

**fordham**

***Economic and Investment Review  
Breakfast***

*Thursday 8 December 2011*

**fordham**

***Opening***

*Mark Cummings  
Regional Manager*

- **Good Morning and Welcome**
- **30<sup>th</sup> Fordham Investment Management Breakfast**

*We collected insights from workshops, presentations and interviews with over 70 people from 30 companies in the USA and UK*



***“Flat is the new up.”*** Michael Knight, Wellington Management

***“In the current environment, the best defence is to hold lots of different risks.”***

Vikas Kapoor, Ramius

***“Utility is not symmetric – clients do not want to lose money.”***

Andrew Windmueller, Fidelity

***“Clients can tolerate disappointment. What they don’t like is surprises.”*** Dan Offit, Offit Capital

## *Wealth preservation / protection*

# 58%

of HNW investors  
now cite wealth  
protection as their key  
investment objective

FINANCIAL SERVICES  
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## *Portfolio Review*

*Luke McMillan*  
*Investment Specialist*  
*Fordham Investment Management*



## *This morning...*

1. World economic growth snapshot
2. The importance of asset allocation (& risks of market timing)
3. Fordham asset allocation update

## 1. Economic growth: remember Monty Python

	IMF growth projections at September 2011 (%)		
	2000-2007 average	2011	2012
<b>World</b>	<b>4.1</b>	<b>4.0 (3.9)</b>	<b>4 (3.6)</b>
Advanced Economies	n.a.	1.6	1.9
United States	2.4	1.5	1.8
Euro Area	1.9	1.6 (1.6)	1.1 (0.4)
Japan	1.6	-0.5	2.3
Emerging Economies	6.6	6.4	6.1
Emerging & Developing Asia	8.6	8.2	8.0
China	10.7	9.5	9.0
Latin America	3.5	4.5	4.0
Middle East/North Africa	5.4	4.0	3.6

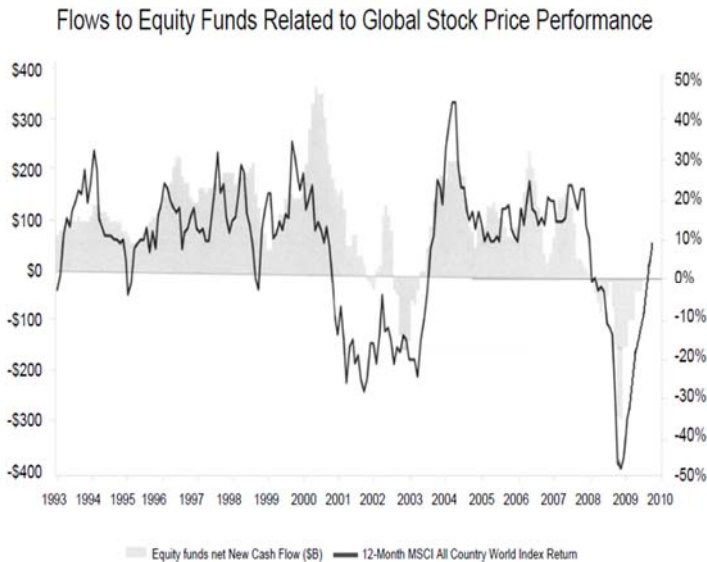
The bright side of life:

- Global growth in base case still most likely to be 'not that bad'
- Thank God for China & India & the rest of the emerging & developing countries
- Australia well positioned for the 'worst'

## 2. The importance of asset allocation (& risks of market timing)

Determinants of Portfolio Performance (on average)	Volatility/Risk	Return
Asset Class Allocation (LT)	94%	>100%
Market Timing (AAA)	2%	<0%
Security Selection	4%	<0%

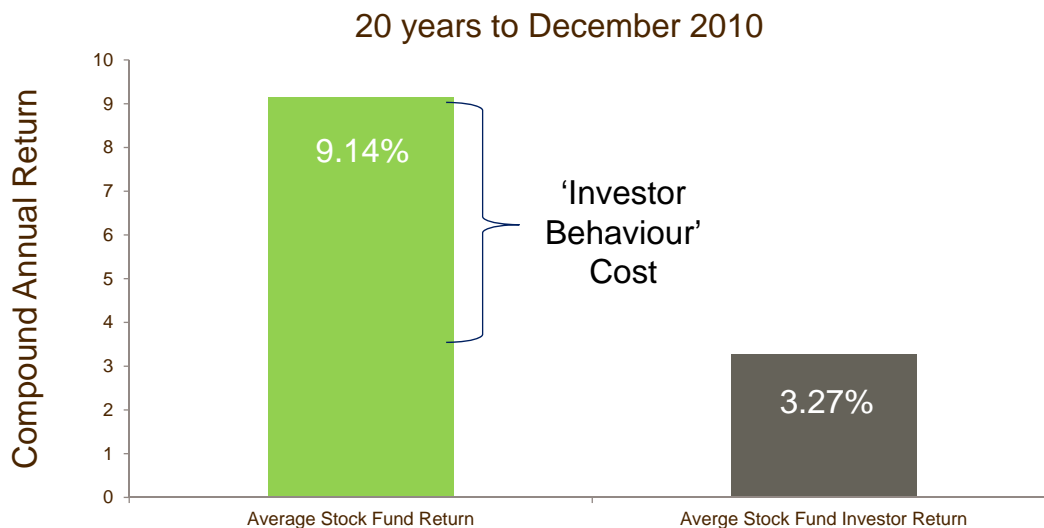
## Most 'market timers' get it wrong.....



*"Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac's talents didn't extend to investing: He lost a bundle in the South Sea Bubble, explaining later, 'I can calculate the movement of the stars, but not the madness of men.' If he had not been traumatized by this loss, Sir Isaac might well have gone on to discover the Fourth Law of Motion: For investors as a whole, returns decrease as motion increases."*

Warren Buffett

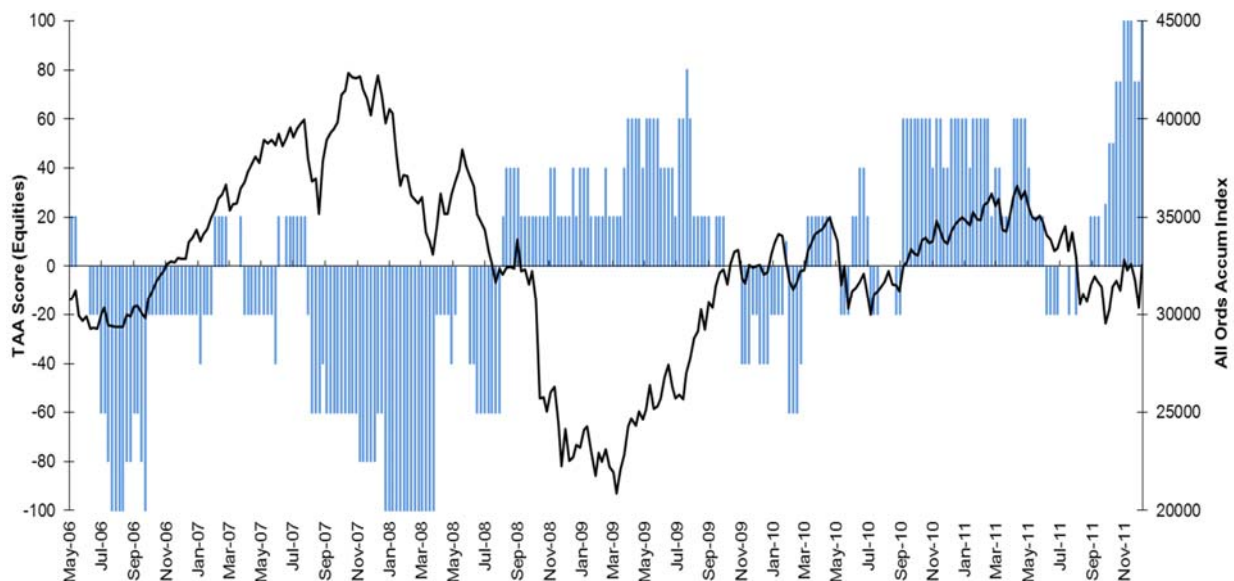
## ..... and the penalty is big.....



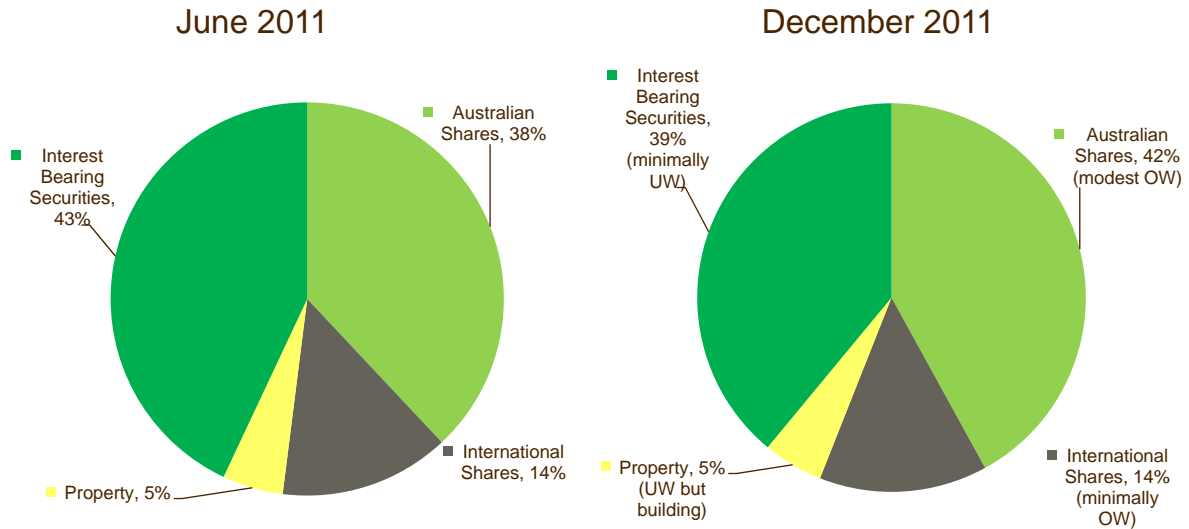
## The Fordham approach to active asset allocation

- **Incremental**: there are signposts but no absolute conviction is possible (forecasting not an exact science)
- **Contrarian**: 'be greedy when others are fearful, and fearful when others are greedy' (Warren Buffett)
- **Systematic** and process driven (ongoing monitoring, formal 6 monthly review)
- **Quantitative** statistical approach combined with **Qualitative** (reasonableness) overlay

## Quantitative input

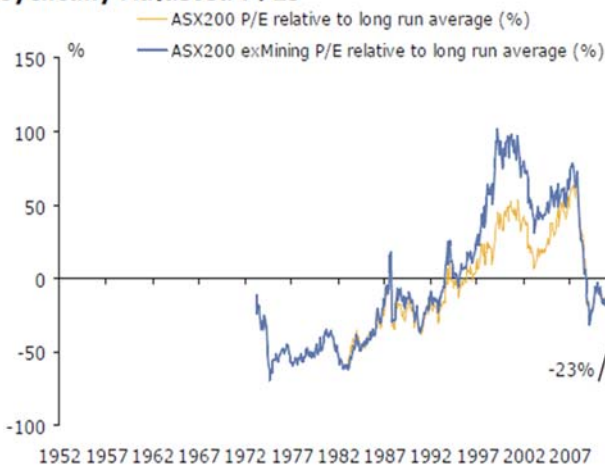


### 3. Fordham asset allocation update



### Australian equities – how cheap?

#### Cyclically Adjusted P/Es



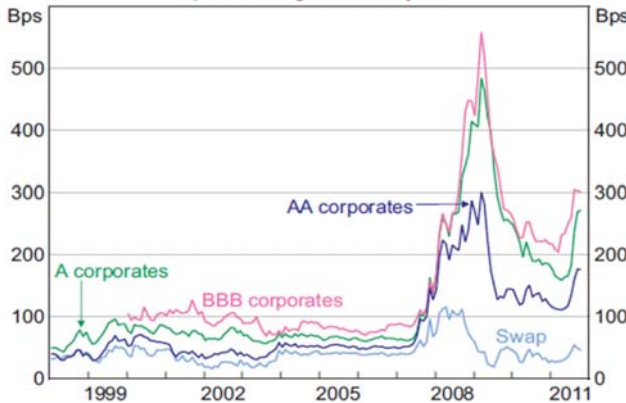
#### Australia : Implied Perpetuity Growth (consensus)



