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CONFERENCE

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building shock resistant portfolios

Communiqué

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BUILDING SHOCK RESISTANT PORTFOLIOS

PortfolioConstruction Conference, held over three days in August each year, is one of PortfolioConstruction Forum's six exceptional, interactive professional development programs. It facilitates debate on the markets, strategies and investing.

The theme for Conference 2010 was "Building shock resistant portfolios" – because sovereign uncertainty and global systemic risk were at unprecedented levels and are likely to remain so for much of this decade. Markets are likely to be volatile for years, lurching from one shock to the next, with rallies between.

This Conference 2010 Communique – commissioned by PortfolioConstruction Forum and written by BlueChip Communication – documents the key points raised by our faculty of presenters from the Critical Issues Forum plenary program.

It forms part of the 2010 Conference Resources Kit, a unique and invaluable set of continuing education material including the presentations, podcasts, videos, and research papers covering:

- The 10-hour Critical Issue Forum plenary program, featuring leading investment thinkers from around the world presenting on key contemporary and emerging portfolio construction issues, and challenging delegates' thinking regarding how to build shock resistant portfolios.
- The 6-hour Due Diligence Forum (elective) program, featuring 20 more international and local investment experts from our carefully-selected Conference Partners, presenting pre-approved Research Papers written specifically for Conference to showcase the quality thinking behind their investment solutions.
- The 8-hour Asset Allocation Masterclass program, featuring international and local investment experts discussing that, with Western economies burdened by debt at a level not seen before, asset allocation has to take into account an entirely new landscape that in fact is a reversion to the past.

To access the 2010 PortfolioConstruction Conference Resources Kit, go to:

<http://www.portfolioconstruction.com.au/Conference/2010-PortfolioConstruction-Conference-Resources-Kit>

The online Resources Kit allows you to revisit the jam-packed program, access support material referred to during the program, review the key takeouts and portfolio construction implications, better determine actions you'll take to build better quality investor portfolios – and share the content and conclusions from Conference with business colleagues and clients.

All the best,

Graham Rich,
Publisher, PortfolioConstruction Forum
<http://portfolioconstruction.com.au/>

IS THIS AS GOOD AS IT GETS?

By BlueChip Communication Group

Is this it then? That's the question posed by PortfolioConstruction Forum publisher Graham Rich at the outset of the 2010 PortfolioConstruction Conference. And, judging from the content of subsequent presentations, the answer could well be in the affirmative.

That's not to say the mood was all doom and gloom. On the contrary, the prevailing market pessimism was of a decidedly different flavour from that which has prevailed at the PortfolioConstruction Markets Summit in February 2010 (refer <http://portfolioconstruction.com.au/markets-summit/portfolioconstruction-markets-summit-2010-resources-kit>)

If the culmination of rot and disease that was the Global Financial Crisis marked the death of the markets as we knew them, then it appears that we have moved through the various stages of grief: from denial, through to anger, on to bargaining and into depression. Now, a few years down the track, it seems we're heading toward something closer to acceptance.

A calmer, more focused mood has taken hold, perhaps in recognition that – as Graham said – where markets have been for past 12 to 18 months may well be as good as it gets... for the next 10, 15 or 20 years. And in a sense, that acceptance is liberating. Because it means that instead of proceeding blindly, railing against the system, making extreme tradeoffs or spiralling into despair, we now have a baseline and reference point from which to meet the big challenge. And that challenge is crafting portfolios that continue to deliver in a market environment that's vastly different from the one that we'd grown used to.

However you like to characterise this environment – whether it's the new normal or the old normal come back to haunt us, or the result of the unfortunate convergence of a range of economic and geopolitical cycles – the net result is the same. We are all stuck with it for the duration.

So, if we take as a near certainty that future market realities include reduced growth in the developed markets, the surging of the emerging markets, increased volatility across the board and the likelihood of more and greater extreme events, then forewarned is forearmed.

In which case, bring on the experts to advise us on how to go about building shock resistant portfolios....

Portfolio perspective**GET THE MACRO RIGHT****Professor Niall Ferguson, William Ziegler Professor, Harvard Business School (UK, US)**<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-portfolio-perspectives>

In an extract from his recent address at the launch of the PortfolioConstruction Academy, Professor Niall Ferguson, of book and TV documentary 'Ascent of Money' fame, set the scene for delegates. Foreshadowing a 'world of uncertainty', he highlighted the intensified importance of the macro economic environment on micro economic thinking.

According to Ferguson, it will be essential to get the macro right in the next five to ten years in particular – to understand the forces at play in the broader economic and geopolitical world and apply that understanding to investing and portfolio construction. "There's never been a more challenging time to think about the macro and realise its implications," he said.

Portfolio perspective**A FUTURE OF SLOW GROWTH AND HIGH VOLATILITY****Russ Koesterich, Global Head of Investment Strategy, BlackRock (US)**<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-portfolio-perspectives>

Koesterich stressed that, in the USA and most other developed economies, a low growth, high volatility environment is the reality. Since 2000, US growth has averaged only 1.8% per year, compared to an average of 3.3% per year in the prior 60 or so years (post Great Depression). Simultaneously, we are dealing with another change – low inflation with high volatility. US consumer inflation is at its most volatile since 1958.

So, how to deal with this in terms of portfolio construction?

Koesterich highlighted what became a key theme of the Conference – correlations in risk models are even more important than ever.

However, he stressed, that doesn't mean we can rely on previous correlation models. In fact, a commonly held view across presenters was that these old models should, to all intents and purposes, be thrown out the window. That's because so many are based on the era of great moderation, between 1982 and 2007 – an era that will, in Koesterich's view, not be repeated (or not any time soon). The new environment is characterised by a dramatic shift in causal relationships between assets that needs to be closely addressed – and with fresh eyes – for risk management success.

Echoing Niall Ferguson's words, Koesterich also advised investors to be mindful of the macro situation, and position asset selection accordingly. He called for a more dynamic, more nimble investment approach, advising that the set and forget days of feeding statistics into a formula are over.

Critical Issues Forum**ALICE IN WONDERLAND MEETS THE NEW REALITY****Jonathan Pain, Publisher, *The Pain Report* (Australia)**<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-alice-in-wonderland-meets-the-new-reality>

Pain posited his view of the new reality as a world divided between submerging and emerging nations – a world no longer divided by geography, but by debt. Included on the emerging side of Pain’s ledger are China, India, other Asian nations including Indonesia and Vietnam and, among other South American economies, Brazil. The submerging nations include most of Europe, the UK and the US, he said.

Australia falls somewhere in the middle, he argued – a land with developed potential and infrastructure that, if we play our cards right, will continue to be underwritten by emerging Asian growth and thus enjoy the best of both worlds.

In response to speculation that the China bubble might burst, Pain said that China’s sleeping giant was well and truly awake and maturing fast – but that there’s no real concern that its growth will fade anytime soon. Rather, he predicted a slowing of China’s 10% per annum annual growth figures to a more sustainable 7% per annum for the long term – a rate that he predicted would, along with growth of other emerging markets, help offset the submerging developed nations.

Supporting his case that the greatest economic force in the world today is the seismic rise of the Asian middle classes, he highlighted that its spending power is predicted to rise from \$2.9 trillion per year today to some \$5 trillion per year within five years.

Tracking error – our ‘dirty little secret’

Pain asserted that the prerequisite to succeeding in this new reality is that we throw away what he called “that most monstrous of hypotheses”, efficient markets theory, and along with it the myth that markets, or those who operate within them, are rational. “We need to understand and expect that ugly and unexpected events can, do and will happen – and we ought not plan on the basis that they will not,” he said.

“Most peculiar and pernicious of all” is the practice of using tracking error as a measure of investment risk, Pain argued, saying it was time to expose the ‘dirty little secret’ – that tracking error is not about managing investment risk at all, but rather, business risk. Managing to tracking error constraints, he argued, forces fund managers to follow peers and buy overpriced, unwanted stocks merely to follow an increasingly bizarre and unrealistic benchmark (citing international equities indices which effectively expose investors to the myriad risks of the submerging economies as these make up some 70% of the index).

Keeping portfolios afloat

In Pain's view, while the economic decoupling of the emerging and submerging markets has largely occurred, in financial terms there is still very strong correlation between the two, and this must be addressed by investors. Therefore, in the here and now of building a shock resistant portfolio, the aim, he said, should be to identify big name, strong brand companies around the world with investments that are leveraged to the emerging Asian middle class. In this way, investors gain or increase exposure to the boom side of the equation, while limiting the risks associated with investing directly in those markets.

He also challenged ratings agencies in particular to recognise and respond to the new reality, and step out of the old paradigm and conventions (benchmarking, efficient market theory and construction of indices, to name a few). Instead, he called them to look freely and without fear or favour on a new system of rating that does more than putting managers into "cosy little benchmark baskets" and instead frees managers to more effectively operate in the new reality.

Finally, he reiterated the nature of the new divide – that in the future, submerging nations will spend less and save more while emerging nations will spend more and save less. And portfolios that are intelligently constructed with that reality and its numerous associated nuances and implications in mind will be the most shock resistant. "It is as simple as that," he said.

So how do we stop this nonsense?

- Cash benchmark
- Buy the stocks you like, sell the stocks you dislike
- Money manager and client in alignment



THE PAIN REPORT
www.thepainreport.com.au

Portfolio Perspective**LOW SPEEDS ON THE NEW FINANCIAL FREEWAY****Bill Gross, Managing Director & co-CIO, PIMCO (US)**<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-portfolio-perspectives>

“High risks and low returns call for seatbelts,” said the man who coined the term ‘the new normal’. “In the new normal, we have to get used to an economy that grows much more slowly than we’re used to – and when it does grow, it offers much lower asset returns.”

