

The road(s) to recovery

Communiqué

The Mother of All Stimuli and Beyond

(Or why everything is getting very, very real – and what to do about it)

Just as celebrated New York broker and Ponzi scheme fraudster Bernard Madoff is headed for justice, so too have developed world economies had their day of reckoning.

Bruce Madden and the BlueChip Communication team – Nicki Bourlioufas, Carden Calder and Paul Cheal – attended the Portfolio Construction Investment Markets Summit 2009 to hear how a world, in crisis, is suddenly very, very real, and the ways our local wealth management industry can meet the challenges.

February 2009

in association with



BLUECHIP COMMUNICATION

supported by

Money Management

SuperReview



IF DELEGATES CAME looking for soothing words and “glass half-full” rhetoric regarding the crisis engulfing world financial markets, the PortfolioConstruction Investment Markets Summit 2009 was not the place to be.

That is not to say the messages were overly pessimistic. Pessimistic, yes, but not irrationally so.

The term to describe the opening presentations from guest speakers Jonathan Pain (a noted pessimist) and Dr Jack Gray (a self-confessed market atheist) was matter of fact. Pragmatic, realistic, sensible. Let the facts speak for themselves. With an additional gloss of hope to help ward off the fear that the raw data shows, as Pain put it, that “we may all soon be living in caves”.

The big lesson was that we have entered a new era – in Huxley-esque terms, a Brave New World where markets have suddenly priced in an underlying reality. But whether we fragile humans will learn from the lessons of a past decade of easy credit and obscene corporate debt; whether we are able to adapt properly to a new reality – including ever increasing levels of Government intervention – remain just a couple of the imponderables tackled at the Summit.

A world in crisis

The late Kerry Packer was a big man fond of the defibrillator, a portable resuscitation device used one time by paramedics to jolt his larger than life frame back to life after suffering a cardiac arrest on the polo field. He was a noted punter and entrepreneur who would have appreciated the large set of numbers behind the global government intervention gamble – a monetary and fiscal defibrillation of unprecedented magnitude – which now holds the key to the immediate future of investment markets, especially those of the Anglo Saxon variety. As Pain described it: “there is an extraordinary quantum of money, the mother of all stimuli” underway around the globe right now.

And while the longer-term economic outcomes of the various stimuli are uncertain, the immediate market future looks grim.

Pain suggested that we collectively face a far more frugal future, though we first must endure a “ghastly” 2009, due largely to the after-shocks of last year’s massive global economic dislocation – a little like a detox programme for a recovering drug abuser.

Having taken our medicine, an economic recovery may be possible towards the end of this year, he argued, as capital continues its “glacial speed” thawing, and global Central Banks race to zero on official cash rates. The encouraging news is that market recovery will often precede key economic signals – so the market timers will need to take account of this.

But just as a plain-speaking medico might deliver a difficult prognosis to a heart attack victim, Pain shared his direct diagnosis for overcoming the “global economic cardiac arrest” of 10 October 2008. “But the bigger question is: how on Earth did we get here in the first place?”

He pointed the finger directly at the “shameful and predatory” lending practices of large financial institutions – the rise of the so-called NINJA loans in the United States (no income, no job, no assets required) which, together with cheap capital and a compliant Government policy of allowing the population’s disenfranchised to sign up to a house mortgage they did not have the means to repay, underpinned the sub-prime credit bubble. Australia was not immune, with the “no deposit, no worries” syndrome equally symptomatic of the local easy credit, quick profit binge mentality.

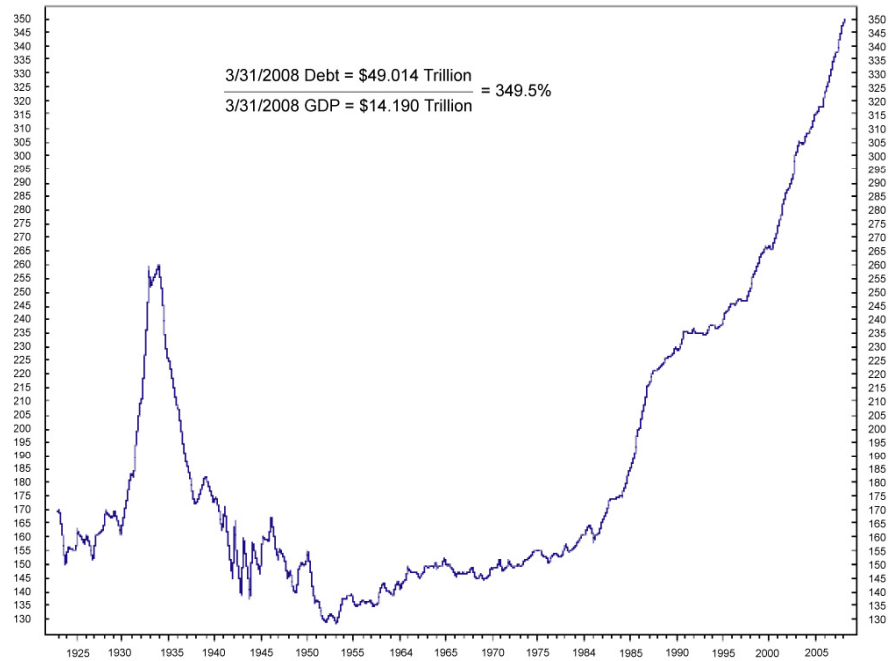
Pain highlighted the very real effects of the sharp credit contraction in stark examples: a mosquito plague in the US city of Stockton, due to stagnant swimming pools in vacant lots; the Baltic Dry Index, a global measure of international shipping and trade activity, which took an unprecedented plunge mid October 2008; and – as Graham Rich pointed out in his opening presentations – forward orders for Volvo trucks which similarly fell off the proverbial cliff, to just 100 trucks on order this year, down from 42,000 in 2007. Such are the harsh facts of the rapid decline in real economic activity gripping the globe.

But the “scariest graph of all” said Pain was one demonstrating the massive blowout in the ratio of

global debt to Gross Domestic Product (Figure 1 below).

In more recent times, Japan and Germany are but two developed nations to have produced “catastrophic” GDP numbers in terms of their severe 10 per cent plus contraction, with more bad news to come.

