

Searching for Operating Leverage

Investing in Asian markets requires a great deal of research involving the study of several country-specific constraints. T. Rowe Price New Asia Fund portfolio manager Frances Dydasco and her research team search for all-cap size companies with a lot of undiscounted operating leverage in the diverse Asian markets including India and China by following a unique research method of visiting, talking to companies, assessing industry trends, and comparing valuations in different markets.

Q: What is your investment philosophy?

A: We are growth investors targeting Asia, excluding Japan and Australia. We believe Asia is a high growth environment where markets tend to focus on “hyper-growth” areas. Our investments are not driven by the benchmark, since in this region indexes are somewhat less relevant as their construction will lag the fundamental changes.

Our core philosophy is that stock returns are mostly driven by the direction of a company’s earnings, rather than the absolute quantum of earnings. Markets tend to increase valuations for companies with rising returns and lower those with declining returns, even if they have more stable earnings growth. Consequently, we look at companies of all sizes with a lot of undiscounted operating leverage. Our goal is to have a portfolio that will have companies in different stages of harvest - just like a plantation that always has some seedlings, some saplings and some full-grown trees.

Q: What is your investment strategy?

A: Our approach to investing is bottom-up and our strategy is to build our portfolio one stock at a time. We try to add value mostly by stock selection.

We believe in a long-term perspective in order to take advantage of opportunities created by short-term market volatility. We will hold through a difficult cycle or buy a stock when it is out of favor, and wait. We

are also prepared to buy significant stakes in companies.

Our valuation method varies from company to company and the type of industry we are looking at. For example, we use the discounted cash flow (DCF), as our guiding principle for infrastructure assets. These assets are long dated and tend to have very predictable cash flows where we can project some percentage of growth based on the area or economic growth. Ironically, the market tends to focus on price-to-earnings ratio for these assets.

Q: How is your research process organized?

A: T. Rowe Price has been covering Asia since 1985. We have a research team of eight analysts organized by sector. We believe in field research. Our research process involves frequent visits to companies, meeting people in different industries, and assessing industry trends.

We operate primarily out of Singapore and Hong Kong but as part of the T. Rowe Price Group we are integrated with the global research efforts on a sector basis.

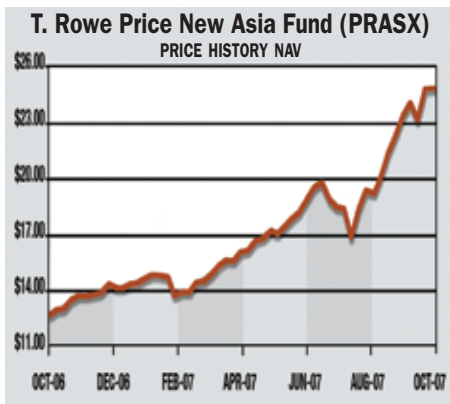
Ideas generally come from various company visits and sometimes from a totally random source. One has to be prepared to think at multiple levels. Not all ideas lead to investments but they enrich our knowledge base and help us to probe better across industries and deeper into companies.



FRANCES DYDASCO is vice president of T. Rowe Price Group, Inc. She is vice president and Investment Advisory Committee member of T. Rowe Price International Funds Inc., and a vice president and portfolio manager of T. Rowe Price International, Inc. (Singapore), covering Asia (excluding Japan). Dydasco has been with the firm since 1996 and has a total of 19 years of investment experience.

Prior to joining T. Rowe Price, Dydasco was an investment manager with LGT Asset Management (Asia) Limited, Hong Kong. She earned a B.A. with Honors in East Asian Studies from Harvard University.

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Through this process if we like a company we compare it to other similar companies and then we'll go and visit those companies. That is how we find companies. We don't start from some abstracts, sift through quantitative metrics, but try to look at every industry from every possible angle so that we can understand what's actually happening in that industry.

Q: Can you give us a few examples of how your research approach led you to buy stocks in a company?

