



asset allocation
masterclass

[Asset Allocation Masterclass 2010]

Allocating between developed and developing markets

Tim Farrelly

Principal, farrelly's Investment Strategy



portfolio
construction

CONFERENCE

Where are we going?

- Does high GDP growth mean high EPS growth?
- Will returns be higher?
- What are the long term risks?
- How much diversification do we get?

Where are we going?

- Does high GDP growth mean high EPS growth?
- Will returns be higher?
- What are the long term risks?
- How much diversification do we get?

Are we getting access to the growth?

Sector	Emerging markets weight
Industrials	7.7
Consumer goods	7.1
Consumer services & healthcare	5.7
Mobile telecommunications	7.1
Computer and software services	1.5
Domestic GDP growth beneficiaries	29.6%

Source : FTSE All World Index

farrelly's

Are we getting access to the growth?

Sector	Emerging markets weight
Industrials	7.7
Consumer goods	7.1
Consumer services & healthcare	5.7
Mobile telecommunications	7.1
Computer and software services	1.5
Domestic GDP growth beneficiaries	29.6%
Oil and gas	15.2
Basic materials	14.4
Financials (ex REITs)	27.8
Utilities & Fixed line Telcos	6.2
Technology hardware & equipment	7.2
The rest	70.4%

Source : FTSE All World Index

farrelly's

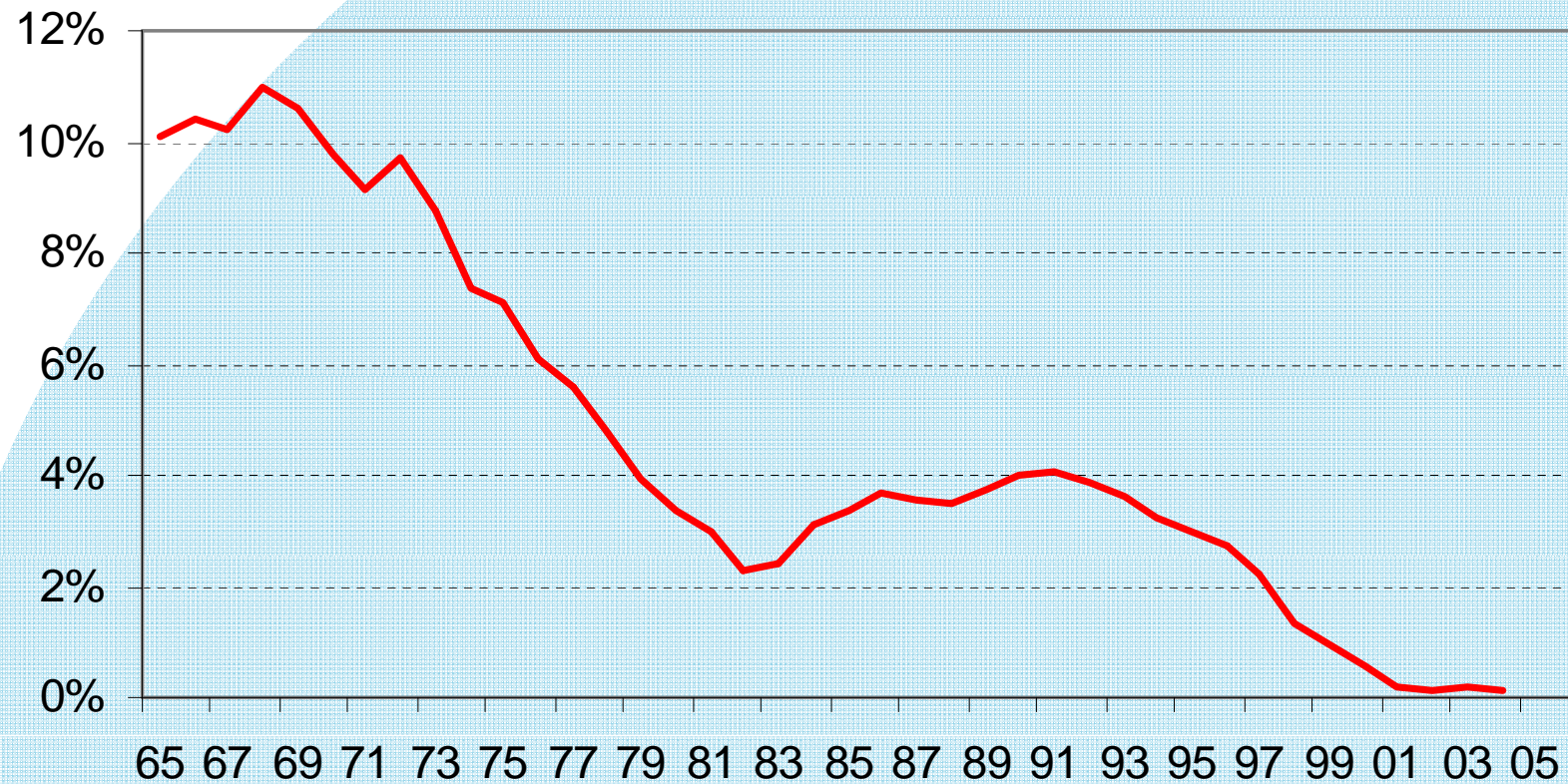
Does high GDP growth = high EPS growth?

