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ARE WE THERE YET?

A SYNOPSIS OF THE 2010 PORTFOLIO CONSTRUCTION MARKETS SUMMIT

By BlueChip Communication Group

PortfolioConstruction Markets Summit is part of the PortfolioConstruction Forum, a professional development service for portfolio construction practitioners. The Summit facilitates debate on the outlook for the markets.

As we entered a new decade, the 2010 PortfolioConstruction Markets Summit featured a dozen independently selected investment experts engaging in a high quality discussion of the short- to medium-term (2010-2012) outlook for markets and the risks and opportunities ahead.

This Communique forms part of the Summit Resources Kit, and is split into four parts, around the four themes of the Summit:

- *The Big Picture* — *page 3*
- *The current status and 2010-2012 outlook for the global debt markets* — *page 8*
- *The current status and 2010-2012 outlook for the global equity markets* — *page 11*
- *Key takeouts and portfolio construction implications* — *page 19*

'Just when you thought it was safe to go back in the water…' Yep, cue the Jaws theme music and you have the overriding theme for portfolio construction in 2010 and beyond, according to the PortfolioConstruction Markets Summit 2010. The unexpected strength of the global recovery in 2009, and the green shoots that held such promise have, in the main, remained exactly that – shoots. And while there are pockets of opportunity, the economic and investment outlook in the developed world at least, is generally gloomy, with caution the order of the day. Even the optimists are tempered by caution.

Time and again during the presentations and Q&A at the PortfolioConstruction Markets Summit 2010, issues were raised around the deep seated structural problems that led to the Global Financial Crisis – and, more especially, the very real danger that there is not the political or corporate will in place to address them. New bubbles are already forming as we return to old (bad) habits and, as one presenter put it, bubbles burst, they don't deflate with a gentle sigh.

Spending and debt are the big issues. Many presenters were at pains to point out that more than a few stimulus measures in fact encouraged spending, rather than saving, and that we are feeding debt-instigated problems with more debt – putting out the fire with gasoline, as they say.

And, even if we do end up with a thriftier consumer, the results of even further suppression of demand and the flow-on effects in the markets are less than thrilling – at least judged by 'old normal'

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standards – another of those damned-either-way situations leading to lesser-of-two-evils choices… which pretty well summed up much of the mood at the Summit.

Other recurring themes were there when and how of the withdrawal of stimulus packages around the globe, sovereign debt, high unemployment levels and the as yet unknown, but feared, effects of greater financial regulation and capital controls in response to what's gone before and impending crises. Emerging markets and Asia ex-Japan were identified as offering more appealing prospects but not without difficulty and risk. The impending decoupling of East and West and the timing of predicted outflows of capital were also much discussed.

Of course, Australia's performance was painted a bright spot on the landscape, however to believe we are immune to the ills of others in our ever more 'joined up world' is wishful thinking.

Against that background, it's over to the 12 investment experts from the PortfolioConstruction Markets Summit 2010.

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THE BIG PICTURE

Doug Hodge, COO, PIMCO (USA)
Robert Swift, Head of Multi-Strategies, BT Investment Management (Australia)

Investing in the new normal

If 2008 was the year of financial collapse, and 2009 the year that saw the power of government policy, then 2010 is the year that will see the limits of government policy tested as the world's economy is reset into a new normal, according to Doug Hodge, COO of global bond house, PIMCO. And, while we are yet to see the full shape and form of the new normal, what is certain is that it will not be like the old normal, he said. That is, those who expect trends and curves to follow their traditional, rationally driven linear or bell-shaped courses - and invest accordingly – are likely to fail.

The same factors that limit government policy, or that may influence it in a direction counter to free market rational tradition, are those that must be taken into account in constructing portfolios. Debt and the changing patterns of indebtedness are chief among these factors, Doug said. The ballooning balance sheets of the developed markets clearly illustrate the massive movement of debt from the private to the public sector that the past few years have seen, he argued, adding that what's really significant about these levels is that they limit the ability of government to address issues. In fact, while notionally, debt has made the move from the private to the public sector, in reality, we are looking at a boomerang effect – that is, it's the individual taxpayer that will, in the end, have to pay.

The ring of fire: bond investors beware

Nowhere is the above situation more starkly illustrated than in Greece, Doug noted, adding its woes may well be only the tip of the PIGS iceberg. The looming sovereign debt crisis among these EU nations brings us to the question: does contamination lead to contagion? Will the crisis in these countries spread to their fiscally healthier neighbours and in turn limit their ability to recover?

Doug characterised some of the most critically affected nations, those with large budget deficits and large debt stocks, as the 'ring of fire' – specifically Spain, Ireland, the UK, USA, France, Italy, Greece and Japan (refer Figure 1 overpage). Other nations, including Australia, are hovering on its rim, he warned.

The risks associated with these debt factors must lead to thinking beyond traditional interest rate risk. We must now factor in the effects of major industralised nations expanding indebtedness at an unprecedented pace, at the same time as their share of global economic activity declines precipitously. There's a whole new shape to the pattern of global indebtedness that must surely have an effect on how credit and debt markets will operate now and in the future (refer Figure 2 overpage).

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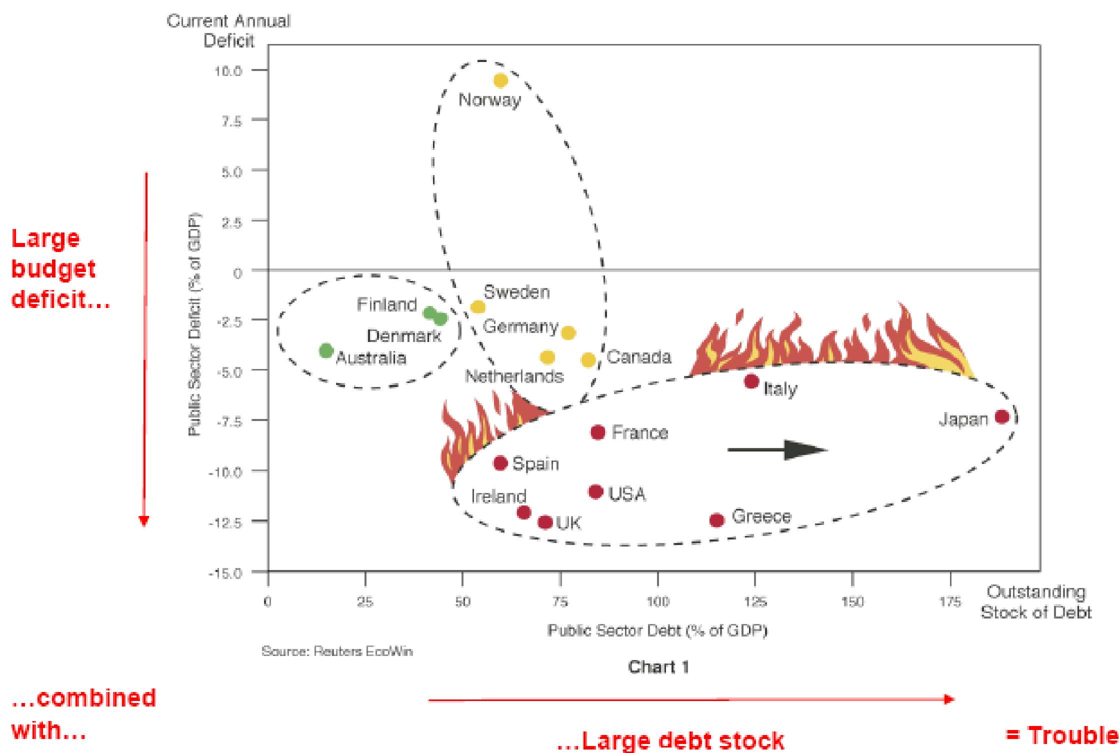
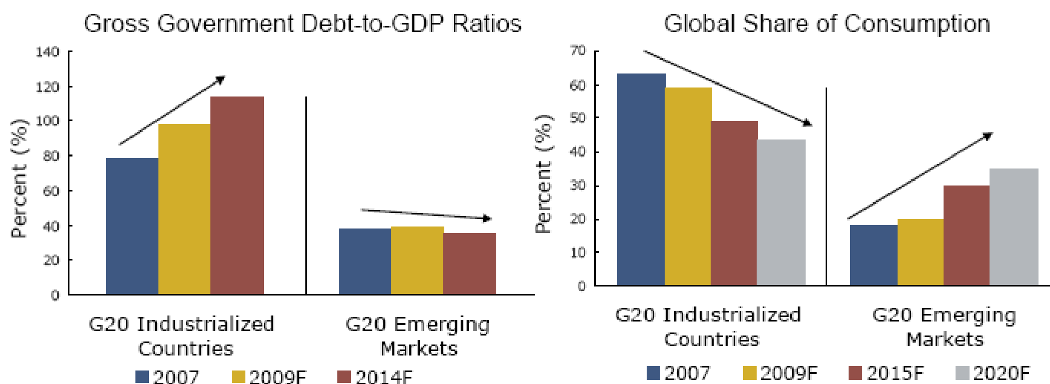
Figure 1: The Ring of Fire



