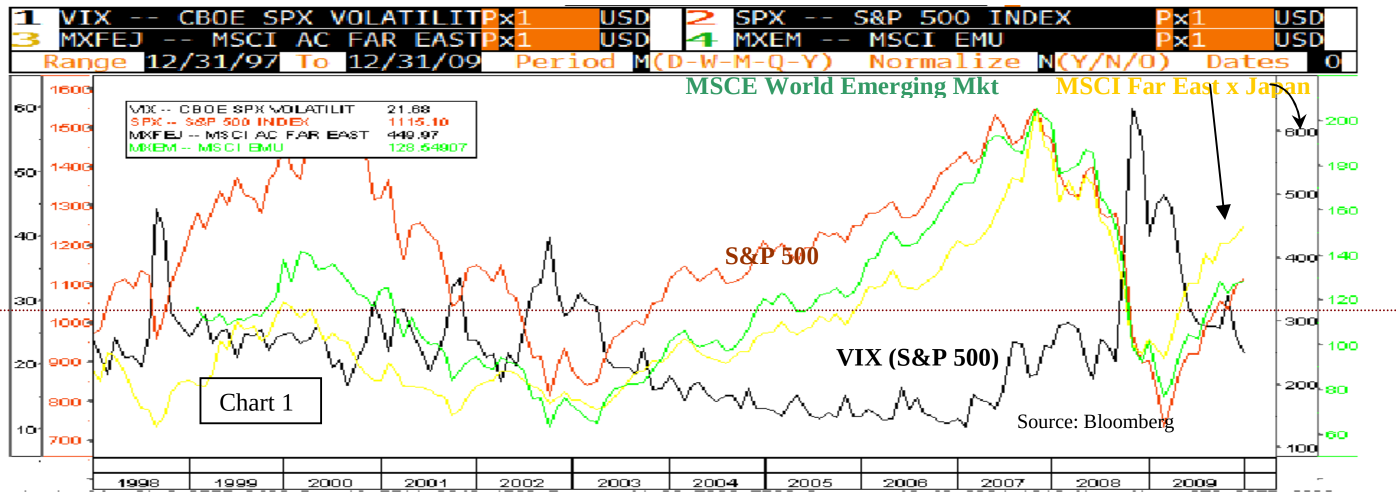
The Issues

February 2010

MARKET VOLATILITY--A SEPARATE RISK FACTOR

Once again, rising volatility has returned to haunt stock markets. Based on recent history, volatility is nothing new. Chart 1 shows many interim double-digit swings within two major market cycles in the S&P 500, MSCI Far East ex Japan and MSCI World Emerging Market indexes from 1998 to 2009.

