CAMBRIDGE ASSOCIATES LLC

ASIAN MARKET COMMENTARY

THE MORE THINGS CHANGE...

December 2007

Eric Winig
Andrew Beatty

Copyright © 2008 by Cambridge Associates LLC. All rights reserved.

This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC ("CA"). Copying of this publication is a violation of federal copyright laws (17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. This means that authorized members may not disclose any information or material derived from this report to third parties, or use information or material from this report, without prior written authorization. An authorized member may disclose information or material from this report to its staff, trustees, or Investment Committee with the understanding that these individuals will treat it confidentially. Additionally, information from this report may be disclosed if disclosure is required by law or court order, but members are required to provide notice to CA reasonably in advance of such disclosure. This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that are described in the report. This report is provided only to persons that CA believes to be "Accredited Investors" as that term is defined in Regulation D under the Securities Act of 1933. When applicable, investors should completely review all Fund offering materials before considering an investment. No part of this report is intended as a recommendation of any firm or any security. Factual information contained herein about investment firms and their returns which has not been independently verified has generally been collected from the firms themselves through the mail. CA can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results delivered through the mail. The CA manager universe statistics, including medians, are derived from CA's proprietary database covering investment managers. These universe statistics and rankings exclude managers that exclude cash from their reported total returns, and for calculations including any years from 1998 to the present, those managers with less than $50 million in product assets. Returns for inactive (discontinued) managers are included if performance is available for the entire period measured. Performance results are generally gross of investment management fees. CA does not necessarily endorse or recommend the managers in this universe.

Cambridge Associates LLC is a Massachusetts limited liability company headquartered in Boston, MA with branch offices in Arlington, VA, Dallas, TX and Menlo Park, CA. Cambridge Associates Limited is a Massachusetts limited liability company headquartered in Boston, MA and registered in England and Wales (No. FC022523, Branch No. BR005540). Cambridge Associates Limited also is registered to conduct business in Sydney, Australia (ARBD 109 366 654). Cambridge Associates Asia Pte Ltd is a Singapore corporation (Registration No. 200101063G).

The More Things Change…

"We continue to believe that Japan's underlying strengths make it the preferred centerpiece of an Asian investment strategy in the current market environment…. Likewise, the Asian growth story provides a compelling long-term rationale for investing in the Asia Pacific ex Japan markets, despite the potential for short-term bumps on the road."—Cambridge Associates December 2006 Market Commentary *Rational Exuberance*.

A year ago at this time we said investors should continue to overweight Asian equities, particularly Japanese stocks, given the solid growth prospects and reasonable valuations in much of the region. Today our view is … much the same. Indeed, in many respects 2007 was a carbon copy of 2006 for Asian equities. Broad indices posted solid returns—the MSCI All Country Asia Index, for example, returned 7.5% in local currency, and 12.3% in US$ due to the sliding greenback—that represented a combination of poor returns from Japan and stellar results elsewhere (Table A). The MSCI All Country Asia ex Japan Index, for example, returned a whopping 38.0% for the year (40.5% in US$), with only one market (Taiwan, 8.6%) returning less than 15%, and eight markets returning more than 33%. Small caps also told the same story for the second straight year, with horrible performance in Japan (-20.2% for the Topix Second Market Index) offset by stellar results elsewhere (40.2% for the Nomura Asia Small Cap Index).

Given that recent returns (particularly in emerging markets) have pushed valuations sharply higher, we have cooled somewhat on Asia ex Japan on a *tactical* basis; however, we continue to believe the region will reward investors over the long term. Our conviction on Japan, meanwhile, remains unshaken despite yet another year of underperformance relative to just about all other global equity markets.[1] In a nutshell, we continue to believe in the strategic (i.e., long-term) case for Asian equities, particularly given the overvalued state of financial assets in general, although parabolic run-ups in markets such as China have certainly increased price risk in the short run.