Figure 1: Global Debt/GDP



source: Ned Davis Research Inc. Quarterly data 31/12/1922-31/03/2008

Deafness and inertia

For Dr Jack Gray, Adjunct Professor at University of Technology Sydney, one of the biggest lessons of Q4 2008 was the inability of market participants to heed the warnings. He listed at least 10 wise prognosticators, including the likes of Bogle, Gross, Grantham, Shiller, Krugman et al who went largely scolded or unheard). He also highlighted the inertia which led the economic fundamentalists to continue to believe that markets are both moral and optimal.

Professor Gray said that investors must focus on the long-term (which does not mean relying on set and forget portfolio construction), and that courage and culture are required in the corporate sector to defend against the dangers of the herd mentality and the effects of momentum pushing prices beyond fair value.

He cited Canadian-based Toronto Dominion Bank as a prime example of a corporate culture led by a Board which had the courage to say no to the sub-prime nonsense – a culture of prudence that has seen it emerge somewhat heroic and far sighted in this new market environment.

What were the key takeouts?

- Global markets will be in a very difficult period for the next 6 – 12 months;
- The global stimuli of governments remains an uncertain part of the equation;
- We may be entering a more balanced world environment, with a greater fusion between East and West, and the chance to flush out the worst of rampant capitalism and greed; and,

- China is the new global locomotive, followed by India – expect 6 to 7 per cent growth in the coming year for China, with India at 6 per cent.

Global equity markets

Charlie Lanchester, Portfolio Manager with Perpetual Investments, was an optimist when it came to Australian equities.

While he acknowledged he'd keep some of his own personal assets in cash as a security measure, he argued that equities are still worth buying, even in the current times. For investors, it is a time to pick value and quality stocks, he contented – and they do exist, as long as you're not looking at the listed property sector or dabbled in financial engineering stocks (and frankly, who would be, anymore?).

"In an environment of fear and uncertainty, history suggests better times will return for the stock market, but it's important to focus on quality companies that will prosper in future times," he said.

"Now is a great time to buy stocks which have been heavily sold down. There are once in a lifetime opportunities," Mr Lanchester said, convinced that value investing will have a key role to play in the equities recovery. "For only the second time since the 1950s, shares are yielding more than cash. Dividends would have to fall another 60 per cent to equal the cash return. This has never happened. On this measure, the [Australian equities] market is looking attractive."

But, he warned, investors have to pick companies where yields can be substantiated.

Indeed, the challenge is to choose companies with low debt levels and good management, which will differentiate those stocks in hard times, Lanchester said. "Avoid companies without it. There are some stocks which have been sustainable businesses and strong balance sheets that have nonetheless been oversold, particularly in consumer based sectors. Some of these companies are priced on extremely attractive valuations."

Key signposts of a recovery to watch for include the unfreezing of credit markets and the emergence of business credit growth and a pick up in the housing sector, Lanchester said – but, until then, balance sheet strength would be key to investing. Strong companies will survive and go on to thrive after the downturn passes.

"Stronger balance sheets will eat the weak (or their assets) at value-creating prices. The listed market will be able to acquire assets from leveraged structures such as private equity and unlisted vehicles."

Speaking next on global equities was Rob Gensler, Portfolio Manager Global Equity Strategy with T.Rowe Price. Gensler was also upbeat on buying opportunities, despite expectations of a long economic downturn.

The current "transition" phase of the global downturn could last several years, he argued, and warned that during this transition phase, the news will get worse before it gets better. There will be "numerous indiscriminate market rallies" and, at least in 2009, only a modest improvement in financial system stability. Huge fiscal stimulus packages will take time to take effect and deleveraging and liquidity need to return to markets before the global economy recovers.

But Gensler was bullish on a two- to three-year view. "Quality companies that take market share will win. Balance sheet strength and cash-flow generation will be rewarded," he said.

For him, like for Lanchester, strong companies exist, even in weak times.

While stocks may not yet be at fair value, there will be huge dispersions between stocks and between countries, Gensler argued. "Quality companies that take market share will win," he said. "Investors will be able to share in the spoils, even though there will be less to share around."

Like Lanchester, Gensler pointed to relatively high dividends yields as a carrot for investors. Average dividend yields in developed countries now exceed not only cash rates, but yields on 10-year government bonds – so equities are heading towards attractive valuation levels.

Like all commentators now, Gensler noted that risk needs to be addressed. While his role is to still allocate money to equities, the process of selection is changing to incorporate more qualitative, as well as quantitative, measures.

“Risk management needs to be a holistic process. Both quantitative and qualitative tools need to be incorporated.” So, as well as crunching the numbers, investors need to be asking whether the deal feels and smells right.

“It’s not the end of the world as we know it, it’s the end of the world as we knew it,” Gensler said.

Emerging market growth

Allan Conway, Head of Emerging Market Equities with Schroders, was a bit more sober on the economic outlook, believing a global depression to be a distinct possibility. He expects equity markets to retest the lows of 2008 and for economies to remain depressed for a long time, with the real risk of a depression despite huge fiscal stimuli around the globe.

“That’s the issue,” he said. “Are we in a prolonged recession in a depression, for which we don’t even have a definition?”

Despite the expected gloom, emerging markets are expected to outperform developed markets in coming times – even if the global economy falls into an extended recession or depression, emerging market economies will still grow, he argued. And he had the numbers to back up his de-coupling theory.

“This year, emerging markets will account for 100 per cent of global growth and going forward, after the recession passes, they will account for 70 to 75 per cent of global growth. The baton has been passed from developed countries to emerging markets,” he said.

Conway noted that emerging market growth rates depend on the economic scenario, but the numbers are positive – as high as 3.5 per cent in 2009 and 4.5 per cent in 2010 on a base case scenario. The outlook is so much more optimistic than for developed nations because emerging markets rely on domestic demand to grow, rather than export-driven growth to developed countries, he explained. On top of that, countries like China export more to other (growing) emerging markets than developed countries. “So emerging markets are far more able to confront a recession or depression than developed markets,” Conway said.

“On an 18-month to two-year view, it’s highly likely there will be some very strong absolute returns to be had [from emerging market equities]. But over the short term, at least over the next three to six months, markets will remain volatile and we could possibly retest recent lows,” he warned.

This generated discussion between panel members and Dr Jack Gray and Jonathan Pain, who stayed on in the role of Inquisitors, challenging the equities presenters on their views.

