

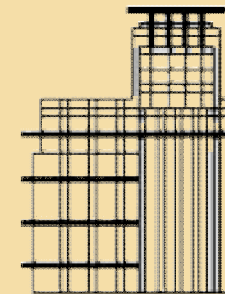


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Trends To Watch in Cross-Border Investment

Thomas W. Shreve

Financial Club
August 20, 2009



FINANCIAL CLUB
JAKARTA

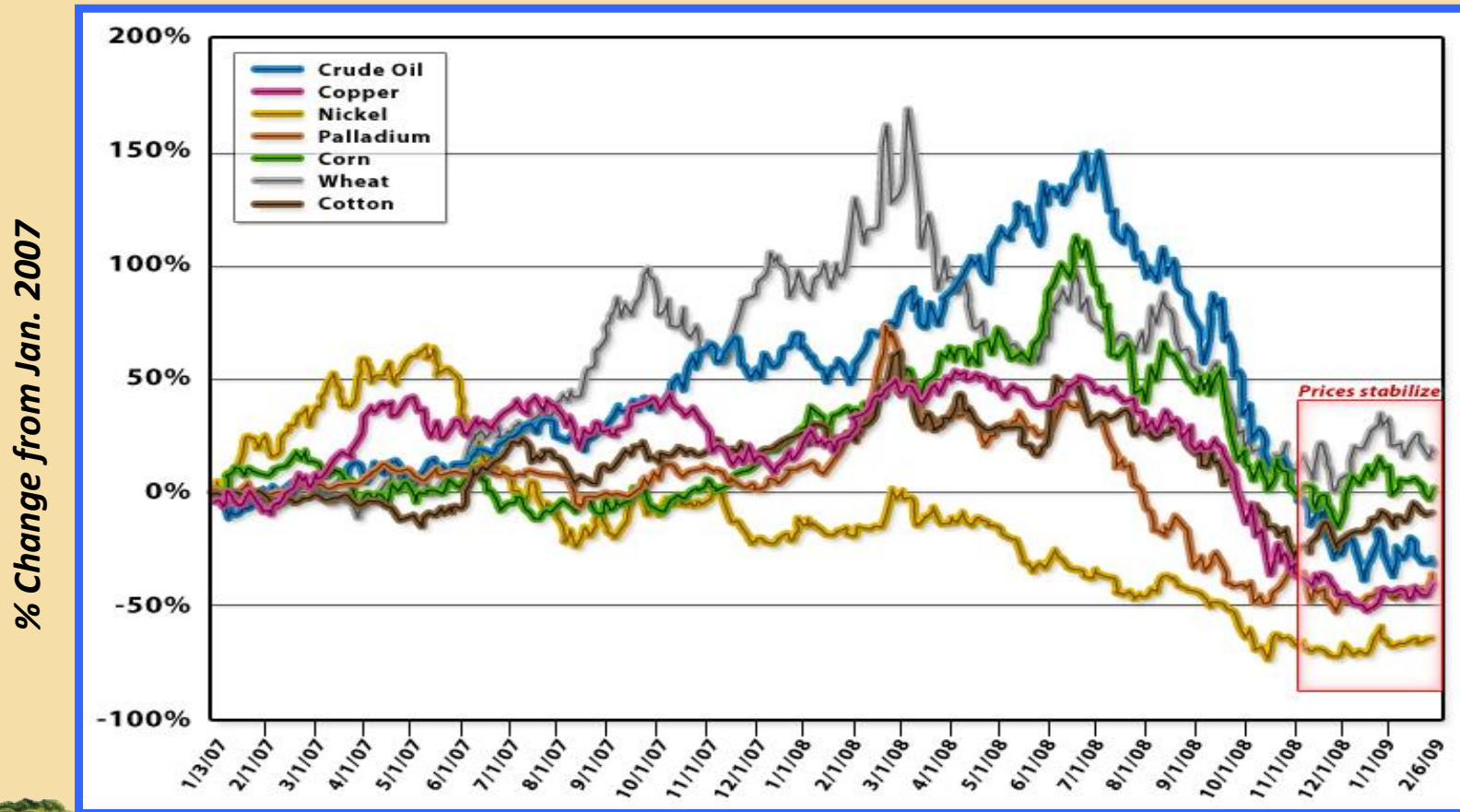
September 2008: The Defining Moment

- All trends and strategies must be reevaluated in light of the commodities price boom of 2007-2008 and the market crash which followed.
- The commodities price boom made many unattractive investments, such as green energy and agribusiness, very interesting.
- The commodities price boom also exacerbated trade imbalances, especially the US trade deficit, leading many to predict a dollar crisis.
- At the same time, financial sector companies were making high earnings, resulting in high financial stock prices without unusually high P/E ratios.
- The collapse of financial firms precipitated a stock market crash, commodities price crash, credit crisis and worldwide recession.
- The crash also reduced the magnitude, but did not reverse the direction, of imbalances in the flow of trade and investment.