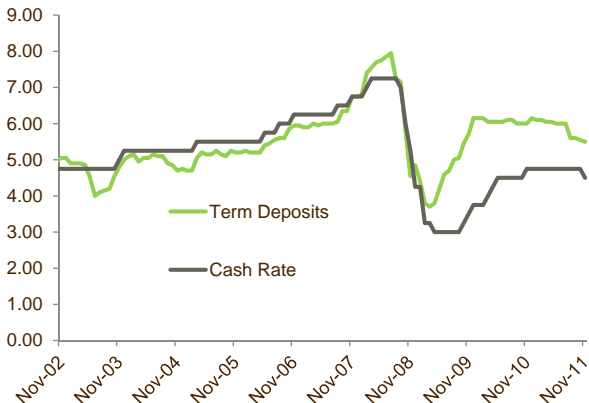
- On 10-20 year historical view 'very cheap'
- Versus the 70's & 80's 'reasonable value'
- Market pricing in implied nominal earnings growth of approx 1.5% into perpetuity – after target inflation (2.5%) this is no real earnings growth!
- Allocation to increase 4% (modestly overweight)

# Interest Bearing Securities

**Australian Bond Spreads\***  
Spread over government yields



**Australia Cash Rate v's TD specials**



- Inverted yield curve pricing in IR cuts, questionable value in long duration, keep it short/liquid
- Credit spreads widening again increases attractiveness of investment grade credit v's gov't bonds.
- TD spread to Cash Rate decreasing but competitive environment likely to persist near term.
- Recent issues to market: WOW Notes, ORG Notes (attractive yields, mindful of offer terms).
- Allocation to decrease 4% (minimally underweight)

# Upcoming: asset allocation alternatives

## Long term asset allocation targets

Status	Sample Asset Allocation Alternatives	Interest Bearing Securities & Cash	Property	Australian Shares	International Shares	Total Growth Assets	Total Defensive Assets	Expected Return p.a.	Expected Volatility p.a.
New	Diversified	50%	10%	20%	20%	50%	50%	7.8%	7.4%
New	Balanced	40%	10%	25%	25%	60%	40%	8.2%	8.8%
<b>Current</b>	<b>Fordham - Core</b>	<b>40%</b>	<b>10%</b>	<b>38%</b>	<b>12%</b>	<b>60%</b>	<b>40%</b>		
New	Growth	25%	10%	33%	32%	75%	25%	8.8%	11.1%
New	Domestic Growth	25%	10%	50%	15%	75%	25%	8.7%	11.7%

Increasing risk

## Summary

### 1. World Economic Growth:

- Elevated uncertainty around forecasts with mounting downside risks – but base case is ‘not that bad’!

### 2. The value of asset allocation:

- Market timing is fraught with danger – most get it wrong.
- Economic and financial market forecasting is difficult but there are signposts.
- Be incremental, be contrarian.

### 3. Fordham asset allocation update:

- Australian Shares cheap, near term rebound catalyst not apparent yet (Europe dependant).
- Interest Bearing Securities – inflation risks abating. Inverted yield curve with market pricing in big cash rate cuts so keep it to short maturities. Preference for highly rated credit – credit cheaper than Aust. Gov’t debt.
- Some structured long term asset allocation alternatives on their way!



## The changing investment climate – do we need to switch gears or change roads?

### Presented by:

Matt Sherwood

Head of Investment Markets Research

Perpetual Investments

December 2011



Perception is reality

*'Reality isn't the way you wish things to be, nor the way they appear to be, but the way they actually are'*

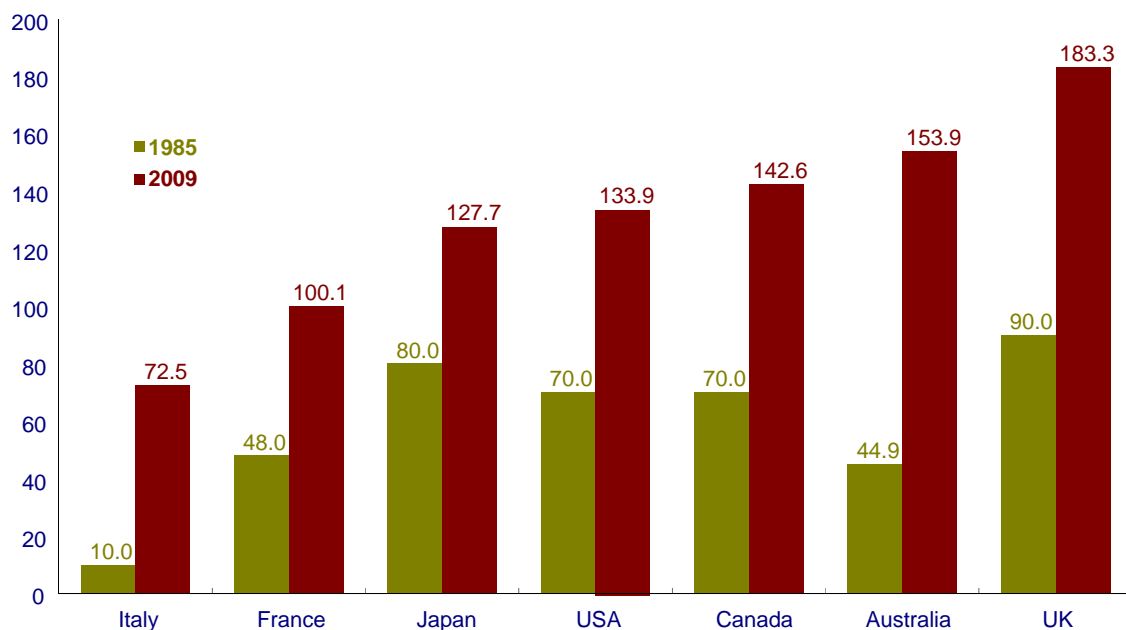
Robert J Ringer 1978



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We have lived through the biggest 'leverage boom' in history

Household debt as a percentage of disposable income (%)



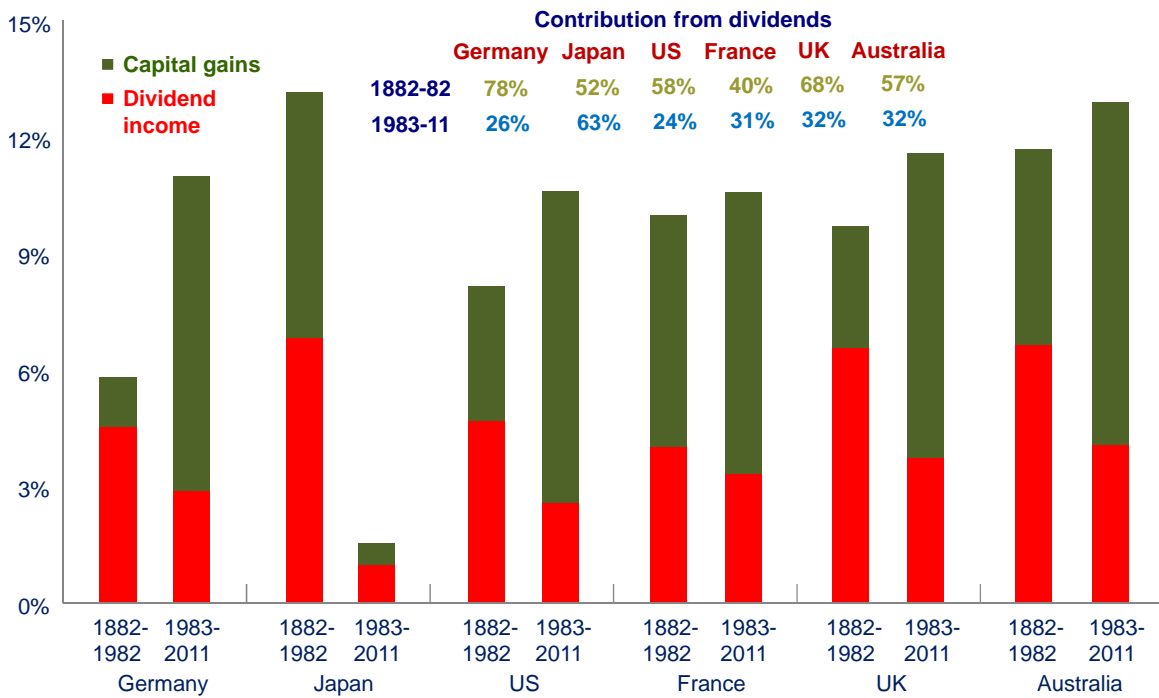
Source: Macquarie Equities as at December 2009.



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## Effect 1: Returns were higher due to 'unusually high' capital gains

### Composition of Investment Returns: Pre-1983 and Post-1983 (% pa)

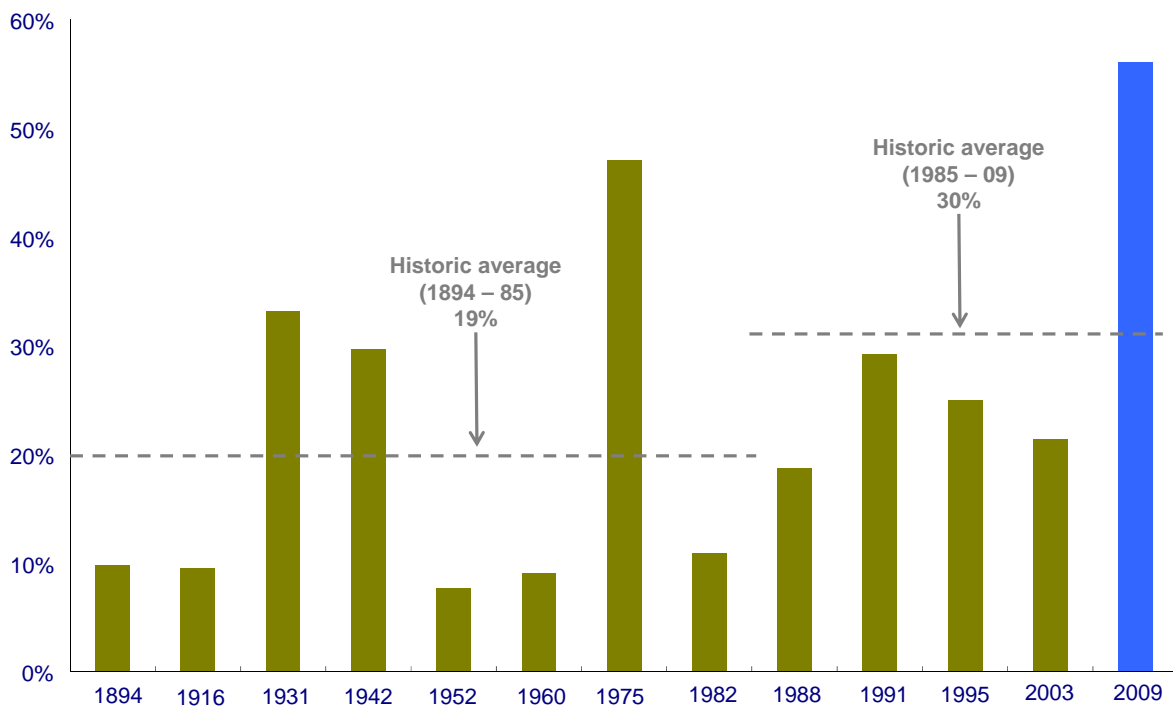


Source: Australian Stock Exchange, Reserve Bank of Australia and DataStream as at 30 September 2011.



