


Current issues in pensions seminars

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**A crisis of confidence –
the changing face of supervision
in the light of market failure, and
the response by investors**

The changing face of supervision

- Numerous past failures of supervision
- An intense regulatory debate building up
- Conflicting objectives for policy makers
- Considerable uncertainty about the market implications
- The developing role of fund managers in supervising the companies
- Changing financial market behaviour and timescales

Risks and opportunities for investors

Past failures of regulation

- Prohibition
- BCCI and Barings
- LTCM and hedge fund leverage
- Northern Rock, Self certified mortgages, Fannie Mae and Freddie Mac
- The shadow banking system and securitisation of complex products
- The Tripartite Agreement in the UK
- The Maastricht Treaty – the financial position in Greece
- Local government links with banks in China

Too many to count!

The political debate is hotting up

- The banking commission in the UK
- The Monetary Policy Committee vs. the Financial Policy Committee
- Fannie Mae and Freddie Mac
- 100 reports from the Frank-Dodd legislation
- European debates about AIFM, commodities, derivatives and hedge funds
- Chinese regulation of banks: quantitative measures vs. interest rates
- Swiss gold plated levels of capital vs. a Basle level playing field

“I am here from the government and I am here to help you”

Some questions for policy makers

- How are the objectives of the MPC and FPC reconciled?
- Are central banks being given too much power?
- How do governments cope with the backlash from electorates?

Remember the warnings from Jefferson and Tucker

Some questions for investors ...

- What is the impact of regulatory changes on future profits?
- How much new capital will banks need to raise?
- What is the impact of such capital raising on future economic growth?

Uncertainty about the market implications

How do fund managers respond?



The role of fund managers as investors

Selected quotes from policy makers

- **... there is “some considerable distance to travel before we can begin to use the word ‘normal’...”**

Source: Mervyn King, Governor of the Bank of England, in testimony to the Treasury Select Committee, July 2010, via FT.com

- **... the outlook is “unusually uncertain”**

Source: Ben Bernanke, Chairman of the US Federal Reserve Board in testimony to the US Senate Banking Committee, July 2010, via Reuters.com

- **“... left unchallenged, a lack of accessible finance for business could prevent the recovery accelerating”**

Vince Cable, Business Secretary, UK Coalition Government, via government paper “Financing a Private Sector Recovery”

