GaveKal Platform Company Fund Newsletter: June 2009

GaveKal Capital HK

Suite 3903, Central Plaza,

18 Harbour Road,

Wan Chai, Hong Kong

852-2869 8363 (tel)

852-2869 8131 (fax)

Regulated by the SFC

GaveKal Fund Management (Ireland) Limited

33 Sir John Rogerson's Quay

Dublin 2, Ireland

Regulated by IFSRA

Electronic Contacts

Email: sales@gavekal.com

Website: www.gavekal.com

A V-Shaped Recovery in Profits

In a recently published ad-hoc (see *What Will 2009 Be Remembered For?*), Louis argues that the current economic recovery is different in that China, rather than the US, is now the driver of global economic growth. But as far as originality goes, that may be it! Indeed, in most other ways, the current recovery seems to be following the dull pattern of previous economic rebounds:

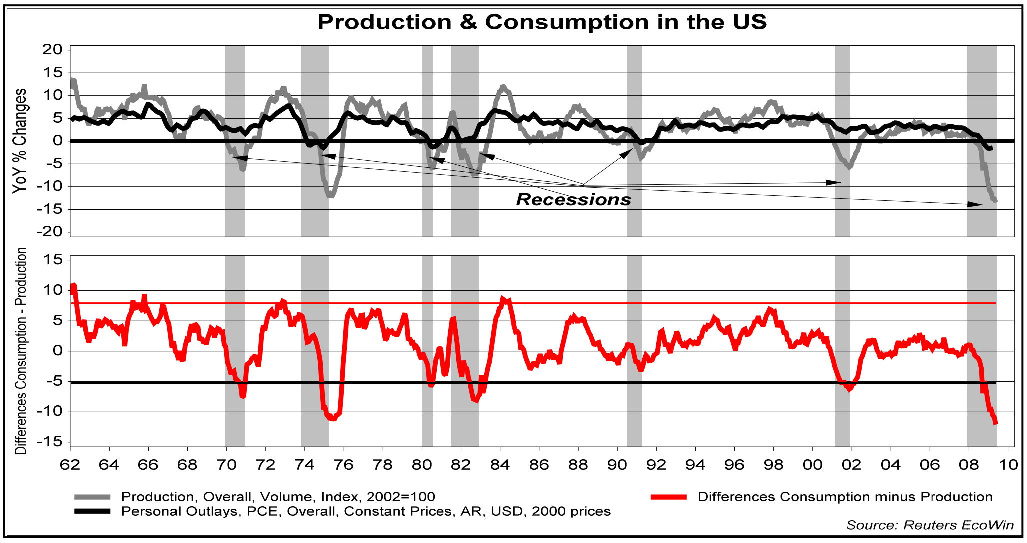
1. As always, every commentator is frantically trying to place a letter (L, W, V….) on the recovery's shape (see *What Shape the Recovery?*).
2. Once again, we seem to be going through the same motion of events: first, we were told that the fiscal and monetary stimulus would, this time around, not gain any traction (remember the "pushing on a string" and "ice age" arguments of 2003?). Then, as 'green shoots' sprout into a jungle, we are told that the economic recovery is simply an "inventory-led" rebound. Logically, this means that the next step from here on out should be declarations that the recovery is a "profitless recovery". Following that, and as profits emerge, we will likely be told that the recovery is "jobless". In turn, the recovery will be 'unsustainable'… until, of course, books are written (maybe by us?) about how we are living a "new paradigm"...

So, on previous patterns, we should soon be entering the phase of the cycle whereby investors ponder how "profitless" the recovery really is? Of course, for investors, the question of profits is always critical. After all, corporate profits are one of the two main determinants of stock market performance (the other being the cost of money). But in a period when most investors are still overweight cash, corporate profits are all the more important since they can give investors the courage to deploy capital in risk assets.

Interestingly, looking through our series of indicators, we find that there are a number of reasons to believe that corporate profits could surprise on the upside. In fact, as we will try to show in this paper, if economic growth continues to stabilize, there is every reason to hope for a very forceful rebound of profitability.

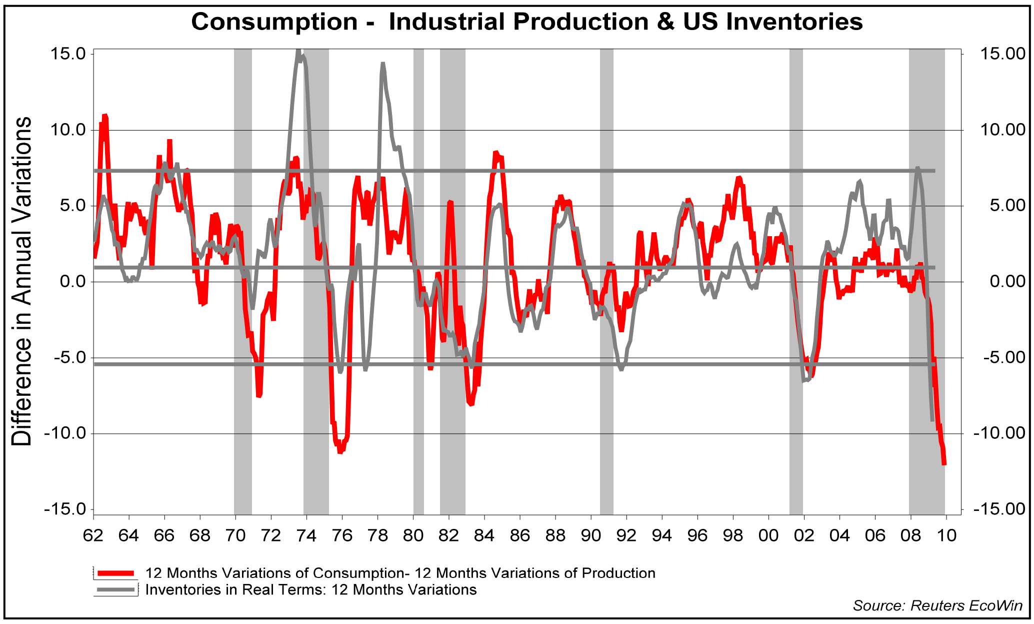
1– The Unprecedented Speed of Adjustment

In a recent meeting, a client labelled the recession the "first SAP recession". And undeniably, one of the key reasons behind both the severity of the recession, and the likelihood of a rapid recovery, is the speed with which U.S. corporations adjusted to the dramatic drop in demand. The chart below serves as a good illustration of this phenomenon:



In the chart on the previous page, the black line at the top of the chart is the 12-month rate of change in US personal outlays (consumption). The grey line is the 12-month rate of change in industrial production. The red line at the bottom is the difference between the two, and the two horizontal lines represent two standard deviations of this measure. **In short, when the red line "falls out of bed", it means that production is falling faster than final demand.** The implication is thus that, most probably, inventories are being liquidated with gusto. Let's try to verify this first assumption. Once again, we shall use a chart:

