

First Eagle News

AUGUST 2010

Views on Developing Markets

At First Eagle we are often asked how we view the developing markets. Some prospective investors also wonder about our noticeable lack of exposure to the BRIC countries (Brazil, Russia, India and China). After all, the world's wealth seems to be created in developing economies at an increasing rate, and many Asian nations in particular are growing at a pace that underscores the supposed resiliency of their economic models. As the developed world stumbles from crisis to crisis, many developing countries seem poised to continue taking a greater share of the world's wealth.

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While we do not dispute the notion that the developing markets are becoming the world's growth engines, we are value-oriented, bottom-up investors who do not automatically interpret this trend as a signal to invest. According to Matt McLennan, Portfolio Manager and Head of the Global Value Team, the top-line growth of an economy does not necessarily translate into strong returns from the ownership of equities. "The problem with buying the developing market-growth story is that a great many companies are trying to get into the market and participate. In economies with a lot of structural change, the companies that will generate earnings in five or ten years may not be the same companies that are thriving today. It's very hard to know who the winners will be."

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Portfolio Manager Abhay Deshpande adds, "When we think about a potential investment, we think long-term. As a result, there is often a mismatch between our time-horizon and the potentially short lifecycle of a developing market business. This sometimes makes it difficult for us to apply our approach to companies in the developing world."

Our commitment to risk management also dampens our enthusiasm for developing markets today. We seek, first and foremost, to avoid permanent impairment of our clients' capital, which we consider the most serious form of investment risk. To minimize this risk, we strive to invest with an embedded margin of safety. According to Ben Graham's definition, a margin of safety is the difference between the price we pay and the value we receive. Without the right price, and therefore an embedded margin of safety, we often do not invest in specific securities, even if this discipline keeps us out of certain sectors or regions. "We can buy sound, well-established, well-capitalized, prudently managed businesses in places like Japan, Europe and the United States at single-digit multiples of operating profits," McLennan says, "whereas in China, India, or Brazil—the most sought-after developing markets—we'd have to pay double-digit multiples. And we'd have to pay these multiples in economies where inflation and monetary growth are trending higher than in the developed markets. The combination of these factors suggests that the margin of safety is currently significantly smaller in developing markets than in developed markets."

Price to Book Ratio: China vs. Japan



Source: Bloomberg, 06/30/10.

The MSCI Japan Index is a free float adjusted market capitalization index that is designed to measure large and mid cap Japanese equity market performance. The MSCI China Index provides deep exposure to the China A share market and is calculated according to the MSCI Global Investable Market Indices (GIMI) Methodology.

Other Obstacles

There are additional factors that give us pause. There are some developing markets where we believe that the accounting practices are questionable and respect for property rights is weak. In many developing markets, the volume of share issuance is high because businesses need more and more capital to fuel their rapid growth. Many of these companies have negative free cash flow, and those that have positive free cash flow, in our view, do not always allocate capital in ways favorable to shareholders. As Deshpande explains, a recent deal in China highlights this risk. “In March 2010, China’s largest mobile phone company, China Mobile—a state-owned enterprise that is also publicly listed—purchased a 20% stake in a Shanghai-based bank that found itself undercapitalized after supporting the government’s 2009 stimulus package. In fact, many other listed Chinese companies remain largely state-owned and clearly have motivations different from those of developed-world shareholders. While government intervention in the economy is no stranger to our shores, it is clearly much more prevalent in China.”

State intervention into corporate affairs can take other forms, as well. In Russia, for example, the risk that the state will abolish property rights creates a virtually insuperable hurdle for us. “We have had limited exposure to Russia over time because of the value we place on transparency and property rights,” McLennan notes. “I recall clearly what happened to Yukos a few years ago, when the assets of what was one of the key global energy companies outside North America were effectively expropriated by the government in a tax case.”