Investors need to position for a difficult recovery

An unusual period lies ahead

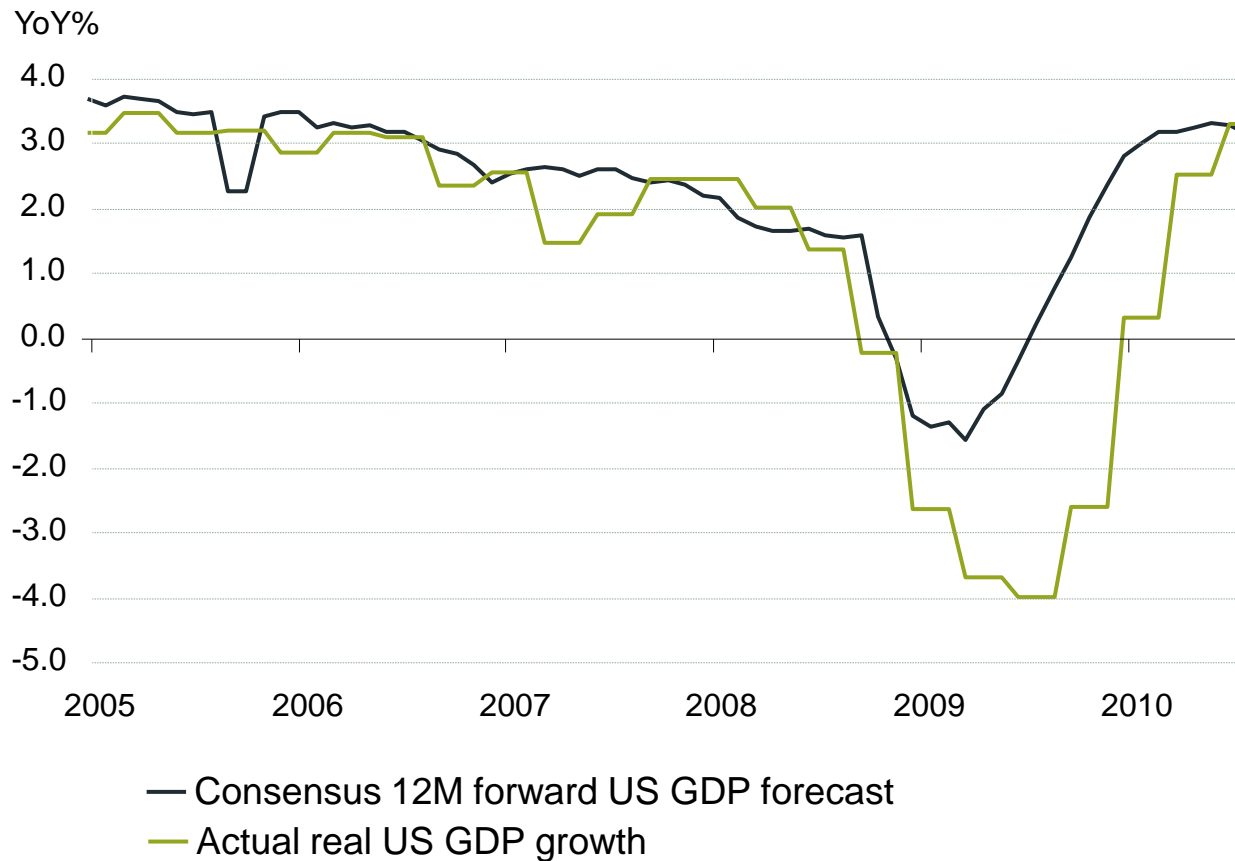
Investors have to navigate an uncertain and unusual recovery

- An IMF study of over 100 financial crises suggested that it took 5 years for developed economies to fix their systems following the crisis, and 7 years for emerging market economies
- Every post-recession period has brought 4 years of moderating prices – what chance deflation again?
- The world economy is still extremely leveraged – the lengthy process of deleveraging creates volatility in asset prices

