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Mackenzie Cundill Recovery Fund & Mackenzie Cundill Emerging Markets Value Class

"Investors, not just in Canada but throughout the developed world, are woefully under-allocated in emerging markets" – James Morton

James Morton, Portfolio Manager, Mackenzie Cundill Recovery Fund and Mackenzie Cundill Emerging Markets Value Class, often visits with the executives of the companies he invests in, from Indonesia to China and Russia.

Morton believes the economies of Europe and the US will continue to struggle, while many emerging market economies prosper in the years ahead. And yet, he says, many Canadian investors are missing out on an opportunity to invest in the economies of tomorrow.

In the commentary below Morton lays out a compelling argument to explain why investors should include the rapidly-developing emerging markets in their portfolios.

Mackenzie CUNDILL FUNDS

Emerging markets: shifting from poverty to growth

In 1972 I was on a flight from Sydney to Rome, and I was one of only three people who got off in Jakarta. After getting through customs and immigration, I was greeted by a very tall man wearing "Papa Doc" Duvalier sunglasses and carrying a submachine gun. He then escorted me to a car which traversed several blockades manned by soldiers, before finally reaching the Hotel Indonesia where I was staying. At that point I realized I hadn't done my due diligence on whether this was a good time to visit. In fact, those of you who have seen the movie The Year of Living Dangerously that's the era it was. It wasn't a particularly good time to be Indonesian, particularly if you were ethnic Chinese, as tens of thousands of them had been massacred in a military coup.

I was recently in Jakarta again and staying at the same hotel now called the Kempinski, and it is looking much happier after a few face-lifts. The hotel is no longer the tallest building in town – it's dwarfed by some Grade-A office space and is part of a shopping complex with all the top brands you would expect to find in an upper-end mall: Prada, Gucci, LVMH – they're all there, and the mall's hopping with lots of customers.

> To use that old Chevrolet advertising line: "this is not your father's emerging market."

Other things have changed. When I went sightseeing in Jakarta in 1972, I was told to take my watch off. These days, you can see a lot of expensive watches on people's wrists in Jakarta.

In 1997 I went to Kiev for the first time and stayed in the only hotel that didn't have bedbugs. In fact, you had to have an invitation from the Communist Party to even stay there, and I was told to be very careful what I said on the telephone.

The next morning I went down to the breakfast buffet – absolutely awful. The only thing which looked remotely edible was a cheese sandwich. I remember that sandwich to this day – I'm convinced no milk had gone anywhere near that cheese. In August of this year, I was in Kiev again. This time I had dinner at a very nice Italian restaurant with the top managers from one of the companies we're invested in. I ordered a salad Caprese, and instead of getting hard and dried up mozzarella, I had a most wonderful, creamy Burrata cheese, which had been flown in that morning from Naples.

Do emerging markets carry more risk that developed markets?

Why am I sharing these experiences with you? Well, it's because I think it's very hard for people who haven't lived through them — as I have been very fortunate to have — to fully understand the scope, the scale, extent and pace of the change that is taking place out there. It's truly dramatic.

The fact that most people haven't experienced such change is a key reason why investors, not just in Canada but throughout the developed world, are woefully under-allocated in emerging countries. There's just a total mismatch between what's actually going on in terms of value creation in emerging markets and the average investment portfolio.

The second reason people don't invest in emerging markets involves their perception of risk. If I say to you, "Emerging markets," what word immediately comes to mind? "Risk is the first word that everyone thinks of. Emerging markets are risky. But I think a lot of that is perception and a lot of it is looking in the rear-view mirror. But to use that old Chevrolet advertising line: "this is not your father's emerging market."

Benjamin Graham, the father of value investing, was spot on about this. We're value investors at Cundill and whenever I have a question about something, I always turn to Graham's seminal work, The Intelligent Investor, in which he wrote: "The investor's chief problem, and even his worst enemy is likely to be himself." This is because people really prefer to invest in their own personal comfort zone – things they understand.

It's understandable that people want to invest that way, but unfortunately it's not necessarily the best way to invest. I hope that during my presentation today I will be able to articulate a case that you will find plausible, if not convincing. First of all, I believe investors need to have more money allocated to emerging markets; secondly emerging markets are not actually nearly as risky as they are perceived to be. In fact, I'm going to make the case that in many instances, emerging-market assets carry less risk than comparable assets in developed countries.

