MARKET VOLATILITY: FRIEND OR FOE?
We at Principal Global Investors are pleased to be partnering with CREATE-Research in our fourth annual report. Professor Amin Rajan of CREATE-Research is one of the most respected commentators on the subject of asset management and we look forward to sharing this research on volatility, a topic that is top of mind with all investors.

This year’s report provides a view of the challenges and opportunities presented by market volatility. The subject of volatility is particularly important considering the last four years have been among the most volatile in the history of global markets.

The current sovereign debt crisis in Europe and the 2008 credit crunch have led to fragile investor sentiment that has amplified market movements. Nevertheless, history shows that opportunity is inherent in periods of high risk and times of high risk can reward active management.

The effectiveness of diversification has been a topic of debate over the last few years. One of the most compelling insights from the study is that investors’ views about risk and return are evolving rapidly, calling for a more dynamic approach to managing volatility. We at Principal Global Investors believe that it’s never been more important than now to have a trusted partner, a long-term investment strategy, and disciplined execution, to benefit from volatile times.

Jim McCaughan
CEO
Principal Global Investors
This 2012 global survey is part of an annual research programme by Principal Global investors and CREATE-Research.

It is designed to highlight the forward trends in global asset management. The programme has delivered a number of acclaimed reports, white papers and articles to be found at www.create-research.co.uk. Brief details are given on the last page of this report.

On this occasion, I am deeply grateful to three groups of organisations and people who have made this report possible.

The first group comprises 289 asset managers, pension plans, pension consultants and fund distributors who participated in our global survey. One hundred of them were also involved in our post survey structured interviews, thereby adding the necessary depth, rigour, colour and nuances to our survey findings.

Their unstinting support over the years has helped to develop an impartial research platform on issues that are critical to a vibrant investment industry after the turmoil of the past four years.

The second group comprises Principal Global Investors, who sponsored the publication of this report, without influencing its findings in any way. Their impartial support over the past four years has enabled us to share valuable insights with all the players in the investment value chain in multiple jurisdictions.

The final group comprises my immediate colleagues. I would like to record my special thanks to Lisa Rajan and Dr. Elizabeth Goodhew.

After all the help I have received, if there are any errors and omissions in this report, I am solely responsible.

Prof. Amin Rajan
Project Leader
CREATE-Research
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INTRODUCTION
The last four years have been the most volatile in the history of equity markets.

Price fluctuations of 4% or more in intra-day sessions have occurred six times more than they did on average in the previous forty years. Extreme spikes in market volatility and asset class correlations have been common. 2011 was a nerve-shredding year.

Fear, greed and stress have amplified market cycles. The price-earnings ratios have no sensible anchor points for now.

The debt crisis in the West is the prime cause. Tackling it will be a long haul, fraught with policy errors and political expediency. Politics, more than economics, will likely drive the markets during this decade.

But history tells us that times of high risk are also times of big opportunities. Naturally, investors in all client segments are asking whether asset managers can convert market volatility into an investment opportunity for their end-clients. After all, that is the raison d’être of active management.

The golden era of high-growth, low-inflation is over. We’re transitioning to more cyclical markets, where price dislocations are significant, as are buying opportunities.

- AN INTERVIEW QUOTE
Accordingly, this study addresses four questions:

- Are capital markets in an era of frequent volatility and price dislocations?
- If so, what will be the end-clients’ predominant approaches to risk?
- Which asset classes are likely to feature strongly in their investment choices?
- Which capabilities do asset managers need to develop if their clients are to benefit from volatility?

As with previous reports in this Principal Global Investors/CREATE annual series, our research approach relies on two phases: a global survey followed by structured interviews.

289 asset managers, pension consultants and fund distributors from 29 countries participated in the survey, with a total AUM of $25.2 trillion. The survey was followed by 100 interviews, which included pension plans.

Following are four key findings and the seven core themes that emerged from them.
KEY FINDINGS

Four headlines sum up the findings from the survey and interviews.

1. Political horizons, market horizons and investor horizons will remain out of sync

The unusual market volatility and asset correlation sparked by the 2008 credit crunch will not abate as long as the sovereign debt crisis overshadows growth in the West. Far from an early resolution, there are signs of back sliding on key reforms.

There are also concerns about the unintended side effects of new financial regulation in the West. It will force perverse investment behaviours from banks and insurance companies. It will also impact market liquidity and price discovery.

Aided by other forces, e.g. globalisation, high frequency trading and leveraged exchange traded funds (ETFs), regulation will accelerate the directional velocity of markets.

78% of respondents anticipate prolonged turbulence. Over 60% expect two or more systemic crises before this decade is out. Fear, more than fundamentals, will drive the markets. Price anomalies will be rife.

Having weathered many rollercoaster rides since the bear market of 2000, investors have grown weary of new risks. But they haven’t given up on chasing a bargain when they see one.

2. Investors will blend caution with opportunism in the face of too many wild variables

Worldwide, corporate fundamentals look good. Fears of a hard landing in China have receded. The debt mountain in the U.S. has started to shrink. End-clients see a silver lining to the volatility cloud. Hence, there is as much concern about missing the next rally as about being caught by its untimely demise.

Flight or fight will not be the only choice. Many clients will blend both within a bigger permutation. If caution is the new watchword, opportunism is the new interest. Some investors will ramp up risk, some will squeeze extra returns from their existing risk budgets and some will drive down costs.

Discretionary re-risking will exist alongside automatic re-risking activated by glide path mechanisms in many retirement products.

De-risking will rely on a new form of diversification that is far removed from the traditional asset-based approach that has long relied on historical assumptions of risk premia and correlations. Liability Driven Investing will remain in the ascendancy.

Hedging tools, e.g. stop-loss mechanisms, option contracts and structured products, will command limited appeal because of their cost and counter-party risks. Style box investing, too, will take a back seat while the markets remain wild.

3. Equities and credit will come under the spotlight

In the Defined Benefit (DB) space, clients are likely to tilt towards equities in their medium-term asset allocation. They are seen at their most attractive relative to bonds in 50 years. Volatility has driven out swathes of panic sellers since 2008, creating conditions for a generational bull market.

Emerging market equities are also likely to benefit from the projected tilt. Many clients also see them as an opportunistic play via low-cost ETFs.

However, the bulk of their opportunism will occur in the credit space, dominated by distressed debt, high yield bonds and the ‘secondaries’ in real estate, private equity, commercial mortgages, collateralised loan obligations and senior debt.

New opportunity sets will gain traction, as banks in the West withdraw from these areas to beef up their capital base by $3.5 trillion under Basel III.

In the Defined Contribution (DC) space, plans that are managed by trustees will aim to de-risk their portfolios while investing in structures that permit re-risking when required.

Our clients want to see a good track record and merit-based incentives from their managers before buying into the volatility story.

- AN INTERVIEW QUOTE
Those that are managed by individual members will rely on glide path mechanisms to do automatic re-risking and de-risking in the face of random market swings.

In the retail space, clients are expected to err on the side of caution, on the whole, with brief bouts of opportunism. There will be a clear divide between the West and the East. Those in the West will remain over-cautious in the wake of past losses and impending retirement. Those in the East will continue to be momentum-driven.

4. Asset managers will need to reboot their business models, if they are to convert volatility into an opportunity

Investing during turbulent times is scary. Whereas 71% of our respondents see volatility as an opportunity, only 13% are convinced that they can convert it into an opportunity. Two hurdles stand in the way.

INVESTMENT HURDLES
The first is the rapid ‘industrialisation’ of asset management over the past two decades. With the dilution of its craft heritage, the skills that translate market ructions into investment opportunity have become scarce. The big picture understanding of investing has become rare when specialist mandates replaced balanced ones. There is an industry-wide shortage of managers with the requisite insights into holistic drivers of risk premia, asset correlation and tactical tilts in periods of dislocation. Our 2009 report highlighted the actions being taken by a minority of asset managers. The rest have yet to follow suit.

Besides, the level of trust required to motivate clients is not there in many parts of the industry: after all, clients were rarely advised to cash out in good times.

The second hurdle is clients’ own herd instinct that often ignores the cardinal investment rule: buy low/sell high.

Driven by the greed/fear cycle, they often make choices contrary to their own best interests.

To overcome the obstacles, actions are being taken by asset managers in four key clusters.

ACTIONS BY ASSET MANAGERS
The first cluster seeks to promote enhanced investment capabilities around price dislocations, improve the track record on volatility and avoid unrealistic claims about returns. Success is about having multi-asset class capabilities.

The second cluster seeks a better alignment of interests. Success is about replacing skewed incentives with ones that ensure that investment professionals share pain and gain in volatile times.

The third cluster seeks to promote corporate nimbleness via free thinking and high conviction investing within the talent pool. Success is about having a small company mindset in a large company environment—a mind-set that is quick to spot opportunities and mobilise all corporate resources in their pursuit.

The final cluster seeks to promote greater client engagement to minimise the ‘wrong time’ risk and the ‘regret’ risk. Clients want product alpha that is time dependent and solutions alpha that is need-dependent. Both need greater engagement. Success is about getting the timing right as much as choosing the right strategies.

In sum, if volatility persists, the asset industry will need a big makeover to avoid the prospect of another ‘lost decade’.

Peer risk, agency risk and market risk have dumbed down what we do. We all use the same mean-variance optimisers. – AN INTERVIEW QUOTE
Like fear, volatility feeds upon itself. 78% of our respondents believe that markets are now in an era of prolonged turbulence; and 19% think this is possible (Figure 1.1a).

Hence, over 60% expect two or more systemic crises before the decade is out (Figure 1.1b). As ever, the definition of crisis is subjective. But few believe that the worst of the last four years is over.

The reason is obvious: the mother of all debt bubbles in the West is being deflated against the most disorderly political background. Policy attempts have reshuffled the debt, not reduced it. But there are other reasons, too.

