

# APS Asset Management

## **ASIA EX JAPAN INVESTMENT THEME 4Q09**

### **SOME PORTFOLIO THOUGHTS FOR 2010**

**20<sup>th</sup> January 2010**

## ASIA EX JAPAN INVESTMENT THEME 4Q09

We were fortunate to finish with a very strong year in 2009 for all APS funds across the board. Instead of dwelling on our past success, however, we prefer to look ahead at how we can continue to create alpha in 2010. We must not depend on last year's strategy to win this year's war, which is as true in warfare as in investing. For example, Asian consumption and health care have been popular themes and, as a result, these stocks fill many investors' portfolios. We wonder how much more alpha is left. At APS, we have decided that this will not receive much attention this year. In investing, as in warfare, victories need surprises and overwhelming victories demand strong surprises. While we have no crystal ball in our hands, there are some things that we can prepare in advance. As Sun Tzu once said, "The general who wins the battle makes many calculations in his temple before the battle is fought. The general who loses makes but few calculations beforehand."

### Some APS Portfolio Thoughts for 2010

2009 saw Asian equity markets rebound 50-80% across the board from their March lows, witnessing one of the strongest yearly performances in recent times. Despite this strong performance, we still believe the markets provide ample opportunities and we have evaluated the areas or themes we believe will provide strong alpha-generation possibilities.

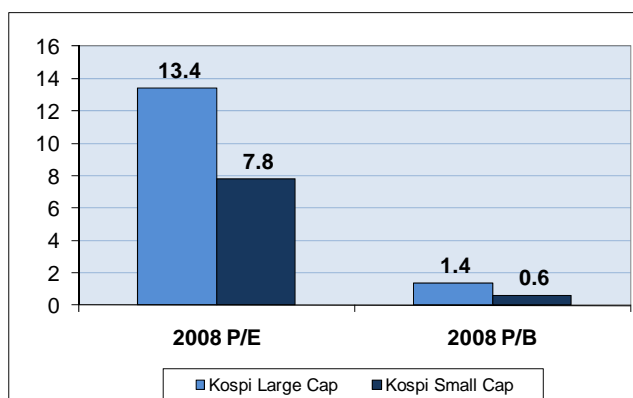
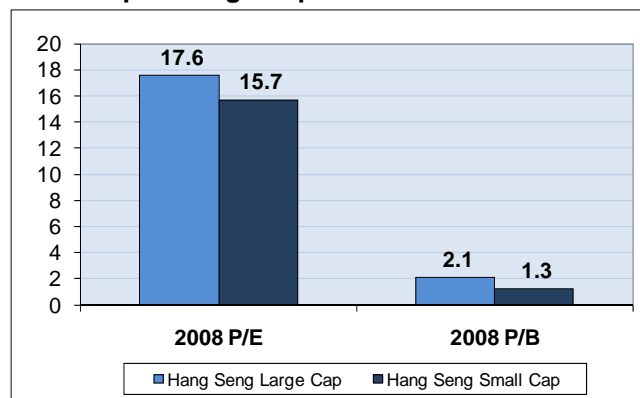
First, however, we must comment on equity market valuations. Notwithstanding last year's rebound, we are still of the view that Asian equity markets are cheap relative to property, bonds or cash. With bond yields at 3-4%, bank deposit rates at 1% and property yields at around 3%, there is a growing pool of Asian domestic liquidity searching for an investment home. With stocks generating earnings yields of 6-8%, we believe this pool of liquidity will provide strong support to equity markets. Furthermore, valuations are not stretched in our opinion, given the solid growth most companies will enjoy.

	2009 P/E	2009 EPS Growth*	2010 EPS Growth*
<b>Hong Kong</b>	18.1	32%	19%
<b>China</b>	24.1	45%	24%
<b>Korea</b>	13.9	55%	33%
<b>Taiwan</b>	25.1	339%	54%

\* Bloomberg estimates

On valuations alone, small- and mid-cap stocks continue to offer more attractive investment opportunities in 2010. Some of the companies in our portfolio, for example KH Vatec and Ju Teng, have posted very strong growth in a tough economic environment. Their strong earnings growth surprised many analysts and investors alike last year as many of these stocks have not been well covered or understood by the investment community. At APS, however, we were not surprised by their share price performances last year. As the market tends to be less efficient in this space, the valuations are thereby more attractive.

### Small Cap vs Large Cap Valuations



## ASIA EX JAPAN INVESTMENT THEME 4Q09

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We also believe there will be further profits to be reaped in the technology sector, which is seeing a strong resurgence in demand and little new capacity additions. The IT cycle witnessed a downturn between 2004 and 2007. The PC replacement cycle, which began in 2008, was delayed by the financial crisis and only was able to take hold in 2009, driven in part by the introduction of Windows 7. PC shipments were subsequently up 22% in 2009 and we believe all IT segments and equipment makers will continue to see a strong recovery in earnings in 2010. Outside the traditional technology areas there are also new and high growth areas, such as LEDs and touch screens.

A further area of opportunity in 2010 is what we call “Barking Dogs” or turnaround stocks. There are still many companies which have not yet seen a recovery in earnings and whose recovery may be one to two years out. These are often shunned by impatient investors and thereby afford very interesting valuations. These can either be company-specific or industry-specific turnaround stories—for example, industries where the worst has passed, such as container shipping or chemicals.

An additional theme we are evaluating is regional M&A targets for mainland Chinese companies. With so many Chinese companies flush with cash and benefiting from rich market valuations, we think **that** there is a high likelihood for a wave of outward investment by Chinese companies, especially in sectors such as resources, technology and distribution networks. These targets have to meet certain criteria, such as a management amenable to a takeover, fragmented share ownership structure and attractive fundamentals and valuation. The companies must be stocks we would be happy to own outright and whose investment case stands on its own. Whether we are fortunate enough to identify actual individual targets is less important as we believe the sector will see a re-rating should takeovers occur.