Source: PIMCO

Figure 2: Traditional patterns of indebtedness are being turned around



Industrialized countries are expanding their indebtedness at an unprecedented pace …

…even as their share of global economic activity declines precipitously.

Source: PIMCO

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"The new issue that needs to be addressed is, what's preferable: a debt-weighted approach, and lending in proportion to a household's debt? Or a credit-weighted approach, and lending in proportion to a household's income?" Doug asked. "It's clear which makes more sense."

In the face of uncertainty, he nonetheless pointed to some keys to success.

"Investors must ensure real diversity within their portfolios, be forward looking or choose managers that are forward looking, and focus on risk factors – particularly those associated with traditional indexing – and be prepared for more tail events, perhaps not of the magnitude that we've experienced recently but essentially, expect the unexpected and expect it regularly.

"Those who are prepared, open and alert are most likely to succeed. The new normal calls for increased adaptability and flexibility from each of us."

The end of the beginning

The outlook for 2010-2012 presented Robert Swift, Head of Multi-Strategies at BT Investment Management, held little joy for investors of any stripe.

While acknowledging that 2009 was "not as bad as we thought it would be", Robert highlighted that the surge back to the markets in 2009 was, in his view, driven by the feckless hope of a return to the old normal – and has increasingly been tempered by the growing awareness that this will not be the case. The issue of moral hazard – succumbing to the temptations of easy money as we have done in the past with such catastrophic effects – is an enduring one. "Much as the markets loved the idea of growth and love the idea of a rally, this is unfortunately driven by Homer Simpson economics – the belief that the ill effects of beer can be overcome by… more beer," Robert argued.

In his view, the 'reflation of the soufflé' – a feat achieved twice post the Asian crisis and the tech bubble – will not prove possible a third time. Instead, the heavy ingredients we need to factor into investment planning include:

- a diminishing money supply;
- a dysfunctional banking system – banks are sitting on large reserves that they don't want to lend;
- the bursting of the Chinese bubble – bearing in mind that its money supply grew 30% in six months and that food inflation is on the rise;
- the fall and fall of purchasing power of the US (and UK, and European) consumer and the continued shrinking of middle class incomes will continue to lag inflation; and,
- budget deficits of a magnitude where interest payments do (or threaten to) exceed GDP.

Like Doug, Robert argued that government attempts to prop up an ailing global economy have reached their limits. "There are no more magic bullets," he said.

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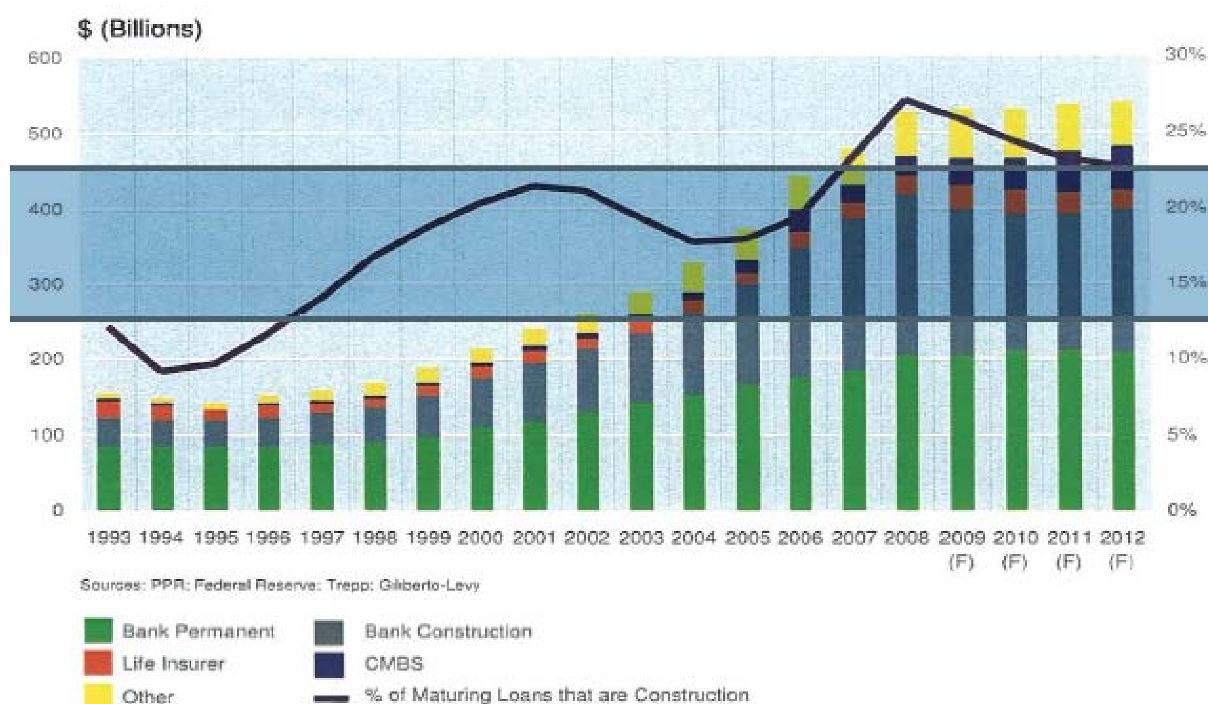
And, more bank failures may be looming, he warned, adding that we need to acknowledge and prepare for growth debt maturity issues arising from commercial real estate loans (refer Figure 3). "Failure to roll over this debt may well result in more bank failures."

