

Investment strategy for pensions actuaries

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The age of active

5 April 2011

The age of active

The global financial crisis marked the end of an extraordinary period for the global economy and world stock markets.

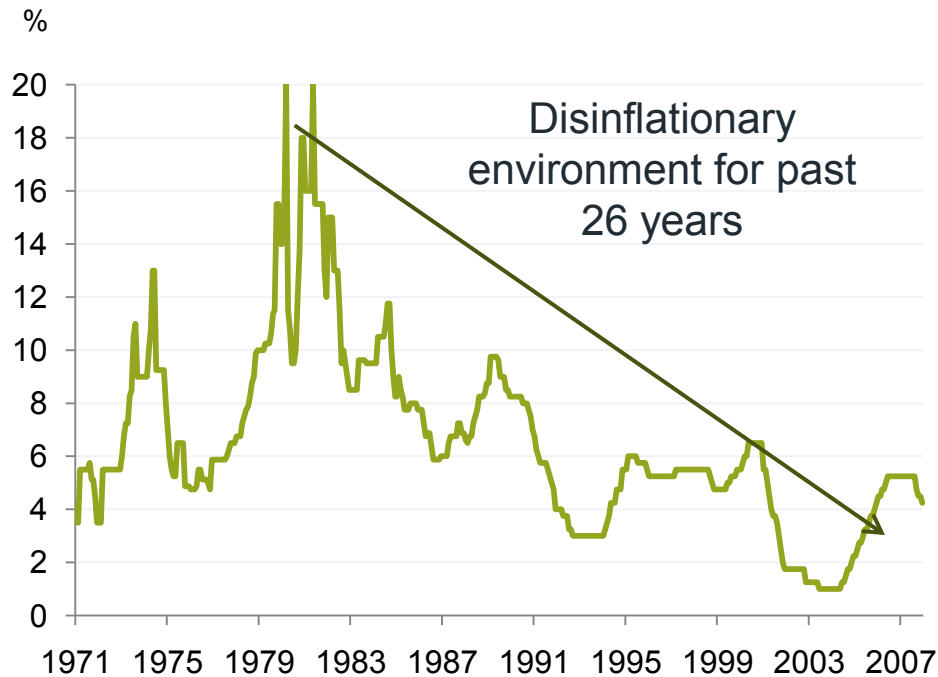
The 26 year accumulation of debt and wealth that drove prolonged and powerful economic cycles has reached a turning point, with profound implications for the future behaviour of asset markets. In terms of growth, concentration and risk it will change the way we manage equity portfolios for the next decade.

In particular, successful equity portfolios are likely to be driven by the ability of investment managers to find superior growth at attractive valuations, and a willingness to focus on what you own, rather than fearing the opportunity cost of stocks that are not owned.

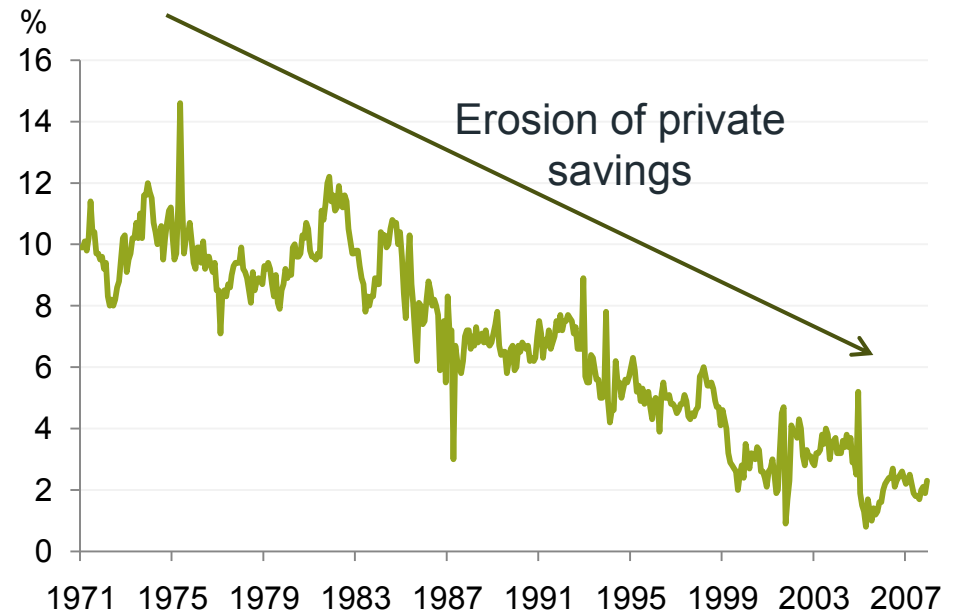
The great leverage build-up (1980-2007)

Low inflation, cheap credit

Federal Reserve interest rate



US personal savings ratio

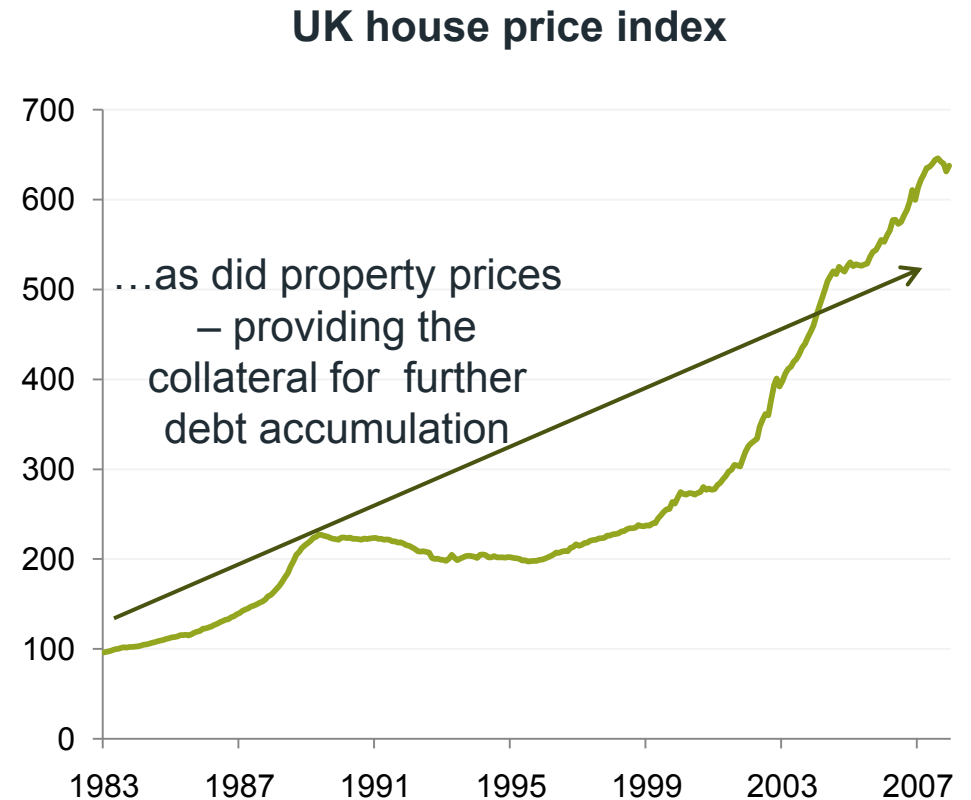
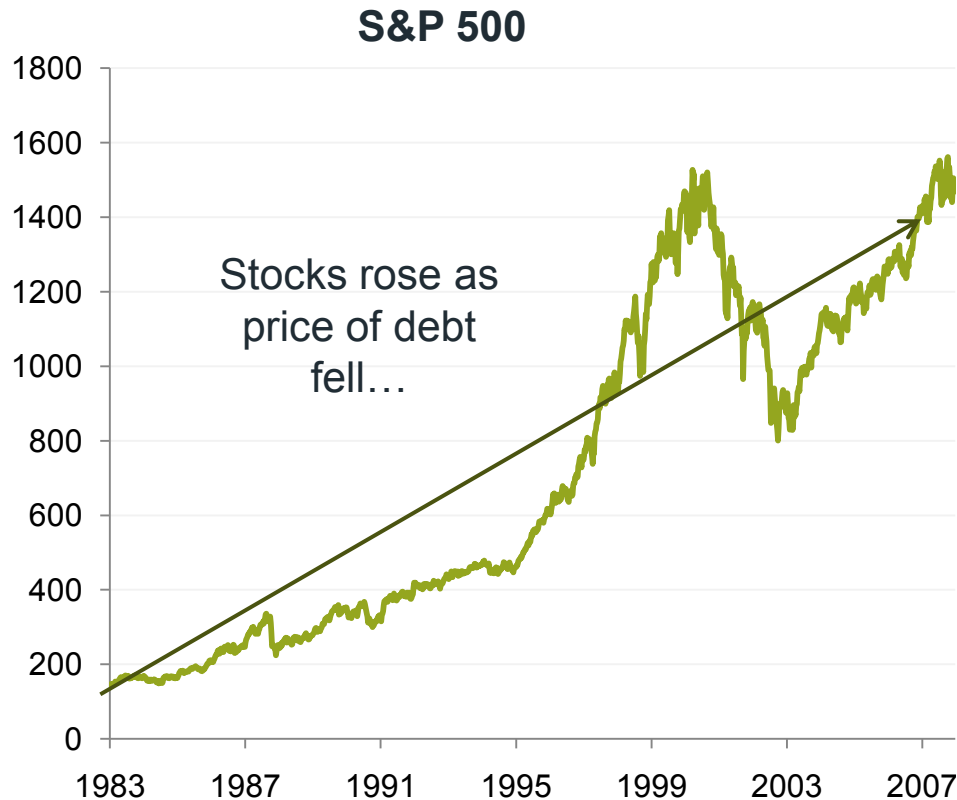