So let's further examine what's going on in emerging markets. In 1960, when Prime Minister Harold MacMillan told the people of the UK that that they'd never had it so good, Hong Kong had a GDP per capita that was only about a quarter of the UK's. But by 1997, when Chris Patten, or Fat Pang, as he's known to the Chinese, pulled down the flag and handed it back to China, that ratio had changed dramatically – Hong Kong had achieved a GDP per capita well in excess of the UK, and the gap continues to widen.

So the question is: were we sitting on our laurels in the UK or were the people of Hong Kong just doing a wonderful job? You get a similar story when you compare Korea to Japan. In fact, thirty years ago Korea's per capita GDP was a quarter of Japan's, now it's more or less the same.

Go back to 1950 and the US dominated car production. Three quarters of the world's vehicles were produced in the US that year. Last year, it was less than 10%. Looking at it from the other side, in just 10 years China's share of vehicle production has gone from less than 5% to over 20%, and that number is growing as we speak.

Many emerging markets have a rising middle class.

At $7 trillion a year, China's emerging middle class already has extraordinary spending power and it's going to triple over this decade. That means its emerging middle class will be spending twice as much as the US current consumption, and that means a material shift in spending patterns around the world.
We all know the headline: "US, the largest economy in the world today. China's going to overtake it fairly soon and become a whole lot bigger. India, close behind." But what is perhaps less obvious is the change lower down the ranks, where Indonesia is expected to replace the UK as the seventh largest economy in the world, and Nigeria is expected to become nearly as big as Germany.

Why is this happening? Well there are a lot of people out there who have money to spend, and there are more of them every day. It's really dramatic, when you look at the number of households that have $5,000 to $15,000 to spend over and above the basic necessities. India, for example, saw the number of households with this type of income increase by 10 times in 20 years to over 100 million households. That's a serious amount of spending power.

You can find rising incomes even in places where you don't expect it. For example, everyone says Africa is a basket case. But actually GDP on the continent is growing, and other signs of improving affluence — mobile phone and Internet usage — are growing as well.

Now let's look at consumer non-durables which have very different penetration rates in different parts of the world. But it is going to equalize out. Air conditioners have a very high penetration rate in Taiwan at 88%. Thailand, where it's a lot hotter than Taiwan, is at only 14%; India, where it's even hotter is at 2%.
In Japan, 98% of households have a fridge, but only 25% in Indonesia do. So you can see where some of this expenditure is likely to go.

> Where do you, as investors, want to be positioned? Do you want to be positioned in front of that change, or would you try to play catch up?

Russia has a somewhat different profile. Their use of services such as retail banking or discretionary expenditures such as eating out in restaurants is currently less than 20% or one fifth of the comparable expenditure per capita in Western Europe. They do excel at vodka consumption, and I will make a prediction here — I think a safe prediction — that vodka consumption in Russia is going to be coming down, and eating out at restaurants and the use of retail banking services will be going up. The good news is this is not a fanciful story because people have the purchasing power to do this.

It's a different story in the U.S. If you look at the level of consumer debt relative to GDP, it's nearly 100% – these people are totally tapped out. They cannot spend any more, and we're not much better off in the UK. But in emerging markets, consumerism really is accelerating.

In China, the debt to GDP ratio is only 16%, in the Philippines it's 2%. There's lots of capacity here for people to supplement their existing income through borrowing, and they are beginning to borrow. What's more, they're being offered lending products similar to those offered by Western banks – two or three credit cards per person.

Consumers in places like India and Indonesia just don't have any yet, but they're starting. It's going to be a big growth area. People in these countries have got the desire and they're going to have the capacity financially to do it. All of this will drive huge expenditure growth. It's going to be a big growth area.
I think it's also important, in the context of understanding this change, to recognize what is and isn't reality. China is generally regarded as the manufacturing centre of the world, the factory for the US and Europe. Of course, this is true as far as it goes. But if you go back to 1978 only 20% of the Chinese economy was related to the service sector. By 1999 it had moved above 30%, in 2009 it was 40%

and rising as we speak. This should not be a surprise: China and other emerging markets are following the trajectory already achieved in the developed world, only they're doing it at a much faster pace.

