

## Performance (in %)

|              | Q3/13 | YTD  | 1 y. p.a. | 3 y. p.a. | 5 y. p.a. |
|--------------|-------|------|-----------|-----------|-----------|
| <b>B EUR</b> | 3.8   | 7.0  | 10.2      | 13.3      | 8.6       |
| <b>I EUR</b> | 4.1   | 7.7  | 11.2      | 14.3      | 9.5       |
| <b>Index</b> | 9.1   | 13.1 | 18.1      | 9.0       | 6.8       |

Benchmark: MSCI Europe Index TR net

Source: Bank Vontobel AG. Past performance is not a guide to current or future performance. The performance data do not take account of the commissions and costs incurred on issue and redemption. The return of the fund can be a result of currency fluctuations rise or fall.

## Performance analysis

During the third quarter, the Vontobel Fund – European Value Equity recorded a gain of 3.8%, whilst its benchmark generated 9.1%. At a country level, the third-quarter underperformance relative to the benchmark was partly due to the strategy's stock selection in the UK and underweight position in Spain, where the market rose by 25% in the quarter. Performance was negatively affected by our exposure to the high-quality consumer staples held, alongside strong performance from more cyclical sectors in which we held and underweight position.

While the strategy's underweight to the energy sector and overweight to the healthcare sector were beneficial to relative performance in the third quarter, leading detractors were its stock selection within the consumer discretionary and overweight to consumer-staples sectors.

Our underweight positioning in the banking sector, especially to lower-quality names, hurt performance in the third quarter. In general, domestic European cyclicals have done well since April 2013 at the expense of performance of quality franchises like British American Tobacco, Philip Morris International, Nestlé, etc. We feel that with time the excitement for European recovery is likely to dissipate

somewhat, and that the relative earnings security of staples will come back to fore.

### Positive contributions

#### Relative

Bureau Veritas, UBS, Sanofi\* , Royal Dutch Shell\* and Wirecard.

### Negative contributions

#### Relative

Philip Morris International, Paddy Power, Unilever, British American Tobacco and Domino's Pizza Group.

( \* This company was not held in the portfolio. When a company that comprises a significant portion of the benchmark index makes a significant gain or loss during a quarter, it can affect the relative performance of the portfolio significantly.)

## Outlook

The recent currency rebalances will be helpful for companies across, or exporting from, emerging markets (EM) as their pricing against foreign competition (notably China) will improve. As a result, the current outlook for consumption in major emerging-market countries remains relatively solid on a longer-term basis, with growth rates, albeit lower than in the past, still outpacing those in the developed markets. We believe this should provide a healthy environment for high-quality franchises to continue generating the solid earnings growth we look for. The death-of-middle-class-growth story in emerging countries is a little exaggerated in our view. In fact, we are expecting structural growth in new consumer

income. This new consumer demand should drive volume growth for a number of industries over the coming years. As bottom-up investors, we fully understand that just because a big box exists, it does not mean an investment opportunity automatically does. Large companies that continue to compound their growth year after year need big numbers to support their ongoing expansion. We view Asian demand as the cornerstone of structural new consumer demand over the medium and long term.

Looking at the euro zone, despite the massive and still rising non-performing loan ratios in Spain, investors are willing

to pay the same price-to-tangible book multiples for the Spanish bank Santander as for an emerging-market-focused Standard Chartered. Asia appears out of favour with the markets and Europe is in, albeit we think this honeymoon period is unlikely to be sustainable.

In addition to this, as the euro is strengthening, another concern arises. Over the past 15 years, export growth has

been driven by sales to emerging markets. As Europe is a major exporter, with exports accounting for 43% of its GDP in 2011, if the euro continues to strengthen against EM currencies and China continues to slow its growth, the market outlook for exports of items such as capital goods and luxury autos may be challenged.

## Market developments

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It has been a wild quarter. It started with an improving outlook in the US with house-prices rising and a lack of European calamities. However, an upbeat comment from the US Federal Reserve (Fed) turned into a "rate normalisation" scare that tested the resilience of a number of emerging markets to currency shock, as money that had streamed away from the US and Europe since the 2008-2009 crisis flooded back. By the end of the quarter, emerging markets (EM) had settled and the attention shifted back to the US and the concern over its first government shutdown since 1996.

