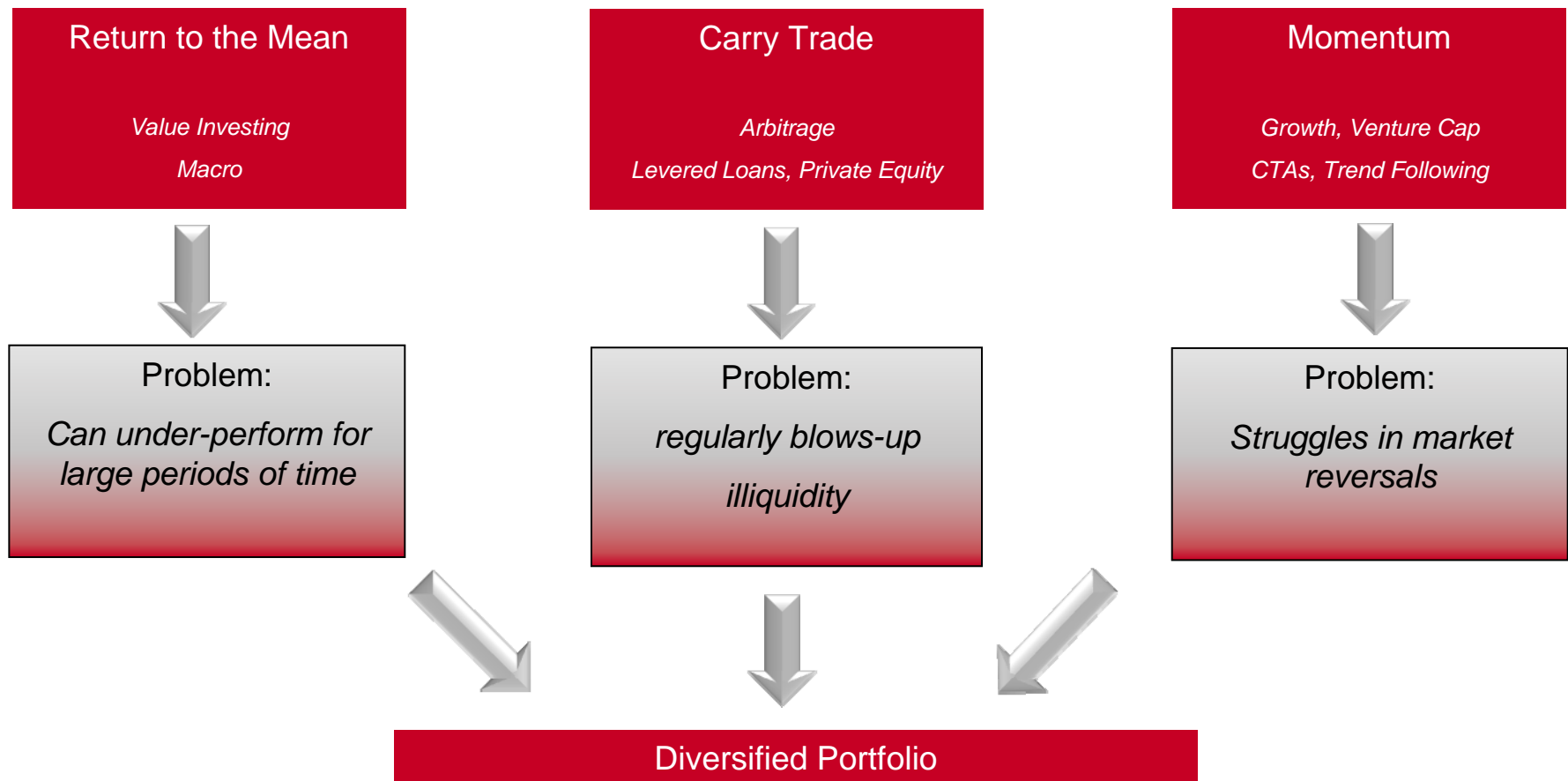




The Challenges of Investing in Asia
MW GaveKal Investor Conference Call
June 2010

There Are Three Ways to Make Money



Reviewing the Asian Investment Landscape

Since 2006, Asian Equities have been a notable outperformer

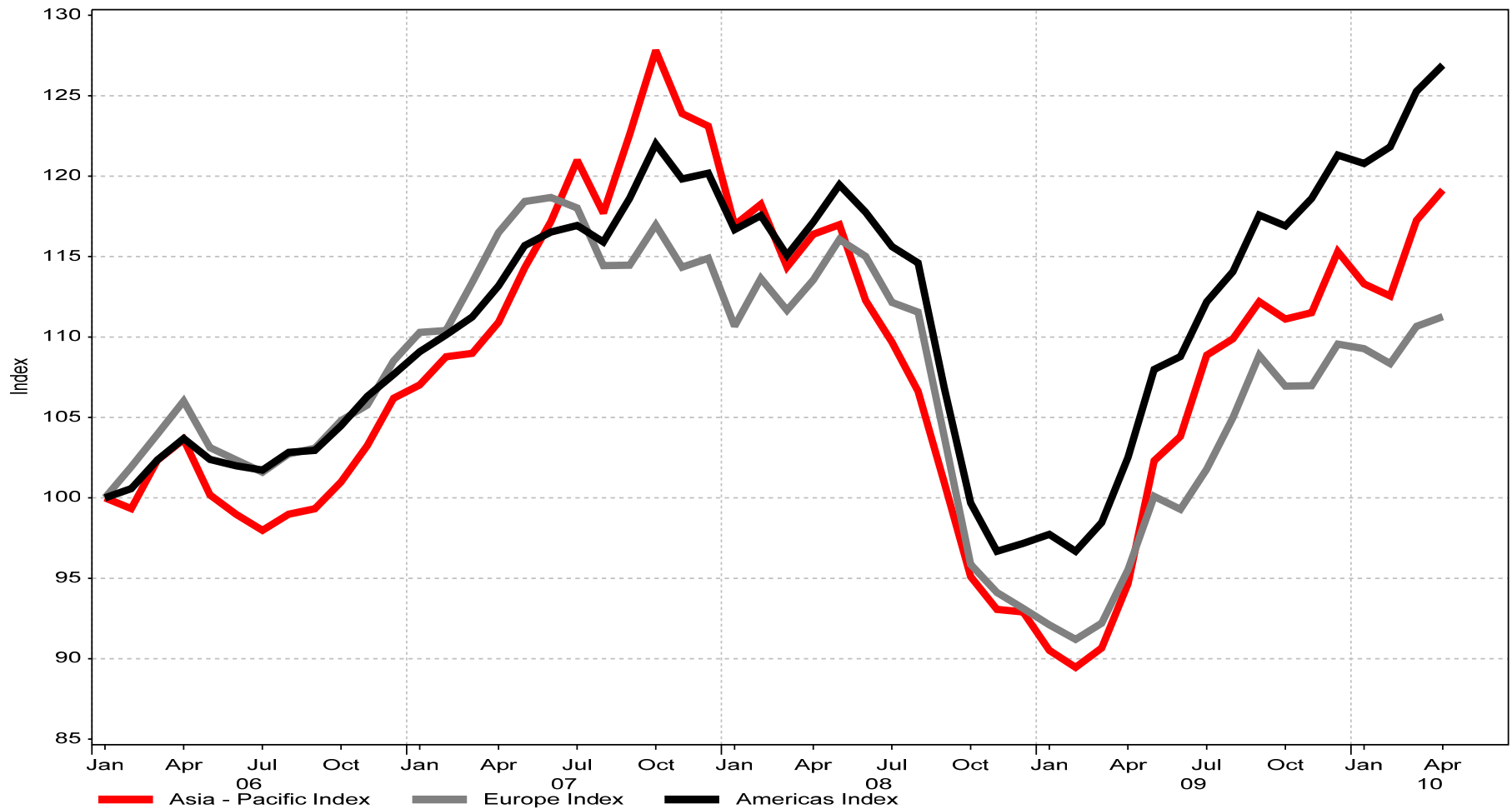
Asia, Europe & North America MSCI Indices



