INVESTING IN ISRAEL

The Impact of Geopolitical Risk

Updated September 2014:

Including analysis of Operation Protective Edge

BlueStar
GLOBAL INVESTORS

EFFICIENT EXPOSURE TO COMPLEX MARKETS

FOREWORD

BlueStar Global Investors develops investment solutions and research on Israeli and Middle Eastern/Mediterranean markets and economies. This is an updated version of our inaugural “BluePaper,” originally published in February 2014, on a topic that is highly relevant to prospective investors in Israeli equities. We contrast the perception of risk in Israeli markets versus the reality of economic resilience and correlations with global rather than local events.

Our conclusion supports an allocation to Israeli equities based not on emotions, but on empirical data and economic performance.

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INTRODUCTION

Conventional wisdom suggests that living in a dangerous neighborhood can negatively impact your finances. High-risk areas may result in lower property values and higher insurance premiums. Following the same logic, one might assume that the residents in a rough neighborhood would be more likely to cower in their homes than to venture out and help build a vibrant, innovative local economy.

You may be wary of putting money into such a neighborhood due to fears that your investment would be at risk.

Well, what about when it comes to equity investing, where conventional wisdom also seems to suggest that investing in "risky" parts of the world is not good for your portfolio?

Nowhere is this frame of reference more relevant than when it comes to investing in Israel, where recent investment outcomes surprise even many experienced investors.

HISTORICAL PERSPECTIVE: A VERY ROUGH NEIGHBORHOOD

Israel has fought six major wars in the 66 years since gaining independence in 1948. And, when it hasn't been engaged in full-scale combat against one or more of its less than friendly neighbors – only two of which actually recognize its right to exist – the

country has been subject to a steady stream of terrorist attacks from both outside and within its borders.

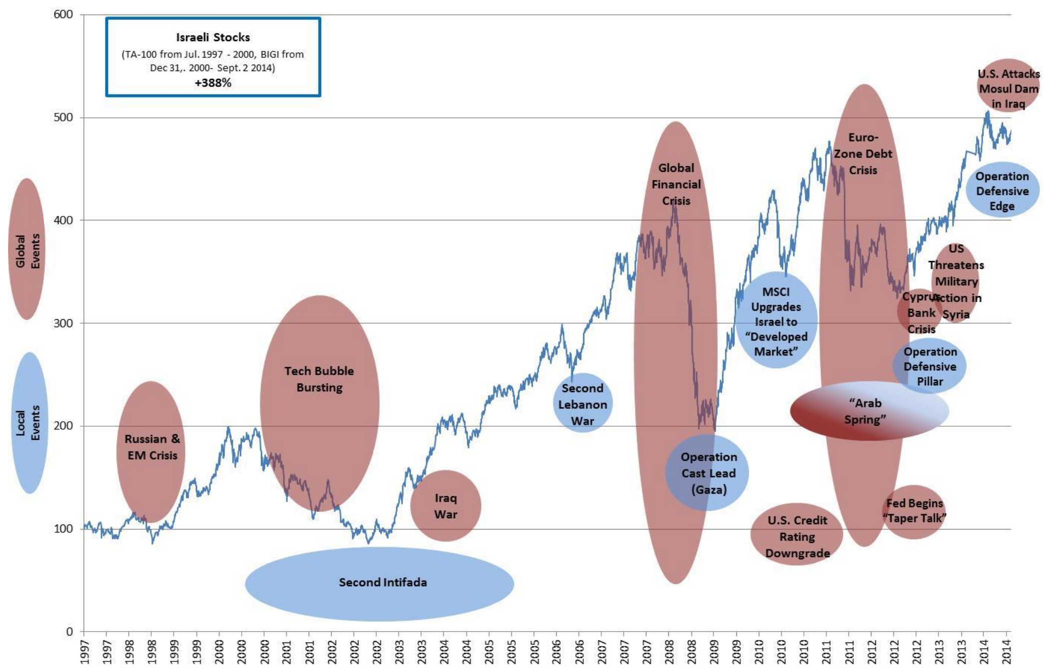
How has a country subject to constant security threats been able to develop a vibrant, diversified economy? How has Israel posted enviable rates of economic growth over the past twenty years and, in the process, become a recognized global leader in certain industries? Similarly, what has driven the strong returns in Israeli equities over the past fifteen years — returns that have surpassed those of popular equity market benchmarks including the S&P 500 and the MSCI EAFE developed market indexes? These compelling absolute and relative returns, highlighted in the chart below, suggest that Israeli equities have delivered for investors despite the substantial geopolitical risks the country faces.

