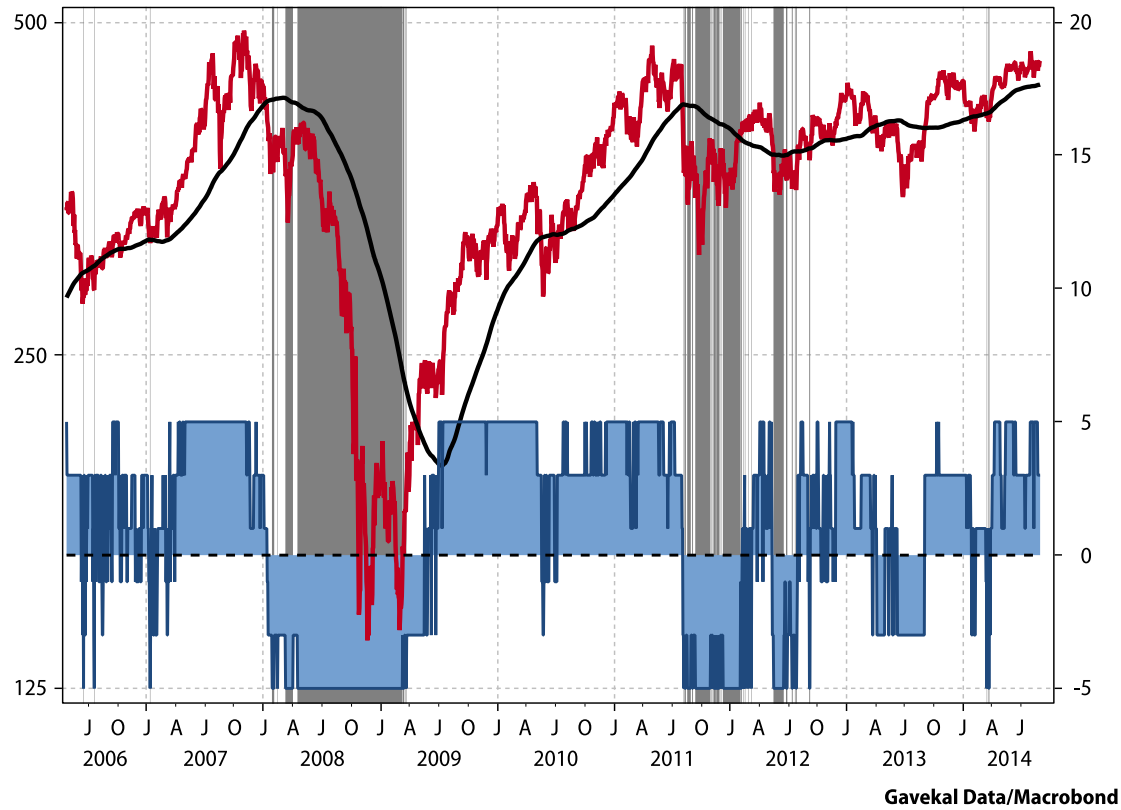


China equities & the relative performance indicator

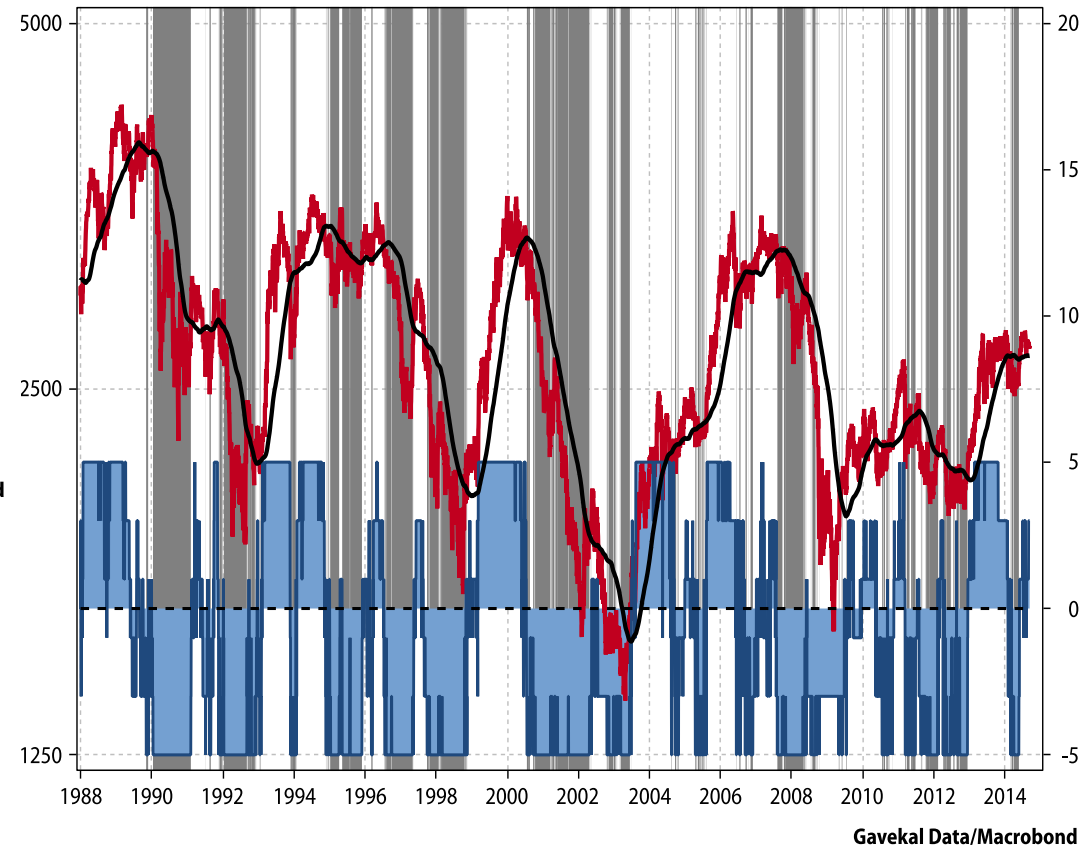


Or slight positive readings

Korea equities & the relative performance indicator



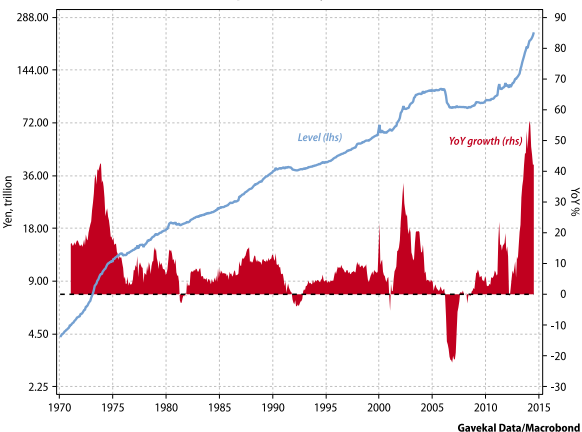
Japan equities & the relative performance indicator



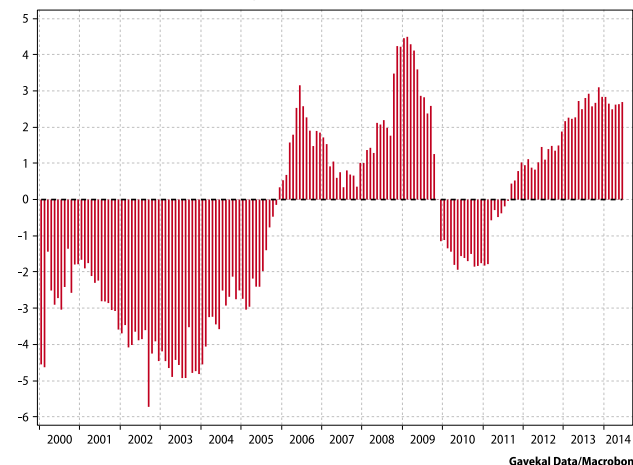
3- The uncertainty regarding the liquidity situation

Q3: Where does excess liquidity come from?

Japan monetary base



Annual growth in Japanese bank loans



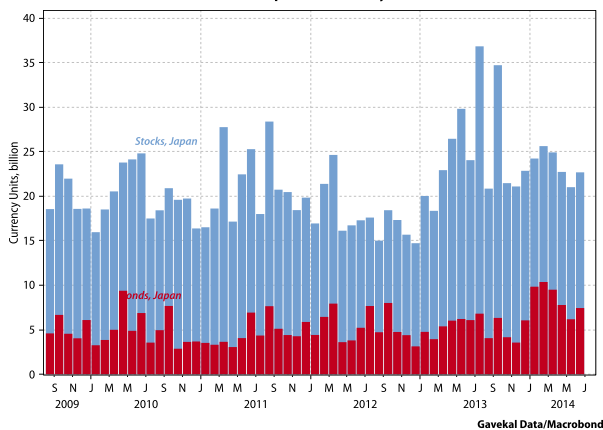
Excess liquidity

Central banks

Commercial banks

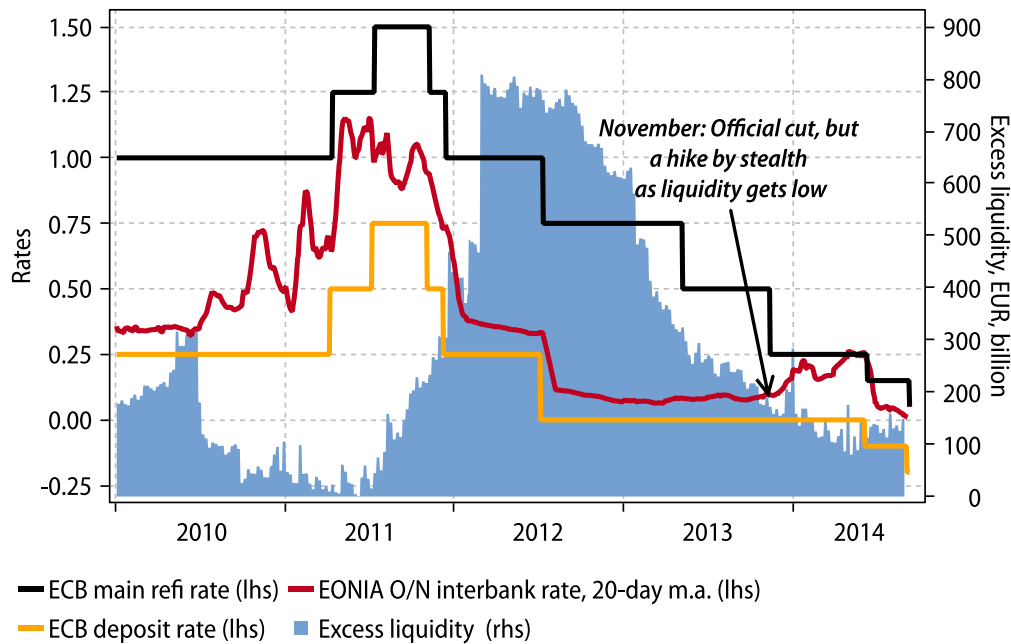
Foreign flows

Gross Purchase of Japanese Stocks by US Investors



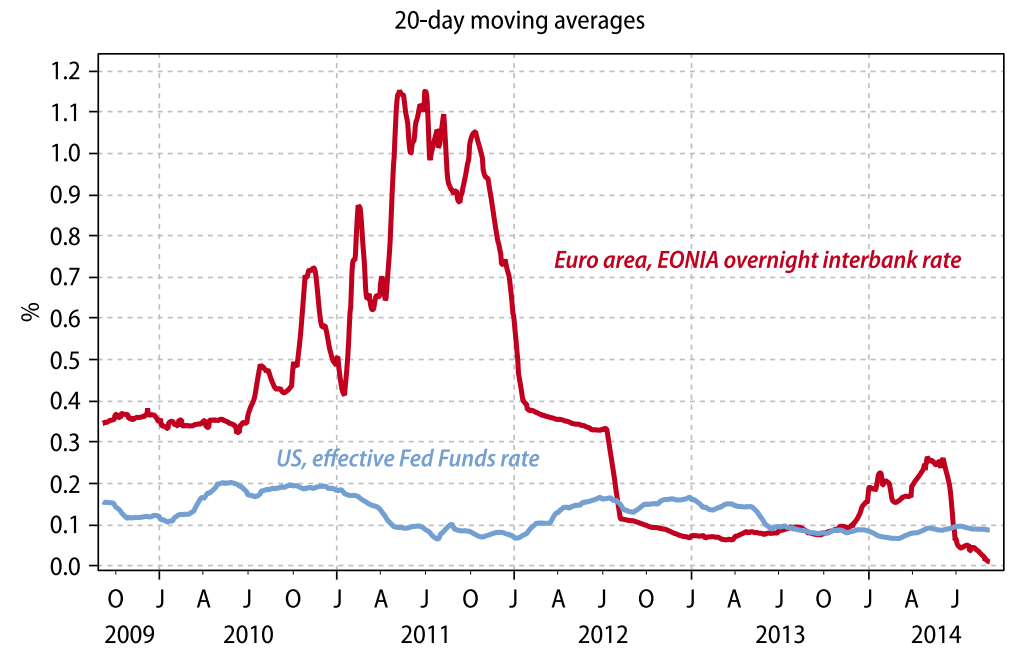
How to make sense of ECB actions: excess liquidity & policy rates matter

LTRO repayments = less excess liquidity = stealth rate hikes



Gavekal Data/Macrobond

Short rates in the eurozone have moved below US levels



Gavekal Data/Macrobond

In November, the ECB cut its headline policy rate, the main refi rate, from 0.50% to 0.25%. But the facts on the ground were quite the opposite. Short rates were already at about 0.1%, but soon after the official rate cut, rates started to rise, not fall.