Emerging Markets Asia—It Was a *Very* Good Year…

Asian emerging markets posted their fifth consecutive year of strong returns in 2007, with seven of nine constituents in the MSCI Emerging Markets Asia Index returning more than 33%. The 2007 rally was also widespread with regard to economic sectors, with only consumer discretionary (24.6%), health care (12.8%), and information technology (0.7%) posting returns of less than 30%; indeed, three sectors (energy, industrials, and materials) returned more than 70%. (It is worth noting that returns were driven primarily by a few countries and economic sectors due to their large weightings in the index.) China (66.7%) and Indonesia (61.9%) led the way for the second year in a row, with prices once again driven by multiple expansion: for the year, price-earnings (P/E) ratios on the MSCI China and Indonesia indices rose by 28.7% and 10.2%, respectively, to 27.0 and 21.5. Multiples also soared in India, as the country's 54.2% return pushed the market P/E up by 43.2%, to a whopping 32.8 times trailing 12-month earnings. Still, while equities rallied

[1] For more details, please see our November 2007 Market Commentary *Japan: Stay the Course?*

across the board in 2007, these three markets are the exception rather than the rule with regard to valuation. Indeed, while it has become fashionable to warn of an emerging markets bubble, we find it interesting that the other six constituents in the index have P/Es below the 17.2 ratio of the U.S. market.

The 2007 emerging markets rally appeared to be driven mainly by a growing belief in the emerging markets "story"—in short, that emerging markets have become self-reliant enough to "decouple" from developed markets, particularly the United States, in the event that the rest of the world slows or falls into recession. Investors (particularly those in the United States) also seemed to gravitate to emerging markets as a way to bet against the US$, which has become so universally hated that supermodels and rap stars are taking steps to distance themselves from greenbacks.

Looking forward, we are of two minds regarding emerging Asia. On one hand, we continue to believe the region is well positioned from a long-term standpoint, and that economic growth will continue to outstrip not only that of developed markets, but of other emerging regions, as well. That said, we feel the concept of decoupling is seriously flawed, as consumers in developed markets, particularly those in the United States, continue to be the primary end users of many of the products produced in Asia. That is not to say there is no truth whatsoever to the idea; indeed, according to Morgan Stanley, emerging markets economies accounted for almost half of global GDP growth over the past year (more than four times the contribution of the U.S. economy), while China's contribution to global growth exceeded that of the United States for the first time ever. However, the United States still makes up more than a quarter of global GDP, while the United States, Europe, and Japan together make up two-thirds of the global total (US$32 trillion out of US$48 trillion). China, by comparison—the largest emerging market—has a GDP of US$2.6 trillion, while the nine constituent countries in the MSCI Emerging Markets Asia Index have a *combined* GDP of less than US$6 trillion. Thus, it seems overly optimistic to expect emerging markets to flourish if the developed world sputters. Simply stated, we believe emerging Asia has solid fundamentals and is well positioned to benefit from global growth going forward; however, we do *not* believe the region will be spared if the rest of the world stumbles.

That's the good news. On the other hand, given that the single biggest determinant of the future return of any asset is the price paid, the recent parabolic spike in many of these markets gives us great pause. In effect, we have two separate (but related) concerns. First, one can make a case that we are currently witnessing the final stages of an emerging markets bubble, with sharp declines to come when the fever finally breaks. To that point, we remain concerned[2] about short-term price risk in these markets, as the recent run-up and concomitant spike in investor bullishness about the region certainly look and feel like a market top. Indeed, despite the ongoing turmoil in credit markets and their swelling knock-on effects to global economic growth, earnings growth expectations for Asian companies remain quite robust. Of the nine constituent markets in the MSCI index, only Malaysia (8.9%) and Indonesia (11.9%) are expected to post profit growth of less than 15% in 2008, with heavyweights China and India (which together make up nearly 45% of the index) expected to show growth of 21.9% and 27.6%, respectively.

[2] This issue is discussed in depth in our November 2007 Market Commentary *Emerging Markets: What To Do, What To Do….*

The second issue is that while we remain confident emerging Asian *economies* are not only well positioned to grow at a rapid rate in coming years, but are also in very solid financial shape, it can be argued that a majority of investors agree with us, and that this positive outlook is therefore *in the price*. As noted in our recent comment on emerging markets: "The key determinant of returns for investors is not the rate of economic growth, but the price paid relative to the potential for future corporate profit growth."