2010 will be much more of a stock picker’s market than 2009 and we believe investors will pay a premium for companies with higher earnings visibility and strong, diverse business models. Creating alpha certainly won’t be easy, just like 2009 or any year in the past. But those who continually look for new ideas, especially those bold enough to take a contrarian approach and kick the tyres diligently—those investors should have better odds. Also, in such a stock picker’s environment, those who spend less time on macro predictions and most of their time on new idea generation and company fundamental research may be rewarded with a few more alpha points. It is this that we must do again this year—sadly or proudly, depending on how you see it, doing the same work year after year. It may seem boring to some but, for us, it is in such daily grind that we endeavour to be innovative and refreshing.

***“God is on the side not of the big battalions, but of the best shot.”***  
***- Voltaire***

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# APS Asset Management

## **CHINA INVESTMENT THEME 4Q09**

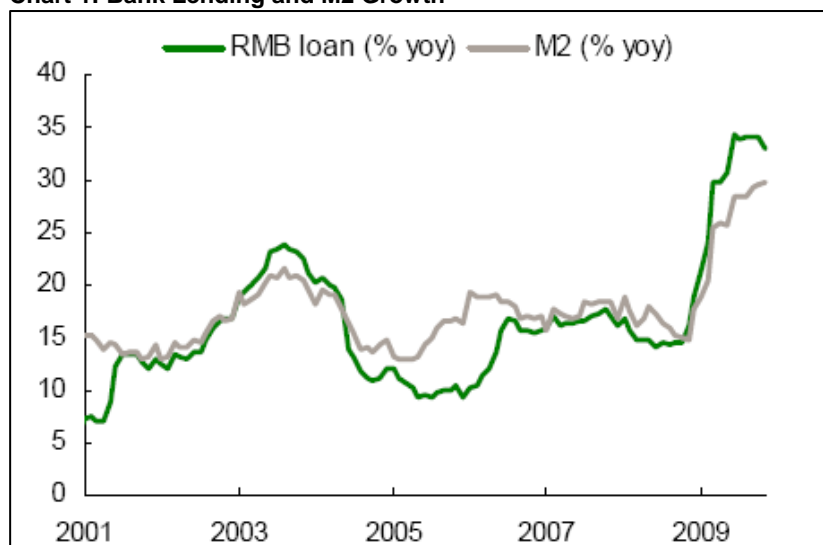
### **CHINA: THE BEGINNING OF THE TIGHTENING CYCLE**

**19<sup>th</sup> January 2010**

## CHINA INVESTMENT THEME 4Q09

Since early 2009, massive fiscal stimulus and extremely loose monetary policy have resulted in an unprecedented expansion of bank loans for infrastructural projects (see chart 1).

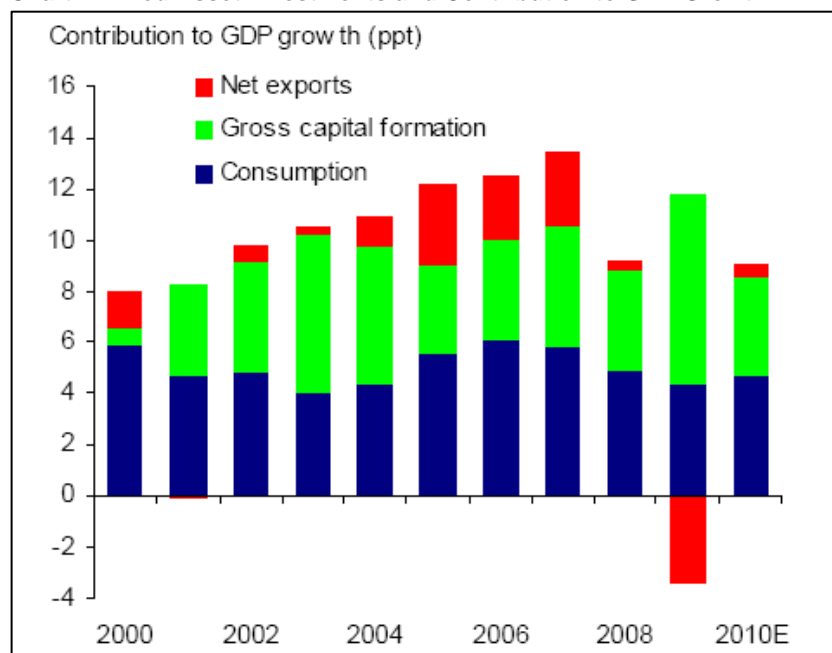
**Chart 1: Bank Lending and M2 Growth**



Sources: PBC, CEIC, CS

The strong expansion in fixed asset investments is estimated to have contributed about 7.5 percentage points to GDP growth in 2009, counter-balancing the -3.0 percentage points resulting from net exports decline. Together with the 4 percentage points contributed by private consumption spending, GDP is expected to increase by 8.5% in 2009 (see chart 2).

**Chart 2: Fixed Asset Investments and Contribution to GDP Growth**

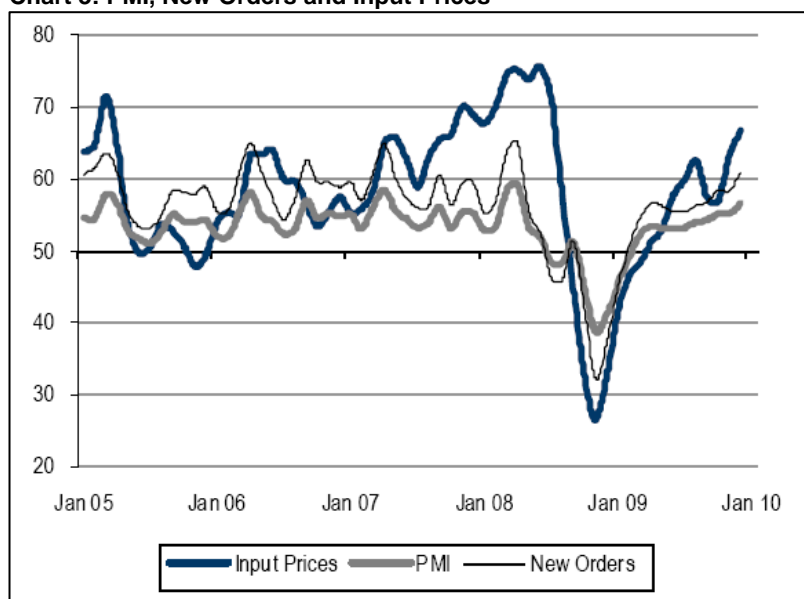


Sources: NBS, CEIC and UBS

Latest indicators on the PMI survey in December 2009 show that the expansion in activities continues. New orders rose further, from 58.4 in November to 61.0 in December (see chart 3).

