

Random Walk

Investment 101

Random Walk wishes all investors a very happy and prosperous 2009; investors also should offer thanks that 2008 is finally over. Across all asset classes, returns were abysmal, with significant drawdown and high volatility. Consensus at the present seems to be leaning towards another miserable year, on the back of terrible news flow and generally weak sentiment globally.

2008 in numbers

Asset Class	Ticker	Return
World Equity Index	MXWO INDEX	-42.1%
Developed Market Equity Index	SPX INDEX	-38.5%
Emerging Market Equity Index	MXEF INDEX	-54.5%
Emerging Market Bond Index	CTRB INDEX	-42.7%
Global Commodity Index	SPGSCITR Index	-46.5%
Agricultural Commodities Index	SPGCAGTR Index	-28.9%
Energy Index	SPGCENTR Index	-52.4%
Industrial Metals Index	SPGCINTR Index	-49.0%
US Real Estate Index	SPCS20 Index	-16.4%
UK Real Estate Index	F3REAL Index	-46.0%
Global Macro Hedge Fund Index	INVXGLMA Index	-22.2%

Source: Bloomberg, Mashreqbank

Two primary questions should form the basis of any strategy for 2009 and beyond in our opinion.

1. What happened in 2008?
2. What impact does it have on the intrinsic value of businesses going forward?

The first one is easy; the first truly global bubble (defined as a bubble in every major asset class simultaneously) burst and is deflating rapidly. The fact that it burst is not a surprise, but the speed of its deflating is awe inspiring. It also highlights clearly that regional events last year were a result of a global dynamic. A clear view on the global economy is the starting point for any regional investment strategy for the Middle East in 2009 and beyond.

The second one is even easier; for well run businesses which are economically viable in a reasonably competitive environment, there has been no meaningful reduction in intrinsic value. We firmly believe stock prices are the present value of claims on very long term cash flow streams, with the appropriate growth and discount rate. If this is to be taken as correct (if it is not, then equity prices have no basis linked to the business, an absurd assumption) then it follows that a significant portion of the total value of a business derives from the terminal value. Hence, well run businesses where the going concern assumption is not suspect have not suffered any meaningful reduction in value. Our point is best illustrated by the impact on fair value by assuming that earnings for a given number of years fall to zero.

1	2	3	4	5	6
-10.9%	-20.7%	-29.4%	-37.3%	-44.3%	-50.6%

(assuming 3% growth in perpetuity, and a 15% discount rate)

So, if earnings for one year disappear, intrinsic value falls by less than 11%; for 2 years, by 21%, and so on. To put these changes in context, fair value changes by about 19% when the growth and discount rate are changed by 100 basis points.

The above bit of basic math is not meant to suggest that all businesses in the region are worth a lot more than their current market prices because a few years of missed earnings are not that significant. On the contrary, we wish to assert that quality businesses with sustainable operating models offer excellent investment opportunities given that short term earning fluctuations do not materially impact intrinsic value.

2009 Strategy: Global Factors

As discussed above, last year was an excellent example of globalization at play. Factors beyond the borders of the region were primarily responsible for the speed and extent of the damage in 2008, and this year will be similar in terms of the influence of global drivers.