Source: Reuters EcoWin

But Asian Hedge Fund Managers Have Neither Outperformed, Nor Provided Much Diversification in Portfolios

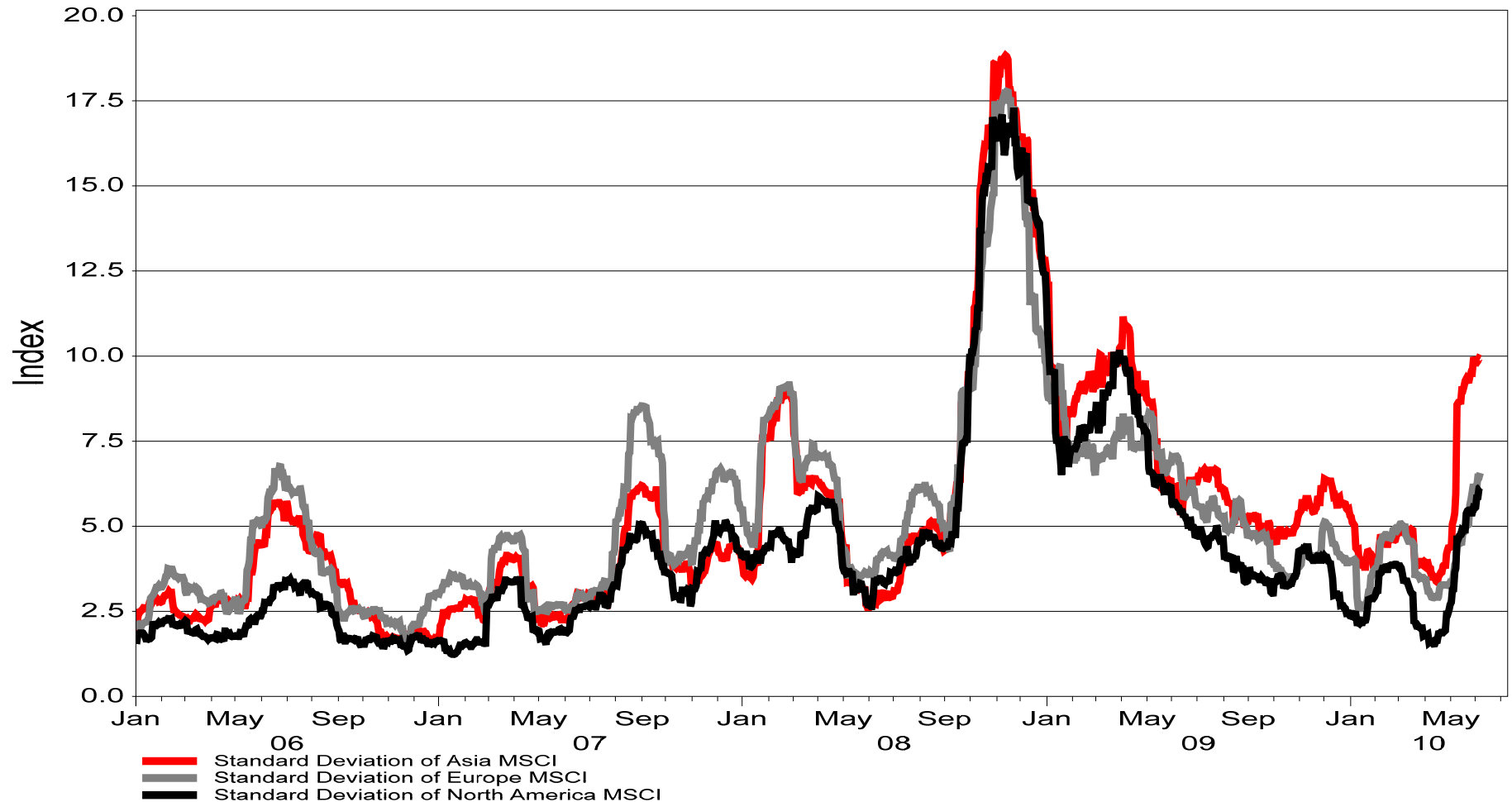
Hennessee Hedge Fund Indices for Asia, Europe & Americas



Source: Reuters EcoWin

And it's not as if higher volatility is really the main culprit. So what explains the lackluster performance?

