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ASIAN MARKET COMMENTARY

Asia ex Japan: Will It Continue to Lead?

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While the long-term case for Asia ex Japan remains compelling and equity valuations are still reasonable, in the near term we continue to see greater risks on the downside. We view Japanese equities as inexpensive and Australian equities as reasonably priced, albeit more expensive than developed markets equities as a whole.

The Asia ex Japan growth story remains intact. Indeed, 2010 provided further evidence of the region's economic resilience and support for the proposition that it will drive global growth for years to come. The past few years have provided evidence of how much Asian fundamentals have strengthened since the late 1990s' financial crisis.

While the long-term case remains compelling, in the near term we continue to see greater risks on the downside. Although we do not consider Asia ex Japan equities overvalued, we believe they are slightly rich and therefore somewhat more susceptible to disappointing than to rewarding investors used to the 12.2% annualized returns of the past decade. Valuations discount aggressive earnings expectations at the same time that earnings per share (EPS) have exceeded their mid-2008 peak. Moreover, we have concerns about inflation, adverse changes in the global economic environment, potential asset bubbles, China-related risks, and geopolitical events.

For contextual purposes, we begin with a brief discussion of performance during 2010 and then look more closely at Asia ex Japan's macro-economic strengths and growth prospects, with a particular emphasis on China. That leads to a discussion of current and prospective valuations, followed by a look at the key risks to equities. In addition, we also look at reasons why, notwith-standing the region's long-term attractiveness from an equity beta perspective, investors should also consider how they might gain alpha through increased focus on manager selection, including in the area of alternative investments. Thereafter, we discuss Japan and Australia, the region's largest markets.

Performance in 2010[1]

When 2010 began, we were concerned that the Asian juggernaut (excluding Japan) would under-perform and experience a sizable pullback at some point during the year due to stretched valuations and diverging monetary policies as Western developed markets were easing while parts of Asia ex Japan were facing increased inflationary pressures. At the same time, we did not believe Asia was in a broad asset bubble and affirmed our bullish strategic view of the region even as we cautioned against a tactical overweight.

Asia proved more resilient than we anticipated,[2] outpacing other large markets for the ninth time in the last ten years (2008 being the exception). The MSCI All Country Asia ex Japan Index returned 15.6% in local currency terms, 555 basis points (bps) above the MSCI World Index and 432 bps above the MSCI World ex Japan Index. Performance was even stronger in developed Western market currency terms, with the index returning 19.9% in U.S. dollars, 23.7% in sterling, and 28.3% in euros (Exhibit 1). The sizeable

[1] More detailed performance analysis for the full year is provided in our *Calendar Year 2010 in Review*.
[2] For a more detailed interpretation of the relative over-performance and underperformance of emerging markets equities, including emerging Asia, versus developed markets *within* 2010, please see the Q&A on Quarterly Market Activity section of our December 31, 2010, *Market Update*.

retreat we were prepared for never ensued, although Asian equities did decline 10.9% from early January through early February and experienced a -12.4% return during the difficult months of April and May. Asian equities only moved firmly into the black during the huge global rally in September.

All ten economic sectors in the index delivered positive returns, with consumer discretionary (31.1%) leading the advance, and utilities (5.9%) bringing up the rear (Exhibit 2). The performance of consumer discretionary equities comes on the heels of the sector's index-leading 107.7% return in 2009, suggesting that investors are embracing the story that domestic consumer demand will grow strongly as the Asian economies grow. Meanwhile, all ten constituent markets were in the black, with Thailand (41.3%) far ahead of the pack and Indonesia (29.1%) and the Philippines (28.4%) also posting particularly impressive results. China was the worst performer, returning 5.1%, with underperformance beginning in the first quarter as authorities began to tighten. Four of the remaining six markets (Hong Kong, India, South Korea, and Taiwan) contributed more than two-thirds of total returns (Exhibit 3).

Asia ex Japan—the Apple of Investors' Eyes

Solid Fundamentals and Growth Prospects

While Asia ex Japan benefitted from the (at times spotty) recovery in Western developed economies, its performance also suggests that the region is increasingly capable of standing on its own two legs. Average GDP growth among Asia ex Japan's ten economies is projected at 8.1% in 2010 (with no economy experiencing sub-6% growth) and 5.5% in 2011 (Exhibit 4). China and India's size and prodigious growth rates make GDP-weighted growth even higher. Meanwhile, the regional index of leading economic indicators, which had been negative since June, turned upward in September (Exhibit 5).

Growth figures represent a continuation of the pattern of the 2000s, when Asia ex Japan real GDP grew (on a GDP-weighted basis) by an average annual rate of 7.1%, compared with just 1.8% on the part of developed markets economies.[3] However, the broad numbers do not do justice to Asia ex Japan's dynamism or how central it has become to mature global firms looking to grow their businesses. To give just one example, Chinese stock exchanges, including the one in Hong Kong, were reported late in the year to be on track to raise almost three times as much as U.S. initial public offerings in 2010. Truly, the center of economic gravity is shifting, with senior officials of large Western firms moving their headquarters to Asia or spending significant amounts of time there.

Asia appears to be on much firmer footing than in 1997–98, when it was shaken to its core by a financial crisis. Foreign reserve levels are much higher today (Exhibit 6) and S&P rates the sovereign debt (in local currency terms) of all markets other than Indonesia (BB+) and the Philippines (BB+) as investment grade. For many countries, the cost of protection against sovereign default is less than in much of Europe (Exhibit 7). This is one reason for increasing foreign interest in Asian debt.

Given Asia ex Japan's enormous population, growing middle class, current stage of development, and strong fundamentals (Exhibit 4), not many would bet against the region, at least relative to major developed markets. However, this begs the question of whether and how *investors* can benefit.

[3] For a discussion of the divergent path of emerging and developed markets in the 2000s, please see our 2010 report *Reflections on a Decade*.

Analysis of the region should begin with China, as virtually all roads in Asia these days seem to lead to (and from) the Middle Kingdom. China serves as a production base for the region's more developed markets such as Japan and Taiwan and as the major source of marginal demand (and pricing) for commodities. It is the world's largest exporter, has just eclipsed the United States as the world's largest automobile market (in annual purchases), and surpassed Japan in 2010 to become the world's second-largest economy.

China's real GDP growth is estimated at 10.1% in 2010 and 9.1% in 2011 (Exhibit 4). These are the highest rates in the region and among mid-to-large sized economies globally. They are even more impressive when one considers that China has grown by 9.8% a year for the last *30* years.

The combination of growing wealth and the world's largest population is formidable. China accounted for over 44% of global growth in 2008.[4] The International Energy Administration estimated in 2010 that China would account for 35% of the world's total oil consumption growth for the year, as well as 70%, 57%, and 46% of the increase in global consumption of cotton, copper, and soybeans, respectively. If International Monetary Fund (IMF) projections of China's current account surpluses prove correct, China's more than $2.6 trillion in foreign exchange reserves could rise to $5 trillion to $6 trillion by 2015.

China is still not a rich country by developed markets or even advanced emerging markets standards, with 2009 per capita GDP of $6,700 compared with $39,900 for Australia and between $28,000 and $33,000 for South Korea, Taiwan, and Japan. Basic infrastructure needs alone indicate substantial growth opportunities. It is no wonder that foreign businesses salivate when they consider data showing that less than 5% of Chinese own a car or that there are less than 150 (civilian) helicopters in the entire country (due to regulations, which are being eased).

Notwithstanding the China growth story, investors in Asia are by no means overlooking what is happening in its southern neighbor (and sometime nemesis), India. India is easily the region's second-largest economic growth engine. Its real GDP grew 7.4% in 2009, an estimated 8.4% in 2010, and is expected to rise 8.5% in 2011.

With GDP per capita less than one-third that of China, India holds out the potential for many years of strong growth, and its long-term demographics are also much better. In addition to a booming equity market, with five- and ten-year average annual compound returns in the 18% range (and a 16.2% return in 2010), transactions are up sharply. Five years ago, merger & acquisition deals worth more than $1 billion were almost unheard of in the market, but as of the end of October, there had been 13 deals of at least this size, with volume of $67 billion near the 2007 record of more than $76 billion.

India is still only the fourth-largest market in the Asia ex Japan region, behind China, South Korea, and Taiwan. The latter two markets, of course, are much more developed than the first two, with the information technology sector making up the largest part of each index (57% in the case of Taiwan!) and financials holding a small weight compared to indices for the other markets in the region. Together, the four countries account for 71.4% and 87.3% of the MSCI All Country Asia ex Japan Index and MSCI Emerging Markets Asia Index, respectively (Exhibit 8).

Valuations

While positive macroeconomic fundamentals provide a compelling long-term case for Asian equities, investors must always focus on what is

[4] We use 2008 data because real global GDP was negative in 2009 even as that of China grew.

priced in to current valuations, as the price paid for an asset is the most important determinant of subsequent intermediate- to long-term returns. We look at a wide range of metrics in our valuation work, with some pointing to Asian equities as cheap and others expensive. Overall, despite the huge run-up in equity prices since March 9, 2009, Asia ex Japan equities still appear fairly valued, although moving toward overvalued.

The rebound in Asian earnings has been remarkable, reflecting the strong economic recovery. EPS grew at a frenzied 76.2% clip in 2010, based on data for the MSCI All Country Asia ex Japan Index, and now exceed their previous high, which was reached in June 2008. This has helped equity valuations moderate this year after 2009's surge, as earnings had to catch up with market expectations. Indeed, despite the complete rebound in EPS, equity prices at year-end remained 17.4% below their October 2007 peak.

Consensus estimates are for EPS to grow 23.6% in Asia ex Japan and 22.9% in emerging Asia in 2011 (Exhibit 9). This implies attractive forward earnings ratios of 12.8 and 12.3 for Asia ex Japan and emerging Asia, respectively, in each case below their post–June 1994 means (Exhibit 10). Should such estimates prove correct, Asian equities could move to new highs. However, these estimates assume earnings will essentially grow at the same pace as that seen over the previous cycle: EPS grew 24.2% annually during the 2003–07 period. Such estimates may be too aggressive, and perhaps explain why investors have placed such a low forward multiple on equities.

Indeed, our normalized price-earnings (P/E) metrics show Asian equities as somewhat pricey. During the last month of 2010, the P/E ratio for Asia ex Japan moved to slightly more than 1 standard deviation *above* its historical mean using trend-line (22.8) and Shiller (23.7) P/E methodologies, although it was not as high (0.7 standard deviation above the mean) using our preferred return on equity (ROE)–adjusted methodology (18.7) (Exhibit 11). The price-to-book (P/B) ratio of 2.1 is also 0.7 standard deviation above the historical mean while, at 15.8, the trailing P/E ratio is about 0.3 standard deviation *below* its historical average.[5] Finally, the 9.9 price-to–cash flow ratio is 0.1 standard deviation above its mean and the 2.1% dividend yield (DY) is 0.4 standard deviation less than its historical average. Taking all of the above into account, we believe Asian equities are not cheap, but not yet overvalued.

On a relative basis, Asia ex Japan trades at a slight premium to developed markets. Its P/B ratio of 2.1 is 5% less than that of U.S. equities, but 14% more than the 1.9 P/B ratio of developed markets as a whole (and its own historical average). This is also slightly above the 12% premium seen at the end of 2009. Historically, Asia ex Japan equities have traded on a P/B basis at a 25% *discount* to developed markets equities, but the relative ratio has, on average, been equal since June 2006. This reflects investor recognition of Asia's increasingly strong fundamentals and suggests one should be cautious about placing too much stock in the full set of historical data when making comparisons.[6] The Asia of today is much different that that of the 1990s.

The premium commanded by Asia ex Japan equities on a P/B basis also reflects the fact that its 13.4% ROE is 17% higher than that of developed markets. Asia ex Japan's ROE is 0.8 standard deviation above its post-1987 historical average of 11.3%. By contrast, developed markets' 11.4% ROE is slightly *below* its historical averages

[5] The analysis excludes three months in 1999 when P/E ratios were more than 100; the inclusion of such data would more than triple the standard deviation for the rest of the data set.

[6] When assessing historical figures, we note that data from the 1990s include periods of negative earnings or other periods when the numbers skew the distribution significantly.

since 1974 (11.9%) and 1987 (11.7%). While it may be difficult for Asia ex Japan to sustain such a high ROE, it is worth noting that the premium to developed markets is just half of what it was a year ago. So long as the Asian growth and Western deleveraging stories continue, one can make a case for higher Asia ex Japan ROEs and for an accompanying premium, although investors should maintain a close watch as to whether it becomes too large to be justified. Likewise, investors should be sensitive to signs that deleveraging is slowing in developed markets amid a recovery. While this would likely be a temporary phenomenon, given long-term imperatives, it is certainly possible that emerging markets in Asia (and elsewhere) would play catch-up in such an environment, and in fact this may have already played out to some extent since last fall.

The bottom line is that should Asian equities continue to generate strong earnings, current valuations are reasonable on both an absolute and relative basis. However, given their slight richness on a relative basis, higher historical beta, and the existence of a number of serious risks (as discussed below), Asian equities may have more downside risk than developed markets equities.

Risks to Equities

Despite the undoubted merits to the Asia growth story, we believe risks today are slightly more to the downside given current valuations and aggressive earnings expectations. The major risks, in our view, are inflation, an adverse change in the international economic environment, the potential for expansion and subsequent popping of asset bubbles, China-related risks, or a major geopolitical crisis.

Inflation. Headline inflation in Asia is running at a much higher rate than in developed markets. Commodity and food prices (which affect poorer countries disproportionately) have been rising especially rapidly. While emerging Asian sector allocations to materials and energy are roughly similar to those of the MSCI All Country World Index, inflation seems more likely, at least in the shorter term, to spook investors concerned about economic growth and political stability than to translate into higher goods prices that in turn bolster equities. Still, while central banks in eight of the 13 markets in the region raised rates in the last half of 2010 (Exhibit 12), regional equities as a whole appear not to have been harmed thus far by tightening. However, this may be because monetary policy is still quite loose relative to conditions, as indicated by the fact that real interest rates are negative in eight markets (and no higher than 3.1% in any single market).

Certainly, measures taken in response to inflation concerns have hurt Chinese equity prices. CPI was up 5.1% year-on-year in November (the rate fell to 4.6% in December), while purchasing prices, nationwide property prices, and food prices were all reported to be rising at an annual rate of between 8% and 10%. City and regional authorities have instituted double-digit wage increases and the government is considering price controls in food and other commodity markets, all of which could have a longer-term impact on companies and the equity market. The government reacted by raising lending and deposit rates by 25 bps in both October and December and increasing the required bank reserve rate three times (to 18.5%) in the space of little more than four weeks in November and December.[7] These actions contributed to equities being in the red in both months.[8]

Similarly, the Bank of Korea raised its base interest rate twice (to 2.5%) in the second half of the year to combat rising inflation, which was 3.5% year-over-year in December. The Reserve Bank of India,

[7] In January and February, China raised the reserve rate by a total of 100 bps to 19.5%. In February, it increased the lending rate by 25 bps to 6.06%.

[8] For the full year, the reserve rate was raised six times (seven times in the case of China's six largest banks).

meanwhile, tightened rates by 150 bps in 2010 to combat a 9.4% inflation rate, by far the highest rate in the region. Further increases could hurt growth—and India's 10.8% unemployment rate is already more than twice the average of Asia as a whole and above that of the United States or Europe.[9]

Adverse Change in International Economic Environment. Rate increases may have whetted the appetite of Western investors seeking higher bond yields and perhaps also viewing Asia as a currency play. This in turn may increase the possibility of capital controls that curtail investment flows or cause investors to retreat from equity markets, even though there has been no apparent fallout from controls put into place thus far.[10] The South Korean government, for example, despite welcoming a weak currency, which benefits exports, showed its increasing concern about the issue of hot money last June when it instituted measures such as capping foreign exchange forward positions at banks. As of mid-November, about 17,000 billion *won* (US$15 billion) of foreign funds had flowed into the Kospi in 2010. The government supports recently introduced bills to implement a 20% capital gains tax and reimpose a 14% withholding tax on interest income on Korean sovereign bonds purchased by foreigners.

Notwithstanding the muted reaction to capital controls enacted in 2010, the imposition of further or more stringent measures could affect financial flows dramatically in individual markets or Asia as a whole. Likewise, a ramp-up in protecttionist measures or a sharp rise in developed markets interest rates (making developed markets bonds more attractive or the carry trade riskier) could impact Asian markets significantly.

Although Asia ex Japan seems increasingly independent from an economic standpoint, its equity markets remain very highly correlated with those of developed markets and other emerging markets. Moreover, we consider Asia ex Japan equity markets high beta, a view supported by regional performance during the volatile months of January, May, and September 2010. Accordingly, events that cause a pullback in developed markets could also have an outsized impact on the region. Some obvious examples are renewed fears relating to the European sovereign debt crisis or a growth scare in Western developed markets. A global inflation scare would also likely hurt Asian equity markets.[11]

Asset Bubble. Asian asset prices have benefitted from significant capital inflows. The Institute of International Finance forecasts that emerging Asia will receive nearly $430 billion in net private capital flows in 2011, only slightly below the inflow in 2010. Financial inflows helped regional currencies appreciate 2.0% on average in 2010, harming the competitiveness of exporters, whose health is central to many of the region's markets.

