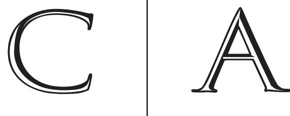

CAMBRIDGE ASSOCIATES LLC

INVESTING IN ASIA

2006

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ABSTRACT

1. Investors have been pouring money into the Japanese and Asia ex Japan equity markets with predictable results: in the 12 months ended February 28, 2006, Japan's Topix Index returned 42.7% and its three-year average annual compound return (AACR) is now 28.0%; the MSCI Emerging Markets Asia returned 26.1% in the past 12 months and have a three-year AACR of 31.1%; the MSCI All Country Asia ex Japan index returned 24.1% over 12 months and has a three-year AACR of 29.8% (all returns given in local currency terms). In addition, investors have been flocking to Asia's biggest emerging growth stories: India and China. The Bombay Stock Exchange has shot up about 50% in the past year, soaring past previous peaks to ever higher highs amidst delirious sentiment and frenzied speculation. In China, the mania is concentrated in real estate and private equity—every private equity firm in the world now seems to be marketing a new China fund.

   Despite our unabashed enthusiasm for Asia, this buying spree makes us predictably nervous. Consequently, we do *not* think investors should be plunging helter-skelter into any of these markets today (March 2006): as the Federal Reserve raises interest rates, global equity investors are increasingly at risk, and these markets are certainly vulnerable to sharp corrections should the current complacency give way to increased risk aversion.

2. Nevertheless, we do believe that most investors should craft a coherent, long-term Asia investment strategy, potentially covering all asset classes—public and private—across all Asian economies, so that they are well positioned to invest when the opportunity presents itself. While tactical considerations should affect when and how best to implement such a program, we stress that this is a *strategic* rather than a tactical recommendation—because we regard Asia as a *secular* growth story likely to play out over decades.

3. Most western investors have made only cautious forays into Asia, with toe-in-the-water investments, which do not constitute a viable long-term Asia investment strategy. Those truly interested in building a coherent Asia investment program should develop a strategic plan that articulates their policy objectives, lays out a roadmap for implementing the program, and identifies benchmarks for performance measurement.

4. In implementing such a program, investors should *not* focus first on China, but on Japan, the dominant economy in the region, which is in the early stages of sustainable recovery from prolonged economic malaise of 1990-2003 and the first few years of a secular bull market. After Japan, investors should next consider opportunities in Singapore, Hong Kong, South Korea, and Taiwan. In other words, although China certainly stands at the epicenter of the Asia growth story, the primary *investment* opportunities are in these more developed markets.

5. The best way to invest in China is through public market investments in Chinese companies listed outside the mainland and companies in Hong Kong, Taiwan, Singapore, Japan, and South Korea that benefit from (and contribute to) China's expansion. However, only a few of the 90 or so products dedicated to Greater China public markets investment are worth considering. Likewise, almost all of the 40 or so hedge funds dedicated to Greater China investment strategies (up from 14 in 2003) are worthless.

6. India has many of same advantages—and faces many of the same challenges—as China. However, India's economic liberalization of the past 15 years has done relatively little to attract anything like the same level of foreign direct investment as China, due to a persistent antipathy to foreign firms, stifling regulatory barriers, poor infrastructure, rigid labor laws, and cumbersome approval procedures for business and legal settlements of commercial disputes. All of these are gradually improving and in some respects India presents more compelling investment opportunities than China. Both, however, are "hot" markets today, fraught with considerable risks investors should not overlook.

7. Excluding China and India (but including the almost-developed markets of Korea and Taiwan), the emerging Asian markets constitute about 18% of the MSCI All Country Asia Index. Substantial differences both among the component countries and between these markets and that of Japan (which constitutes almost 70% of the MSCI All Country Asia Index) result in imperfect correlation among the various Asian equity markets, mitigating some of the country-specific risk. Because each market is relatively small, however, institutional investors cannot readily deploy a meaningful amount of capital in any one, and should take a regional approach. On the risk side of the equation, it should be noted that these markets are both fragmented and concentrated, that each carries country-specific idiosyncrasies, and that political and economic risks are always a concern.

SUMMARY

Introduction

Asia beckons western investors, its allure predicated on three compelling attractions:

1. The continued broadening and deepening of relatively immature capital markets whose development will reflect the expansion of most Asian economies at growth rates substantially faster than those of North America and Europe.
2. Reasonable valuations in light of these macroeconomic tailwinds.
3. Portfolio diversification benefits: notwithstanding the globalization of capital flows, the correlations of Asian equity market returns with those of North American and European markets are lower than are the correlations of North American and European market returns with each other.

As noted in our November 2005 Global Market Commentary: *Increasing Strategic Equity Allocations to Asia*, we largely endorse this enthusiastic view and believe most investors should craft a coherent, long-term Asia investment strategy, potentially covering all asset classes—public and private—across all Asian economies. As always, tactical considerations should affect when and how best to implement these allocations, but we would stress that this is a *strategic* rather than a tactical recommendation—while acknowledging the inevitability of cyclical setbacks along the way, we regard this as primarily a *secular* growth story likely to play out over decades.

Investor optimism about Asia should *not* be based on measures such as the number of highly qualified scientists and engineers China and India graduate each year (relevant though these may be), because both human and financial capital can always be squandered where bad policies and economic mismanagement prevail. Rather it must be grounded on the perception that good policies are gradually replacing bad policies in most Asian countries, that governments are increasingly willing to allow *markets*—rather than bureaucrats—to determine how capital is allocated and prices set, and that these authorities also recognize that capital market development is critical to further economic progress. Only under these conditions will Asian countries reap the economic benefits of huge additions to their workforces, leveraged by rapid gains in productivity and significant investments (drawing on large pools of domestic savings and reserves) in health, education, social security, and infrastructure. Looking at Asia's developing economies in this light—especially, of course, today's hot markets, India and China—one sees not only their progress over the past 20 years, but also how far they have to go, and some of the dazzle is dimmed. Meanwhile, the merits of more stable, sophisticated, and better-regulated Asian markets like Hong Kong, Japan, and Singapore, gain luster by comparison.

We should stress that generalizations about Asia are fraught with risk, as the environment varies dramatically from country to country. The uninitiated may not realize, for example, that the flight time from Tokyo to Bangalore is roughly ten hours. More important than physical distance, however, is the striking cultural, linguistic, religious, ethnic, political, and economic diversity that defines the region. For this reason, we try to organize our thoughts by dividing Asia into four blocs: Japan, China, India, and the rest. This last category is particularly messy, covering a wide spectrum of developed markets (Singapore and Hong Kong), almost developed markets (South Korea and Taiwan), developing markets (Indonesia, Malaysia, Thailand,

and the Philippines), and undeveloped markets like Vietnam and Pakistan. And in many instances these economies have less in common than do those of, say, the United States and France: for example, natural resources constitute a considerable percentage of the Malaysian and Indonesian economies, while Taiwan is highly leveraged to global information technology (IT) manufacturing. Consequently, global economic developments favorable to, say, Indonesia, are not necessarily favorable to Taiwan, and vice versa. One must also keep in mind that not only are these nations at markedly different stages of development today, but to a large extent each is pursuing a distinctive growth agenda, with differing degrees of hospitality to foreign capital, so that a cogent investment approach to one might prove entirely inappropriate for another.

However, from an investment perspective virtually all of these markets share one common denominator: China. Throughout Asia, economic consciousness is dominated by China, which is not only the largest export market for many other Asian countries but also a lodestar for their economic strategies. Chinese growth poses five questions for more developed economies like Japan, Korea, Taiwan, and Singapore: (1) What can we do better than China?; (2) In what areas can we simply not compete with China?; (3) Should we relocate our manufacturing plant to China?; (4) What can we sell to China?; and (5) What capabilities do we have (or can we develop) that might thrive by *complementing* China's strengths?

For developing Asian markets, meanwhile, China's growth poses similar questions: (1) Given China's greater economies of scale and cost advantages, how long can we expect to remain competitive in *any* manufacturing sectors (e.g., auto production in Thailand and Korea)?; (2) What natural resources can we sell to China's voracious market? (Malaysia and Indonesia, in particular, have significant opportunities here.); (3) How can we attract more Chinese tourists? (As increasing numbers of Chinese have disposable income, both developed and emerging Asian markets are competing for Chinese tourists.); and (4) How can we invest in China? (In this context, it is worth noting that ethnic Chinese control a disproportionate percentage of the wealth in Indonesia, Malaysia, the Philippines, and Thailand. For them, China often represents the next logical business opportunity.)

In other words, China's rapid growth has accelerated the creative destruction inherent in the capitalist process, and its neighbors must adapt or die. The questions its developed and developing Asian neighbors must solve are very similar, but are being asked at different stages of economic evolution; what they share is a common effort to understand how best to exploit their comparative advantages in this rapidly changing environment. On balance, however, China's rise is a net positive for other Asian economies, constituting a powerful tailwind that will blow for decades.

Developing an Asia Investment Program

To date, most western investors have made only cautious forays into Asia, with toe-in-the-water investments in this or that public equity manager or private investment partnership. This has some merit as a means of keeping Asia on one's radar screen, but does not constitute a viable long-term Asia investment strategy. Those truly interested in building a coherent Asia investment program should first develop a strategic plan that articulates their policy objectives, lays out a roadmap for implementing the program, and

identifies benchmarks for performance measurement. The ability to implement will of course depend upon what opportunities are available—more on this shortly—but the first step is to formulate a strategy.

Asset Classes

The first step in developing a coherent program is to identify the asset classes to be included. A comprehensive program would include public and private equity, private real estate and real estate securities, hedge funds, distressed assets, bonds and cash, and currency management. However, some investors who feel they already have satisfactory exposure to Asian equity markets through, for example, global, EAFE, and/or emerging markets managers, may prefer to focus exclusively on private equity and/or real estate. Conversely, others with more limited private equity programs may decide to concentrate exclusively on the public markets.