This was because the decision by banks to repay LTRO disbursements made by the ECB had reduced excess liquidity to such an extent that interbank rates faced upward pressure (this point appears to be between €100-200bn).

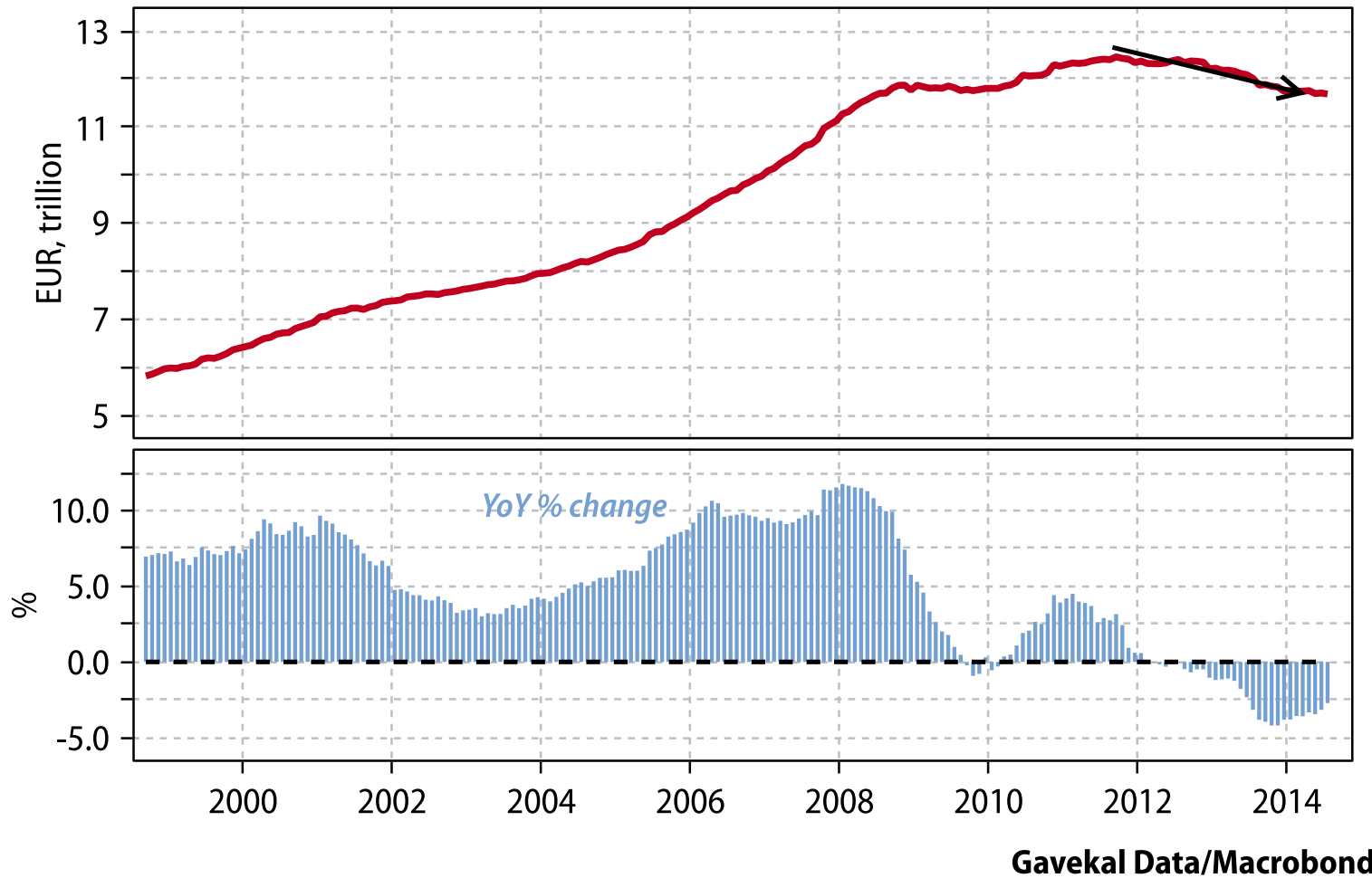
In June, the ECB cut rates again, and this time the interbank market responded differently. This partly reflects that LTRO repayments have slowed (total excess liquidity has plateaued at around €150 bn throughout the year).

But also, this probably reflects the new liquidity measures that the ECB unveiled in June: the much ballyhooed targeted LTRO program. **As a result euro short rates are now below US rates.**

So far, the ECB's policy has not been able to trigger bank lending

European bank lending is still shrinking

Euro area, consolidated balance sheet, loans, total, non-MFIs



Despite multiple cuts in borrowing rates, various liquidity programs and an overall improvement in European financial conditions, the ECB has not managed to boost bank lending.

This is eerily reminiscent of the Japanese experiment.

But given that bank surveys are now positive, should we expect this to change?

The Targeted LTROs

What are they?

4-year loans made by the ECB to banks aimed at improving the monetary transmission mechanism. In practice, the loans should lower the interest rate on lending to small and medium sized businesses especially in peripheral eurozone countries. Critically, the loans will have a fixed interest rate of 0.15% (the MRO rate at take-up, now 0.05%, plus 10bp).

What can we expect?

The ECB expects banks to borrow between €450bn and €850bn over the next 8 quarters via TLTROs. At the first two operations, to be held in September and December this year, banks can borrow up to 7% of the total loans they have extended to the private sector (excluding home mortgage loans) or roughly €400bn. From March 2015, new lending limits will be introduced.

What's the catch?

The loans are conditional on banks meeting specific lending targets. Banks that have increased loans to the private non-residential sector (in the year to April 2014) must continue to grow their loan books (at any positive rate). Banks that have contracted their loan books must at least slow the rate of contraction. If banks fail to satisfy this requirement, the ECB will recall the TLTRO loans after two years.

What is the likely impact?

Initially there will be an overlap between the old 3-year LTROs due to expire in January and February 2015 – currently €375bn and the new TLTROs. Excess liquidity currently stands at €125bn. With the addition of €400bn in TLTROs, excess liquidity could jump as high as €525bn until it drops back down to €150bn in February (as expiring 3-year LTROs are repaid).

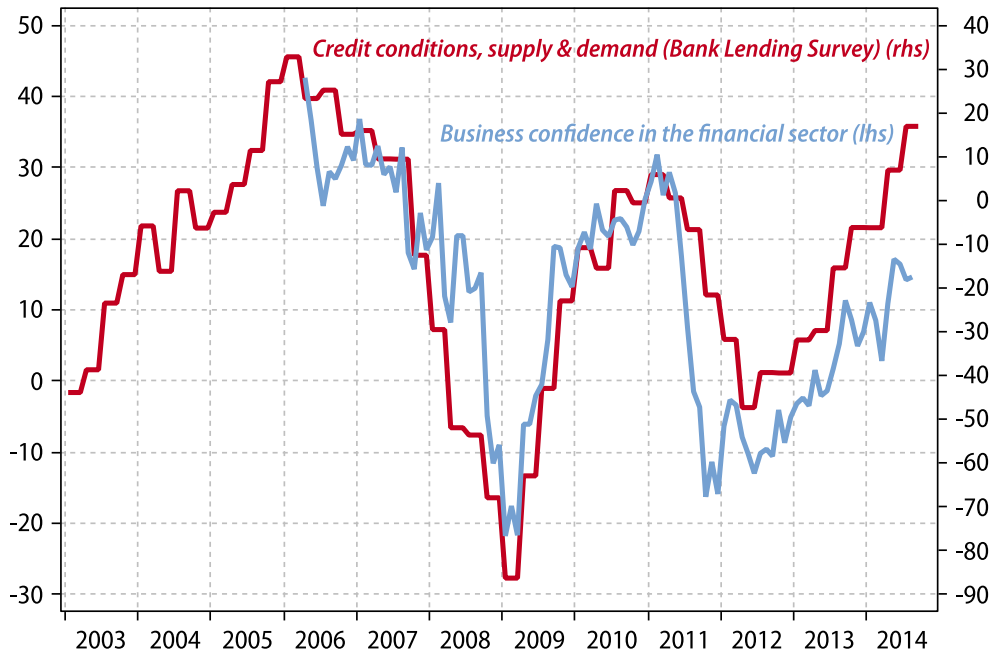
Excess liquidity will then rise again depending on how much more banks borrow in the remaining six quarters. This means excess liquidity could rise from €150bn towards an upper limit of €600bn. Additionally, the ECB announced outright purchases of asset-backed securities and covered bonds in September which will also increase excess liquidity, but as yet the size of these programs is unknown.

Will it work?

TLTROs will likely lower interest rates on new loans to the private sector which should encourage businesses to borrow and invest. Businesses with existing loans may now refinance at lower rates, supporting profit margin growth. Moreover, the program should support new business start-ups. However, given the continued need for private sector de-leveraging the boost may be limited.

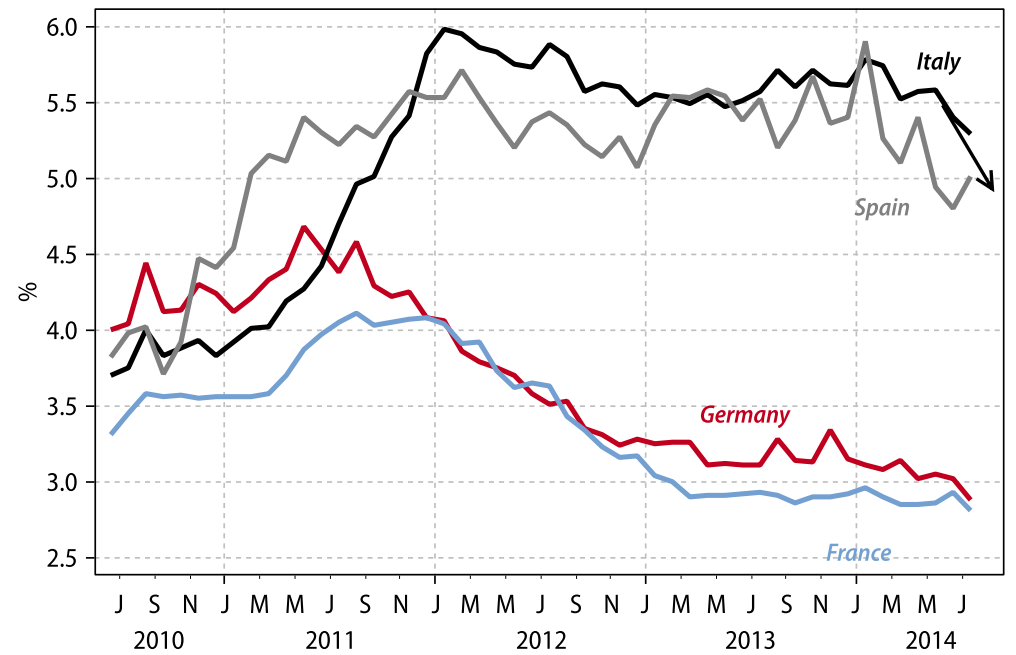
Will monetary policy be enough to trigger credit growth in Europe?

Business conditions have clearly improved in the financial industry



Gavekal Data/Macrobond

Bank interest rates, loans < €0.250mn, non-financial corporations



Gavekal Data/Macrobond

The big problem in Europe has been that despite the impressive fall in sovereign and corporate borrowing rates, bank lending has remained anemic.