Commodity Price Crash

Commodity Price Fluctuations



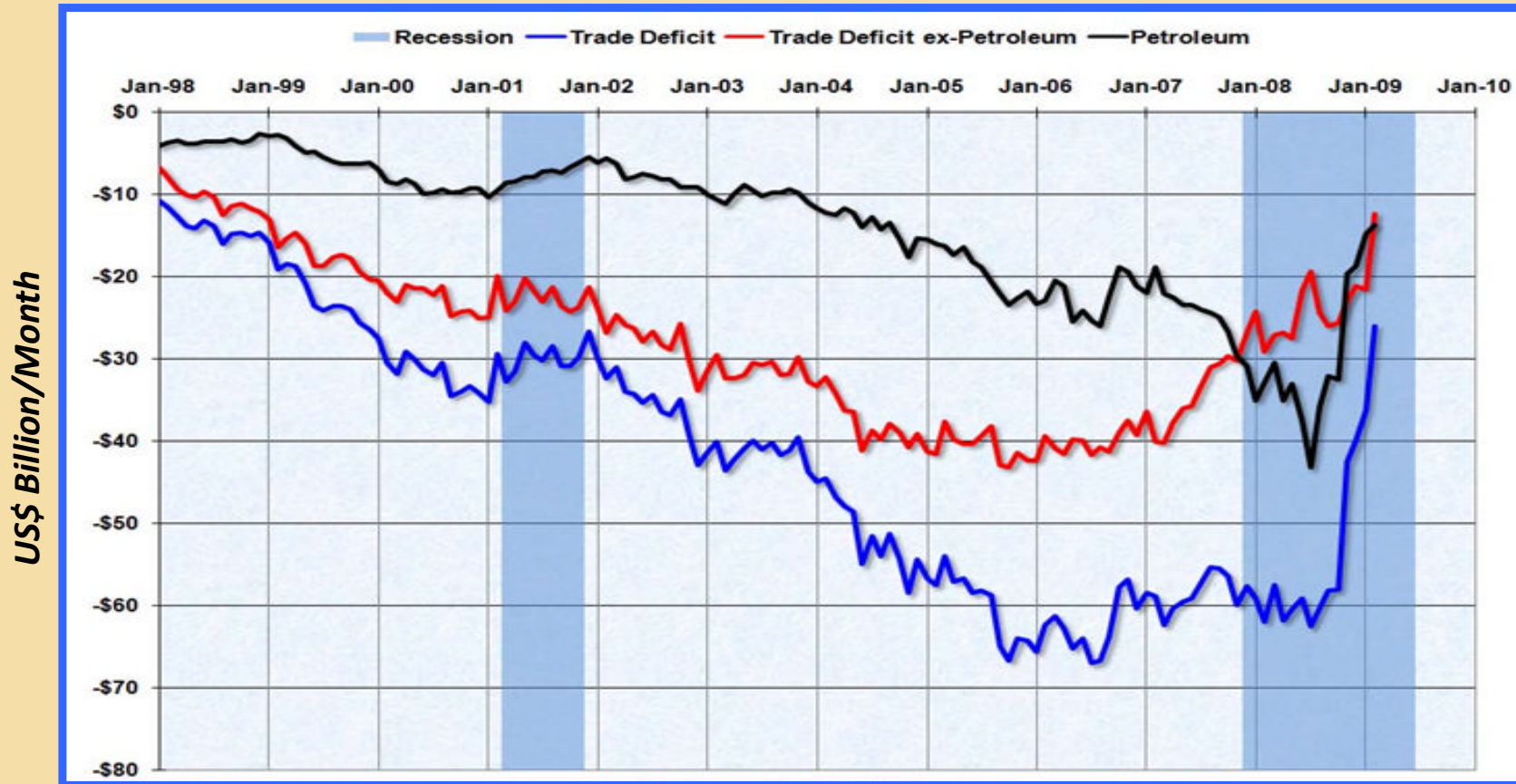
Source: Stratfor Report, 2009



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Reduced Trade Imbalances

US Trade Deficit



Source: www.calculatedriskblog.com



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The Major Trends

- 1. A Crushing Blow to Wall Street Values**
- 2. The Beginning of the End of Bretton Woods**
- 3. Geopolitically Driven Investor Base**



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The Minor Trends

- 4. Social and Environmental Focus**
- 5. Syariah-Compliant Financing Techniques**
- 6. Shortages of Expertise and Skilled Workers**



1. A Crushing Blow to Wall Street Values



Michael Lewis, "The End," Portfolio.com, December 2008



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Breach of Trust

- Financial institutions were deregulated because regulators believed that their efficiency will be maximized by leaving them unfettered control over risk management.
- New York and London-based fund managers and advisors sold mortgage-backed securities and other financial engineering hocus pocus promising “guaranteed” returns with minimal risk.
- More productive uses of financial assets were squeezed out.

the growing misalignment of interests between the people who trafficked in financial risk and the wider culture.

*Michael Lewis, “The End,”
Portfolio.com, December 2008*

disastrous experience searching for yield buying ... all sorts of dubious structured excreta.

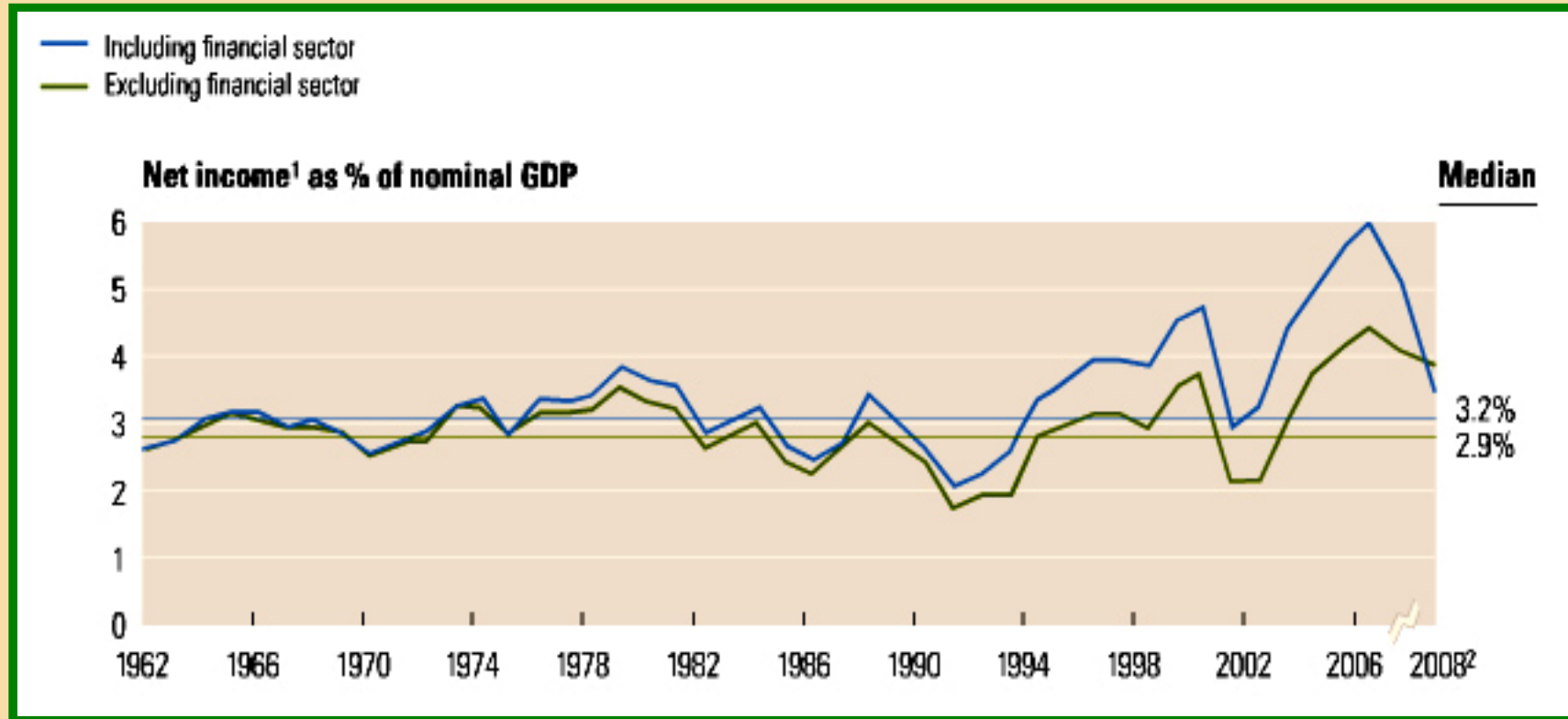
*Chris Wood, CLSA,
Greed & Fear, May 7, 2009*



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Profits: From Excessive to Negative