An unusual recession brings an unusual recovery

High economic and hence investment risks

The consensus misjudged the extent of the downturn



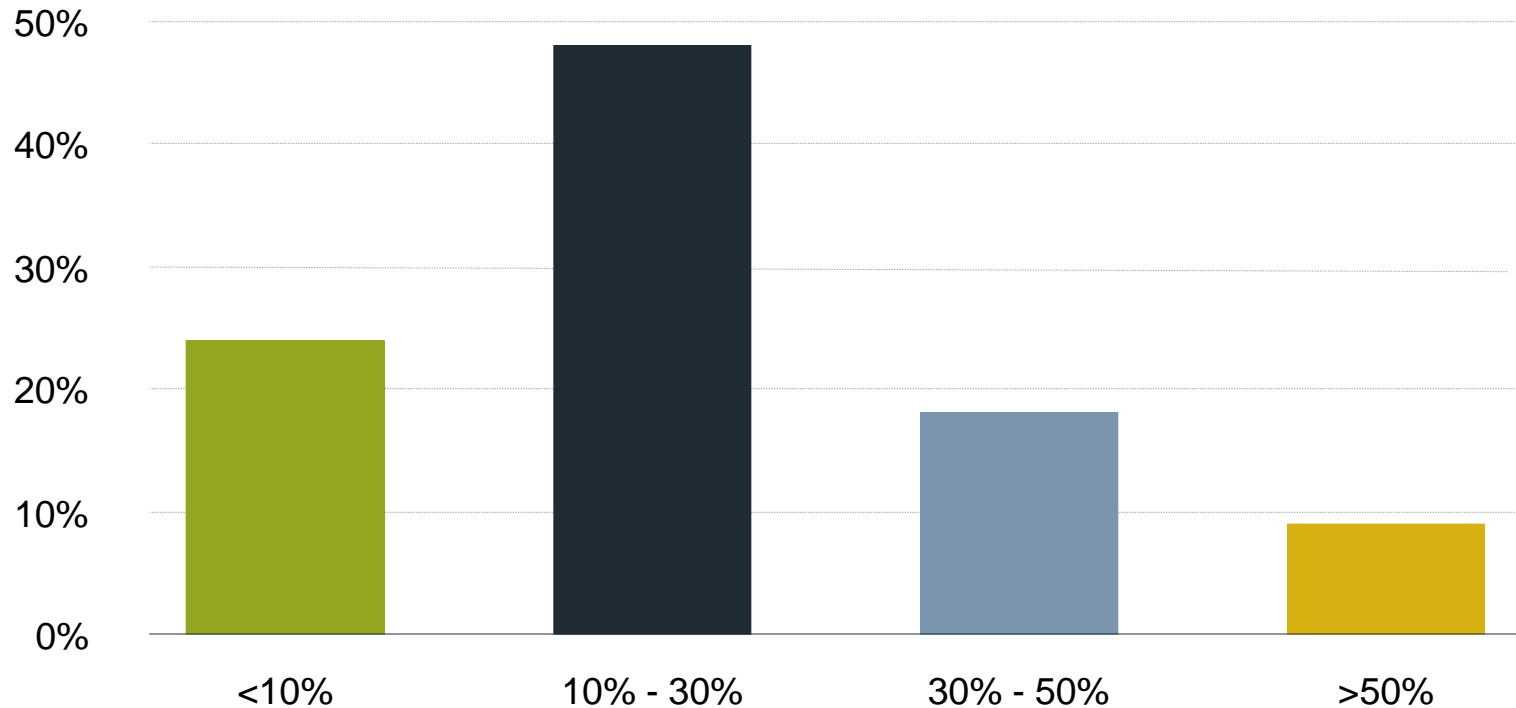
- Forecasters were too optimistic on the recession outcome
- Consensus suggests that the recovery may be fading again

Source: Consensus Economics, Thomson Datastream

Predicting the extent of the downturn turned out to be difficult

What is the probability of double dip in the UK?

Analysts are unclear about the outlook



Source: Survey of participants at Fathom Consulting's Monetary Policy Forum, London, August 2010

Investors may be anticipating more than one scenario

New investment styles are needed

- Being paid to wait is an efficient use of a risk budget
- Traditional asset class funds are waiting to be paid
- Holding risk efficiently is an important attribute
- Implementing ideas efficiently is key

Taking risks that are rewarding in a number of scenarios

Absolute Return investment approach

A broad range of return opportunities

Market returns

- Equities, Bonds and Property
- Good long term return expectations
- But can be negative returns over shorter periods

Opportunistic

- Specific directional investment ideas
- In markets with little or no long term risk premium
- With significant return potential on a 3 yr view



Stock selection

- Active stock selection
- Added value through our approach
- **Overall contribution 1%**

Relative value

- Seek highly correlated markets or segments
- Where their relative valuation is strained
- We exploit their realignment

Enduring diversity – through a wider opportunity set

A time line for investment decisions

Short-term trading	House View	Absolute return investing	Strategic decisions
Recognising deep value opportunities in markets	Sustainable yield as cash rates will remain low	Relative value trades eg US large cap vs. US small cap	Inflation proofed bonds depending on the inflation path
Analysing behavioural finance	Preference for more secure earnings	Market dislocations eg currencies	Analysing global commercial property

The role of fund managers as stewards

- Shareholders admit to past failures
- We look to the board to manage the company ...
- ... But we shall hold it to account
- Principles of good stewardship set out in recent Code ...
- ... But those responsibilities will evolve

Asset owners and advisers have a role

Conclusion

- The aftershocks of the financial crisis will last for some years
- Time horizons have shortened and uncertainty levels are high
- Investors are warned about continued market volatility
- New investment approaches are being developed
- The risks remain of future regulatory failures

Focus on Change

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