BIGI vs. Global and US Benchmarks: Long- Term Total Returns

	YTD 6/30/14	Q2 '14	Q1 '14	1yr.	3yrs.	5yrs.	10yrs.	15yrs.	Inception[1]
ACWI	6.50%	5.23%	1.21%	23.58%	10.85%	14.88%	8.02%	4.88%	8.29%
EAFE	5.14%	4.34%	0.77%	24.09%	8.59%	12.27%	7.42%	5.03%	7.27%
MSCI EM	6.32%	6.71%	-0.37%	14.68%	-0.06%	9.58%	12.30%	9.21%	8.34%
S&P 500	7.14%	5.23%	1.81%	24.61%	16.58%	18.83%	7.78%	4.35%	9.35%
MSCI Israel	21.57%	2.41%	18.71%	32.52%	0.74%	4.61%	6.47%	6.87%	6.39%
TA-100	5.03%	-0.58%	5.64%	24.16%	3.88%	12.32%	10.67%	8.83%	7.89%
TA-25	5.72%	0.78%	4.90%	23.81%	4.15%	12.97%	12.56%	9.58%	8.19%
BlueStar	5.02%	-1.60%	6.72%	25.95%	5.41%	13.64%	11.45%	-	-

*Annualized
Inception Date: Dec. 1992
Source: BlueStar Global Investors LLC
Jun. 30, 2014
**MSCI Israel Uncapped Index

Rather than being vulnerable to local and regional geopolitical events, the Israeli equity market has, over the past 16 years, been more closely tied to major global trends and economic shocks. To put it another way, the Israeli market has acted like other developed stock markets in this age of economic and geopolitical interdependence. It therefore surprises many investors to learn that Israeli equities gained 388% from 1997 through August 2014 even though the country faced major security threats during that time, including the Second Intifada (Palestinian terror campaign), a full-scale war (Second Lebanon War), and three more localized conflicts in the Gaza Strip (Operation Cast Lead, Operation Pillar of Defense and Operation Protective Edge). The chart above highlights how the Israeli market fared much worse during periods of global economic stresses (e.g. the bursting of the technology bubble in the early 2000s and the global financial crisis of 2008-2009) than during periods of regional turmoil (blue highlights).



SPECIFIC RISKS: THE POTENTIAL IMPACT OF GEOPOLITICAL EVENTS ON ISRAEL'S ECONOMY AND CAPITAL MARKETS

Before looking at several historical examples, it is useful to review some of the potential impact that geopolitical events could have on Israel's economy and capital markets.

Unfortunately, broad-based Israeli stock market indexes only began calculation in the early 1990s, so it is impossible to analyze the impact of Israel's most recent "major" wars (the Six Day War in 1967, the Yom Kippur War in 1973 and the First Lebanon War 1982-1985) on its stock market[1]. For that we must look at more recent, limited conflicts such as the Second Lebanon War (July 2006) and Israel's first invasion of the Gaza Strip, known as Operation Cast Lead, (December 2008 – January 2009.)

It is informative to look at the scope of costs that the Israeli economy incurs as part of any broad conflict. These go well beyond the annual costs of maintaining its military readiness and its defense budget, which is currently estimated at $14.5 billion or 5.7% of GDP. [2]

For Israel--which maintains a small standing army and relies heavily on reservists in times of conflict--the cost of war transcends the basic cost of military hardware and manpower. Indeed, due to the reliance on reserves, which can be called up at a moment's notice for long periods of time (measured in weeks and months), it is the broader economy in general, and individual companies that directly bear part of the cost of conflict.

When full mobilization is required, companies lose key employees for an undefined length of time. When a good part of its workforce is on military

[1] Though precise data is not available, one economist has estimated the total cost of the Second Lebanon War as $5 billion. See "The Israeli Economy from the Foundation of the State through the 21st Century, " Paul Rivlin, Cambridge University Press, 2011.

[2] CIA Factbook – 2014.

duty or a company may have to shut down production or R&D due to the threat of rocket attacks, products don't get produced and innovative research may come to a halt. Exports and imports may be impacted if ports and airports are subject to attack or are taken over for military use.

