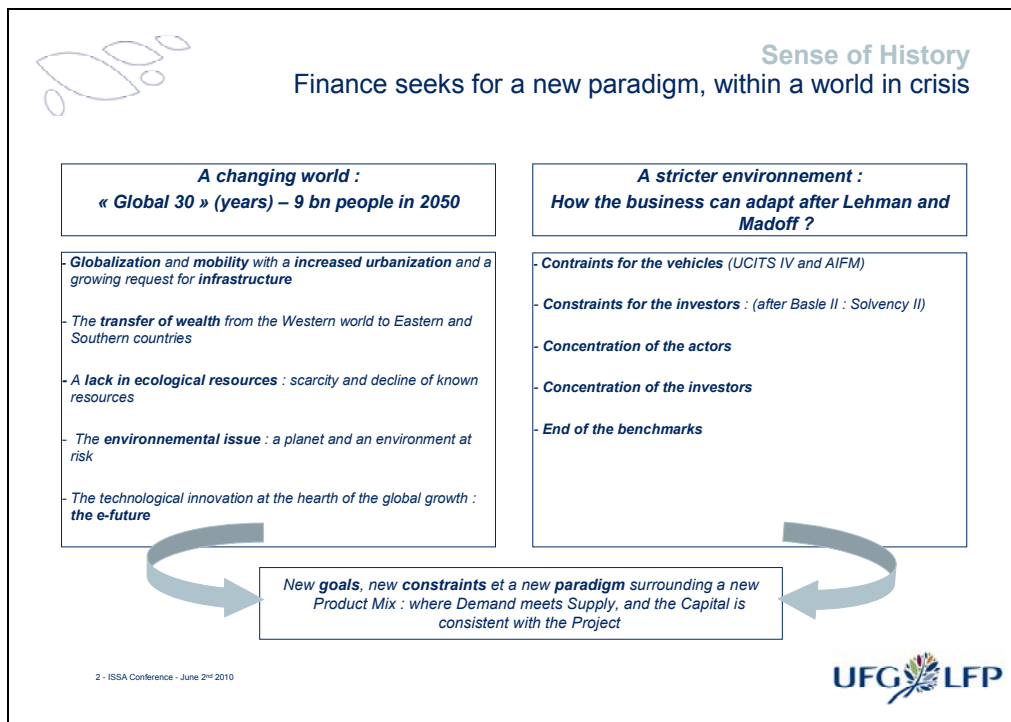


Just as a short introduction, UFG-LFP is the largest independent fund manager in France. We are the leaders in non-listed real estate funds, and the market leader in funds of hedge funds.



Looking at the "big picture", it appears clear that global development cannot continue in the same way as it has until now. Many people wonder if we are on our way to crash against a wall. Perhaps we are in the wall already!

The picture above gives a traditional view. On the left side, you have globalization with its effects that have generally been seen positive: lower prices, improvements in our infrastructures, wealth distribution from the Western world to the East and the South. We have limited ecological resources, which is both a problem and a basis for business opportunities. We have environmental issues that put the planet at risk, and we have to find appropriate solutions. There is the promise of innovation which will make everything better.

On the other side, we experience a new wave of regulation and restrictions because of the financial crisis. The crisis has an economic side, and a loss of confidence side.

In our opinion, we are making a big mistake here. We do not just have a financial market crisis. We are now living through something much more important than that. We have a global demand crisis. What do I mean by that?

Thirty years ago – before globalization took off – we were more or less consuming what we were producing. Wages were not only seen as a cost issue. When we increased wages, we increased people's purchasing power, we created demand. With the emergence of globalization, wages came to be viewed just as a cost factor, not as a means to increase demand.

As a result, there was a kind of a social pact in the Western countries to say that wages will not increase, but instead to have a wealth effect. The wealth effect took place in the USA, in the real estate market. Real estate owners got richer and richer. The banks were there to lend them ever more money. Bank clients who wanted to buy a 100,000 dollar home received a loan of 80,000 dollars. When the value of their home increased to 200,000 dollars, the bank increased the loan to 150,000 dollars and the consumption game started all over again. For thirty years, this system enabled a sustainable long-term demand, basically without substantially increasing wages.