Aside from state intervention, we often see that in high-growth markets or sectors, management teams tend to adopt an

expeditionary mindset, stretching businesses to their operational or financial limits in order to achieve aggressive growth targets. Whether we look at Tata Motors’ 2008 top-of-the-cycle purchase of Jaguar or Chinese oil companies’ recent high-priced purchases of oil fields across Canada and the Middle East, aggressive management behavior abounds in the developing markets—and not just in large companies. Earlier this year, a small Hong Kong manufacturer of cigarette lighters, Sino-Tech International, decided to invest four years of accumulated earnings in a real-estate project in order to gain some exposure to Hong Kong’s “hot” luxury property market. “Such an aggressive mindset is often a red flag for us,” says McLennan. “We try to align ourselves with management teams that we see as prudent.”

In some markets, valuations are the most serious obstacles to our involvement. “Many of the management teams that we have met in India are quite shareholder-oriented, though fiscal discipline at the government level has not been very strong over time,” McLennan reports. “However, for us the biggest challenge in India has been the level of valuations. In many cases, you have to pay not just double-digit multiples of cash flow, but sometimes multiples in excess of 20 times EBIT (earnings before interest and taxes) to buy good businesses in a country where the inflation rate is in the double digits. Even if we find an underlying opportunity that intrigues us, there simply isn’t the margin of safety that we require for direct investment.” However, as McLennan further explains, we have found opportunities for indirect investment. “Nestle India trades at 40 times trailing earnings, while its 50% owner Nestle SA, which is listed in Switzerland, trades for just 16 times earnings. We own the latter, which gives us modest exposure to Indian growth at a much more reasonable price.”

Our Approach to Investing in China

A recent trip to China by Deshpande, Senior Analyst Alan Barr and Senior Adviser Jean-Marie Eveillard highlights some of the immediate risks associated with investing in the Chinese market, but it also reinforces our belief in the longer-term ascent of many Asian countries. “There truly are two Chinas,” Barr says. “While the central government is rich, the people are generally poor. Particularly in coastal cities, the highways, buildings and airports are world class, but they may be well ahead of the expectations and needs of the people at large. For instance, the Shanghai Airport’s international terminal sometimes operates at 20% capacity, while 10–15% of Class A and up to 20% of Class B office space in Shanghai is vacant, with more office space being added every day.” On the other hand, growing personal income and consumption have led to a boom in sales of autos, luxury goods and electronics, among other items. March 2010 auto sales were double the level of the prior year, while sales of watches, appliances and computers were up 30–40% over the same period. No doubt, residential real estate prices were spiking as well. As Eveillard explains, residential property represents a way for wealthy Chinese to deploy excess cash; they sometimes buy a property as an investment and leave it vacant.

Capturing the dynamism of Chinese growth requires some creativity by the team at First Eagle, as stock prices and management behavior within the country leave us hesitant—especially when so many of the available equities are highly geared to China’s area of greatest risk: infrastructure. We’ve generally solved this dilemma by investing indirectly via foreign and U.S.-listed companies with significant exposure to Chinese consumers. “Fanuc, a Japanese-listed robotics