Annual Monthly Volatility of Asia, Europe & North America MSCI



Source: Reuters EcoWin

An Answer: Investing in Asia Comes With Its Own Distinct Challenges

- The first and greatest challenge of investing in Asia is that a large number of companies have not been listed that long. As such, the track record of companies, CEOs and CFOs is unproven and a lot of questions are unanswered: what is a company's capacity to weather an economic cycle? A financial cycle? etc...
- The second challenge is that the degree of 'institutionalization' of companies is not what it is in the West. For example, how many Asian companies are today running management training programs so that the cream rises to the top? Are procedures in place to routinely sack the bad managers? Are CEOs controlled by independent boards or are firms run like little empires in which no-one dares contradict the top management?
- The third important challenge when investing in Asia is that the 'distress factor' in Asia is typically not 'financial leverage', but instead 'operational leverage'. Indeed in the Western world companies in 'trouble' have typically mismanaged their balance sheets and, for a financial analyst, this is easy enough to identify and work through. Meanwhile, in Asia, a company in trouble has usually mismanaged its operations... and this is much harder to identify, especially if a company has a limited track record.
- Importantly, the above third challenge is amplifying rather than abating as the Western world continues to outsource more of the cyclical, capital and labor intensive, part of their processes (i.e.: Apple and Hon Hai/Foxconn is a perfect example of this trend whereby while Foxconn faces negative headlines and is forced to agree to wage hikes which hit the share price by -20%+ in a week, meanwhile Apple continues to soar to all time highs!).

As a result of these challenges, the typical return to the mean strategies fail to deliver attractive returns in Asia

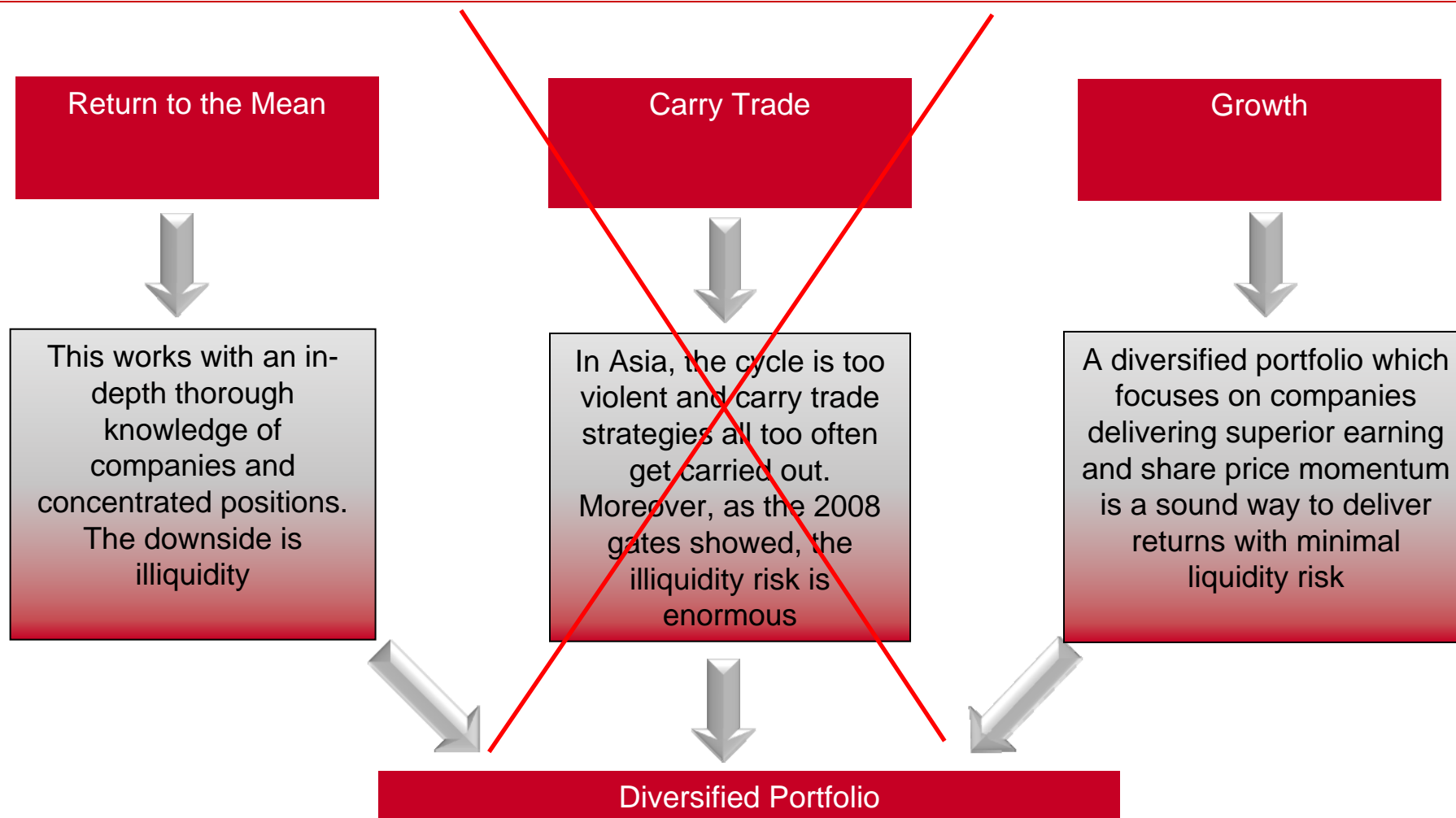
Annualised Information ratio of selected market neutral style strategies across global markets

Style	US	Europe	Pacific Ex-Japan	Japan
GARP - deviation from fair P/B	+0.47	+0.75	+0.49	+1.36
Earnings Revision	+0.02	+1.07	+0.52	+1.05
Low 30 day return	+0.40	+0.33	-0.66	+0.89

MSCI regional indices; style performance measured as the difference between equal weighted top quintile and bottom quintile for each style from February 1995 to February 2008