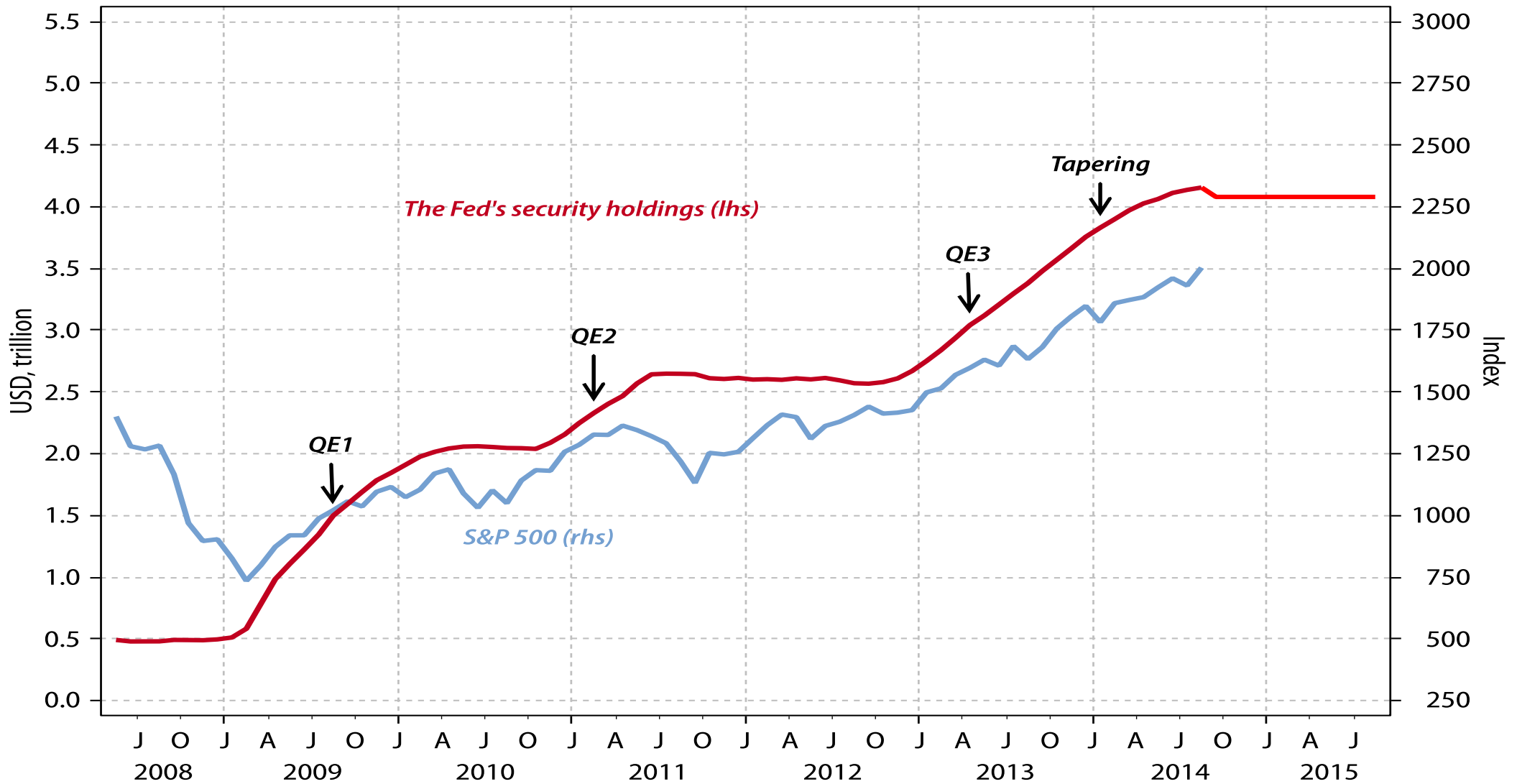
As a result, capital has been scarce for the areas in the eurozone that need it the most: small and medium businesses in Italy and Spain.

The targeted LTROs mentioned on the previous page are an attempt to address this issue. And we have also seen a small improvement in bank lending rates for the weaker part of the European economy.

But the clear improvement in credit supply conditions is not enough, which is why it is probably likely that we will see a more aggressive turn towards an easier fiscal policy as well.

Meanwhile, fed is set to stop adding excess liquidity

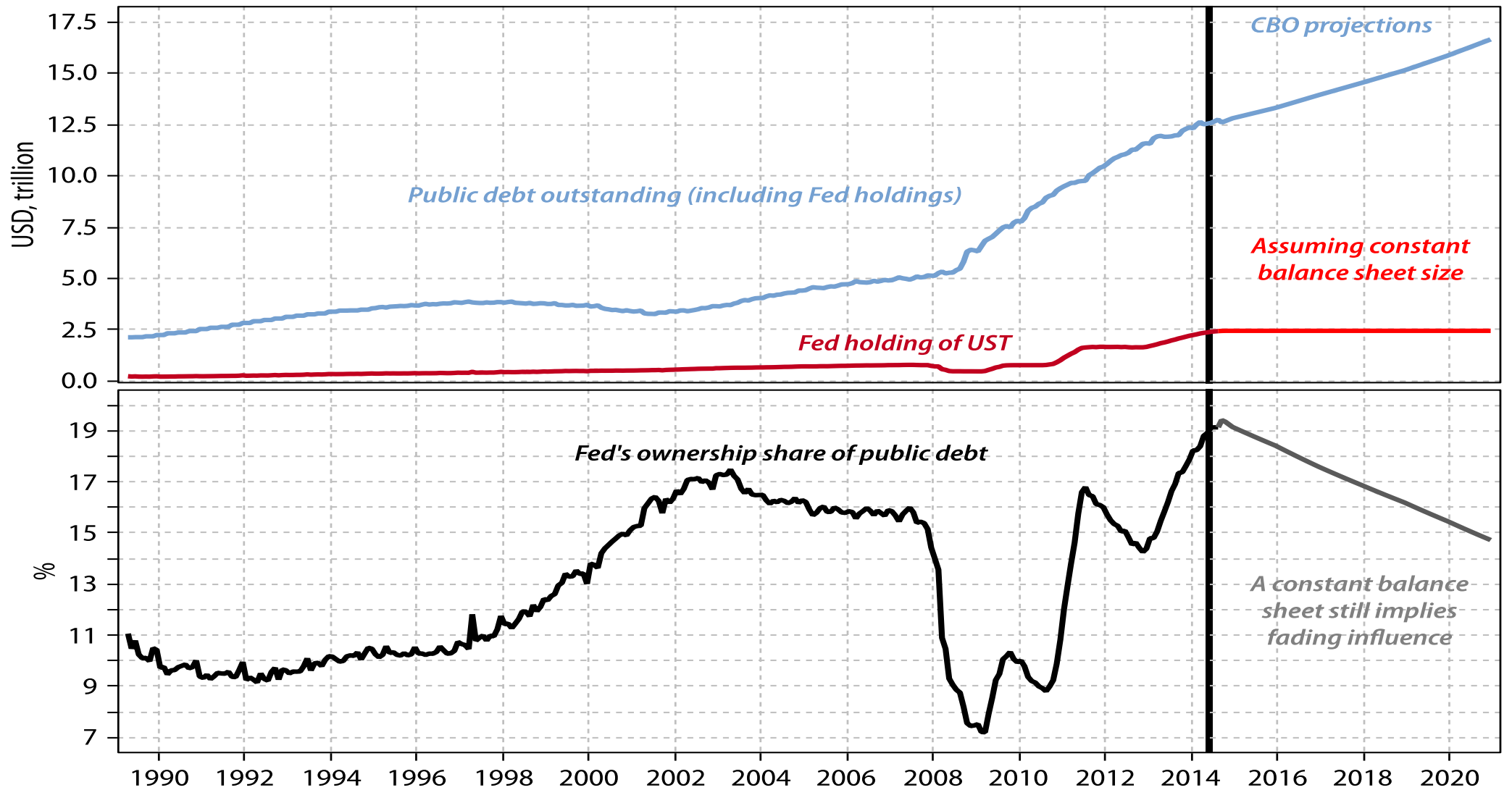
Tapering = slower balance sheet expansion; not contraction



Gavekal Data/Macrobond

Will the Fed's lack of appetite for more government debt impact yields?

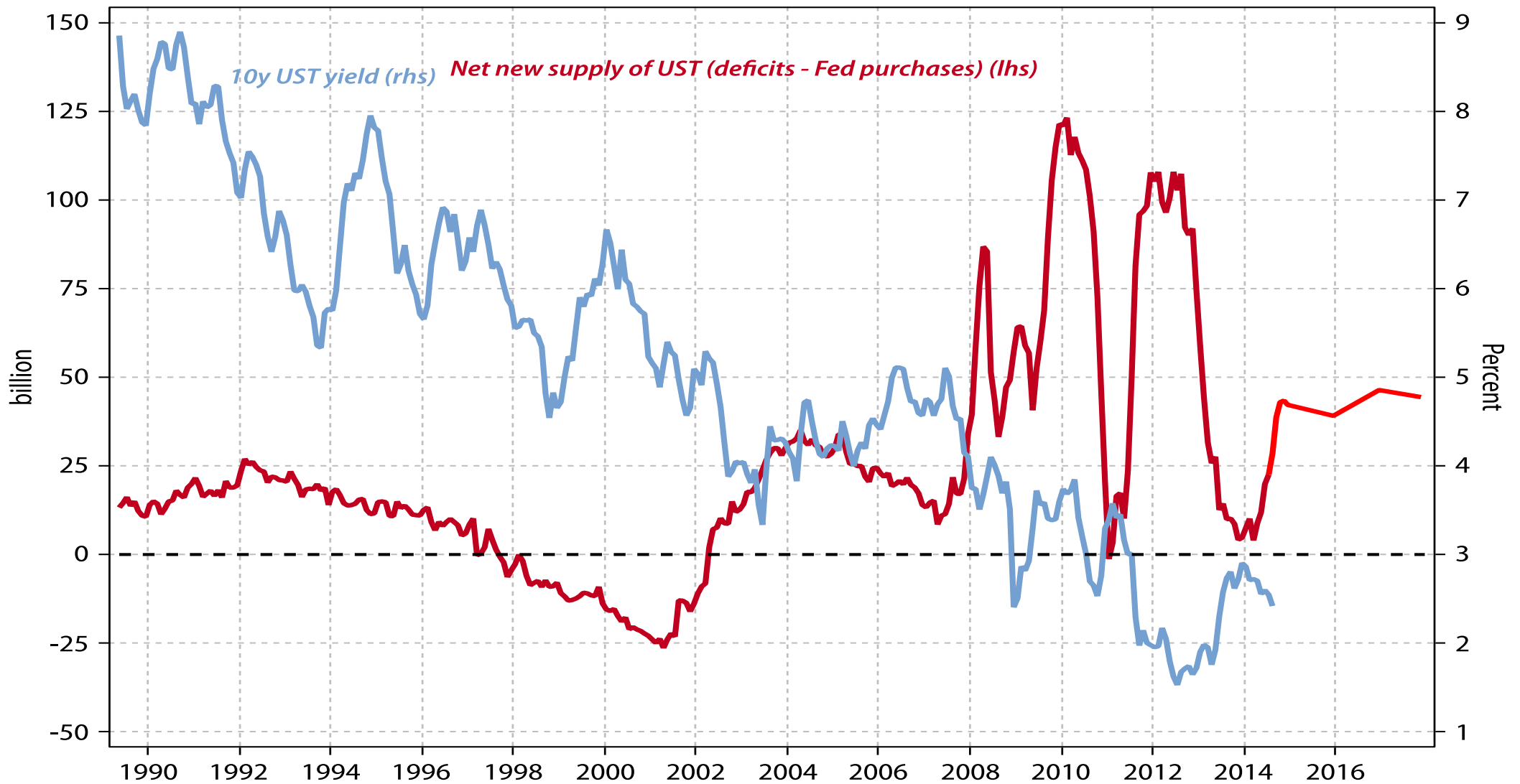
Fed's ownership share of public debt set to fade



Gavekal Data/Macrobond

In recent years, the Fed has been up to 100%+ of new supply

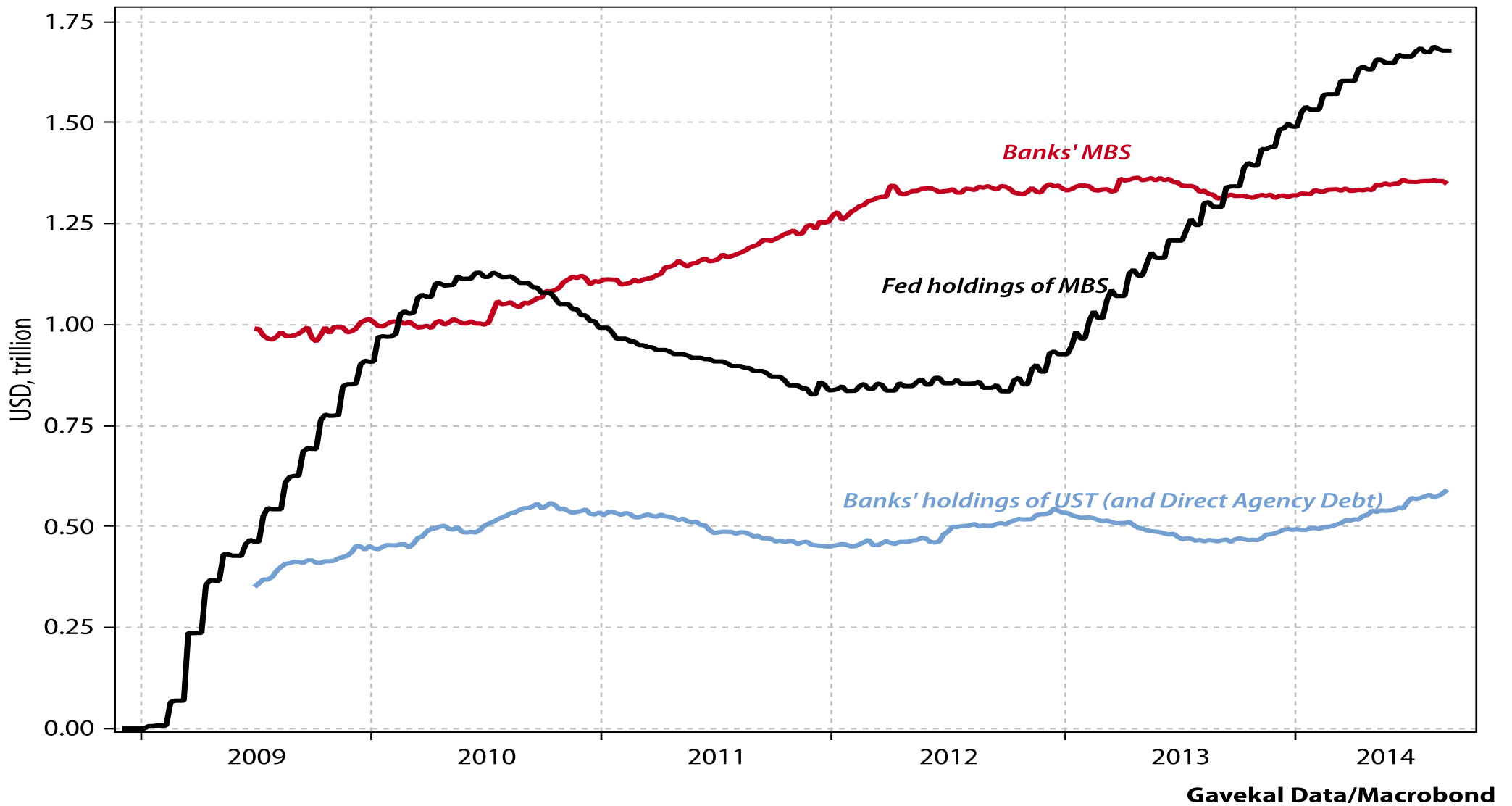
But the relationship with UST yields is far from clear



Gavekal Data/Macrobond

As Fed takes a step back, will mortgage costs start to creep higher?