Gross went on to point out the flow-on effects of low growth are continued high unemployment, fewer job openings and a correspondingly reduced optimism, compounded by banks being hesitant to lend, and business and investment opportunities being thin on the ground. The policy responses to counteract this new normal have had limited effect, he argued, describing the continued very low interest rates in the US, the UK and Euroland as “something of a shock”, paling only when compared with the looming European sovereign debt crisis.

Highlighting that Australia and the emerging economies are the exceptions, he nonetheless signalled low average yields and low prospective equity returns in the near- to mid-term. Global bond markets are typified by the prevailing conditions in the US, with a yield of 2% to 3%. He said that investors should be prepared to live with this for at least the next six to 12 months, but more probably, for the next few years.

Building a shock resistant portfolio thus calls for managing expectations and a ‘safety first’ approach, he counselled. “While the 10 to 12% returns from the last years’ performance will not be repeated, the safe alternative is still attractive,” he said.

Critical Issues Forum

THE OLD NORMAL AND WHAT IT MEANS FOR THE FUTURE

Chris Watling, CEO & Founder, Longview Economics (UK)

<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-the-old-normal-and-what-it-means-for-the-future>

The contrarian counterpoint to Bill Gross's 'new normal' followed with Chris Watling taking the stage. What we are experiencing today is more like the old normal come back to haunt us, he said – the inevitable and natural result of the confluence of a number of medium- and long-term cyclic forces. In fact, it's quite normal over history to have long cycles of 20 to 30 years of bad markets followed by good and, in fact, even longer cycles are in play at any given moment. What's less normal is the environment in which these cycles operate and the way they have, in the past few years, coincided.

There's good news and bad news

On the bright side, both the S&P 500 and the ASX S&P 200 have hit their lows and we have entered a cyclical bull market with some two years to run, Watling argued, adding that there is still value in the market and likely to be for some time. However, we are in a long-term secular bear market of some 25 years' duration. But, we're almost half-way though the 25 years, he said – however, there is a host of other factors conspiring against us in the longer term. We are currently a critical point in each of the long range cycles.



1. The Old Normal – The Long Cycle:

A confluence of a number of Long Cycles at this current time, incl:

1. **Kondratieff** Commodity Super (20-30 yr cycle)
2. **Kindleberger** cycle; regarding the handover of world economic primacy – i.e. from US to China and/or India (100 year cycle)
3. **Howe & Strauss** Generational Cycle (80-85 year cycle); driven by ebbing and flowing of generational memory – Howe & Strauss's view = currently entering Fourth Turning – crisis period (2005-2025?)
4. **Toynbee** – 80-90 year cycle of peace and war...

Kondratieff Commodity Super Cycle

Partly propping the Australian economy up, offsetting the more negative effects of other cyclical and macro-economic forces, is a Kondratieff commodity super cycle. Kondratieff, a Russian economist working in the 1920s, showed super cycles are characterised by the surging and retreating of commodity prices for periods of some 12 to 30 years' duration, dating back to the 1780s. Kondratieff super cycles have continued since the 1920s, although appear to have shortened in duration. Current demand for commodities from emerging markets is driving the current Kondratieff cycle, Watling argued, as is the fondness Western nations have developed for printing money – and the consequent need to store 'hard value' assets such as commodities as a hedge.

Kindleberger Cycle

This is the shifting of power from one global economic and political force to another, which occurs every 100 or so years. Just as we saw a shift in power and influence from the UK to the US in the 1900s, we're now seeing a shift to China – with the resulting economic and financial upheaval. According to Kindleberger, seven preconditions must exist for the cycle to be complete, most of which are disturbingly familiar:

1. heavy indebtedness
2. massive overseas energy dependency
3. debasement of currency
4. political corruption – or at the very least the vesting of political interest outside its core legitimacy, in the finance sector, for example
5. overstretched foreign policy – such as having military bases in 150 of the world's 250 countries
6. an inflated and overvalued financial sector (say no more); and,
7. loss of technological leadership – the area which Watling maintains that the US has not quite suffered yet.

Howe and Strauss Generational cycle

This sees the move from crisis to awakening of every fourth generation or so with a full cycle lasting some 80 to 100 years. And didn't we get lucky? We are, according to Howe and Strauss, currently in the heart of the Millennial Crisis, which is slated to last from 2005 to 2026.

Toynbee's Peace and War cycle

This is an 80-90 year cycle characterised by periods of peace – and then war – with the associated economic demands and stimulus it creates – and its aftermath.

But there's more

If the shadows cast by so many overlapping cycles weren't enough, we must also overlay other macro-economic features onto our portfolio construction picture, Watling warned – and none cast a rosier hue. They include risks such as a sovereign debt crises or loss of confidence in the US dollar.

Add to that budgetary concerns and the continued tepid recovery and you have the very real risk of repeated financial crises.

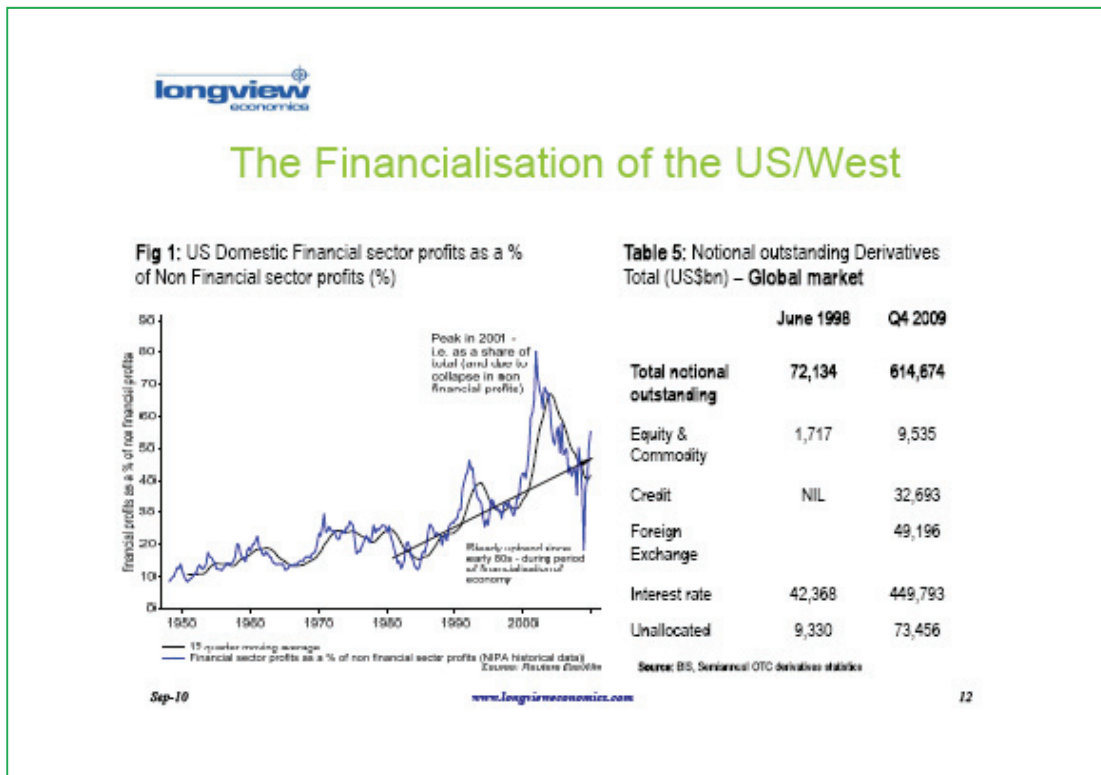
There's also the widespread dampener to global growth and demand caused by continued deleveraging and the prospect of a potential Euroland breakup, or a China slump caused by an asset collapse. Throw in an inflation spike and you have another perfect financial storm in the making.

And the ageing population in the world's developing countries also brings massive potential economic, political and social problems. It will take a brave government to say no to the demands of its ageing but most numerous constituents. And yet with shrinking growth and a tax base to match, its capacity to meet those demands will be at an all time low.

And finally there is the potential geopolitical threats brought about by the current global power shifts – China and India and their increasingly jealous guarding of ever-tightening oil and trade corridors, being a case in point.

Money makes the world go round... but how you make it counts

Last but not least in Watling's catalogue of concerns for the developed world is the ascendancy of the financial markets, the change in role and position of banks from financial intermediaries to trading operations and the massive proportion of the economy (even if only notionally, in the form of derivatives and debt) that's now concentrated in the hands of a relative few monolithic entities.