- Japan : 1955 to 1990
- US : 1875 to 1929
- Singapore : 1972 to 1997

Super GDP growth until the early 80's

Japan

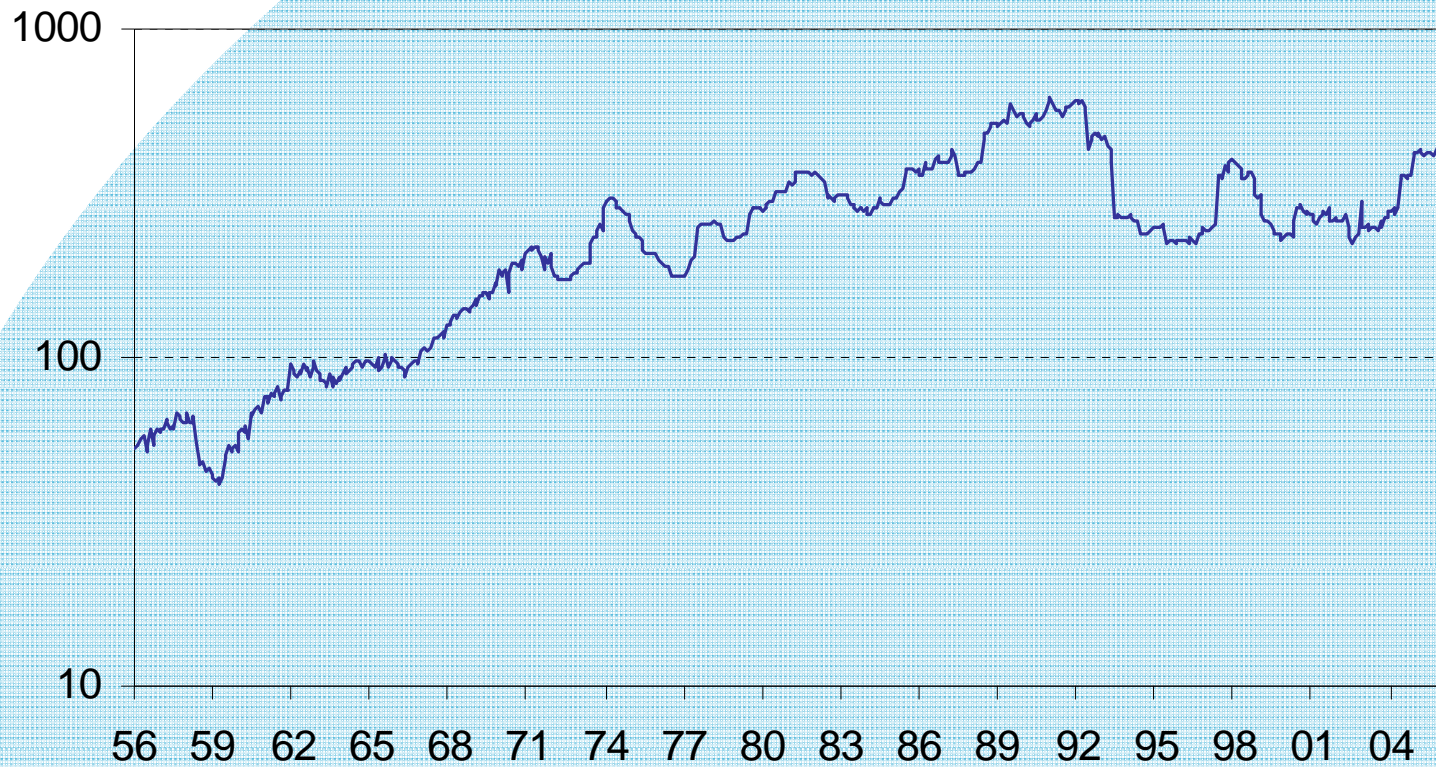
10 yr Real GDP Growth



farrelly's

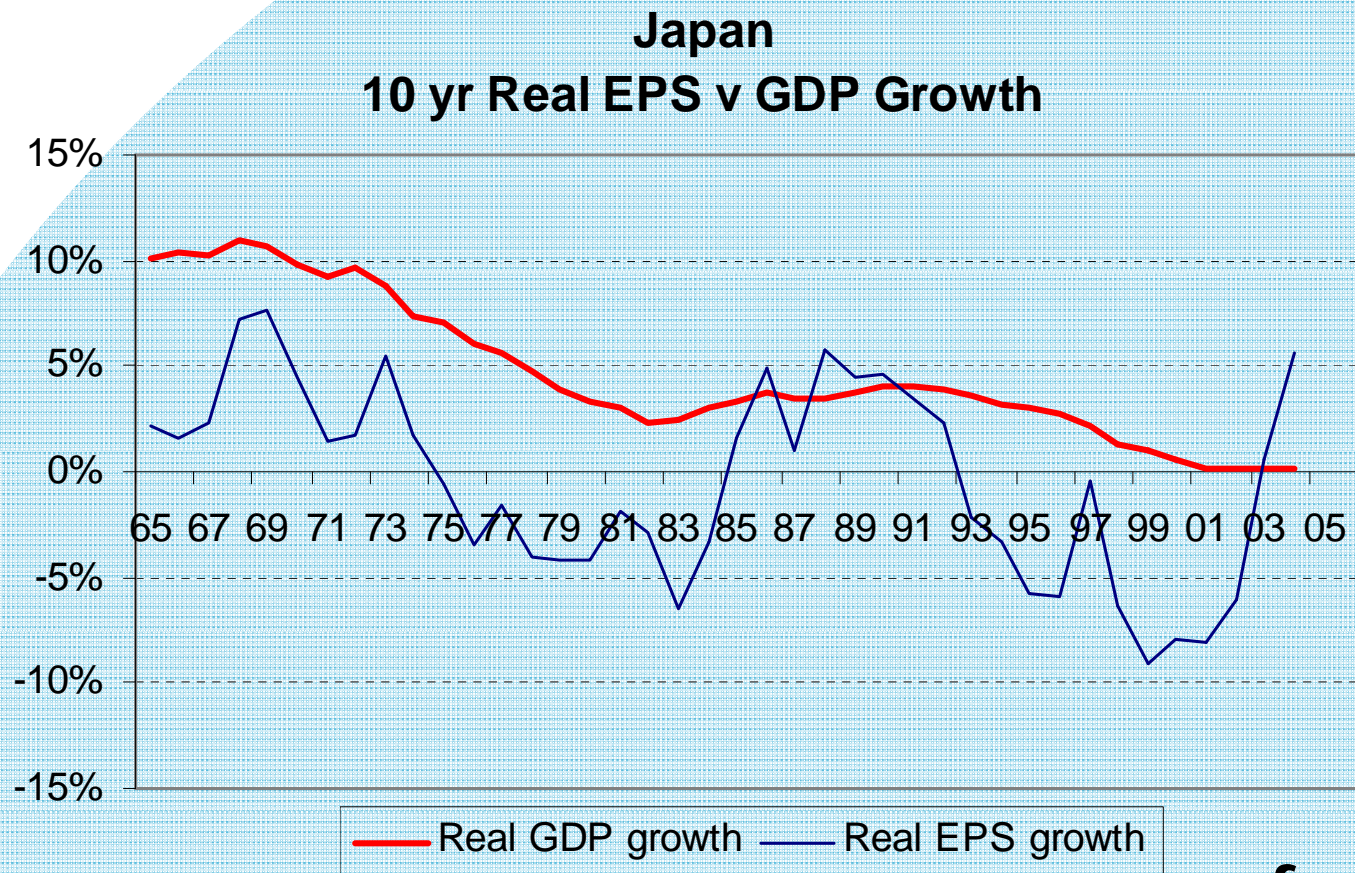
Translates into relentless earnings growth...

Japanese EPS in Yen Tems



farrelly's

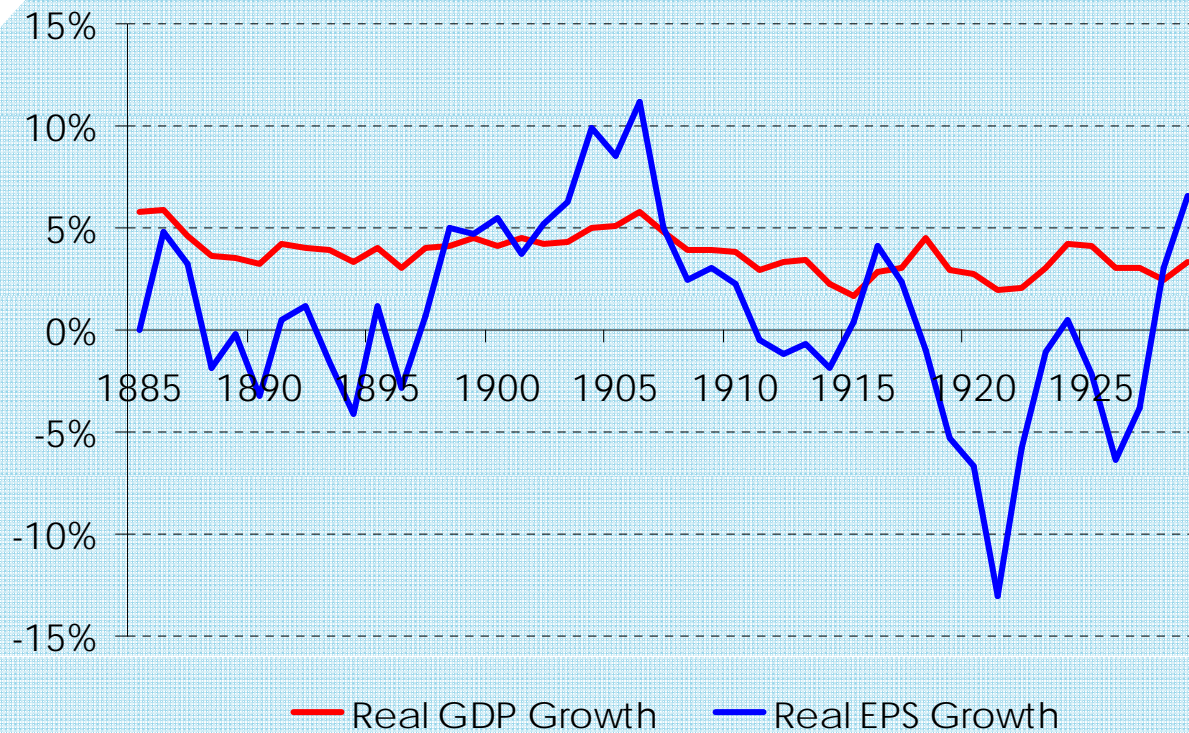
But in real terms EPS growth very modest even in the good years...



farrelly's

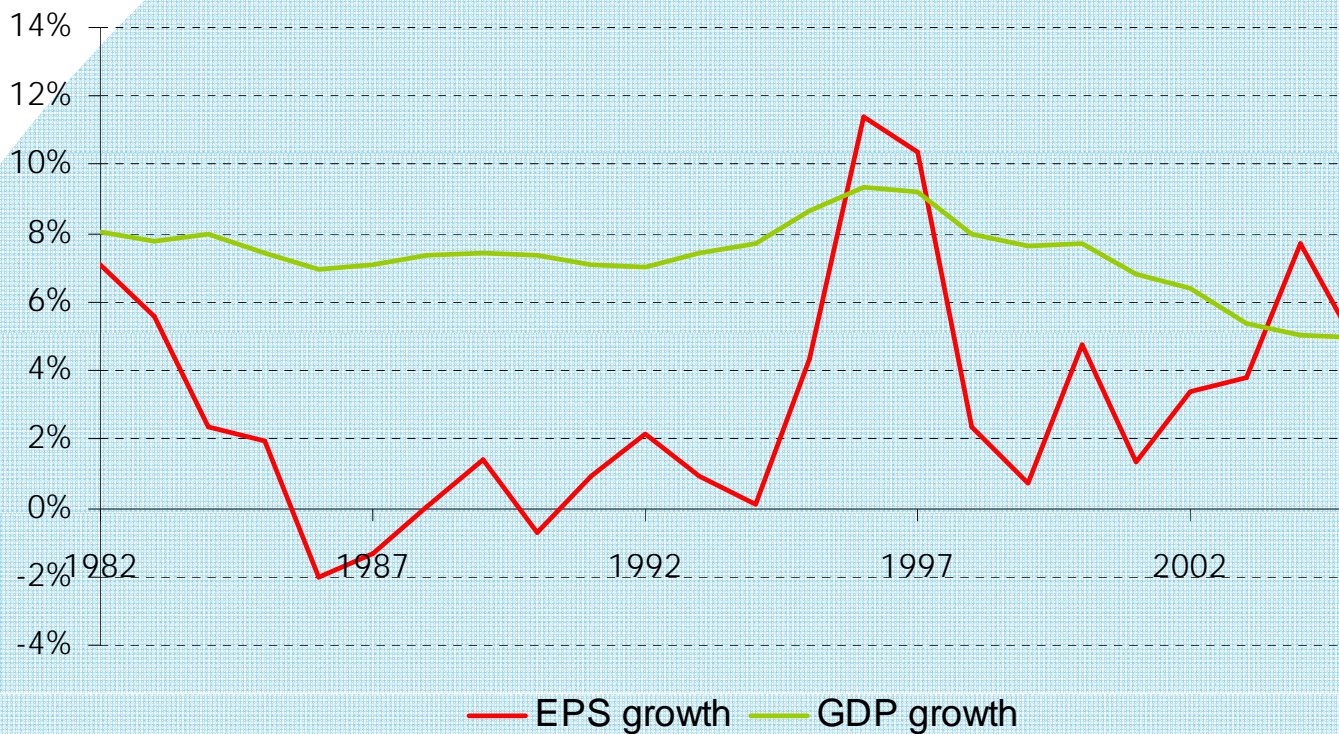
US not a typical high growth story...EPS much the same though

