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listeningin

The New Indian Raj

Asia's Embrace Of Capitalism Challenges West, But Spurs Growth

***Jon Thorn** doesn't claim perfect market timing. Indeed, rueful consternation is still quite evident in his voice as he recalls how, after several years of painstaking research and groundwork, he and his former partner launched their baby, then called the India Smaller Companies Fund Ltd., a decade ago. Their debut, as it turns out, occurred just a matter of days after India's BSE30 index scaled a peak it didn't come close to approaching again for 10 long years. A peak that still looms overhead, in fact, for dollar-based investors (like Jon's fund) in India's equities market.*

*Nonetheless, Jon and the fund, which was restructured, rechristened and re-launched as the **India Capital Fund** in 2001, have managed not only to survive, but to thrive over the last decade. In large part, through Jon's steadfast adherence to such old-fashioned investment principles as careful stockpicking—buying the best growth companies only when their shares are available at very good prices—and ignoring benchmarks. But it has also helped, Jon is quick to point out, that the fee structure he adopted for the fund isn't the annual "2 and 20" (or more) so typical in the alternative universe, but a less volatile scheme of more modest and more frequent* rolling per*formance payouts that keep his interest better aligned with his investors' every day of every year. The upshot: Jon, who watched many a rival fund manager implode during India's long bear, is now the longest-serving portfolio manager of an India-only fund extant, and he can boast of his fund's long-term 8.4% CAGR, which trounces that of the BSE30 over the last decade by 900 basis points—a stretch in which even some* surviving *funds run by competitors* lagged *the index by as much as 700 basis points.*

*Relative performance, however, very much isn't Jon's thing. Absolute returns are. **India Capital Management**, the fund's management company, is Jon's company. He is the managing principal, as well as sole portfolio manager —and only trader—of India Capital Fund. Which means that as meaningful as the fund's 123% gain since inception is to Jon, he is also acutely aware of how much patience on his part—and on his investors'—was required as the fund navigated India's turbulent market between 1994 and its big double-digit return last year. The fund, whose assets—for years on end before 2003—bumped along below $20 million, doubled last year and have shot up to $140 million recently. But Jon is determined not to let success change either the way he invests, or the conservative ways he does business. Case in point: He's adamant about resisting the siren song of unbridled asset growth to stay focused on long-term performance. Hence, he*

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Jean M. Galvin
Page 1 Illustration
Jeff Parker
Page 1 Cartoon

RESEARCH DISCLOSURE:
KMW has been solicited and may invest in India Capital Fund.

contemplating closing India Capital to new investors in the near future and he won't even consider taking money from leveraged funds of funds, which he fingers as, "the biggest potential banana peel out there."

Clearly, though still far from a greybeard, Jon has managed to learn quite a few very useful things about the investment business. This, despite a checkered early career that includes a Ph.D. at the London School of Economics as well as stints on a Drexel desk and as a trade journalist in Asia—all before he made his entrepreneurial leap into the investment world.

I first met Jon not long after he started India Capital, and was delighted to catch up with him as he swung through New York a couple of weeks back. Not to mention intrigued enough with what he had to say about India, China, the greenback, the alternative investment scene and, of course, his fund, to continue our conversation in several long phone calls after he returned home to Hong Kong. Read on, and I trust you'll see why.
KMW

"India is, in effect, just a very, very large and very, very poor version of Eastern Europe, Russia or even China."

You're obviously a hard man to discourage, Jon—
You mean because we're still around? You may be right, considering that back in 1994, our debut pushed the total number of international funds investing in India to 40—and that by the end of 1999, there were only 16 of the others left. We attempted to either takeover or merge with six of those, all sub-$10 million funds at that point. But it didn't happen. We got as far as lawyer-to-lawyer conversations with two, but ultimately the lawyers always advised the directors of the other funds not to pursue a merger. Their reasoning: even if a combination would have been in the interest of their shareholders—it wouldn't have been best for the directors! But oh well, now the business cycle is starting to come full circle: We're seeing almost weekly or monthly investment fund launches. There are some 30 India funds out there now for foreign investors; the total has probably doubled in the last 12 months. Yet there's very little Indian market expertise to be had. How do I know? We have had offers to start 3 Indian hedge funds in the past 6 months, to start 2 white-label India funds in the past year, and to take on 3 co-manager roles in the same span. We've said no, to all—but it just shows how interest has been picking up. Investment interest in India demonstrated by high-profile U.S. based foundations and institutions, the likes of **CalPERS** and **The Bill & Melinda Gates Foundation**, just seems to be feeding on itself.

That can't strike the confirmed contrarian in you as particularly good news—
Ultimately, no. But we're nowhere near that turning point yet. The astonishing thing to me is how easily some of these funds seem to have raised money—even if, terms of asset allocation, this renewed investment thrust in India is definitely rational. But then I would say that, wouldn't I?

You're reading my mind.
I believe I can actually prove that India is a better place to invest today than just about anywhere else.

You're on—
The reality is—This goes back to some concepts that I believe **Dr. Marc Faber** (who happens to be the chairman of India Capital Management) has been writing about longer than anyone else—that our world is in the midst of extraordinary changes that are going to affect our lives, and especially the lives of our children, in myriad ways that most people today can't even imagine.