Fed has been instrumental in supporting MBS



The uncertainties surrounding liquidity

In the US: By late October, the Fed will be done adding liquidity into the system. Does this mean that the Fed will soon hike interest rates? Or rapidly move back towards QE4? One positive for the US is that bank loans appear to be accelerating. Meanwhile, one open question is whether the rapid rise in the value of the US\$ should be seen as a sign that excess liquidity in US\$ might not be as plentiful as previously imagined?

In Euroland: The ECB talks a great game and seems to be putting together various plans to boost domestic liquidity in Europe. Unfortunately, so far, there seems to be little follow-through from the talk to the monetary aggregates. Meanwhile, bank lending continues to contract and fund flows have turned negative.

In Japan: The BoJ continues to remain the most aggressive central bank out there. But following the recent spate of disappointing data, could it get even more aggressive?

In China: The most important recent financial development out of China is the renewed strength of the RMB, in spite of an overall weak economic environment. This is a sign that China is serious about continuing to internationalize the RMB; which in turn means that China will continue to embrace financial sector liberalization, and not press the monetary pump too hard.

4- Behavioral finance: looking for red flags

Two risk regimes in equity markets

Large gains and large losses belong to the same risk regime. Equity markets experience a phase transition around 20% risk quantiles.

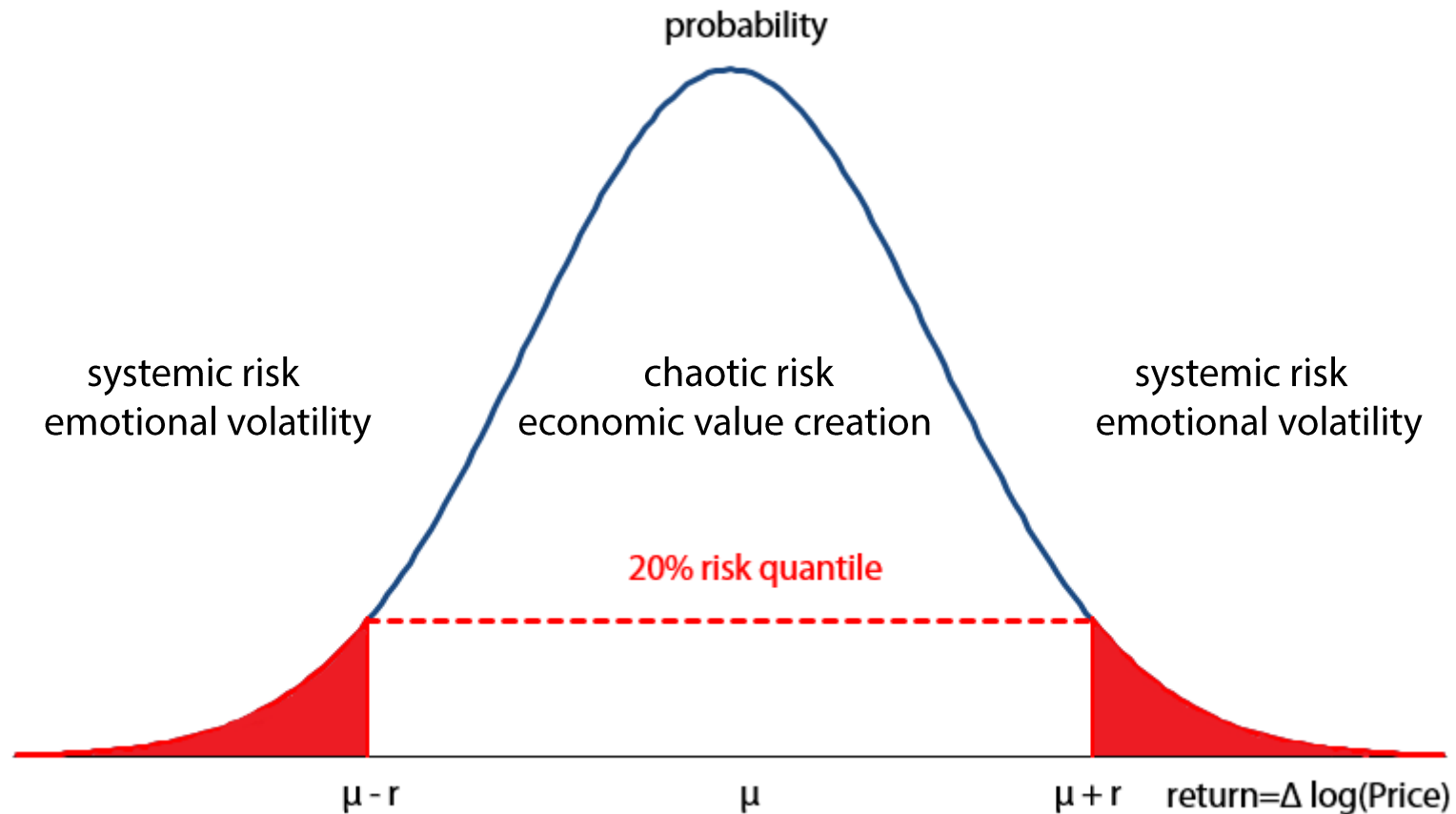
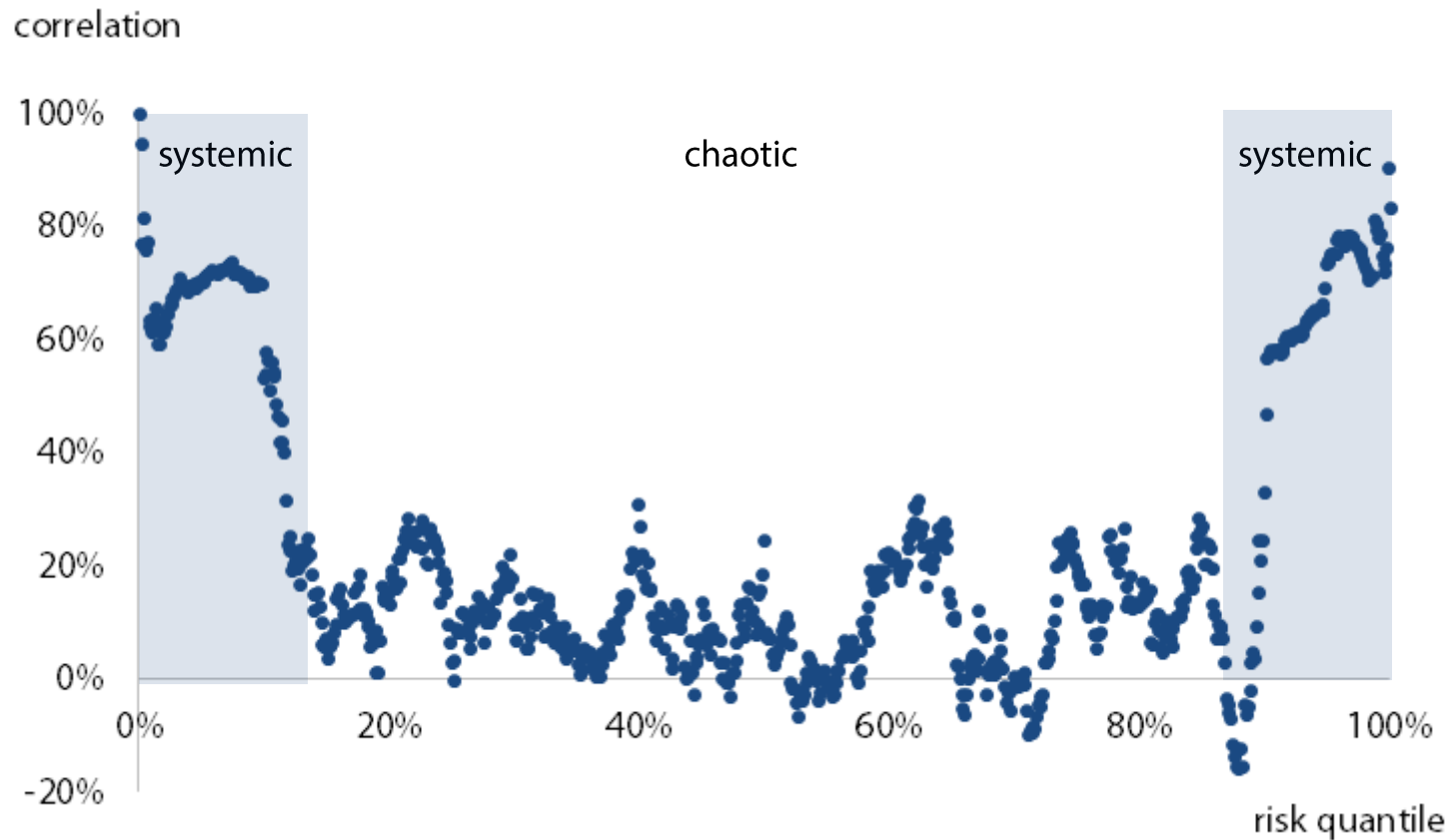


illustration: distribution of equity returns

Evidence of regime switch

Example: correlation of MSCI US vs. average of 40 MSCI Country indices



Source: Bloomberg data, 08/1999 to 03/2014

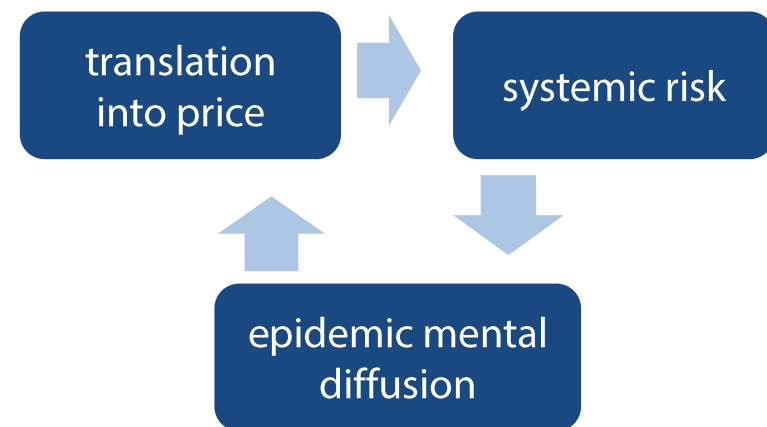
Endogenous vs. exogenous risks

When market participants buy or sell because other people buy or sell the market enters a systemic risk regime, leading to tail-end returns.