US Real GDP v EPS Real Growth
1875-1929



Again, super GDP growth translates into disappointing EPS growth

Singapore : Real EPS growth vs Real GDP growth
10 years ending



Where are we going?

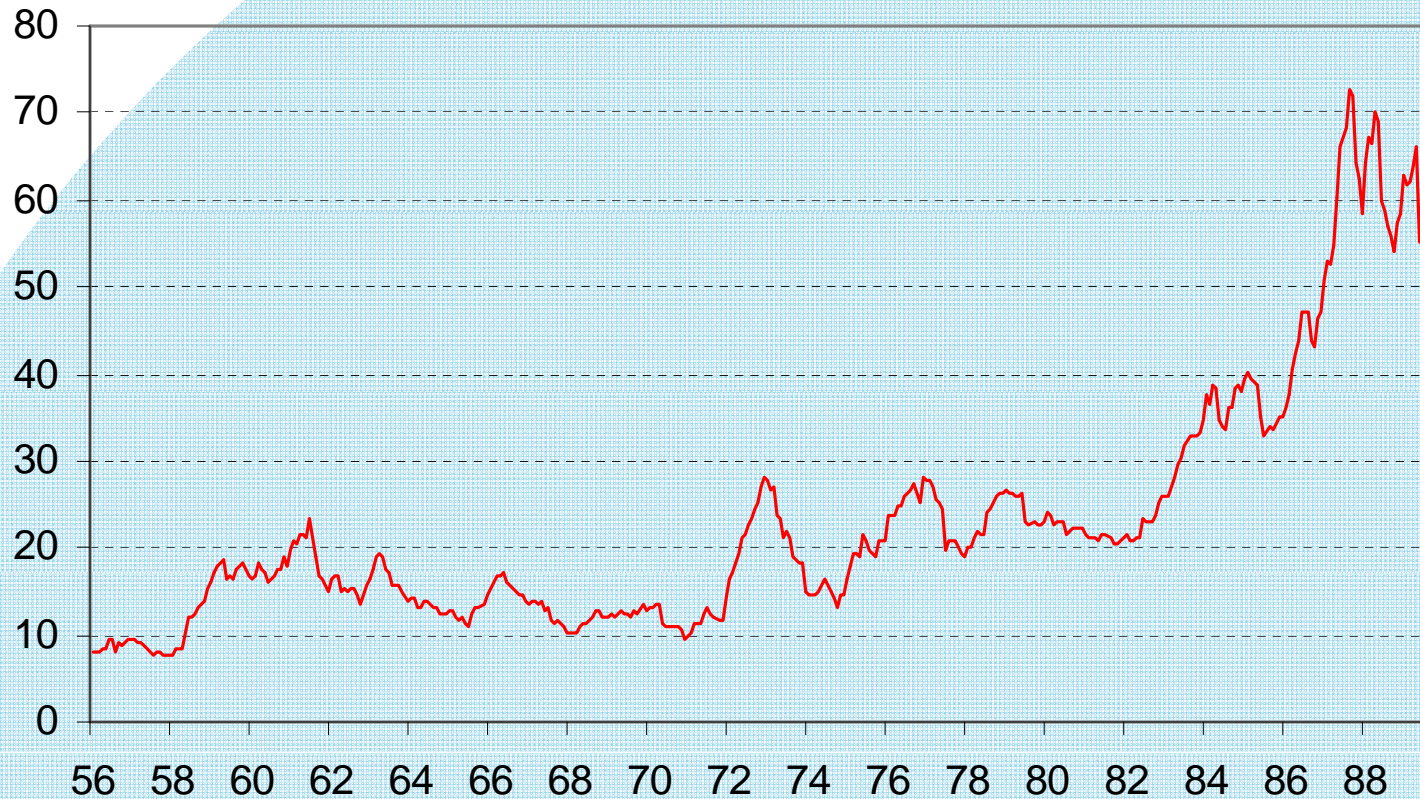
- Does high GDP growth mean high EPS growth?
- Will returns be higher?
- What are the long term risks?
- How much diversification do we get?

It's not just about earnings..

- Dividends
- Earnings growth
- PE expansion
- Currency gains

Japanese PE growth was substantial...