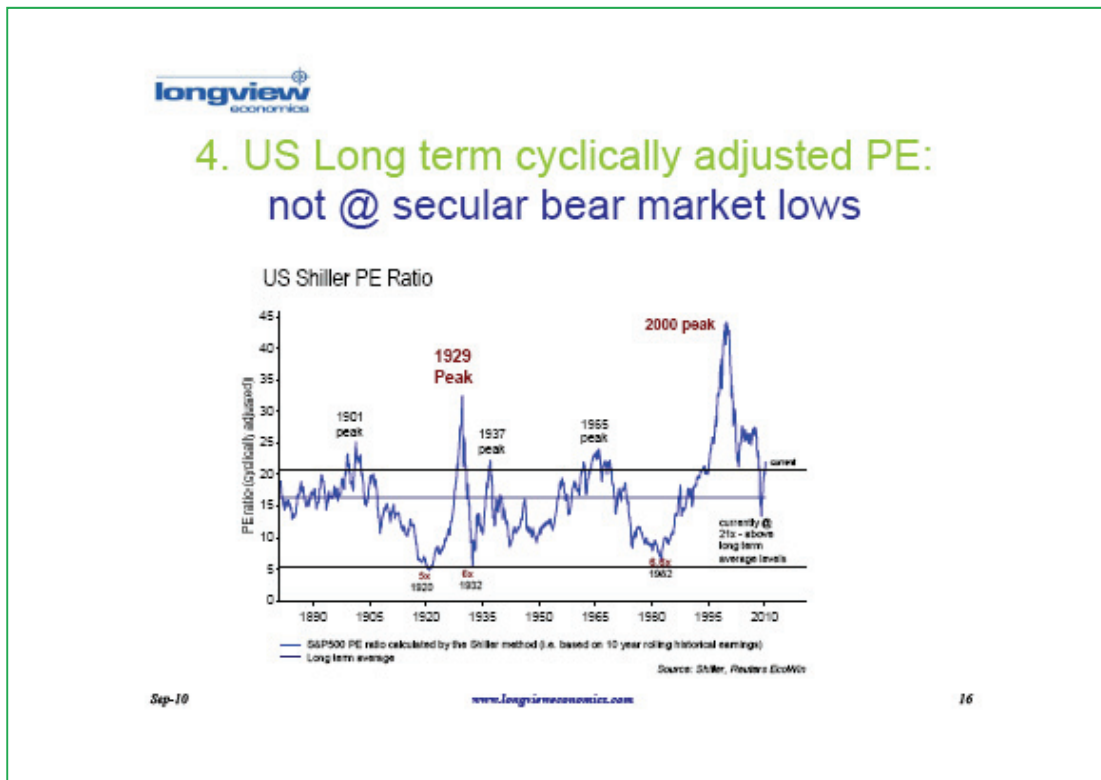


What happens when one entity in the chain falls over? Well, we've all just seen it and we're certainly still living with the longer-term fallout from the chosen solution – in this case, literally printing money to fix the problem, creating inflation and essentially passing paper rather than real value around, for a net effect of undermining the strength of, in this case, the US's economic primacy (note the ticking of various Kindleberger boxes in this scenario). The shift to China and Asia has resulted in the hollowing out of American manufacturing. As a consequence, recovery – traditionally led by jobs growth which provides income and hence demand – has been slow due to a diminished base of precisely the sorts of jobs that traditionally underpinned recoveries. This slow recovery and its chronic long term links to the dearth of employment and growth opportunity in the USA was a recurring and generally agreed theme among most presenters.

In short, instead of doing and making things, the developed world's pre-occupation with doing and making money in whatever dubious form has led to a situation in which there is no confidence in the financial markets. Who can forget that a certain breed of asset backed securities were (a) invented and (b) given triple AAA ratings?

What about portfolios?

Given the likelihood of inflation, Watling argued that bonds were a “dreadful long term buy” – also pointing out that they tend to underperform in a commodities super cycle. In contrast, Watling said, US equity valuations are still not at secular bull market lows in P/E terms (see the slide below). But, he too warned that investors should proceed in an orderly and cautious fashion.



Portfolio Perspective**VOLATILITY IS BACK****Larry Kantor, Global Head of Research, Barclays Capital (US)**<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-portfolio-perspectives>

Kantor offered more glimmers of hope, asserting that, while the great moderation theory has been blown out of the water and volatility is back – and with it a corresponding need for investors to adjust their portfolios – in the near term, the equity outlook is relatively favourable. The earnings yield on the S&P 500, compared to real corporate bond yields is around 2.5%, a historically wide spread of 600 basis points.

Looking to the longer term, however, he too argued that returns are likely to be lower than in the 20 or so years before the GFC because while short term fixes such as monetary easing may support valuation growth for a while, they don't provide a firm foundation to support low volatility and growth. Rather, longer term issues such as government debt and the ageing population are likely to prevail.

So, what does that mean for portfolios? Kantor recommended boosting exposure to emerging markets for their better demographics and fiscal positions. He also warned against falling into the trap of avoiding risky assets altogether, bearing in mind that relative equity valuations are attractive compared to bonds and that interest rates are likely to rise. To provide an effective hedge to a portfolio that contains stocks, it's worth looking at taking a long volatility position, he said.

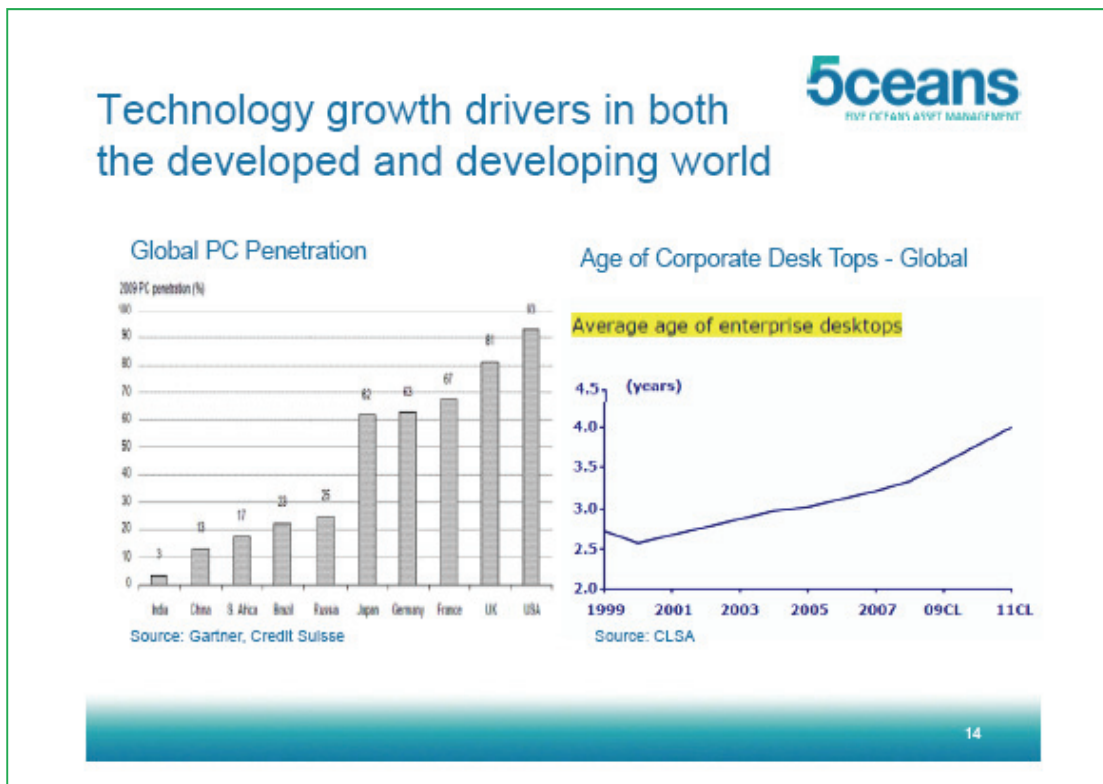
Critical Issues Forum

THE SEEDS OF POTENTIAL FUTURE FAILURE

Chris Selth, CIO & Lead Portfolio Manager, 5 Oceans Asset Management (Australia)

<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-the-seeds-of-potential-future-failure>

Selth agreed broadly with Chris Watling on the trading shift to China and the financialisation of the markets. But he also focused on the rate and impact of technological change (Moore’s Law – loosely, that computer power doubles every 18 months to two years, a massive acceleration that changes the way interactions are taking place, and means those changes are coming ever faster. As a profound factor to be considered in relation to all aspects of the economy and investment in coming years, the role and impact of technology cannot be underrated, Selth warned.



The question that needs to be asked

According to Selth, given the historic cheapness of the S&P 500 with an implied growth rate of 11.6% per annum, an optimist would say the world is excessively gloomy. So is it good news? Maybe not, he said, noting that Schiller would say that the level of profitability is overstated because it is based on averages. The question that needs to be asked, Selth argued, is what is going on in the fabric of a country? In the US market, for example, is this profitability sustainable or is it at risk? And if the latter, what does what that tell us about the future? Pointing to the sector moves in the S&P, he

argued that there's a real need to look away from averages and instead focus on compositional drivers to answer questions about sustainability.

Picking stocks in a sea of one-ness... winners and losers

Next Selth turned to the performance correlation between high and low growth stocks – a recurring theme of the Conference – as being a feature that investors have to learn to deal with and move on from as the difference between weak and strong performers becomes increasingly apparent. As he pointed out, this level of correlation is attributable to the cheap credit that was a consequence of financialisation. “With cheap money driving performance, it became more difficult to differentiate between strong and weak performers as everything converged into a oneness in which sat an intriguing blend of risk and opportunity.”

Lessons for the portfolio

In terms of the US market and the questions of valuation and sustainability, Selth warned delegates to bear in mind that some 50% of US earnings come from offshore, providing good opportunities for investors to capture what he called the best of both worlds through investing in established US stocks with a strong emerging presence or exposure (a la Jonathan Pain). In this way, he posited, the globalisation of markets may save us, if we get the differentiators right, and embrace (appropriate) diversification. “Applying an across-the-board mechanical diversification rule will result in shock. There's a need to understand the real relationship between diversification and risk.”

Portfolio Perspective

THE WORLD AND ITS CHALLENGES

Jim O'Neill, Head of Global Economics, Commodities and Strategy Research, Goldman Sachs (UK)

<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-the-world-and-its-challenges>

The key message from O'Neill – the man who coined the term BRIC – is that the world is essentially turning upside down as the developed West swaps places with the developing world. He cited various evidence, including massive changes in past and forecast GDP (see the two slides over page).