CHAOTIC RISK regime generates economic value

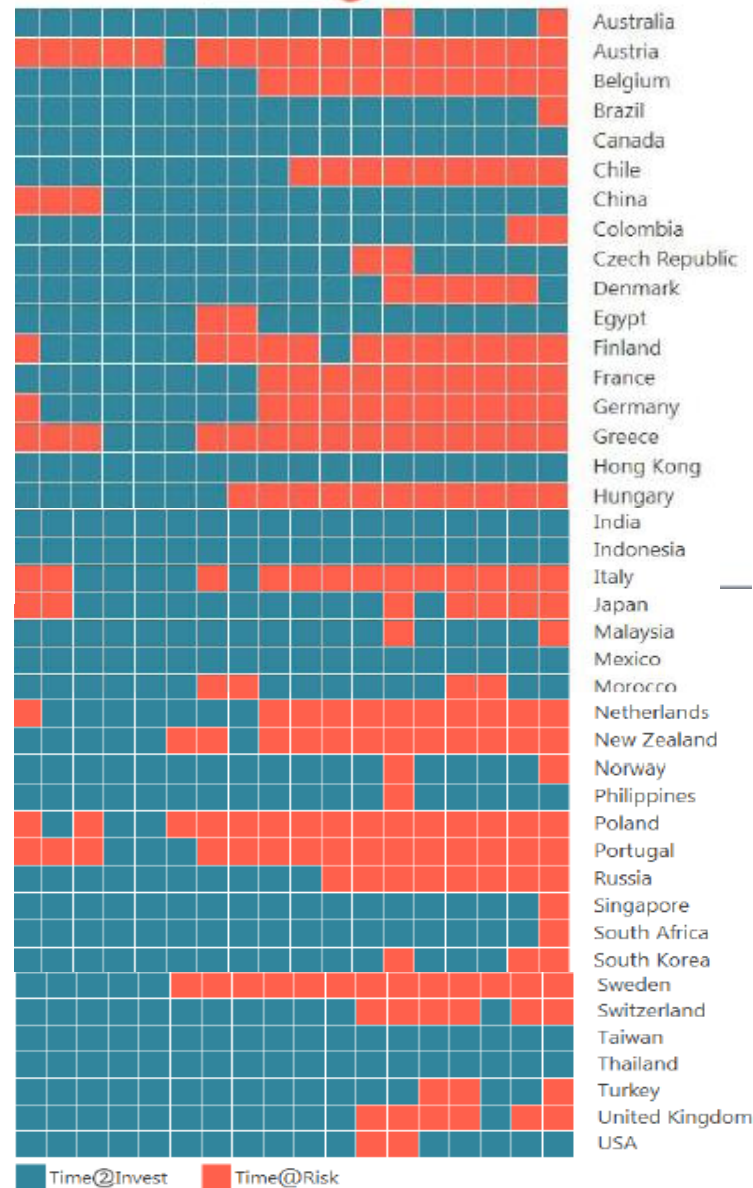


SYSTEMIC RISK regime induces “emotional” volatility



European markets seem to be displaying systemic risk

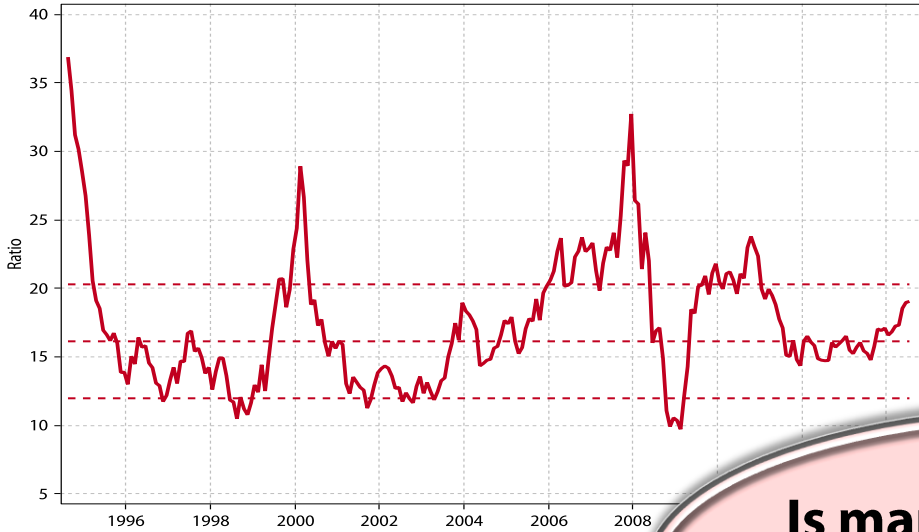
16/05 23/05 30/05 06/06 13/06 20/06 27/06 04/07 11/07 18/07 25/07 01/08 08/08 15/08 22/08 29/08 05/09 12/09



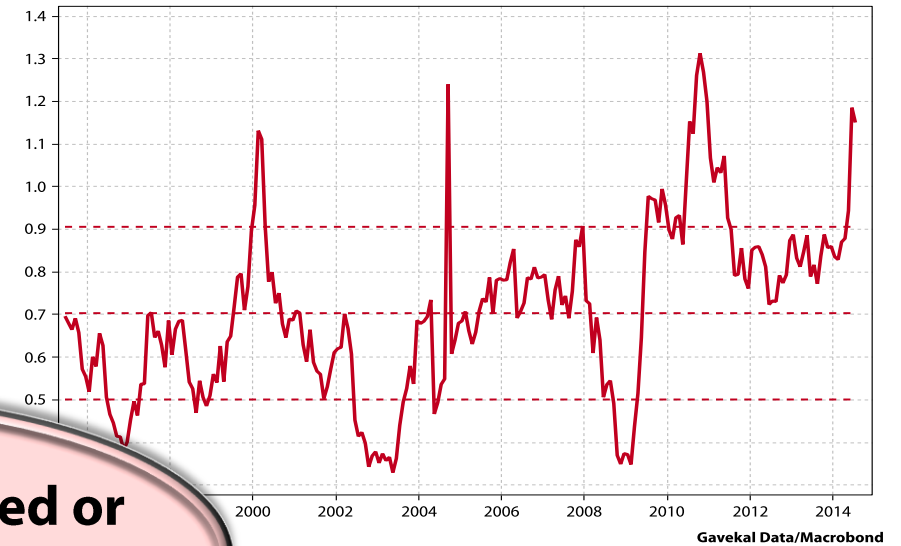
5- Valuation: extreme enough to be a trump card?

Q5: There are many ways to look at a market's valuation

India MSCI mid & large-cap index, p/e ratio



India MSCI Price-Earnings to Growth



Is market overvalued or undervalued?