Figure 3: A maturity problem – estimated loan maturities by lender type by year



Source: BT Investment Management

Developed nations awash in debt are running out of options, Robert warned, identifying as a real risk that governments will be tempted to fall into their own moral hazard and inflate their way out of debt, much as occurred in the post-Thatcher era. In addition, Europe's hand will likely be forced by the PIGS' events. "It's looking problematic all over, with the EU's likely interventionist reaction to sovereign debt issues having sub-par results, with profits not maximised, and governments forcing behaviour that will not necessarily be good for equities," Robert said.

What about me? It isn't fair – has Australia had its share?

We all know that Australia has emerged well from the past few years in relative terms. But there is no room for complacency, Swift believes. "As positive as the picture has been, we need to factor in our expensive currency and its consequent lowering of our terms of trade," Robert said. "Our exchange rate is driven by the terms of trade and our trading partners may well put on the brakes."

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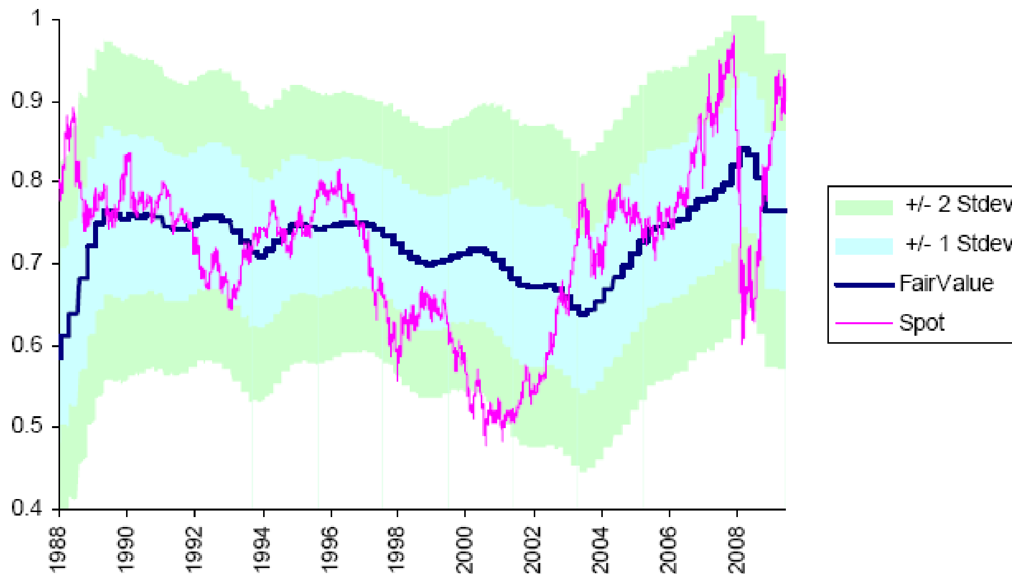
Figure 4: AUD Fair Value



Source: BT Investment Management

Portfolio Positioning

In the face of these considerable risks and a less than positive outlook, Robert nonetheless argued for a portfolio favouring equities over bonds.

Asset class	Allocation	Notes
Australian Equities	25%	AUD$ decline – impacts?
International Equities	20%	Bias to Asian small caps and quality names. Prepare to remove currency hedges
Australian Property	0%	
International Property	0%	
Australian Fixed Interest	20%	Favour corporate bonds
International Fixed Interest	10%	Emerging debt to price through G7?
Alternatives	20%	Minimal beta portfolio. Maximum liquidity
Cash	5%	Expensive asset class – equities?
Total return expected	**7.5%pa**	
Volatility expected	**6%**	

Source: BT Investment Management

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THE 2010-2012 OUTLOOK FOR GLOBAL DEBT MARKETS

Kumar Palghat, Managing Director, Kapstream Capital (Australia)
Dan Norman, Head of Senior Loans Group, ING Investment Management (USA)

Global debt markets

Amid all the talk of lessons learned from the GFC, it's easy to focus blame on the higher profile players, such as sub prime lenders. However, as Kumar Palghat, Managing Director at Kapstream Capital (Australia) noted, sub-prime activities may have been *a* cause of the meltdown, but they certainly weren't the only cause. Poor lending and underwriting standards outside the sub-prime space, and the rise and rise of increasingly arcane examples of financial engineering also played their part, leading to a situation where there remains an estimaged US$1.8 trillion of unidentified toxic assets yet to land on unfortunate balance sheets.

And, despite the rush back to risk markets, there are no clear positive signs for a sustained recovery in credit markets, Kumar warned. Underlying, and illustrating, the problem for these markets is, once again, our friend debt.

Spending it faster than they're printing it?

"When the government is issuing money and the central bank is buying it, then that's printing money," Kumar said. Looking at the US situation, on the one hand the Fed is printing money, while on the other, government spending alone takes it straight back to zero. "For every US$100 printed, some US$20 to US$25 goes to debt; US$20 to US$30 goes to social service and retirement funding and US$20 to US$30 goes to healthcare expenses," Kumar explained. As a consequence, the typical safe haven currency – the US Dollar – is taking a hit as awareness of the unsustainable nature of the situation increases investor wariness and the search for (perhaps long-term) alternatives.

The usual avenues of hope for US growth are closed – unemployment persists, the housing market remains dead and there is, as yet, no obvious source of new jobs – while some 15 million are required to be found over the next five years to get back to (old) normal levels.

Real concerns centre around the severity of stimulus withdrawal symptoms on this already very ill patient, Kumar said, adding that Europe is in a similar sorry state and has clearly illustrated the 'rule of the jungle' in its treatment of Iceland and now Greece. "At a time when everyone's looking for debt funding and there's big competition, the market goes after the weakest link," Kumar warned.

The highly unpalatable scenario of governments having to raise taxes while cutting spending is looming, with potentially deadly political and economic effects, he said.

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Figure 6: Key Risks

US cannot afford:
- a drop in GDP
- a fall in equity markets
- rise in interest rates

European economies in a mess:
- PIGS in trouble
- Have to cut spending, increase taxes when eco growth is on shaky ground!

RBA
- a little too trigger happy
- domestic economy in good shape
- global backdrop remains tricky

Source: Kapstream Capital

The Australian story

Australia, however, is a different story (refer Figure 8 overpage). Monetarily and fiscally it is tracking well, with government debt under control. There is some concern about high levels of corporate debt and how long the boom in commodities fuelled by Chinese growth can remain. However, unlike the US, which has shed in the order of 7 million jobs in the past five years, Australia has added 2 million.

"Overall, investors in Australia can still find rewards in fixed interest," Kumar argued. "But I would caution with a few provisos. Hugging indices is a mug's game. To really succeed you are going to have to step away from the benchmark and undertake a whole new assessment taking into account the new shape of the debt markets. Then, once you've done that, if you see something good, go for it."