Such inflows have also created the potential for asset bubbles, several of which may already be forming. Negative real interest rates in countries such as China, India, and South Korea have encouraged individuals to pump money into real (as well as financial) assets. This has boosted both commodity markets and property markets, causing some to believe that bubbles are forming in several of these markets.

Should any of these potential or already-formed bubbles pop, it could significantly affect not only the local markets but also the entire region. While

[9] In January, the Reserve Bank of India raised its lending rate by another 25 bps, while the Bank of Korea raised its policy rate by 25 bps.

[10] It is a sign of the times that, notwithstanding the fact that currency controls are outlawed in many trade agreements, the IMF now is on record for the proposition that they can be a legitimate means of controlling the flow of hot money.

[11] Please see our 2011 Global Outlook Market Commentary *Into the Unknown* for a more detailed discussion of these key risk factors.

Asian economies are much less fragile than they were 13 years ago, one must not underestimate the possibility of contagion should one or two markets falter, as we saw in Europe in 2010.[12]

China as a Major Risk Factor. China is a particularly significant candidate for an asset bubble or other major risk event as it is confronted by a number of serious, often related issues. For starters, maintaining a balance between an economy that could overheat and one that grows too slowly to meet the population's expectations is difficult. Thanks in part to China's aggressive effort to combat the global slowdown in 2008, its banks nearly doubled their (official) lending to a record 9.6 trillion *yuan* in 2009, and then lent another 8 trillion *yuan* in 2010, 6% above the government's target.

Such actions, while promoting economic growth in the face of a global downturn, have led authorities to tighten, as discussed above. A failure of such policies to rein in inflation could cause social unrest in China, result in too-rapid tightening (which could also lead to unrest or choke off growth), or contribute to an asset bubble (some would argue China is already in one, particularly with regard to residential real estate). It could also create major difficulties for the rest of Asia and, quite possibly, global markets.

Indeed, negative real interest rates have spurred would-be depositors to park their funds in real and financial assets (as noted above),[13] while the rapid expansion of the money supply and surge in lending (in both the official and underground economies) have made ample funds available. The government has tightened property buying rules, but the effectiveness of such changes remains unclear. At some point, there will be an upsurge in bad loans. This will hit financials first and foremost, but also have a broader effect on the rest of the market, property prices, and investor and consumer psychology.[14] We believe, however, that the government's overflowing foreign exchange stockpiles and central role in the economy make it unlikely that the banks will face significant non-performing loan issues in the shorter term.

Last but not least, China faces a number of challenges on the external front, beginning with trade tensions caused by what developed markets, at least, consider an undervalued currency, which is reflected in China's huge trade surplus. China loosened the peg on June 21, but the real trade-weighted value of the *renminbi* actually dropped 3.2% over the remainder of the year. A currency or trade war would obviously be damaging for China and its trading partners.

Geopolitics. Finally, geopolitical events could also cause a nasty shock to Asian markets. While such factors (some of them existential) are ever present—and it is unlikely that the market can discount them in any rational fashion—we consider them more serious in 2011 than in prior years. Although China-Taiwan relations have improved (the two even signed a landmark trade agreement in June 2010), tensions between China and several of its other neighbors have increased due to disputes over regional waters and islands. The biggest immediate threat, however, is North Korea's recent attacks against South Korea and the broader questions surrounding what happens when the apparently terminally ill Kim Jong Il breathes his last. This has the potential to severely disrupt regional markets—or worse. Given the North's nuclear arms and formidable conventional forces,

[12] While Asia ex Japan shares no common currency or union, it is still generally perceived by foreign investors as a single investment market.

[13] Valuation metrics for China are presented in Exhibit 13.

[14] This may be priced in to some degree already as financials were the fourth-worst-performing sector in the MSCI China Index in 2009 (albeit with a 72.1% return) and the third worst in 2010, returning -0.5%. Such concerns could also explain why China lagged other Asia ex Japan markets in 2010, given that financials still make up 37.4% of the index.

the economic repercussions of a clash could be extreme and would likely reverberate far beyond the Korean Peninsula, with South Korean equities bearing the immediate brunt of the blow. There are, of course, many events that could occur outside of Asia, but still impact the region's markets significantly, given the aforementioned high correlations among global markets.

The Role of Active Management

As noted above, despite these risks we consider Asia ex Japan equities fairly valued although somewhat rich and more vulnerable on the downside than not. At the same time, we have long believed that managers can add substantial value, particularly those with local presence, experience, and connections. This is because we consider emerging markets much less efficient than developed markets.

If more subdued expectations on both an absolute and a relative basis are in order based on current pricing and risks, this raises the question of whether more attention should be paid to seeking alpha.[15] It is noteworthy that pricing at year-end was particularly rich in the three markets in the region (coincidently the most populous) that are expected to experience the fastest economic growth in 2011: China, India, and Indonesia.[16] Policymakers in the region are also taking divergent paths with respect to monetary tightening, the adoption of capital controls, and other measures that will impact local markets. In addition, extreme valuation disparities between the various Asian markets are noteworthy, even if not new. At year-end, for example, DYs ranged from 3.2% in Taiwan to 0.9% in much-less-developed India. Indonesian equities traded at a P/B level of 4.4, far above the 1.6 ratio in South Korea. India's trailing 12-month P/E of 22.4 was 85% higher than South Korea's 12.1 (Exhibits 14 and 15). Such variations, together with the factors discussed above, lead us to believe that the environment of 2011 may be one in which manager selection is increasingly important.

In addition, with equity beta not cheap, investors for whom such a course of action is appropriate should consider adding other strategies and asset classes such as hedge funds and private equity[17] (so long as they are reasonably valued[18]); certainly, firms following each of these strategies have been ramping up their regional activity and presence. With respect to hedge funds, we continue to believe that regional market inefficiencies create substantial opportunity, although we stress what we have called "the paramount importance of meticulous manager selection."[19] The ability of hedge fund managers as a whole to add value over the last decade is shown in Exhibit 16.

As for private equity, large components of many Asia ex Japan economies are private and therefore inaccessible to investors in public equities. Moreover, certain country indices are heavily weighted to certain sectors, leaving those who desire more exposure to other sectors with fewer options. Market growth and less mature capital markets create a need for private financing while (non-valuation) risks, though very much present, have been reduced.[20] As in the case of hedge funds, however, manager selection remains critical.

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[15] Interestingly, many of the Asia ex Japan managers we follow most closely outperformed the benchmark index even in the strong market of 2010.

[16] Indeed, India and Indonesia were Asia ex Japan's worst-performing markets in January 2011.

[17] In a forthcoming paper, we will discuss more broadly how investors with a robust allocation to emerging markets should diversify their portfolios to include investment strategies and asset classes such as hedge funds and private equity.

[18] Currently, we consider Asian private equity overvalued on the whole.

[19] Please see our 2009 report *Asian Hedge Funds*.

[20] For a discussion of these issues with respect to China, please see our 2010 report *Private Equity Investing in China*.

Conclusion

Since mid-2009, equity valuations have made us cautious about Asia ex Japan equities (as with emerging markets generally) from a tactical standpoint even as we maintained our view that they merit a strategic overweight given the strong long-term case. We have therefore advocated maintaining policy target allocations, averaging in to the region (for investors not yet invested to target) rather than seeking to time the market, but increasing exposure more rapidly if markets drop sharply. This is because periods of underperformance may be brief and many investors may not be able to move quickly at such times even assuming they are so disposed. For example, Asia ex Japan equities have lagged developed markets in just ten of the last 37 quarters in local currency terms (11 in US$ terms)—and just once each over two and three consecutive quarters, respectively, during that period.

We remain confident that Asia will continue to be a leader in economic growth, although we expect it to experience setbacks over time. There is always a risk that policy tightening or political uncertainties will hinder the extremely rapid growth to which observers have grown accustomed. Earnings in 2010 have come in even more strongly than last year's consensus estimates, making valuations look somewhat more justified and suggesting that fundamentals are better aligned with pricing than they were at the close of 2009. Moreover, while Asian markets remain very highly correlated with other markets, both emerging and developed, events over the past year provide further indications of the region's internal strengths, with impressive growth coming even though fiscal stimulus has decreased.

The key question for investors, of course, is whether this will translate into reasonable returns, and on this subject we are positive, notwithstanding our view that Asia ex Japan equities remain somewhat stretched, with prices discounting aggressive earnings expectations, and our belief that risks are slightly to the downside. In other words, we believe that investors should not *expect* returns to hit their ten-year average of 12.2% or their 11.2% mark since 1988. Still, we would not be surprised to see Asia ex Japan continue to outperform developed markets equities, particularly in developed markets currency terms.[21] An increase in the strength of Asian currencies is more likely than not to prove a tailwind for investors, as it did in 2010, and could mitigate the effect for unhedged Western investors of a downturn in Asian markets, even though this scenario would not play out if there were another flight to safety. We also believe a strong case can be made for seeking alpha, including through private investments if valuations improve.

The Developed Outliers

In terms of market capitalization, Japan and Australia account for 39.5% and 15.7%, respectively, of the MSCI All Country Asia Pacific Index. Because (1) these percentages are so large, (2) Japan's peculiar economic situation differentiates it from the rest of Asia, and (3) investors tend to invest in Japan and, for the most part, Australia, separately from the Asia ex Japan region, we analyze and consider Japan and Australia separately. Nevertheless, readers should keep in mind both that these two countries remain the region's largest by market cap and that their economic fate appears increasingly tied to that of region, particularly China.

As discussed below, we continue to see Japanese equities as inexpensive, but remind investors considering a tactical overweight of their recent history as a value trap—the hoped-for light at the end of the tunnel may still be far off. As for

[21] We have discussed in various other reports our view that emerging currencies, including those of Asia, are likely to appreciate over the long term against the major developed markets currencies.

Australia, we see equities as reasonably priced, albeit more expensive than developed markets equities as a whole, and advocate a neutral stance.

Japan

In 2010, Japan witnessed the ascension of yet another prime minister—the fifth in the last five years. Like his predecessors, the new occupant of the office, Naoto Kan, quickly ran into difficulties and lost popularity. His party, the Democratic Party of Japan (DPJ), whose Lower House win in 2009 marked the end of 50 years of virtually uninterrupted rule by the Liberal Democratic Party, also was punished in the July 2009 Upper House elections.

Kan's difficulties and those of his party reflect the fact that the DPJ has been unable to deliver the kind of change voters seek. Japan has grown little since its bubble popped a generation ago, has wrestled with deflation for more than a decade, and has a staggering 160% public debt–to-GDP ratio.[22] It also faces regional economic challenges that did not exist in the 1990s. In particular, China, while providing a low cost center for Japanese manufacturing production, increasingly serves as a magnet for global firms doing business in the region. South Korea, meanwhile, has become a more formidable competitor as the quality and innovativeness of its products increase and as a result of substantial yen appreciation versus the *won*.

The strong yen has posed a significant issue for Japanese exporters and has been much more negatively correlated with rising equity prices since May 2010 than has historically been true (Exhibit 17). On a trade-weighted basis, the yen rose 13.5% during the year and ended 2010 near nine- and 15-year highs versus the euro and U.S. dollar, respectively. Japan's intervention in currency markets in September for the first time in more than six years had little effect, and in October the prime minister called for South Korea and China to "act responsibly within common rules" on exchange rates. Yen strength may help explain why Japanese small caps (using MSCI data) outperformed large caps by roughly 400 bps in 2010.

Japan's stagnation presents a sharp contrast to the dynamism seen in the rest of the region and has been reflected in the significant underperformance of its equities. Japanese equities turned in the worst showing in 2010 among developed markets other than the European peripherals, Australia and Israel[23]—and this followed on the heels of Japan's double-digit underperformance in 2009. Foreign investors, who drive market trading, had soured on the market—at least until the fall—while Macquarie Securities noted in November that retail participation in the market was at an eight-year low. While the Nikkei 225 rallied to reach a seven-month high in December, Japanese equities still underperformed emerging and most other developed markets for the month in local currency terms.

Business sentiment has fallen since September and small- and medium-sized enterprises and large firms all forecast that conditions will worsen, according to the quarterly Tankan survey released by the Bank of Japan (BOJ) in December. More broadly, the general mood within Japan is exceedingly pessimistic. Although Japan's real GDP increased at an estimated 3.0% for the full year, the growth rate is expected to fall to 1.2% in 2011. Moreover, given the high level of growth necessary to pay off Japan's debt, the possibility of a financial crisis must be considered seriously.[24]

[22] This figure does not include the substantial amounts of debt issued by regional authorities.

[23] Performance was much better for unhedged US$ (15.4%), U.K. pound (19.1%), and euro-based (23.5%) investors.

[24] Indeed, in January S&P lowered its rating on Japanese sovereign bonds to AA-.

In spite—or perhaps because—of its difficulties, Japan remains a reasonable value play. Equities look attractively priced both on a historical and a relative basis. Ratios at year-end were at perhaps their most attractive levels in several decades, with the trailing 12-month P/E just off its lowest point since the early 1980s, the P/B ratio and price-to–cash earnings (P/CE) ratios near their lowest levels since our data begin in 1974, and the DY at its highest mark since 1980 (and equal to the yield on 30-year Japanese government bonds), apart from eight months in 2008–09, when the market was at extreme lows (Exhibit 18).

While Japanese equities' P/B ratio of 1.2 is up from the 0.9 level it fell to in the first two months of 2009, it remains one of the lowest in the 40-plus markets tracked by MSCI. Japan's 6.1 P/CE ratio compares favorably with that of other developed markets (9.7); this 37% discount compares with a historical premium of 26%. And though its trailing 12-month P/E ratio of 16.6 is higher (barely) than the 16.1 for developed markets overall, the more important normalized P/E ratio, adjusted on the basis of the long-term average ROE, shows Japan to be much cheaper on a historical basis than other markets, both developed and emerging. At 7.0%, ROE is just above its historical average and 43.5% less than that of the MSCI World ex Japan Index (although Japanese ROEs have historically been just half those of other developed markets), suggesting much more room for profits to grow. Finally, the 2.0% DY (up from 1.7% at the end of 2009) is 19% less than the MSCI World ex Japan Index's 2.4% mark, but slightly above that offered by U.S. equities. However, Japanese DYs have historically been 61% lower than those of other developed markets.

Such valuations indicate plenty of upside if the yen weakens, growth picks up in overseas economies (particularly the United States), or deflation (the rate of which has been declining) ends. Obviously, any true structural reforms or increased attention on the part of corporate managements to shareholder value would be a boost. At the same time, long-suffering investors could be hurt once again if the yen strengthens, consumers retrench further, reform takes another step backwards, or earnings fail to match high expectations. All bets would be off with a financial crisis, of course.

Corporate earnings rebounded in 2010 to reach 62.1% of their June 2007 peak and are expected to rise 21% in 2011. While this number is not small, several factors need to be kept in mind when assessing the feasibility of hitting such targets. EPS were *negative* in 2009, real EPS in Japan are at post-1969 trend-line levels, and both manufacturing and non-manufacturing profits remain well below past highs (Exhibit 19). In addition, even if 2011 expectations are met, EPS would need to rise another 33% just to regain their peak. However, the combination of a strong yen and plentiful corporate cash, which is at its highest level in at least 14 years, creates potential for Japanese firms to boost returns by investing in faster growing overseas markets.

On the reform front, it is important not to confuse temporary political actions with structural measures. For example, the BOJ has instituted a ¥5 trillion ($62 billion) asset purchase program and is buying exchange-traded funds and Japanese REITs in addition to government and corporate bonds. While the reach of the program thus goes beyond anything put forth by the Federal Reserve or the European Central Bank, the scale is much smaller—as is the fiscal stimulus proffered by Japan's government. Such actions may boost growth and support equity prices in the short term, but in the final analysis, Japan needs fundamental reform, not monetary easing or more government spending.

Japan remains attractively priced from a tactical perspective, but faces the same structural challenges we have identified for many years. Investors that overweight Japan are betting that they can avoid the value trap experienced (to date) by their predecessors. They are perhaps also banking on a weaker yen, which would boost the fortunes of Japanese exporters.[25] Such a scenario is certainly possible, particularly should Asian and other emerging markets economies facing inflationary pressures allow their currencies to appreciate.

Australia

Like Japan, Australia experienced a change in political leadership in 2010. Prime Minister Kevin Rudd was replaced in June by his deputy, Julia Gillard, after the government was weakened by a proposed super tax on resources and the shelving of a planned carbon trading program. Even so, and notwithstanding the global tumult of the past few years, the 19-year Australian economic expansion continues. Consensus estimates are for good 2011 real GDP growth of 3.5%, following estimated growth of 3.3% in 2010. The economy is increasingly tied to Asia, with 72% of exports going to the region, compared with about 40% ten years ago. Over 60% of all exports are to just four Asian markets: China (25%), Japan (19%), South Korea (10%), and India (6% to 8%).

