

## GENERAL ADVICE WARNING

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# CONFERENCE TAKEOUTS 2010

## BACKGROUND

For the fourth year running, I attended Brilliant's annual portfolio construction conference. The conference facilitates debate on investment markets, strategies and investing. Since August 2002, it has gained a reputation as 'the' investment conference of the year.

This year, key note speakers included:

- **Jonathan Pain** - Editor; The Pain Report; *Australia*
- **Chris Wattling** - CEO & Founder; Longview Economics; *UK*
- **Chris Selth** - CIO & Lead PM; 5 Oceans Asset Management; *Australia*
- **Manu Bhaskaran** - Partner; Centennial Group; *Singapore*
- **David Owyong** - Head of Quant Research; MSCI Barra; *Hong Kong*
- **Dr Horace 'Woody' Brock** - Founder; Strategic Economic Decisions; *USA*
- **Tim Farrelly** - Principal; Farrelly's; *Australia*

Two weeks prior to this conference being held, I attended a presentation by professor Niall Fergusson of Harvard University. During the presentation he asked the group which scenario we believed was more likely over the next twelve months: inflation or deflation. About two thirds of the room raised their hand for deflation, while the remainder opted for inflation. He then described how a few months ago he ran the same exercise with a larger group of 'sophisticated' money managers in the US (hedge funds, pension funds etc). The outcome in that case was a fifty-fifty split. His conclusion, after running this exercise several more times, was that no-one really had any idea what will happen with inflation (amongst other economic indicators)! This theme around a lack of economic consensus seemed to resonate throughout the portfolio construction conference.

Investment managers, who prior to the crisis could focus just on picking the best stocks or the best derivatives to trade, are now being forced to rethink their entire investment strategy. Welcome to a world dominated by macro-economics. An environment where you can no longer afford to just think little picture...

Jai Parrab  
Head of Investment Research

## WELCOME TO A MARKET DOMINATED BY MACROECONOMICS...

To put it in context, the Encyclopaedia Britannica defines 'macroeconomics' as: the study of national or regional economies in terms of the total amount of goods and services produced, the total income earned, the level of employment of productive resources, and the general behaviour of prices.

So macroeconomics essentially refers to the study of **economic growth, employment and inflation**. And coincidentally, these three topics formed the centrepiece around which the conference was predicated.

If you look at where markets are currently trading, some investment market specialists (predominantly equity brokers) would fiercely debate that valuations are cheap. This means that if you compare the dividend yield plus forecasted returns on equities to the running yield on government or corporate bonds, you are getting a better deal for the price paid by investing in shares. However, if you reflect on the age old saying that 'sometimes things are cheap for a reason', you start to question whether share markets really are the place to be.

Forecasted returns for share markets are primarily calculated by evaluating the economic outlook. This in turn allows investors to analyse the economic environment within which companies will be trying to grow earnings, or profit. If the economic outlook is weak, then companies are unlikely to grow earnings, and vice versa.

Looking back at some of my key takeouts from the conference, I think it would be fair to say there weren't many speakers, if any, ploughing their personal money into the share market.

**Jonathan Pain**, in his usual manner, made some very broad and high conviction calls. He described the economic environment going forward as one that would be separated not by geography but by debt. This leaves us with two distinct groups of economies – those that are submerging, and those that are emerging. He further believes that in addition to Spain's 20% unemployment rate, and 40% youth unemployment rate, the UK is entering a period of warlike mentality - a culture of savers. His optimism is tilted strongly towards the emerging nations of China and India, and their geographic neighbours. He believes that

Australia will benefit from this growth with 80% of Australian exports currently making their way to Asian nations. An important caveat he concluded with however, was that while we may have decoupled economically, we have yet to decouple in the context of financial markets.

**Chris Watling**, who looks at extremely long-dated historical evidence to support his theories, presented the outlook from another perspective. He directly targeted PIMCO's description of a 'new normal', rephrasing it as the 'old normal'. By this he means that what we are about to see has happened before - you just need to look back far enough! He further described how jobless recoveries were only the norm for the last three recoveries, and perhaps this time a rise in employment will not lag, but will instead need to lead. The crisis, he said, was a function of the fact we had 'financialised' our economies, pointing out some confronting statistics in regards to how much of the America's total economic output was comprised of US bank profits. His outlook for markets however is mixed to say the least. He believes that we are in the midst of a secular bear market (function of a secular commodity bull market), but that we will initially experience a two year cyclical upswing starting in September 2010.