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Figure 7: Australian assets "the sweet spot" - non-annualised return Dec 1999 – Dec 2009

Source: Kapstream Capital

Global corporate credit

You might think that providers of credit to non-investment grade (BB+ rated and lower) corporations would have been be hardest hit once the meltdown began. However, according to Dan Norman, Head of Senior Loans with ING Investment Management (US), the low hit only in the final 10 weeks of 2008, when all the major originators of corporate loans sold every investment grade asset they could. Since then, thing have been on the up – reductions in the order of 30%, followed by an upward surge of around 50%. "It's been a perfect v-shaped recovery," Dan said. Default rate expectations were not only lower than the expected 20% to 25%, but actually peaked at around 11%, half of which was directly attributable to five LBOs, notably that relating to the Tribune companies in December 2008. "This was all about investor fear without analytical support," said Dan. "And the rate is now dropping, back to the order of 3%."

Already in 2010, with LIBOR at 600, the senior loans asset class is as good as it was pre-2008. The asset class offers portfolio diversification opportunities and, being driven mainly by an interest rate index, very low risk. "I believe we are looking at strong returns driven by capital return opportunities as they are paid out at par," Dan argued. He pointed to external risks, including those posed by regulatory shifts, but said that concerns surrounding impending maturity cliffs are overrated.

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THE 2010-2012 OUTLOOK FOR GLOBAL EQUITY MARKETS

Martin Conlon, Head of Australian Equities, Schroders (Australia)
Simon Flood, CIO, Lion Global Investors (Singapore)
Hamish Douglass, MD & CEO, Magellan Financial Group (Australia)
Kurt Umbrager, Portfolio Specialist, T. Rowe Price (USA)
Andrew Clifford, Deputy CIO, Platinum Asset Management (Australia)

Australian equities

In one of the day's rare brighter spots, the focus turned not only to Australia's strong equity performance in 2009 but, perhaps more importantly in structural terms, some of the positive signs that accompanied it. These included the aggressive deleveraging and intensive capital raising, and the emergence of the banks relatively unscathed. "Australia punched way above its weight in terms of capital raising, as a nation comprising for 2% to 3% of the world economy, we were responsible for raising some 10-15% of capital during the year," said Martin Conlon, Head of Australian Equities with Schroders.

Don't throw the debt baby out with the bathwater

Further, Martin argued, the strong ongoing performance of a number of big players demonstrates a fact that's too often forgotten, especially in the current debt demonising environment. "Leverage isn't always bad," he said. "Rather, it's something that needs to be understood: you need to understand returns, the cost of debt, cashflow – and when leverage works to amplify returns. The greater the margin between cash flow returns and the cost of debt, the better."

Volatility risk v. fundamental risk – and what lies ahead

"It's time to throw out the volatility benchmark. When we focus on that rather than the fundamental risk, that's when we saw stocks getting savaged," Martin said. "We have to get back to an assessment of fundamentals – cash flow, and leverage, and understand that volatility risk is more about human behaviour and the last thing on which we should be basing investment decisions."

Martin tended toward bullish, however flagged certain limits. "Don't believe that PE is all telling. We believe the market is currently at about fair value and that we can expect average but not spectacular returns.

"We're cautious on resources in the medium term (refer Figure 8 overpage). There's been a supply/demand squeeze that's caused overpricing and we think it should be priced on what it earns on average – so sure it might have elevated returns now, but not forever."

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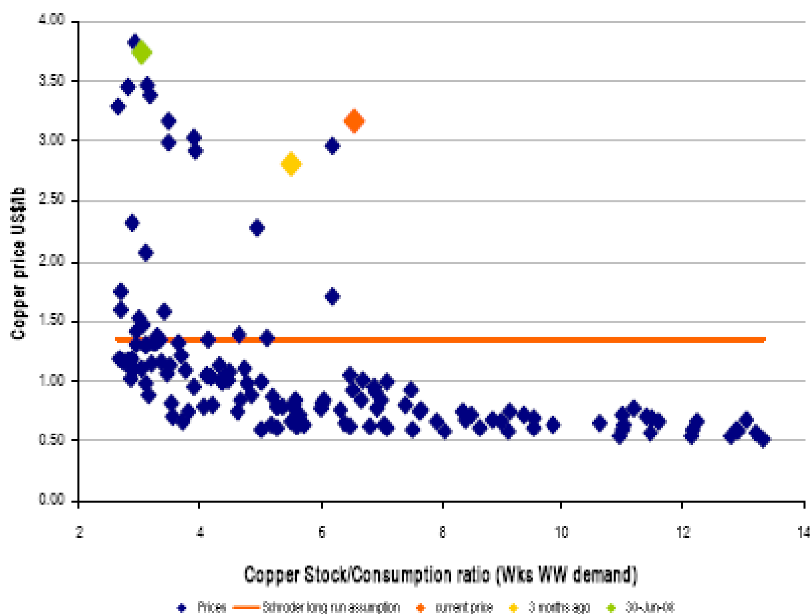
Figure 8: The resources outlook



Source: Schroders

Demographics, housing and other potential problems

Martin flagged a number of other risks that apply both globally and in Australia and are likely to have long term impacts on portfolio construction.

"One major risk is demographics and the ageing population (refer Figure 9 overpage), an issue that's hitting every developed market. Soon, massive pools of retirement savings will be drawn down and that poses many portfolio challenges. If we follow the traditional path of putting older investors into fixed income to the detriment of equities, we are in real danger of further polarising the market," he said.

Martin joined a number of the other Summit presenters in warning about the effects of our (and some other nations') overly buoyant property market. "You're looking at a cash flow return lower than the cost of borrowing and frankly, on a macro scale, it's simply not sustainable to be borrowing from the rest of the world to fund a flat asset. We cannot assume continued 8% to 10% growth in this sector."

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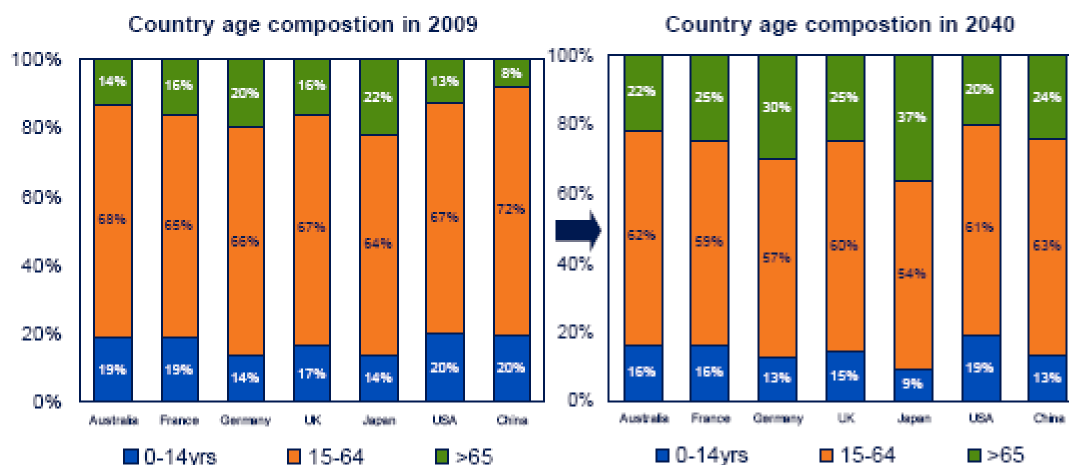
Figure 9: The demographic headwind



Source: Schroders

Asian equities

Unlike much of the rest of the world, the picture for Asia (ex Japan) was glowing. According to Simon Flood, Chief Investment Officer, Lion Global Investments in Singapore, the story is one of value, strength, strong reserves, affordable currency, low debt, relatively younger demographics, growing market share in terms of production (with its products developing a global following) and share of the world economy, he said. Intra-Asia trade is on the rise, major population centres such as China and India are producing millions of graduates each year, economies and markets are gaining maturity and stability and, of course, there's always China. While there may be arguments about the extent to which it's the engine of world growth, and/or how long it can last, an engine it certainly is – and it's pulling its neighbours along at a fair clip.