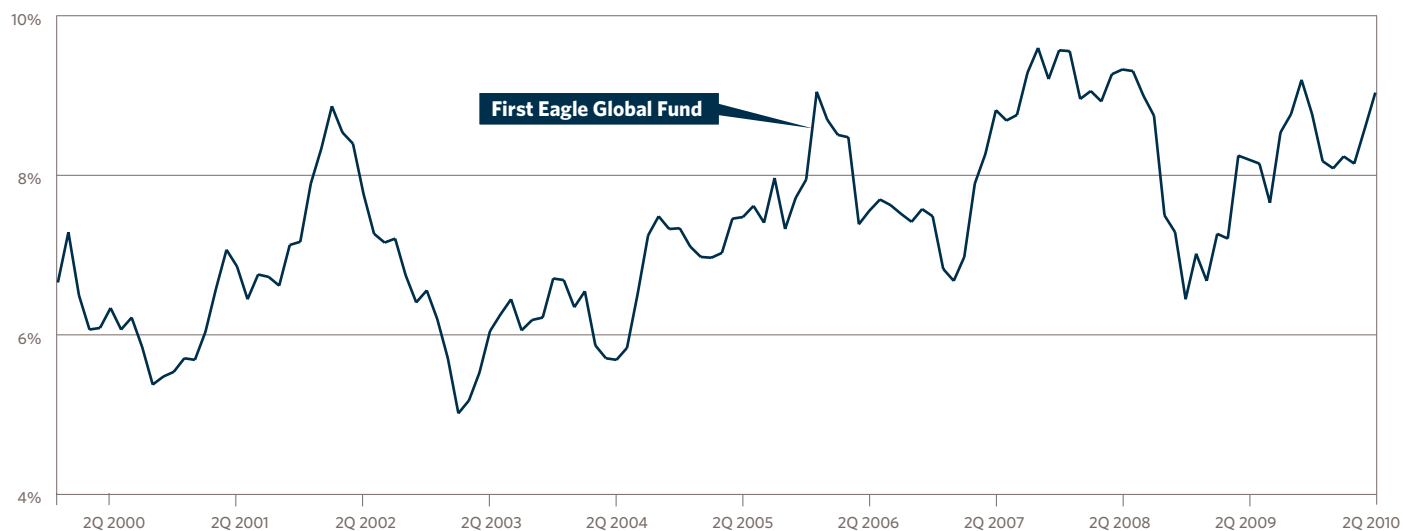
company, derives almost 20% of its revenues from China,” says Senior Analyst Matt Lamphier. “Its products are used to manufacture many of the goods that we feel Asians will want to buy as they get richer.” Significantly, because Fanuc is listed in Japan, it benefits from the “Japan discount” and is therefore a less expensive way to access Asian consumer growth.

“This is the kind of solution we’ve applied across the developing world,” adds Associate Portfolio Manager Kimball Brooker. “Rather than blindly following the herd, especially when so many signs suggest caution, we’ve sought direct and indirect exposure to consumers as the prudent way to capture the growth potential of many developing markets.”

Direct Investments

First Eagle’s current view on investing directly in developing economy stock markets should not be construed as dogmatic or inflexible. In fact, during the depths of the Asian financial crisis more than 10 years ago, our team spent most of its time investigating opportunities in Asia. Furthermore, as recently as 2005, the developing markets constituted more than 9% of the First Eagle Global Fund’s equity exposure and 15% of the First Eagle Overseas Fund’s equity exposure. Deshpande adds, “Today, in addition to our direct exposure to such markets, we estimate that another 5% of First Eagle Global’s foreign stock exposure is indirectly tied to China via non-China-listed companies such as Fanuc.”

Percent of Total Net Assets: Historical Developing Markets Portfolio Weight



Source: Factset, 06/30/2010

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the markets are hot.”*

— Matt McLennan

The developing-market-listed companies that First Eagle follows tend to fall into one of two categories. The first is long-duration asset opportunities and the second is royalty-like businesses. The first category includes very long-lived precious metals mines, such as Industrias Peñoles, a Mexican silver company. First Eagle Gold Fund's Portfolio Manager Rachel Benepe comments, “With mines that have been worked for over a century, Industrias Peñoles can truly be considered long-lived.” In addition, our positions in gold-mining companies from South Africa and Papua New Guinea are further examples of our quest for long-duration assets.

Royalty-like businesses are companies that have the potential to generate high recurring returns on capital because they have a lock on a particular market. Examples include Grupo Televisa, a Mexican broadcaster and leading provider of Mexican content; Thai Beverage, Thailand's leading spirits company; and Genting BHD, Malaysia's dominant gaming company. These businesses generate attractive cash flows while continuing to grow. They exemplify the application of our value approach to developing markets.

A Patient Approach

Given that growth in developing markets can be volatile, we prefer to buy companies during periods of distress, when we can provide liquidity that no one else is willing or able to supply. Today, however, there is no shortage of liquidity flowing into the developing markets. As we see it, investors are paying a premium to buy the new economy when value is more likely to be found in the old economy.

