Tradewinds
GLOBAL INVESTORS

Understanding Risk in a Changing World

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REPORT**

> "If you are not willing to risk the unusual, you will have to settle for the ordinary."
>
> - Jim Rohn

A healthy approach to investing requires a balanced, realistic assessment of risk. Value is rarely found in neat packages free of any uncertainties, but leverage in a single speculative position can quickly backfire, and negative perceptions "everyone" holds may be obscuring great prospects. A sophisticated investor must be willing to look past conventional wisdom, spending time and thought in a multi-dimensional assessment of possible outcomes to synthesize an appropriate level of conviction toward given opportunities. At Tradewinds, we try to evaluate investments from a fresh perspective, going beyond groupthink to appraise truly important driving factors. This thoughtful analysis of value and certainty flows to our choice of investments, our weightings in those investments and our decisions about how to combine investments.

Our approach is grounded in our view of risk as the chance of the permanent loss of capital. While this understanding sounds simplistic enough, it is difficult to determine if a given loss of capital is permanent and how the chance of this loss can be quantified before it occurs. A robust accounting of loss must also take opportunity cost into consideration, as well as the effects of purchasing power dilution over time. Other challenges include the constantly changing nature of risk, and the complexities involved in the interactions of multiple sources of risk. As with much of what we do at Tradewinds, we attempt to think sensibly yet unconventionally about this topic, ultimately arriving at a non-consensus view which we believe broadens our investing landscape and allows us to generate superior long-term returns for clients.

ANALYZING RISK

In our view, the primary way to mitigate the chance of losing capital is to pay less for assets than what they are worth. This is much easier said than done, and

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ultimately comes down to quite subjective analysis. Unlike bonds where cash flows are objectively known (with the exception of possible default) and readily amenable to discounting to a present value, equity investments exist in a more uncertain environment. Cash flows, asset values and likely impediments to each must be estimated. Accordingly, much of a Tradewinds analyst's work is to utilize expertise and experience in identifying the intrinsic value of a given company, in order to determine whether or not it is trading at a discounted price.

We begin our analysis of intrinsic value by referencing a theoretical value, a price based on target valuation metrics for the perfect company within a particular industry. This company would be free of all regulatory and geopolitical issues and would have the best possible management. The company would also have high quality assets and the ability to generate consistently high margins and cash flows over time. The metrics we evaluate are sector-specific, with a focus on absolute levels; for example, 1x Enterprise Value to Sales for an auto manufacturer, or 1x Net Asset Value for a mining company.

The next step is the more difficult task of risk-adjusting the evaluated metrics with respect to the actual company under analysis, discounting the theoretical value to reflect our level of certainty that it will be realized. We're specifically not looking for a catalyst, or a 12-month price target. Rather, we are considering what the company should be worth given our assessment of likely factors affecting certainty. We've found these factors are often similar among companies within a sector, so we believe our global sector analysts are well positioned to appropriately rate the various threats to certainty. The governing factors will change from sector to sector, but our methodology gives us the ability to fairly credit good management, assets or brands while fairly discounting companies with poorer assets or challenges with regard to regulation or location. Within this framework we are able to estimate intrinsic value for a specific company, determine which pressures have already been priced in and compare our estimates of the chance of permanently losing capital with our upside evaluation. We believe this non-consensus approach compares favorably with the typical statistics-based capital asset pricing model (CAPM), which arrives at a discount rate by considering betas and risk-free rates, but not prices.

THE CHANGING FACE OF RISK

Though we are confident in the relevance of our analytical approach, we are well aware of the many challenges involved in assessing the certainty of value for a given company. These challenges are compounded by the fact that what was relatively dependable yesterday may be quite uncertain today. We believe an unbiased perspective goes a long way toward clarifying these issues, and we think such an independent outlook naturally leads to some unorthodox conclusions about risk as it manifests today.

In the past, the default and generally correct assumption was that developed markets are less risky than emerging markets, and should therefore trade at a valuation premium. Given the changes of recent years, however, we would argue that this conventional view can no longer be consistently applied. If one contemplates the diverse array of political and business philosophies currently at work around the globe, it is clear that each country must be investigated independently, with decisions made on a case-by-case basis as to whether or not risks are adequately priced into a given company considering the geographies within which it is domiciled and in which it does business.