There are of course downsides but, in Simon's view, the pluses in Asian equities outweigh the minuses.

"For Australia, our currency is an issue and needs to be addressed when looking at Asia from a competitive or investment standpoint. There are also geopolitical factors, in particular in relation to the growing gap between rich and poor and much, as always depends on China," he said.

"Asia will also be affected to varying degrees by some of the broader global risks that the developed word is grappling with. However in the long term, we are very bullish."

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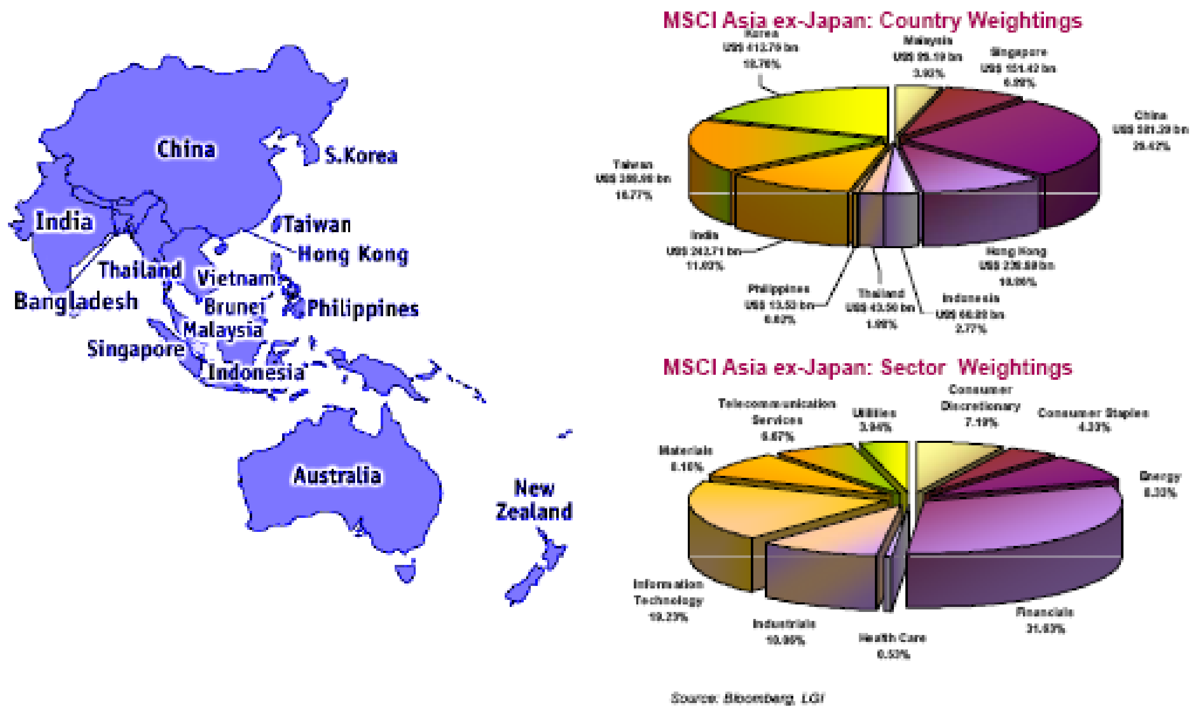
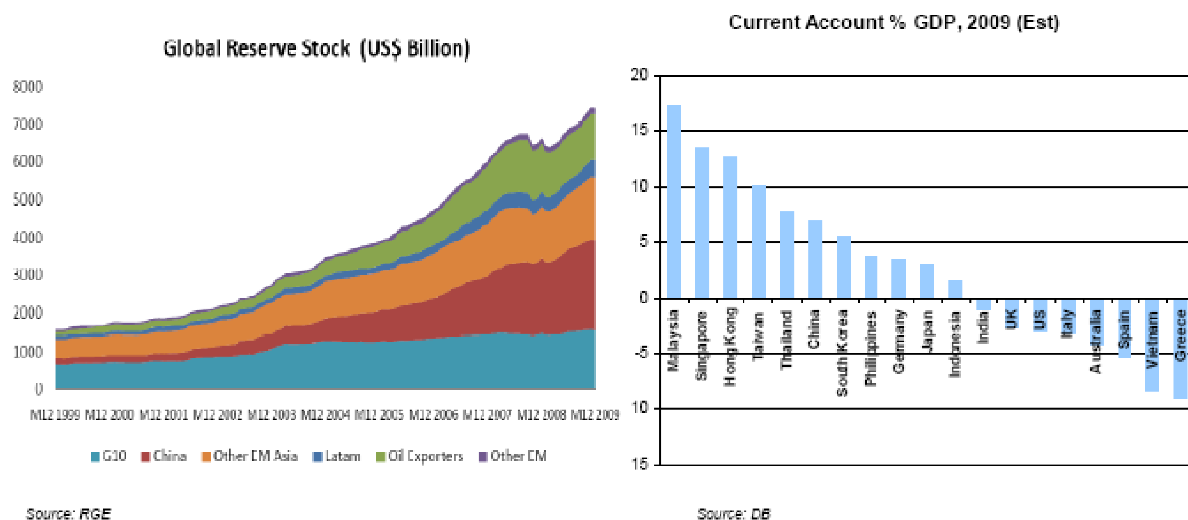
Figure 10: The market – countries and sectors



Source: Bloomberg, LGI

Figure 11: Asia Limited – trading its way to financial strength



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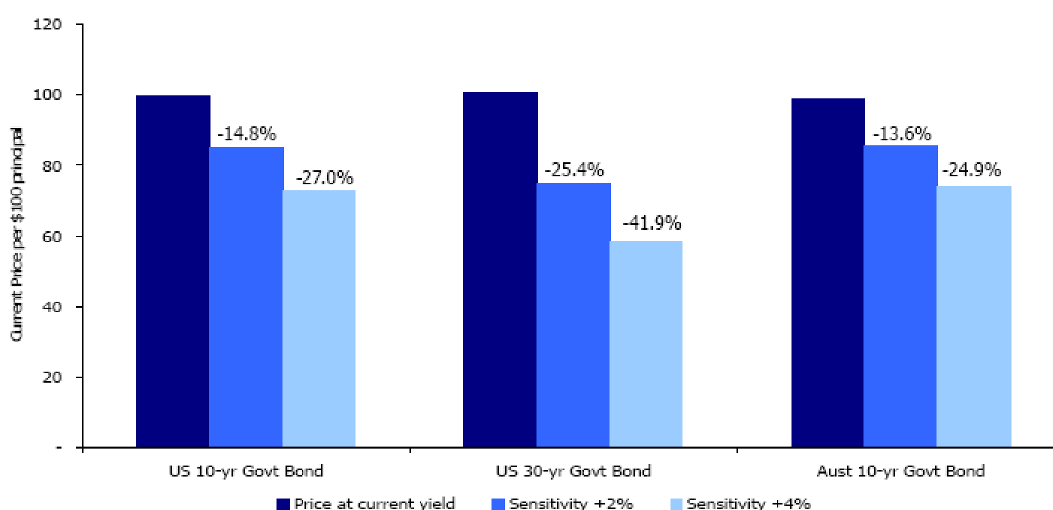
Global equities: an Australian-based perspective