The sharp currency sell-off in the quarter did not result in any sovereign or company blow-ups due to exposure to foreign-denominated debt. This was an important test of the structural change across the EM resulting from increased domestic savings, foreign investment in local currency and the build-up in foreign reserves.

In the second quarter of 2013, the euro zone managed its first quarter-on-quarter growth (0.3%) in seven quarters, although it remained negative (-0.5%) against the second quarter of 2012. This positive bump alongside Angela Merkel's CDU party winning the German elections is regarded as a step towards stability. General comfort was also reflected in the market signals of low interest-rates across the European periphery with the Spanish and Italian 10-year sovereign rates both ending the quarter around 4.4%. However, we are not too sure that a return to sustainable growth is close for the euro zone and believe demand will remain subdued over the medium term. While the numbers appear stable on aggregate for the euro zone, we see little growth ahead. Serious problems remain in the periphery and exports with a strong currency and slowing growth in China. This could prove to be challenging for exporters such as Germany.

In the second quarter of 2013, on a year-over-year basis, GDP in Greece fell by 4.6%, Spain by 1.6%, Portugal by 2% and Italy by 2%. These falls without a quick solution would not matter so much if there were a transfer of wealth mechanism within Europe, as seen in the US. If a country is running a deficit, it needs to borrow or be forced to undergo fiscal consolidation, which further weakens growth in the short term. In addition, the European banks are shrinking their balance sheets (partly because of the need to improve

their leverage ratios), which is another headwind in the path of returning to sustained economic growth.

In the US, house prices continued to show solid improvement as measured by the S&P/Case-Shiller Home Price Index. The 20-city index has risen across all its constituent cities for four months in a row, and rose by 12% over the 12 months to June 2013. Construction is an important driver of economic activity, even if construction on its own only represents a relatively small part of GDP. However, when houses are being built, banks lend for mortgages, appliances are bought, and labourers work and spend. However, we are concerned about how much of this growth relies on extraordinarily low interest rates. In short, we believe demand from the US is set to be driven by an extended period of low, albeit stable, economic growth.

China kept its pedal to the metal through the EM squall. The country, recorded second-quarter 2013 GDP growth of 7.5%, a slightly slower rate than the previous year, yet still a break-neck pace in a global context. Premier Li Keqiang stated in September that the authorities intend to let growth slow, which we were glad to hear as we think the amount of new debt being issued to fuel the investment-led growth is unsustainable. To put China's growth into perspective, GDP is expected to end this year around nine trillion US dollars, which is 50% larger than it was in 2010 (in dollar terms) – the year it became the world's second-largest economy.

A further area of concern that affects western multinational corporations with large operations in China has been the spate of accusations of illegal activity, bribery and price fixing, made by Chinese authorities and the press against consumer-goods and pharmaceutical companies – are these new industries of "strategic importance"? Recently, one domestic and five foreign companies who manufacture infant formula were fined for price fixing (Danone, Biostime, Mead Johnson, Fonterra, Abbott Labs and Friesland). At the same time, the Financial Times broke a story that the Chinese authorities intend to provide 4.9 billion US dollars' worth of subsidies to five domestic infant-formula producers to develop their brands.

Accusations have moved from bribery at pharmaceuticals to price fixing at infant formula and then to bribery in infant formula with accusations against Danone (again). We are

concerned this might mark a new facet of industrial policy. If so, it adds risk to the kind of quality companies in which we have traditionally invested. We remain cautious and underweight in China.

Staples valuations – sentiment has turned decidedly negative on staple companies with large EM exposure. For example, Kraft Foods, the grocery manufacturer with 99% of 2012 revenue from North America, is trading on a price/earnings (non-tariff measures) of 17.1 times, in line with global multi-nationals such as Coca Cola (17.1 times) and Nestle (17.3 times). Yet we feel Kraft faces a considerably less attractive growth-outlook. A significant proportion of Kraft's business lines are mature, including its two 1 billion US-dollar plus brands (Kraft Cheese and Oscar Mayer meats) and, as a result, the company's organic growth rate in 2012 was just 0.1%. The company faces price and volume headwinds from the continued growth in private label competition and does not benefit from the structural demand growth coming from the EM. This is also the case for other mature developed-market focused food-companies such as Britvic in the UK (14.5 times with declining volume) and Associated British Foods (18.4 times).