While at pains to stress that the 'R' for Russia should remain in BRIC, as it now outstrips Spain and has made a bigger contribution to the world economy in GDP terms than Japan, O'Neill similarly stressed that it's not only the BRIC nations that are galloping to the fore, but also the Next11. He noted that no single country from Euroland will be in his future top 10, and some of the new players in the Next11 include Mexico Korea and Turkey. (Greece was predicted to display GDP performance somewhere behind that of Bangladesh.)

China in a bull shop?

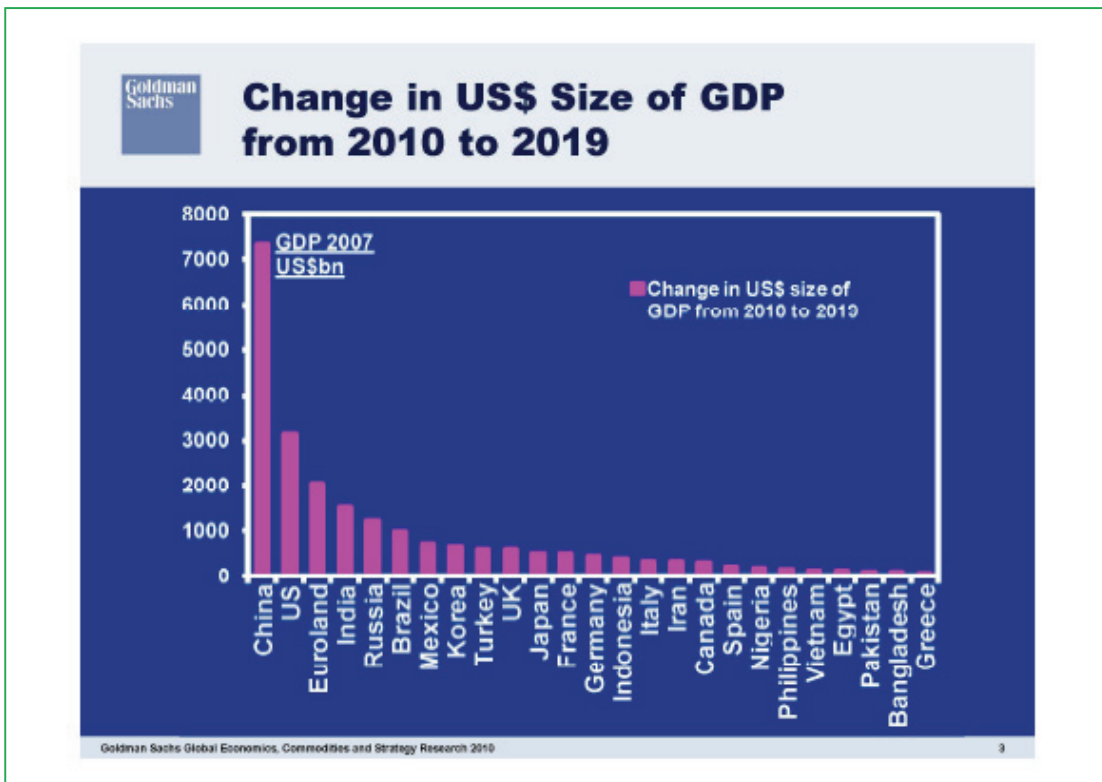
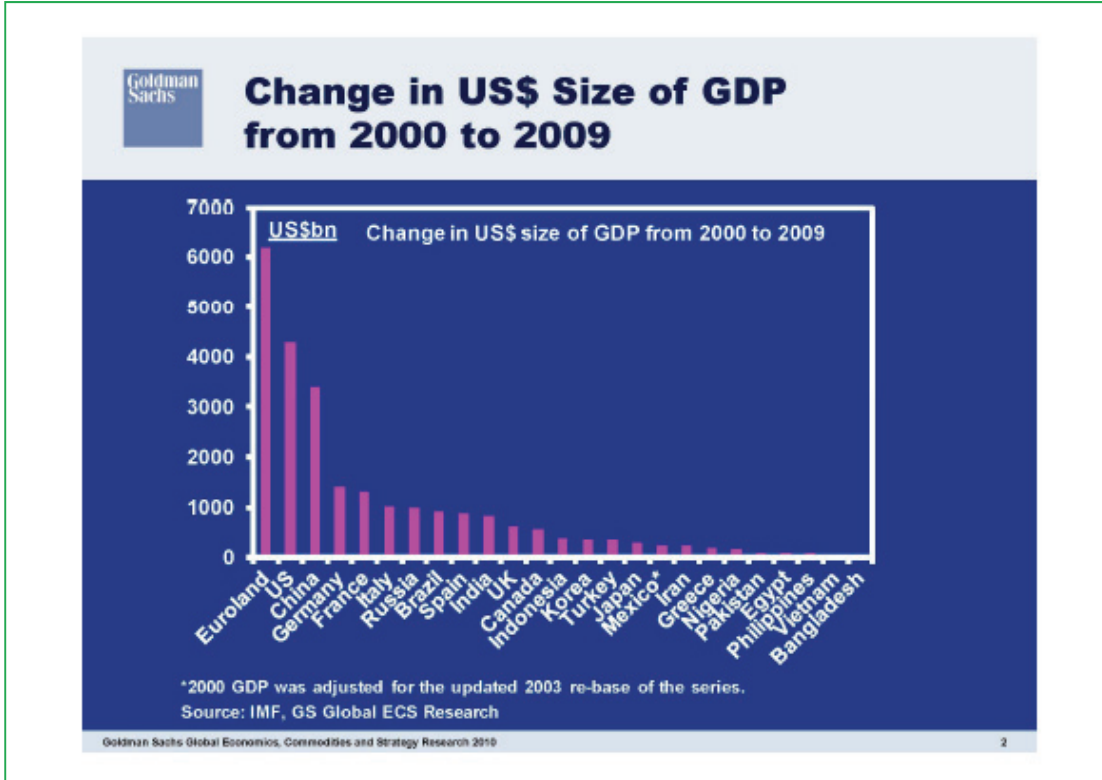
The massive growth China is the single most important economic issue of the decade, O'Neill reiterated. "Its influence will become so powerful that no one will be able to ignore it – it will impact on everything: commodities, equities, forex, and so it goes on," he told delegates.

And, while investment professionals have for years been saying China's economy is small compared to the US, he stressed that that is no longer true. "China has overtaken Japan as the second largest economy at 9% to 10% of the world's GDP, compared to 28% for the US. So, yes, it's still smaller but it's the rate of growth that's important," he said. That growth, he predicted, is in the order of \$7.5 trillion in the next decade, on top of \$3.5 trillion in the previous one – which effectively means China will 'create' another two Chinas in the next decade.

Making sense of it all – no new normal

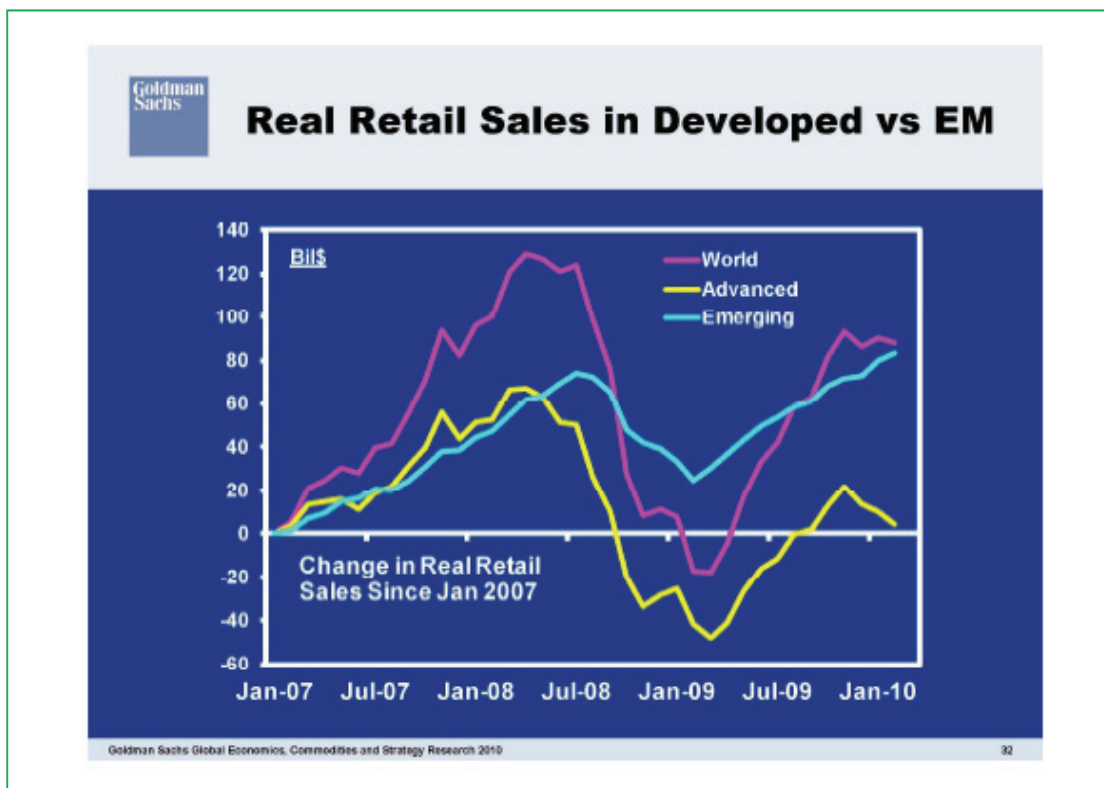
O'Neill acknowledged that the new upside down state of the world can be a confusing picture, especially for those of a certain generation who were led to expect a *status quo*. "There are still those who cannot believe that this can happen, raised in an era where the US catches cold and the world gets pneumonia," he said. But the credit crisis stopped all that, he argued, as it trained countries to learn to be more dependent on domestic demand rather than supplying another. This, he said, will be part of the whole new shift of the world coming out of the slump and moving ahead.