Because of the war in Iraq and decline in the buck?
No. Those sorts of things are only noise, or symptoms. What Marc has been pointing to is the way that the (relatively) sudden conversion of the world's two biggest economies to capitalism is throwing everything from global foreign policy and trade relations to comfortable notions about job and social security in Western societies up in the air. The globe, it seems, is becoming an extraordinary economic melting pot. Which is profoundly threatening to any number of what had been presumed to be secure sinecures in places like the U.S., Japan and Europe. For all the lipservice that has long been paid to "free trade," G-5 economies are riddled with protected industries—France is the grossest protector of domestic companies there is. It has been an extraordinary party (for the privileged invitees) at least since the end of WWII, but it is now unsustainable even in the medium term. Unsustainable because China and India's embrace of capitalism is unleashing the creation of a tremendous amount of productive capacity, a process being fueled by the tremendous returns available on capital invested in those nations.

I rather expect that sort of flair for the dramatic from Marc. But from you?
It really is happening. Even if people in the U.S. and throughout the West, by and large, are in denial. But that is as ludicrous, when you stop and think about it, in the 21st Century, as it was for Bush and Rumsfeld to mount their "War on Terrorists" as if they were fighting the Napoleonic army. I certainly wouldn't describe the War on Terror as "a battle between nation-states that can be expected to respect certain rules of engagement," would you? It is equally absurd to expect Western economies and relationships to continue to function as they did in the last century when they suddenly have two, new, enormous and fast-growing *capitalistic* competitors. Then again, I do recognize that what we're talking about is an awful lot of change for for people to swallow.

Gee, Merry Christmas to you, too!
Just keep repeating to yourself: "Change creates opportuni-

ties." And at bottom, understanding that we're living through period of epochal change can help you and me, as investors, sift meaningful opportunities out of the barrage of daily markets events.

Such as?

Take all the headlines I've been seeing about America's massive twin deficits and declining dollar. All the fingerpointing at China for not letting the price of the renminbi rise is missing the point. China and all of the Asian central banks have been helping themselves (and global economic growth) by providing, in effect, buyer financing to U.S. consumers for the longest time. But that is not a story that can simply play and play. The problem is what happens when it starts to turn around a bit. You don't have to be a forward-looking member of the People's Bank of China anymore to think, "Maybe we need to hedge our dollar exposure with euros."

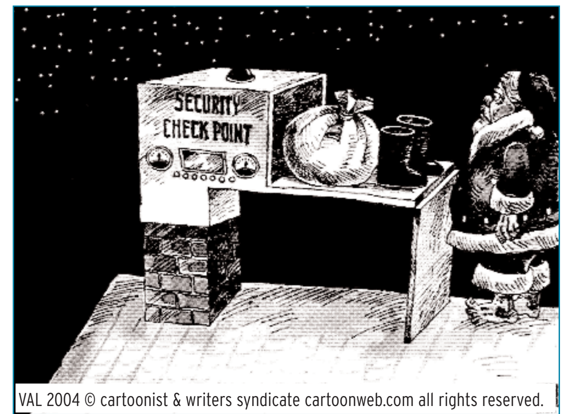
Once that starts to happen, then little bits of all sorts of other changes will be set in motion, as well. Global economist **Steve Roach** of **Morgan Stanley** came up with an analogy that sums up the current state of the world economy quite well: It is basically an airplane flying on two engines, one producing stuff and buying paper and the other engine buying stuff and producing paper. These engines are, of course, China and the U.S., respectively. The only trouble, says Roach, is that this arrangement is systemically dangerous–and he is quite correct.

But as long as everyone's happy–

Ah, but there's the rub. People are only starting to catch on to something **Christopher Wood**, the global emerging market strategist for **CLSA Asia-Pacific Markets**, has been saying for about two years. The whole risk to this "trade," if you like (and therefore to low interest rates in middle America, to your continued GDP growth and to relatively quiescent inflation in the U.S.) is that *Asia actually is no longer a U.S. dollar zone.* It is very critical for investors to understand this. The traditional view has long been that the likes of Korea, Taiwan and Singapore, etc., constitute a dependable U.S.-dollar zone. After all, their currencies are pegged to the greenback. But that assumption is completely wrong. Those currencies remain pegged to the dollar today, Wood was the first to point out, *only* because the renminbi is pegged to the dollar. What's more, if you look at where those economies are going, you see that their growth is less and less tied that of the U.S. Exports to America are becoming less and less important to those nations' economies as they do more and more business with the giant next door–China. In fact, 50% of incremental export growth all across Southeast Asia is being driven by China. The biggest slug of foreign direct investment going into many of those economies now is coming from China. Which means they really are, as Wood says, a renminbi zone. It's truly hard to overestimate the impact China's growth has had on the rest of Asia. And so, if China is pressured into revaluing the renminbi, all those other nations will likewise revalue. Don't underestimate, either, the impact that revaluation would have on the yen. Japan, too, is actually in the renminbi zone. The worst thing that could happen to the U.S. economy, frankly, at least in the near term, would be that they reflate the renminbi against the dollar, because then a whole lot of things would start to change out here in Asia. Then again, even if they took the Chinese currency up by 20% against the dollar overnight, it wouldn't make any difference in terms of the real change taking place in the world. There'd still be huge trade and investment flows and capital imbalances. And you and I would still be buying stuff made in China because no one else can make enough of that stuff. So the price of the renminbi is irrelevant, it's a red herring, a smokescreen.

I'm hearing a lot of theory, Jon, mostly about China. But you said you can "prove" that India is the best place to invest today?

