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Newsflash

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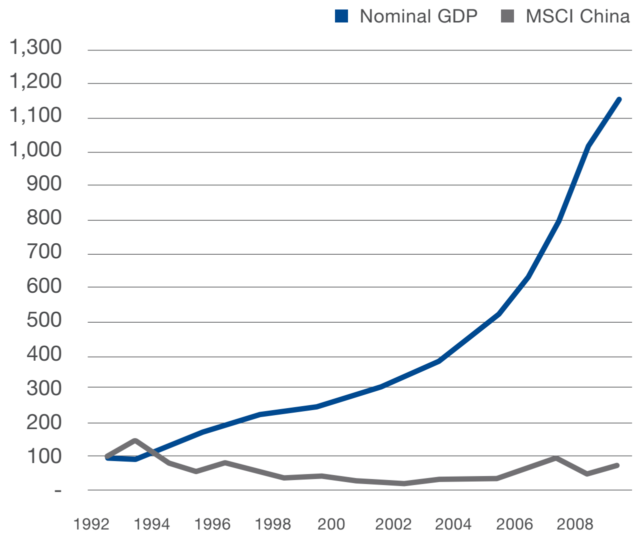
On the 11th and 12th of October RMB Asset Management held its annual Think Tank for the 11th consecutive year. This time around the setting was Hong Kong, and the focus was on the theme of global rebalancing – essentially the Asian growth story. It was interesting to note how many of the investment professionals that presented across a range of asset classes and geographical regions emphasized the importance of valuations when considering investments. Economic growth certainly plays an important role, but as Hugh Young from Aberdeen illustrated with the two graphs on the next page, strong growth in GDP does not necessarily translate into strong growth in the same country's stock market.

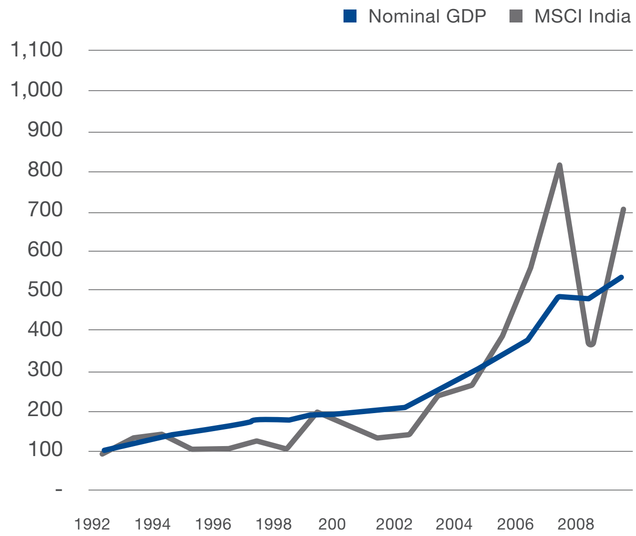
In China, top line growth has flowed to stakeholders including government, employees and local suppliers, but not to the minority shareholders. Contrast this with India, where a well-established culture of corporate enterprise going back more than a century, set within a strong legal framework, has enabled shareholders to benefit from the buoyant growth in the economy.

September has historically been the worst month for equity markets, but last month's improvement in the tone of US economic data has gone a long way to easing fears of a double-dip recession and resulted in strong performance for global equities. In local currency terms the major markets rallied with the United States' S&P 500 (+8.9%) leading the way. In Europe (+4.3%), the United Kingdom (+6.5%) and

China: Nominal GDP versus MSCI China index (US$)



India: Nominal GDP versus MSCI India index (US$)



