

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Generating Free Cash Flows in Emerging Markets



LEWIS KAUFMAN, CFA, is a Managing Director and Portfolio Manager of the Thornburg Developing World Fund and Co-Manager of the Thornburg International ADR portfolio. He joined Thornburg Investment Management, Inc., in 2005 as an Associate Portfolio Manager. In 2006, he was promoted to Co-Portfolio Manager for the ADR portfolio and named Managing Director. Before joining Thornburg, Mr. Kaufman held various investment-related positions at Morgan Stanley and Citigroup. He holds an MBA from Duke University's Fuqua School of Business and graduated cum laude from Colgate University with a B.A. in English.

SECTOR — GENERAL INVESTING

TWST: Please begin with a brief introduction to Thornburg Investment Management and tell us a bit about your role there.

Mr. Kaufman: I joined Thornburg in April 2005 having previously worked at Morgan Stanley and Citigroup. What really drew me to Thornburg was the global generalist approach. I think that there is a natural tendency in this business for us to be too narrow in our investment approach. That is, we may focus on a particular industry and maybe not do as good a job of looking at the industry in the context of what else is out there. So from the ground up, from our most Junior Analysts to our most Senior Portfolio Managers, we want all of our investment professionals to be able to put investment opportunities in context. For example, most investors that would go to Brazil would see the 15 mining companies and the five energy companies and really have a natural resources sort of focus. We have a skill set where we not only go down there and see the mining companies and the energy companies, but we also see the banks and the retailers and the central bankers and the Internet companies and whatever else might exist in Brazil. Through that process we're able to really scour the world across sectors,

across industries for the best opportunities out there. If the end goal is to know the greatest number of facts about a company or an industry, maybe that's not a game we'll win. If the end goal is to make the best investments and to be able to put investments in context, that's something we're very much focused on doing.

Another important aspect of Thornburg is the three-basket approach. We structure most of our equity portfolios according to three baskets: basic values, consistent earners and emerging franchises. While we typically have a good balance across those three baskets in our portfolios, it's not necessarily a number we manage to. Rather, it's a construct for thinking about value in different ways. What I mean by that is sometimes there is very good value in a stock that is, let's say, low multiple of earnings. Other times there's better value in companies that have much higher multiples of near-term earnings but where there is a more durable business model or where the duration of cash flows is longer or where growth prospects are better. So we want to be able to think about value in different ways. We want to be able to strike a balance between promise and discount. I think a lot of firms do one of those things at the exclusion of the other, and we try to structure portfolios in a manner that does both.

The last thing I would emphasize about Thornburg is that we are not a marketing-driven firm. We are an investment-driven firm. What I mean by that is that every product that's been started here at Thornburg has not been started because we think we can sell it. Rather, it's been started because we believe we can deliver on an excellent investment program to our clients and because the portfolio managers believe in the product. So we're an investment-driven shop, not a marketing-driven shop. I think the evolution of our product development reflects a focus on products that we believe in and what we think we can do well.

In 1995 we launched our first equity product, the Thornburg Value Fund, and by 1998 that portfolio was approximately one-third invested in international stocks. We took a look at that and said, "We're pretty good at this; it probably makes sense for us to have a portfolio that's specifically focused on international investments." And so in 1998 we launched the Thornburg International Value Fund, which is now our biggest product. In 2002, we had an International Fund that was taking us to some interesting parts of the world where income opportunities were perhaps out-sized relative to what you might find in the developed world. We felt that we could deliver a very attractive income-oriented strategy to our clients focused on growing dividends per share on a global basis, and so we launched the Income Builder Fund in 2002. Then most recently, we were running the International Value Fund at approximately 20% emerging markets, so we made the decision to launch the Developing World Fund in December 2009. That is broadly an overview of Thornburg.