## Effect 2: Market recoveries were faster and larger

### Australian sharemarket returns 12 months after bear market

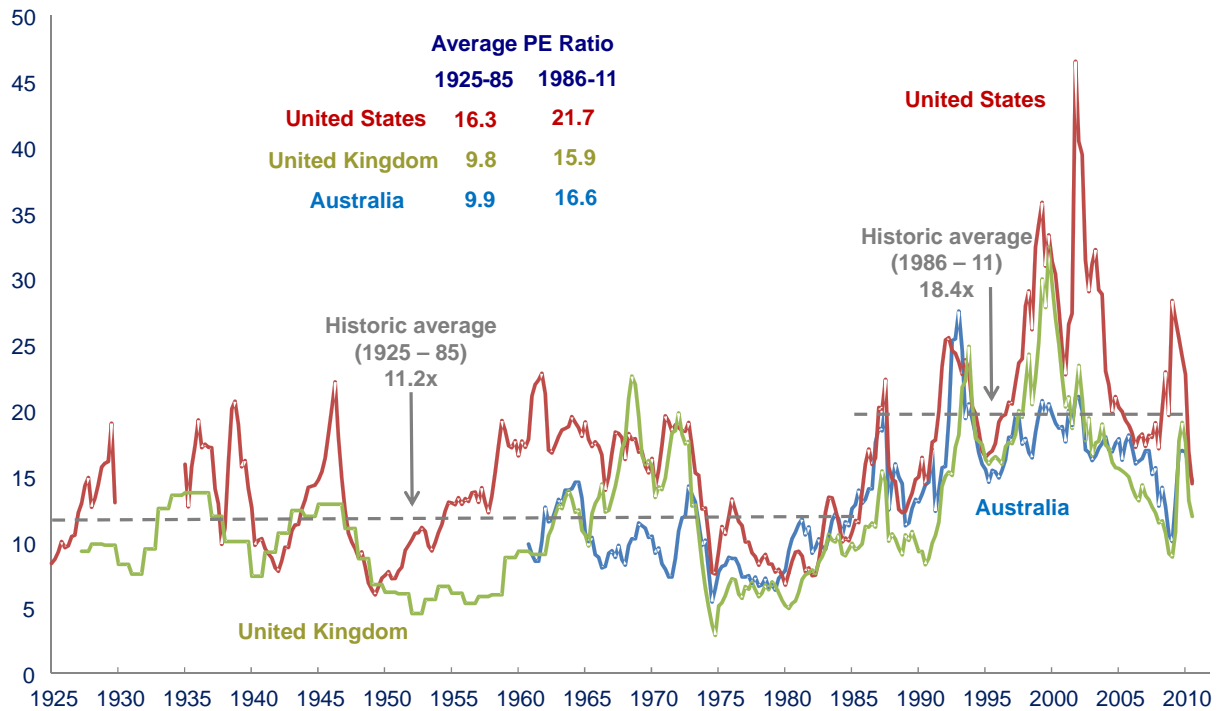


Source: Australian Stock Exchange as at 30 November 2011.



# Effect 3: lower risk premiums meant that valuations rose globally

## Market Valuation: US, UK and Australia (X earnings)



Source: Australian Stock Exchange, Reserve Bank of Australia and DataStream as at 30 November 2011..



## The investment world we know

Earnings growth

Global growth driver

Australian dollar

Inflation risk/cost of capital

Main driver of returns

Lowest-risk debt

Preferred risk hedge

Asset exposure

Boom times  
(1983-07)

Above average

Leverage

Below parity

Declining

Capital gains

Government

US bonds

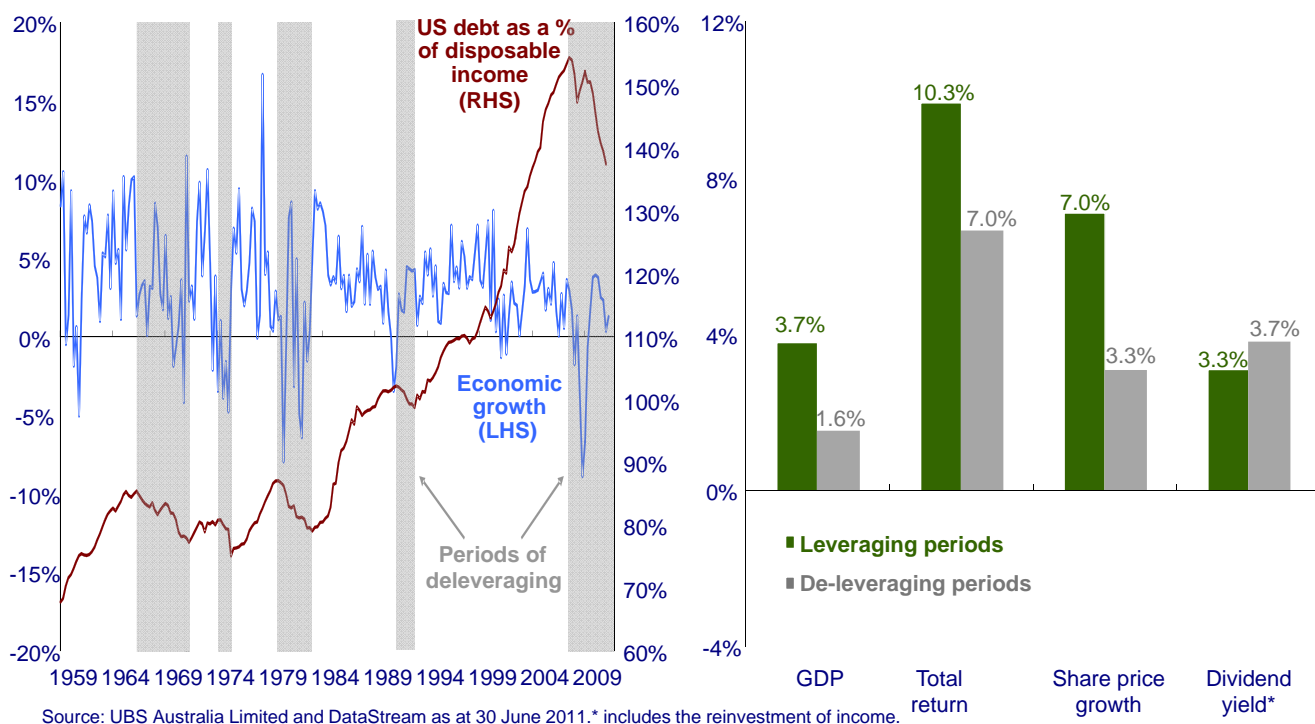
'Growth'

Any downturn in the global markets and the global economy were short-lived as rate cuts sparked a rise in leverage and a recovery



# All booms end and we are now living in the aftermath...

US HH debt to disposable income, US economic growth during periods of deleveraging (% pa)



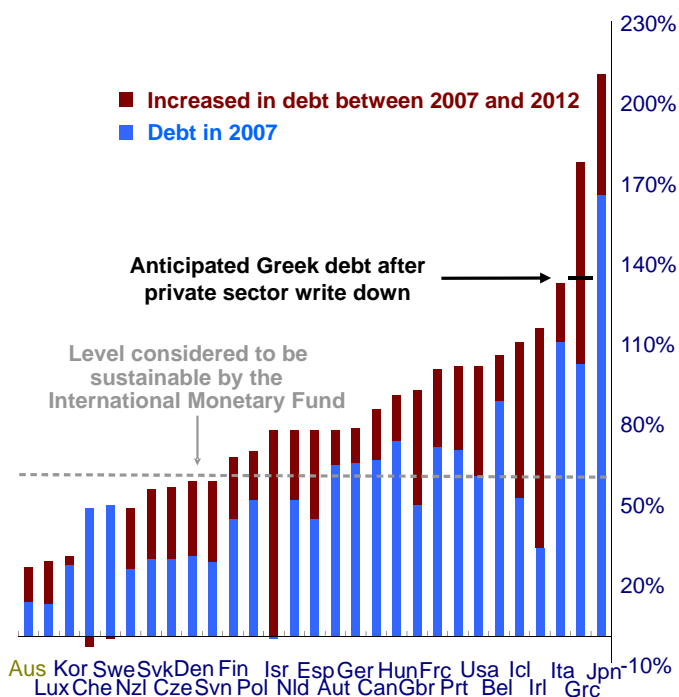
Source: UBS Australia Limited and DataStream as at 30 June 2011.\* includes the reinvestment of income.



# But household balance sheets aren't the only problem...

Gross government debt to annual economic production (%)

- Government debt ratios have been higher historically and declined. How?
  - grow the nominal economy quickly
  - inflation – won't work work this time
  - fiscal restructuring
- The northern hemisphere's problems:
  - too much debt in the government, household and banking sectors
- Is Greece the major problem? And what is the concern?
  - it isn't - the problem is contagion
  - Italy, Ireland, Spain, Portugal, France
  - Euro 'rescue package' has design flaws
  - nothing is over until the debt levels fall



Source: OECD Economic Outlook 88 Database (October 2011).



## Summary - the new macro environment

The global economy will be dominated by long-term trends from:

- balance sheet adjustment
- large demographic changes
- environmental problems/adjustment
- the emergence of the BRICS into the global economy
- productivity and technical innovation

The markets will also be dominated by long term trends:

- lower earnings growth from advanced economy operations
- a temporary decoupling between earnings and price growth
- the renaissance of income investing
- some riskless assets now being considered as 'risky'

**If the environment has changed, that means investor's strategy will also need to change as the 'old rules' may not be applicable any more**



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### Effect 1: Market rises become more grinding

Australian sharemarket trends after a 40%+ price decline (%): Indices rebased to 100 at peak



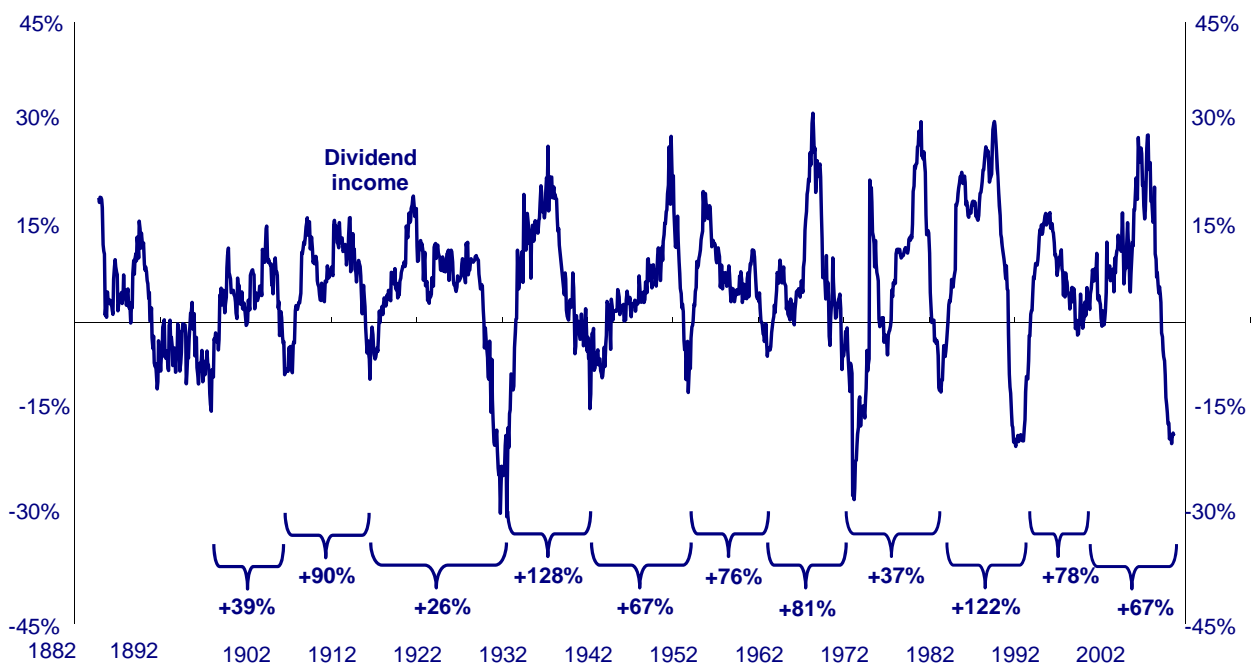
Source: Australian Stock Exchange as at 21 November 2011.