Precious metals – the significant pain taken across equities in this sector has led to a sharp focus on cost cutting and cash-flow generation. We think this bodes well for longer-term returns as the managements have rarely been under as much pressure as they are now, with a number of CEOs having been let go, huge write-downs taken and many projects cancelled. With this newfound focus on cash generation and cancellation of projects, we would not be surprised if 12% to 15% of supply is removed over the next two to three years. This is important as the main drivers behind physical demand, including emerging-market savings growth, increased leverage, lack of growth and massive quantitative easing, remain in place. Currently, we believe this is one of the cheapest industries anywhere with forward-looking valuations at 10 to 15-year lows (depending on margin assumptions), while at the operating level, supply has not increased despite gold prices having increased fivefold over the last decade. We find it surprising how little focus there is on supply and the physical demand – that around 70% of demand is coming from emerging markets does not appear well understood.

### Special topic: banks with built-in advantages and the role of the state

After a sharp jolt in the financial markets, it's crucial to reassess the health of the banks and banking systems. Cheap funding is drying up and growth in some emerging markets is cooling. This could leave bank loan books vulnerable. If a bank is over-exposed to a certain industry, region, or consumer segment, its book can quickly turn into a pile of non-performing loans (NPLs) and ultimately poor results.

The question we are often asked when the lending environment looks so weak is whether or not the bank franchises we own will be able to generate stable growth. The starting point is that we invest in individual companies and not broad sectors. Any bank, unless it has a large market share, can operate in a world that looks very different to the aggregate sector or franchises with different business lines.

There are in fact many examples of banks that have managed well through a broad banking crisis, short of a systemic meltdown. In some cases, the banks are more valuable now than before the crisis. Some of the attributes that worked in their favour include:

- A relatively small market share that allowed cherry-picking of clients and a higher-quality portfolio
- Understandable risks – diversification is not an answer in itself, e.g., AIG
- A conservative approach to leverage and controlled growth rates

-Balance-sheet strength to consider opportunistic bolt-on acquisitions

-Above-industry return on assets that reflect a profitable core franchise

-Managed by proven bankers for the benefit of minority shareholders

-Operating in a system with well-regulated state-owned or controlled banks that are able to provide countercyclical support and absorb the lion's share of politically directed lending and services

There's another aspect to stability that we want to highlight, which is often overlooked, but is a structurally important aspect of many banking markets: state-owned or controlled banks (SOE banks). It might seem counterintuitive, but the existence of these large banks often benefits privately-owned banks by acting as a magnet for social or politically motivated lending or services. Also, the use of SOE banks as risk-taking countercyclical lenders to support credit-starved economies during the 2008-2010 downturn not only helped the broader economy, but also specific clients of private banks. In other words, well-regulated SOE banks can and have provided a critical support function to the entire banking system during downturns.

Not much research is written on SOE banks, as for the most part they do not have minority shareholders. These banks are of significant size and importance in a number of

economies so we thought a primer, with a view on whether they help or hinder private banks, would be of interest.

### How big are SOE banks?

SOE banks play a significant role across the emerging markets even though the headline numbers of global SOE assets imply a sharp fall in importance over the past 40 years. The World Bank calculates across the EM that the average share of SOE assets per country has fallen from 67% in 1970 to 17% between 2008 and 2010. In developed economies, SOE banks accounted for just 8% of total assets in 2010, even following an uptick from government bailouts during the crisis. The fall in state control across the globe has been largely due to privatisation programmes in ex-socialist countries and across Africa. However, the headline numbers are not weighted by size of banking system. Developed-market SOE banks are less visible. The UK government owns about a quarter of its bank assets due to the bailouts of Lloyds and RBS during the crisis. The government is looking to exit the banks. Until that time, however, they are owned and influenced by the government.