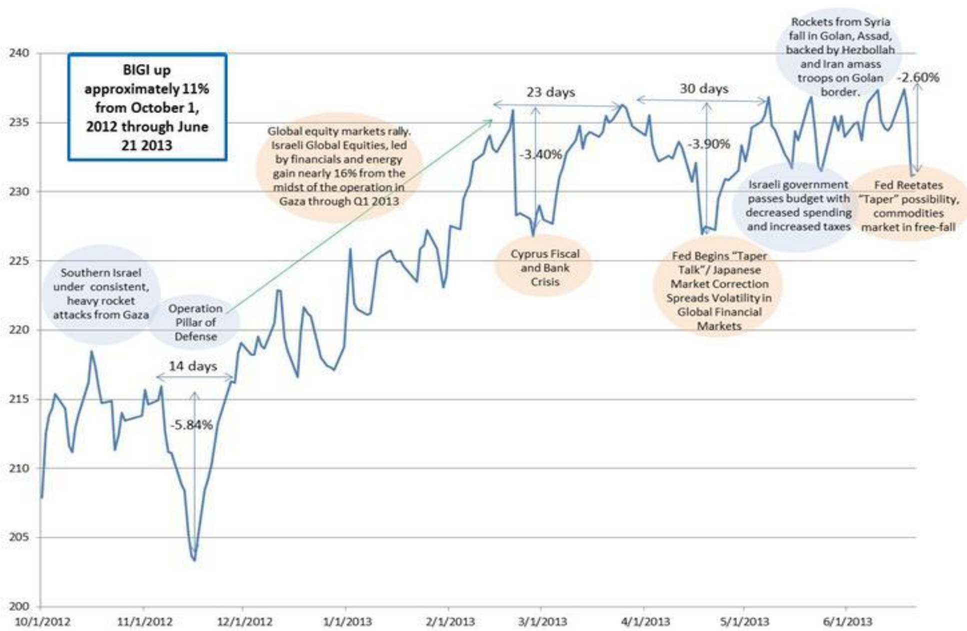
Then, of course, there is the direct impact on markets. These are not just the equity markets, where panic selling may result from a conflict, but also the money markets and international bond markets, where risk premia may rise, increasing the cost of borrowing for the Israeli state and companies alike. An increase in risk premia also negatively impacts the valuation of Israeli companies as it is a key input that analysts use when determining equity valuations.

To some extent, the highly global nature of many Israeli companies helps insulate them from some of these potentially dire circumstances. For example, many companies maintain production and R&D facilities outside of Israel that are capable of taking up the slack from domestic facilities in the case of a crisis. They also maintain logistical alternatives such as an ability to shift ports and/or ship via airfreight. Finally, all companies maintain adequate levels of business interruption insurance to offset the direct costs of such events.

Case Studies: The Second Lebanon War, Operation Pillar of Defense and Operation Protective Edge

As noted previously, comprehensive Israeli stock market indexes data only goes back to 1992 (although some index data goes back to 1987). It is therefore useful to look at three of the country's conflicts since then to gauge the impact of geopolitical events on the local stock market.

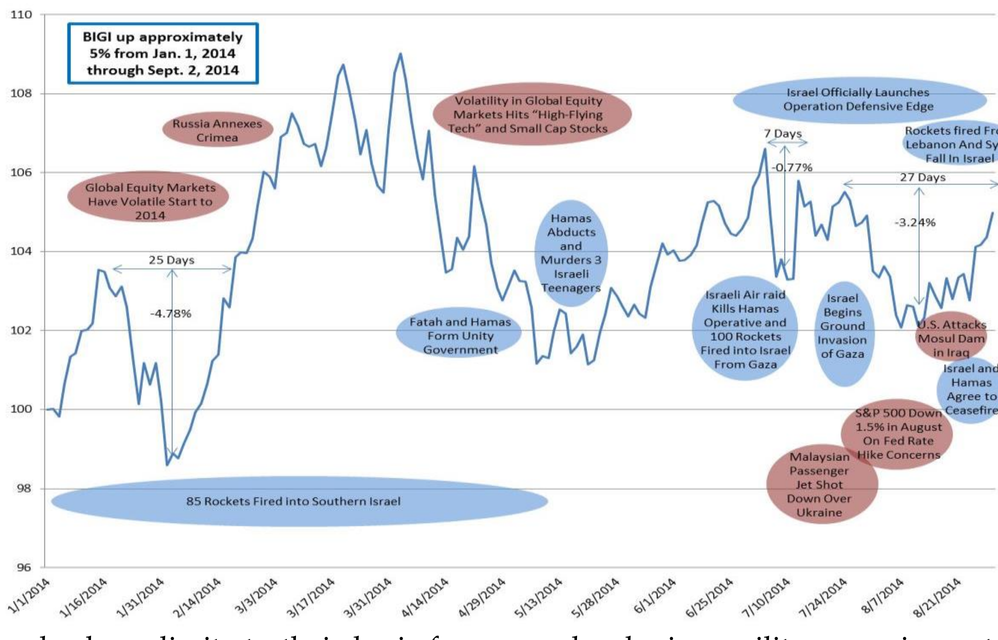
The Second Lebanon War erupted in mid-July 2006, when Israel--provoked by incessant shelling from Lebanon-based Hezbollah guerillas and the kidnapping of two soldiers along the Lebanese border-- invaded Lebanon in a conflict that lasted 34 days. On the first day of the war, the Israeli market (as measured by the benchmark TA-25 index) fell 5.7%. By the third day of the war it was down 13.0%.[3] But, the market began to recover within one week. By the middle of August 2006, one month after the war began, the Israeli market was back to its pre-conflict level. Within six months, the index was trading 16.6% above the pre-war level; on the one-year anniversary of the start of the war it was 35.5% higher.



