



INVESTMENT STRATEGY UPDATE

September 30, 2009

CHINA, INC.

A global economic recovery is now well underway and, for the first time since World War II, it is not being led by the United States. This fact is emblematic of what many consider to be a new economic world order: the decline of the West and the rise of Asia (excluding Japan). Although the 1997 Asian financial crisis is still fresh in our minds, developments since then have made it clear that the emergence of Asia's economies is neither a fluke nor a false start. What does that mean for investors? Fortunately, it does not have to mean a portfolio of stocks in companies whose names and, more importantly, accounting practices are largely unfamiliar to western investors. However, it does mean an increased focus on what emerging nations are doing, what they need, and in what arenas they will be competing directly with us. Although by no means the only global economic growth engine, China is nonetheless the biggest and one of the fastest growing.

Perspective

The prospect of an economically dominant China would not be new. In 1750, when North America was part of the "developing" world, China accounted for approximately one-third of global economic activity. Unfortunately, a conservative imperial system that didn't promote economic growth resulted in China being left behind during the Industrial Revolution. Eventually, that system collapsed and was replaced by a group of regional warlords and an overly fragmented economy. Although political power in China was re-centralized in 1949, the policies put forth failed to promote sustained economic growth – that is until, beginning in 1979, market-based reforms were implemented.

China's more recent success can be partly attributed to the fact that its current form of economic and political organization has very little to do with Marxism. It seems more accurate to describe the People's Republic as a "nominally" communist country. From an economic point of view, China is in fact very capitalistic. It is simply overlaid by an authoritarian central government that dictates and oversees its long-term economic plans. Some may even argue that the combination of capitalism and unchallenged central authority provides an ideal environment for fostering economic success. As an example, when the global financial crisis broke out in late 2008, the Chinese government was able to move very quickly to provide fiscal stimulus and loosen credit availability, thereby maintaining an economic growth rate that is the envy of the developed world. It's as if their economy is being run like an efficient business: the happy combination of a decisive and results-oriented executive team at headquarters in Beijing and a large, skilled, highly motivated, and upwardly mobile work force deployed throughout the country.

China Today

While the U.S. economy has been struggling in recent quarters through what is arguably the worst recession since the 1930s, China's economy has continued to grow at a near 8% annual pace. This rate of growth has been possible because of increasing productivity and attractive demographics. Obviously, the population is huge, but it is also one with relatively few dependents. In other words, unlike in Japan, a large proportion of the Chinese population is neither too young nor too old to work. Furthermore, more than half the population lives in rural areas and is thereby currently under-employed in the agriculture sector. For some time it has been China's policy to promote migration to urban areas where workers can be employed in manufacturing or service industries that generate ten times the economic activity that farming does. Indeed, South Korea, and Japan before it, experienced a very similar phenomenon.

Another benefit of manufacturing or services employment over farming is the relatively more-reliable income stream. When there is a possibility that crop failure will lead to starvation, people tend to behave conservatively, saving a large percentage of their income. The more reliable a person's income, though, the more he is inclined to spend, rather than save. Even after years of migration to the cities, the Chinese savings rate is still 50%, so now that reduced American consumption has caused exports to shrink, a primary government goal is to promote domestic spending. Fortunately, exports haven't been the true growth driver of China's economy. While it may sound counterintuitive, the reality is that from 2003 to 2007, domestic consumption and gross capital formation generated the vast majority of the country's economic growth, while net exports accounted for only about a sixth.

Whether the Chinese economy can truly "de-couple" from the more developed economies remains to be seen, but the odds of that coming to pass seem to be improving. Of the \$585 billion China has targeted for stimulus spending through 2010, 25% will go towards earthquake-related reconstruction, and nearly 38% will be focused on infrastructure, including transportation and electricity. This goes hand-in-hand with the government's policy of promoting or subsidizing the purchases of automobiles and certain home appliances. The numbers are staggering. Over the next ten years, for example, 500 new coal fired power plants are expected to be built – more than currently exist in the U.S., where we generate half of our electricity from coal. That's not to say that China is de-emphasizing exports. Currently, 65% of its global trade depends on only 4 of its 31 provinces. The massive planned transportation investments are intended to better link the inland provinces with the coasts. And we all know what the Interstate Highway System and the rise of the automobile did for U.S. economic activity.