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## Effect 2: Dividend income becomes more important

Australian listed company dividend growth (% pa)

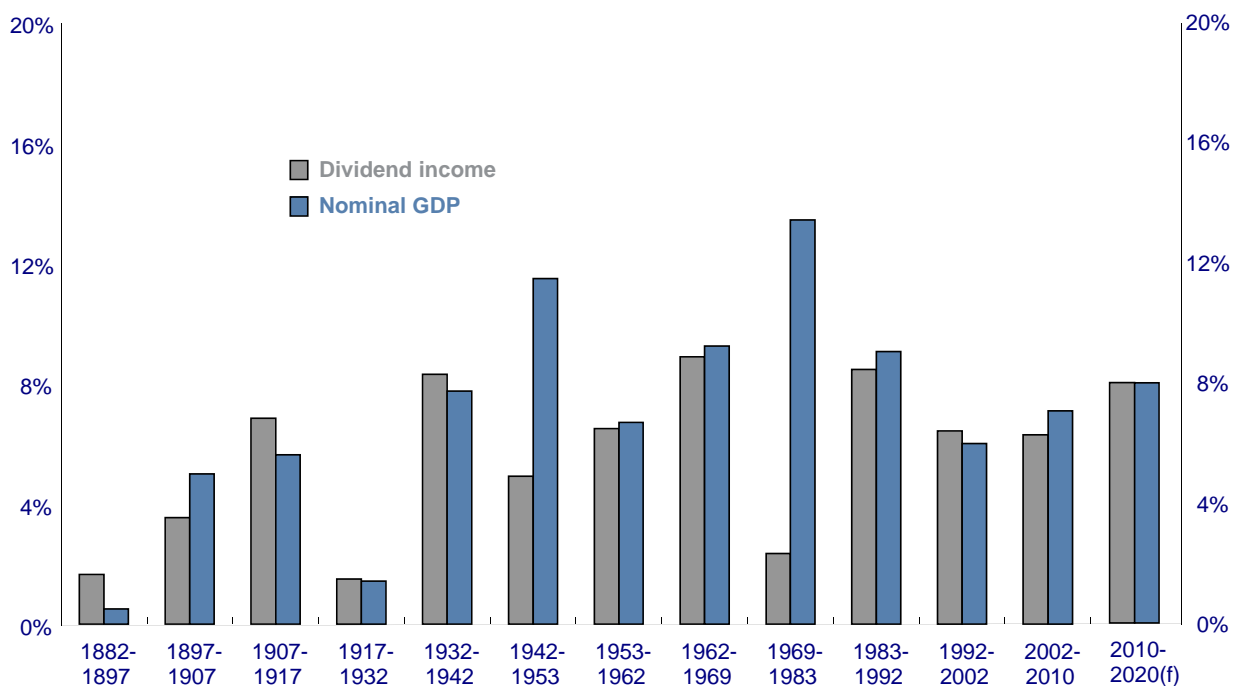


Source: DataStream, Morgan Stanley and Reserve Bank of Australia as at 31 August 2011.



## The main driver of income growth is economic/earnings growth

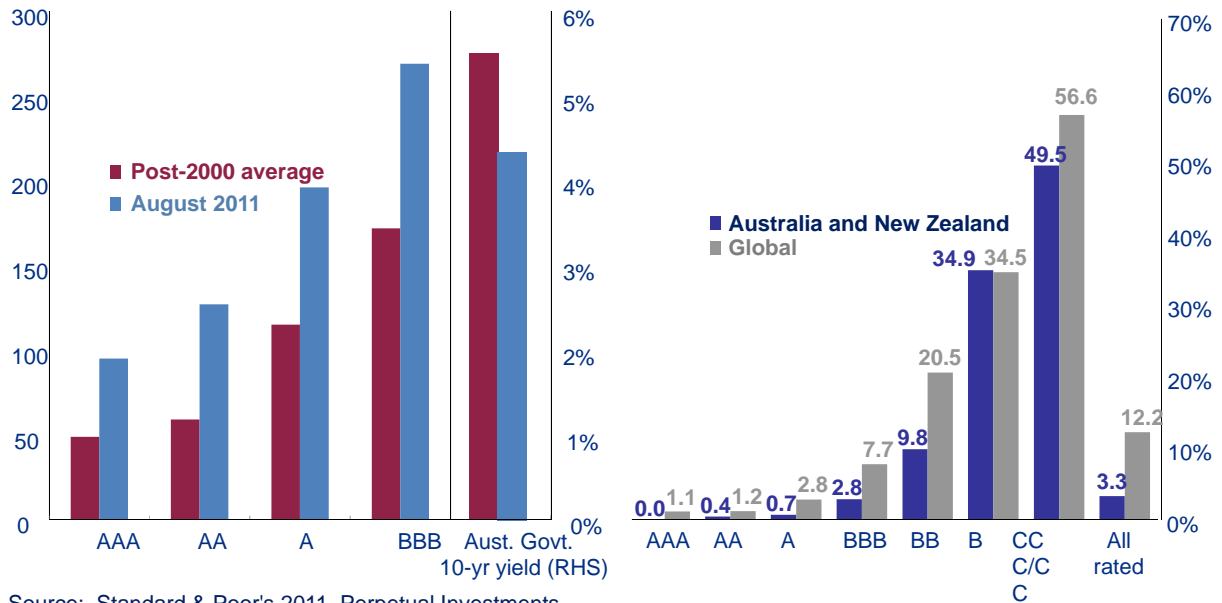
Australian listed company dividend growth and nominal economic growth (% pa)



Source: DataStream, Morgan Stanley and Reserve Bank of Australia as at 31 August 2010.



Effect 3: A change in perception about risk and how to benefit from it  
 Credit spread and 10-yr Government bond yield; Average default rate 1981-2010 (%)



Source: Standard & Poor's 2011, Perpetual Investments

Investors need to change gears and switch roads

	Boom times (1983-07)	Period ahead (2011-15)
Earnings growth	Above average	Below average
Global growth driver	Leverage	Asia
Australian dollar	Below parity	Above parity
Inflation risk/cost of capital	Declining	Rising
Main driver of returns	Capital gains	Income growth
Lowest-risk debt	Government	High-grade corporates
Preferred risk hedge	US bonds	Gold
Asset exposure	'Growth'	'Quality'

The investment climate is different and investors need to focus more on risk and income and less on capital gains

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Morgan Stanley

## Investing After A Bubble

Morgan Stanley Australia Limited+

Gerard Minack

Fordham Investment Breakfast, 8 December 2011

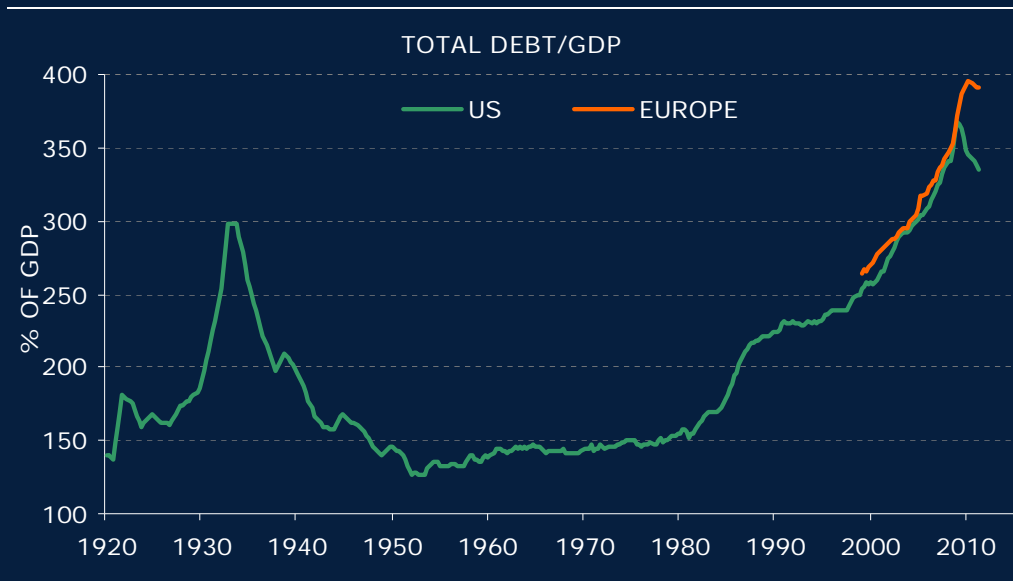
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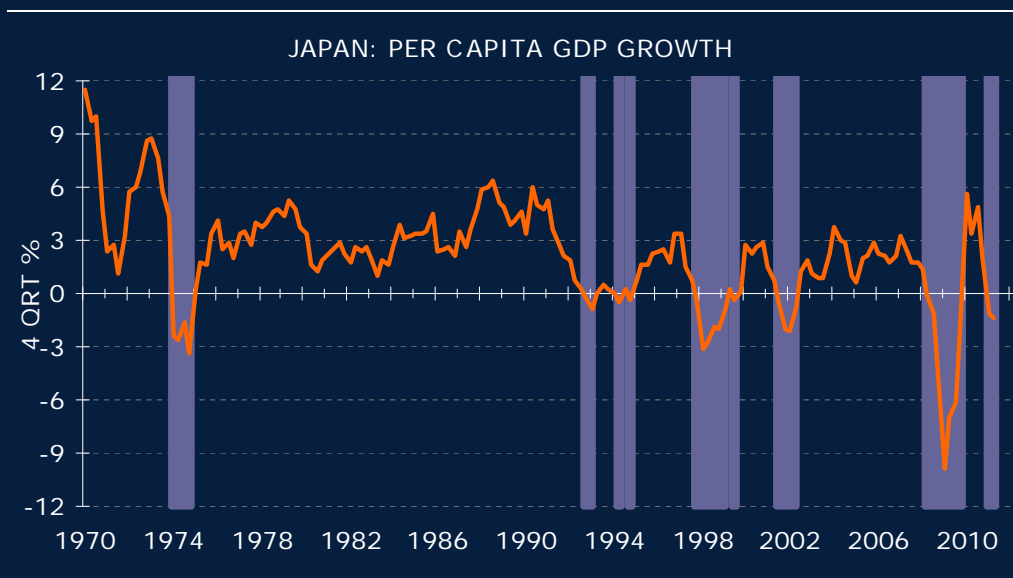
# Past 30 Years No Guide To The Next 10 Years

The 30 year debt super-cycle is over; now it's leverage reduction



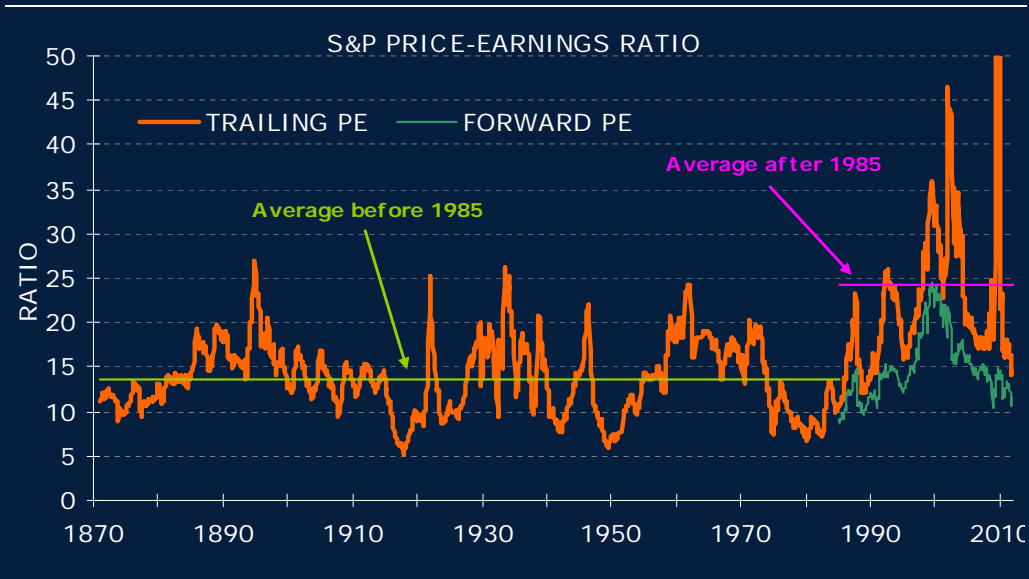
# Change #1: From Macro Resilience, To Macro Fragility