Bringing his characteristic twist to proceedings, Managing Director of Magellan Financial Group Hamish Douglass, exhorted Summit delegates to think outside the square. First of all, he predicted that the US would surprise us all and show a much stronger upside than any of the presenters were picking. However, he countered this with a warning that this performance would be strictly short term, resulting from the Fed's activities and the sheer volume of reserves. "Where has all the money gone? The answer is that the banks have put it back on deposit with the Fed and, as unemployment and eases and the credit market eases, this will be re-injected into the market, and into the SMEs who need it the most and can then provide the further employment the market is looking for," he said. However, the gradual kicking in of other factors – consumers deleveraging and reducing spending, the dampening effect of stimulus exit strategies, the cost of paying back the stimulus – all will result in a slowing after the initial surge. "We'll be looking at a US and developed world that's a lower spending, higher taxing, higher interest rate environment. In terms of the so-called 'Keynesian free lunch' – well there won't be a crumb on the table."

The elephant in the room

"I am in no way saying this is going to happen, but I would ask you to consider this scenario – and that is, real interest rates," Hamish said. "I believe concern about sovereign defaults is not valid and that there will be bailouts. The concern is then a situation where the massive competition for money causes interest rates to rise – because in that scenario, why would people lend for a mere 3%? – but inflation stays low. The net result would be the real risk of government bond yield rates increasingly rapidly, effectively eroding the value of 30-year bonds dramatically. This is a very scary loss scenario because even small interest rate movements can have a massive effect."

Figure 12: Increasing real bond yields – impact on asset prices (15 Feb 2010)



Source: Bloomberg, Magellan Asset Management

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For best results, Hamish said, investors need to be looking forward and choosing an asset allocation with the ability to withstand the risks you see, with a strong focus on hedging strategies. He also urged investors to quiz their consultants about risk scenarios and strategies and expressed the view that China will not save the world – and to bear in mind that despite its size, it still comprises only 7.5% of world GDP.

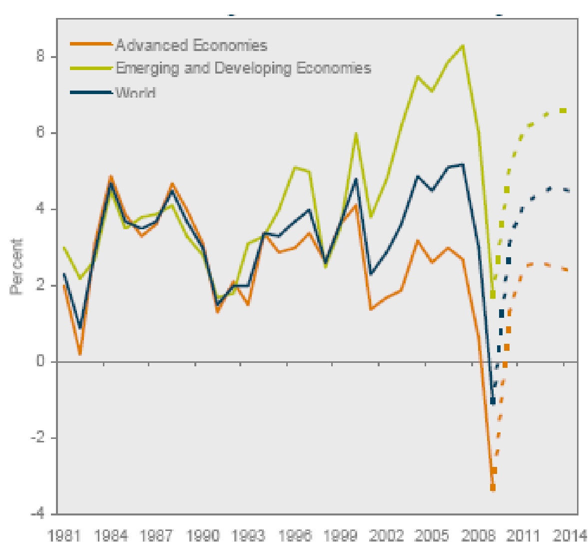
Global equities: a US-based perspective

"The world doesn't end that often," countered US-based Kurt Umbarger, Portfolio Specialist with T. Rowe Price. It may be a process of fits and starts but the global economy will heal, he argued. "A return of confidence will come with time and, with it, higher EPS growth and declining risk premiums. However, any real value must come from improvements in earnings and cash flow." But, we're not out of the woods yet – high unemployment and large budget deficits still pose difficulties, he warned.

Emerging markets leading the way

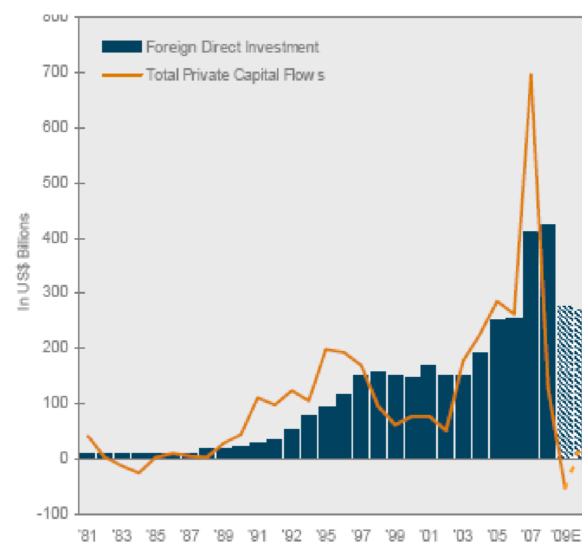
The emerging markets are where the real opportunities lie, Kurt argued. "It's interesting to note that, unlike other recent times, the latest crisis did not originate in the emerging markets. Although they reacted, they emerged relatively unscathed, with far stronger fundamentals. In a sense, they led us out, accounting for 100% of GDP growth during the transition phase… Post recovery, as we move into the new normal we are predicting that around 75% of global GDP growth will be attributable to emerging markets… although we consider emerging markets at around fair value now, there are still opportunities to be found."

Figure 13: Real GDP growth (annual % change)



Actual data 1981-2008. IMF forecasts 2009-2014
Source: IMF, T. Rowe Price

Figure 14: Capital flows to developing economies



Actual data 1981-2008, IMF forecasts 2009-2010
Source: IMF, T. Rowe Price

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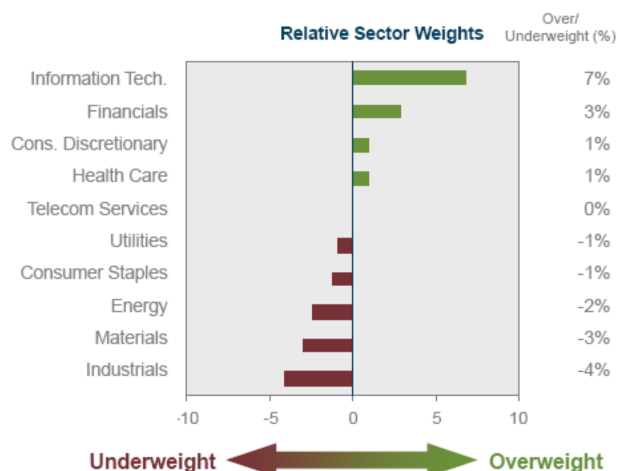
Figure 15: The global landscape is transitioning

	Old Norm	Transition Period	New Norm
Global Real GDP	>5%	0% or below	2% to 4%
Inflation	Modest but rising	Spike then collapse	Deflation or Inflation?
Real Interest Rates	At 0%	Rising	Resetting higher
Consumer	Excess consumption	Deleveraging	Moderate consumption
Pricing Power	Strong	Disappeared	Return slowly
Profit Margins	Continuously improving	Free fall	Improving
ROEs	All-time highs	Collapsing	Normalizing
Fixed-Asset Investment	Excessive	Falling sharply	Recovering
Valuations	Modest expansion	Rock bottom	Normalizing
Risk Premiums	Historic lows	Historic highs	Declining
Source of Global GDP Growth	< 50% emerging markets	>100% emerging markets	~ 75% emerging markets

Source: T. Rowe Price

"We will be looking at technology," Kurt expained. "With CapEx so tight recently, there's likely to be a need to restock and upgrade technology, so while there may not be the excitement of a new investment area, this is something to look toward. While we are down on energy, materials and industrials believing that excess capacity will cap growth, we think in the three-year horizon they will be okay as demand returns."