Geography

The next step is to decide the program's geographical scope. For example, is it too ambitious to attempt to span the entire region, with all its diversity? Should one instead concentrate one's resources on the rapidly growing Indian and Chinese markets only? Alternatively, should one take a somewhat contrarian approach and focus exclusively on the more developed markets of Japan, Singapore, Hong Kong, South Korea, and Taiwan[1] on the theory that these offer a better risk/reward proposition as well as better opportunities for exploiting China's growth than do more direct investments in China itself? How do India and the smaller developing and undeveloped Asian markets fit into the picture? Should one delegate country and regional allocation decisions by hiring only pan-Asian managers? Should one hire only Asia-based managers or managers with an Asian presence?

We present these as questions because there are no right answers applicable to all investors. The right answers for any given investor depend very much on its policy objectives, the size and time frame of the commitment to Asian investments, the quality and breadth of the opportunity set in various markets, and the resources available to implement and monitor effectively.

Opportunity Set

Ultimate decisions about allocations among asset classes and countries/regions depend upon the opportunities actually available. For example, in contrast to the situation in the United States (and to a lesser extent in Europe), determining whether public or private equities provide better opportunities in particular markets may depend less on relative valuations, exit opportunities, and access to top-quality private equity funds (although these are also important concerns), and more on the various roadblocks many countries place in the path of foreign investors with respect to private equity. The relevant questions include the following:

[1] For purposes of this discussion, we have not included the Australian and New Zealand markets, but investors must, of course, decide whether to include these two markets in their Asia strategy.

- Is the regulatory and sociopolitical climate more hospitable to public than to private equity investment by foreigners?
- Are sellers in this market willing to cede control? This is a significant issue across Asia, both because foreign investors may find a dearth of sellers and because naïve investors importing western norms may mistakenly equate technical ownership with control that sellers do not recognize.
- Are there legal, cultural, or regulatory barriers that constrain private investors (especially foreign investors) from restructuring companies they buy? Do effective—and enforceable—bankruptcy laws exist that enable investors in distressed assets to realize returns?
- Is there sufficient breadth and diversity of private equity opportunities, such that managers can mitigate risk by constructing reasonably diversified portfolios, or is it better to invest in funds with broad regional mandates to achieve this goal? Notwithstanding the attractiveness of a particular country-specific allocation (a hypothetical example might be commercial real estate in Indian cities), investors should not compromise on quality in an attempt to fill some theoretically attractive investment bucket.

Similarly, Asian real estate is equally diverse and multi-faceted, reflecting the different stages of development of the various Asian markets. Thus, for example, Japan affords opportunities in value-added plays in its highly built-up cities, whereas in India regulatory restrictions, rapid economic expansion, and relative lack of infrastructure dictate a focus on development. More generally, development projects are naturally more prevalent in the emerging economies—especially India and China—than in more advanced economies where the markets have already matured.

Meanwhile, public real estate is a relatively new but rapidly developing asset class, with established REIT markets in Japan and Singapore expanding rapidly, and new REIT markets just evolving in Malaysia, Thailand, Korea, and Hong Kong. In all cases, the securitization of real estate in public vehicles enhances the private markets by creating new exit opportunities and by bringing greater transparency to the asset class.

Managers' Strategies

Many managers in the Asian public markets pursue trading-oriented momentum strategies, which we generally distrust. However, the investment approaches of more disciplined institutional-quality managers cover the same spectrum as one finds among European equity managers, ranging from heavy dependence on top-down market analysis to completely bottom-up, stock-picking regimes. But beware: the labels "growth" and "value" do more to obfuscate than to clarify manager strategies in this region—although managers will use them to provide prospective investors with an illusory comfort. Of course, we certainly favor managers who set valuation parameters and are disciplined as to price.

Although still in a relatively early stage of development, most Asian private markets can be segmented into four submarkets: early-stage venture capital, growth or expansion capital, buyouts, and distressed situations. The specific strategy a manager is pursuing will dictate the relative importance of financial, operational, management consulting, and prior private equity experience. What works in one locale

does not necessarily work in others, however, and no single market provides evidence of success in all four areas.

The distinctions among private real estate fund managers tend to revolve around their geographic and strategic focus. The clearest distinction is between those focused on the major emerging markets of India and China (and to a much lesser extent Thailand and Malaysia), and those focused on more developed markets like Japan, Hong Kong, Singapore, Korea, and Taiwan. In the former, managers tend to concentrate on office and residential property to meet the demands of foreign professionals. In addition, the growth of the middle class in these countries has stimulated increased demand both for better housing and for improved retail developments. In the latter, there are greater opportunities for value-added funds that seek to upgrade secondary properties, although some funds also seek to fill the need for newer office properties in cities like Tokyo and Seoul where the existing stock is aging (as is also the case in Bangkok).

Tactical Implementation

Step 1

Start with Japan (***not*** China). At year-end 2005, Japanese equities constituted 70% of the Asian public equity universe (61% of the Asia Pacific universe, which includes Australia and New Zealand). Given Japan's economic dominance in the region, our belief that it is in the early stages of a secular bull market after the long drought of 1990-2003,[2] and our perception of expanding opportunities in Japanese private equity, a similar weighting seems reasonable in an Asia investment program unless one wants to construct a program skewed heavily to *developing* markets. Admittedly, Japan is primarily a value play—its equities have relatively attractive valuations—but there is also a strong growth story, as Japanese companies are already among the major beneficiaries of China's torrid growth. On the private equity front, the success of firms focused on nonperforming loan disposals is well documented, but the more interesting opportunities going forward are likely to be in the buyout space, where the market has been slow to develop in scale, but holds considerable promise. Depending on the role of real estate in the investor's portfolio, allocations to Japan may also include private and/or public real estate, where the opportunity set is good and the correlation of returns with those of other asset classes is low.

Step 2

Next: Singapore, Hong Kong, South Korea, and Taiwan (***not*** China!). The Singaporean and Hong Kong markets are among the freest in the world. Major Singaporean firms are among the best managed in the region and, with government prodding, are expanding their operations across Asia, often through strategic acquisitions. In addition, the Singapore dollar is likely to appreciate steadily over time as the

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[2] We have been browbeating readers on this subject for several years. For more details, see these Global Market Commentaries: *Bullish on Japan* (May 2004); *Japan, Still Bullish* (September 2004); and *Japan: Still Time to Get In?* (October 2005).

government adjusts the managed float in line with economic progress. However, Singapore is leveraged to the global economy, so the market beta is relatively high relative to the world market beta.

Investor confidence in Hong Kong (and lack of confidence in the domestic Chinese exchanges) is reflected in the high number of Chinese companies that have listed on the Hong Kong market in recent years. Through these listings and through its unique role as a conduit for Chinese exports, Hong Kong is a major beneficiary of China's growth and represents one of the best ways to play China. In addition, one should expect the Hong Kong dollar, which is now pegged to the US$, to shift in time to a managed float that mirrors the value of the Chinese *renminbi* and appreciates gradually.

Taiwan is perhaps the next best indirect way to invest in China. Taiwanese bilateral trade with China, already considerable, will probably expand dramatically if domestic political shifts result in closer *rapprochement* with the mainland. Taiwan also offers considerable homegrown advantages as a market, but investors should not overlook the shorter-term reality that this is a high-beta market that tends to shadow the Nasdaq. It is therefore vulnerable to any slowdown in the global economy—let alone increased tensions with the mainland.

South Korea also claims some world-class companies and a high level of entrepreneurship, but struggles with an inflexible labor market that inhibits growth. However, Korean households—long underinvested in equities—are finally moving some of their savings into equity-related installment funds, which should provide a rising tide of liquidity and encourage institutional investors to follow suit.

On the private equity front, these economies are generally too small (and in some cases, inhospitable) to support country-specific funds and are therefore appropriately covered through regional vehicles. Therefore, allocations to these markets in a strategic investment program will likely be effected predominantly through public market investments.

In real estate, the Hong Kong market is booming, boosted by increasing inflows of mainland tourists, who are now permitted to take larger amounts of currency out of China and are taking advantage of the relaxation of restrictions on foreign travel. The nascent REIT market, in particular, is likely to expand rapidly as the benefits of securitization become increasingly apparent. Like Tokyo, Seoul offers opportunities for value-added plays while demand for Grade-A office space remains strong—as it does in most of Asia's major business centers. Despite substantial increases in valuations and significant inflows of foreign capital, Asian real estate markets are generally highly inefficient, which makes for significant opportunities for those managers with the expertise required to exploit local anomalies. This means, of course, that manager selection is critical.

Step 3

China. Despite its enormous potential, China is fraught with significant problems. For investors, perhaps the most important caveat to a direct China-focused strategy is that it may be naïve to presume that the country is moving steadily to a fully private market economy, supported by the legal and regulatory

infrastructure found in western societies. Private companies are not free of state control; indeed, every firm must still have a communist party unit in its offices. Despite a few well-publicized success stories, the vast majority of private Chinese companies are small and barely profitable. In a country where banks provide 99% of corporate financing, state-owned enterprises (SOEs) have priority access to capital and scarce resources, making it difficult for private companies to compete. Such companies are also squeezed on the other side, as it were, by China's openness to foreign investment, which has enabled foreign firms, with their superior technology and managerial experience, to set up shop in China. Most Chinese exports are manufactured in Chinese factories owned by foreign firms.

The vast majority of Chinese-listed equities are SOEs, whose business priorities are ultimately dictated by government officials at various levels, operating a *dirigiste* economic regime.[3] This is at cross-purposes with a free market and has been a prime cause of the massive buildup of bad debt that will need to be addressed at some point, with worrisome investment implications. It also helps explain the dismal performance of the Shanghai and Shenzhen exchanges, even as broader China indices have posted strong returns. That being said, the Chinese authorities have placed an appropriately high priority on domestic stock market development, aggressively addressing the problematic issue of "legal person" shares, starting to rationalize the alphabet soup of A, B, and H shares, and increasing foreign investor access to domestic exchanges. Recognizing the key role of well-regulated, efficient capital markets in a capitalist economy, they are attempting to build a world-class financial infrastructure, but are unlikely to accomplish this in just a few years—a decade, perhaps. By expanding the definition of Chinese equities from the roughly 1,381 companies listed on the two domestic exchanges to a Greater China universe of some 3,700 companies that have 50% or more of their assets or revenues in or derived from China, one has a much larger opportunity set, with a capitalization of about $2 trillion.