In sum, we are short-term cautious and long-term bullish on emerging Asia, which is a fancy way of saying we think markets will trend higher over time, but that the risk of a steep fall in prices over the next year or so is particularly elevated. Thus, investors with holdings in the region should at the very least look to pare back investments to policy weight, while those looking to fund a new allocation may want to take a "go-slow" approach.

Pacific ex Japan—It Was a *Pretty* Good Year

While developed Asian markets could not keep pace with their emerging counterparts for the year, they still acquitted themselves quite well, with Hong Kong (41.6%), Singapore (20.4%), and Australia (15.2%) more than making up for laggard New Zealand (-0.2%). Returns were even better in US$ (the region returned 30.7% in US$, versus 20.7% in local currency), as the sliding greenback boosted returns for all four constituent markets.

Returns were driven in large part by the heavyweight financial (16.5%) and materials (41.8%) sectors, which together make up nearly two-thirds of the index. Indeed, relative to the rest of the world, the Asian financial sector was a beacon of light, as the region's institutions have thus far suffered fewer losses from the credit crisis than U.S. and European lenders. The region also benefited from surging Hong Kong equities, which continued to ride the coat-tails of the manic Chinese market.

Going forward, high valuations are likely to hold down returns over the long term, although prices could of course continue to rise in the short run. We had viewed Pacific ex Japan as fairly valued until very recently, but the sharp rally in 2007 pushed the region into overvalued territory. While P/E ratios based on trailing 12-month earnings (17.5) are not particularly excessive, other metrics (price-to-book [P/B] and price-to-cash flow) look noticeably stretched, while measures that seek to minimize the impact of the economic cycle (either by averaging multiple years of earnings or adjusting P/Es for the level of return on equity [ROE]) show Pacific ex Japan to be expensive. In other words, current multiples look reasonable largely due to rapid recent earnings growth that has itself been driven by rising ROE. Along those lines, it is worth noting that earnings expectations for the region are far more muted than they are for emerging Asia: the four constituent markets in the MSCI index are expected to show earnings growth of between 9.7% (Australia) and -11.1% (Hong Kong). This suggests something of a disconnect between investors (who, given the region's high multiples, seem to expect strong profit growth to continue) and analysts (who do not). That said, the region's high dividend yield (3.1%, similar to that of the "defensive" U.K. market) provides investors with a bit of a cushion in the event that conditions take a turn for the worse.

Japan—It Was Another *Bad* Year

There is an old Wall Street joke: What's the difference between being early and being wrong? Answer: There isn't any. To wit, while we have steadfastly stuck to our bullish stance on Japan since first staking it out several years ago,[3] we are cognizant that the market has underperformed virtually all global markets over the past two years; indeed, this continued weakness has forced us to revisit our conclusions.[4] Our *new* conclusion is, well, much like the old one. Put simply, while recent returns have been quite poor, both on an absolute basis and relative to the rest of the world, the risk-reward equation in Japan continues to be, in our opinion, the best in the developed world. As such, the recent spike in investor pessimism toward Japan has only increased our level of conviction. In short, most investors—conditioned by nearly two decades of false starts and deep losses—continue to view Japan with a jaundiced eye, even as fundamentals and valuations paint a reasonably optimistic picture, particularly relative to those of other developed markets.

Japan returned -10.1% in 2007 and was the worst-performing major market for the second straight year. Seven of ten economic sectors finished in the red, with the only exceptions being energy (6.5%), industrials (1.0%), and telecommunication services, which eked out a 0.1% return thanks to a 4.3% surge in December. Indeed, while economic fundamentals have changed little and valuations have come down significantly since equities topped out in early 2006, investors have been quick to sell on the slightest hint of bad news. In September, for example, Morgan Stanley's Robert Feldman summed up a week of meetings with European fund managers thusly: "In the whole week of meetings with European investors, I did not hear a single positive comment on Japan. Not one." Around the same time, Merrill Lynch released a survey that showed investors were underweight Japan for the first time since July 2003, while investors looking to reduce their weighting outnumbered those looking to add to positions for the first time since June 2006.