One important aspect of this analysis is the relation between sovereign bond yields and valuation discounts. The conventional academic perspective declares the government bond yield to be the very definition of a risk-free rate, and the discount rate used in conventional analysis is linked to this rate. In reality, it can be a stretch to consider these yields risk-free, particularly in the developed world where government debt often approaches or is in excess of 100% of GDP, before factoring in additional retirement and health commitments which can be many multiples of this level. In nominal terms, governments in control of monetary policy and with a floating exchange rate can create enough money to pay off any debt, and therefore are indeed risk-free in this sense. This does not take into account the protection of real wealth, however. Further, as we see in the Eurozone, much of the developed world no longer has sovereign control over monetary policy, so defaults will likely increase in the developed world as the debt burden for many countries passes a point of no return.

In this area, we believe the past will make for a poor predictor of the future as the debt burdens of governments and their

constituents continue to weigh on the developed world. These governments face a great temptation to revert to the printing presses to eradicate their debts—austerity alone will not be an option, nor will continual delays of the day of reckoning in hopes that growth will arrive *ex nihilo* to solve the problem. We think that developed government bond yields at current levels, held artificially low by monetary policy, cannot reasonably be seen as being risk-free.

Tipping the Scales – Public Debt to GDP Ratio Estimates for G7 and E7 Countries*

As of March 5, 2012

G7 Country	Debt to GDP*	E7 Country	Debt to GDP*
Canada	83.5%	Brazil	54.4%
France	85.5	China	16.3
Germany	81.5	India	51.6
Italy	120.1	Indonesia	24.5
Japan	208.2	Mexico	37.5
U.K.	79.5	Russia	8.7
U.S.	69.4	Turkey	42.4
G7 Average	104%	E7 Average	34%

Source: CIA World FactBook, 2011 estimates. * Debt to GDP figures don't include off-balance-sheet liabilities, which would greatly amplify the disparity between G7 and E7 indebtedness.

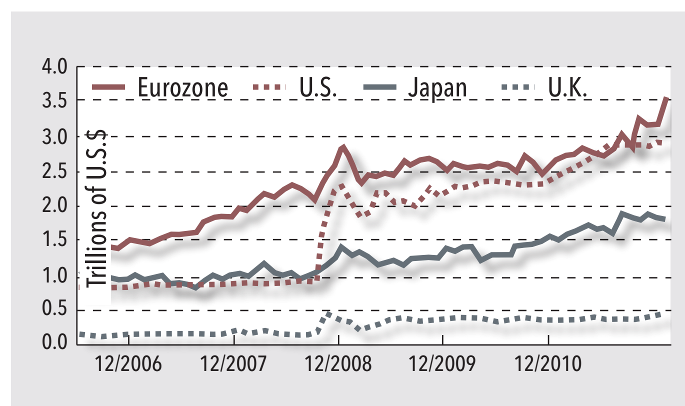
Past performance is no guarantee of future results. Data based on estimates and assumptions that may not occur.

We recognize that the developing world has historically been rife with crises, as in late 1990s Asia, Russia and Argentina. Nevertheless, with declining debt levels and rising current account surpluses, it is our belief that much of the emerging world currently looks sounder than the developed world. Having said this, valuation discounts reflecting past excesses may take some time to work through.

Just as historical profligacy can overshadow a more reliable current state, past success can extend trust even when it is not justified. Over the last thirty years the developed world has built a reputation for prudent monetary policy, with independent central banks often having a stated policy of price stability above all else. As we have now seen, that focus has actually been on consumer price stability, which can easily be manipulated, and did not fully take into account significant price increases in non-CPI items, CPI items with low weightings or, importantly, assets. Indeed, in recent years we have seen a substantial surge in developed world money supply as the balance sheets of the Fed, the Bank of England, the BoJ and the ECB have increased exponentially. While most recently inflation has been a concern of the developing world, we believe currency debasement is a risk in the developed world.

Easing Does It – Central Bank Assets in Trillions of U.S. $

As of January 15, 2012



Source: Credit Agricole Chevreux.

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The political realm is another area where emerging markets seem to be passing the torch of risk to developed markets. Political risks usually come down to understanding the dangers of buying assets or investing in a country where the rule of law is not engrained in the mindset of the ruling classes—as such, the chance of expropriation of assets or earnings is relatively high. Many emerging market countries have had a long history of nationalizing key industries, favoring politically connected businessmen and using legislative powers to coerce companies into being instruments of public policy. Emerging economies have certainly traded at a valuation discount to the developed world for these reasons, and some investors find certain emerging markets such as Russia, or frontier markets such as Venezuela, accordingly un-investable. However, with developed world liabilities dramatically exceeding assets at this point in time, and with populist measures gaining increasing traction, we see special taxes being levied on oil companies in Europe's North Sea, mining taxes increased in