1. **Credit Markets:** The sooner some semblance of normalcy returns to credit markets, the better it will be for the world economy and ultimately capital markets. Unfortunately this process is likely to be gradual, as financial institutions remain cautious due to low capital adequacy and the fear of rising losses on existing loan books. Credit growth has essentially fallen to nothing, and banks and other credit providers are rapidly adjusting to a new environment of old fashioned prudent banking. On balance, compared to the gogo years, the availability of credit (or lack thereof to be more precise) is likely to be a drag on capital market performance in 2009.
2. **Global Consumption:** The consumer is in retreat globally, due to various factors in various geographies. In developed markets, tumbling housing prices coupled with high indebtedness are prompting consumers to forego current consumption and finally save up. In emerging markets, the whole model of growing by exporting to the developed world has suddenly disappeared, putting a question mark on the source of future growth for the moment. The net result is that consumption has fallen sharply, as is being evidenced by collapsing trade volumes across the world. This trend is likely to continue for the time being, if only until the base effect kicks in at about the same time next year. This fall in consumption has underscored a quick pullback in commodity prices, where the speed of the fall in oil prices for example has surpassed the steep ascent. Global consumption is not likely to recover strongly in the short run, simply because the issue is structural in the west (tackling housing in the US for example is a task that has not even been attempted as yet) and the best intentioned policies (China's fiscal stimulus package for example) will require some time to gain traction. In our opinion, falling commodity prices should act as a big tax reduction for consumers globally, reducing inflation and halting the wealth transfer to commodity producers. Commodity producers are suffering a massive negative term of trade shock, which is likely to create some stress in the external account and correspondingly the currency regime; the Russian ruble is a good case in point. We expect commodity prices to broadly consolidate this year, and view low prices as supporting the ultimate recovery of consumption.
3. **Fiscal Policies:** Almost without exception, policymakers have grasped the magnitude of the economic challenges and have responded with sharp increases in government spending. Government support for financial institutions has also been forthcoming quite readily, which has at least prevented a complete collapse of confidence in the banking

sector. Globally, central bankers are reducing interest rates, governments are increasing spending, and support for the financial sector remains strong. On balance though, this strong fiscal stimulus will still fail to completely counter the negative impact of lower consumption and wealth destruction. At best, these fiscal policies will mitigate the impact of a weaker consumer in the short run, while creating the environment for persistent inflation in the long run.

To summarize, global drivers will determine the cost and availability of credit, with a knock on impact on the region. Global consumption will determine the near term sentiment for commodities, including energy. For the Middle East, developments in the emerging world, mainly China, will be quite important, as China represents perhaps the only potential consumer on the margin.

2009 Strategy: Regional Focus

Moving on to the region, things are a bit more interesting, after a uniformly disastrous 2008, when only the asset allocation call worked and security and market selection all failed miserably due to a correlation of almost one on the way down. The gaps opening up between various markets now, both in terms of current conditions and the outlook, should make up for a very interesting 2-3 year period, in our view. However, investors chasing short term performance in 2009 are likely to be disappointed; positioning for the ultimate end of the bear market (that started in late 2005) will prove to be much more fruitful.

Being a major commodity producing region (primarily energy), the Middle East is obviously suffering from the collapse in oil prices. Government budgets have gone haywire, and suddenly large budget deficits are likely to be the norm this year. Due to the sheer magnitude of the reduction in oil prices, nominal GDP growth numbers will be negative for Saudi Arabia, Oman, Kuwait, Qatar, UAE, and Iran this year. Most likely, all of these countries will also post significant budget deficits as well. In 2008, the last bubble, that of real estate prices, also started its inevitable process of deflating. Combined with a sharp curtailment in the availability of credit, falling real estate prices are likely to hurt consumers much more than the equities bear market. Stock ownership is limited in the region, at least compared to real estate ownership, and consequently the fall in real estate values will hurt more. Dubai being the poster child of real estate booms, is likely to top the list of victims as well. The good news is that the above is already known, and extrapolating the bad news is fast becoming fashionable, suggesting that the ultimate absolute bottom in prices cannot be that far off.

The UAE is perhaps the market with the worst outlook for 2009. As mentioned briefly above, financial services and real estate dominate the stock markets of Dubai and Abu Dhabi. Both these sectors will struggle for surviving in their current shape and form during the year; Emaar's offer of relaxed payment schedules to clients is a classic example of companies struggling in the current environment. That wealth destruction has and is taking place at a massive scale due to falling real estate prices is a fact; this wealth destruction will show up in smaller consumer balance sheets (where the equity and asset base has contracted, but the liabilities have not) and deteriorating loan books across the banking sector. Bear in mind that in mid 2008 the entire UAE sector was at a loan to deposit ratio of 120%, with non performing assets at less than 1% of gross loans. Well from those rosy days balance sheet growth has tanked and will continue to tank, loan books will season with higher losses, and investment portfolios will continue to remain under some stress. In a nutshell, 2009 will continue to provide bad news on the banking front. Real estate companies will not be far behind, with only accounting gimmicks likely to show continuing revenue or profit growth. After the destruction of

share prices last year, exactly this scenario and possibly worse is being priced into stock prices already. Hence there would appear to be limited absolute downside in the UAE (as measured from the bull market top), though momentum may continue to be absent for the whole year. UAE is not amongst our favored markets this year. Any takers betting against the DFM General Index breaching 1,000?