The impact on private-sector banks is driven by the legal mandates of the SOE banks and whether or not they compete directly with the private sector either to sell products or raise deposits. There are three main structures that SOE banks can be broken down into, although there often are overlaps:

- State commercial banks: compete with private commercial banks, e.g. State Bank of India, PKO Bank Polski, Hamburger Sparkasse (German savings bank)

- State development banks: focused lenders to agriculture, infrastructure, SMEs, housing etc., e.g. Banobras (Mexico), Credit Guarantee Corporation of Malaysia

- Development institutions: government-funded tools of industrial policy, e.g., BNDES (Brazil), KfW (Germany)

The state commercial banks are the closest structure to private-sector banks since they are generally deposit-taking institutions operating a network of branches. However, the state development institutions tend to be the largest individual institutions.

### Do SOE banks help or hurt a country's growth?

SOE banks dominating a bank system have been criticised for a number of reasons, including cronyism based on political connections, crowding out deposits from private banks, high-cost operations allowing inefficient private banks to survive due to weak competition rather than sharpen up, and the impact over the long term of investing in less productive assets. Criticism voiced by the International Monetary Fund and the World Bank has been

supported by empirical studies, although the general tone seems to have softened since 2008 when the SOE banks proved to be effective tools for keeping the credit taps open.

The established views of SOE banks tend to line up between two main trains of thought based on two landmark papers both written by Harvard University academics, although a post-crisis macro argument has recently surfaced:

- Development view (beneficial): based on case studies by economic historian Alexander Gerschenkron in "Economic Backwardness in Historical Perspective" (1962)

- Political view (detrimental): based on "Government Ownership of Banks" (2000) by La Porta, Lopez-de-Silanes and Shleifer (LSS)

- Macro stability (beneficial): state-owned banks able to take up the slack in credit availability when private banks withdraw in a crisis, as well as providing a safety wall for depositors

### Development view

The funding needs of a developing country cannot always be provided by its private-banking sector. The government is usually the only institution able to bridge the funding gaps. The challenge facing the government was eloquently summed up in a recent speech by the retiring governor of the Reserve Bank of India, Duvvuri Subbarao:

"When I was appointed governor of the Reserve Bank in 2008, I went to call on the prime minister before I took charge. A man of few words as we all know, he told me one thing that stuck in my mind: 'Subbarao, you are moving from long experience in the IAS into the Reserve Bank. In the Reserve Bank, one runs the risk of losing touch with the real world. With your mind space fully taken up by issues like interest rates, liquidity traps and monetary-policy transmission, it is easy to forget that monetary policy is also about reducing hunger and malnutrition, putting children in school, creating jobs, building roads and bridges and increasing the productivity of our farms and firms. Keep your ear close to the ground.'"

Inability or unwillingness of private-sector banks to lend can be due to a number of reasons. In less-developed markets, banks may be not able to raise enough deposits to finance large projects, the system could lack property rights or the legal structure may not allow effective collection of collateral on default. Gerschenkron cited his native Russia as an example for a country where private banks could not operate in the late nineteenth century:

"...the scarcity of capital in Russia was such that no banking system could conceivably succeed in attracting funds to finance a large-scale industrialisation; the standards of honesty in business were so disastrously low, the general distrust of the public so great, that no bank could have

hoped to attract even such small capital funds as were available, and no bank could have successfully engaged in long-term credit policies in an economy where fraudulent bankruptcy had almost been elevated to the rank of a general business practice."

His positive view on government-owned development banks was based on Germany in the 1850s and Russia in the 1890s where industrial policy focused on large investments into heavy industry. Government banks underwrote the large investments needed, and otherwise not available, which led to important development phases for both countries.

Across different markets today, it is clear that the mandates of SOE banks vary by level of economic development, as the gaps narrow or disappear. Governments in more open systems have tended to regulate a sector to achieve their goals rather than directly manage parts of the banking system. For example, the German system of savings and state banks has successfully lowered costs to customers and kept a focus on smaller local businesses through territory limits.