Take the Guangzhou economic zone, which was the place all the Hong Kong businessmen first went to build their factories with cheap labour. This is now an economy which is more service than manufacturing oriented. These ratios will only rise, and it's encompassing all manner of services.

By 2015 the number of Internet users in the BRIC countries will be around 1.2 billion – three times the current user base in US and Japan.

We know when we go to buy a toy from Costco or Wal-Mart that it's likely made somewhere in Asia. Almost all plastic toys are imported. Plastic hips are next, and not just the manufacture of them, but the insertion of them. If you look at the cost of hip replacement in the US, it's currently about $50,000. Across Asia, you can get the same procedure for about a quarter of the price. I can tell you from my personal experience that the average quality of health care in Singapore is better than it is in the US. I also have it on reliable authority that if you want a transgender operation, Thailand is the place to go.

So where are we going from here? I'll try to answer that with a few statistics to illustrate the scope and scale of the change that's going on. Taiwan already has the highest number of patent filers, per million of population and they're exploding in leading-edge areas of electronics and communication. By 2015 the number of Internet users in the BRIC countries will be around 1.2 billion – three times the current user base in US and Japan.

Online shopping is exploding — nearly 5% of sales in China are done over the internet and its heading to 15% by 2015. That's on the back of notebook penetration which was only about 10% last year, but is absolutely exploding. So there's a total transformation in how Chinese consumers operate.

As I noted earlier, only 2% of India's population have air conditioning, and I think that's going to be high on their priority list. In Indonesia, mortgages represent only 2% of GDP, but that's changing. All the banks have discovered mortgages, and this business is exploding, and the property market with it. But these things are just in their infancy.

Here's an interesting statistic. In Uzbekistan, the total annual insurance spend is just $3 per person. What is even more interesting is that less than 10% of the population actually has any insurance of any kind. And then you need to know that 20% of the population drive. Wine represents only 3% of alcohol consumption in China, and all these things are going to change in a big way. The point that I want to get across is: where do you, as investors, want to be positioned? Do you want to be positioned in front of that change, or you try to play catch up? I know which place I'd rather be in.

Market fundamentals in emerging markets are healthy

So let's put some of these things in context of financial markets, and talk through a few ratios. At Cundill, we're focused on the value of assets and margin of safety. But most people in emerging markets prefer to focus on earnings, so I'm going to talk more about earnings here. If you look at the consensus P/Es for these main indices today, the MSCI World, just under 13; MSCI Emerging Markets, a little under 12; and MSCI Frontier Markets is at nine.

In 2003 when these gaps were actually quite a lot greater than they are today, I made the case that I thought emerging markets deserved to trade at premiums to the developed world. The reason then was all to do with growth. I'm still making the case today. I believe very shortly these PE ratios will reverse. And the case today isn't just about growth; it's also about risk, because many companies in emerging markets are actually less risky than their counterparts in developed countries today.

Now let's look at the funds themselves. In Cundill Recovery whenever I look at a company, I look at the valuation metrics over time to see how they've developed, and whether my entry point is a good one or a bad one. Today on a price to net asset value, mark to market basis you can see that today the portfolio has a ratio of about 0.61, which tells me we've got a really good margin of safety right now in the holdings in the Recovery Fund. We're at a 40% discount to basic value, and stocks often go above basic value as you know.

Looking back over time this ratio is a lot lower than it was in 2003, which was a good time to invest, and a great deal lower than it was in April 2006.

In Cundill Emerging Markets, I'm going to look at the absolute ratios to give us better guidance. Here, I think it's useful to explore the fact that not only do we have a good discount to net asset value, mark to market, but the P/E ratio is also very low. The point of this particular product is to give investors an opportunity to get access to growth, but with a value orientation.

The most important statistic to me is the leverage: negative 4%. It means that, excluding the financials in the portfolio, if you add up every single holding we have on a weighted average basis and turned it into one company you'd have a company that has net cash with very low financial risk.