“The fundamentals for EMs are extraordinary,” Pain agreed. “The liquidity crisis drove overselling... so I am longer-term bullish on the emerging markets.”

Gray agreed, with reservations. “Yes, the baton has been passed, but those secular moves take a long time. But never write off America, it recovers enormously quickly and can move on. It can recover – at great human cost, but it can do it.”

All three equity presenters, along with Gray and Pain, agreed a global recovery required a return of liquidity to market and that the huge fiscal stimulus was necessary, if ultimately inflationary.

The risk remained, though, of a move towards protectionism. “That’s the one thing that really could spill this into a depression,” warned Pain.

The Culprit: Credit Markets

Onto global credit markets, the mood at the Summit was perhaps more pessimistic, but investment strategies have been sharpened for the downturn.

Graham McDevitt, Head of Global Strategy at Macquarie Funds Management, said the global credit market could be considered the cheapest asset class at the moment due to a huge widening in spreads. Spreads could widen further still, he argued, and great uncertainty remained over the asset class due to the possibility of corporate defaults exceeding levels reached during the Great Depression. But still, the sell-off exposed value.

“Credit markets are offering value,” McDevitt said. “But we have a very bottom-up approach, a very conservative approach. There are things still to watch out for.”

- Liquidity needs to improve. There are signs of improvement, such as deals being cleared and upsized. This depends on continued government support;
- Banks earnings need to be watched for their ability to cover credit losses; and,
- More equity volatility is another key risk.

For that reason, 2009 will be the year of the credit analyst, he predicted, with a downside risk to credit ratings and upside risk to defaults.

“Credit is cheap, but focus on quality. We prefer investment grade credit to high-yield and emerging markets and we prefer banks to corporates.”

However, McDevitt offered a sobering caution that any recovery would likely be L-shaped, rather than V-shaped. “At best, we’ll get a W- or U-shaped recovery,” he predicted.

As for government bonds, the good times are over after outperforming other asset classes in 2008.

“On a longer-term basis, bond yields look extremely expensive relative to inflation... it is hard to find value in government bonds.”

Head of Fixed Income Asia for Aberdeen Asset Management, Anthony Michael said that like McDevitt, he sees comparisons to the Great Depression, saying the current environment “isn’t dissimilar” to a 1930s-style depression.

Michael sees upward pressure on longer-dated government bonds due to increased budget deficits and the ongoing debate about the inflationary impact of global monetary policy easing.

But, he said, non-government bond spread sectors have become increasingly attractive. “The investment grade credit markets offer compelling value on a medium-term basis.”

However investors should pick their fixed income funds cautiously, Michael warned, noting a huge divergence in global fixed income fund performance in 2008, “with 27 per cent difference between the best and worst global bond managers.”

While government bond investors did best, those exposed to mortgage-backed securities and high-yield product suffered the worst of the credit crisis, “or were the bottom dwellers of 2008.”

That’s a scenario which might well be repeated in 2009, he warned. He doesn’t expect an economic stabilisation until 2010 when real growth will return to economies. “It’s still too early to talk about a recovery in a macro sense, we’re still on the slide.”

“We need to see signs that the economic stimulus is working... and we need more deleveraging from the finance sector,” he argued.

Bricks and Mortar, anyone?

It's not only the finance sector that's dealing with leverage, the property sector has similar issues.

Andrew Parsons, Managing Director and senior portfolio manager with boutique property investment manager Resolution Capital, is by nature an optimist – but admitted that the current reality is all too challenging for some investors.

“If you don't go out and kill yourself, you're actually an optimist,” was an exchange which was greeted with some applause, after responding to comments from Dr Gray who tackled Parsons' outlook on the property sector (and tackled fund managers generally).

Parsons was particularly critical of Australian listed property trusts (A-REITs) which had adopted high levels of gearing and high dividend payout ratios in recent times – unsustainable and damaging to investors, in summary. He predicted that dividend payouts will fall 39 per cent in 2009.

On top of that, asset devaluations have only just started, he argued, and some of the \$8 billion in equity raised in recent months by A-REITs will go towards covering damage caused by bad investments, as well as future debt commitments and currency hedging losses.

“Tenant defaults is becoming an issue. We expect the greatest pressure in office rents, in part as the banking sector shrinks. Rents will be under pressure and we expect average market rents will fall by over 25 per cent over the next two to three years.”

So, is the news all bad?

Parsons argued that global property trusts offer superior diversification for investors. Equity and bond investors diversified globally decades ago, he noted, and now is the time for property investors.

The challenge will be to focus on income resilience and quality property assets. His simple rule for investing is that in contracting economies, those with the lowest gearing win. Like the other portfolio managers, he sees investment opportunities, but warned that careful management is necessary in today's times. “The market is starting to look attractive. Valuations are fair to attractive but extreme valuations are likely to emerge over the next six to 18 months.”

Bracing for the regulatory and legislative backlash

What is a sensible reaction from the government regulators and lawyers? If you are a government Minister would you be inclined to continue, for example, to ban short-selling of stock? Would the quasi-nationalisation of super default fund options create an optimal outcome? What are sensible approaches to regulating the superannuation environment – free market forces or greater government intervention?

Dr Justin Wood, speaking on behalf of IFSA, explained his four part rationale for the global financial crisis, to help set the scene for discussion on the local industry and potential regulatory fallout.

1. Easy Money = the formation of asset bubbles = crisis;
2. Relaxed lending standards;
3. Increased complexity, decreased transparency; and,
4. Conflicts of interest and the over- reliance on modeling.

Notably, in relation to point four, Dr Wood said the elements of liquidity, solvency and moral hazard

must be taken into account, as well as controlling systemic risk. As well, informed and educated investors are a vital part of the mix in helping to stem conflicts of interest in the system.

For Jo-Anne Bloch, Financial Planning Association Chief Executive, a key element of future government reaction is the need for more effective financial literacy programmes. Citing the recent Storm Financial scenario, which Bloch said was a “complex, multi-faceted... debacle, to put a name to it”, she noted that affected investors would no doubt have benefited from understanding in greater clarity what they had signed on to, especially the risks, as part of their lengthy statements of advice.

Bloch also firmly stated that the entry level bar for financial planning is set too low. “The standards are not good enough – we have recognised this and have been focused on this for some time.”