A heady brew

Source: Federal Reserve and Bureau of Economic Analysis

The great leverage build-up (1980-2007)

The virtuous circle of rising asset prices and borrowing



High spirits: intoxicating returns

Source: Bloomberg and Lloyds

The great leverage build-up (1980-2007)

Expanded cycle reduced volatility and increased confidence

US economic cycles since 1982

	Start to finish	Duration
1.	Nov 1982 to Jul 1990	92 months
2.	Mar 1991 to Mar 2001	120 months
3.	Nov 2001 to Dec 2007	73 months

Home equity as % of loan portfolio



Lowered inhibitions

The great leverage build-up (1980-2007)

Companies flourished in strong demand environment



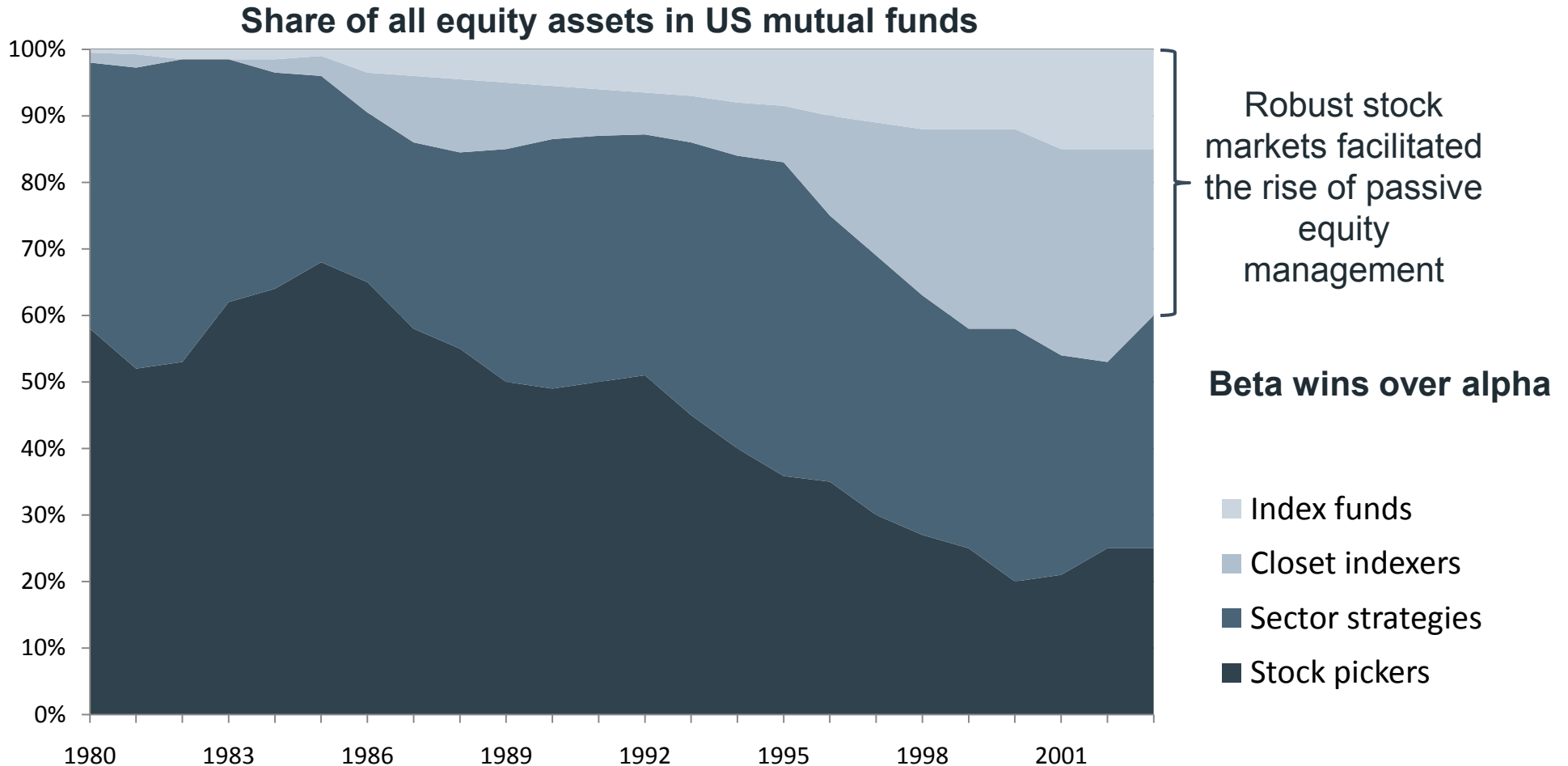
Rising corporate profits only accounted for 40% of stock market returns over this period