This is extremely important because we want the management to be running the companies. If there's some kind of crisis, the banks are not going to be a problem. This makes me feel very good about the level of risk in the portfolio because there are no financial problems.

So let's look at these ratios compared to the global indices. In the Recovery Fund, on the major metric, the one that really means most to us, we look for a margin of safety. Recovery looks very attractive compared to the MSCI World and MSCI Emerging Market Index. It's hugely cheaper on that dimension and cheaper also on earnings as well.

With Cundill Emerging Markets the gap is even greater. Relative to the indices, you'd have to see the shares in the particular portfolio go up two to three times just to hit the index levels, and those are the averages. What is interesting is that at 1.8, the 10-year average on the price to book also happens to be exactly where we are now, but Cundill Emerging Markets is at only 0.75.

"It's important to understand the businesses you're investing in."

So let's talk about some of the largest holdings in that fund because it's important to understand the businesses you're investing in. Hong Kong Chinese Ltd. is a little bit of a misnomer here because it has nothing in Hong Kong and not much in China. But it does have a lot of lovely property in Singapore, because it is the largest shareholder in a listed company there called OUE (Overseas Union Enterprise Ltd.) which is part of the Lippo Group, a big Indonesian conglomerate.

> I made the case that I thought emerging markets deserved to trade at premiums to the developed world.

It does have a tech park in Beijing and a bank in Macau. But the important point is that this company, when you look at the true mark to market value of its assets, it's trading at an 80% discount. Or, to put it another way, you'd have to see the share price go up five times to get to NAV.

Lonrho Plc is an African-based conglomerate listed in London with a wide range of businesses. A lot of them are tagged onto growth themes in that part of the world, ports and airlines being two of them. When we look at a conglomerate, we disaggregate all the business units, try and put fair values on them, and then compare it to the market price. We think this company is trading at a discount of about 60% of the sum of its parts. Interestingly enough, this company is considering a listing in Hong Kong next year which could be the catalyst to unlocking value because Chinese investors these days are interested in Africa.

Magnificent Estates Hotel Company in Hong Kong is owned by the son-in-law of the richest man in Hong Kong. Two things are interesting here: Price to NAV on a fully diluted basis is a little below 0.3 in a sector that trades somewhere between 0.7 and 0.75. On top of that, this is a company which is doubling the number of its hotel rooms over the next two years, so we expect the NAV to rise considerably.

Motor-Sich JSC is a Ukrainian company and a market leader in the former CIS in the manufacture of engines for helicopters and small planes. The current market value of this company is less than half the money that it's invested in R&D over the last 10 years. It's very, very cheap by any measure. This year's current EV to EBITDA is expected to be only 2.4 and the P/E a little over four times – that's for a world-class company with huge barriers to entry in an exciting technology.

Panin Financial is an Indonesian insurance company. But the real interest here is its ownership of Panin Bank, which is the only national bank in Indonesia which has not been acquired by a foreign owner. So it's a really interesting acquisition target. If Panin was to go at the average price to book multiple of banks which have been sold in the last four years in Indonesia, the cash would accrue to the Panin Financial shareholders and would be well over 500 rupiah for a stock that's trading below 200 rupiah.

Other companies that have also done well include: BFI Finance, which is the leading independent finance company in Indonesia, Filinvest Land, one of two largest residential

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You cannot eliminate risk, so you've got to make sure that you're paid properly to take the risk that you're taking.

developers in the Philippines, Kazan Helicopter, the largest manufacturer of helicopters in Russia, Prosperity Minerals, a cement producer in China, Rizal Bank of the Philippines and Sintal, an agricultural company in the Ukraine.

Obviously, we're going to have some losers in any portfolio. This year, Vyborg, a Russian shipbuilder, has been a big disappointment, as has Dakor another Ukrainian agricultural company.

Growth is going to be stronger in emerging markets.

Now I want to switch gears a little bit and come back to the second part of my proposition, because I think it's hard to disagree with the basic premise that growth is going to be in emerging markets. I don't think anyone would really argue that point, but I think there's a lot of room for discussion on the question of risk.