Australian equities appear reasonably priced on a historical basis, with the ten-year normalized real P/E ratio 17.2 at year-end, just below its long-term average of 17.3. They are somewhat more expensive—about 0.5 standard deviation above their historical mean—using trend-line (17.9), ROE-adjusted (18.0), and trailing 12-month (17.2) P/E ratios (Exhibit 20).

On a relative basis, Australian equities are priced more aggressively than those of other developed markets as a whole. As of year-end, Australian equities had a P/B ratio of 2.1, 12% higher than the 1.9 ratio of the MSCI World Index, compared with a historical *discount* of 16%, using data that go back to December 1974. On a P/CE basis, meanwhile, Australian equities are 46% more expensive than developed markets equities, well above their 12% historical premium. On the other hand, Australia's 4.1% DY (one of the highest in the world) is 75% above that of developed markets as a whole, even more than the 54% by which it has historically exceeded the DY on other developed market equities. Using normalized P/E metrics, Australian equities are more expensive than developed markets equities as a whole on both an ROE-adjusted and a trailing 12-month basis, but slightly less expensive on a Shiller or trend-line basis (Exhibit 21). However, Australian equities have historically traded at a 9% to 14% discount to developed markets equities on the basis of normalized and trailing 12-month P/E measures, making them more expensive today in each case than has historically been true.

EPS grew an estimated 68.8% in 2010 and are expected to grow another 35.3% in 2011, which would put them 10% above their December 2007 peak. Trailing EPS have tracked previous forward (12-month) EPS estimates fairly closely over time, with the significant exception of the period from September 2008 to February 2010 (Exhibit 22). The forward P/E ratio of 12.7, which is 0.9 standard deviation below the post-1994 average of 14.6, seems to allow room on the upside although, as in the case of the forward P/E ratio for Asia ex Japan, one could also argue that it suggests investor skepticism that estimates will be met (Exhibit 22).[26]

Investors will need to keep a close eye on what happens outside of Australia, given that Australian equities remain very highly correlated with those

[25] A weakening of the yen might also provide further buying opportunities to investors that are underweight (at least to the extent it was not immediately reflected in higher equity prices), but would, of course, also reduce the value of existing holdings of unhedged investors.

[26] While this is not to suggest that the trailing 12-month P/E ratio will track the forward P/E ratio, we note that since mid-1994 the former has averaged 18.1, 24.4% *more* than the latter.

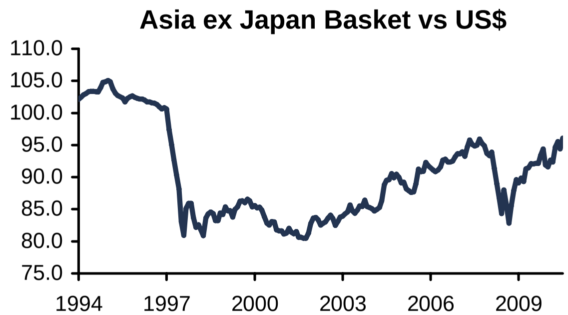
in the region and in other developed markets, on both an absolute and historical basis. Much depends on the continuation of Australia's mining boom, given that materials account for almost 30% of the MSCI Australia Index. While growth in emerging Asia supports this sector, the strength of the Australian dollar (up 10.2% in 2010 and 46.5% since January 2009 on a trade-weighted basis) is a headwind; the Reserve Bank of Australia has raised the policy rate a full percentage point since February as a result of concerns about inflation. Indeed, the country's ability to avoid an ugly end to inflated housing prices will have a big impact on equity prices. A recent estimate that the household savings rate is now 10% of disposable income implies that households may deleverage, which would be a welcome sign for long-term stability. Finally, the effect of massive floods in Australia is as yet undeterminable.

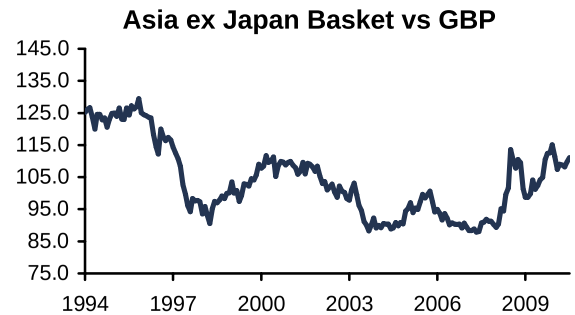
Like Asia ex Japan, Australia is reasonably priced, but on the high end of fairly valued, with current valuations discounting high earnings expectations and rapid growth in Asia. Investors may also pull back somewhat if they believe concerns about inflation will lead the Reserve Bank of Australia to tighten too much (notwithstanding the fact that the country's materials sector would likely benefit from broader global inflation). However, we do not advocate underweighting at this juncture. ■

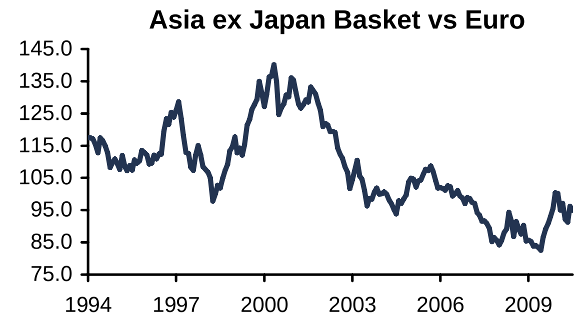
Exhibit 1

Asia Pacific Returns and Exchange Rate Movements

June 30, 1994 – December 31, 2010







2010 Total Returns

	Local Currency Return (%)	US$ Return (%)	Currency Impact (ppt)	GBP Return (%)	Currency Impact (ppt)	Euro Return (%)	Currency Impact (ppt)	Aus Dollar Return (%)	Currency Impact (ppt)
AC World	11.1	13.2	2.1	16.8	5.7	21.1	10.0	2.6	-8.5
AC Asia ex Japan	15.6	19.9	4.4	23.7	8.1	28.3	12.7	10.7	-4.9
China	5.1	4.8	-0.3	8.1	3.0	12.1	7.0	-0.5	-5.6
Hong Kong	23.5	23.2	-0.3	27.1	3.6	31.8	8.2	14.4	-9.2
India	16.2	20.9	4.7	24.8	8.5	29.4	13.1	10.7	-5.5
Indonesia	29.1	34.6	5.5	38.9	9.7	44.0	14.9	14.4	-14.7
Korea	23.9	27.2	3.2	31.1	7.2	36.0	12.1	15.3	-8.7
Malaysia	23.4	37.0	13.6	41.3	17.9	46.5	23.1	19.9	-3.5
Philippines	28.4	35.5	7.1	39.8	11.4	44.9	16.5	24.8	-3.6
Singapore	11.5	22.2	10.7	26.0	14.5	30.7	19.2	12.7	1.2
Taiwan	11.9	22.7	10.9	26.6	14.7	31.3	19.4	13.8	1.9
Thailand	41.3	56.3	15.0	61.2	19.9	67.1	25.8	43.1	1.8
Australia	0.7	14.7	14.1	18.3	17.7	22.7	22.0	7.0	---
Japan	0.7	15.6	14.9	19.2	18.5	23.6	22.9	-1.6	-2.3
EM ex Asia	13.7	18.9	5.3	22.7	9.0	27.2	13.5	8.6	-5.0

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

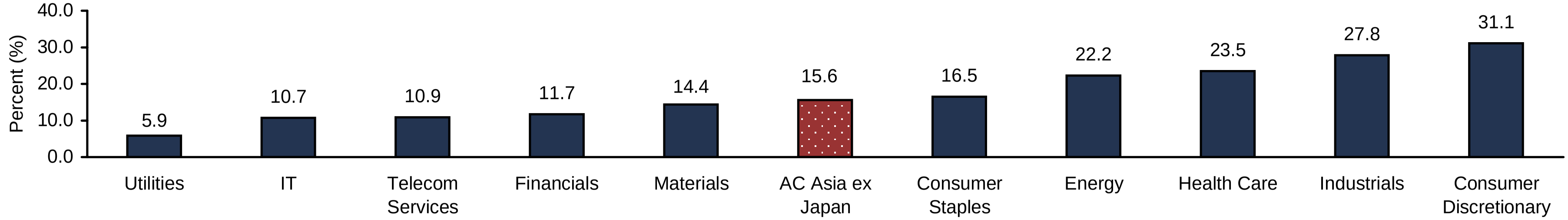
Notes: Graphs are based on monthly data. Asia ex Japan currency basket is the cumulative differential between returns for the MSCI AC Asia ex Japan Index in local currency terms and the corresponding returns in US$, GBP, and euro terms. Thus, it represents the movement of Asian currencies weighted by each country's market capitalization in the MSCI Index. Currency baskets are rebased to 100 on December 1987 (not graphed). All returns are shown gross of dividend taxes.

Exhibit 2

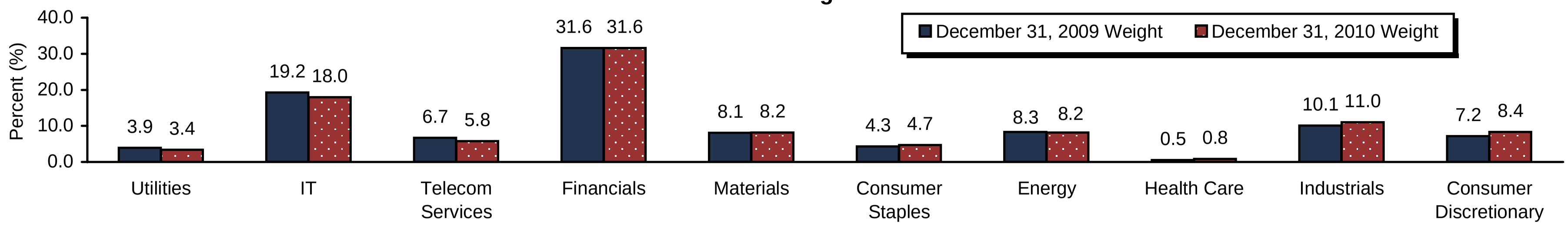
Sector Performance Attribution for MSCI All Country Asia ex Japan Index

December 31, 2009 – December 31, 2010

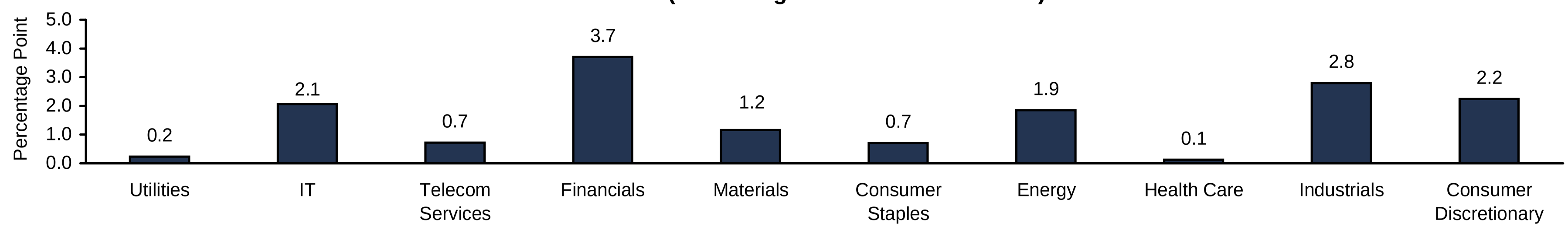
Cumulative Performance



Sector Weights



Contribution (Percentage Point Added to Index)



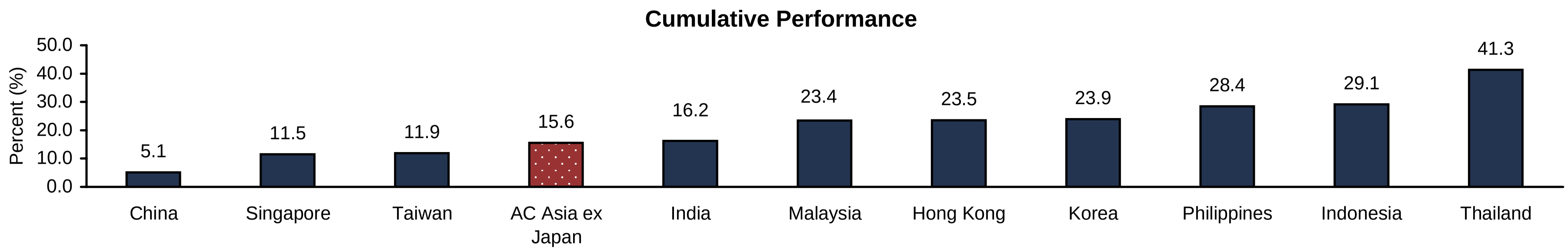
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

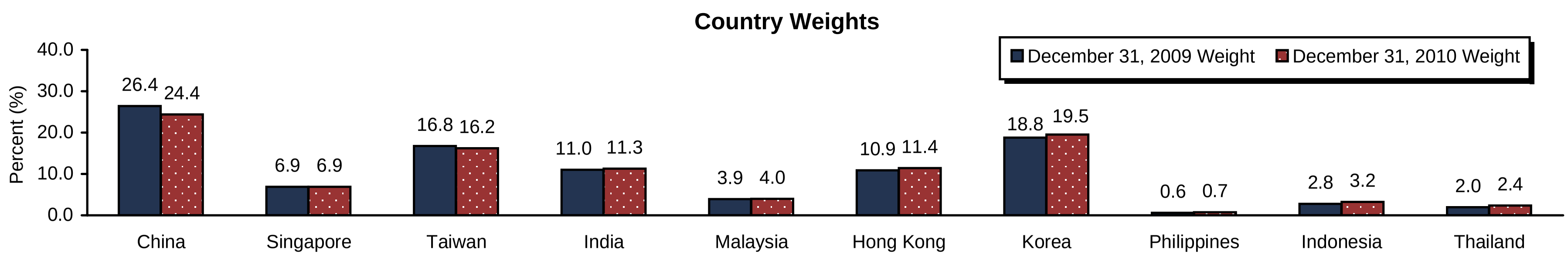
Notes: Contribution represents the sector's percentage point addition to the AC Asia ex Japan Index return of 15.6%. Sector contributions are calculated by multiplying the sector's December 31, 2009, weight by its cumulative local currency return from December 31, 2009, to December 31, 2010. Percentages may not total due to rounding. Total returns for MSCI All Country indices are gross of dividend taxes.

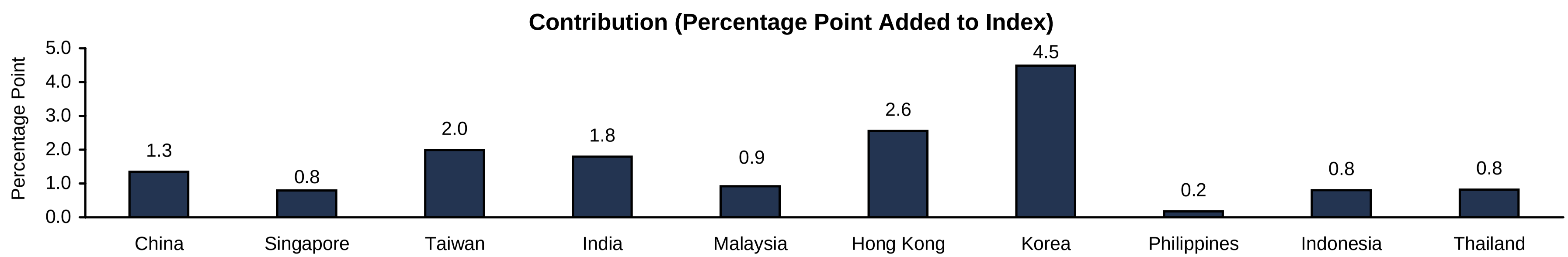
Exhibit 3

Country Performance Attribution for MSCI All Country Asia ex Japan Index

December 31, 2009 – December 31, 2010







Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Contribution represents the sector's percentage point addition to the AC Asia ex Japan Index return of 15.6%. Sector contributions are calculated by multiplying the sector's December 31, 2009, weight by its cumulative local currency return from December 31, 2009, to December 31, 2010. Percentages may not total due to rounding. Performance is measured by gross total returns in local currency.