On the private equity front, most funds targeting China focus on expansion capital provided either by dedicated China funds or by Greater China or pan-regional funds (which still account for the lion's share of such investments on a cap-weighted basis). However, entry multiples have been rising steadily as competition for deals has increased. Prices seem bound to rise further as new participants—including U.S. funds now raising China partnerships—enter a market driven by the Chinese companies' need to raise capital to fuel their expansion into international markets (e.g., Lenovo's partnership with Texas Pacific Group, General Atlantic Partners, and Newbridge in a US$1.25 billion acquisition of IBM's PC and notebook business). Both the buyout and distressed securities markets are political minefields for foreign investors. Only a few well-capitalized pan-regional funds with carefully cultivated connections are involved and their success is questionable.

Despite some high-profile success stories, true venture capital investing in China is limited by a lack of skilled management, threat of intellectual property theft, and unclear paths to commercialization. In addition, government-sponsored initiatives dominate the market. Although reliable figures do not exist, there

[3] Nevertheless, generalizations about Chinese SOEs are likely to oversimplify. Some are the lumbering, uneconomic, politically directed zombies of popular western lore; others, however, are professionally managed, high-quality companies competing effectively on the world stage. These are most likely to be found in key industries, which the authorities have targeted as of strategic significance to the nation's economic development.

are likely more than 250 such domestic venture capital firms controlling perhaps $250 billion, crowding out private efforts and likely skewing valuations.

The opportunities for third-party investing in Chinese real estate are relatively meager because the market is dominated by locals and by well-capitalized development companies in other Asian markets (e.g., Hong Kong, Singapore, and Taiwan). That being said, any emerging country that is open to foreign investment and experiencing rapid economic growth is bound to present some opportunities in real estate—if not constrained by regulatory impediments. While investments tend to be concentrated initially in one or two major cities, they subsequently tend to expand geographically as these cities become sufficiently developed. Countries like China and India therefore have many more chapters in their real estate story beyond just Beijing, Shanghai, New Delhi, Mumbai, and Bangalore. As the service sector of the economy expands, creating more white-collar jobs, demand for office space increases, as does the need to build housing that meets rising bourgeois aspirations.

Summary Recommendations: The best way to invest in China is still though public market investments in Chinese companies listed outside the mainland and companies in Hong Kong, Taiwan, Singapore, Japan, and South Korea that benefit from (and contribute to) China's expansion, rather than through direct investments in the mainland. Only a few of the some 90 products dedicated to Greater China public markets investment are worth considering. Likewise, almost all of the 40 or so hedge funds dedicated to Greater China investment strategies (up from 14 in 2003) are worthless.

Meanwhile, despite the breathless publicity China attracts, truly compelling private equity and real estate opportunities—with some reasonable promise of earning returns commensurate with the substantial risks involved—are few and far between, and unlikely to constitute more than a small percentage of any well-designed Asia investment program. With an eye to the future, investors should certainly become familiar with the leading groups, but the absence of robust track records, a shifting regulatory environment and general overheating of the private markets in China should cause most investors to remain on the sidelines for now.

Step 4

India. India has many of same advantages as China: a vast labor pool, an influential community of highly skilled ex-pats with western expertise, world-class technical institutes that graduate large numbers of software programmers and engineers, and a huge, growing, domestic market of middle-class consumers. Nevertheless, with the exception of IT, the economic liberalization of the past 15 years has done relatively little to stimulate sharp increases in foreign direct investments or development of the manufacturing sector due to a persistent antipathy to foreign firms, stifling regulatory barriers, poor infrastructure, rigid labor laws, and cumbersome approval procedures for business and legal settlements of commercial disputes. The upshot is that India has fallen far behind China in attracting investment.

Nevertheless, in recent years the Indian investment climate has improved dramatically, thanks to major banking, tax, and legal reforms, and restrictions on foreign investments (including investment in real

estate development projects) have steadily been lifted and in some cases removed entirely, opening more of the Indian economy to private equity investors—perhaps in part because India has seen how China has benefited from its more hospitable attitude to foreign capital.

Moreover, India also boasts a democratic government and English-based legal and tax systems, which may ultimately prove to be a long-term advantage over China from an investor perspective. However, India's fiscal deficit of about 10% of GDP represents a significant macroeconomic risk. And with 200 million citizens still living in abject poverty, India's basic needs in health care, nutrition, and education are enormous.[4]

The Indian stock exchange has 4,763 listed companies with an aggregate market cap of about $553.1 billion, up from $110.4 billion in 2001. Some of this growth is from the listing of a few major companies, but mostly from bull market price increases. As it has roared past previous peaks to ever higher highs, foreign money has poured in, sentiment become deliriously optimistic, and speculation frenzied. The bulls cite companies' robust annual earnings growth of 20% since 2001 (stimulated by continued deregulation), but book values and price-earnings multiples have also expanded, which has resulted in valuations above their historical average and at a sharp premium to those of other Asian markets. This is not to deny that India presents an imposing secular growth story, but rather to stress that there have been (and will be) strong cyclical waves within the secular trend; for example, from 1994-99, despite strong economic growth, the stock market was relatively stagnant. Consequently, although bullish on Indian equities for the long run, we would be cautious about chasing the current boom and see this as a good time to develop an investment plan to implement when conditions are more favorable.

In private equity,[5] many of the firms that survived the bursting of the dot-com bubble have shifted from seed and start-up to later-stage investments: expansion capital (including public-to-private transactions) and even buyout opportunities. Historically, high real interest rates have discouraged buyout transactions, but rates have eased in recent years. Merger and acquisition activity has picked up as leverage has become both more affordable and available, and as a result a more developed buyout market appears to be emerging.

Media sources point to approximately 90 firms said to be targeting private equity investment opportunities in India. However, the investable, institutional-quality universe of private equity managers with a dedicated focus on India is significantly lower, totaling no more than 25 firms, including those private equity firms that target Indian investments from regional/global mandates. Still, India seems to offer better private equity opportunities than China.

Summary Recommendations: Many of the top-tier domestic groups are flush with capital following successful fund-raising exercises over the past 12 months to 18 months. While we generally favor the relatively stable investment environment for private equity in India over that of China, investors have few high-quality names to choose from in implementing an allocation over the near term. Those interested in deploying capital in India's private markets would be well served by identifying a short list of prospective

[4] These needs are mirrored, of course, in many other Asian countries, including China.
[5] See the July 2005 edition of our publication *Capital Call* for a more detailed discussion of this subject.

managers and beginning to build relationships with these teams in advance of the next fund-raising cycle (circa 2007/8).

In real estate, India can boast nothing like Pudong, the new industrial city across the river from Shanghai, and has not experienced the same sort of manic boom seen recently in Shanghai and Beijing. Consequently, the real estate opportunities are greater than those in China precisely because India is developing from a lower base and has until recently been inhospitable to foreign investment in property. Regulatory restrictions still funnel foreign capital toward development projects, where the risks are always higher, and so India presents a classic case of a secular bull market likely to be punctuated by cyclical setbacks.

Step 5

The Rest. Excluding China and India (but including the almost-developed markets of Korea and Taiwan), the emerging Asian markets constitute about 18% of the MSCI All Country Asia Index. Substantial differences both among the component countries and between these markets and that of Japan (which constitutes almost 70% of the MSCI All Country Asia Index) results in imperfect correlation among the various Asian equity markets, mitigating some of the country-specific risk. In addition, investors' focus on China and India has left the rest somewhat overlooked, despite the considerable opportunities they afford, especially in natural resource sectors that are under-represented elsewhere. Because each market is relatively small, however, institutional investors cannot readily deploy meaningful amount of capital in any one, and so we would favor managers with regional mandates. On the risk side of the equation, it should be noted that these markets are both fragmented and concentrated, that each carries country-specific idiosyncrasies, and that political and economic risks are always a concern—as the political climate of one country stabilizes (e.g., Indonesia and Malaysia recently), that of another may be deteriorating (e.g., Thailand recently). And although we would *generally* expect their currencies to appreciate over time relative to the US$, investors cannot afford to ignore currency risks.

In private equity, most of the focus has been squarely on the bigger, headline markets of India and China where the opportunity set is substantially greater than in the smaller Asian markets. However, there has been some interest in natural resource plays in countries like Indonesia and Malaysia, while in other markets, such as Thailand, the line between public and private markets is blurred (as is the case also in India) by crossover transactions.

Because India and China have attracted investors' attention to the detriment of other developing Asian markets, these present intriguing and varied opportunities for real estate investment, where investors can identify managers whose local connections and expertise enable them to negotiate the regulatory thickets and identify compelling opportunities in highly inefficient markets.

Concluding Recommendations

There are three ways to invest in Asia. For most U.S. investors the most common is the conventional allocation of some percentage of their equity portfolio to a manager with an MSCI EAFE mandate, perhaps supplemented by a smaller allocation to an emerging markets manager. This is the bilateral, United States/Rest of the World approach that we deplored in our recent Global Market Commentary: *Increasing Strategic Equity Allocations to Asia*.

The second course of action is to make bottom-up, targeted investments in specific Asian funds, public or private, on a purely opportunistic basis. These may be highly concentrated investments in, say, Chinese private equity, or a Japan-focused hedge fund, or they may be broader pan-Asian funds. The common denominator is the opportunistic, manager-specific character of such investments. This is what we characterized in the introduction as a toe-in-the-water approach for those trying to feel their way in the diverse thickets of the Asian investment landscape.