New financial regulation is fraught with unintended consequences. The Dodd Frank Act in the U.S. and Solvency II in Europe will perversely turn banks and insurance companies into forced sellers of securities in times of distress. The Volcker rule risks the worst of both worlds: reduced market liquidity and distorted price discovery.

Aided by technology and the 24-hour news cycle, growing globalisation will amplify investor mood swings and compress their decision spans from calendar time to real time.

High frequency trading (HFT) will be a further reason. If the May 2010 ‘flash crash’ had been a little later in the day, prices would not have had the chance to recover before the U.S. markets closed, potentially causing carnage when Asian and European markets opened the next day. By ‘front running’, HFT will continue to accelerate the directional velocity.

In summary, fear will continue to obscure the fundamentals. Historic parameters and investment assumptions will remain suspended while the turbulence lasts. It all adds up to a changed landscape.

INTERVIEW QUOTES:

“Europe’s broken banks are in a deadly embrace with their broke governments.”

“The biggest risk is political. You can’t model it in a spreadsheet.”

“The average stock holding period on the NYSE has fallen to 4 months.”

**FIGURE 1.1a**

Are capital markets now in an era of frequent volatility and price dislocations?

**FIGURE 1.1b**

How many more systemic crises—like the current one—do you expect over the rest of this decade?

Source: Principal Global Investors/CREATE Survey 2012
**THEME 2: The volatility cloud still has a silver lining**

While markets have been yo-yoing, corporate balance sheets worldwide have been unusually strong. Many of them have hoarded cash, paid down debt, done buy-backs and locked into low interest rates.

U.S. joblessness is on a downward trajectory. Its industrial bellwethers report record profits. America has outpaced its European peers in deleveraging since the start of this ‘balance sheet’ recession sparked by the trans-Atlantic sovereign debt crisis. The fears of a ‘hard landing’ in China are also receding, as it transitions towards a consumption-led economy with a rising yuan.

No wonder the Dow flirted with its pre-recession levels at the start of 2012. As in early 2009, a big wall of money is parked on the sidelines waiting for the green light. Unlike 2008, this is a confidence crisis, not a liquidity crisis.

Hence, 71% of our respondents believe that continuing volatility will offer a great opportunity to active managers to deliver good returns to their end-clients; a further 22% see this as a possibility (Figure 1.2, left-hand chart).

Yet only 13% of total respondents believe that they can capitalise on it; a further 54% see this as a possibility (Figure 1.2, right-hand chart).

The reported gap is indicative of certain hurdles that need to be overcome (Theme 7). But it also signals a lack of consensus on the global economic outlook, as revealed in our post-survey interviews.

There are divisions in asset managers’ views about the future:

- 35% of asset managers are ‘inflationists’ who think positively about quantitative easing despite its inflationary side effect.
- 40% are ‘undecided’. They fear that markets may revert to their pre-1985 state when politics mattered more than economics.
- 25% are ‘deflationists’ who envisage no clear directional shifts in the markets until the debt mountain shrinks visibly.

**INTERVIEW QUOTES:**

“Equities have dropped from 60% to 18% in our clients’ portfolios. Is this panic selling or a lasting shift?”

“Asset managers and clients are learning to live with volatility—as a matter of necessity rather than choice”

“Where else are opportunities, if not in volatility?”

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**FIGURE 1.2**

Will greater volatility offer a great opportunity to active managers and will they succeed in delivering good returns net of fees over the next 3 years?

**OPPORTUNITY**

- Yes: 71%
- Possibly: 22%
- No: 7%

**SUCCESS**

- Yes: 13%
- Possibly: 54%
- Unsure: 20%
- No: 13%

Source: Principal Global Investors/CREATE Survey 2012
The regular headlines on risk-on/risk-off trades imply that investors only make binary choices as markets fluctuate. This caricature is too simplistic.

End-investors have been responding differently to the crisis (Figure 1.3a).

- 5% are ‘adventurists’ who believe in contrarian investing and market timing amid turmoil.
- 35% are ‘pragmatists’ who believe in portfolio re-balancing when momentum is working.
- 40% are ‘purists’ who believe in buy-and-hold investing and see volatility as a risky game.
- 20% are ‘pessimists’ who lost a bundle in the last decade and can’t wait to exit at an opportune moment.

Such behavioural differences show that flight or fight will not be the only choice. It can also be both or neither. Caution will prevail alongside opportunism. All client segments are likely to blend the two (Figure 1.3b).

Worldwide, DB clients are more likely to de-risk; while DC clients and retail clients are more likely to de-risk as well as re-risk. Value investing will retain its hypnotic appeal but it will be tempered by value traps from periodic dislocations.

Notably, in the face of acute funding gaps, DB clients will resort to one or more of three options.

First, a small minority will dial up the risk by venturing further out on the risk frontier via higher yielding assets.

Second, the majority will chase the investors’ equivalent of the Holy Grail: getting additional alpha without taking on further beta risks. Via periodic portfolio re-balancing, some will aim to use fundamental indices to create ‘smart betas’ that deliver cheap alpha at no extra risk.

Third, some will squeeze costs to get existing returns at a reduced fee.

In sum, even though investors worldwide have grown weary of new risks, the greed-fear cycle will still be lurking in the background.

**INTERVIEW QUOTES:**

“Once the green light comes, markets will bounce by 20% before Joe Public knows it.”

“Distant history is a better guide to today’s turmoil than the past 20 years.”

“Investors who took the pain can’t wait to get out when the time is right.”

**FIGURE 1.3a**

How have end-clients reacted to volatility since 2008?

- Adventurists: 35%
- Pragmatists: 5%
- Purists: 40%
- Pessimists: 20%

Source: Principal Global Investors/CREATE Survey 2012

**FIGURE 1.3b**

Over the next three years, what will be your clients’ predominant approach to risk?

- De-risk:
- Re-risk:
- Both:
- Neither:

DB Clients | DC Clients | Retail Clients

Source: Principal Global Investors/CREATE Survey 2012
**THEME 4: Equities will re-emerge from the wilderness**

When asked to identify the asset classes that are most likely to be chosen in the face of prolonged volatility, our respondents drew a distinction between those that will be targeted for short-term opportunism and those for medium-term asset allocation (Figure 1.4). The ‘adventurists’ and ‘pragmatists’ are more likely to target the first group and ‘purists’ the second group.

In Figure 1.4, starting with institutional clients, between 27% and 43% of respondents expect them to chase high total returns by going opportunistic via one or more of the asset classes listed in the ‘High total returns’ quadrant. High on their list will be distressed debt and ETFs.

Alongside, 43% to 58% of respondents expect their institutional clients to go for modest returns with high liquidity via asset allocation (‘Returns & liquidity’ quadrant). Top on their list will be global equities and emerging market equities and bonds.

Similarly, 14% to 23% of our respondents expect their retail clients to chase absolute returns via opportunism (‘Absolute returns’ quadrant); and 28% to 46% expect them to chase capital protection via asset allocation (‘Capital protection’ quadrant).

Variations by regions and behavioural groups are set out in Section 3 of this report. Four points are worth noting here.

**INTERVIEW QUOTES:**

“30% of our clients no longer slavishly follow the benchmarks. They see opportunity in periodic downdrafts.”

“ETFs account for nearly 40% of the trading volume in the U.S. stock exchanges.”

“Retail clients in the East are far more opportunistic than their peers in the West.”

**FIGURE 1.4 Which asset classes will feature in tactical opportunism and in asset allocation?**

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<thead>
<tr>
<th>High total returns</th>
<th>Returns &amp; liquidity</th>
<th>Absolute returns</th>
<th>Capital protection</th>
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<tr>
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<td>Global equities</td>
<td>Indexed funds</td>
<td>Capital protection funds</td>
</tr>
<tr>
<td>Exchange traded funds</td>
<td>Global equities with EM revenues</td>
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<td>Tax efficient retirement funds (e.g. IRAs in USA)</td>
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<tr>
<td>Emerging market equities</td>
<td>High income equities</td>
<td>Theme funds (e.g. Shari’ah, SRI, environment)</td>
<td>Actively managed equities and/or bonds</td>
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<tr>
<td>Hedge funds</td>
<td>Infrastructure</td>
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% of respondents

<table>
<thead>
<tr>
<th>Institutional clients</th>
<th>% of respondents</th>
<th>Asset allocation</th>
<th>% of respondents</th>
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<td>Tactical opportunism</td>
<td>High total returns</td>
<td>Returns &amp; liquidity</td>
<td>Absolute returns</td>
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<td>Distressed debt</td>
<td>43%</td>
<td>Global equities</td>
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<td>Currency funds</td>
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<td>Infrastructure</td>
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</table>

<table>
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<th>Retail clients</th>
<th>Capital protection</th>
<th></th>
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</thead>
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<td>Indexed funds</td>
<td>Capital protection funds</td>
<td>46%</td>
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<td>Actively managed equities and/or bonds</td>
<td>Tax efficient retirement funds (e.g. IRAs in USA)</td>
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<td>Theme funds (e.g. Shari’ah, SRI, environment)</td>
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<td>Mutual funds using hedging tools (e.g. Newcits)</td>
<td>30%</td>
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<tr>
<td>Capital protection funds</td>
<td>Indexed funds</td>
<td>28%</td>
</tr>
</tbody>
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Source: Principal Global Investors/CREATE Survey 2012
Three conventional investment assumptions have not worked:
- Risk generates returns
- Hedged portfolios give better returns than the unhedged portfolios
- Diversification is a free lunch

The new wisdom is that nothing is an opportunity, until we know its risks, their likelihood and their impact. Also, volatility and asset correlations may not follow their historic norms.

