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CHINA AND INDIA, TWO EMERGING GIANTS

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by Alex Nicholas Lee

Nick Scott, Chief Investment Officer at Prudential Asset Management (Hong Kong) shares on his bullish outlook and the investment prospects for both China and India.

1. What do you make of China's move to reform its currency system and allow a modest appreciation of its currency?

We do not expect rising currencies in either China or Asia to cripple Asia's economic growth. We view China's recent moves as being more important in that they have regained a measure of control over their domestic monetary policy that was denied by the rigidities of maintaining the peg. In all, we view it as a positive step forward.

2. The Indian bourse has done extremely well this year. What are the reasons for the strong performance and do you see the stock market heading higher?

After losing steam in the second quarter, India is back on top. The market came under downward pressure earlier this year largely because valuation ceilings were being reached. While valuations were not as high as they have been, they were approaching short-term, cyclical highs. With concerns surrounding higher inflation and interest rates, many investors decided to lock in some profits.

Since then, several factors have swung in the market's favour. Initial disappointment at the undoubtedly good results season was overcome as investors acknowledged that earlier high expectations had been excessive. Corporate and government news since then has been good leading to an upgrading of the profits forecasts. Earlier fears that the central bank would be more aggressive in raising domestic interest rates also proved unfounded. These factors resulted in international investors again re-entering the market, which was already buoyed by a high level of domestic liquidity.

As at late August, however, valuations are again an issue. They are sufficiently high to stop any rally on any bad news but sufficiently low to trigger further rallies should more good news appear. Prudential would thus not be surprised to see the rallies again temper in the coming months.

Our medium term view remains positive. We believe that economic growth should continue to be strong in the current financial year. The GDP forecast is for growth to be at 7% in 2006, and has the overnight borrowing rate to remain unchanged at 5%. Consumption and investment growth trends remain positive. Fundamentally, the market outlook remains sounds. India can provide decent upside for a patient investor with a medium-term investment horizon.

Over the longer term, the strength of India's economic and stock market performance is grounded on the outsourcing phenomenon. Growth in the higher-income white-collar jobs sector is creating a vibrant middle-class. And because India is young and educated (half the population is under 25), demand for services such as banking, telecommunication, and cars are expected to grow in the next decade.

3. What is the proportion of the Fund invested in China and India respectively? If there were changes, can you explain the reasons for this? Looking ahead are you more bullish on stocks in China or India?

As at 31 July 2005, the Fund was 43.6% invested in India-related equities and 47.2% invested in China-related equities. In January 2005, the Fund was 51.63% invested in India-related equities and 43.38% invested in China-related equities. Prudential has become more positive on the China stocks over the past six months that until recently, we saw as being expensive. Value is emerging in selected sectors, particularly the power companies and port operators as the latter are best exposed to China's export growth, in our opinion.

The major tilts of the portfolio have also swung away from the infrastructure-related stocks in favour of more direct consumer related stocks such as the auto manufacturers and software firms.

We remain positive towards growth in both China and India - not only for the rest of 2005 but also for the rest of the decade. India's consumption and investment growth trends remain positive. Even though valuation has been moving up sharply, fundamentally, the market outlook remains sound. We expect the Indian market to be volatile in the short run, but have a positive long-term outlook for India.

4. What are some of the key risk factors investors should bear in mind when investing in the China and India markets.

A downward revision in global growth or a reduced risk appetite globally could set off a reversal in the strong foreign investment inflows that have fuelled both economies in the last few years. Further hikes in oil prices can also affect growth, as both economies are increasingly dependent on imported energy. Oil at over US$70 a barrel will definitely begin to bite.

Prudential's over-riding concern, however, is that global growth, while better than generally expected, is highly dependent on two engines – the US consumer and China's capital investment. Should either falter, for whatever reason, the attitude towards Asian investment generally, could swing rapidly.

In China, some sectors are almost glowing red-hot. This situation continues to feed fears that China's government will again introduce measures aimed at slowing growth. Investors' fears seem focused not so much on the slowing, but on any miscalculation that could easily send China spiralling again into a deflationary situation as in the early 1990s. We doubt China will re-impose direct controls rapidly. Policy measures this time round seem focused on rebalancing consumption-based growth.

The major macro-risks in India appear to be both the high level of liquidity (which could fuel inflation) and the deteriorating external accounts. Many fear that the central bank will become more aggressive though we are less convinced on this issue. Seemingly off the radar is the fact that India's rupee is increasingly expensive on a trade-weighted basis. That's not good for exports, but most of the fund's holdings are geared to domestic stocks.

In both instances, it is vital that one recognises that these are emerging markets. The standards of reporting, compliance and clarity are not of the levels of the more developed markets. They are, as a result, far more volatile than more established markets.

5. The PRU Dragon Peacock Fund has done well since inception. What would you say were the key factors which have contributed to its good performance?

Good stock selection is priority and has played a major role. The Fund will not invest in stocks just because they are in the benchmark index. Stocks are selected because they are perceived to offer capital appreciation over the medium-term and are undervalued given their future prospects.

Additionally, combining the two markets in one fund allows the fund manager alternative ways of best benefiting from wider issues. For example, with oil prices rising, the fund can gain an exposure via either China's CNOOC or India's Oil and Natural Gas Corporation. While the fund has opted for both in this instance, it is significantly overweight CNOOC. As such, the fund aims to add value through an active asset allocation process.