Economies are resilient when leverage is rising, but fragile in deleveraging



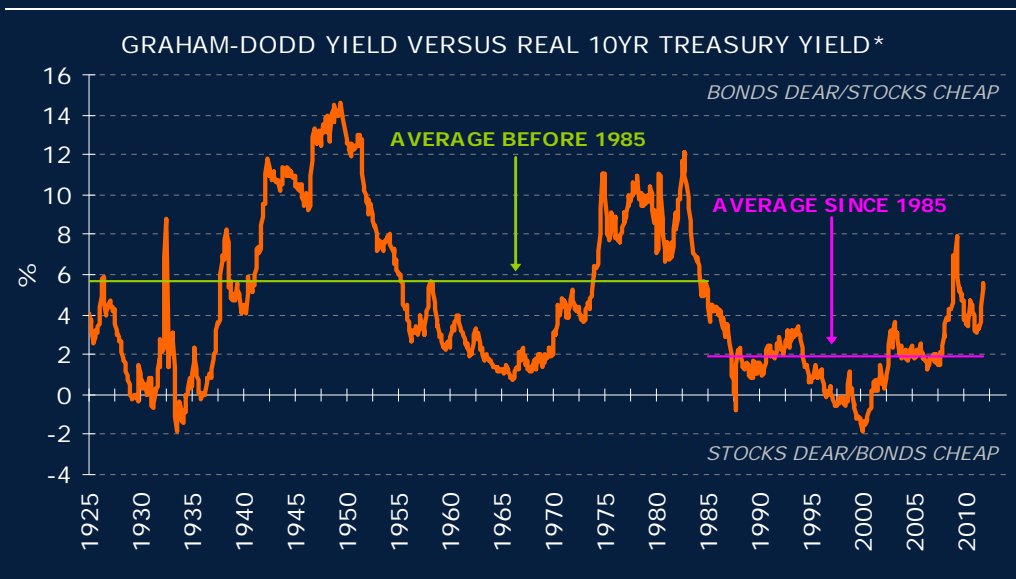
# Change #2: Recalibrate What's 'Cheap'

The leverage super-cycle lifted the absolute valuation of risky assets



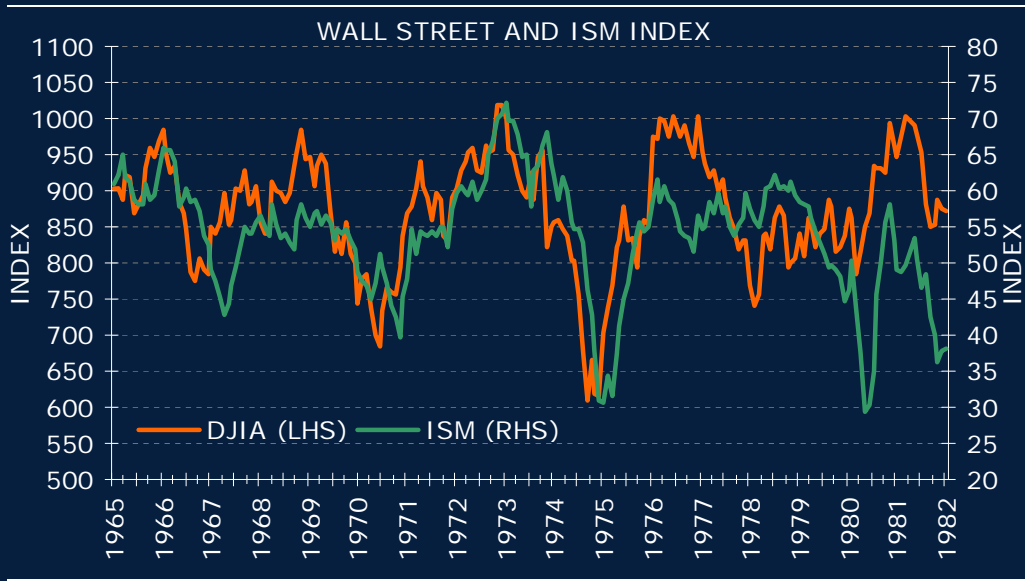
# Change #2: Recalibrate What's 'Cheap'

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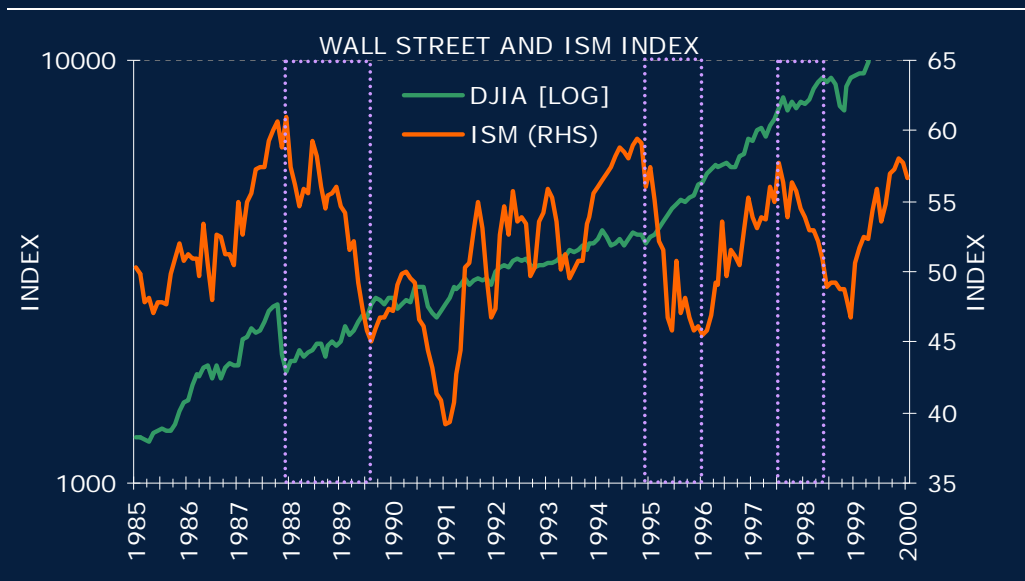
# Change #3: Equities Are All About Macro Growth

After bubbles, earnings drives equities, and the cycle drives earnings



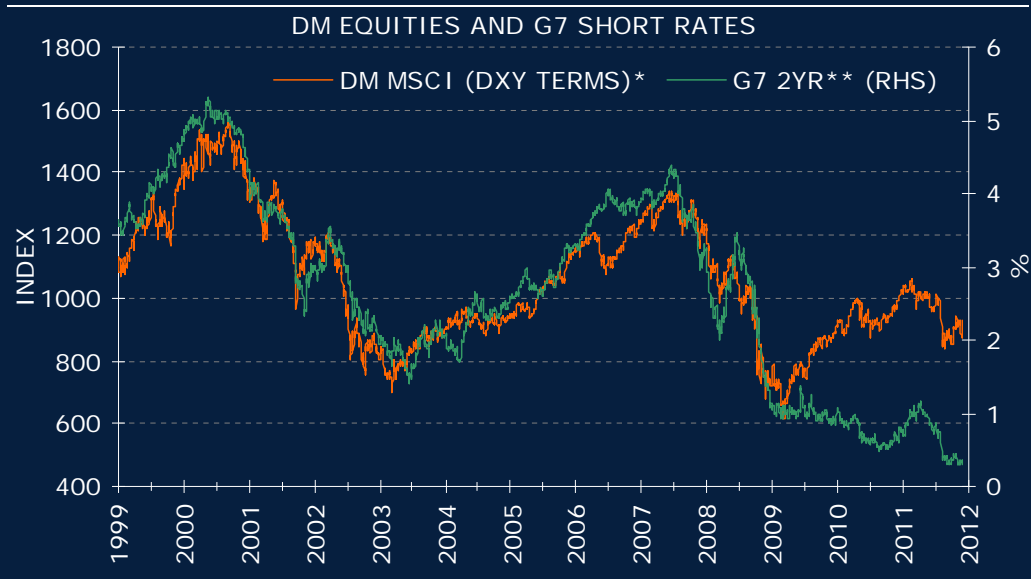
# Change #3: Equities Are All About Macro Growth

In credit super cycles, 'bad' (macro) news can be 'good' (market) news



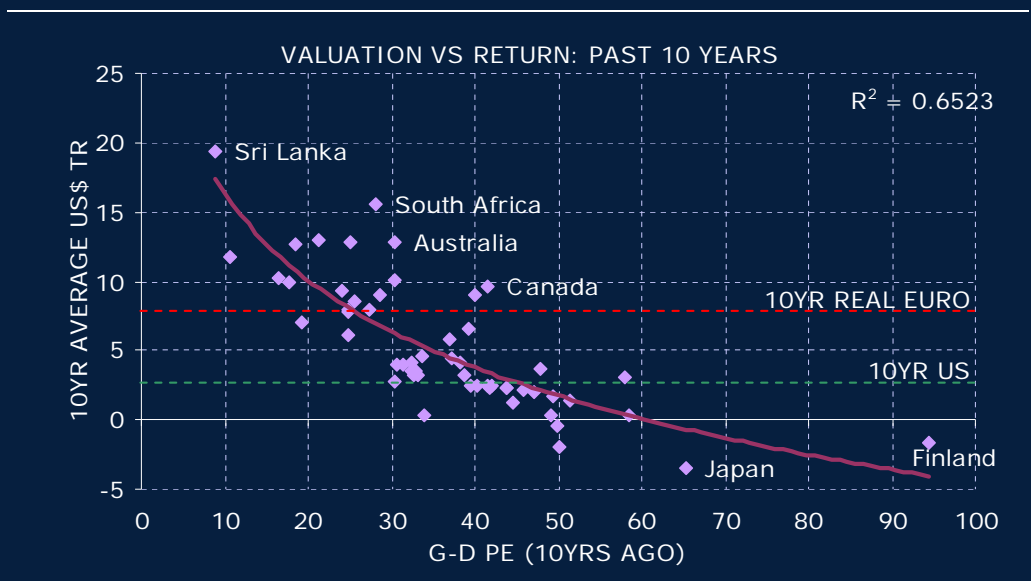
# Change #4: Low Rates Don't Help

Low rates go hand-in-hand with weak growth, and it's growth that critical



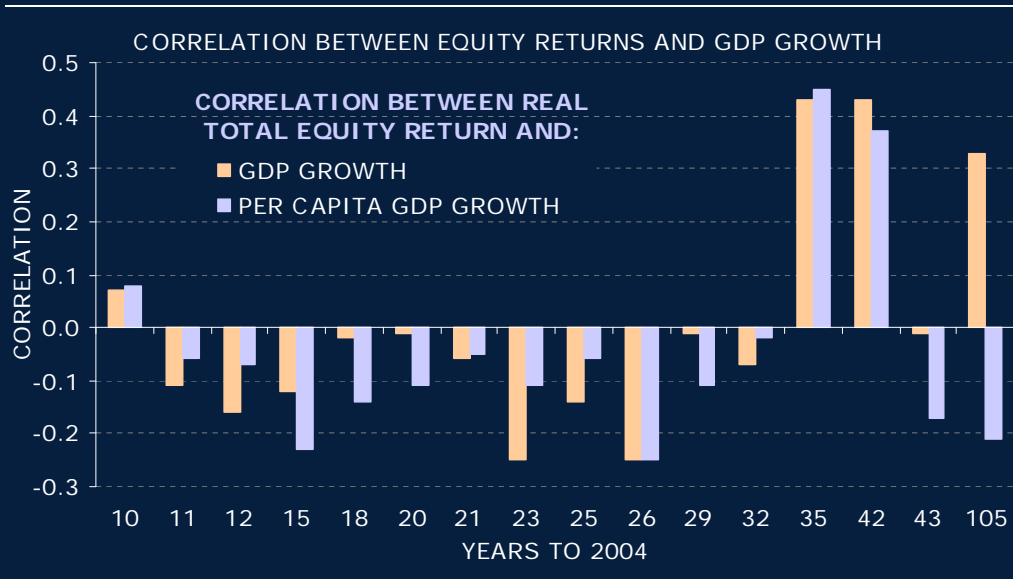
# What Still Matters: Valuation

It's important to buy risk assets at a price that offers reward for taking on risk