At the end of the day, we had a system where, in essence, Chinese people earning 2,000 dollars per year lent money to US people earning 20,000 dollars per year. How long can that last? For some time, but not forever.

*Peter Mathias:* This is a very important point to highlight and understand. Xavier says that we did not have a financial crisis, we had a demand crisis. There is a school of thought that supports his view and it can be substantiated with very interesting statistics: The average US wages have not gone up since 1980, but per capita consumption has increased 50–60%. How was this possible? First, more people per household joined the workforce and earned wages. Almost all households have become two income households. Second, by increasing debt. Much of the additional demand was not created by increased wages, but by increased debt. Consumers borrowed more and more money, not only in the US but world-wide. It reached a point in the US where household debt was 140% of annual household income. It cannot go much further than that, because the cost of servicing the debt would otherwise be too high.

Over the last 18 months, we have replaced individual demand and individual debt with government debt. How long can that continue? We need to reduce the debt, but when that is done, consumption will fall immediately. If a demand decline happens right now, we will probably have deflation. Interest rates are already close to zero, the US federal deficit is 12%. There are not many bullets left to fire to fight deflation. The view that we have a demand-driven problem is a view from a bit a different angle than what Christian Raubach said.

How does that affect custodians? The custodians hold 140 trillion dollars of debt in custody: government bonds for pension funds, central bank liquidity, etc. The top five custodian banks worldwide hold 65% of that. If the value of those assets goes down, the custodians will be the first to notice, because they value those assets regularly, and this will heavily affect all custodians' revenues.

All of this has been possible because we changed our paradigm for financing the economy three times over the last fifty years:

- The first paradigm after World War II was state financing.
- The second paradigm since the early 1970s: bank financing.
- The third paradigm was financing by the market, with securitization and similar instruments.

In the third phase, it became impossible to know lending volumes. It was an exogenous variable, as Peter Mathias said. That has an impact on the way we are now managing the money of our clients.

I no longer believe in the diversification of risks. When the economy and the markets are global, everybody has the same information at the same time, the same regulation and constraints. Everyone then acts in the same way at the same time.

The negative impact of regulation is terrible for investors. There is a correlation between regulation and market volatility. More regulation will increase volatility, because everyone – in particular the institutional investors – has to respond to change in the same way. Let's take an example: If you are a European institutional investor, you have to invest in European bonds. How are European bond indices created? Sovereign, risk free, weighted by the amount of the outstanding debt, not by GDP. This means that every single institutional investor in Europe has 20% of non-core European government bonds.

European sovereign bonds, as all sovereign bonds in the world, were supposed to give an indication of future inflation. Now there is uncertainty over what is going to happen to Greece, Spain, Portugal, and Italy. All of a sudden you have a risk premium on the bonds which is based on the likelihood of default, not on inflation. And then you have a major rating agency telling you that Greek sovereign bonds are junk bonds. The consequence is that you are, by law, not allowed to hold Greek bonds anymore. It is clear what happens now: Everyone has to sell their Greek bonds. And you have to tell your clients that their portfolio also contains Portugal and Spain. Now, do you want to keep your bonds or your clients? So you sell your Portuguese and Spanish government bonds and as a result, Portugal and Spain are in trouble, too. That is the way it works. It is not a good way, but that is current reality.

There is also a view that Exchange Traded Funds are risk free, a commodity. But are you, as custody professionals, sure that they are really risk free operationally? ETFs are a product that is not sold, but bought. The fund manager never sees a cash flow. He does not know how many investors are buying and selling. Are you sure that we are not creating a new bubble based on ETFs? It could well be that in two or three years from now, we will all meet again and we will say: "Like with the mortgage-backed securities and the subprime loans, we should have seen that some of those ETFs and tracker funds were crazy." Many tracker funds work with swaps, never a cash delivery. So what makes you sure they are safe...?

*Peter Mathias:* That is an interesting view: ETFs are a notional security, involving risk but no cash flow. What does the audience think? We should come back on this point in our discussion session. It is a fact that many hedge funds and other active fund managers are using ETFs as an essential part of their investment process, because ETFs are a cheap provider of Beta.