India MSCI mid & large-cap index, price/book



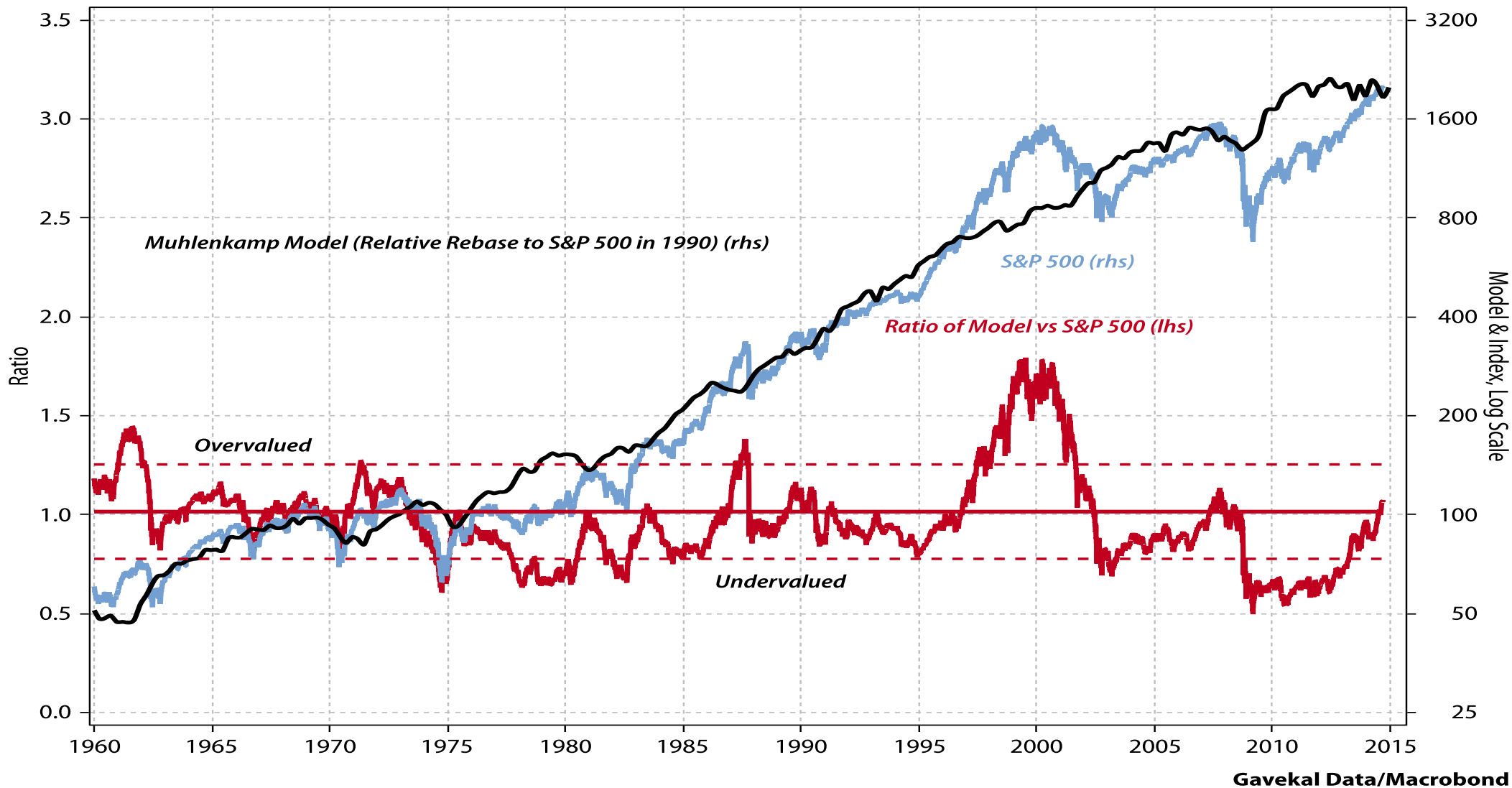
India bond yields minus earnings yield



The low interest rate environment makes equities look good

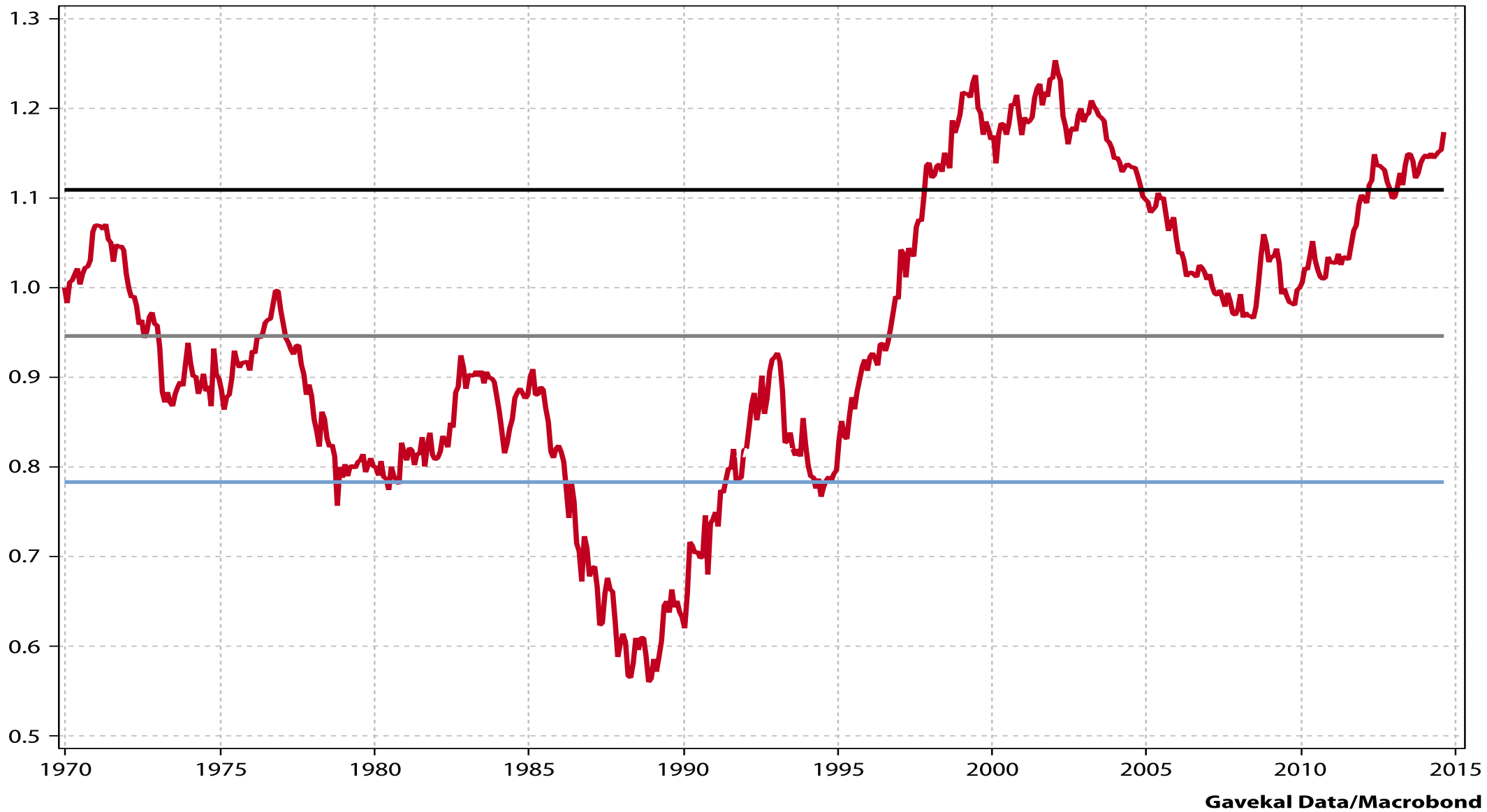
S&P 500 vs. Muhlenkamp Model

Model: Trailing corporate cash flows discounted by 10 year avg inflation + 3%



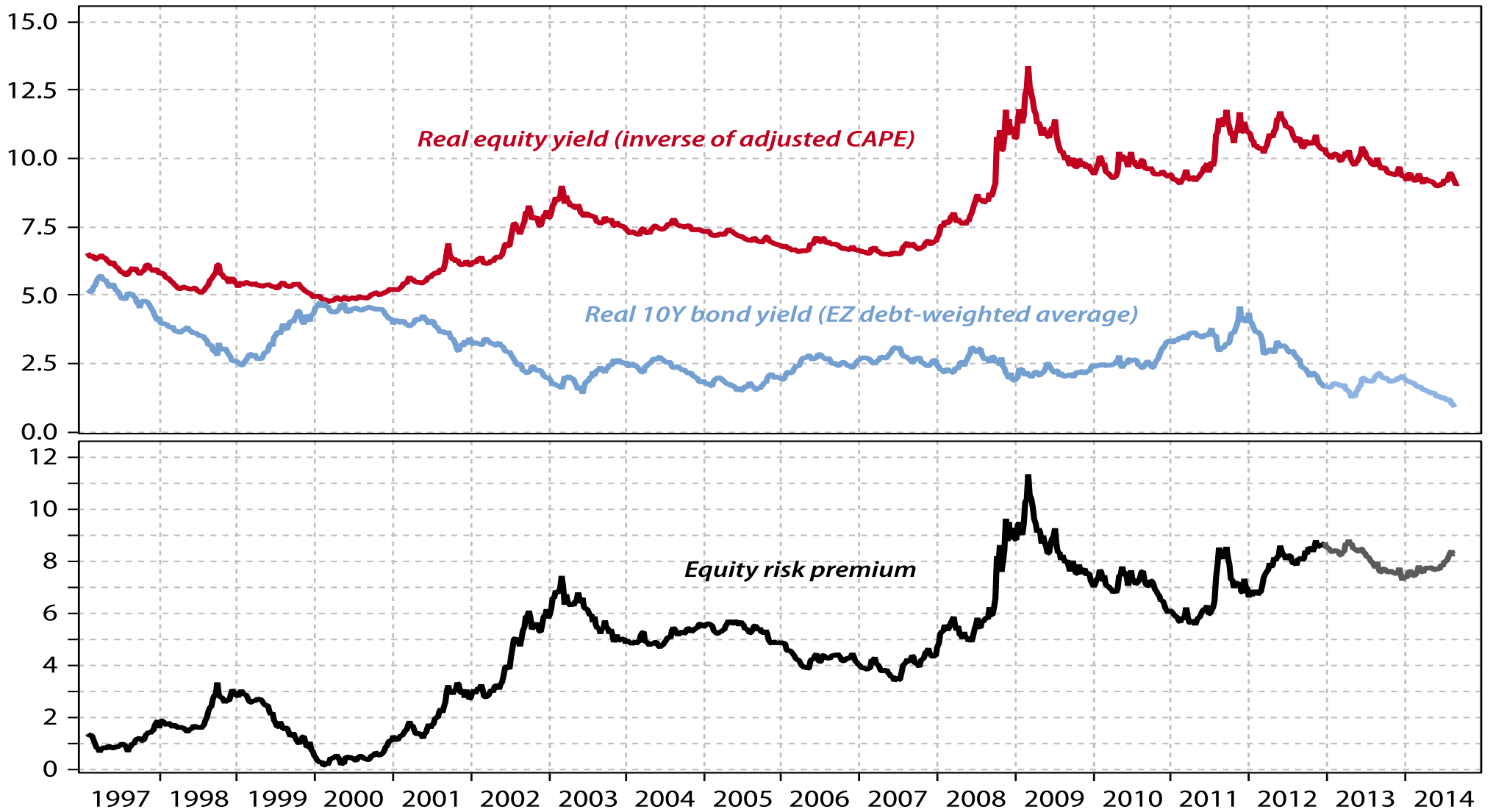
Can US outperformance be sustained?

Equity Indices, MSCI, Mid & Large Cap, United States/World, Total Return, USD



The valuation gap between the US and other DM has grown

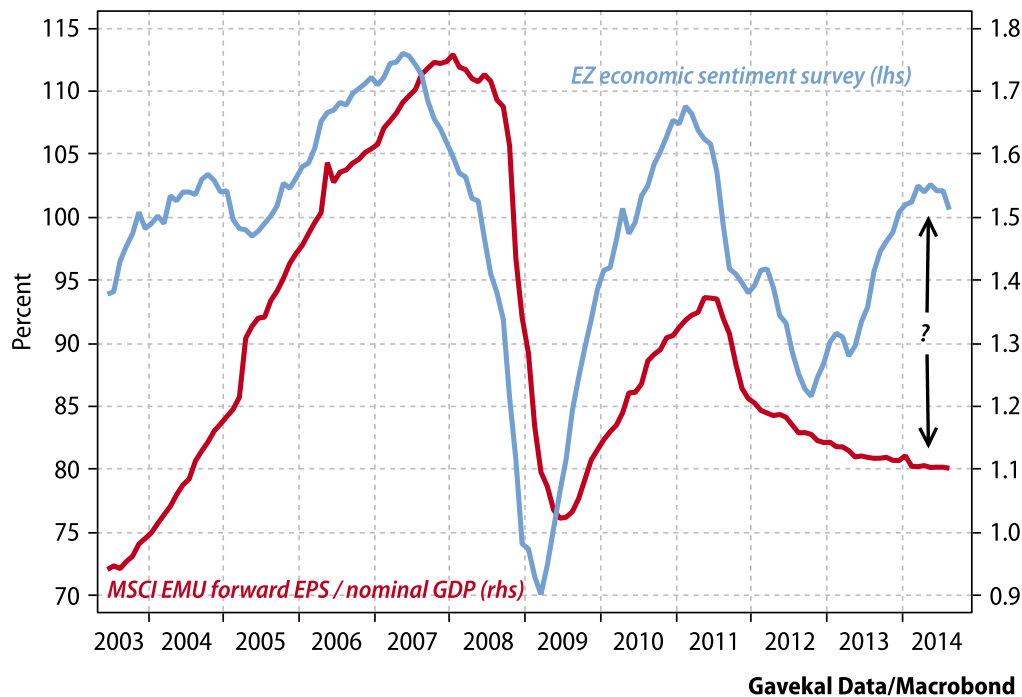
Equity risk premium in Europe not far off its high



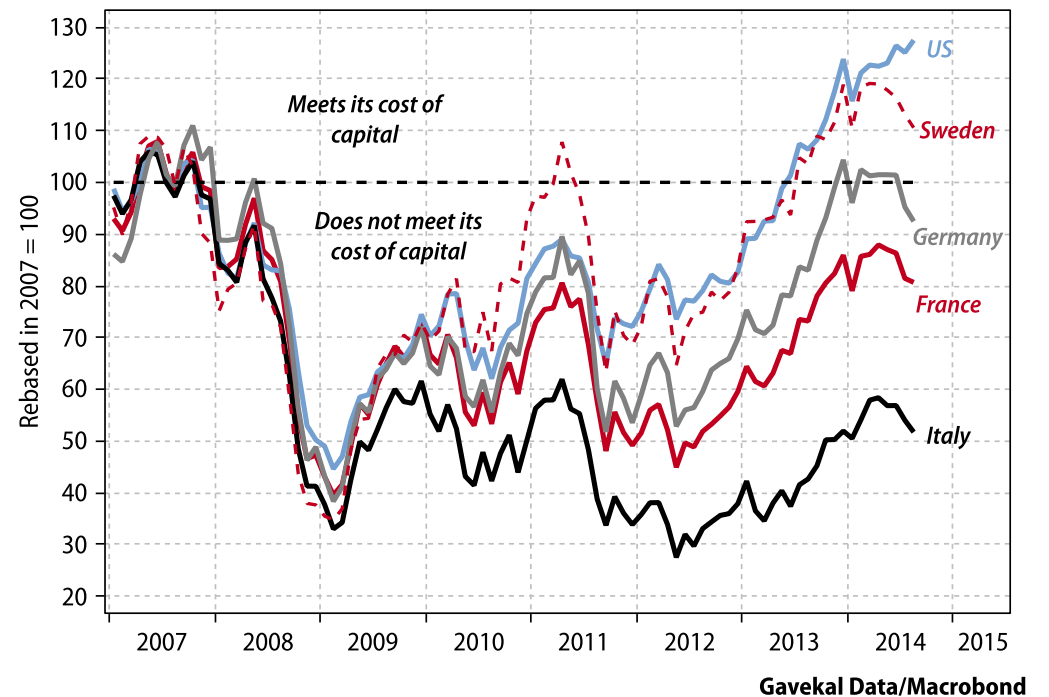
Gavekal Data/Macrobond

But European corporate profitability is still lagging

Investors are becoming impatient about EZ corporate earnings



Long the local stock market in dollars, short a 10-year US zero



At the moment, it appears that eurozone policymakers view the lack of bank lending as a supply problem. In other words, if we just fix the banks, credit is certain to grow.

But is it really that simple? The problem in Europe is that corporate profitability is just not picking up.

We know that a company needs to have a return of at least its cost of capital, otherwise it eventually goes bust. For simplicity, let us assume a general cost of capital equal to a 10 year US zero coupon bond (and this is a generous assumption).

If we consider a ratio between the total return in dollars of each market since 2007 vs. the 10-year constant duration bond, we see the countries in which the local companies as a group have met their cost of capital, and which have not.

The reality for the eurozone is that most countries have a return on capital way below the cost of capital, at least as measured by the markets. Needless to say, this is not good news for capital spending, nor for growth.

Will Europe simply follow Japanese path to irrelevance?

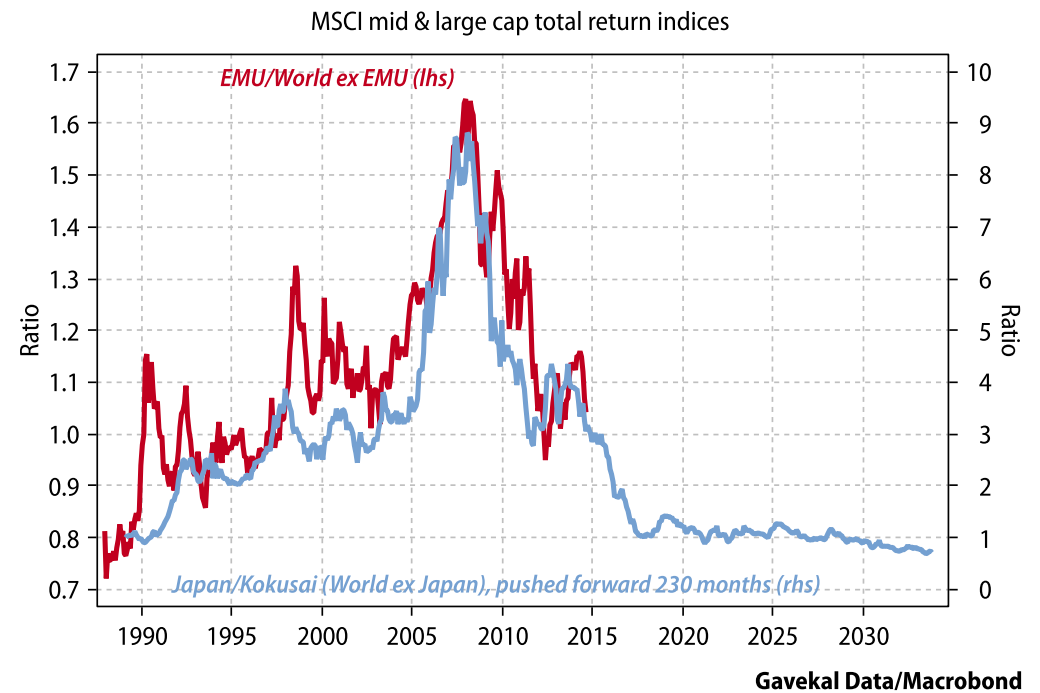
A clear deflationary signal



All things considered, investors seem to be endorsing the stagnation scenario.

Sovereign bond yields in Europe have never been lower, the euro is slowly weakening and European financial stocks are struggling. These developments are all reminiscent of the great Japanese stagnation.

Following the Japanese footprints?

