FIRST EAGLE
INVESTMENT MANAGEMENT

August 2010

The PM's Perspective

Matt McLennan on Emerging Markets

Matt McLennan on Emerging Markets is the first issue of ***The PM's Perspective,*** a series of interviews with senior members of First Eagle's investment teams. As a firm with a long tradition of independent thinking, we invite you to read market views and strategic insights that come straight from our investors. Whatever your viewpoint, we believe you'll find them of interest.

Q: Why are investors so enthusiastic about the emerging markets?

Investors often take a thematic approach, and emerging markets are very much subject to this kind of thinking. As I travel around the world, I frequently hear people say that they've made a strategic allocation to the BRICs or to the emerging markets because they want to participate in what they perceive to be the growth areas of the world economy.

There's a seductive logic to this notion, but unfortunately the empirical evidence doesn't necessarily support the idea that you're better off making a thematic allocation along those lines. In emerging markets, whilst GDP growth can be very quick from time to time, there's also a lot of structural change in the economy, so the companies generating the earnings today in those economies may not be the companies that will generate the earnings in five or ten years time.

Secondly, there's a great deal of share issuance in the emerging markets because companies that are trying to grow themselves quickly in a fast-growing economy need to use a lot of capital. Often, their free cash flow is negative, and capital allocation for those companies that have positive free cash flows is not always in the shareholders' best interests.

So there are reasons why the top-line growth of the economy doesn't necessarily translate neatly through to the expected return from the ownership of equities. I think that the thematic approach is based upon a premise that's not supported well by the data.

Q: How does your approach differ from the thematic approach?

Our approach to investing is all about trying to preserve capital in real terms over time. We're seeking to avoid the permanent impairment of capital, and to generate an attractive real return. So it's almost like we are seeking winning by not losing.

When you start with that perspective in mind, it makes no sense to adopt a thematic approach. Rather you analyze security by security, asking whether you have a margin of safety when you're investing. The challenge we've found in implementing an investment program in emerging markets today is that many of the emerging markets trade at a valuation premium to the developed markets.

We're able to buy sound, well-established, well-capitalized, prudently managed businesses in places like Japan, Europe and the United States at single-digit multiples of cash flow, whereas in many of the emerging markets that are most sought by investors – including China, India and Brazil – we have found that you have to pay double-digit cash flow multiples to buy many businesses. You're paying a higher price, a higher multiple of cash flow, which means that you're getting a lower yield going in.

The second thing is that in these economies the structural cost of capital ought to be higher because the trend level of inflation is higher and the rate of monetary growth is higher. If you've got a higher multiple of cash flows and you have a higher discount rate, holding all else constant, you're actually likely to be getting a smaller risk premium – or a smaller margin of safety – by investing in emerging markets.

Q: Are you taking a contrarian stand here?

If you look at the acts of omission that we've made over the last three decades, it's often involved being out of the hottest areas of the market – avoiding pockets of the highest valuations or highest balance sheet growth or most new era thinking.[1]

In the late '80s, Japan was seen as the new economy. Obviously, tech, media and telecom were seen as the new economy in the late 1990s. These were dangerous places to be deploying capital because of the prices you had to pay, the balance sheet growth and the dilutive actions of many management teams at the time of those bubbles.

The challenge we find with emerging markets today is that people are paying a premium to buy the new economy. And the value, unfortunately, is in the old economy. As a general principle, trying to just buy the new economy is not necessarily a way to lock in good investment returns.

Q: Are there other factors that give you pause in the emerging markets?

We've been very focused on management behavior One of the things that makes investing in emerging markets quite challenging is that often the management mindset can be quite expeditionary in nature. Of course, it can be in developed markets, as well, but when you've got rapidly growing economies, there tends to be a lot of balance sheet growth. And that's an area where we tend to be somewhat on the more conservative side.

Furthermore, accounting practices can sometimes be questionable in some markets. And often, the largest shareholder in many of the companies in emerging markets is not a family group, but the government. In most cases, the government's objective is to maximize employment, not to maximize cash flow. So you have important stakeholders who aren't necessarily fully aligned in terms of shareholder value. And this is one of the things that's kept us cautious in our general positioning in the emerging markets.

Q: Are there emerging market stocks that you like?

Many of the people who are adopting a thematic approach to investing are buying benchmark-like exposure in these economies, so they end up owning big positions in banks and basic materials companies. This leaves them most susceptible to any form of economic disappointment in these regions. History teaches us is that the process of urbanization and industrialization is not smooth and linear. There are discontinuities; there's social change; there's often political unrest. Yet most investors are getting exposure to the companies that will be most susceptible to these kinds of ups and downs. Banks and basic industry businesses in the emerging markets also tend to consume a great deal of capital as they grow, which means that they are often free-cash-flow negative. Shareholders don't get to see the benefits of these companies' growth and are totally dependent on the exit price of their investments.

First Eagle, by contrast, is very benchmark agnostic. We tend to go where we feel the individual opportunities are, rather than investing along the lines of a benchmark. The composition of what we own in emerging markets is quite different from the traditional investor because we've approached these markets from the bottom-up standpoint and we've sought a margin of safety in our investments.