## CHINA INVESTMENT THEME 4Q09

**Chart 3: PMI, New Orders and Input Prices**

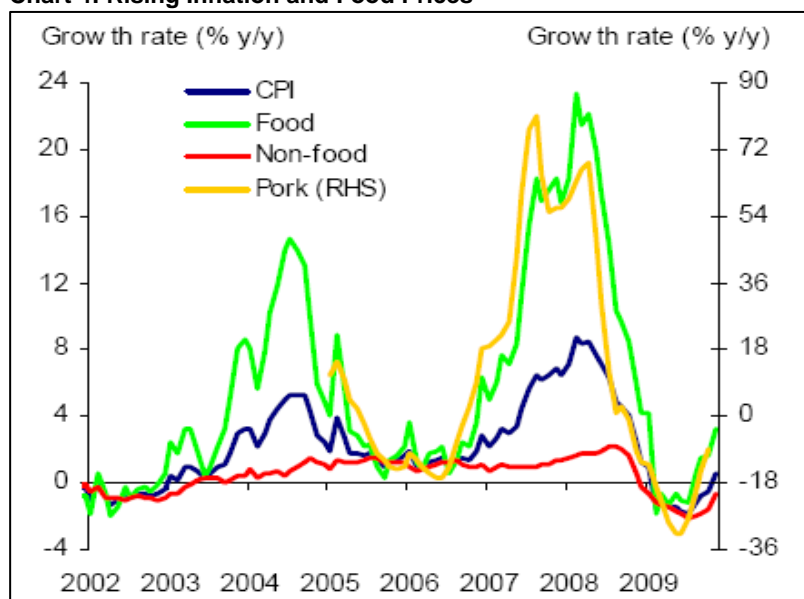


Source: CLIC

There is increasing concern of overheating in the economy and the rise of an asset bubble. While yoy increase in headline CPI has been muted at 0.6% in November, the momentum of increase has been strong. Month on month indicators show that CPI has been rising at an annualized rate of 4-8%. In particular, politically sensitive prices like food and pork have risen substantially in recent weeks (chart 4). In addition, leading indicators for future CPI, like upstream prices on PPI raw materials and PPI consumer goods, have been rising as well (chart 5). More significantly, the latest December PMI survey shows a strong rise in input prices that will feed into CPI over the next 6-9 months (chart 6).

While official data on property prices have been muted at 2-5% over the past several months, actual transaction data indicate that prices have been rising at 40-50% in major cities like Beijing, Shanghai and Shenzhen. The internet and blogs have been filled with citizens' complaints on the increasing lack of affordability of apartments by the aspiring urban middle class. This has raised increasing concern among the political leadership in Beijing.

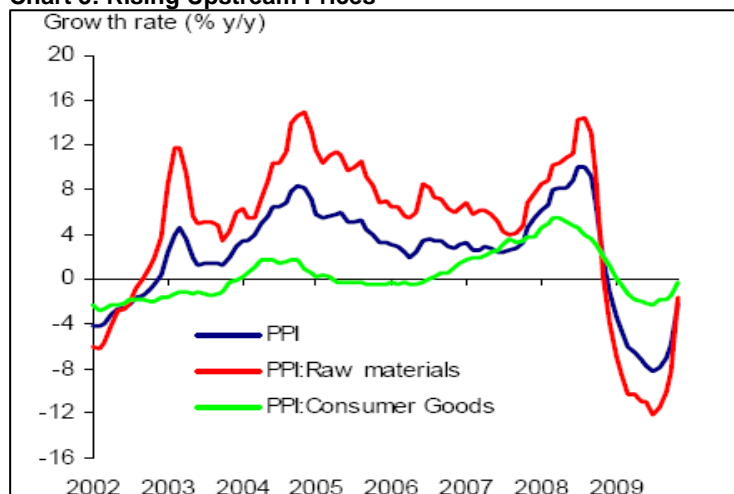
**Chart 4: Rising Inflation and Food Prices**