#### **Political view**

The political view, which is based on empirical data, is negative on the impact of SOE banks. The belief is that politicians use state-owned banks to make loans that private banks would not contemplate. Perhaps unsurprisingly, research has also shone light on government abuse at SOE banks in a variety of ways such as making political contributions, particularly in election years and supporting investment into regions with politically favourable demographics.

The LSS study covered 92 countries and compared the proportion of bank assets that had been state-owned before 1985 to economic growth between 1960 and 1995. They found that for each additional 10% proportion of total bank assets that SOE banks accounted for, average economic growth was 0.25% lower per year. LSS concluded that the core reason for the slower-growth relationship was lower productivity gains as SOE bank lending tends to go to less productive investments and the economy fails to benefit from growth compounding at a higher level. This was a significant finding and has been used by institutions such as the World Bank to encourage governments to privatise SOE banks.

LSS also found that the prevalence of state ownership was more related to the structure of the economy than to its size. They found SOE banks larger in countries with lower incomes, more interventionist 'statist' governments, heavier regulation, higher frequency of price controls and weaker property rights. In 1995 the average government ownership in ex-socialist countries was 62% compared with 29% in

common-law countries (including UK, US, South Africa, and India).

An example of SOE regulation being dragged by political benefit was the growth of sub-prime lending by Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corp). Fannie Mae and Freddie Mac are the largest US housing financiers, created to provide liquidity to the mortgage market and allow more Americans to buy homes. In 1968, Fannie Mae's status was changed from federal agency to a privately owned, albeit still a government-sponsored enterprise (GSE). In other words, it became a profit maximiser that could issue triple-A-rated securities, but was guided by a government department. The US Department of Housing and Urban Development (HUD) had regulatory power over Fannie and Freddie and from 1995 onwards the HUD required the GSEs to meet certain lending goals. Central to these goals were targets for the proportion units underlying their mortgage purchases that were to be made to low-income or underserved borrowers, which ultimately led to the underwriting of subprime loans. While the GSEs focused on growing their business under both the Clinton (Democrat) and Bush (Republican) administrations, HUD raised its goals for low-income and underserved households. This tested the limits of finding credit-worthy borrowers as the GSEs, along with big banks, were growing so quickly that lending standards fell precipitously. The growth was huge – Freddie Mac alone increased its assets to 802 billion US dollars by 2003 from 84 billion US dollars in 1993, a 10-year compound annual growth rate of 25% – and the most explosive boom years had not even begun yet. The ensuing fallout has been well documented.

#### **Macro stability**

Many cyclical crises evolve from a structural weakness in the financial system that ultimately turns into a crisis triggered by a "surprise" event. The risk of contagion looms, credit gets pulled and rates rise in the race for liquidity – and that directly impacts the real economy.

A number of governments used state-owned banks as tools to maintain credit flowing when private banks pulled back on risk and capital-adequacy concerns during the recent 2008-2009 crisis. Furthermore, when large deposit insurance is not available, implicit government-backed guarantees behind SOE banks provided a safe haven for depositors.

The Cyprus economic mess reminded investors that their savings account is not in effect a "safe deposit box" rather the purchase of a liquid, very low-yield bond issued by the bank. During a crisis, particularly if the yield is basically zero, there is logic for savers to withdraw their cash and deposit it outside the system or store cash at the bank in a safe deposit box since the risk of loss through uninsured physical theft is lower than bankruptcy. This loss of cheap and stable

funding to the banking system would likely lead to a rapid deepening of the credit shortage.

During the crisis, there was a broad range of SOE bank behaviour across the EM. Some bank's actions were positive (e.g., Mexico and Poland), some appear to have engaged in political-view lending (Brazil) and others did little (Eastern Europe ex-Poland). The full costs to the portfolios and any increase in non-performing loans have yet to be determined as these were recent events. Furthermore, little of the credit expansion from the SOE banks has been unwound during the recovery.