Kuwait is next; if anything, probably Kuwait's prospects look even poorer. Kuwait has a very "hands on" government, and this time has been no different. The government has pumped in USD1 billion to shore up stock prices (we have no clue why) and has failed to do so. So far, Gulf Commercial Bank has failed, and Global Investment House has defaulted on its liabilities. Not bad for merely the beginning. Investment companies, banks, and real estate dominate the stock market, and news flow and actual performance is likely to be miserable-Kuwait looks like one to avoid for the year. Kuwait has serious challenges on the fiscal side, with a dominant share of current expenditure, and we doubt the government's ability to spend its way out of the current slowdown. At present government officials are insisting that investment companies will not be protected by the government, but we are confident that as the malaise spreads, the government will relent.

Qatar is a bit of a special case, given the rather small size of the market itself. The government is the overwhelming player in the economy, and is in reasonable shape to ensure that growth continues, although sharply slower than last year 28% GDP growth. The larger Qatari Banks, like Qatar National Bank, perhaps offer the only opportunity of a growth (relatively) story among regional banks. However, the current environment is of a sharp adjustment for most banks, and we would be avoiding even the Qatari banks. Beyond the banks, most of the rest are going to suffer due to the sharp fall in global commodity prices (gas, steel, fertilizer) and are not likely to excite investors much. After Dubai, Qatar is perhaps the second market likely to experience a significant real estate price correction, which cannot augur well for equities. However the macro outlook is definitely not comparable to Dubai, though equities turning in a decent performance without a significant commodity price rebound would be a big surprise.

Oman, as is normally the case, is actually in half decent shape. Valuations have fallen, banks are in slightly better shape (definitely compared to some of their regional peers) and overall the economy may still continue to show strength in certain pockets. Oman suffered last year due to the withdrawal of offshore funds; as this source of supply is exhausted, prices should find some support. We are not overly bearish on Oman and would advise investors to build positions in select stocks using any weakness. However weakening liquidity across the region is making Oman even less investable with no immediate signs of improvement.

Bahrain in our opinion is too small a market at present in terms of liquidity to offer any benefit to regional investors, either from diversification geographically, or any unique security selection. In the current environment of risk aversion, it is a market best avoided completely. The debacle at Arab Banking Corporation should also serve as a good example of the potential problem at some of the financial institutions in Bahrain. We do not see any reason to be excited about Bahrain, either at the macro or at the micro level.

Egypt is somewhat behind the rest of the region in the current cycle. Monetary easing is yet to begin, inflation is still high, and it never had a banking boom. However, it is dependant on FDI, tourism, and trade passing through the Suez Canal, neither of which is going to hold up this year. Trade volumes globally are falling about 20%, FDI will remain weak, and tourism will also suffer as discretionary spending is curtailed. Given Egypt's reliance on government subsidies to keep the purchasing power of the population intact, the fall in food prices will come as a relief.

However, the beneficial impact of strong global fund flows (recall the fabulous valuations that Bank of Alexandria was sold at) will be absent, and the government will be hard pressed to keep growth intact. Egypt again is a market best left untouched, barring the odd opportunistic investment.

Other smaller markets in the region namely Lebanon, Morocco, Tunisia, and Jordan are relatively more expensive compared to their bigger counterparts, and are likely to rank lower on investors' wish lists should some risk appetite return during the year. We currently see no reason to be bullish on these smaller markets.