Sources: CEIC, UBS

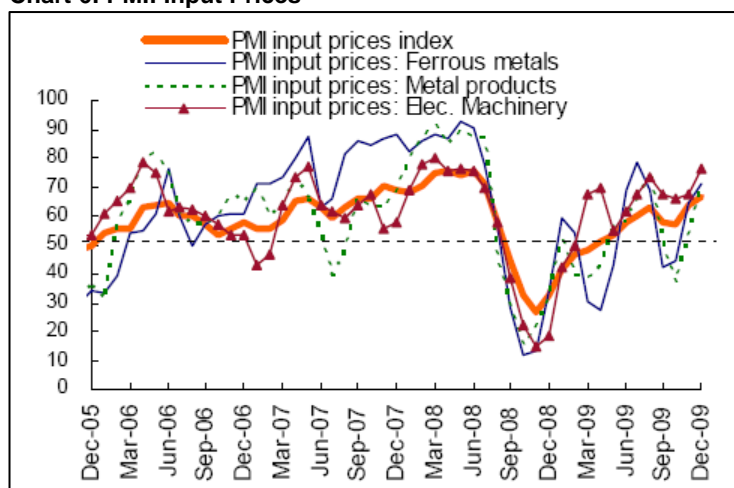
## CHINA INVESTMENT THEME 4Q09

**Chart 5: Rising Upstream Prices**



Sources: CEIC, UBS

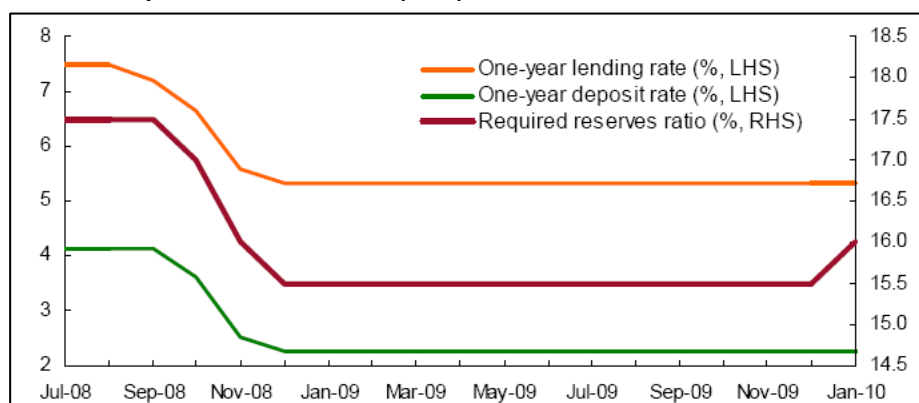
**Chart 6: PMI: Input Prices**



Source: CLIC

Concerns of overheating of the economy and a possible asset bubble finally have prompted the first major salvo of monetary tightening. On 12 January, the PBC hiked the reserve requirement ratio (RRR) by 50 bps to 16.0% from 15.5% for large state banks and to 14.0% from 13.5% for other smaller banks. The hike will be effective from 18 January (see chart 7).

**Chart 7: Required Reserves Ratio (RRR) and Interest Rates**



Sources: PBC, CS

## CHINA INVESTMENT THEME 4Q09

With about RMB 56 trillion in total bank deposits, this hike is estimated to lock up RMB 280 billion, curbing the surge in liquidity.

Based on extensive discussion with our contacts in the State Council, World Bank and PBC, this earlier than expected hike is likely to have been triggered by the rapid surge in bank loans and credit expansion in the first week of 2010. Credit growth expanded at an unprecedented rate of RMB 100 billion per day in early January, compared to the moderate increase of RMB 295 billion for the whole month of November.

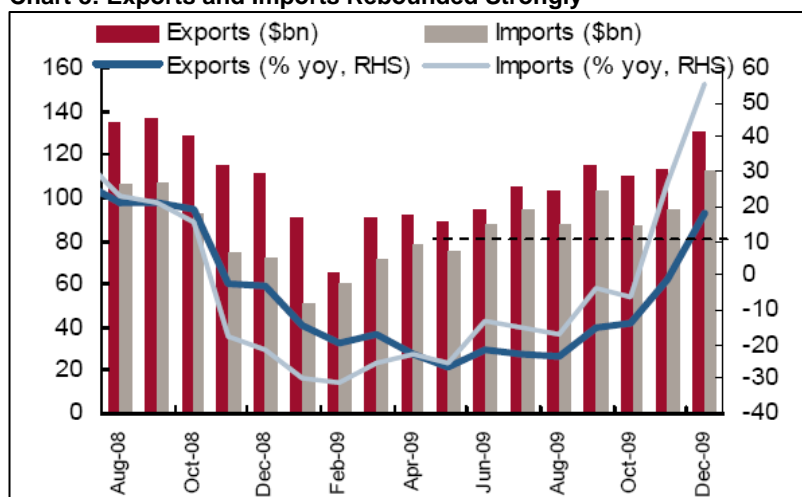
It is noteworthy that the tone of the government has shifted after the state council meeting on January 10, with local media highlighting that the government is now on guard against inflows of speculative capital, rising inflation and asset bubbles.

This increase reflects rising concern about inflation. The momentum of price increases has been rising. On a month on month basis, CPI has been increasing at an annualized rate of 4-8% over the past few weeks. Given this momentum, it is likely that the December data will show an increase of about 2% yoy, rising to over 3% yoy by March. For Chinese policy makers, 3% yoy CPI growth is beginning to raise alarms. This hike in RRR could be a preemptive move as the 18 January data on CPI and GDP could indicate greater overheating of the economy.

This hike is in line with the change in monetary policy stance signaled last December when the government sets a much lower credit growth rate of 18-19% (7.0-7.5 trillion) for 2010.

The RRR hike also indicates the victory of the PBC against Premier Wen in their insistence that there is a need to stem property bubbles and manage rising inflation expectations through reducing credit expansion. In addition, the strong export growth of 18% in December may have convinced Premier Wen that his perennial fear about export decline, rising unemployment and social political instability may have been overdone (see chart 8).

**Chart 8: Exports and Imports Rebounded Strongly**



Sources: NBS

It is the beginning of the tightening cycle. There will be several RRR hike totaling at least 150bp in H1.

The PBC is reluctant to raise interest rates and will use the hike in RRR to tighten and reduce liquidity. Given the present institutional structure in China, the hike in RRR and consequent tightening of liquidity is more effective at slowing down the economy than an increase in interest rates. Another key reason is due to the large inflow of hot money speculating on RMB appreciation. Given the present low level of US interest rates, the PBC is fearful that a rising interest rate differential would lead to further inflow of speculative capital into China. Data on estimated capital flows indicate that a monthly average of US\$ 20-40 billion of hot money flowed into China in the second half of 2009. This has led to surging liquidity.

