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What in the World?

Despite his general bearishness, specialist in foreign stocks finds places to invest

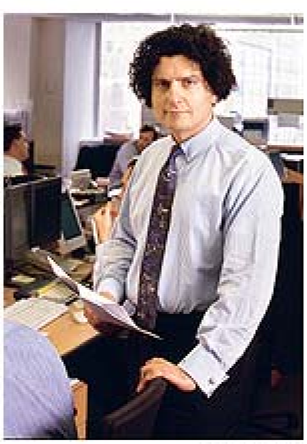
By SANDRA WARD

An Interview With Rudolph-Riad Younes -- If it weren't for the corkscrew locks that seem to grow sideways and the silver and turquoise turtle cuff links, Younes would appear to be like any other guy managing money. What he doesn't wear on his sleeve is his superior performance picking foreign stocks, a skill that most certainly separates him from the pack. The contrarian manager of the **Julius Baer International Equity**Fund, along with his colleague Richard Pell (who with Younes shared Morningstar's Manager of the Year honors last year), plays on little-known themes in out-of-the-way places to achieve outstanding returns for his clients. The two oversee a total of $4 billion in various portfolios. Younes, who is in charge of daily decision-making while Pell provides strategic oversight, has steered the fund to a gain of 27% so far this year. The MSCI Europe Australasian Far East index, which has gained about 27.3%, has caught up, but only because of the heavy weighting in the gung-ho Japanese market. Younes, you'll see, has taken a different approach to achieving his returns.

Barron's: *Are you still bearish?*

Younes: We are a bit more bearish than we were before because valuations are more stretched than they were last year. This is all about basics. Earnings. Valuations. The economy.

Q: *But earnings and the economy are improving.*
A: Yes and no. We value the market based on our estimate of mid-cycle earnings on the S&P 500, which we still put at about $38-$40. Based on that, the market is trading at about 25 times earnings. The market is very stretched; it should trade at about 17 times earnings, or in the 650-700 range.


Greg Martin

Q: *What's your view of the economy?*
A: A year ago, we worried because the bond market was forecasting lower economic growth as yields were making new lows almost every day. The Federal Reserve was not as bearish a year ago. Remember, Greenspan was saying last October or November that tax cuts were not needed.

Then, finally this spring, the Fed acknowledged that there was a risk of deflation. This was the key that changed the fundamentals and created a much more positive environment. Just by acknowledging the risk, the Fed was able to move the long bond by about 100 basis points [one percentage point]. There was huge momentum for refinancing and corporate borrowing, and that shifted our sentiment more positively in the near term because the Fed was signaling it would follow the policy of growth at any price. You don't want to fight the tape when the Fed is succeeding in creating short-term stimulus.

Q: *Yet you're more bearish than you were?*
A: You don't want to fight the tape, but at the same time you need to fight it. Money management is a combination of dogmatism and pragmatism. You need to know where the truth is. How you manage around it is the difficult part, and that is what we are trying to do. We are trying to determine where the truth lies and which side of it we should be on and how close or far from it we should be. We are seeing very strong short-term earnings and strong short-term momentum in economic data. We had the mother of all stimuli in the U.S. economy over the past year: a weaker dollar, tax cuts, yields collapsing, corporate spreads collapsing, war spending, real-estate prices going higher. And stocks are up. But these measures are not sustainable. The economy is barely growing, and we are losing jobs. What more can they give us next year? Unless we make new lows on the long bond, it is going to be very difficult, and it is highly likely the momentum is going to slow down.

Q: *The consumer keeps spending.*
A: Consumers never stopped spending, but it's hard to see how you get them to spend more. You can't give them any more tax cuts. You can't get them to do any more refinancing unless interest rates go lower. State and local governments are stretched. So is the federal government. We need corporate capital spending to pick up like crazy and we need foreign markets to grow. This rally is only momentum-driven. We are in a bear-market rally. We created a short-term temporary sweet spot for economic recovery. Once that stops or slows down, people will once again focus on valuation and the market will correct again.

Q: *So how do you invest here?*
A: That is a difficult question. If you look at all three asset classes, equities, bonds and cash, you would see ugly, uglier and ugliest. Definitely cash is the ugliest asset class. You earn nothing on it, and it is overvalued. The U.S. economy is highly leveraged. We have a high current-account deficit, almost equal to 6% of gross domestic product, which will demand close to 90% of world savings. The dollar is very high-risk.

Q: *And bonds?*
A: The second ugliest asset class is U.S. bonds because they are artificially supported by foreign central bankers. Foreigners today own about 45% of U.S. government bonds. What supports bond-market fundamentals is that we are going to be in a below-average growth rate during the next five to 10 years because the global economy has structural problems as China has come to provide the labor supply to the global economy. China ensures that at least tradable goods are going to maintain lower inflation in the global economy. Now the combination of technology and globalization is making some service-sector jobs exportable.