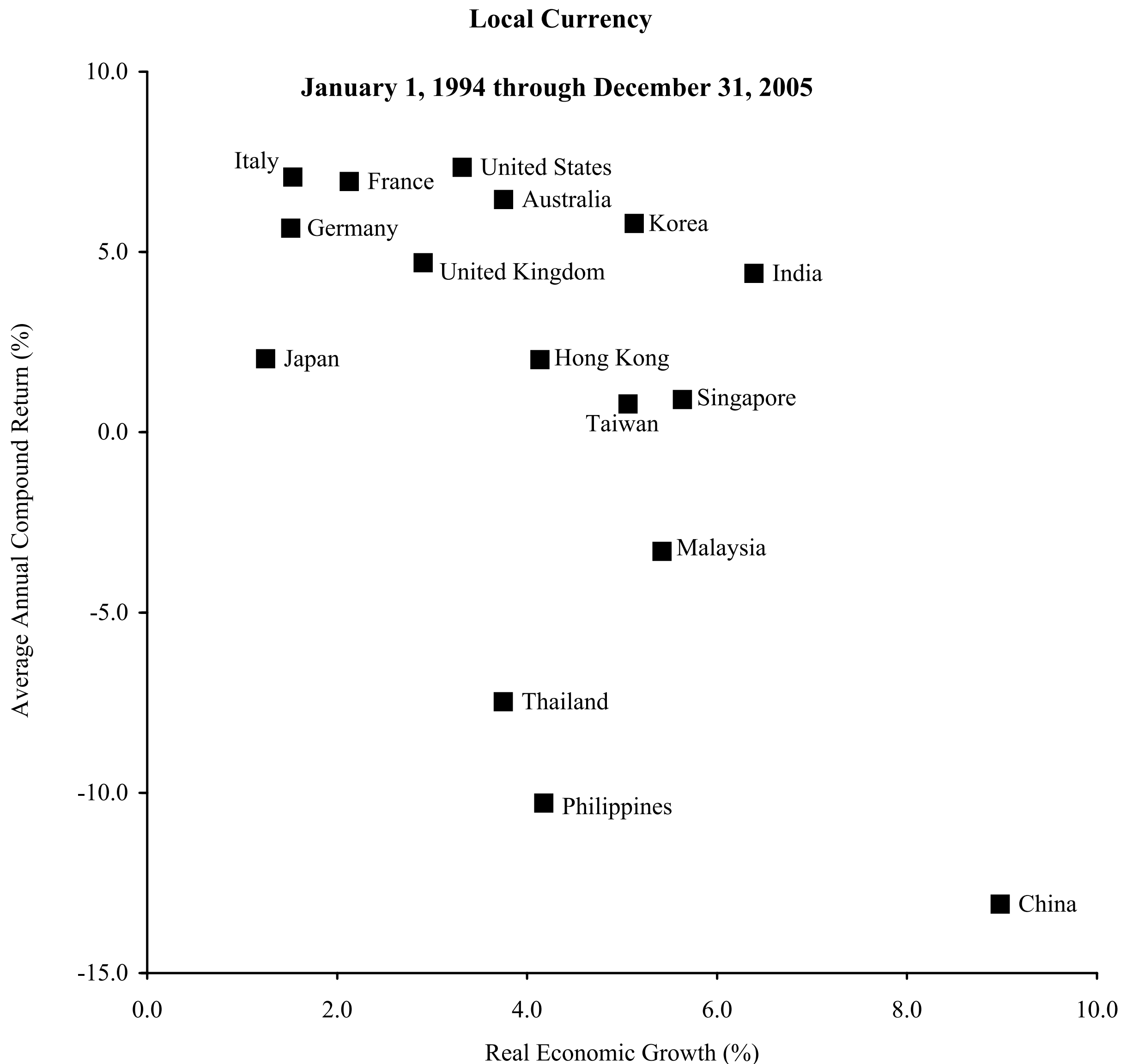
Our thesis here, however, is that more investors should consider making far larger, strategic commitments to Asian investments, developing and implementing a coherent, disciplined investment plan that looks at all of Asia, not just China or India or Japan, and at all asset classes in all markets. Although China's rapid development is the dominant force in the Asian *economic* story today, that does not make China the next best *investment* story. As noted above, we regard Japan as the logical starting point for anyone developing an Asia investment program and, with respect to mainland China, would favor a Greater China approach that seeks the homegrown benefits of more mature and stable markets such as Hong Kong, Taiwan, Singapore, and South Korea, combined with the extra *oomph* that continued Chinese growth is likely to provide these markets. We have a more wait and see approach with respect to India, but advocate formulating a strategy for this market that investors will be ready to implement once expected opportunities materialize in both the public and private Indian asset classes. Finally, investors should not ignore the other emerging Asian markets, which may be too small individually to warrant separate allocations, but collectively provide investors with many and varied opportunities with which to round out a well-diversified Asian investment program.

EXHIBITS

Exhibit 1

REAL ECONOMIC GROWTH RATES AND EQUITY MARKET RETURNS

Local Currency



Sources: Economist Intelligence Unit, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Each country's real economic growth rate reflects the average annual compound growth of its GDP from the period indicated. GDP growth rates for 2005 represent forecast figures. Equity market returns reflect total returns of MSCI country indices in local currency adjusted for inflation. Total returns for MSCI emerging markets indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes. U.K. inflation data are represented by the U.K. RPI until December 2003 and the U.K. CPI from December 2003 to the present.

Exhibit 2

DEVELOPED AND EMERGING MARKETS COUNTRY ALLOCATIONS

December 31, 2005

U.S. Dollars

	Percent (%)	
	GDP	Market Capitalization
Developed & Emerging Markets		
All Country World	100.0	100.0
All Country Asia Pacific	24.8	17.8
All Country Asia Pacific ex Japan	13.7	7.0
Developed Markets		
Pacific	13.7	14.2
Pacific ex Japan	2.6	3.3
Australia	1.7	2.2
Hong Kong	0.4	0.7
New Zealand	0.3	0.1
Singapore	0.3	0.4
Japan	11.0	10.8
Emerging Markets		
EM Asia	11.1	3.7
China	4.6	0.5
India	1.8	0.4
Indonesia	0.7	0.1
Korea	1.9	1.3
Malaysia	0.3	0.2
Pakistan	0.3	0.0
Philippines	0.2	0.0
Taiwan	0.8	1.0
Thailand	0.4	0.1

Sources: Economist Intelligence Unit, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Market capitalization is float-adjusted. GDP data are 2005 estimates.

Exhibit 3

MSCI REGIONAL ASIAN INDICES COUNTRY COMPOSITION

As of December 31, 2005

	Weight (%)					
	AC Asia Pacific	AC Asia	AC Far East	Pacific	EM Asia	EM Far East
Australia	12.4	---	---	15.6	---	---
Hong Kong	3.9	4.5	4.6	4.9	---	---
Japan	60.8	69.7	71.7	76.5	---	---
New Zealand	0.4	---	---	0.6	---	---
Singapore Free	2.0	2.3	2.3	2.5	---	---
Developed	79.5	76.4	78.6	100.0	0.0	0.0
China	2.9	3.4	3.5	---	14.3	16.1
India	2.3	2.6	---	---	11.1	---
Indonesia	0.5	0.6	0.6	---	2.6	3.0
Korea	7.2	8.2	8.4	---	34.8	39.4
Malaysia	1.1	1.3	1.3	---	5.4	6.1
Pakistan	0.1	0.1	---	---	0.5	---
Philippines	0.2	0.2	0.2	---	0.9	1.0
Taiwan	5.5	6.4	6.5	---	27.0	30.5
Thailand	0.7	0.8	0.8	---	3.4	3.9
Emerging	20.5	23.6	21.4	0.0	100.0	100.0
	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Factset Research Systems and Morgan Stanley Capital International. MSCI data provided "as is" without any express or implied warranties.

Exhibit 4

FTSE REGIONAL ASIAN INDICES COUNTRY COMPOSITION

As of December 31, 2005

	Weight (%)		
	Global All-Cap Asia Pacific	World Asia Pacific	All-World Asia Pacific
Australia	12.1	13.5	12.5
Hong Kong	6.0	6.8	6.3
Japan	56.8	61.5	56.9
New Zealand	0.5	0.5	0.5
Singapore	2.0	2.1	2.0
Developed	77.5	84.5	78.1
China	1.7	---	1.9
India	3.4	---	3.1
Indonesia	0.5	---	0.4
Korea	8.2	8.8	8.2
Malaysia	1.4	---	1.2
Pakistan	0.1	---	0.1
Philippines	0.1	---	0.1
Taiwan	6.5	6.7	6.2
Thailand	0.6	---	0.7
Emerging	22.5	15.5	21.9
	100.0	100.0	100.0

