

PENDO LLC



THE VALUE INVESTOR

International Core Value Strategy Quarterly Commentary Q1 2009

April 1, 2009

CHINESE STIMULUS PACKAGE APPEARS TO BE WORKING

We at Pendo believe that, as an emerging economy, China will be one of the fastest and largest growing economies on the planet; not just in our typical “long-term,” 3-5 year time frame, but indeed for a generation or more. Contrary to the caricatured communist, the Chinese government has a healthy respect for capitalism, and the authoritarian clout to see that it is followed in a way that is most beneficial to the State as a whole. This “Market Socialism” is a result of the reforms of the 1970’s, when Deng Xiaoping proclaimed to the masses, that “to get rich is glorious.”

Indeed, this is ruthlessly pursued by the Chinese government. The State has *de facto* final say on all matters pertaining to business and industry, and how they are run. Whereas in the US you are free to pursue any business endeavor you choose, with no regard for redundancy or efficiency, China is the exact opposite. They have learned well by observing us over the last century. They understand economies of scale, and work to reduce any inefficiencies and redundancies wherever possible, much like the US corporate raiders of the 1980’s. We see this with utilities, oil companies, and telecom companies. If large companies have overlapping business models, the government will decide which is/are most efficient, and act accordingly. Companies with overlapping agendas will also be modified; this was most recently seen when in October of 2008, China Unicom and China Netcom were merged into China Unicom, the second largest mobile phone company, which just posted a 58% increase in full year (2008) profit. The pre-merged companies operated two wireless technologies as well as its fixed line and broadband business. As part of the restructuring of the industry, Unicom sold one of its wireless technologies to China Telecom leaving it better positioned to expand the technology it retained. Following the merger, Unicom has been granted several wireless licenses in the southern rural parts of China, and appears to be building out its wireless network rather rapidly. The company is adding in excess of 1 million wireless subscribers per month.

While much has been made of the impact of Chinese exports decreasing due to world demand easing, it should be noted that, according to a recent finding by the *International Herald Tribune* that for every \$2.50 of value the US produces via manufacturing, China only produces \$1. While this is due to the types of goods manufactured, it points out that any unit of export has much less fiscal impact than one would expect in the US.

Although we expect growth in China to fall to ‘only’ 6-7% or so for 2009 (Chinese government officials, along with Mr. Jiang Jianqing, chairman of Industrial & Commercial Bank of China Ltd., are still committed to a more robust 8%), overall China remains in a strong fiscal position. This is due in part to its high savings rate (nearly one-third of income), just under two trillion dollars in foreign reserves, an increasing demand in consumer goods (heartily encouraged by the government), and will be further fueled as an estimated 600 million people begin relocating from rural areas to the larger cities. Additionally, we believe that when the economy, both global and local, turns around, that China should be able to maintain consistent growth for years to come. In fact, due to these factors as well as government action, the Chinese economy is likely to be one of the first to turn around, its reliance on exports notwithstanding.

The initial \$585 billion stimulus appears to be working; bank lending surged in December, and in January set a record. Consumer spending has also increased. Now, they are talking about doubling that infusion within the next three years. Unlike the US, this would not have such a drastic effect on their debt, since they are much better capitalized. They are also making what we feel are great investments in their own future. At record low prices, commodities are being gobbled up by the Chinese for the planned future needs of infrastructure, manufacturing, and construction. China has historically had much more of a long-term outlook than most countries. Indeed, government officials certainly do not have to worry about quarterly returns in order to meet their target, the way US fund managers do, nor do they have to worry about near-term yearly returns to keep their jobs, as US politicians do.

Until mid-2008, economic inflation was cited as a main threat to China. Today, as shown above, China is actively working to prevent debt deflation. This concept was first noticed by the American economist Irving Fisher, who warned about it in the 1930’s, and was most recently seen in the 2008 world-wide market correlations: assets must be sold off to meet loan requirements (unfortunately, he was ignored in his own time, having been discredited as he continued to insist after the crash of 1929 that a recovery leading to new highs was “just around the corner”). This forces down the price of the asset, which results in additional loan pressure, which pushes the asset down further, and so on.

Their economy is also much nimbler, in part because they rule by centralized fiat, and not bi-partisan committee-ship; “populist sentiment” is also not a consideration. The other factor is ease with which capital can be injected into the market. While waiting for the banks to act (and sometimes in place of banks all together), Chinese businesses and individuals can get loans at “pawn shops.” These are not like our image of a dank room full of ersatz jewelry and an old tuba; in fact, in China, the pawn shop is one of the most efficient parts of the banking system. Chinese pawn shops can have hundreds of branches, hundreds of millions and even billions in loans, and assets ranging from precious metals to heavy machinery and even real estate as collateral.

Proof of centralized support of individual capitalistic behavior abounds. The *Shanghai Daily* newspaper reported that “Non-Shanghai natives who graduated from local universities can now apply for government-guaranteed business-starting loans.... People will also be able to get the money *before* they start a business, *as long as their business plan is approved* (emphasis added).”

As a support for small-sized growth companies, the government recently announced the formation of the Growth Enterprise Market, or GEM, to be patterned after the NASDAQ market in New York, with an emphasis on smaller, cash-strapped technology companies that show solid growth potential. It will have lower listing thresholds than the main boards in Shanghai and Shenzhen.

With the already disbursed \$585 billion package beginning to stimulate the economy from large-cap companies down to the worker, and China's long-term disciplined outlook towards their future, we see tremendous value and growth potential not just in the relatively short-term, but for years, if not generations, to come.

We at Pendo LLC hope that this review is of help to you, and will better enable you to understand our thinking and strategy.

Sincerely,

Tina Larsson
CEO
Lead Portfolio Manager
Pendo International Core Value Strategy

Mark J. Foley
President
Pendo LLC
Pendo Capital LLC

No information contained herein either in whole or in part may be reproduced or redistributed without the express written consent of Pendo LLC. Any statements of opinion constitute only current opinions of Pendo, which are subject to change and which Pendo does not undertake to update. Many factors affect account performance, including changes in market conditions and interest rates, and in response to other economic, political, or financial developments. References to future returns are not promises or even estimates of actual returns Pendo or the strategy may achieve, and should not be relied upon.