Figure 16: Sector positionings vs MSCI All Country World ex Australian index (unhedged)



Key structural perspectives
- ubiquitous and experience rich Internet
- cost effective health care
- US consumer – end of an era?
- emerging market exposure
- high quality energy

Source: T. Rowe Price

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Global equities: an Australian-based perspective

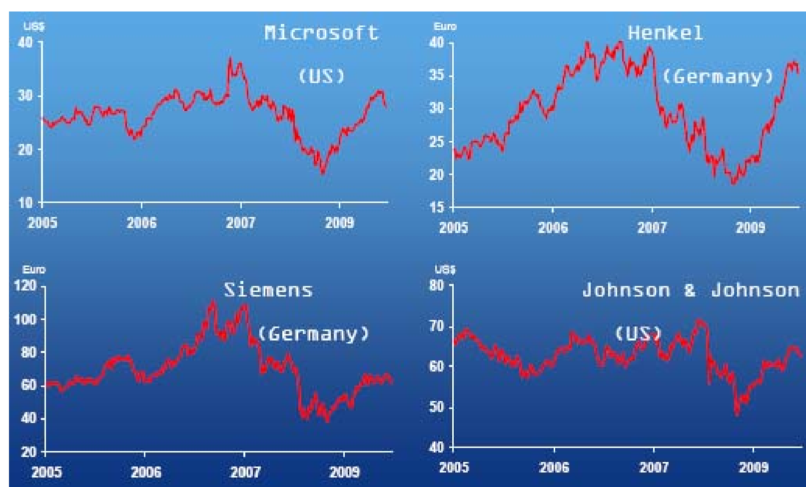
Applying the learning from recent lessons to future activities offers the best prospects for success, according to Andrew Clifford, Deputy CIO, Platinum Investment Management. And those lessons include: price is everything; avoid the crowd; understand what you own; and, perhaps most of all, don't expect an investment decision to be comfortable. Buy up when sentiment is at its lowest, he recommended, and don't afraid to go where others have been leaving in their droves – in Platinum's case, Japan, and now Greece. "If you do the work and apply the logic, then have the courage of your convictions," Andrew said. "If you buy comfortably, think hard about what you're missing, because you're bound to be missing something."

The China syndrome

"While there have been concerns about China overcooking, inflation pressures and a residential housing bubble, we consider that there's not real cause for concern now," Andrew said. "Sure, building five million new homes raises eyebrows – but you need to consider that there was no modern housing stock, so we're coming from a very low base. And couple that with low mortgage debt to GDP." There is a blow up down the track, he warned, but not right now.

Andrew highlighted geopolitical and growing food inflation as being greater threats warning that we should be prepared for a big slowdown and its effects in the mid term. "A better way of playing it is to buy blue chip equities anywhere – look for quality names trading at 15 times earnings or less."

Figure 17: Opportunities



Source: Platinum Asset Management

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KEY TAKEOUTS AND PORTFOLIO CONSTRUCTION IMPLICATIONS

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Key takeouts

The final session of the Summit pulled together the day's discussion to ensure delegates determined their key takeouts and the portfolio construction implications. The day's Inquisitors – Tim Farrelly, Stephen van Eyk, and Robert Swift – were charged with drawing together their reflections into the key takeouts from the Summit. Their 10 key takeouts were:

1. *Are we there yet?* Emphatically, no. We're still on the journey to the new normal and no one is yet sure what it will look like. The consensus was the end point would be one more likely to be a humble (but clean and respectable) motor inn, than the five star resorts expected in the past.

2. *The new www and the new black* – Perhaps the overriding conclusion from the Summit was that, as we await the arrival of the new normal, there are no certainties, and no hard and fast rules except www – watch, wait, and be wary. The consensus was that investing in the next five years will be all about risk management and limiting the downside. Hedging will be the new black, as we seek to guard against a myriad of potential downsides.

3. *The earnings and unemployment conundrum* – The big kicker, with a profound effect on every aspect of the market, is the earnings and unemployment conundrum – until it's resolved, deep-seated structural problems assailing the word's economies will remain. On the plus side, consensus was we have reached the bottom for unemployment but that's small consolation in countries like Spain where it is sitting at close to 20%. A key concern is political will – in addition to the drag that unemployment has on growth, it poses significant political problems and can lure governments into adopting economic policies that form long-term impediments to a sustained and deep seated recovery. In terms of outlook and earnings, it was agreed that the big issue is that there is no natural earnings driver on the developed world's horizon and we are not likely to see a return to the pre-2008 levels of production and consumption that fuelled those earnings.

4. *The index is dead* – Success will be the reward of forward-looking management, abandoning preconceptions and being brave enough to seeking opportunities in sometimes expected and counterintuitive places.

5. *Many happy returns???* – While not what delegates wanted to hear (or were thinking themselves as the Summit voting results showed), the most that can be expected from a standard balanced portfolio over the coming three years is 5% to 10% per annum.

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6. *Inflation vs. deflation* – One of the surprises of the Summit was that none of the investment experts seemed terribly concerned about inflation. Exceptions were in the Chinese context; as a (token?) acknowledgement of a potential result of increased liquidity and, finally, in relation to the risk that governments will be tempted to inflate away the massive piles of debt.

7. *Interest rates stirring little interest* – Similarly, interest rates were causing the investment experts surprisingly little concern, although all acknowledged their potential to stir the pot. The notable exception was Hamish Douglass's scenario in which real interest rates could potentially rise as a direct result of the massive competition for money in the face of the need to pay down mounting debt, driving bond yields very high (the chance that they will stay at 3% to 3.5% in the face of such huge demand being low). If rates go up even a couple of percent, the potential effect on 30-year bonds is a devastating erosion of some 20% to 30% of total yields.

8. *Government stimulus was good* – Yes, it may have gone too far and yes, the issue of the timing and the pace of its withdrawal is going to create pain and uncertainty – but the general agreement was that governments got it right, that they correctly erred on the "better too much at the right time" option, as opposed to the worse option of "too little too late".

9. *Opportunities ahead* – Fair value prevails across the equity markets – but that's not to say, however, that there are not good opportunities over the 2010-2012 period. Some that were identified were:
   - small cap Asian companies;
   - quality names and blue chips, wherever they occur (sector or country);
   - areas of weakness where bargains may lurk, such as Greece, Japan (i.e. see where the crowd's running and head the other way); and
   - In fixed interest, bonds that are reset every three to 12 months, and those linked to a regulatory entity (for example, utility companies).

   It's often easier to spot what to avoid investing in, and over the the 2010-2012 period, that includes commercial real estate and the US$.