New highs

Source: Thomson Reuters Datastream

Benchmark-driven investing dominated

High opportunity cost of being different

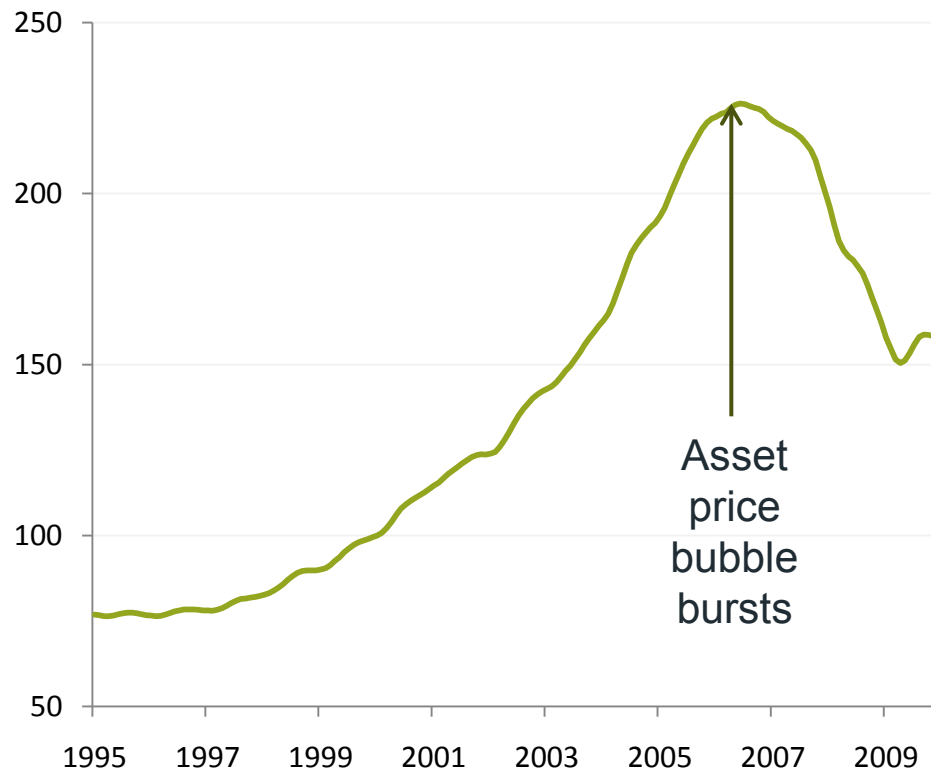


Source: Cremers and Petajisto (2006) and DrKW Macro research

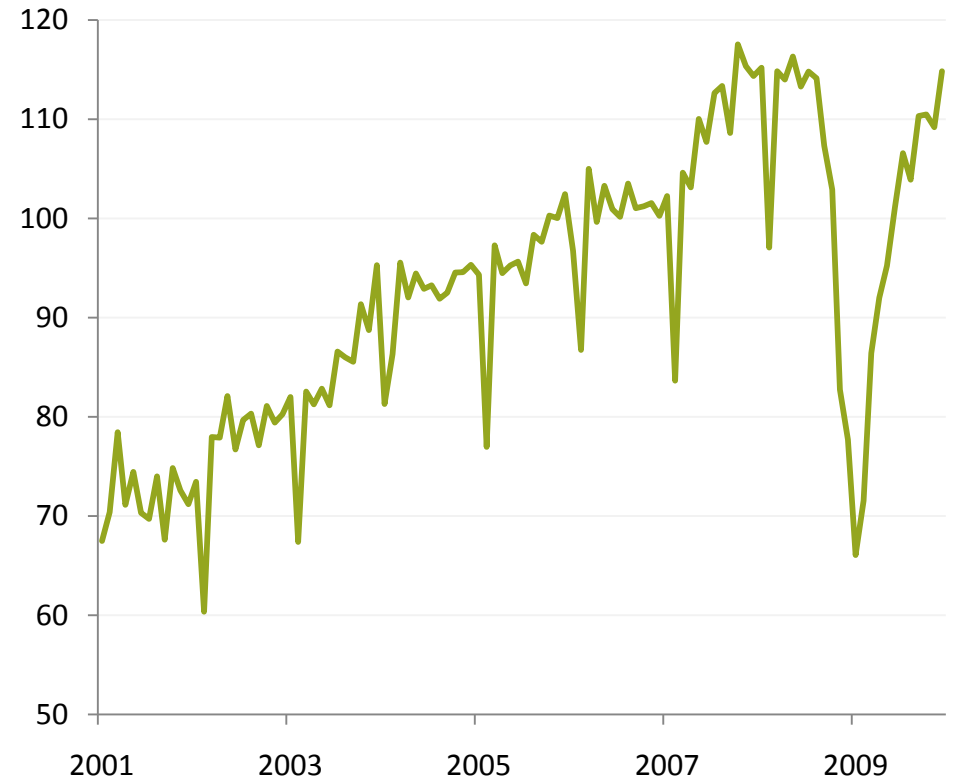
The inflection point (2007-2009)

The party ends

S&P/ Case Shiller index of house prices



Taiwanese industrial production



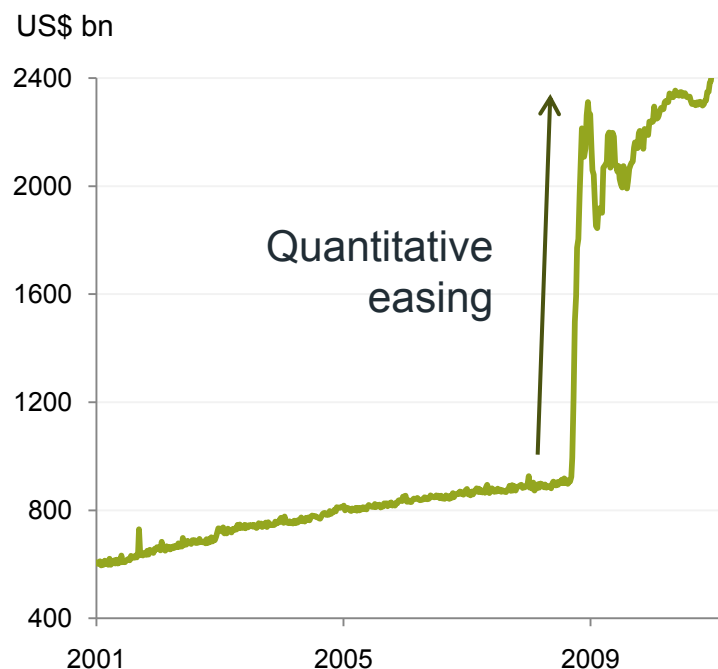
...and the hangover begins

Source: Case Shiller and Ministry of Economic Affairs Taiwan

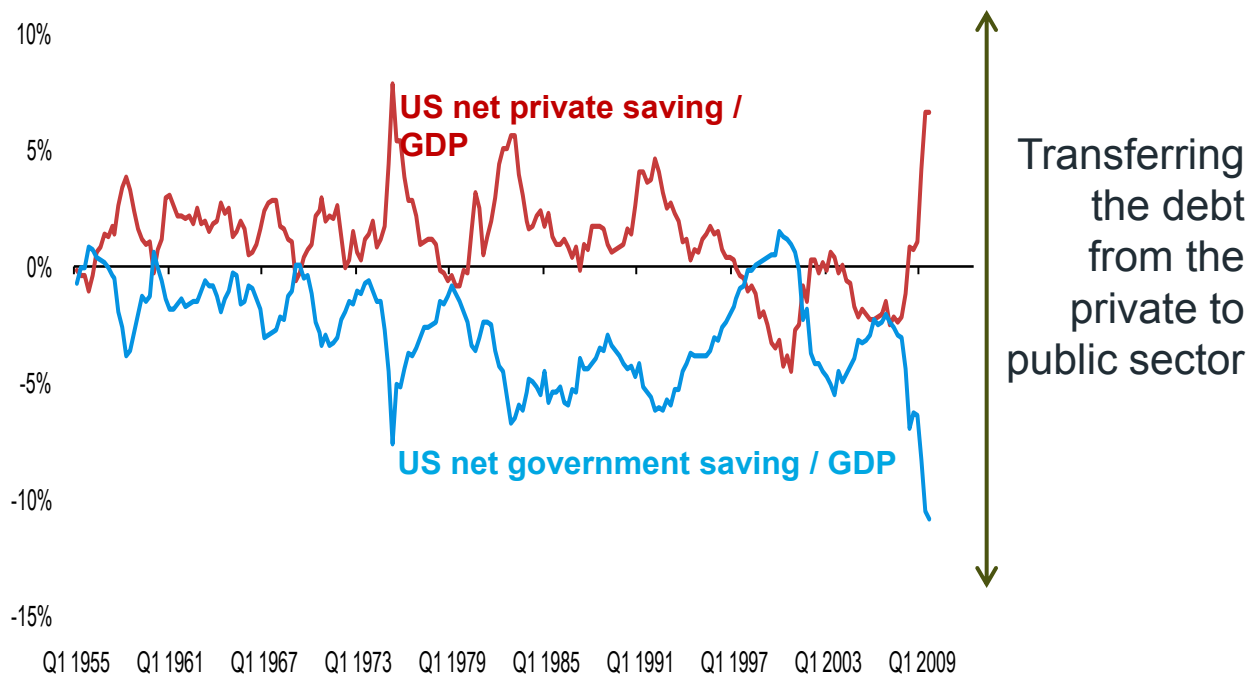
The inflection point (2007-2009)