It is true that the unsettled political situation and cloudy outlook for reforms has contributed to the sense of gloom, but in our view such issues are well reflected in market prices, which continue to look cheaper than most other global markets on a variety of metrics. For example, Japanese equities look very attractive on measures adjusted to normalize ROE,[5] both in absolute terms and relative to other global markets, as well as on standard P/B ratios. While dividend yields of 1.5% remain low, they have more than doubled since 2000; dividend *payouts*, meanwhile, have doubled over the past four years. Further, given the tremulous state of the world economy, investors may at some point come to prize the inherent cautiousness found in many Japanese corporate managers who, having suffered through times when bank financing was difficult to obtain, tend to hold plenty of cash.

---

[3] Please see our May 2003 and May 2004 Market Commentaries, respectively, *Japanese Equities: Getting Interesting* and *Bullish on Japan.*

[4] Please see our November 2007 Market Commentary *Japan: Stay the Course?*

[5] We typically assume a long-term sustainable value of 12.0 for ROE. Since Japanese ROE (9.6) is currently below this level, while EAFE ex Japan (17.4) and the United States (17.0) are above it, this tends to flatter Japanese multiples and compress P/Es for EAFE ex Japan and the United States. The assumption, of course, is that ROEs of Japan and other markets will converge over time, partly due to the belief that Japanese ROEs have been artificially depressed since 1990 due to the long process of debt reduction following the bursting of the equity market bubble.

Finally, while we fully recognize the difficulty in sticking with an investment that is not working, we cannot help but be struck by the contrast between the Japanese and U.S. equity markets. In Japan, valuations are reasonable; profit growth is strong and appears, thanks to years of below-average growth, to have room to run; the economy has at the very least stabilized; and corporations are becoming more shareholder-friendly. In the United States, normalized real valuations are higher than at any point other than the late 1990s–early 2000 bubble and the period surrounding the 1929 crash, profit growth seems to have peaked after an extraordinary run of above-average growth, and the economy is teetering on the brink of recession. Nevertheless, any negative data point in Japan sends investors fleeing for the exits, while every minor uptick in U.S. housing starts or announcement that a struggling U.S. financial firm has obtained financing bring cries that the bottom has been seen.

We understand that investors have been conditioned on the one hand by the long bear market in Japan, and on the other by the entrenched U.S. attitude that authorities will not "allow" markets to fall. Further, as discussed in our November 2007 Market Commentary on Japan, we fully recognize that challenges persist for the Japanese market. Japanese investors, for example, remain extremely reluctant to commit funds to domestic equities, while there is no apparent catalyst to get investors excited about the market; thus, while we believe the market is attractively priced, investors with an interest in Japan need to understand—and be able to tolerate—the risk of a continued period of underperformance by Japanese equities before things get better. Nevertheless, the behavioral differences are quite striking, and (we believe) bolster our case that the potential upside in Japan outstrips the risk of a protracted drawdown. In short, equities are priced for a bleak future even as conditions have at a minimum stabilized, and on many measures have improved markedly. We are still bullish on Japan.

Conclusion

Recent events have done little to change our strategic view on Asian equity markets, although we have certainly become more cautious on a tactical basis. We continue to believe Asia ex Japan is well positioned from an *economic* standpoint, both in terms of developed and emerging markets, but the relentless rise in equity prices over the past 18 months or so has pushed valuations beyond what we consider "fair value." In short, investors should continue to look for ways to increase exposure to Asian equity markets, but also be aware that better entry points are likely to present themselves at some point in the future. With regard to Japan, we continue to beat a relatively lonely drum for the world's second-largest economy, whose markets, we believe, offer a fairly compelling risk-reward proposition. Nevertheless, there is nothing to say a cheap investment cannot become cheaper still (witness the past two years for Japan), and given that there is little on the horizon to spur excitement in Japanese equities, investors should understand the very real possibility that things may get worse before they get better.