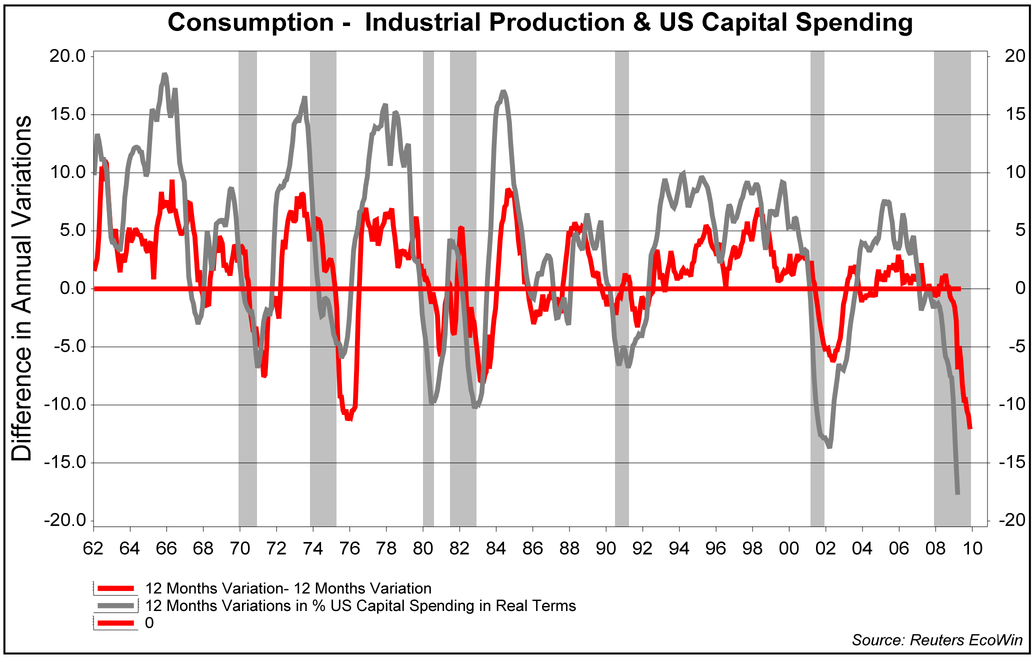
We have witnessed a truly astonishing liquidation in inventories and industrial production.



As with the previous chart, the red line represents the difference between consumption and production, while the grey line is the 12-month variation of the values of inventories in real terms. We have just witnessed the biggest inventory liquidation in modern times! Today, we are three standard deviations from the average, and much lower than we were even back in 1974.

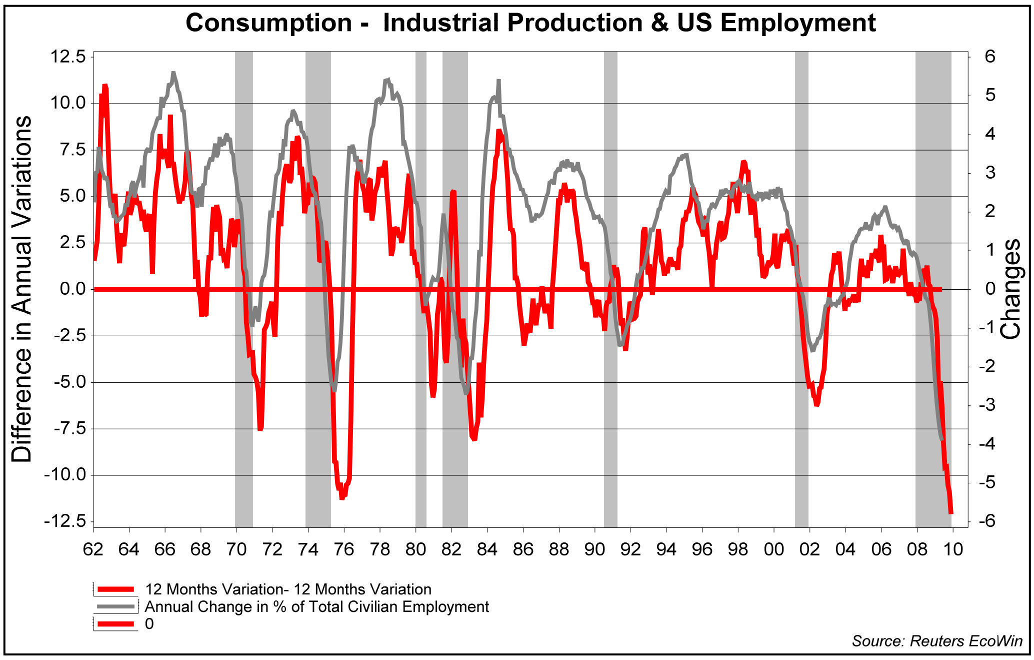
Undeniably, US companies have savagely cut into their inventories in this cycle. But this is not all—they have also cut both capital spending and employment at a pace that has simply no historical precedent.

U.S. companies have also drastically cut both capital spending and employment— at rates never seen before.



The sharp cuts in employment rates (implemented almost from the beginning of the recession) raises an important question: now that, thanks to SAP, Oracle and other management software, executives can see in real time how their businesses are faring, and make consequent immediate adjustments, will employment remain a lagging indicator? Instead, could we not be going through the first cycle where employment is a co-incident indicator?

Employment could be more of a leading indicator this time around.



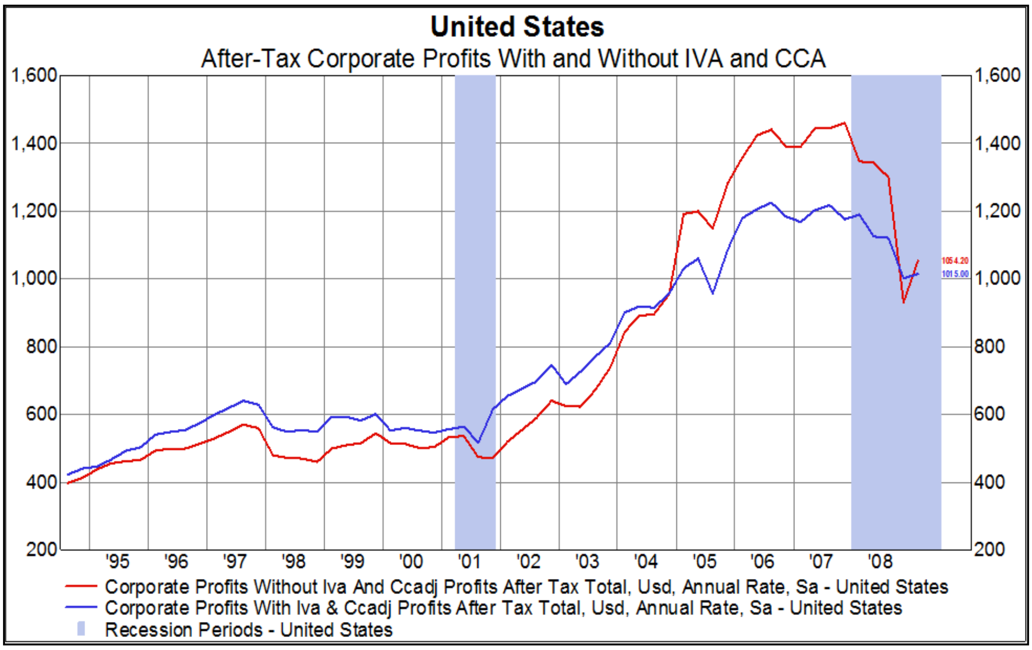
In any event, it seems obvious to us that, in this cycle, US companies have reacted extraordinarily early, and extraordinarily brutally, to a decline in final demand. In turn, this raises the question: what will happen to production if final consumption stops falling?

2 - A Closer Look at Profits and Inflation

The extraordinarily brutal and rapid response by U.S. companies makes one wonder what could happen to production if final consumption stops falling...?