US Corporate Earnings, 1962-2008



McKinsey Quarterly, December 2008

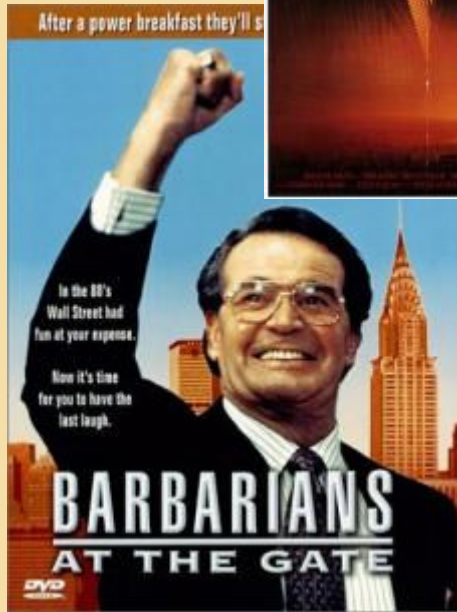


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The Culture of Wall Street

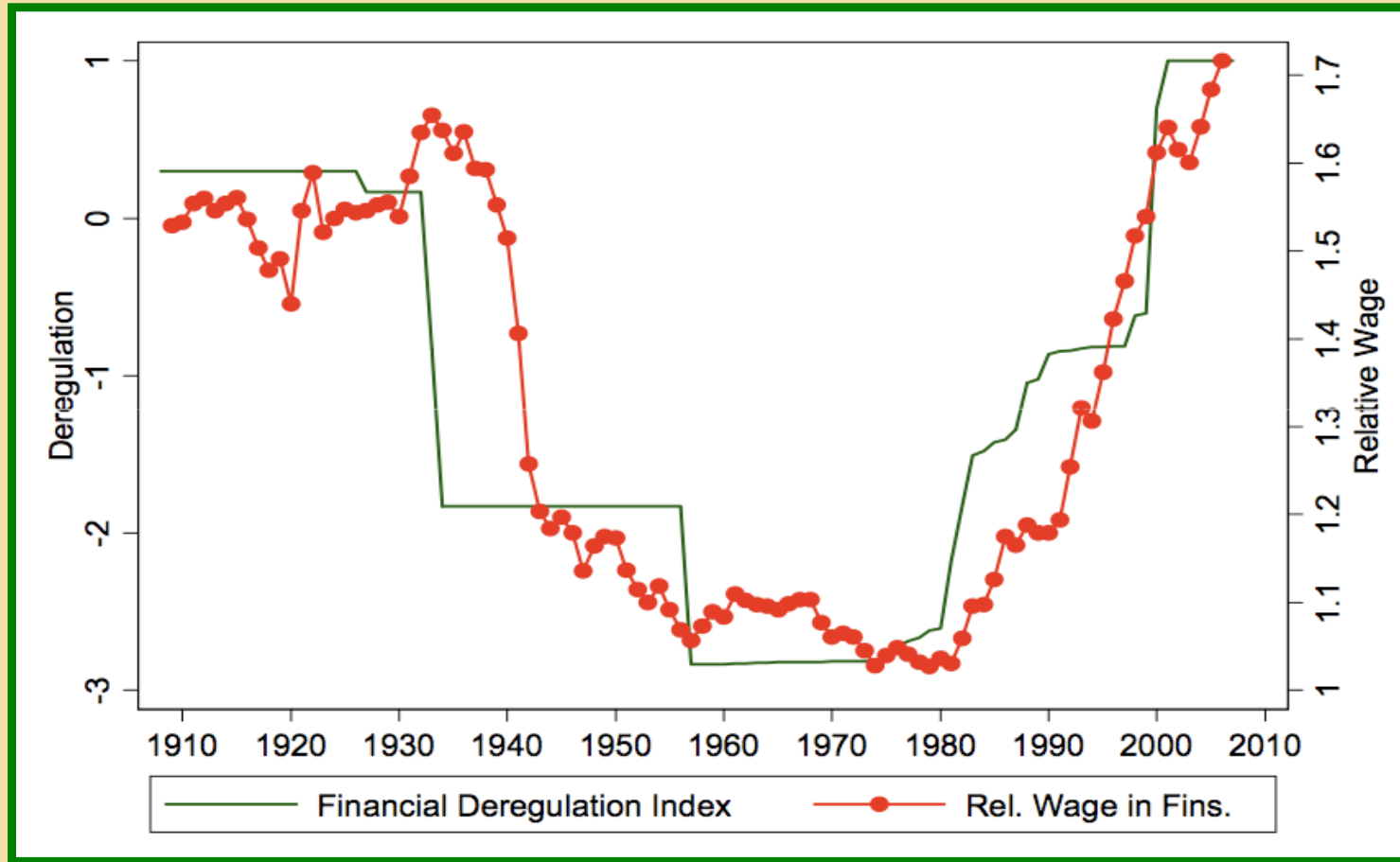


Greed Is Good



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Masters of the Universe



Blog.swivel.com, March 2009



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The Theoretical Underpinning

- Modern Portfolio Theory (Harry Markowitz, Chicago School of Economics): Because the result of any investment will vary according to a normal distribution curve, any risk profile can be created in any market.
- Efficient-Market Hypothesis (Eugene Fama, Chicago School of Business): The price of any financial asset always reflects all known information, and instantly changes to reflect new information.
- The Washington Consensus (Ronald Reagan, Margaret Thatcher): Free trade, unrestricted capital markets and unfettered international capital flows are the only effective method by which to promote development.

The upside of the current Great Recession is that it could drive a stake through the heart of the academic nostrum known as the efficient-market hypothesis.

*Roger Lowenstein, "On Wall Street, the Price Isn't Right,"
Washington Post, June 7, 2009*



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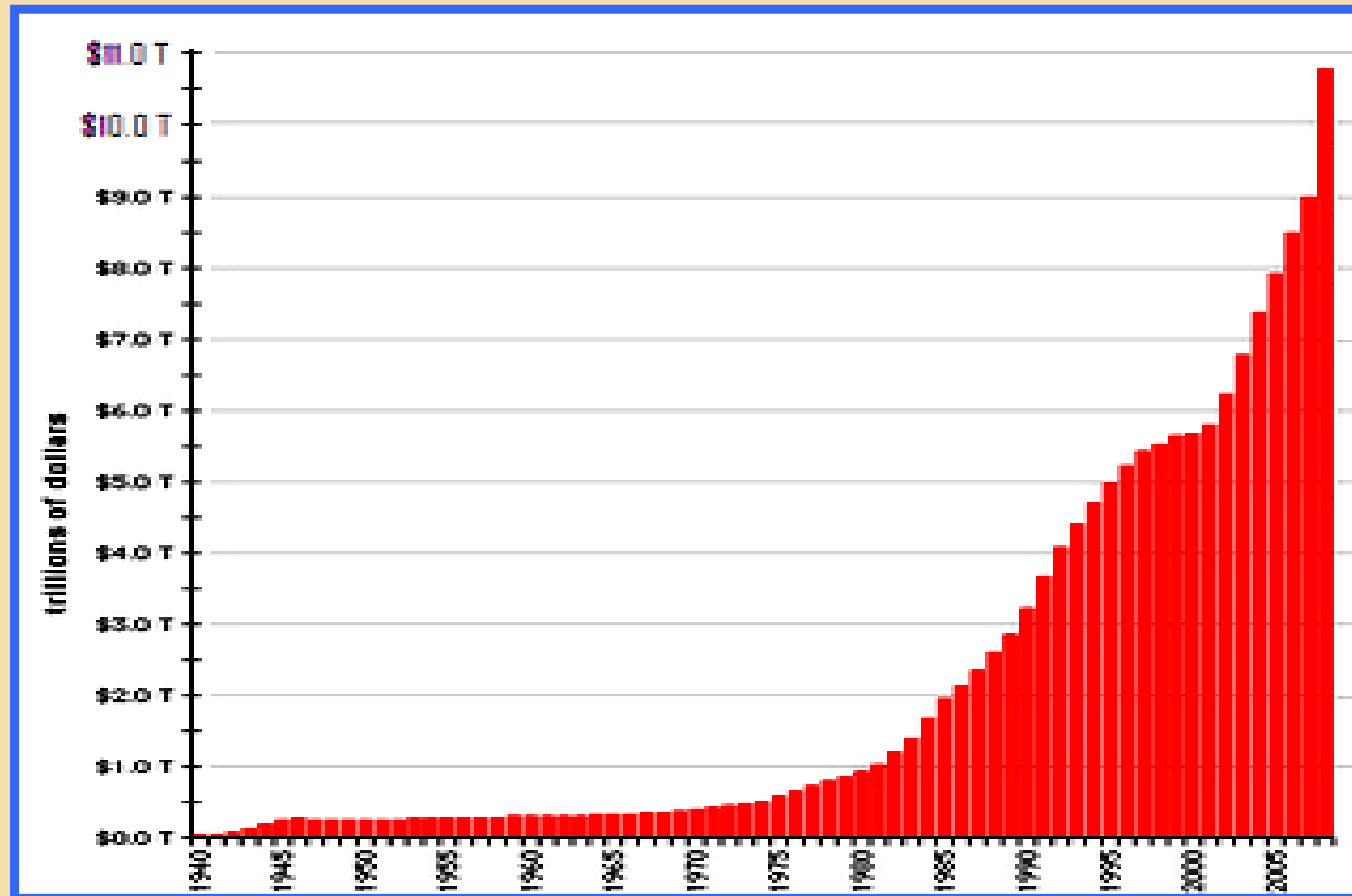
The Consequences

