

Introduction by Peter Mathias

We heard three very different asset manager views today, with different implications on investment strategy. What has become very clear is, that what we have done for the last thirty years, does not fit the bill anymore for the years to come. But nobody knows what the new "normal" or the "new safe" is. The new rules are not visible yet. We know that the 60% equity and 40% bond asset allocation for a traditional pension fund no longer works. The "Risk-adjusted Capital Markets Pricing" paradigm, as we learned it in our MBA Finance courses, does not work if the risk free return on government bonds is higher than the dividend yield of Coca Cola.

Asset management strategies, investor choices, drivers

What did you take away from our discussion so far? What do the changes in the investment management process mean to you? Do you agree with what our panelists said? What are the implications on the full value chain?

Infrastructure: We heard three asset managers, three very different views. What struck me as being exemplary, were the comments about gold. We heard one strong conviction to stay away from gold, because it would have no productive value and just generally would not make any sense at all. Next, we heard an equally strong recommendation to put one third of one's assets into real assets, including gold. Then we heard that investors basically fall into two types, those who want to create wealth and those who want to maintain their wealth. In these uncertain times, even the younger investors seem to just want to maintain what they have. So, after hearing such diverging views from the experts, and given that there is such a high level of conservative investors in the market, I think the implication for the infrastructures is that most investors will just stay in cash and wait until the fog has cleared. They just cannot make investment decisions they would feel comfortable with in the current environment.

P. Mathias: We heard from one of the panelists that cash may be the best thing to hold in times of deflation, or at least disinflation, to say it a bit less alarmingly. Disinflation is a very likely scenario right now. It would mean shorter durations, higher credit quality, more liquid instruments, because in times of disinflation, you typically see very high increases in the number of bankruptcies.

Let's look a bit closer at the mechanics of the build-up phase that led to the Lehman crisis. There are 20 trillion US dollars of outstanding loans in the US. The banks have 7 trillion dollars on their books. Prior to the crisis, the banks generally had around 5% of tangible capital. They were not in a bad shape. The other 13 trillion dollars are in the so-called shadow banking system, i.e. in an environment without any, or hardly any regulation, and a lot of off-balance sheet activity. In that environment, large amounts of long-term assets were financed with short-term money market funds and commercial paper. When people stopped believing in the ratings issued by the well-known agencies, the short-term financiers left the scene. It was no longer possible to roll-over the short-term funding of those long-term assets. We ended up with around two thirds of all long-term loans underpinned with very little or even no capital. Unwinding such a shadow banking system poses huge challenges. As you know, the US Government then guaranteed all those money market funds and the commercial paper to calm down the short-term financiers and lure them back into the market. The unwinding is still continuing slowly, as asset values are coming down.

X. Lépine: I was said that investors can choose whether to try to create wealth or to just maintain their wealth, and that most people today are on the maintenance side. That is true. But there are some investors who do not have that choice. Pension funds just have to create wealth. They know that, if they just focus on preserving what they have, they are unable to meet their liabilities. They have no choice but to take more risk.

A second point: Cash is definitely deflation's best friend, but cash also *creates* deflation. If everybody gets rid of all their invested assets and goes into cash, that creates deflation.

A third point: What I like about the real assets, is that the proportion of money invested in real assets today is very tiny compared with investment in financial assets. If you move only one or two percent of financial assets into real assets, such as commercial real estate, that will make a big difference in the behavior of the real asset market. Now, you always have to take the risk of being wrong. So, by making an intelligent allocation between cash and real assets, you can achieve a reasonable level of protection.

Custodian: I think we heard a rather bleak outlook for the asset managers. But there was recognition that there is a lot of money around that needs investing. It has to go somewhere, so there must be a default option. But what is it? There is still a significant division between those who are fundamentally risk takers and those who are fundamentally cautious. The proportion of the cautious has certainly gone up, but the risk takers are still there and they are looking for yield. Yes, the environment has become very unfriendly, but a significant minority of risk takers and active investors are still out there. The others are keeping their options open. They sit on a pot of money and move only moderately. Exchange traded funds are one of the current options that look reasonably safe, liquid and flexible. The majority of investors will opt for very short-term investments for as long as the world remains uncertain, keeping their options open.