A similar phenomenon--that of a sharp immediate decline, but a rapid recovery --was evident during the December 2012 Israeli operation in the Gaza Strip, known as *Operation Pillar of Defense*. The TA-25 fell roughly 3% in the two days after the initiation of hostilities, but snapped back in an equally short time before again moving higher.

[3] Source: Bloomberg L.P.

This summer's conflict in Gaza, *Operation Protective Edge*, lasted approximately six weeks and, unlike *Operation Pillar of Defense*, involved the deployment of Israeli ground troops into Gaza. This conflict also marked the first time since the Gulf War of 1990 that numerous rockets were directed at the greater Tel Aviv area as well as points as far north as the Port of Haifa. The economic impact of this conflict was greater than that of *Operation Pillar of Defense* in that consumer expenditures were delayed and there was a more serious blow to the tourism industry. Nonetheless, Israeli equities performed more or less in-line with their Developed Market peers. The chart below shows a sharp initial stock market reaction to the official announcement of a military operation in Gaza. It took just seven days for the market to nearly fully recover from pre-conflict highs. After these initial seven days one cannot accurately attribute negative stock market returns to correlation with other Developed Market Equities or the ongoing conflict in Gaza.



While these episodes have limits to their basis for extrapolation – they were relatively short, localized conflicts that occurred during generally buoyant periods for global equities – they do illustrate the resilience of Israeli equity markets in the face of military conflict and negative news flow.

Israel Reaps a "War Dividend"

Just as living in a rough neighborhood may prompt one to bulk up at the gym or learn a martial art in order to better protect family and property, there have been very tangible benefits to Israel's economy --and companies--from being under constant conventional military and terror threats.

Facing those threats, often in conjunction with broad international political and economic isolation, has fostered a unique level of self-reliance in the Israeli economy. Initially, this manifested itself in developments in agricultural technology as produce, primarily citrus fruit, was the only viable export industry in the country. Although oranges long ago ceased to be Israel's leading export product (though agriculture still ranks fourth) the country remains a global leader in related agricultural technology such as irrigation.

The biggest benefit to the Israeli economy, though, has come through the billions of shekels spent on developing military equipment and technology, both hardware and software, which has been the only way the country could compensate for being vastly outnumbered by its enemies in terms of both manpower and military hardware.

Much of the research and technology development historically done in Israel has, of necessity, focused on military applications. This, in turn, has made

Israel a major global player in cutting edge military hardware and software development, production and sales. Indeed, Israel exports roughly $7 billion of military goods each year, placing it among the top five global military exporters.

However, this number greatly understates the benefit of military R&D and production to Israel's broader economy. Indeed, it is the spin-off of technologies originally developed by and for the Israeli military that has powered Israel's rise into a global hotbed of technology development and the commercial application of once top-secret technologies. Much has already been written of this phenomenon, but it is still useful to review some prime examples.[4] They go a long way to explaining why Israel has the most Nasdaq-listed companies of any foreign country except China, and virtually every major global technology company-- from Intel to Google, from Samsung Electronics to Microsoft-- has a research and/or production presence in Israel. It also goes a long way toward explaining Israel's ability to maintain a wide qualitative military edge over all of its potential military adversaries.