World Fund is a low-risk strategy. It's not, but we are focused on achieving good returns for the level of risk that we're taking. Let me describe a little bit how we try to do that. The first way is through a focus on financially sound, free-cash-flow-generative companies with business models not predicated on leverage. Why is that important? A few different reasons. First, volatility tends to be more pronounced in emerging markets. Certainly we've seen that recently, and if you have business models that are going to have to tap the capital markets during a period of duress, bad things can happen to shareholders. Let's say you have a company with a capital budget based on a certain level of cash generation and the fundamental outlook deteriorates for that company. It may be that they need to issue equity capital at a very low price and that they dilute shareholders on a per share basis. When you look at U.S. banks at the center of the 2008 global financial crisis period that trade for \$5 versus previous highs of, say \$50 or \$60, that primarily reflects them having to issue equity at very unattractive prices because the business needed capital at exactly the wrong time. That is precisely the type of situation that we like to avoid. We like to focus on businesses that are going to generate capital in a way where they're not going to have to tap the equity capital markets in a period of duress.

Second, if you have a debt-driven business, oftentimes you can borrow say at 7%, 8% in Mexican peso and you can borrow at 5% in the dollar bond market. If you are a Mexican company and you have a peso-denominated revenue stream and you incur liabilities in U.S. dollars, that's all fine and well until your currency depreciates — and in fact, that's exactly

Highlights

Lewis Kaufman, CFA, discusses the investment strategy for the Developing World Fund. When investing in emerging markets, Mr. Kaufman pays close attention to local stock performance and currency performance, and he currently favors some financials in a handful of select markets. He discusses specific bank stocks in the Fund, as well as consumer- and enterprise-driven names, and he says the Fund's focus is on financially sound, free-cash-flow-generative companies. Mr. Kaufman also shares insight into getting exposure to the emerging markets via U.S.-based companies.

Companies include: Sberbank (SBER03.ME); Credicorp Ltd. (BAP); Turkiye Garanti Bankasi A.S. (IST:GARAN); Bank Mandiri (Persero) Tbk. (BMRI.JK); Asian Paints Ltd. (ASIANPAIN.NS); Wynne Macau Ltd. (1128.HK); Wynn Resorts Ltd. (WYNN); Totvs S.A. (TOTS3.SA); Oracle Corp. (ORCL); The Coca-Cola Company (KO); Colgate-Palmolive Company (CL); Yandex N.V. (YNDX); Mercadolibre (MELI) and Tencent Holdings Ltd. (0700.HK).

"Like most emerging markets funds, we are focused on long-term capital appreciation in an emerging markets context, but where we feel we differentiate ourselves a little bit is through an additional focus on risk-adjusted returns."

TWST: What is your investment philosophy specifically as it relates to the Developing World Fund?

Mr. Kaufman: Like most emerging markets funds, we are focused on long-term capital appreciation in an emerging markets context, but where we feel we differentiate ourselves a little bit is through an additional focus on risk-adjusted returns. I don't want to suggest in any way that the Thornburg Developing

what's happened not only for some Mexican corporates but broadly across emerging markets. We've had perhaps on average a 15% to 20% decline in most major emerging markets currencies from the recent highs. And so if you're a company with a local revenue stream and U.S.-dollar-denominated borrowings, your interest payments just got 15% to 20% more expensive, and that again is a situation we would like to avoid.

Finally, cost of funding. You might be a company that's dependent on tapping the debt capital markets every six months, every year, and that works well until it doesn't work well. Maybe you're accustomed to issuing debt at 5%, 6%, 7%. And if the market gets risk averse in general, it's going to get all the more risk averse about companies in the emerging markets and the rate that you pay might be prohibitive. Let me just give you a few examples of companies we prefer. We own four banks in the Developing World Fund at present: **Sberbank** (SBER03.ME), the largest bank in Russia; **Garanti** (IST:GARAN), we believe the best privately managed bank in Turkey; **Credicorp** (BAP), perhaps the best bank in Peru; and **Bank Mandiri** (BMRI.JK) in Indonesia. These four banks on average have assets to equity, which is a crude measure of financial leverage, of about 10 times.