The cure: inject cash & socialise the debt

Federal Reserve bank assets



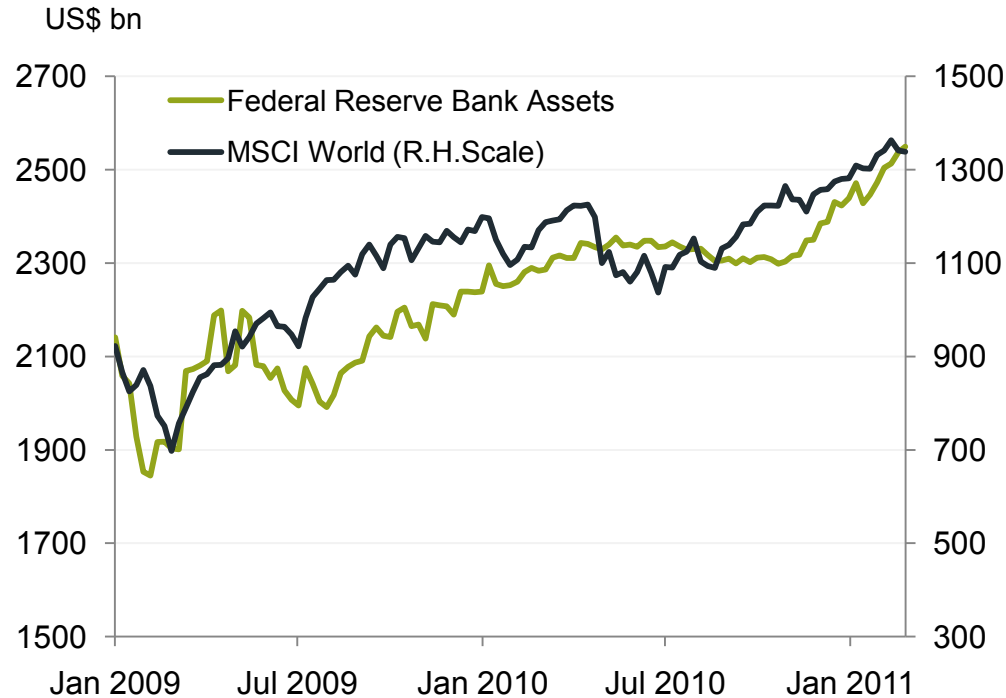
US net private vs net government saving/GDP



...don't come down

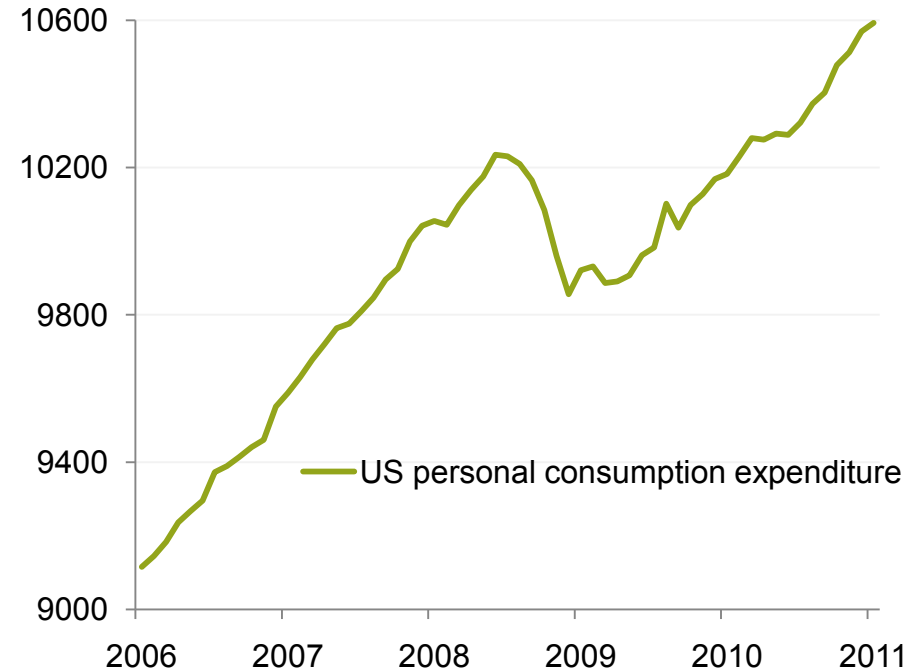
Source: Federal Reserve

The cure: has it worked?



Yes, in stock markets

Yes, asset price deflation halted



Yes, economic recovery

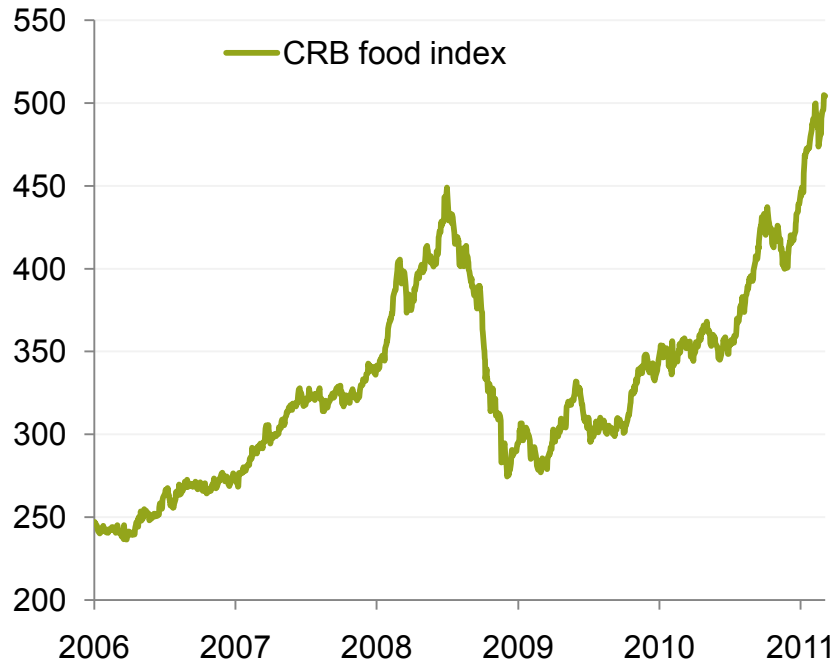
Relief for the symptoms, the underlying adjustment is still with us

The cure: has it worked?