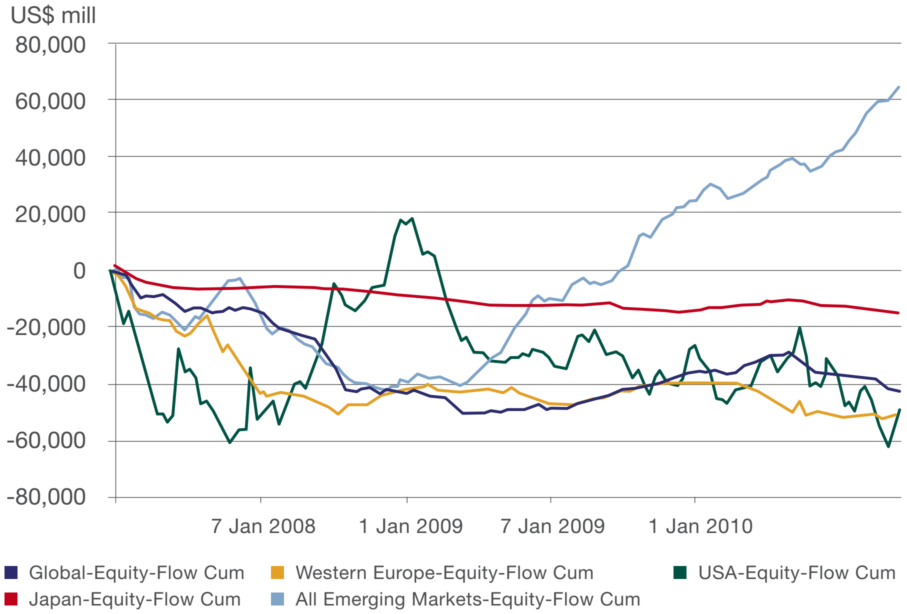
Source: Bloomberg, end Dec 09

Japan (+3.9%) equities also pushed ahead but the weak US Dollar resulted in a stronger performance in markets pegged to the greenback than in these markets. Emerging market equities gained 11.1%, with global developed markets (as measured by the MSCI World index) ending the month 9.3% higher.

Even though the month's strong equity performance could be ascribed to a fair number of positive economic data surprises, this was more a reflection of a lowering of expectations than a genuine improvement in the data flow. Data across housing, employment and industrial production still points to a lethargic recovery, especially in the US. Despite the headwinds that abound the US should nonetheless avoid a double dip recession. Other news out of the land of the brave and the free is that the second round of quantitative easing (or QE2 as it's now affectionately known) will in all possibility take place before the end of the year in order to support asset prices. This has pushed down real interest rates in the US, but has not (yet) created a government bond bubble. The yield on the ten year US treasury should roughly equate to the market's expectation of what the geometric average of the Federal Reserve's funds rate would be for the next ten years. Historically the real Fed funds rate has been 2.5% on average. In the light of the market's current long term inflation of around 2%, it seems as if an equilibrium funds rate should be around 4.5%. Given our expectation that short-term interest rates will remain at their current levels for some time we can't see the Fed rushing to get to this "appropriate" level. As deleveraging is a multi year process and will produce a drag on the economy as debts are repaid, the Fed will have to compensate for this damper on growth by keeping their rates lower than what conventional theory would suggest. If this equates to a Fed funds rate which is consistently one percent lower than during a "normal" economic recovery, it's easy to see the Federal Reserve keeping rates between three and four percent for most of the next decade. This means that a yield of between 2.5% and 3% on the 10-year government note does not relate to a bubble in bond markets.

Bond markets were somewhat weaker over the month as yields on government bonds in the US, UK and Europe stayed flat or increased, after probably being overbought in August. Global government bonds (as measured by the JP Morgan Global Government Bond Index) gained 2.2%, but this was entirely due to the weakness of the greenback against the

Cumulative flows into major equity fund groups. 08-YTD 10



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Japanese Yen, euro and Pound Sterling. Investment grade corporate bonds held up somewhat better, with high yield bonds in the US (+3.0%) and Europe (+3.2%) benefiting from the improvement in equity markets. Convertible bonds also gained (UBS Global Convertible Bond Index +5.5%) but the valuation anomaly that existed throughout the end of 2008 and 2009 has now been fully priced and the asset class does not look significantly more attractive than a combination of equities and corporate bonds.

The greenback struggled against most currencies, with the euro unexpectedly leading the charge. Talk of "currency wars" abounded in early October as it's clear that many major economies would benefit from a weaker currency. We think that "war" is a very strong word to describe what's going on, but the occurrence of periodic tussles would seem to be all but a certainty. The Germans (whose industrial production was up strongly in July and August on the back of a weak euro) have tasted the benefits of a weak currency and policymakers around the globe will surely contemplate currency intervention in order to boost exports and thus aid their struggling economies.