Every single system has a natural life span. Nothing can go on forever. We have to find a new paradigm to finance the economy now. That is what we do in our firm.

We do not think that risk distribution will continue to follow the law of normal distribution. Remember that for a long time there was a simple rule of thumb in private banking which said that the optimal equity ratio in a client's portfolio was in a relation to his or her age. It should be 100% minus the client's age in years. For a forty year old private investor, a portfolio containing 60% equities was considered ideal, as it was close to the law of normal distribution. Most funds and even the pension funds were structured according to this rule. The assumption was that there was a natural law governing the distribution of risk and profit, and therefore there was no need to focus on market timing. Is that rule correct or not, for the next ten years? Was it correct for the last ten years? We are not sure.

So, what are clients expecting from us today?



**Sense of History**  
A new business model for asset managers  
to face clients' new requirements ?

- **A logic driven by cash flow**
- **A long-term thematic approach**
- **Two approaches for portfolio management :**
  - *Marked-to-model* : portfolios valued with models (Real Estate, Private Equity...)
  - *Marked-to-market* : portfolios valued at market value (benchmarked funds, funds of hedge funds, absolute return funds...)
- **Clients' new objectives :**
  - « *Stay rich* » when the main goal is to protect the capital
  - « *Get rich* » for investors willing to assume a higher degree of risk
- **Clients' new expectations :**
  - Security – Transparency – Confidence - Liquidity – Responsibility
- **An increased need for liquidity**

3 - ISSA Conference - June 2<sup>nd</sup> 2010



First of all, they expect from us a view from the moon, meaning they expect us to see their portfolio in a global context. We need global diversification. That is nothing new.

Governments will want to create inflation in order to reduce the debt they are now piling up. But they do not know how to do it. In the past, inflation was created through wage increases. But since the Western economies do not make substantial profits, wage increases are not possible right now or in the near term. As a consequence, inflation and wage increases will inevitably come from the emerging markets. Let's make an example:

In a globalized world, how much longer will we have a nurse in the US earning 40,000 dollars a year, and a nurse in China only 300 dollars? Educated people in China will want

to achieve the same level of consumption like those in the West. China alone produces more university graduates every year than the rest of the world combined. In Europe, we find it natural nowadays that there must be equal pay for equal work done by men or women. In the same way, the purchasing power parity between the rich and the emerging countries will move towards a balance over the next ten years. So, inflation will come through wage increases in the emerging economies.

*Peter Mathias:* The last big inflationary bout in the world started in the 1960s, as we started to hit capacity constraints. And it really took off in the first oil shock. The oil price went up from one dollar to ten dollars. That increased the cost of production right across the whole Western world. This time around, we could have another commodity shock, because China and India decided to go into the oil business in a big way. Chinese oil consumption is growing very rapidly because millions of new cars were brought into circulation in China last year. We could very well have commodity inflation generated from the emerging markets feeding back into our cost of production, just like it happened in 1973.

Yes, we share that view, plus the fact that those countries' currencies will go up because ours go down. Taking a five-year view, this seems inevitable.

The second factor is the growing social differences. If we look back at the last thirty years, inequality between the social classes in the Western society has never been greater. That will increase but it is not sustainable.

