Julius Baer

Julius Bär

Wealth Report: Asia

September 2012

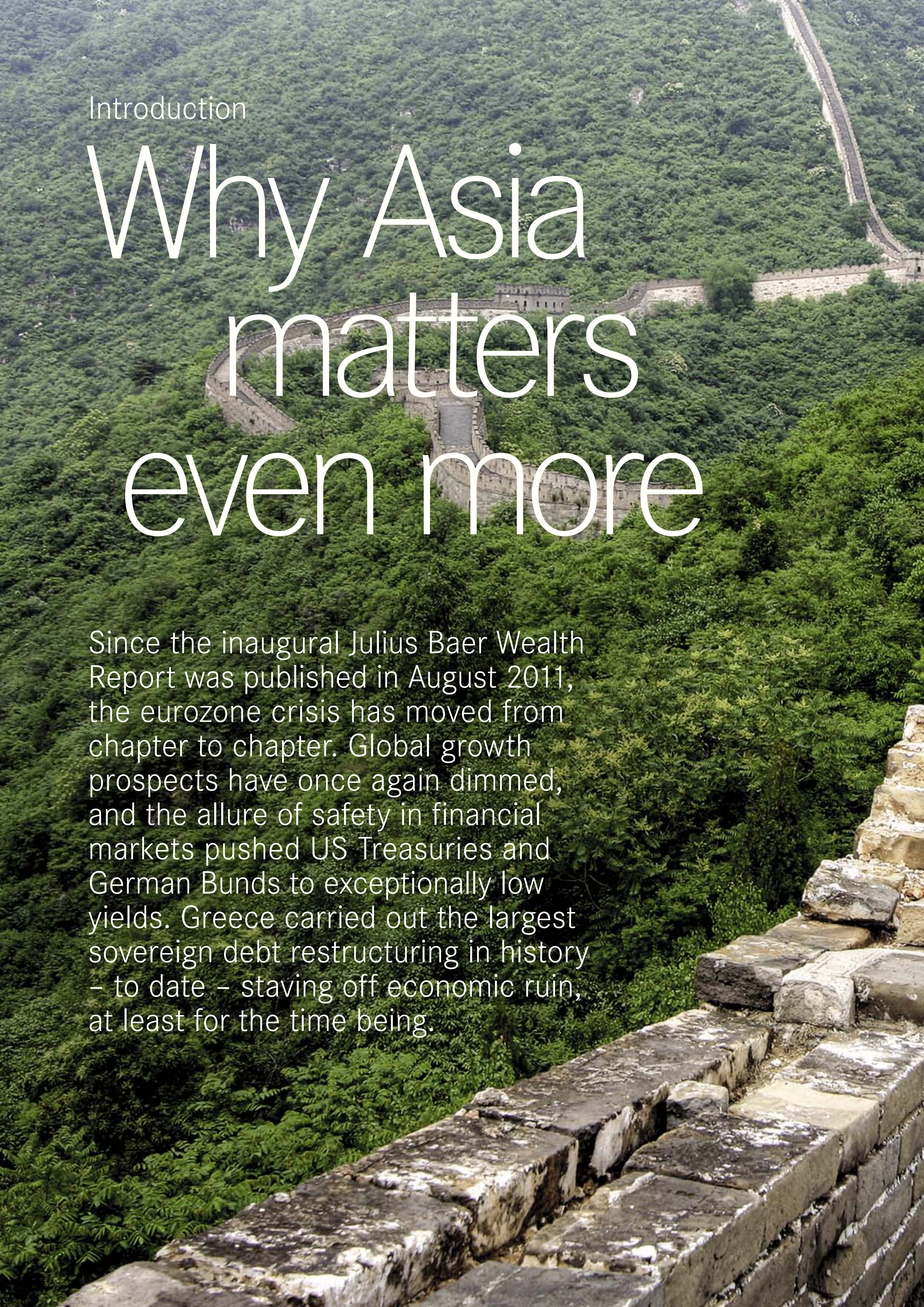
Dear Reader

Few would have predicted the tumultuous events of the past twelve months across political, economic and financial spheres. Amidst the challenges and opportunities facing us all, Asia has remained the bedrock of growth and prosperity. With this in mind, we again dedicate the 2012 Julius Baer Wealth Report to our second home market, Asia, re-examining in closer detail which key economies in the region are on the frontier of wealth creation. We pay particular attention to China, India and Indonesia, given the unique role and combined size of these three economic giants in Asia. Overall, we find that the region's strong economic fundamentals leave it in pole position to drive global wealth creation through 2015.

The second Julius Baer Wealth Report also marks the next instalment of our Lifestyle Index, which tracks the cost of living for high net worth individuals in Asia. The results thereof reinforce the need for providing sound and innovative long-term investment advice and planning: a key focus point that we address in the 2012 report as well. As we look forward to the medium term and expect the world to continue to change at a rapid pace, we reaffirm our deep commitment to being long-term partners in wealth management.

I trust you will find the 2012 Julius Baer Wealth Report on Asia as insightful a guide as our inaugural effort.

Boris F. J. Collardi
Chief Executive Officer
President of the Executive Board
Julius Baer Group



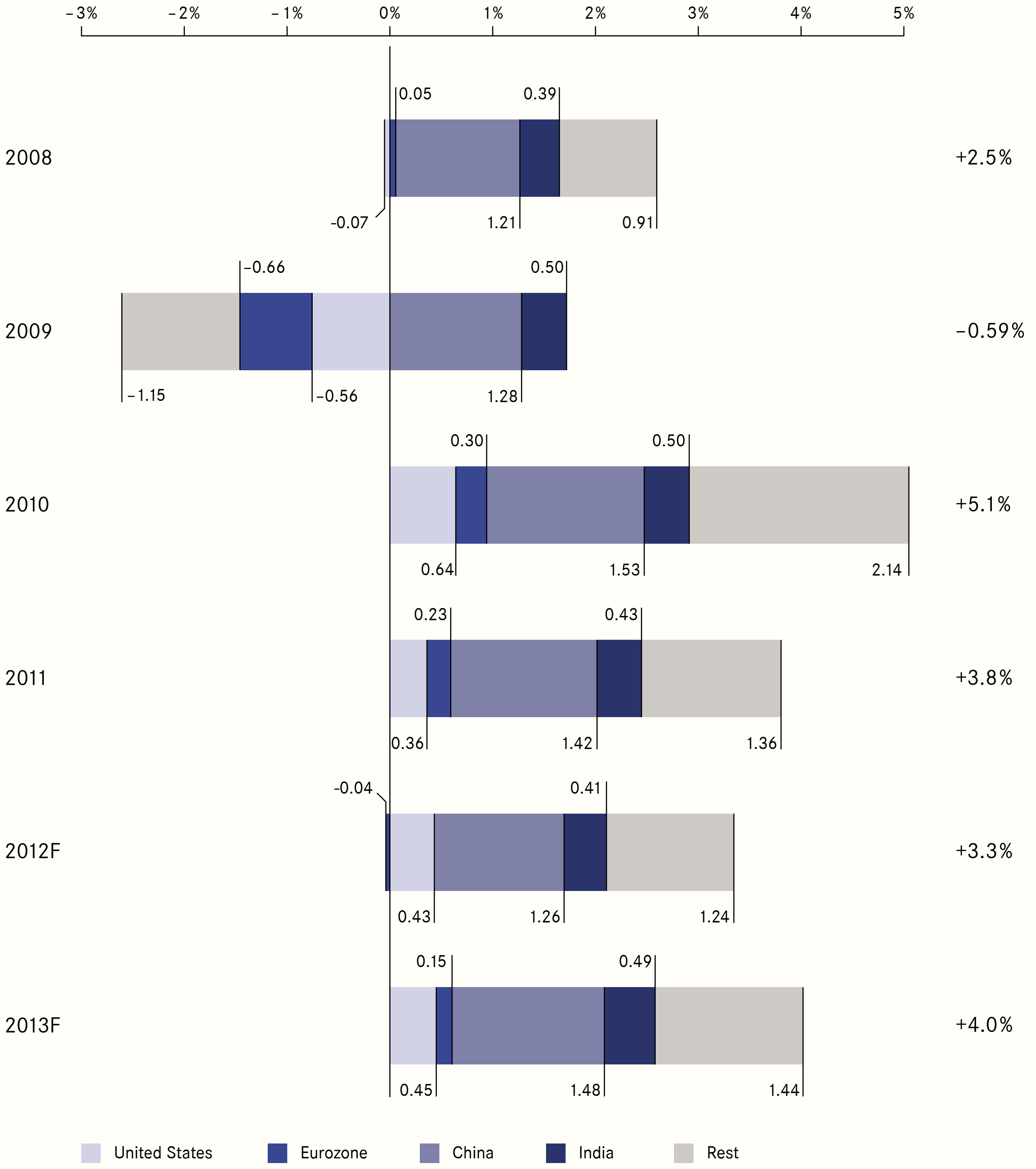
Introduction

Why Asia matters even more

Since the inaugural Julius Baer Wealth Report was published in August 2011, the eurozone crisis has moved from chapter to chapter. Global growth prospects have once again dimmed, and the allure of safety in financial markets pushed US Treasuries and German Bunds to exceptionally low yields. Greece carried out the largest sovereign debt restructuring in history – to date – staving off economic ruin, at least for the time being.

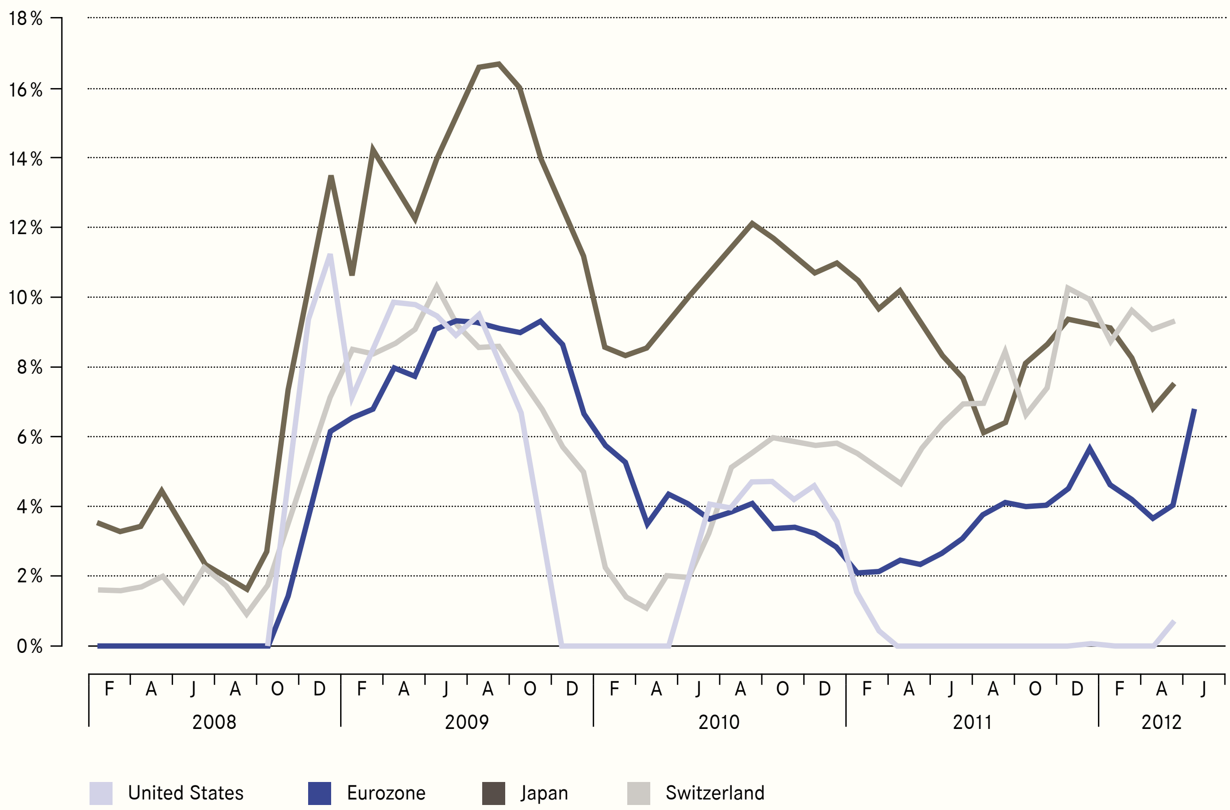
Most developed economies face serious fiscal and debt challenges owing to demographic trends, well beyond the immediate crises that have dominated the eurozone. At the same time, the collapse in house prices since 2007 means that the median household's real net worth in the United States has fallen to the 1995 level, according to some estimates. Put succinctly, uncertainty remains high, structural headwinds persist and hence the outlook for significant wealth creation in developed economies is difficult, to say the least. Against this backdrop, we again dedicate the second Julius Baer Wealth Report to our second home market, Asia.

Chart 1
Contribution to global GDP growth: Asia in pole position



Source: Datastream, Julius Baer

Chart 2
Julius Baer Deflation Indices: Developed economies face the threat of falling prices

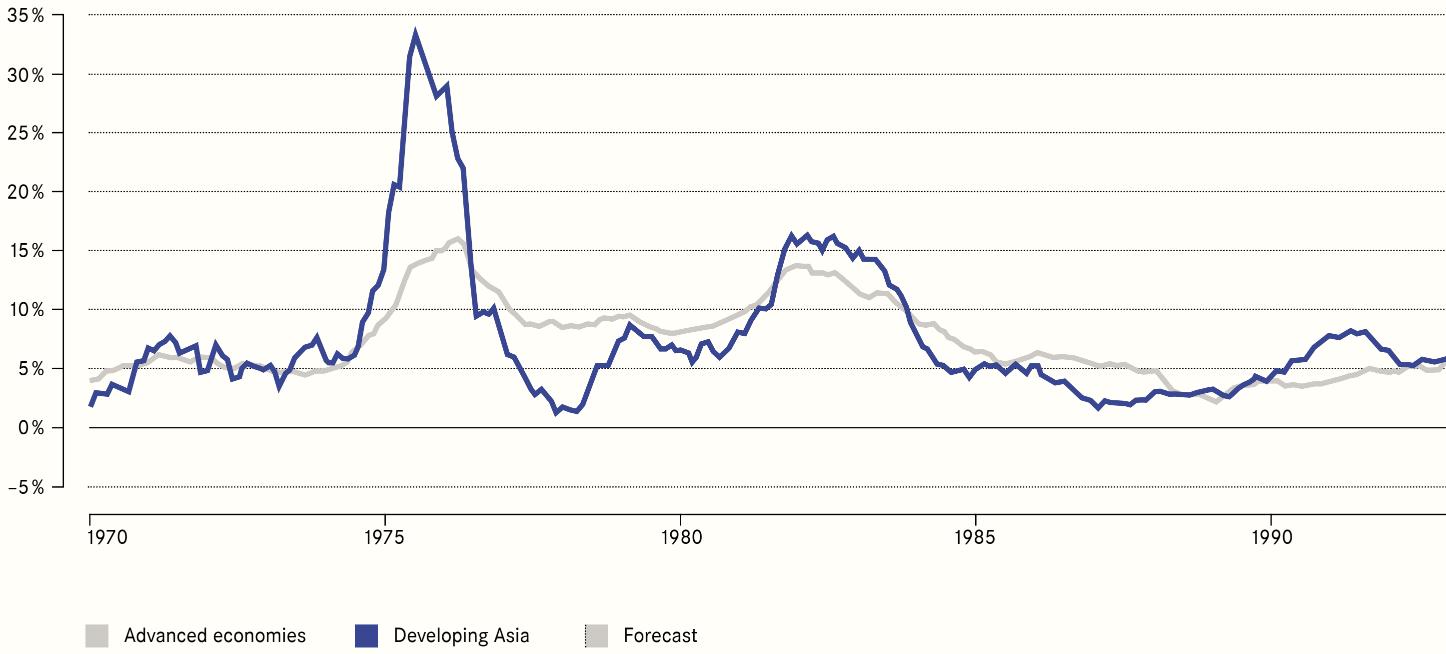


Source: Datastream, Julius Baer

The key exercise in the second Julius Baer Wealth Report is to stress-test the assumptions and conclusions of the inaugural effort. The world has not changed for the better in the intervening period; therefore the re-examination of our outlook is prudent. Secondly, closer attention is paid to the economies in Asia that are on the frontiers of wealth creation, namely China, India and Indonesia. To gain valuable insights into the economic transformations that underpin the creation of wealth, we have interviewed key business leaders whose own operations give them a unique vantage point into that process. We proceed by detailing the next instalment of the Julius Baer Lifestyle Index, a proprietary indicator that measures the changes in the cost of living for Asia's high net worth individuals (HNWI). Lastly, we consider essential concepts in preserving and managing wealth over the longer term.

The Julius Baer Lifestyle Index speaks volumes about the realities that Asia's high net worth individuals face when it comes to covering their cost of living. At the same time, it also demonstrates a key difference between Asia and developed economies outside the region. Namely, structurally higher inflation pressures can be found in Asia compared to deflation fears that tend to grip developed economies as shown above. The latter carries the risk of slipping into a Japanese-style malaise, especially given that the deleveraging process has yet to start in earnest in Europe and arguably still has some room to run in the United States.

Chart 3
Inflation over the longer term



Source: Datastream, Julius Baer

Against stagnant or only moderately growing G3 (the USA, the UK and Japan) economies, we find that Asia matters to the global economy more than ever. The summer of 2012 has seen global growth forecasts suffer downgrades across the board – but the relative lead of Asia has remained unchanged. Indeed, looking to 2013, we forecast that China and India will again deliver half of the world's overall growth, as has been the case since 2011. This is without China resorting to powerful monetary or fiscal stimulus packages as was the case in 2008. Given the deepening linkages between emerging markets, China's growth in particular has far-reaching implications across Asia and beyond.