- Fund managers will buy fixed assets to diversify their portfolios of capital markets instruments.
- Exit strategies, especially those involving an IPO or other capital market-based sale, will become less critical.
- Investment structures will be simpler and attempts to control risk through financial engineering will be met with skepticism.
- New York and London-based financial institutions and advisors will have less of a competitive advantage over those with regional expertise.
- Careers in finance will attract fewer talented young people, and finance expertise will be seen as less important to sound investment strategy.
- In the policy realm, opponents of free trade and unregulated international capital flows will have the upper hand.



2. The Beginning of the End of Bretton Woods

National Debt, 1940-Present

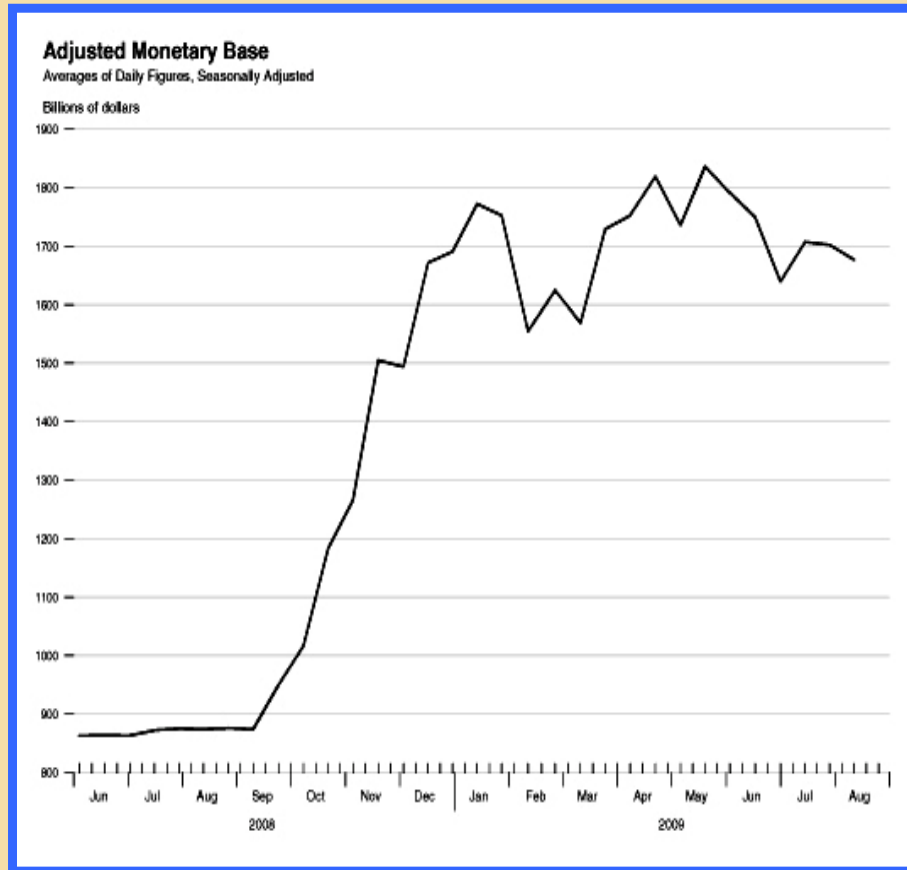


Source: www.brillig.com/debt_clock

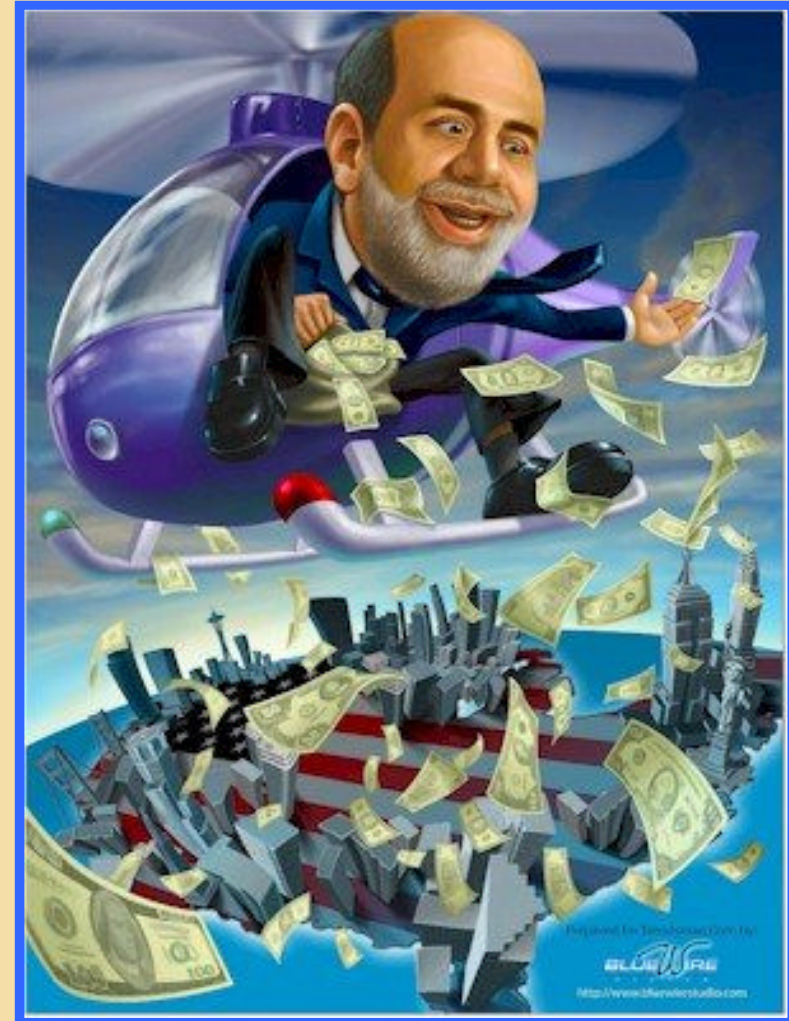


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Money Supply: Out of Control