“The first and most important thing to us is to avoid permanent impairment of capital,” McLennan reiterates. “We expect that many developing markets will face choppy seas at some point in time. That is why we prefer to invest with a valuation margin of safety and why we are prepared to wait patiently for the opportunity to do so. We like to buy businesses that either have very enduring characteristics—such as scarce real assets—or that have a strong lock on a particular market that we believe will enable them to generate positive free cash flow as they continue to grow. As disciplined value investors, we believe we best serve our clients by keeping our heads cool whenever the markets are hot.”

Average Annual Returns as of 06/30/2010

	YTD	1 Year	5 Years	10 Years	Expense Ratio
First Eagle Global Fund – Class A (without sales charge) (SGENX)	-1.43%	15.39%	7.25%	11.94%	1.19%
First Eagle Global Fund – Class A (with sales charge) (SGENX)	-6.35	9.62	6.16	11.36	
First Eagle Overseas Fund – Class A (without sales charge) (SGOVX)	0.15	14.69	7.46	11.91	1.20%
First Eagle Overseas Fund – Class A (with sales charge) (SGOVX)	-4.85	8.95	6.37	11.34	
First Eagle Gold Fund – Class A (without sales charge) (SGGDY)	10.07	33.21	21.14	24.16	1.26%
First Eagle Gold Fund – Class A (with sales charge) (SGGDY)	4.57	26.55	19.90	23.52	
	YTD	1 Year	5 Years	Since Inception 09/04/01	Expense Ratio
First Eagle U.S. Value Fund – Class A (without sales charge) (FEVAX)	-2.29%	13.95%	3.85%	8.26%	1.26%
First Eagle U.S. Value Fund – Class A (with sales charge) (FEVAX)	-7.18	8.25	2.79	7.63	

The performance data quoted herein represents past performance and does not guarantee future results. Market volatility can dramatically impact the fund's short-term performance. Current performance may be lower or higher than figures shown. The investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Past performance data through the most recent month end is available at firsteaglefunds.com or by calling 800.334.2143. The average annual returns for Class A Shares "with sales charge" of First Eagle Global, First Eagle Overseas, First Eagle Gold and First Eagle U.S. Value Funds reflect the maximum sales charge of 5.00%.

There are risks associated with investing in funds that invest in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. Investment in gold and gold related investments present certain risks, and returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets. Funds whose investments are concentrated in a specific industry or sector may be subject to a higher degree of risk than funds whose investments are diversified and may not be suitable for all investors.

The holdings mentioned herein represent the following percentage of the total net assets of the First Eagle Global Fund as of June 30, 2010: China Mobile Ltd. 0.00%, Tata Motors Ltd. 0.00%, Jaguar 0.00%, Sino-Tech International Holdings Ltd. 0.00%, Fanuc Ltd. 1.89%, Nestle India Ltd. 0.00%, Nestle S.A. 1.26%, Industrias Peñoles 0.92%, Grupo Televisa S.A. 0.81%, Thai Beverage PLC 0.00%, Genting BHD 0.60%. The holdings mentioned herein represent the following percentage of the total net assets of the First Eagle Overseas Fund as of June 30, 2010: China Mobile Ltd. 0.00%, Tata Motors Ltd. 0.00%, Jaguar 0.00%, Sino-Tech International Holdings Ltd. 0.00%, Fanuc Ltd. 1.87%, Nestle India Ltd. 0.00%, Nestle S.A. 1.48%, Industrias Peñoles 0.93%, Grupo Televisa S.A. 1.01%, Thai Beverage PLC 1.09%, Genting BHD 0.60%. The portfolio is actively managed and holdings can change at any time. Current and future portfolio holdings are subject to risk.

The commentary represents the opinion of the Global Value Team Portfolio Managers as of June 2010 and is subject to change based on market and other conditions. The opinions expressed are not necessarily those of the firm. First Eagle Investment Management, LLC (FEIM) became investment adviser to the Funds commencing January 1, 2000. **These materials are provided for informational purposes only.** These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Any statistics contained herein have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. **The views expressed herein may change at any time subsequent to the date of issue hereof.** The information provided is not to be construed as a recommendation or an offer to buy or sell or the solicitation of an offer to buy or sell any fund or security.

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