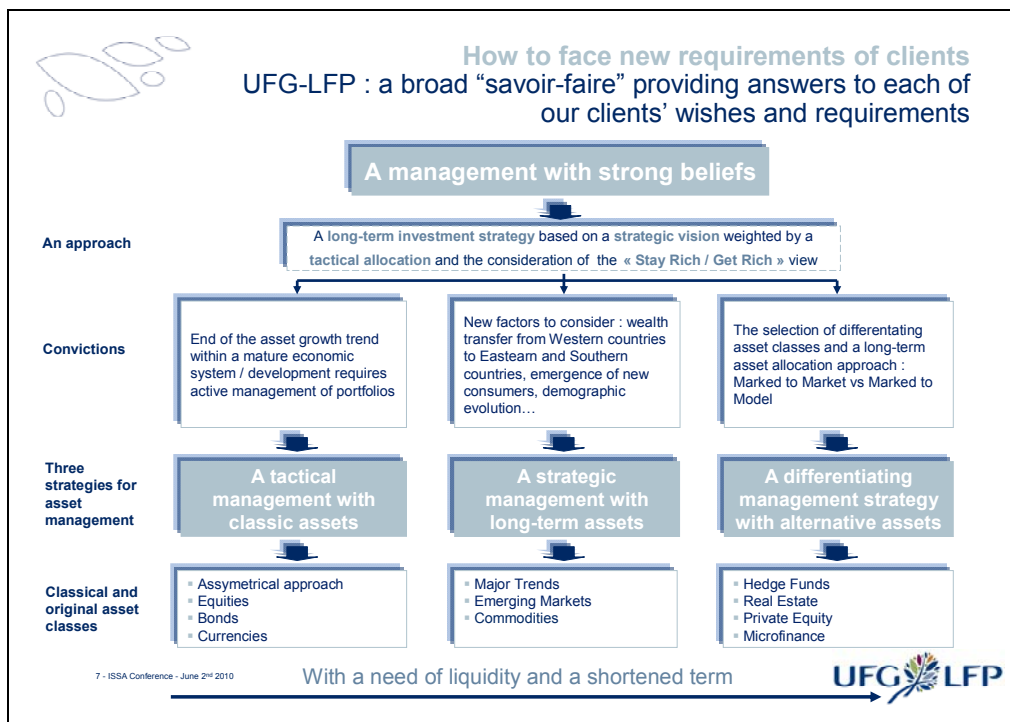
The third element: In Greece and Spain, we had the same trend as in the private housing market in California where people bought their homes with heavy leverage. After Greece and Spain joined the Euro zone, it became very easy for consumers to borrow money. Everyone had the feeling that life had become easy. But the productivity of those economies is very low. There is a scenario saying that Europe is about to face a "Japanese" situation: zero interest, zero inflation, zero growth, zero everything. That is not realistic for Europe. Reality will be worse than that. We will see zero growth coupled with inflation. We will see people rioting in the streets. In France we are already experiencing this, and now we also have an unemployment rate of 20% in Spain.

So, what can we do? Take a view from the moon and invest in real assets, such as commercial real estate. I am not sure that real assets will not go down, but I am sure that their value will always give adequate protection. More generally speaking, what we do is to engage in a variation of the so-called Barbell strategy: We buy long-term real assets and play short-term market opportunities. That is hugely different from what we were doing until recently.

Asset managers generally believe that they should bring financial assets to the clients. We believe that we are here to create for our clients the capability to increase their wealth in the future. The beauty with the public sector in Europe is that it will privatize some of their operations to raise cash. That creates future opportunities for us, and we are following this closely. We will continue to invest in real estate, and maybe private equity, but that is less certain because the driver of investing today is liquidity and cash flow, plus tactical versus strategic asset allocation.

We also tell our clients that they should substitute market risk with fund manager risk. It was discussed before that active asset managers take risks, and whether it was worth taking them. Investors should be aware that they also take the risk of losing assets when they invest passively. Yes, fund managers do make mistakes, but they have ideas. Investors should rather diversify fund managers than markets.

In the long term it is not wrong to say that globalization may have positive effects and may induce strong economic growth. The probability is there. So we have to play that as well.



What we need most at the end of the day, are strong convictions – always. Our clients are not coming to us because they expect a slightly better performance than the benchmark index, which can eventually lose 50% of its value. We believe in conviction coupled with tactical management, using the classical instruments, and always taking an asymmetrical approach. We always tell clients that it is better to miss an opportunity to make some money, than to jump on every opportunity and risk losing a lot of money.

Lastly: flexible asset allocation. In the last twelve months, in 25 out of 30 tenders from public and private pension funds, where we participated in the bidding process, the clients wanted a flexible asset allocation. At least in France, institutional investors no longer ask for traditional benchmarks. They ask the fund mangers to do better than Beta. That is why we also diversify with hedge funds.