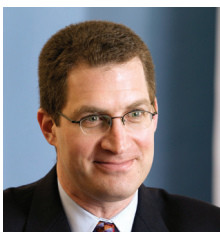


## Q&A

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### Global equity portfolio manager **Eric Stern**

As the immediate outlook for the global economy remains uncertain, many global investors are concerned about the wild swings in the market. Eric Stern, a Capital International global equity portfolio manager, deals with the uncertainty by taking a long-term perspective on individual companies. In the following Q&A, Eric shares his belief that despite short-term concerns over economic growth, he's finding plenty of companies that present attractive long-term investment opportunities.



**Eric Stern** is a Capital International portfolio manager whose investment responsibilities include U.S. core, U.S. growth and global equity mandates. Prior to joining Capital in 1991, he served two years as an analyst in the mergers and acquisitions department of Morgan Stanley & Company. He holds an MBA from Stanford Graduate School of Business and is a Phi Beta Kappa graduate with a BS in business administration from the University of California, Berkeley. He is based in Los Angeles.

#### **Given the uncertainty in global markets, what is your view of the world today and its risks?**

I am cautiously optimistic on long-term global economic growth. In the near term, I expect the developed markets to be in for a period of slow growth. In particular, Europe is teetering on the brink of recession due to fiscal austerity and deleveraging. I expect that the U.S. economy will muddle through without a significant recession and that emerging markets will continue to be the primary driver of global economic growth. My portfolio is moderately pro-cyclical given significant exposures to energy, consumer discretionary and technology companies.

I think the main risk to this scenario is the impact of potential policy errors. In a slow-growth environment, the global economy will not be as resilient to policy mistakes. So the European sovereign debt crisis is top of mind for me. I also worry about policy in China and their efforts to control inflation and rising real estate prices. They have to balance policies that protect the poor and policies that stimulate continued economic growth. Finally, I worry about how developed market governments and economies can handle the promises they've made to their populations in the form of pensions, health care and other safety-net policies.

## You have targeted investments in the energy sector. Where are you finding your highest convictions there?

Energy is an important theme in my portfolio, in particular the oil and gas service companies. I strongly believe that underlying energy demand, particularly from emerging market consumers, will outstrip conservation efforts from the developed markets, thus driving up the long-term price of energy. Given a 6-8% decline curve for existing oil and gas fields, we can't rely on what we've already discovered to meet growing demand. Supply increases will need to come from fields that will be more difficult to locate and from which the oil and gas will be more difficult to extract. As a consequence, companies are turning to the oil service industry for expertise, technology and equipment to locate and extract the commodity. We're seeing this in the form of shale gas exploration in the U.S., oil sands activity in Canada and deep-sea drilling around the world.

**"At my core, I'm a bottom-up investor. I identify businesses that I want to invest in and a stock price at which I think they will generate attractive returns for our clients."**

## Google is one of your top holdings. Could you share your thoughts on the internet and where you're finding opportunities to invest?

The volume of bits that we consume will rise inexorably as more and more people become connected to the internet and as the number of devices that we interact with increases. It's interesting that in the last 20 years we've gone from connecting to others using a telephone to including a desktop computer, a laptop computer, a cell phone, a smart phone, and now tablet devices. As this trend spreads across the globe, the diverse ways we connect will continue to expand as will the content that is available to consumers. I view that as a secular trend that has a lot of legs to it.

Google is a large holding, reflecting the strength of their search business and their ability to penetrate new geographies and mobile platforms. I see them as a key enabler, from a software perspective, for consuming content. Other convictions related to this theme include key product and component companies such as Qualcomm, Murata and Taiwan Semiconductor, which are producing key components and technologies necessary for the consumption of broadband. Similarly, a company like Juniper provides critical technology for enabling bits to move at faster speeds and higher volumes around the globe. I also like cable companies in the US and Europe given their roll as primary broadband service providers.

## How do you see this ecosystem evolving?

I expect that connectivity in our lives will continually increase, whether it be the devices we touch or the cars we drive. Today there is a lot of focus on the living room and how technology can make that experience integrate with user experience at the desk and when mobile. I'm looking for companies that can benefit from creating an effective and appealing integrated system for consumers.