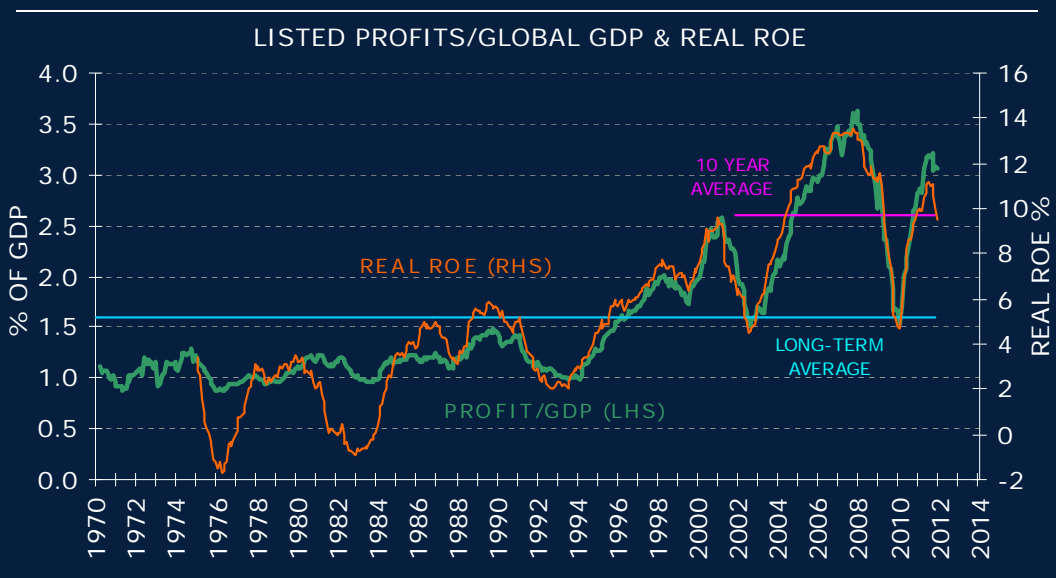
# What Still Does *Not* Matter: GDP Growth

There is little correlation between GDP growth and equity returns



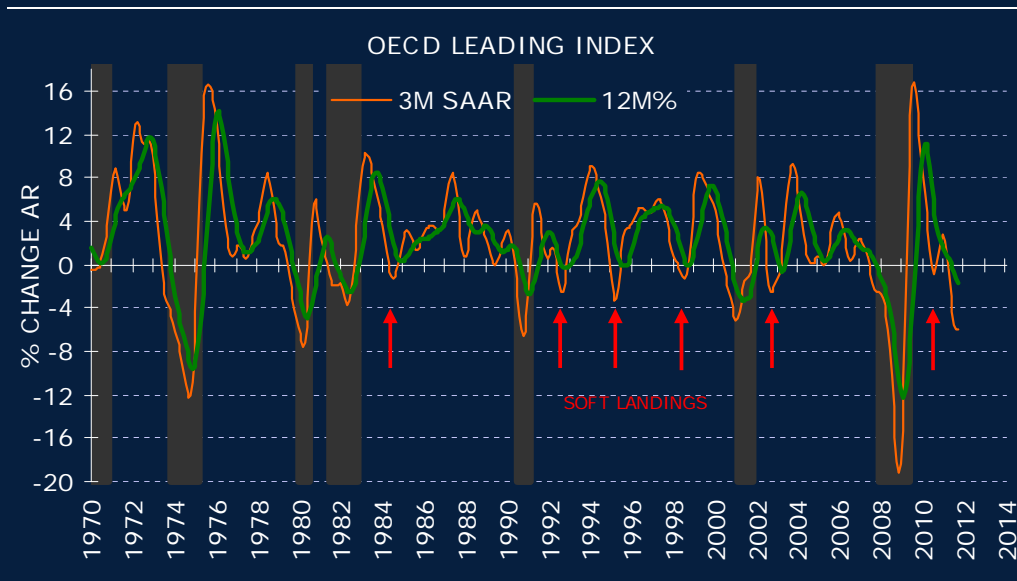
# The Next Issue: Can Earnings and Returns Stay High?

Profits, profits shares of GDP, and real returns are all very high



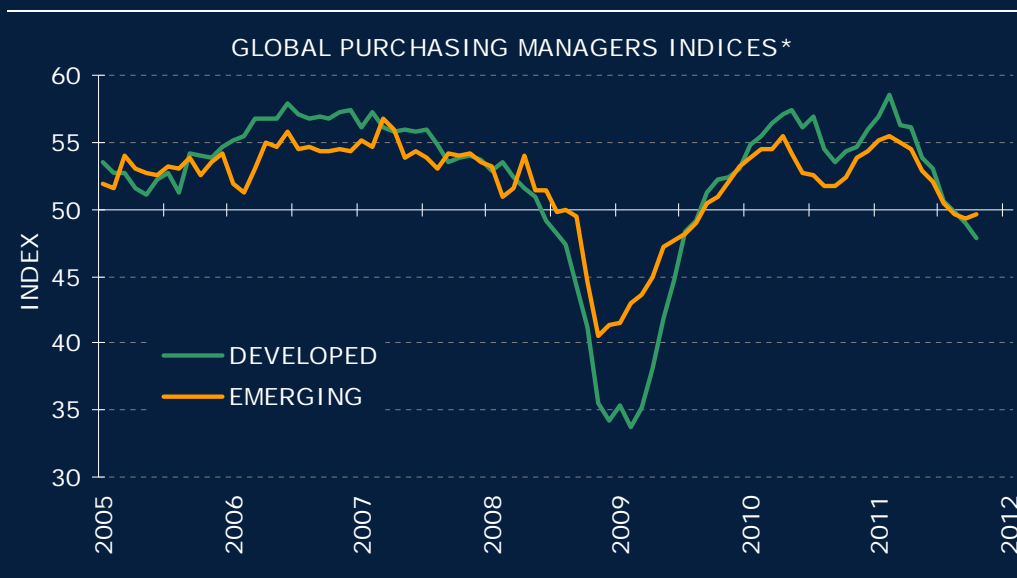
# Recession Warning #1: Leading Indicator Weakness

OECD leading index below typical 'soft landing' levels



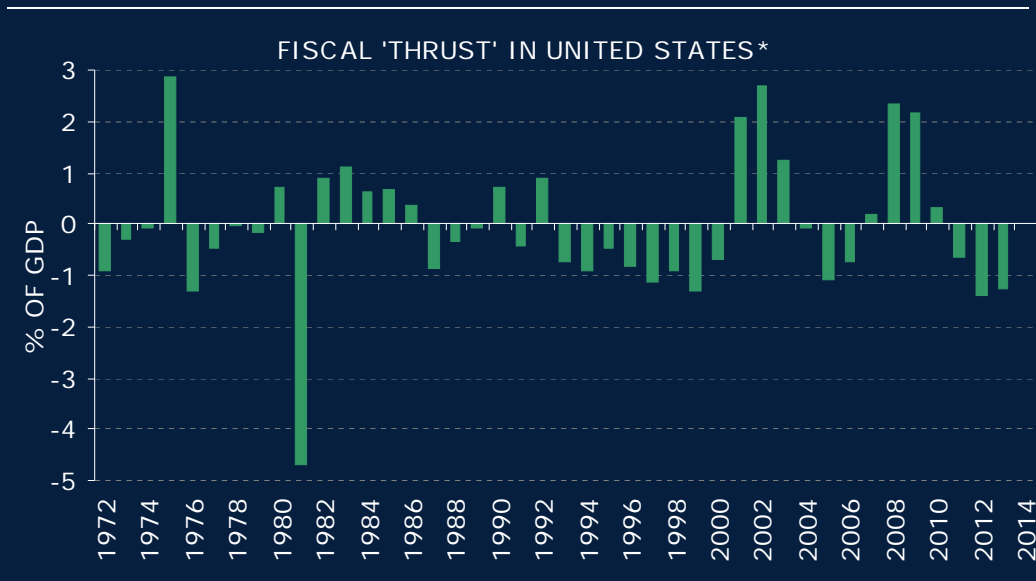
# Global Business Sentiment Is Down

Biggest risk is to developed world, but emerging has also slowed.



# Recession Warning #2: Fiscal Tightening

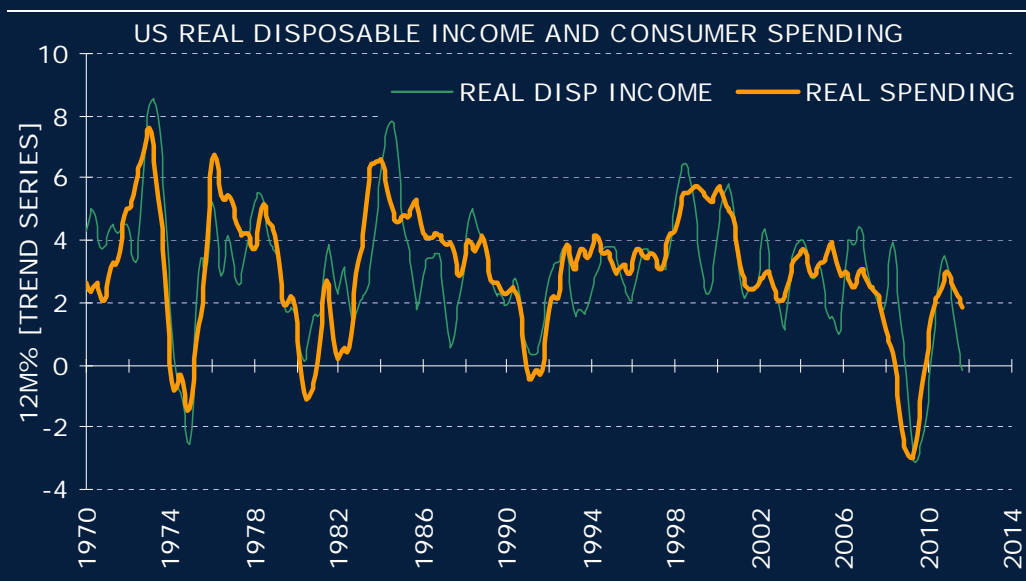
Just what the macro doctor didn't order...



