LESSONS FROM THE GLOBAL FINANCIAL CRISIS: *NEW INSIGHTS FOR INVESTING*

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Key messages

- The journey matters, and “bad times” are inevitable
- Investors must be prepared for the inevitability of “bad times”
- When you need it most, the only reliable risk diversifier and provider of liquidity is the US Treasury market
- Diversification of risk assets is best seen as diversification of opportunities not diversification of risks.

"The two most important words in investing are "bad times" " Prof Andrew Ang

- "Bad times": when an extra dollar of extra cash feels especially valuable – Antti Ilmanen
- We know that surprising things happen in markets "surprisingly often"
- We must not ignore "known unknowns"

"The two most important words in investing are "bad times" " Prof Andrew Ang

- Measures of "tail risk", such as excess kurtosis, are almost always unreliable
- They can be worse than useless
- When accompanied by reasoning and simple analysis, they can be very powerful.
- This is true whether the measures look reassuring or worrying

"The two most important words in investing are "bad times" " Prof Andrew Ang

- We can do more than treat risk measures with scepticism
- Bad luck rarely explains poor investment outcomes
- Andre Perold: *"Risk is a choice rather than a fate."*

Lesson from Madoff: *know where performance comes from*

- All investment products offer an alluring pattern of risk and return:
- Only sensible explanations:
  - An anomaly
  - Rare skill, or
  - A reward for risk taking

Know where performance comes from

- Equity strategies: low volatility, fundamental indexation,
  - An anomaly or a reward for risk taking?
  - Just new ways of accessing small cap and value?

- All investors should explore how investments might perform in bad times.
  - "Good beta, bad beta"
  - Is there option writing?
  - Or a liquidity premium?
  - If so, there will be "correlation risk"

Protection for bad times: *we are all fearful of losses but also greedy*

- Attractive low correlations in good times are useful, in good times
- Bad times may be infrequent, but they - and "correlation risk" - are disproportionately important

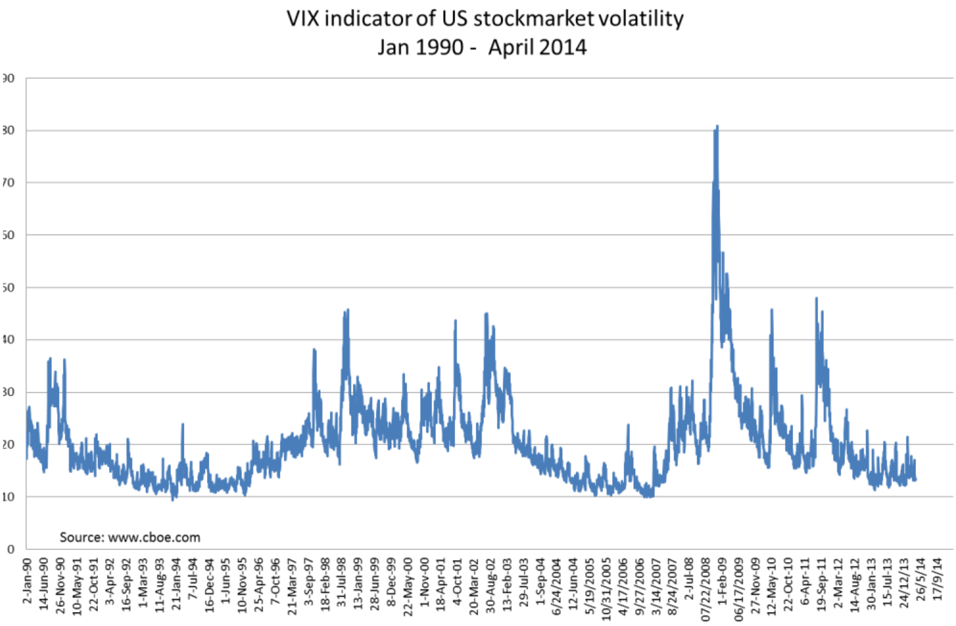
Protection for “bad times”

- For UK investors, gilts and Treasury bills always have been and are the safe harbour
- Explicit insurance is expensive
- Some “free” insurance sometimes exists:
- Some “bad times” risk asset diversifiers may exist, but they are rare and probably unreliable

Managing “bad times” risk:

Market timing, or buy-and-hold diversified asset allocation models

“Investment policy in today’s environment should be opportunistic, to be played more by ear than by rigid policy allocations” Peter Bernstein, 2003


VIX indicator of US stockmarket volatility
Jan 1990 - April 2014
Source: www.cboe.com