The newly evolving approach to asset allocation aims to manage risks more than returns, conserve capital rather than grow it, connect the dots between asset classes rather than treat them as isolated islands, and blend top-down and bottom-up styles rather than see them as rivals. It reflects a risk-minimising mindset more than a return-enhancing mindset. One is holistic, the other siloed.

This is a far cry from the asset allocation approach that prevailed in the 1990s and the 2000s (Figure 1.5, boxes one and two). Now it’s about clarity of means and clarity of ends.

The means separate out alpha and beta; opportunism and buy-and-hold investing; re-risking and rebalancing (box three).

The ends rely on distinct buckets to target five distinct goals: growth assets, high income, regular cash flow, high liquidity and inflation protection (box four). Markets can turn on a dime. So, the new approach also covers a time element via short-term assets like cash and Treasuries, medium-term assets like equities with high dividends, and long-term assets with a deep value bent.

The evolving asset allocation approach also replaces benchmark-related measures, e.g. tracking error and information ratio, with those focused on absolute risk. This is the key difference in the findings between this survey and its predecessor in 2010.

The percentages in Figure 1.5 are indicative, not definitive. They illustrate how DB clients are developing new ways to deal with volatility that are far removed from simple binary risk-on/risk-off trades.

**INTERVIEW QUOTES:**

“Multi-asset class portfolios will dominate the core in the core-satellite model.”

“Not all betas are created equal, or cost the same. We need to know their granularity.”

“We want to pick the bandwagon premium when momentum is working.”

**FIGURE 1.5  How are the large DB plans changing their asset allocation approaches?**
THEME 6:
The DC space will polarise under the new risk dynamic

Three segments populate today’s global DC spectrum (Figure 1.6). At one end are the employer-led schemes where the employer guarantees the contributions and target returns.

In the middle are the trustee-led schemes where investment choices rest with trustees or default options, but members bear all the risks.

At the far right are employee-led schemes where members make the choices and bear all the risks.

By their very nature, the employer-led schemes are largely de-risked and will remain so. The trustee-led schemes, on the other hand, were historically overweight in equities. The poor returns of the past five years have been driving them towards either diversified funds (Theme 5) or lifecycle investing.

The latter relies on advice-embedded products such as target date, target risk and target income funds. Some follow a fixed glide path on asset allocation that allows automatic rebalancing of portfolios in the event of turbulence. Some have a dynamic path that allows discretionary rebalancing. Some embrace LDI-lite vehicles that benchmark members’ liabilities. Some move growth assets into cash and use the collateral to buy interest rate swaps—instead of wasting growth assets to buy bonds when approaching retirement.

All varieties are likely to grow, since their embedded advice features expressly counter clients’ behavioural biases in periods of high volatility. Their automatic rebalancing—buying low, selling high—is deemed a big plus. Hence, two changes are likely in the DC landscape.

First, there will be more diversity in the trustee-led schemes via diversified funds and lifecycle investing; thus veering them towards the employee-led schemes. Second, lifecycle investing will spread from the U.S. and the UK to other DC markets; thus ensuring that their discretionary risk tools embrace non-discretionary elements.

INTERVIEW QUOTES:

“Like their peers in the DB space, trustees of the DC schemes want to offload the risks one way or the other.”

“The trustee-led schemes will switch from single to multi-strategy portfolios that can withstand large market shifts.”

“Lifecycle investing will grow in Australia, Hong Kong and Europe.”

FIGURE 1.6 What will happen in the global DC space?

Source: Principal Global Investors/CREATE Survey 2012
The 2000s was a ‘lost decade’. To prevent its repeat, clients are reconsidering their approaches, but they fear that, in pursuit of scale and scope, asset management has diluted its craft heritage and the nimbleness essential to cope with volatility. Long-term relationships have given way to brief affairs. Peer risk, agency risk and skewed incentives have prevented a strategic understanding of client needs. Funds are sold, not bought. Worse still, clients’ own herd instinct has not helped. They often make choices that are contrary to their best interests.

Remedial actions have been identified in four clusters that expressly recognise that investing in today’s markets is a massive leap of faith.

The first cluster covers skills. It enjoins managers to enhance their capabilities around price dislocation, improve their track record on volatility and avoid unrealistic claims about returns.

The second cluster covers culture. It enjoins managers to adopt meritocratic incentives that share pain and gain with their clients, while promoting common time horizons and investment beliefs.

The third cluster covers structure. It enjoins managers to encourage nimbleness, free thinking and high conviction investing within its talent pool.

The final cluster covers client engagement. It enjoins managers to go beyond regular reporting and engage in issues that deliver mutual benefits (Figure 1.7).

Few products have survived the panic buying and selling of the past four years, no matter what their intrinsic merits. Many have fallen prey to ‘wrong time’ risk. Also, the level of engagement necessary to help clients to identify bargains has not been there in large swathes of the industry. There is a clear need for new ways of engagement to manage expectations on what can and can’t be delivered in today’s volatile markets.

For their part, asset managers recognise that they can no longer rely on the fine print of their product prospectus to educate their clients. Winds of change are evident.

**INTERVIEW QUOTES:**

“Will today’s new approaches prove to be just another costly phase in our industry’s history?”

“Our clients are not too worried about returning to the table because we’re their co-investors who eat our own cooking.”

“Client behaviours often seem like buying/selling a bet on a horse half way through the race.”

Benefits for Managers

- Understand their clients’ dreams and nightmares
- Solicit new ideas by tapping into clients’ investment expertise
- Manage expectations in what can and can’t be delivered
- Minimise ‘wrong time’ risk and ‘regret’ risk in buying and selling
- Communicate bespoke research that addresses unique issues to clients
- Highlight proactive buying opportunities in periods of big price dislocations

Benefits for Clients

- Seek better alignment of interest via common beliefs and time horizons
- Obtain a second opinion on their asset allocation and correlation risks
- Gain deeper insights into what works at different stages of market cycle
- Develop mental agility to capitalise on periodic market dislocations
- Minimise behavioural biases and herd instincts provoked by periodic volatility
- Understand the ‘health warnings’ that are usually lost in the fine print of legal agreements
History tells us that times of high risks are also times of the big opportunities. Our biggest challenge is to convince our clients that intrinsic value always triumphs in the end, but they should not ignore opportunities thrown up in the meantime.

- AN INTERVIEW QUOTE
How do clients see it?

Overview

Since the Lehman crash in 2008, markets have displayed unusual volatility and unusual correlation. Asset classes have moved in lock-step. Price-earnings ratios have lacked sensible anchor points. Fear, greed and stress have amplified market cycles.

Against this background, this section explores the views of asset managers, pension plans, pension consultants and fund distributors on four questions:

- What factors will drive volatility in capital markets over the next 3 years?
- As a result, what will be their clients’ predominant approaches to risk?
- What tools are likely to be used by clients who choose to de-risk their portfolios?
- What tools are likely to be used by clients who choose to re-risk their portfolios?

2 Volatility Dynamics

Of the 20 biggest daily upswings in the S&P 500 since 1980, 10 have occurred in the last five years. Similarly, of the 20 biggest downswings, 13 have taken place in the last five years. Rarely have the stock markets been so wild; nor is there a precedence of so many asset classes fluctuating so much and so uniformly.

- An interview quote
KEY FINDINGS

Volatility Drivers

The strong rally in the first quarter of 2012 is already overshadowed by the latest banking crisis in Spain. So big is the current debt overhang in the West that the deleveraging will be a long haul, fraught with policy errors, political expediency and social turmoil over the rest of this decade.

Recent attempts have reshuffled the debt, not reduced it, causing it to remain the key driver of volatility in the 2010s. It will be reinforced by others, too. These include: the unintended effects of the new financial regulation, the globalisation of markets, and the fear of a ‘hard landing’ in China, high frequency trading and complex ETFs.

However, there is no clear consensus on their future impact in the light of the market rally in early 2012.

- 35% of our survey respondents still detect positive straws in the wind while recognising their inflationary consequences.
- 40% remain undecided. They do not rule out the possibility that markets may revert to their historical long-term state where politics matter more than economics—as happened before the long bull market that started in 1985. Yet, they do not rule out a continuing recovery in the U.S. that could act as a locomotive for Europe.
- 25% hold a pessimistic view. They envisage no clear directional shifts in the markets, as further quantitative easing merely piles up the current ‘cash mountains’ on both sides of the Atlantic.

Yet, one thing is clear: while investors worldwide have grown weary of new risks, they are unwilling to forego a bargain when they see it.

It is reinforced by the widespread belief that successive bouts of volatility since the 2008 credit crunch have severely distorted market valuations. The resulting price anomalies argue for blending caution with opportunism.

Dominant Risk Approaches

Some investors will de-risk their portfolios, some will re-risk them, some will do both and some do neither. Notably, all client segments are likely to re-risk, at varying degrees.

On the whole, though, DB clients are more likely to de-risk; while DC clients and retail clients are more likely to re-risk as well as de-risk. This diversity reflects the emergence of four investor groups since 2008, as identified by individual asset houses in our post-survey interviews:

- ‘Adventurists’, who believe in contrarian investing and market timing during turmoil
- ‘Pragmatists’, who believe in momentum investing that may or may not deliver more returns with no extra risks
- ‘Purists’, who believe in long-term investing backed by short-term fee compression
- ‘Deflationsists’, who can’t wait to get out at an opportune moment

In sum, like their asset managers, clients also see opportunity in volatility. But they need convincing that their managers can deliver it.

De-Risking Portfolios

In the meantime, those who de-risk are likely to rely on a variety of avenues.

- DB clients will use LDI, diversification, and fiduciary management.
- DC clients will use advice-embedded products, diversification and capital protection strategies.
- Retail clients, too, will rely on diversification, advice-embedded products and capital preservation tools.