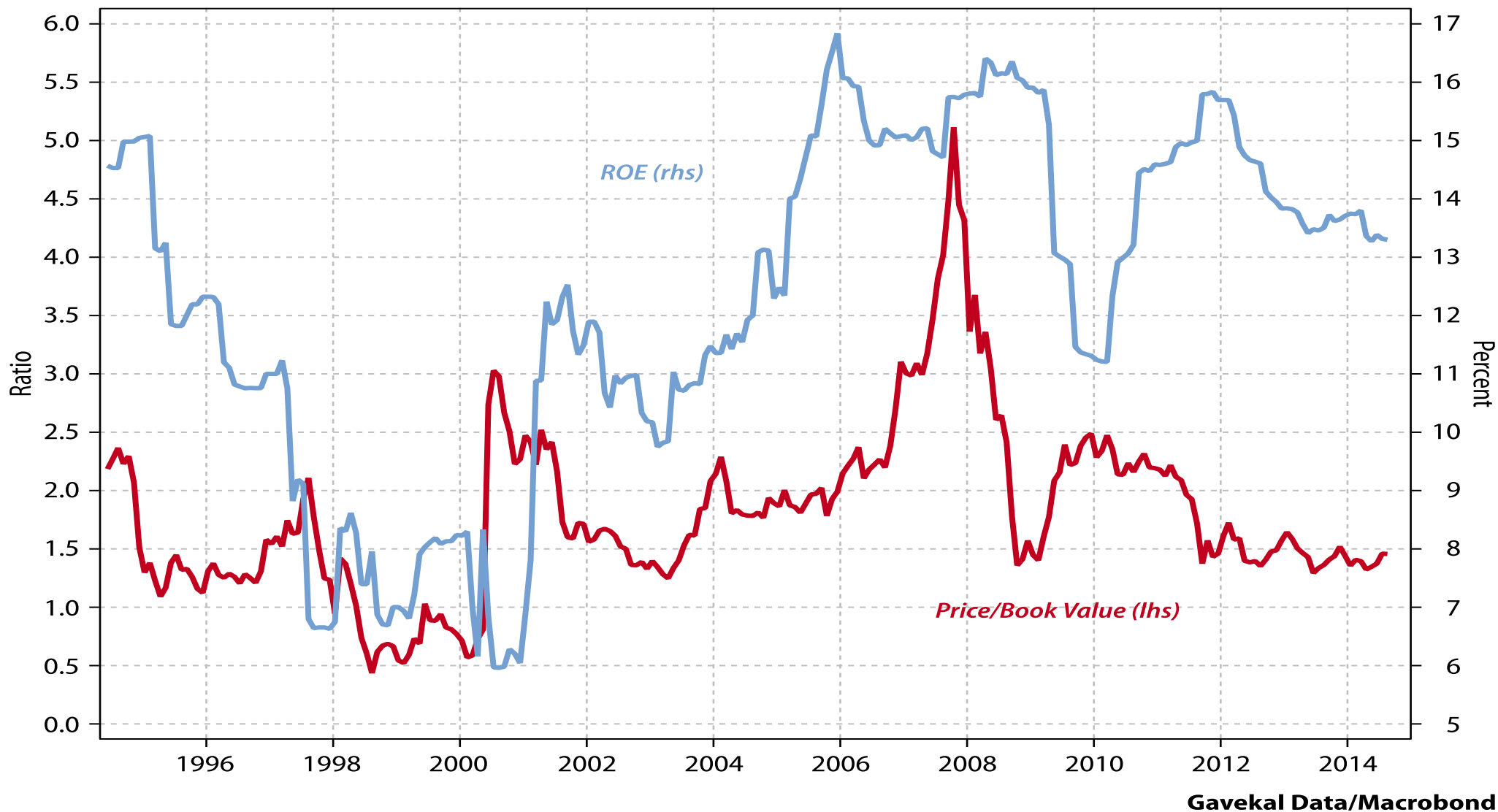


And thus we have the prospect of a Europe that lumbers on towards irrelevance. The good news is that the eurozone economy represents less than 17% of global GDP, which by coincidence is about what the Japanese economy represented in 1995.

The world was able to digest the Japanese decline, and we see no particular reason why the European story should be different. A resilient US economy and resurgence in developing economies will hopefully be enough to compensate.

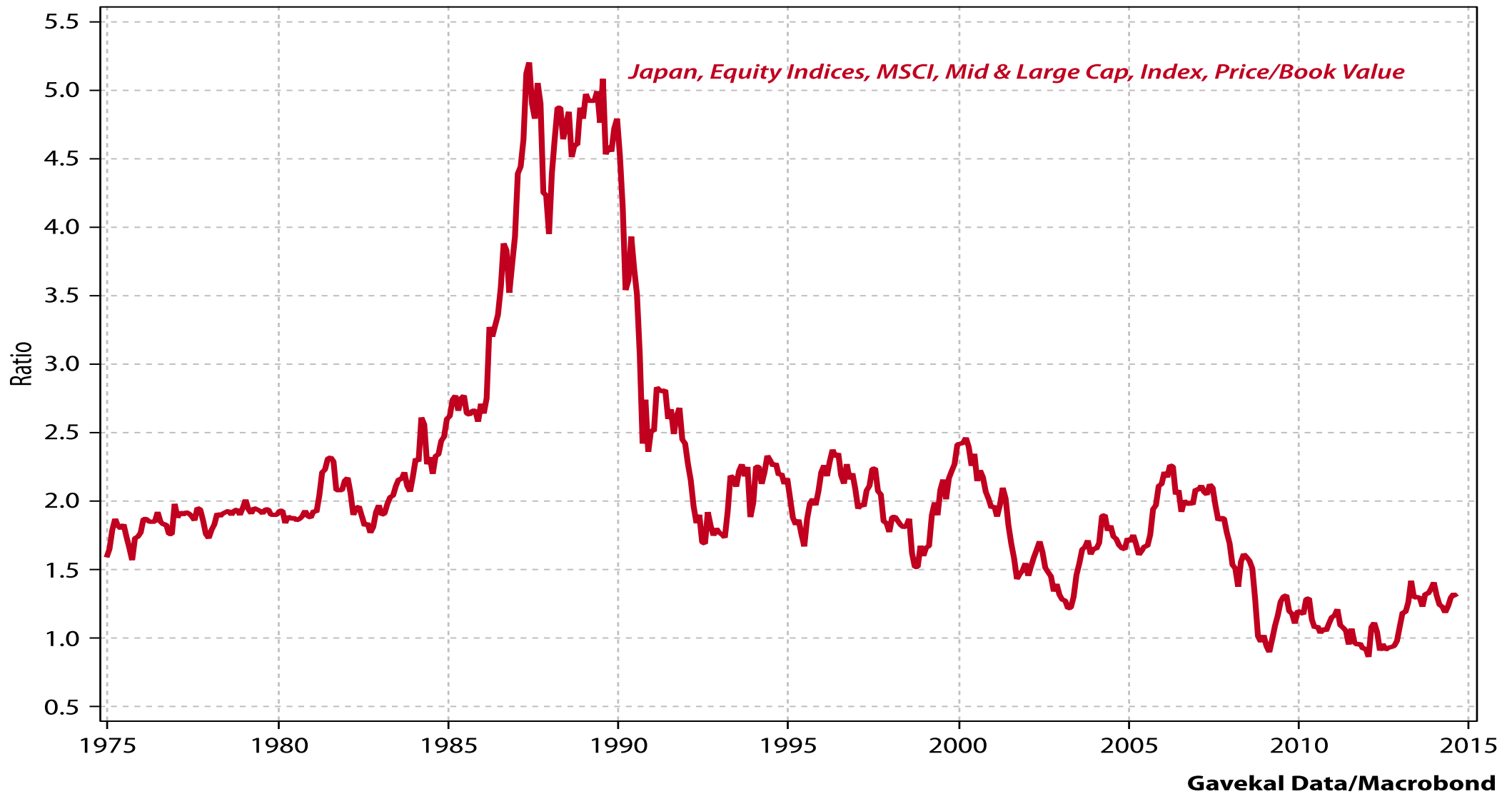
Fortunately, other markets are also attractively valued

China: Valuations Are Attractive Given High ROE And High Profit Growth



In fact, a number of (non-US) markets are still close to their valuation lows

Japan, Equity Indices, MSCI, Mid & Large Cap, Index, Price/Book Value



6- Conclusion

An investment landscape with still a lot of green

	Economic Activity				Momentum	Excess Liquidity			Behavioral	Valuations			
	<i>Demos</i>	<i>Labor Prod</i>	<i>Capital Prod</i>	<i>Global Integ.</i>		<i>Central bank</i>	<i>Comm banks</i>	<i>Fund Flows</i>		<i>PER</i>	<i>PIBK</i>	<i>PEG</i>	<i>Yield Diff</i>
USA	Green	Green	Yellow	Green	Green	Yellow	Green	Green	Green	Red	Red	Yellow	Green
Euroland	Red	Yellow	Yellow	Green	Red	Yellow	Red	Red	Red	Green	Green	Yellow	Green
Australia	Yellow	Green	Red	Red	Green	Green	Green	Green	Red	Red	Yellow	Red	Green
New Zealand	Yellow	Green	Red	Red	Yellow	Red	Green	Green	Red	Red	Green	Red	Green
India	Green	Green	Green	Green	Green	Yellow	Green	Green	Green	Red	Red	Yellow	Red
Thailand	Green	Yellow	Green	Green	Green	Green	Yellow	Green	Green	Yellow	Yellow	Red	Yellow
Malaysia	Green	Yellow	Green	Green	Green	Green	Yellow	Green	Red	Red	Yellow	Red	Yellow
Vietnam	Green	Green	Red	Green	Green	Green	Red	Green	Green	Yellow	Yellow	Green	Green
Singapore	Green	Green	Green	Green	Green	Green	Green	Green	Red	Green	Green	Green	Green
Indonesia	Green	Green	Green	Green	Green	Yellow	Yellow	Green	Green	Red	Red	Yellow	Yellow
Philippines	Green	Green	Green	Green	Green	Green	Green	Green	Green	Yellow	Red	Green	Yellow
Taiwan	Yellow	Green	Green	Green	Green	Green	Green	Green	Green	Yellow	Green	Green	Green
Hong Kong	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
China	Yellow	Green	Red	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
South Korea	Red	Green	Green	Green	Yellow	Green	Green	Green	Red	Green	Green	Green	Green
Japan	Red	Green	Red	Green	Yellow	Green	Green	Green	Red	Yellow	Green	Red	Green

The big questions for asset allocators

Should we worry about the EMU growth outlook? Probably not. As things stand, it seems more likely that Euroland will gradually slip into a low growth/low impact Japan-like scenario. One potential concern is that Europe will export its deflation problem through a weaker currency. But the grind from that will be gradual instead of sudden.

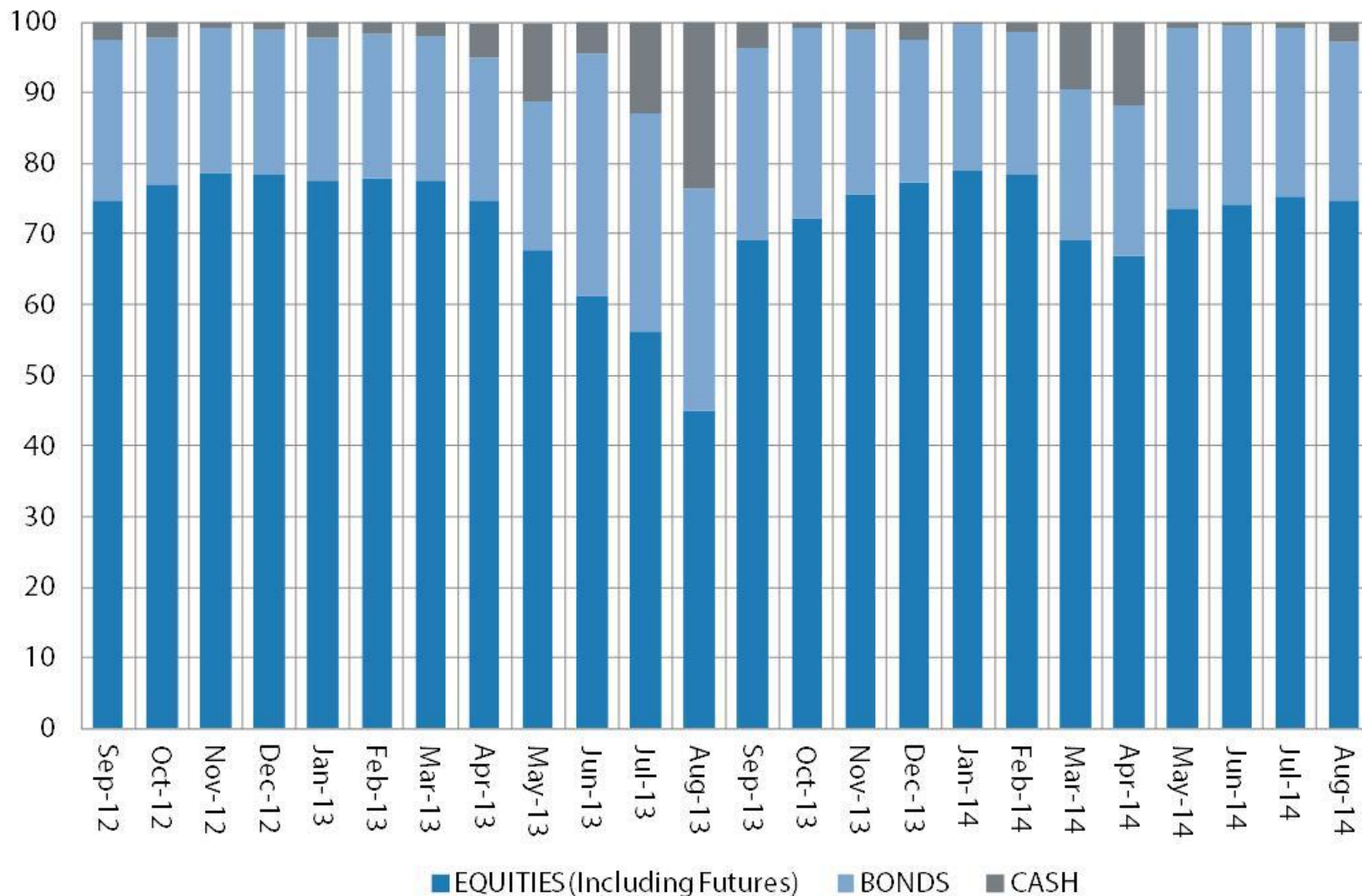
Should we worry about Chinese growth? All Asian industrialized countries have gone through the struggle now confronting China on finding a balance between the need for financial reform (i.e. becoming more Wicksellian) and the obsession with stabilization (i.e. try to maintain growth with credit expansion). All ends up with the different type of debt and destinies. Those which faced external crisis were forced to restructure which set a better macroeconomic backdrop for growth (Korea in 2000's and somewhat in Malaysia). But those which were protected by a more closed capital account or sufficient self-funding (like China) faced internal deflation, which created a tough environment for the private domestic sector (see Taiwan and Japan). This seems the most likely scenario for China: weaker growth but no crisis.