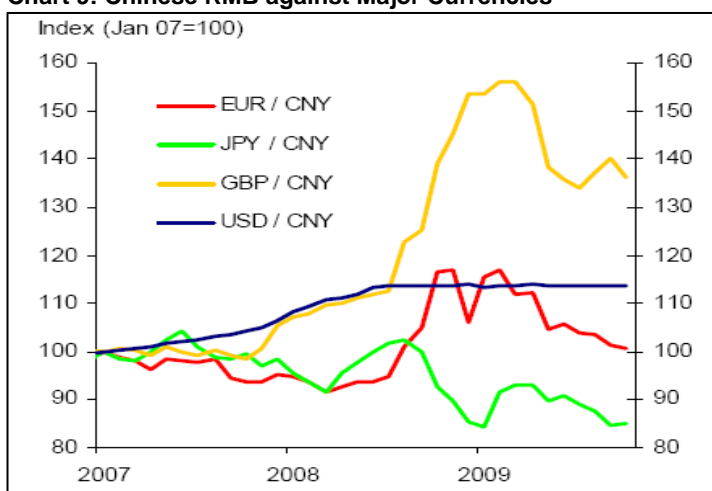
## CHINA INVESTMENT THEME 4Q09

The internal debate on tightening has been raging for a while. Premier Wen has been very reluctant to listen to the technocrats in the PBC, CBRC, et al. on the dangers of economic overheating and rising asset bubbles. He is looking at his legacy after 2012 and does not want to leave behind a collapsing economy.

This RRR hike is good for the economy as the government have now decided to tighten before bubbles become too big and grow out of control.

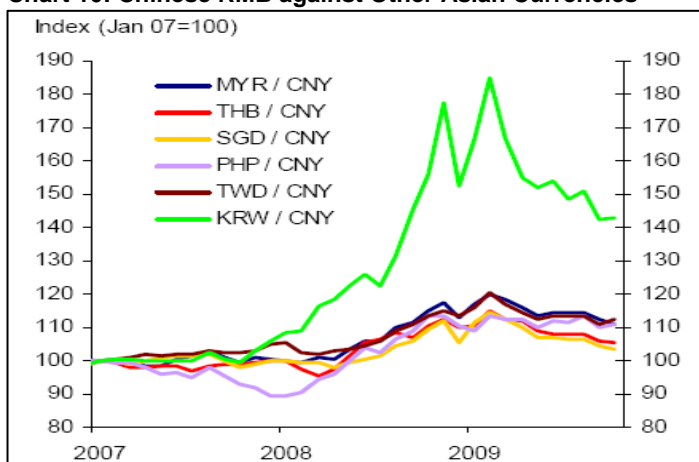
The informal pegging of the RMB to the weakening dollar over the past year has resulted in substantial depreciation of the RMB against the Euro, Yen and other Asian currencies (see charts 9-10). Consequently, there has been rising global clamor for the Chinese currency to appreciate, particularly given China's robust GDP growth. However, the Chinese government has resisted this external pressure, partly due to concern over export competitiveness in the face of falling external demand. In China, the PBC has no independence and the exchange rate policy is set by the political leadership and not the technocrats. During the first nine months of 2008, the RMB appreciated substantially on the advice of the technocrats in PBC. Since early 2009, the resulting fall in exports, closing of factories and rise in unemployment in the coastal provinces were blamed on the technocrats, though it corresponded with the period of global financial crisis and falling external demand. The governor of PBC, Zhou Xiaochuan also lost his job during the process. Consequently, the technocrats have been very careful and have not been vocal in calling for appreciation. Premier Wen Jiabao has been the dominant voice in this area and has been the most vocal voice for concern on the loss of export competitiveness and the resulting effect on employment and social political instability. As such, the RMB has been kept pegged to the US dollar since July 2008.

**Chart 9: Chinese RMB against Major Currencies**



Sources: Bloomberg, UBS

**Chart 10: Chinese RMB against Other Asian Currencies**



Sources: Bloomberg, UBS

## CHINA INVESTMENT THEME 4Q09

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Given the present shift towards beginning a tightening cycle as well as increasing concerns over rising inflation and inflationary expectations, a movement on the exchange rate is likely to be the next adjustment. In particular, the 18% expansion in export in December has convinced the political leadership that China's export competitiveness remains strong and sustained. It is likely that over the next 3-6 months, the government will begin a return to the earlier policy of slow and steady 3-5% annual appreciation of the RMB. It is also possible that this steady appreciation could be benchmarked against a basket of currencies instead of bilaterally against the US dollar.

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# APS Asset Management

## **JAPAN INVESTMENT THEME 4Q09**

**SOME OF OUR FOCUSING INVESTMENT THEMES**

**20<sup>th</sup> January 2010**

## JAPAN INVESTMENT THEME 4Q09

We have researched several investment themes and added several stocks in the fourth quarter 2009. We will discuss these investment themes and stocks in this report.

The investment themes we reviewed are:

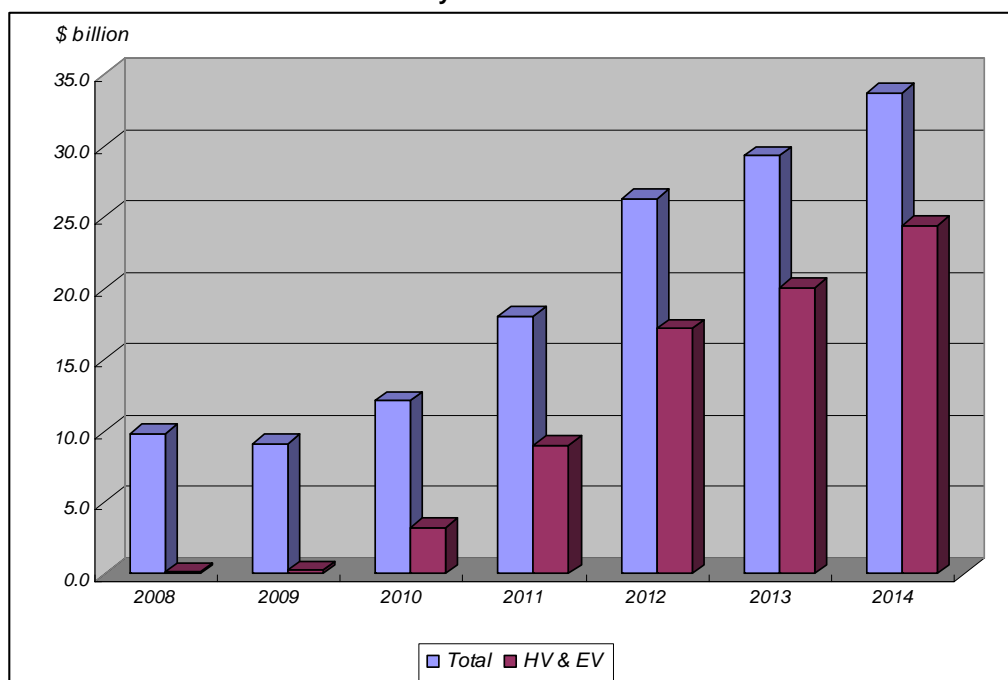
1. Environmental friendly technologies and products
2. Emerging market growth
3. Deflation proof companies
4. Aging society