Exhibit 4

Select Macroeconomic Indicators

2009–11

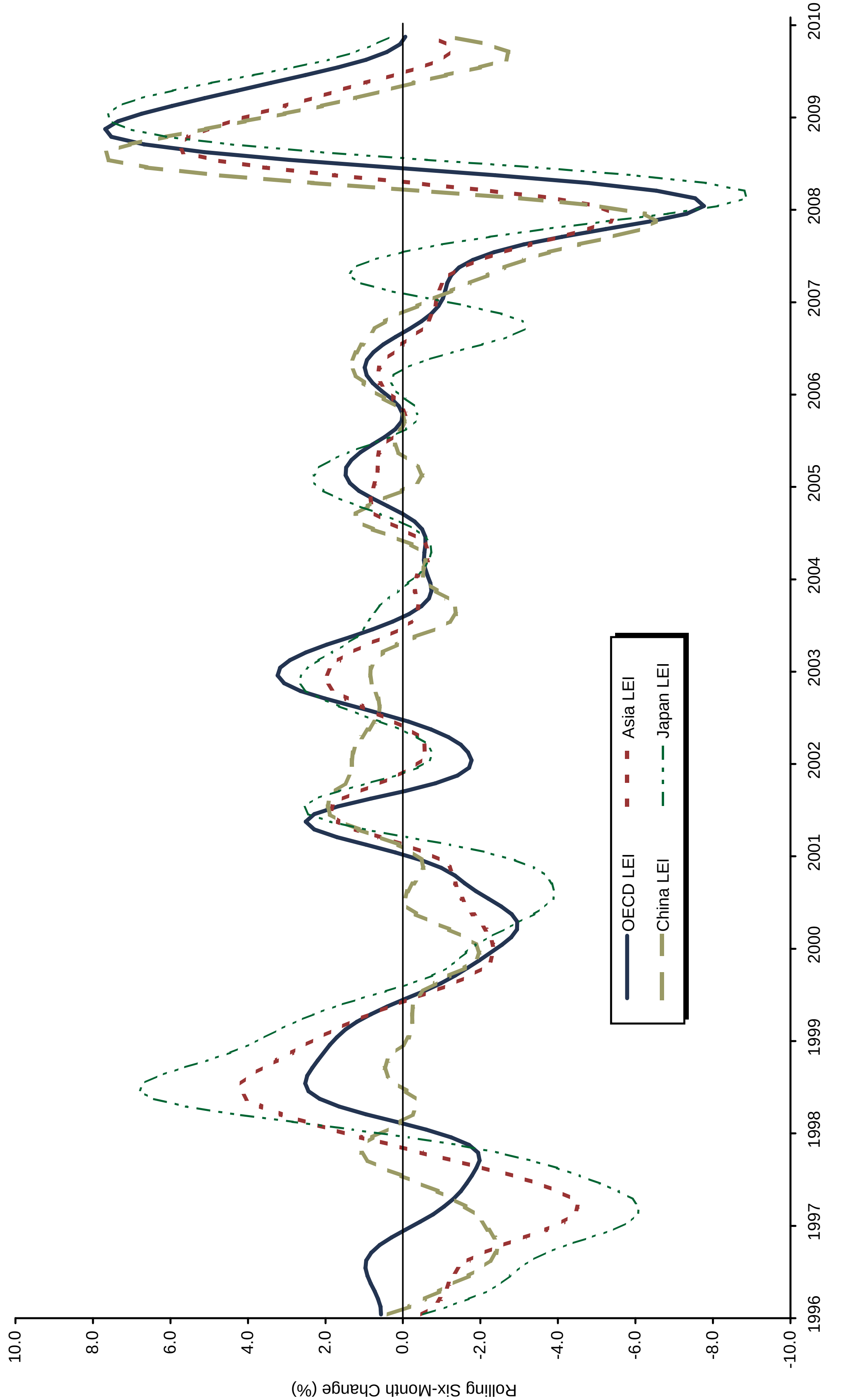
		Real GDP Year-over-Year Change (%)			Consumer Price Index Year-over-Year Change (%)			Unemployment Rate (%)			Fiscal Balance Percent of GDP (%)		
		2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
China		9.1	10.1	9.1	-0.7	3.0	3.0	6.3	6.1	6.5	-2.2	-2.2	-1.7
India		7.4	8.4	8.5	12.4	9.4	6.8	10.7	10.8	10.6	-6.5	-5.5	-5.3
Hong Kong		-2.8	6.0	4.6	0.6	2.5	3.1	5.2	4.3	3.9	1.6	3.0	2.7
Korea		0.2	6.0	4.2	2.8	2.9	3.1	3.7	3.6	3.3	-1.7	-1.9	-1.4
Singapore		-1.3	14.4	4.7	0.6	2.8	2.5	3.0	2.3	2.1	-1.0	-0.7	-0.4
Taiwan		-1.9	8.4	4.1	-0.9	1.1	1.5	5.9	5.3	4.7	-2.8	-1.7	-1.0
Indonesia		4.5	6.0	6.1	4.8	5.1	6.1	8.1	7.1	6.7	-1.6	-1.4	-1.3
Malaysia		-1.7	7.1	5.0	0.6	1.7	2.5	3.7	3.5	3.3	-7.0	-5.6	-5.5
Philippines		1.1	6.7	4.9	3.2	4.0	4.0	7.5	7.5	7.3	-3.9	-3.9	-3.2
Thailand		-2.2	7.5	4.3	-0.9	3.4	2.9	1.5	1.0	0.9	-4.4	-1.5	-2.7
Asia ex Japan	(Average)	1.2	8.1	5.5	2.3	3.6	3.5	5.6	5.2	4.9	-2.9	-2.1	-2.0
Asia ex Japan	(GDP-Weighted)	6.2	8.9	8.4	1.1	3.8	3.0	---	---	---	---	---	---
Australia		1.2	3.3	3.5	1.8	2.9	3.0	5.7	5.2	4.9	-3.9	-2.4	-1.0
Eurozone		-4.0	1.1	1.5	0.3	1.3	1.4	9.5	10.0	9.9	-6.4	-6.5	-4.9
Japan		-5.2	3.0	1.2	-1.4	-0.9	-0.3	5.2	5.1	4.9	-7.2	-7.5	-6.9
United States		-2.6	2.7	2.4	-0.3	1.6	1.4	9.3	9.7	9.5	-10.0	-9.0	-7.0
G3	(Average)	-3.9	2.3	1.7	-0.5	0.7	0.8	8.0	8.2	8.1	-7.9	-7.7	-6.3
World	(GDP-Weighted)	-0.6	4.9	4.6	1.7	3.0	2.8	---	---	---	---	---	---
G7	(GDP-Weighted)	-3.5	2.5	2.0	-0.1	1.2	1.1	---	---	---	---	---	---
BRICs	(GDP-Weighted)	5.3	8.9	8.7	2.5	4.3	3.6	---	---	---	---	---	---

Sources: Consensus Economics, Economist Intelligence Unit, Goldman, Sachs & Co., and Thomson Datastream.
Note: Data for 2010 and 2011 are estimates as of December 20, 2010.

Exhibit 5

Asian Equities Versus Leading Economic Indicators

December 31, 1996 – October 31, 2010

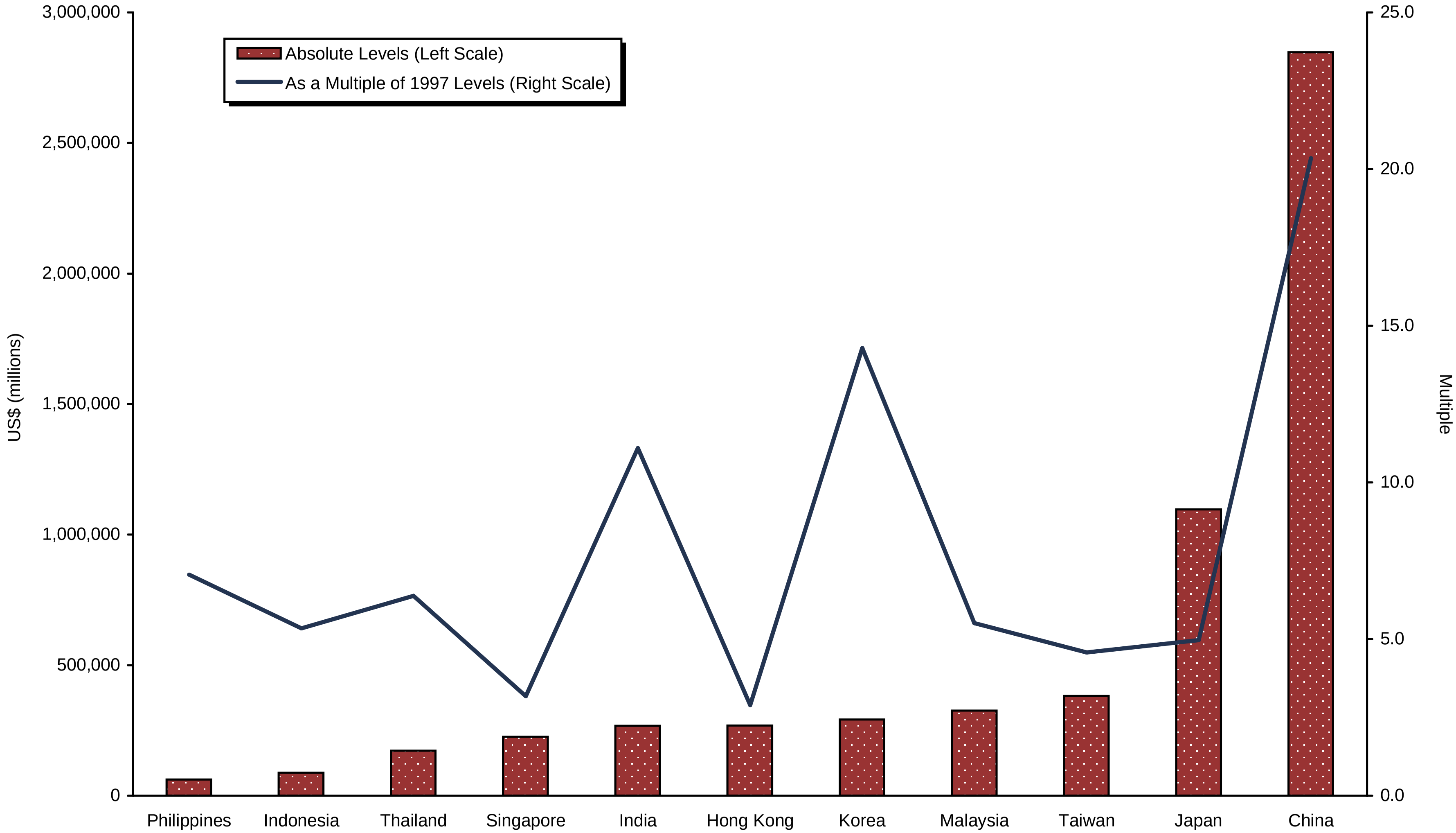


Source: Thomson Datastream.

Exhibit 6

Holdings of Foreign Reserves

December 31, 2010 • U.S. Dollar



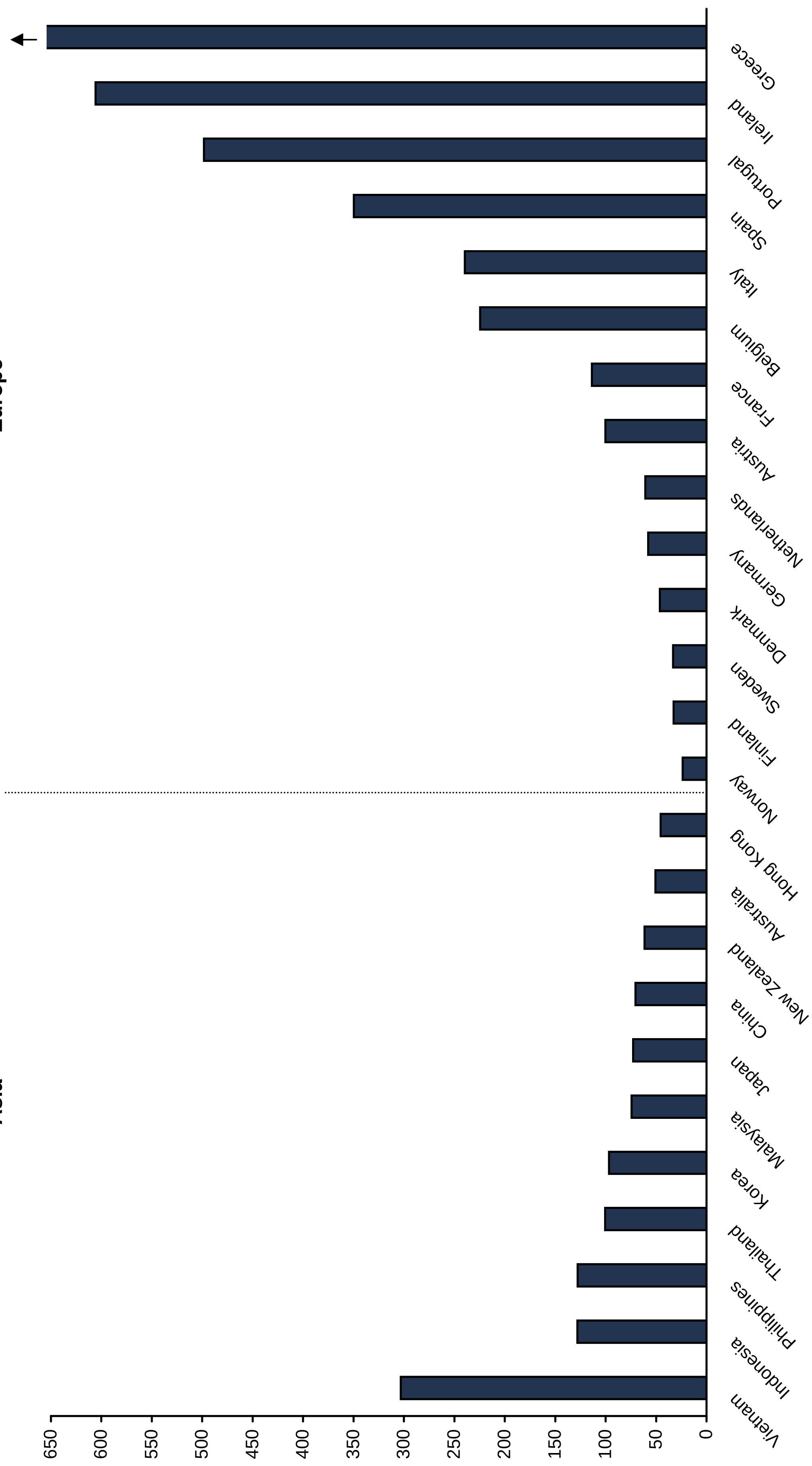
Source: Thomson Datastream.

Note: Indonesia reserve data are as of October 31, and Malaysia data are as of November 30.

Exhibit 7

Five-Year Credit Default Swap Spreads

As of December 29, 2010



Source: Bloomberg L.P.

Notes: As of December 29, 2010, Greece had a five-year credit default swap spread of 1,035.