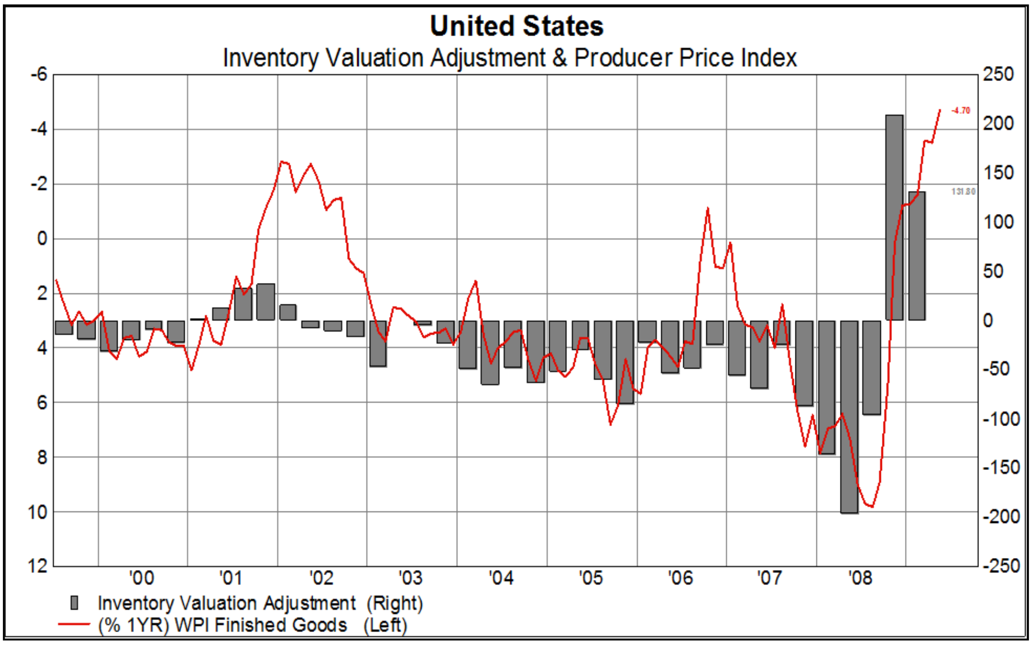
There are many nuances to government accounting, and most are trivial and mind numbing—but sometimes the complexity serves a purpose in helping reveal the truth. When we mention corporate profits, we refer to corporate profits after tax, adjusted for an inventory valuation adjustment (IVA) and a capital consumption adjustment (CCA). These two adjustments are designed to remove the impact inflation has on profits. In particular, the inventory valuation adjustment removes the inflation carrying gains imbedded in profits by simply changing the accounting of current production from a FIFO basis to a LIFO basis. As a simple example, let us imagine a company that sold a widget for $1 in period *n*, sourced the widget in period *n-2* at $.90 and whose replacement cost for the widget is $.95. In GAAP accounting, the company would effortlessly record a profit of $.10 by simply booking the gain between source cost and sale price. In government accounting, however, the result is a bit different as the inventory valuation adjustment equals the difference between source cost and replacement cost. In this instance, the IVA would be $.05 and inflation-adjusted profits would be $.05, not $.10. In short, IVA assumes that all sales in period *n* should be set against the replacement cost of the widget in period *n*.

Ordinarily, this results in a subtraction from profits, as profits are reduced by the difference between original cost and replacement cost of inventory. But, in the last year, as inflation has collapsed, the IVA has actually been accretive to profits. Let us show what we mean. In the chart overleaf, we have plotted after-tax corporate profits adjusted for IVA and CCA in blue along with unadjusted profits in red. In the early years of the last recovery, inflation began to creep up and worked its way into profits. This is easy to see as the red line rises at a steeper pitch than the blue line from 2002-2006. In the last year, this inflation-unadjusted measure of profits declined significantly more (some -40% from peak to present) than the inflation-adjusted measure of profits (which only fell by about -20%).



Due to two adjustments in government accounting procedures, corporate profits are affected by the level of inflation.

The closest variable we can find to further illustrate the idea of the inventory valuation adjustment is the producer price index of finished goods. In this next chart, we can see how the YoY change in the producer price index is closely related to the IVA. When cost-push inflation works its way through the system (largely as a function of rising oil prices in recent years) and pushes up wholesale prices of finished goods, the inventory valuation adjustment rises. Conversely, when inflation drops, the inventory valuation adjustment pushes up profits as the difference between source cost and replacement cost becomes negative.



While inflation penalizes profits, mild deflation has the opposite effect.

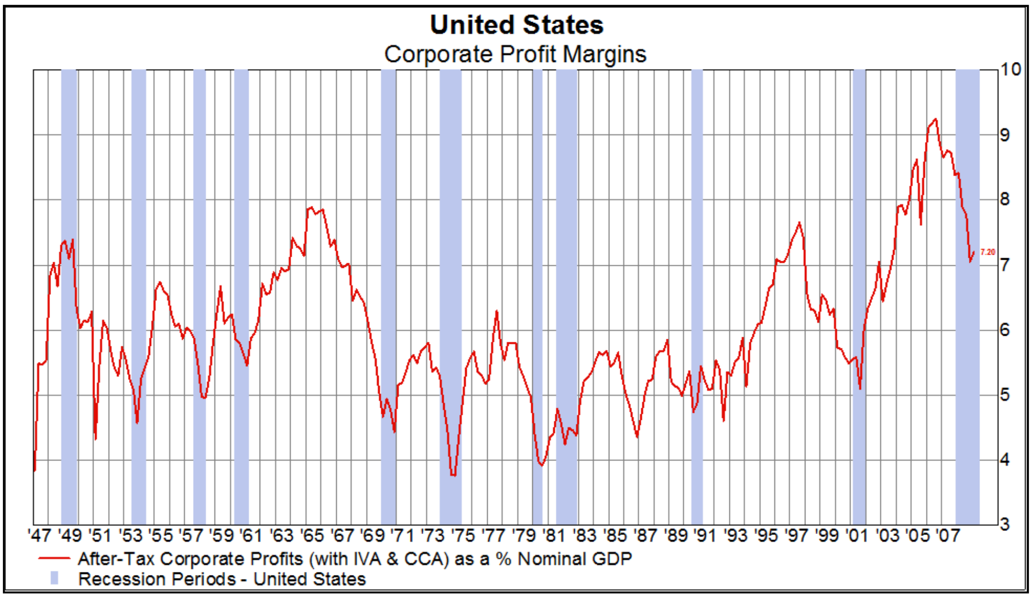
The important point here is that inflation penalizes profits, while mild (and temporary...) deflation pushes them up. As we have tried to show so many times (see *Our Brave New World*), **the US is not a price-monetizing economy but rather a volume-monetizing economy that thrives in an environment of stable to falling input costs.**

3 - Profit and Cash Flow Margins

About three years ago, we wrote a piece arguing against the idea that profit margins are a mean reverting series (see *The Myth of Reverting Profit Margins and Why We Love US Equities*). While the slide in profits may or may not be completely over, we think the maximum delta has by now already occurred. Believing that

The U.S. Economy, more sensitive to volumes than prices, tends to thrive in an environment of stable to falling input costs.

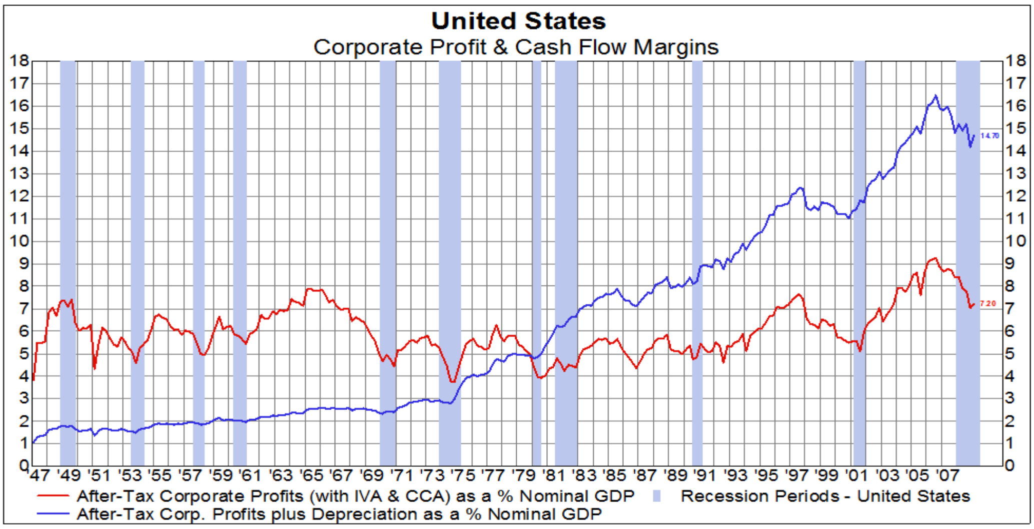
the maximum rate of change of profits has already taken place, we now have a chance to look at margins and see whether or not our theory of the lack of mean reversion to profits was accurate or wrong. When we mention profit margins, we are referring to the relationship between after-tax corporate profits adjusted for IVA and CCA, and nominal GDP. We can see in the following chart how profit margins began a secular increase in the early 1980s as inflation peaked and began to recede. What is interesting to note is that the trend of higher highs and higher lows is still intact.