A region where economies seem to be anything but struggling is Asia, as we saw first-hand during the conference. There is a lot of optimism in emerging markets, and investment flows have clearly shown this so far this year as illustrated by the graph above. The question from an investment point of view is surely whether this optimism is fully priced into emerging market valuations – we certainly think so. RMB Asset Management's Chris Mahon explores this in September's FOCUS section. It's a time to focus on valuations, and be brave in your allocation of capital, as large short-term market fluctuations are not behind us.

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. September 2010. Past performance is not indicative of future returns.

Asset Class Performances

Asset Class/Region	Index	Currency	Sep 2010	YTD 2010
Equities				
United States	S&P 500 NR	USD	8.9	3.4
United Kingdom	FTSE All Share TR	GBP	6.5	6.7
Continental Europe	MSCI Europe ex UK NR	EUR	4.3	2.9
Japan	Topix TR	JPY	3.9	-6.9
Australia	S&P/ASX 300 TR	AUD	4.8	-2.6
Global	MSCI World NR	USD	9.3	2.6
Global Emerging Markets	MSCI World Emerging Markets TR	USD	11.1	10.8
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	0.0	9.0
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.6	7.1
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.7	10.8
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	3.0	11.4
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-0.6	9.9
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	0.0	11.4
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-1.2	4.6
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-0.3	6.5
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	3.2	14.9
Australian Government	JP Morgan Japan Government Bond Index TR	AUD	0.1	3.4
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	-1.0	6.3
Global Government Bonds	JP Morgan Global GBI	USD	2.2	8.4
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	2.2	6.2
Global Convertible Bonds	UBS Global Convertible Bond	USD	5.5	5.8
Global Emerging Market Bonds		USD	1.8	14.5

Asset Class/Region	Index	Currency	Sep 2010	YTD 2010
Property				
US Property securities	MSCI US REIT TR	USD	4.3	18.6
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	5.7	-2.4
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	10.0	17.9
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	9.9	7.6
Australian Property securities	FTSE EPRA/NAREIT Australia TR	AUD	7.8	9.3
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	8.3	10.1
Currencies				
Euro		USD	7.4	-4.9
Sterling		USD	2.5	-2.4
Yen		USD	0.5	11.4
Australian Dollar		USD	8.8	7.7
Rand		USD	5.8	5.6
Commodities				
Commodities	RICI TR	USD	8.6	2.7
Agricultural Commodities	RICI Agriculture TR	USD	8.4	11.3
Oil	ICE Crude Oil CR	USD	2.6	0.5
Gold	Gold index	USD	4.9	16.2
Interest rates	**Last meeting**		**Current rate**	**Change at meeting**
United States	21 September 2010	USD	0.25%	No change
United Kingdom	07 October 2010	GBP	0.50%	No change
Eurozone	07 October 2010	EUR	1.00%	No change
Japan	05 October 2010	JPY	0.10%	No change
Australia	05 October 2010	AUD	4.50%	No change
South Africa	10 September 2010	ZAR	6.10%	-50bps

Source: Lipper Hindsight, August 2010

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. September 2010. Past performance is not indicative of future returns.

FOCUS: The days of emerging market outperformance are over

Chris Mahon, international strategist, RMB Asset Management International Investors banking on a strong economic performance to underwrite emerging market ('EM') returns are taking a leap of faith that is not justified either by history or by the current valuations, argues Christopher Mahon, International Strategist at RMB Asset Management International.

"Better GDP numbers = better equity returns". This relationship is one of the great leaps of faith that investors make when deciding their regional asset allocation; and the implication is simple: go for the region with the best economic performance. For many investors today, this means channelling investments into emerging markets.

But over the long run the relationship between GDP and equity returns is much weaker than investors might hope.

For example (according to MSCI Barra), of the major developed markets from 1969-2009, the top three fastest growing economies were Australia, Norway, and Spain. Yet real returns from those equity markets were actually worse than equity returns in the slowest growing countries: Germany, Denmark, and Switzerland.

Market analysis

Extending the time frame or including emerging markets doesn't change the picture. A recent London Business School analysis of stock market returns of 53 countries over 108 years, encompassing both developed and emerging economies, found the most sluggish economies outperformed sharply, posting 12 per cent equity returns, against returns of 6 to 7 per cent for the remainder of the sample.

Both studies show that backing GDP growth in the hope of better equity returns wouldn't have worked.

To some extent, this can simply be explained by using valuations as a starting point. High growth regions often have even higher expectations built into the price of the equity market, and so are more likely to disappoint. This is most certainly true of emerging markets today which already trade at a premium. High hopes are already built into the price.