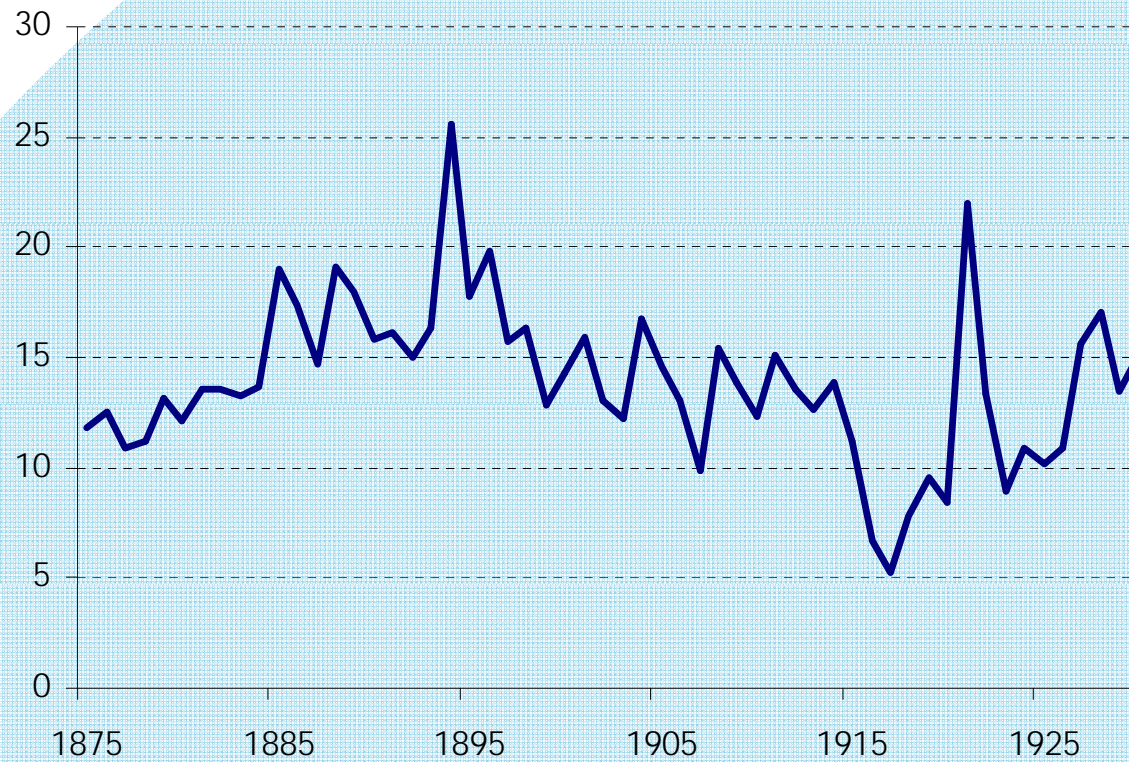
Japanese PE Ratios



farrelly's

Boom and bust in the US

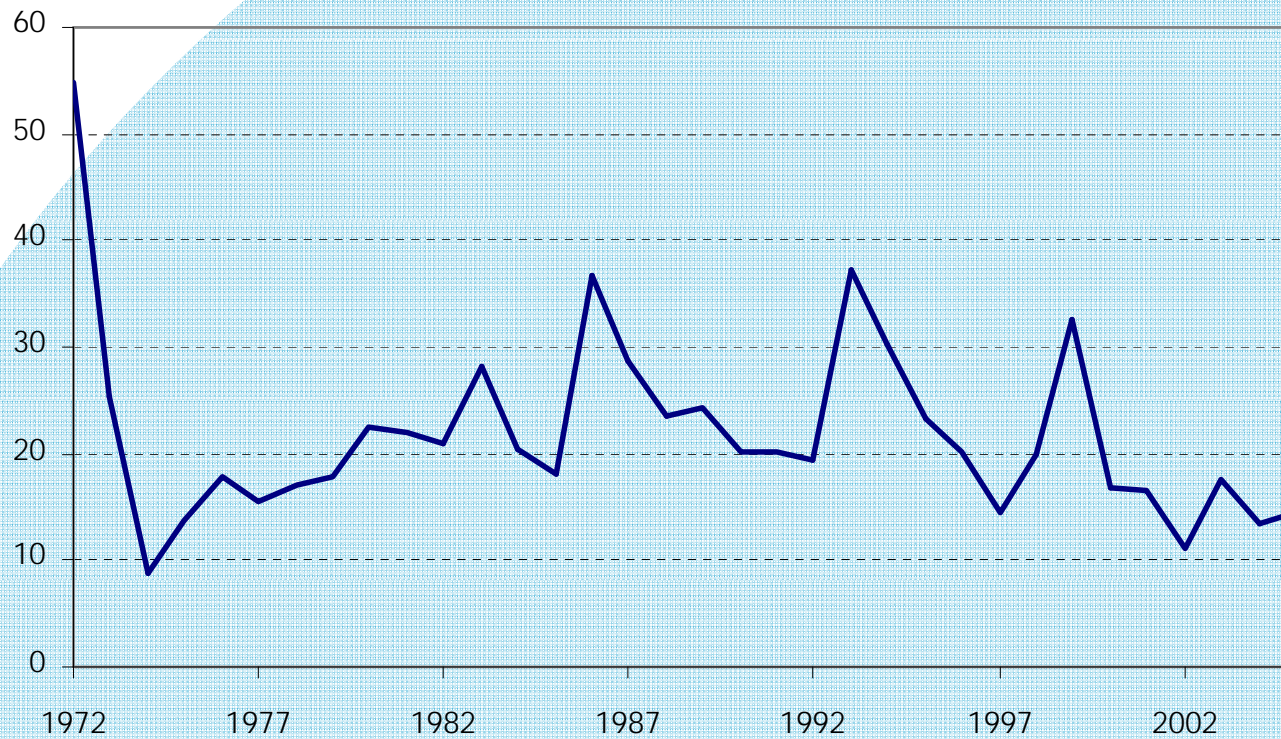
US PE Ratios 1875 -1930



farrelly's

Singapore: more boom & bust...

Singapore PE ratios



farrelly's

Emerging markets vs Europe, August 2010

FORECASTS August 2010	Emerging markets		Europe	
Dividend yield		2.4		3.3
Nominal GDP growth Dilution Return to trend	Real 6%pa	9.0	Real 1.5%pa	3.0
EPS growth				
PE expansion				
Total Return (Local \$)				
Currency				
Total Return (A\$)				

Emerging markets vs Europe, August 2010

FORECASTS August 2010	Emerging markets		Europe	
Dividend yield		2.4		3.3
Nominal GDP growth	Real 6%pa	9.0	Real 1.5%pa	3.0
Dilution		-3.0		-2.0
Return to trend				
EPS growth				
PE expansion				
Total Return (Local \$)				
Currency				
Total Return (A\$)				

farrelly's

Emerging markets vs Europe, August 2010

FORECASTS August 2010		Emerging markets		Europe	
Dividend yield			2.4		3.3
Nominal GDP growth		Real 6%pa	9.0	Real 1.5%pa	3.0
Dilution			-3.0		-2.0
Return to trend		ROE 14.4%	-2.0	ROE 10.4%	+2.5
EPS growth			4.0		2.0
PE expansion					
Total Return (Local \$)					
Currency					
Total Return (A\$)					

farrelly's

Emerging markets vs Europe, August 2010

FORECASTS August 2010	Emerging markets		Europe	
Dividend yield		2.4		3.3
Nominal GDP growth	Real 6%pa	9.0	Real 1.5%pa	3.0
Dilution		-3.0		-2.0
Return to trend	ROE 14.4%	-2.0	ROE 10.4%	+2.5
EPS growth		4.0		2.0
PE expansion	14.4>14.0	-0.3	14.8>17.5	1.7
Total Return (Local \$)				
Currency				
Total Return (A\$)				

farrelly's

Emerging markets vs Europe, August 2010

FORECASTS August 2010	Emerging markets		Europe	
Dividend yield		2.4		3.3
Nominal GDP growth	Real 6%pa	9.0	Real 1.5%pa	3.0
Dilution		-3.0		-2.0
Return to trend	ROE 14.4%	-2.0	ROE 10.4%	+2.5
EPS growth		4.0		2.0
PE expansion	14.4>14.0	-0.3	14.8>17.5	1.7
Total Return (Local \$)		6.1		7.0
Currency				
Total Return (A\$)				

farrelly's

Emerging markets vs Europe, August 2010

FORECASTS August 2010	Emerging markets		Europe	
Dividend yield		2.4		3.3
Nominal GDP growth	Real 6%pa	9.0	Real 1.5%pa	3.0
Dilution		-3.0		-2.0
Return to trend	ROE 14.4%	-2.0	ROE 10.4%	+2.5
EPS growth		4.0		2.0
PE expansion	14.4>14.0	-0.3	14.8>17.5	1.7
Total Return (Local \$)		6.1		7.0
Currency	Unhedged	2.0	Hedged	2.0
Total Return (A\$)		8.1%pa		9.0%pa

farrelly's

Where are we going?

- Does high GDP growth mean high EPS growth?
- Will returns be higher?
- What are the long term risks?
- How much diversification do we get?

China and India, March 2007.

FORECASTS March 2007	China	India
Divs	1.4	1.1
EPS growth	4.0	4.0
PE expansion	-1.1	-3.9
Total Return (Local \$)	4.3	1.2
Currency	3.0	2.0
Total Return (US\$)	7.3%pa	3.2%pa
PE Now (PE 2016 =17)	18.9	23.9

farrelly's

Emerging markets

What could go wrong?

FORECASTS August 2010	Emerging markets Base case		Emerging markets Pessimistic	
Dividend yield		2.4		2.4
Nominal GDP growth	Real 6%pa	9.0	Real 5%pa	10.0
Dilution		-3.0		-5.0
Return to trend	ROE 14.4%	-2.0	ROE >10%	-4.0
EPS growth		4.0		1.0
PE expansion	14.4>14.0	-0.3	14.4>13.0	-1.1
Total Return (Local \$)		6.1		2.3
Currency	Unhedged	2.0	Unhedged	-2.0
Total Return (A\$)		8.1%pa		0.3%pa

Where are we going?

- Does high GDP growth mean high EPS growth?
- Will returns be higher?
- What are the long term risks?
- How much diversification do we get?

Diversification benefits?

Sector	Emerging markets	Australia	Developed World
Industrials	7.7	5.9	10.8
Consumer goods	7.1	3.2	12.6
Consumer services & healthcare	5.7	13.1	18.0
Mobile telecommunications	7.1	0.0	1.7
Computer and software services	1.5	0.6	4.1
Domestic GDP growth beneficiaries	29.6%	22.8%	47.2%
Oil and gas	15.2	6.9	9.4
Basic materials	14.4	25.6	6.9
Financials (ex REITs)	27.8	33.4	20.8
REITs	0.0	6.1	1.3
Utilities & Fixed line Telcos	6.2	5.2	7.0
Technology hardware & equipment	7.2	0.0	7.5
The rest	70.4%	77.2%	52.8%

farrelly's

Source : FTSE All World Index

This is not straightforward!

- High GDP growth does not mean high EPS growth
- Total returns depend on price as well as growth
- Risks are very real
- Diversification benefits may not be as good as hoped

Disclaimer.

This presentation has been prepared on the basis that it is only for the exclusive use of the person for whom it was provided. Although information is derived from sources considered and believed to be reliable and accurate, farrelly's, it's employees, consultants, advisers and officers are not liable for any opinion expressed or for any error or omission that may have occurred in this presentation. Any forecasts included are reasonably believed to be reliable based on current information but due to our inability to predict future events with certainty, they cannot be guaranteed. This presentation is of a general nature only and has been prepared without taking into account any persons particular investment objectives, financial situation or particular needs.

farrelly's

China, India and Brazil, August 2010

FORECASTS August 2010	China	India	Brazil
Dividend yield	2.4	1.0	3.1
EPS growth	4.8	2.5	2.9
PE expansion	4.3	-3.2	0.0
Total Return (Local \$)	4.3	1.2	6.0
Currency	3.0	2.0	-2.0
Total Return (US\$)	14.6%pa	3.2%pa	4.0%pa
PE Now (PE 2016 =15)	9.8	20.7	14.0

Spotlight on Brazil...

	Forecast	Optimistic forecast
Yield	3.4	3.4
EPS Growth ¹	5.0	7.5
PE expansion	-1.4	1.0
Total (R\$ terms)	7.0%	11.9%*
PE Now	14.9	14.9
PE 2020	13.0	16.3

1. EPS 20% ahead of trend. High ROE.
Inflation is 4.5 to 5%pa

farrelly's

Can good managers pick the eyes out of this market?