While capital markets are driven by fundamentals in the long-run, liquidity and sharp swings in investor sentiments distort markets in the short-term. These factors create pricing anomalies. Prudential believes that taking advantage of these anomalies through a disciplined, value oriented investment style can generate superior long-term returns. This approach has worked well for the Fund. Since inception to 31 July 2005, the Fund has returned 21.58% on an offer-bid basis and 27.32% on a bid-bid basis. How this works:

The Fund's long-term strategic asset mix is in 50% China related stocks and 50% India related stocks. However, like all emerging markets, both China and India equity markets are volatile. There are times whereby these markets are driven by liquidity rather than fundamentals. Additionally, China and India's economic cycles are not always in tandem. Thus, the Fund adopts a tactical allocation strategy on a shorter-term basis to bolster the Fund's performance. How this works is, when one market shows signs of euphoria, the Fund can cut its position by as much as half (25% minimum position in a market), and invest in stocks deemed more attractive.

This flexibility built into the PRU Dragon Peacock Fund allows the fund manager to not only switch into good valued stocks but also to switch between both markets (and cash) so as to take advantage of each market's volatility at the correct time. This is a huge advantage over buying single funds in either market.

The complementary nature of these two markets also allows great flexibility in constructing a well-balanced portfolio.

note: Nick Scott, who has more than 17 years of investment experience, manages the fund. Prudential's team of Asia specialists supports him. Together, they have 39 years investment experience.

6. How many stocks are there in the Fund? What's the portfolio's turnover been?

The portfolio of the PRU Dragon Peacock Fund will consist of a concentrated selection of stocks based on ideas generated from our India and China equity specialists. The Fund will generally hold no more than 40 holdings, and a minimum of 20.

The portfolio's turnover is 21.21% as at 30 June 2005.

7. Can you review the top three holdings of the Fund and tell us briefly why you chose to include them in the portfolio? -- So that our readers have a better understanding of your investment process. Can you also briefly share how you go about selecting stocks for the Fund?

The Fund's top three tilts as at 31 July 2005 are Bajaj Auto, Satyam Computer Services and Zhejiang Expressway Co Ltd.

Bajaj posted higher than expected consolidated profit-after-tax with an increase of 80bps on EBITDA margin y-o-y. Despite a weaker product mix, Bajaj was able to expand its margin by neutralising raw material cost pressure via reductions in SG&A and staff costs. There have been reports on company plans to eventually demerge investments on book into a separate company. If executed, we believe this could unlock significant shareholder value for the company.

Satyam Computer Services posted robust revenue growth of 36% year-on-year as of 30 June 2005. It has gained significant global business wins in the FMCG, Retail, Auto and Insurance sectors. Satyam added 31 new customers in Q1, of which four are Fortune Global 500 and Fortune US500 corporations. Although Satyam could face increased margin pressure in the short term, we believe that its relative valuations (on an ex-cash basis) are supportive.

Zhejiang's profit rose 18% for the first half of 2005, on revenue of 14%. Income from toll road operations grew 11% y-o-y and accounted 92% of Zhejiang's gross revenue in this period. Even though traffic growth momentum is slowing down, we believe yield is still attractive and remain positive on the stock.

As at 31 July 2005, the top three holdings are China Mobile (HK) Ltd (7.7%); CNOOC Ltd (6.2%) and Satyam Computer Services Ltd (4.9%).

We expect China Mobile to continuously outperform other Chinese telecommunication companies even after a robust ramp up. Although industry restructuring and the 3G-licence issuance could bring in new entrants to the mobile market, we do not expect a meaningful competitive threat until the first half of 2007. Less risk exposure to restructuring integration and the TD-SCDMA rollout will also make China Mobile a relatively safe play.

China National Offshore Oil Corporation (CNOOC) accounts for more than 10% of China's domestic crude oil production. It is the third largest oil producer in China. Its stocks climbed 28% in July after the company dropped its US$18.5 billion bid for Unocal Corp and as oil prices climbed to record highs. Investors had been concerned that the Unocal bid would have increased CNOOC's debt levels and could have led to rating downgrades. Rating agency Fitch Ratings removed CNOOC from negative watch and affirmed its BBB+ rating with a positive outlook in July, after CNOOC's shelved bid. Moody's has assigned the company with A2 rating, and given it a stable outlook. We believe CNOOC will continue to perform, amid the firm's strong gearing to oil prices and on expectations of strong liquidity flows into China.

Stock selection is based on a rigorous fundamental analysis consisting of (i) qualitative assessment and (ii) valuation analysis of stocks in the Fund:

Valuations
- market valuations relative to history
- absolute valuations (PB, PE, PCF, Div Yield)
- Earnings yield versus cash/bond yields and equity risk premium

Earnings
- Index earnings forecasts
- Corporate margins
- Consensus earnings upgrades/downgrades and earnings revision ratio

Stock price performance
- Country performance
- Index composition
- Sector performance

This rigorous stock selection process aims to uncover mis-priced investments as opposed to simply buying stocks of good companies. We believe that our robust investment process increases the likelihood of identifying good value stocks in relation to their future prospects.

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