

August 17, 2012

*"It is the long history of humankind (and animal kind, too) those who learned to collaborate and improvise most effectively have prevailed. "*

-CHARLES DARWIN

By now most readers expect to open EVA each Friday and read our take on the ever-changing financial markets. Occasionally, something arises thatâ??s compels us to deviate from our normal range of topics.

Even casual EVA followers know by now Evergreen has joined forces with Louis Gave, of GaveKal, and his world class team of research and investment professionals. While we make our admiration of their work no secret, there has been some quizzical interest as to their attraction to Evergreen. Below is a personal explanation from Louis himself describing their motivation behind our combined entity.

*Tyler Hay, Evergreenâ??s CEO, recently called me and said, "Louis, many people are curious as to why you decided to purchase an interest in Evergreen Capital Management. Would you please help clarify this for clients and friends of Evergreen?"*

*This request puts me in a quandary. I could undeniably wax poetic for pages on how, together, we are able to better service our clients. I could talk about how well our respective businesses complement each other. Or, I could dwell on the opportunities ahead for both of our firms. And all of these points are true (as I will detail later). Yet, a lot of opportunities have arisen throughout the course of my professional life. And, although many of them could make sense economically or strategically, I havenâ??t been moved to act. To act, an opportunity needs to make more than strategic sense; I have to enjoy the people with whom I will be working.*

*Charles and I have known the management team at Evergreen for almost a decade now. We have skied together in Whistler and gone out for dinners in Seattle and California. Weâ??ve even entertained them in Hong Kong (under sweltering conditions that tested Daveâ??s climatic fortitude). And from every occasion we have come away more impressed, and liking each one of them increasingly more. In short, over the past decade, we have become good friends with the Hay family, and the Evergreen family as a whole.*

*That said, I meet many likable people all the time, but I donâ??t reach for my checkbook. When evaluating a money management firm, only three things matter to me: people, process, and performance. On all three fronts, we find Evergreen to be unique.*

*The work the Evergreen team has done over the years to decipher fund flows has played a significant role in our interest in the firm. More specifically, the flowsâ?? ability to strongly indicate contrarian market shifts has been very convincing. Combine this tool with solid valuation work, a thorough understanding of how economic cycles evolve, and, most importantly, a steady discipline based on years of experience, and the result is undeniable performance.*

*Staying on the investment side of things, the other key attraction for us is the expertise and track record that Evergreen has built over the years managing US income portfolios. Indeed, within GaveKal, we have developed solid expertise in understanding the Asian and global equity markets, along with being well versed in Asian income investments. However, we have never*

*spent enough time or resources building up a proper US income perspective. The reason for this was simple: In a world in which the greenback was underperforming every currency, a US income strategy was not very attractive for an international investor. We think this has changed, as is shown on the following page in a more in-depth description of why we are viewing the US more favorably from a macro-economic perspective.*

*Our alliance with Evergreen also brings a US private wealth management arm to GaveKal. At our core, we have long focused on building financial products and doing research. However, we recognize that this leaves a void for US investors looking for a more holistic solution to managing wealth. It is our belief that this alliance serves as the appropriate extension of our brand into this segment of the investment world. Evergreen's ability to navigate client portfolios and grow their business through the crisis we saw in 2008 displayed the firm's capabilities and commitment to its clients.*

*For those who would like a condensed overview of why we have become increasingly bullish on America's long-term competitive position, here is a short piece I wrote last month. My apologies to those who may have already seen it via the Evergreen GaveKal Daily.*

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## **The Important Structural Trend**

### **By Louis Gave**

With market positions and investment trends rotating more wildly and frequently than a Mitt Romney policy-position, and with fears on US and global growth growing by the day, we thought that taking a step back to review the broader investment landscape might make sense. Now, as every one knows, there are basically four factors that go into the production of any good or service: land, labor, commodities and capital. Typically, these four inputs of production are fairly stable; but over time, large differences can build up between countries, or even regions, providing investment opportunities, and even paradigm shifts.

Such a shift occurred in the years following China's 2001 entry into the WTO. All of a sudden, millions of very inexpensive workers were added to the global labor force, creating a shock in the factors such as the world has seldom seen. As we described in our 2005 book "Our Brave New World" ([PDF version here](#)), we moved to a world where the real winners were the companies who could most quickly adapt to benefit from the new very low-cost of labor (we called these "platform companies" and even built a fund which is still going strong to capitalize on the idea). Now, as China roared, fears accelerated that in the labor-land-commodities-capital equation, the rise in the emerging market labor would de facto imply a surge in commodities which would end up throwing the whole equation off balance. We were never convinced by such Malthusian arguments which ran the most stridently on oil (remember the whole "peak oil" debate?) for a good reason: of all the commodities, energy is undeniably the most important in the overall production process.

Which brings us to today. For the first sixty years after WWII, the cost of energy was roughly the same everywhere around the world; basically priced off a (usually cheap) fungible and transportable barrel of oil. On the back of the China and emerging markets boom, oil prices shot up over the past decade; a price action which forced every country to look for energy alternatives. The UK and German governments decided to bet on wind. The French government decided to bet on fifth generation nuclear power plants. The Chinese government bet on coal. The Indian government bet on thorium based nuclear plants. And the US private sector bet on fracking (actually, a rather old technique) and natural gas. And now, the results are in (no prizes

for guessing who won).

The disparities in the success of these various energy investments means that we are now entering a very different world than the one that has prevailed since the end of WW2. Basically, the cost of energy amongst the various industrial countries will, going forward, most likely continue to diverge. And this is happening just as the cost of capital is basically the same everywhere (i.e., zero!) and the cost of labor will continue to matter less and less.

In short, with a) some of the cheapest land and real estate in the world, b) some of the cheaper costs of energy amongst industrial nations and c) still one of the world's most flexible labor forces, should we be surprised that the marginal dollar flowing into equity markets today is going into US equities rather than elsewhere? Or to put it another way, if one was to build a new chemical plant or a new factory today, where would one deploy capital? Five years ago, the answer would have been China for this is where the cheap labor was. Today, the answer is the US for this is where the cheap energy will be found. In our view, this is the paradigm shift that markets are undergoing right now and the reason why we have argued for the past two years that a period of stronger US\$ and outperforming US equities was a distinct possibility.

Now we acknowledge that US growth numbers are worrying, that US politicians are immensely uninspiring, that Fed policy makes little long-term sense. But even with all these hurdles, we believe the stage is set for the US\$ and US equities to maintain their structural outperformance. We have moved from a world where companies looked for the cheapest source of labor to a world where companies seek the most flexibility and the cheapest energy costs. This is a world that favors North America.

Your Evergreen GaveKal Team

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