It's absolutely a shift that must be taken into account in portfolio construction, he warned.



It's also the reason that O'Neill believes PIMCO's prediction of a new normal, characterised by a world stuck in permanently low growth due to the troubles of the US, is wrong – because it's a view based on the old US-catches-a-cold perspective.

In the new world, it won't matter if the US sneezes, O'Neill argued, because so many other nations are inoculated against the effects of US contagion either by their own domestic demand or by a massive reversal we are already seeing – boosted demand from the developing economies for products created by the developed ones.



He pointed to Germany as a case in point. In what O'Neill called "the most interesting economic data I have seen all year," he showed that if Germany maintains its current rate of trade with China, within a year China will have overtaken France as Germany's major trading partner.

Australia is already there, he said. India is now Australia's fourth largest trading partner, and the US and UK have long been replaced in Australia's export universe by China, Korea and Japan.

"Already you can see that domestic demand in the BRICs surpasses that of the US. We're now living in a two cylinder world -and we've got to get used to it," he ended.

Critical Issues Forum

IS CHINA A GLOBAL SHOCK IN WAITING?

Manu Bhaskaran, Partner, The Centennial Group

<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-is-china-a-global-shock-in-waiting>

So with all this talk of China, is it going to blow up? Not any time soon, according to the next speaker to take the stage, Manu Bhaskaran. A booming China is here to stay, all things considered and at his best guess, anyway. However, he stressed, that's not to say there won't be (some considerable) bumps along the way, with consequent negative effects.

Bhaskaran went on to highlight what he sees as the three key sources of China risk: internal political stability; economic and financial risks; and, geopolitical risks. The general thrust was that, although there are more than a few vulnerabilities, the important thing for investors to understand about China is its extraordinary resilience and great capacity to bounce back and overcome challenges.

It's all about the Party

In Bhaskaran's view, while China faces a range of internal social and political challenges and is not an easy place to govern, the party – which is at the core of the political system and likely to stay that way for the foreseeable future – has more strengths than weaknesses and an underlying structural resilience that will enable it to successfully adjust and adapt.

Critically, this strength and resilience is institutionalised and not dependent on one man – and already has a demonstrated track record of successfully containing rising incidents of mass unrest, he noted, pointing to labour unrest involving increasing numbers of people in the last five or so years, and separatist unrest relating to Tibet and Xinjiang. The party's ability to stop such unrest from spreading even to provincial level, let alone further, eliminates the chance of an alternative ideology arising as a rallying point. In terms of separatist struggles, Bhaskaran's view is that, brute force will prevail.

However, aside from labour and separatist unrest, there are other simmering, unresolved issues linked to the increasingly affluent, educated and internationally-connected nature of the Chinese population. These have contributed to a greater awareness of human rights, greater and more entrenched political and financial corruption, increased social inequality and a heightened rural and urban divide. While yet to be resolved – and Bhaskaran feels that there are inadequate mechanisms for airing grievances – once again, these issues are at least being contained and in some cases gradually addressed, he said.

Again, the party's ability to adapt to change is key – co-opting rather than outcasting the new social elements; allowing some grass roots forms of 'democracy'; loosening the reins on media and tolerating more diverse views. Coupled with this, continued systematisation of leadership succession plans further adds to the party's strength and stability.

These factors all led to Bhaskaran to conclude that the party will remain in power – and to warn us about making Western-based assumptions about the Chinese psyche. “We must not make the mistake of assuming that what happens in the West will happen in China,” he said. “The difference in the psychological profiles and ideas of self actualisation between the two cultures are vast.”



THE BOTTOM LINE

The CCP will still be in power in 2020

- **No collapse of Communist rule**
- **CCP evolving → more tolerant**
 - But forget democracy
- **Unrest will continue**
 - But localised, won't expand nationally

14

Will economic boom turn to bust?

Bhaskaran was quick to acknowledge that there is definitely risk in China's domestic economy – but, he said, again the leadership has recognised this and is responding to it in a “humongous” fashion.

The surge in lending that accompanied recent boom times and the Beijing Olympics has exposed a still weak credit culture with a wildly speculative bent that makes it prone to extreme bubbles. Bhaskaran told of pig farmers who, on hearing of a garlic boom, removed the pigs from their sties and replaced them with garlic ... and so on. Couple surging credit, speculation and a nascent equities market that rises and rises along with real estate, wages and currency, and it's clear that, in Bhaskaran's words, China's financial system is its Achilles heel.

What doesn't help, added Bhaskaran, is the lack of visibility in the system, which makes it hard to see what's happening where and to know where the real dangers lie, illegal bank lending being just one case in point. “We are talking big time syndicates making illegal \$30 million or \$40 million overnight deals,” he said “In fact, some estimates are that up to 20% of loans are occurring outside the system,

with no supervision, no structure, no credit checks. We saw the same thing in Korea in the Asian financial crisis and that country went to the wall.” At the same time, however, the People’s Bank is trying to control things, Bhaskaran stressed. However, whether or not these levels of debt can be unwound successfully by the blunt instrument of policy tools available in China is another question.

“Clearly the risks in the domestic economy are huge. On the plus side, there is the fact that they are acting quickly before bubbles burst, but equally, they don’t have the finer calibration tools of the west to address them,” he said. “There’s also the issue of the political will to address the structural flaws that increase these domestic risks – there’s a fundamental dispute between those who want to go with growth and those who say now it’s time to stop and fix it that leads to deadlock.”

He also pointed to the influence of vested interests, which have in his view dramatically increased, impairing the ability of investors to make good investment decisions in a timely fashion.

“Despite this picture it’s not just a question of how many vulnerabilities there are. You also need to ask – do you have sufficient shock absorbers to contain the shock amplifiers or multipliers – and in my opinion, the answer is yes – but it will be a bumpy ride.”

CHINA IMPACT: MORE RISK?(3)

Policy tightening averted crisis

- Risk is of blunt policy tools
 - Admin measures → outsized reaction
 - Stop-go pattern of policy likely
 - Compounded by differences within elite
- Shocks will occur: how resilient is China
 - Shock absorbers: policy, momentum, reserves
 - Shock multipliers: financial system

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China v the rest of the world: clash of the Titans?

In talking to the third risk – China versus the rest of the world – Bhaskaran noted that this risk is not just about China. It's about China and India rising at the same time as the US continues as a sizeable political force. "It's almost inevitable that there will be a clash of some kind," he warned. Bhaskaran had a much more bullish view of the US's fortunes than other Conference presenters, believing that the US will maintain military supremacy, remain economically vibrant and culturally appealing as what he termed an "unmatched soft power".

China is already (as noted by Chris Watling) flexing its muscles, expanding its "core areas" beyond Tibet and Taiwan to the South China Sea, warning both its smaller neighbours and pushing back on the requests of larger powers. But in Bhaskaran's view, China asserting itself in this way does not constitute cause for real alarm. What does pose a major risk, he warned, is a clash with India. In addition to geographic and economic factors such as competition for resources, and the continuing move of China as a rival in southern Asian, there are also strong cultural and political factors in play. "The Chinese and Indians have a fundamental divergence in world views that it is difficult to see being reconciled. They can see an identical situation and construe it completely differently – or come to an identical conclusion via a dramatically different routes," Bhaskaran explained. "Further, on the world political front, India's ties with the US alarm China."

The bottom line? India and China will keep bumping into each other – for the time being, peaceably.

CONCLUSION

China's rise: bumpy, not catastrophic

- **Internal political stability**
 - CCP will adjust ahead of changes
- **Economy: huge risks but resilient**
 - More shock absorbers than multipliers
- **Geo-political shock less likely**
 - But a clash of some kind with India likely

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PortfolioPerspective

SHOCKS AND HOW TO DEAL WITH THEM**Tim Farrelly, Principal, farrelly's Investment Strategy (Australia)**

<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-portfolio-perspectives>

On a day when the recurring message on shocks was “get used to ‘em”, Tim Farrelly took us through his very own shock categories and how to deal with them.

Category one shocks occur when the market reacts to overpricing and drops back to more normal levels, he said. How to deal with this? Simple – don’t buy in overheated markets. Accept that markets are inefficient and try to develop ways to identify when they are overpriced – because the effects of buying too high is long term, and the effects of buying into a bubble are permanent, he warned.

Category two shocks come along when you get a significant deterioration of an underlying fundamental, causing a default. For example? The current sovereign debt environment and the very real possibility of economic disaster in one or more of the major nations. In dealing with this, Farrelly advised making sure there is a secure part of the portfolio that is up to the task of insulating against the potential shock concerned. These assets must be secure, genuine assets and in large enough proportions to provide a meaningful defence, he warned.

Category three is when panic sets in and the market falls for no apparent good reason. Be aware, he said, that where there is a category three shock, there is also often surprise – so take that element out of it by making sure your clients are aware of the risks they are taking, he advised. For example? Tell them that it is not unusual for equity markets to fall 30% to 35% or even 50% when there’s an over-evaluation or deterioration in underlying fundamentals. If your clients are aware of the possibility, they may not be happier, but the surprise and the shock will be lower, he said.