Of course, risk is a tricky concept, because it matters how you define it. Lots of people in the financial community use ratios which I find really not particularly helpful, and I know a lot of people equate volatility with risk. I think volatility should be equated with opportunity. I like Warren Buffet's definition: "Risk is not knowing what you're doing." That is risk, because if you don't know what you're doing, you may be risking your capital and, at the end of the day, you want your capital back with interest. So you might have a volatile ride, but you only actually book a loss when you sell something.

We go about the analytical process in two ways. We want to de-risk portfolios from a financial standpoint, and we want to make sure a company has a solid balance sheet and good cash flow. I think you can see that in the Cundill Emerging Markets. We have achieved that because the net leverage position in the portfolio, on a weighted average basis is actually cash positive, so very low financial risk.

If you're concerned about risk in emerging markets, you can feel a lot more comfortable about it. Even if you don't like the idea of being in Turkey or Thailand you can feel a lot more comfortable about it if you're invested in companies which have no financial risk.

Then there's operating risk which is much more difficult to assess, and you can't do it sitting in front of a Bloomberg terminal in New York. You have to get out there and beat the bushes, meet management and understand the business. This means understanding actual cost structures and seeing what moves the margin. Then you have to tie it back to the financial statements. Does it make sense? Are management's plans realistic or are they pie-in-the-sky?

Anyway, you've got to tie back and make sure the whole proposition is logical. Even then, we're going to make mistakes, but we are going to reduce the level of risk because we will have very little financial risk and we will understand the operational risk. It is not possible to avoid risk. You can't do it. People have tried to create structured products to eliminate risk. You cannot eliminate risk, so you've got to make sure that you're paid properly to take the risk that you're taking. And I believe in the emerging markets, you're going to be paid better than anywhere else.

There is more debt in the Western world than in emerging markets.

If we look for the common denominator in all the big financial crises over the last 20 years — the Asian currency crisis of 1997, the collapse of Long-Term Capital Management and more recently the sub-prime crisis — they have one common denominator: too much debt.

So where is leverage in the world today? There's a lot more debt in developed countries than in emerging markets. Taking it to the extreme the least risky country in the world is Pakistan. But let's compare Europe to Indonesia, which is fighting off capital inflows at the moment.

Europe currently has nearly four times as much public debt to GDP as Indonesia. This is important, because during the Asian financial crisis Thailand's debt to GDP ratio stood at 32%. Malaysia was at 32% debt to GDP. Today, Greece has a debt to GDP ratio of 115%, Ireland 64% and Japan is over 200%.

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Let's look a little closer at Greece. As far as we know, the first people to debase their currency were the Greeks in about 700 BC when they started to add lead to the silver obol, and it's been downhill ever since. Greece became independent from Turkey in 1832, and during half of this period they've been in default on their government debt. At the moment, Greek government debt is about 80% owned by foreigners. So if you're calling for sacrifice and you're the Greek prime minister, who do you think would make a good target?

This is a problem that we're going to see more of because of quantitative easing, which is borrowing from the future. This can be a good idea in the right place at the right time if you make investments that have good returns. If you look at the US back in the 1950s, it didn't cost very much to generate an extra dollar of GDP. That was a good thing. Unfortunately, the trend has been in the wrong direction. It's been increasingly difficult to get a dollar of GDP out of the US economy.

This is a trend which is quite disturbing because at some point you start asking yourself: "Is stimulus spending a good thing? And I'm afraid the answer is no, because actually we are now at a point in the US, Europe and the UK where actually putting more money into the economy through debt expansion is going to have a negative effect on GDP growth in the future. So we have reached this point, and we have passed it.

Are investors putting their money in the right place?

When you look at the sort of investments people are now making, you have to conclude that this is wacky world we live in – the world of bonds. Look at Norfolk Southern Corporation, a railroad company with a decent business. It just issued a 100-year bond yielding less than 6%, and I don't have any idea whether goods will still be shipped by railroad in 100 years. IBM, one of the world's great companies issued a three-year bond yielding 1% and people put $1.5 billion into this instrument. Surely there's something, somewhere in the world which is better than this as an investment.

The average yield on investment grade debt with maturity exceeding 15 years is now at its lowest level since the bond index began. I think that should be of some concern. Mexico recently issued a 100-year bond at 5.6%. Will there even be a Mexico in 100 years? Now we are facing some very difficult times because in the US, millions of houses are worth less than their outstanding mortgage — including 68% of homes in Nevada, to give you one horrific statistic.