While margins have undoubtedly compressed over the past year, it is remarkable (given the state of the economy) that they have only fallen back to the peaks achieved in the 1990s tech boom. Current profit margins exceed all most others' achieved over the past 62 years. Margins, in the midst of the worst economic epoch since the Great Depression, are still above the levels achieved at the height of US manufacturing dominance in the 1950s.

Margins, in the midst of the worst economic environment since the 1930s, are still above the levels achieved at the height of U.S. Manufacturing dominance.

If our reader finds this to be a shockingly good performance for US profit margins, then he should brace himself for the performance of US cash flows. When we mention gross cash flow margins, we are simply taking profits after-tax (adjusted for IVA and CCA), adding back depreciation (consumption of fixed capital in economic jargon) and comparing it to nominal GDP. Even the most hardened sceptic would be hard-pressed to argue that cash flow margins have demonstrated any mean reverting tendency of the last several decades. Instead, they have exploded! While they have also come down in the last year, cash flow margins remain at record levels compared to the 60 years of corporate history shown in the chart below.

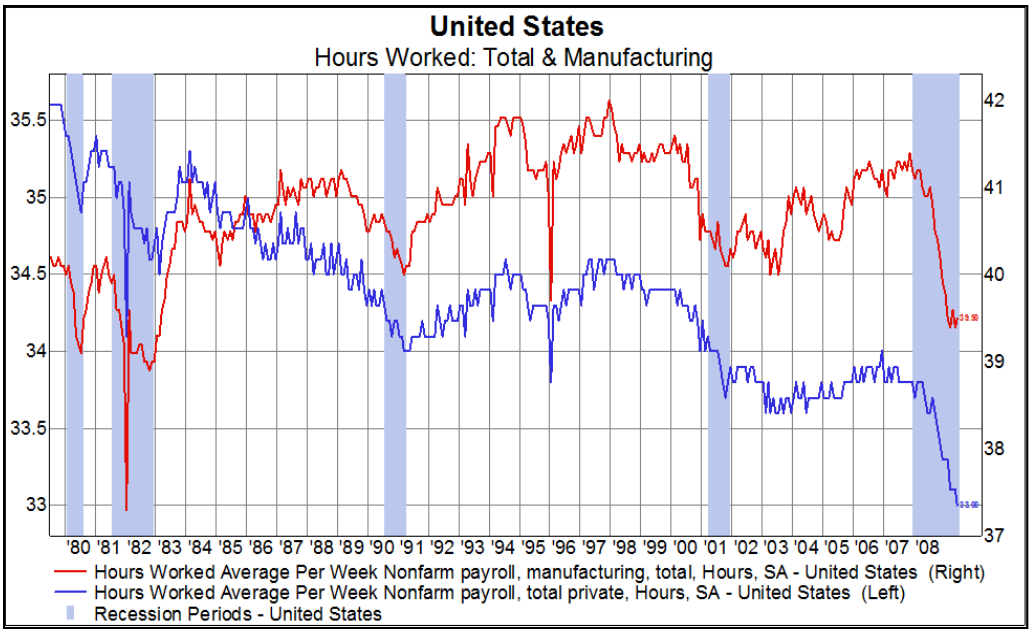


Cash flow margins seem to grow 3% from recession to recession—in the back to back recessions of the early 1980s (which we lump together for simplicity's sake), they were 5%; by the 1990s recession, they were 8%; by the 2001 recession, they were 11%; today, they stand at 14%.

And corporate cash flows, despite a mild decline recently, are still at record levels.

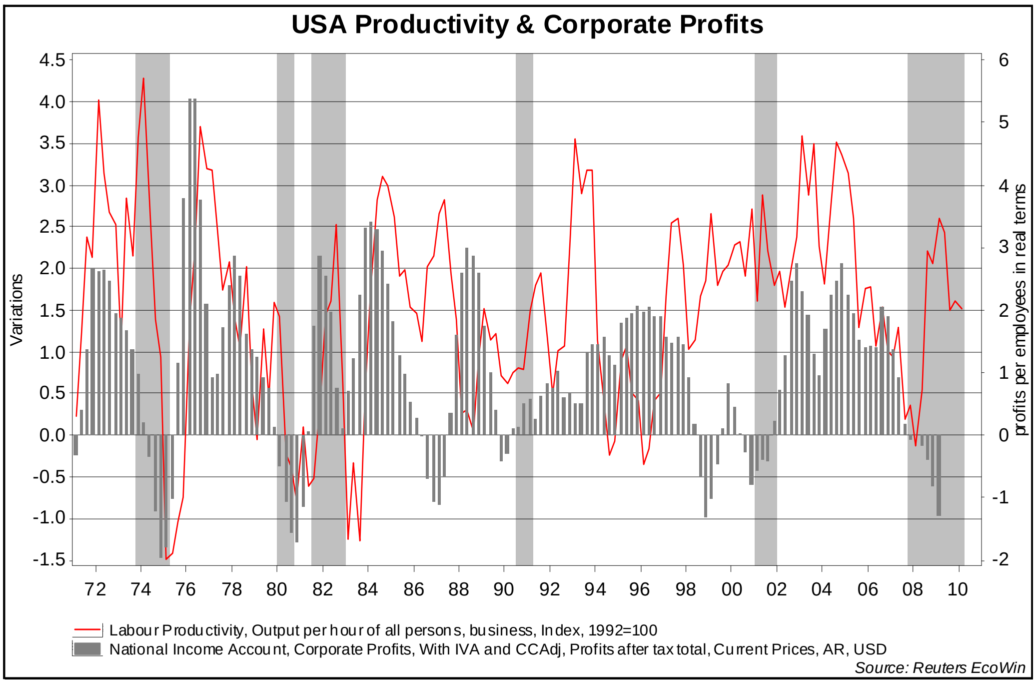
4 - Labor Costs and Productivity

On the back of digitization and globalization, the US is in the midst of the most enduring cycle of productivity the country has ever experienced. As we cited at the outset of this paper, companies have been very aggressive about trimming labor costs in this recession. In fact, hours worked have dropped by about -7% from the peak to current levels. In the chart below, the recent drop in manufacturing and total weekly hours worked can be seen in greater historic context.



With output having fallen by some -2%, corporate profits have held up extremely well. Simply put: we have never seen anything like this before. In every recession before the 1990s, productivity took a big hit, dragging profits down with it. However, in the last few recessions, productivity has held up remarkably well. And in the current recession, productivity has actually increased, thanks mostly to the brutal and swift adjustments made by companies.

The rapidity of adjustment in manufacturing and total weekly hours worked has played an important role in productivity.

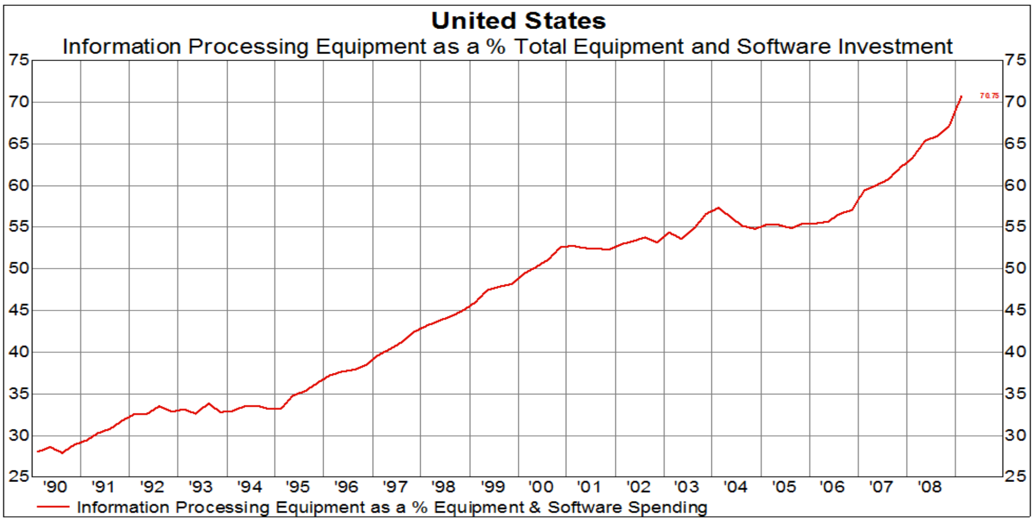


Adept companies have managed a rare feat: their productivity has been increasing during this recession.