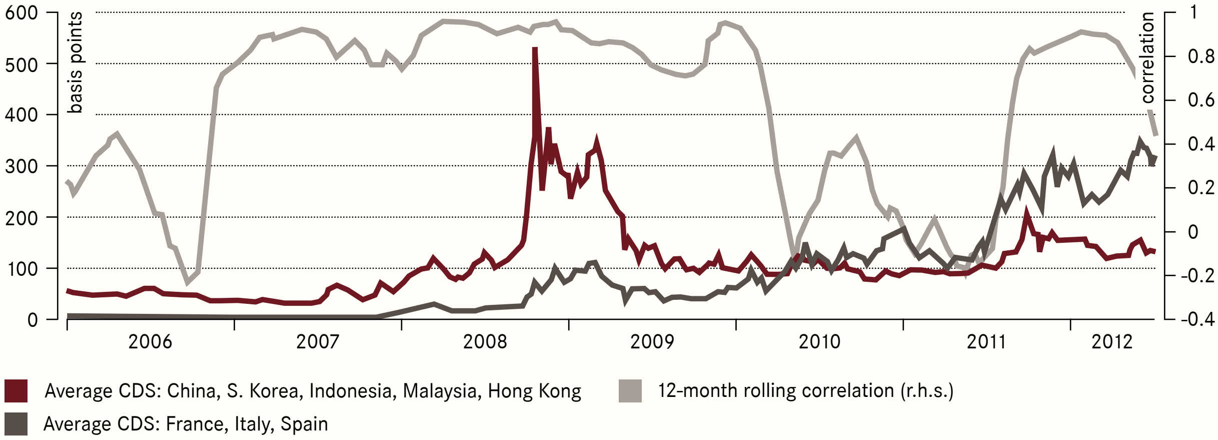
Beyond conventional drivers of economic growth, China has shown its commitment to financial sector reform as well. For example, the June decision by the Hong Kong Monetary Authority to bolster the liquidity of the offshore renminbi (CNH) market and the People's Bank of China's move to liberalise interest rates are major steps. In other words, as the euro-zone has struggled to regain institutional coherence, ring-fence weaker states and contain the risk of bank runs, China has pressed ahead with important measures that build the base upon which future growth can emerge. This leads us to conclude that Asia, and China especially, is becoming ever more important for growth and wealth creation. One of the main risks to Asia's shorter-term growth prospects remain contagion effects from the eurozone crisis, but all indications so far are that regional policy-makers have the tools at their disposal to mitigate the worst effects.


1995
2000
2005
2010
2015

Becoming wealthy in a more difficult world

In the year after the inaugural Julius Baer Wealth Report, global growth concerns resurfaced as the eurozone crisis entered into its second year. The process to address the institutional shortcomings that initiated the crisis has been slow as competing political and economic interests prevented a workable consensus from forming quickly.

Chart 4
Asian credit default swap (CDS) correlations to Europe have fallen

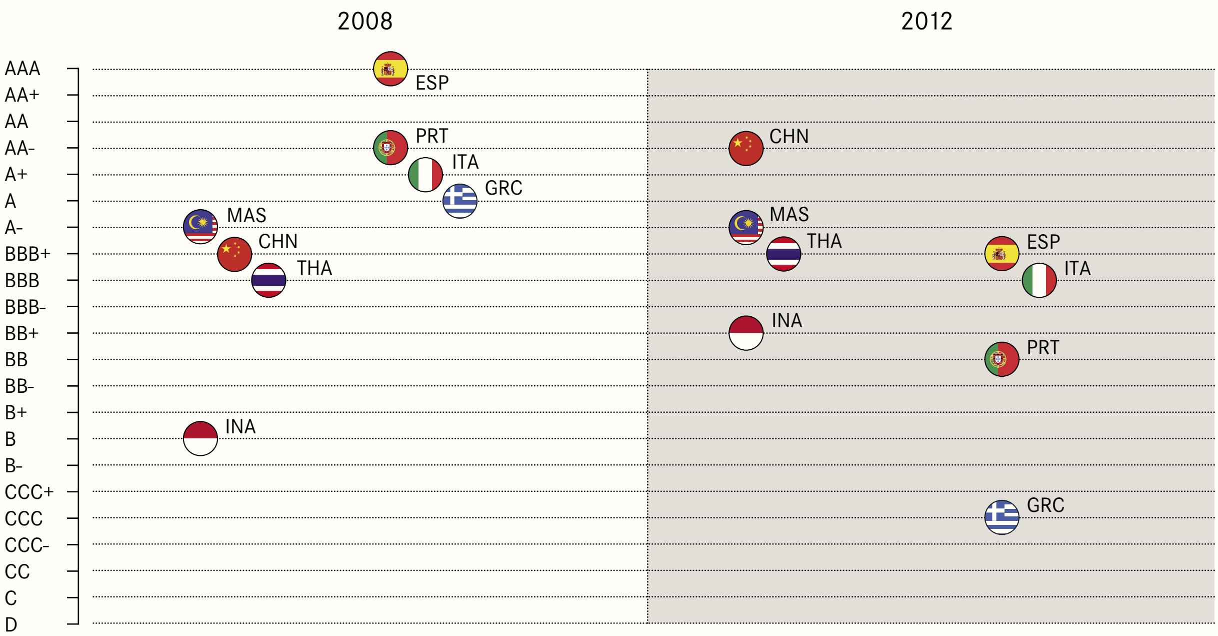


Source: Datastream, Julius Baer

In the midst of the crisis, measures to reduce the systemic risks in the European banking system by raising capital requirements aggravated the decline in credit extension. Despite extensive efforts by central bankers to avert a credit crunch via liquidity provision measures, the combination of these factors has left much of Europe with an anaemic GDP growth outlook over the coming years. While the growth outlook in the United States is relatively sanguine, structural headwinds such as the impending fiscal consolidation and still weak labour and housing markets have sustained a growth path that is below its previous potential.

Yet the economic outlook for Asia remains comparatively robust, according to the International Monetary Fund's (IMF) July assessment. It is clear, however, that Asia cannot remain immune to weak economic activity in Europe indefinitely. The transmission mechanism of the eurozone crisis works along three basic paths: financial markets, export demand and credit extension. On the first avenue, the degree to which financial market contagion has weighed upon Asia is debatable. For one, the country risk premium of Asian sovereign issuers decoupled from the eurozone, as measured by the rolling correlation between the two. This idea is captured by the observation that as the European country risk

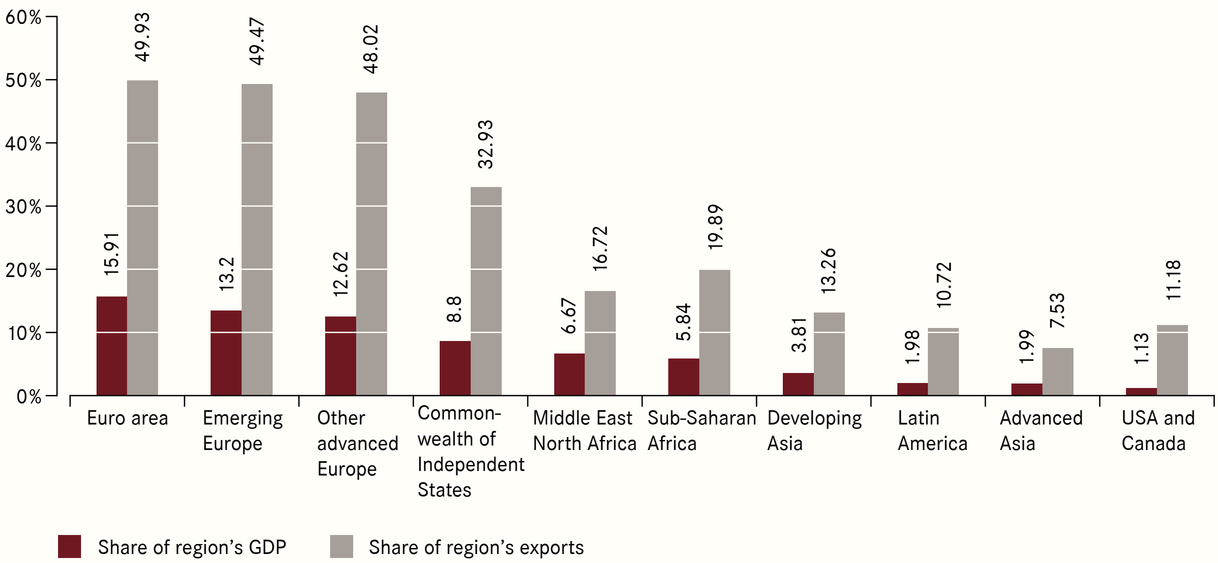
Chart 5
Asia's sovereign credit ratings have held their ground while Europe has faltered



Source: Datastream, Julius Baer

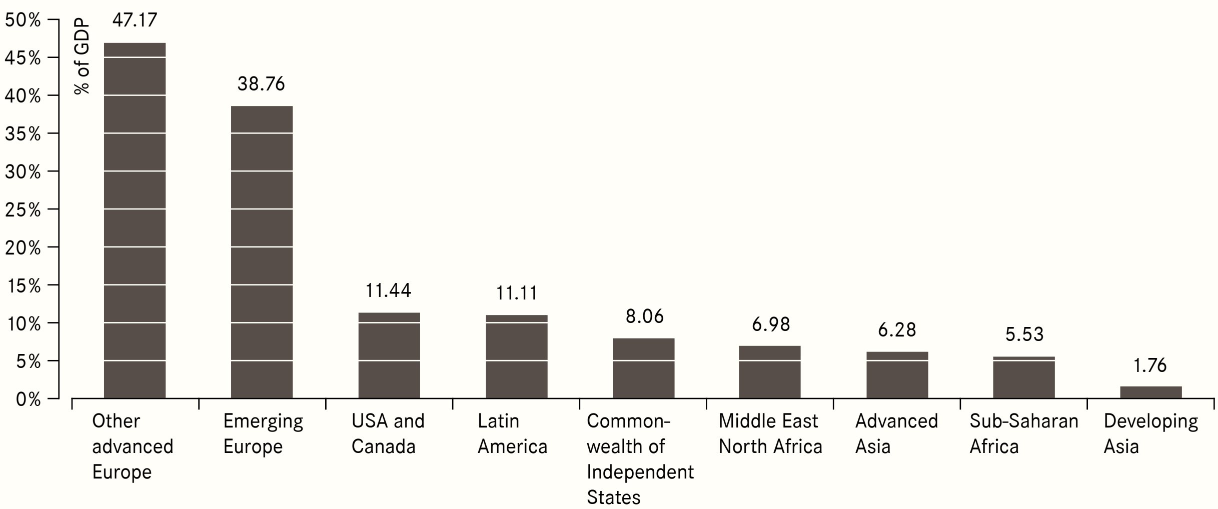
rises (using an average of country risk from France, Italy and Spain), the correlation to Asia falls. Indeed, the sovereign credit rating of Asian issuers has remained largely stable while the eurozone has been hit with a series of sharp downgrades. On the other hand, in terms of equity markets, the performance of Asian stocks has on average not been markedly different from global peers for most of 2012. Hence it is difficult to say that Asia has suffered inordinate levels of financial market contagion due to the euro-zone crisis. On the trade demand side, there has been evidence of weak eurozone consumption for much of 2012. In part, sluggish eurozone demand has been compensated for by better conditions in the United States. Also the rise in intra-emerging markets trade has diminished the role of European

Chart 6
Exports of goods to the eurozone by region



Source: IMF, Julius Baer

Chart 7
Exposure to eurozone banks, via claims such as deposits



Source: IMF, Julius Baer

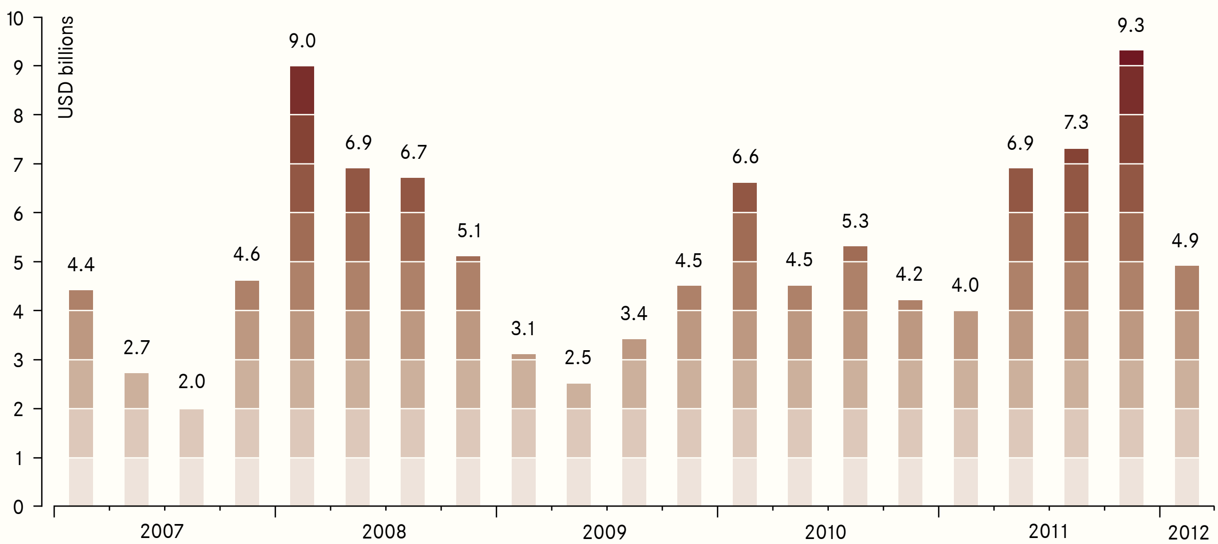
demand, but it remains difficult to conclusively disaggregate what is end demand in emerging markets versus demand that is linked to intermediate stages in production for re-export to developed economies. As a percentage of Asia's GDP however, manufacturing exports to Europe are relatively small – which should limit the downside. In terms of exports, the eurozone itself and emerging European countries remain substantially more at risk given the crisis.

The third transmission mechanism is Asia's exposure to European banks in terms of credit. In this area, high-level statistics suggest that impact should be limited because eurozone banks' lending as a percentage of Asian GDP is small. However, this only captures part of the story. Arguably, more important is the question of trade finance for export transactions. Data from the first quarter of 2012 shows a significant drop-off in Asian syndicated trade finance. According to Morgan Stanley, this can be explained by curtailed lending by French banks, which has in part been compensated for by an increase in trade finance issued by Japanese banks. Nevertheless, the risk of a drop-off in trade finance is serious given the immediate impact it would have on production. What negates this risk to some extent is that Asia's government finances are in good health – this means that fiscal resources could fill in where market resources fail in the shorter term.

Against this backdrop, we re-examine the conclusions reached in the first Julius Baer Wealth Report on Asia. In 2011's report, we found that the combination of currency appreciation, GDP growth, stock market and property returns would propel Asia's high net worth population (in US dollar terms) from 1.16 million in 2010 to over 2.8 million in 2015. China would capture almost half of the region's increase in high net worth individuals by having 1.37 million individuals in this category. On a growth rate basis, Indonesia was forecast to be ahead of even China, tripling the number of wealthy individuals to 99 thousand by 2015. The combined stock of wealth of Asia's high net worth individuals would surge from USD 5.6 trillion to almost USD 16 trillion over these five years. Once again, China would represent almost half of this wealth increase.

Of the assumptions made in the model, the sensitivity of the currency changes used has the highest impact in terms of final outcomes. Indeed, under the original model, the weaker dollar over the forecast period resulted in an additional 600 thousand high net worth individuals for Asia as a whole. The reason is that currency moves instantly revalue the accumulated wealth stock, whereas the other variables add to wealth but do not influence the value of past wealth. In order of influence, currency appreciation is followed by nominal GDP growth, property and stock markets.

Chart 8
Asia-based trade finance dropped off in 2012 as the eurozone crisis escalated



Source: Morgan Stanley, Dealogic, Julius Baer

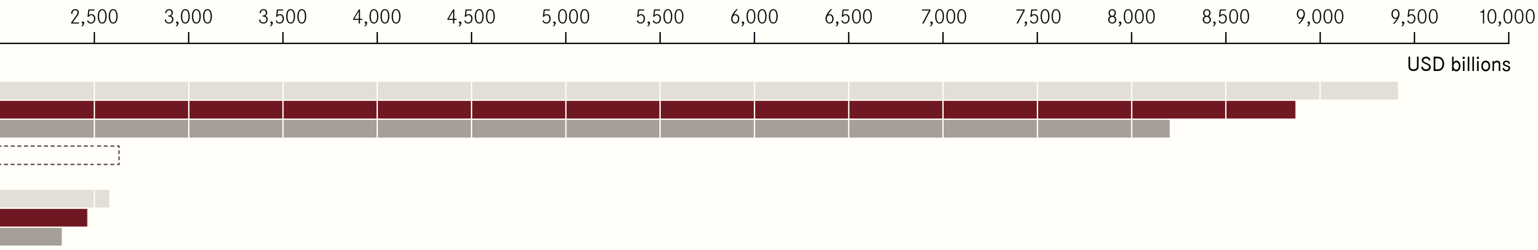
Our approach in the 2012 Wealth Report is to use the outcomes published last year as a baseline scenario and model 'upside' and 'downside' variations around the centre. The reasoning is as follows: With resilient domestic economies, Asia has become less exposed to cyclical swings in export demand, therefore we do not expect a major deviation from the original assumptions on nominal GDP growth. Structural demand for property in Asia should remain robust and stock markets should parallel earnings growth and nominal GDP over the medium term. Hence, for three of the four variables, we see little cause to make dramatic changes to the underlying methodology. However, we recognise that economic cycles have become shorter in duration and the unprecedented nature of recent events troubling the eurozone means that uncertainty remains high. These two factors combined warrant a prudent approach that takes into account 'downside' to our baseline scenario.