Many, if not most, of the technology savants that Israel has produced, and who started now world-class companies, are alumni of the Israeli military's most secretive units which are focused on intelligence gathering and tasks that require constant technological advancement. The founders of Checkpoint Software (Nasdaq: CHKP) are two such alumni. Their products, work on which began while they were still in the military, provide unbreachable security for corporate computer networks. The company, which was founded in the early 1990s, went public in 1996 and now has a $15 billion market capitalization.

Similarly, the technology for Given Imaging's (a $990 million market cap company in the process of being acquired by Covidien) flagship product, an ingestible "pill-cam" to aid in the diagnosis of digestive track disorders, was developed by a former employee of Israel's Rafael Industries who specialized in developing optical sensors for missiles. The technology used by Ituran Location and Control (Nasdaq: ITRN) to track vehicle fleets and recover stolen cars was originally based on Israel Air Force software and hardware to locate downed pilots.

ENERGY SECURITY: THE LATEST PIECE IN THE PUZZLE

One frequently ignored element of Israel's security picture has been its almost 100% reliance on imported energy. Yes, Israel is a global leader in utilizing solar energy – and developing technologies related to it – but for most of its history as an independent state, Israel has been dependent on imports of crude oil, coal, natural gas and refined oil products to meet its energy needs.

From shortly after independence until the 1979 Iranian Revolution, virtually all of Israel's energy needs were met by imports from Venezuela and then Iran. After the Islamic revolution cut off Iranian exports to Israel, that oil was largely replaced by imports from Egypt, which agreed to sell Israel oil from the Sinai oil fields that Israel returned as part of the post-war peace process. All of this came at a cost, though, particularly after world oil prices spiked in the wake of the Arab oil embargo launched after the 1973 Yom Kippur War. The rising price of oil, as well as higher consumption by the rapidly developing Israeli economy, meant that by 1979 oil imports were costing Israel roughly 12% of GNP, up from 4.6% in 1974.[5]

Clearly, the high cost of energy imports and Israel's lack of resources has cost the Israeli economy billions of dollars over the past 60 years, money that could have been much more productively utilized elsewhere in the economy.

A sea change in Israel's energy situation occurred in 2009 with the discovery of the first of several huge natural gas fields in Israel's territorial waters in the

[4] See, for example, "Start-Up Nation: the Story of Israel's Economic Miracle, " Dan Senor and Saul Singer, New York, 2009; and "Tiny Dynamo: How One of the World's Smallest Countries is Producing Some of Our Most Important Inventions, " Marcella Rosen, New York, 2010.
[5] Rivlin, "op. cit."

Mediterranean Sea. The fields have combined proven reserves of 35 trillion cubic feet of natural gas. Gas from the first operational field, called Tamar, which went online in 2012, already provides 45% of Israel's electricity. Plans call for Israel to be completely self-sufficient for its energy needs and to become a major exporter of natural gas within the region and even globally within the next six years. Although a discussion of the geopolitical implications of this development are beyond the scope of this paper, suffice it to say that Israel's energy windfall is already transforming regional energy politics, as evidenced by the agreement between Israel and the Palestinian Authority regarding the latter's gas purchases and the development of a gas pipeline between Israel and Jordan, among others, to supply that country's large and growing energy needs. We believe, in fact, that given the size of Israeli energy potential, diplomacy in the region might follow economic opportunity and logic.

CONCLUSION:

It is necessary to transcend numerous preconceptions when considering an investment in Israeli equities. Chief among these is the view – usually based on a quick reading of news headlines rather than objective analysis of financial and economic facts – that Israel is a war-torn country in a constant state of conflict and uncertainty. These preconceptions do not reflect the reality on the ground, as this essay demonstrates. Israel's economy and its equity market are highly resilient. While neither is immune to short-term shocks from local events, Israel's economy is more likely to be impacted by global political and economic trends than from localized and generally short-lived political and military conflict. The companies that comprise its stock market are similarly resilient. This makes Israel more comparable to, than different from other international equity markets.

Furthermore, most leading Israeli companies have a 'global footprint' in both their operations and their ultimate markets. This global orientation provides a substantial degree of diversification for investors, mitigating risk that may come from local events. This diversification is especially apparent in the *Bluestar Israel Global Index* (BIGI®) benchmark, with its 30%+ weight in non-Israeli listed companies. Checkpoint, SodaStream (Nasdaq: SODA), CaesarStone (Nasdaq: CSTE) and Wix.com (Nasdaq: WIX) are some of these global companies.

Ultimately, as reflected in the previous examples, the short-lived impact of geopolitical tensions on Israeli equities has historically provided investors with an excellent buying opportunity rather than a reason to rush for the exits.

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