Perf. to 30 Oct 2009	1 yr	5yrs	10yrs
Russell EM (Class S) (US\$)	63.7 %	16.6 %pa	11.2 %pa
MSCI EM index (US\$)	64.1%	16.8 %pa	11.2 %pa

The managers

- AllianceBernstein
- Arrowstreet Capital
- Genesis Asset Managers
- Harding Loevner
- T. Rowe Price International
- UBS Global Asset Management

Source : Russell Funds 2009 Annual report

farrelly's

Can good managers pick the eyes out of this market?

Perf. to 30 Oct 2009	1 yr	5yrs	10yrs
Russell EM (Class S) (US\$)	63.7 %	16.6 %pa	11.2 %pa
MSCI EM index (US\$)	64.1%	16.8 %pa	11.2 %pa

The managers

- AllianceBernstein
- Arrowstreet Capital
- Genesis Asset Managers
- Harding Loevner
- T. Rowe Price International
- UBS Global Asset Management

Source : Russell Funds 2009 Annual report

farrelly's

What do we get?

Sector	Emerging markets	ROE	PE
Industrials	7.7	13.8	13.3
Consumer goods	7.1	17.6	19.3
Consumer services & healthcare	5.7	18.0	21.5
Mobile telecommunications	7.1	23.9	13.5
Computer and software services	1.5	30.3	21.6
Domestic GDP growth beneficiaries	29.6%		
Oil and gas	15.2	15.8	9.7
Basic materials	14.4	9.6	21.4
Financials 60 % Brazil, India & China	27.8	15.9	12.4
Utilities & Fixed line Telcos	6.2	10.0	14.5
Technology hardware & equipment	7.2	6.8	31
The rest	70.4%		

farrelly's

Sources of emerging market returns

- Dividends
- Earnings growth
- PE expansion
- Currency gains

Does inflation matter?

Real Japanese EPS growth	5%
Plus high inflation	8%
= Nominal Jap EPS growth (Yen)	13%
Less currency loss if PPP holds	-5%
= Nominal Jap EPS growth (US\$)	8%

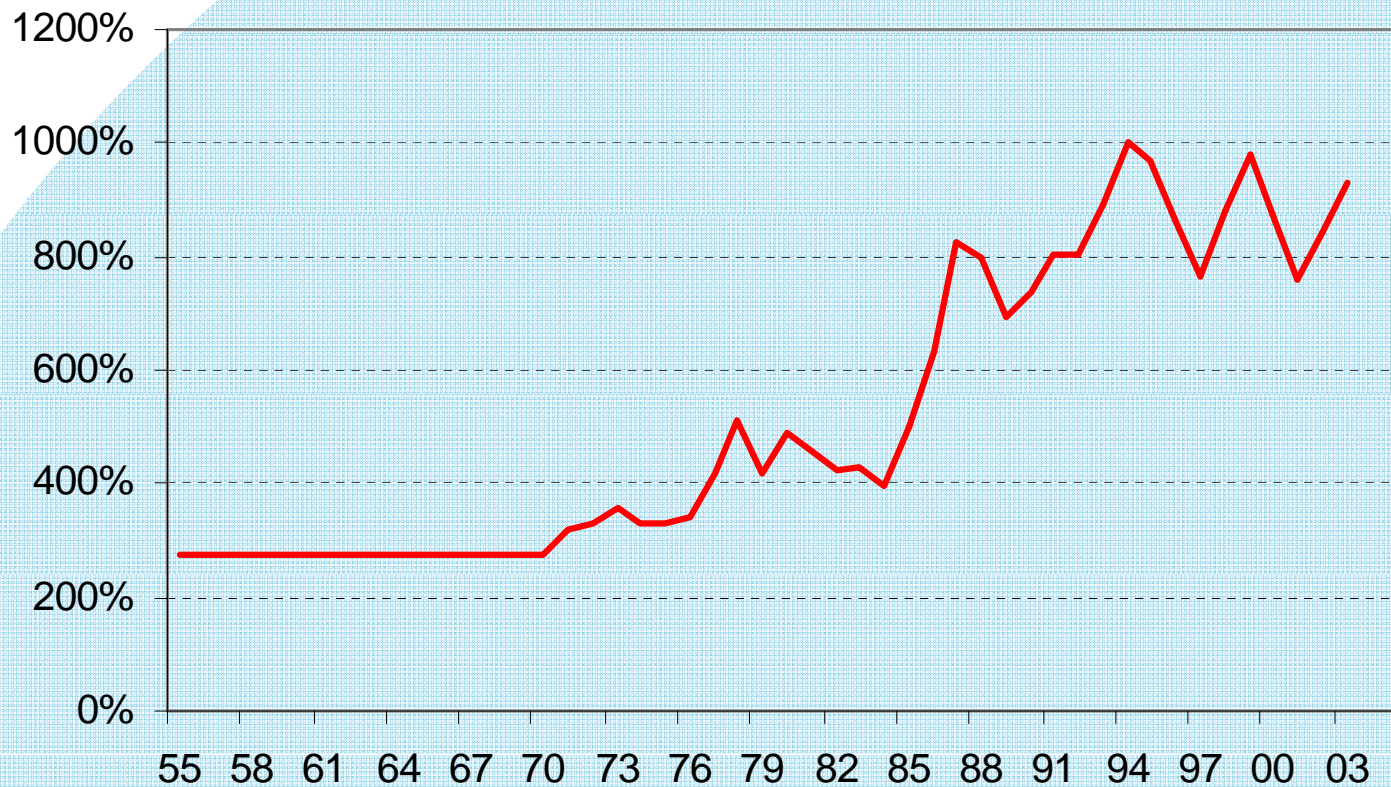
vs US EPS growth of 5% real + 3% inf 8%

But what if PPP doesn't hold?

farrelly's

... currency pushed things along...

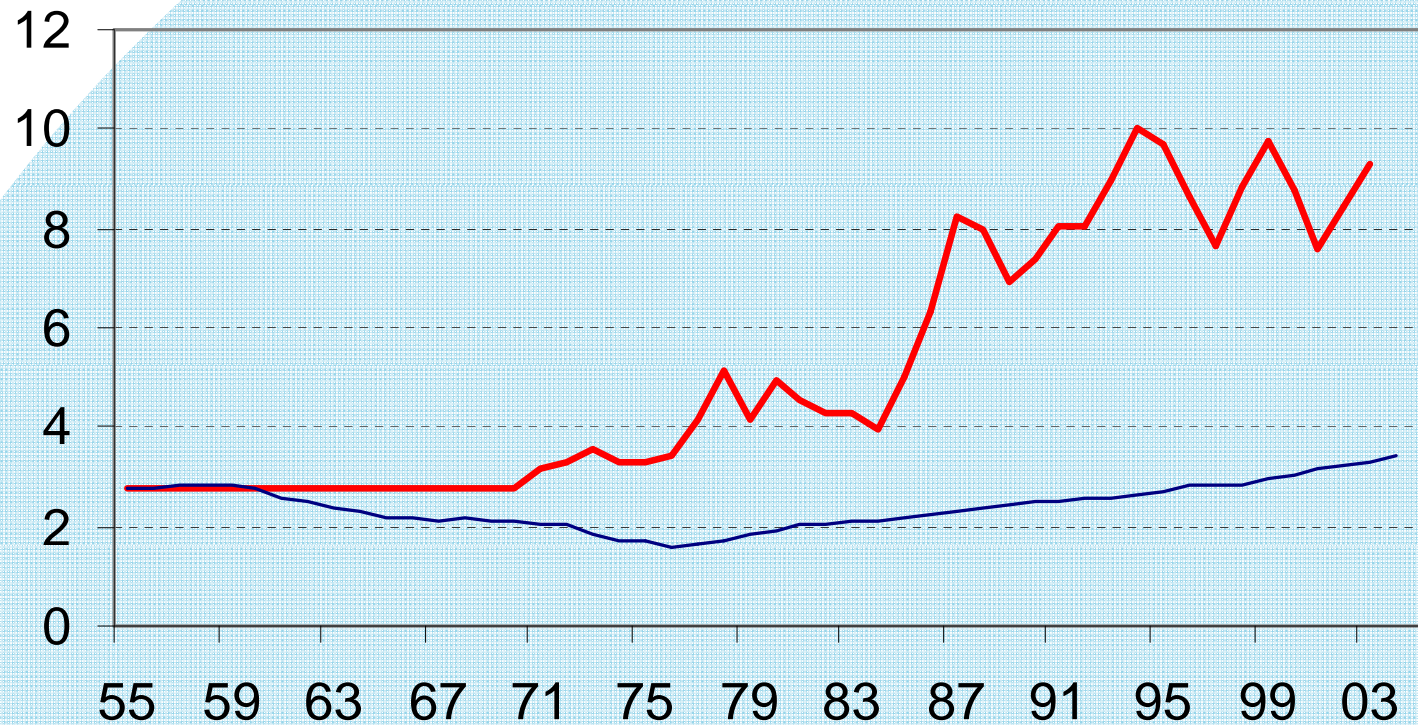
Japanese Yen/US\$



farrelly's

And currency gains were real...