### **Do they help or hurt private banks?**

#### **Absorbing high credit risk**

The greatest benefit we see for the private sector operating alongside SOE banks is the reduced pressure to lend into developmentally or politically important projects, many of which are not catered to by the private sector due to the risk relative to the size of loan. Areas such as infrastructure, low income housing, and SMEs are generally more economically sensitive – as seen with the sub-prime crisis. A 2012 policy research working paper for the World Bank titled Global Survey of Development Banks provided some insight to portfolio quality within 90 development banks across 61 countries. The figures for non-performing loans (NPL) provided from this group were dramatic: some 15% of the banks were operating with NPLs above 30%. All banks with NPLs above 5% were state commercial banks.

If a government was intent on having a banking system provide loans to such poor-quality assets, the private banks could either face much greater risk of loss or have to slow their expansion to avoid absolute exposures that could sink the ship.

Thailand: The country has a banking market with eight specialised financial institutions (SFIs) accounting for almost a quarter of the financial-sector assets. The two largest of these deposit-taking SOE commercial banks account for approximately 90% of the SFI assets. Bank of Agriculture and Agricultural Cooperatives (BAAC) is one of the largest. The SFIs are regulated by the Ministry of Finance and not the Bank of Thailand and have been used to boost spending post floods and support an extremely generous guarantee for rice prices to increase farmers' income, which has had the perverse effect of dramatically cutting exports. When farmers deliver their rice, they get a receipt that can be used as collateral to obtain a loan from the BAAC. The output of rice has risen as farmers take advantage of prices some 40% above market prices, and BAAC appears in need to raise new funds to cover the scheme as the ministry is only willing to inject its proceeds from rice sales. There have been news reports talking of the potential for the second-largest SFI, Government Savings Bank, being used to support the

BAAC. Meanwhile, the private-sector banks have not been drawn into this extra-curricular government spending.

#### **Low-cost competition**

State-owned banks, due to their implicit government guarantee, often enjoy a lower cost of funding than the private banks. In the case of Germany, this has left the market unattractive for private banks. However, the banks need to provide customers with competitive products and services since pricing will only provide so much of an advantage when competing directly.

In markets such as India and Brazil where the SOE commercial banks are large and saddled with social mandates, they are generally less efficient than the private banks and the latter are taking market share. In Brazil last year, the government looked to maintain growth through cutting costs to local companies and consumers, notably interest expense and energy costs. The government unsuccessfully asked the banks to lower their interest margins (the profit margin on lending), so it took action by leading the rates down through the use of the state-owned banks.

#### **Crowding out deposit takers**

The implicit government guarantee can also attract depositors, particularly in markets with limited or no depositor insurance. This is only available when the SOE banks have a commercial-bank operation such as in India or Indonesia, but not, for example, in Mexico. Amongst big Indonesian banks for example, the SOE banks account for three of the top four in terms of CASA ratio (current accounts and savings accounts), offering attractive low-cost and sticky funding for banks. As a result, most private-sector banks find it hard to compete for funding, with the exception of Bank Central Asia (BCA). Over the past few decades, BCA has built the most secure deposit franchise in the country through its high-quality service platform (branch/ATM/mobile/internet). Its 80% CASA ratio has underwritten its low-cost structure and superior profitability.

#### **Tools of industrial policy**

Beyond the large project risks often placed on state-controlled banks, there are the ongoing needs of broader bank networks to support underserved communities – either poor or geographically isolated – that add costs, but not necessarily great volatility. Risk comes with the lending-portfolio guidance from the government, primarily from focused lending to sectors such as agriculture or accelerated lending when a shortage of credit could exaggerate an economic slowdown.

Any increase in NPLs at state banks arising from new loans supporting existing clients of the private-sector banks works to the benefit of minority shareholders of private banks.

A recent example is Banco do Brasil (BB), an SOE commercial bank and the largest bank by assets in Latin America. It is listed, but is 51%-owned by the government. Traditionally, it has played an important role in funding agriculture. The government used BB to boost lending during the recent slowdown. Furthermore, on the outset of the slowdown, the government wanted to lower the costs of doing business in Brazil that included orchestrating a cut in interest-rates and energy costs. Both resulted in lower profit margins to the companies operating in the bank and energy sectors. The banks had not moved their rates on moral suasion from the authorities, so the government took the initiative by getting the SOE banks, including both BB and Caixa Economica Federal (CEF) to lower their net-interest margins. The private banks had little choice but to follow, although with smaller rate cuts and slower loan growth.