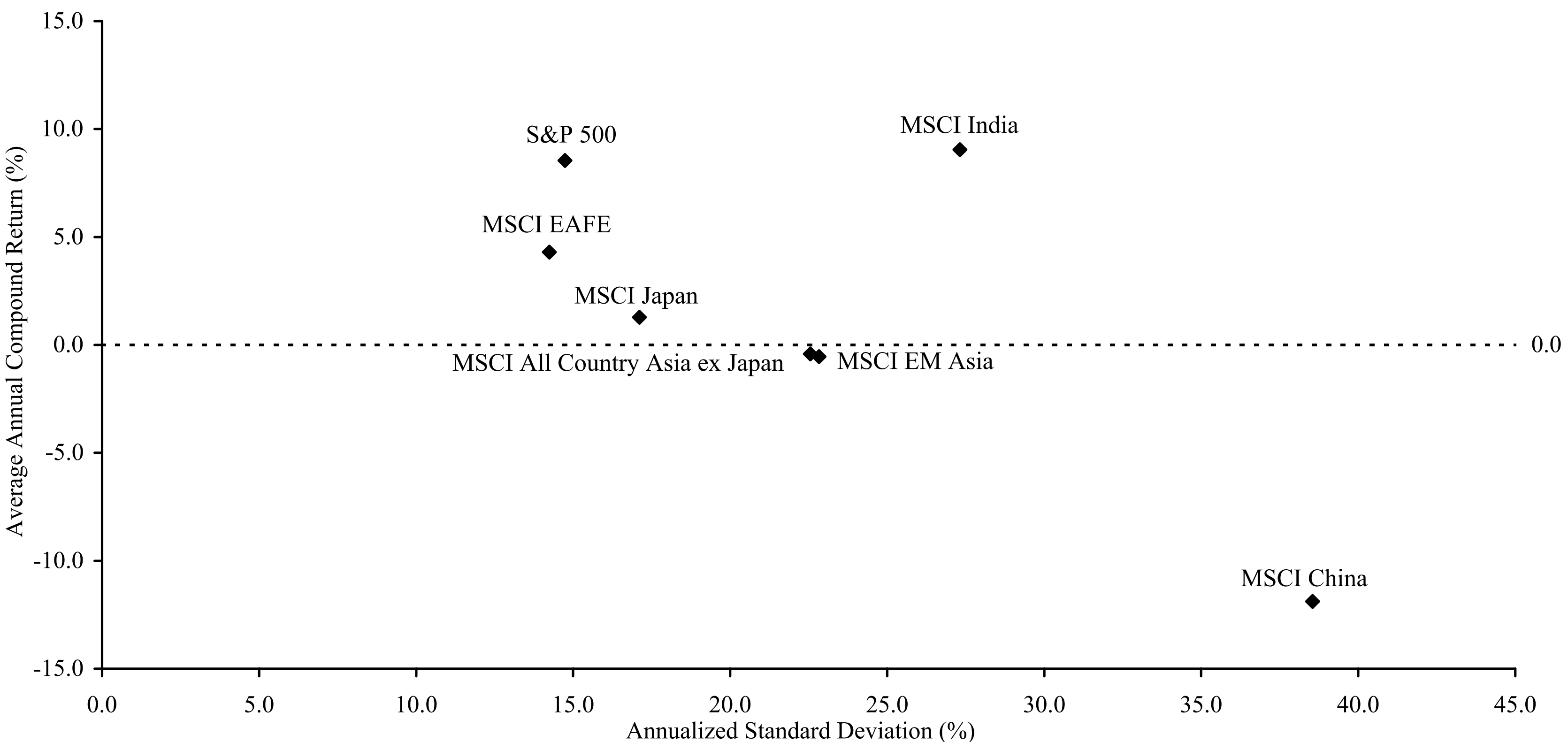
Sources: Factset Research Systems and FTSE International Limited.

Notes: FTSE classifies countries as developed, advanced emerging, and secondary emerging. Korea and Taiwan are considered advanced emerging countries. China, India, Indonesia, Malaysia, Pakistan, the Philippines, and Thailand are considered secondary emerging countries. The FTSE Global All-Cap Asia Pacific Index includes large-, mid-, and small-cap stocks. The All-World Asia Pacific Index includes only large- and mid-cap stocks.

Exhibit 5

RISK AND RETURN COMPARISON

January 1, 1994 - December 31, 2005



Sources: Morgan Stanley Capital International, Standard & Poor's, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

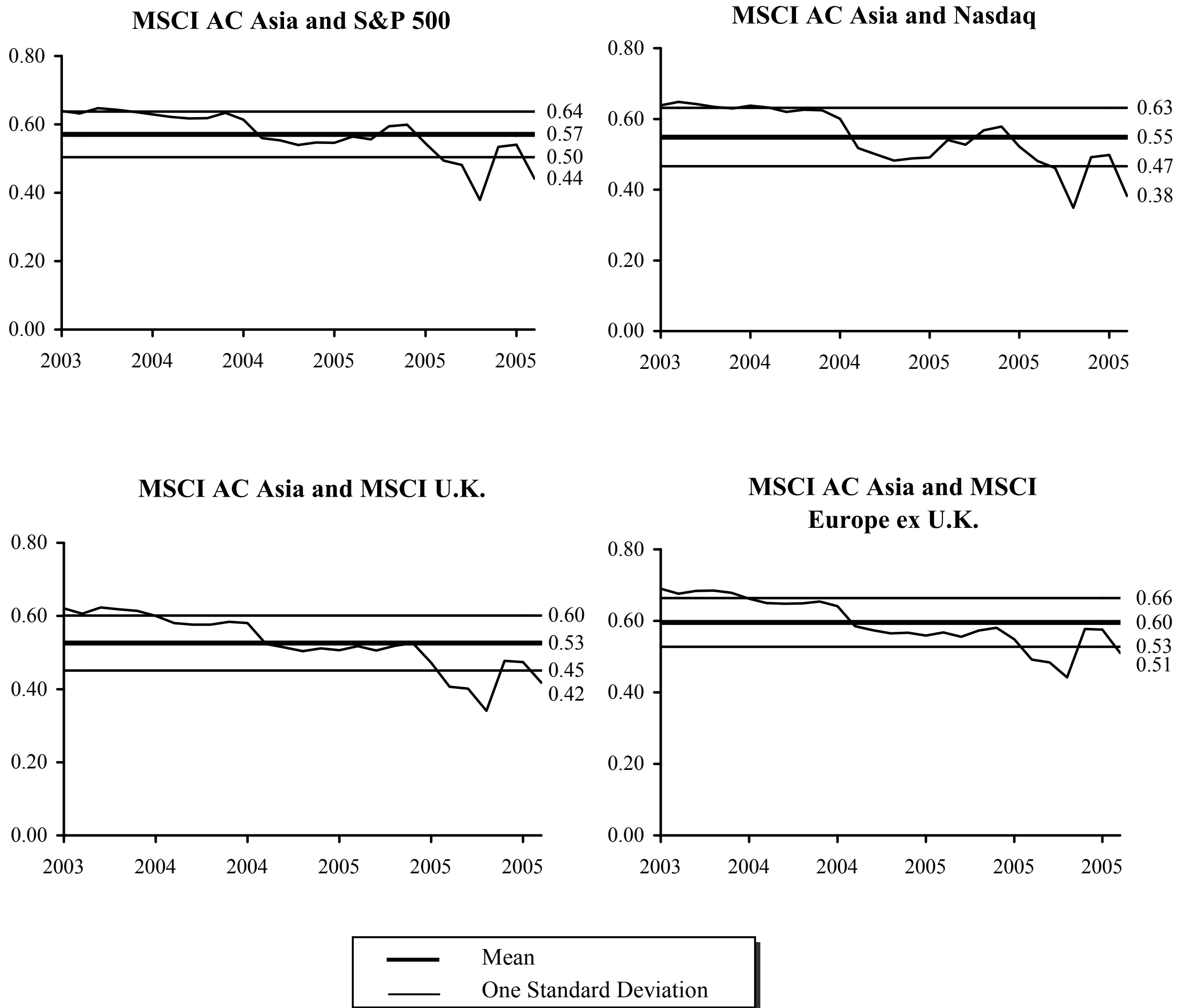
Note: Average annual compound returns are calculated from price returns in local currency.

Exhibit 6

36-MONTH ROLLING CORRELATIONS OF MSCI ALL COUNTRY ASIA WITH MAJOR WESTERN EQUITY INDICES

November 1, 2000 - December 31, 2005

Local Currency



Sources: Morgan Stanley Capital International, Standard & Poor's, Thomson Datastream, and *The Wall Street Journal.* MSCI data provided "as is" without any express or implied warranties.

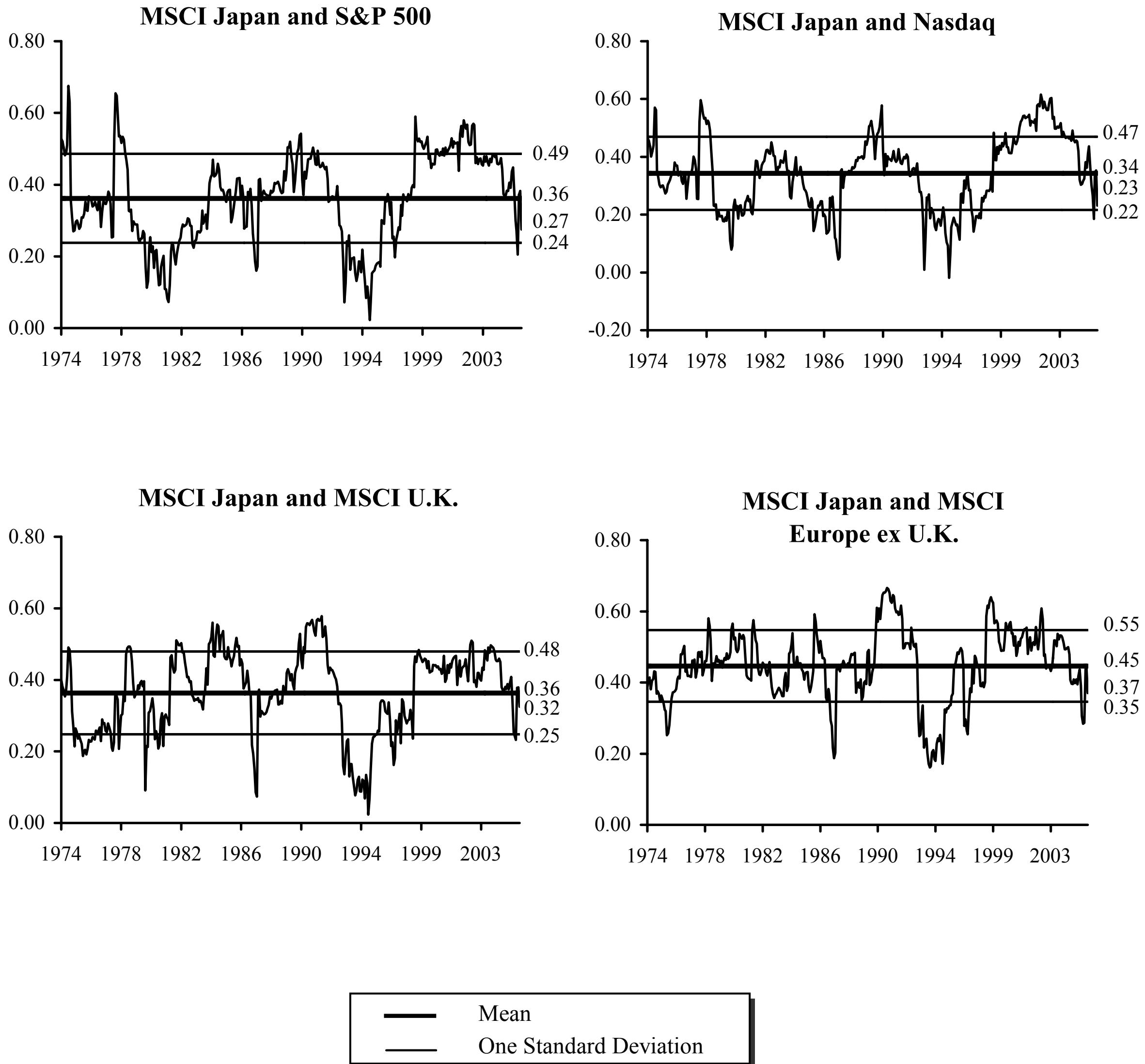
Notes: Nasdaq data are price returns. Total returns for MSCI All Country indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.