Notably, hedging tools—that deliver stop-loss mechanisms, option contracts and structured products that limit upsides and downsides—are likely to be used on a limited scale because of their costs and counter-party risks.

Re-Risking Portfolios

Similarly, those who re-risk their portfolios expect to use a variety of avenues.

- DB clients will use absolute return strategies, unconstrained mandates, and high conviction approaches—while intensifying pressure on fees. Reputation risk and career risk will limit the scale and scope of their re-risking endeavours, however.
- DC clients will use glide path strategies, absolute return approaches, and high conviction investing.
- Retail clients will use active trading strategies, absolute return approaches and unconstrained mandates.

Style box investing will take a back seat, while the market cycles remain wild.

In summary, some clients will aim to ramp up risks, some will aim to squeeze extra returns from their existing risk budgets and some will seek to drive down costs.

“20% of our clients do contrarian investing.” - AN INTERVIEW QUOTE
Political horizons, market horizons and investor horizons are out of sync due to forces with no historical parallels

As we saw in the Executive Summary, the worst is far from over. At least nine in every ten respondents expect further upheavals over the rest of this decade due to the current debt overhang.

The first attempt by the U.S. Federal Reserve in 2009 merely socialised the bank losses. The latest one by the European Central Bank (ECB) has merely pre-empted sovereign defaults. Debt shows no sign of going away, despite a good start in the U.S. No wonder financial markets have been displaying a split personality via random bursts of risk-on/risk off trades unrelated to business fundamentals.

Our respondents expect volatility to persist over the next three years under the joint impact of six political, economic and structural factors (Figure 2.1):

72% of respondents expect the sovereign debt crisis in Europe and the U.S. to continue dogging the markets, since many key governments either lack the necessary majority for swift actions (the U.S. and the UK) or the requisite governance mechanisms (Europe).

68% expect the Dodd Frank Act in the U.S. and the Solvency II Directive in the European Union (EU) to create unintended consequences that will hit market liquidity or force perverse investment behaviours on the part of banks, insurance companies and pension plans.

64% expect greater contagion susceptibility from globalisation, as technology and 24-hour news cycles continue to amplify investor mood swings and compress their decision spans from calendar time to real time.

55% see high frequency trading as a significant source of instability, arguing that if the May 2010 ‘flash crash’ had been a little later in the day, prices would not have had a chance to recover before the U.S. markets closed, potentially causing carnage when Asian and European markets opened the next day.

43% anticipate a hard landing in China in response to the asset bubble at home and the economic turmoil in Europe, its largest foreign market. But this does not rule out the scenario in which China transitions to a resilient consumption-led economy with a rising yuan.

33% envisage ETFs to remain a notable source of instability—especially when they rely on synthetic structures, excessive leverage or inverse bets.

As for the future, post-survey interviews with asset managers identified three schools of thought:

INTERVIEW QUOTES:

“Dodd Frank deals with too-big-to-fail but has ended up too-big-to-read.”

“The risk-based rules of Basel III and Solvency II will herd investors into using the same tools to seek the same outcomes.”

“High frequency trading is far removed from the real functions of the capital markets.”

Source: Principal Global Investors/CREATE Survey 2012

FIGURE 2.1 What factors would drive volatility in capital markets over the next 3 years?

Source: Principal Global Investors/CREATE Survey 2012
The ‘inflationists’ (35% of asset managers) detect positive straws in the wind via recovery in the U.S., debt resolution in Greece, and currency revaluation in China. They expect the U.S. growth engine to lift Europe out of its current mire before long. But they expect inflation to accelerate as the current cash mountain unwinds in the West.

The ‘undecided’ (40% of asset managers) believe that the period 1985-2007 may have been an historical aberration, thriving on a rich stew of financial irresponsibility, political ineptitude, lax regulation and perverse incentives. These ramped up leverage, causing a raging bull market. From here on, notions of fair value may be driven more by politics than economics. But neither the greed-fear cycle nor mean reversion is dead. This school believes that blending caution with opportunism may not be such a bad idea until the fog clears (“A view from the top”).

The ‘deflationists’ (25% of asset managers) describe the current Western political dynamic as inertia at best and procrastination at worst. They see deleveraging as a bumpy ride, causing frequent policy errors and investor over-reactions, leaving few directional shifts in the markets; with no certainty that the U.S. will return to its long-term growth trajectory any time soon. How can it be that the excessive leverage that got it into such a sorry mess is also being relied upon to rescue it?

Unless quantitative easing rebalances the economies in the West away from finance, there will be a repeat of the 2008 meltdown. For now, historic parameters and assumptions are not valid—this group believes that there are more ways of losing money than making it.

Thus, there is no consensus about how markets will evolve from here on. The nascent rally in the first quarter of 2012 may fizzle out like similar ones in the past two years. Or it may not, if the U.S. story gains traction. Only time will tell.

One thing is certain, though: having weathered many rollercoaster rides since the bear market of 2000, investors worldwide have grown weary of new risks, but they haven’t given up chasing a bargain when they see one. Most are sitting on the sidelines watching events unfold and looking out for opportunities.

INTERVIEW QUOTES:
“China remains a wild card: with a lot in its favour and a lot against it.”

“QE2 stinks. It’ll stoke up inflation and debase our currencies. But the alternatives are even worse.”

“The U.S. will recover to the point at which it will drag Europe out of its economic mire.”

A VIEW FROM THE TOP...

Financial markets have seen extreme volatility, with daily moves of 3% to 5%. The ‘flash crash’ of May 2010 was the most dramatic example, when the Dow tumbled by 990 points in about 5 minutes, only to snap back part of the way.

That apart, reactions to the debt crisis in America and Europe have brought extreme spikes in market volatility and asset class correlations. These things have also happened in the past but there is a big difference now: our governments have run out of policy bullets. The lowest interest rates and highest budget deficits in living memory have not worked, forcing successive rounds of quantitative easing. But, as in Japan, our households and corporates are simply hoarding cash: they fear deflation.

To compound the problem, there are other structural forces at work; regulatory creep being one of them. The sheer complexity of the Dodd Frank Act makes you wonder what its eventual rule book will look like. The Volcker Rule, in particular, will hit market liquidity and price discovery. Solvency II will disproportionately hit risky assets and perversely turn insurance companies and pension plans into forced sellers in times of distress. The problems are compounded by high frequency trading and ETFs, which are amplifying directional velocity and market volatility.

However, we also see some positives on the horizon. The U.S. recovery is gathering momentum. The European Central Bank’s (ECB’s) Long Term Refinancing Operation has offered a breathing space to tackle Europe’s deep-seated debt and competitiveness malaise. China may well avoid a hard landing since it is also doing a lot of things right.

But history tells us that times of high risks are also times of the big opportunities. Our biggest challenge is to convince our clients that intrinsic value always triumphs in the end, but they should not ignore opportunities thrown up in the meantime.

– A GLOBAL ASSET MANAGER
Investors are being pragmatic in the face of too many wild variables that cannot be modelled on a spreadsheet

As discussed in the Executive Summary, a very large majority of our respondents believe that the current volatility offers an opportunity to achieve good returns for their clients. However, they also recognise that things are viewed differently by the client.

After a turbulent decade, end-investors have learnt that the timing of entry points and exit points have a big impact on returns. Some have learnt that it pays to be bold when others are fearful. Some accept that every crisis is a concealed opportunity. Yet, others display the once bitten, twice shy mentality. Investor expectations are adaptive and eclectic across the risk spectrum. This much is clear when our respondents were asked to identify the predominant approaches that are likely to be adopted by their three core client segments over the next three years (Figure 2.2).

Taking each segment in turn, 46% of our respondents expect their DB clients to de-risk their portfolios in this era of frequent volatility and only 9% expect them to re-risk. Notably, a further 39% expect both de-risking and re-risking. And a tiny 6% expect neither.

There are differences between the countries as well as within them. The emphasis on de-risking is evident in Europe and Asia where the recovery periods allowed under pension regulations are shorter in the event of deficits. In Asia (excluding Japan), DB plans remain home-biased, peer-biased and bond-biased. The emphasis on re-risking is evident in the U.S., especially in the public sector plans with big deficits and mounting political pressure to tackle them. A pragmatic re-risking and de-risking will be the norm in all regions.

Moving on to DC clients, the picture is different. 25% of the respondents expect their clients to de-risk their portfolios and 19% expect them to re-risk. A notable 35% expect both approaches to prevail while 21% expect neither to prevail.

De-risking is more likely on the Continent where DC plans are managed by trustees, who tend to prefer safer insurance-based investment options and higher contributions. Re-risking is more likely in the U.S. and the UK where target date funds with fixed glide paths automatically increase allocations to equities when they are down.

The pragmatic re-risking and de-risking is more likely in Australia where the 70:30 equity-bond mix is being gradually replaced by a more dynamic version of the old style balanced funds.

Finally, 33% expect their retail clients to de-risk, against a hefty 38% who expect an eclectic approach. Regionally, de-risking will be more prevalent in Europe, re-risking in Asia, and the eclectic mix in Europe and the U.S.

We encountered examples of clients capitalising on both temporal volatility via market timing and cross-sectional volatility via portfolio rebalancing since 2008.

**INTERVIEW QUOTES:**

“Everyone’s fearful about markets. Yet few are willing to miss the next rally.”

“Black Swans await those who ignore the sources of the current global malaise.”

“Risk as we know it now was not factored into returns historically. Its metrics ignored the dynamic side of risk.”

![Figure 2.2](image.png)

**FIGURE 2.2**

Over the next 3 years, what will be your clients’ predominant approaches to risk?

Source: Principal Global Investors/CREATE Survey 2012
Research done within individual asset houses, reported in the Executive Summary revealed the prevalence of four behavioural groups:

- **Adventurists (5%)**: they believe that the risk pendulum has swung too far in the wrong direction, distorting asset prices and rewarding market timing via contrarian investing. Examples of such investors came from retail clients in Asia and high net worth individuals in Europe.