So, are the policies working? Can increased domestic consumption keep the Chinese economy growing? Apparently, yes. China's marginal propensity to spend (retail sales divided by income) has been rising steadily since 2005. Currently, consumption is growing at an 18% rate, year-over-year, whereas from 2000 through mid-2008 it never achieved even 14% growth. Furthermore, real estate investment, which fell significantly during the second half of 2008, is now growing again. And, while fixed-asset investment growth

flattened for a while during 2008, such spending has again surged in 2009. All in all, China is now contributing more to global economic growth than all of the developed nations combined.

Investing in China

Since the China story appears to be both real and sustainable, how should a U.S. investor participate? Fortunately, there are plenty of ways to approach the issue. Obviously, one can invest directly in Chinese companies as there are many that trade on U.S. exchanges. Also, there are a number of mutual funds and exchange-traded funds that focus on China.

It is important to remember, however, that few if any consumers and companies buy domestic products and services exclusively. So one can also invest in China's growth indirectly. Perhaps the easiest way is to acknowledge one all-important fact: Although it is the world's largest consumer of most major commodities (except oil), China is a very resource-poor country. For all of its manufacturing prowess, it has to import enormous amounts of raw materials, such as iron ore, copper, and coal. Resource-rich countries, such as Australia, Canada, Brazil, and the U.S., all have companies that operate globally and sell to China. And, most have familiar accounting standards.

There are, of course, any number of finished products the Chinese need that are also produced by developed economies. For example, while the telecommunications networks being built there are owned by Chinese companies, the equipment used to operate them and the devices used to access them are heavily sourced from companies headquartered elsewhere. On the services side of the economy, beginning in May of this year, foreign companies are now being allowed to offer consumer finance products within China. As we have heard it summarized by one investment strategist: Buy the companies that produce what China needs, and sell those with which China can successfully compete.

What Could Go Wrong

We do not intend to suggest that the China investment story is a one-way street. Remember that in 1989, it seemed as though the Japanese were going to take over the world, whereas that turned out to be the beginning of their two "lost decades," economically speaking. So, what could go wrong for China? For one thing, there have been serious issues with product safety. Tainted pet food, toxic drywall, and dangerous chemicals in children's toys have caused justifiable leeriness among global consumers. Also, the sheer scale of China's success will create enemies. Its attempted acquisition of Unocal in 2005 was a public relations disaster since it resulted in a political backlash that led to Unocal's acquisition by Chevron. Wherever it goes, China needs to tread carefully.

It also needs to promote fair play in its dealings with the developed world's economic players. Among the many impressive statistics cited about China's booming economy, at least one is impressive for the wrong reason: 70% of all pirated goods come from China.

Respect for intellectual property has to be more deeply ingrained into the nation's economic behavior or it will lose credibility, and thereby customers. While most companies will tolerate some inconvenience in return for the benefits of selling their products in China, there could eventually be a backlash. There is also the risk that the intense pace of economic development may ultimately come with costs that the citizenry will not abide, such as social injustice or environmental damage that inevitably leads to some level of economic reversal.

Conclusion

Despite some missteps, the Chinese authorities seem generally to be doing the right things. Economic growth is rapid, but apparently sustainable. Debt levels have grown since 1997, but not as rapidly as domestic financial deposits. Full industrialization is still a long way off, as it tends not to be reached until an 80-90% level of urbanization. Tightening loan provisions on second mortgages to prevent the inappropriate investment of bank loans in non-productive investments has been adopted as a mature, disciplined approach to avoiding speculation. And, the easing of restrictions on private equity companies shows a healthy respect for the influence and expertise of private investors. Most or all of the necessary elements are in place to maintain a growth engine that could support economic development for decades to come. They are also what make China attractive from an investment standpoint.

A Brief Stock Market Comment

The U.S. recession appears to have ended but, with the exception of some early inventory restocking-related strength, we anticipate a labored recovery, slowed by the headwinds of continuing consumer deleveraging, as well as by the need for the Federal Reserve Board to drain excess liquidity from the system. With the rebound since March, stocks have risen to what is essentially fair value, in our opinion. Further stock market advances from here will have to be justified by rising corporate earnings. While we would not be surprised to experience one or more nerve-wracking interim stock market corrections, there is still a lot of money on the sidelines, earning very little interest, with few attractive investment alternatives. Our expectation is that the stock market will grind its way higher over the coming months.

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