1-Year Daily Chart of Sberbank



Chart provided by www.BigCharts.com

Much has been made about the crisis of confidence in European banking. One of the reasons is that European banks on average in general are levered about 25:1, so that's a pretty big disparity in leverage. Another real focus point in the debate about European banks has been funding. Most European banks have loan-to-deposit ratios of perhaps 120%. That is a crude way of measuring a bank's dependence on wholesale funding, and wholesale funding is less sticky, less robust particularly during periods of duress like we're experiencing now.

The four banks that I mentioned have a loan-to-deposit ratio on average of maybe 80% or so, and so they're far less dependent on wholesale funding. You look at those measures of capitalization and those measures of liquidity that I just described, and they are far more attractive for the emerging markets banks in general. What does that all mean? The four banks that I mentioned are generally growing book value about 20% a year. They're doing that with lower levels of leverage, and they're doing that in a sustainable and durable way. The European banks really don't have the same consolidated market share position. In other words, there's a lot more fragmentation, a lot more competition, so in order to achieve double-digit re-

turns on equity, they're having to lever themselves up to drive the return on equity for shareholders. And so when bad things happen, those banks are far less well capitalized to absorb that. Our emerging markets banks may experience share price volatility, but we don't expect them to issue equity. That's really the pond that we want to swim in.

1-Year Daily Chart of Bank Mandiri (Persero) Tbk.



Chart provided by www.BigCharts.com

TWST: In which geographic areas do you see the best developing market investment opportunities, and what are the catalysts creating opportunities in those areas?

Mr. Kaufman: When I think about emerging markets investments for U.S.-dollar-based investors, I think of two broad components: the local stock performance and the performance of the currency. When I think about currencies, there are a few broad things that I like to focus on. One is the relative fiscal health of a particular country, the second is the trade position of a given country and the third is the capital flows of a given country. I think emerging market countries as a group generally compare favorably to developed market countries. So if you look at the fiscal positions of most emerging markets, you've got government debt to GDP levels of generally between 20% and 60%. Most major developed markets are close to 100% at this juncture. That's important because currencies tend to reflect investors' relative feelings about the fiscal outlooks for various countries, particularly in periods of risk aversion. Trade balances are important because a trade surplus will put upward pressure on a currency and a trade deficit will put downward pressure on a currency. When I think about the countries that I like, one of the things that I will look for is situations where the country has a competitive trade advantage either with manufacturing, as with China, or natural resources, as with Russia. Emerging markets generally compare favorably on trade.

Capital flows generally take the form of two things: portfolio flows, such as stock and bond flows, and foreign direct investment. Foreign direct investment is the more stable of those two things, but either one tends to put upward pressure on a currency. So if you look at a country like Japan, Japan has been ex-

periencing foreign direct investment as a percentage of GDP of about 0.5% for the last 10 years. You contrast that to countries like India, where there's a lot of foreign direct investment despite capital controls to pursue domestic demand in India, and you look at a country like Brazil, where there's a lot of foreign direct investment as the natural resources sector grows. Those dynamics put upward pressure on those emerging markets currencies. Similarly, if a portfolio manager like me wishes to purchase Brazilian stocks or bonds, he has to go out into the market, sell his dollars and buy Brazilian real. That physical exchange pushes up the exchange rate. All things being equal, we would certainly prefer to invest in countries with upward structural pressure on their currencies.

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One country that I would like to highlight is Indonesia. When people think about the large economies in Asia, they're typically focused on China and India. And rightly so, those are two countries with a billion people. So if you have a good business model there, it has a potential to be replicated across a large number of people. Indonesia is another very large country. Now, it's not a billion people, but the population is approximately 235 million people. And so it has that same positive characteristic of being able to support a business model across a very large number of people.