Exhibit 8

Developed and Emerging Markets Country Allocations

As of December 31, 2010 • U.S. Dollar

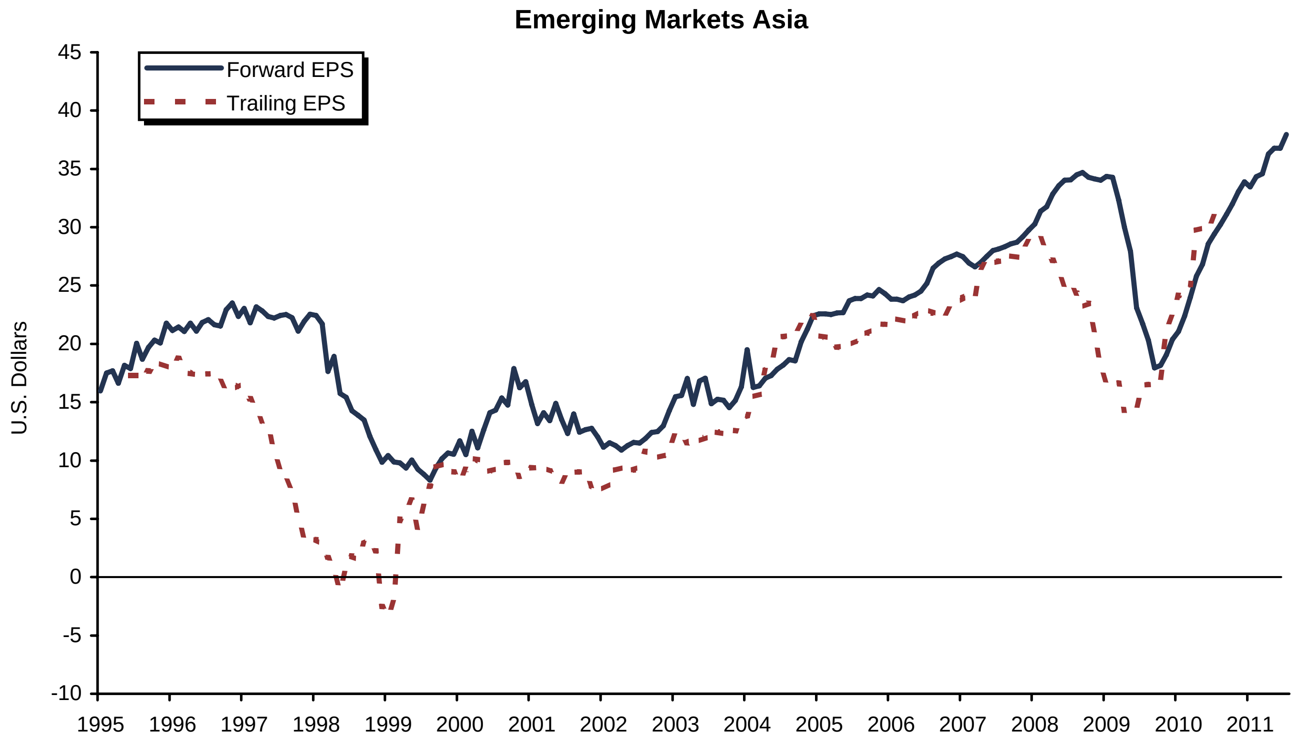
	Percent (%)	
	GDP	Market Capitalization
Developed & Emerging Markets		
All Country World	100.0	100.0
All Country Asia Pacific	30.2	22.0
All Country Asia ex Japan	18.2	9.8
Developed Markets		
Pacific + Japan	12.8	14.0
Pacific ex Japan	3.2	5.3
Australia	2.2	3.4
Hong Kong	0.4	1.1
New Zealand	0.2	0.0
Singapore	0.4	0.7
Japan	9.5	8.7
Emerging Markets		
EM Asia	17.4	8.0
China	9.7	2.4
India	2.7	1.1
Indonesia	1.2	0.3
Korea	1.7	1.9
Malaysia	0.4	0.4
Philippines	0.3	0.1
Taiwan	0.7	1.6
Thailand	0.5	0.2
EM Asia as a % of Global EM	57.7	57.8

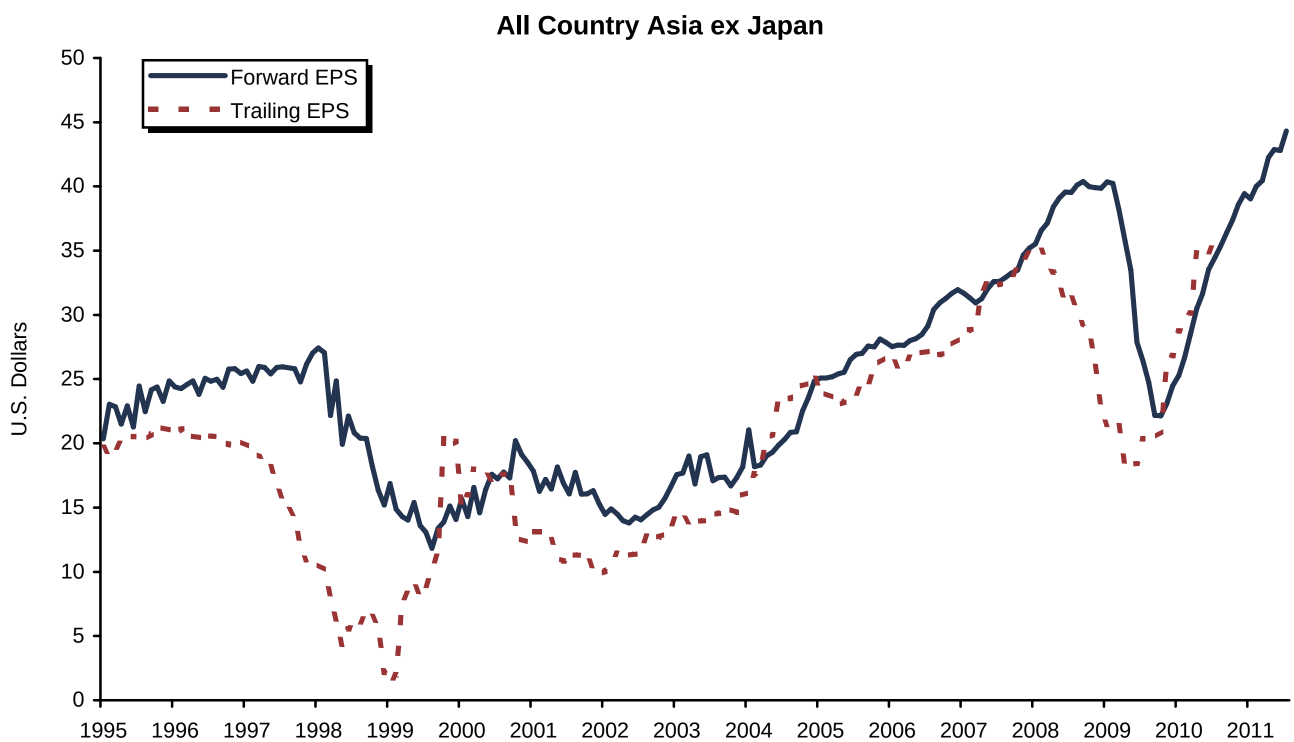
Sources: Economist Intelligence Unit, FactSet Research Systems, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Market capitalization is float-adjusted. GDP data are 2010 estimates.

Exhibit 9

Forward Earnings Estimates

June 30, 1994 – December 31, 2010



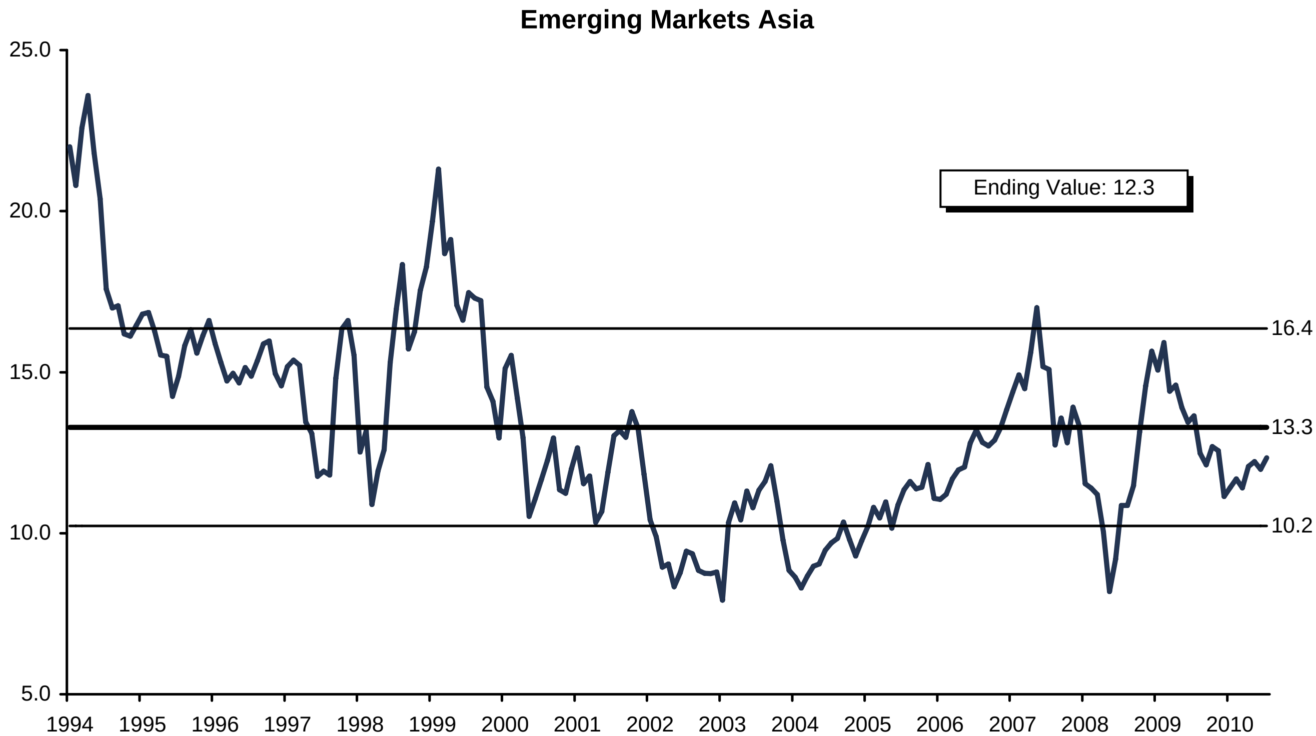


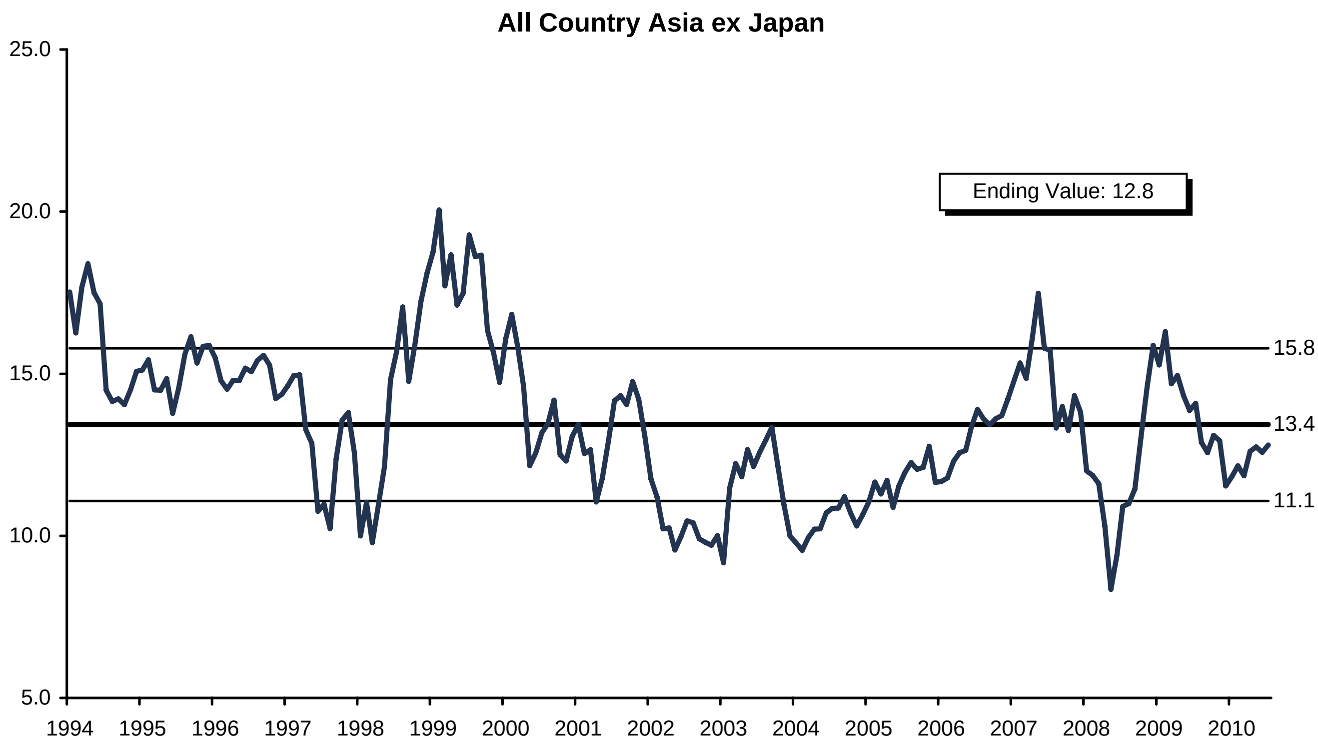
Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Note: Forward earnings per share are graphed leading by 12 months.

Exhibit 10

Forward Price-Earnings Ratios

June 30, 1994 – December 31, 2010





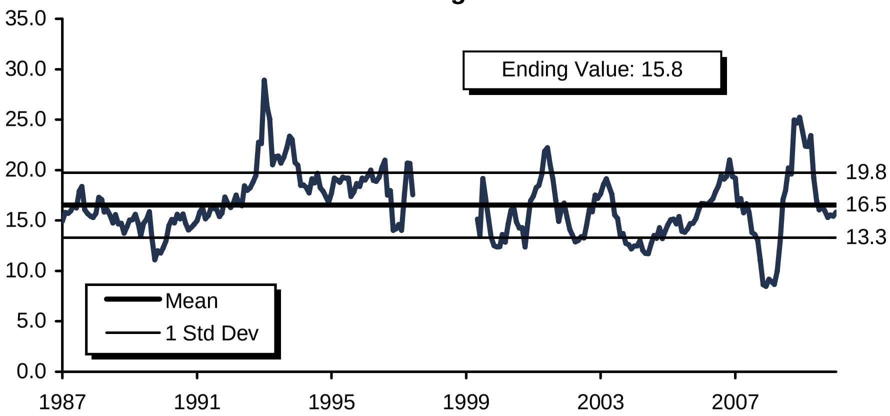
Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

Exhibit 11

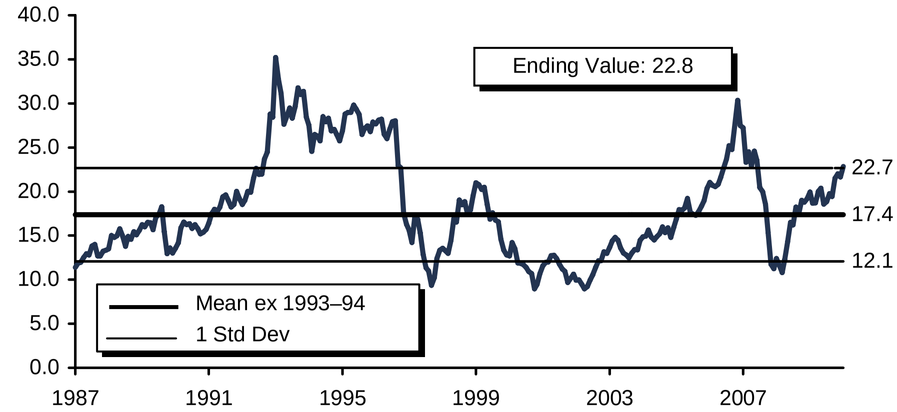
MSCI All Country Asia ex Japan Price-Earnings Valuations