I'm getting there. Consider this: 2003 was the first year–I suspect since the 1880s–but certainly since the early 20th Century, that the U.S. economy was *not* the largest recipient of business investment on the face of the globe. *Today, the largest recipient of business investment is China.* As I said, the whole world is being thrown out of its old equilibrium and into a still-evolving new equilibrium by the shock of these two enormous economies (three, if you count Russia) becoming a part of the now-global *capitalist* economy. As I mentioned, too, Marc Faber has been writing about this for quite a while, exploring what this enormous change may mean for investors. What's lately become quite evident to me is that some very large endowments and foundations have actually been listening to Marc and Chris and Steve.



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CalPERs and the Gates Foundation have made a splash in India?

The astounding thing is not that they are allocating assets to India (China, too) but that they are doing it the *very* hard way. They have acquired licenses to invest, themselves, in the local shares in both countries. The majority of the big international banks in the world still do not have those licenses. It's an intensely complex and expensive process to go through, requiring immense documentation, and many significant payments. But they have their Indian licenses now, and Gates has started four sub-accounts under their license, meaning that they can have four separate managers investing in Indian shares for them. CalPERS has gone to the trouble of establishing 11 sub-accounts. In other words, they have relationships with 11 managers they want to be able to invest for them in India. And since these are managers like GMO, Alliance, Artisan, and BlackRock–large scale investment managers, who are only going to be investing reasonably significant amounts–I would assume that each portfolio will be at least $50 million. Otherwise it wouldn't make sense to have those managers doing the work.

Nor are these the only mega-investors turning their attention to India. We have found ourselves making presentations to very large endowments and foundations lately. Our largest single investor, today, is the endowment fund of a very prominent U.S. university, which has been investing with us since early this year. What is striking is that these sorts of institutional investors are generally characterized as more conservative and slow-moving than many others, actually seem to be in the vanguard of this renewed interest in India. But I think it is because they actually get it. If Marc and Chris and Steve are correct, the most significant investment move anyone can make is to get as much money as they comfortably can invested in China and, especially, India.

Why is that?

That does two things. It captures the growth that is going to be taking place in these economies–which will be far in excess of the growth in any other economy. It already is today. So one is buying growth. Secondly, it diversifies an investor's U.S. currency, stock market and economic risks. These endowments and foundations that are moving first are long-term investors. They have mandates to produce returns out towards infinity. They aren't concerned with my life cycle or anybody else's, only the life cycles of their institutions. In many cases those institutions have existed for hundreds of years and are bound to exist for hundreds more. While that often makes them seem like the most conservative investors, it also means that are specifically charged with positioning their endowments to withstand the sort of epochal changes in the established world order that Marc, especially, has been writing about. They really do have to worry the very long term.

Perhaps. But they've also been known to be as susceptible to fashion as the next investor. And "alternate investments" could scarcely be more trendy. Maybe they're merely following the dictates of their consultants, lemming-like, again.

Part of that is correct, I think. We've had a lot of contacts and even dealings recently with a number of consultants, even the likes of **Cambridge Associates**. Two years ago, even, that would have been highly unlikely. But we may not be typical here. There are a lot of funds that are easier to find than ours. Anyone who comes to us has usually had to get off their backsides and do their homework to determine that they need exposure to this asset class. What's more, we've definitely gotten the sense, when we've met with some of these institutions, that their consultants hadn't been doing any pushing. In fact, the impetus has generally seemed to come from internal managers. They are the ones doing the legwork. The clear impression I've gotten is that these top-drawer foundations believe they absolutely must do their own research to get early access to funds like ours.

Bragging rights are that important?

That's not it. Every single endowment we've spoken to is very concerned about capacity constraints. It's no secret that small funds generate better returns than big funds. It is a widely recognized problem with all the big hedge funds now. So it's no surprise that the endowments have figured it out, like everybody else. They are so concerned about capacity constraints that they are focusing extraordinary attention on getting into funds early, while they are still relatively small.

So it's really too bad that you've more than tripled your assets under management in the last year?

I didn't say that! But India Capital is a small fund, and our intention is to remain a relatively small fund. This whole industry is completely bifurcated–in my mind, anyway–between managers who focus on gathering assets under management as their business model and those who focus on performance to drive their businesses.

Gee, really?

Yes, although most managers, I think, try to make it appear that they can play both sides of the Street, which produces mostly cheap thrills for their management companies. My own view is that asset managers should stick to going down one road or the other. It is very clear what our model is. We don't want to get so big that we can't produce the level of outperformance we have generated historically. And if we allowed our assets to grow to $1 billion, say, that simply could not happen. If we cap the fund a few hundred million, considerably less than $1 billion, then it is still possible. So there will come a point when we simply stop taking new money. Even from a very attractive investor, in terms of stature. A lot of these endowments and foundations have figured that out. So they are going out looking for our kind of fund. They are aware that once we get to $220-$230 million or so, we will close this fund, so they're moving fast to try to capture capacity, especially in Asia, where experience, focused, absolute return investors are pretty rare. And where every investor should be.

Pardon my cynicism, but when you talk about a "capacity shortage," I hear echoes of that bogus old broker's line about a "shortage of stocks."