Which leaves Saudi Arabia. We are excited about Saudi Arabia as we have not been excited about any market in the region for a long time. This may come across as slightly counter intuitive, with Saudi Arabia being the biggest victim of the fall in oil prices. In line with the rest of the region, Saudi GDP growth will also slow to a crawl, and may turn negative as well. Government spending will need to rise, and rise dramatically to offset the weakness in private sector demand. Anecdotal evidence suggests this is already happening, with the King announcing plans to spend USD400 billion over the next five years. Crucially, Saudi Arabia lacks hindrances like a deflating real estate bubble which would hurt consumers badly. Hence with the government likely to take up the slack from the private sector, we do expect the Saudi economy to come out of 2009 in better shape than most of its regional peers. The equity market has been grinding lower since early 2006, and as of writing is down 78% from its peak in 2006. Despite our belief that on a relative basis Saudi Arabia is an attractive market, actual investment opportunities lie away from the obvious choices. We believe banking offers little excitement, with the possible exception of AlRajhi. Most commodity producers offer little short term joy, though on a long term basis Sabic would appear to be a no brainer trading at historical book value. Then there are the curiosities of stocks like Maaden, trading at the value of net cash on its balance sheet, with 1.35 million ounces of gold reserves thrown in for free. We favor companies like Jarir, Red Sea, even Al Hokair for the long run, Mobily, Saudi Telecom, Savola (we believe 2008 will serve to improve focus at the company), and our own favorite, Al Marai. For long term investors (most suited to equities in any case) Saudi Arabia is too good to miss at the moment; it is worthwhile to remember that equity investing is a long term pursuit and long term returns at this point in time are looking extremely attractive in Saudi Arabia. Sadly, market timing is an elusive skill, at least one which we do not possess. Our only advice on this account is to gradually phase in investments, possibly aiming to use up the next 4-6 quarters in the process to avoid the negative impact of volatility that is almost assured to be significant.

Wrap:

2009 is likely to mark the final throes of the bear market that started in late 2005. We expect vast differences in market performances in the region, with significant volatility, and anemic market liquidity. Investors need to have a long term horizon, and strict discipline to avoid value traps as stock prices plummet towards zero in some cases. We find several attractive opportunities in Saudi Arabia, which is the only exciting market in our view. Abu Dhabi has sound overall fundamentals but the dominance of real estate and banking rules out any short term joy. All other regional markets appear lackluster, with the possible exception of Oman to an extent.

Appendix on the Riskiness of Equities:

Investors tend to become risk averse at the worst possible time. Now is again a good example, at least for a properly constructed portfolio. Duration is a concept applied almost exclusively to fixed income, but it has a certain application to equities as well, especially to overall multi asset class portfolios. For equities, duration measures the percentage change in price for a given change in the rate of return that equities are priced to deliver. As a general rule, the higher the duration, the riskier the asset, in this case equity. Duration for dividend paying equities is measured by the price/dividend ratio, so, as prices move up or down (clearly prices are the more volatile series here), the duration of stocks also moves up or down. Now, as we saw with a market like Saudi Arabia above, stock prices are down 78% from their early 2006 peak. Assuming Saudi Arabia had a 3% dividend yield, the duration of the market was 33.3, meaning that an investor needed an investment horizon of 33.3 years to be reasonably certain of earning the return implied by security prices in 2006 (also keep in mind that the higher the valuation at the starting point, the lower your expected long term return; returns are simply the sum of dividend yields and capital gains, as multiples stay stable, in the long term returns are primarily a function of dividend yields and earning growth. Valuation does matter). So, not only was the expected return quite low in 2006, the required investment horizon was 33.3 years. At present, assuming that the dividend has not fallen from the 2006 level, the market duration has now dropped to 7.4 years. In addition, as valuations have fallen, the expected return has also gone up. So, compared to 2006, investors in 2009 in Saudi Arabia expect to make significantly higher returns over a relatively short time frame in the context of equity investing. The bottom line is that even for investors with an investment horizon of around 8 years or so, it makes sense to have a significant portion of their portfolios allocated to equity and still be confident of meeting their return objectives.