The Final Word

Picking up the key takeouts for institutional investors, Simon Eagleton, Business Leader with Mercer Investment Consulting, said the Summit presented timely, relevant content: “I ran out of paper taking notes,” he said.

Eagleton said he took away three key points:

- **The extent of uncertainty**

“In an uncertain world what are our levers, what are our tools for institutional investors? The one we come back to again is diversification,” Eagleton said.

“Diversification is extraordinarily important. The traditional reliance on the equity/risk premium – as we all have done – has been revealed as flawed. And in fact (Professor) Jack had a little gem buried in his presentation where he talked about some alternative sources of long-term return in insurance-linked securities.”

Eagleton suggested the insto market must adopt a cautious re-entry approach to markets – coining the world gradualism to describe it. “The best we can do is take incremental steps (caution) and we need also to take a medium-term view (two to three years, seeing value in equities). For insto clients, the outlook is many decades long. And in that longer term context, there are some opportunities emerging.”

- **The importance of truly skilful active management in this environment**

“The dispersion and total dislocation in pricing has been dramatic,” Eagleton said. So hiring truly skilful contrarian active managers is important, he argued, and questioned the skills of hedge fund managers.

- **Opportunity knocks**

“Despite the doom and gloom, value may well indeed be finally emerging in many sectors of the capital markets, and I am impressed by investment grade credit,” he said.

“Convertibles also appear to be offering great value, as do emerging market equities.”

Eagleton made a further point about illiquidity and resilience. In other words, those able to withstand illiquidity (or rather the ability to exploit a tolerance for illiquidity and volatility) will be rewarded. “If you can tolerate illiquidity, this could be the buying opportunity of our lifetimes.”

Eagleton finished on a broader note – the obligations of industry to show leadership. “We are all influential and have an obligation to remain calm,” he said. “We do not always have to remain optimistic, rather we should be confident about the advice we are giving our clients, and steward them through this panic.”

He said the key challenge is setting realistic expectations about future returns – and helping clients “be contrarian” against the flow of bad news.

For Tim Farrelly, principal of specialist asset allocation research house farrelly's, the Summit produced four themes, which he posed as key questions:

- **How bad will the economy get?**

“Ghastly,” Farrelly agreed with Jonathan Pain. The complete drying up of the real market is remarkable, and the worst thing is, it’s really only just begun. The Japanese economy has gone backwards at a rate of 10 per cent per annum, which no one can ever recall happening before. Retail US went back by 2.7% in December alone, compared to the biggest ever one-year downturn of 2.4%. S&P500 sales were down 10% in 2008. We’re used to seeing profit going up and down, but sales are something you expect to run in line with GDP, and if GDP fell by 10% we’d be in real trouble.

“I expect the news to get worse and worse, and that came out very clearly (at the Summit),” he said. “Is it a lost decade we are in for [aka Japan]?”

Farrelly agreed that the baton has been passed to emerging market economies from the US. “We’re highly confident that there will be better growth in emerging markets,” he said. But, he noted, there’s very little correlation between good economic performance and good share market performance – but there’s a very strong correlation between bad economic performance and bad share market performance.

“The whole question of inflation vs deflation was very important,” he noted. “The sense I got was we don’t really know, but it’ll probably be both. We’ll probably see deflation for a while, then inflation, so we have to worry about both.”

- **When will it be safe to get back into the market?**

Soon but not yet, Farrelly concluded. “There seemed to be a consensus that it may not be too far away... but we’re not there not yet.”

Buy equities? Not yet. Farrelly noted that while there was a lot of scepticism across the Summit speakers as to whether it’s a good time to invest in equities right now, there was a very clear consensus that quality is important – low gearing, good cashflow, strong balance sheets, etc. But, he warned, “when every fund manager is focused on quality... then maybe the quality stocks aren’t the bargain they appear”. The exception on equities may be emerging market equities.

Buy REITs? Again, not yet. “I didn’t get the sense that the bad news was over,” Farrelly warned. “There’s clearly still a lot of risk applying, particularly on the re-financing side. With 25% reductions in rents and... potentially, a reasonable rise in yields, the value of that market could yet fall very substantially and with the amount of gearing there is clearly still come problems.”

High Yield credit? Probably not yet. “The risks might be justified,” Farrelly said. Given the “horrible” state of the economy, you may need every bit of the 18-19 per cent spreads to get anything back, he argued.

Government bonds? The general sense is that yields are too low, Farrelly noted, particularly given the consensus that inflation will pick up later on.

“The standout for the day was investment grade credit spreads,” he said, noting that you’d need a 38 per cent failure rate before you’d get back to Treasury rates.

- **What to do now with client portfolios?**

“We’ve heard that things really are different this time,” Farrelly said. “On this one occasion, things really do seem to be different.”

“But everyone was also saying ‘stick to your process’. If your process has been built to deal with very different times to what we’re in now, you have to ask yourself whether it’ll work in this new reality. My guess is that for most, not much will need to be changed, but it’s worth thinking long and hard about.”

Farrelly noted that all the Summit speakers believed there are huge opportunities in country selection and stock selection. He sounded a note of caution: “Normally what happens when you find a broad market that is tanking, and you find a whole pocket of opportunities, you get wiped out,” he warned. “My takeout is that there will be an enormous amount of variability [in fund performance].”

“Whatever you do, diversification will be absolutely critical in these times. The idea that was emerging a year or so ago of concentrated portfolios is a very dangerous idea right now.”

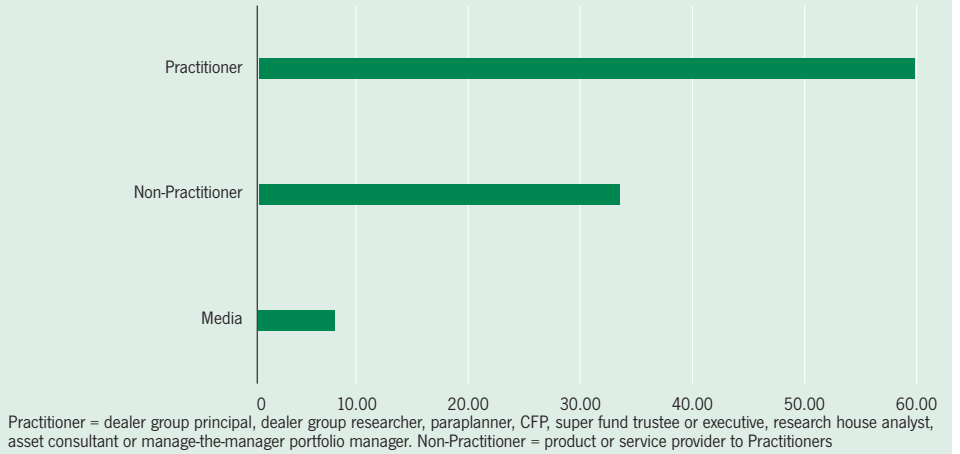
In particular, you should be asking “how good are these valuations?” Farrelly said. “Identify where there’s value and ease in. One of the beauty’s of easing in is that things can stay cheap for a long time. At times like now, when there’s so much uncertainty, dollar cost averaging makes sense.”