Now, what I like about Indonesia relative to India is the fiscal situation, balance of payments and currency dynamics for the country relative to a place like India. So for example, you're talking about two very fast growth countries, two countries with relatively high inflation, but when I look at the trade surplus for Indonesia, it's running at about a positive 1% per year reflecting its natural resources in coal, palm oil and to a lesser degree some manufacturing capability. You contrast that to India, where current account projections are running at about negative 3.7% clip for

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2011. On the fiscal front, government debt to GDP in Indonesia is only 31%; government debt to GDP in India is 72%. Budget deficit is roughly nil in Indonesia, and in India it's running at mid-single-digit clip, maybe negative 5%. So if you look at the underlying economic fundamentals, if you examine the balance of payments, they're very much in favor of Indonesia, and you can see that in the foreign exchange reserve accumulation at the Indonesian central bank. So when I take a long-term view, a medium-term view of Indonesia relative to India — all things being equal — if I find a stock in Indian currency and a stock in Indonesian currency, I'm much more confident as a dollar-based investor in the long-term structural outlook of Indonesian rupiah

relative to the Indian rupee for all the reasons I mentioned.

Now, the other anomaly as compared to India and Indonesia is that India is very well recognized as a domestic-demand story. That's very important to investors at a time when people are fearful of the export outlook to Europe and the U.S. So India is a stock market that is viewed as relatively defensive in a global context. The unfortunate news for investors is that Indian stocks generally reflect that. So we have a company we're very optimistic about the long term called **Asian Paints** (ASIANPAIN.NS) in India, but it's hard to get excited about the valuations certainly in the context of what else is out there. We contrast that to most of our Indonesian holdings, where we also have a good domestic demand

outlook, but where we have lower valuations, comparable growth prospects and a better currency outlook. So as dollar-based investors, that's a market we're very much excited about.

One final point on currency: When I take a step back and look at the European sovereign debt crisis, it really highlights for me that investors have been perhaps too narrow in their focus on dollar diversification. So if you rewind 10 years, there's really been a movement toward international investing, toward diversification, toward getting money out of the dollar. And that's all fine and well — and you may have a relative preference for the euro or the dollar — but I think the sort of traditional line of thinking has been that if you get your client's money out of the dollar and put it into the euro, you're doing a good thing. That may or may not be true, but what I'm arguing for is to extend the notion of dollar diversification to include currencies in the developing world. Why? For all the reasons that I mentioned. The fiscal outlooks are better, the trade positions are better, reflecting either natural resources endowment or a labor cost advantage. And the capital flows are better, reflecting continued movement of capital to places where returns are better.

Those are trends that I expect to continue, and I think they certainly argue for a broader and more diversified approach to currencies that includes the emerging markets.

TWST: You mentioned a couple of holdings in the financial sector. Would you give us some additional examples of holdings from other sectors that are representative of Thornburg's approach?

Mr. Kaufman: Sberbank is unique. It has 53% market share of deposits in Russia. I'm not aware of a bank with anything close to that market share position globally. It's got 30% or so market share of most lending products. What that market share endowment means is that **Sberbank** doesn't have to stretch too far

to drive returns on equity for shareholders. Why? Because the markets are so consolidated that **Sberbank** enjoys a high degree of pricing power across most of its banking products. It has extremely low levels of leverage. It has a very limited need to access wholesale funding. So it's mostly immune to a lot of the issues that plague the European banks. In terms of its lending outlook, we think the credit outlook for Russia is certainly favorable or compares well to many emerging markets. In a normal economic environment, **Sberbank** has shown a propensity to grow its loan book at say 25% a year, a little slower in corporate, a little faster in retail. Household debt to GDP is under 10% reflecting limited access to credit during Soviet times. So you've got a bank that's very well capitalized, that's very well funded, that has an unmatched market share position. That means that it doesn't have to stretch too far to drive returns for shareholders, and it's pretty inexpensive for what it is. **Sberbank**, just on consensus estimates for 2011, is trading for 5.1 times earnings and 1.25 times book value, and that is pretty inexpensive in a global emerging markets banking context. So **Sberbank** is a company that we think is well positioned to grow book value at say a 20% plus rate over a very long and sustainable period of time.