Q: *Why are equities so ugly?*
A: The equity asset class is over-hyped. There's too much indexing. The prime investment criterion in indexing is market capitalization. Indexers are blind to valuation. That causes what's called an externality cost on society, when you inflict costs on others because capital is misallocated. The more people invest with market cap as a guideline rather than valuation, the more we end up investing in the wrong sectors of the economy, which is going to hurt the economy. That is one of the biggest costs of indexing. Secondly, the long-term return of equities is over-hyped. Long-term returns of 10%-12% are always cited for equities. No asset class can grow above gross domestic product growth in the long term. Unless we believe the U.S. economy will grow 10%-12% a year, there is no reason to assume returns for equities of 10%-12% a year.

Q: *What are the biggest issues facing investors?*
A: There are two eyes to the storm. One is the U.S. current-account deficit and how it will be reduced. The second is the inevitable slowdown in the rate of growth of fixed-asset investment in China. It has been growing in the mid- to high teens and right now stands at almost 45% of their economy. In 2002 it was 42% of GDP. This year it is growing about 15% to 18%, and that is really, really a very high rate. If fixed-asset investment continues at this rate, next year it could reach about 50% of GDP. In its heyday in 1991, Korea's fixed investments were about 38% of GDP. That lasted for two to three years and then went down to as low as 26%. In the 'Seventies, Taiwan's fixed investment was about 30% of GDP, and now it is about 17%. Korea, Taiwan and Japan are benefiting immensely from the infrastructure buildup in China, and that may last for a year or two. But once it slows up, which is inevitable, the biggest losers are going to be Taiwan and Korea. China is hollowing out the manufacturing base in Taiwan and Korea because the labor cost in China is so cheap.

In the short term, it isn't showing up because although they are losing manufacturing, they are selling the Chinese capital goods. Once China stops importing much of what they now do, the pain is going to be intolerable.

Q: *Can the rally in Japan continue?*
A: Japan has been benefiting from the boom in China. And definitely there have been some positive external and internal forces at work in Japan in the short term that are creating positive momentum for the Japanese economy. The question is how sustainable they are, but at least there is some improvement.

Q: *Are you investing in China?*
A: China is still more a labor-based economy than a consumer-based one. You want to take advantage of the labor more than take advantage of their consumption. You are not going to see a mass market that is going to be a locomotive for the global economy. Remember, most of these people make $1 to $2 an hour. People save 70% of their salaries to go to Hong Kong and buy one or two luxury items. They tried to create a consumer boom in Korea. It took 12 months and that was it. You had bad-loan problems. The same thing is happening in Thailand today. The government has been following an expansionist fiscal policy, and now essentially there are warnings that things are getting overheated. These economies can't sustain a consumer boom for too long because you don't have the same level of wealth that exists here.

Table: Younes' Picks[1]

Q: *Interested in other Asian countries, such as Thailand and Indonesia?*
A: They have commodity-based economies and benefit more from China's growth. If anything, the Chinese will be consuming more. For the global economy to really grow, Japan, Europe and some of these more developed Asian markets have to do what the U.S. has already done and move from being a manufacturing-based economy to a service-based economy. So far, the Germans and the Japanese have failed to do that.

Q: *So how have you positioned your portfolio?*
A: We've been trying to address all these issues and trying to find areas of the world that aren't highly correlated to a slow-growing global economy. We're looking for sectors and companies whose internal factors are very strong and that can withstand a world experiencing sub-par economic growth.

Q: *What countries? What sectors?*
A: We have liked Central Europe for a while because of the structural changes there as the countries join the European Union. That is still unfolding. The weaker dollar and increasing fund flows leads us to expect emerging markets to do very well, especially in Asia. An important factor in emerging markets is the low cost of capital. Some of the interest rates are mind-boggling. The 10-year interest rate in local currencies in Thailand and Korea is below the U.S. government dollar rate. Even the 30-year Chinese government bond's rate is below what the U.S. government is paying in dollar terms. For the first time, they have a very strong competitive advantage because they can borrow at the same rate as U.S. corporations can. You need significant appreciation in the currencies to slow down the loss of manufacturing that's occurring in the developed world.

Q: *A lot of people have been burned badly investing in emerging markets. What's different now?*
A: What doesn't break you will make you stronger. The region now offers good trading opportunities. And there have been structural changes. Dollar debt as a percentage of GDP has been declining since the last crisis. Secondly, the cost of capital is the lowest they've ever had. The countries have huge foreign reserves. China is still growing and, at least for the short term, a source of growth for the region. Many of the countries have had their debt ratings upgraded recently. Their companies are becoming more and more global. The valuations are much cheaper than in developed markets.

Q: *Which Asian countries do you prefer?*
A: We like the Philippines, Indonesia, India, Thailand and Malaysia because there's less competition with China and low correlation with the markets. Given our belief that the global economy is not going to grow that much, these countries will maybe do better. We would be underweight Hong Kong, Korea, Taiwan and Singapore.

Q: *Any other emerging markets you favor?*
A: Turkey. The government is restructuring. A more stable Iraq will help Turkey because Iraq was a very important trade partner with Turkey. Even more important, in October 2004 the EU may officially declare them a candidate for member status. That could be a really big catalyst. The market is down sharply from its high, almost 70% lower. It's an exciting market and it is very cheap, with a P/E of nine times earnings.