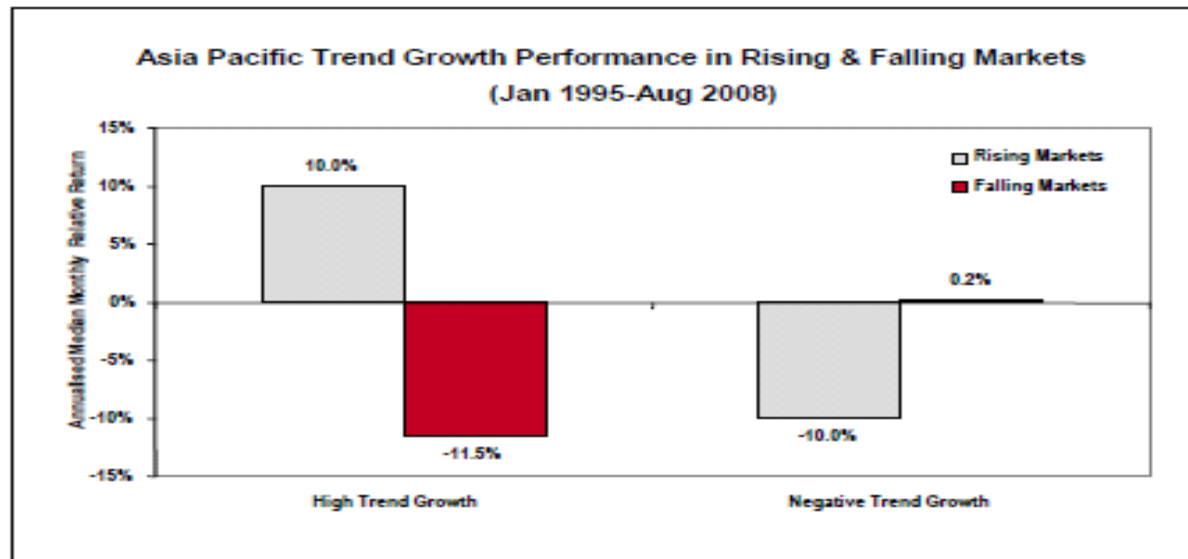
Source: Citi Investment Research

So what works in Asia?



Stock Selection: In Asia, a Growth Bias Pays Off Handsomely in Bull Markets

- The chart below tracks the out-performance or under-performance of Asian ‘high trend growth’ stocks and ‘negative trend growth’ stocks in both rising and falling markets.
- **In bull markets, investors into Asia should want a strategy oriented around growth stocks and in bear markets, investors should want a value bias.**
- **Alternatively, investors should want a fund that focuses on growth stocks in bull markets but has the ability to reduce its equity exposure in more challenging periods so as to avoid the nasty equity growth bear markets that sometimes prevail in Asia.**



Trend growth is the log linear growth rate from a log linear regression of 7 years of 12 month rolling forward EPS estimates, i.e.: the rate at which earnings forecasts have grown over 7 years. This closely approximates the growth rate in actual earnings and is a decent measure of whether a company can grow its earnings through a whole cycle.



Shouldn't We Just Index?

The first problem with indexing is, of course, the volatility

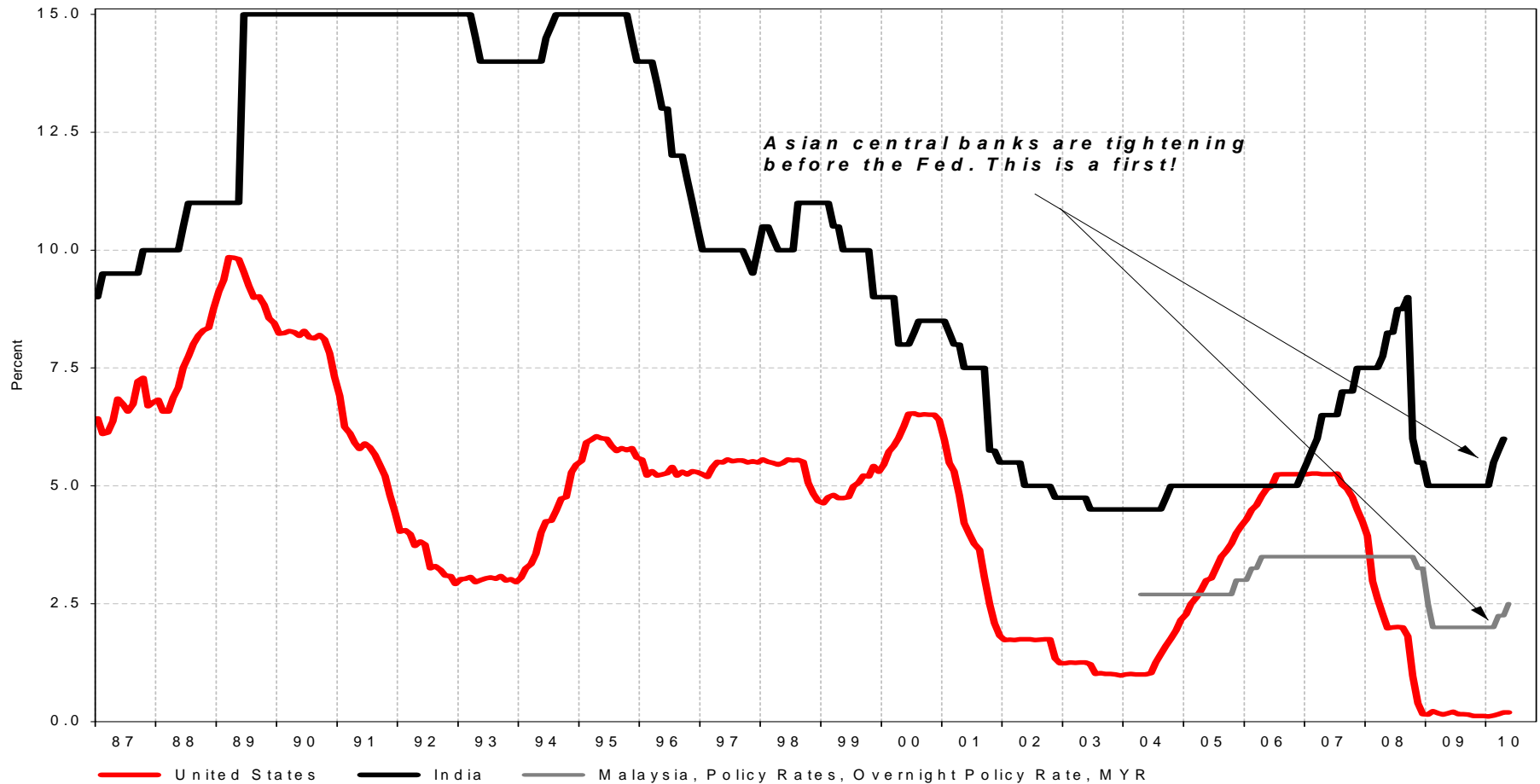
Standard & Poors Asia - Pacific YoY % Change