Chart 9
Number of HNWI

Chart 10
Wealth stock of HNWI

Source: CLSA, Julius Baer

To model our 'downside' scenario, we shaved off 10% from all four inputs: nominal GDP growth, currency appreciation, property and stock market returns. The cumulative impact of these changes results in a 2015 population of high net worth individuals of 2.6 million or 174 thousand fewer than in the baseline scenario. The 2015 stock of wealth under the downside scenario declines to USD 14.75 trillion, or just over one trillion dollars less than the baseline. The population ranking is unchanged, with China, India and South Korea experiencing the largest population growth through 2015. The least sensitive to the revised assumptions in the downside scenario is Hong Kong, as we assume that the existing pegged arrangement of the Hong Kong dollar will remain intact over the forecast period. As a result, Hong Kong's modelled outcome is the consequence of three, not four, variables.



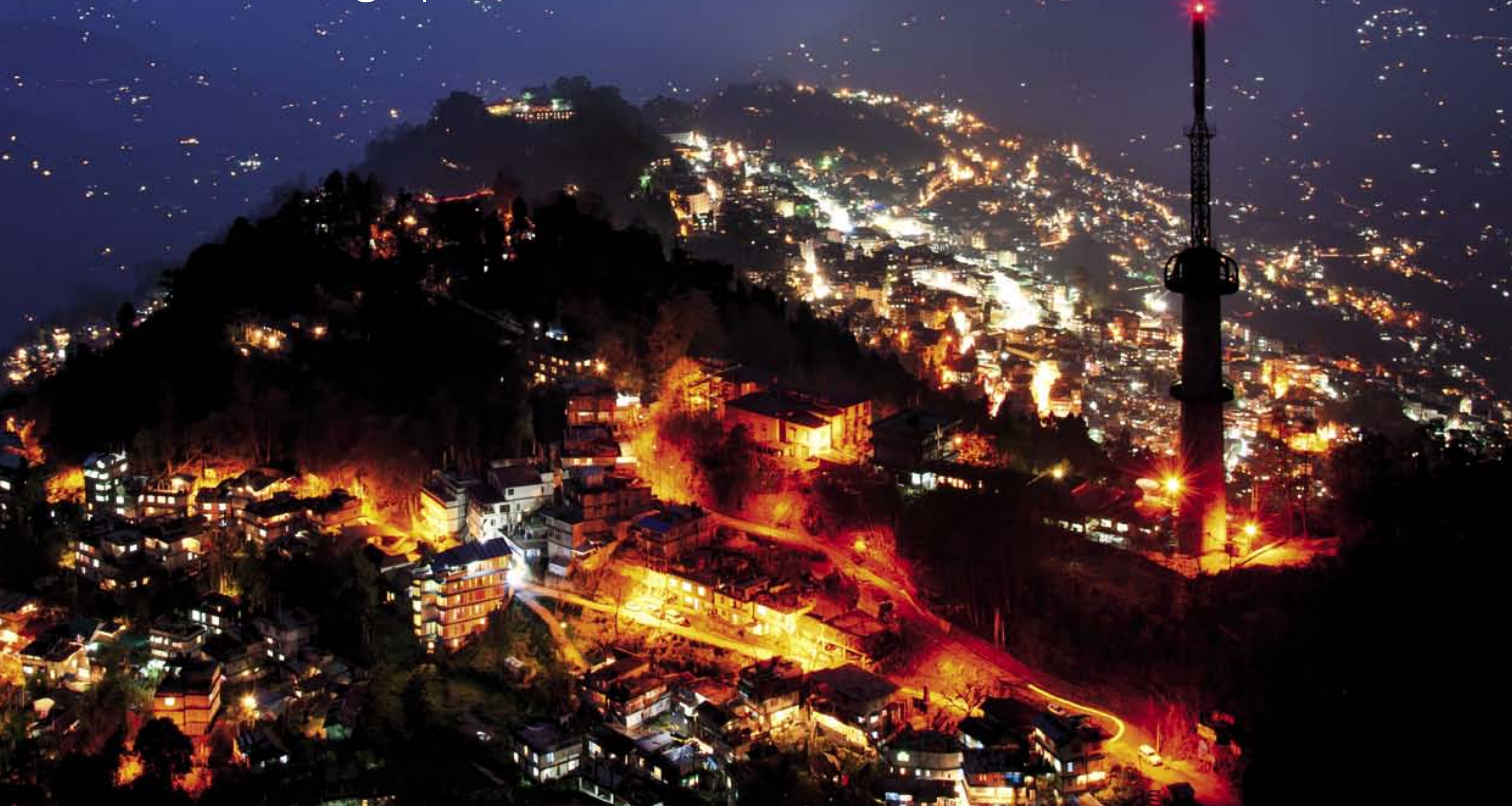
To complement our downside scenario, we have added 10% across three variables under the upside outcome. This captures the idea that sentiment and economic activity may be inordinately depressed in the midst of the eurozone crisis, but then bounce back over the forecasted horizon. In a bid to prevent our upside from being overly optimistic, we have added only 5% to the original currency appreciation input. This approach introduces a degree of prudence that would have been lacking otherwise. Under the upside scenario, Asia will see an additional 139 thousand high net worth individuals through 2015, bringing the total to 2.96 million. The total stock of wealth would reach USD 16.7 trillion, or USD 855 billion more than under the baseline scenario. Once again, China is set to dominate in terms of new high net worth individuals, followed by India and South Korea.

Given the resilience of Asia so far in spite of the worsening external backdrop, we expect to see an outcome that lies between the baseline scenario and the upside outcome. Unlike the United States, Europe and Japan, Asia's economies still have ample fiscal room to manoeuvre which therefore limits the negative impact of contagion. The downside scenario would present a greater risk, the longer the eurozone crisis persists, however, as this would magnify the depth and duration of the external shock. On the other hand, if external and financial market conditions recover faster, then the upside scenario should have a higher likelihood of transpiring into reality. In any case, the bulk of the risks facing Asia's wealth-generating capacity remain exogenous to the region.

China, India, Indonesia

Frontiers of growth

Of the ten Asian economies covered in the Julius Baer Wealth Report, China, India and Indonesia emerge as the region's giants of wealth creation. With over half a million individuals, China is already home to the largest number of high net worth individuals in our sample of countries while Indonesia and India hold enormous promise of catching up.

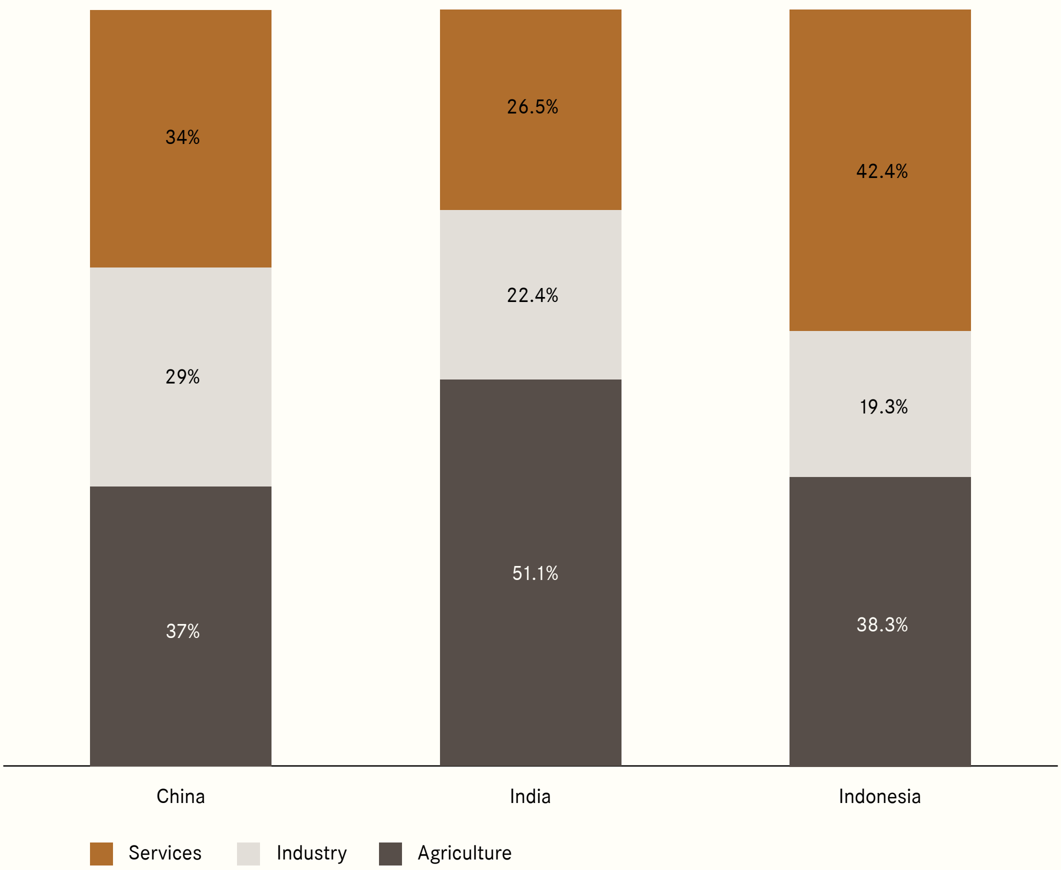


At first glance, the reasons for China, India and Indonesia's dominance seem deceptively simple: The combined adult population of these three giants is 1.86 billion, or 90% of the total covered in our selected countries. With the exception of Indonesia during the 1997–1998 Asian financial crisis, all three have seen GDP growth remain well above the global average over the past 20 years. It stands to reason therefore, given the combination of rapid growth and large populations, that these countries should be at the forefront of wealth creation in Asia.

At the same time, they are very different economies with unique development paths. We believe that China, India and Indonesia stand at critical inflection points in terms of their growth models, and what has worked in the past may not generate growth and prosperity in the future. In this section we examine in detail their economic models and what the future holds for wealth creation in these Asian giants.

Thus far China's economic model has relied heavily on large fixed asset investments that focused on the export sector and real estate construction. With an effectively closed capital account, China has been able to drive savings into real assets owing to low or negative real interest rates. Running large external balances has resulted in the record accumulation of international reserves. The seemingly endless supply of rural labour moving to cities up until now meant that low wages kept China very competitive. India has forged a different path, sustaining a large agriculture sector for a much longer period of time. Important reforms in the early 1990s opened the economy, but rather than leaning the focus on manufacturing exports, IT and business outsourcing grabbed the spotlight. Indonesia's economy is relatively diversified, with the credit cycle having played a larger role than in China and India. At its core, however, the economy still has significant exposure to commodities, both energy and non-energy.

Chart 11
Employment by sector

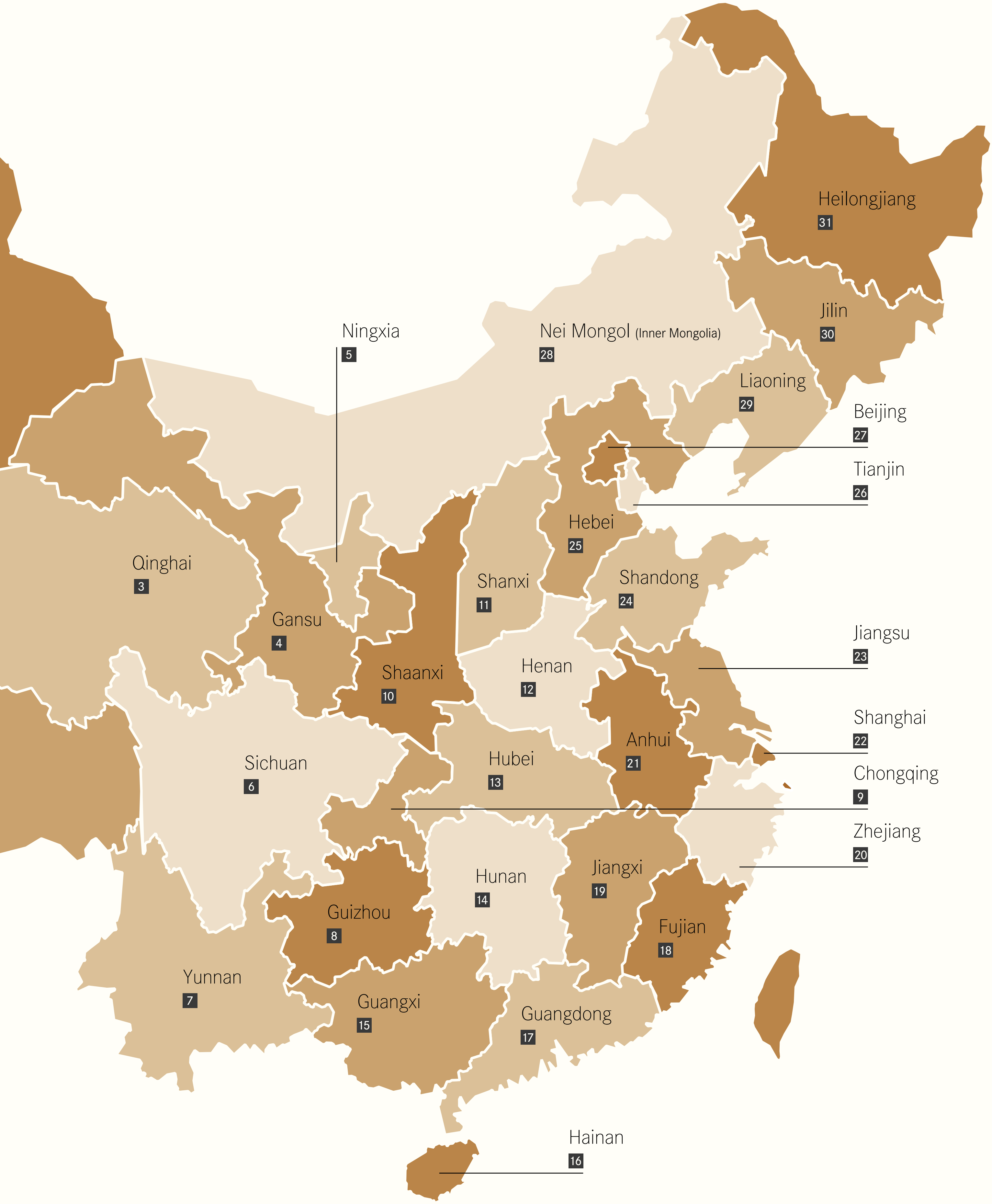


Source: Datastream, Julius Baer

The central theme that unites China's economic policy-making framework is 'rebalancing'. As outlined in the current Five-Year Plan, China must adopt a more consumption-oriented model and narrow the income gap that has arisen as a consequence of the coastal regions' dominance in the global manufacturing export market. Hence 'rebalancing' seeks to raise the standard of living not just across income groups but across geographic regions as well. Is China achieving its goals of generating prosperity in the central and western provinces? To put it in a nutshell, yes.

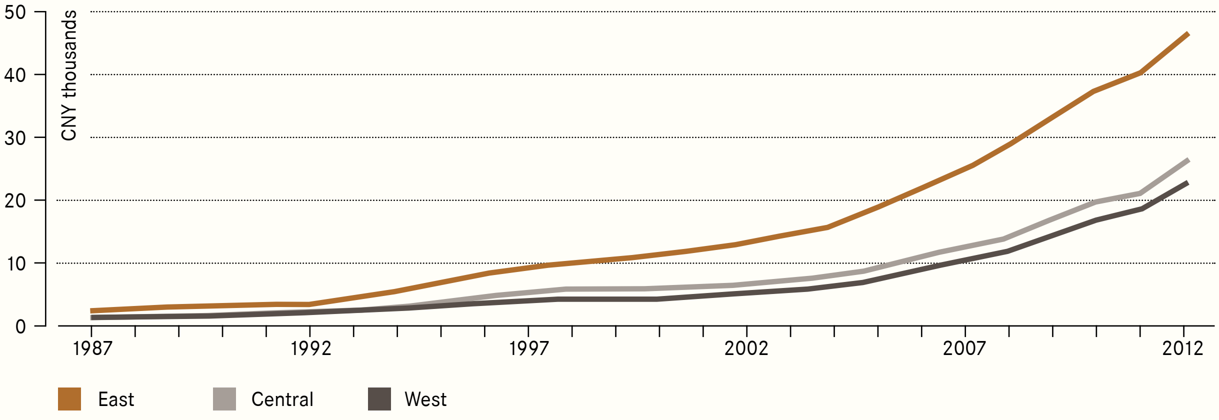
Chart 12
China – Population vs. GDP

	Province	GDP per capita (USD)	Population (million)	2011 inflation (%)
1	Xinjiang	4,567	22.1	5.9
2	Tibet	3,108	3.0	5.0
3	Qinghai	4,473	5.7	6.1
4	Gansu	3,022	25.6	5.9
5	Ningxia	5,015	6.4	6.3
6	Sichuan	4,046	80.5	5.3
7	Yunnan	2,935	46.3	4.9
8	Guizhou	2,541	34.7	5.1
9	Chongqing	5,342	29.2	5.3
10	Shaanxi	5,131	37.4	5.7
11	Shanxi	4,796	37.4	5.2
12	Henan	4,487	93.9	5.6
13	Hubei	5,284	57.6	5.8
14	Hunan	4,618	66.0	5.5
15	Guangxi	3,919	46.5	5.9
16	Hainan	4,459	8.8	6.1
17	Guangdong	7,787	105.1	5.3
18	Fujian	7,273	37.2	5.3
19	Jiangxi	4,008	44.9	5.2
20	Zhejiang	9,083	54.6	5.4
21	Anhui	3,923	59.7	5.6
22	Shanghai	12,783	23.5	5.2
23	Jiangsu	9,545	79.0	5.3
24	Shandong	7,317	96.4	5.0
25	Hebei	5,198	72.4	5.7
26	Tianjin	13,058	13.6	4.9
27	Beijing	12,447	20.2	5.6
28	Inner Mongolia	8,905	24.8	13.7
29	Liaoning	7,788	43.8	5.2
30	Jilin	5,933	27.5	5.2
31	Heilongjiang	5,050	38.3	5.8



