SeaBridge Asia Strategy
Third Quarter 2014
Commentary

The economic data coming out of China has been weak, particularly in fixed asset investment which has turned down substantially since late summer. While this is in keeping with the latest five year plan's reduced reliance on low return investment for economic growth, it raises concerns about growth generally. The People's Bank of China has responded to this and other tepid signals of growth by injecting $80 billion dollars into the commercial banking system. Other stimulus may follow. While we are discomforted by the need for strong central bank intervention, as we are by all extraordinary quantitative easing initiatives around the world, there is some truth to Premier Li's downplaying the action and stating that the government won't be distracted by short-term fluctuations in individual economic indicators and will maintain its focus on structural adjustments for the long term. So long as China's economy avoids a precipitous decline, as we expect, we tend to agree with the premier.

China badly needs "structural adjustments" to promote a successful transition to a self sustaining, consumer oriented economy. However, the efficacy of these reforms now underway, such as the liberalization of the financial system, will not be known until years from now. In the interim, there will be investor uneasiness over their China exposure. We would like to take the opportunity to address these concerns by assessing in this letter portfolio risks associated with investing in China specifically and, more broadly, in emerging economies.

An emerging economy is one that moves away from a necessary reliance on agriculture, natural resource exploitation and low grade manufacturing toward a more productive economic model involving the production and distribution of higher value added goods and services. Emerging economies are characterized by rapid growth, rapid change and higher volatility in the measures we use to gauge soundness. An emerging market is further defined by illiquidity in markets (both debt and equity) and the inadequacy of its securities exchanges and their regulation. If we were to apply this definition in its entirety to the Asia strategy portfolios, only China among all countries represented, by domicile of company, could be considered emerging. Even among countries sometimes deemed frontier markets such as Indonesia and the Philippines, there are active, regulated markets in both debt and equities. Clearly, this definition of emerging does not capture the total risk of investing in these countries. On the other hand, there are countries characterized as emerging by such risk assessors as Standard and Poor's and MSCI BARRA that seem to have clearly gone beyond the spirit of that designation. South Korea and Taiwan fall into this category. We view both as developed markets and include them in our Asia strategy portfolios.

To truly assess country risk in the portfolio, we really should take into account those characteristics we associate with developed status such as high literacy rates, the quality of the health care system, the rule of law and the inclusiveness and transparency of the political system. To an investor, these are the risk dampening elements to the investment environment. Perhaps the short cut measure that best captures the developed vs. emerging construct is per capita GDP under the assumption that personal income is a proxy for quality of life and, importantly to investors, the legal protections minority shareholders, like us, require as a condition for investing.

Applying these criteria in our country risk assessment, we don't discount domicile but recognize that place of incorporation neither captures the true risk associated with minority ownership nor a firm's growth trajectory, which may deviate dramatically from GDP growth of the host country. Instead, we have focused on revenue source in our portfolio companies by geography under the reasonable assumption that the quality and the sustainability of those revenues is higher in those countries where per capita GDP comfortably exceeds the emerging standard which is cited by the World Bank as about US$12,500. Although our the data is difficult to pin down, our review indicates that roughly 2/3 of revenue from portfolio companies emanates from countries including those inside and outside Asia with GDP per capita of US$32,000 or higher.

Taking the analysis further, we estimate that about 10% of portfolio company revenues comes from China, our largest holding in an emerging market. At this level, the downside to a hard landing in China would hardly be catastrophic. On the other hand, China and its 7% GDP growth rate, with the rest of fast growing emerging Asia, represents the growth dimension of portfolio companies firmly established in more developed markets. We believe that we have the best of both worlds in the portfolio. We mitigate our emerging risk by having a preponderance of Asian companies anchored in the developed world by revenue source, but we aim to participate in the potential upside that the higher growth emerging world brings.

The world is rapidly changing. If the designation of emerging becomes ever more elusive, the idea of globalization becomes ever more entrenched. It is clear to us that the domicile of a company has little bearing on a company's prospects. In addition to geographically diversified earnings streams, companies are now more than ever on the move seeking lower taxes, cheap capital and competitive advantages in producing and distributing their goods and services. This diversification is not only characteristic of larger companies but is a feature all the way down the market cap spectrum. Li & Fung, for example, is a quintessential Asia firm, yet most of its revenue comes from the US. Although it sources its soft and hard goods in Asia, it also procures from outside the region and we believe will increasingly do so. We have the much smaller Hong Kong listed Johnson Electric, a manufacturer of micro motors used in automobiles and industrial applications. For many years, before it fell on hard times, Johnson Electric was a constituent stock of the Hang Seng Index. The company has long had factories in Asia producing for Chinese and other Asian customers. But now they also manufacture in Mexico and Eastern Europe with through sales to North America and Europe. And it is the case that many of their Asian customers, like the Japanese car companies making autos in Thailand, are selling much of their product in overseas developed markets.

The portfolio is filled with such examples. There probably isn't a pure Asia play in the portfolio, both by design and for the simple reason that there are few purely Asian companies. Coach is another case in point. Most of its revenue comes from North America, but it is the Asian business that is growing and, unlike North America, is in no need of repair. To the extent the firm has value which exceeds its current traded price, it is certainly, at least partially, because of its Asian business. We hold it for this reason and for the hopeful eventuality that the North America business is fixed.

It may now be more difficult to make the case that the global component in any regional portfolio mitigates the investment risk of that region. Currently, we are experiencing asynchronous growth prospects with the US accelerating and the rest of the world, including importantly Europe, for the most part slowing. The current obvious geopolitical risks, including the global war on terrorism, and an adventurous Russia could upend energy and currency markets which would have profound effect on both the emerging and the developed worlds. In Hong Kong, there have been demonstrations in the streets over China's insistence that candidates running for chief executive in 2017 must first win majority approval by a pro-Beijing nomination committee. On the other hand, salutary outcomes in elections in India and Indonesia, which are more local in their economic profiles, served as catalysts for stock market rallies in those countries. Still it is our view that the geographic diversification of earnings streams in our portfolio dampens investment risk.

We have never been seduced by the hyper growth prospects that the emerging markets have to offer. In this context, we are unlikely to participate meaningfully in the coming listing of China companies on the Hong Kong exchange commonly known as the Hong-Kong Shanghai Stock Connect. Under the scheme, local investors, institutional and retail, would trade Shanghai 'A' shares via the Hong Kong stock exchange while Chinese mainland investors would trade Hong Kong 'H' shares via the Shanghai Stock Exchange for the first time. (At present, only qualified institutional investors abroad with secured quota from the government can invest directly in China's domestic markets.) We have shied away from China specific companies already listed in the H share market in Hong Kong because of their China only pedigree and see little reason to change our view simply because there will be more of these companies listed.

We are fundamental investors. We judge companies by competitive advantage, quality of management, returns on capital, treatment of shareholders and earnings growth potential. We are satisfied that if we adhere to our investment discipline, that over time the portfolio should produce satisfactory returns.

David Descalzi
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See general disclosures at the end of the document.

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