10. *Diversification, a fine balance* – Diversification will be more critical than ever to a portfolio's success in the new normal. It may also take on a new, less traditional form, as traditional hedges may not offer the safety they did in the past. In fact, in the higher risk environment, portfolio construction will become a very fine art, as the hedging that works for one asset class can have the opposite effect on another.

Recurring themes

- *Japan* – is it in fact a microcosm of what the world might now expect? Is it the model of the new normal to which we are headed? A "dead duck in a pond" as one commentator described it? With deflation, 1.5% returns? Is there even anything wrong with this? Were our previous

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experience and expectations beyond what's reasonable anyway? Bear in mind that, unlike the US and elsewhere, much Japanese debt is funded by the Japanese.

- *China* – There was, understandably, much talk of China. Major concern/risks that were batted around included:
  - China cannot maintain growth of 8%+ per annum forever. This will have to ease off, it's just a question of when. While China certainly may offer short-term – say two- to three-year – opportunities and will in that term continue to support resource booms and so on, it is likely that massive growth will drop off dramatically after a point, in line with what we have seen in Thailand, for example. We need to factor this into portfolio construction;
  - There's a real danger of overheating and resultant bursting of bubbles;
  - Internal political factors are a growing risk as the gap between the urban rich and rural poor grows. This needs to be factored into Western assessments of what China may do (which can not be based on West-centric considerations and economic rationalist approaches that may not take internal political factors into account);
  - While an upward revaluation of the RMB would potentially ease many of the world's economic difficulties, there are internal political factors leading many to consider such a revaluation unlikely – rather, some are speculating that the Chinese government will simply let inflation do its work for them;
  - China is not the cure for all the West's ills. Although it is about to overtake Japan as the world second-largest economy, it still comprises only 7.5% of world GDP.

- *Asia ex Japan* – The old Asia is the world of cheap exported consumer goods, for which there is now a diminished market. The new Asia comprises smart companies that value-add in knowledge-based industries, the net result being quality products and services that will (and in some cases do already) compete the developed world's socks off (think Samsung and Kia, to name just two). While before it had the will but not the wallet, the new Asia now has both.

- *Emerging markets* – The emerging world is one of low debt, stronger, more stable economies backed by sounder fiscal policies, with more stable political environments and, significantly, a strong and growing middle class creating a whole new potential for strong internal consumption that may in time grow to replace (at least in part) that of the declining (submerging) developed countries. Delegates were warned however, to take into account the Australian equities and fixed interest holdings in portfolios as many opportunities in the Australian space replicate what's on offer in emerging markets (think BHP and other stocks that derive much of their earnings from the emerging markets). The current strength of Australian currency also means it is important to factor in currency erosion when investing offshore.

- *East is still east and West is still west* – In the opinion of many (but not all) of the investment experts at the Summit, mutually assured destruction is enough to keep the rush of funds from west to east contained for now. As relatively strong as the emerging economies are, they are still consolidating and only starting to flourish. Stability is still an issue and, despite drops in demand from the west, there isn't enough domestic demand to render them self sufficient. Further, the

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long-established financial centres, precepts and elites continue to hold considerable sway. In other words, Rome was not demolished in a day. So, for now, there's reward enough for both east and west to maintain some facsimile of the status quo – which is why we have not had the $US rug yanked out from under us (yet).

- *Resources and financials: can they last?* The Summit consensus was that resources and financials – the dominators of the Australian benchmark – will not remain so. While resources may continue to run in the short term, a decline in demand is considered inevitable due to a number of factors. Equally, in a world of increased financial regulation and with real potential for increased sovereign capital controls in response to general economic lethargy and especially massive sovereign debt, we may well see financials return to their more conservative, stable, low PE, nice dividend norm of the pre-2001 era.

- *Hard assets: the gold debate* – While some at the Summit continued to extol the virtues of hard assets, others found it difficult to justify investing in an asset class without cash flow. Inquisitor Tim Farrelly in particular questioned gold's reputation as a hedge or insurance against inflation.

- *Quality counts* – Corporate retrenching has ceased, cashflow is on the rise, and corporates are preparing for a new investment round. That's good news for equity and bond markets. The private sector is now better equipped to lift the world's economic fortunes than it has been since 2007. The other plus of this refreshed corporate environment is that its newfound strength and improved fundamentals mean it is better able to withstand the inevitable future shocks. The Summit concensus was that the key challenge for corporates – and what will mark the winners from the losers – is their ability to generate meaningful earnings from genuine productivity, in the face of suppressed demand, rather than continuing to slash the bottom line. High levels of corporate debt in some areas continue to bear watching and risks come from movements from the private to the public balance sheet, from whence it inevitably returns to hit individuals in the form of higher taxes and reduced government spending, at a time when governments need to be spending to generate employment and economic growth and tax payers can ill afford to be paying more.

- *The US Dollar and currency in general* – Currency in general and the $US in particular came in for much scrutiny at the Summit. There was consensus that currency offers opportunities if dealt with intelligently. It was agreed that the $A is strong right now (with associated downside) however, as a commodity currency, we need to keep a close eye on potential falls down the track when commodities experience their inevitable decline. In addition, its strength is eroding much of the benefits of investing in Asia and emerging markets, albeit that this can be overcome by investing in Australian companies with a presence in those markets. The Summit consensus was that for now at least, the $US will remain the world's base currency, and can shift away its problems. But for how long was everyone's key concern.

- *Liquidity* – Where has all the money gone? With the Fed printing it like there's no tomorrow and other developed nations following suit, we can expect to at some stage see the dollars peeping

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out from behind the banks' skirts. This will offer some shorter term opportunities and may boost the fortunes of the US in particular. Equally, it poses potential for inflationary forces to rise.

- *Debt and hidden toxic assets* – Debt in its many forms was not so much the elephant in the room, as the room itself. With household debt at unprecedented levels across the developed world, public debt equally so, and no realistic avenue of redress short of the looming threat of governments' adopting policies to inflate their way out of trouble, the associated investment downsides are myriad. And there's more to come. The IMF estimates there was US$4 trillion in toxic assets, only half of which has yet been declared on balance sheets leaving another US$2 trillion of toxic assets yet to be admitted to, and dealt with.

- *Demographics* – It may not hit in the next three years, but hit it will – and some of us sooner than others. Developed nations in particular are leading the ageing population charge with all its consequent implications for reduced tax bases, decreased productivity, increased use of healthcare and pension fund resources. Japan is most affected but it's significant that the poster (one) child China is right up there, too.

- *Pricing* – When the means of production exceed the means of consumption, it's never good. Or is it? Flatter price rises also equates to flatter inflation, which could be a pale silver lining.

- *Increased capital controls and regulation of financial markets* – It's payback time. When governments stepped in to save the world, they scooped up the good, the bad and the ugly. The privatisation of profits and the socialisation of losses will have an inevitable political effect. If it results in centrally directed, socially controlled behaviour in which banks that are (in effect) nationalised dance to populist political tunes, the future direction and behaviour of markets, already cloudy, will be even less clear.

About BlueChip Communication Group

BlueChip Communication is one of Australia's leading financial services communications firms. 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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This communiqué was written by Kaitlin Walsh, Director of Media and Content, BlueChip Communication. BlueChip supports PortfolioConstruction Forum to help give Australian audiences access to high quality local and global investment expertise.

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