\* Change in structural budget balance (sign reversed) as a percentage of potential GDP. IMF forecasts for 2011 and 2012.  
Source: IMF

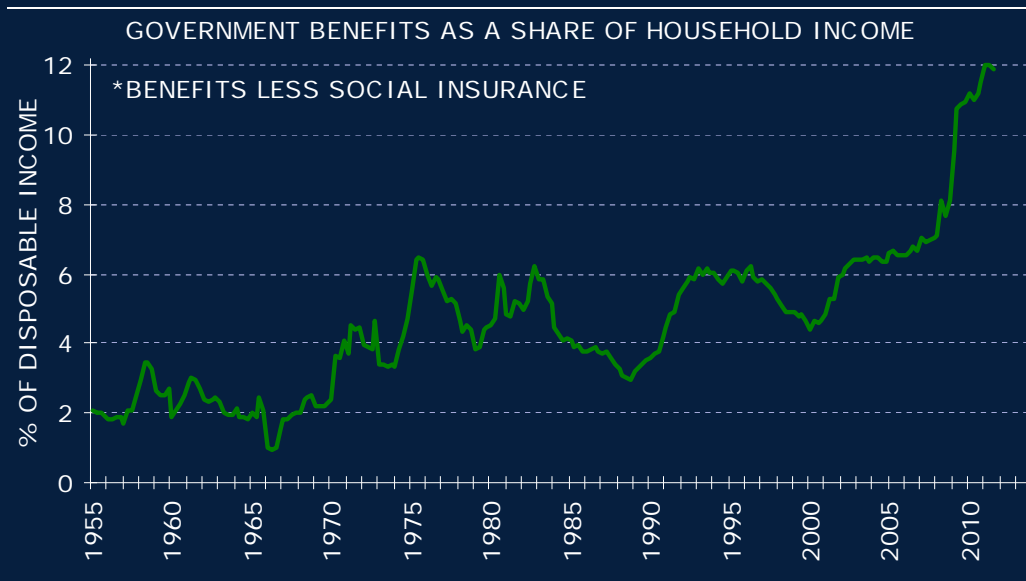
# Consumer: Bedrock Of The US Economy

...and the consumer can't grow without income



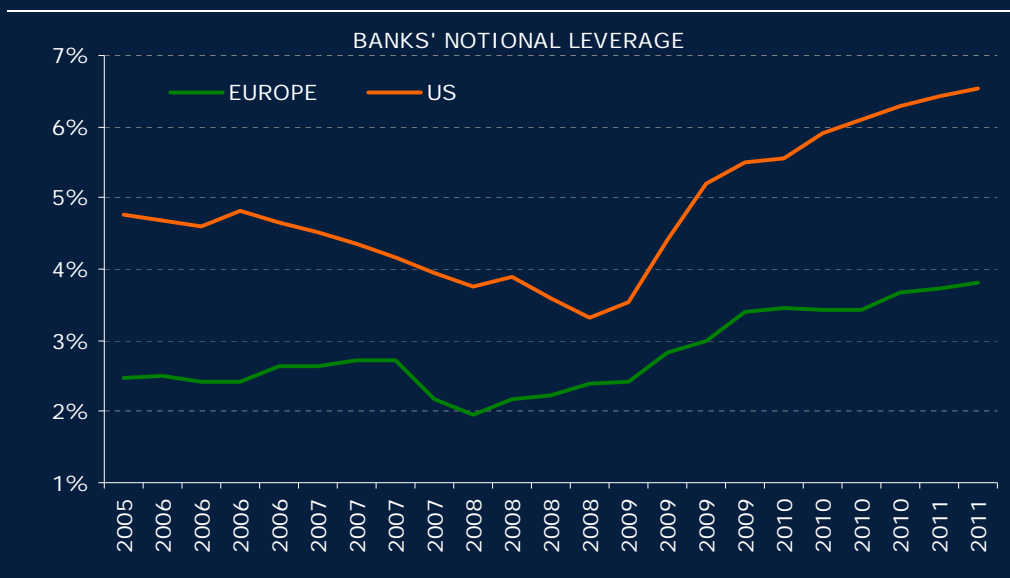
# Government Support For Consumer Income

...and that support is about to fall.



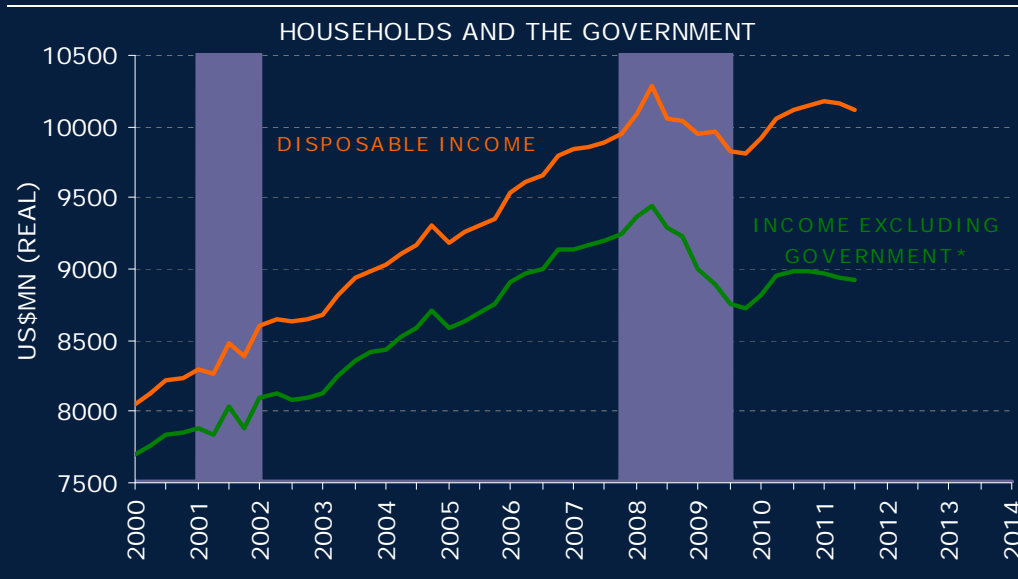
# Recession Warning #3: Bank-imposed Credit Crunch

And the financial linkages could go global.



# A Recovery That Business Didn't Pay For

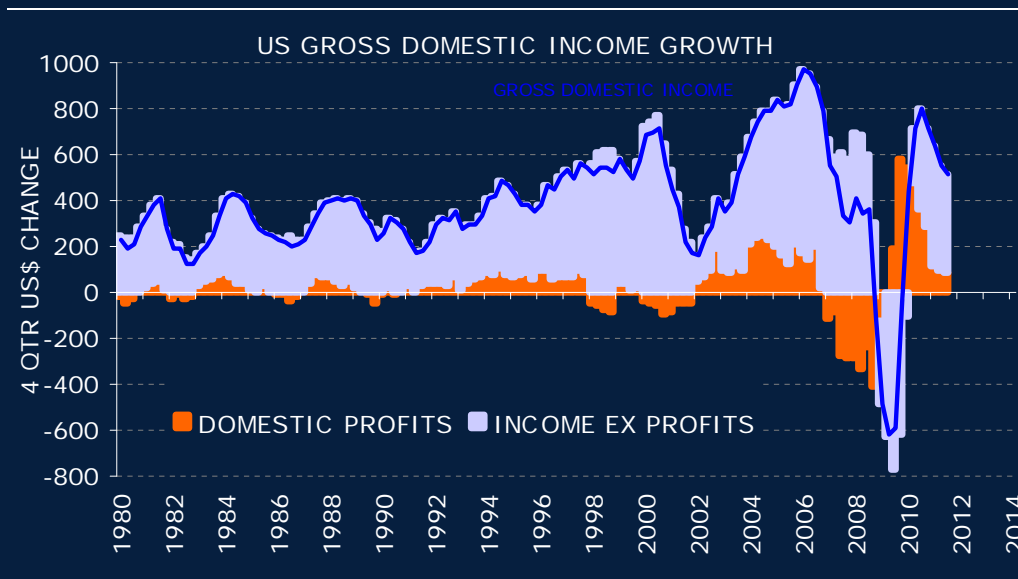
Because the government did.



Both aggregates are inflation-adjusted. Income excluding government is income net of benefits, less social security contributions.  
Source: BEA

# Profits Took An Unprecedented Share Of Recovery

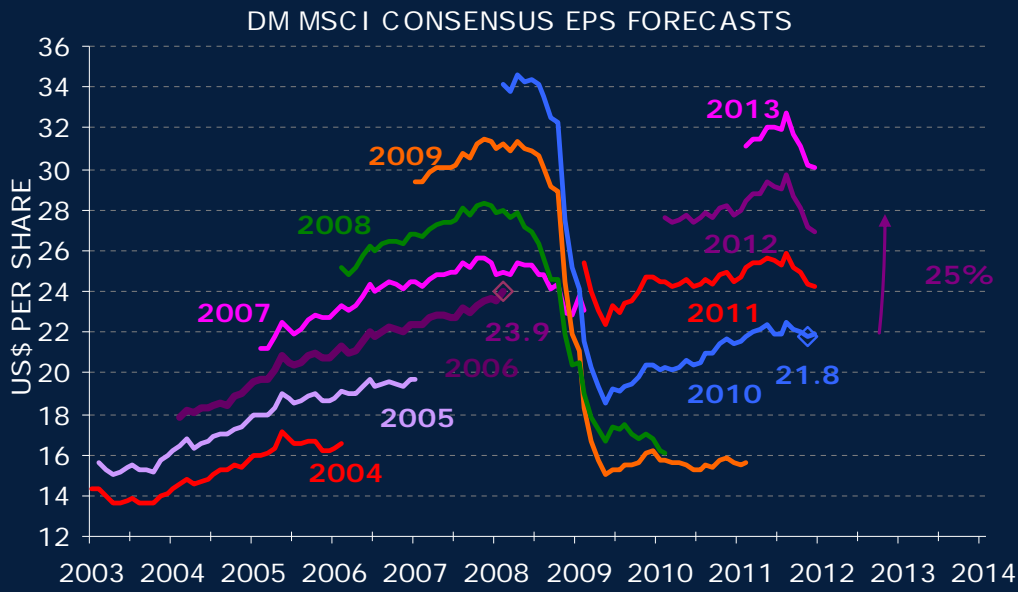
It wasn't a V-shaped macro recovery, but it was for profits



Source: Federal Reserve

# Seeing Weaker Earnings Growth – But No Recession

But earnings declines are *never* forecast by consensus

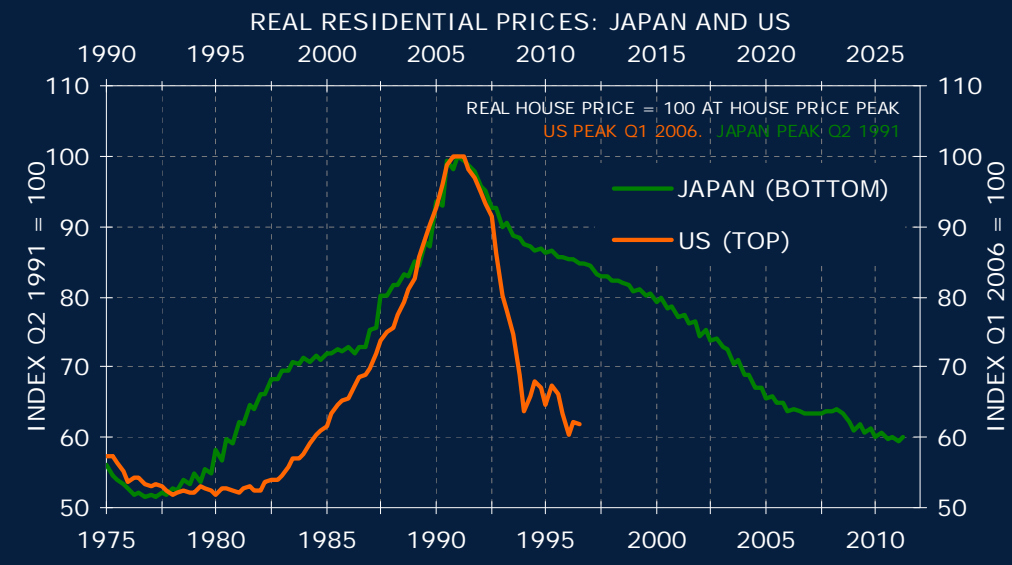


Based on IBES consensus forecasts earnings for DM MSCI index.

Source: DataStream IBES

# A Bigger Initial Wealth Shock

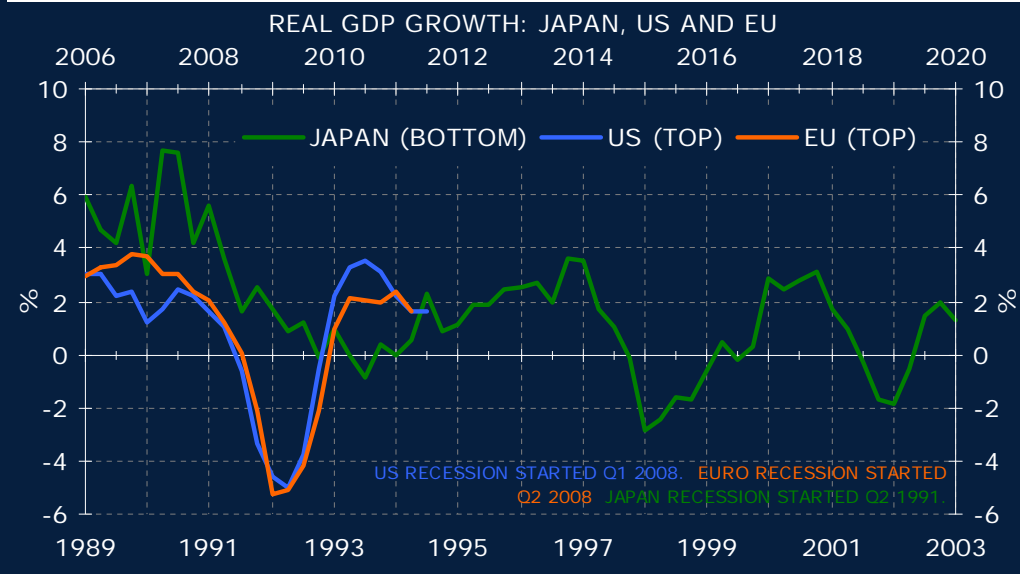
Perhaps not a bigger bubble, but a faster pop.