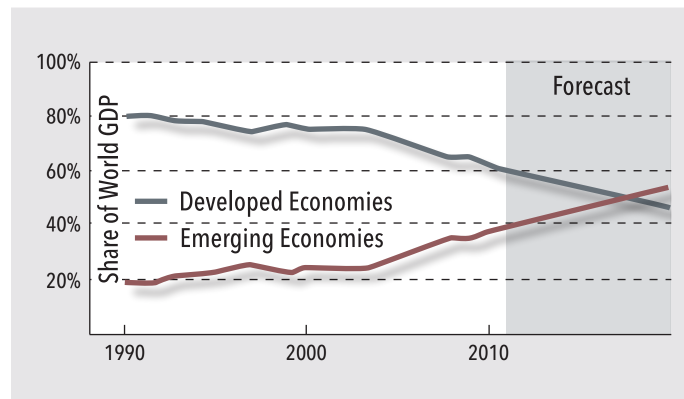
Australia and ramping anti-business rhetoric in the U.S. as the presidential election season begins in earnest.

Poor corporate governance and disclosure is a risk associated with investing generally, but these factors have historically been somewhat exacerbated in many emerging markets. In recent years, though, many emerging economies have increased disclosure, started reporting under internationally accepted accounting standards and clearly provide much greater information and access now than in the past. The risk of cronyism and corruption still exists, and we believe this must be analyzed across all geographies. These concerns are somewhat intrinsic to the separation of ownership and control in corporate structures. Developed market examples can easily be found in many management- and board-dominated companies in Japan, or in Europe where we have seen instances of lax corporate governance, or indeed even in U.S. companies where shareholders have no direct say on compensation.

Considering all these factors, then, we believe buying overpriced or even fairly valued assets in markets where there is little perceived risk can actually be riskier than buying high quality, hard to replicate assets which are trading at a bargain price due to negative geographic sentiment. A hypothetical example of this contrast could be the different risk profiles of a Peruvian firm versus one located in Russia. Though Peru is nominally a representative democracy with little notability in the global consciousness, the country faces many challenges in extending government resources to poverty-stricken rural areas with rising narcotics trafficking. Russia, in contrast, is an asset-rich country which may well be entering the World Trade Organization in 2012. Admittedly, Russia has never really known democracy, the specter of Putin continues to loom large and the rights of individuals and businesses are still opaque, but on balance the hypothetical Russian company arguably could prove to be a less risky overall investment than the company in Peru.

Crossed Roads –
Economies' Share of World GDP at Market Exchange Rates

As of August 6, 2011



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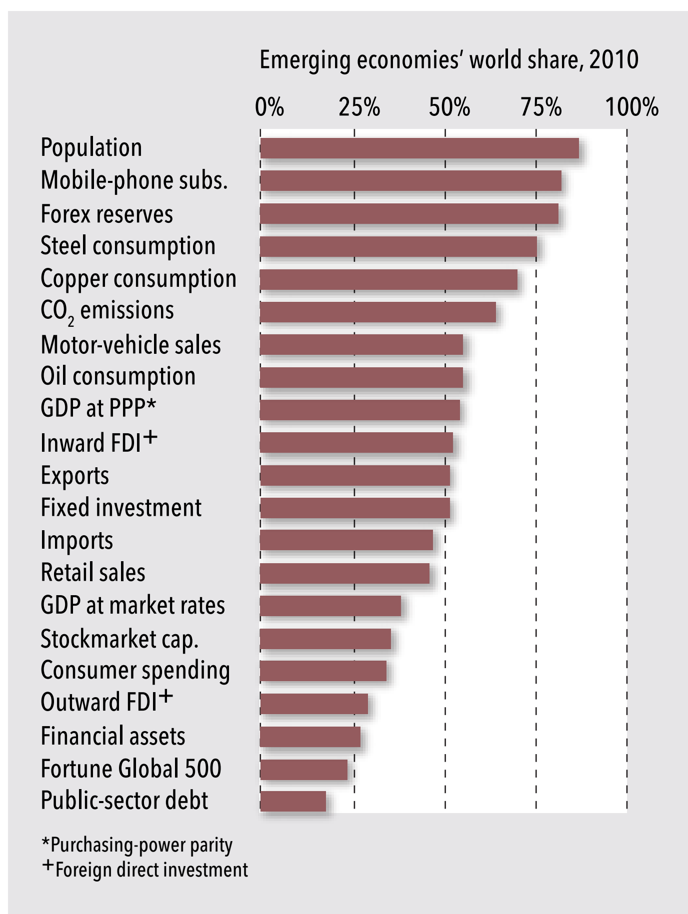
Not So Silent Majority – Emerging Economies' 2010 World Share of Various Metrics



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While all of the evolving risk dynamics mentioned above form part of the mosaic which contributes to our determination as to whether or not an asset is truly undervalued, we also consider investments in the context of an overall portfolio.