Source: FRB St. Louis, 13-Aug-09



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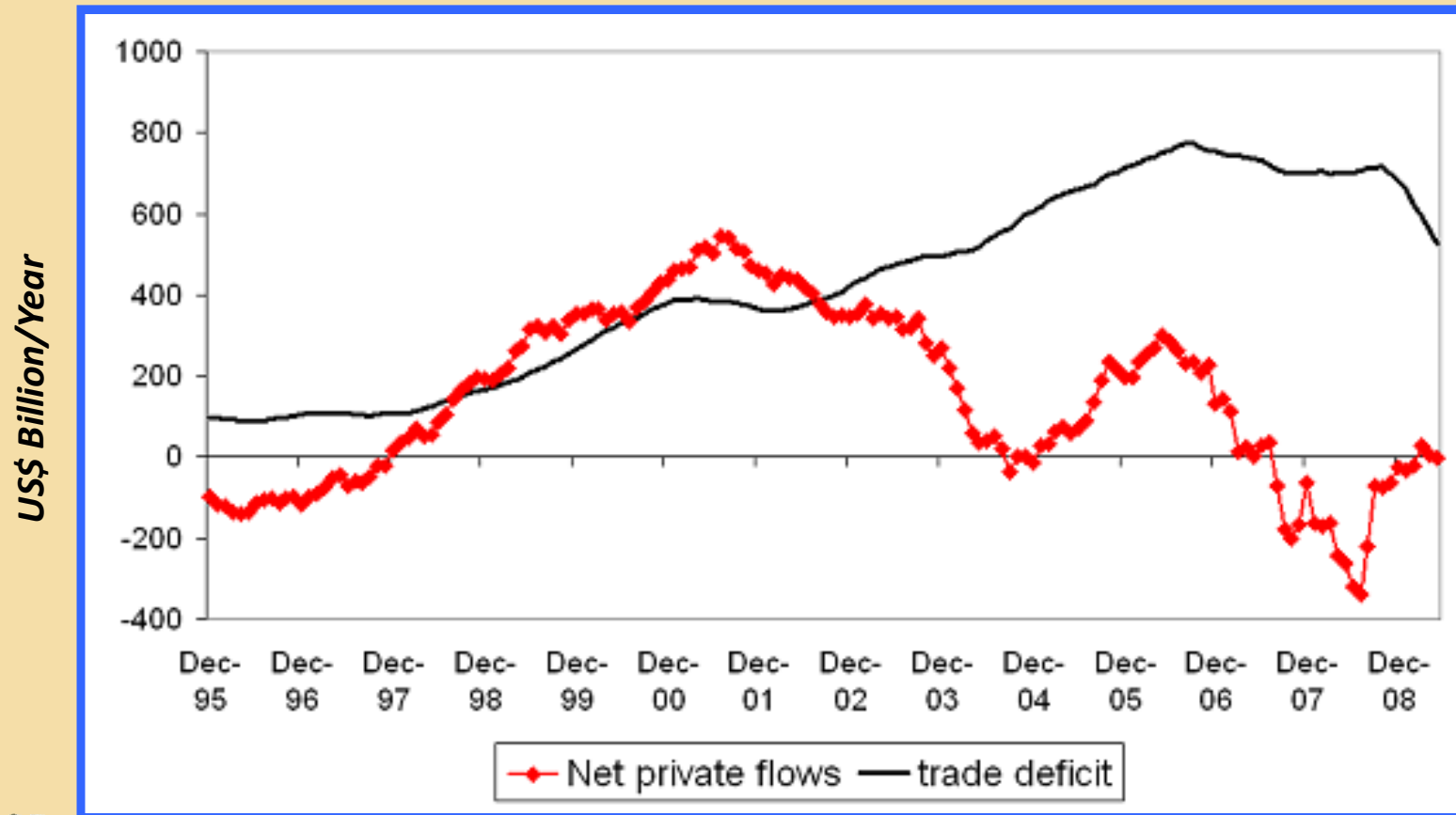
Credit Crisis-Dollar Crisis Interface

- While many economists expected a dollar crisis for some time, the crash which occurred paradoxically strengthened the dollar and perpetuated the imbalances which threaten a dollar crisis in the future.
- The credit crisis has reduced the rate of growth in net financing required by the US, but the US must still absorb capital on a continuous basis.
- Private sector investors began reducing their exposure to US debt in mid-2007, then returned to equilibrium (but not a net inflow) after the crash.
- The gap was filled by huge increases in sovereign reserves held in US dollars by emerging market countries, particularly China and Middle Eastern countries.
- However, the sovereign deposits are generally short-term and do not involve any commitment to continue financing trade and budget deficits.



Financing the Deficit

Net Private Sector Financing vs. US Trade Deficit



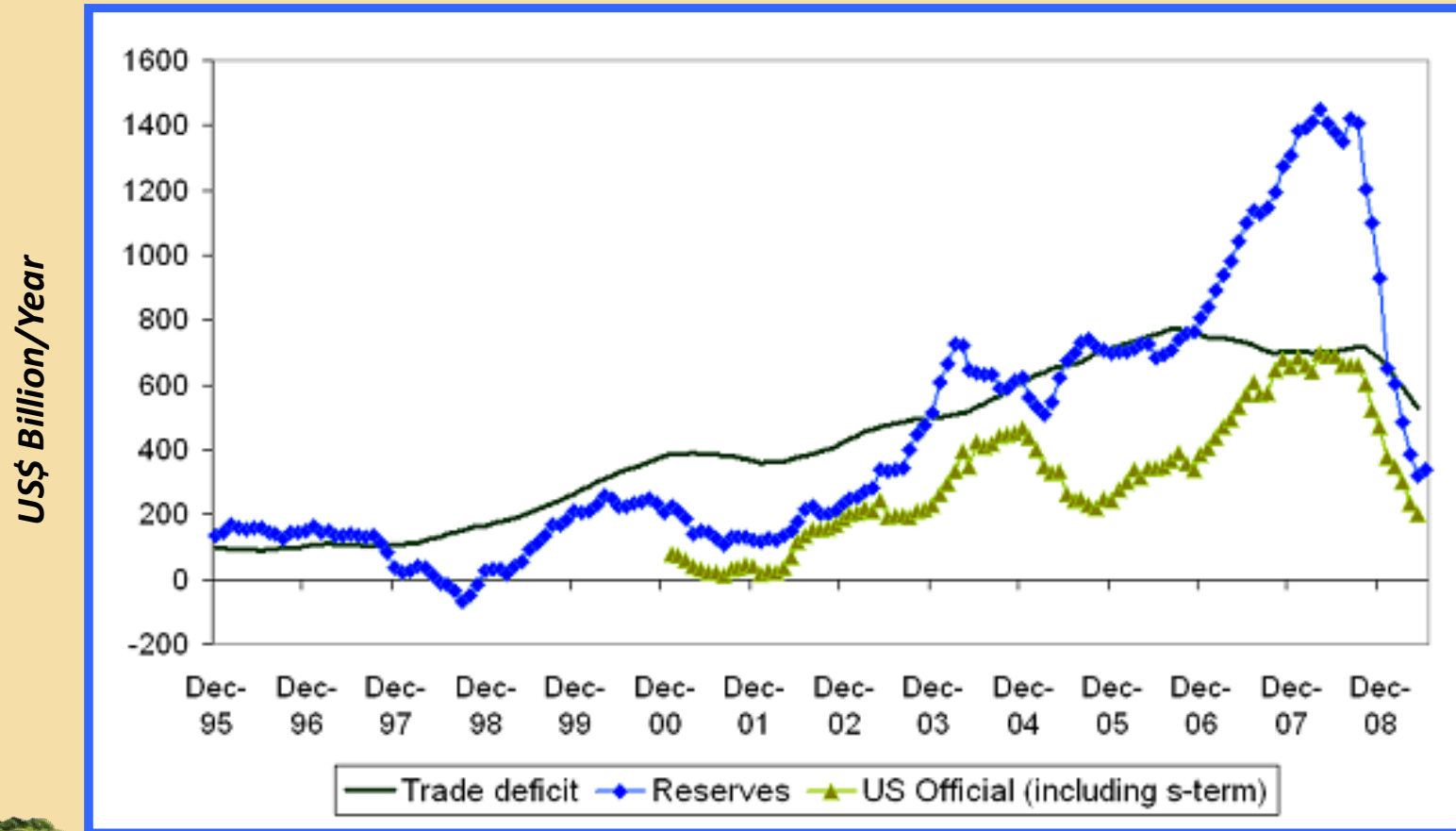
Source: US Treasury Department, 16-Jul-09