Not everywhere: the two day hangover

The cure: unintended consequences



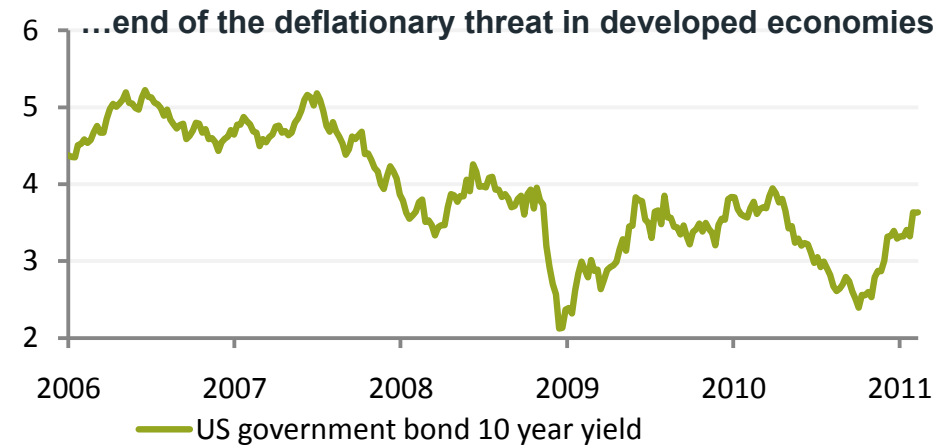
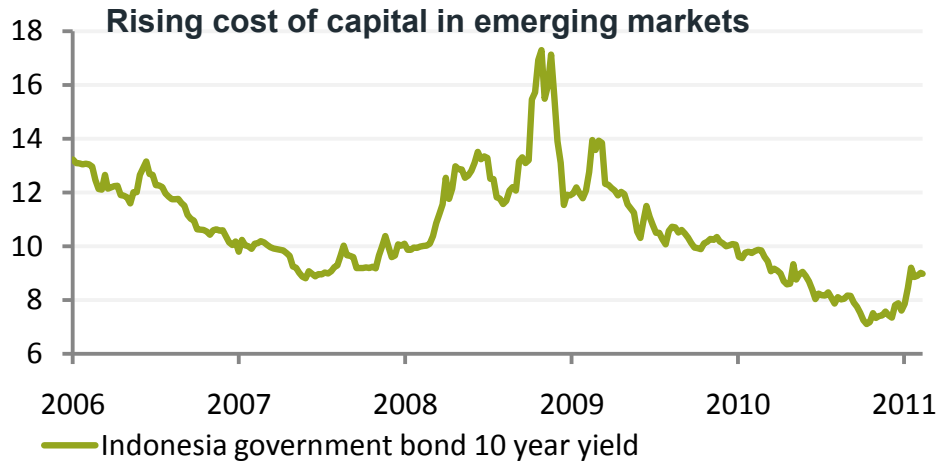
Commodity price inflation is back



Rising inflationary pressures

Inflation: a threat to emerging markets

The cure: unintended consequences



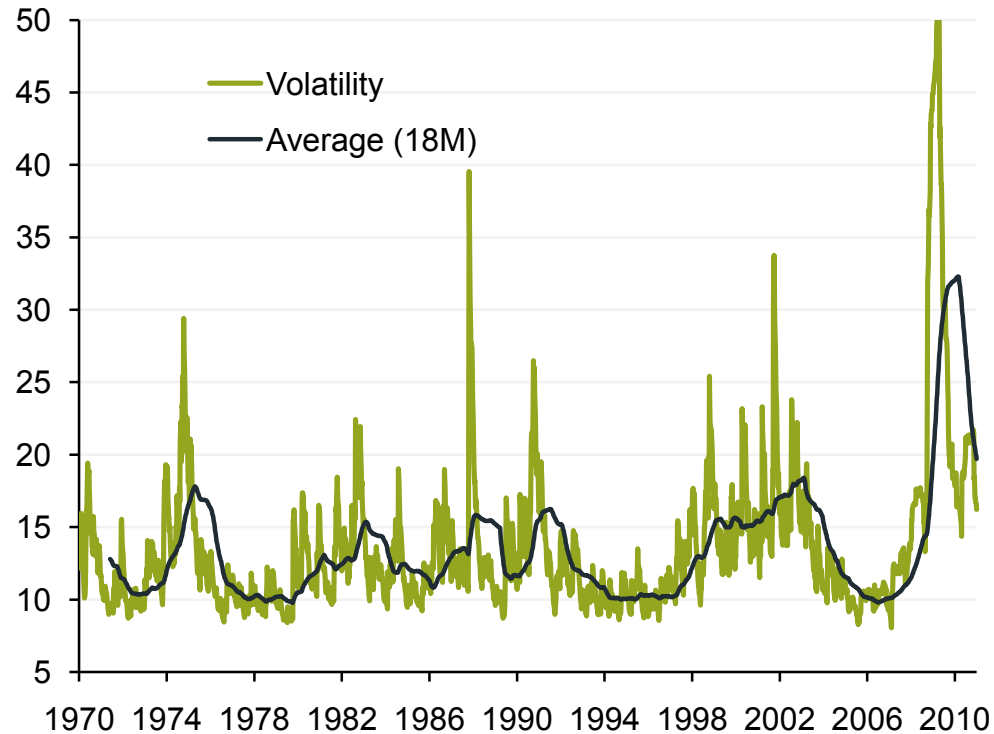
Rising cost of capital: differing outcomes

Source: Bloomberg

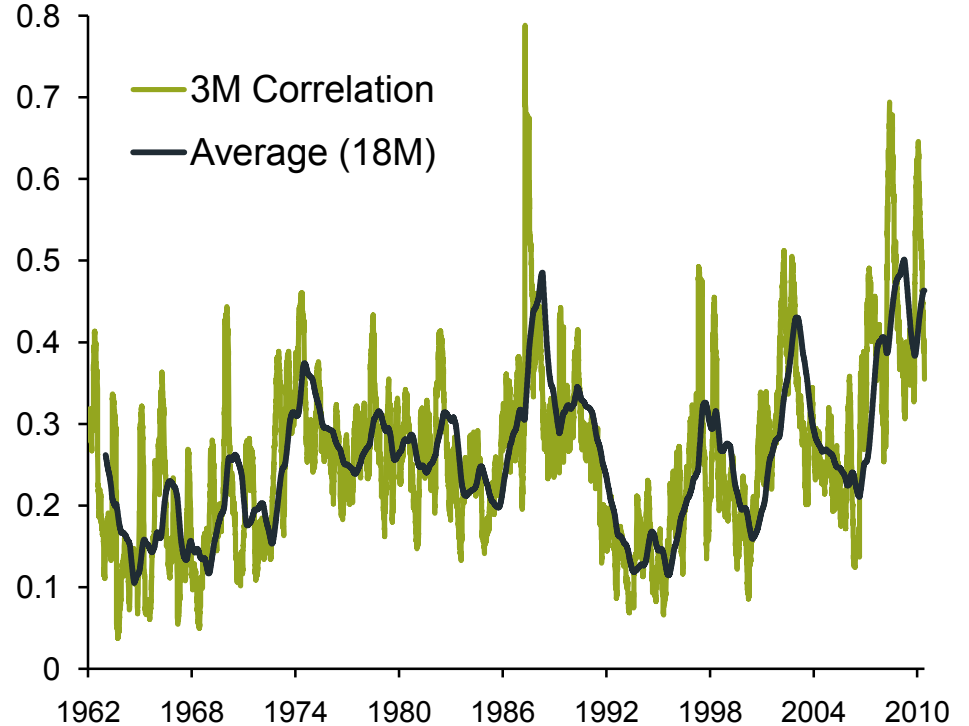
What does this mean for stock pickers?