Japanese Yen/US\$



— Yen/US\$ — PPP

farrelly's

A triple bunger....

	1955-1965	1965-75	1975 - 85
Divs	3.0	1.0	1.0
EPS growth	6.4	7.9	5.9
PE expansion	6.1	3.7	5.3
Total Return (Yen)	15.4	13.6	13.2
Currency	0.0*	1.7	4.3
Total Return US\$	15.4	14.3	16.5
Total Return US Equities	11.0	3.3	14.3

*Currency pegged to US\$

farrelly's

A triple bungler....

	1955-1965	1965-75	1975 - 85
Divs	3.0	1.0	1.0
EPS growth	6.4	7.9	5.9
PE expansion	6.1	3.7	5.3
Total Return (Yen)	15.4	12.6	12.2
Currency	0.0*	1.7	4.3
Total Return US\$	15.4	14.3	16.5
Total Return US Equities	11.0	3.3	14.3

*Currency pegged to US\$

All of the difference due to:
PEs: -4.7%pa vs 3.7%pa
& Currency : +1.7%pa

arrelly's

No triple bunger here...

	1973-1983	1983-93	1993 - 05
Divs	2.1	1.8	1.1
EPS growth	10.1	2.6	7.8
PE expansion	1.1	2.8	-7.6
Total Return (Sing \$)	13.3	7.2	1.3
Currency	1.3	2.8	0.2
Total Return (US\$)	14.6%pa	10.0%pa	1.5%pa
Total US Equities	10.3%pa	15.6%pa	11.0%pa

*Currency pegged to US\$

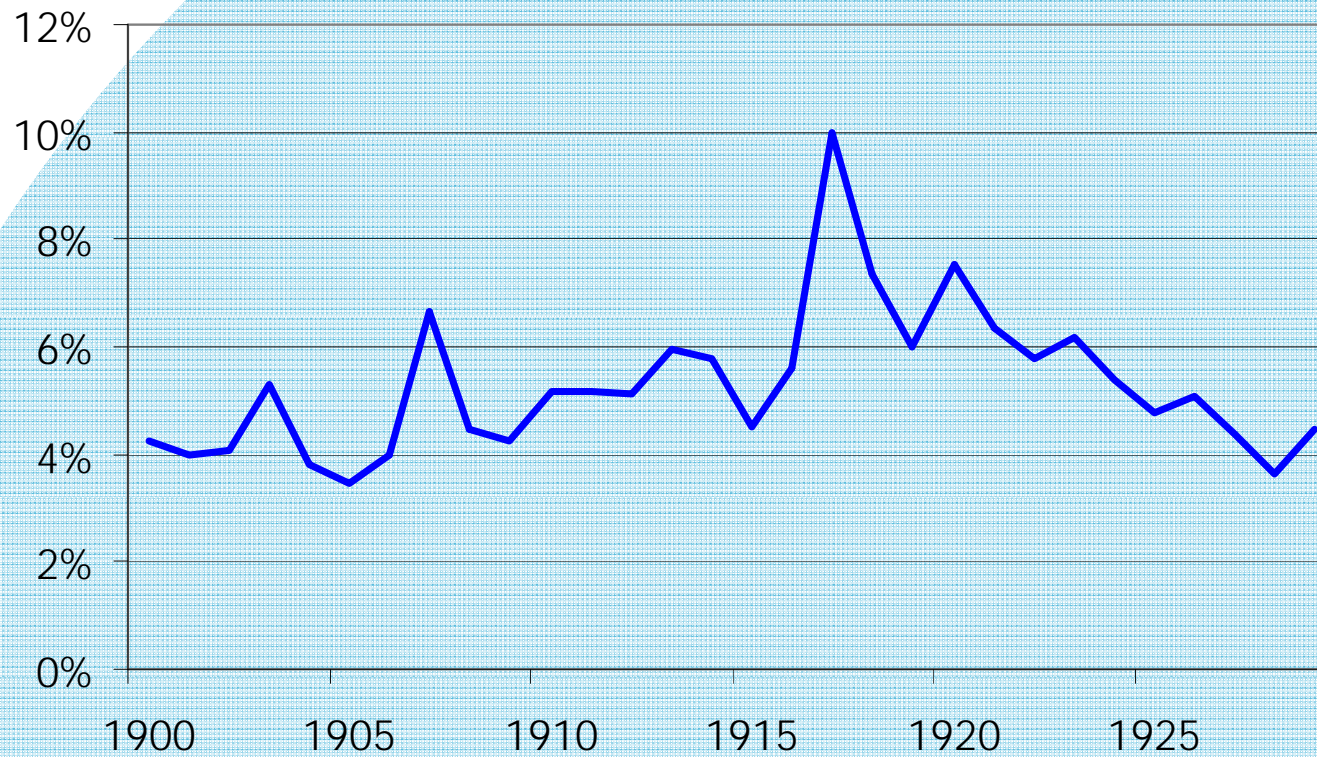
farrelly's

The US 1895 to 1929...

farrelly's

Fairly solid yields throughout...

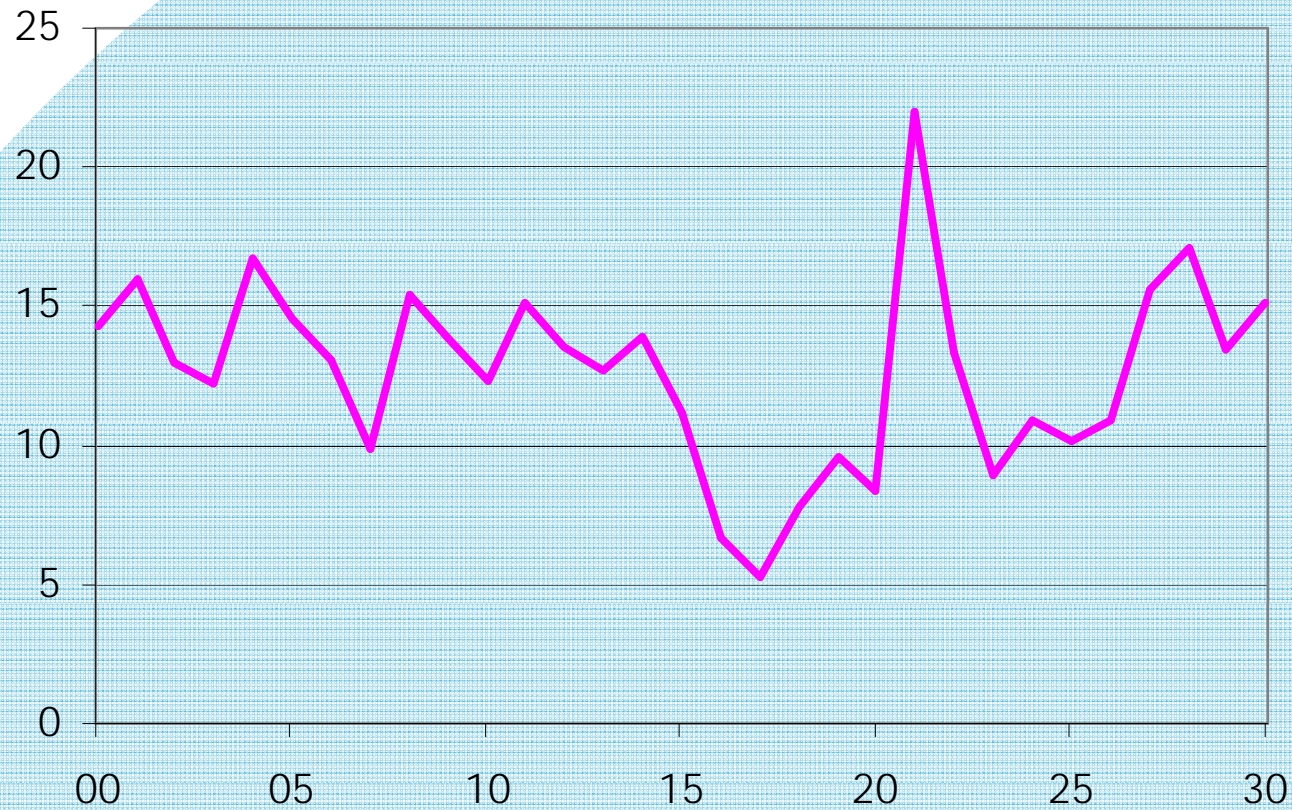
US Dividend Yield
1900-1929



farrelly's

No great PE expansion...