- **Can we get some sensible regulation?**

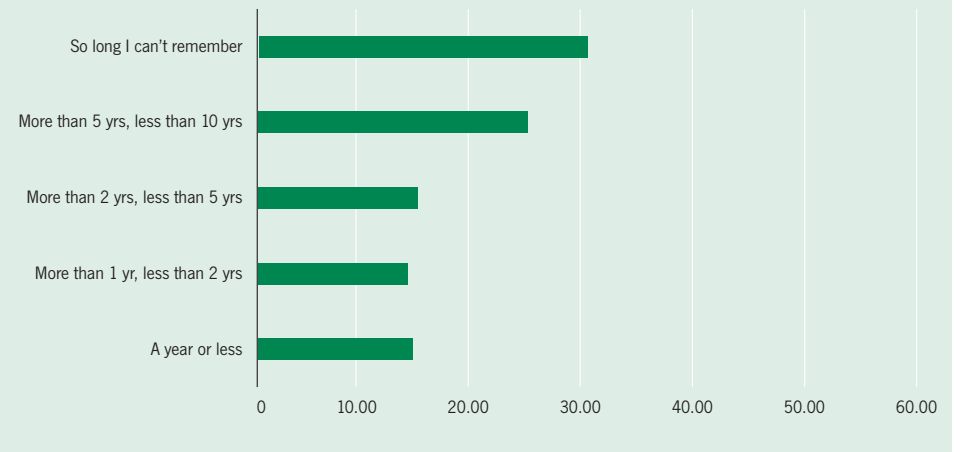
“It feels like everything to do with borrowing in the banking sector will get an overhaul, right down to legislation concerning margin lending,” Farrelly said. He questioned the wisdom of reforming bank lending practices through legislation, while simultaneously trying to rescue banks. “You want to start them lending, but the regulation is all around stopping them lending,” he noted.

“Yes, one of the challenges is financial literacy – but it’s tough right now. If the great investors don’t know what’s going to happen, then communicating with clients is going to be tough.”

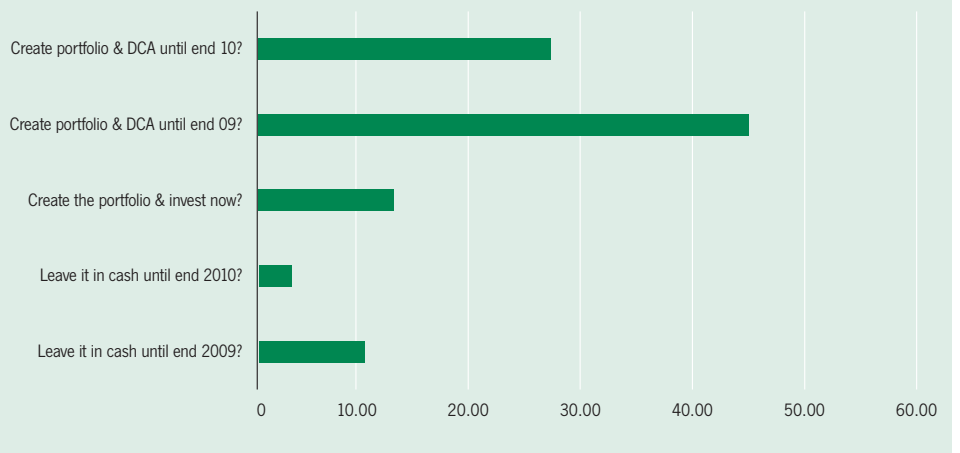
PortfolioConstruction Investment Markets Summit 2009 – delegate profile



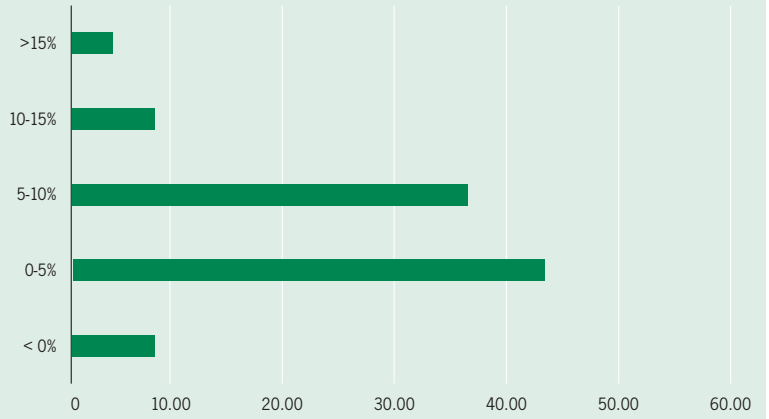
How long have you been in your current role?



