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The Investment Landscape for 2012

Bonds

If we look at the bond landscape, we can make some broad generalisations that will help guide us in our fixed income investments. Globally, bond yields will remain low until a sustainable economic recovery is clearly underway, and hence bond returns will be muted as there is limited room for yields to fall further. US government bonds are currently expensive, though relatively safe. Bonds of the troubled Eurozone countries are distressed and may provide opportunities for investors with the appropriate risk appetites and expertise. Lastly, there are the Asian bonds, both corporate and government, which we feel may provide undervalued opportunities. The yields for Asian bonds more than compensate for the risks. While Asian bonds are definitely riskier than US Treasuries, they can be properly managed by on-the-ground knowledge of Asian market environments.

Historically, US Government 10 year bond yields have ranged from a high of 15.8% in Sep 1981 to a low of 1.72% on 22 Sep 2011. The latter level is lower than the 2.2% witnessed during the panic of Dec 2008. As we are now at the bottom of the range for US long bond yields, the upside for bond investors is limited after a 30 year bull market in bonds. However, at the same time, it would be premature to write off US Government bonds. There are a few reasons why we feel that the downside for US government treasuries is limited.

Yield on US 10 Year Treasury since 1970



Source: Bloomberg, 6 Feb 2012

The resilience of US government treasuries was illustrated by a major bond fund manager's painful lesson when it went short on US Treasuries a few months before S&P downgraded the credit rating of the US. Instead of fleeing US government debt, investors fled to the only safe assets they could think of: US Treasuries. In addition, turmoil in the Eurozone has accelerated the flight of investors to the safe haven of US Treasuries.

We have also observed how the US government has repeatedly resorted to various measures to kick-start the economy, including the series of quantitative easing operations. Such measures will ensure that bond yields stay low.

Keeping bond yields low and below the rate of inflation is one of the means for governments to deleverage. This was the course of action taken for many years after World War II, when debt-laden governments had to deleverage after massive wartime spending. This was especially so in post-war Japan, Italy and Germany, in which bonds have outperformed equities over the last 50 years. The current efforts by Western governments to de-leverage will likewise maintain a bond-friendly environment in the years to come.

We are favoring the Asian government and corporate bond markets for 2012. For example, Thailand has a relatively low debt to GDP ratio of 43%, in comparison to Europe's average at 85% and the US at around 70%. There is more potential for Asian governments to be upgraded by the rating agencies, and a case in point would be the upgrading of Indonesia to investment grade by Fitch. Asian governments also have more room to lower interest rates, which are at relatively higher levels, and hence there is more potential upside for Asian bonds.

Our investments in Asian bonds will leverage on the presence of PhillipCapital Group's asset management teams in Thailand, Malaysia, Singapore, Indonesia and Hong Kong. This Asian regional presence gives us a first-hand understanding of the risk and opportunities associated with Asian corporate bonds, which in many cases are not covered by credit rating agencies. For such bond issues, we have our own independent credit rating process. This has served us well over several investment cycles without a single credit default in the funds we manage.

From a client flow perspective, the greater demand for Asian bond mandates comes from the uncertain outlook for growth, and a need for more certainty in returns. Our sterling investment track record in the bond markets has won us significant inflows from government agencies, private banks, institutional clients, and high net worth individuals.