Long-term equity volatility

Long-term equity volatility



Long-term US equity correlation

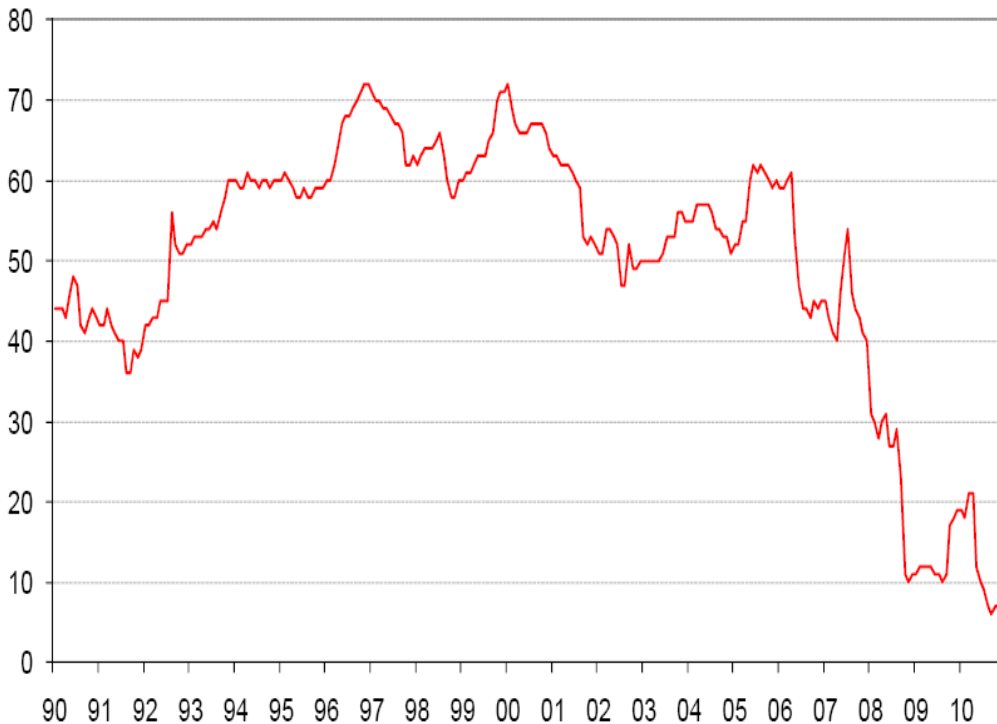


While volatility has fallen, correlation has remained stubbornly high

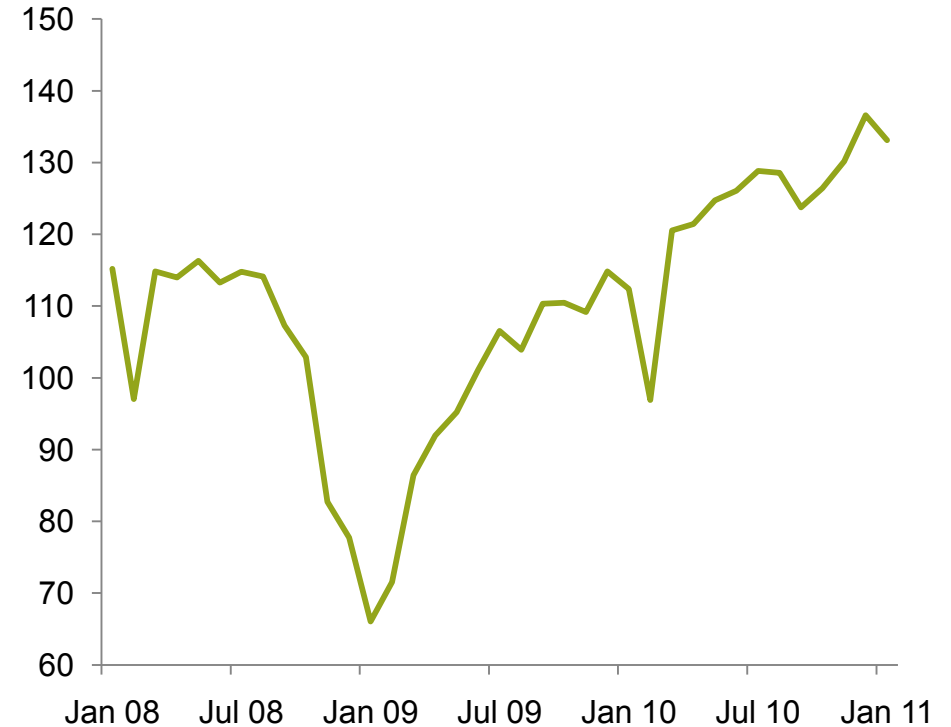
What does this mean for stock pickers?

The risk on/ risk off world

Market dimensionality – number of themes driving Pan-European markets



Taiwanese industrial production



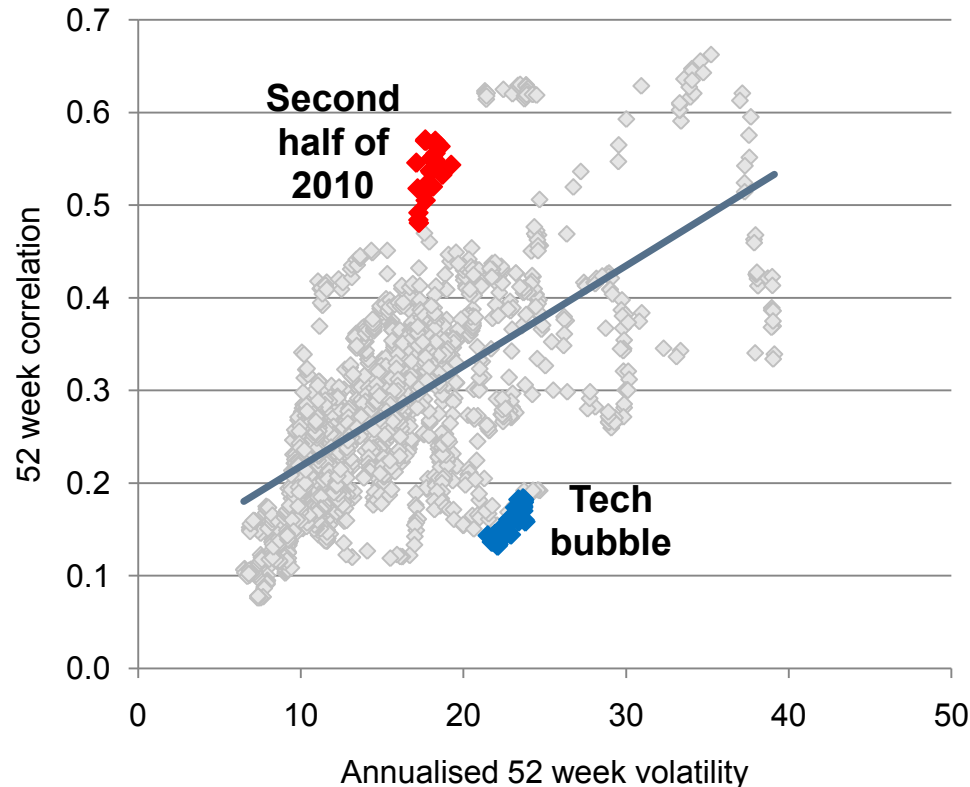
Macro risks (cycle) dominated micro risks

Source: Macquarie and Ministry of Economic Affairs Taiwan

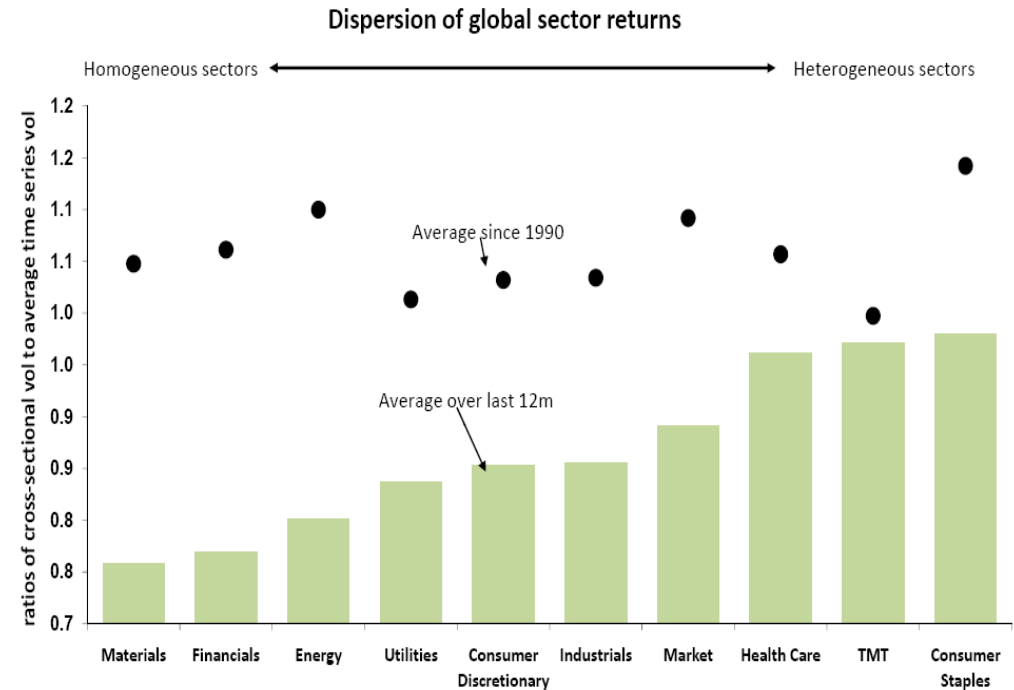
What does this mean for stock pickers?