Granted, capacity can always be expanded, and the temptations to do so are enormous. But if you're a manager really focused on the performance fee side of your business, you know very well that if you take too much money, your performance will deteriorate. There's no doubt that there's a narcotic-like attraction to asset-gathering; the more you gather, the bigger your annual annuity stream (management fee), and if you have a blowout year, you'll be in hog heaven. But in the non-blowout years, too many assets will drag down your performance, and you'll make less. The simple reality is that there are more non-blowout years. So to me, the choice is clear: you either run an index fund (and personally I don't understand why people invest in index funds that aren't ETFs), or you can run an absolute return fund like you mean it. But we both know that most funds try to do both.

Are you at least enjoying all of the attention?

How could I not, after what we've been through in the last 10 years? An airborne plague, nuclear weapons tests, the Indian taxman trying–twice–to break foreign funds' privileged tax status, a small but intense war with Pakistan. And those were external events. The Indian market had the worst year you could imagine in 2001: A textbook-style capitulation. 100% of new investment flow went into government debt–the appetite for risk was nil. We went from being 40% in cash to actually having *negative cash* in the fund during that awful year–at the point when troops were massing on the border with Pakistan.

***"Negative cash?"* You mean you leveraged up?**

What I mean is that , we couldn't pay fees due at the end of that quarter out of the cash we had in the bank. We had to sell holdings. That's the kind of *annus horribilis* 2001 was. The largest leveraged investor in India defaulted. The board of the Bombay Stock Exchange was fired. Badla, the indigenous system of leverage in the market, was ended. And since it had been more than 50% levered, the market hit the wall. Then, UTI 64, arguably the largest Indian mutual fund (on the basis of market cap to GDP), defaulted. It represented 16% of total mutual fund assets in India. In the aftermath, significant structural changes were mandated in the operations of the BSE: compulsory demat [dematerialization] of shares and rolling settlement at T plus 5. But then came 9/11–and then, the Dec. 13, 2001 attack on India's Parliament that led to the troops massing on the border with Pakistan. There were people jumping off buildings–I'm not joking, there was literally blood in the streets.

Don't tell me, all that misery gave you an irresistible urge to buy?

Why not? It was a classic buying opportunity. The structural changes in the market would turn out for the best. Demat–what you Americans call trading shares in book form–and the end of Badla mean there is now a secure and clean rolling settlement process, titles are secure, intermediation is enhanced and transactions are cheaper, plus, there are now separate cash and futures markets. And the proof is in the pudding, so to speak. Foreign net portfolio investment in India totaled $7.6 billion in 2003 which was significantly more than in previous years. This year, through the end of November, we've seen $7 billion pour in, an exceptionally large $1.8 billion last month alone. So India is well on track to see record net foreign investment this year, too. These are very significant asset allocations. While some small part of last month's flow may represent window-dressing on the part of managers who want to show India exposure at yearend, the vast majority has been coming into the country because emerging market and international funds have been making deliberate decisions to invest where prospects are best for long-term earnings and GDP growth.

And chasing performance has had nothing to do with it? The BSE was up 83-84% in dollar terms in 2003.

Well, a lot of money came into the market at the end of '03 and didn't benefit from that performance. India Capital had a spectacular year, we were up some 113% for 2003. And I grant that we saw a lot of money come in early this year. But the market was still cheap on a historical basis, considering anticipated 22% year-over-year earnings growth and a yield of 2.5%.

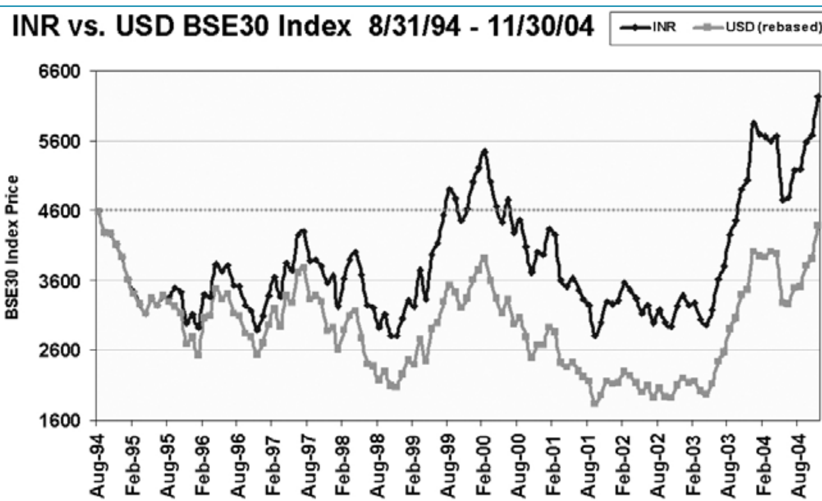
Then came India's election swoon and it got even cheaper—

That's exactly what is was. A totally bizzare event. Sonia Ghandi herself had no idea her party would win. Their victory came totally out of left field. So the day after the election, you had no idea who the prime minister would be,

no idea who the finance minister would be, no clue about the economic policy, and not the faintest notion of who would serve in the coalition. So of course the market tanked. At the end of May, our fund was off 18%. Yet apart from that one month, India has seen positive net investment flows in every single month this year. That is what encourages me that at least some of this institutional inflow is a little bit stickier than a cynic might think. This doesn't smell like just a flash in the pan, or the latest reverse carry trade.

It has to help that the BSE30 has bounced back.

True enough. The BSE30 Index has recently hit an all-time high. That's not much cause for celebration by U.S. dollar-based index investors, though, who are still underwater by 4.7% over the last decade. India Capital Fund is dollar-based, and doesn't hedge the currency. But year to date, we've made up almost all of our early 2004 losses. We were down only 3.2% at the end of November. And I obviously couldn't be more confident long-term.