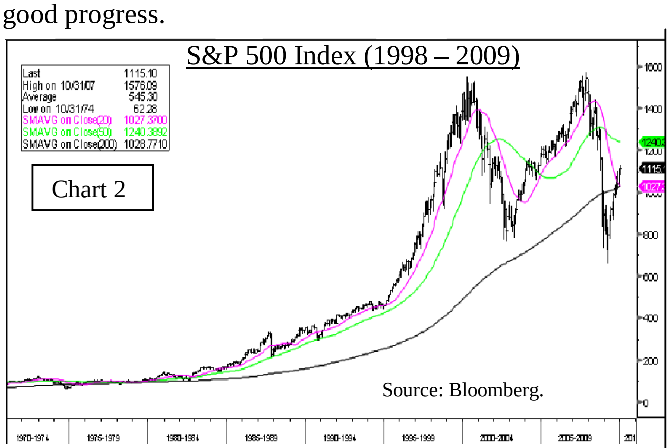


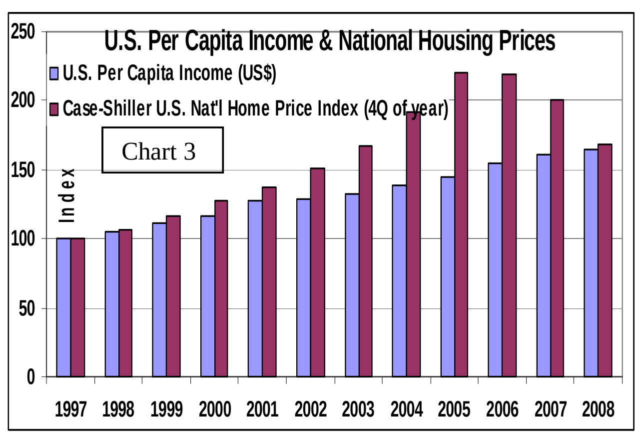
In terms of the magnitude of volatility and frequency, two record-breaking global stock market booms and busts occurred within this 12-year period (for perspective on the S&P since 1970, see Chart 2, below). Note that the origins of the most recent stock market crashes were excesses in capital markets (the sky-high share valuation of IT bubble in 1999 and securitization running amok 2004-07)→drove financial meltdowns→economic downturns—a reverse of the patterns of prior decades when real economic excesses→credit crunch→economic recessions→bear markets.

Disconnect with the Real Economy

Cumulatively, the S&P was up a paltry +14% and the World Emerging Markets Index was up +12% (based on records from January 1999) during the 12 years from 1998 to 2008. The MSCI Far East x Japan doubled, thanks to the base effect from Asian bourses being in the depth of the Asian financial crisis at end-1997.

In contrast, U.S. per capita income rose a cumulative +65% (Source: BEA, U.S. Dept. of Commerce.), and home prices nationwide, based on theCase-Shiller Index, were up +68% from1998 to 2008 (Chart 3). Clearly, the real economy made good progress.





What has been the utility (meaning usefulness or something useful such as a service to the public) for investors in capital markets over the 12-year period? Nothing. An investor in an S&P-linked ETF (exchange-traded fund) and half of all U.S. mutual funds benchmarked against that index would have made less money than bank deposits over that period. In fact, factoring in the volatility experienced, the risk-adjusted return has been decidedly negative.

Reasons for Market Volatility

1. *Increased use of leverage*. Carried trades and the use of geared instruments, derivatives and futures all offer final exposure at a multiple of the invested sum. An elevated scale of buying exaggerates the rise in price of a security. In a downturn, the urgent reversal of gearing accelerates the plunge. Instruments for shorting are also leveraged products and greatly increase the amount of selling. Investment banks would agree: at the depth of the 2008 financial meltdown when bank shares were under attack, they wanted short selling--the very instrument of their invention--banned.

2. *Speculative capital* in financial markets has grown to a size that can majorly influence market directions. In commodity as well as stock markets, it is the change of supply/demand at the margin (of a few percentage points) that dictates prices for the 95%+ rest of the market. A size of a few billions to tens of billions of dollars is sufficient to set trends in most commodities and emerging stock markets.

Financial speculators were a major force behind the huge price spike in oil, metals and soft commodities, including grains, during 1H08 and the severe plunge thereafter. When a financial speculator buys futures in oil or grains using ETFs or commodity futures and options, the economic impact of that purchase is the same as hoarding. Why? Let's assume the seller is one of the commodity producers. Once a producer sells part of his supply (spot or future) to a speculator/buyer, supply (spot or future) is reduced by that amount until the buyer/speculator unloads their position. Thus, the net economic effect during the holding period is the same as hoarding--prices are driven higher than otherwise. In a downturn, shorts accentuate the downtrend.

3. *Structured products and derivatives,* typically structured with put features, have been channels of huge amounts of speculative capital. Prime examples are CDS (credit default swaps) and Accumulators (distributed to retail investors in Hong Kong)--pure speculative bets undertaken by two parties (on corporate defaults and stock prices, respectively) with *zero* economic utility, as the gain of one is the loss of the other. Contrast that with a win-win situation such as the rise in share price of a successful business, which benefits shareholders (buyers of the shares) and the firm (the issuer/seller).