The opportunity going forward

US volatility and correlation weekly from 1970



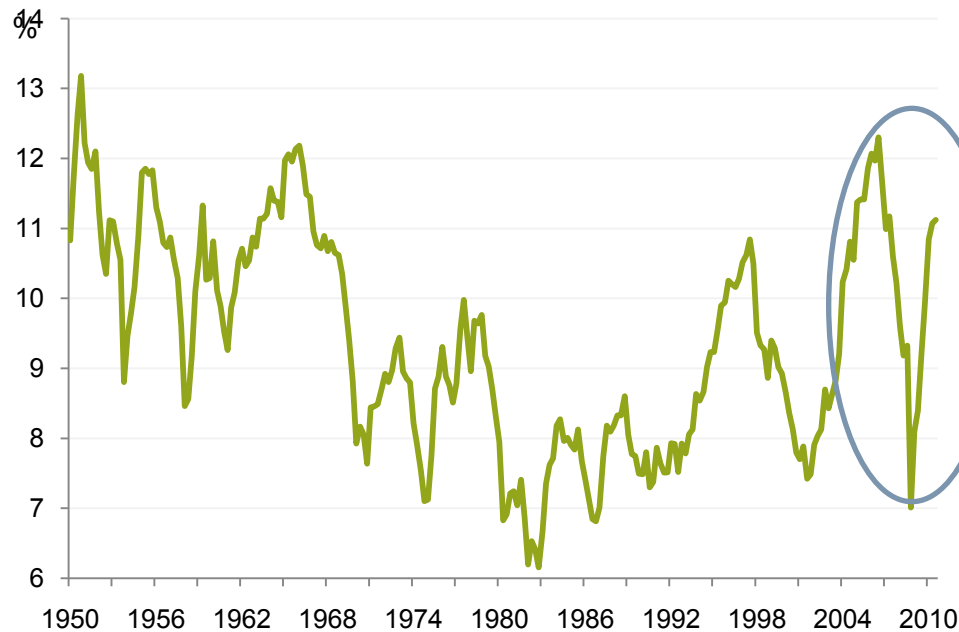
Opportunities for stock picking in almost all sectors



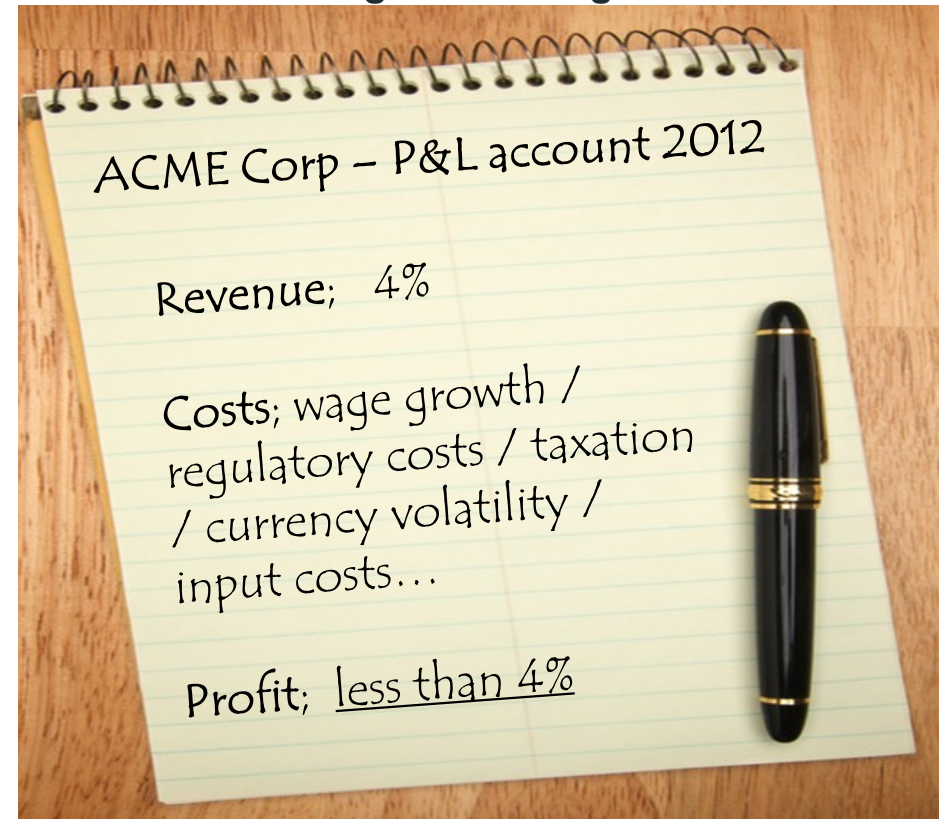
Falling correlation implies greater stock selection opportunity