Q: *How do you play emerging markets?*
A: Usually, we buy the country baskets because there is no liquidity, and the top five names in the countries make up 60%-70% of the market anyway.

Q: *What's your take on Russia?*
A: We don't like the oil sector, but we love Russia. The tax system is too lax now, but we believe that, ultimately, the tax rate on the oil sector in Russia will be very close to that of Norway, around 65%-70%. Now the rate for many Russian companies is about 30%. Some of them are paying half that.

Q: *How is a higher tax rate positive for investors?*
A: You want to create the middle class in the economy. You want to redistribute the wealth, and taxation is a way to redistribute the wealth.

Q: *How about a stock idea?*
A: UES, or **Unified Energy System**, is the national holding company for the Russian power sector, and it is going to be broken up and its pieces sold. That will unlock a lot of value. A lot of foreign energy companies are showing interest. It's cheap based on the value of its assets and the replacement value of the assets.

Q: *Any other picks in Eastern Europe?*
A: In Central Europe we like **Matav**, the Hungarian incumbent telecom company. They are majority owned by **Deutsche Telekom**. They are the leader in wireless. They are generating lots of cash and following a very aggressive dividend policy. We would expect in a couple of years their dividend yield could be as high as 10% to 12%, and while there are regulatory and competitive risks, we don't think the payout will be affected. This is a very cheap company. The stock has been going sideways the last three years, and I think it's ready to make a move.

Q: *Any others?*
A: Another company we like in Eastern Europe is Petrom, a Romanian oil and gas company. It's the largest company in Romania. The government owns about 93% of the company, but they want to sell 33.3% of the company to a specific shareholder. Eleven big companies, including **ConocoPhillips**, a subsidiary of **British Petroleum** and **Gazprom**, are bidding for it. The winner will be required to make investments that will raise the stake to 51%. Its valuation is very cheap, especially on the basis of price to cash flow and Ebitda [earnings before interest, taxes, depreciation and amortization].

Q: *What are you betting on outside of Eastern Europe?*
A: We all know German banks are not very profitable, and they have problem loans because of the bad economy and a rise in bankruptcies. But as we have seen in Japan, when things start to turn around, the banks are the most highly leveraged. **HypoVereinsbank** is a play on German recovery. It's trading at a big discount, 0.6-0.7 times book value compared with 2.4 times book for the average European bank. It's been restructuring, selling small banks and spinning off a piece of Bank Austria. As the equity markets improve, HVB, as it's known, will benefit because of its large stakes in **Munich Re** and **Allianz**. You could double your money in this easily. It could also be a possible takeover candidate, especially since **Credit Suisse** mentioned recently they are looking to expand in Germany.

Q: *If you think Germany's economy is improving, how else are you playing it?*
A: Another company we like is **ProSieben**, which has about a 43% share of the German TV market. Broadcasters usually benefit from an upswing in the economy as advertising picks up. This one had been losing market share to RTL, the other big German broadcaster. But the company has been undergoing very, very severe restructuring. Now ProSieben's margins are about 8%, compared with an average of more than 20% for other European broadcasters. We expect ProSieben to get margins to 15% in three years. Based on enterprise value [stock-market value plus net debt] to sales, ProSieben is very cheap at about 1.48 times, compared to about 2.4 times for the sector.

Q: *What else?*
A: France's **Renault** is another company we like in Europe. We have always been a fan of Carlos Ghosn, the CEO of **Nissan**, and we used to own Nissan. Now given the valuation of Nissan, which Renault owns 44% of, we sold it and we switched to Renault. If you strip out its Nissan stake, you are getting the French operations free. Plus, in 2005 Carlos Ghosn becomes CEO of Renault. We put a premium on management, and he has always delivered. There's room for margin improvement, and management is targeting an increase to 4% from the current 2%, which is very low.

Q: *Any other favorites?*
A: We like **Satyam Computer Services**, an Indian software company that specializes in IT [information technology] services. It is gaining market share as more service-sector jobs are exported overseas. Their contract costs are $20-$22 an hour, compared with $60-$70 here. It's highly profitable. Its margins are among the highest in the industry and two to

three times higher than companies in the U.S. It trades at only 14 times next year's earnings, and its earnings growth is in the double digits. It's also ultimately a takeover candidate by a U.S. or European IT company.

Q: *Do you buy the American depositary receipt or buy in the local exchange?*
A: Locally. The ADR is trading at a 33% premium to the local listing.

Q: *How about one more pick?*
A: Elekta is a little bit sexier. It's a Swedish medical-technology company. It specializes in radiation oncology and is the leader in minimally invasive neurosurgery. Its valuation is reasonable, though the stock has run-up a bit since General Electric made it known it is targeting medical technology as its future growth business by bidding for Amersham, a U.K. medical company. Elekta trades at 15 times 2004 earnings, one times sales, has improving margins, and cash on the balance sheet is 20% of its market cap, which is roughly the equivalent of $700 million.

Q: *Thanks, Riad.*

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