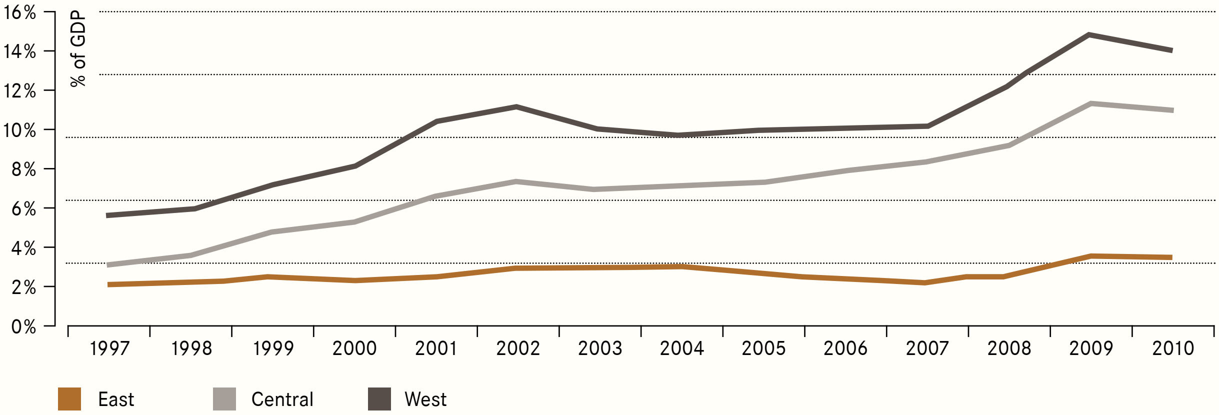
Source: Credit Suisse, Julius Baer

Chart 13
China's GDP per capita by region



Source: JP Morgan, Julius Baer

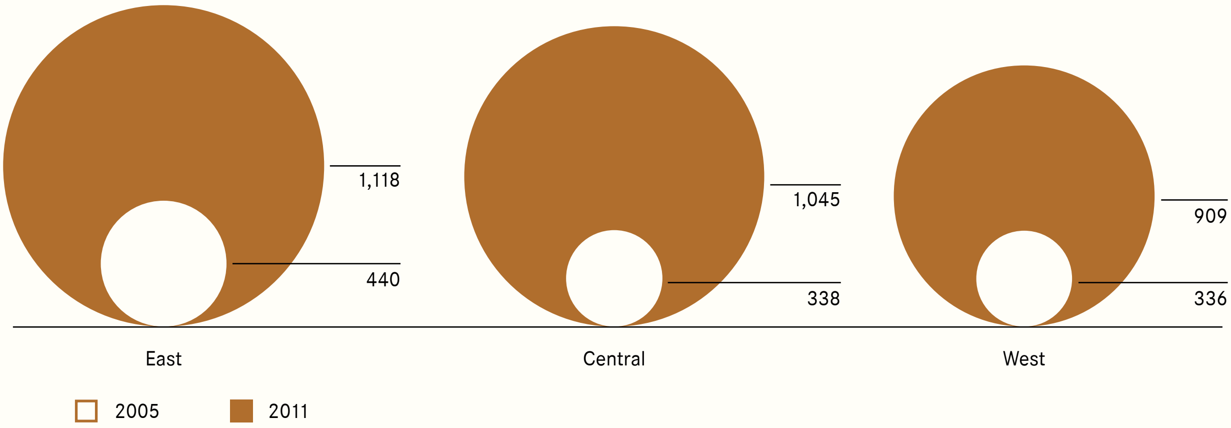
Chart 14
Central government subsidies and transfers to regions



Source: JP Morgan, Julius Baer

China's government has made a concerted effort to pull economic activity from the coastal provinces to the central and western parts of the country. This is evident from the share of fixed asset investment that the interior of China has attracted as well as from direct fiscal transfers. Western China receives subsidies and transfers equal to almost 14% of GDP, four times as much as the higher-income eastern provinces. In terms of wage policy, the gap between the average minimum wages across the three regions has narrowed sharply. In 2005, the minimum wage in the far westerly Xinjiang province was CNY 300 per month, among the lowest in China. As of 2011, it has equalled Beijing's. Whether raising minimum wages will result in higher employment and actual realised incomes is a matter of debate – but as a proxy for regional distribution of incomes, it appears safe to say that the gaps are closing.

Chart 15
Minimum wage in CNY per month

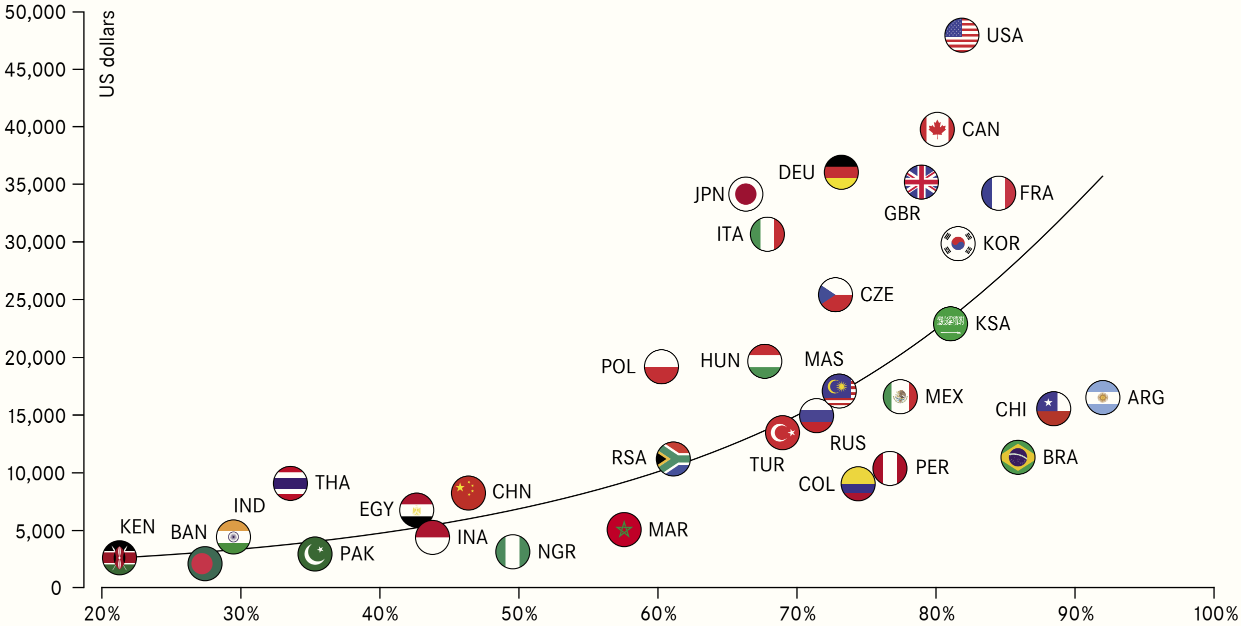


Source: Credit Suisse, Julius Baer

It is safe to say that incomes in cities are generally higher than in rural areas. This is the primary motivation that drives urbanisation, i.e. the movement away from agriculture into higher value-added manufacturing and services. As it stands today, approximately 47% of China, 44% of Indonesia and 30% of India's population is urbanised. Of the world's total population, the United Nations (UN) estimates that around half of all individuals live in cities, and this is expected to reach 69% by 2050. That said, countries are forecast to show differing rates of compound annual growth rates of urbanisation. China, India and Indonesia are among the fastest to show urbanisation, according to the UN.

This bodes well for increases in income, all else being equal. The interesting reality is that 'all is not equal' in practice. Put differently, the link between income growth and rising urbanisation is not guaranteed. At lower levels of urbanisation, per capita incomes tend to be clustered. However, as urbanisation rates grow, the distribution of incomes tends to increase as well. Hence, something can still 'go wrong' when the countries are evolving towards ever larger cities. Understanding how to avoid such outcomes is critical for China, India and Indonesia, especially given their still relatively low urbanisation rates, which tells us that at least on this score, there is much to gain or lose.

Chart 16
Urban population versus GDP per capita purchasing power parity (PPP) (2010)

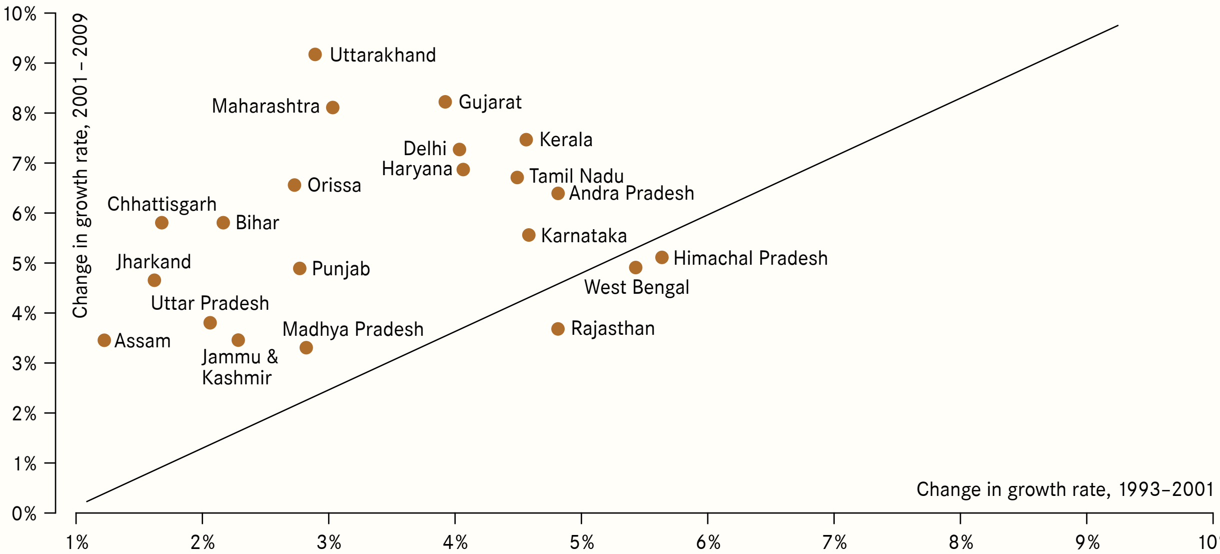


Source: Credit Suisse, Julius Baer

Amongst China, India and Indonesia, India's economic growth trajectory is arguably, for the lack of a better phrase, the most elusive to understand. In the century prior to independence in 1947, India's per capita GDP grew by merely one per cent per year. Post-independence, under the largely closed, centrally planned model through to the end of the 1980s, growth did not fare much better. Indeed, during the 1980s, China and India had very similar per capita GDPs (USD 300) and lagged behind Indonesia's USD 600 per capita income. The key turning point is generally acknowledged to be 1991 after which economic reforms saw growth rates triple. That said, taking 1991 as a base year, China's per capita income has grown at a compounded annual rate of 14% through 2011, compared to 7% for India and 8% for Indonesia. India's per capita GDP really took off in 2002, tripling from the USD 480 then to the current USD 1,500. Over the past decade, income per head has grown at a compounded 11%, clearly catching up with China's growth rates. This tells us that at least on a nation-wide basis, India has been enjoying a structurally higher per capita income expansion rate – perhaps even the fastest in modern history.

But has India shown similar convergence as China has witnessed in terms of addressing regional income discrepancies? In short, no. Nevertheless there is good and bad news. First, the good news is that comparing the periods 1993–2001 and 2001–2009, research shows that all 21 of India's most populous states grew faster in the latter period relative to the former. Some states, namely Uttarakhand, Maharashtra, Chhattisgarh and Gujarat, showed dramatic increases in their GDP growth rates. The bad news is that initial starting levels of per capita income seem to have a significant bearing on the outcome. In other words, the states with higher per capita income tended to grow faster than lower-income peers, thereby limiting the convergence between the two.

Chart 17
Growth rates of net domestic GDP per capita across Indian states

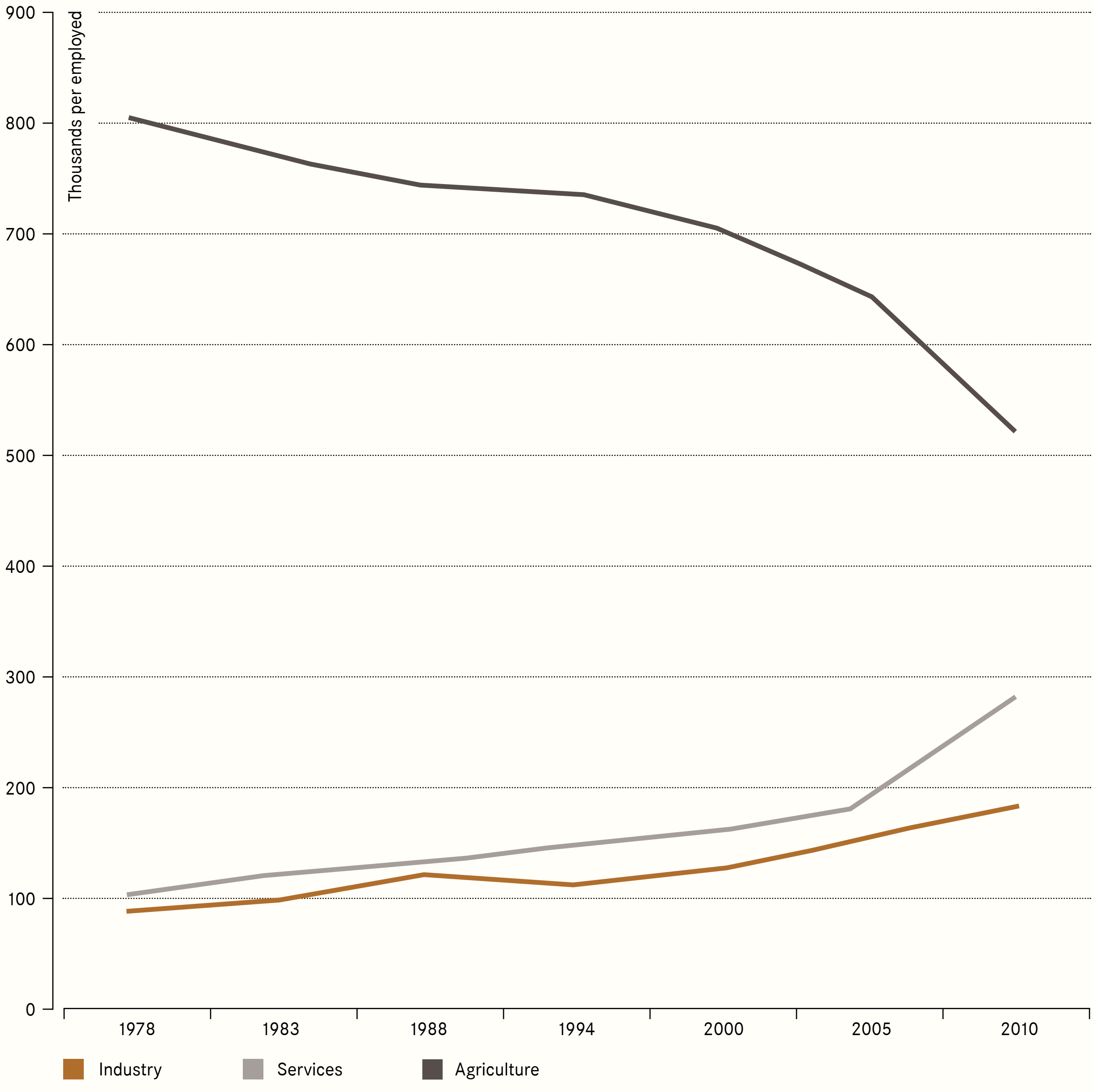


Source: India office of Central Statistics, Utsav Kumar and Arvind Subramanian, Julius Baer

The explanation for India's lack of state-level convergence is challenging. A typical line of argument is to test whether openness to international trade and manufacturing is the key to sustainably higher income growth rates. Gujarat, Karnataka (home of IT and business outsourcing powerhouse Hyderabad), and Maharashtra have indeed shown above-average growth rates and also have the highest share of manufacturing and business services. However, this has proven to be a double-edged sword as during the crisis years of 2007–2009, these states also suffered the largest GDP growth slowdowns. On the other hand, Kerala, with a very low exposure to manufacturing (less than 10% of GDP), has consistently enjoyed above average-growth rates since 1993 and felt very little of the 2007–2009 crisis.

Perhaps another explanation of India's growth conundrum lies in classification issues. 'Rural' need not imply agriculture, as recent research highlights. As infrastructure spending (i.e. roads, electrification) upgrades the productive capacity of India's rural environment, individuals outside of cities are switching to manufacturing but stay put in terms of their physical location. Over the past decade, 150 million Indian males in rural communities have left farming and went into industry and services, but not moved to cities. This trend is arguably unique in the emerging markets and may be India's 'best kept secret' in terms of how wealth will be created in future: Not in Mumbai, Delhi or Bangalore, but the next wave of millionaires may hail from newly industrialised hubs in the countryside.