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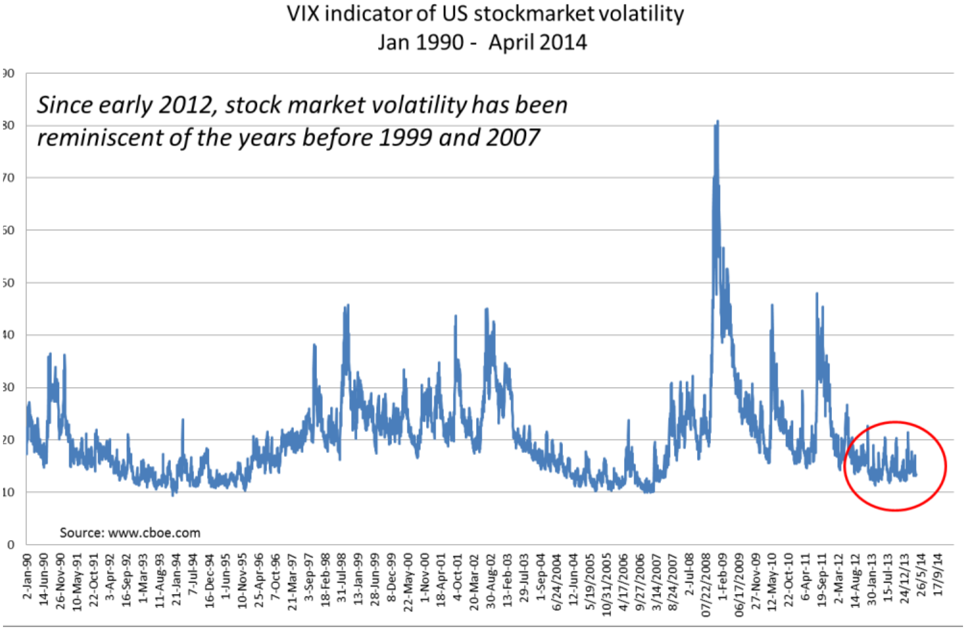
VIX indicator of US stockmarket volatility
Jan 1990 - April 2014
Since early 2012, stock market volatility has been reminiscent of the years before 1999 and 2007
Source: www.cboe.com

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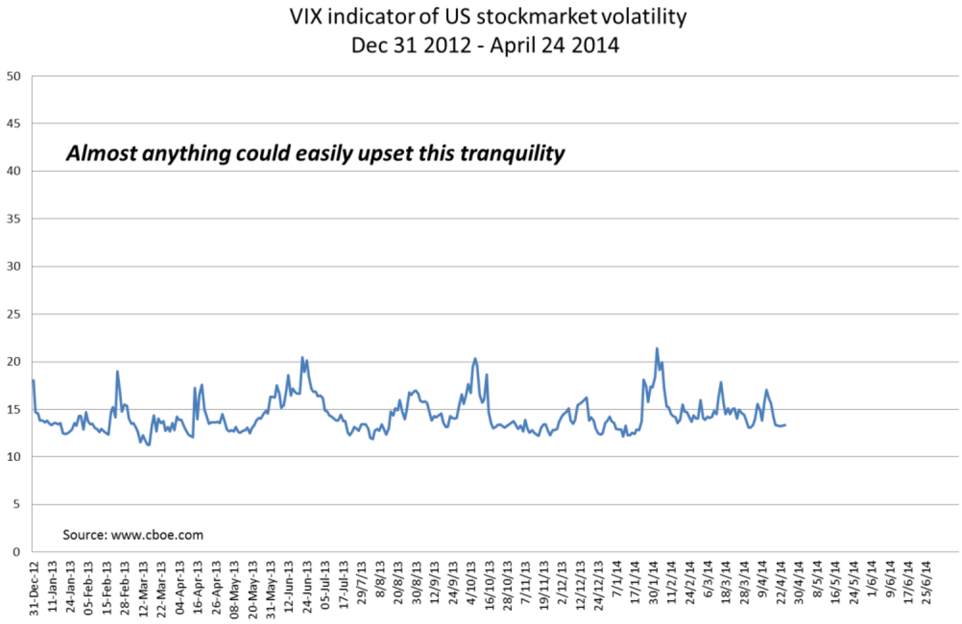


The role of model investment strategies

- Most investors have them:
  - Sovereign Wealth Funds
  - University endowments
  - Pension funds
  - Private investors

The role of model investment strategies

- An expression of risk tolerance
  - Division of investments between safe-harbour and risk assets
- Benchmark for measuring performance and for anchoring discretion given to managers
- But, they rely on long run estimates or expectations for average returns, volatilities and correlations, which we all know are unstable.

Tobin's separation theorem:

Do investors only need government bonds and passive equities?

- An investor's risk aversion only influences the allocation between cautious and risky assets
- Willem Buiter: "this is an important and beautiful result." Rather than warning against putting all your eggs in one basket, Tobin says "regardless of your degree of risk aversion and caution, you will only need two baskets for all your eggs."