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Financing the Deficit

Net Public Sector Financing vs. US Trade Deficit



Source: US Treasury Department, 16-Jul-09



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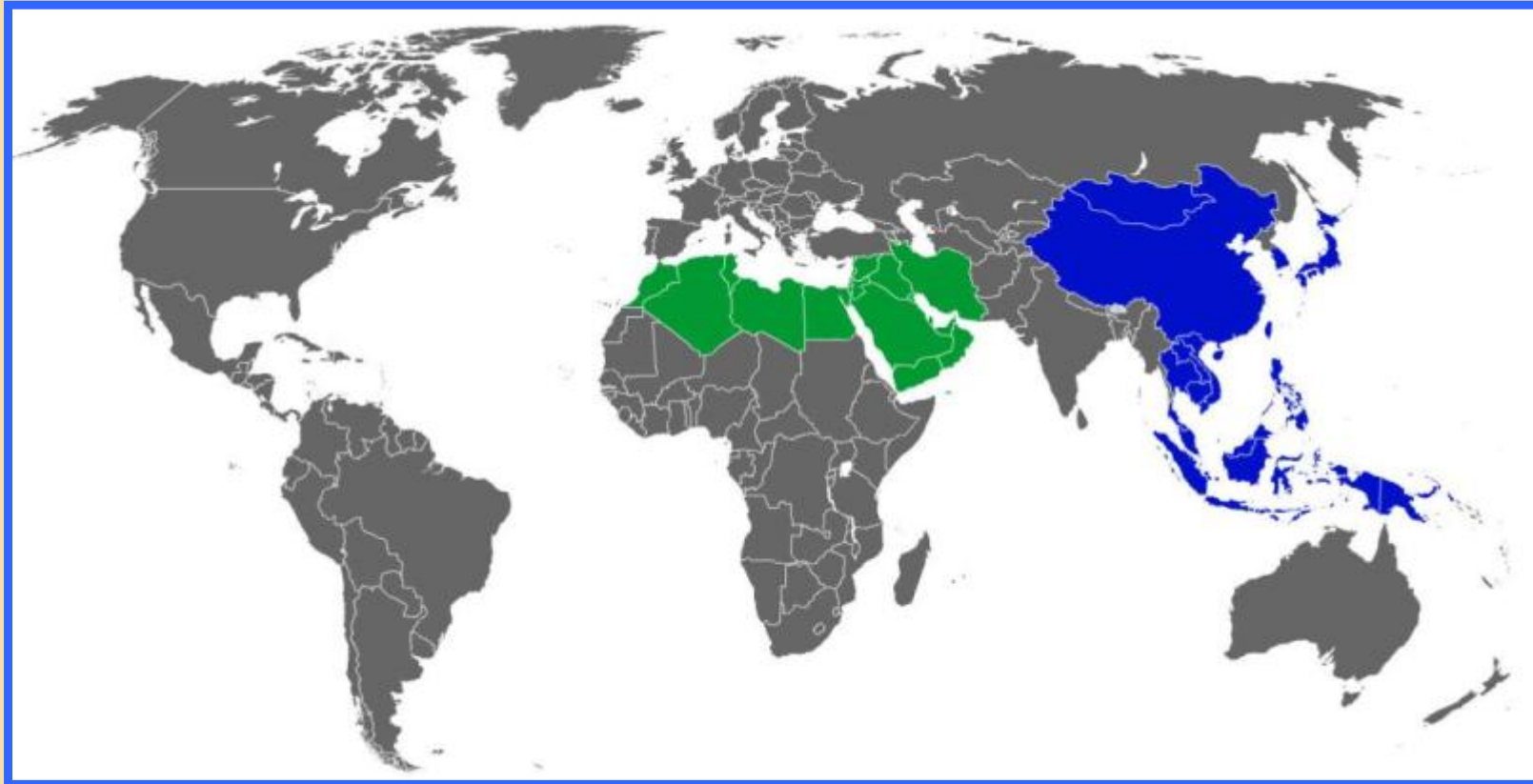
The Consequences

- US dollar interest rates will increase because the US will be forced to compete for funds to finance its deficits, and because the market will begin to fear inflation.
- US dollar-based investors will expect high returns – but the value of their investments will be eroded by inflation.
- Commodity prices will increase in US dollars as the value of the dollar shrinks, or is expected to.
- Alternative reserve and international transaction currencies will be considered – but this will take many years as no currency is currently in a position to supplant the US dollar.

In 1945, the US held 70% of the world's foreign exchange reserves.
Today, China holds 20% of the world's foreign exchange reserves.



3. Geopolitically Driven Investor Base



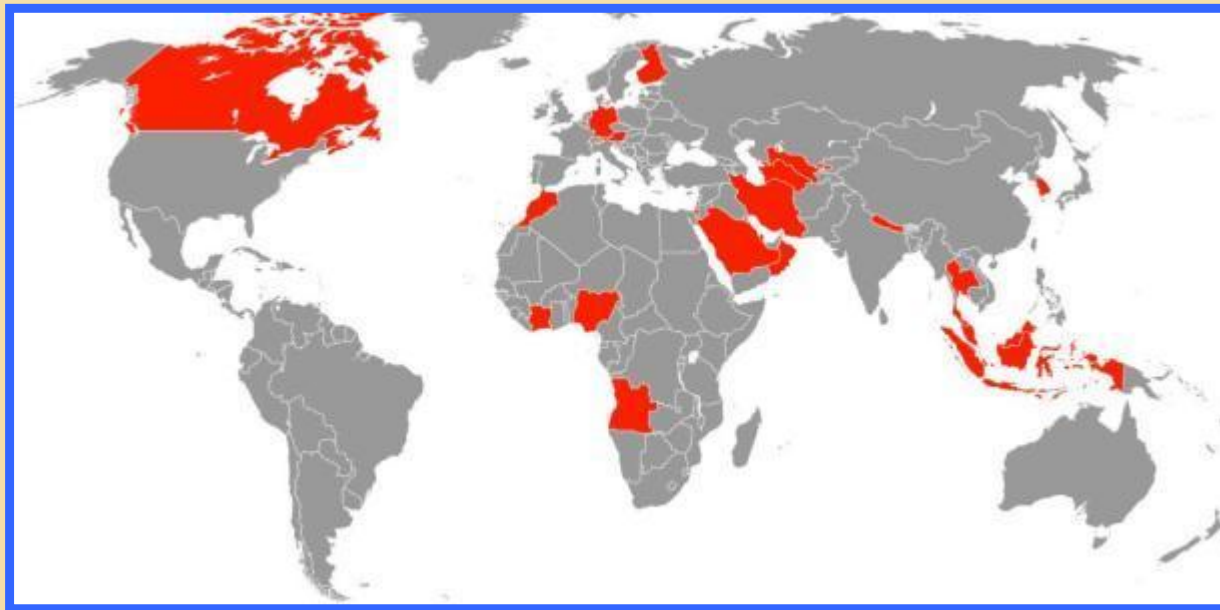
*Source: IMF, World Economic Outlook Database, April 2009
Map courtesy Gunn Interactive, www.gunn.co.nz*