Examples of good banks in difficult sectors The bottom line of this argument is that private banks can produce considerably more stable earnings growth through the down cycle, even when the banking system in which they operate generates poor aggregate figures.

Sweden: During the banking crisis in the early 1990s, Svenska Handelsbanken, one of the big four Swedish banks, fared considerably better than its peers. The Swedish crisis was caused by a housing bust following a rush of lending competition post financial deregulation. Handelsbanken was the only Swedish bank that did not need a capital injection through the crisis. The company has always focused its retail business on better credit-risk clients.

United States: An example of a high-quality bank that performed well through the 2008-2010 crisis was First Republic Bank. Through 2008-2012, First Republic's loan charge-offs peaked at just five basis points in 2010 compared with the countrywide rate of 2.7%. Founded in 1985, the bank is focused on wealthy clients based primarily on the West Coast. With year-end 2012 assets of 34 billion US dollars, the bank is small in the US context. The company has followed a simple strategy of deposit gathering and loans to wealthy individuals and companies with fees bolted on top and a low-risk approach to lending. Based in a market blessed with wealthy tech-industry executives, the home market has continued to drive growth as the bank expands into New York and Boston. The foundation on which its success with stable wealthy clients has grown is being small by headcount and providing a personal and high-quality service. The bank only has 2,200 employees, the size of a large community bank, and quite unlike the automated dial-in experience of its larger rivals.

India: The Indian market is dominated by state-owned banks. As a result, even the largest private bank, HDFC Bank, still only has 4% market share even though it has grown its assets at a compound rate of 28% in US-dollar terms in the 10 years prior to March 2013.

The Indian private-banks are still at a relatively early stage of development and able to benefit not only from an under-banked market (i.e., able to cherry-pick the customers they lend to), but they are also able to pull existing deposits away from the vast branch network operated by the SOE banks. Recently, the earnings outlook for the private Indian banks has been significantly aided by low exposure to iron and steel, power, and infrastructure. The SOE banks have been the primary lenders to these sectors that are not only capital-intensive, but also exposed to India's often dysfunctional politics.

In a recent conversation, we asked the CFO of a large Indian SOE bank to compare the profitability of the bank with private-sector banks and explain the difference. He sighed and said, 'you have to understand, we are doing the heavy lifting in the economy'. As a result, we believe the private-sector Indian banks operate with a structural advantage over the banking system as a whole. An important factor is the existence of large SOE banks that absorb large quantities of developmental, or otherwise higher-risk, lending.

## Country illustrations

### Germany

Around 32 percent of Germany's bank-assets are government-controlled, including 426 municipality owned savings banks (Sparkassen) and seven Landesbanken wholesale banks. Many of these savings banks were founded before the country of Germany 142 years ago (1871) and served their original region. They were originally established as savings banks to allow the poor to safely hold savings and earn interest and are committed to the public interest – low pricing, broad service coverage and support for sustainable development – and are not intended to maximise profits. Today, Germany has 16 states (Länder) held in a federal structure where states have a fair amount of autonomy.

The Sparkassen are independent regional franchises that work under an umbrella organization, DSGV. Their operations benefit from economies of scale by being coordinated by the Savings Banks Finance Group enabling advanced banking services. Since the savings banks technically do not have an owner, there is no pressure for dividends, although tax is paid into the local regional budget. Unlike their Spanish counterparts, the Cajas, they are not allowed to expand geographically and, as a result, focus on lending to local businesses. The backbone of the German economy is made up of private small and medium regional businesses (Mittelstand), which have benefited from the attention of fully dedicated local lenders.

The Landesbanken are owned by the Sparkassen and provide wholesale services to them allowing, for example, coordination in placing large exposures, as well as specialist services such as leasing or insurance. The largest savings

bank is Hamburger Sparkasse, Haspa for short, which manages 1.4 million accounts in the Hamburg metropolitan area with assets at year-end 2012 of 39 billion euros.