December 31, 1987 – December 31, 2010

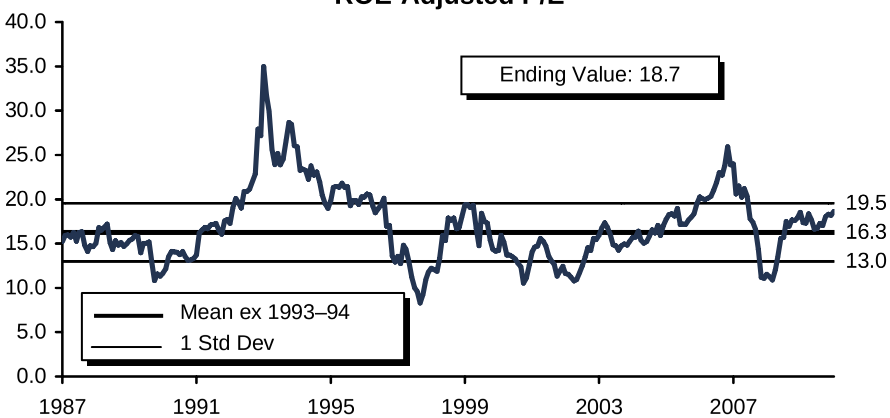
Trailing P/E



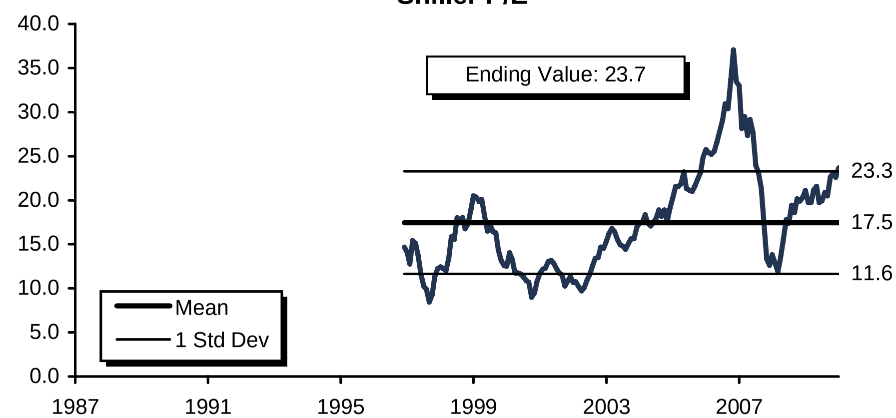
Trend-Line P/E



ROE-Adjusted P/E



Shiller P/E



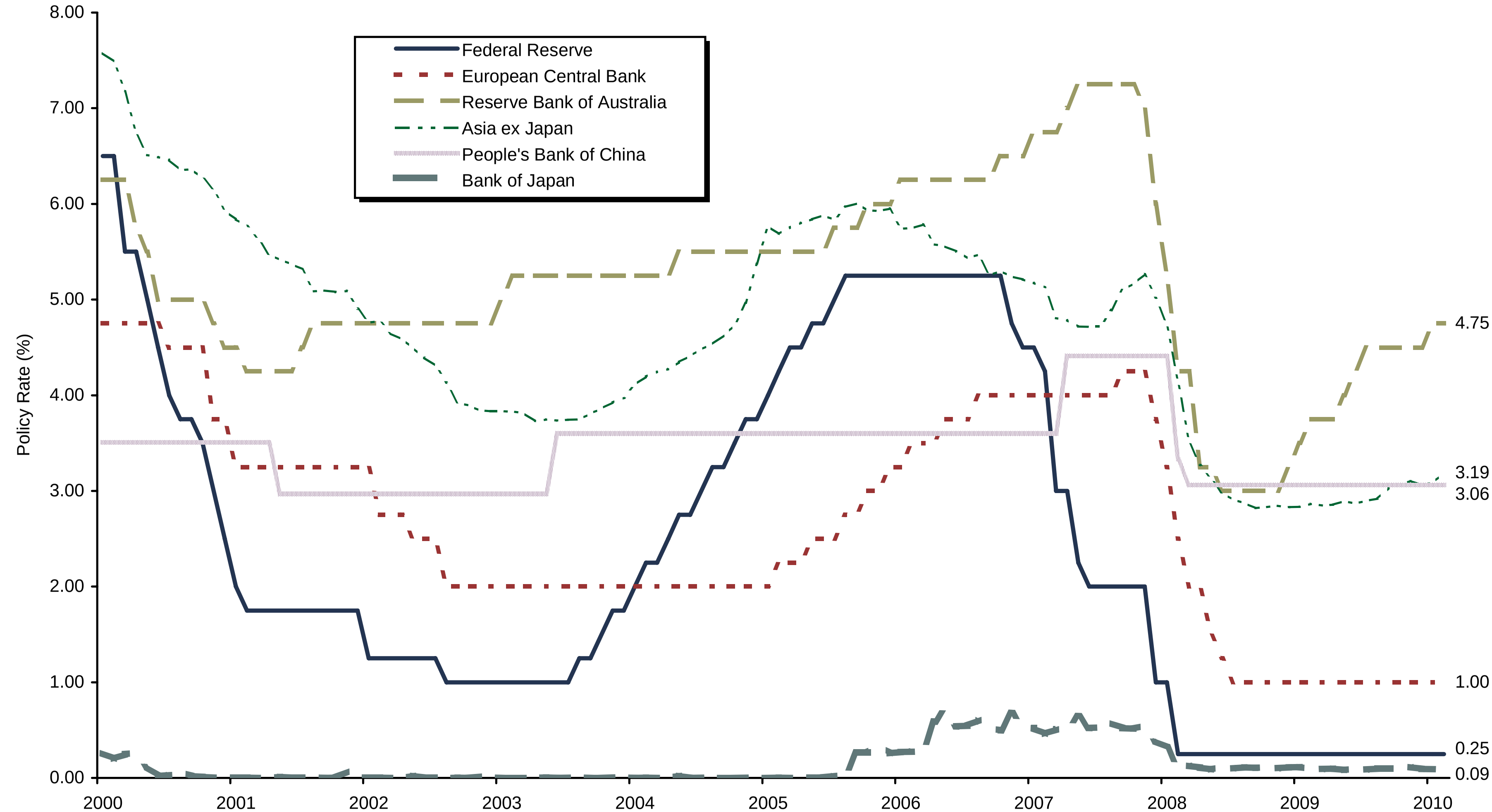
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: We have removed outlier data from June 1998 through March 2000 from the trailing price-earnings (P/E) graph due to negative earnings resulting in nonsensical P/E ratios. We have removed the years 1993 through 1994 from our mean and standard deviation calculations for the return on equity (ROE)–adjusted and trend-line P/E graphs to achieve a more normal distribution. Valuation history for the All Country Asia ex Japan Index is re-created for the pre–November 1995 period by taking the market cap–weighted average of country level valuation data. From 1974 to 1991, the index includes only Hong Kong and Singapore. In 1992, Indonesia, Malaysia, the Philippines, and Thailand are added; in 1994, India; and in 1995, China, Korea, and Taiwan. Starting in November 1995 the official MSCI value is used.

Exhibit 12

Policy Rates

November 30, 2000 – December 31, 2010

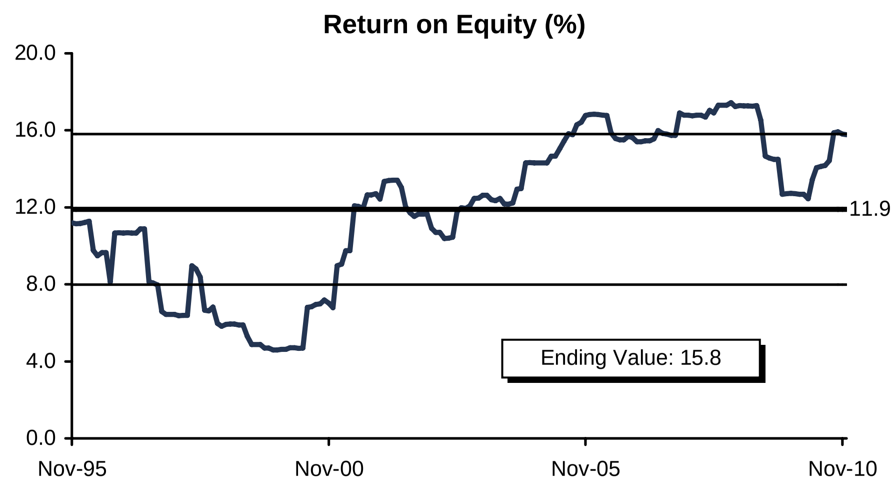


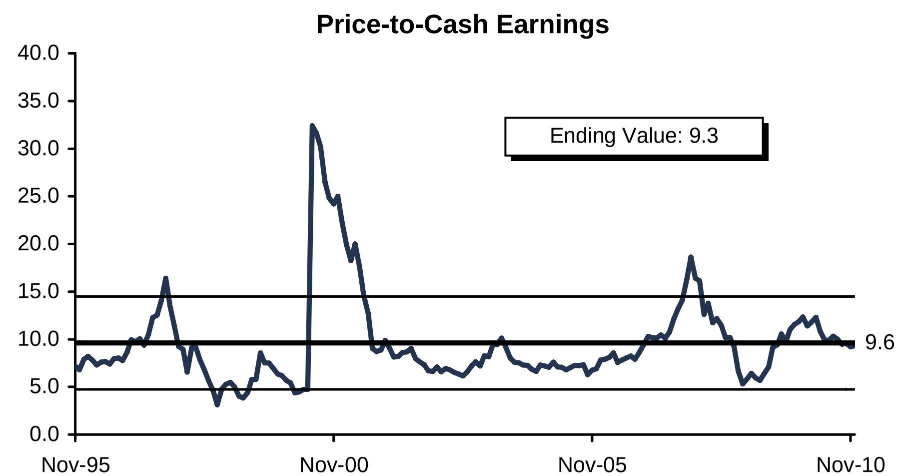
Source: Thomson Datastream.
Notes: The Asia ex Japan policy rate is the simple average of the policy rates for China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand. Japan policy rate is as of November 30, 2010.

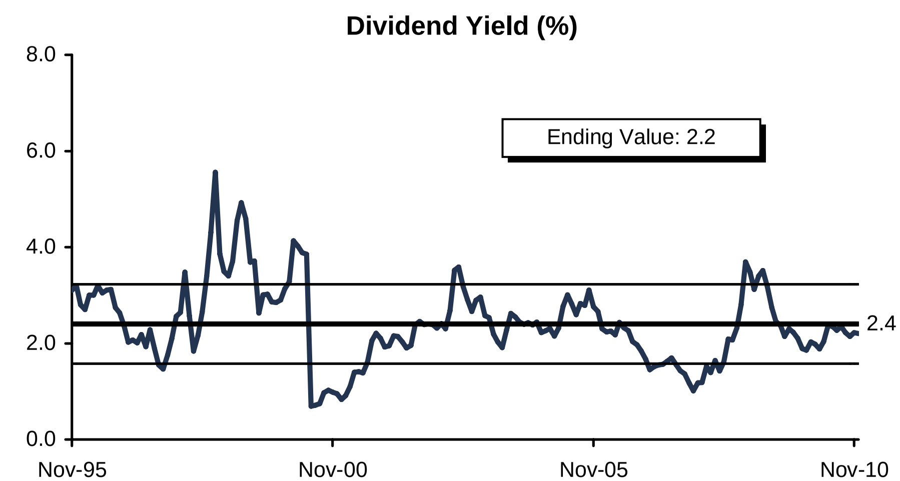
Exhibit 13

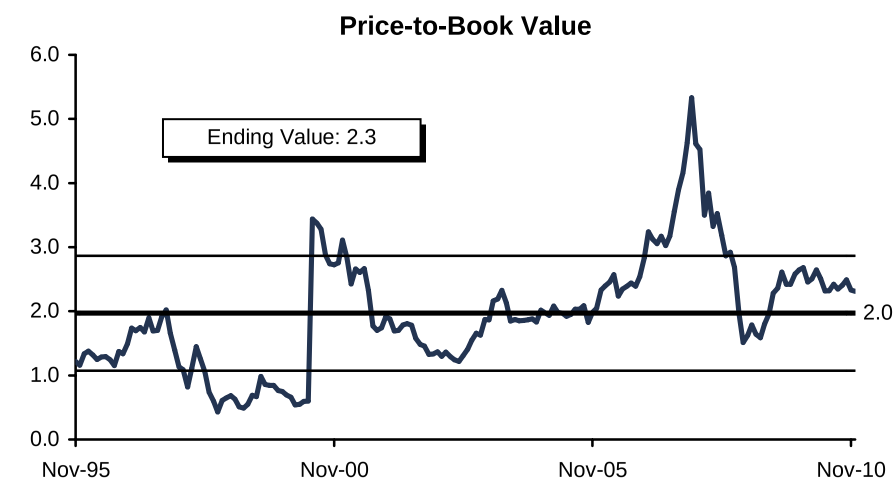
MSCI China Index Valuations

November 30, 1995 – December 31, 2010 • U.S. Dollar







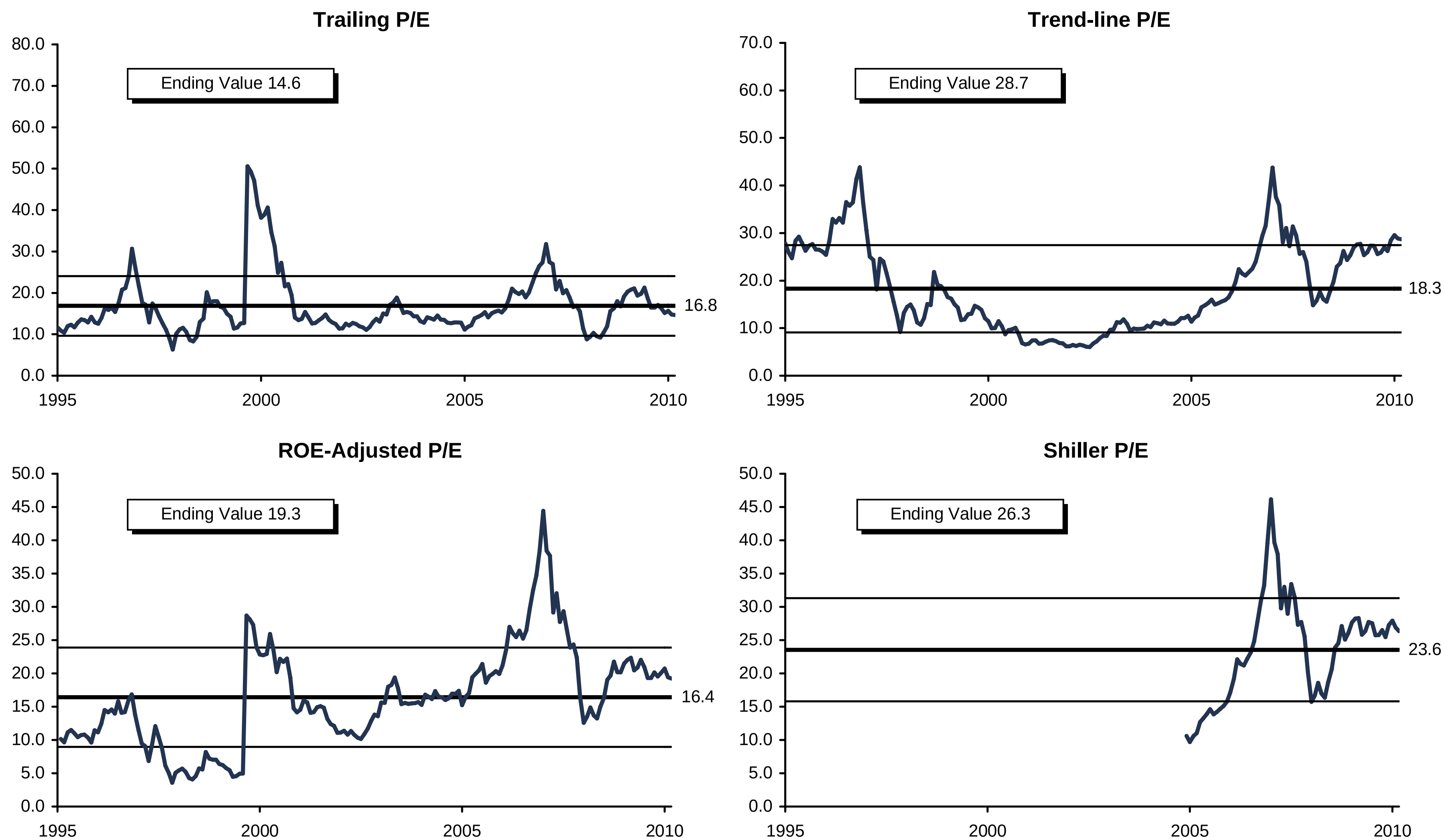


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Return on equity is calculated by dividing the index's price-to-book ratio by its price-earnings ratio.

Exhibit 13 (continued)