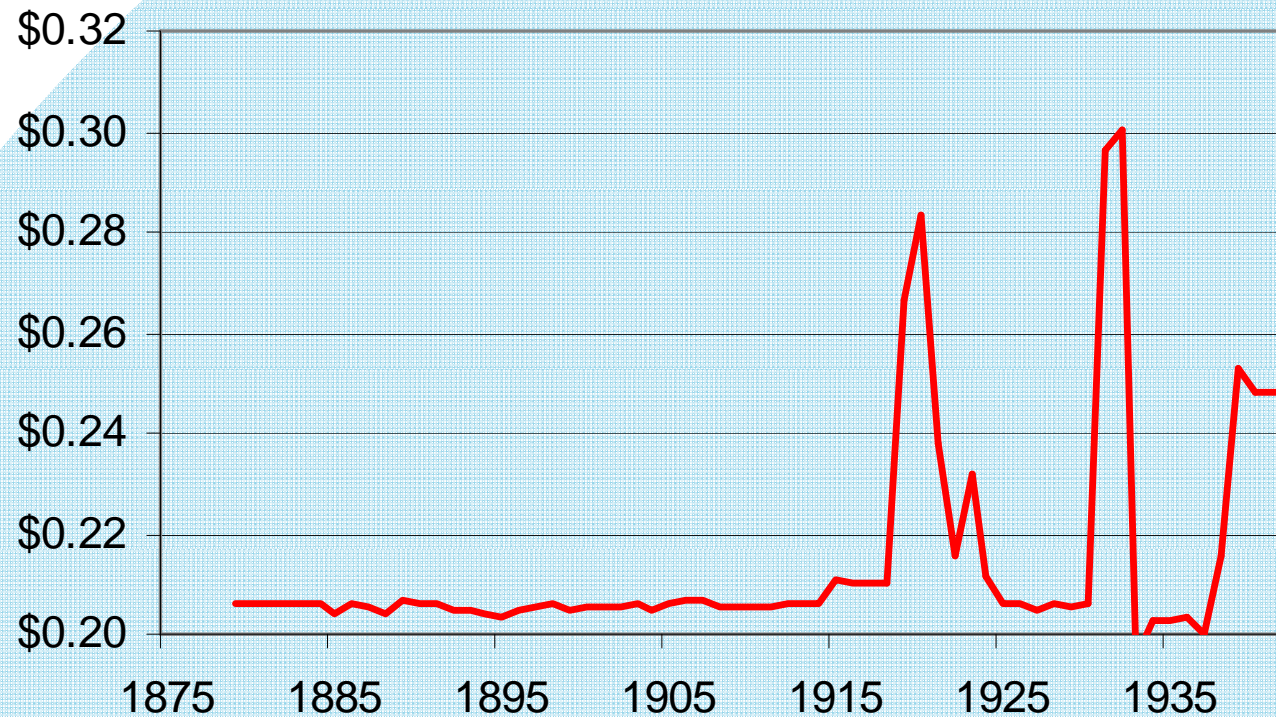
US PEs:



farrelly's

A stable currency, with a little growth

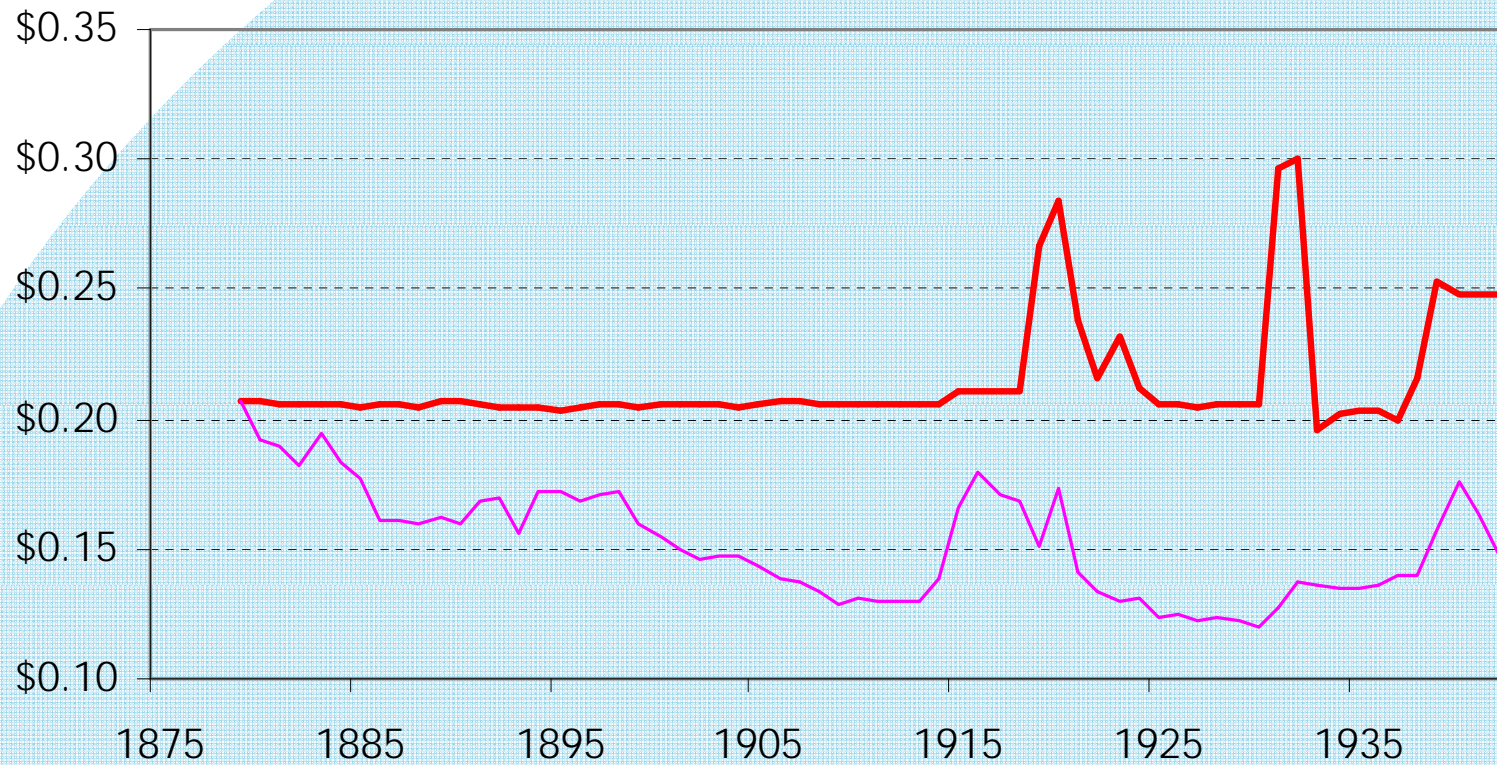
Pound/US\$



farrelly's

But relatively high inflation not punished...

US\$ vs British Pound



— Pound/US\$ — PPP

farrelly's

Nice at first.....

US equities : drivers of returns			
	1895-1905	1905-15	1915-25
Divs	4.4	3.4	4.5
EPS growth	10.4	2.8	3.6
PE expansion	-2.3	-1.3	1.2
Total (US\$)	12.5	4.9	9.3
Currency	0.0*	0.1	0.2
Total (Stg)	12.5	5.0	9.5

*Currency pegged to pound sterling

farrelly's

...and much better than the UK

US equities : drivers of returns			
	1895-1905	1905-15	1915-25
Divs	4.4	3.4	4.5
EPS growth	10.4	2.8	3.6
PE expansion	-2.3	-1.3	1.2
Total (US\$)	12.5	4.9	9.3
Currency	0.0*	0.1	0.2
Total (Stg)	12.5	5.0	9.5
UK market performance	1.6	0.9	5.8