- **Pragmatists (30%)**: they believe in value investing but fear value traps caused by price dislocations. So, they are keen to capture the bandwagon effect while momentum is working. Examples of such investors came from all client segments and regions.

- **Purists (45%)**: they remain buy-and-hold investors and see volatility as a mug’s game. They have done rebalancing to pursue value investing and liability matching, without incurring extra risks. Examples came from the DB space in Canada, Japan, Europe and the U.S., and the DC space in the U.S.

- **Pessimists (20%)**: for them, risk failed to generate returns in the last decade. The traditional return drivers—like risk premia, diversification and bar belling—have lost their hypnotic appeal. They see a large lumpy risk legacy where any initial market bounce will not last long. They can’t wait to get out when the time is right. Examples came from private sector DB plans planning buy-out options; and retail clients in their late accumulation phase, as exemplified by mutual funds in the U.S., which recorded net outflows for a fifth straight year in 2011.

The numbers associated with each camp are indicative, not definitive. However, they show that clients have a more discerning approach to volatility, being gripped by uncertainty like their asset managers. Their time honoured behavioural traits—opportunism, herding and prudence—have yet to be dented by successive bouts of volatility. But they need to be convinced that their managers understand their needs and know how to meet them in a volatile environment. We return to this point in Section 4.

**Interview Quotes:**

“The cash mountain is getting bigger everywhere. The key concern is whether all this money can be put to good use.”

“Times of high risks are also times of big opportunities. Clients know that. But it’s a matter of once bitten, twice shy.”

“Unconstrained mandates are on the rise.”

### A View From The Top...

The debt crisis in the EU has forced our coverage ratio into uncharted territory. There are definitely new forces at work that make investing more erratic in this decade. At the same time, our room to manoeuvre is restricted by the tough Dutch regulatory regime. It not only requires us to have a minimum coverage ratio of 105% and a risk-free discount rate for calculating our future liabilities. It also enjoins us to have capital buffers as we venture into risky or illiquid assets—as now being proposed in the Solvency II regime for all the pension plans on the Continent.

So, we’re left with three options. The first one is to dial up the risk. This means venturing further out on the risk frontier via higher yielding assets, as done by the iconic Yale Foundation in the last two decades. But our trustees would have none of it because our earlier forays into alternatives were hit by the mass redemptions in 2008 when liquidity dried up.

The second choice is to squeeze more juice out of our existing assets. This is the investor’s equivalent of the Holy Grail: getting additional alpha without taking on further beta risks. We’re doing this by using fundamental indices, pursuing long-term themes and a diverse asset base to create ‘smart betas’ that deliver cheap alpha. This approach is also used to make tactical rebalancing when we spot bargains in the markets.

The final option is to squeeze our costs: get existing returns at a reduced fee. We’re in-sourcing many of our active strategies and switching them into the smart beta bucket, which is now by far the largest one. We’re also recruiting smart managers who can help us develop new absolute returns strategies, with low volatility. Our biggest problem is to find out what constitutes a bargain when there have been no sensible anchor points for P/E ratios in the last 10 years.

— A DUTCH PENSION PLAN
De-risking will rely on the refinements of old tools

Before looking at the specific tools, there are two general points to make about the de-risking tools that are likely to be used over the next three years.

First, in all client segments, the key tool will be diversification (Figure 2.3). Its newer version is deemed superior to the old one crushed by the Lehman crash. It will focus more on managing risks than targeting returns; conserving capital than growing it; connecting the dots between asset classes than seeing them as exclusive entities; blending top-down and bottom-up styles than treating them as rivals (“A view from the top” on the facing page). The new version will have a macro overlay on stock picking.

The second general point relates to overt hedging tools such as stop-loss mechanisms with clear thresholds, option contracts, and structured products that limit upsides and downsides. Contrary to their inherent appeal, their cost and counter-party risks vary directly with volatility. As such, their use is likely to be somewhat limited.

As for the rest of the tools, their use will see refinements of the old tools within different client segments (Figure 2.3).

Starting with DB clients, more than two in five survey respondents cite LDI, fiduciary management and robust stress tests as the most likely tools. Taking them in turn, LDI will be morphing into a holistic balance sheet tool, while providing a dynamic hedging strategy in light of changing funding ratios. So far, these changes are confined to Europe. But they will spread to Japan, South Korea and the U.S., as ever more plans migrate to mark-to-market rules. LDI will gain traction in Asia.

INTERVIEW QUOTES:

“In this inter-connected world, it’s hard to connect the dots on all conceivable risks.”

“Options contracts or stop-loss tools are expensive: with no sucker at the other end.”

“Our LDI pipeline has grown from $6bn to $26bn in two years.”

FIGURE 2.3

What tools and approaches are likely to be adopted by clients who choose to de-risk their portfolios?

Source: Principal Global Investors/CREATE Survey 2012
Second, fiduciary management will be gaining traction outside the Netherlands, as newer mandates link the manager’s incentives with the solvency ratio of the client. Finally, stress tests will focus on geo-politics as well as macroeconomics.

Moving to DC clients, more than one in three respondents cites the established advice-embedded products and capital preservation strategies as the most likely tools for de-risking. These reflect the growing popularity of target date funds whose asset allocation varies with the age of clients, thereby minimising herd instinct and investor foibles so common in the 1990s. Some of these products will be LDI-lite by targeting retirement income and capital conservation at various phases of the glide path. Their use will spread from the U.S. to Australia, Hong Kong, the Netherlands, South Korea, Taiwan and the UK.

On the Continent, the DC market will grow rapidly over the next three years, especially in Belgium, France, Germany, Italy and Scandinavia. Currently, capital preservation remains a key end-goal and insurance contracts the preferred means. However, growth is expected to promote diversity: employee-led DC products, where individuals bear all the risks—as in Australia, the UK and the U.S.—are likely to become more visible in the Continental DC landscape.

Moving on to the retail clients, more than three in every ten respondents cite advice embedded products, capital preservation strategies, and structured products as the most likely tools for de-risking—for reasons that are similar to the ones cited for DC clients.

Notably, outside the U.S., the advice infrastructure is likely to improve in Hong Kong, the Netherlands and the UK due to new regulations. In the past, clients were rarely advised to sell and cash out. When they were, advisors’ choices were marred by conflicts of interest. Thus new tools will evolve alongside the old.

INTERVIEW QUOTES:

“In the last decade, risk failed to generate returns. So the burden of proof has increased for asset managers.”

“We’ll fail if we equate risk with opportunity. Today, risk also means unknown outcomes.”

“Most of today’s de-risking tools have not had a mid-life crisis yet. We don’t know what they will eventually deliver.”

A VIEW FROM THE TOP...

The biggest debt mountain we’ve known is being unwound at a snail’s pace. Today, policy makers do not have the means to reboot the global economy. We need growth to improve the public balance sheets. We need inflation to vapourise the debt. We need defaults to reduce the uncertainty. We need structural reforms to ensure that weaker nations do not live beyond their means. Instead, there is back-sliding on reforms.

Our clients have learnt painfully that the term ‘market risk’ now involves all the things that can go wrong. That means looking well beyond the normal macro risk factors. Nothing is an opportunity unless you understand the sources of risks, their likelihood, their potential impact and their mitigating tools. Our DB clients, on the whole, are de-risking, since there are too many contingent events, which may or may not happen. If they do, they can kill the portfolios. It is wiser to de-risk and extend the liability horizon.

So, clients are changing the asset allocation approach: asset classes are now being replaced by risk budgets. Everything is stress tested to death to distinguish factors that can generate alpha from those that can kill it. The emphasis is on risk minimisation rather than return maximisation. The new approach favours multi-asset class funds in the DB space and diversified growth funds in the DC space. A new broad-based diversification is emerging, akin to the old style balanced mandate, but with four differences: a wider range of assets, frequent tactical tilts, absolute-return benchmarks and absolute-risk focus.

A growing number of clients are also resorting to liability-driven investing, in which the risk-budget approach is embedded in the returns-enhancing portfolio. The popularity of LDI was initially driven by the European DB plans when interest rates were high, with a strong likelihood of decline. But even at today’s low levels, our clients are continuously seeking to lock their assets into their liabilities and escape the tyranny of relative returns and peer benchmarks, at a time when up to 80% of changes in their funding ratios come from interest rate movements.

Clients are also showing interest in fiduciary management. These are small and mid-size plans which have neither the skills nor the governance nor the nimbleness to make ends meet in today’s volatile environment. They see fiduciary management as a sound way to access the right expertise and enjoy scale economies in the process.

— A GLOBAL PENSION CONSULTANCY

57% expect DB clients to use LDI
55% expect DC clients to use advice-embedded products
48% expect retail clients to diversify significantly
No client segment wants to miss the next rally even though caution is the new watchword

All client segments have learnt one lesson: it is unwise to ignore the power of mean reversion, since intrinsic value always shows up in the end; but it is equally unwise to bank on it, in the light of the random bursts of risk-on/risk-off trades of the past three years.

Opportunism will prevail. So far, its degree is not big enough to make a large difference to client portfolios either way. The near 30% drop in equity volatility as measured by the Chicago Board of Exchange’s VIX, taking it below the psychological threshold of 20 in January 2012, is a welcome development. Some asset managers view that as a game changer, others, as the lull before the storm.

In the absence of another August 2011 type meltdown, our respondents expect their clients in all three segments to re-risk their portfolios over the next three years (Figure 2.4).

In the DB segment, more than one in three respondents expect their clients to pursue one or more of four strategies: absolute returns (45%), unconstrained mandates (37%), active trading strategies like hedge funds (34%), and high conviction investing (32%). They will be favoured by pension plans which have been the biggest victims of a double squeeze: falling value on the asset side and falling discount rate on the liability side.