Critical Issues Forum

HOW TO KILL A BLACK SWAN

David Owyong, Head of Quant Research, MSCI Barra (Hong Kong)

<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-how-to-kill-a-black-swan>

On the subject of portfolio shocks and how to deal with them, David Owyong took the portfolio risk management bull by the horns and wrestled it to the ground. Traditional forms of risk management no longer provide the benefits we thought they did, he said, due to various factors, including contagion and strong correlations. The result is that these render old concepts of diversification at best ineffective and, at worst, even more damaging to portfolios. Owyong highlighted that deficiencies in management of non-investment risks, such as counterparty and operation risks, have also been either mismanaged or confused in recent years. Again, the notion of *appropriate* diversification to address the strong correlations that have become par for the course was a feature.

A framework for managing risk

In more good news for delegates, Owyong did a lot more than bemoan the current environment – he presented a strong framework for managing these risk regime shifts. Ironically, coming from a quant guy, the core of his risk management approach is qualitative. Chiming in with another common theme of the forum, he declared that the days of investing by numbers – feeding stats into a formula and getting an investment recommendation out the other side – were dead (also buried and cremated, judging by the concurrence of other presenters).

According to Owyong, in the new risk regime we need to apply the same sorts of measure to portfolio construction and management as we do for disaster recovery relating to other aspects of business. “We need a stop-loss trigger that offers meaningful protection in times of crisis, especially as so-called extreme events are not as rare as we think they are. In fact, one such event happened around every two years between 1987 and 2008,” he said.

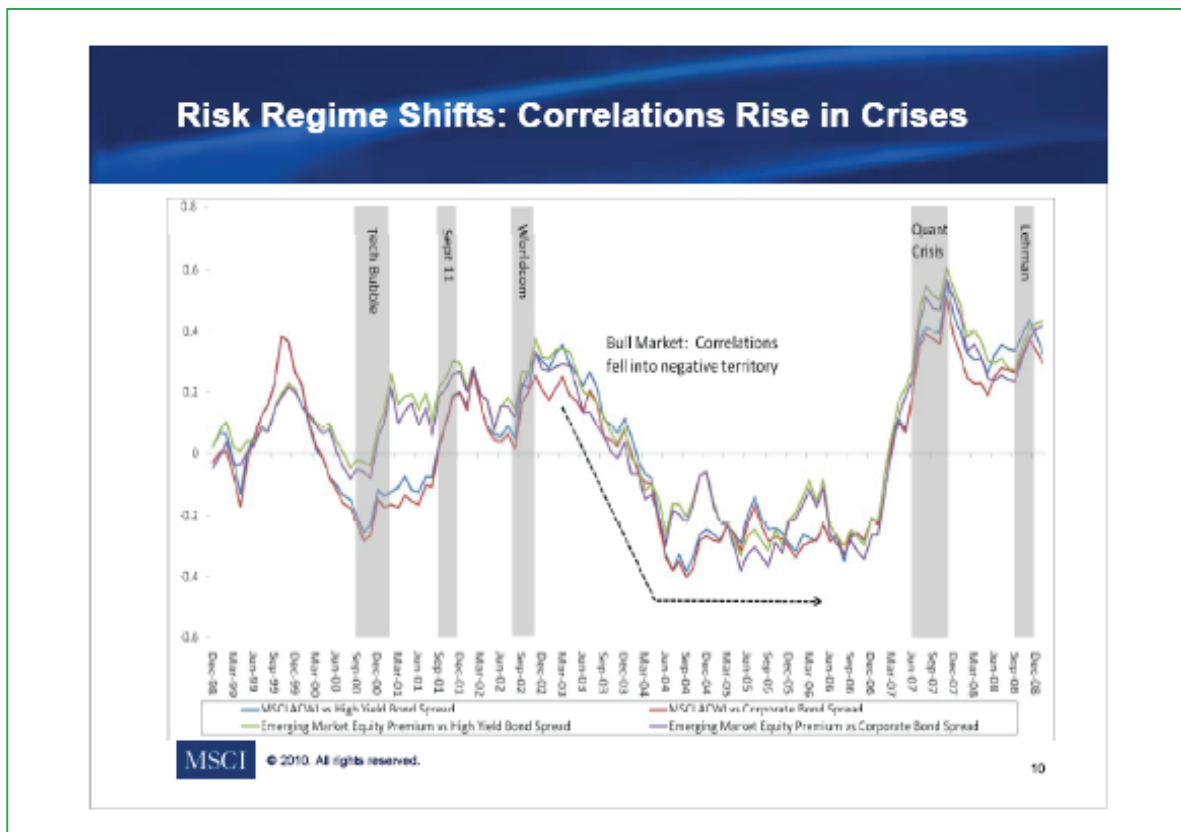
His rationale is that, typically in a crisis, inertia sets in while everyone argues about what to do – and in the meantime, the dollars trickle – or pour – out of the portfolio. “Having strict, pre-considered and clear cut procedures – for example cashing out a certain part of the portfolio at a certain point – can at the very least help minimise the compounding of losses caused by inertia,” he said.

Typically, he suggested, a risk plan (what he called a business continuity plan) for a portfolio would include defining extreme events, quantifying their probability and severity, constructing scenarios to cover them, determining in advance what the portfolio trades would be for each – and rehearsing those responses.

Time for an asset rethink

In the new risk regime, Owyong said, investors need to take a longer, harder look at their portfolios and specifically, in the categorisation of asset classes. Risk horizons must be more carefully matched

with a portfolio's downside risks, he advised – with explicit accounting for cash-flow requirements rather than notional value. This clearly did not happen for many investors during the GFC. Owyong's contended that traditional forms of diversification – for example, a simple equities versus bonds approach – do not always work because, in times of crisis, there can be dramatic correlations between these asset classes (as we saw in the GFC in relation to equities and corporate bonds).



Given the point of diversification is to guard against adverse impacts from crises, it is clearly inadequate for diversification strategies to be based on performance averages and modelling for non-crisis times which, Owyong points out, has frequently been the case. “This simply does not work for risk management purposes,” he said.

Instead, what we need to look at to achieve true diversification is how various assets perform in times of crisis – and then choose investments accordingly. “As a general guide, negative or low correlation during crisis times is a good indication of true diversification,” he said.

Tools to predict and avoid correlation

Of course, Owyong highlighted, in order to effectively assess risks, correlations and modelling, we need data. And data is not always in strong supply. “Looking at numbers gives us a better idea about

maximum loss in a month and although history may not repeat, at least we can get an idea of the quantum or magnitude of what we may be dealing with," he said.

So, for example, looking at Australian sovereign bond and equity performance in crisis times reveals relatively low correlations – and indicates that, in the Australian context, bonds can be a good hedge.

Australia: Biggest One-Month Losses

- To understand extreme risk, need to examine biggest losses historically (from Dec 1985)

MSCI Australia		Australian Govt Bonds	
% Loss	Month	% Loss	Month
-41.5%	Oct-87	-4.0%	Oct-87
-11.3%	Oct-97	-3.4%	Jul-86
-11.0%	Oct-08	-3.2%	Aug-92
-10.7%	Jan-08	-3.1%	Jun-94
-10.3%	Sep-08	-2.9%	Sep-94
-8.5%	Nov-88	-2.9%	Mar-94
-8.4%	Aug-98	-2.7%	May-88
-7.9%	May-10	-2.5%	Jan-92
-7.5%	Sep-90	-2.4%	May-09
-7.3%	Nov-94	-2.4%	Feb-94


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In the absence of data, Owyong suggests relying on a considered process for determining likely co-movement, thus correlation, in a crisis. This calls for intensive scenario planning across:

- **Industry** – look at different sectors and their performance in different circumstances;
- **Country** – emerging, country-specific risks;
- **Asset class** – including how they are categorised (see below for more about risk classification);
- **Company-specific** – bottom up factors;
- **Macro-economic** – including factors such as interest rates, protectionism;
- **Liquidity** – high or low or in between;
- **Style** – can have a profound effect. For example, value and momentum investors can find themselves weighting the index, leading to greater losses than for investors with other styles when it falls;
- **Instrument type** – bear in mind that at times of crisis when liquidity goes, loss of confidence in certain instruments will affect their performance (for example, the recent situation with mortgage backed securities). Fear and panic can also spread along the instrument pipeline, whether or not there is valid cause;

- **Bubble similarities** – if two asset groups have appreciated greatly in one or two years and have developed other characteristics that are aligned, it's likely that they are correlating and hence you'll compound risk if you over weighted both in a portfolio;
- **Investor groups** – sometimes certain investors favour certain asset classes, so a pension fund or long-term investor may have greater confidence in a crisis compared to shorter-term investors such as hedge funds and trading groups, which are more likely to liquidate in times of price decline.

Risk-based asset allocation

Against this backdrop, Owyong again highlighted the importance of recategorising assets according to their purpose.

Risk-Based Asset Allocation

- Asset class categories to be set according to its purpose
- Four broad segments: equities, real assets, liability hedging and absolute return strategies
- Equities to provide the highest long-term real returns available
- Real assets provide protection against inflation
- Liability hedging assets (mainly low-risk government bonds) to provide downside protection near the pay-out phase
- Absolute return strategies capture additional sources of returns or risk premia (e.g. small cap stocks, high-yield bonds, etc)

Portfolio Perspective**IS IT THE END OF THE AMERICAN EMPIRE?****Professor Niall Ferguson, Harvard University, Harvard Business School**<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-portfolio-perspectives>

In this extract from a *Sky News* interview recorded in July when he was in Australia to present the inaugural PortfolioConstruction Academy seminar, Ferguson painted a grim picture of an America pouring \$1.5 trillion a year (and rising) in loan interest out the window forever, in a situation that would see a larger and larger proportion of tax revenues going to pay off loans – many of them to China – rather than addressing the issues that already plague the US. In fact, according to Ferguson, at the current rate and if something is not done to address it, by 2050, half of all US tax revenue will be absorbed by interest payments. The resulting squeeze on security at a time in history when other powers – notably China – are also on the rise will have major implications.