Currently, we tend to own two classes of business in the emerging markets. The first consists of companies that own long-duration scarce real assets, such as very long-lived precious metals mines. So we have businesses that we believe are likely to be around, selling commodities that are likely to be in demand for the long haul.

Our second group of preferred emerging market companies consists of royalty-like businesses have a lock on a particular market, companies like these operate with very high margins and can generate free cash flow while they are also growing.

Q: Do you participate in the growth of these economies in indirect ways?

One doesn't have to buy a company listed in an emerging market to benefit from the development of emerging markets. Many of our best investments, over time, have been in businesses that invest across the world for their production and also have customers across the world. These "global platform companies" may be listed in developed markets and are often run by management teams that are quite shareholder-oriented.

Our portfolio is full of businesses that are global in nature and are benefiting from the overall rising tide. For example, one of our holdings is Shimano, a Japanese bicycle components company that doesn't just sell bicycle components in Japan; it's the world leader in high-end bicycle components and sells quite a meaningful part of its output into the emerging market world in Asia and the Americas. It's a business that is positioned to grow well over time, but one that is serving its shareholders well by paying a dividend, by buying back its stock, by running with a conservative balance sheet with net cash, and by sticking to is core competency and improving its market share gradually.

The other indirect way we've benefited from the development of emerging markets is through our gold holdings. The emerging markets today, I would argue, have become the monetary epicenter of the world. That's where the growth in the stock of money is occurring. M2 growth, in dollar terms, in China over the last decade has been more than twice that of the United States. In recent years, while M2 growth in the United States, Japan and Europe has been very sluggish at around 2%, it's accelerated to above 20% in China.

We also see very rapid monetary growth in India, with double-digit inflation. And so these economies are growing their money stock at quite a rapid clip. Because the industrial model pursued by many of the emerging markets has been one of being a net exporter, they've also been an accumulator of reserves.

The combination of rapid monetary growth and demand for foreign reserves has also produced, at the margin, a demand for greater gold reserves and also, for the private individuals in these economies, continued demand for gold as a potential hedge against any kind of monetary incident that could occur in these economies.

Obviously, India has been one area where we've seen both central bank buying, but also, over the longer term, strong retail demand for gold. China is a market where, perhaps, there will be more demand going forward for gold.

Q: Beyond the issues of monetary growth and gold, what is your overall assessment of the Chinese economy?

China is the one area where we're looking for evidence of a potential bubble in the economy. In fact, I would go so far as saying that the price of money in China has been somewhat fake. When the currency is pegged and when interest rates are set at a level well below the nominal trend of the economy, we feel it's inevitable that there will be pockets of mal-investment.

Indeed, in the process of industrialization, there has been a property boom of fairly epic proportion in China. Nobody disputes the longer-term trend towards urbanization in China and the gradual shift of the population from rural to urban areas, but the pace of property completion appears to have grown much, much quicker than the underlying trend in population movement. Anecdotally, the cap rates on commercial and residential properties have come down dramatically over the last five to ten years, which implies that people are paying higher and higher multiples for the underlying rent that the properties would otherwise generate.

This gives us some cause for concern, and when we look at some of the industries related to this urbanization trend, we see fairly eye-popping statistics. China today accounts for nearly half the world's steel production, despite being only one-fifth of the world's population with a below-average GDP per capita. This just seems out of line to us. China has almost half the world's cement production and is now the world's largest emitter of CO_2.

So we're starting to see signs that the investment patterns in China could, arguably, be somewhat distorted, and this gives us a little pause for reflection. It's interesting to me, anecdotally, to hear – and this is arguably symptomatic of monetary inflation – that the source of marginal demand not only for things like gold and platinum, but also for other perceived scarce real assets like first-growth Bordeaux wines is now highest in Hong Kong, that the leading purchasers of Antwerp diamonds are now the Chinese, that the Chinese now buy more cars than Americans do on a monthly basis, yet are driving less far. Someone went so far as to indicate that the car is like a real asset that's just stored – a couple of tons of steel as it were. In fact, I believe the most valuable condominium in New York this year was sold to a Chinese business buyer.

Often, the place where we see the marginal dollar of demand for the scarcest real assets is also the region of the world where there is monetary distortion. So we have a wary eye on developments in China. This doesn't mean that things will deteriorate immediately, nor that they have to. There's a great productivity increase in China that can help absorb some of these imperfections. Still, it is an area where we're cautious. And much of the enthusiasm around emerging-market investing in the last couple of years has centered around the China theme.

I think it's fair to say that people's expectations with respect to Chinese growth are somewhat complacent. The idea that China will continue to grow at 10% a year for the next five to ten years when it already emits more CO2 than the United States and already has a monetary stock greater than the United States in M2 terms would seem to be implausible.

Q: Given your questions about the Chinese economy, do you still devote research time to China?

We do, indeed. Our approach is one that's built around patience, and we have a time horizon that's different from many. So we're always doing research into the wish list of businesses we'd like to be owners of and we wait for the prices to come into range.

We have a team of people, including Jean-Marie Eveillard, recently went to China to continue to build their knowledge of businesses in that part of the world. We came across some interesting businesses, and we'll be patient and wait for our opportunity to own them at the right price.