Infrastructure: If the banks enjoy an implicit government guarantee and financial services are being eroded, maybe there could be market for products by someone willing to put some form of guarantee in place. Some sort of hybrid-structure whereby you get a near-cash return and a kicker, if certain blue chip assets suddenly outperform, that give you a bonus on top of cash.

P. Mathias: There are already many kinds of synthetic financial products created in the banking and insurance markets to manage the perceived riskiness of the financial system.

Custodian: We touched upon full risk disclosure as the new norm, increased efficiency in the infrastructures, and can they cope with the unexpected, etc. We also talked about the "new safe" portfolio approach. The asset managers did not say much about the risk of foreign currency exposures. Can there be a "safe haven portfolio" without it, or how do you optimize it?

P. Mathias: We tend to confuse familiarity with safety. Christoph Schenk mentioned that Swiss investors now switch from foreign shares into Nestlé shares, because reading about the company daily in their local newspaper makes them feel safer. But that gives them a false sense of security. However, who wants to take up the question: "What currencies would you want to have an exposure in right now, how do you select them?"

X. Lépine: The governments, generally, are going to work off their debt by creating inflation. But some governments are not plagued by the debt problem at all, or to a very limited extent only, compared to others. Also, some currencies are more closely linked to

commodities than others. Those are useful selection criteria. Switzerland, Canada, Australia and a few others would be countries and currencies to examine more closely.

Custodian: One common view of all asset manager panelists today was that the volatility in the markets keeps rising. Could someone elaborate on this one way street?

Ch. Raubach: Why is volatility going only into one direction which is up? To me, the reason is the victory of the Internet and all the new telecommunication tools. More people know everything with ever less time delay. That is why the bear markets tend to become more ferocious but shorter. Today, I can set up an asset management company in any one location of the world and have almost the same information and at the same time as the trader in the heart of Wall Street. With information moving so fast and available so widely, volatility going up is a logical consequence.

P. Mathias: One of my own take-aways from listening to all of this is that the asset managers are moving more towards clearly targeted investment. Strategies that involve buying an index bring it with them that you end up with too many things you are not comfortable with holding. Therefore, an index-relative performance model is probably not going to be very popular in the near future. More selective, targeted investment styles will prevail. That is where the rising volumes for the clearers, custodians and depositories will come from.

Asset managers and operations

P. Mathias: Asset managers become increasingly aware of operational issues and the potential risks associated with them. Why the new interest? An example: the "new safe" includes cash. Now the fund manager learns from his custodian that there may be situations where he can not be sure where his cash is, or whether he can get it back from a deposit at the time he most urgently wants it. That is a very important point in terms of fund managers' expectations of the infrastructure.

Custodian: Given the current debt level in the economy, the inflation scenario and the real asset investment model could well be the right one if we had to pick just one or the other. But if we look at the implication for our industry, we fear that, at the end of the day, all the different new models are going to run in parallel. All of them are going to be popular in new investment theories. They will have their followers who will want to implement them, and therefore custodians and infrastructure must gear up to be able to manage whatever comes up.

P. Mathias: Let's take a vote by show of hands in this room. Who is in the inflation camp (4% or more), and who is in the disinflation camp (0% - 1%), taking a two year view and looking at the US or Europe, because Japan is already in a disinflation scenario?

I see about 10 "inflationistas" versus about 50 people not raising their hand which I take to mean that they are in the disinflation camp. So, if we have disinflation, let's look at what happens to real estate prices and other "hard" assets.