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Emerging Market Economies Now Profitable

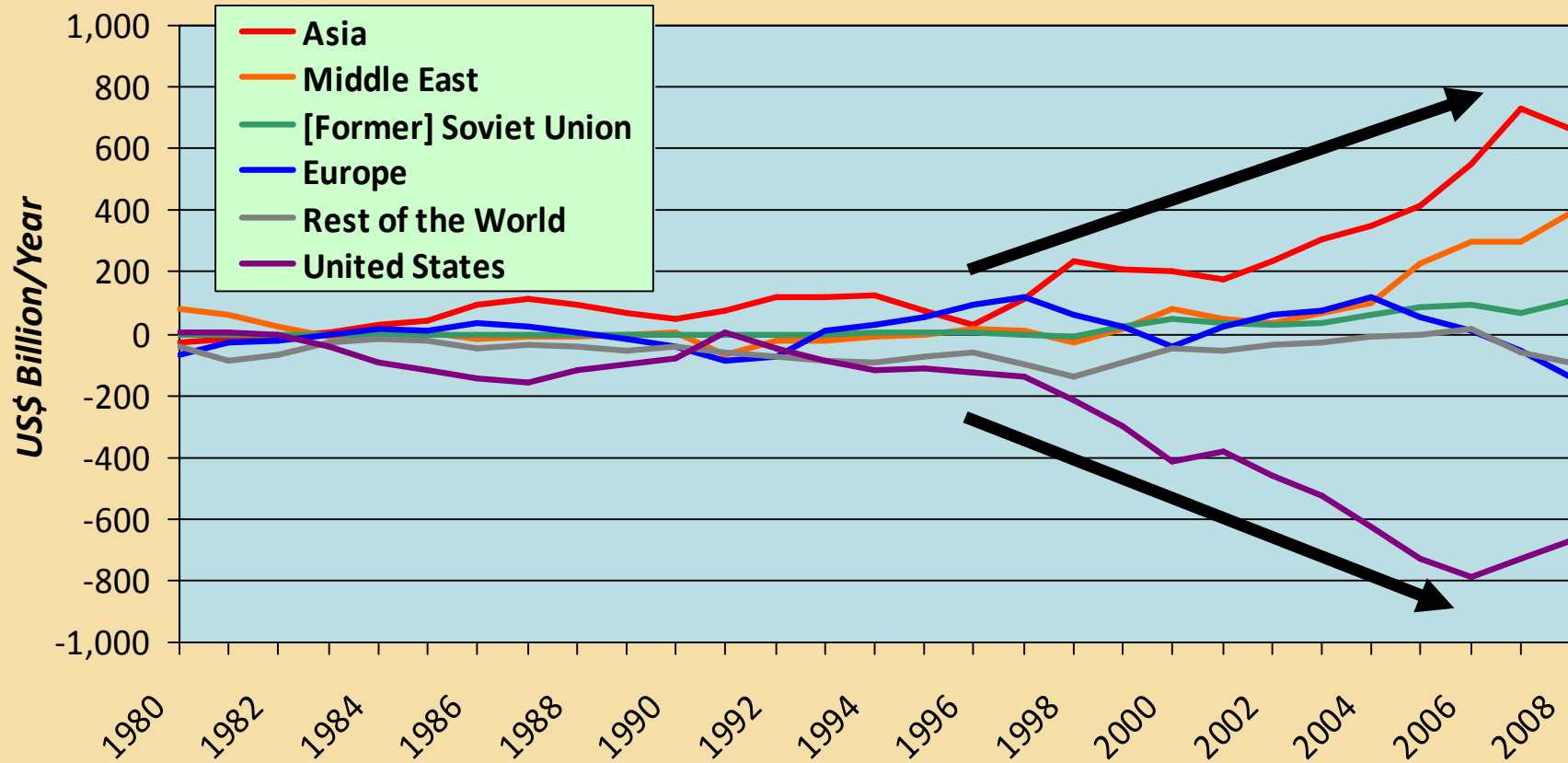
- In the 1980's and 1990's Indonesia had a chronic "current account deficit." In a current account deficit condition, the economy as a whole is not making money, and the shortfall is overcome by attracting a sufficient net amount of new investment.
- In 1998, the problem largely disappeared worldwide. 20 countries went from losing money in 1990-1997 to making money in 1998-2005:



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*Source: IMF, World Economic Outlook Database, April 2009
Map courtesy Gunn Interactive, www.gunn.co.nz*