Various structured products were sold in global markets, the common thread being their put features. Without their creation, the underlying holders (hedge funds, proprietary traders, creators of securitized debts) would never have built up such overtly large, i.e., excessive, long positions in stocks, CDOs and the like in the first place. Thus, the way these instruments were used greatly contributed to the formation of financial froth and the subsequent bust.

Human herding instincts are very susceptible to trends and momentum, the driver that causes *greed and fear* to self-feed into upward or downward spirals. Leveraged <u>derivatives and speculative bets are thus the steroids of greed and fear,</u> sharpening a market's uptrend and subsequent plunge. Greed drove AIG to underwrite CDS in such volume that a systemic financial bomb was created. Accumulators were distributed in Hong Kong to retail investors, who did not understand the risks of writing puts at stated prices and quantities with locked-in maturities of up to two years. The vicious cycle of forced selling by retail investors caught by the triggering of successive puts as the market declined had greatly steepened the 2008 fall, a plunge that, in turn, heightened the fear factor that resulted in panic selling.

Disconnect with Real Economic Performance: Higher Volatility = Greater Risks

The greater the volatility of stock markets, the greater the risks for investors being caught with the wrong timing. Higher risks require a higher discount rate on potential future returns in compensation. In PER terms, that means derating, the source of the disconnect and overall lack of progress for stock market indexes over the 12-year period studied. <u>Market volatility has become a significant type of risk that cannot be ignored</u>, a risk different from risks associated with economic and political fundamentals.

Current Market Conditions

Of late, markets are back in a jittery period. When investors cite known negative news to justify selling that was ignored when markets were going up, that's the fear factor taking charge. Major surfacing concerns have ranged from China's tightening loan growth and rising CPI to the credibility of Bernanke and Geithner being under fire, which has cast a shadow over the economic policy stewardship of the Obama administration when the U.S. economy is still sailing in stormy waters.

All of the above concerns are valid. Will credit controls derail economic growth in China? In the U.S., can the Obama administration maintain public confidence to set things right or will it become tangled in a political impasse?

Loan Growth in China

Runaway loan growth in China reflects the structural deficiency of the system. Bankers at local levels tend to entertain the credit needs of large, local business/politically vested interest groups. The networking and allegiance of these groups are to relationships in their local areas, not to the top management of banks with headquarters in Beijing or Shanghai.

Banks in China therefore have a tendency to over-lend. The central bank sets overall lending targets annually, and at the start of every year a new accounting period begins. Thus, for years, more loans are made during the first half of a year, as by the second half, the system is usually already over-loaned, and the central bank may step in with quotas.

When loan flood gates are initially opened, borrowers grab what they can because if they don't, others will; and if enough borrowers think that way, the bigger the rush will be, eventually forcing the gates to close, which happened in 2009. This year is again the start of a new accounting period and, sure enough, the rush is on. Over Rmb1,000 billion in loans were made in the first three weeks of January (vs. Rmb9,600 billion net loan growth for the whole of 2009, in itself a record).

The problem, therefore, is not about credit tightening, which is the market's current (wrong) interpretation. So much has already been loaned that even if no loans are made for the rest of 1Q10 (an unlikely event), the economy would still be flush with liquidity. The problem is structural: how to reform bank management so that credit extension is based on economic terms rather than on social/political relationships. The stock market fall has already discounted a rise in CPI to 3% to 4% over coming months, including a modest rise in interest rates. CPI pressure should abate by mid-year (low base effect from the plunge in commodity prices in 1H09). Government policy in China is definitely very much pro-growth, and domestic consumption (especially in the rural sector) will be the key engine.