Should we worry about the end of the tapering? Yes. In recent years, markets have struggled at each previous instances of Fed liquidity withdrawal. It may of course be different this time – but maintaining some government bonds in portfolios as a hedge against a deflationary shock makes sense.

Should we worry about valuations? Certain markets are starting to display rather stretched valuations (USA, India, Malaysia, Australia...). However, most other equity markets remain much more attractively valued than bonds.

The environment remains a positive one for Asian equity markets

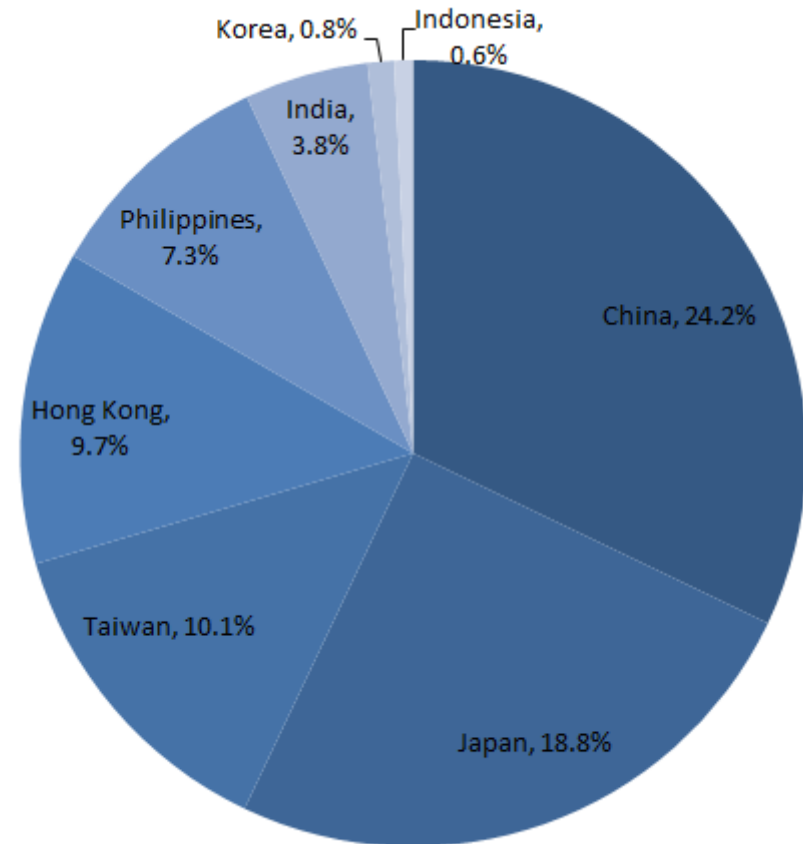
Asset Allocation of Gavekal Asian Opportunities UCITS Fund



Especially for investors willing to deploy capital in North Asia

Asset Class	Port. Ending Weight	Contr. to Absolute Risk	Percent Factor Risk	Percent Stock Specific Risk	Percent Total Risk
Derivatives	0.16	0.47	4.64	--	4.64
Australian Dollar	-4.12	-0.17	-1.65	--	-1.65
Japanese Yen	-17.13	0.18	1.74	--	1.74
New Zealand Dollar	-0.85	-0.03	-0.32	--	-0.32
U.S. Dollar	22.26	0.50	4.87	--	4.87
Equity	77.39	8.75	78.39	7.53	85.92
China	25.00	3.15	27.98	2.95	30.93
Hong Kong	9.83	1.03	9.52	0.55	10.07
India	3.81	0.49	4.45	0.36	4.82
Indonesia	0.60	0.05	0.48	0.01	0.48
Japan	19.40	2.39	21.82	1.66	23.48
Korea	0.87	0.03	0.24	0.03	0.27
Philippines	7.50	0.67	5.51	1.10	6.62
Taiwan	10.38	0.94	8.40	0.86	9.27
Fixed Income	19.59	0.82	8.03	0.02	8.05
Australia	1.22	0.06	0.57	0.00	0.57
China	1.84	0.07	0.68	0.00	0.68
Hong Kong	0.48	0.01	0.12	0.00	0.12
Indonesia	6.13	0.23	2.25	0.01	2.25
Korea	2.91	0.14	1.40	0.00	1.40
Malaysia	5.52	0.25	2.45	0.01	2.46
New Zealand	1.50	0.06	0.56	0.00	0.56
[Cash]	2.86	0.14	1.39	--	1.39
[Cash]	2.86	0.14	1.39	--	1.39
Total	100.00	10.18	92.45	7.55	100.00

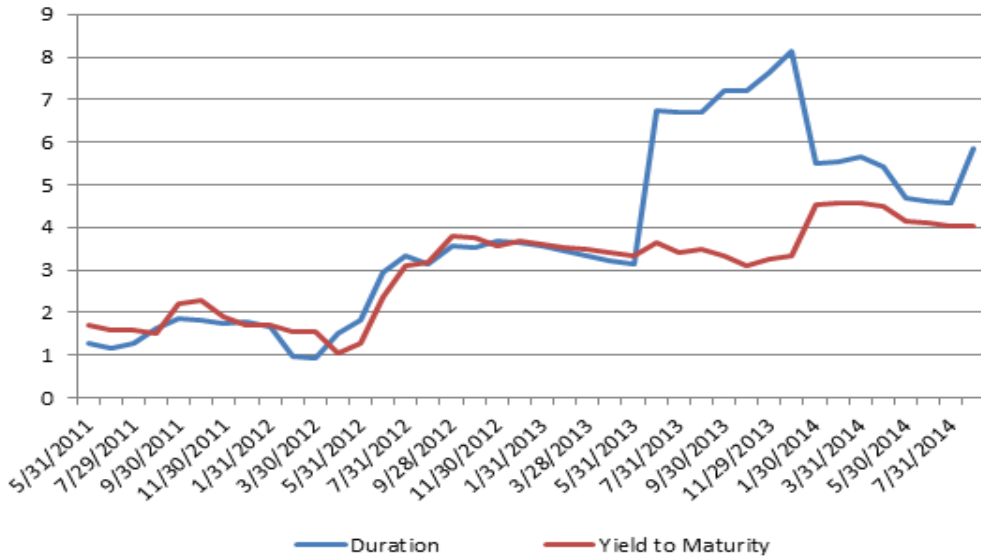
Equity Allocation by Country as % of Total NAV



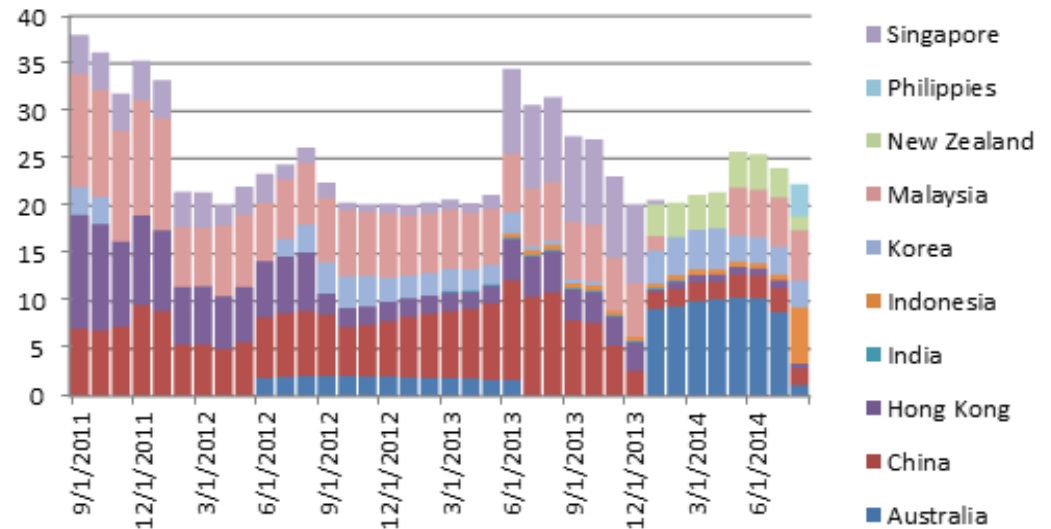
* Includes exposure in futures

On the fixed income side, diversifying with government bonds

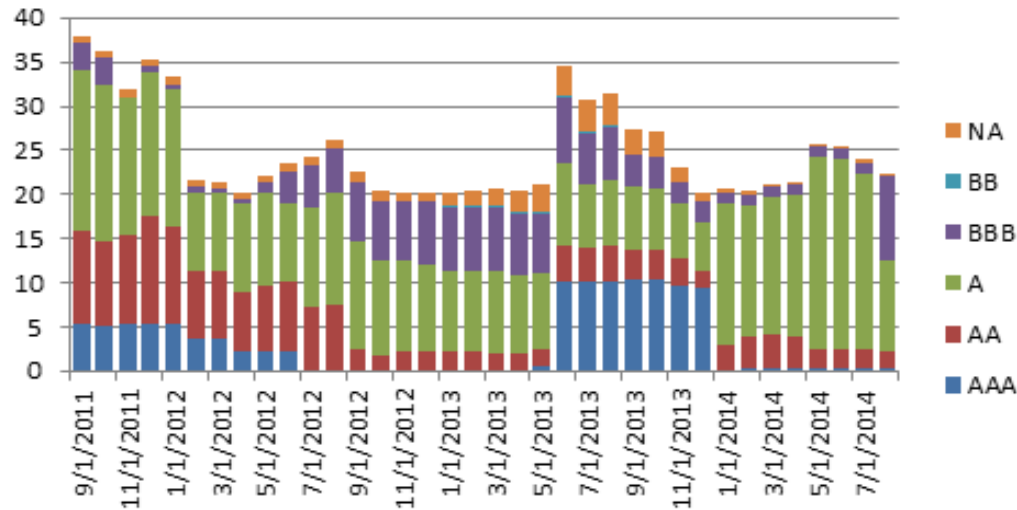
GAOUF's Bond Portion Duration & Yield



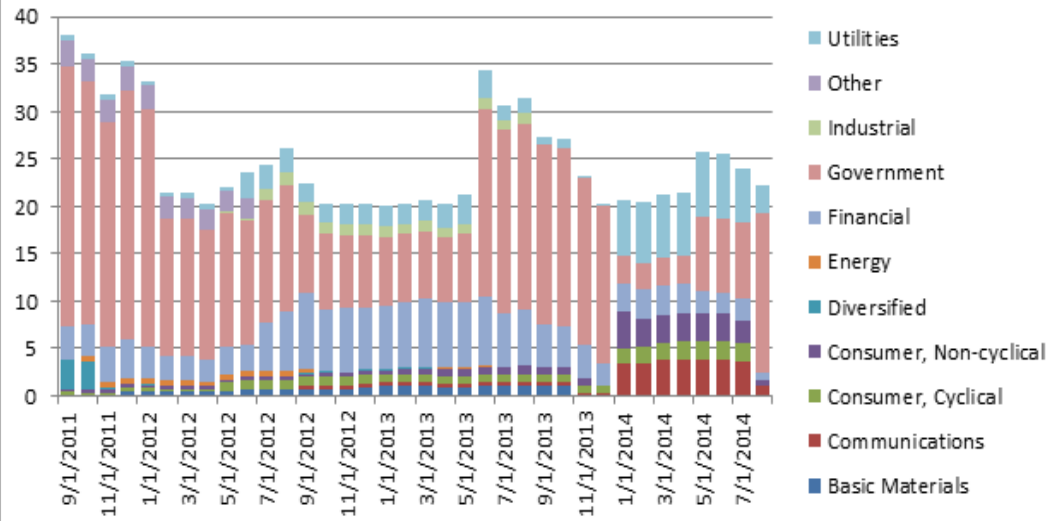
% of Country Weight in Asia Opp's Bond Portion



% of Credit Rating in Asia Opp's Bond Portion



% of Sector Weight in Asia Opp's Bond Portion



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