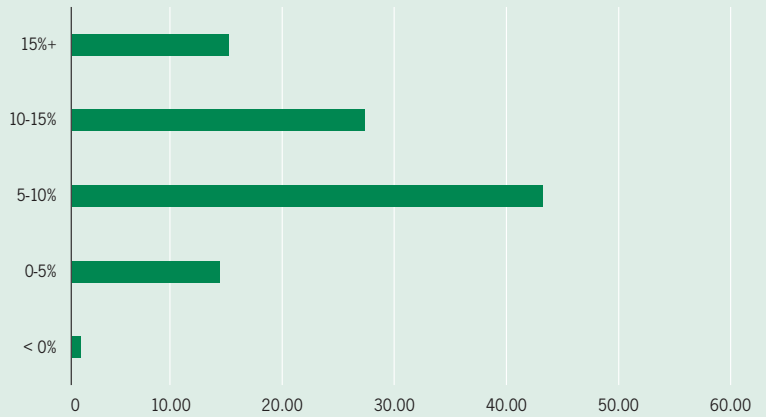
A client has new money to invest for the long-term. Do you agree to:



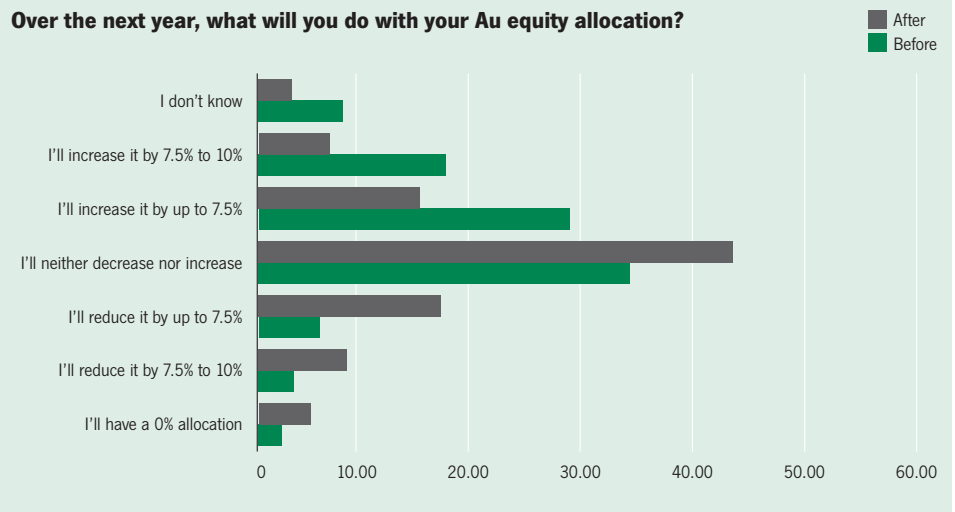
What is the expected return of your model balanced portfolio for the next 12 months?

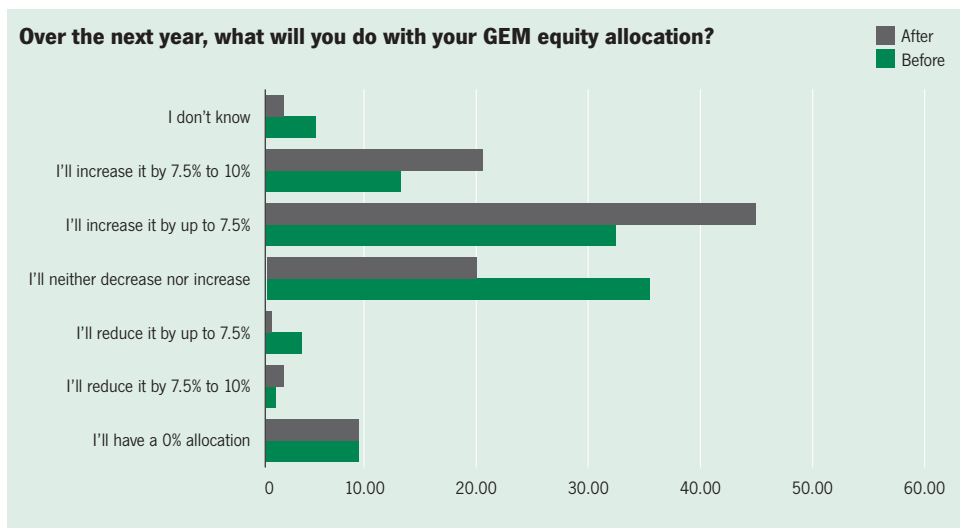
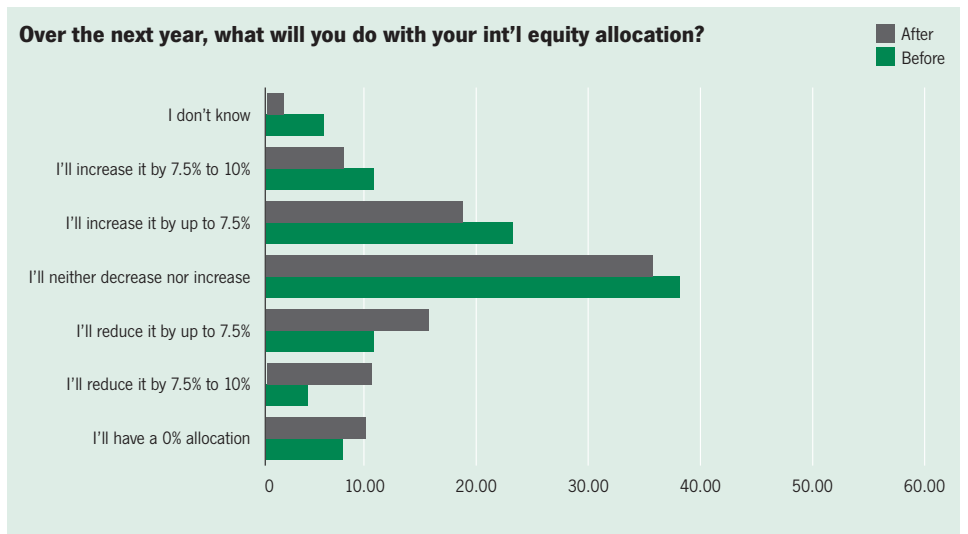


What is the expected return of your model balanced portfolio for the next 2 years?

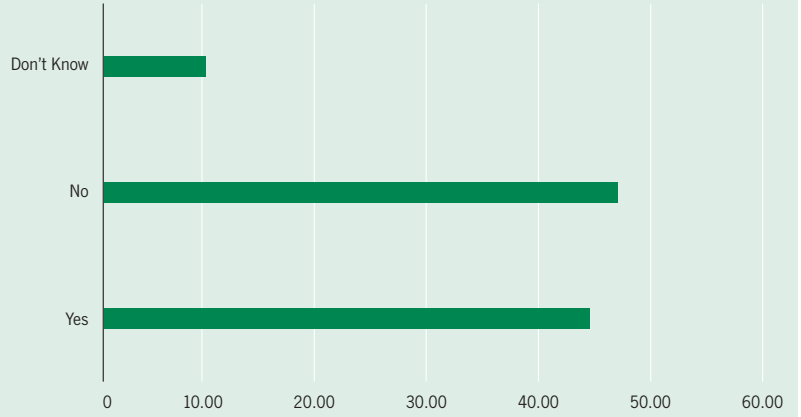


Over the next year, what will you do with your Au equity allocation?