In the DC segment, nearly one in two respondents expect re-risking via the adoption of more glide path strategies in target date funds.

INTERVIEW QUOTES:

“The risk pendulum has swung too far in the wrong direction causing over-reactions.”

“The ultra-safe sovereign debt pool has fallen by 70% in the space of six months.”

“The timing of the entry point and exit point determine returns; nothing else.”

FIGURE 2.4

What tools and approaches are likely to be adopted by clients who choose to re-risk their portfolios?

Source: Principal Global Investors/CREATE Survey 2012
These are likely to embrace LDI-lite vehicles that aim to benchmark implicit liabilities of the member, by targeting a pre-set level of retirement income. They will also have the discretion to change the pre-set asset allocation formula to prevent losses from potential major market events. These changes are in the pipeline in the UK and the U.S. However, high conviction investing is likely to be more popular in the trustee-based plans in Australia, the Netherlands and Scandinavia. In Australia, the weaknesses of the old 70:30 equity-bond formula chasing relative returns have been exposed dramatically in the past four years. Superannuation funds are now considering more dynamic approaches that target CPI plus 3% (p. 29).

Finally, in the retail segment, the incidence of re-risking is likely to be lower. Around one in every three respondents expect their clients to pursue active trading strategies (34%), absolute returns strategies (28%), or thematic plays on sectors or regions. Such re-risking is more likely in Europe and the U.S.—although clients will require a lot of convincing, as we shall see in Section 4.

In our post-survey interviews, two pertinent points emerged. First, the well-groomed style box investing approach has less relevance in today’s climate where the past is a poor guide to the future. Outside the U.S., style box investing has lost its bloom, at least for now.

Second, many DB plans in Canada, Japan, South Korea, the UK and the U.S. find it hard to become more adventurous because of the career-risk and reputation-risk of their boards. In some cases, neither their committee structures nor their sponsor covenants permit anything more than periodic rebalancing, and then only after a big review. The required degree of nimbleness for re-risking is just not there.

INTERVIEW QUOTES:

“There’s a pile of cash waiting for the green light: nobody wants to miss the big bounce when it comes.”

“Sooner or later, pension plans will have to dial up risk or seek extra cash from their sponsors.”

“In hindsight, periods of market distress have been good entry points.”

A VIEW FROM THE TOP...

A DC plan is very different from a DB plan in who bears the investment risk. That does not mean that it can’t borrow innovations from its older cousin.

The target date DC funds, based on a pre-set glide path, have proved superior to the traditional approach, where individuals make their own asset allocation decisions. Its ‘set-it/forget-it’ mechanism adapts investors’ risk profile to their age—starting out with aggressive equities and switching to cautious bonds nearer the retirement date. This has prevented poor asset allocation choices, driven by herd instinct that was rife in the 1990s.

From the volatility standpoint, these funds have also had another spin-off. Their pre-set allocation formula buys equities when markets are down and sells them when they are up. Such automatic re-risking has proved beneficial in the aftermath of the 2008 market collapse.

They are now likely to witness further improvements. The glide path is perceived as overly oriented towards the target retirement date rather than the target retirement pot. The latter is implicit. Furthermore, the path has no automatic mechanism to ring-fence the accumulated gains at the time of big market upheavals.

Accordingly, two innovations are likely over the next three years, both of which will improve the risk approaches implicit in the glide path strategies.

First, the current target date funds will also have a clear retirement income benchmark, akin to liabilities in DB plans. Asset allocation will be outcome driven. It will aim to deliver a minimum acceptable level of income in retirement relative to the income earned in employment. This implied replacement ratio will become the de facto liability benchmark against which asset allocation will be adjusted on a discretionary basis.

Second, the resulting dynamic glide path will bring LDI-lite structures into the DC space. They will move growth assets into cash and use the collateral to buy interest rate swaps. The current method of using growth assets to buy bonds prevents the pot size from getting bigger on approach to retirement.

The automatic re-risking mechanism in the current glide path strategies will embody a discretionary element to boost the returns and target a pre-set income ratio.

– A UK ASSET MANAGER
HOW WILL RE-RISKING AND DE-RISKING PAN OUT?

OVERVIEW

Clients see a silver lining in the volatility cloud. But they are also plagued by uncertainty.

Lack of consensus on economic outlook suggests that markets can go either way in the foreseeable future. Regular bouts of risk-on/risk-off trades since 2009 have thrown up bargains for those brave enough to act. Most of all, such bouts may well become an important feature of the investment landscape.

Against this background, this section aims to identify the strategies that are likely to be used by clients to pursue:

• **Short-term opportunism.** This may involve market timing or portfolio rebalancing or both. These may involve dialling up risk and/or squeezing extra returns out of existing risks.
Medium-term asset allocation. This may involve individual or multi-asset class strategies.

The report focuses on four investor segments:

• DB clients
• DC clients
• Retail clients
• High net worth clients

KEY FINDINGS

DB Clients
Banks are likely to offload their asset-backed mortgage (ABM) securities and loan books to meet the new solvency margins under Basel III. In response, DB clients are likely to move up the risk curve and go opportunistic in the credit space dominated by distressed debt, high yield bonds and the ‘secondaries’ in real estate, private equity, commercial mortgages, collateralized loan obligations (CLOs) and senior debt.

Alongside such opportunism, those DB clients taking an optimistic view are also likely to tilt heavily in the direction of equities in their medium-term asset allocation. Equities may well re-emerge from their recent ice age.

Those DB clients who take a pessimistic view of the future will favour minimum variance equities, macro hedge funds, global tactical asset allocation (GTAA) and distressed debt.

Emerging market equities are likely to be accessed via ETFs as a cost effective means to capitalise on new bursts of momentum. However, there are concerns about ETFs as a source of volatility. Their leveraged versions are seen as market setters, rather than market followers.

DC Clients
DC clients are expected to adopt a variety of approaches to reflect their diversity.

Those that guarantee nominal returns via insurance contracts are already de-risked and expect no change.

Those that are managed by individual members will proceed along two separate tracks:

• Those using target date funds will do automatic re-risking and de-risking through the glide path mechanism
• Those doing their own asset allocation will also do discretionary rebalancing.

Over time, however, the discretionary element is likely to diminish, as target date funds increasingly become the default option.

Retail Clients
Retail clients are expected to err on the side of caution, on the whole, with periodic bouts of opportunism. But there will be a clear divide between the West and the East.

Those in the West have become over cautious in the wake of past losses and impending retirement. A large cohort will soon be migrating from the accumulation to the decumulation phase. But they may well pursue risk-on trades when opportune.

In contrast, in the East, notions like de-risking and re-risking are far removed from the reality on the ground. Driven by client foibles, all investing is opportunistic. It is unlikely to change in the absence of more financial education.

High Net Worth Clients
They, too, will remain ultra-cautious in the face of volatility, but this will be punctuated by periodic opportunism. Those in the developed markets remain to be convinced that their wealth managers can convert volatility into an opportunity.

In contrast, those in the emerging markets attribute their poor returns in the recent past to structural forces that work against client interests. Better returns will require a rapid transition from a savings culture to a buy-and-hold culture.

Stocks are at their most attractive in 50 years.

- AN INTERVIEW QUOTE
When asked to identify asset classes that are likely to be chosen by their DB clients, our respondents drew a distinction between those that would be targeted for short-term opportunism and those for medium-term asset allocation (Figure 3.1).

The ‘adventurists’ and ‘pragmatists’ (p.19) are more likely to target the first group and the ‘purists’ the second.

Six asset classes that are likely to be targeted for opportunism include:
- Distressed debt (43%)
- ETFs (37%)
- Emerging market equities (30%)
- High yield bonds (29%)
- Currency funds (29%)
- Hedge funds (27%)

In contrast, four that are likely to be targeted for asset allocation are:
- Global equities (58%)
- Equities with emerging market revenue (54%)
- High income equities (46%)
- Emerging market equities (43%)

Behind these numbers lie five salient points.

First, it is widely held that equities are due for a generational bull market. Volatility has driven out swathes of panic sellers since 2008. In the U.S. alone, equity mutual funds have seen net outflows since 2008, despite the near doubling in the stock market since the March 2009 low. Fear has obscured the fundamentals. But on a three to five year view, equities look cheap, according to the ‘pragmatists.’ They are already rebalancing in favour of minimum-variance equities that have outperformed their high volatility peers since 1926. The ‘purists’ will favour minimum variance equities, macro hedge funds, GTAA and distressed debt.

**INTERVIEW QUOTES:**

“An equities bounce is long overdue. Bond prices defy logic.”

“Since 2000, cash has outperformed equities in our portfolio.”

“You can’t have good returns without taking risk. But we need to know what that risk is and what its pay-off is.”

**FIGURE 3.1** Which asset classes and generic products are most likely to be chosen by your DB clients for short-term opportunism and which ones are likely to be chosen for medium-term asset allocation?

Source: Principal Global Investors/CREATE Survey 2012
Second, DB clients have also been moving up the risk curve in search of yield in the credit space. The ‘secondaries’ in private equity, commercial mortgages, CLOs, and senior debt are expected to notch up good returns as banks offload their ABM securities and loan books; and replace them with ‘covered’ bonds to meet the new solvency margins under Basel III. Some $1.5 trillion of credit is likely to materialise in Europe alone over the next 5 years. Investors are already eyeing the $125 billion junk bond market. Besides, borrowers are now favouring bonds over loans due to favourable coupons, quicker deal process and ample liquidity in bond markets. These will see far more re-risking than the equity markets.