"The BSE30 Index has recently hit an all-time high. That's not much cause for celebration by U.S. dollar-based index investors, though, who are still underwater by 4.7% over the last decade. India Capital Fund is dollar-based, and doesn't hedge the currency. But year to date, we've made up almost all of our early 2004 losses. We were only down 3.2% at the end of November. And I obviously couldn't be more confident long-term. "

I'm still wondering, why do you *invest in India*? You choose to *live* in Hong Kong, which just happens to be part of that even bigger, even faster-growing Asian economy.

Essentially, being domiciled offshore (in Mauritius) confers certain tax advantages on the fund, which is officially registered as a foreign institutional investor in India. I *like* living in Hong Kong; my wife works here, too. But I *invest* in India because it is a good idea now–and, in all honesty, because investing in India also seemed like a good idea 10 years ago…before the nuclear tests, the challenges by the tax authorities, and the small war with Pakistan. Back then it also seemed like a good idea to **Soros Fund Management**–they were early investors with us. India then was basically in a situation to similar to the U.K.'s at the beginning of the 1970s, when it had to be bailed out by the IMF. India more or less ran out of foreign exchange reserves in 1990-'91 and had to call on the IMF and World Bank for assistance. Part of the price it had to pay for that aid was an agreement to open up its market and economy. On that score, I must say (based on my experience in India, which is the only instance I can really speak of with any degree of expertise), the influence of the IMF has been almost entirely benign and deeply positive. Precisely because the government had to start dismantling the many-layered payoff, tariff and license system that had been built up in the 40 years since India gained its independence, the so-called License Raj (raj means rule). Under it, in effect, India had suffocated as a socialist, five-year planned economy. It's very important to appreciate that it was the end of the License Raj that made India so exciting to investors back when we were starting the fund.

It is?

Yes, because of the License Raj, India's economy has to be understood in the context of Eastern Europe. India is, in effect, just a very, very large and very, very poor version of Eastern Europe, Russia or even China–of any of the countries making the transition from communism into capitalism. While India was never communist, per se, it was certainly socialist in its development–which is very similar. And the transition from communism to capitalism, as we have seen in Western Europe, Eastern Europe, and even in Russia, creates very exciting opportunities for asset investors. Not to mention that this transformation of China and India into capitalist economies is what is profoundly unsettling so many traditional market relationships.

Maybe too exciting.

You're quite correct. The transition is rarely smooth. I can't remember a single smooth one, except maybe Estonia. Anyway, it was by looking at India in the context of Eastern Europe that my former partner and I recognized it as a potentially great story back in 1992. But we, like everybody else, significantly underestimated the amount of shareholder value that would be destroyed during the transformation. It took much longer than anyone expected. Hadn't the Berlin Wall just crumbled practically overnight?

No, actually. "The Triumph of Capitalism" is anything but instant.

That's right. Although they tried instant capitalism in Russia. I've spent a lot of time studying privatization, once we figured out that things weren't going to be quite the snap we had assumed. I've tried to unravel what actually happens as the process unfolds. The Russian model, of course, is the one that no one suggests should be emulated. Yeltsin's one-time privatization czar, Anatoli Chubais is generally blamed. But it is very important to distinguish *what* he did from the actual *way* he did it. Basically, he was forced to sell the state's assets very cheaply to–some people call them "crooks," others call them "businessmen" now.

Don't be squeamish. He sold them to the "oligarchs," otherwise known as the "Russian mob."

My point is that Chubais acted, in part, on the advice of the good old OECD, which had a policy that privatization should be done quickly and completely, so the market could take over. I assume that the OECD would argue with that assertion–now. But when Chubais was privatization czar, that was its consensus operating principle. The thing is, that advice was handed out–and followed in many cases–on the basis of zero evidence, zero testing and, as far as I can see, zero analysis. Because, *if there is no established market to take over,* how can you depend on "the market" to sort out the operations, valuations and relative of performance of the newly privatized companies? Of course, all

hell breaks loose. So *now* , the OECD's policies have changed. The other thing that it's necessary to appreciate is that mass privatization was invented by Margaret Thatcher.

Now your British upbringing is showing.

No, seriously. I often have trouble explaining this to Americans because you are very fortunate. You have never had to endure the nationalization of core sectors of your economy. You have quasi-nationalized companies, like Fannie Mae and Freddie Mac, but you don't have anything like what we used to have in the U.K.–whole industries nationalized–and barely functional. My point is that until Margaret Thatcher came along, that was the norm in Europe. Much of the theoretical work the Iron Lady relied on in promoting privatization was done by a small organization called the Adam Smith Institute. But it was the Prime Minister who pursued it relentlessly, to the extent that some of the grandest grandees in her party stood up in the House of Lords and criticizing her for "selling the family silver." By which they meant things like British Airlines. It was a lousy airline then, but it is a great airline now–and profitable. So how right she was. How smart she was to ignore her critics and to push ahead to sell that "family silver." Today, around 100,000 companies, the Adam Smith Institute estimates, have been privatized, globally. It has been a godsend for GDP, for shareholders and for taxpayers.