## In what ways do you incorporate emerging market themes into your portfolio?

My expectation of continued strong growth in emerging markets is an important theme in my portfolios. I mentioned previously my energy holdings which rely on growing demand from EM. I hold many branded consumer goods companies such as Avon, Danone, Philip Morris and Pernod Ricard which will benefit from the rising EM middle class. Luxury goods demand is also increasing substantially given rising incomes and wealth accumulation which attracts me to companies such as Coach and Swatch. Rising living standards also increases demand for financial services which is driving growth at companies such as AIA, Prudential and Visa.

From a more industrial perspective, I like companies that enable efficiency and productivity improvements for labour- and resource-constrained markets. For example, in China, where wage rates and imported commodity costs are rising rapidly, productivity improvements are essential to sustaining growth. Thus, companies such as Schneider in electrical efficiency and SMC in industrial automation should see substantial growth opportunities. I also like Monsanto's seed technology as it enables farmers to increase output per arable acre.

## How would you describe your approach to investing?

At my core, I'm a bottom-up investor. I identify businesses that I want to invest in and a stock price at which I think they will generate attractive returns for our clients. I assemble a portfolio of these attractively valued businesses that makes sense for the environment that I anticipate. If I have a central tendency, it is to be a GARP – growth at a reasonable price – investor. That said, I am open to and invest in a variety of opportunities that include cyclical and income generating companies.

So, what do I look for in a company? I am particularly attracted to companies that have a strong track record of innovation as they have the ability to generate high margins and strong returns. I also like to identify companies with significant franchise value, which may take the form of a superior brand, cost position, distribution, product quality or managerial execution. These attributes can lead to sustained pricing power, growth, margins and returns on invested capital. I think meeting company managements is vitally important in identifying the attributes above and evaluating the sustainability of a company's key competitive advantages.

### You were a research analyst for a number of years, how was that experience formative to your approach to investing?

I used to cover medical technology, which demonstrated to me the value of innovation and how meeting previously unmet needs, provides an opportunity for very attractive financial returns. My coverage of the healthcare industry also gave me great experience for investing in growth businesses. I also covered the insurance industry where financial statements require a great deal of scrutiny and surprises are often negative. My experience in insurance has encouraged me to set high standards for management and transparency and to have lower risk tolerance when investing in the financial sector. Finally, my tenure as a U.S. autos analysts gave me valuable insight into cyclical industrial businesses. Given my view that the US auto companies were in decline and their balance sheets unsustainable, I never held the stocks over the five years I followed them. This perspective fit well with Capital's long term approach and proved to be a beneficial decision for our clients.

### You travel a lot, how does this benefit you as an investor?

You really can't do this job sitting at your desk. You have to meet people who run companies. You need to experience the environments and cultures where companies operate. Firsthand experience is very valuable in forming opinions and making informed decisions. Companies are much more than a name at the top of a research report.

### Can you share a recent experience where your travel yielded an interesting investment insight?

I was recently in Macau where our research analysts organized a day trip to visit a number of the gaming companies there. We spent the day visiting company managements, their facilities as well as ancillary service providers. Over the course of a day, I gained insight into the critical components of demand, industry regulation and future development. I came back excited about several investment opportunities. The trip spurred further study of company financials, industry supply/demand dynamics and determination of a fair entry price for the company of greatest interest. I've since made my first purchase for client portfolios. To me, this was a great example of getting out in the field and it having an immediate impact.

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### How would you describe the balance of investment approaches of the global equity team?

What we try to achieve with the Multiple Portfolio Manager System is a diverse blend of styles, experience and approach to investing in one portfolio. For example, Darcy brings a wealth of experience investing in cyclical industries and pays a lot of attention to income and growth of income when investing. Lionel tends to be more thematic and likes higher-quality companies. Rudolf has a strong growth-orientation and brings a lot of focus to opportunities in emerging markets. Over time, these diverse approaches and skill-sets help us to find attractive investment opportunities in a range of market environments. ■

#### About the Multiple Portfolio Manager System

Capital International's investments are managed through the distinctive 'Multiple Portfolio Manager System' (MPMS). This disciplined yet flexible approach has been in place for over 50 years and is aimed at tempering volatility, providing continuity in portfolio management and enhancing long-term results. It divides a portfolio among several portfolio managers, with each manager having autonomy to invest according to his or her convictions.

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