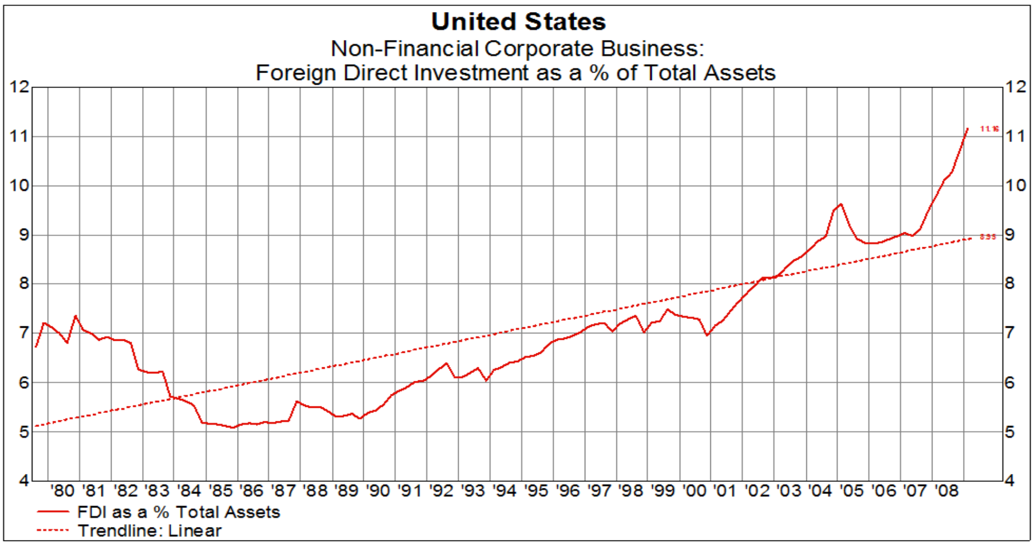
Why have productivity and profitability remained so resilient this time around?

One cannot help but conclude that something is different this time. Productivity and profitability have held firm while, previously, they were the balance of adjustment. Why? We think there are three reasons, all related to the shift toward the platform company model. Consider the following:

- Companies have been increasingly investing in information processing equipment. This gives them the ability to rapidly adapt to changing demand patterns and seize on new market opportunities when they arise.



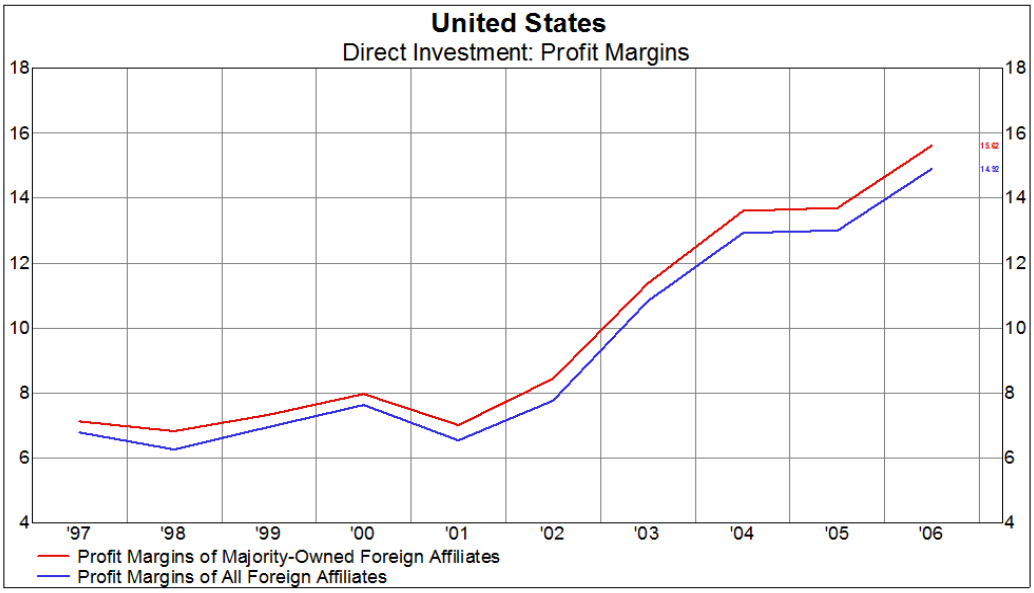
- US companies have been growing their international footprint, expanding operations to the most far-flung corners of the world. This has led to a more efficient allocation of capital and will, in the coming years, lead to huge profit opportunities as the emerging markets come of age. Foreign direct investment has been on a steady march upward since the Berlin Wall fell and now comprises over 10% of total non-financial corporate assets.
- Sales by U.S. affiliates overseas are around $5 trillion per year, while profits top $700bn. While this data is not a high frequency data, it is truly a testament



to the commitment US multinationals have shown in building global businesses. And, not only have U.S. multinationals been building businesses overseas, they have been making quite good money in the formative stages of their development. The most recent data point we have on US affiliates is a couple of years' old—and surely this global recession has dented margins—but take a look (chart next page) at margins earned by US multinationals: they are much higher than total corporate margins.

- US corporations have been investing huge sums of money in intangible assets such as research and development, brand development, employee training, etc. Leonard Nakamura, of the Philadelphia Federal Reserve, has been busy publishing a body of work over the last few years in an attempt to assess the value of aggregate intangible investment. He concludes that US companies spend about $1.2-$1.4 trillion per year on intangible assets. Baruch Lev, a leading thinker on accounting dark matter, has opined that US companies spend, on average, the equivalent of 1% of employee payrolls on training and education. And this was pre-Kindle, mega-bandwidth, streaming video, etc.

Hefty investment in intangible assets (some $1.2-1.4 trillion per year) make platform companies more proficient at profiting from creative destruction.

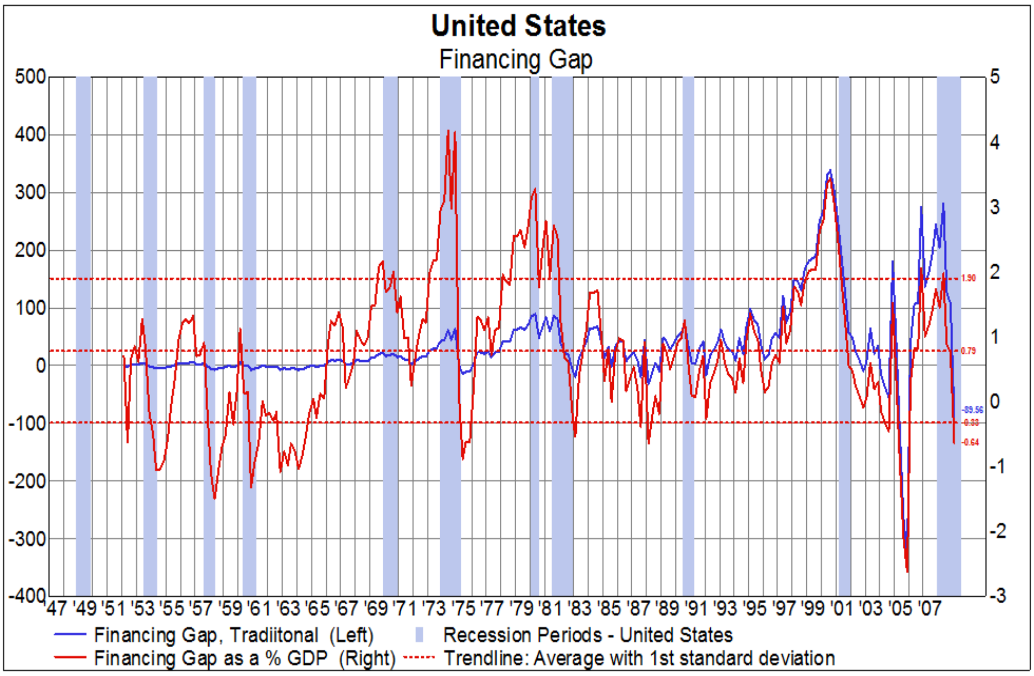


Basically, successful companies are now organized around a set of capabilities, rather than a portfolio of physical capital. This makes them very adept at change—and more accepting of creative destruction.