Except in Russia–

I was getting to that. When an economy is properly privatized, two very significant and separate things occur. 1) You get much improved productivity and profitability in the private sector. That's no surprise: When an industry is opened to new entrants, you've suddenly got more companies competing for that business–against the remnants of the formerly government-owned company that previously didn't have to lift a finger to control the business. So everybody sharpens their acts. 2) You generate a sense of ownership among customers who often get cheap or even free shares as part of the privatization process. And a client who becomes a shareholder–in effect, an owner of a tiny part of a company –tends to develop a slightly different relationship to it than he had as just another customer. The problem is that neither of these things occurred in Russia. The economy wasn't opened up. Monopolistic companies that had been owned by the government were simply transferred into private hands. They weren't effectively broken up. The benefit to GDP was zero. The taxpayers and citizens of Russia got nothing out of it.

Lamitube Consumption 2000

	Pop Mil	Tubes	T/per capita	CAGR %
Asia	3,458	9,950	2.88	12
Africa	728	440	0.60	5
LatAm	482	3,020	6.27	9
E. Euro	347	3,375	9.73	7
W. Euro	380	6,185	16.28	2
NthAm	293	3,020	10.31	2

Except the dawning realization that their patrimony had been stolen, again.

It *was* stolen. Now, of course, the taxpayers and citizens of Russia *will* get something out of it, in the sense that the government has taken back Yukos, so between $8 billion and $12 billion annually should start flowing into Russia's treasury. But Russia's way is surely no way to run a mass privatization. In India, by contrast, it has been a very slow, incremental process. And very good–for the government, which is extracting more cash out of the process. It's been good for the companies, too, because the path to the private sector has been eased a bit; there haven't been too many shocks. But the key point is–what you have to understand about the economic benefits of mass privatization–is that they do *not* stem from privatization, per se, *they come exclusively from increased competition*. This is true both for the companies and for their shareholders and customers, in the long term. Which is why the Russian model hasn't worked. The transformation into a capitalist economy requires both privatization and increased competition. And that's very much the route India has been taking. The extraordinary thing is that India may end up being the largest single beneficiary of this "Capitalist Reformation" in the world. There have been many privatizations and breakups of government companies to create competition–but there are still many more to come. The government (along with promoters) still controls 54% of the equity in the wider Indian market, as represented by the BSE200 index. Foreign investors, in various forms, account for just 21% of the market, so India still is not over-owned by foreigners. And the government still arguably holds too much. So the process still has a lot further to run. And a lot more growth to generate. Meanwhile, while most people are at least vaguely aware India is densely populated, they generally don't appreciate how densely. Singapore and Hong Kong are the most tightly packed places on the planet, then comes India, at 390 people pr square kilometer. Germany is next, at 340, while China has only 240-290. What's stunning about India is that despite its population density, only 20% of its population is what you'd call urbanized. It is still very much an agrarian economy–as China was 15 years ago. Which again points to enormous economic growth potential. Actually much greater than China's at this point and significantly in excess of any other economy in the world.

Why should India grow faster than China?

In 1978, both countries were more or less in the same place in terms of GDP per capita and percentage of global exports. Since then, China has significantly outpaced India. All because Deng that year traveled just across China's southern border and famously uttered, "It's a good thing to become rich." His words changed Chinese government policy. Its special economic zones suddenly were able to tear up Mao's Little Red Book and basically do anything they liked. Deng's observation unleashed extraordinary energy in China. Everything is new over there; you have to see Shanghai to believe it. You would be astonished at what they have accomplished. However, the reality *now* is that China's growth is slowing. Its infrastructure has been stretched pretty much beyond capacity. The Chinese plan *had* to change. They are actually trying to retard asset growth in Shanghai, put a lid mainly on property speculation. The development focus is shifting inland. They are trying to bolster farm income, to keep farmers on the land. But that will require *immense* infrastructure improvments in China's interior. China has reached the point where building another dozen highways on the coast won't have a big impact on GDP. Putting electricity into 10 million homes a year in the interior would have a very significant impact, *but it will only be felt gradually*.

India, you're implying, still has more instant-gratification-type projects to undertake?

What has been going on in India since the election in May is rather like what is happening in China. The new government is focusing on raising farmers' incomes to better distribute GDP growth, which is extremely important for India's next leg up. There are plenty of rich people in Shanghai, Beijing, Delhi and Mumbai. But outside those cities there are a whole lot of poor people. At this point in their development, both India and China have to distribute income growth more broadly. To keep order, especially in China, and also purely on the basis of equity. So the headline rate of growth will slow a little bit in both places. But this is a necessary and desirable. The more people they get functionally employed, earning cash money and spending it, the more they build out the consumption bases in their economies which will create the next leg up in GDP growth.

I'm still not clear on why you like India better than China–

From the start of our fund, my call has been that while China offers real investment opportunities, anyone who isn't Chinese and doesn't speak the language would be at a material disadvantage there. No. 2, there's a a more congenial investment environment, if you will, in India, based on its well-developed (and Anglo-Saxon) legal structures, on its large pools of highly trained investment and accounting professionals, etc. It basically comes down to economics and demographics. India today is the fourth-largest economy in the world, measured by purchasing power parity. It is projected to be the third largest in terms of GDP, by mid-century. It's growing fast. GDP growth this