Table A

PERFORMANCE ATTRIBUTION FOR MSCI ALL COUNTRY ASIA INDEX

December 31, 2006 – December 31, 2007

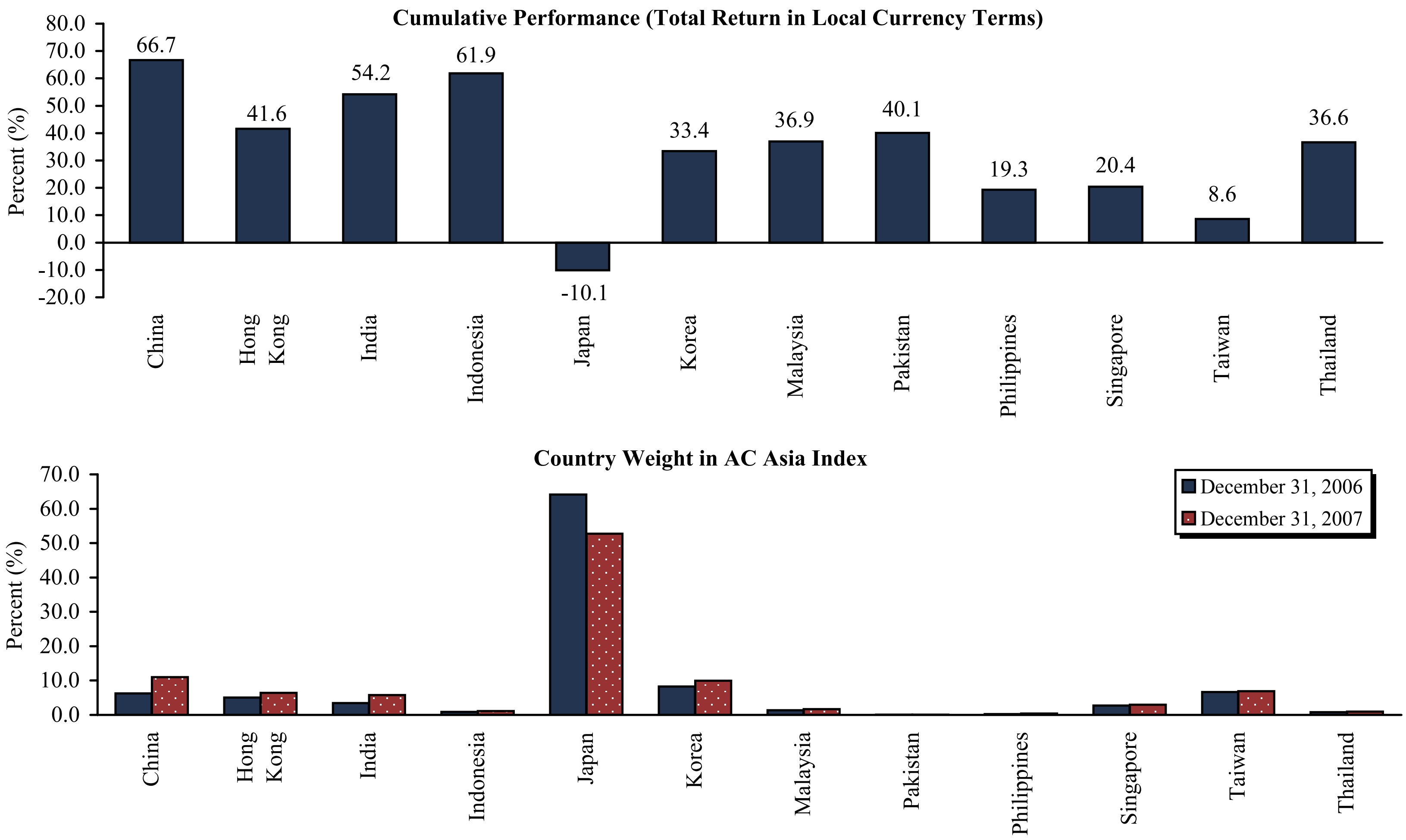
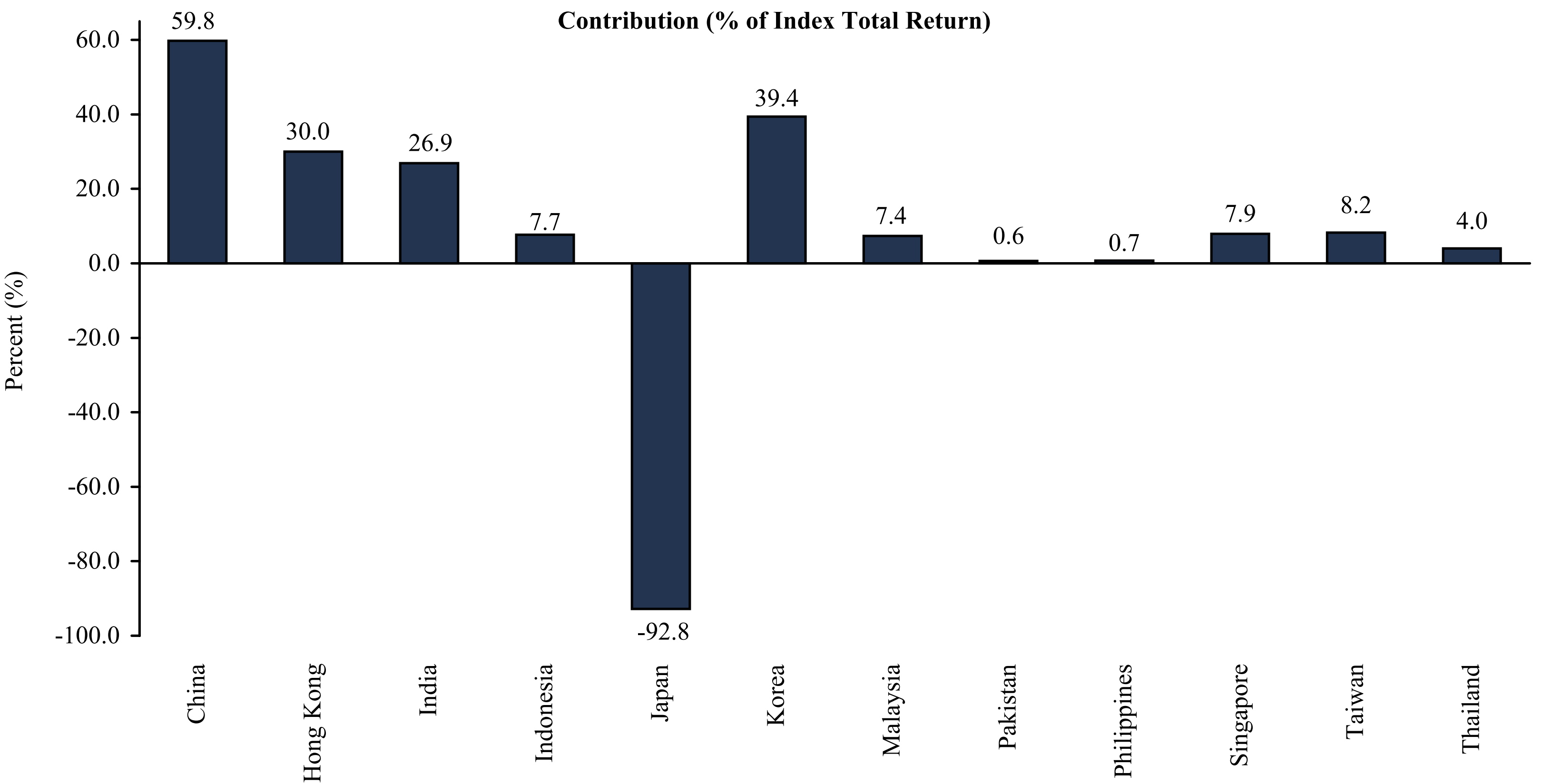


Table A (continued)

PERFORMANCE ATTRIBUTION FOR MSCI ALL COUNTRY ASIA INDEX

December 31, 2006 – December 31, 2007



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

Notes: Contribution represents the country's percent share of the MSCI All Country Asia Index's total return of 7.5%. Country contributions are calculated by multiplying the country's December 31, 2006, weight by its 2007 total return. Total returns for MSCI All Country Asia indices are gross of dividend taxes. Country weight based on market capitalization.