The big question? How sustainable is requiring the US to borrow from China, thus giving China leverage over the US in so many different ways? This food for thought provided a pertinent introduction to the next presentation...

Critical Issues Forum**WHETHER THE US HAS MORE SHOCKS TO COME****Dr Horace “Woody” Brock, President, Strategic Economic Decisions, Inc.**<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-whether-the-us-has-more-shocks-to-come>

In a stirring and stimulating live cross from the US, Woody Brock snatched the deficit ball from Niall Ferguson and ran with it. He first dealt broadly with two issues before homing in hot and strong with his own have-your-cake-and-eat-it-too fix for the third, the anatomy of the US recovery and what to do to fix it. His bold solution proposes the recrafting of the whole notion of what constitutes a deficit and the recharacterisation of government spending in order to open the door to more investment, growth and, especially, employment – a subject on which he is passionate.

Caterpillar come home...

Like the other Conference presenters, Woody sees the rise of the developing nations as a positive for the declining developed ones. “A reverse East/West dependency is now evolving,” he explained. “For the past 40 or 50 years, the West has needed the east to buy cheap goods – their TVs and Hondas. The East did not need or want our things. However with the rise of developing markets, we will soon see emerging nations’ citizens wanting our goods and services and assets more than we want theirs,” he predicted. (Remember Jim O’Neill’s ‘most interesting’ economic snippet of the year – that China will soon overtake France as Germany’s major trading partner?)

Brock described this phenomenon as driven by branding and a kind of consumer snobbery that would apply to Western items across the board – from Swiss watches to German cars to apartments in Paris, ski lodges in Vail, and so on. We will see a net benefit for the West in terms of pumped up demand and new inflows of much needed cash.

Associated with this trend is Brock’s prediction that some major manufacturers which had moved production offshore would return home to the US, lured by a more available labour pool and driven by the prospect of rising labour and currency costs in the emerging markets. US equipment giant, Caterpillar, is a case in point, he noted. Its base is heading back home to Alabama and Brock believes it will be the first of many. “The 40-year period of the West needing the East will end. A more level playing field will develop and it will be good for everyone. In a global world, what matters is profits, not where they come from. We need each other,” Brock argued.

Welcome to a 40-year crisis of red ink and political paralysis

Brock then went on to summarise current events in Europe as pivotal in history and akin to the end of communism in 1989 and 1990. “In both cases, nations and systems have been brought down by pathological reward structures – very different reward structures in each case, but each flawed enough,” he said. “From California to Greece, citizens are now learning the hard way that liberal democratic capitalism has its own internal contradictions.”

According to Brock, the real crisis is that, while at the start of 2010, people may have been angry at the banks – the Goldman Sachs bailouts and the rest of it. But by year’s end, he predicted, workers from Greece to California will understand that there’s a whole lot more to be angry about. And that is, that the social contract defining liberal democratic capitalism is broken – that their faith that they will pay taxes and in return the state will provide structures for employment and care for them in their old age and in their ill health is unfounded. Scary stuff.

According to Brock, this has occurred – or will shortly occur – for two reasons.

One is the changing concept of the public good and the ever stretching demands on governments to provide more, more and more – a far cry from the once-upon-a-time days of straight taxes to fund an army. “The problem is that every four years, the state offers more bribes we can’t afford as we hit election mode and this has now escalated to the point where we have mortgaged the future,” Brock said. “Once these citizens hit retirement, boy-oh-boy. They think they are worried now. Well, they are going know a whole new meaning for worry and red ink.” Even Australia, which has done better than many others due to its SGC regime, will struggle in retirement, he warned.

The second causal factor is that people stopped having children – or cut down drastically at any rate. As a consequence, we are facing critical age-related demographic issues of the kind mentioned by several other presenters.

“Add this to the Ponzi scheme of the aged pension and there you have it,” said Woody. “We are standing over the rotting corpse of the conceit of the modern cradle-to-grave welfare state, and this is the year that ordinary people are sniffing it out and then entering an age of rage.”

“It’s the deficit, stupid”

As we could not fail to have noticed, the US recovery has been variously described as sluggish at best – non-existent at worst – and Brock’s view was no different. After going into some detail about why this is the case, looking at the increasingly “wimpy” patterns of recent downturns and upturns, factors such as the lack of the all-important employment recovery – and factoring the huge monetary and fiscal stimulus, Brock concluded that what we are experiencing today is a Gestalt. “We have had 35 years of overspending and over borrowing by everyone and are now returning to more conservative spending in 2020-2030,” he predicted.

The real long-term issue is employment – or the lack thereof, he said. Specifically the inability in the foreseeable future, if things remain as they are, for US growth levels to ever reach the point required to (notionally at least) provide employment for each year’s quotient of school leavers and graduates, let alone the 12 million others currently seeking work.

“In the US, we need to grow at about 3.4% per annum to reach the point where we are hiring the new labour naturally coming on and clearly much faster if we want to rehire anyone else,” he said. “Given the magnitude of the downturn, we need a much bigger upturn – and we simply don’t have it.”

Faced with low, slow GDP forecasts, this is a grim dilemma and one likely to keep the US firmly entrenched, to use Brock's words, "in Dante's ninth circle of hell". "And there's nothing to happen tomorrow to cause that growth to come back," said Brock.

Mr President, you can have your cake and eat it too

According to Brock, there is a solution to the seeming endless – or bottomless – conundrum of US government debt. He first canvassed the conventional approaches and pointed out why they all, one way or another, amount to too little, too late:

1. **Focus on deficit reduction and accept the high unemployment tradeoff** – This may make the bond market happy and citizens miserable;
2. **Ignore the deficit** – Leave it unchanged, stimulate GDP growth by doing so, and say to hell with bond market vigilantes? And let that debt continue to mount up;
3. **Muddle through** – Compromise by reducing the deficit a bit to help boost GDP a bit, knowing that growth will still be far too weak to make much of a dent in the jobs market.

Funnily enough, Brock was not enamoured of any of these solutions. Instead, he shared with us (and Mr Obama) his epiphany. "Is it possible during this ostensibly 'lost' decade for the US both to radically reduce its deficit and to achieve full employment and to significantly raise productivity and GDP growth?" The answer, in Brock's view, is a very emphatic 'yes'.

It's an epiphany

In explaining the hows, whos and whyfores, Brock took us on a journey through recent economic theory, before settling on the Arrow Kurz theory, articulated in 1970, as the source of his epiphany. This essentially generalised and unified the previous disarray in macro economics which prevailed prior to that time: the Keynesian theory of deficit levers; the growth theory of optimal consumption with an investment tradeoff; and, the public finance theory detailing the best way for treasuries or states to finance red ink.

As Brock explained, none of these individual theories worked alone. "Arrow and Kurz slotted them together dynamically, recognising that, as they are all interdependent, they must be solved simultaneously. Macro economics was thus reconfigured," he explains. "And we need to do the same thing with spending and deficits. We need to fundamentally redefine macro concepts like deficits and private versus public investment."

The net result of Brock's reconfiguration involves keeping the deficit at 10.5% GDP for the next 15 years, but reconfiguring government spending so that this 10.5% of GDP becomes good public investment. And, Brock said, good public investment does not mean digging ditches to nowhere. It means projects with high rates of return on capital invested on much-needed infrastructure, roads, transport, energy efficient power grids and the like. Ideally, a good proportion of these capital investments will eventually be privatised, a la the Macquarie Bank model.

Finally, it's important to realise that the bond market will not view spending relating to such investments as problematic – or indeed, as true deficits at all. Rather, it would see the expenditure as

merely the amortised portion of the new public investments which renders the nominal \$1.5 trillion per annum deficit a negligible \$30 billion.

The Policies Required to Square the Circle

1. Keep the deficit at 10.5% of GDP for the next 15 years.
2. Reconfigure government spending so that 10.5% of GDP each year is “good” public investment. No animal spirits needed.
3. Recall from the Arrow-Kurz analysis that “good” public investment requires investment in projects with *high* rates of return on capital invested. No boon doggles allowed!
4. Extend the Arrow-Kurz analysis via the Macquarie Bank (Australia) model so that a good portion of these projects can eventually be privatized.
5. Understand that the bond market will not view deficits resulting from such investments as problematic. Rather, they will see the true deficit as merely the *amortized* portion of the new public investments. Thus, the nominal \$1.5 trillion deficit becomes a negligible \$30 billion deficit.

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And then there’s the cream on the cake

Aside from the direct, on-the-face-of-it economic benefits of Brock’s proposed solution, there are more, he asserted. First is that the switch from deficit to investment spending will trigger “remarkably high” accelerator and multiplier effects, he explained. This essentially poses the best hope of reducing the unemployment rate, the critical success factor in any recovery equation.

Brock also confidently anticipates that increased investment in high-yielding projects will lead to an increase in productivity, and consequent faster growth of output and wealth.

One final and further critical factor underpinning the workability of the Brock Epiphany is the attractiveness of public infrastructure investment in the US and the UK. Brock maintains that neglect of infrastructure assets in the past decades is likely to boost returns from investments made today. He also pointed out that, in practical terms, on such major projects only governments can carry out the work successfully. The private sector simply cannot capture the rates of return on projects with so many variables and at the scales envisaged. Further, the risk premium encompassed in such investments is appropriate for governments, he argued, because it is lower than for private organisations due to governments’ abilities to pool risks.