Source: Case-Shiller, JPRI

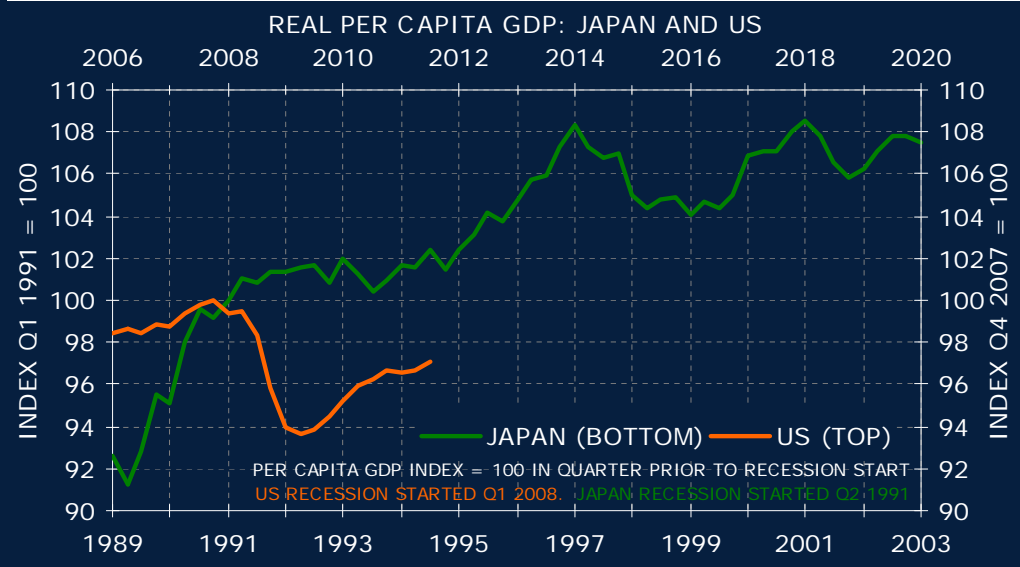
# A Deeper Initial Downturn

...the initial shock was larger.



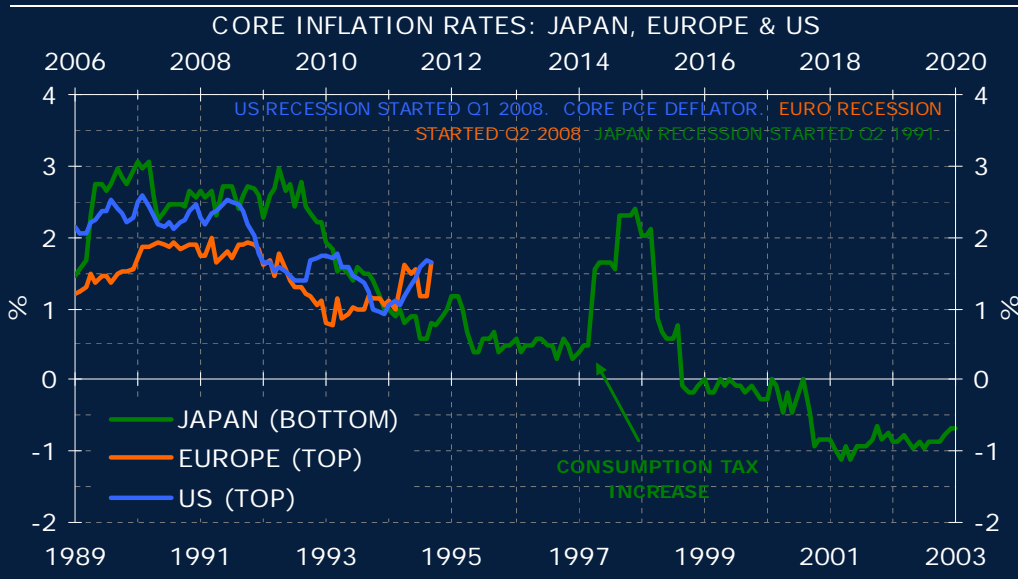
# A Weaker Initial Recovery

Weak by any standards...



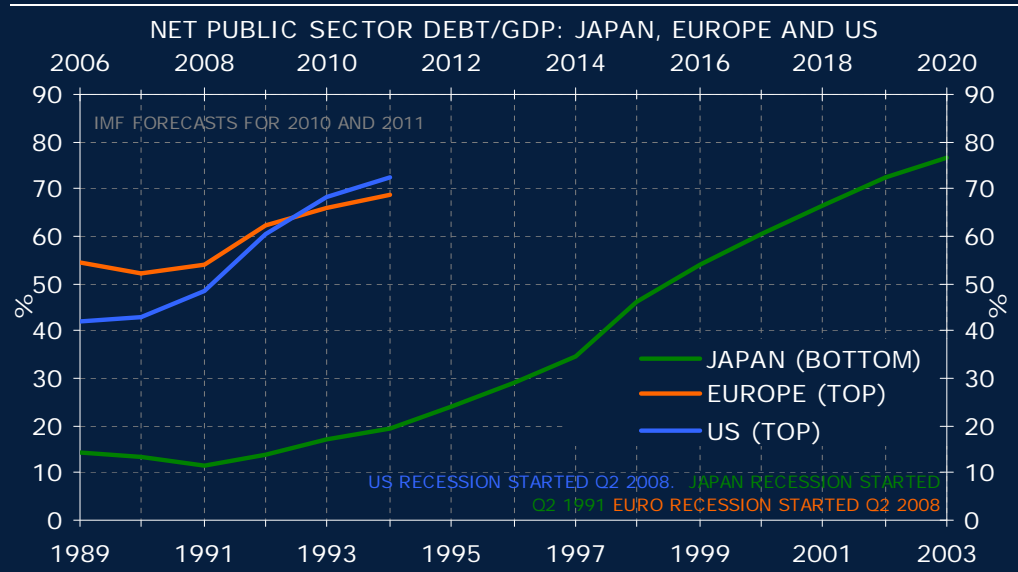
# Inflation Declines

They weren't worried about deflation at this stage in Japan



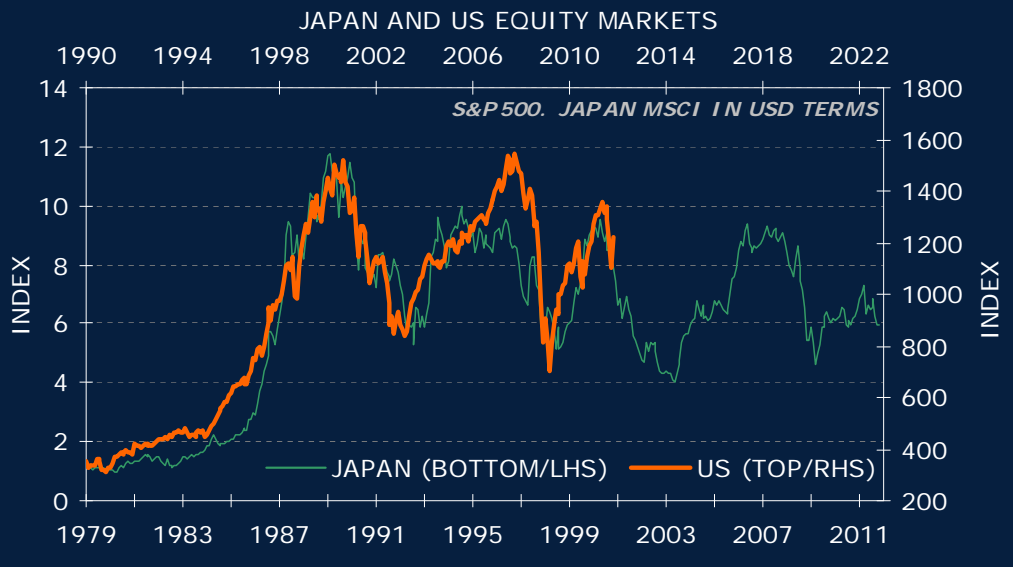
# The 'Great Swap' Further Progressed Now

Japan's government increased leverage as the private sector reduced leverage



# It's All Looking Very Japanese...

Most likely post-bubble outcome is extended range trading



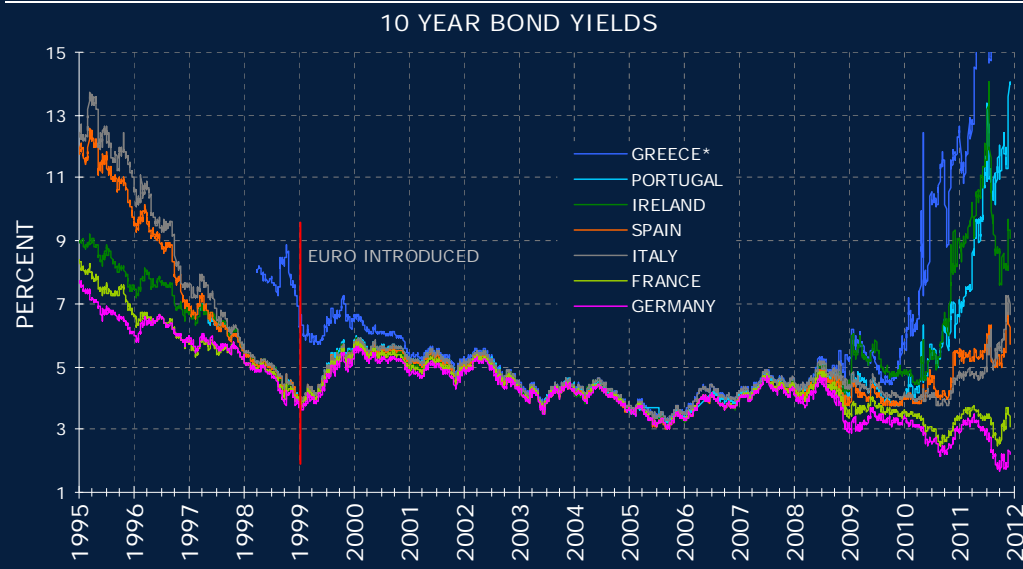
Morgan Stanley

Source: MSCI

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# Europe's End-game Gets Closer

They weren't the same credit risk, by the way.



Morgan Stanley

\* Drachma/euro rate set 19 June 2000, Greece joined euro zone in 2001. Greek 10yr yield now 'off the chart'.  
Source: Bloomberg

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Equal-weight/Hold	1176	42%	431	42%	37%
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Underweight/Sell	418	15%	115	11%	28%
<b>Total</b>	<b>2,828</b>		<b>1018</b>		

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**The Americas**  
1585 Broadway  
New York, NY 10036-8293  
**United States**  
Tel: +1 (1)212 761 4000

**Europe**  
20 Bank Street, Canary Wharf  
London E14 4AD  
**United Kingdom**  
Tel: +44 (0)20 7425 8000

**Japan**  
4-20-3 Ebisu, Shibuya-ku  
Tokyo 150-6008  
**Japan**  
Tel: +81 (0)3 5424 5000

**Asia/Pacific**  
1 Austin Road West  
Kowloon  
**Hong Kong**  
Tel: +852 2848 5200

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Breakfast***

*Thursday 8 December 2011*