The US market has 50 trillion dollars of debt outstanding. This includes everything from consumer debt to private real estate debt, commercial real estate debt, bank debt, government debt, etc. There are 120 million housing units in the United States. 75 million of them are owned. We have a home ownership rate of about 65%. Before Fanny Mae and Freddy Mac were founded, it used to be 45%. Of those 75 million home owners, 57 million have a mortgage and 18 million people own their home outright. The latter tend to be over fifty years of age and they typically have no plans to buy another house

in their lifetime; and if they do it will typically be a smaller house. 45 million home owners are now sitting on a mortgage that was either written or last renewed between 2003 and 2007. In 25 million cases, the home owners are either under water or upside down, because the market value of their home is below the mortgage amount, or they have not performed on at least one payment, which often is an early stage of foreclosure. What does that mean?

18 million home owners will not buy another house. 25 million cannot buy another one, because they are under water. The whole housing market threatens to choke on itself. And now, what happens to the banks with outstanding loans in a deflation scenario? What happens to the commercial real estate industry, to government agencies that back those home owners? What happens to the value of the real assets? And to come back to our business, what happens to the financial services industry? The US custodians hold a total of 140 trillion dollars of financial assets. How much of that is taking a major hit in a two year deflation period? There is a large amount of uncertainty and it will prevail for quite some time because – in reality – deflation periods tend to be longer than just two years.

Infrastructure issues

P. Mathias: Let's now look a bit closer at the capital market infrastructures. What does it mean for them? Investment styles are going to diverge. Can we carve out three big implications for the capital market infrastructure?

Custodian: We need more interoperability between the infrastructures, and extend this also to the emerging markets and to commodities, in order to react to quickly shifting investment styles.

And, if we are going to have large amounts of impaired assets in some markets, that will have huge implications on the daily work of the custodians and infrastructures.

A third point: There is no stability anymore. What was safe is no longer safe. Infrastructures will need to take certain risks to innovate their products and services. That also implies for the banks – that typically own and support the infrastructures – to invest money into them. They should do that now, but the problem is that they do not have the revenues now that would enable them to make those investments. There is no willingness now to invest in infrastructure. We are running the risk of having a new problem, if we do not ensure continued stability in the infrastructures to handle the existing products and give them the means to take on the new challenges that are on the horizon. That may backfire in a dangerous way a few years down the road!

P. Mathias: Let's build on that. The first point to note is: Just because the infrastructures did relatively well in the last market meltdown, there is no guarantee that they will do well in the next crisis. As Lord Keynes said, "It is not the inevitable, it is always the unexpected you have to worry about."

The second point to note: Almost all fund managers seem to be reinventing their business model right now. They recognize that they not only have to change their investment process and redefine it from the ground up, they also have to build new products to meet their changing customer needs. This will cause a range of new products coming into the market, and this will have tremendous implications on operations, on the custodians and the infrastructure. It affects clearing, safekeeping, fund accounting, investment reporting, corporate actions ... – everything that happens in the back office.

We see today the richness of the dialogue that the asset managers are having right now with their clients. This should have some sort of an equivalent in the discussions that the custodian and infrastructure sides need to have.

Closing remarks by Peter Mathias

I want to leave you with a couple of points: What does our world look like two years from now? Yesterday, you made the point that, when we met here at Wolfsberg two years ago, we had no idea that this would be what we are discussing today.

If you are right on the deflation scenario for the next two years, these will become – as the Chinese like to word it - very "interesting" two years. We will probably see a transformation of the entire value chain. Today, nobody knows the landmarks of tomorrow. But if we really have two years without asset inflation, almost all rocks would be out of the water by then, giving us a better sense of who the future winners will be. New regulation will be in place by then. Housing prices will have corrected. We will know more about the future of Greece, Portugal, Spain and other countries that now look very uncertain. By then we would be left with a small group of large markets to figure out; markets and economies that do not move that swiftly.

You all have a role in shaping this new world, at least to some extent. Thank you very much for your active participation.