Source: Reuters EcoWin

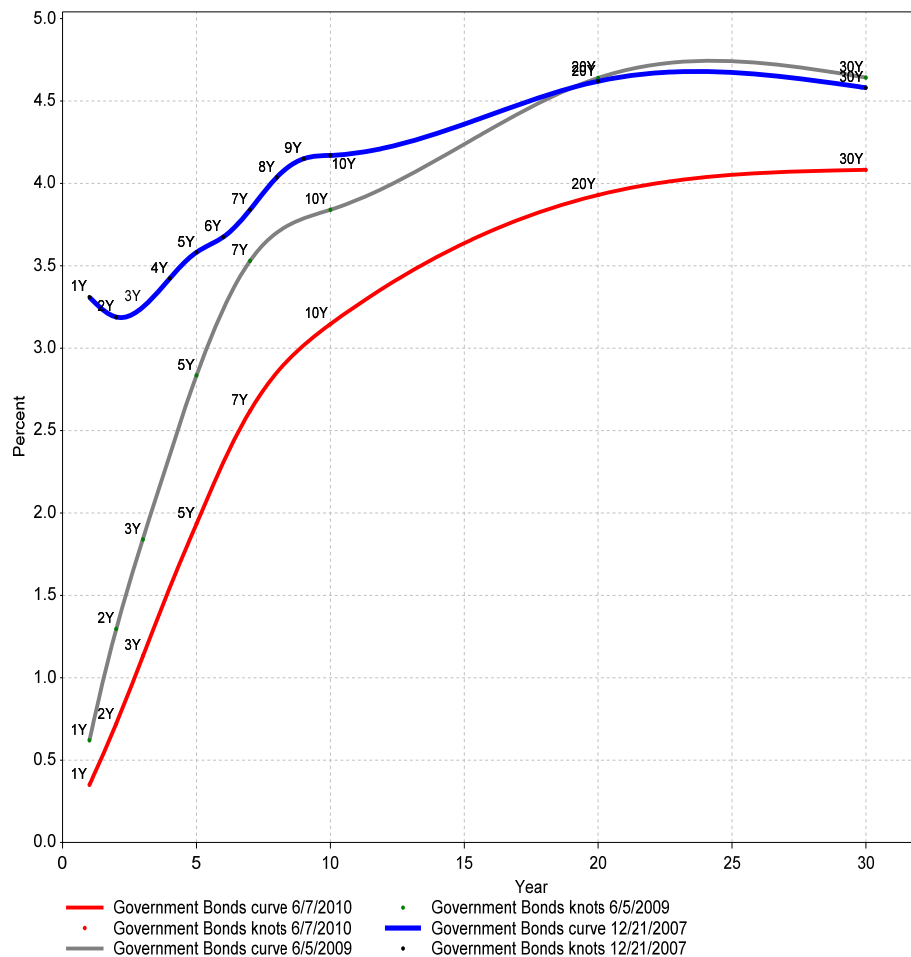
But there is a greater problem with indexing: we are entering into a new cycle

Policy Rates in US, India and Malaysia



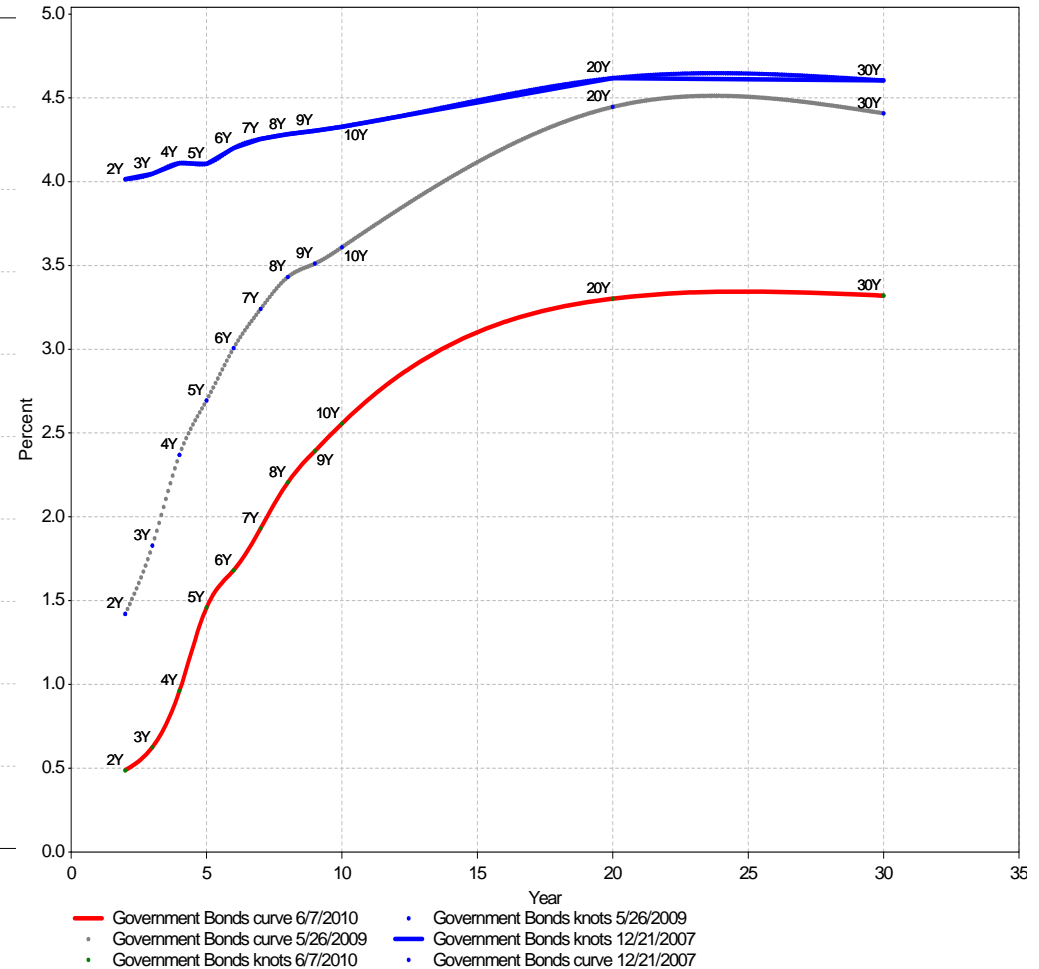
In the Western World, interest rates will remain low and yield curves steep (blue is before the GFC, grey is one year ago, red is today)

