Amwal Investment Outlook is a periodical report that we author, to share with investors our analysis and views on expected returns and valuations in Qatar and regional markets.

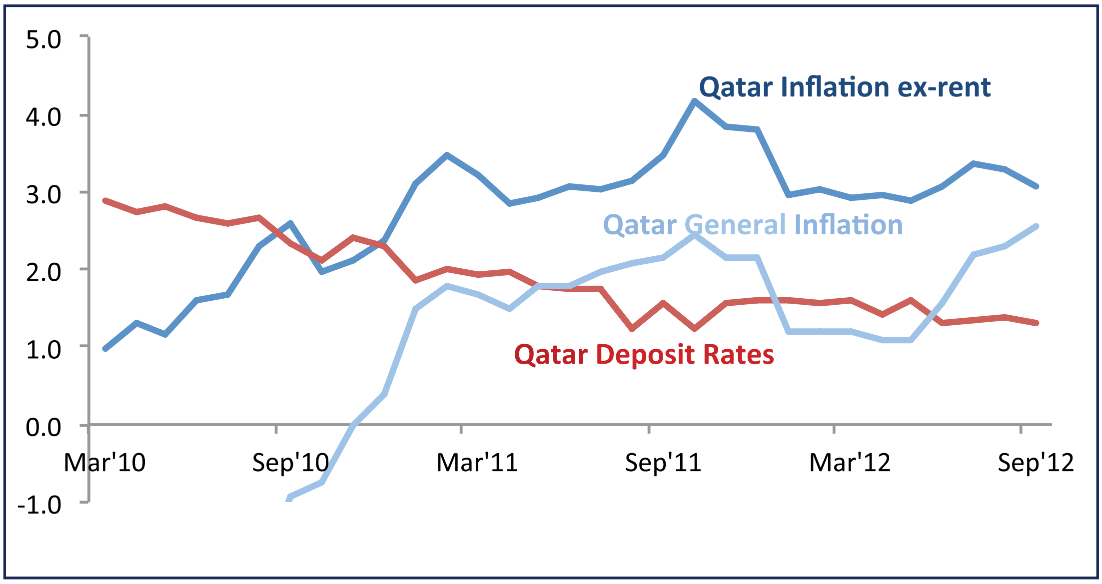
Warren Buffett recently said "The main risk in investing comes from not knowing what you are doing."

In essence, this is the risk of not knowing future events. By analyzing businesses and their key drivers, investors can minimize the impact of the unknown and aim to profit from price fluctuations. Any investment made without truly understanding the underlying drivers of a company's future prospects is speculative and, in some respects, a gamble. At Amwal, our investment research focuses purely on proprietary fundamental analysis.

With this preface, we share in this edition, our analysis of expected returns on Qatar equities, and compare it with fixed return investments (bank deposits and bonds).

Fixed Return Investments – Beware of Inflation

Currently bank deposits in Qatar yield about 1.75%. This has been declining steadily in the last two and a half years. On the flipside, Qatar's inflation has been steadily increasing, with general price inflation recently reported at 2.6%. Excluding rent (which has a rough weight of 30%), Qatar's inflation is around 3%.



Source: Qatar Central Bank

Deposit rates are currently below both inflation measures, making bank deposits a poor investment choice for the medium or long term. In other words, the real value of money placed on deposits is declining due to higher inflation.

The key question investors need to ask themselves is whether funds invested in deposits have been consciously set aside for actual short term needs.

To illustrate, if funds sit in bank deposits for five years without actual being used in the short term, the cumulative return will be a mere 9% at current deposit rates. In comparison, certain Qatari stocks currently trade at similar one-year dividend yield.

Equities – Stock Selection is Key

Equities work as a much better hedge against inflation in the long term, especially when the underlying businesses possess the ability to pass on price increases to their customers. Equities are not suitable as short term investments, as their price is subject to short term fluctuations from a variety of factors such as liquidity, news flow and sentiment. Over the long term however, unless current valuations are very unattractive, or the fundamental outlook of the company or economy changes very materially, stock prices tend to bounce back from short term losses.

In some respects, equities are similar to bonds, with two notable differences (1) their maturity is indefinite, and (2) coupons (i.e. dividends) are uncertain but generally a function of profits.
Although many investors do not take advantage of it, indefinite maturity is actually a very important advantage of equities, particularly in dealing with risk. For instance, when a stock's price goes down, investors who still believe in its future profit prospects do not have to sell it and realize losses. They can instead hold it and assuming business prospects do not change, the stock price will eventually recover.

We strongly believe investing in equities has to be for a long term horizon and stock selection is key. At Amwal, we do this first by carefully analyzing both valuations and earnings prospects, and then by closely monitoring any changes to the business prospects and the stock price. While this sounds like common sense, the market does not always function this way. Investors often sell merely because others are selling, disregarding the robust benefits of long term investing. Their conviction flags and they display a poor understanding of fundamental stock valuation. A stock should be sold if its long term earnings prospects have materially deteriorated in relation to its valuation, but most other reasons for selling tend to be noise.

Source: Qatar Central Bank

In the real world, if the price of a car you intend to buy falls, you would not be scared to buy it. On the contrary you might probably consider buying two. In the financial world, investor psychology often works the other way. When the price of a stock drops sharply, investors panic and sell. This is largely because they do not know whether the company's business prospects have changed or not.

Outlook for Qatar Economy and Corporate Earnings

If one looks at the last ten years, Qatar has seen very strong economic growth, and as a result, profit growth for businesses. During this period, GDP grew tenfold from around USD 20 billion to an estimated USD 190 billion. A large part of this was on the back of increase in energy and petrochemicals production capacity and prices, but also growth in other sectors. Going forward, economists are estimating 5% average real growth (around 7.5% nominal growth) for the next three years. We expect earnings growth close to 10% for this period.

Currently the market is valued at an earnings yield of around 9.1% based on 2012 earnings, although 2012 was not a particularly good year for some sectors like banks due to margin pressures. This earnings yield is obviously very attractive compared to Qatari deposit rates. To compare, the average earnings yield of US companies is currently around 7.5%, China is around 10% and the closest comparable market Saudi Arabia is around 8%. So as long as earnings do not decline significantly, equities are very attractive.

The main driver of corporate profits in Qatar is government spending and energy prices. Government spending is also to some degree driven by government revenues, which are in turn dependent on energy prices in the long run. In the coming 3-5 years, spending is also set to receive a significant boost from expenditure that the government has committed itself to, notwithstanding short term fluctuations in oil prices, in preparation for Qatar's hosting of the 2022 FIFA World Cup.

In fiscal 2012, the government spent about QAR 120 billion in current expenditure, and around QAR 50 billion in "development expenditure". This compares with total revenues of around QAR 250 billion. Taking a long term view, barring a very sustained and significant drop in oil prices, spending will not change materially, and neither should the business prospects of Qatari companies.

Next Issue: *Focus on Oil*