So my question is: how safe is US debt? I'm going to talk about federal, state, and municipal debt and the fact that 48 states in the US today have a budget shortfall, and they're not supposed to. California's is a horrendous 25%. Thirty-two states have already run out of money this year to pay unemployment benefits. Every single state has unfunded pension liabilities, including $3 trillion in California.

> As of last year, the prices relative to income here were 15% above the post-1970 average, according to the IMF.

Municipal governments need to raise a lot of money right now. The US federal government is leading by example. It's projected to issue almost as much new debt this year as the rest of the world put together, and this means that the US debt is now above the ratio to GDP where it stood in 1933. Not a happy comparison.

Where has all the money that's been pulled out of equities and been put into people's accounts gone? A lot went into safe US debt. Investors have poured $480 billion into debt mutual funds in the US in the last couple of years — more than went into equity funds in the time of the Internet bubble. Ladies and gentlemen, you want a bubble, this is a bubble.

Is Canada in a real estate bubble?

I'd like to ask you a few questions about Canada, which has obviously had a very good financial crisis. I don't know if it's because your banks are better run or better regulated, but you did very well relative to the rest of the developed world, and you've also got a lots hard and soft commodities that people want. Great.

As investors you can participate in emerging market growth by investing in resource stocks and companies here at home. That's terrific and you should do that, but it's not the whole story. So when you say, "We're a great place to be. We feel comfortable in Canada. We can make these good investments. Why should we bother to go anywhere else?" Well, one of the rules I have about giving a presentation is you never want to put forward a hypothesis about which your audience knows more than you do.

So I'm not going to put forward a hypothesis, but let's talk about some statistics here on Canadian real estate. As of last year, the prices relative to income here were 15% above the post-1970 average, according to the IMF. Now, this doesn't really sound like much of a deviation until you look at what happened in the US and you realize that at its peak before the crash that brought prices down 40% or more, this number was only 11%.

Again according to the IMF, house prices are above historical average here by 60%. Now, that does sound a bit of a scary number. The US peak, by comparison was only 30%. Again, the IMF is telling us that on a price-to- rent basis, apparently residential real estate in this country is the most expensive in the world. According to RBC, the typical house eats up 41% of median income in Canada today. In Toronto, its 49%, and I hope this number isn't correct, but I'm told in Vancouver it's 73%. That's a frightening number.

The Canadian Mortgage and Housing Corporation apparently has only 1.2% of equity compared to $773 billion of exposure to housing as well as another $223 billion of I don't know what liabilities. But at its worst, before it went technically bankrupt, Fanny Mae had 1.5%. So I'm not saying that Canadian real estate is a bubble, but I am asking the question: do you think that maybe you want a bit of diversification?

Are we headed for inflation or deflation?

One of the great debates in the investment world today is between people who believe that we're headed into deflation, and those who feel that inflation is around the corner behind every tree. My point is, you can actually have a world in which both things are happening simultaneously. If you think about it, it's logical, because when you take a country like Japan and, I'm afraid, an increasing percentage of Western Europe, we do have all these rather investment unfriendly trends going on that would create deflation, including a shrinking population, aging population, excess capacity mature housing markets and excessive levels of debt. These are not good things. It's a pretty grim list.

On the other side, developing countries have a lot of good things going on: a growing youthful population, and most importantly an increase in the productive cohorts which are likely to boost economic output.

There is insufficient infrastructure in emerging markets, and this is a really important point because we're talking about making investments that deliver a positive return to society. So instead of like the Japanese, trying to build a billion dollar bridge to an island with ten people on it, you've got the Chinese building an airport in a small town of, say, four to five million people, which is likely to yield a very good economic return for that type of investment. And equally important, in emerging markets there is moderate, to low penetration of consumer non-durables, so lots of demand and lots of supply will be created to meet it.

So in the developed world we have deflation or low inflation. But in the developing world, some inflation, and that can be actually a benign thing if it's the right sort of inflation.