Exhibit 7

36-MONTH ROLLING CORRELATIONS OF MSCI JAPAN WITH MAJOR WESTERN EQUITY INDICES

March 1, 1971 - December 31, 2005

Local Currency



Sources: Morgan Stanley Capital International, Standard & Poor's, Thomson Datastream, and *The Wall Street Journal.* MSCI data provided "as is" without any express or implied warranties.

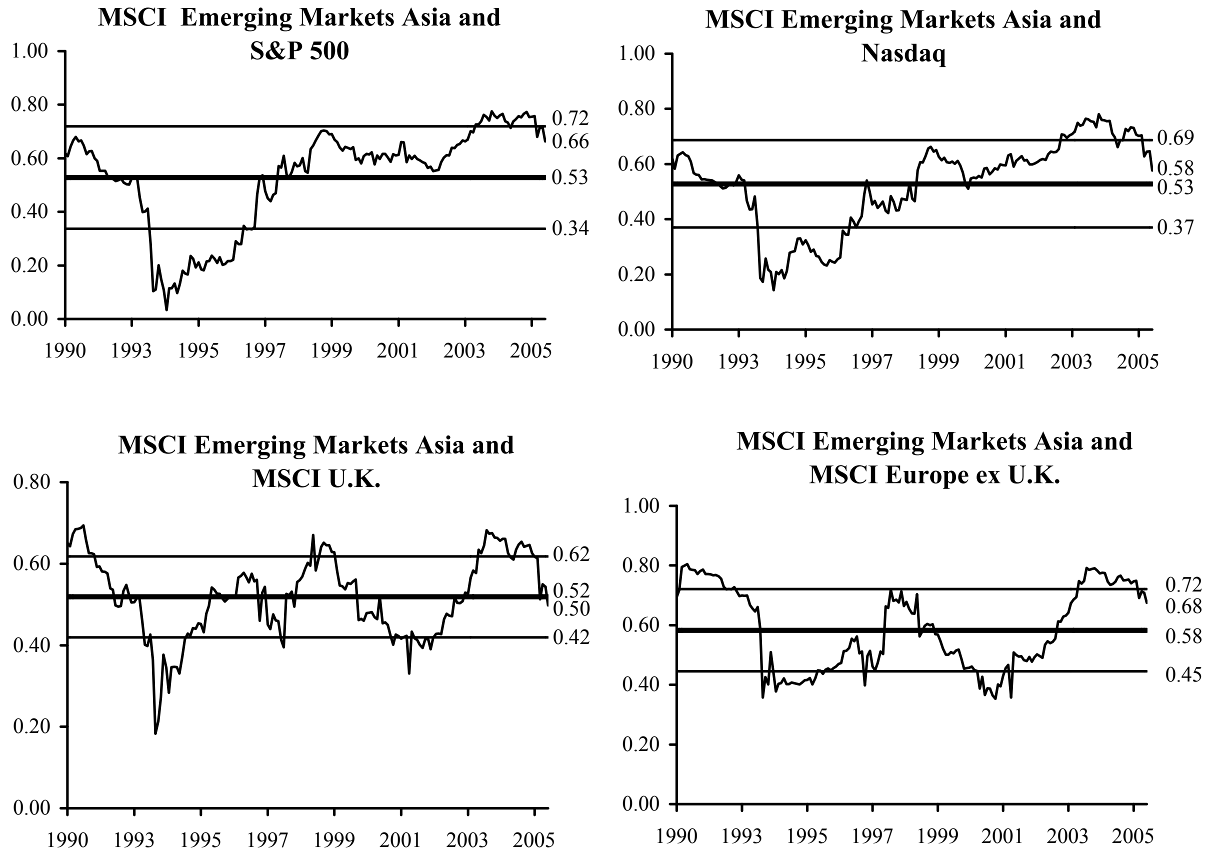
Notes: Nasdaq data are price returns. Total returns for MSCI developed markets indices are net of dividend taxes.

Exhibit 8

36-MONTH ROLLING CORRELATIONS OF MSCI EMERGING MARKETS ASIA WITH MAJOR WESTERN EQUITY INDICES

December 1, 1988 - December 31, 2005

Local Currency



Sources: Morgan Stanley Capital International, Standard & Poor's, Thomson Datastream, and *The Wall Street Journal*. MSCI data provided "as is" without any express or implied warranties.

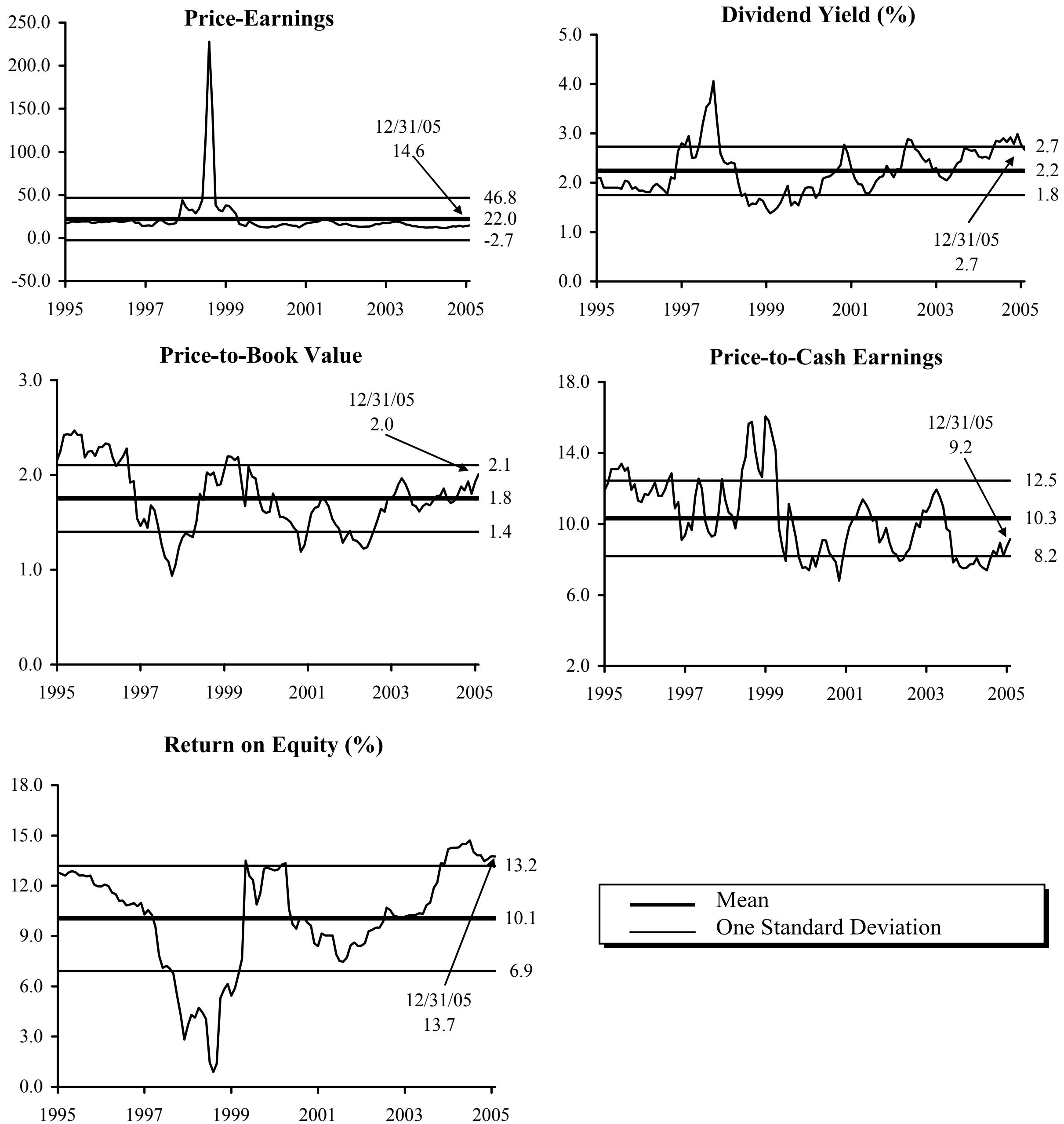
Notes: Nasdaq data are price returns. Total returns for MSCI emerging markets are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.