5 - Corporate Balance Sheets Are Very Strong

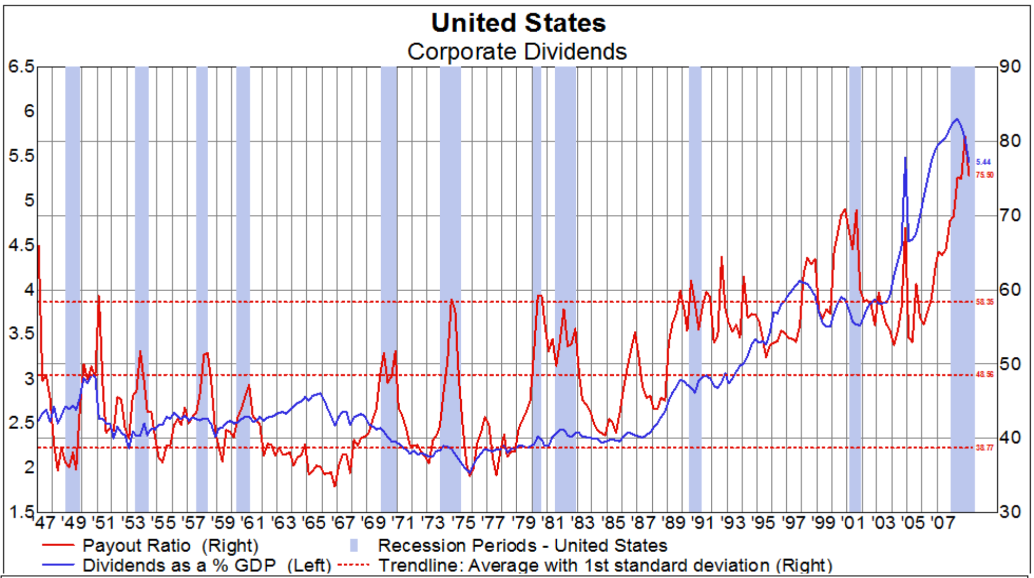
Radical corporate decisions, executed very early in the cycle, have left US companies in a better financial situation than during almost any previous recession. To illustrate this, let us first look at the so-called "financing gap" for US non-financial companies. This compares internally generated funds with capital expenditures. Most recessions (blue shaded areas on the chart below) start with a financing gap equal to, or above, 2% of GDP. Right now, U.S. companies—despite going through their worst recession since 1974—are generating an excess of cash equal to almost 1% of economic output.

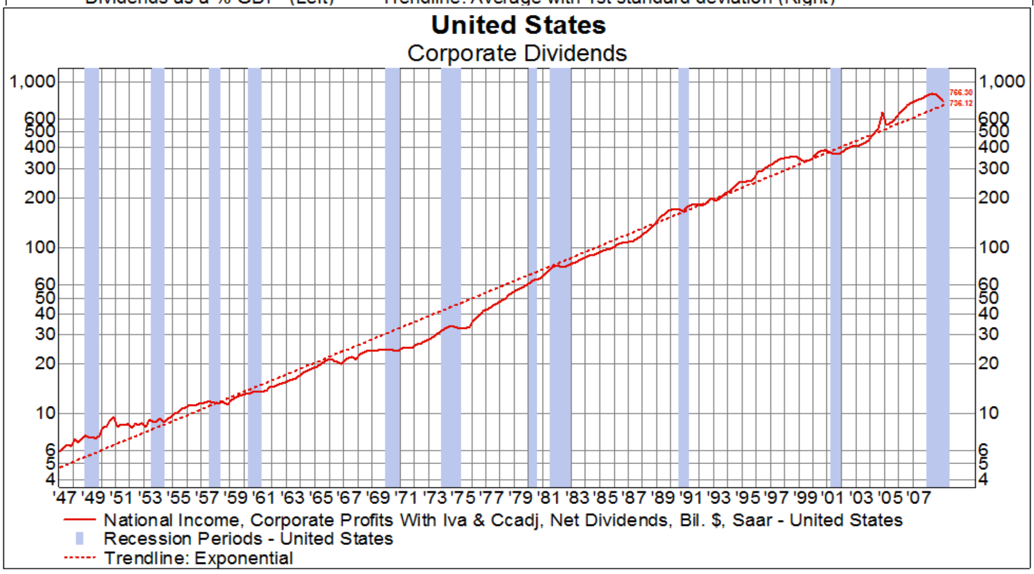
Companies' relatively strong balance sheets have enabled them to generate an excess of cash equal to nearly 1% of economic output.



In addition, corporate America pays dividends equivalent to almost 5.5% of GDP—that's over $750bn a year!

The financing gap, as we mentioned, uses internally generated funds (otherwise known as cash flow after dividends are paid out). We have always thought that methodology strange, especially as owners of a small business. In our opinion, a business looks at its cash flow, does its capital spending, and if there is something left, pays a dividend to its owners (at least, that's how we do it at GaveKal... At the end of the year, we look at how much is left in the till and then pay the partners). The dividend, in our way of thinking, is the residual. This is especially relevant currently, given the massive dividends companies are paying out. Today, corporate America (financial and non) has a 75% dividend payout ratio (dividends relative to after-tax earnings) and kicks out dividends equal to almost 5.5% of GDP (1st chart), or over $750bn on an annualized rate (2nd chart):

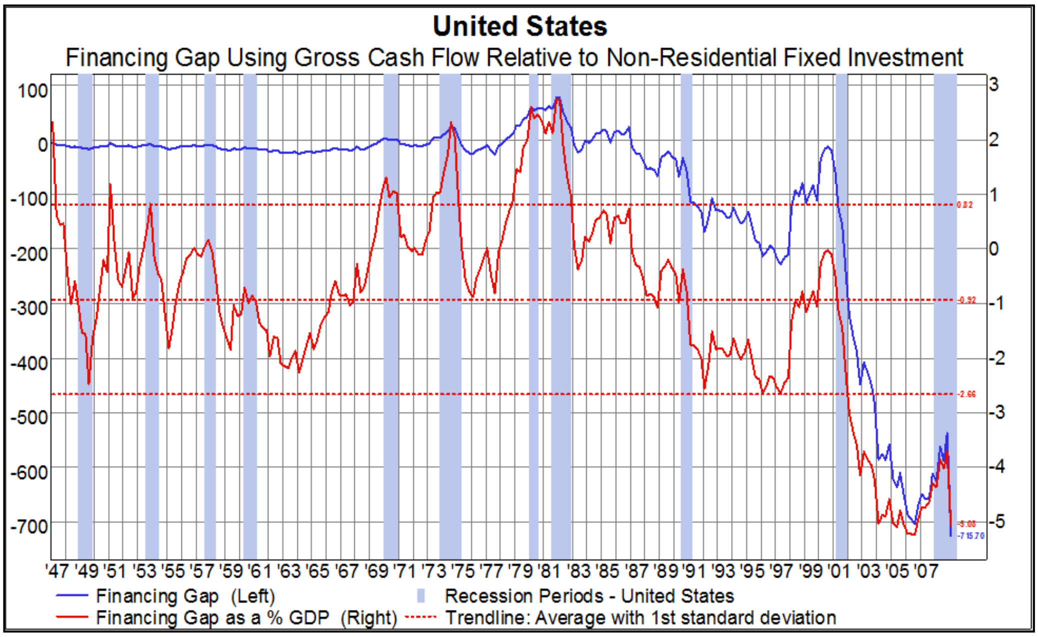




And, despite having to expense all of their investment in intangibles, non-financial companies are still generating free cash flow of about 5% of GDP.