### 1. Environmental Friendly Technologies and Products

Mr. Hatoyama, the prime minister of Japan, declared that Japan would reduce its CO<sub>2</sub> emission by more than 25% by 2020 from that of the 1990 levels. Due to disagreement between developed countries and developing countries which produced huge CO<sub>2</sub> emission such as China, this declaration has not been ratified. However, oil price is still high and global energy demand is increasing more rapidly than its supply due to strong economic growth of emerging countries. Environmental friendly, energy saving technologies and products are still very important as long-term investment theme.

We hold two Lithium ion battery related stocks, Stella Chemifa and Nippon Denko, in our portfolio. Demand of Lithium ion battery is likely to increase rapidly in the next five years. Hybrid Electric Vehicle (HV) and Electric Vehicle (EV) will drive this demand growth.

**Chart 1: Demand of Lithium ion battery**

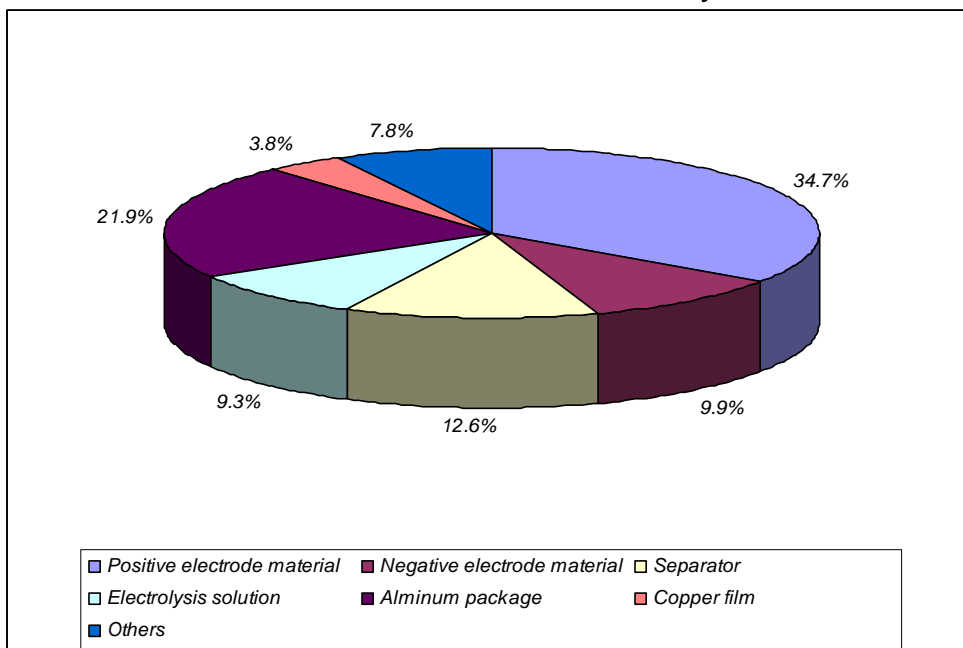


Source: Nikkei Electronics

Stella Chemifa manufactures special chemical material for the Lithium ion battery's electrolyte solution. The company is a global market leader with a 35-40% global market share in this field. This material is made from fluorine compound which needs special technologies and know-how to produce. Stella Chemifa has such technologies and know-how through its long experience. This is a niche market and therefore it is not attractive to large chemical companies. Stella Chemifa will be one of beneficiaries of Lithium ion battery market growth.

## JAPAN INVESTMENT THEME 4Q09

Chart 2: Raw-materials cost breakdown of Lithium ion battery



Source: Nikkei Electronics

Lithium ion battery is made from various materials. As Chart 2 shows, the positive electrode material is the most expensive raw material of a Lithium ion battery. Cobalt has been used as key material for the positive electrode so far due to its high power storage ability. The search for a cheaper alternative to cobalt continues because HV and EV need much larger volume of batteries than consumer electronics products such as mobile handset and notebook PC. Manganese is such an alternative material. Manganese is much cheaper than Cobalt and its electric power storage capacity is close to Cobalt. Nippon Denko is a leading Manganese Ferro alloy maker in Japan and has developed Manganese materials for Lithium ion battery's positive electrode. Manganese Ferro alloy is the raw material of blast furnace steel alloy production. However, blast furnace steel production volume in Japan is unlikely to grow very much as the Japanese Manganese Ferro alloy market is a matured one. Nippon Denko has developed Manganese materials for Lithium ion battery's positive electrode. Nippon Denko is already a supplier of Manganese to manufacturers of Lithium ion battery for electric bicycle and electric machine tool used by carpenters. The company is adding a 2,000 ton per year new production facility by mid 2010 and appears to be planning to expand it. We think Nippon Denko will be another beneficiary of the Lithium ion battery market growth.