Chart 18
Indian rural employment trends: Shifting out of agriculture

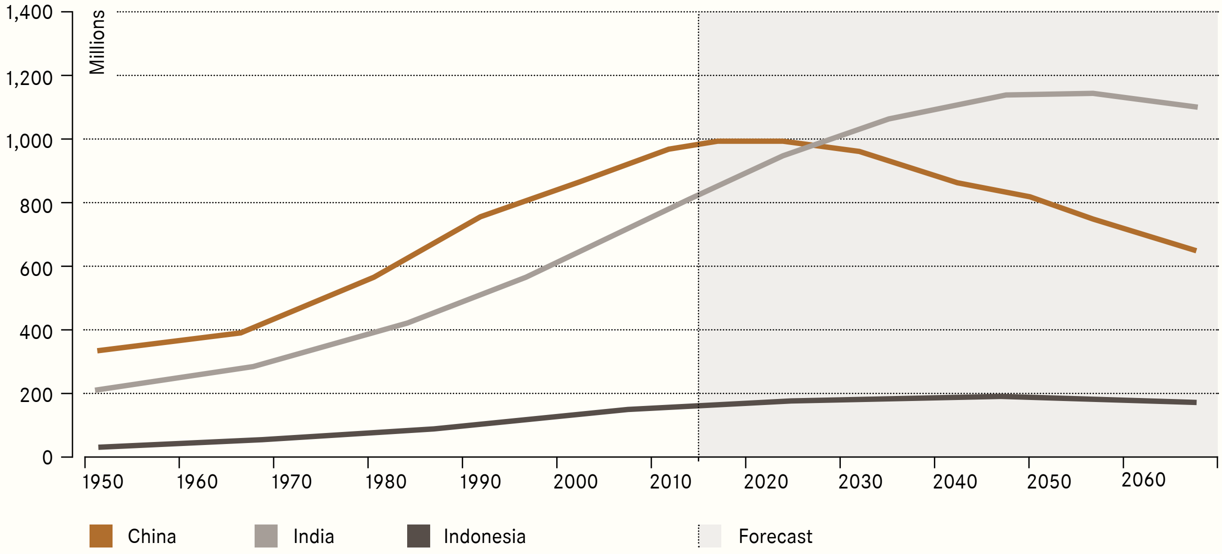


Source: Credit Suisse, Julius Baer

Turning to demographics, it is by now well understood that among China, India and Indonesia, China has entered the much maligned 'ageing' phase and hopes are high for the demographic dividend to accrue to Indonesia and India. Some caution is warranted here. Why is so much attention paid to the benefits of the demographic dividend? The reason is simple. To quote Utsav Kumar and Arvind Subramanian, "demographics affect growth because different age groups exhibit different economic behaviour". Hence, a large and growing working-age population presents an economy with a powerful force of producers, consumers and savers that lay the foundation for rising standards of living and wealth accumulation. On a national level, India has the clear lead with a working-age population that is set to peak only in 2050, whereas the same point was reached in China in 2010. However, national statistics often disguise important regional differences that, when examined more closely, may confound the conclusions reached based on the country-level data.

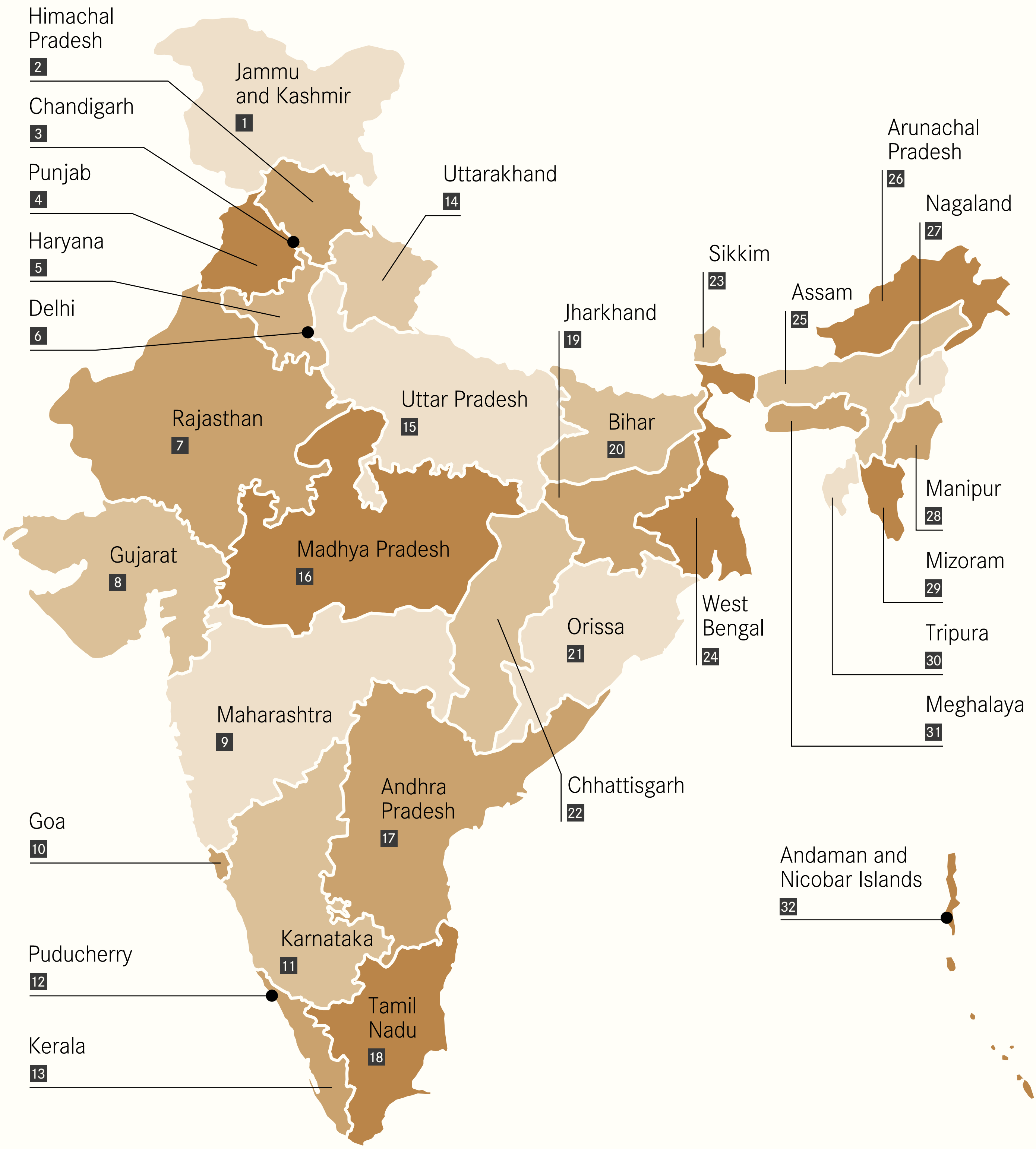
Chart 19

Demographic dividend – Working-age population (15–64 years)



Source: United Nations, Julius Baer

Chart 20
India – Population vs. GDP



For this reason, before a priori assuming that demographics will become a drag on growth for China, a closer look at India's state-level data is useful. For one, the bulk of the increase in India's working-age population has centred on Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh. The economic performance of these states is mixed, at best, when compared to average growth rates over time. It is not possible to deduce that there is an unambiguous boost to income per capita given working-age population increases per se. Other factors must have been at work that were a drag on growth – either exogenous or endogenous – and overruled the beneficial demographic profile. Secondly, the data suggests that across India, the demographic dividend was higher over the period 1991–2001 (the first decade of major reforms) than over 2001–2009, where the coefficient, surprisingly, is even negative.

This again challenges the notion that by virtue of having a growing working-age population, economic outperformance is guaranteed. So is a vanishing demographic dividend going to present an insurmountable challenge for China? We disagree.

	Province	GDP per capita (USD)	Population (million)	2011 Inflation (%)
1	Jammu & Kashmir	1,029	11.7	10.1
2	Himachal Pradesh	1,772	6.8	6.1
3	Chandigarh	3,198	1.4	9.8
4	Punjab	1,731	29.0	6.4
5	Haryana	2,291	25.3	6.8
6	Delhi	3,488	16.6	8.7
7	Rajasthan	1,053	67.4	8.9
8	Gujarat	1,916	58.7	9.2
9	Maharashtra	2,014	112.0	8.0
10	Goa	4,504	1.7	7.3
11	Karnataka	1,501	59.2	9.8
12	Puducherry	2,431	1.2	7.4
13	Kerala	1,762	34.5	7.5
14	Uttarakhand	1,674	9.9	8.8
15	Uttar Pradesh	654	199.3	7.6
16	Madhya Pradesh	794	71.7	9.0

	Province	GDP per capita (USD)	Population (million)	2011 Inflation (%)
17	Andhra Pradesh	1,529	84.4	5.9
18	Tamil Nadu	1,783	67.3	8.2
19	Jharkhand	747	31.3	6.3
20	Bihar	491	97.2	7.3
21	Orissa	1,026	41.7	4.6
22	Chhattisgarh	1,031	25.0	5.1
23	Sikkim	2,034	0.6	5.5
24	West Bengal	1,165	89.2	6.9
25	Assam	750	30.4	9.3
26	Arunachal Pradesh	1,319	1.4	8.6
27	Nagaland	1,242	2.0	7.0
28	Manipur	727	2.8	7.6
29	Mizoram	1,172	1.1	7.1
30	Tripura	1,059	3.6	6.4
31	Meghalaya	1,272	2.6	18.3
32	Andaman and Nicobar Islands	1,834	0.5	9.0

Source: UBS Investment Bank, World Bank, CEIC, Julius Baer

The 'one-child policy' was launched in 1979, setting into motion the inevitable path towards an ageing society as the overall birth rate in China fell and mortality rates stayed more or less stable. China's demographic trend is as predictable as the United States' or Japan's, since the relevant variables are moving and the data is relatively easy to observe. The main conclusion is that China can no longer rely on falling dependency ratios (the percentage of non-working-age population relative to those of working age) as an engine of economic growth. What worries many is that China's demographic dividend is declining faster than has been the case in other economies – and with China having played such a key role in global growth in recent years, should we not all worry?

The answer is that if economic and structural reforms continue at a healthy pace, the role of the retired population in China will be central to the so-called 'second demographic dividend'. This second wind works as follows: As the retired population increases over time, current workers will be motivated to maintain or augment their savings to finance a stable or even rising standard of living once they retire. Those accumulated savings can or should be invested in capital that enables productivity growth and in turn drives higher per capita income. In other words, the future for China is not so much investing in real estate or opening more factories in coastal regions targeting low value-added exports, but a revolution in productivity that underwrites higher wages and positive real returns on capital.

What could challenge this rather benign view on China's waning 'first' demographic dividend is the well-known 'life cycle hypothesis' made famous by Franco Modigliani in the 1960s. This tells us that individuals smooth out their consumption over their lifetime, implying that savings ratios should fall as people retire. If that is the case, then there would be little room for a 'second dividend'.

So how should China maintain a high enough savings rate? The overall savings rate is likely to decline, as witnessed in other economies with an ageing population, like Japan. However, the corporate sector contributes to savings as well, and in recent years this sector has seen a substantial increase in savings. The key is not so much savings per se, but it is the returns on these savings that matter, and here the combination of reform-driven productivity increases and urbanisation are paramount. We believe that China is different in that even during a political transition period like 2012–2013, the pace of structural reform is slower but has not halted. Further reforms to the social welfare and financial system would cushion the 'life cycle hypothesis' and enable a 'second demographic dividend' to kick in.

The ultimate method by which China, India and Indonesia will build up their incomes per capita and ultimately drive wealth creation is via moving their economies up the value chain. This is a concept that is often discussed but difficult to condense into simple policy choices. Producing higher-value goods and services (and in turn being able to demand a higher wage) goes beyond simple statistics such as educational attainment, investment and infrastructure. Rather, it is the confluence of a number of factors, extending to the social, economic and political arrangements of a country. At the grassroots level, a good business operating environment represents the most effective way that new businesses and wealth can be created. One way to measure this is by considering foreign direct investment (FDI) flows, indicating how attractive a country is to international investors.

Over the past decade, China has attracted a large amount of capital from abroad, far more than India and Indonesia. In GDP terms, China has received between 3% and 5% of FDI. Why is this the case?

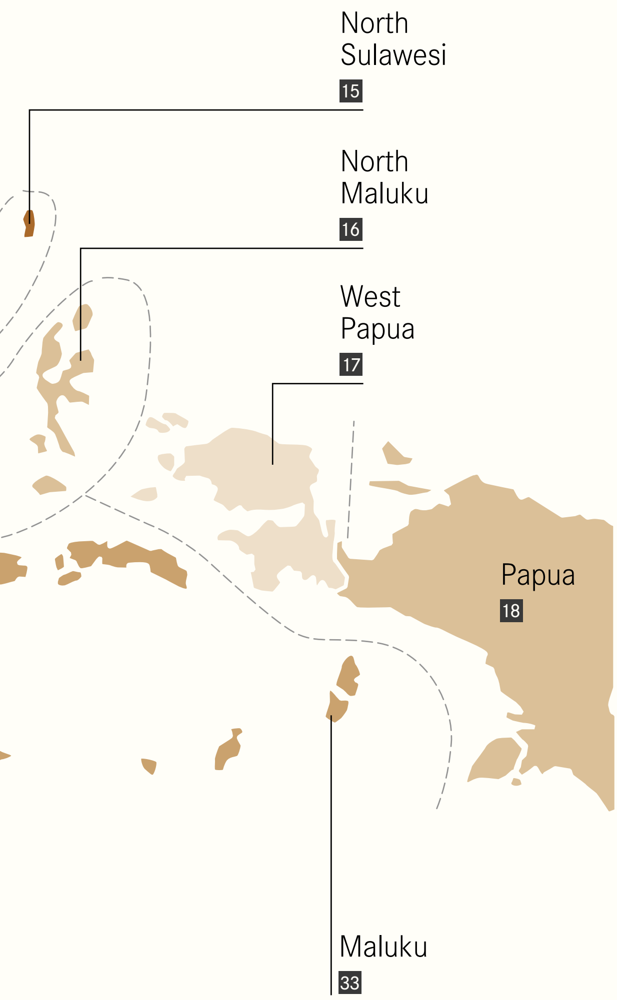
In part, China has led the way in terms of FDI thanks to economic reforms that served to make it an attractive destination for global manufacturing industries. Six years ago it would take an entrepreneur 48 days and 13.6 times average income per capita to officially start a business in China. Today it takes just 38 days and 3.5 times average income per capita to get a company up and running, reducing time taken and start-up costs by 20% and 75%, respectively. Additionally, as a percentage of GDP per capita, the amount of capital required to start a business today is 90% lower than in 2006. Not only this, but China has also eased the permission process to build, for example, a warehouse. Over the past four years the number of days and costs associated with commercial building plans has been cut by nearly 10% and 48%, respectively.

In general, the higher a nation's GDP, the easier it is to do business there. It is probably no surprise then that the World Bank ranks China as four to five years ahead of India and Indonesia in its ease of doing business index.

That said, Indonesia is fast closing the gap. There, GDP per capita has almost doubled over the past four years: Rather impressively, Indonesia has slashed the number of days needed to set up a business by 70%, reduced start-up costs by over 82% and cut capital requirements back by more than 50%. Furthermore, it is 20% quicker and 65% cheaper to receive a building permit in Indonesia today compared to four years ago. In January 2006 an entrepreneur could realistically expect to start business operations by the summer. Now, a business could be up and running by the end of the current season.

Despite higher volatility in its ease of doing business scores, in the past four years India has also taken great steps in creating a more business-friendly environment. While home to quintuple the population of Indonesia and politically far more fragmented, India has still managed to reduce the number of days needed to push through start-up administration by 60% and costs by almost 25% of average income per capita. Transfer of property has also sped up 35% taking the days needed from 67 to 44. Additionally, registering a property in India today costs approximately 20% less.

Chart 21
Indonesia – Population vs. GDP

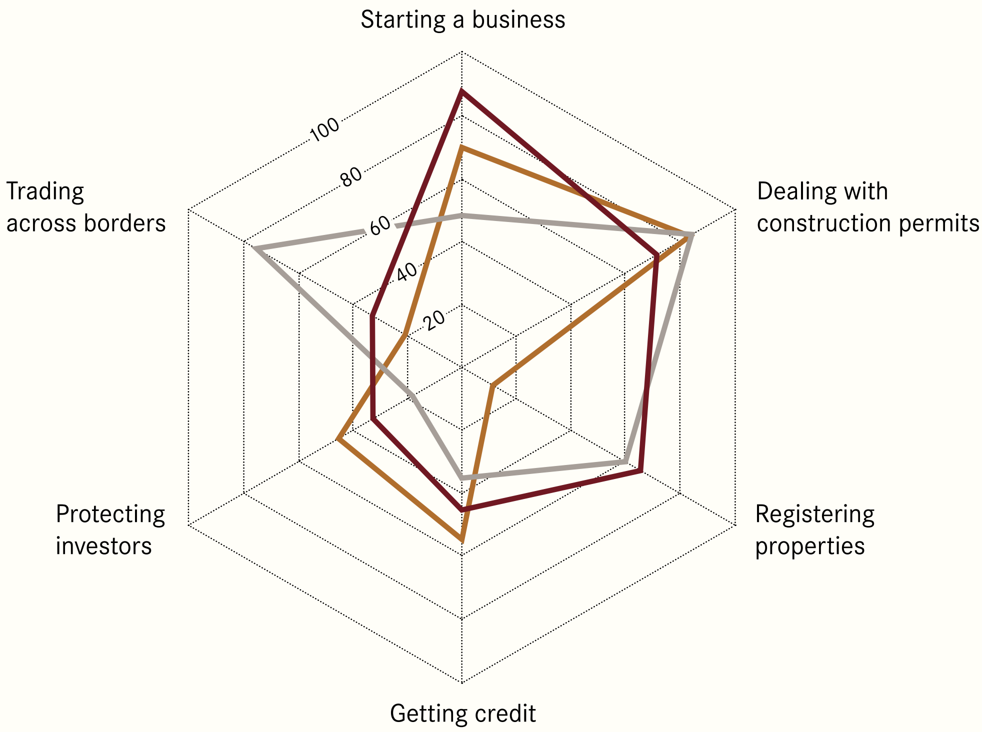


	Province	GDP per capita (USD)	Population (million)	CPI (%)*
1	Aceh	1,898	4.5	3.3
2	North Sumatra	2,337	13.0	3.5
3	West Sumatra	1,981	4.8	5.4
4	Riau	6,810	5.5	5.1
5	Jambi	1,915	3.1	2.8
6	South Sumatra	2,331	7.5	3.8
7	Bangka Belitung	2,313	1.2	5.0
8	Riau Islands	4,694	1.7	3.3
9	West Kalimantan	1,514	4.4	4.9
10	South Kalimantan	1,777	3.6	4.0
11	East Kalimantan	9,941	3.6	6.2
12	West Sulawesi	1,044	1.2	4.9
13	Central Sulawesi	1,509	2.6	4.5
14	Gorontalo	853	1.0	4.1
15	North Sulawesi	1,786	2.3	0.7
16	North Maluku	571	1.0	4.5
17	West Papua	3,138	0.8	3.6
18	Papua	3,475	2.8	3.4
19	Bengkulu	1,157	1.7	4.0
20	Lampung	1,552	7.6	4.2
21	Banten	1,542	10.6	2.8
22	West Java	1,970	43.1	2.8
23	Yogyakarta	1,452	3.5	3.9
24	Jakarta	9,876	9.6	4.0
25	Central Java	1,510	32.4	2.9
26	East Java	2,286	37.5	4.7
27	Central Kalimantan	2,118	2.2	5.3
28	Bali	1,827	3.9	3.7
29	West Nusa Tenggara	1,075	4.5	6.4
30	South Sulawesi	1,614	8.0	2.9
31	East Nusa Tenggara	651	4.7	4.3
32	South East Sulawesi	1,399	2.2	5.1
33	Maluku	580	1.5	2.8