year has been better than 7%, Indian exports surged 19% in 2002-'03. Its foreign exchange reserves are at all-time highs. Even today, it's the world's 10th most industrialized economy. And there's the simple fact that 25% of the people in the world who are younger than 25 live within its borders. That translates into an abundant, quality, cost-effective base of manpower. India is, after all, home to the world's second-largest English-speaking population. And it's an increasingly well-educated population. India produces over 100,000 new IT professionals every year–for an IT industry currently generating $14 billion of sales and growing at a 30% annual rate. Its schools are churning out huge numbers of the skilled scientists and engineers. That's another place where India may well have an advantage now, over China. The majority of Chinese exports are manufactured goods–hard and often heavy things that you have to ship by rail and container ship. India's fastest-growing exports, by contrast, "ship" by satellite (via email.) So India's potential for increased growth without enormous capital expenditures is significantly greater than that of any other economy in the world–despite its clogged ports. Meanwhile, billions of investment dollars are being poured into infrastructure improvements in India to keep all this growth coming. To cite just one statistic, power projects adding over 100,000 MW to its generation capacity will be put in place over the next decade. Sure, there also are risks and quite clearly, it has been more fashionable to invest in China for the last decade. So maybe we made the wrong choice 10 years ago. But I'm not sure that most investors–or at least most *non-Chinese* investors–have actually made more money in China. They may have, but I don't know who has been able to take that money *out*. The checklist still is very much in India's favor.

How quaint. You actually worry about *investment returns*?

Absolutely. That's what we do. We don't do private equity. Nor are we like Wal-Mart, trying to run a business at the lowest possible cost. We try to make money for our investors, over the long haul. And when you really look at opportunities to do that today, we think you have to put as much money as you can feel comfortable about into India.

You seem a mite nonchalant about the prospect that the torrid pace of growth in both China and India slowing–

It's not necessarily a bad thing. Fixed investment as a percentage of GDP has gotten significantly out of whack again, all across Southeast Asia and in China, where growth has been running at unsustainable levels, no matter what indicators you look at. That has to be incredibly inflationary. Significant foreign-currency-denominated debt has been taken on, both by the governments and by the corporate sectors–and that's an accident just waiting to happen. Not to mention that the stock markets around Asia have been bid up enormously on expectations of their growth continuing, uninterrupted, to the sky. It's very important, I've learned in this business, not to be impatient. I also know that most things revert to the mean. So I constantly try to focus on the fundamentals. People and markets periodically get carried away, but sooner or later, they are brought back to earth. That's what happened in the U.S. back in 1987. Everyone looked around and suddenly figured out that the emperor had no clothes; that earnings growth definitely did not support valuations. That may be the case in places in China today, though I'm not making any predictions. There are analysts who insist China is an accident waiting to happen. But it is just so very much larger than any other economy it is compared to, not to mention that its political/economic structure is so different, that I'm not sure how meaningful any comparisons are. What it is important to recognize about all of Asia today, from an investment standpoint, is its incredible potential for consumption growth. Enormous revenues and earnings will be created by satisfying it. That is why I am a commodities price bull, long term. It's not that the commodities markets won't be volatile, they always are, but anywhere close to 10 million homes a year get wired to build out China's interior, that will consume *lots* of copper. Likewise, India will.

Let's talk about what you sorts of stocks you will and won't put into your fund these days. You don't buy Indian stocks listed on the NYSE, I take it.

We don't, because the offshore securities, the ADRs and GDRs, tend to sell at premiums to the underlying shares, which we can very easily buy. We're an ethical fund, so we don't by tobacco companies or arms makers. We're attracted to world-beating companies that just happen to be Indian. The largest manufacturer of bicycles in the world, for instance. By far the largest manufacturer in the world of laminated tubes is an Indian company. It is making all of Proctor & Gamble's tubes for the U.S. market.

You're still nursing your toothpaste tube fetish?

I know, you've commented before that it is a bit odd, but I still contend that laminated tube consumption is a great indicator of the growth potential of developing economies. The lamitube consumption table we use in investor presentations [see page 6], tells you more graphically than anything I have ever seen, why you should invest in Asia. Consider: Asia's 3.5 billion people used almost 10 billion lamitubes in 2000–more than North America and Western Europe *together*. Yet per capita tube use in Asia was only 2.88 vs. more than 10 in the North America and 16 on the Continent (a disparity I blame on the U.S. penchant for supersizing). The key, though, is that tube consumption is growing at a 12% CAGR in Asia. It's a proxy for the growth of Asia's consumer economy, which is huge in scale and starting from a very low base. Asia is in a *very* steep cycle of long-term consumption growth.

What's the name of the tube company?

Essel Packaging–now called **Essel Propack**. It *was* the first really big, efficient integrated laminated tube company in India. I'm really a long-time fan of its founder, one of the genuinely great entrepreneurial businessman in India, Subhash Chandra. He also pioneered India's amusement park business (**Esselworld**, which is like rather like Disney Land, in Mumbai), and satellite television (**Zee TV**). An amazing accomplishment, starting three massively capital intensive businesses in totally separate sectors of the economy.

Do you hedge against company and market risks?

Not the ways you might think. A lot of managers *talk* about hedging portfolio and market risks, but the reality is that unless you have very efficient dis-intermediaries in the the financial system–like you do in the States and in parts of Europe–you really can't hedge out market or company risk. So we attempt to manage risk in a more fundamental way. I'm not at all apologetic about imitating Mr. Buffett in many respects. The two key risks that any investor faces are valuation and management risk. Valuation risk is obviously high if I buy something very expensive, as I have done once or twice in my life, only to see it become cheap. I've experienced management risk when companies have told me wonderful stories only to do the opposite, or have been unable to execute. But if you buy low-valuation stocks in core franchise businesses that are run by the best managements you can find (in other words, follow the standard Buffett model), that's what I call risk management. As Buffett has said, it's better to have a slightly less good company or product with better management than the reverse. Because good management has a better chance of making you money over the long haul.