A: BF Utilities is an example in India. The company is implementing a massive fully integrated project that includes a highway stretching all the way from Bangalore to Mysore. The company has also bought land all along the proposed highway route and its long-term plan is to develop industrial parks and residential areas. As it builds the parks it will retain the utility companies that service it, such as, water purification companies and individual power units. The first stage of the road is almost complete.

Infrastructure investments are very location specific. We therefore had to do a lot of groundwork, visit areas, look at the demographics and the growth characteristics of specific areas. Except for infrastructure constraints, Bangalore is a very attractive area, with a large base of international companies. Furthermore, we think that building of this highway close to Electronic City will benefit these companies. BF Utilities have also managed to obtain a single window approval in place of the otherwise 40 to 50 typical government approvals that are required to set up a facility including power and water, very unusual in India. So

we think that this whole project has a lot of competitive advantages.

The influential Kalyani family in Bangalore is also interested in seeing the project completed. Hence, we decided to take a stake in the company and now own nearly 9%. And given the cash flows that this highway itself will throw off, the company should be able to fund every subsequent phase of the toll road construction without having to come back to the capital market. We liked the structure of the company as well. We also own other infrastructure companies including GVK Power and GMR Infrastructure.

In China too, we adopted the same process where, a few years ago, we did a lot of groundwork to identify attractive assets. The infrastructure scene in China revealed a huge build-out and also a nascent level of private home ownership. Cement companies were one of the main beneficiaries of these two activities. Therefore, we visited a whole bunch of them including some of the foreign companies that are not listed.

The Chinese cement industry, at the time, was going through a difficult phase as there was an over-supply resulting in very low prices. However, there were clearly a few that stood out from the whole pack of players in terms of their size, technology, and cost efficiencies, and therefore their inherent profitability. They were very cheap on a replacement value basis because essentially this is a high capital employed business and equipment obsolescence is not high in the cement industry.

Now, replacement value in China is a fraction of what it is elsewhere in Asia hence cement prices will tend to be lower. Moreover, the biggest, most efficient player Anhui Conch, was also consolidating and starting to buy some of the smaller more inefficient players, and was trading at significant discount to its Chinese replacement value. Its cash flow growth was rising and operating leverage was picking up due to increased market share. We realized that if the consolidation continued, their earnings were really going to escalate further and

if the consolidation resulted in an actual closer matching of supply and demands prices would actually start to go up from a very depressed base. So we bought the company, Anhui Conch, which has gone up several times since we bought it.

Q: Do you carry out a comparative analysis of same sector companies in China and India?

A: Comparative analysis is only useful to a point. For instance, in the case of cement, it's useful in trying to understand the import-export flows between countries because then there could be price arbitragers. We see if those can be arbitrated out practically or not, are there infrastructure constraints, transport costs, etc. And we'll look at comparative costs of production and efficiency.

Q: How do you go about building your portfolio?

A: We want companies that have rising operating leverage in our portfolio. Often, when we take a thorough look at the total portfolio, we might spot commonalities among the companies. Once the commonality is identified, we might look for opportunities with similar characteristics. For example, we have a lot of life insurance stocks. We started with Chinese companies when we bought Ping An, about two years ago. At that time half of their enterprise value (EV) of the company was under water, because they had sold policies at a time when interest rates were much higher.

Our research revealed the incremental yield they were getting was much higher than their bulk deposit yield. That negative EV part of the portfolio had a tipping point which was roughly 150 basis points above where the prevailing deposit rate was at that time. But the marginal rate they were getting was clearly much higher than that.

In our estimation the stock looked cheap to us so we bought it. We also started looking at other life insurers around the region. In addition to looking at the ones in China, such as China Life, we also look at the ones in Taiwan, Korea and India. In fact, we own nearly all the players in India.

Q: How many stocks do you have in your portfolio?

A: When I took charge of the whole fund last April, it had 150 holdings in the portfolio. Since then the number has fallen down to about 81 holdings. I want to be able to invest down the market cap scale because many new sectors in Asia tend to be not capital intensive, service industries, and they tend to start as relatively small cap or mid cap companies. Also, I prefer not to own more than 10% of companies.