## 2. Emerging Market Growth

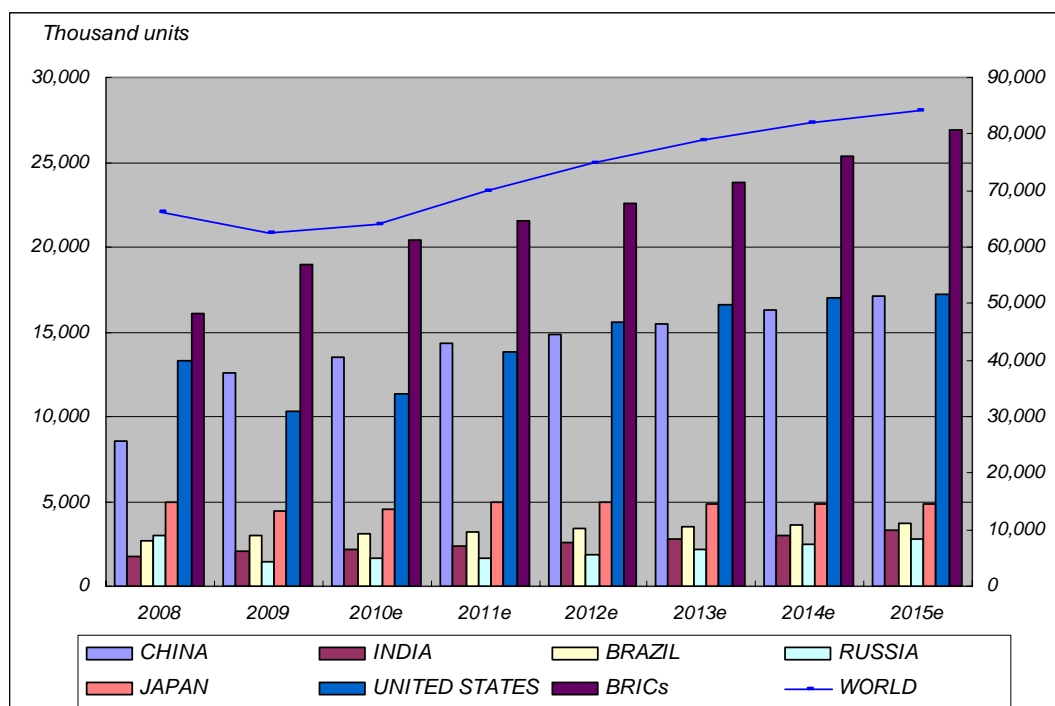
This is also the long-term investment theme for APS Japan.

We bought Bridgestone as a dynamic alpha stock which will benefit from emerging market economic growth.

Motorization has already started in some emerging countries and annual auto sales in China surpassed that of the US in 2009. This trend will continue as emerging countries' economic growth continues. Auto demand in the US declined sharply in 2009 from 2008. However, US Auto sales will recover and grow from the bottom in 2009 for the next several years. According to "Global Insight", a research firm, the global auto sales will grow 6.2% p.a. for the next five years. BRICs countries, especially China and the US auto sales recovery will be the driver of this growth.

# JAPAN INVESTMENT THEME 4Q09

**Chart 3: Annual auto sales forecast**



Source: Global Insight, APS Asset Management

The Tire market will grow with the auto market. This market is oligopoly and the top three companies, of which Bridgestone is one, are taking a large global market share. The market for special tires used in mining machineries and airplanes are also growing. Bridgestone and Michelin dominate this market. These special tires need high durability and reliability and therefore are not easy to produce. Entry barrier in this field is high. We think Bridgestone will be a beneficiary of emerging markets' economic growth.

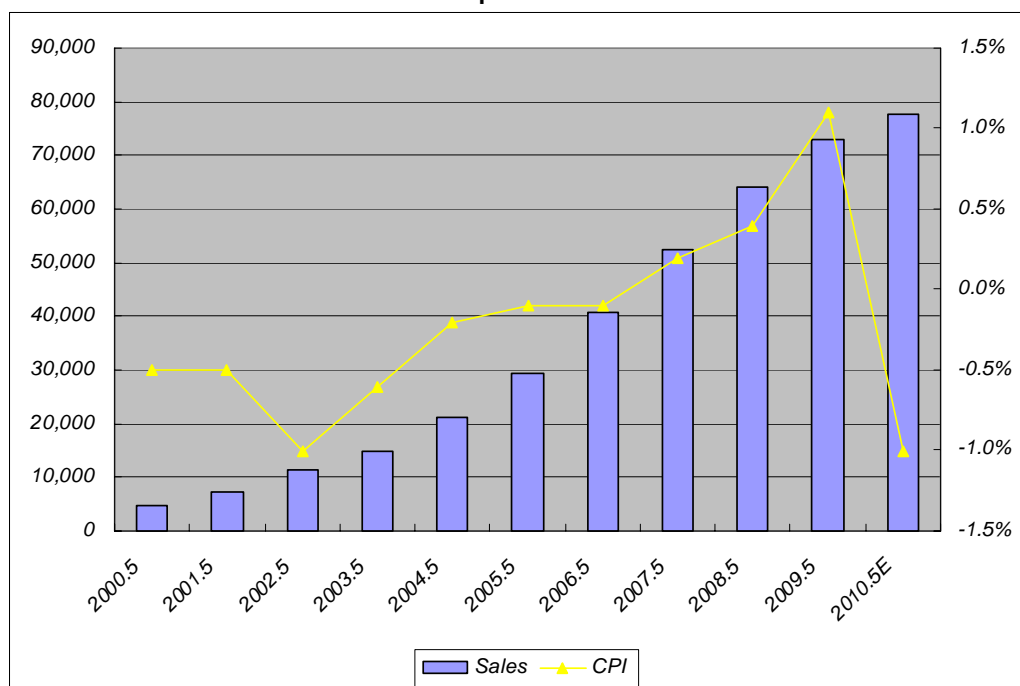
### 3. Deflation Proof Companies

According to the Japanese Government, the GDP gap of Japan is about 8.5%. We recognize deflationary economic environment will continue until a real global economic recovery occurs or the Japanese Government deploys huge fiscal stimulus policy to fill this GDP gap. Under these conditions, deflation proof companies in the Japanese consumer market is one of important investment themes.