Third, anything up to 50% investment in the emerging markets will be via ETFs. They will aim to capitalise on frequent bursts of momentum via cheaper options and better liquidity. Besides, as the S&P 500 has far outperformed BRIC equities since 2008, they no longer offer a free lunch. Their correlation with the developed markets has risen steadily towards 0.9.

Fourth, ETFs will be increasingly seen as a mixed blessing. Their ability to slice and dice the investment landscape, track indices rather than outperform them, and offer low cost exposure to different markets is widely recognised. On the flip side, there are concerns about ETFs as a source of volatility. While the leverage and inverse funds make up just 3% of ETF assets, they account for around 15% of ETF trading. Investors hold them for an average of 3 days, compared with 16 days for plain vanilla versions.

Finally, for DB clients, preference for one asset class over another is increasingly spurious, as they resort to a broad diversification (“A view from the top” below). The old style balanced mandates will stage a reincarnation with a variety of asset classes, tactical tilts and a focus on absolute risks.

INTERVIEW QUOTES:

“Fundamental credit is strong. But it’s dogged by irrational fears about Europe and America.”

“We select funds rather than managers. This allows a lot of opportunism within a diversified portfolio at much lower costs.”

“The index universe is excessively fuelled by ETFs. Far from tracking the markets, they’re leading them.”

Our funding levels had a double whammy. The S&P 500 index returned 2.7% p.a. over the past decade, including re-invested dividends, compared with our target rate of 12%. We had assumed a discount rate of 8% for calculating our liabilities, which also turned out to be too optimistic. This was before the big losses in 2011. Our funding ratio is now so low that we would need a 30-year recovery period in the absence of big changes. So we’ve changed our asset allocation approach. To start with, we no longer believe that volatility and correlations among asset classes will follow their historical norms. We’ve gone from asset diversification to risk diversification by adopting five risk buckets.

The first one covers assets that provide ready liquidity in times of extreme volatility. They include cash and Treasuries. The second bucket covers inflation-proof assets like commodities and infrastructure. The third bucket covers fixed income assets that provide a steady cash flow. The fourth one covers real assets like property and forestry that deliver high illiquidity premia. The final bucket includes growth assets like equities. A large chunk of our assets are now in this growth bucket because we believe that the U.S. economy may well be on the verge of a come-back. It may experience an unusual second recovery over the next three years, after a weak one in the last three years. We also see potential in the credit space as banks retreat to beef up their balance sheets under Basel III.

This form of diversification also incorporates a time element, since the markets can turn on a dime. So, within the buckets, we have a mix of short-term assets like cash and Treasuries; medium-term assets such as stocks with safe and rising dividend payouts; and long-term assets with a deep value bent.

Finally, our diversification is significant within as well as between the buckets. It involves both single and multi-asset class strategies. It involves risk parity portfolios that include gold and leverage on low-risk assets. It also permits opportunistic rebalancing within and between the buckets. In the immediate aftermath of the Lehman debacle, we became ultra-cautious. As events have unfolded, we’ve learnt that volatility is here to stay and we have to make a virtue out of necessity. We’re replacing benchmark-related measures, e.g. tracking error and information ratio, with measures that focus on absolute risk.

A VIEW FROM THE TOP...

58% expect their DB clients to use global equities in their asset allocation

43% expect their DB clients to use distressed debt in opportunistic investing

37% expect their DB clients to use ETFs in their opportunistic investing
In the DC landscape, automatic re-risking will be more prevalent than discretionary re-risking

Three broad segments define the global DC spectrum today. At one end are employer-led schemes where employers guarantee the nominal returns on investments. Such schemes are popular in Belgium, Chile, Denmark, Germany, Slovenia and Switzerland.

In between sit the pooled trustee-led schemes where investment decisions rely on trustees or default options, with members bearing all the risks. Such schemes exist in Austria, Australia and South Africa.

At the other extreme are employee-led schemes, where members make the investment choices and bear the associated risks via individual accounts. Such schemes are popular in Hong Kong, Ireland, Japan, Sweden, the UK and the U.S.

This diversity, in turn, will influence their approach to risk over the next three years.

Taking them in turn, the employer-led schemes are already de-risked to start with, given their nature. By law, most of them are invested in long-term insurance contracts, with a strong focus on fixed income.

In contrast, the trustee-led schemes will increase diversification. Those in Australia expect to move away from the 70:30 equity-bond mix that has proved too risky in the aftermath of 2008 (“A view from the top” on the facing page). They will migrate to structures similar to diversified growth funds in the UK or multi-asset class vehicles in the U.S. These allow very broad diversification across risk buckets with regular tactical tilts. Other countries in this group will follow suit, as they reduce overall risk in their portfolios but with the flexibility to re-risk when opportune.

Finally, the employee-led schemes will see limited opportunism (Figure 3.2). It will occur via automatic as well as discretionary means. The automatic ones will rely on a fixed glide path in target date, target risk and target income funds. They will rebalance their portfolios: buying equities when they fall and selling when they rise. These funds are likely to become more popular in the English-speaking world, where they are viewed as advice-embedded products. On the other hand, their closest competitors, diversified growth funds, relying on a very broad diversification, are likely to grow in popularity on the Continent.

**INTERVIEW QUOTES:**

“Trustees want to offload the risk on the individual. The middle ground in the DC space will shrink over time.”

“Individuals who manage their own plans end up with low plan balances due to poor asset allocation and timing choices.”

“Without intelligent rebalancing, opportunism can be very costly in DC schemes.”

**FIGURE 3.2** Which asset classes and generic products are most likely to be chosen by your DC clients for short-term opportunism and which ones are likely to be chosen for medium-term asset allocation?

Source: Principal Global Investors/CREATE Survey 2012
Finally, the discretionary rebalancing will occur in schemes where members manage their own funds—as in Hong Kong, the UK and the U.S. Like retail clients (p. 30), they remain prone to herd behaviours: buying high, selling low, thus inadvertently burning their portfolios regularly. To counter that, the 2006 Pension Protection Act in the U.S. overtly endorses target date funds, as does the new National Employment Savings Trust in the UK.

As a result, the target date funds will come to dominate default options over time. Even trustee-led schemes are likely to move in that direction over time, since their current plan balances are deemed too low to buy a decent annuity on retirement.

The DC landscape will polarise over time between employer-led and employee-led schemes.

**INTERVIEW QUOTES:**

“The employer-led schemes sound great. But they are like savings accounts with little investment content and meagre returns.”

“Trustee-led schemes are either too cautious (Europe) or too risky (Australia). Both are changing.”

“Over time, target date funds will become the default option in most DC countries.”

---

52% expect their DC clients to use target date funds in their asset allocation

49% expect their DC clients to use equity funds in their asset allocation

20% expect their DC clients to use equity funds in opportunistic investing

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A VIEW FROM THE TOP...

Investment strategies pursued by many Australian superannuation funds (“supers”) appear to say one thing, but do another.

Nearly every fund has a return target expressed as inflation plus 3% but their investments are generally managed and assessed against peers on an annual basis. Members have the option to switch funds, but very few ever do. So there has been little pressure to reduce peer bias, at least until recently. The resulting short-termism has forced many supers to be more worried about the financial risk of their businesses and the career risk of their executives than with generating the returns that members are led to expect.

Supers’ default options typically have a mechanical allocation of a 70:30 equity-bond mix. Over 80% of members use this option, such that it holds 70% of assets across all supers. Such peer-herding has long ignored a big undiversified equity risk. It didn’t matter in a period like 1990-2007, when a raging bull market delivered double-digit returns almost year-on-year. Since then, however, outcomes have been sub-par. Most of the default funds have neither met their real return objective nor performed well against low-cost cash funds over five, seven or 10-year periods.

Unsurprisingly, many people are opting to manage their own funds in a Self-Managed Super Fund, akin to a private retirement plan in Sweden, the UK or the U.S. From a late start, this option already holds more than a third of Aus$1.4 trillion of total super assets in Australia.

Another contributory factor is the one-size-fits-all approach. The fund of each member is managed similarly, with no reference to his/her age, financial circumstances or retirement needs. Such uniformity worked so long as the markets were booming. But it has caused a lot of soul searching since the Great Financial Crash of 2008. One state government fund has already broken ranks by taking the bold step of looking at lifecycle investing—popular in the USA—and ditching the peer league tables. Others may follow soon.

Accordingly, the DC segment will become more diverse, albeit gradually. Self-managed plans will exist alongside trustee-managed plans; lifestyle products will exist alongside pooled assets; advice-embedded products will exist alongside mechanical default funds. Consolidation among the supers will accelerate, since the current industry structure only works in a bull market.

The key challenge for the supers now is two-fold: they need to de-risk their portfolios that have long been weighed down by equity risk; they also need to find smarter ways of investing that deliver absolute returns at times when simple cash products fetch around 5%.

Supers are responding by re-examining their asset allocation approaches. Old-style balanced mandates are being re-adapted under the guise of diversified growth funds. The aim is to achieve broad diversification via separate risk buckets, encompassing a wide array of assets that lend themselves to periodic tactical switches. Risk parity portfolios are using leverage on safer assets. As in Europe and the U.S., a new form of diversification is coming to Australia that offers re-risking and de-risking within a broad product structure.

– AN AUSTRALIAN ASSET MANAGER
Risk will divide the retail markets between East and West

The investment choices of retail clients will err on the side of caution. 46% of our respondents expect their retail clients to choose capital protection products for medium term asset allocation. 34% expect them to opt for tax efficient products (Figure 3.3).

However, opportunism is unlikely to go away. Four strategies are likely to be deployed:

- 23% vote for index funds
- 22% for actively managed equities and bonds
- 22% for theme funds
- 19% for mutual funds that use hedge fund-type tools (e.g. leverage, shortage and derivatives)

Our post-survey interviews identified two salient points with a clear East-West divide.

The first one concerns the retail investors in the West. On the whole, their behaviours have followed a jagged path.