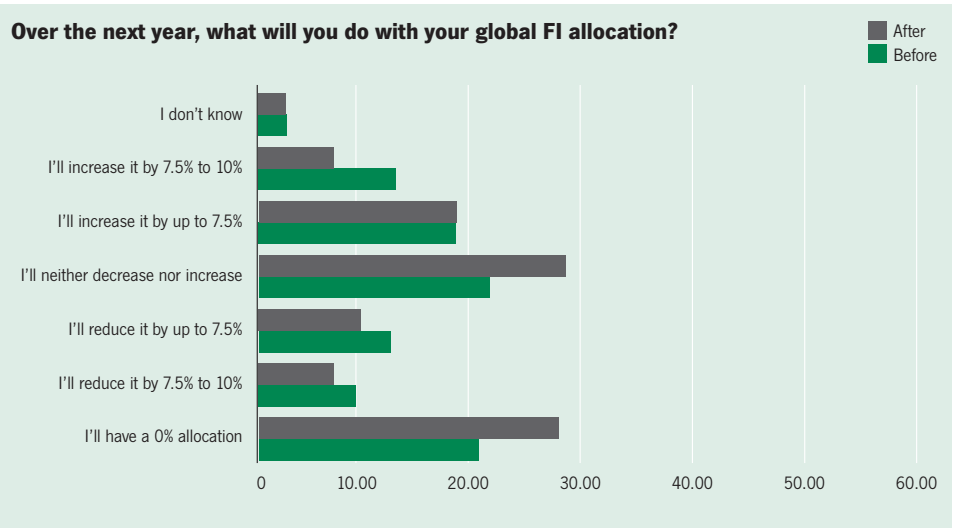




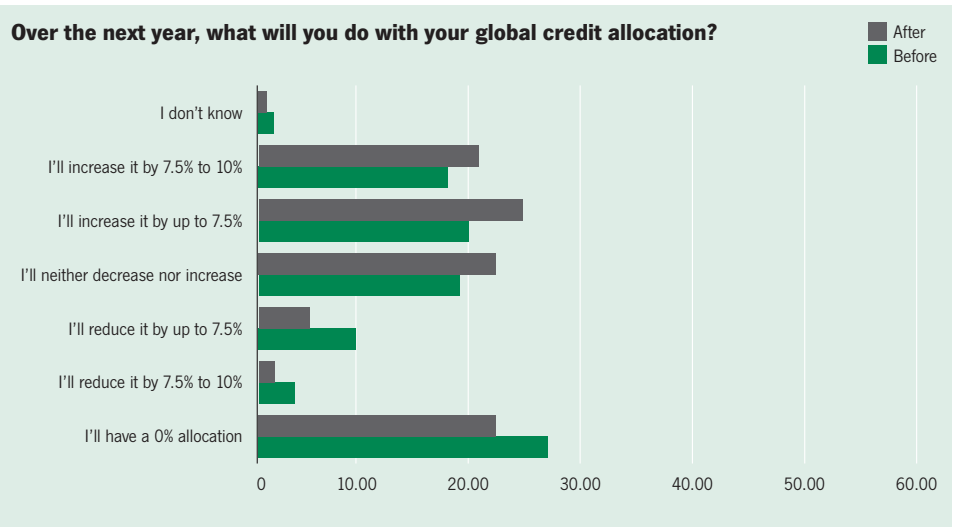
If you are going to increase your GEM equity allocation, will this come from your global equities allocation?

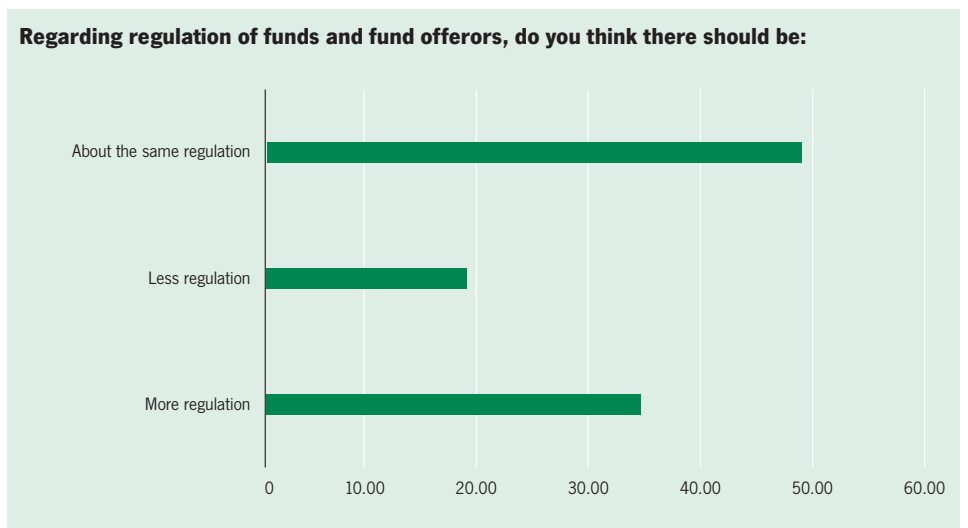
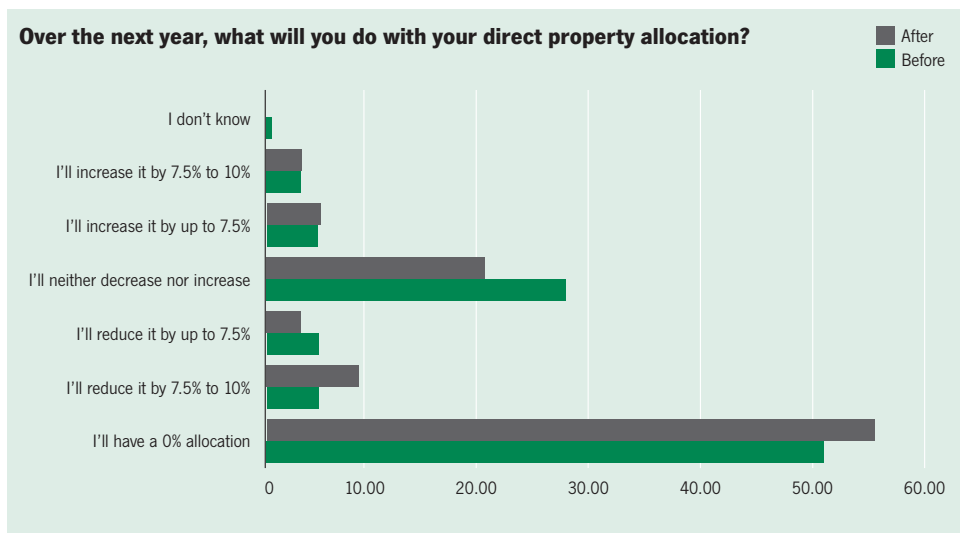
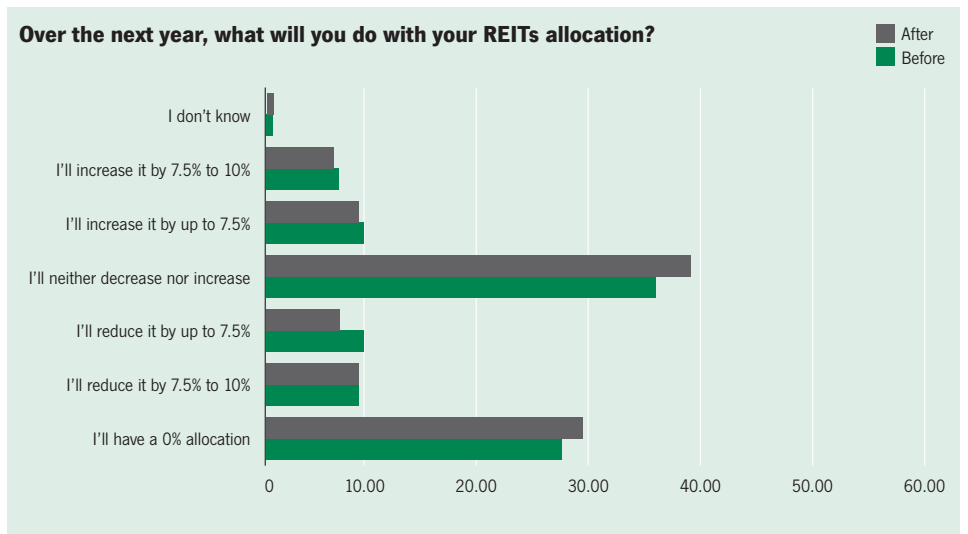


