

October 17, 2011

Dear Friend,

Global stock markets continued to taunt and test investors this past quarter, in the end plummeting since their Spring peak. From April 29th through the end of September, the S&P 500 declined about 17%, and the MSCI China Index fell approximately 30%.

In this letter, we focus on China because while our investments there have been responsible for so much of our outperformance in the past, they have had the opposite effect in the most recent quarter. Here's why we think the tide turned, and why we believe the recent underperformance of the Chinese market will not last over the long term.

Macroeconomic issues have been the ruthless driver of much of the recent market volatility. In Europe, the sovereign debt crisis entered a perilous phase with Greece on the brink of default. Dysfunctional political leadership in the European Union - imagine trying to get 17 national parliaments to agree on anything - coupled with a near credit freeze among European banks, have mired world markets in a vicious cycle of fear. At home, our own dysfunctional Congressional leadership has weakened economic policy, feeding worries about a double dip recession.

In China, the fear factor is the specter of slowing growth. In response to the global financial crisis, the Chinese government stimulated internal consumption through massive spending on infrastructure projects. To reduce inflation, which emerged as a side effect of this policy, the government introduced a series of fiscal and monetary tightening measures which have been effective. Now, with property prices falling and the pace of inflation moderating, the tightening cycle is likely finished. This, combined with very low valuations, is positive for the market.

The turmoil in the developed world does not change our view on China. The long, relentless rise of Asia continues to be the biggest structural change in the global economy. It's possible that this current wave of unrest will serve as a marker in the transition to the next stage of the structural shift away from the developed world toward the emerging markets of Asia. Those economies have now gained enough critical mass that they can grow even if those of the U.S., Japan, and Europe do not. In 2010, for the first time, Asia's top ten nations generated more demand than the U.S. Since September, 2008, GDP in the U.S., Europe and Japan has grown less than 1%. During the same period, China's GDP climbed by 29%.

Incremental global GDP growth will continue to come from Asia - predominately China. Two things are needed to drive global incremental GDP growth: size and growth. China has both. An exercise in forecasting GDP growth to 2020 (not that far off) helps illustrate this point. If we assume that China grows its GDP 8.5% per year for the next 10 years – far below its recent growth rates- and that the U.S. grows about 2.75% per year – an improvement from its current growth, we get the following results.

GDP in Constant 2010 USD

| | <i>China</i> | <i>US</i> |
|----------------------|----------------------|----------------------|
| 2010 | 5,825 | 14,660 |
| 2020 | <u>13,168</u> | <u>19,214</u> |
| Change in GDP | 7,343 | 4,554 |

Even though the U.S. economy will still be bigger in 2020, China will have added 1.6 times more to global GDP. The top ten Asian economies will add over three times more than the U.S. to global GDP. Investment dollars will flow to where the growth is.

Asian GDP growth starts with its people. The top ten Asian countries will add an estimated 310 million people over the next ten years, over 80% of which will come from China and India. Essentially, Asia will add the entire population of the U.S. over the next ten years. For every one person the U.S. adds, Asia will add ten. Japan will shrink and Europe will have no growth.

The next stage in growing Asian GDPs is boosting productivity, a process which has just begun. In China, we see the exciting early stages of its move up the “value-added” manufacturing chain. Improving technology and infrastructure are allowing China for the first time to compete in the core products of developed countries. For example, China is expected to overtake Germany and Japan in construction machinery exports by the end of 2011, becoming the world’s second largest exporter of heavy equipment, after the U.S. As China transitions from making socks and t-shirts to heavy equipment, its export markets will shift from the U.S. and Europe to other emerging economies. Additionally, promoting the development of higher value-added manufacturing will drive up wages.

Today, China’s per capita GDP is about 10% that of the U.S. Stated another way, China is about thirty years behind the U.S. in terms of productivity. If China’s per capita GDP were to grow 6% a year for the next ten years, the country would still be well behind the U.S. Historically, per capita growth slows to the rate of technological advancement - somewhere around 1.5% to 2.5% per year. For example, over the past four years U.S. per capita GDP has grown about 1.4% per year, but China’s has grown about 21% per year. The fact that China’s productivity needs to improve doesn’t mean that it will, but its current level of per capita GDP or productivity is so low it is not remotely close to a ceiling.

Here’s an example of China’s ample room for improvement. In the U.S., we produce about \$3.9 of GDP for each kWh of electricity we consume. China only produces \$1.7 of GDP per kWh of electricity, well less than half the U.S. rate. Although China has made tremendous progress and grown rapidly for a long period, there is nothing in its current level of advancement that says it can’t continue growing many times faster than the developed world.

There is another component to GDP growth that has remained largely untapped in China: consumption. Even as China’s GDP has grown steadily over the past 20 years, its rate of personal consumption as a percentage of GDP has not nearly kept pace. In fact, it has declined. This is not shocking, as it is common for consumption as a percentage of GDP to decline during the early stages of development in order to fund investment. In China it has continued to move lower in recent years due to the increased infrastructure investments made in response to the global financial crisis. Still, as government policies begin to shift growth from external trade to internal consumption, wages will rise. In addition, much of China’s economic prosperity has been limited to the coastal region. But as manufacturing moves inland, and as high speed trains connect central regions with economic hubs, the consumption potential of about 357 million central Chinese will become apparent.

We have been running higher levels of cash than we would normally. Slowly and very cautiously, we have started to buy companies at depressed valuations. However, high volatility and uncertainty will continue. In truth, we have more confidence in what we believe our companies will be worth in two years than at what price they might sell in 20 minutes. But all of our data support that China and Asia will be contributing far more to global economic growth over the next ten years. Investment dollars will follow growth.

Sincerely,



Nels Wangenstein



Dan McCarthy

Performance Disclaimer:

The performance prior to the inception date of May 31, 2008 for the Chinese Consumer Composite and the All Cap Opportunistic Equity Composite, is based on accounts managed by Nels Wangenstein at another Investment Advisor. The accounts were subject to a lower fee schedule. If the current fee schedule had been charged in periods prior to May 31, 2008 the returns would have been lower in such periods due to the higher fee schedule. Both the accounts and the Composites are managed for growth and preservation of capital using substantially the same strategy. Performance is shown net of expenses for the accounts (including a management fee) and reflects the reinvestment of all dividends and other earnings. Past performance is no guarantee of future results. Any investment program has a potential for loss as well as profit. The results achieved by individual clients will vary. Comparisons to the MSCI China index, S&P500, and other indexes are for tracking performance and are for informational purposes only, as the Account and the Composite are not intended to track the indexes and may hold or have held positions not included in such index. These results are not intended to be AIMR/GIPS compliant. A current fee structure and composite summary are available upon request.