Tobin's separation theorem:

- Model has weaknesses, but they are expensive to overcome
- A combination of government bonds and passive equities is a sensible low cost strategy
  - It gives a challenging reference model portfolio or benchmark for any investor, however large or small, however sophisticated or disinterested

Nothing is stable

- Moves away from a long term strategy should be made with humility, fully aware that the move may with hindsight not be profitable
- The journey matters and will only be completed if investor confidence is maintained throughout

HOW DO INVESTORS ACTUALLY INVEST?

Indicators of global investible wealth

	Total assets, US $ billions		
	2002	2007	2012
Global private clients	27,200	40,700	46,200
Global pension funds	14,259	24,680	28,279
US endowments	225	411	406
Sovereign wealth funds	634	2,355	4,118
Central bank foreign exchange reserves	2,408	6,704	10,951

Sources:

Global high net worth financial investments: *Capgemini and Merrill Lynch Wealth Management World Wealth Report 2003; Capgemini and RBC Wealth Management World Wealth Report 2013. "High net worth" refers to individuals with at least US $1 million financial wealth.*

Global pension funds: Towers Watson Global Pension Asset Study 2012. Data refers to sub-sample of seven largest pension fund markets, Australia, Canada, Japan, Netherlands, Switzerland, UK, US.

US endowments: NACUBO-Commonfund Study of Endowments 2012 , NACUBO Endowment Study 2002, 2007

Sovereign wealth funds: Institutional Investor's Sovereign Wealth Center www.sovereignwealthcenter.com

Central bank foreign exchange reserves: IMF, Composition of Foreign Exchange Reserves. Gold holdings are excluded from these totals.

Indicators of global investible wealth

Five year percentage growth in total assets

	2007	2012
Global private clients	50%	14%
Global pension funds	73%	15%
US endowments	83%	-1%
Sovereign wealth funds	271%	75%
Central bank foreign exchange reserves	178%	63%

	2002	2007	2012
Average yield on 20 year US Treasury bonds	5.4%	4.9%	2.5%
Average yield on long dated US TIPS	3.1%	2.3%	0.2%

Sources: as previous slide

Global asset allocation

Global high net worth financial investments

	Equities	Fixed income	real estate *	Alternative investments	Cash/deposits
2013 March	26	16	20	10	28

* Real estate excludes primary residences.

Global pension funds **

	Equities	Bonds	Other	Cash
2002	50	38	9	3
2007	55	28	15	2
2012	47	33	19	1

** includes both defined benefit and defined contribution pension arrangements

Source: see previous chart

Global asset allocation

US endowments

	Listed equities	Fixed income	Alternatives	Cash and other
2002	50.2	23.4	24.3	2.2
2007	47.4	12.9	37.4	2.2
2012	31.0	11.0	54.0	4.0

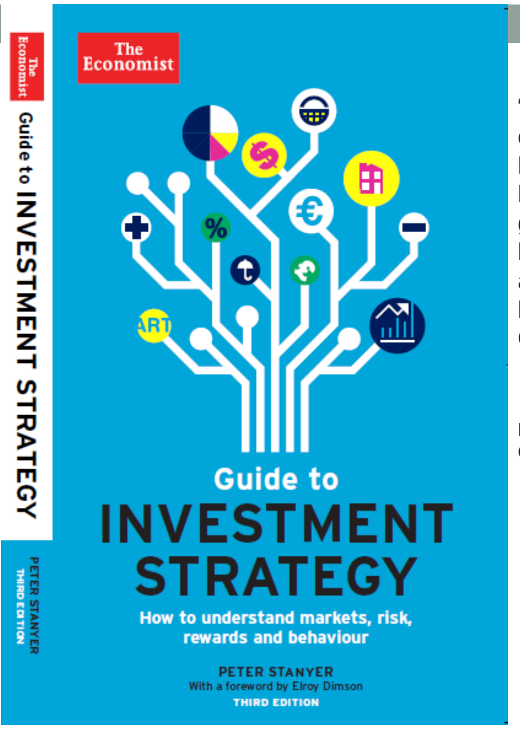
Sovereign Wealth Funds (equally weighted averages)

	Listed equities	Fixed income and cash	Alternatives
2002	42.6	48.1	9.4
2007	46.7	40.7	12.6
2012	46.7	29.3	24.0

Sources: See previous chart

Trends in global asset allocation

- Growing popularity of alternatives
- Shift in hedge fund investing from private clients to institutional investors
- Decline of hedge funds of funds
- Liquid alternatives for private clients
- Preoccupation with trigger yields to buy back into the assurance of government bonds



"Peter Stanyer stands out as an extraordinarily clear thinker and he carries that clarity through to his writing. He is tremendously good at explaining what works best in establishing and adapting an investment strategy. This is a book every Chief Investment Officer should read."

Roger Urwin, Global Head of Investment Content, Towers Watson