Demographics is another important point. Here, we have a thing called the support ratio, which basically means the number of people in the potential workforce relative to the retired population. In Japan right now, there's just over two potentially economically active citizens for every one retired person. And, unfortunately, we can predict with absolute certainty that unless Japan decides to import most of the Philippines, this number is going to fall to one economically active person to one retiree. It won't work. And, on the other hand, you have the Philippines where the number is more like 14 to one. It will be coming down, but it'll still be a respectable six to one in 40 years.

So where do you expect that you're going to find the income that your clients are going to want in their retirement? And where do you think value is going to be created which will give you a decent total return? I would suspect that we will not find the answer in Japan, but we might find it in the Philippines.

The other thing I want to talk about briefly is the global banking industry because it's the engine room. If banking works, the economy works and unfortunately, vice versa. So on one hand, you have Indonesia where there's loads of capital right now. Deposit growth is high, and they're able to fund all these interesting investment projects which exist there, so loan growth is high and it's a virtuous cycle and everything is working wonderfully.

In the developing world, some inflation, and that can be actually a benign thing if it's the right sort of inflation.

On the other hand, you have Ireland where the banking system has basically ceased to exist. It's on life support being kept alive by the Irish government, but actually probably by the German government – but for how much longer? In fact, last week, the Irish government said, "Everything is wonderful but, by the way, tier two capital holders in Anglo-Irish will have to take 20 cents on the dollar. Sorry about that." And you can see why Ireland is in a state of economic depression and contraction. Here is a little pop quiz: What's the difference between Iceland and Ireland? One letter and two years.

Emerging markets are not in a bubble.

People talk about bubbles. Particularly I note in New York where I've heard people say that emerging markets are potentially in a bubble. I'm going to show you a few statistics which I hope will convince you that this is not correct, at least for now. Of course there have been bubbles in the past and there will be bubbles in the future. Emerging markets are like that. Actually, all financial markets are like that. But there is one risk that you take when you invest in strange places: you get strange currencies.

Currencies collapsed during the Asian currency crisis in 1997, but the good news is that although Asian currencies are coming back, they aren't as expensive as they were in the mid '90s. And yet these countries are all hugely more financially, politically and socially stable than they were 15 years ago. So it looks to me like we don't have to worry about that one.

Politics is another risk you take, and it's a real one, but it's also true all over the world. For example, we had one industry in the UK a few years ago which woke up to find out the government had confiscated it and actually sent out faxes to the managing directors.

Thailand is obviously a place which has lots of political risk. Military coups seem to be a regular event. You had recent riots in the street, people setting off bombs. And, you know, it's not over yet. The royal family is a big problem. The king, who has been a pillar of stability and is revered throughout society, is dying. People don't like the crown prince, and the princess has no children so she can't be considered. So there's going to be a succession crisis here.

On the other hand, the Bangkok index, The SET, was 1,600 in the mid-1990s. It's less than 1,000 today and yet this country is hugely better off in every dimension. The state is more solvent, companies have less debt and are more profitable. This is clearly not a bubble.

If they want to buy a REIT Thailand is stopping foreign investors, or at least penalizing them relative to domestic investors.

One of the things I'm sure you can't have missed is that lots of commentators in the press and one or two short-sellers in New York, are absolutely messianic about the fact that there is a Chinese property bubble. So I think it's useful to look at the data before determining whether there is one. And I've looked at China compared to Japan where, definitely, there was a bubble, no question. It started in the mid-1980s, got progressively worse and probably peaked about 1991 when I think somebody said that the Imperial Palace was worth as much as the state of California. That would have been a good trade, wouldn't it?

So let's look at China today and compare where the real estate industry is with Japan. If you look at urbanization, value of housing stock, rooms per person, residential land value to GDP, it's kind of like Japan in the 1950s — a long, long way from Japan's peak in1991. If you look at mortgages as a percent of GDP, which is 14% in China, that's where Japan was in 1980, but Japanese house prices went a long, long way after that.

I really feel that there is no bubble in Chinese property at the moment, and I'd like to pile on a couple of other statistics here. The affordability index for the average Chinese family buying an apartment of 80 square metres is twice where it was in the 1990s, so it's much, much easier.