The fundamental prospects of the average company

US corporate profits as share of GDP

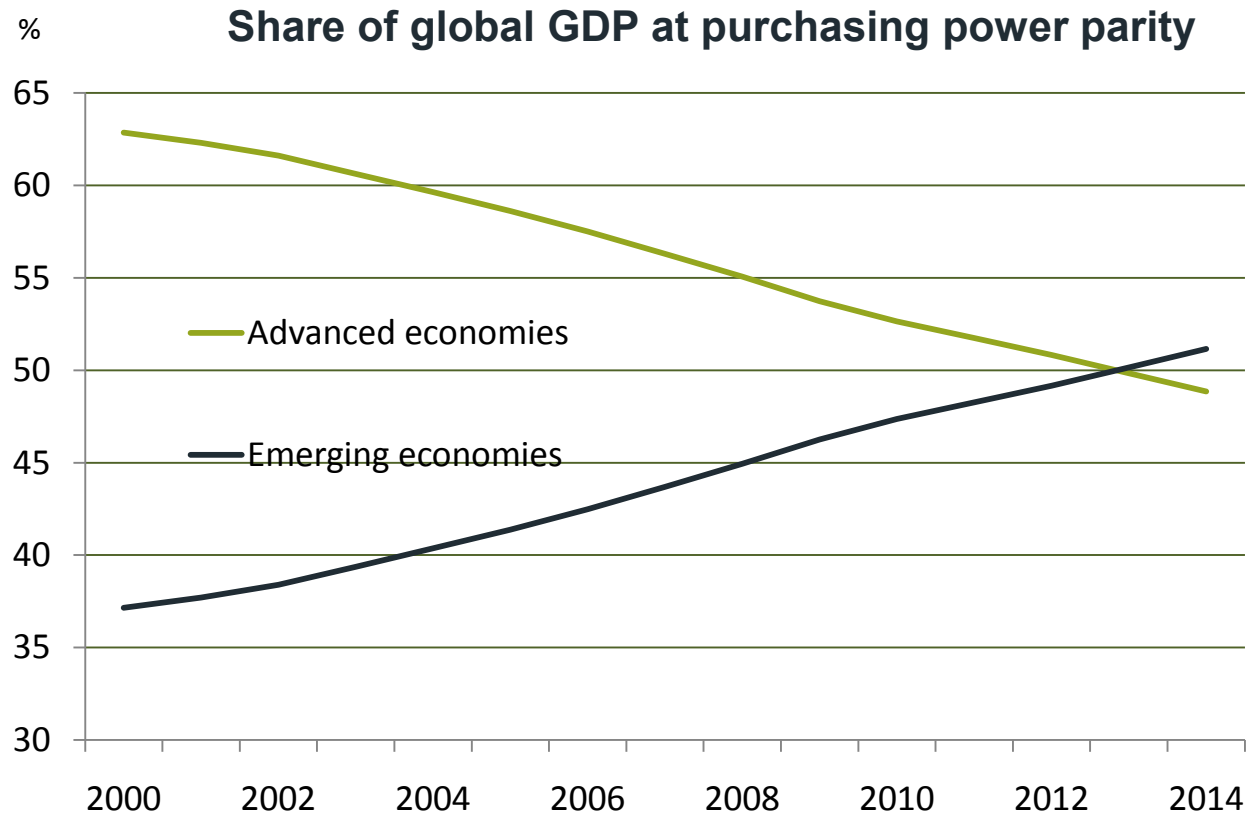


...after which average companies will struggle to grow earnings



Owning average companies will be unexciting

Focus on growth: global emerging markets



Seeking growth in emerging markets - but what about the other 90% of world market capitalisation ?...

Focus on change: dare to be different

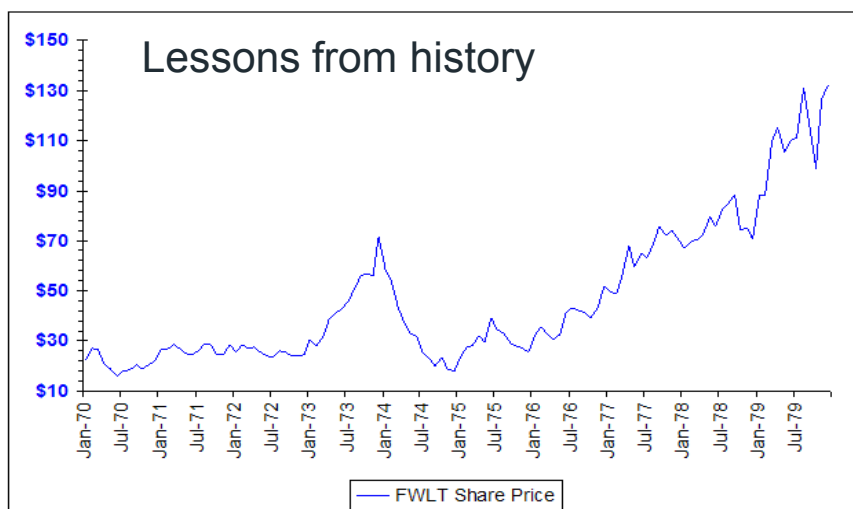
Sales growth

External environment

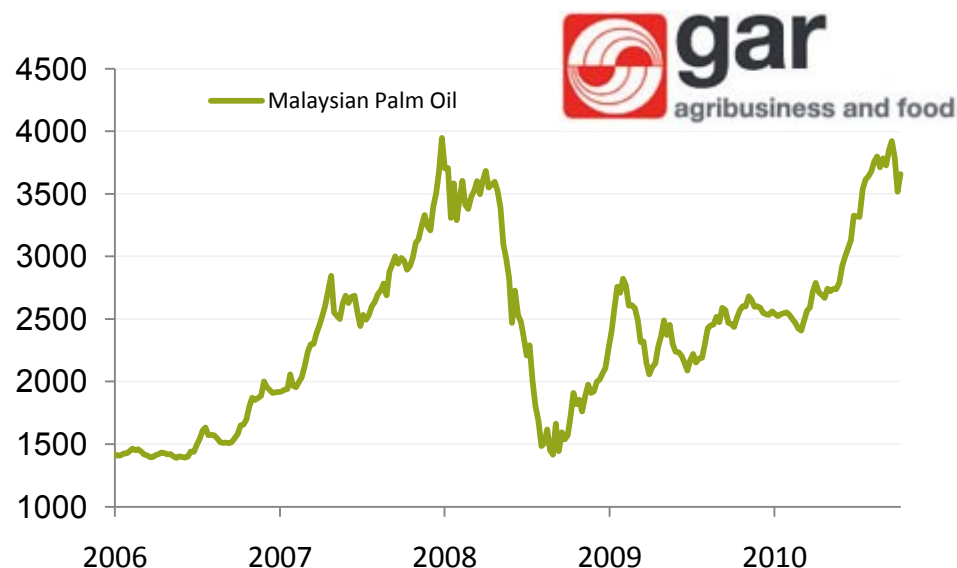
DAI-ICHI LIFE

Volume: Growth niche

FOSTER WHEELER



Pricing power



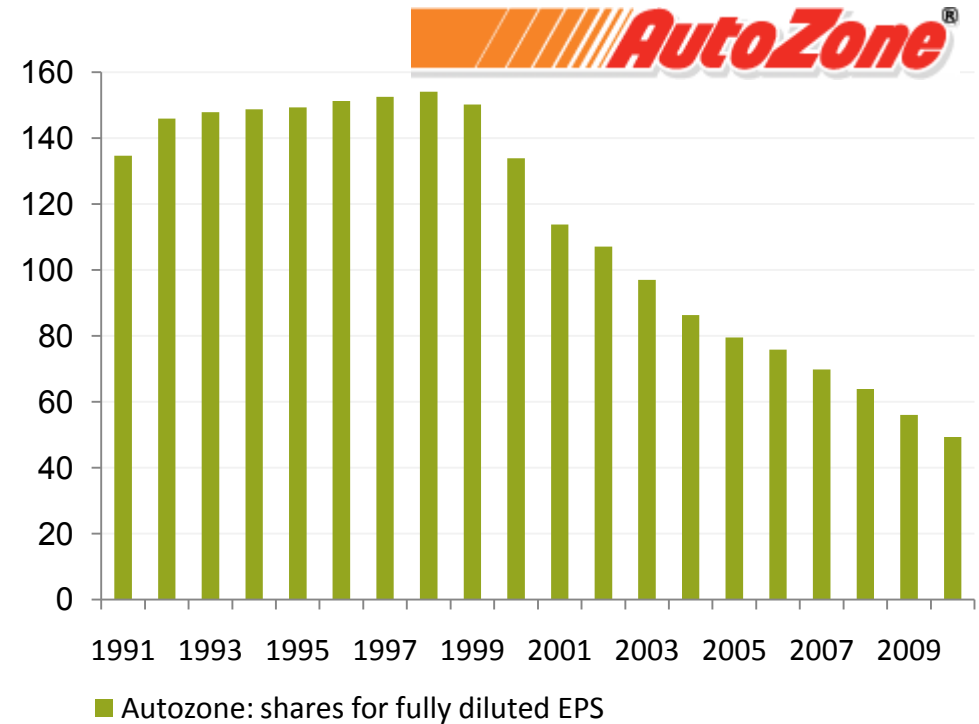
Source: Stifel, Malaysian Palm Oil Board

Focus on change: dare to be different

Margin leverage



Management value creation



Conclusions

- Indexing is cheap, but what are you locking yourself into? Dare to be different?
- Shifting environment benefits stock picking as a source of returns.
- Equities appear cheap relative to fixed income, but how many can demonstrate growth? Those that do will attract significant premium.

Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.

The views expressed in this presentation are those of the presenter.



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