Current Account Movements



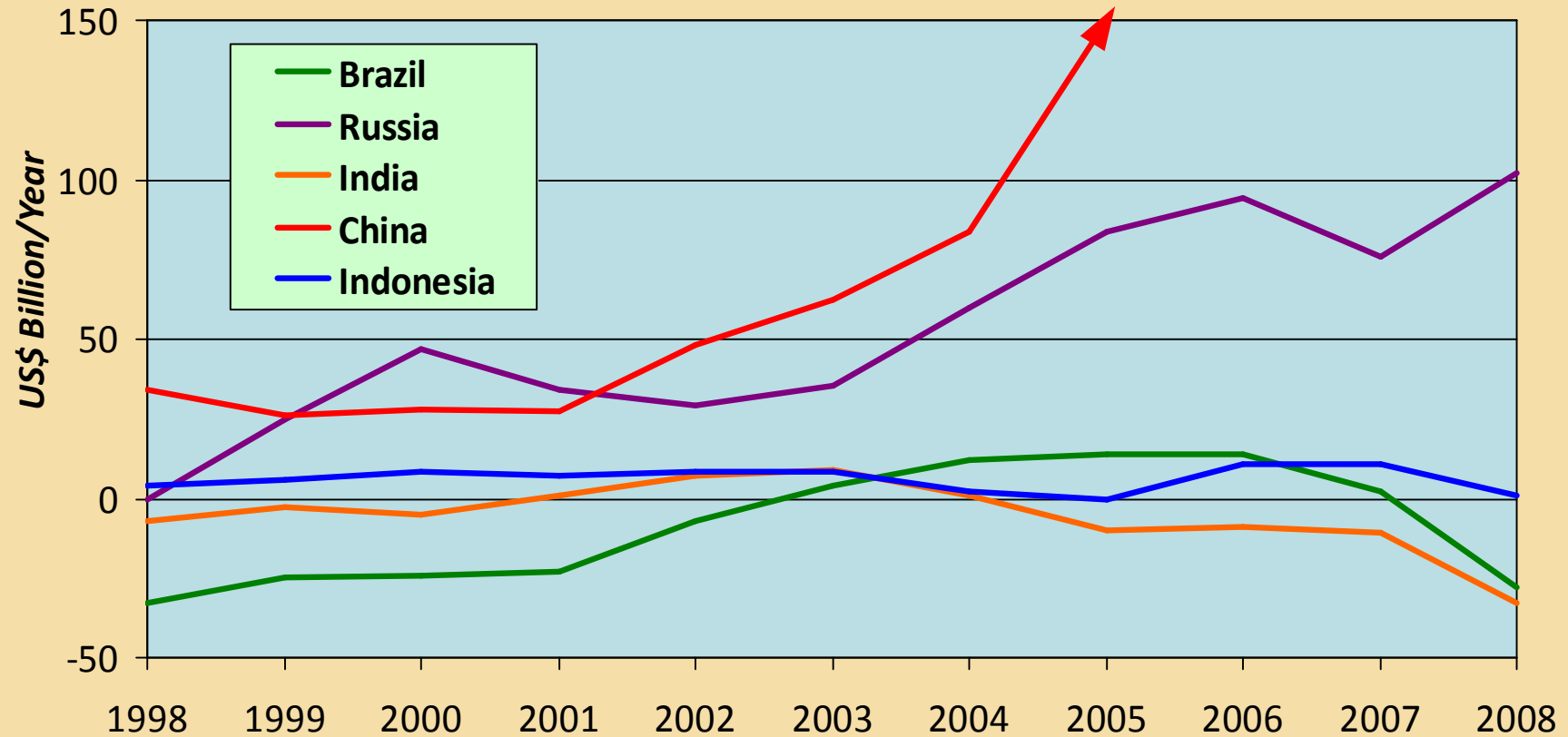
Source: IMF, World Economic Outlook Database, April 2009



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Indonesia: Not Dominant but Well Positioned

BRIC + I Performance Since 1998

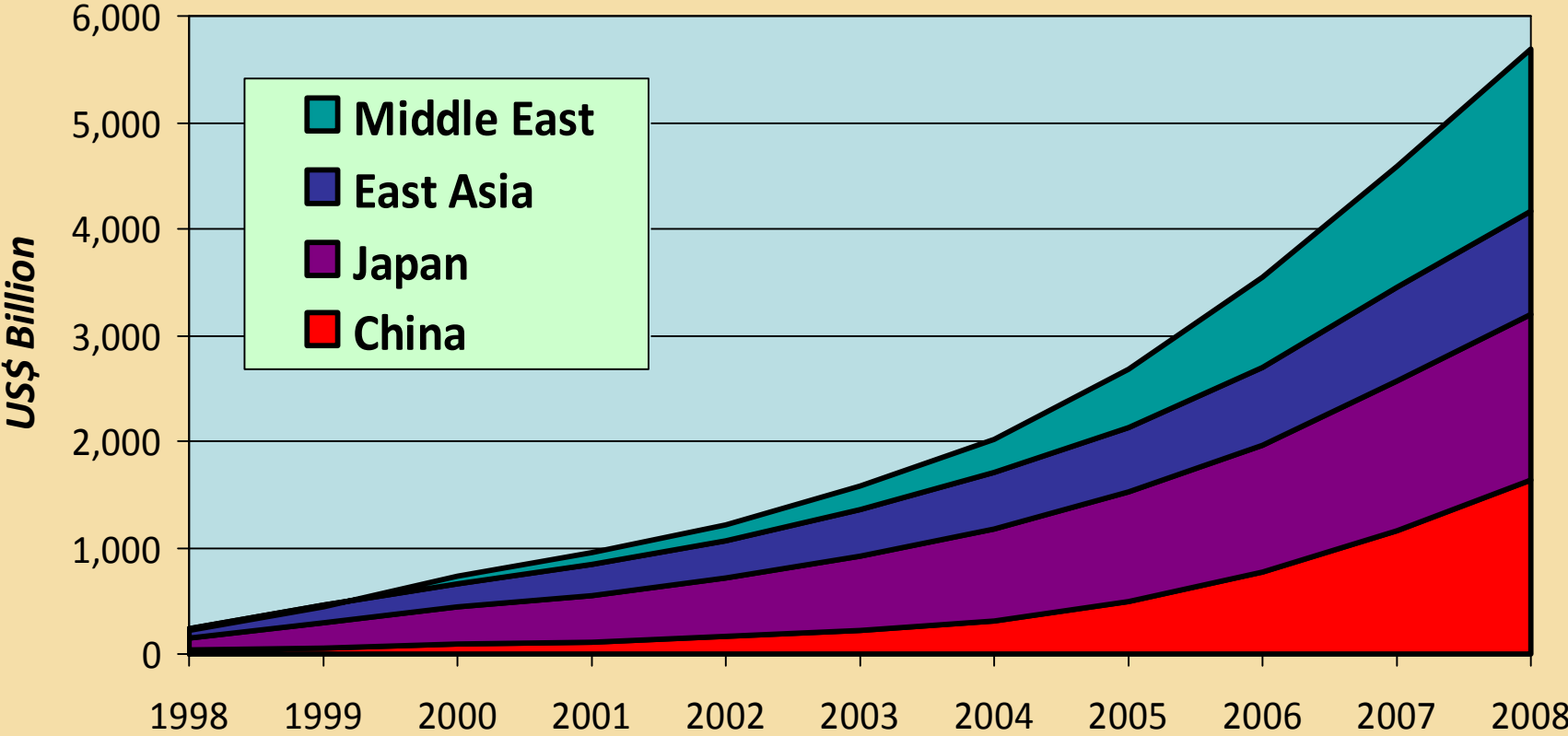


Source: IMF, World Economic Outlook Database, April 2009



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Cumulative Capital Generated Since 1998



Source: IMF, World Economic Outlook Database, April 2009



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Capital Flow-Credit Crisis Interface

- The wealth of China, the Middle East and other profit generating areas was not lost in the crash. For example, China Investment Corp. (CIC), with US\$300 billion under management, announced it achieved a net return in 2008 of -2%.
- Reduced imports into developed markets have only reduced the rate of capital flows, not reversed their direction. Current capital flow rates are reduced to about 2003 levels, and are likely to rebound.
- Wealthy emerging market investors are now less likely to invest in New York and London markets. Several large emerging market investors, including Temasek, have announced a change in investment strategy, either away from developed country capital markets, toward hard assets, or both.



The Consequences

- Investors from the surplus economies will be more coordinated at the national level, and therefore more geopolitical in their orientation.
- They will use some of the same New York and London-based advisors and fund managers, but not so much as previously because of Wall Street's loss of credibility.
- They will be less oriented toward maximizing returns using scientific techniques and more oriented toward building a portfolio of the kind of assets they want to own over the long term.
- The capital available to these economies and the growth which results will drive a commodities price rebound over the next two years.
- In Indonesia, this will translate into a strong preference for natural resources-based investments. Indonesia's less developed capital markets will be less of an impediment than previously.





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- Project Management

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