US Yield Curve



Source: Reu

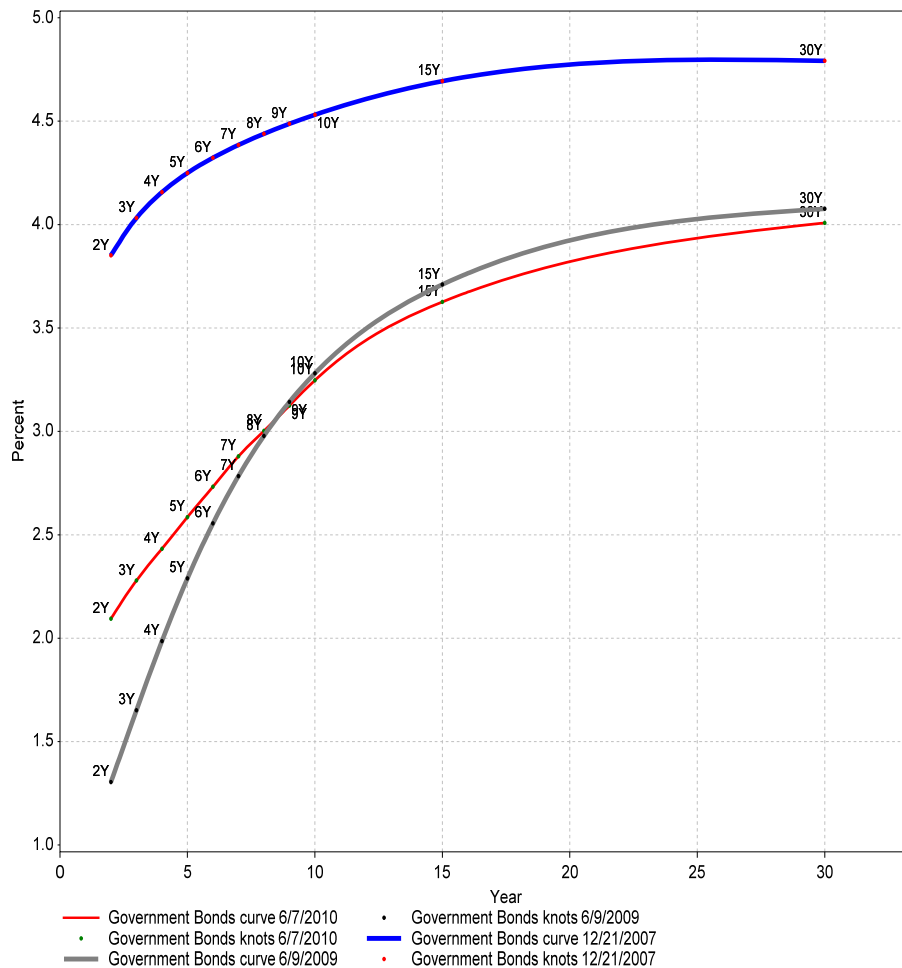
Germany Yield Curve



Source: Reuters EcoWin

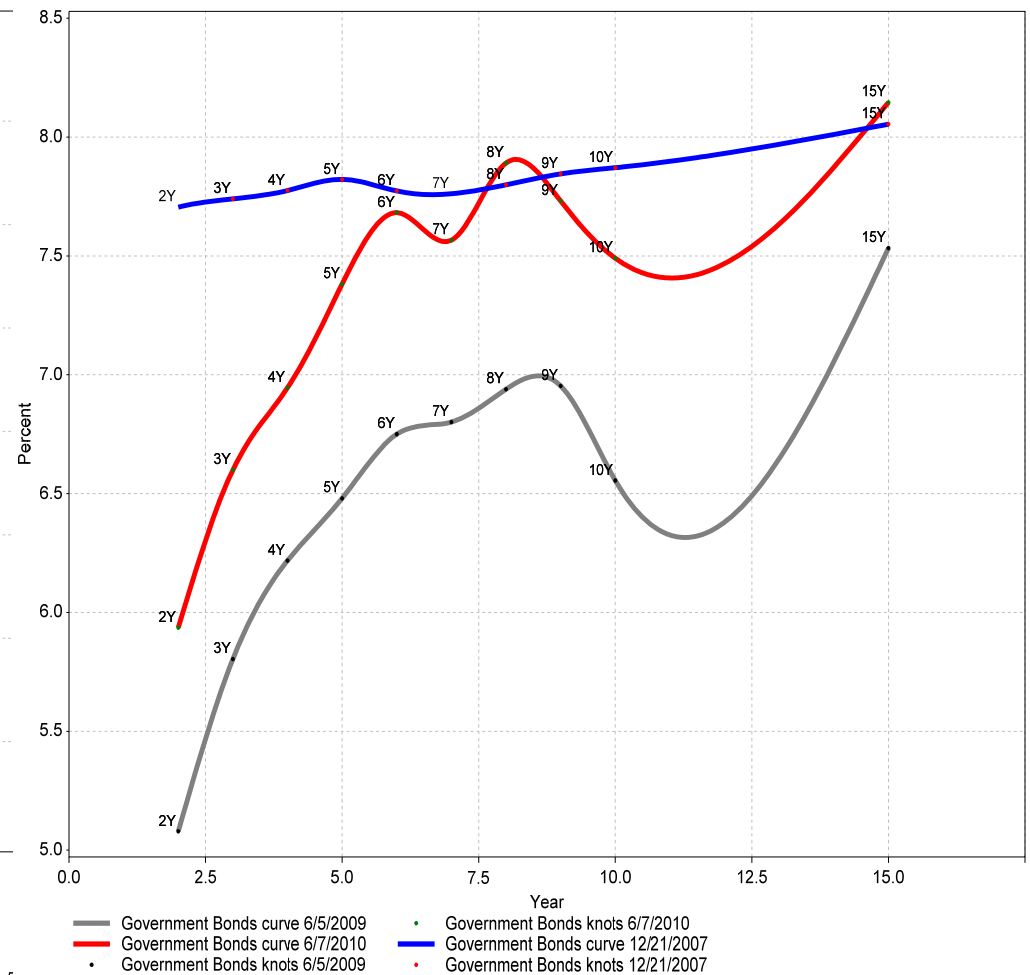
In Asia, tighter monetary policies, necessary because of inflation, should lead to flatter or even inverted yield curves