U.S. Politics

We cannot discount the risk of a policy vacuum such as an Obama administration rendered inept by political fighting. For this reason, our investment policy has continued to be cautious. Since 4Q09 we have reduced portfolio beta, focusing only on "safety island" sectors and bottom-up stocks in Asia Pacific that can maintain double-digit earnings growth in the face of very sluggish global growth. We view the current stock market correction as a healthy process because it will dampen overly optimistic investors and present buying opportunities in sectors and stocks we like.

Our Investment Policy

Using a mix of sector and bottom-up stock situations (typically, non-major index stocks that produce low index correlations) driven by their own fundamentals is one of the ways we manage market volatility risk. Within this mix, we maintain an appropriate exposure to marketable stocks. Should the fear factor escalate, we actively use cash to hedge across-the-board decline risks. Chart 4 shows the alpha and beta readings of various periods over 10 years for our GSI Asian Capital Growth Fund. Consistently, the fund has the lowest beta versus a selected universe of competitors, and its alpha is among the top-ranking funds.

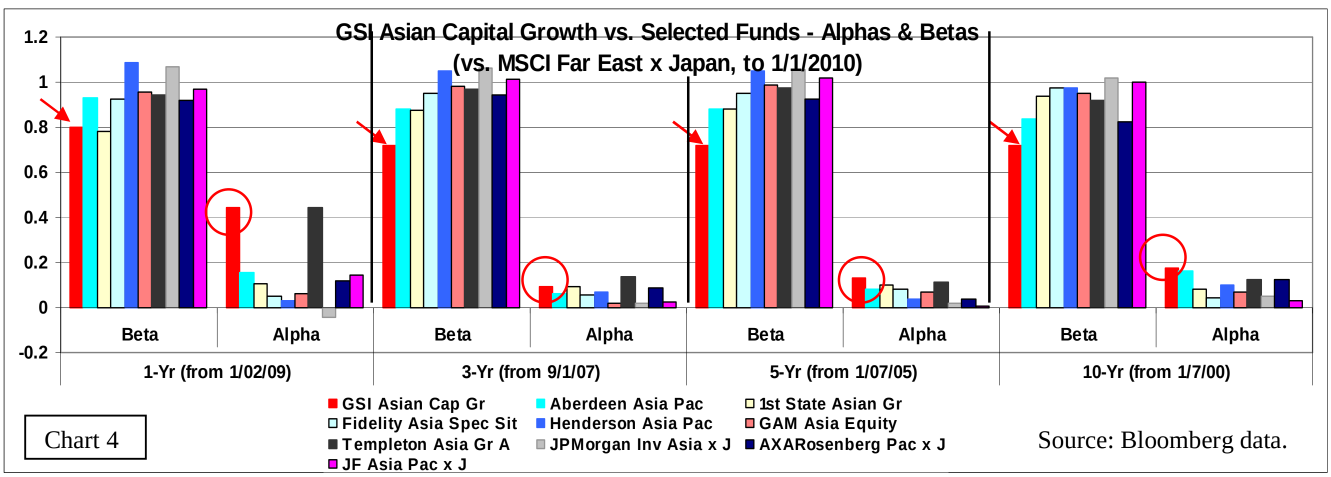


Chart 4

Source: Bloomberg data.

Currently, our regional funds have already raised cash of nearly 10%--the fire-power to bargain hunt when sentiment stabilizes. We see the current setback as a much-needed consolidation of the hefty gains in 2009. Public policies in China and the U.S. will likely stay pro-growth, and liquidity conditions in Asia-Pacific remain plentiful. In the U.S., it will be a long time before the Fed can really undertake any exit policy. Private sector debt in the U.S. is still shrinking, and economic activities over coming quarters will thus remain very sluggish. The Fed will likely keep liquidity conditions easy well into 2010, which is positive for equities. And in an election year, politicians will go for pro-growth, populist policies.

The Net Asset Values GSI Asia Capital Growth—US$23.64 & the Long/Short Fund—US$21.96 (Jan 28, 2010)