Due to the commercial nature of these SOE banks, Germany is a tough market for retail banks. The market leaders such as Deutsche Bank have historically focused on investment banking as an important avenue for profitable growth.

## **Mexico**

Mexico's SOE banks are low-profile institutions. Mexico's banking market is very concentrated, with the top-seven private banks accounting for 82% of bank assets, of which five are subsidiaries of foreign banks. Mexican deposit insurance is by far the highest in Latin America standing at 137,000 US dollars per person and institution, which is more than three times greater than the next-largest Latin market, Brazil.

There are six development banks and three public-sector funds which accounted for around 13% of bank assets in 2011. Combined, the development banks manage fewer assets than the top-two private banks (Banamex and Bancomer). At year-end 2012, Banobras (National Bank of Public Works and Services) and Nafin (Nacional Financiera) each managed 27 billion US dollars in assets. Banobras is focused on road and energy projects and Nafin on SMEs.

In June 2013, the new government announced a huge 316 billion US-dollar investment-plan (2013-2018) that covers roads, railways, ports and telecom infrastructure. To support this effort, the government is in the process of passing a bill aiming to increase the supply of credit in Mexico at lower rates, as well as to change the mandate of the development banks. Until now, the development banks had capital preservation as their core obligation and are covered by the same laws as the private sector. As a result of this, state and private banks ended up competing. The new mandate will encourage more risk-taking and is anticipated

to reduce competition between state and private banks. The law also allows for higher pay to support the hiring of higher-quality professionals – a constraint we see in many SOE banks around the world.

To date, we have found that the Mexican authorities have not intruded on the private sector's management of its banks, nor have we detected moral suasion to pressure the private banks to make significant portfolio shifts towards politically driven assets. The public announcement of a major new capital-intensive initiative is always a little concerning, although we see no indications of pressure to fund and anticipate that the development banks will be used to support the private sector where investment gaps appear.

## **Spanish savings banks – the political view illustrated**

In Spain, savings banks date back to the 18th century, which were set-up to offer safe custody of savings and provide focused lending and services by region. The banks had no owner by structure and, therefore, paid no dividends and reinvested profits. With deregulation in 1988, the Cajas were no longer bound to their regional limits and started to expand. By the end of 2009, Spain had almost one branch for every 1,000 inhabitants, and by 2010 the Cajas accounted for 40% of Spain's banking assets. The lack of legal ownership, weak oversight and significant involvement of local governments eventually turned into a tragic loss of control. Having massively overinvested in real estate, the savings banks experienced a painful slowdown, and by 2010 NPLs for the savings banks were running just shy of 10% of gross loans, up from 1% in 2007. Needless to say, there are a number of ongoing investigations into relationships between board members of Cajas and local businessmen. The savings-bank sector has been restructured and the number of Cajas has been cut back from 45 at the end of 2010 to just two; the rest have been transferred or merged into newly formed commercial banks.

## Fund information

| Share Class | Currency | ISIN         | Inception Date |
|-------------|----------|--------------|----------------|
| A           | EUR      | LU0153585053 | 16/12/2002     |
| B           | EUR      | LU0153585137 | 16/12/2002     |
| I           | EUR      | LU0278085062 | 03/04/2007     |

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Investments in the securities of emerging market countries may exhibit considerable price volatility and – in addition to the unpredictable social, political and economic environment – may also be subject to general operating and regulatory conditions that differ from the standards commonly found in industrialised countries. The currencies of emerging market countries may exhibit wider fluctuations.

Investments in riskier, higher yielding bonds are generally considered to be more speculative in nature. These bonds carry a higher credit risk and their prices are more volatile than bonds with superior credit ratings. There is also a greater risk of losing the original investment and the associated income payments.

Commodity investments can be very volatile and are prone to sudden swings over the long run. Governments may at times intervene directly in certain commodity markets. These interventions can cause significant swings in the prices of different commodities.

Investments in derivatives are often exposed to the risks associated with the underlying markets or financial instruments, as well as issuer risks. Derivatives tend to carry more risk than direct investments.

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