RISK IN A PORTFOLIO CONTEXT

Our analysts are experts in understanding their own industries and will never knowingly recommend overvalued companies, but they will not always get every recommendation right. Similarly, our portfolio managers will at times make mistakes when constructing portfolios from analyst recommendations. Consequently, the diversity of positions in our portfolios is explicitly designed to mitigate stock-specific risk by diffusing the effect of lackluster performers. If one could have only a single investment position, a closely held Indian company would make for an unlikely choice. It would be more rational to choose a conservative investment in such a scenario. If that closely held Indian company is a small portion of a broader portfolio, however, and the prospective upside is significant, the investment might deserve analysis. The chance of permanent loss of capital must be a primary focus in any company analysis, but at the portfolio level, where this risk can be somewhat muted, a modest allocation to a less certain company may be sensible given an attractive enough ratio of reward to risk.

While investments in particular emerging or frontier markets may at first appear risky, it is useful to understand that each company in which we invest is thoroughly vetted by our experienced investment team as noted above. If we buy five companies with significant prospective upside, but also with prospective downside, and they are in different markets, with different risks, it is impossible to know *ex ante* which will provide significant upside—but by buying all five rigorously scrutinized companies, we believe our odds of success on average will be greater than the market, even if some of these investments are in perceived "riskier" locations. If we were to otherwise limit our investment universe to only relatively certain opportunities, we may very well miss out on gains strong enough to offset the losses which are an unavoidable aspect of investing.

For all of the reasons above, where the mandate allows, we ask our clients to give us the greatest investment opportunity set possible. This could include certain "lower quality" emerging or frontier markets, or financial instruments such as P-notes which give us access to undervalued or less liquid securities. Where there is a risk generated by a counterparty or settlement in a particular country we will try to mitigate that risk as best we can—we will not knowingly put our clients' capital at undue risk. We also will not look to uncritically avoid every possible risk; rather, we will take advantage of other's fears or misunderstandings to buy into opportunities to build robust portfolios.

As Howard Marks points out in his latest book, price is an important risk factor: as prices drop, risks go down, even for "dicey" situations. Pessimism makes for an easy retreat

when faced with all the various threats to capital offered in today's investment environment. Even initially grounded investors may be rattled into running back indoors, locking the deadbolt and peering from behind the curtains after experiencing extreme volatility or unexpected setbacks. As in so many areas of life, however, it is active engagement of challenges, not avoidance, which leads to success. The ravages of inflation and opportunity costs mean indecision is its own decision. Throwing aside all restraint in a hasty pursuit of outsized returns is equally ill-advised. While a wholly perfect equilibrium between risk and reward may be impossible to attain, we believe our independent investment perspective can offer a meaningful framework for analyzing uncertainty and uncovering value.

RISKS AND OTHER IMPORTANT DISCLOSURES

It is important to remember that there are risks inherent in any investment and there is no assurance that any investment or asset class will provide positive performance over time. Equity investments are subject to market risk or the risk that stocks will decline in response to adverse company news, industry developments or a general economic decline. There are special risks associated with international investments, such as foreign company risk, political risk, market risk, currency risk and correlation risk. These risks are magnified in emerging markets. A high concentration in energy, natural resources, utilities and other specific sectors presents further risks due to non-diversification. Possible loss of principal is also a risk.

Value style investing presents the risk that the holdings or securities may never reach their full market value because the market fails to recognize what the portfolio management team considers the true business value or because the portfolio management team has misjudged those values. In addition, value style investing may fall out of favor and underperform growth or other style investing during given periods. It is important to review investment objectives, risk tolerances, tax liability and liquidity needs before choosing a suitable investment style or manager.

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GLOSSARY

Developed countries are highly industrialized nations such as Australia, Austria, Canada, France, Germany, Italy, Japan, the UK and the US.

An **emerging market** is the financial market of a developing country, usually a small market with a short operating history.

Frontier markets are less advanced capital markets in the developing world. Frontier markets are countries with investable stock markets that are less established than those in the emerging markets.

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