Exhibit 9

GLOBAL EQUITY MARKET VALUATIONS

MSCI All Country Asia ex Japan

November 30, 1995 - December 31, 2005



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

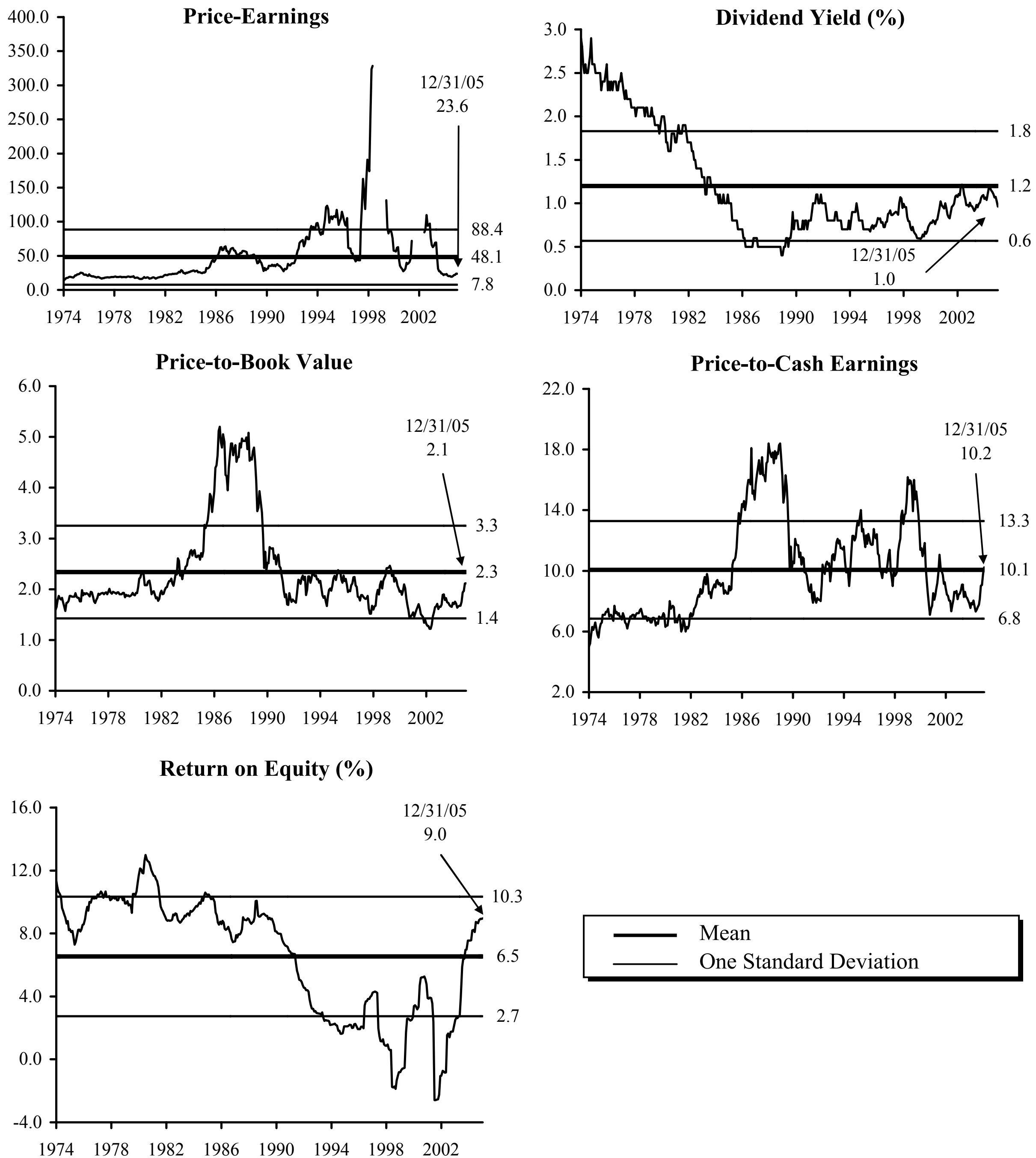
Notes: ROE is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.

Exhibit 10

GLOBAL EQUITY MARKET VALUATIONS

MSCI Japan

December 31, 1974 - December 31, 2005



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: ROE is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio. Gaps in the P/E graph represent periods for which negative P/Es have been removed.

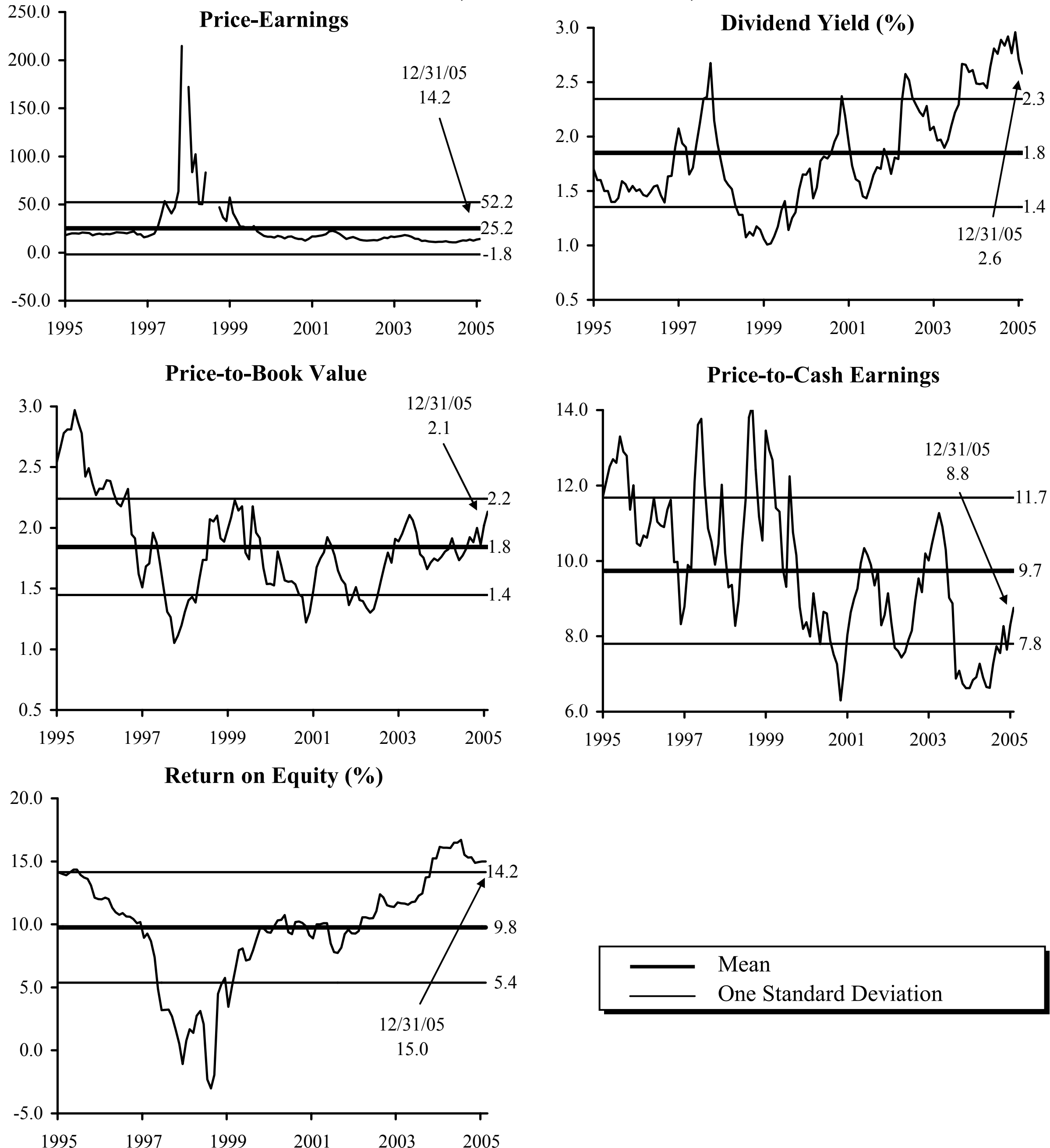
028q

Exhibit 11

GLOBAL EQUITY MARKET VALUATIONS

MSCI Emerging Markets Asia

November 30, 1995 - December 31, 2005



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

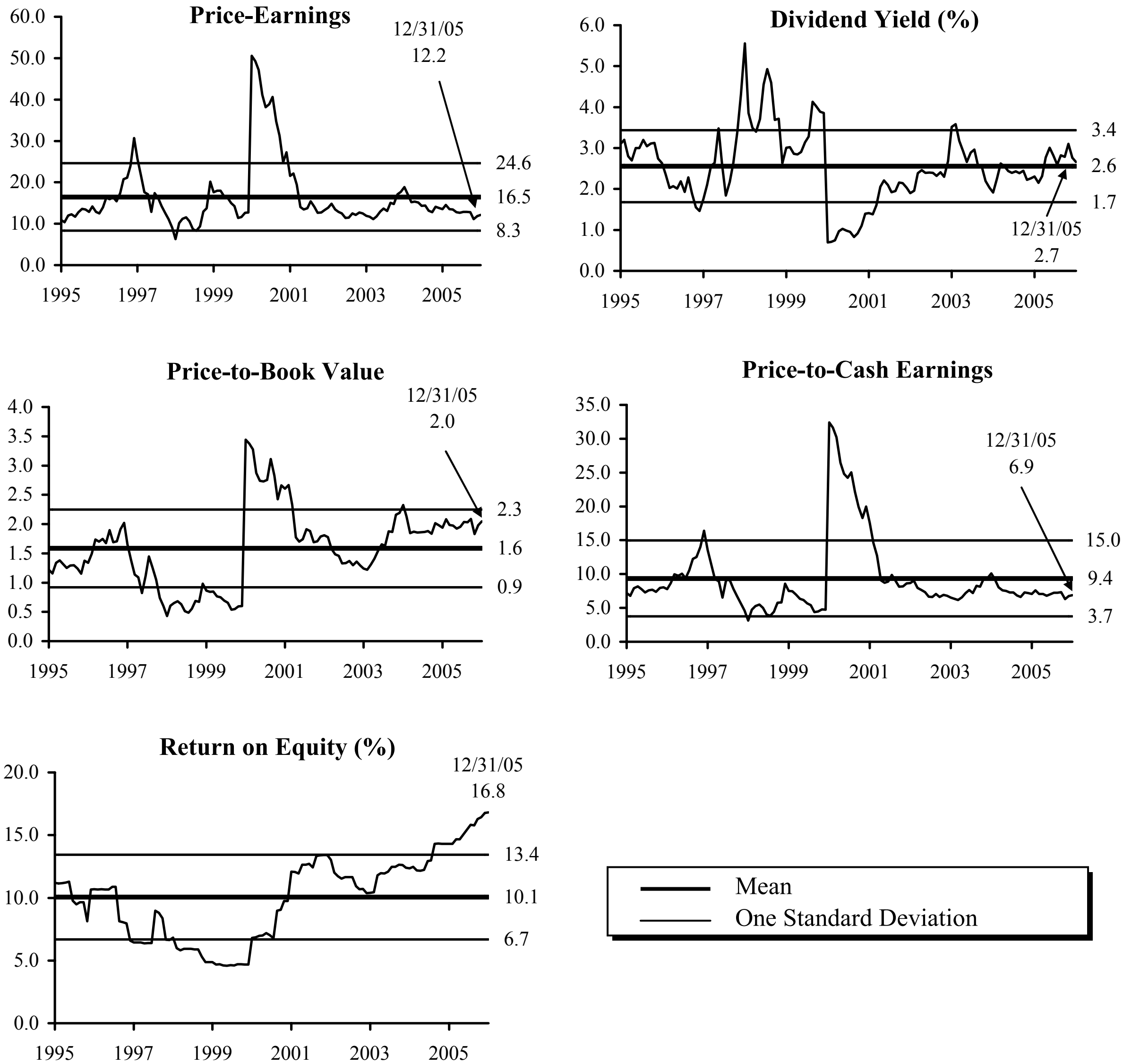
Notes: ROE is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio. As of January 29, 2004, MSCI renamed all regional Emerging Markets and All Country indices so that the suffix "free" no longer appears in the index name. Breaks in the price-earnings graph represent periods for which negative ratios have been removed.
622m