Another company we like is **Wynn Macau** (1128.HK), the Macau subsidiary of **Wynn Hotels** (WYNN). The reason that I highlight **Wynn** is I think it speaks to the ever-increasing purchasing power of the Chinese consumer. Here is an interesting way of thinking about Chinese purchasing power over time. U.S. disposable income has grown 41% in

1-Year Daily Chart of Wynn Macau Ltd.



Chart provided by www.BigCharts.com

aggregate from 2000 to 2010 in nominal terms — in other words, including inflation. Now the oil price over that same time period has increased in aggregate by 241%. So our income has increased 41%, the oil price has increased 241%. I think it's fair to conclude that oil is relatively less affordable for us. Now, Chinese disposable income, when you factor in currencies and when you factor in inflation, has increased at a 295% clip over that same period. Said differently, oil is actually cheaper to the Chinese consumer than it was 10 years ago, despite the fact that oil prices increased from \$35 to \$85.

I think that's a pretty powerful example of the increased purchasing power of the Chinese consumer, which really comes from two things: disposable income growth and currency appreciation. I think at the margin, the Chinese government takes a look around at the underlying inflation dynamics in China, which are not favorable reflecting labor cost pressures and urbanization and all the things that you read about. So I think at the margin the government is going to be more inclined to do things that make Chinese consumers feel more confident about their future, including letting the Chinese renminbi appreciate. I believe it will be more inclined to increase social spending on health care and pension reform and those sorts of things. And I think that, combined with real disposable income growth in China, is going to lead to a transition away from this sort of investment-led growth, this infrastructure-driven growth in China and toward much more of a domestic-demand orientation.

I think **Wynn Macau** is a great vehicle for participating in that growth. I think it very much is in keeping with the financial characteristics I described early in our conversation, namely financially sound free-cash-flow-generative companies. **Wynn Macau** financed its casino and its properties in Macau several years ago. And that has been paid for, and now the company is just enjoying increased capacity utilization and better spending in that casino asset over time. The other reason I like **Wynn** is that it is a scarce asset. The Macanese government has set a limit on the capacity growth that it will allow in gaming in Macau. There is something called table cap, which will restrict the new supply that can come on the Macau market. What that means in practical terms is that the new supply of hotel rooms will be relatively finite while tourism will grow. Most projections I've seen suggest 15% annual growth in tourism over the next five years in China. Not only will they come to Macau, but they are going to have a lot more money to spend because of the disposable income trends I identified. So I think **Wynn** is a great vehicle for participating in domestic consumption because supply is relatively scarce and demand is going to be increasing at a rate that's significantly in the double digits.

One last name I would highlight is **Totvs** (TOTS3.SA), which is a Brazilian software company, very similar to what you'd see with the **JD Edwards** (ORCL) in the United States, sort of a small business-business software company, if you will. Overall, we're constructive on the economic outlook there. But if you read about the situation in Brazil, you read about a couple of things right now in particular that aren't favorable. The first is inflation. **Totvs** is a software company that gets about 50% of its revenues on a recurring basis in the form of maintenance contracts. What's unique about or unusual about the maintenance business in Brazil is that it's inflation linked. So here we've got an environment where the inflation backdrop was already precarious. Now the government has lowered interest rates, which has led to a period of currency depreciation, which exacerbates the inflation outlook. Here is a company that is essentially hedged. That's one reason we like **Totvs**.

A second reason is its lack of consumer credit exposure. **Totvs** is a company that's focused on small-business spending in Brazil. While we actually don't think the Brazilian consumer is overleveraged, **Totvs** allows us to participate in Brazilian economic growth and domestic consumption without making a bet one way or the other on the Brazilian consumer. **Totvs** also has potential to benefit from new business formation. As the economy grows, there are lots of entrepreneurs springing up across Brazil. You can imagine an entrepreneur gets better access to credit and those sorts of things, starting a business is the logical thing to do.