Last year only 2.2% of the population bought a new house in China, so that doesn't sound like a bubble. Here's another interesting point: there is currently approximately $4.5 trillion sitting in bank accounts in China earning negative real interest rates, so where is that money going to go? I would hypothesize that some of it might just find its way into the property market.

Will governments restrict investment in emerging markets?

Investing in these markets isn't easy, and it's not going to get any easier. In particular, government policy tools could turn out to be a real problem. I am concerned about the mobility of international capital. I think governments around the world are concerned about the side effects of quantitative easing, and they may start restricting the global investors' ability to participate in some of the best investment opportunities.

In fact, they already have. Twenty years ago you could not give Brazilian bonds away. Nobody wanted them. The very idea was fanciful. Today, in order to buy a domestic bond in Brazil, you have to pay 800 basis points for the privilege of doing so. The world has done a 180 degree turn.

Two or three years ago most people couldn't invest in Indonesia, now it is actually restricting the ability of investors to buy their government bonds because there's too much demand. If they want to buy a REIT, Thailand is stopping foreign investors, or at least penalizing them relative to domestic investors. Vietnam has two classes of shares: one for foreigners, one for locals. And the foreign quota, I'm afraid, on most of the best companies in Vietnam is currently full. So you may think we can sit around and debate this matter, but opportunities come and opportunities do go.

The whole issue of when to go in and how to time it is a real problem. Even in the US — which I'm using for an example here because the CGM Focus Fund did a path-breaking piece of analysis on their shareholder base. In the last decade, this fund returned 18%, which is actually pretty good in the US, but the average investor lost 11%.

So my point is, if you are persuaded, as I hope you are, that the asset allocation of your clients needs to be raised in terms of their emerging market exposure, you do need to get in but you probably need to average in. I've always said this, and I will continue to say it because emerging markets are volatile, they have been volatile and they will continue to be volatile.

From water supplies to income disparity: there are risks out there.

I don't want to leave you with the impression that I think everything is a bed of roses and it's a wonderful world. Yes, it is, but it is a world full of risk. Some of the risks that one has to consider include a rising GINI (Named for an Italian economist, the GINI measures the income gap between rich and poor). It's is a big concern because this is a measure of income inequality across society, and it's particularly bad in countries going through this kind of evolution and development because the rich get very rich quickly and the poor don't, so you get all sorts of social tensions arising. When everybody's poor, it doesn't matter.

> My proposition is that, in emerging markets, you will get paid properly for taking the relevant degree of risk.

So the Chinese, I think, are managing this process very well. I'm not sure the Indians are doing such a good job. Unfortunately, the Indian government seems totally incapable of dealing with the Maoist Communist Naxalites. And the Naxalites, who are active across twenty states are like Nepalese Maoist rebels on steroids, so this is a big, big area of concern.

Secondly there are too many men. We all know that in a normal society, there are more female babies than male, but in India and China notably, that has not been the case recently. A combination of infanticide and an enormous number of abortions has meant that there are now tens of millions of men in the age group 15 to 35 who will never find a female partner (assuming they want one) and this certainly has the potential to exacerbate social unrest.

Water shortages are really serious in parts of the world and in my opinion it's the most likely single reason, other than, perhaps, Iranian nuclear power, to cause a war. We all know about piracy, terrorism and global financial imbalances. I think I've said enough.

So yes there is lots of risk, but there's risk everywhere in investment — particularly if there's going to be inflation out there — and I think there is plenty of evidence that there's lots of inflation in the world and some of it's going to find its way back to the mature countries sooner or later. Being in cash can be an absolute catastrophe. It can be the riskiest investment around. Bonds have certainly moved from safe haven to bubble status.

So there's risk everywhere. You want to make sure you are paid properly for taking the risk and that you understand the risk. And my proposition is that, in emerging markets, you will get paid properly for taking the relevant degree of risk.

Let me leave you with one last question. Would you buy shares in a company which has the right to issue further shares in any quantity at any time and in any manner whatsoever it chooses, with no concern at all for existing shareholders? The answer, of course, is that you wouldn't. However, US treasuries are the investment which is considered the blue-chip, benchmark, and safest investment in the world, and it's used by all academics as their risk-free rate of return. We live in a world that is truly Alice in Wonderland. Thank you very much.

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