Q: What is your view of India?

I was in India at the end of last year, and there are some things about India that we like compared to China, such as the fact that it is a democracy and the fact that it's earlier in the process of infrastructure build-out and has the Chinese model to follow. Since a lot of companies in India came out of government concessions, a number of them have fairly dominant positions in their industries. I would also describe many of the management teams that we've met in India as quite shareholder oriented.

One problem we have in India is that fiscal discipline at the government level has not been so strong over time. Also, somewhat like China but to a lesser extent, the price of money has not necessarily been fully representative of true supply and demand forces. For example, the banks are forced to own more than a quarter of their assets in government bonds. This pushes down the real yield on government bonds and makes the local population willing not only to bid for scarce real assets like gold, but to bid up other scarce real assets, like real estate or even equities, such that the clearing price for real estate and equities is just not that attractive for us.

We like to pay single-digit multiples of pre-tax operating cash flow when we purchase a business. The problem in India, in many cases, is that you're paying not just double-digit multiples of cash flow, but sometimes in excess of 20 times EBIT to buy good business. And yet the inflation rate in India today is in double digits. It seems to us that the real return that you're getting from Indian equities is not that attractive. We just don't see the margin of safety and price to make us enthusiastic, even if we find the underlying opportunity in India to be intriguing.

Q: What's your view of Brazil?

In some ways, Brazil is a beneficiary of what's been going on in China. Brazil is rich in natural resources from iron ore to oil to agricultural commodities, and as the real price of commodities has more than doubled over the last decade, the fundamental terms of trade for Brazil have improved a lot.

We've also seen a period of fairly rational governance in Brazil. When Lula was elected several years ago, there were concerns that his administration would swing quickly towards populist policies, but he has not. So we've had a window that can be characterized by improving terms of trade and rational policy, and this explains the stellar performance of the Brazilian equity market over the last five or six years.

In a stock market like Brazil's that has already gone up a lot, it's tricky for us, as long-term investors, to find many businesses that embody very conservative expectations. That is why Brazil does not feature heavily in our portfolio today. We do have an investment in the energy space in Brazil where we have a lot of reserve life, but for us, it's been hard to translate the general enthusiasm for Brazil into a suite of potential opportunities for the portfolio. We remain open-minded to finding opportunities in Brazil. We just haven't found that many that we feel are demonstrably mis-priced.

Q: What about Russia?

One of the reasons we've had limited exposure to Russia over time has been the value we place on transparency and property rights. I recall very clearly what happened to Yukos a few years ago where the assets of what was one of the key energy companies outside of North America were effectively expropriated by the government in a tax case. Do shareholders really own Russian businesses? At the top of our pyramid of needs, even above clean accounting, is the assurance of property rights.

Q: As a global fund, can you afford to hold little or nothing in China and India?

In our attempt to preserve our shareholders' capital, we're quite willing to be "short social acceptance". Some of the key acts of omission that we've made in the portfolios over the last three decades have really helped preserve capital. Japan in 1989 was the largest market in the world; tech, media and telecom in the late 1990s was the largest sector; financials were the largest sector in 2007-2008. At each point in time, people said, "Can you afford not to be there?"

The mere scale of a market will never force us to invest capital. We don't think in a relative return world. We try to avoid permanent impairment of capital, and we invest only if we find what we believe are good businesses at good prices. We have no need to be exposed for the sake of exposure. As Jean-Marie Eveillard said in the late 1990s, we'd prefer to lose half of our clients than half of their money.

Q: Patience seems to be an important element in your approach.

Given that growth in emerging markets is not linear, given that it's cyclical and somewhat volatile, we'd prefer to buy into windows of distress. We'd prefer to provide liquidity when no one else wants to. And there's no shortage of liquidity flowing into the emerging markets right now. We're positioning ourselves for a less-than-perfect reality, and this makes us more attuned to the importance of demanding a margin of safety in our investments at the individual company level. We're prepared to wait as long as necessary for this condition to be met.

Matt McLennan, CFA, Portfolio Manager

Matt McLennan, head of the Global Value team, joined First Eagle Investment Management in 2008. Prior to that, he worked for Goldman Sachs Asset Management (GSAM) in London as co-portfolio manager of Global Equity Partners, a group he founded, which ran a focused global equity portfolio for offshore private wealth clients. The portfolio used a value-driven approach with an absolute-return focus that emphasized low turnover and downside protection. He was named a managing director at Goldman Sachs after serving as co-founder and equity chief investment officer of the firm's Investment Strategy Group for private wealth clients. Before that, he was senior portfolio manager and co-portfolio manager of Goldman's U.S. Small-Cap Value and U.S. Mid-Cap Value strategies. Matt started his career with Queensland Investment Corporation (Australia) in 1991, where he eventually managed over one billion dollars in international equity portfolios. Born in Rabaul, Papua New Guinea, he grew up in Queensland, Australia and received his Bachelor of Commerce with first-class honors from the University of Queensland.

1. First Eagle began managing the product referred to herein on January 1, 2000. Performance for periods prior to that occurred while managed at another firm.