1-Year Daily Chart of Totvs S.A.



Chart provided by www.BigCharts.com

business value — and in turn, higher stock prices. So you can have periods of capital markets volatility, you can have share prices that ebb and flow. Having a business that does not destroy value on a per share basis, I think, is a key way of differentiating returns over time and really compounding value for shareholders over time. So that focus on financially sound free-cash-flow-generative companies with business models not predicated on leverage, I think, is a useful construct.

A second thing that's really important from a risk perspective is maybe not getting maniacally focused on labels. I think there is a tendency in our business to focus on what the indexes say we should do. We take a different approach. For example, our fund invests in what we call developing-country issuers. A developing-country issuer for us can be one or two things: a company based in an emerging market or economically tied to one, and it's the second group that really speaks to what I'm talking about. At present we have about 12% of our fund allocated to companies that we consider to be developing-country issuers but that are based in a developed market like the U.S., Canada or the U.K. Why would we do that? Because we're focused on pursuing the best risk-adjusted return irrespective of domicile as long as the underlying economic exposure is good, as long as the economic exposure is tied to emerging markets.

One of my favorite examples is the **Coca-Cola Company** (KO), and we own **Colgate-Palmolive** (CL) as well. **Coke** and

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Tax collection is also interesting. The Brazilian government in its attempts to tighten up the purse strings a little bit in Brazil is cracking down on tax evasion. One of the ways that it can do that is by imposing on small businesses the requirement to implement small-business software, accounting software, that sort of thing. And **Totvs** is a direct beneficiary of that. Overall, **Totvs** should benefit from economic growth in Brazil but also circumvent many of the unfavorable aspects of Brazil's economy. It also has these company-specific elements that may allow it to transcend some of the near-term challenges that Brazil faces as a country.

TWST: What are the primary risks associated with Thornburg's investment strategy, and would you tell us a bit about how those risks are managed?

Mr. Kaufman: We are particularly focused on risk-adjusted returns. This notion of financially sound, free-cash-flow-generative companies is really important in an emerging markets context, and all the more important in the type of capital markets environment we face now because you're going to have share prices that ebb and flow. Ultimately, underlying business development, growth in earnings per share, growth in book value per share, whatever metric you prefer, underlying economic growth is ultimately the thing that is going to drive

Colgate are not stocks that might be foremost in your mind when you think about emerging market stocks, but actually roughly half of their businesses are linked to the emerging markets. And what's really interesting about that is when you look at the long-term returns of the emerging markets index and you compare them to the long-term returns of **Coke** and **Colgate**, 10-, 15-year periods, the returns of **Coke** and **Colgate** are correlated and compare favorably with those of the emerging markets index, but they get there with a lot less volatility. So when you think about the very notion of risk-adjusted returns, it's returns relative to the level of risk that you are taking, and we think the risk-adjusted return profile of companies like **Coke** and **Colgate** is very competitive with the overall asset class on a long-term basis, even if our absolute return expectations might be lower.

One last thing that I would highlight is the three-basket approach. Basically, we want to have the flexibility to pursue the best risk-adjusted returns irrespective of style. Some of the best values we're finding right now in the entire stock market are actually companies with very high near-term multiples of earnings where we think the intrinsic value proposition is compelling. We have investments in several Internet companies, for example, across the emerging markets: **Yandex** (YNDX) in Russia, **MercadoLibre** (MELI) in Latin America and **Tencent** (0700.

HK) in China. These are companies that are growing fast, are dominant in their markets, have little to no capital in the business and generate an awful lot of free cash flow. We think they are some of the best investments out there. A simplistic approach to value that only looks at, for example, low p/e multiples might preclude opportunities that exist in other parts of the stock market. We like to be like a chameleon. We like to have the flexibility to go where the value is, and the three-basket construct really allows us to do that.

TWST: Thank you. (MES)

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