We believe that the sweet spot of Asian markets is in the \$1 billion to \$4 billion cap companies. We also have, for the highest conviction holdings, position sizes as much as 4%.

Regarding sector weights - Asia is a region of companies with hyper-growth and although tiny in the index, China and India are the fastest growing economies and that's where we find most of our opportunities. Therefore, in our portfolio, we have roughly 66% in China and India. Korea is a third of the index but is much less significant to us, so we only have 16% of the portfolio there. The situation in Taiwan is very similar - where it's 15% of the index, we have 8%. We have no investment in technology companies in the portfolio across all regions of Asia.

Q: What is your buy and sell discipline?

A: We try to find a company where the return on capital is increasing. A company may have a reasonable earnings progression, its price-to-earnings ratio may be reasonable relative to its growth; but if there's not a lot of operating leverage left, and the returns are stabilizing, we generally will not buy it. We prefer to buy companies where the return trajectory is rising because most analysts including our own will tend to underestimate earnings.

A classic example of this phenomenon is Bharti Telecom, a mobile telecom company in India that we had owned since it was an \$800 million company and which we just sold. We bought the stock when its price was between 23 and 29 rupees. The stock trades above 800 rupees.

The company's core strategy is to keep pushing the mobile phone penetration curve, even if it resulted in lower average revenue per user (ARPU) because their marginal costs were falling faster than marginal revenue. This is because electronics components fall in price and as the company gets bigger they can negotiate lower prices, and benefit from massive economies of scale

Unfortunately, in India the environment is quite inflationary because of material shortages that can result in price surges. So if one-third of the equipment equation is still deflating marginally, and two-thirds of other costs are inflating, then at best, we have an equation where the marginal cost is stabilizing, while marginal revenue is still falling, which means that marginal return is actually falling.

We suspected that the company's quality of service has been declining partially because they have been under-spending. At best, they can keep marginal costs flat. Since they were moving from high penetration urban India to semi-urban and rural areas, where the density of customers is a lot lower, the loading on the equipment and asset utilization are going to be lower because there are fewer people per square mile. So although penetration is still going up and earnings are still good for this company, at the margin, the returns are starting to decline. Consequently, the stock has stopped moving. Even when we had an all-time high in terms of net new subscribers, the stock didn't respond anymore to good incremental news.

Q: What is your view of risk and how do you control it?

A: If our risks are measured against the benchmark, from time to time we know we are going to have a soft period, like if tech stocks outperform or if the dollar rallies, so there's that risk given significant deviations from the benchmark.

The other kind is specific company risk, especially if we own a large stake in a company. That is a risk in any bottom-up portfolio. We try to mitigate those risks by knowing our companies well. 

T. Rowe Price New Asia Fund

Symbol	PRAX
Website	www.troweprice.com
Address	T. Rowe Price Associates Inc 100 East Pratt Street Baltimore, MD 21202
Tel. No.	800-638-5660
Inception	09/28/1990

PORTFOLIO

Total Net Assets*	\$5,000
Avg Mkt Cap (\$ Weighted)*	\$16,300
Average Price/Earnings Ratio	29.39x
Average Price/Book Ratio	5x
Turnover Ratio	76%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$1,000

RISK (MSCI EAFE ND INDEX - 3 YEARS)

Alpha	0.93
Beta	1.28
R-Squared	0.51
Ann. Std Deviation	16.90
Sharpe Ratio	2.10

RETURNS VS. MSCI EAFE ND INDEX

	PRAX	Index
1 Year (Cum.)	87.96%	24.86%
3 Year (Ann.)	45.97%	23.24%
5 Year (Ann.)	38.21%	23.55%

RETURNS VS. MSCI EM FAR EAST GD INDEX

	PRAX	Index
1 Year (Cum.)	87.96%	62.84%
3 Year (Ann.)	45.97%	38.30%
5 Year (Ann.)	38.21%	32.86%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	1.05%

PORTFOLIO MANAGER

Frances Dydasco	11/01/2006
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*millions **3 months after purchase

Data through: 10/31/2007

Source: Company Documents; Lipper

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