*inflation in the capital city of the province

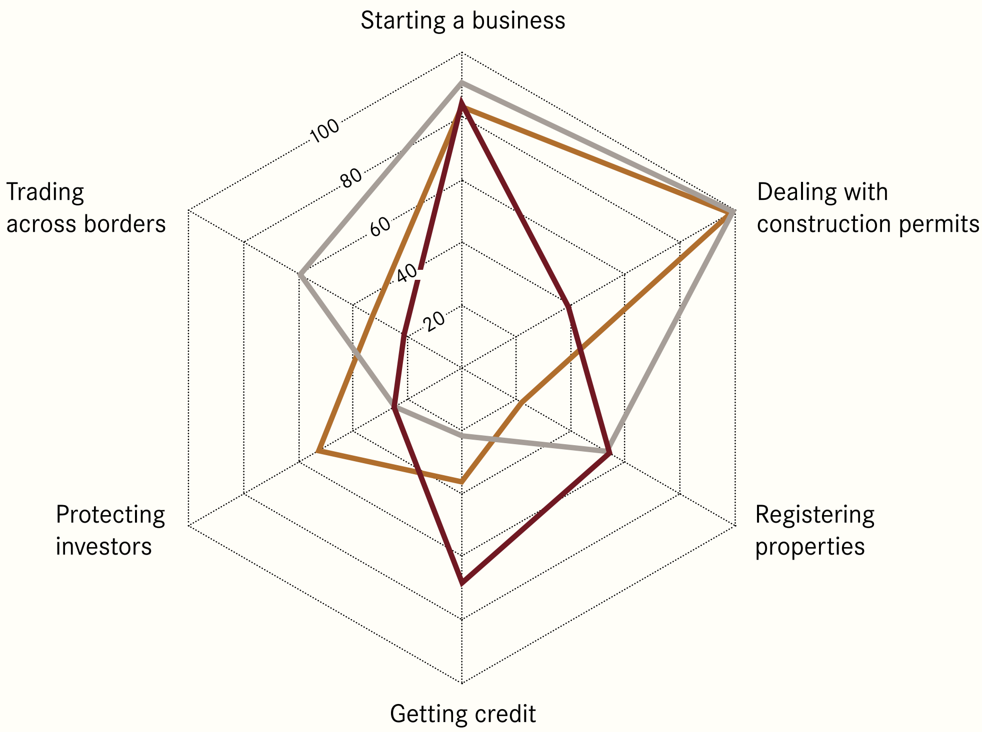
Source: UBS Investment Bank, CEIC, Credit Suisse, Julius Baer

Chart 22
Composite of key World Bank business operating environment metrics



2007

2012



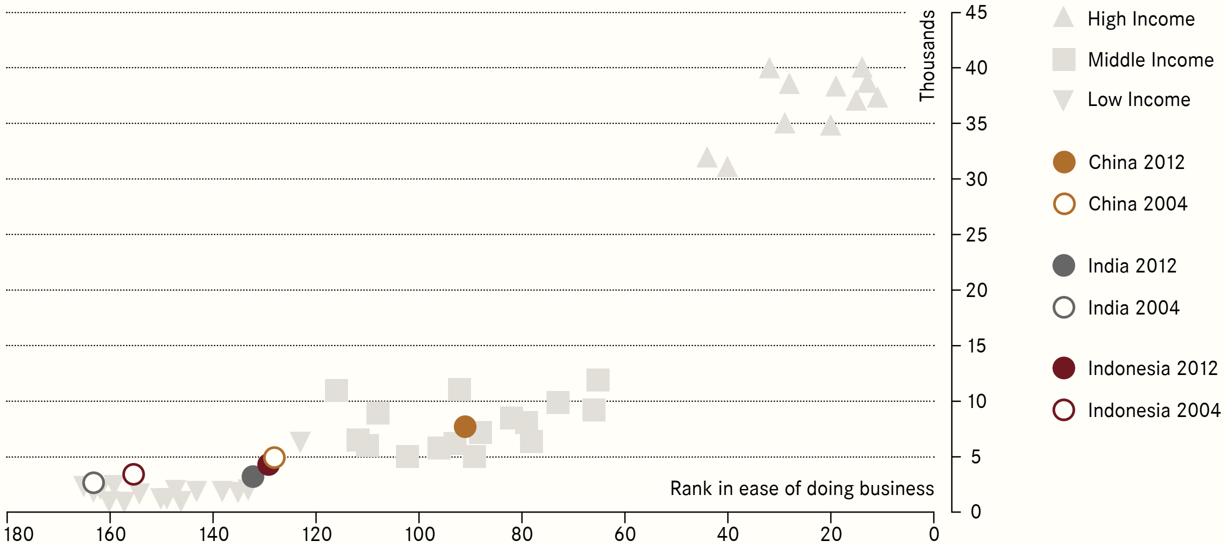
China India Indonesia

Source: World Bank, Julius Baer

As it stands now, China is head and shoulders above Indonesia and India in terms of growth, trading volumes and business friendliness, notwithstanding the progress that India and Indonesia have made. All three have room for further improvement, but if recent trends continue, China, India and Indonesia could join the upper echelons of the most business-friendly countries.

To support this argument, we have combined the ease of doing business outcomes and divided all countries in the survey into three groups based on their GDP per capita. We found that there is a close correlation between the two variables.

Chart 23
GDP per capita, purchasing power parity



Source: World Bank, IMF, Julius Baer

In the first group, the triangles represent high-income countries that are also the easiest places to do business, such as Singapore, Hong Kong, Norway, Denmark and the United States. In the second group, the squares, we find the middle-income countries like China which has been ranking higher and higher, with a corresponding higher GDP per capita, in the past few years.

The third and last group accounts for all the low-income countries, among which we can still find India and Indonesia.

Countries such as China, India and Indonesia have been improving their conditions in terms of doing business and their GDP per capita, but what they are risking right now is not to be able to sustain their rapid growth rate. What often happens in similar cases, and has surely occurred to many South American countries, is that they are not able to go through the invisible barrier that separates them from the developed countries. These countries are suffering the 'middle/low-income trap'.

The 'middle-income trap' refers to countries stagnating and not evolving into advanced economies. In a steadily growing economy, the per capita GDP would rise continuously over time, towards higher incomes, but many middle-income countries do not follow this pattern, having short periods of growth followed by periods of stagnation or even decline. In other words, in most cases these countries cannot make a timely transition from resource-driven growth, with low-cost labour and capital, to productivity-driven growth. Improving the business environment appears a good way to avoid getting stuck in the 'middle-income trap'.

The future is bright for China

Mr. Yeung Kwok Keung, founder of Chinese property development firm Country Garden, tells Julius Baer why he believes his country will go from strength to strength going forward.

Country Garden is one of Forbes top 50 listed companies in Asia 2011. To what do you owe this success?

Call it 'doing the right thing at the right time' if you like. I was born in an era of economic and political reform that has pushed forward the enormous growth of China. My business is construction and the two go hand in hand. There is nothing that can give you a better feeling than knowing you have contributed to the modernisation, urbanisation and prosperity of your country. We are thankful to the society for giving us such an opportunity. In return we are dedicated to leading people into living a better life by producing good-quality products at fair prices.

What do you think the future holds for China?

The way our country has progressed to date pleases me. We have so much to be proud of when you think of our economic development. Thanks to strong leadership, China is one of the world's largest economies nowadays. We have built a system that works because it has been designed to suit us; who we are, our scale, our culture, our needs and our skills. It is my belief that China's success story has just kicked off. There will be many more opportunities for our people going forward.

What we need to focus on is education. For any country to be successful in the long run, it must invest in the quality of its people. Our leaders have already set a good platform for the further development of business. If we can continue to invest in our people then the quality of their skills can only improve that environment even more. We have already shown what we can do in terms of increasing productivity and ensuring that governance is in line with the pace of social progress.

Yeung Kwok Keung, founder of Chinese property development firm Country Garden

Country Garden is present in 40 cities spanning 11 provinces across China. Do you feel that wealth is slowly spreading westward from the coastal cities?

I do not agree that wealth is moving westward as such. The whole country is developing sustainably, however it is obvious that some areas will achieve prosperity earlier than others. Some areas take the lead getting rich first, followed by the rest. This is exactly what our former leader Deng Xiaoping used to advocate in his policies. The coastal region of the country naturally develops faster due to its shipping ports. However, the construction of highways and high-speed rail links makes nationwide transportation more convenient. The combination of currently available resources and an improvement in infrastructure has led to higher than national average GDP growth in some of the relatively remote areas such as Inner Mongolia.

In the future Country Garden will focus on further deepening its nationwide business spectrum. Like the Chinese poet Qu Yuan said: “I will explore in all directions,” we will make every effort to do so. If there are suitable opportunities, we will gladly apply our business model there. Generally speaking, our objective is to contribute to an even stronger and brighter China.

Will Country Garden expand internationally?

Yes. We have projects in Malaysia. In the future we hope we will be able to apply our business model in more countries and areas that will add to the success of our company.

India has the scalability for robust growth and opportunity

The Group Executive Chairman of Fortis Healthcare, Malvinder Singh, believes that India has the right fundamentals for prosperity.

Do you think that India is right to push the services sector growth model?

The majority of India's economy is still focused on farming and manufacturing but the services sector has grown much more quickly over the past 20 years. Still, India plans to increase the manifacturing sector's contribution from 17% to 25% and as long as there is a healthy mix between the three, India's economy should continue to grow at 7% to 9% annually. India's advantage is its large domestic consumption-based economy, which alone is enough to sustain growth rates at an elevated level. Couple that with a growing middle class and a young population eager to earn and consume and you'll have a hive of economic activity. However, India must focus on high-value job creation and continue to play to its strengths and knowledge in areas like intellectual property and technology.

In your opinion, are enough investments being made to keep up with the pace of urbanisation?

Where there is growth there are always opportunities and challenges. The demand and supply gap now for roads, airports and mega cities is so large that India will have to become more strategic in forward planning. While we thrive on the hustle and bustle in our cities, organisation is needed too. The government recognises the importance of this and has earmarked some USD 500 billion on infrastructure spending over the next few years.

Do you think that India and Indonesia's economies are similar?

I wouldn't really compare economies on a like-to-like basis but I think Indonesia is great. Its 250 million population is hungry for growth and that's a good thing. Indonesia has potential and it's a market where many businesses want to be, including us.

What do you think India should be concentrating on most over the next 5 years?

India has the scalability for robust growth and opportunity. Over the next few years, I wish to see more foreign investment across all sectors, more roads and railroads being built. The current plan to introduce a goods and services tax is an additional boost to

Malvinder Singh,
Group Executive
Chairman of
Fortis Healthcare

our economy. Apart from this, more focus on education and greater access to healthcare services for all are important. Lastly, social inclusion is also key; technology helps us reach rural areas much more effectively and many products and services are now available in even the most remote regions.

Do you perceive the BRICs to foster greater cooperation or compete amongst each other?

All economies have to compete and cooperate at the same time. BRIC nations are interdependent and they need to work together and with other economies to fully realise their growth potential.

Is international expansion a primary focus for Fortis Healthcare?

When we started the business in 1999 our vision was to bring affordable world-class healthcare to India. Today, we are India's largest secondary healthcare provider and also the most represented in Asia. We have gone from a small office of 5 to an enterprise of 27,000. Bigger is best when you want to make a difference in the world and influence policy.

To what extent has the eurozone crisis affected your business?

Whatever happens in the financial markets, the underlying global demand for healthcare does not change. Investors seek opportunity and that is certainly plentiful in our sector. Sentiment and timing in equity markets naturally play a role. For us at Fortis, we have been able to grow our business meaningfully and we are now exploring a potential listing in Singapore.

What tips do you have for anyone wanting to invest in India?

Investing in India has to be on a medium to long-term horizon. To achieve a sustainable rate of return you have to be a long-term partner and immerse yourself in our culture to understand how things work locally.

The sky is the limit with the right investments

Publisher & CEO of Indonesian luxury and lifestyle magazine group DestinAsian, Ronald Liem, shares his views on the future of Indonesia with Julius Baer.

Indonesia's GDP is fast approaching USD 1 trillion. Retail sales are expected to reach USD 150 million in 2012, up 50% from 2009. Do you think that Indonesia will continue to grow the way it has in the last 15 years?

I believe that Indonesia will continue to grow regardless of the uncertainty that looms ahead. Indonesia's middle class is expanding fast and its population is young, zestful and eager to consume – key factors that fuel an economy and help to transform the lives of citizens. Disposable income is increasing and products and services are becoming more affordable. A case in point – there are almost 70,000 car sales a month and nearly every Indonesian I know carries a Blackberry or a Samsung smartphone, which speak volumes in terms of growth opportunities across various sectors. Domestic travel is growing at 20% on average annually. Low-cost carrier AirAsia just moved its ASEAN office to Jakarta and hotelier Accor set up 6 hotels last year with a further 8 opening this year. The only caution to foresee is perhaps a growing disconnect between consumer desire and income. However, to mitigate a potential debt crisis, the Indonesian government has introduced new laws increasing down payments on car, home and business loans.

What do you think are the main challenges for Indonesia?

We are among the largest democracies in the world after the USA and India, hence a strong leadership is important. The government must invest more in education, healthcare and infrastructure for our country to truly blossom.

In terms of your business, how important is the Chinese market?

A few years ago, I wanted to ride on the China growth wave and initiated discussions to launch our magazines there. While planning, I realised that there was a whole domestic market to capture instead, so we shelved our plans. Alongside DestinAsian, I am very active in our family business Masari

Ronald Liem, Publisher & CEO of Indonesian luxury and lifestyle magazine group DestinAsian

Group, licensee of luxury retail shops and the second largest duty-free operator in Indonesia. Our clientele have been mainly tourists from Japan and Korea and I do not see a big shift in the demography. We are likely to see an influx of Chinese visitors to our market in the future but not now, as they tend to be travelling with tour groups. For our luxury retail sales business, the sector has proven to be resilient to the global economic slowdown and we will continue to focus on consumers with high spending power. In line with our growth strategy, we have plans for luxury brands like Hermes to be present in the major Indonesian airports, in addition to our Hermes stores in downtown Jakarta currently.

How has the economic situation in Europe impacted your business?

We've seen some impact on our magazine business, in particular our travel publication DestinAsian. More airlines and hotels are now advertising online because they feel that they can better quantify their return on advertising expenses from bookings made through these online channels. Up to 80% of our clients' budget is now spent on online marketing as opposed to print. To meet this demand, we re-launched DestinAsian online and will also be introducing an iPhone app version towards the end of 2012. I believe the print business will continue to grow but I'm equally convinced that the future for us will be in digital publishing.

In terms of luxury or duty-free spending, we have not seen a dip. In fact, tourism in Indonesia is increasing and will continue that way. That said, we will see a shift in focus away from the long-haul fliers from the USA and Europe to the regional markets in Asia Pacific.

2012 Julius Baer Lifestyle Index

The cost of luxurious living

In a world that is increasingly faced with limited growth, risks of inflation have all but taken a backseat. If anything, then this past year markets have been more concerned with deflation, especially in developed economies. Yet higher growth (currently coming out of Asia) is typically accompanied with greater inflationary pressures, all else being equal.

As we see from the growing proportion of food and energy categories in the typical consumer price index (CPI) basket, high inflation has clear policy implications given the social costs associated with the rising prices of these items in Asia, arguably more so than in Europe and North America.

One year ago, Julius Baer launched its Lifestyle Index in the inaugural Wealth Report in an effort to capture the changes in the cost of living for high net worth individuals in Asia. The index comprises twenty items, capturing both goods and services, in Mumbai, Shanghai, Hong Kong and Singapore. Naturally, the selection of items covered in the Julius Baer Lifestyle Index is subject to individual taste. However, the goods and services chosen for the index should better reflect the lifestyle choices and consumption patterns of high net worth individuals than the more traditional consumer price indices available.

The first time data was collated relating to the Julius Baer Lifestyle Index, we found that for the period of April 2010 to April 2011, the index rose 11.7% in US dollar terms. This rate of increase was well above regional, traditional consumer price indices. Singapore was home to the highest price hikes in US dollar terms, followed by Shanghai, Hong Kong and lastly Mumbai. Across the region, the prices of high-end wine, wedding banquets, handbags and business-class air travel underwent the largest increases.