In addition to the valuation story, there is another more subtle reason for a weak link between GDP and equity performance: equity issuance.

Missing link

To demonstrate this, if GDP has any link to corporate performance, theoretically this link should be strongest and most visible at the sales level. Theory suggests the top line should grow fastest in fast growing economies.

But while this is true for corporate income statements, it does not translate to the 'per share' level. Over the last ten years, for example, emerging markets have seen spectacular GDP growth, but sales per share have grown slower than the US.

The difference between the two is mainly due to greater equity issuance, which historically has been very high in the emerging world.

Sometimes the high levels of issuance are underpinned by strong economic rationale: think about the Malaysian food distributor who issues equity to fund his rapid expansion.
Sometimes the high levels of issuance are due to worse corporate governance: think about the Russian oligarch who doubles as CEO for his company, who as majority shareholder votes through fabulously lucrative share options packages.

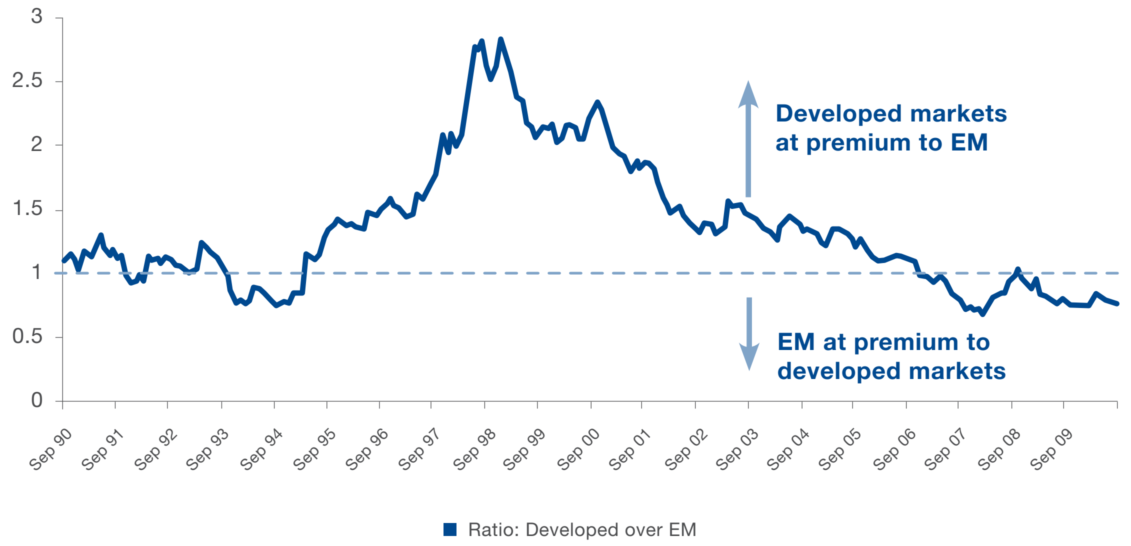
Premium trade

Either way the impact is the same: as an investor, your shareholding becomes diluted. History suggests investors in emerging markets should expect much more issuance than in the developed markets – even in boom times.

Currently EM trades at a premium to developed markets. Believers in EM will claim this is due to higher margins and faster sales growth. Is the premium plausible?

Source: RMB Asset Management / Bloomberg / Lipper Hindsight.
September 2010. Past performance is not indicative of future returns.

Equity markets: Ratio of developed to emerging market P/B ratios



Right now, the MSCI Emerging Market Index trades at a 12% to a 22% premium (depending on the metric) to its developed market peer, the MSCI World Index.

This is not far off 2007 when it traded at a 15% to 36% premium. History shows us that was too much.

Our own analysis suggests that if you believe the EM GDP story, you could just about justify a 10-15% premium, but not more.

Market timing

The time to buy was ten years ago when it was trading at a 25-35% discount.

But today, whichever way you look at the emerging markets, the valuations are too expensive. This means the days of outperformance for EM are over and the days to be overweight EM are behind us.

Put simply, relative to developed markets, emerging markets are an asset class priced for perfection with no margin for error to a long term investor. Expecting EM to continue to outperform is at the very least, optimistic

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. September 2010. Past performance is not indicative of future returns.

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