MSCI China Index Valuations

October 31, 1995 – December 31, 2010 • U.S. Dollar

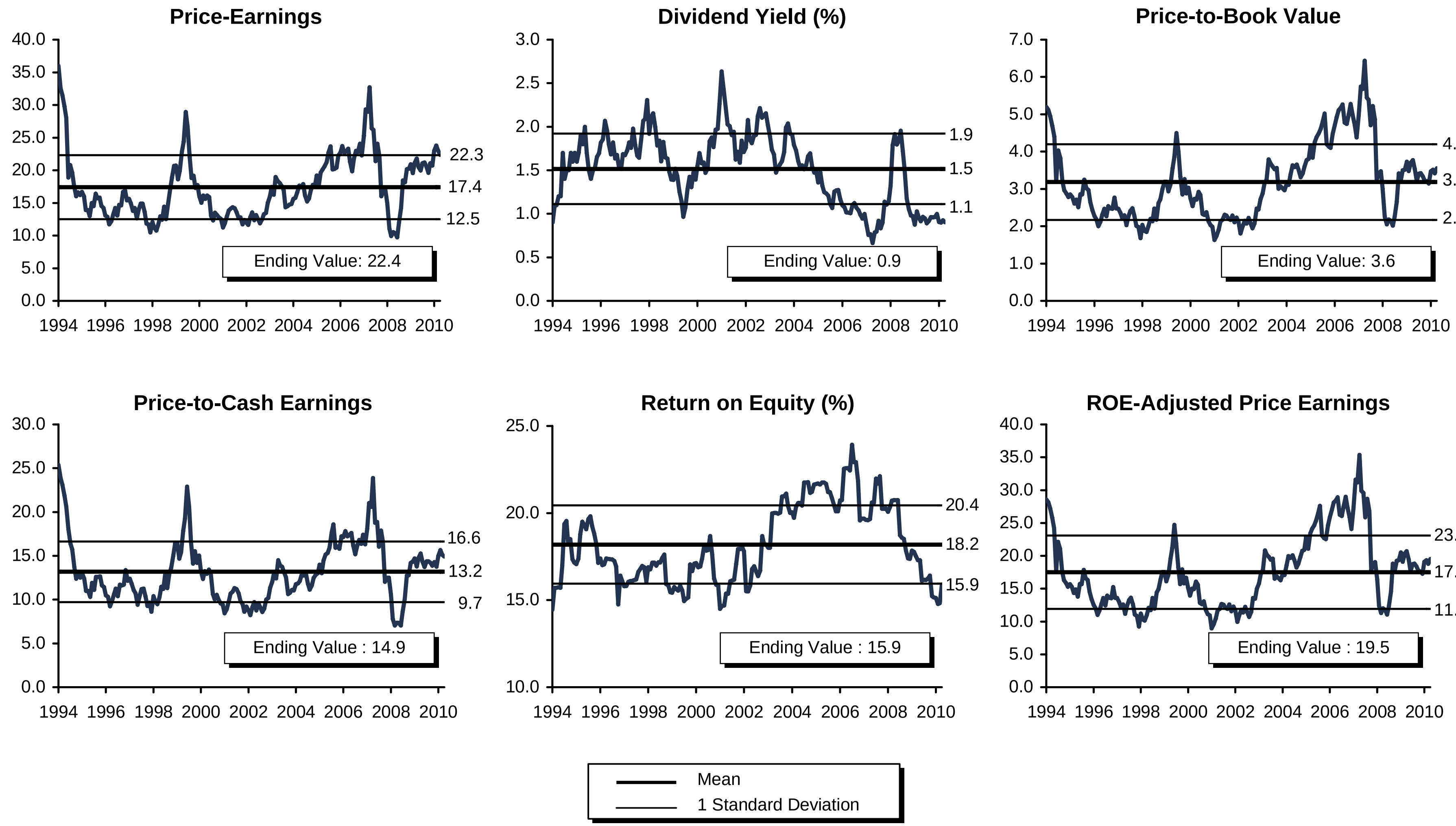


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Exhibit 14

MSCI India Index Valuations

September 30, 1994 – December 31, 2010



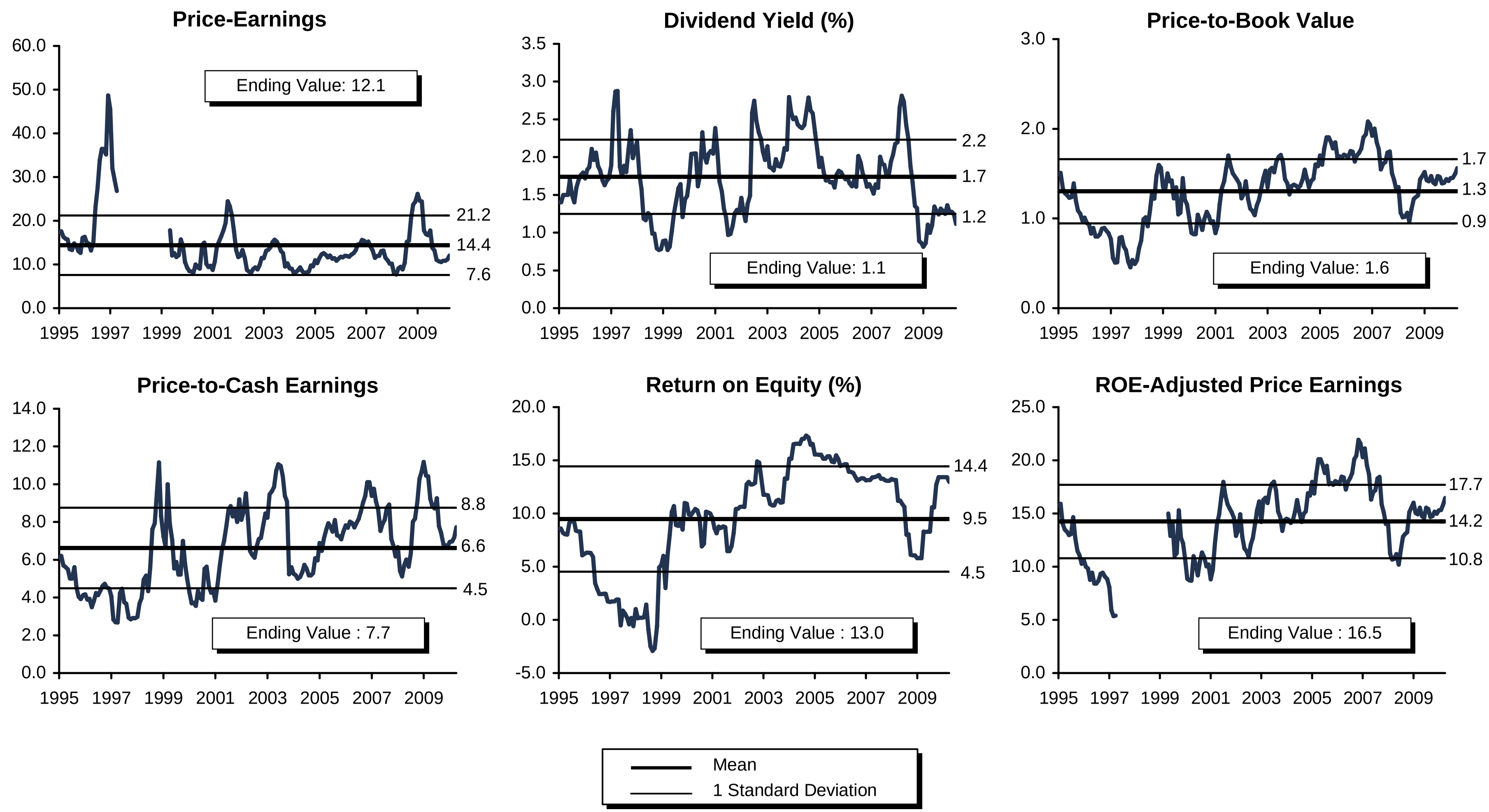
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to the long-term historical average ROE.

Exhibit 15

MSCI Korea Index Valuations

September 30, 1995 – December 31, 2010

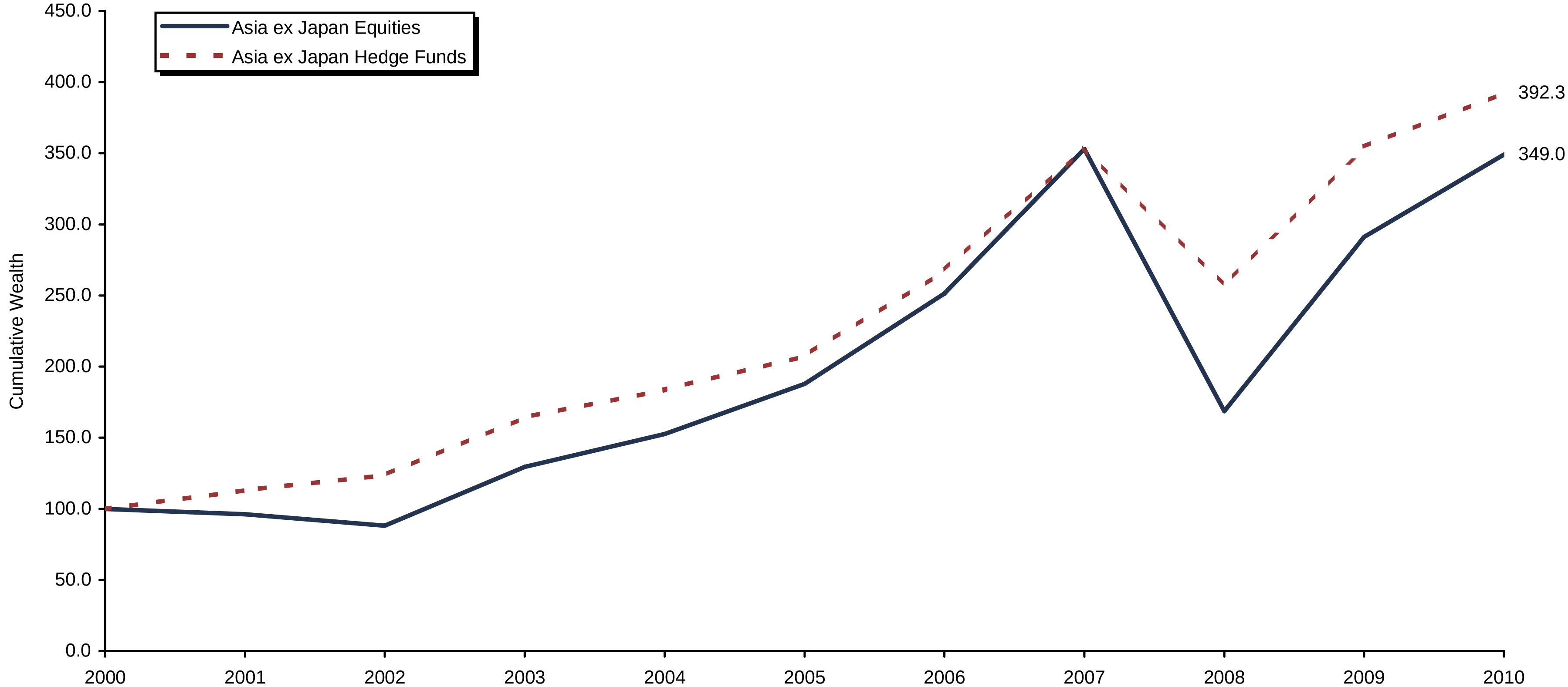


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The years 1998 and 1999 have been removed from the P/E and ROE-adjusted P/E graphs as they featured both negative and extraordinarily high ratios following the Asian financial crisis. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to the long-term historical average ROE.

Exhibit 16

Cumulative Wealth of Asia ex Japan Equities and Hedge Funds

December 31, 2000 – December 31, 2010 • Rebased to 100 as of December 31, 2000



Annual Returns (%)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Asia ex Japan Equities	-3.8	-8.3	47.0	17.7	23.2	33.7	40.5	-52.2	72.5	19.9
Asia ex Japan Hedge Funds	13.0	9.4	32.9	11.8	12.9	29.0	32.2	-27.5	38.2	10.6

Sources: Eurekahedge, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Data are rebased to 100 on December 31, 2000.

Exhibit 17

Rolling 90-Day Correlation of the MSCI Japan Price Index and the Trade-Weighted Yen Index

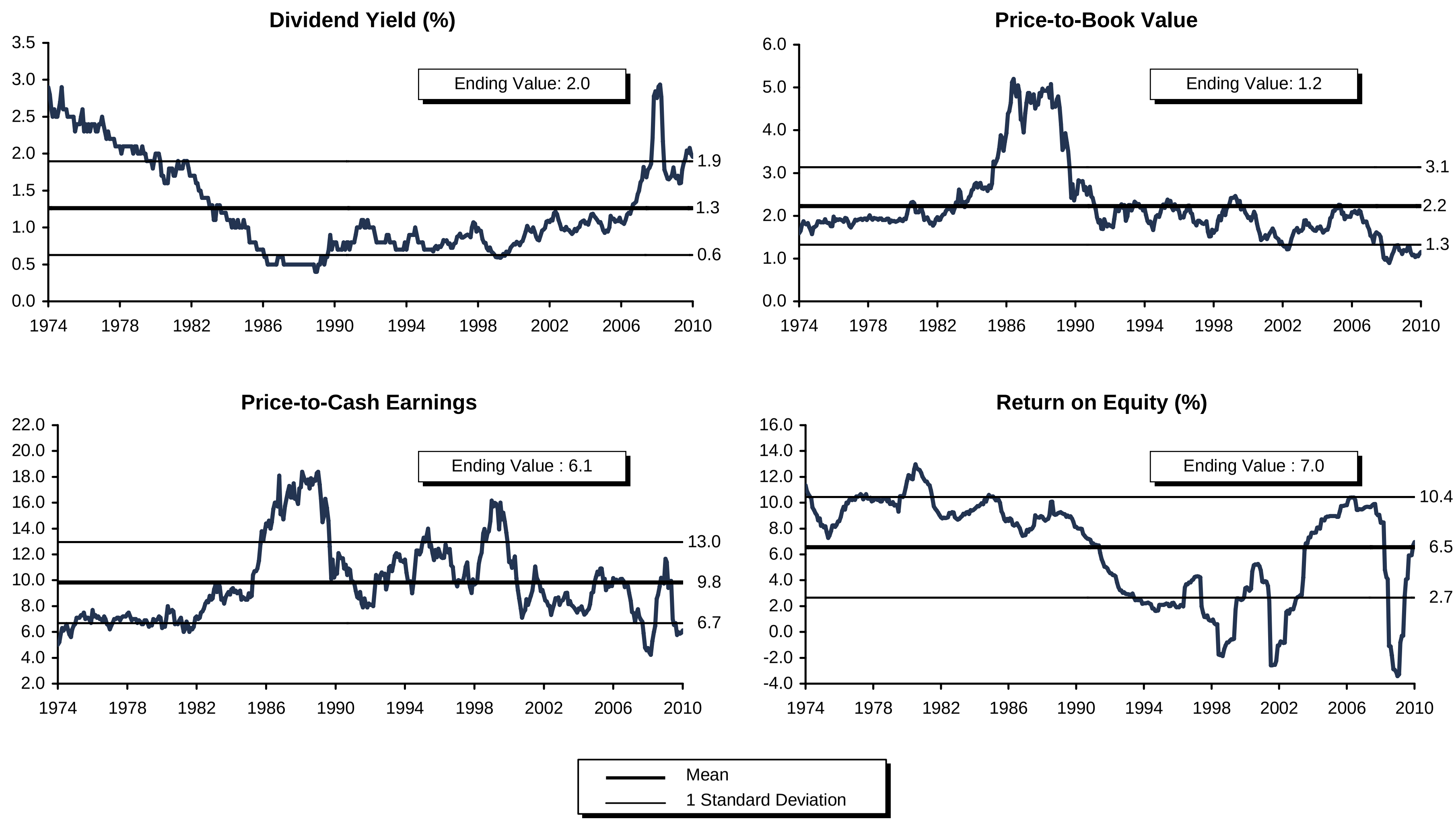
January 4, 1994 – December 31, 2010

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All data are daily.

Exhibit 18

MSCI Japan Index Valuations

December 31, 1974 – December 31, 2010



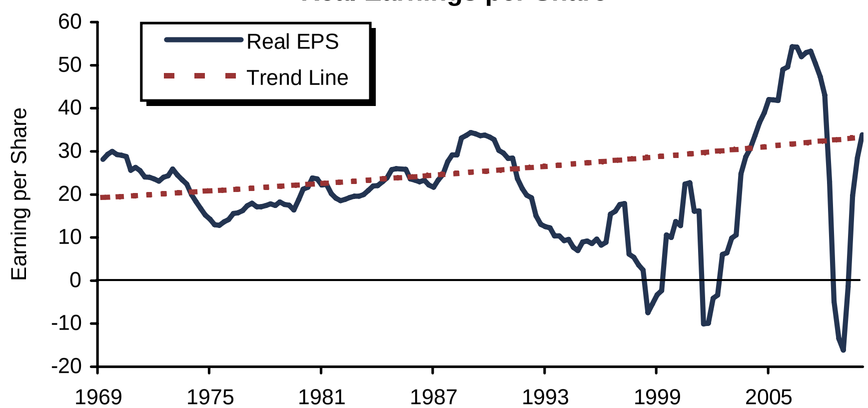
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Return on equity is calculated by dividing the index's price-to-book ratio by its price-earnings ratio.
028q (modified)

Exhibit 19

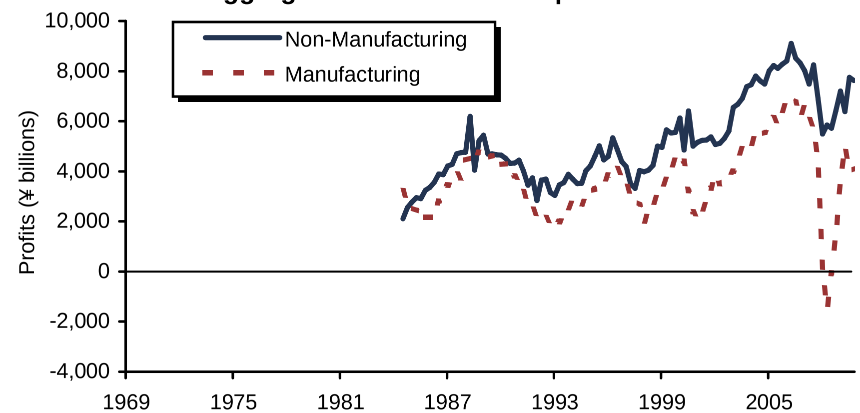
Japan Fundamentals

December 31, 1969 – December 31, 2010

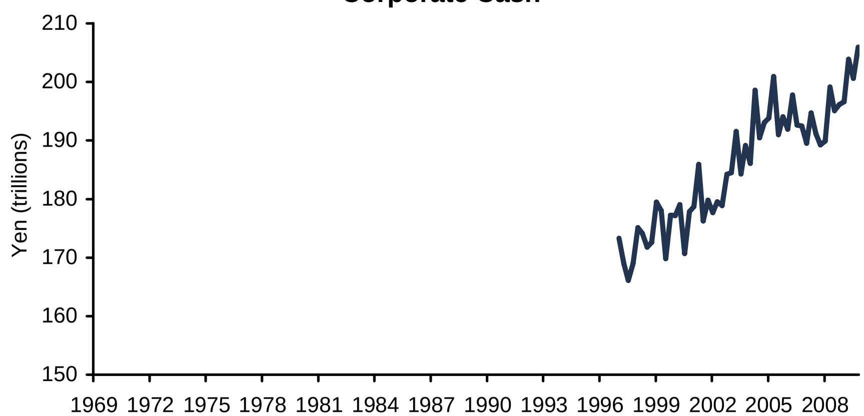
Real Earnings per Share



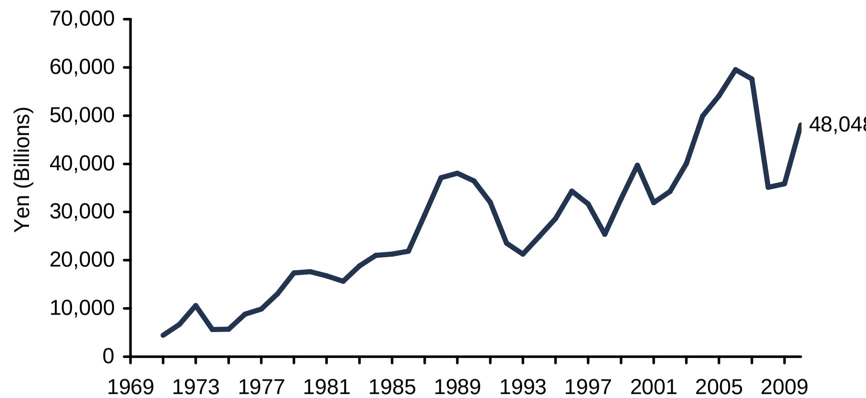
Aggregate Nonfinancial Corporate Profits