Chart 24
Julius Baer Lifestyle Index

Item	Specification	Average price across countries, in USD Current year	1 year ago	Average inflation %
University fees	Oxford/Harvard	60,363	51,016	18.3
Business-class flight	Return to London/New York	7,211	6,121	17.8
Residential property	4,000 sq ft top location	19,000,263	16,847,143	12.8
Watch	Gold Rolex Oyster	35,679	32,102	11.5
Ladies' handbag	Chanel quilted bag	4,583	4,185	9.5
Wedding banquet	500 persons at top hotel	99,602	92,146	8.1
Wine	Lafite Rothschild 2000	3,587	3,336	7.5
Jewellery	Tiffany 2-carat diamond ring	122,493	115,211	6.3
Men's suit	Giorgio Armani	5,819	5,532	5.2
Facial aesthetics	Sculptra liquid face lift	19,370	18,504	4.7
Piano	Steinway grand	207,701	201,021	3.3
Hotel suite	Four Seasons 6-star	670	652	2.8
Car	Mercedes 500 SEL	329,539	321,522	2.5
Root-canal treatment	Top local dentist	1,544	1,510	2.2
Cigar	Cohiba siglo VI	772	760	1.5
Lawyer	Family law, partner 1 hour	523	519	0.7
Boarding school	Eton/Deerfield average	51,883	51,499	0.7
Hospital	1 day top-end hospital	445	443	0.6
Golf club membership	Top local golf club	300,373	304,818	-1.5
Ladies' shoes	Classic Louboutin pumps	1,753	1,868	-6.1
	Lifestyle Index Inflation weighted average across 4 cities			8.8

Another key finding from the first survey was a surprising variation in prices across the four cities covered. Lawyers' fees are almost twice the rate in Shanghai compared to Hong Kong. Yet the opposite holds true when comparing root canal procedures: These are ten times more expensive in Hong Kong than in Shanghai. In the goods arena, taxes and fees can explain why a Mercedes is much more expensive to own in Singapore versus Hong Kong while Mumbai seems to be the best place to buy a Steinway grand piano.

The 2012 survey for the Julius Baer Lifestyle Index shows an aggregate increase of 9%, about 270 basis points lower than the previous year. This 9% is the average US dollar increase for all items covered in Singapore, Hong Kong, Shanghai and Mumbai. In US dollar terms, prices rose the most in Singapore and the least in Mumbai. In local currency terms, Mumbai saw the highest price rises, at almost 20%. The most expensive single item to increase was the price of business-class airfares from Mumbai (+51%) and the largest decrease in price was a root canal procedure, also in Mumbai. Consequently, Mumbai has the highest range of price changes and Shanghai the lowest.

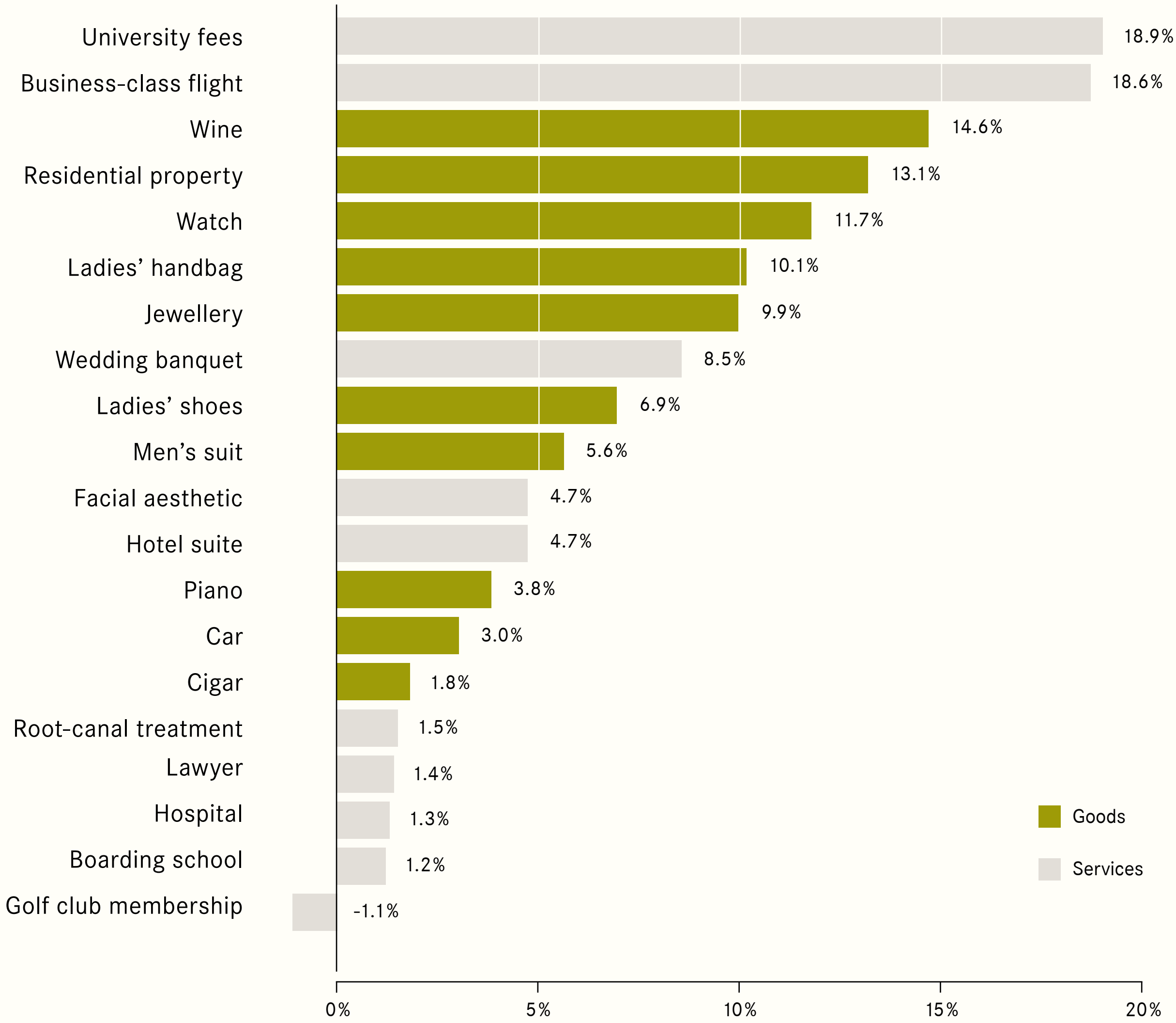
We have kept the weights in the index unchanged from last year. This means that property represents 30% of the index, with the Mercedes 500 SEL constituting the second largest component at 10%. The remaining items are equally weighted at 3.3%.

Chart 25
Prices of Julius Baer Lifestyle items across cities, in USD

Hong Kong	Singapore	Shanghai	Mumbai
59,757	59,756	59,868	62,070
8,902	8,182	6,666	5,095
40,401,021	12,975,134	15,870,749	6,754,149
32,207	33,341	38,572	38,595
4,921	5,781	4,888	2,740
121,100	67,482	111,406	98,418
4,380	3,349	3,492	3,126
116,452	159,910	186,711	26,631
5,926	3,998	6,983	6,368
9,018	2,559	2,393	4,197
197,496	231,870	250,917	150,521
624	959	667	433
229,832	402,085	348,531	337,707
3,350	1,839	524	463
466	1,375	667	579
386	660	794	251
51,363	51,362	51,457	53,349
464	756	333	229
386,489	239,866	285,673	289,464
1,005	2,714	1,460	1,833

Source: CLSA, Julius Baer

Chart 26
Price increases of Julius Baer Lifestyle items, USD terms y/y



Source: CLSA Asia-Pacific Markets, Julius Baer

Based on the results of this year's price survey, we reiterate our conclusions from the first Julius Baer Wealth Report: that a representative consumption basket for Asia's high net worth individuals faces higher price increases than traditional CPI measures. Over time, we expect the differential – which currently remains high at around 400 basis points – will narrow as standards of living across Asia continue to evolve and food and energy become a declining share in the conventional CPI. Nevertheless, the higher rate of price increases in a luxury consumption basket has implications in terms of required investment returns. In other words, the standard approach of deducting typical CPI from nominal investment performance to gauge 'real' returns is insufficient. In the first Wealth Report, we modelled outcomes based on different asset allocations and their projected returns in a bid to cover the rising cost of living for Asia's high net worth individuals. We take this a step further in the next section of this report and showcase a number of concepts that should prove useful in this regard.

Currency movements had a large impact in the period under coverage, April 2011 to April 2012. Against the US dollar, the Indian rupee dropped 16%, the Singapore dollar endured large swings but ended the period unchanged at 1.2577 to the dollar, the Chinese yuan appreciated 4% and the Hong Kong dollar, owing to its pegged arrangement, remained unchanged. The overall decline from last year's data point is consistent with conventional inflation readings across Asia which showed positive price increases but at a declining rate over the covered period.

Chart 27
Aggregate inflation – Local currency vs. USD over the past year

Source: CLSA, Julius Baer

Investment philosophy

Success means becoming and staying wealthy

In the wake of the 2008 global financial crisis, the investment landscape changed dramatically. As a consequence, active management of downside risk has become a key issue in wealth management and wealth preservation over the longer term.

The role of the investment manager

Put succinctly, the ultimate goal of the risk-taking entrepreneur is to achieve commercial and financial success; ensuring that the entrepreneur holds onto those monetary gains is the role of the investment manager. An entrepreneur succeeds because he or she is talented, has worked hard but also because of a degree of risk-taking. On the other hand, the investment manager's perception of risk is different as he or she focuses on wealth preservation.

The perception of risk

The old wisdom 'no return without risk' does not only apply to asset management but generally to any form of wealth creation. Every successful entrepreneur must have taken some degree of risk in order to start and grow a business. In this regard, hedging of risks or diversification is involved per se. We estimate that out of ten start-ups five end up failing, four manage to survive and only one achieves full success. As a consequence, there is a strong survivorship bias when it comes to the clientele of a private bank. In other words, the investment manager will generally have successful entrepreneurs as clients.

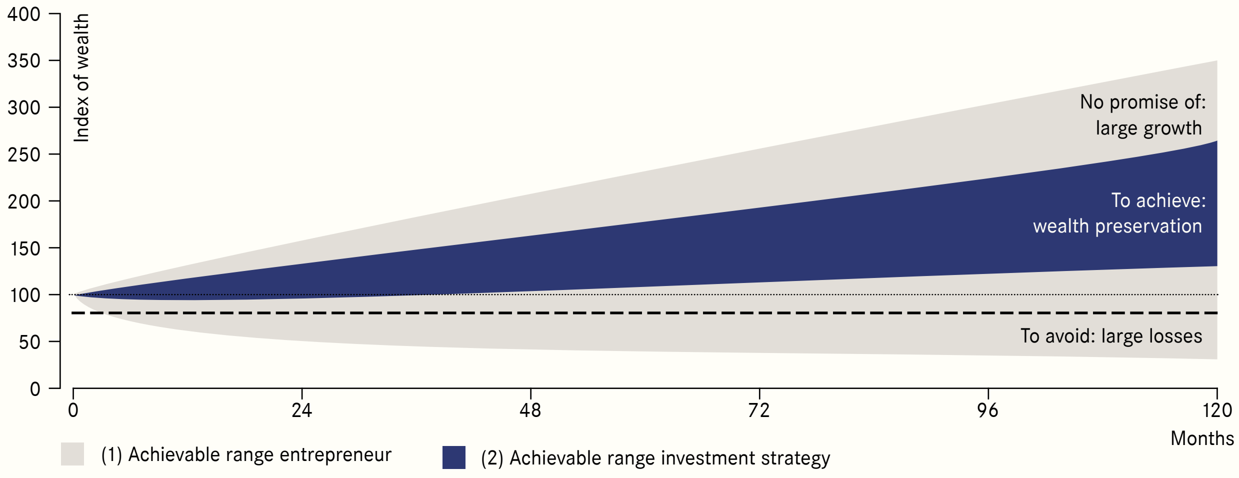
Different investment objectives

The investment manager has a different perception of risk. His or her role is to generate a decent return in real terms and avoid major drawdowns at all costs. The most important objective of the investment manager is to preserve the client's wealth in real terms. This includes taking into account inflation and increased living expenses of the client. The evolution of the Julius Baer Lifestyle Index shows that even the objective of wealth preservation is quite challenging when investment risk should stay at a moderate level.

One should keep in mind that a successful entrepreneur is likely to have taken considerable risks and is part of a select group of individuals. In serving entrepreneurs, the role of the investment manager and his or her perception of risk are different. He or she must run an investment strategy that preserves wealth of all clients in every market situation. This goal is reached by means of less overall risk-taking and strict management of downside risk. Chart 28 exhibits this situation: The objective of an entrepreneur (labelled as (1) in chart 28) is to reach a high return on investments/business. This comes at the risk of high losses. On the other hand, the objective of the investment manager is to preserve clients' wealth (labelled as (2) in chart 28) and to avoid losses. The return of the investment strategy generally lies within the blue area and should never reach the area of large losses. This comes at the cost of a somewhat lower rate of return. Depending on the market situation, the return of the investment strategy can exceed the return objective (i.e. ending up above the range of capital preservation), but there is no guarantee.

Please note that the investment objectives in chart 28 are based on real returns.

Chart 28
Wealth preservation is key



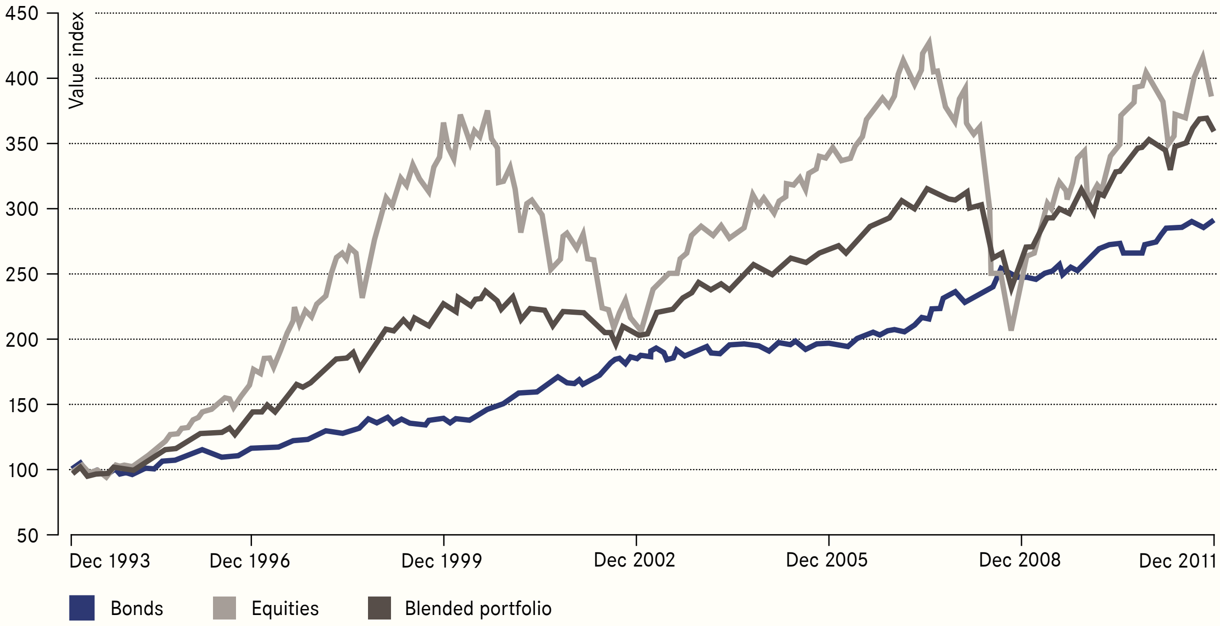
Source: Julius Baer

Managing assets – The good old days

Diversification
Since the publication of Harry Markowitz's famous article 'Portfolio Selection' in 1952 it has been a generally accepted principle that with the right combination of low-correlated assets one can potentially achieve the same return at a lower risk than with a single investment. This effect is referred to as diversification benefit.

Chart 29 depicts this effect: The combination of high-risk investment (grey line) and low-risk investment (blue line) generates a decent return at a low risk level (dark grey line). If high and low-risk assets have a low correlation against each other, the largest swings of the single investment are partially balanced out mutually in a combined asset allocation. Unfortunately, since the global financial crisis the correlation between the various asset classes has increased and therefore the benefit from diversification has diminished.

Chart 29
Diversification effect of a blended equity-bond portfolio



Source: Datastream, Julius Baer

If investors concentrate their exposure to a small handful of instruments, they risk serious, long-term damage to their portfolios if the investments go sour. To invest into various asset classes instead of one is not free due to transaction, research and opportunity costs. However, it is very wise to do so as we will see in the next section. This aspect of diversification is referred to as diversification of risk and has actually become more important since the financial crisis.

Correlation
Before the 2008 financial crisis, emerging market, high-yield and corporate bonds had attractive diversification properties, as can be seen by their low correlation of about 0.2 to -0.2 to equities. During the crisis, the correlation of almost all asset classes surged. The only remaining diversifying asset classes were government bonds and cash. The 2008 crisis can be seen as a regime shift because since then, the benefit from diversification has diminished.

Chart 30 shows the correlation of selected asset classes to equities. In October 2008, we observe a large upward shift in correlations, most pronounced for corporate bonds, where the correlation bounced from -0.4 to 0.6. Since then, the correlations have been at a higher level than before the crisis.

Chart 30
Game changing correlations to equities

Source: Datastream, Julius Baer

Safe-haven assets

In difficult political and economic situations, investors seek risk-free investment opportunities in order to reduce their exposure to risky assets. Given what has happened in recent years, we ask if a risk-free investment still exists. So-called safe-haven assets must fulfil certain requirements: They should have a low price fluctuation (low volatility), should protect against inflation by maintaining their original purchasing power and should be liquid and disposable at any point in time. In chart 31 overleaf we evaluate different assets that are commonly regarded as safe havens based on the required properties described above.