*Currency pegged to pound sterling

farrelly's

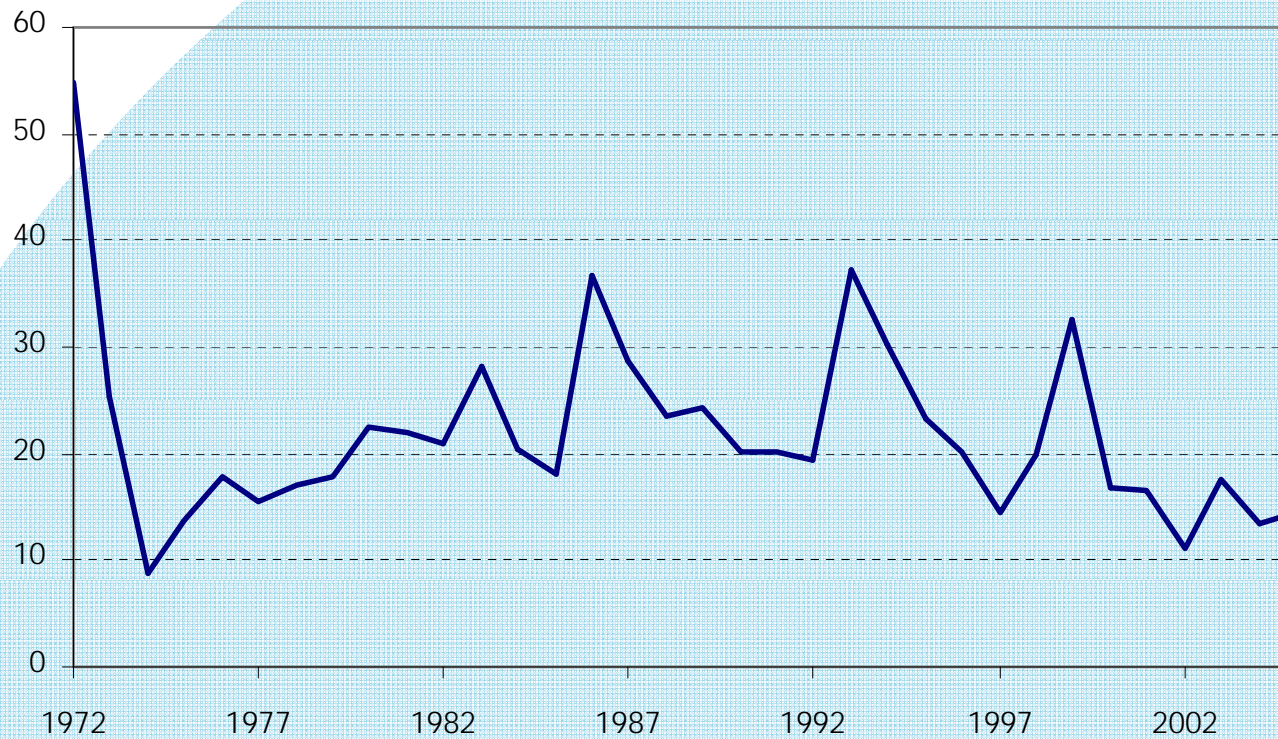
Tiger, tiger burning bright!

- Singapore 1972- 1990

farrelly's

Fluctuating PE ratios....

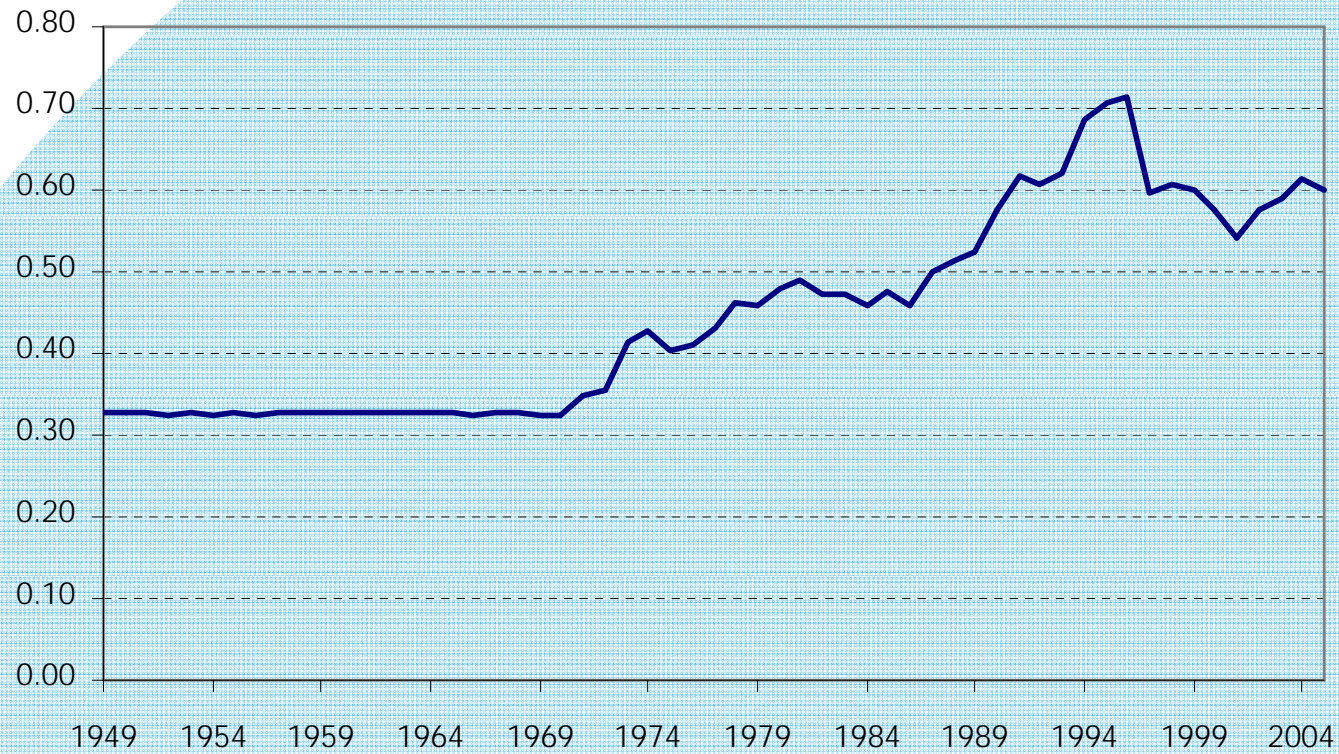
Singapore PE ratios



farrelly's

A strong currency...

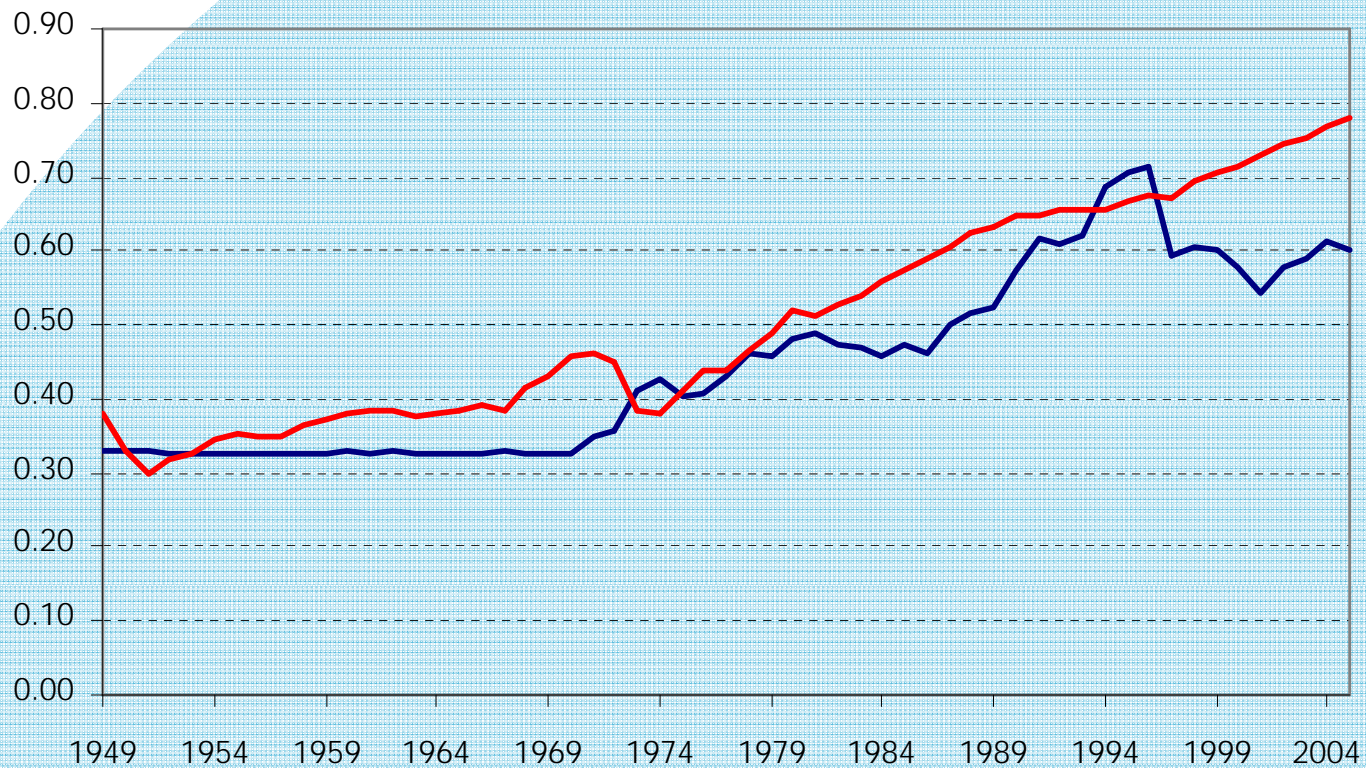
Singapore \$/US\$



farrelly's

...driven by lower inflation

Singapore \$/US\$ vs relative CPI



No triple bunger here...

	1973-1983	1983-93	1993 - 05
Divs	2.1	1.8	1.1
EPS growth	10.1	2.6	7.8
PE expansion	1.1	2.8	-7.6
Total Return (Sing \$)	13.3	7.2	1.3
Currency	1.3	2.8	0.2
Total Return (US\$)	14.6%pa	10.0%pa	1.5%pa
Total US Equities	10.3%pa	15.6%pa	11.0%pa

*Currency pegged to US\$

farrelly's



asset allocation
masterclass