



# Investing in the ‘New Norm’

Portfolio Construction Conference 2009  
Wrap Up

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## Investing in the ‘New Norm’

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*“It’s a very different investment environment compared to a year ago. Some things have changed forever; others only temporarily. Some things have not changed at all. But which is which? What is the new reality? And what does it mean for constructing investor portfolios?”*

### The Recovery

After the most severe financial collapse since the 1930’s, the great debate that now lingers on the tongue of economists, analysts, fund managers and investment strategists is... **What will be the shape of this economic recovery?**

With the very pessimistic outlook of a ‘Great Depression II’ now behind us, the focus is back on the recovery and what path it will take. The current views range from the economy bouncing back in a ‘V’ shaped manner, others believe we are in for a second leg down depicted by the ‘W’, some believe the world is in for Japan like scenario depicted by an ‘L’, and the most recent to surface is the notion of a ‘Square Root’ - whereby the economy will bounce back strongly but that this will be followed an extended period of stagnant and low growth.

Hamish Douglass [MD - Magellan Financial Group], Jonathan Pain [Chief Investment Strategist - HFA Asset Management] and Chris Watling [CEO - Longview Economics] presented their views and debated the subject with the general consensus that:

- We are currently experiencing a short sharp economic bounce being supported by inventory replenishment and a stimulus boost by global governments;
- There is a risk of a second ‘economic’ leg-down’ potentially being driven by a range of factors from a spike in oil prices to the repatriation of the government stimulus currently being injected; and
- Most importantly, that the next few years were going to be tough, volatile and that

equity growth [company earnings] would be challenging.

### Inflation or Deflation

Running a close second to the shape of the economic recovery, and somewhat linked by nature, is the discussion pertaining to the outlook for inflation over the next investment horizon. The debate was broken down into the analysis of three key concepts: **Demand, Supply and the Velocity of Money.**

**Inflationary Pressures:** Global governments have pumped close to three trillion US dollars into their respective economies. This will feed into the consumer and will cause an excess liquidity driven rise in demand thus forcing up prices. Oil and food are scarce resources and natural population growth will also lead to increased demand pressures in these areas.

**Deflationary Pressures:** The consumer has gone into hibernation. With savings rates in the US ticking up to their highest levels in over twenty years, and unemployment forecasted to continue to rise, the backbone of the consumer has been dampened. Further enhancing this is the diminished access to credit and what is likely to be a more stringently regulated lending environment. Tax rates can also be expected to rise as governments claw back their budget blow-outs and this would further impact spending in the medium term.

While there was no definitive consensus, commentary’s from Bill Gross [MD – PIMCO] suggested that:

- Inflation would be low to moderate over the next investment horizon period with both cases being adequately supported by valid theoretical assumptions. He further mentioned that he was happy to buy US Government Bonds on yields in the low four’s further supporting his outlook for weak inflation.

## Key Risks and Opportunities

Mark Faber [Editor – Gloom, Boom & Doom Report] presented a view that the economy and market was a function of a series of artificial bubbles created in order to repair the damage from the previous bubble.

An extended period of loose monetary policy [or very low interest rates] set the stage for the lending practices which ensued, eventually leading to the recently experienced bursting of the housing bubble in the US and Europe. With governments now pumping trillions of dollars in to the economy to help stimulate it, they are merely transferring the current private debt bubble to the public government balance sheet. This effect of printing money and issuing government bonds will be a key risk to monitor both in regards to a liquidity bubble [inflation spike] and in regards to the effect it will have on economic growth when it is sucked back out.

While developed economy's [US, Europe] will face an extended period of benign to low growth, other parts of the world will experience much stronger growth rates supported by their own developing consumer. These economy's include the likes of China, India, Latin America and pockets in Asia. They have a much stronger foundation to work off given the status of their current balance sheets at a consumer, corporate and government level. With strong population demographics and a rising middle income earner, their economies are set to expand at a much faster pace albeit with headwinds as function of their overseas trading partners.

## Investing in the 'New Norm'

With a very different market and economic environment ahead of us, does this change the rules of investing. Greg Cooper [CEO | Schroders] presented a view on modern portfolio asset allocation. It is underpinned by a move away from hard lined traditional strategic asset allocation, and a move towards flexible portfolio management with wide asset

allocation bands. The underlying theory is founded on allowing portfolios the ability to reduce their weighting to 'risky' assets' as their risk premium contracts [ or the risk characteristics change] and rotate in to a range of 'defensive' assets in line with their respective risk premiums.

The key risk to be aware of using this form of investing revolves around 'market timing', benchmarking and discipline. With sentiment playing a key role in markets, valuations and fundamentals are not always at the forefront of returns and therefore an investor needs to be prepared to modestly under-perform in overvalued bull markets, but be compensated by a more defensive portfolio on the downside.

## Investments

Some of the key investment themes this year:

- implementing capital protection
- exchange traded funds
- global fixed income opportunities
- active extension in equity markets
- the role and use of commodities
- secular growth in emerging markets
- portfolio management - strategic tilting
- alternative assets - managed futures
- tapping into Asia

## Summary

The 'New Norm' is evidently on the forefront of the investment world and while some participants chose to remain 'fixed' to the old traditional prophecy of buy, diversify and hold, others including ourselves have taken into consideration the events unfolding around us, and have chosen not to act like a deer staring blankly into oncoming headlights. Fundamentals and risk based investing will always remain paramount to building portfolios, but being aware of a changing economic environment and the risks inherent in the markets that govern them, will dictate both portfolio preservation and returns going forward.