Another key speaker who I took some profound notice of was **Dr Woody Brock**, who continued along Jonathan's line of thought, describing a reversal from the east to the west. He described how the US will be facing around \$50 trillion of unfunded liabilities, while other advanced economies alike will be subject to what he described as 'the prisoners dilemma of electoral politics'.

### FACT BOX

Prisoner's dilemma: a non-zero-sum game in which both players have the individual incentive not to cooperate, even though they would be better off if they did cooperate. This tension between individual incentive and collective incentive is what makes the prisoner's dilemma intriguing.

In the classic prisoner's dilemma, two suspects are arrested by the police. The police have insufficient evidence for a conviction, and, having separated the prisoners, visit each of them to offer the same deal. If one testifies for the prosecution against the other (defects) and the other remains silent (cooperates), the defector goes free and the silent accomplice receives the full 10-year sentence. If both

remain silent, both prisoners are sentenced to only six months in jail for a minor charge. If each betrays the other, each receives a five-year sentence. Each prisoner must choose to betray the other or to remain silent. Each one is assured that the other would not know about the betrayal before the end of the investigation. How do the prisoners usually act? Individually, each has an incentive to defect even though both remaining silent would give a better outcome.

Looking at the US specifically, Woody forecasted that the next big crisis would revolve around the retirement of the baby boomers. On the demographic flip side, he also mentioned that the US economy would need to generate 3.5% pa GDP growth just to hire the kids coming out of school. To bounce back from where it currently is, thus rehiring the millions of people that lost their job during the crisis, it would need growth far in excess of this.

Looking at significant disequilibrium's, he talked to China's exceptional decade of year on year growth. He added however, that according to economic principles, the value of China's currency (the Yuan) should have appreciated by 300% over this time, instead it has risen only 35%. While China is a great story, risks are certainly inherent in their model.

Without dwelling too much further into the remaining speakers, the key messages that resounded from the conference were:

- Get the **macroeconomics** right – understand what is driving economic growth in different regions of the world.
- Get the **geography** right – invest in pockets of growth where the fundamentals are supportive.
- Stay away from **benchmarks** – they are constructed as a function of historical performance, and do not reflect the outlook. For fund managers, they are the business risk scapegoat.
- Have a good **model of the world** – understand the economic risks and opportunities the portfolio is exposed to, and manage it to those risks and opportunities.
- Build a **diversified annuity** – look at investments that will produce income sourced from different uncorrelated markets.

- Be aware of the risk of **surprises to the upside** – when everyone is yelling sell and running for the doors, maybe that is the best time to buy.

### PROFILE'S PORTFOLIOS...

Another key presenter was **David Owyong**. He talked about what I believe is the real core to portfolio construction – risk management. Investment markets are not without risks, there is no such thing as a free lunch. But understanding those risks that you are exposed to, allows you to build a portfolio that is not so much shock proof, but rather more **shock absorbent**.

**Step 1:** Identify the opportunities in investment markets – function of price and fundamentals;

**Step 2:** Build the portfolio increasing your relative exposure to these opportunities.

**Step 3:** Analyse the risks inherent in the portfolio – hypothesise on how these investments might behave in relation to each in different economic environments and under different economic stresses.

**Step 4:** Repeat step 3.

In line with conference takeouts, we agree that that any significant economic growth will be derived from Asia and the emerging markets. Therefore our equity exposures are heavily tilted towards this theme. We maintain our investments both directly, and indirectly, in those companies that should benefit from growth in these geographic regions.

Also in line with conference takeouts, we are cognisant of a period of anaemic world growth, and volatile investment markets. For this reason, we maintain our increased allocation to investment grade debt, syndicated loans, high yield bonds and domestic hybrids. While we believe that earnings growth will be weak, we are confident in the balance sheet of those same companies and their ability to meet interest payments and not default on outstanding debt.

In summary, the portfolio remains conservatively positioned. We think there are some great stories developing, and we are actively running the ruler over the most appropriate access points. There certainly is an 'opportunity risk' that markets run away, but our view is that they are far more likely to stay flat for the medium term.

**You cannot control the markets, but you can manage your risks.**