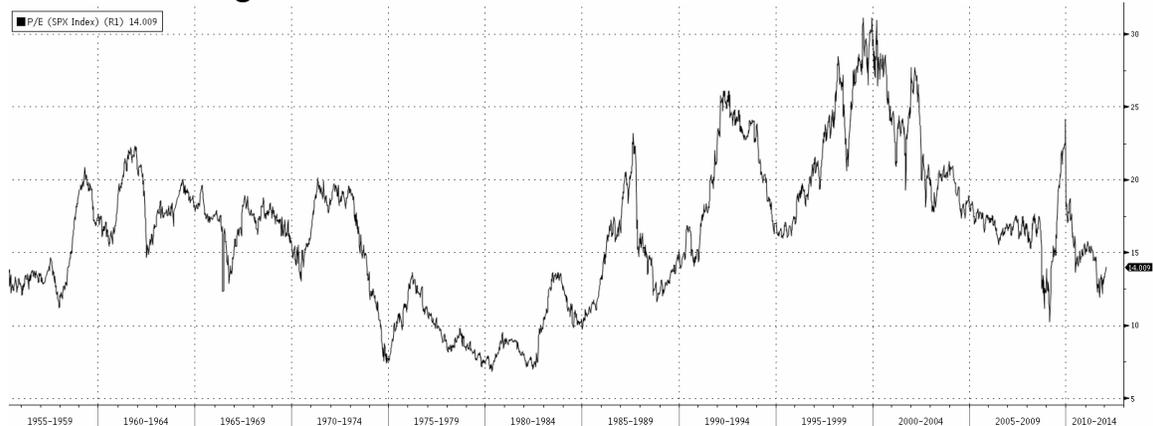
Equities

For equities, despite the uncertainties in the global economy, we see ample opportunities for selective investments. We love to build up positions in equities

when prices are attractive, as they are now. As such, our equities strategy this year involves overweighting our equity allocation and getting into stocks for the longer-term, which goes against several analysts' views that the rally at the start of this year may be short-lived.

The support for our belief is based on a study of historical valuations over the last century. During prior market downturns, such as in 1930 or during the 1970s, the US market's P/E was around 7 times. Conversely, during periods of 'irrational exuberance', as was the case in 1929 and 2000, P/E averaged around 30 times. A quick and dirty estimate of a 'fair P/E' would be in the high teens. Currently, the S&P500's P/E is around 14 times, a relatively comfortable level for long term investors, in view of low interest rates and the potential for the global economy to achieve a better than expected outcome amidst the uncertainties in the Eurozone and US.

Price to Earnings ratio of S&P500 since 1955



Source: Bloomberg, 6 Feb 2012

Although contrarian, we are not alone in our positive stance on equities. Warren Buffett has poured US\$24b into various companies in 3Q2011. These recent investments are significant in size relative to Berkshire's past investments.

The sectors for investment focus

Despite our optimism, we remain selective about the sectors to invest in, as the best investment themes always vary from period to period. Top performing sectors rarely remain the best performers in back to back decades. In the 1960s IBM and the NIFTY 50's were the top-performing investments, in the 1970s Oil and Gold, in the 1980s Japan, in the 1990s Technology, Media and Telecom (TMT). So while Brazil, Russia, India, China (BRIC) and Latin America were the hot investment story of the 2000s, their continued outperformance will be challenging in the current decade. Thus far they have collectively

underperformed significantly; therefore careful thought has to be put into steering our investments' sector allocations.

We feel that the investment theme for the next few years lie in companies that can deliver 'certainty', in the form of sustainable and preferably growing dividends. The company's business model should give us confidence that it will be able to at least maintain its dividend level even over volatile market cycles. Some examples of sectors that match this description would include the telecommunications, Real Estate Investment Trusts (REITs), and consumer staples. Holdings in these sectors would comprise the bulk of our equity allocation. Let us look further into each of these sectors that we have just mentioned.

Technology, Media and Telecom (TMT) is the sector that will begin to regain its popularity just like in the 1990s. They are now reasonably priced, have strong cashflows, huge cash hoards, and will benefit from the explosive growth in social networking, information and communications.

Looking at REITs, we feel that there exist opportunities for investment into the larger Singapore REITs which have strong sponsor backing. REITs, apart from currently providing attractive yields, also add a layer of diversification and in fact enhance the return of a portfolio of stocks and bonds. We noticed that the larger REITs on the whole maintained their payouts even over the 2008 financial crisis. In addition, having reduced their leverage levels from a few years ago, Singapore REITs have balance sheets that are stronger than previously.

For consumer staples, we like the global, large cap companies such as Nestle. Such firms have strong brand names that have enabled them to leverage on their reputations to gain footholds in emerging markets. Downside is limited due to the defensive nature of their business, while there is upside from the growth in China and other emerging markets.

We are also always on the lookout for companies that we term 'Asian Leaders'. These are the mid-cap firms from Asia that have the promise to become regional, if not worldwide, brands. A good track record at growing market share and perhaps expanding overseas, building a respectable and well-known brand, as well as maintaining a healthy balance sheet would flag a company for further study. These companies may be involved in relatively old-economy industries, but long term returns are significant. Recent notable stocks that fit this category have come from industries such as confectionary (i.e. Hsu Fu Chi) and even leather tannery (i.e. Heng Long) which have both been acquired by Nestle and LVMH respectively. Given the market uncertainties, some similar companies may be available at discount prices, and that is our chance to invest at a low cost.

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