We bought Daikokuten Bussan in December 2009 as a structural alpha stock. This company operates a supermarket chain in western Japan and its headquarters is located in Okayama prefecture. Under deflationary environment from fiscal year 1999 to 2005, the company increased its sales volume consistently. Low price imported foods were avoided by Japanese consumers after news reports of toxic frozen foods made in China in 2006. Daikokuten was also affected negatively by the news. Its OP margin bottomed out in fiscal year 2007 and it was 5% in fiscal year 2008. It is expected to improve to 5.5% or more in fiscal year 2009 ending May 2010 even though CPI in Japan is likely to decline to less than 0% at the same time. A 5% OP margin is good statistic for food retailing companies.

## JAPAN INVESTMENT THEME 4Q09

Chart 4: Daikokuten's sales and CPI in Japan



Source: Daikokuten Bussan, Statistical Bureau of Japan, APS Asset Management

Daikokuten was a distributor before it entered into retail market. Therefore, the company knows the inefficient points of the Japanese distribution network. In addition, almost all its employees have experienced supermarket operation at each store. Such experienced employees enable Daikokuten to be creative and flexible in reducing purchase price and developing private label products at reasonable cost. Daikokuten's sales administration expense is also much lower than competitors. Average sales administration expense per sales of Japanese supermarket chains is 22-23% while that of Daikokuten is around 17% and the company is reducing it to below 16%. These low operational costs enable Daikokuten to lower its sales prices. We think Daikokuten Bussan's competitiveness will be enhanced in a deflationary environment and the company will show double digit profit growth in the next five years.

#### 4. Aging Society

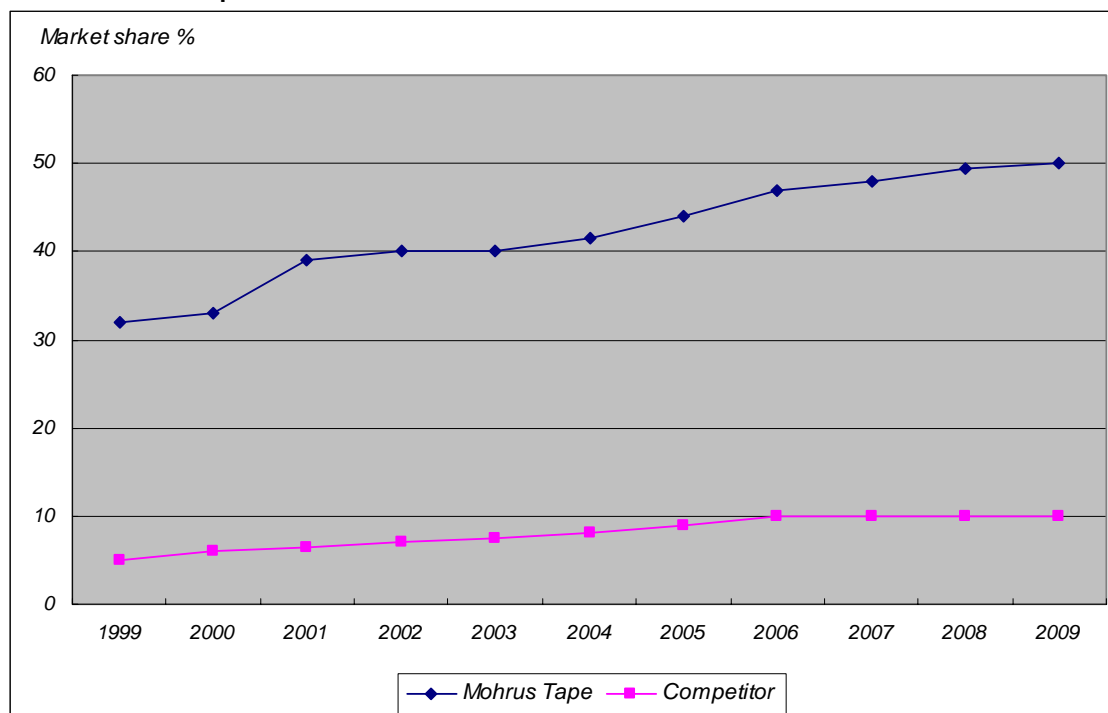
The Japanese demographic profile is that of an older population and the number of 65 years and older citizens will increase continuously in this decade. Products and services for these citizens are expected to grow over the long-term in Japan.

We bought Hisamitsu Pharmaceutical in August 2009 as a structural alpha stock and added to our position in December 2009 after the stock price declined due to an unreasonable drug price cut proposal by the Democratic Party of Japan (DPJ). Hisamitsu is a market leader of mofrus tape drug. It is used for treatment of inveteracy arthritis and most of patients are more than 65 years old people. Mofrus tape needs special production technologies and know-how such as absorbability of drug content from human skin, sustainable adhesive power, comfort of taping, and easy to un-gum. A high level skill is required to make mofrus tape.

Hisamitsu's market share of mofrus tape in Japan has increased from 30% in 1999 to more than 50% in 2009. Although generic mofrus tape has already been launched in Japan, its market share is not high because its quality is not better than Hisamitsu's products.

## JAPAN INVESTMENT THEME 4Q09

Chart 5: Mohrus tape market share



Source: Hisamitsu Pharmaceutical, APS Asset Management

As the Japanese population's age will increase, Hisamitsu's mohrus tape sales will grow due to its strong competitiveness in this market segment. In addition, Hisamitsu is developing mohrus tape for the US market. If the company succeeds in the US drug market, its growth potential would be huge. We expect Hisamitsu to succeed in its launch of the mohrus tape product in the US.

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