Over the next year, what will you do with your global FI allocation?

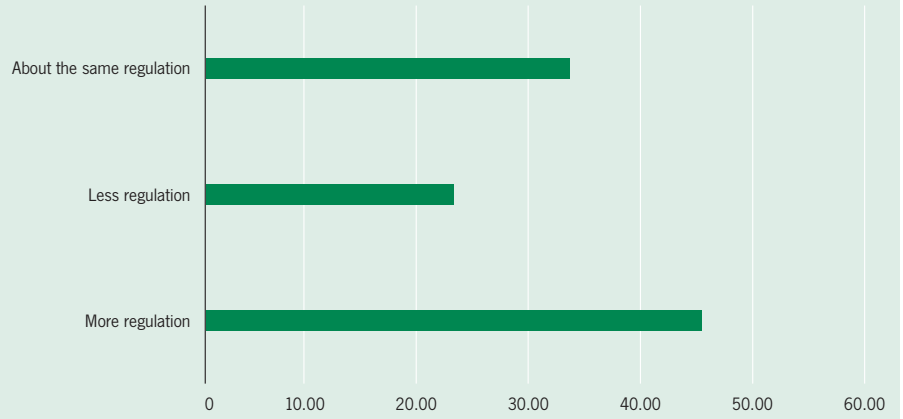


Over the next year, what will you do with your global credit allocation?

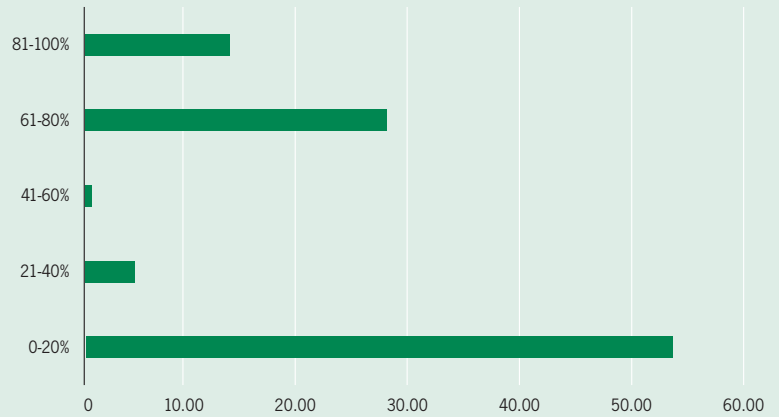




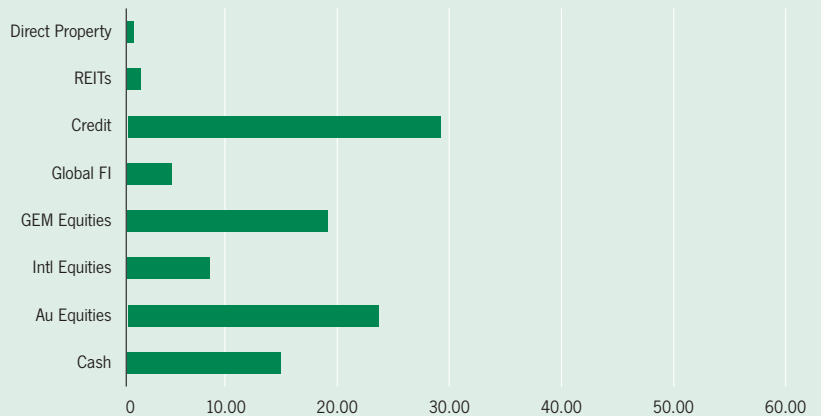
Regarding regulation of financial planners, do you think there should be:



In your OWN investment portfolio, what is your allocation to cash now?



For your own investment portfolio, what is your standout preferred asset class for the next 12 months?



Should I be completely reviewing my asset allocation in light of the markets over the past year?