Although cash maintained its value during the 2008 crisis, it is not a wise idea to safeguard wealth in cash. In the mid to long term, there is a high risk that fiat money will lose its value. As history shows there are many well-known currencies that lost a substantial part of their real value within a short period of time. There have been currencies such as the Deutsche mark, French franc or British pound where investors lost 90% of their real value within a couple of years. In light of the loose monetary policy run by most developed countries, the probability of higher inflation rises.

Gold has proven to be much better at preserving real value in the long term than all fiat currencies. However, short-term price fluctuations of gold are very high, with an annualised volatility in the area of 20%, close to that of an equity portfolio.

During the 2008 crisis, government bonds proved to be most resilient to downside shocks. However, the performance of government bonds was strongly supported by the decreasing interest rate level at that time. Going forward, credit risk will be an growing issue for government bonds.

Chart 31 clearly shows that there is not a single asset class that fulfils all requirements of a risk-free investment.

Chart 31
Selected safe-haven assets

Asset class	Main risks	Remarks
Cash on deposit	Inflation, FX risk	FX = foreign currency
Cash at home	Inflation, FX risk, theft	Some countries limit the amount of cash at home to prevent money laundering
Government bonds	Price fluctuation, issuer risk, FX risk	Price risk due to potentially increasing yield during lifetime; inflation risk can potentially be hedged by inflation linked securities
Gold	Price fluctuation	During times of crisis some countries restrict convertibility (for private investors)
Real estate	Price fluctuation, low liquidity	Cannot be transferred to another country

Source: Datastream, Julius Baer

Managing assets in today's environment

The global financial crisis has dramatically changed the financial world. Before the crisis a multi asset class strategy with a fixed asset allocation was well suited to capture risk premiums for holding bonds and equities and obtain a decent risk reward due to diversification benefits. Since 2008, the investment world has become bipolar. Firstly, there remain few really diversifying asset classes. Secondly, asset classes like bonds, equities and real estate incorporate an increased risk of massive price correction or are kept in a sideways trend until fair values are reached again after they have been artificially boosted by low interest rates and stimulus programmes. Going forward, we will have to cope with low risk premiums for equities and bonds. Chart 32 exhibits some important investment parametres and how they changed during the 2008 crisis.

Despite the changing market environment, some basic principles are still valid:

- No risk – no return. High risk has to be taken in order to have the possibility to be rewarded with a high return in the future. However, taking risk does not guarantee a positive return.
- Diversify the risk. As the diversification benefit diminished, it has become even more important to spread risk among many different asset classes.

Chart 32
Changed investment environment since 2008

Concept	Before crisis	Since 2008
Correlation	Many low-correlated asset classes are available ▶ multi asset class allocations benefit greatly from diversification ▶ approach to pursue: fixed asset allocation with regular rebalancing	Bipolar world: government bonds vs. risky assets ▶ highly correlated risky assets vs. government bonds and cash as sole diversifying asset classes ▶ lower benefit from diversification
Risk premium	Nice growth in developed countries (DC) ▶ high risk premium in DC equities ▶ risky assets pay out in the short term	Low growth rate in developed countries ▶ low risk premium for DC equities expected (without further growth stimuli)
Interest rates	High interest rates are falling ▶ high total return on bonds ▶ high return on low risk assets	Lowest interest rates in DCs to stimulate the economy and ease the sovereign debt crisis ▶ low risk premium for bonds expected

Source: Datastream, Julius Baer

Instruments or the very basics

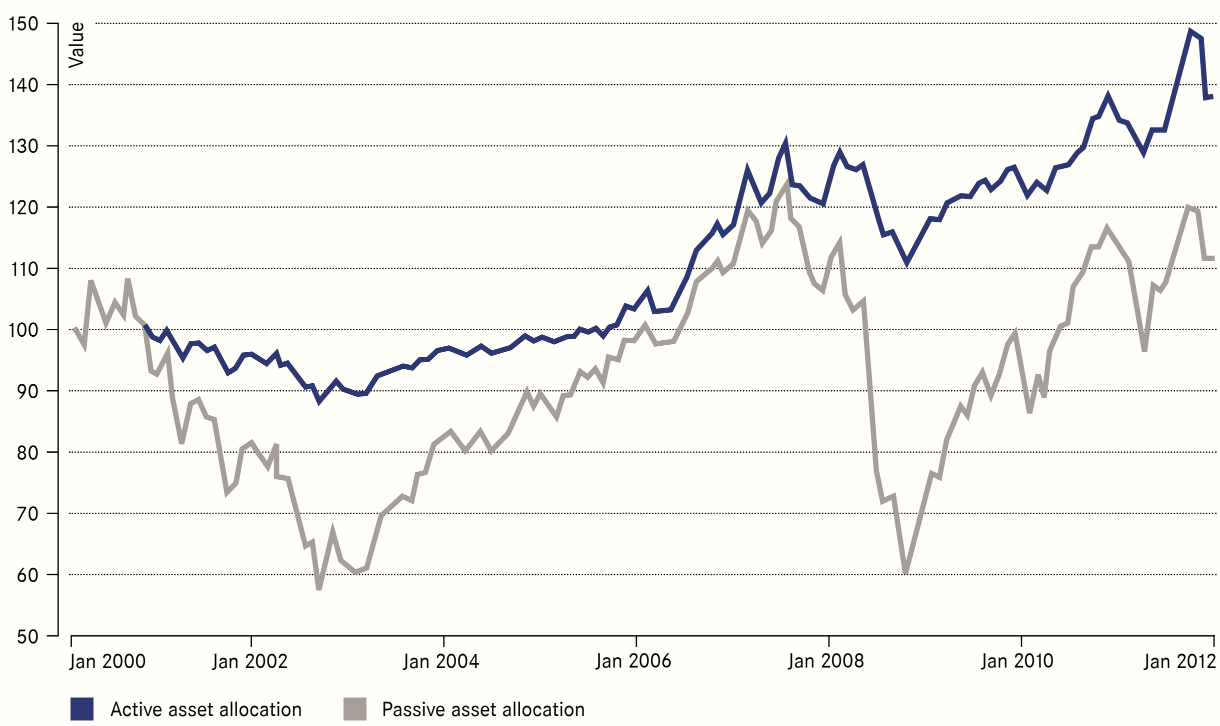
When selecting financial instruments, investors focus on simplicity, transparency, liquidity and cost efficiency. The well-known basic instruments have gained increasing attention: cash, bonds, equities, gold as well as mutual funds and exchange traded funds (ETF). The largest part of the portfolio should be invested in highly liquid instruments. Daily traded financial instruments with an illiquid underlying will not be readily available in a crisis situation where liquidity is of highest importance. Foreign currency risk cannot be neglected when it comes to cash, fixed income investments or loans. And in the home currency, it is the real and not the nominal return that ultimately matters.

Investment approach

Any investment has to be judged against recoverability and substance. Most investments will suffer during times of crisis. However, one should prefer investments with a high chance to recover after the crisis. Companies with sound balance sheets, a strong business case and a proven track record exhibit the attribute of substance. They have a good chance to recover after a crisis and are able to repay their debt.

To recover a loss of 50%, a gain of 100% is needed which is twice the performance of the decline. This means it is of utmost importance to prevent such detrimental losses – which is why downside risk management is so important. It is essential that the investment manager knows the total risk of the portfolio as well as the main contributors and driving factors of portfolio risk. The investment risk manager has to evaluate the risk figures, to think through different scenarios and to prepare options to cope with possible threats. In addition there should be a process in place by which the investment manager is able to hedge the portfolio or part of it in a cost-effective way at short notice if markets tumble.

Chart 33
Investment strategy with active risk management



Source: Datastream, Julius Baer

The effect of controlling downside risk can be shown in the following example. Let us start with 100 units. If markets deteriorate, one could lose 46% with risky assets and have 54 units left. After a loss of 46% one would need a positive performance of +86% to recover to 100. If we succeed to limit the loss to 15%, we would need only 17% to recover! A simulated outcome of this behaviour is shown in chart 33. Controlling downside risk implies active asset allocation, reducing risk in bear markets to avoid losses and increasing risk in bull markets to benefit from high returns.

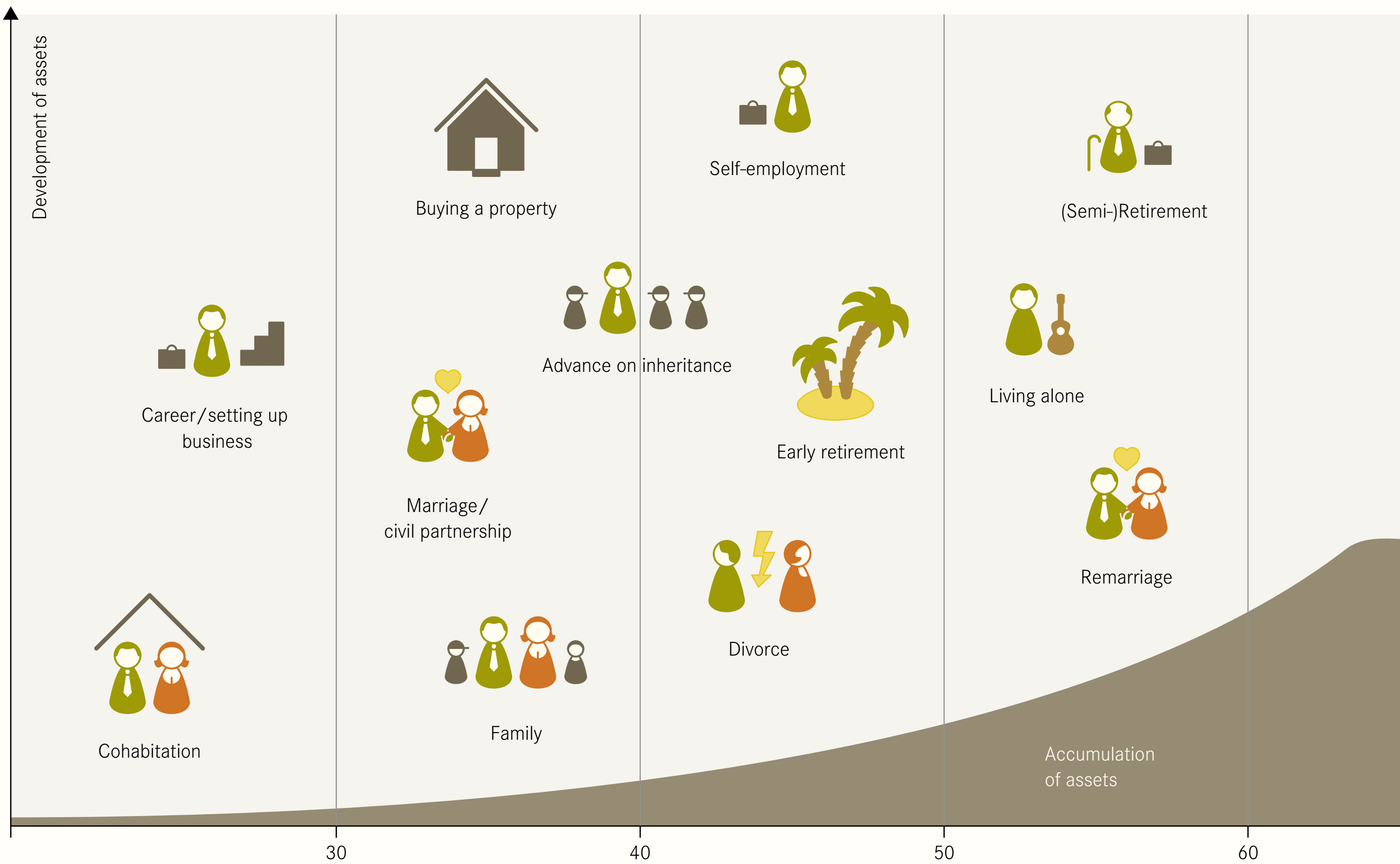
It is clear that such kind of asset management is very different from times before the crisis where a multi asset class strategy with a fixed asset allocation generated a good risk-return reward. The changed investment environment demands a modified investment approach with an active asset allocation, a regular review of each single investment and permanent investment risk management.

The bottom line

The role of the investment manager is to preserve the wealth of his or her clients. This includes managing inflation and increasing living expenses of the client by generating a decent investment return in real terms and avoiding any large drawdowns. In an investment environment that has changed dramatically since the 2008 crisis, where the benefits of diversification have decreased, risk premiums on bonds and equities diminished and risk-free investment opportunities are hard to find, focusing on high-quality assets and active risk management is the key for successful investment management.

Life can get very complicated

Chart 34:
Major events in life require proper financial planning



Wealth planning goes hand in hand with wealth preservation. Along with professionally managed invested assets, it is important to seek guidance in terms of tax and legal implications when it comes to transferring wealth to the next generation. In an increasingly complex world where families live across multiple geographies with their own unique and constantly changing regulatory requirements, it is no question that families benefit significantly from utilising the services of a wealth and succession planning expert.

Source: Julius Baer

To explain the complexity involved, a realistic but fictional situation is described below. Imagine a group of friends of mixed nationalities living in Singapore sit down to dinner together. The conversation turns to plans for the future, specifically what they plan to do when they retire.

Anthony and Elisabeth Tan, from Singapore, are in their fifties. They own an international company and manage part of the business operations from their home in Singapore. Elisabeth feels it is time to change the management of the family business and pass the reins to their eldest son Richard who has been working for the company for a while now and is currently living in England. The couple's other son John also works for the company. Elisabeth also had a son from her previous marriage, Samuel, who unfortunately died shortly after he was married. Anthony and Elisabeth are concerned that their daughter-in-law Susan, Samuel's widow, may also claim rights to the family business as she has been an active manager of the company for a number of years, certainly longer than John has been involved.

"We are currently facing a conundrum because we would like to hand over our business to our son Richard to lead," confides Elisabeth to her friends around the table. "He is very capable but we fear that he might not want the responsibility and that Susan may believe she deserves this entitlement."

Elisabeth's close friend, Lorriane, sympathises with their situation. "Is selling the business an option? Perhaps that would be the fairest for all involved."

Elisabeth is aware that managing the handover of her business to one of her children or even an outsider could take years especially since the company, like many in Asia, is a conglomerate of businesses which has further implications.

"Succession is a really sensitive matter and I know better than to underestimate family politics," comments Lorraine. "It is the mention of international laws that I would worry about most. Then there is the not so small matter of your estate as well. Do you think you need to start giving your wealth away in the form of gifts to minimise inheritance tax?"

"Have you thought about speaking to a wealth planner?" asks their friend Martin who, as a lawyer, has had some experience with such professionals. "They have multi-jurisdictional knowledge so they should be able to provide the best options available to you. What about your wills, are they up to date?"

The enormity of the situation and its impact on the finances of Anthony and Elisabeth's family loom overhead. Anthony thinks of further implications such as the large proportion of their wealth held abroad and his eldest son's wishes to marry. Important paperwork such as prenuptial agreements and updated wills will be necessary to best navigate the changes and potential turmoil ahead.

"You have both worked really hard to build up your business so make sure that success is maintained through future generations," instructs Martin, grabbing the waiter's attention to order more wine.

Anthony begins to imagine what life would be like upon retirement. He would like him and his wife to have the option to move to a slower-paced but comfortable environment abroad. Anthony wonders if his long-term investments will maintain his standard of living and worries that they may also encounter unforeseen tax implications.

"Talking of planning for the future," says Lorraine. "I do not have children, so I am considering setting up a charitable foundation to which I can donate my extensive art collection."

"That sounds like a sensible idea," agrees Martin as his order of Hainan chicken rice is set down in front of him. "I heard through a wealth manager friend of mine that if you donate your collection to somewhere famous like the Museum of Modern Art in Berlin, then not only is the art exempt from gift or inheritance taxation but the museum might pick up the costs of housing the works."

Giving Martin a playful nudge, Lorraine says, "I want to make the donation because I want to be charitable, not because I want to reduce my taxes!"

"In any case perhaps that museum idea applies in Europe," suggests Elisabeth. "I suspect that the tax laws might be different here. What's more, they seem to change daily!"

"When did life get so complicated?" moans Anthony.

"That is precisely why we can't ignore these important issues however much we would like to," replies Martin. "Having an 'easy life' is anything but easy to prepare. If you want to remain in the comfort to which you have become accustomed long into retirement, I advise getting professional help. It will mean less headache and is inevitably more profitable."

Wealth and succession planning is extremely personal and should be tailor-made to specific individual needs. As lives progress be it getting married, starting a business, having a family or retirement, there are many bumps along the way, some financial and market driven and some private. For each important step there are financial and legal implications to consider. The best way to face the future positively is to prepare and plan professionally.

Conclusion

Where do we go from here?

Long after the eurozone crisis is resolved – in one way or another – the headwinds facing growth and wealth creation in most developed economies are likely to persist. Asia is uniquely positioned to withstand the contagion impacts, owing to better domestic economic fundamentals, improved institutions and stronger business operating environments.

Stress-testing our assumptions made in the first Julius Baer Wealth Report on Asia, we reaffirm our original forecasts of the region being home to 2.8 million high net worth individuals by 2015. Our cautiously designed 'upside' scenario could see that number rise to 2.96 million individuals, holding a combined stock of wealth equal to USD 16.7 trillion. China, India and Indonesia are at the forefront of wealth creation in the region, with ongoing economic transformations likely to yield further surges in prosperity. The second data point of the Julius Baer Lifestyle Index underscores that the cost of living for Asia's wealthy continues to rise faster than conventional consumer price indices. This places even greater emphasis on applying an effective and sustainable investment approach over the longer term, in a bid to not only meet these rising costs, but deliver positive real returns.

As a firm focused on embracing growth opportunities, Asia is the central element in this strategy for Julius Baer. At the same time we recognise that global business cycles will become shorter and their amplitudes may increase even further than seen in recent times. This reinforces our focus on sound fundamentals that will weather shorter-term turbulences. With this in mind, we demonstrate our commitment to Asia as illustrated by this Julius Baer Wealth Report.

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