Getting back to our tweaks to the financing gap, and again looking only at nonfinancial corporations, if we use *gross* cash flows instead of *net* cash flows (before dividends, as opposed to after), we can see that US nonfinancials are currently in a rather envious position: **US Inc. is generating around $700bn a year in free cash flow, an amount equal to around 5% of GDP** (see chart next page). Something else to keep in mind here: this includes the expensing of the $1.4 trillion intangible investment they have done. As for the nonfinancial corporation's "residual", over $450bn is paid in dividends on an annualized rate.

Thus, in the midst of a recession, not only is nonfinancial corporate America throwing off huge sums of free cash flow, they began with a very liquid and flexible balance sheet. Liquid assets are over 5% of total nonfinancial corporate assets, and financial assets exceed the entirety of their liabilities.



The other side of the "job-less" recovery is the "profit-full" recovery.

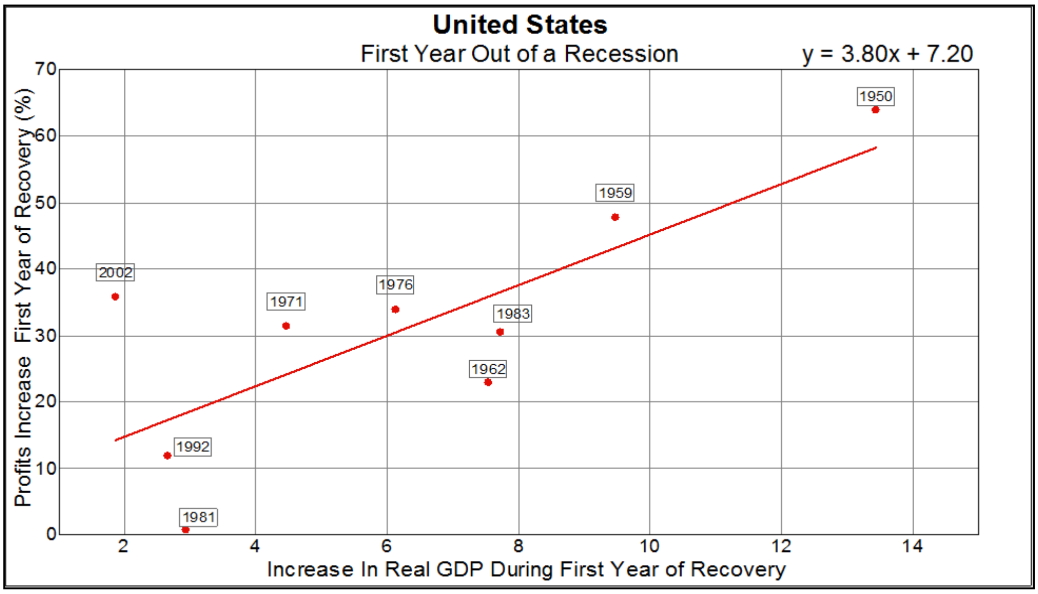
6 - Conclusion

Companies today are showing that they have never been better at managing their business in generating positive cash flows and delivering profitability. Needless to say, this is a direct consequence of the massive progress in technology and information management. We also suspect that a lot of what we have described in this paper has to do with the adoption by many companies of the "platform-company" model.

We imagine that, by now, our reader most likely has data fatigue. However, please bear with us through for just one final chart in which we plot the YoY increase in the first year of each recovery post-WW2 against the YoY increase in profits. While the 2002 recovery helped solidify the idea of a jobless recovery, it also helped illustrate how the leap in profits coming out of recession may have scant relationship to the increase in GDP. Notice how, despite the tepid +2% increase in GDP, profits jumped 35%. The other side of the "job-less" recovery is the "profit-full" recovery.

And with the cost of labor representing 70% of the cost of doing business, it would imply a very low inflation rate as we move into recovery.

What we *can* say with a great level of confidence is that if there is any recovery in production, then corporate profits may have the opportunity to leap to the upside as never before. And, since the cost of labor represents 70% of the cost of doing business in the U.S., it would imply a very low inflation rate as we move into recovery—perhaps even a negative one. Back to a deflationary boom? Now this is the scenario on which no-one is banking!



7—Impact on the Platform Company Fund

While it seems very counterintuitive to favour plays on US consumption, with all the talk of the American consumer retrenching, increasing savings, etc., our logic has more to do with a moderation in input costs that will allow companies to pass on cost savings, and in the process stimulate volumes...and profits.

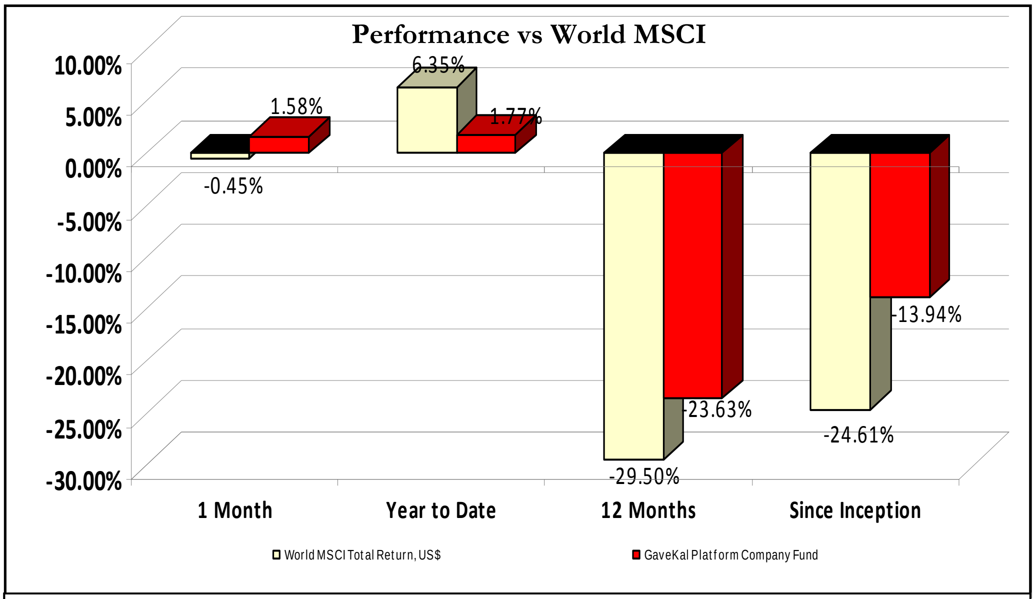
In the month of May, the Platform Company Fund lagged behind the MSCI World Index due to our lack of exposure to the commodity, industrial cyclical, non-US segments of the market. The month of June was more kind, as we gained some 2% in relative performance. The Fund is positioned to capture the cyclical rebound we believe is still underway, but we continue to favour the early cyclical sectors like consumer discretionary; and we continue to favour the US over foreign markets. While it seems very counterintuitive to favour plays on US consumption, with all the talk of the American consumer retrenching, increasing savings, etc., our logic has more to do with a moderation in input costs that will allow companies to pass on cost savings, and in the process stimulate volumes...and profits. The drop in energy and other commodities is alleviating input cost pressure, resulting in falling inventory costs as we mentioned above, but there is more. According to data released today by real-estate research company Reis Inc., shopping center rents in the top 77 US markets declined for the fifth straight quarter. In the 29 years the company has been following retail rents, they have never seen a string of declines that long. The average specialty retailer spent 12% of sales on rent last year, up a percentage point from 2007 and up several percent over the last few years. Many retail concepts spent 7-8% of sales as recently as 2006. Early cyclicals still look like the place to be, and the rotation back to them, which began in early June, still appears to be playing out.

