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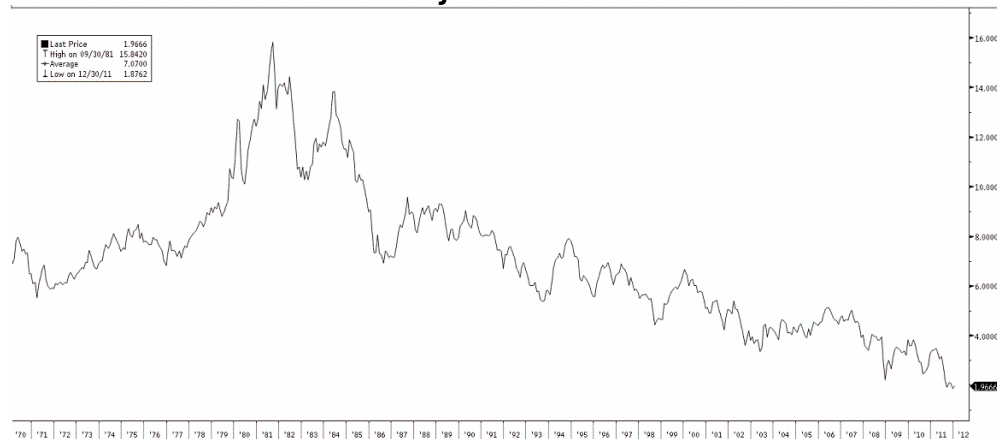
## The Investment Landscape for 2012

### Bonds

If we look at the bond landscape, we can make some broad generalisations that help us to guide our fixed income investments. US government bonds are currently expensive, though relatively safe. European bonds are distressed and may provide opportunities for investors with the appropriate risk appetites and expertise. Lastly, there are the Asian bonds, both corporate and government, which we feel may provide undervalued opportunities. The yields for Asian bonds more than compensate for the risks. While Asian bonds are definitely riskier than US Treasuries, they can be properly managed by on-the-ground knowledge of Asian market environments. These various factors contribute to an overall bond-friendly environment within Asia in which most of our investments are focused.

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

### Yield on US 10 Year Treasury since 1970



Source: Bloomberg, 10 Jan 2012

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

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

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

**We are favoring the Asian government and corporate bond markets for 2012.** For example, Thailand has a relatively low debt to GDP ratio of 43%, in comparison to Europe's average at 85% and the US at around 70%. Thus, there is more room for Asian governments to cut interest rates and hence more potential upside for Asian bonds.

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

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

## **Equities**

For equities, despite the uncertainties in the global economy, we feel that there exist opportunities for selective investments. We love to build up positions in equities when prices are attractive, as they are now. As such, our equities strategy this year involves overweighting our equity allocation and getting into

certain stocks for the longer-term, which goes against several analysts' views that the rally at the start of this year may be short-lived.

The support for our belief is based on a study of historical P/Es. During prior market recessions, such as in 1930 or during the 1970s, the US market's P/E was around 7 times. Conversely, during periods of 'irrational exuberance', as was the case in 1929 and 2000, P/E averaged around 30 times. A quick and dirty estimate of a 'fair P/E' would perhaps be around 20 times. Currently, the S&P500's P/E is around 12 times, a relatively safe level.

### Price to Earnings ratio on S&P500 since 1955



Source: Bloomberg, 10 Jan 2012

Another point of data to support our view, if you believe the wisdom of following the smart money, is that we have all observed that Warren Buffett invested over US\$24b into various companies in 3Q2011. Given that he is typically several quarters early relative to the bottom, a necessity for him due to the size of his investments, this could be interpreted as another indicator that now might be the time for some careful stock picking.

### *The sectors for investment focus*

Despite our optimism towards price levels, we still have to be selective about the sector to invest in, as the winning investment theme always varies from period to period. Top performing sectors rarely remain top sectors in back to back decades. In the 1960's IBM and the NIFTY 50's were the hot investments, in the 1970's Oil and Gold, in the 1980's Japan, in the 90's TMT, Emerging Markets and ASEAN. So while Brazil, Russia, India, China (BRIC) nations were the hot

investment story of the 2000's, their performance may be questionable in the current decade. Thus far they have collectively underperformed since 2010; therefore careful thought has to be put into steering our investments' sector allocations.

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

For telcos, there is not much to say. Stocks like Singtel and Telstra are bellwethers which are relatively less volatile and historically have steady dividends. Such stocks will help to anchor our portfolios and give them a tidy income component.

Looking at REITs, we feel that there exist opportunities for investment into the larger Singapore REITs which have strong sponsor backing. REITs, apart from currently providing good yields, also add a layer of diversification to the portfolio as the value of their property assets are not perfectly correlated with the stock market. We noticed that the larger REITs on the whole maintained their payouts even over the 2008 financial crisis. In addition, having reduced their leverage levels from a few years ago, Singapore REITs have balance sheets that are stronger than previously.

For food retail, we like the global, large cap companies such as Nestle. Such firms have strong brand names that have enabled them to leverage on their reputations to gain footholds in emerging markets. Downside is limited due to the defensive nature of their industries, while there is potential upside should they be able to ride on the growth in China or other emerging markets.

We are also always on the lookout for companies that we term 'Asian Leaders'. These are the mid-cap firms from Asia that have the promise to become regional, if not worldwide, brands. A good track record at growing market share and perhaps expanding overseas, building a respectable and well-known brand, as well as maintaining a healthy balance sheet would flag a company for further study. These companies may be involved in relatively old-economy industries, but the potential gains can be eye-popping. Recent notable stocks that fit this category have come from industries such as the confectionary and even leather tannery industries. I am of course referring to multi-baggers such as Hsu Fu Chi and Heng Long. Given the market gloom, some similar companies may be available at discount prices, and that is our chance to take some positions at a low cost.

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