Exhibit 12

GLOBAL EQUITY MARKET VALUATIONS

MSCI China

November 30, 1995 - December 31, 2005



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

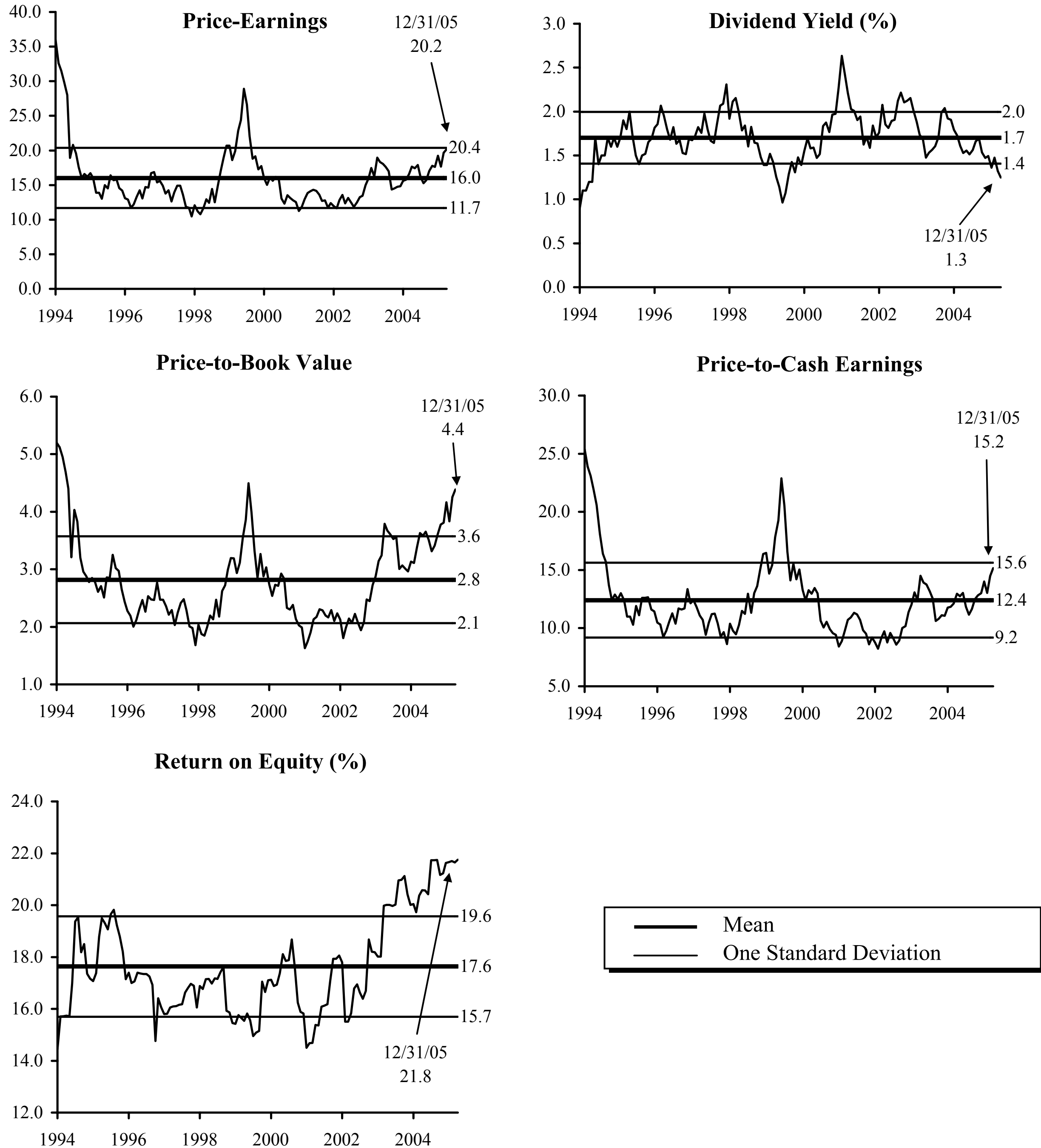
Notes: MSCI China includes equity securities issued by companies incorporated in the People's Republic of China and are listed either as B shares on the Shanghai or Shenzhen Exchange, H shares on the Stock Exchange of Hong Kong, or N shares in New York. ROE is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.
as_204m

Exhibit 13

GLOBAL EQUITY MARKET VALUATIONS

MSCI India

September 30, 1994 - December 31, 2005



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: ROE is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.

as_201m

APPENDICES

Appendix A

PERFORMANCE MEASUREMENT AND EVALUATION

As we argued in our November 2005 Global Market Commentary: *Increasing Strategic Equity Allocations to Asia*, we believe investors should have a *global* equity portfolio, with equally weighted policy allocations to the Americas, Europe, and Asia. The public and private equity components of an Asia investment program would fit into this construct and would be measured accordingly. Thus:

Global Equities

The Americas

- Public Equities
  - Developed
  - Emerging
- Private Equities

Europe

- Public Equities
  - Developed
  - Emerging
- Private Equities

Asia

- Public Equities
  - Developed
  - Emerging
- Private Equities

Whether real estate should be viewed as an additional component of these regional equity allocations or as a separate asset class (or as part of a policy allocation to hard assets) will vary according to the role the investor sees for real estate in the total portfolio.

The selection of an appropriate public equity benchmark index depends primarily on whether the investor has decided to include or exclude Australia and New Zealand in Asia (i.e., Asia Pacific), and on whether emerging markets are included or excluded.

Attribution analysis should then be used to determine the relative contribution to the investor's returns of tactical deviations from the index's country weightings and of security selection.

The results of the private equity subportfolio should first be measured in relation to opportunity cost; i.e., was value added by investing in private rather than public equity markets, net of the higher risks incurred? Secondly, investment decisions within the private equity subportfolio should be measured in relation to the opportunity set; i.e., compared to the Cambridge Associates LLC Asian Private Equity Index data, by vintage year. As we have noted elsewhere, these evaluations should only be made over time horizons of ten years or longer and are far more meaningful for mature than for unseasoned private equity portfolios.

Appendix B

ASIAN COUNTRY PROFILES

2005

Country	China	India	Indonesia	Japan	Pakistan	Philippines	Thailand	South Korea	Malaysia	Taiwan	Hong Kong	Singapore
Population (millions)	1,307.4	1,095.0	242.0	127.4	156.4	87.9	65.5	48.5	25.9	22.6	6.9	4.3
Population Growth (%) 2001-05	0.6	1.5	0.9	0.1	2.0	2.0	1.0	0.6	2.2	0.1	0.7	1.3
GDP (US$, Market Exchange Rate)	1,911.7	758.9	272.2	4,617.1	110.7	95.4	180.7	798.7	129.6	350.1	175.6	114.5
GDP (US$, PPP)	8,116.1	3,718.0	839.6	4,008.2	375.8	411.3	550.4	1,074.0	278.2	676.9	222.9	142.1
Real GDP Growth (%) 2001-05	8.7	6.5	2.6	1.2	5.0	4.3	5.0	4.5	4.4	3.8	3.9	3.1
Real Domestic Demand Growth (%) 2001-05	9.7	6.9	1.9	0.9	4.7	3.3	6.2	3.0	5.1	NA	1.7	-0.4
GDP per Capita (US$, Market Exchange Rate)	1,462.0	693.0	1,125.0	36,236.0	708.0	1,086.0	2,759.0	16,474.0	4,996.0	15,520	25,458.0	26,734.0
GDP per Capita (US$, PPP)	6,208.0	3,395.0	3,470.0	31,457.0	2,403.0	4,682.0	8,402.0	22,144.0	10,725.0	30,010	32,305.0	33,187.0
Inflation (%) 2001-05	1.3	4.0	5.9	-0.4	5.2	5.4	2.2	3.3	1.7	0.6	-1.3	0.6
Current Account Balance (% of GDP)	3.6	0.1	3.9	3.0	1.6	3.1	3.8	2.2	10.5	3.4	9.3	22.8
FDI Inflows (% of GDP) 2001-05	3.4	1.0	-0.7	0.2	0.8	1.1	1.5	0.9	2.6	NA	13.3	12.3
MSCI Market Cap (% of GDP)	6.6	13.1	8.5	56.9	4.1	8.1	16.8	38.6	37.0	68.5	95.1	74.4

Sources: The Economist, Economist Intelligence Unit, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: All 2005 data are estimates. Data for the period 2001-05 are based on annual averages.