Corporate Cash



Corporate Profits



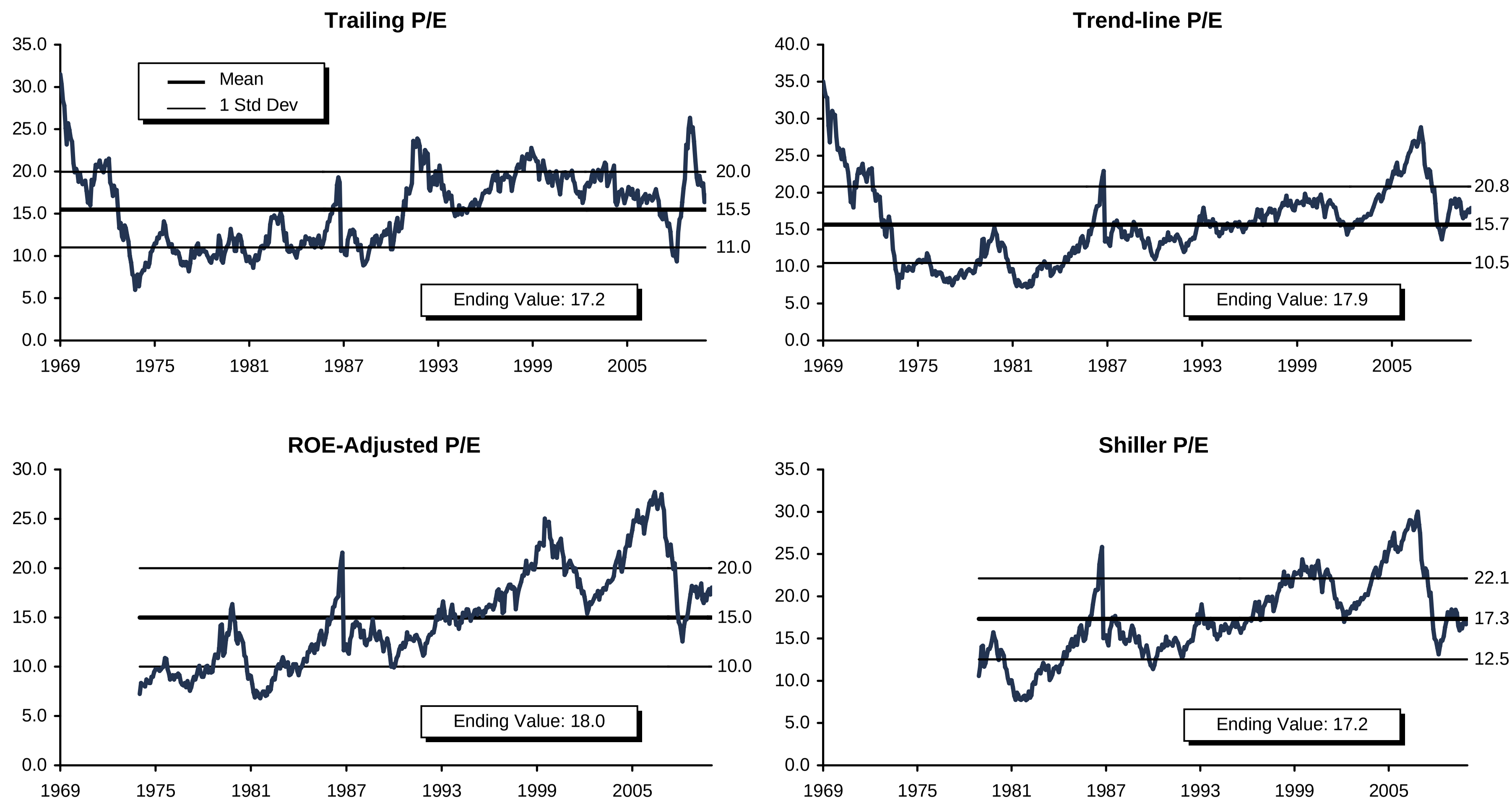
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: All data are quarterly. Real earnings per share (EPS) data are as of December 31, and other graphs are as of September 30. Japan real EPS are deflated by Japan CPI. Trend-line earnings based upon simple linear regression. Data for the corporate profits graph are as of March 31 each year (the end of the Japanese fiscal year), and represent the level of ordinary profits reported by all incorporated businesses in Japan. The most recent profit figure is annualized, based on profits from April 1, 2010, through September 30, 2010.

Exhibit 20

MSCI Australia Index Price-Earnings Valuations

December 31, 1969 – December 31, 2010



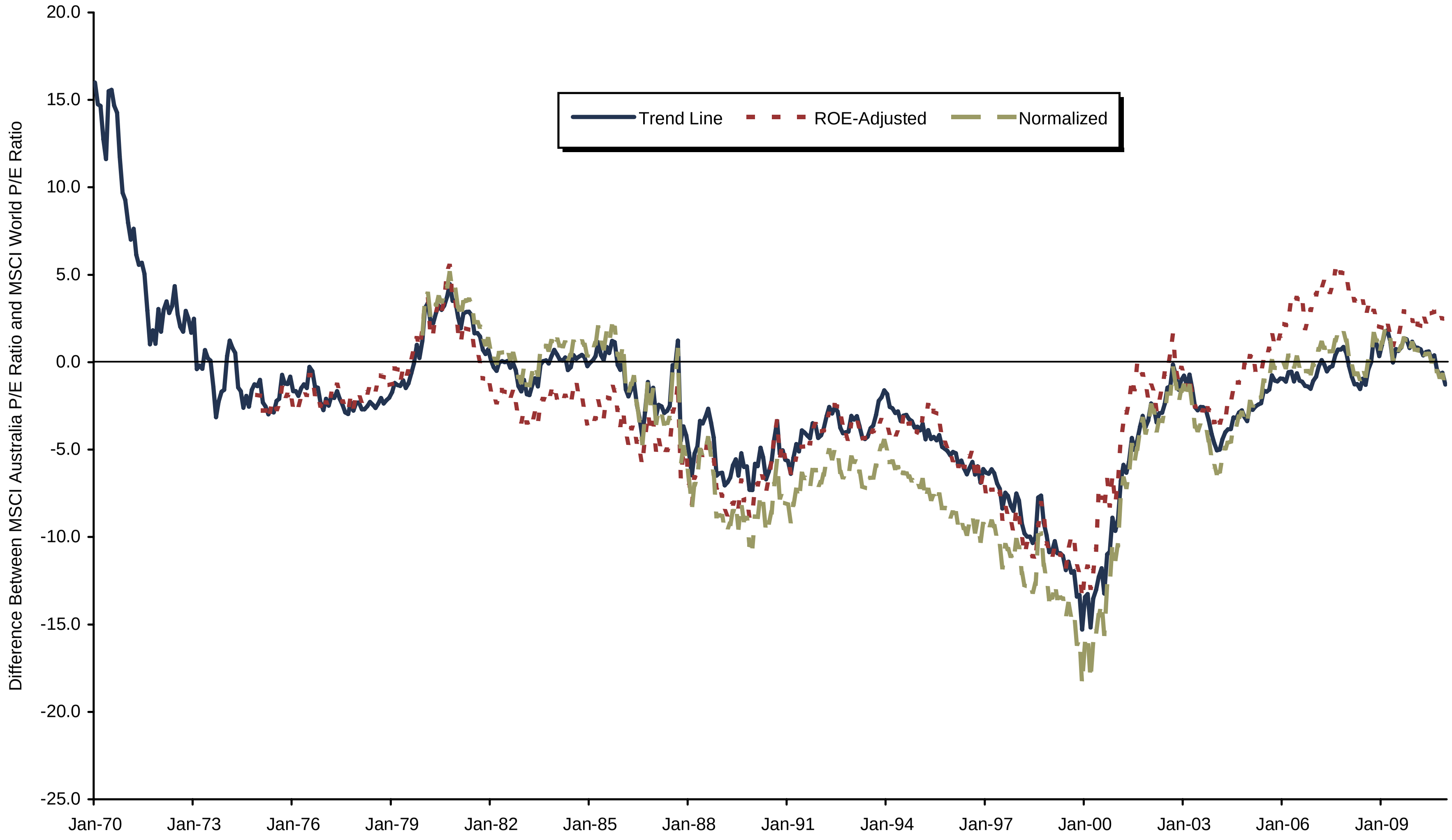
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: The return on equity (ROE)–adjusted P/E ratio is the current trailing price-earnings (P/E) ratio multiplied by the ratio of the current level of ROE to its historical norm. Shiller P/E is calculated by dividing the current price level by the ten-year average of real (inflation-adjusted) earnings per share. Trend-line P/E ratios compare current stock prices to the level of earnings predicted by long-term real earnings growth based on a simple linear regression. Earnings are deflated using Australia CPI data as of September 30, 2009. Data for ROE-adjusted P/E and Shiller P/E begin December 31, 1974, and November 30, 1979, respectively.

Exhibit 21

MSCI Australia Index Relative to MSCI World Index

December 31, 1969 – December 31, 2010

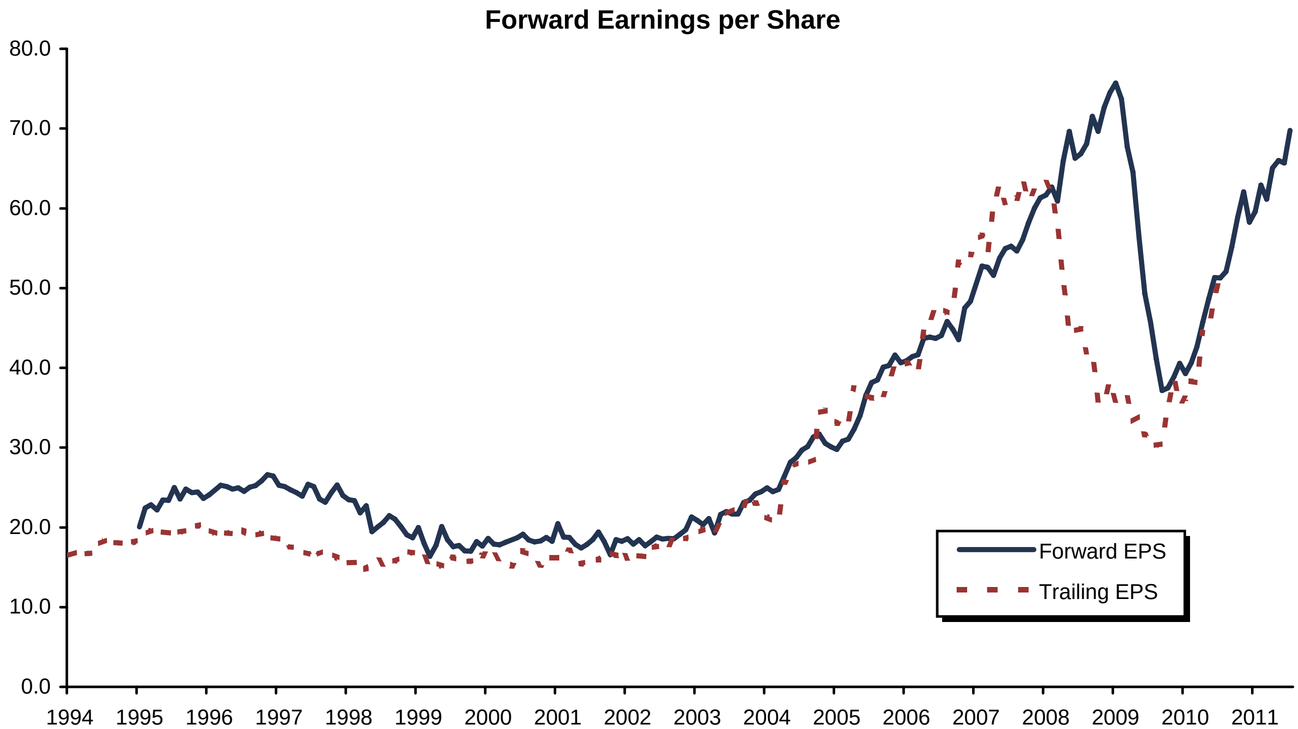


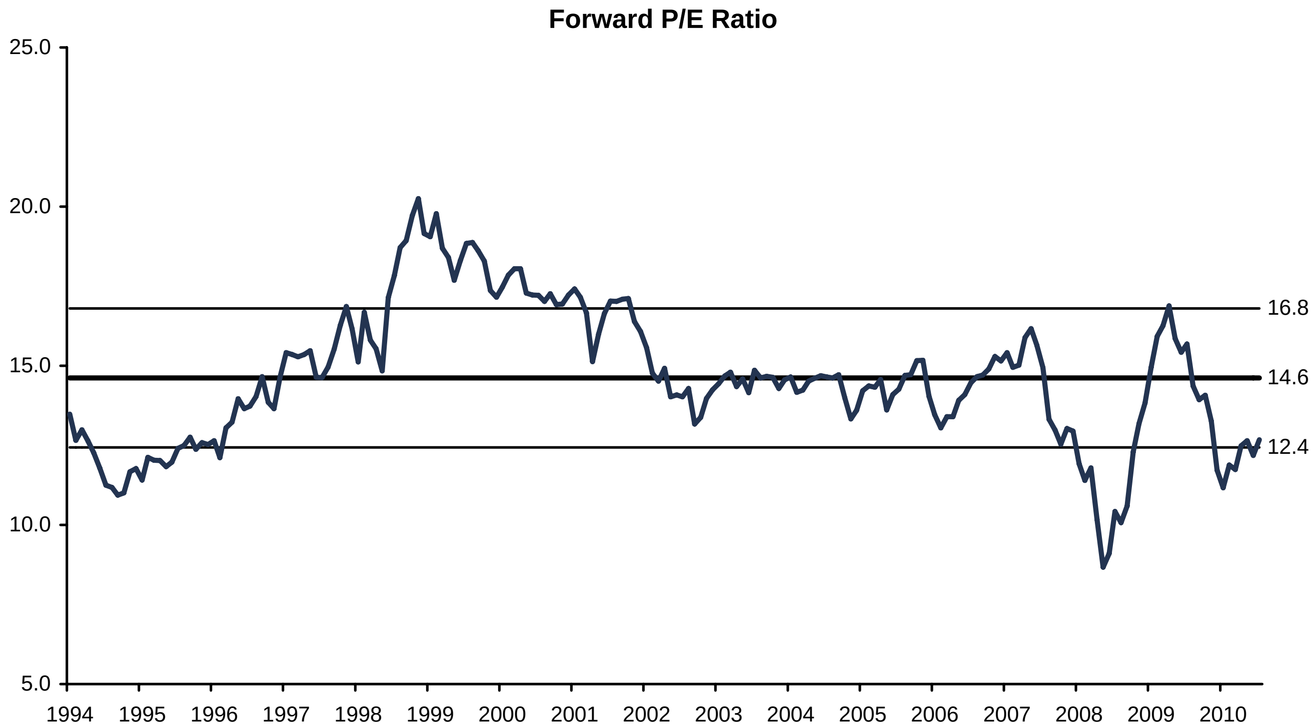
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Return on equity–adjusted data begin on December 31, 1974, while normalized data begin on December 31, 1979.

Exhibit 22

MSCI Australia Forward Earnings Estimates and Price-Earnings Ratios

June 30, 1994 – December 31, 2010





Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Note: Forward earnings per share are graphed leading by 12 months.