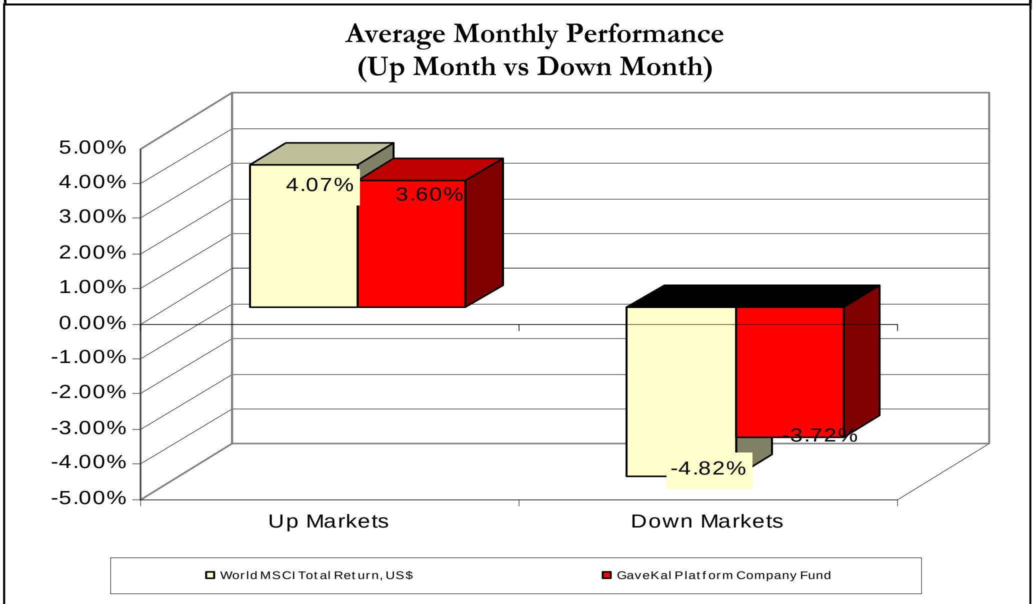
GaveKal Platform Company Fund - Performance Review

The GaveKal Platform Company Fund finished the month with 1.58% gain.

The GaveKal Platform Company Fund ("GPCF") is a long-only global equity fund, domiciled in Ireland (UCITS 3), with the aim to outperform the World MSCI with lower volatility. The Fund seeks to identify and invest in the world's leading "platform companies", as described in the GaveKal book, *Our Brave New World*. The fund does not short individual securities, nor does it use leverage. The fund is managed by Steven Vannelli, using both GaveKal's top-down expertise and bottom-up work.

June-09	Net Return:	1.58%
Total Net Return since Inception:		(13.94%)
Annualized ROR:		(5.16%)
12-month Rolling Performance:		(23.63%)
6-month Rolling Performance:		1.77%
3-month Rolling Performance:		12.78%
Average Monthly Return:		(0.28%)
Annualized Volatility of Monthly Returns:		19.66%
# of Positive vs. Negative Months:		22 vs 12
Sharpe Ratio:		-0.26
Largest Peak to Trough Drawdown:		(47.91%)
NAV (net of subscriptions and redemptions):		US$ 34m



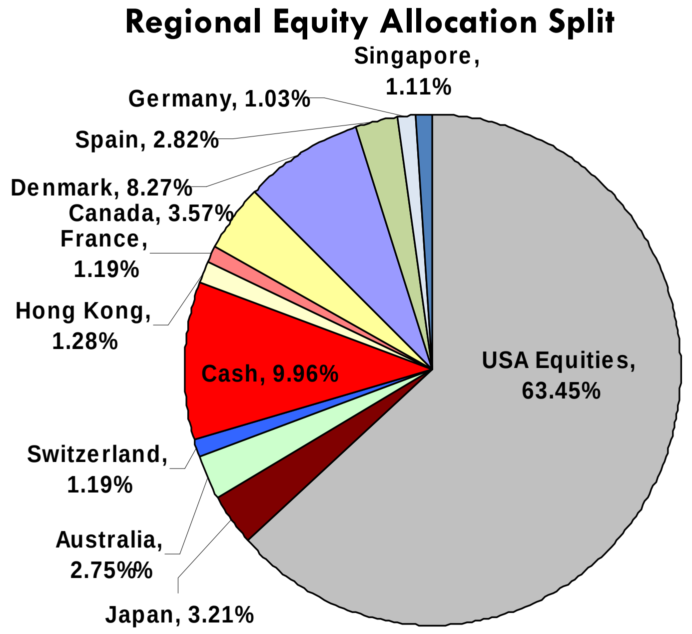


Performance Track Record

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2006 Net Performance (%)									0.16	2.84	0.96	2.16	6.24
2006 NAV per share								100.00	100.16	103.00	103.99	106.24	
2007 Net Performance (%)	2.94	(0.07)	2.84	2.72	2.62	1.71	0.29	(1.11)	8.14	6.59	(4.59)	0.78	24.67
2007 NAV per share	109.36	109.28	112.38	115.44	118.46	120.49	120.84	119.50	129.23	137.74	131.42	132.45	
2008 Net Performance (%)	(12.14)	(0.10)	(1.07)	4.12	1.20	(7.01)	2.72	0.10	(6.71)	(17.65)	(7.91)	3.16	(36.15)
2008 NAV per share	116.37	116.25	115.01	119.75	121.19	112.69	115.76	115.87	108.09	89.01	81.97	84.56	
2009 Net Performance (%)	(7.33)	(8.44)	6.36	7.23	3.53	1.58							1.77
2009 NAV per share	78.36	71.75	76.31	81.83	84.72	86.06							

GaveKal Platform Company Fund - Position Review

The fund remains very overweight US retail, technology and healthcare.



Sector Exposure as % of NAV			
Airlines	2.81	Media	0.00
Autos	4.00	Office Equipment	3.38
Construction	0.00	Others	1.74
Distribution	0.94	Pharmaceuticals	5.29
Electronics	9.97	Real Estate	0.00
Energy	0.94	Retail	15.72
Entertainment	6.45	Semiconductors	2.82
Finance	3.43	Technology Software	4.32
Foodstuffs	7.78	Technology Hardware	8.93
Healthcare	10.56	Textiles	0.00
Industrials	1.03	Utilities	0.00

Top 10 Equity Holdings	
Calsberg, Denmark - 4.52%	Schering-Plough, US - 3.10%
Texas Instruments, US - 3.38%	Garmin, US - 3.01%
William Demant Holding, Demark - 3.34%	Intl Game Telenology, US - 2.94%
Rohm, Japan - 3.21%	Orade, USD - 2.92%
Magna, Canada - 3.12%	Intel Corp, US - 2.82%

Fund Terms & Conditions

Legal Entity:	UCITS fund incorporated in Ireland	Advisor:	GaveKal Capital Limited
Subscription:	Twice Monthly NAV. No Loading and Redemption Fee	Custodian:	Societe Generale
Redemption:	Twice Monthly NAV	Administrator:	Euro-VL
Management Fee:	2% per annum	Auditor:	Deloitte & Touche, Tohmatsu
Performance Fee:	No Performance Fee	Fund Managers:	LV Gave & Steven Vanelli
Start of Trading Date:	September 2nd 2006	Bloomberg Code:	GAVPLAT ID Equity (ISIN: IE00B1DS1042)
Minimum Investment:	US$20,000	Exchange Listing:	No
Base Currency:	US$	Other Listings:	Morningstar Offshore database & Eurekahedge
Dividend Policy:	No Dividend Distribution		