But how do you figure out what's cheap in India?

That is tough. India offers an investment manager a bewildering array of regions and sectors, industries and companies to invest in. I could invest in 40 cement companies. Who knows how many banks and consumer products companies. A whole raft of Indian pharmaceutical companies. A huge software sector. You don't find that kind of range and diversity in emerging markets like Thailand or Russia. You may in China, but how do you invest in them? You normally find it only in very large, very mature economies. That it exists in India makes my job a bit different than many other Asian fund managers'. I do intensive top down sector research, coupled with intensive bottom up company reviews. I look at each sector differently and pay

absolutely no mind to what is in the Index because I have no interest in tracking its return. We only look at sectors that either are the fastest growing or are recovering fast, as if they've just come out of hospital. And hedge risk by holding 3-6 names in every sector we invest in. That said, we don't have one model that we apply across all sectors; no magic set of ratios. That doesn't make any sense to me. A cement company is very different than an IT company or a pharmaceutical maker–and all three are very different from a bank. So while we focus on the cheapest, best managed companies we can find, ones whose ROEs, sales, and earnings are generally greater than the market's, their sector's or their peers', we apply different valuation models in different businesses. For instance, any cement stock trading at less than 8 times next year's earnings is relatively interesting. Even so, that valuation is actually irrelevant to whether we would buy the stock–because capacity utilization pretty much dictates how much a cement company can make for you. Good management is always key. But in another industry, say pharmaceuticals or IT, where capacity can be expanded quickly, we're much more likely to focus on the trend in margins in deciding where to invest. We want companies with defensible margins in growth sectors, because we want to be long-term investors. Other sectors call for still other models. Banks are all about the net interest margin spread.

What have you been buying? Banks?

We have been consolidating our bank holdings this year. They are the biggest concentration in our portfolio, at about 18% of assets. We're focusing exclusively on the purest, top-quality banks, because a lot of the tier 2 government banks, and even one or two of the private banks, have further potential dilution coming. The whole banking world is running scared, wondering what the new "Basel II" capital adequacy rules will mean for them. The biggest of our three core banks holdings is **State Bank of India** , one of the biggest banks in the world with 9,700 branches and 22% of the banking businesses in India. Only 5 or 6 banks in the world have more branches. Its management is very good. It has taken its costs/income ratio, one of the key variables in determining banks earnings, down from 63% to around 50%. That is still very high compared with banks in mature markets, but it's quite good in an emerging market, especially considering India's scale and diversity. Another bank we own actually has *negative* net non-performing loans, **Oriental Bank of Commerce**. I'm not sure there is another bank in the world in *that* situation.

Its borrowers are repaying more than they owe, faster than required?

No. What I mean is that the bank has actually overreserved against its NPLs. While it historically recovers, say, 12% on NPLs, it has very conservatively established reserves on the assumption that it will recover only 8%. Another of our bank holdings, a small regional, has one of the most interesting management teams I have ever come across in a small company. This small regional bank stock trades at about six times earnings, yielding about 4.5%. But its management isn't content to merely clip coupons. Back in November of 2002, India changed its laws to make it much easier for banks to legally recover on non-performing loans, so many banks started legal actions. This bank, though, realized that lawsuits aren't the most productive way to get money back from defaulting borrowers. It researched other lenders' methods globally, then got some staffers to make a few placards saying, "defaulting borrower, cheater, give us our money back now!" Each time they've sent staff to stand outside a deadbeat's plant, office or home with the signs–after calling the local TV station or newspaper–the errant customer has rung them the next day to work out a payment plan.

No doubt. But aren't your bank stocks one of the big reasons your portfolio has lagged a bit this year?

Yes, it's no secret that we've been overweight banks and metals, and that our views on those sectors differed from the consensus among Indian investors for much of the year. But we believe Indian banks offer the best upside of almost any asset class, anywhere. They are clear winners from strong GDP growth, from significantly rising credit off-take by both companies and consumers and from lower NPLs. With low inflation and stable low-cost deposit bases, good bank managements are sure bets to increase earnings, some by a lot. Indian banks' growth potential is staggering. Total retail debt–including mortgage debt– is only 7% of GDP. State Bank of India, our largest holding, controls 50% of that retail loan market. That share may not be sustainable, but they're making a whole lot of money. Everybody should own these Indian bank stocks; the biggest growth in the region is in consumption and credit cards, and these banks make money on both trends.

What else?

We now have about 9 or 10% of the fund in one stock, a recent privatization, called **National Thermal Power Co.** Ltd. We actually took money out of other positions to buy it; it's one of the best plays in the market to day. The IPO came at 62 rupees per share, and by the end of its first day of trading it was at 75.5, up 21%. Happily, we applied for and received a good allocation on the offering and then bought in size at the open on the first day.

You're excited by *a utility* in India?

This sounds really sexy, I know. I've met people who would rather quit the business than invest in Indian utilities. The sector has been a very big black hole–and many companies have poured money into it. But NTPC is India's largest power generator, by far. And it is the second most efficient power generator in the world, operating 20% of India's generating capacity, and producing nearly 30% of the power sold in the country. All that, and an 11% ROE.

Thanks, Jon.

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