

IAPF Investment Seminar

Navigating Through Difficult Investment Markets

Markets in 2009

David Kingston
Chairman
Acuvest Investment Advisers

Tuesday 13th January 2009

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Context

- Main purpose is to look at investment markets.
- But need to set a context
 - What are the important investment decisions?
 - How do we improve the balance between risk and reward?

Warnings!

- Risks in both DB and DC can only be mitigated – can't get rid of them.
- Some risks are always with us; some burst on us and disappear for a while.
- BUT DO MITIGATE
 - Flexible benefits/retirement plans
 - Asset spread

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Keep it Simple

- Complication is an enemy of good decision making.
- The world is full of fancy products and investment strategies which set out to achieve the impossible.
- Concentrate on the important decisions and don't get into illiquid products which rely on very complex strategies and historic relationships.

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The Important Decisions

- Most suitable asset allocation.
- Departures from that due to market conditions.
- Acceptance that there are no absolute answers – just ones that improve risk/reward.

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Investment Decision Hierarchy

- Are the liabilities fundable on any sensible scenario?
- If they are, what is a 'normal' strategic asset allocation, taking into account risk Trustees and sponsor can afford and the nature of the liabilities.
- Bias asset allocation by market view.

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Asset Allocation

- NORMAL asset allocation is the most sensible mix in neutral markets given risk/reward considerations.
- STRATEGIC asset allocation adds a layer which takes into account major movements in risk/reward.
- TACTICAL asset allocation seeks to profit from short term market movements.

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Asset Value

- 'Equities aren't the greatest thing since sliced bread but rather an asset class that can do well or poorly depending on how it's priced'.
- Applies to all asset classes.

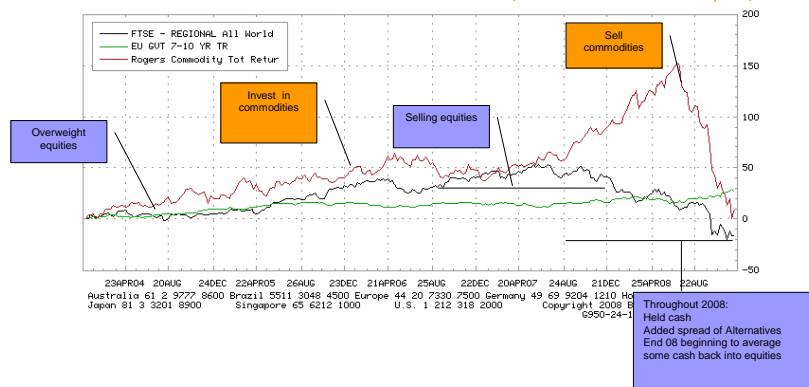
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Strategic Asset Allocation

- When we started in 2003, there was a view that this was a waste of time.
- We believed that pension funds could not avoid such decisions so they had to be managed.
- Can it work?

Examples of Decisions made by some Funds



Strategic Asset Allocation for 2009 & Beyond

- Categories
 - Bonds
 - Equities
 - Property
 - Alternatives
 - Liquid – Currency, Commodity, Hedge funds
 - Illiquid – Private Equity, Forestry, Infrastructure

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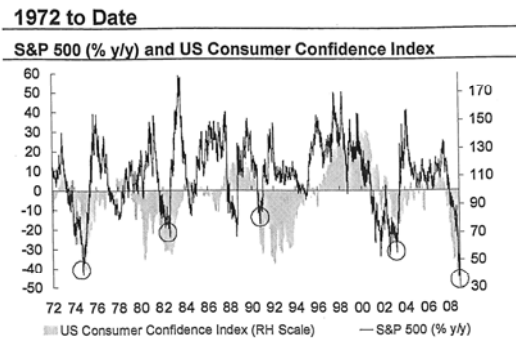
Starting Point

- 2008 was the year everything stood on its head
 - Borrowing went from good to evil
 - Oil prices doubled and 'quartered'
 - Banking went from ultra safe to ultra speculative
 - Volatility was at unheard of levels – and not just in equities
 - Inflation went from major risk to no problem

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S&P 500 and US Consumer Confidence Index



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Our State of Mind

- We have moved from ultra optimistic to ultra pessimistic.
- I have been saying to people that we go into 2009 with such low expectations that we are bound to be satisfied!
- In this kind of environment, risk/reward has changed dramatically as between conservative and aggressive investment.
- This will change – but ?? time scale

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Relative Asset Values

- We have been working on relative value models for some time.

- These take account of various factors such as
 - Fundamental Value
 - Monetary Value/Yield Curve
 - Derivatives Sentiment
 - Momentum

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Problem for 2009

- Two scenarios –
 - Nippon
 - Confidence/asset values continue to spiral downwards
 - Government stimulation does not work
 - Bankruptcies intensify
 - Deflation

 - Rosie
 - Rate of economic decline flattens out
 - Risk of collapse eases
 - Financial systems start to function normally
 - Inflation expectations begin to pick up

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Long Term Cycles

- We are going to see a fundamental break in the economic pattern over the next few years because of the change in attitude to borrowing.
- Over the last long period, individuals and corporates geared while governments borrowed less.
- We don't know how big an effect this will have but it does mean life – and asset values – will be different.

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What Will Happen?

- We will eventually move from Nippon to Rosie.
- The problem is 'in what time scale'.
- The expected time scale is likely to shift around in 2009 as bad news continues to emerge.
- The world is in a very pessimistic mind set – for better or worse.
- Asset values – particularly liquid asset values – are at historically low levels.

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A Few Observations

- 'Darkness before the dawn'.
- The world is short of cheap energy.
- Corporate bond spreads are very high.
- Deleveraging is a long term fact – particular issue for property.
- Dividend yields on many 'good' equities are higher than government bond yields.

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So.....!

- Sort out your liabilities – asset performance alone will not bail us out.
- Sort out your long term asset mix – probably less equities and more alternatives (but watch liquidity).
- Look for sectors such as corporate bonds, equities with strong balance sheets and good dividends, energy, undervalued currencies.

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Simple Decisions

- On liabilities.
- On asset mix.
- On moving when the risk/reward balance looks out of kilter.
- Remember no-one can forecast the future – but you can be prepared and you can assess risk.

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