China Yield Curve



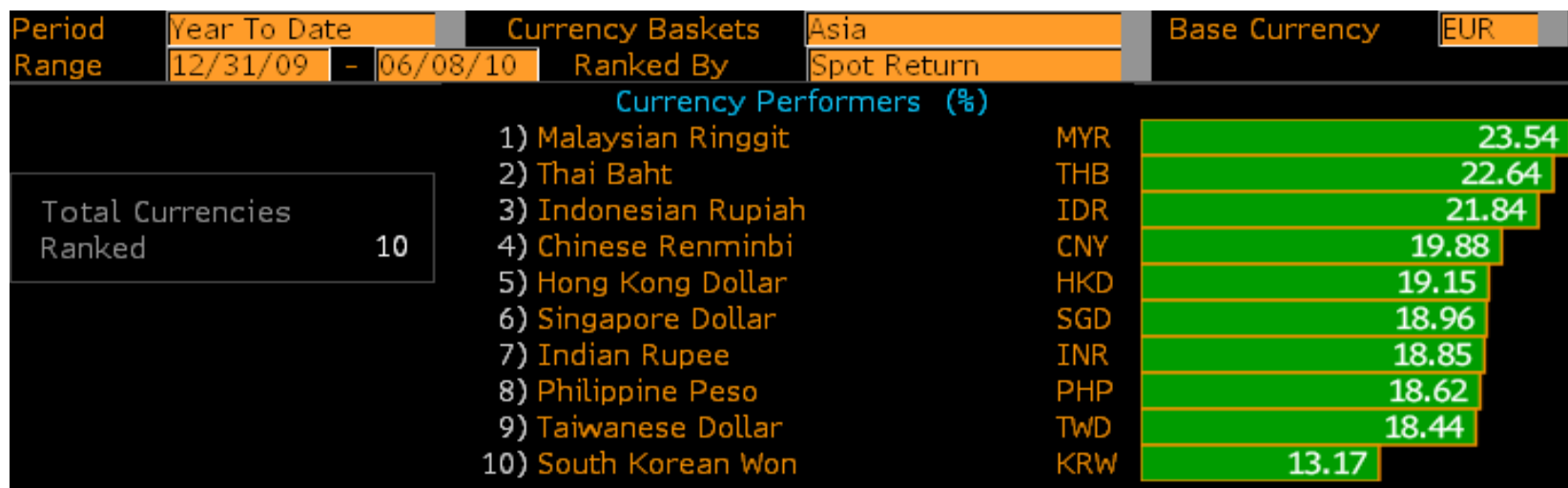
Source: Reuters E

India Yield Curve



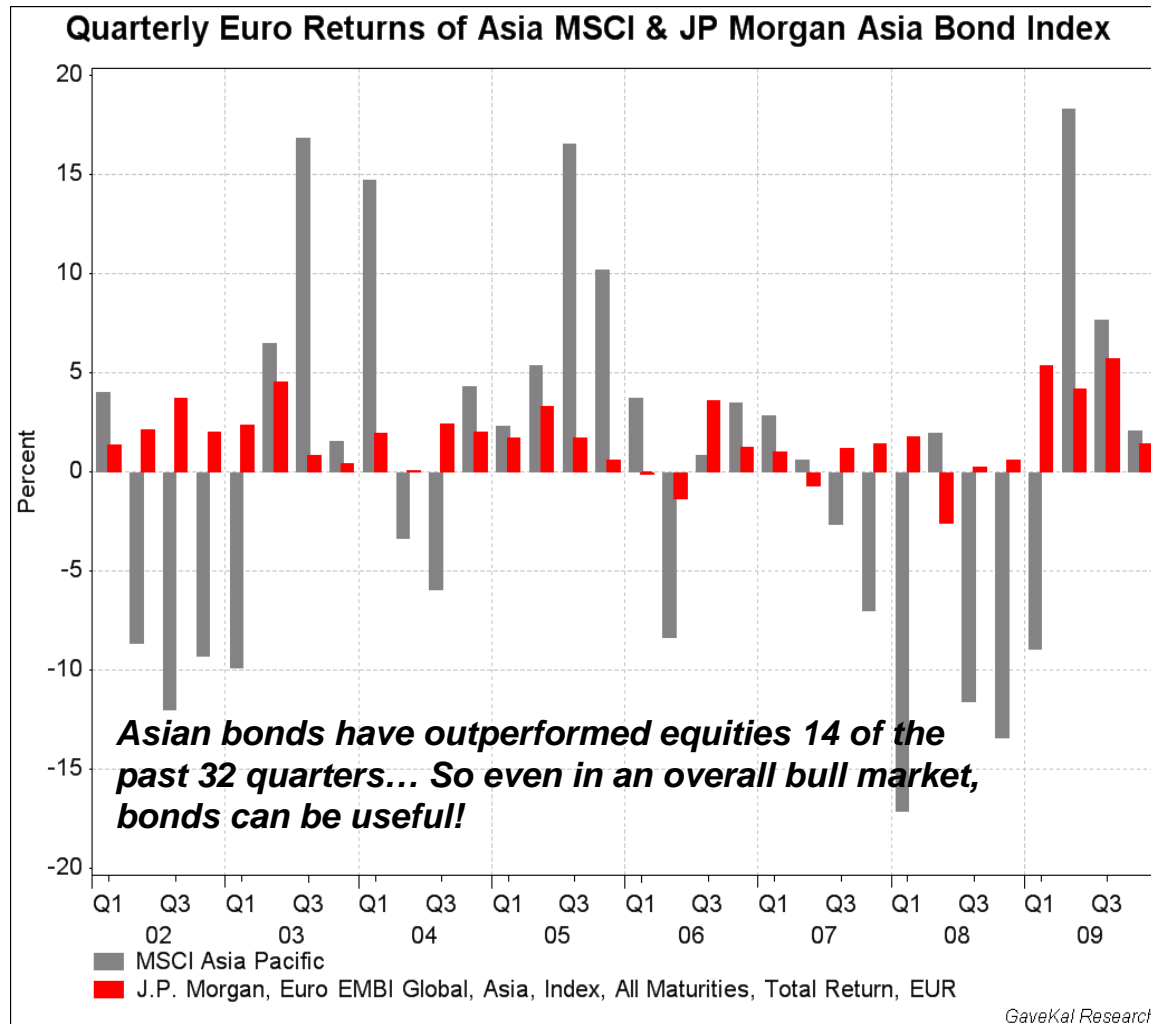
Source: Reuters EcoWin

In turn, this should lead to higher currencies – but how will indices loaded with exporters and financials fare in an environment of flat yield curves and higher currencies?



The Natural Hedge in the Global Macro Environment

When Investing in Asia, Having the Ability to Reduce Portfolio Volatility Through Bonds and Cash Holdings is Key



Two fundamental reasons to own bonds:

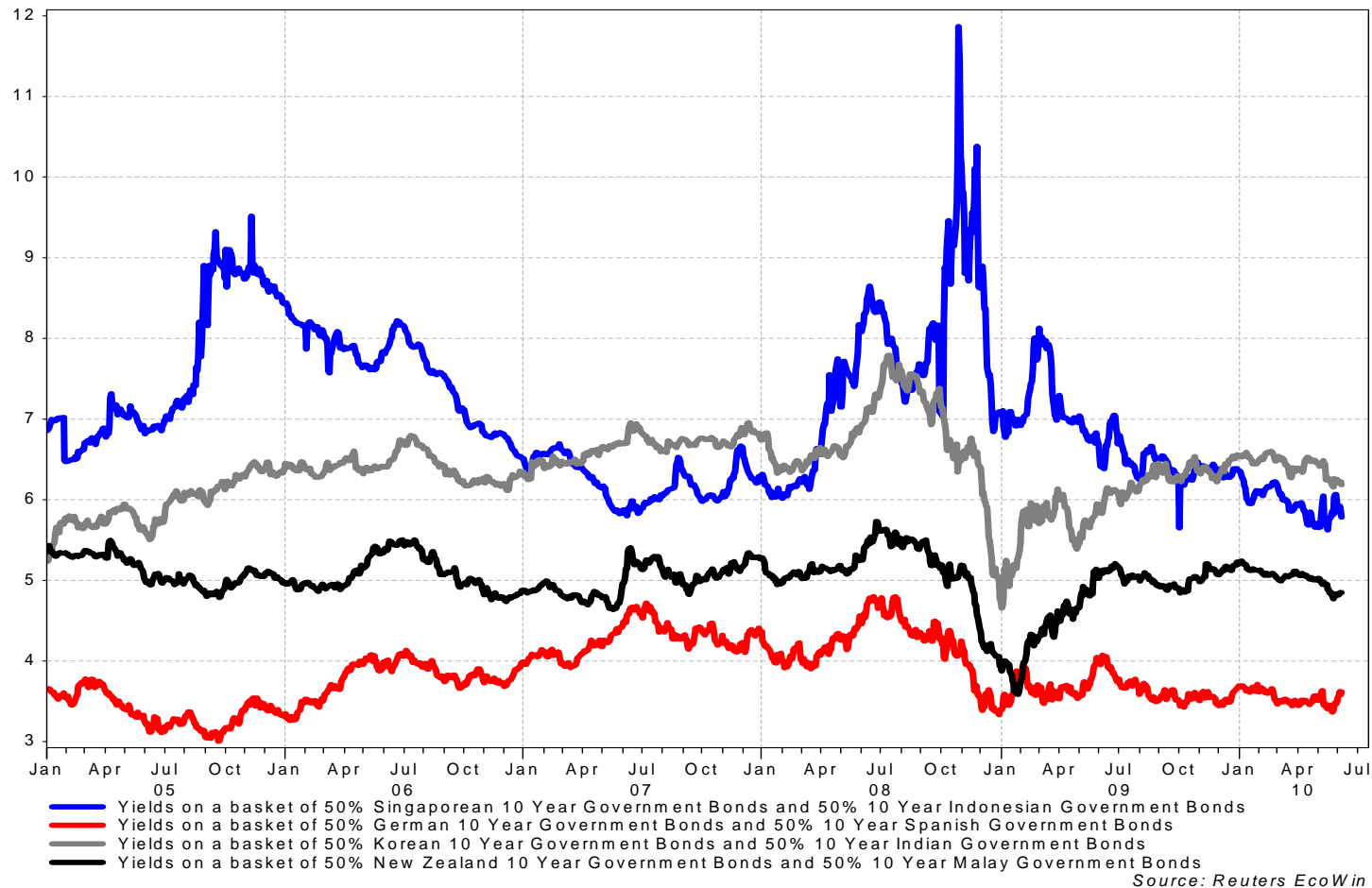
1. Stable Income
2. Diversification from equity, especially in deflationary periods

However,

- Asian bond markets are under-developed only the more mature economies (Australia, Singapore, Japan, Hong Kong, Taiwan) offer liquid bond markets.
- Corporate bonds and emerging market corporate bonds tend to be too correlated to global liquidity conditions, and hence the equity markets, to offer valuable diversification.
- There is a tremendous amount of value in the riskier part of the Asian bond markets, but this is akin to taking equity risk as the correlation with equity markets is high.

Which Would You Rather Own? Looking to the Future, Which is the Best Diversification for Portfolios?

Which Bond Basket is Best Positioned For the Future?





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