Portfolio Perspective**WITHSTAND... AND DELIVER****Hamish Douglass, Managing Director, Magellan Financial Group (Australia)**<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-portfolio-perspectives>

According to Hamish Douglass, we want to build portfolios that will withstand the shocks, but we also want a portfolio that will deliver the returns. He gave four guidelines on how to go about it:

- **Have a safety margin.** Buy at price that makes sense based on fundamentals and that is at a lower price point than it's worth.
- **Invest in shock resistant companies.** These are the ones that are virtually bullet proof with the huge long-term competitive advantages that we need in an uncertain environment. Look for companies that have been established for a long time, or have outstanding brands or huge market positions or very low cost positions. These are the ones that survive, he said.
- **Thirdly, invest in a portfolio with a tailwind.** Although it's easy enough for value investors to get into a portfolio that looks cheap, if the economy is stagnant – as is likely, coming up – pure value often doesn't play out, Douglass warned. But, if you have a tailwind, even in tough conditions, you can get returns. However, this relies on identifying what stocks will attract this tailwind. For example, in his view, the payments industry is one, as we make the final move from cheques and cash to non-cash.
- **Take a look at the construction of the portfolio.** This involves looking at aggregation risk – that is, buying stocks that are so similar in character that they attract similar risks (shades of David Oyewong). It has certainly been difficult to fully understand what these risk are, especially when even if stocks are from different sectors, the same risks still apply. It's an area people have got wrong in the recent past, Douglass said – but an area that's essential to get right if you are aiming to build a shock resistant portfolio.

Portfolio Perspective**THE MORE THINGS CHANGE... THE MORE THEY STAY THE SAME****Peter Gunning, Global Chief Investment Officer, Russell Investments (US)**<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-portfolio-perspectives>

In Gunning's world view, investors do most certainly need to take into account new risks looming on the horizon: the possibility of sovereign debt default from a developed nation; fragility in the Eurozone; and, fear of a double dip recession, to name a few. However, he stressed that there's no need to undertake a wholesale rethink of how to invest. "After all, it is still discipline and hard work that produce investment results. Steps to protect a portfolio must be measured and thoughtful." That should be strongly directed at the issue of diversification, he said. Investors need to explore new opportunities – including areas such as emerging markets, global investing, commodities, listed infrastructure and global listed property, he recommended.

Critical Issues Forum

AVOIDING AVOIDABLE MISTAKES

Tim Farrelly, Principal, farrelly's Investment Strategy (Australia)

<http://www.portfolioconstruction.com.au/conference/2010-portfolioconstruction-conference-CIF-avoiding-avoidable-mistakes>

Tim Farrelly cut straight to the chase, looked not only at how to predict and avoid bubbles but also its equally elusive flipside – how to use objective criteria to get a clear picture of an asset’s true worth. The thrust was that bubbles are a regular feature of the investment landscape, can affect very large parts of the investment universe, and are enormously damaging in both the short and long term. But they can also, in some but not all cases, be detected in advance, he said – adding that given their deadly proclivities, all investors should at least make sure they avoid those that can be anticipated.

Love a good yarn?

Firstly, Farrelly took us through some of the reasons we so love to buy into bubbles (literally). As he pointed out, they are large, compelling and always backed by a gripping story, one that appears to make perfect sense, stands the logic test, and appears to be supported by the evidence of the market forces. Hard to resist, eh? By way of example, Farrelly ran through some of the bigger bubbles to have burst in recent history – the scarring legacies of which, he stressed, remain with us today. However, when the stories behind a bubble are good, we can be sucked in and those seemingly irresistible assets can too often become a way-too-large part of the portfolio.

Can your clients afford one or more of these experiences?

Asset	Year of peak	Fall from peak to trough	Time till trough
Gold (US\$)	Jan 1980	-71%	19 yrs
Japanese equities (Yen)	Jan 1990	-82%	19 yrs
Japanese residential property (Yen)	1991	65%	14 yrs
US equities (US\$)	Mar 2000	-56%	9 yrs
US REITs (US\$)	Mar 2007	-71%	2 yrs

farrelly's

Which brings us to how those bubbles recover. The fact is, they don't (see the slide above). However, too often, investors are very slow to recognise that fact, if they ever do. "In fact, investors often keep on with the bad behaviour, making the investment and losing even more," Farrelly noted.

Forewarned is forearmed

As Farrelly went on to point out, all of this is very interesting but unhelpful to the investor who wants to avoid the avoidable. Looked at through the right filters, these negative bubble outcomes are not only predictable, but in fact, self evident, he argued. He recommended the Occam's Razor forecasting methodology developed by John Bogle – essentially, this 'simplest is best' approach involves forecasting long-term returns by adding together the three parts of returns:

- income – i.e. the yield at the start of the forecast period
- growth in income – i.e. the expected growth rate of that income stream
- effect of changing valuation ratios – i.e. the rate of change of the valuation multiple

Perfect predictions and avoiding the avoidable

According to Farrelly, this methodology shows that over the long term, earnings tend to be around 2% below GDP growth and valuation multiples tend to mean revert over the long term. The result is that we can normally make quite useful long-term forecasts (as in 10 years – he warned it's useless for short term forecasting). But at market extremes, he said, this methodology is close to perfect at predicting when markets have entered a bubble phase.

So the big question for protecting portfolios is: when do you stop buying? "The answer is when you know what's going on – which means you will need backbone because everyone will tell you you're mad," Farrelly warned. "You can be out on a limb for a long, long time. But, the damage inflicted by a bubble is so profound that, in the end, it is worth it."

KEY TAKEOUTS

It seems that the jumbled pieces of recent years have finally begun to resolve themselves into a slightly clearer – albeit far from perfect – picture. Sure, there are pieces are missing and there's still much speculation about exactly what some of the shapes that are forming will become, but there are also areas of increasing clarity. Those are the areas on which the 2010 PortfolioConstruction Conference presenters found consensus:

- **Macro, macro, macro** – In a world that's increasingly interconnected, the impact of macro forces will assume ever greater importance. Ignore them at your portfolio's peril. As Tim Farrelly put it: "Have a good model of the world – have a good theory – so when you hear new information you know what that means to you. You can make sense of it and know what to do with it."
- **Get used to shocks** – Shocks, extreme or 'black swan' events are par for this investment course. We need to learn to anticipate and plan for them as part of business as usual, not wail about how unforeseen they were *ipso post facto*.
- **Emerging, emerging, emerging** – As has been the case for the last five or six PortfolioConstruction Conferences, the importance of positioning portfolios to capture the growth of emerging nations was a key theme. The importance of the role of developing countries and the staggering rise in spending power of a massive, swelling middle class cannot be underestimated and was probably the most canvassed issue at this year's Conference. Further, there was a widely held view that growth of these emerging markets will offset – in various degrees in various opinions – the doldrums of the developed world. There was also general agreement about the upside of gaining exposure to these markets via the developed markets.
- **China** – When it wasn't all about the macro or emerging markets in general, it was all about China in particular. All are keenly alive both to the general upside and to the universal downside that a China collapse would bring; but most presenters agreed that a full collapse, at any rate, is unlikely. However, one would be foolish not to factor the potential downside as well as the rosier picture into risk, scenario and disaster planning.
- **Safety first** – We heard a lot about one- and two-cylinder worlds, financial freeways, shock absorbers and seatbelts, along with gear changing, easing off the accelerator, slowing down and keeping our hands on the wheel. The key message? Safety first...
- **It's all about risk** – Risk and the way it is perceived, anticipated and managed in portfolios is more critical today than ever. However, there is no room for the old rules and conventions – instead we need to take a fresh look at risk and abandon conventional models and theories because they simply do not work. Increasingly, strong correlations between asset classes previously considered to be counter-cyclical is just one illustration of the need to take a new view. In Chris Watling's words, "qualitative risk analysis is very important. We need to apply our critical faculties to the whole story and think the unthinkable". (Refer to David Owyong's qualitative risk management framework.)

- **Diversify or perish** – But, in line with the point above, don't expect a conventional approach to diversification, in which assets can be placed in neat baskets where they will perform like trained seals, to work either. Once again, a fresh and thoughtful approach is required, along with plenty of imagination for scenario planning, lavish factoring of macro issues and a good dose of extreme events.
- **Don't follow the benchmark** – Indexing may be the favoured "safe" strategy of the once-bitten masses, but not one of the Conference presenters favoured a benchmark approach and many went out of their way to highlight the flaws of a system that is, in their view, built on sand.
- **Dividends are back in fashion** – There was suggestion that the 'good old days' of modest but reliable dividends might be back, with investors looking for certainty rather than elusive and volatile capital growth. Similarly, the appeal of properly constructed annuities, minus astronomical commissions to provide meaningful levels of comfort in retirement, was considered and may well be on the rise. As Woody Brock put it, for investors of a certain age, it may be time to forget about the razzle dazzle. "You can build a fabulous annuity with sensible dull solid stock and corporate debt."
- **Get real** – And, on a final note, there was a universal acknowledgement of the need for investors to get real, to go for solid companies that make real things; for governments and economies to return to a focus on real assets and real value, and for the unwinding of a bloated and highly concentrated financial system in which resides an inordinate amount of notional value that is unlikely ever to see the light of a real day.

About BlueChip Communication Group

BlueChip Communication is one of Australia's leading financial services communications firm. It provides clients with a comprehensive range of financial communication services from small-scale media profile building to comprehensive and integrated marketing communication campaigns.

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