On one hand, they have become ultra-cautious in the wake of the losses sustained in the two bear markets of the last decade. Their confidence was especially shattered in 2008, when several U.S. money market funds ‘broke the buck’, with net asset values falling below one dollar.

The ageing population, holding the bulk of retail assets now, has an especially low tolerance for risk in a prolonged era of volatility. When the markets recover, many are likely to de-risk their portfolios; some will even exit altogether in search of plain savings options. The pronounced hemorrhaging in the mutual funds sector in America and Europe since 2008 may be indicative of a new secular downward trend.

On the other hand, it is likely to be punctuated by periods of risk-on trades, if the recent recovery shows signs of turning into a full-blown bull market.

On past form, such temporary bursts of risk taking will involve active and passive equity funds; doing market timing as well as portfolio rebalancing. In the process, style box investing, long popular in the retail space, will be sidelined. Retail money will become ever less sticky. It will expect quick wins when taking big risks.

The second salient point concerns retail investors in Asia. Countries as diverse as China, India, Japan, Malaysia, Singapore and Taiwan display two common traits.

First, up to 55% of household financial assets are held in savings accounts. A decent return plus capital protection is one factor. Even in Japan, the near-zero interest rate translates into a real positive return due to falling prices.

INTERVIEW QUOTES:

“The bulk of U.S. retail money is going from the accumulation to the decumulation phase. Risk aversion is very real.”

“Having lost out in the past, some retail clients will exit in despair but many want a final fling in the next rally.”

“Generation X and Generation Y are keeping a low profile. As yet, their investments are small.”

FIGURE 3.3 Which asset classes and generic products are most likely to be chosen by your retail clients for short-term opportunism and which ones are likely to be chosen for medium-term asset allocation?

![Graph showing asset choices for retail clients](image-url)

Source: Principal Global Investors/CREATE Survey 2012
The second common trait is the lack of buy-and-hold culture. The average holding period of mutual funds varies between four and 12 months. The average shelf life of a mutual fund is around 2.5 years. Most investors rely on stock picking and concentrated bets (“A view from the top” below). All investing appears opportunistic; risk taking is rife, as are behavioural biases. These have badly burnt client portfolios since 2007. Outside the institutional space, notions of re-risking and de-risking have limited validity.

The volatile nature of local markets has blurred the distinction. The BRIC markets have been four times as volatile as the S&P 500 since 2008. The advice infrastructure is limited. Banks dominate distribution and thrive on front-end commissions. Product push remains a powerful factor.

However, there are positive straws in the wind. The abolition of front, trail and exit commissions in India is likely to promote a new generation of fiduciary gatekeepers with their primary oath of allegiance to end-clients. Other Asian countries are contemplating similar moves, as a part of a concerted effort to create a vibrant indigenous fund sector.

Furthermore, their institutional investors are no longer mainly bond-biased, peer-biased and home-biased, after their recent push into broader diversification. They are being emulated by large fund distributors who are introducing multi-asset class funds that divert investor attention from concentrated bets and momentum investing.

46% expect their retail clients to use capital protection funds in their asset allocation

23% expect their retail clients to use indexed funds in opportunistic investing

22% expect their retail clients to use active funds in opportunistic investing

INTERVIEW QUOTES:

“Like Warren Buffett, investors in Asia go for concentrated bets. Without skills, that’s like buying lottery tickets.”

“Herd mentality costs Asian retail investors dear. They promote a casino mentality.”

“Without more financial education, China will not be a fund super power.”

A VIEW FROM THE TOP...

Concepts like re-risking and de-risking are far removed from how the current generation of retail investors operate in China.

For a long period of time, they have been nurtured on positive returns and capital protection offered by savings accounts at banks. Their incursion into the world of investing has been marred by approaches that recognise neither value investing nor time investing. People make choices that seem contrary to their best interests.

Despite the availability of mutual funds, for example, retail investors prefer to make a few big bets based on everything from hot tips, lucky numbers and IPOs to detailed fundamental analysis. Recent data show that the median number of holdings among all Hong Kong investors is four, with a median value of HK$150,000.

Most investors have out-sized exposure to company-specific risks in the belief that returns mainly come from stock selection. The concept of asset allocation has yet to take root, as has the concept of macro risks that regularly buffet all emerging markets.

Worse still, investors also tend to over-rate their stock picking skills even when the markets are doing well. For example, the Shanghai Composite Index bounced back by 80% in 2009. Yet 82% of the investors did not earn more than 50%. Almost a quarter ended the year in negative territory.

Unlike their peers in the West, Chinese investors are often mesmerised by volatility. They prefer high volatility stocks to low volatility stocks in the belief that they can make a quick killing by market timing. They also tend to hang on to losing stocks in the belief that they will recover before long.

There is a strong tendency especially to hang on to mutual funds when their NAV is below 1.0 and to sell them when it goes above it, irrespective of the market conditions and intrinsic value.

Worst of all, there is an unconscious bias towards low-price-stocks syndrome: investors prefer to invest in companies with low nominal value in the belief that they will eventually come to match their high-value counterparts. The latter are often used as benchmarks.

Of course, it is okay to take advantage of price dislocations that have characterised the Chinese stock markets over the past ten years. But the principles guiding their approaches have a high probability of delivering more pain than gain.

As in other BRIC economies, the mutual fund industry is ripe for take-off in China. But it won’t come until we have far higher financial literacy and far better advice channels.

– A CHINESE FUND ADVISOR
After big losses in the last decade, high net worth individuals are turning into ultra demanding investors

In 2008, in all regions, high net worth individuals (HNWI) lost out disproportionately, being overweight in equities as well as alternatives such as hedge funds, currency funds and private equity. For the foreseeable future, like their retail peers, they will err on the side of caution (Figure 3.4).

- 55% of our respondents expect their HNWI segment to invest in capital protection funds.
- 42% expect them to opt for absolute return funds targeting a CPI plus 3% benchmark that relies on cash-plus products.
- 35% expect them to invest in real estate with a ‘distressed’ label.

At the other extreme, they are also likely to go opportunistic when bargains emerge. Commodity funds (especially gold), indexed funds (especially ETFs), currency funds and hedge funds will top their list.

At surface level, these results do not suggest clear regional differences. However, in our interviews, we sensed a marked difference between the developed markets and the emerging markets.

In the developed markets of the West, the psychological impact of past losses was far greater and the resulting loss of confidence in their wealth managers more pronounced.

As a result, since 2008, simple capital protection products offering high liquidity have been the preferred option. There have also been periodic forays into ETFs in the ‘risk-on’ periods, especially in Europe.

However, as the markets have shown signs of revival lately, opportunism is back on the table. But it is unlikely that they will make big bets unless they are convinced that their wealth managers now have the capacity to turn market volatility into an investment opportunity. We return to this point in the following section.

In the emerging markets, on the other hand, past losses have forced a significant introspection amongst HNW clients and their managers. Both are wising up. Rather than focusing on re-risking and de-risking, the talk is about cultivating an investment culture that eschews the entrenched feast and famine mentality.

INTERVIEW QUOTES:

“Our HNW clients want return of capital before return on capital.”

“Market cycles in the West get amplified in the East. There is no sign of decoupling.”

“Volatility has whipsawed the wealth of the nouveau rich investors in India.”

FIGURE 3.4 Which asset classes and generic products are most likely to be chosen by your high net worth clients for short-term opportunism and which are likely to be medium-term asset allocation?

Source: Principal Global Investors/CREATE Survey 2012
The Indian stock market has had a rollercoaster ride. From a peak of around 22,000 in 2007, Sensex went into freefall, hitting 8,000 a year later. By late 2010, it had recovered lost ground, only to tumble again by 20% in 2011 due to the European debt crisis.

The markets have since rallied but the bulls are not in sight. Quite simply, the recovery is a liquidity play. Most of the recent net inflow came from foreign professional traders engaged in ‘carry’ trades based on the low interest rates in the U.S. and the weak rupee at home.

Our clients are staying on the sidelines. The memory of big losses in the recent past is one factor. The other is the unintended consequence of the abolition of commissions on mutual funds and the introduction of advice-based fees. Upon discovering that anything up to 2.5% of their assets are taken up by fees, high net worth investors have flocked to banks that offer up to 10% on term deposits (with an extra 0.5% for senior citizens).

For now, the old beat-the-market mentality that relied on hype, greed and fear is not so evident. Investors are wising up, as are their wealth managers. The latter have, on the whole, welcomed the abolition of commissions as a necessary step towards kick-starting investor education and a buy-and-hold mentality.

Besides, the regulators are keen to ensure that distributors can no longer run tacit auctions that place clients’ money with managers who offered the best commissions—irrespective of clients’ needs or managers’ track record.

While HNWI are drawn into term-deposits, their ultra-rich peers are coming back into the market—albeit cautiously—via two sets of products: asset allocation funds, blending equities and bonds; and high conviction strategies. However, in both cases, they show zero tolerance toward mediocrity, such that the shelf life of a typical product is unlikely to exceed its long-term average of 2.5 years.

Pundits regularly paint emerging markets as a source of untold bonanza for the wealth managers. But they ignore one stumbling block: the magnetism of the traditional savings culture. It has long delivered capital preservation and income upside that the risk-return calculus of the investment culture has yet to match.

This transition from savings to investment needs tail winds from six sources: a long bull market that inspires confidence, compulsory retirement planning that puts the onus on the individual, tax breaks that provide the necessary incentives, higher levels of investment literacy that minimise herd behaviour, an advice overlay that permits sensible asset choices, and good corporate governance that offers accurate financial reporting.

In India, the first is unlikely for a while, the second is not being contemplated, but there are distinct baby steps towards the remaining four. However, their impact will be diluted from time to time by the very volatile nature of our stock market.

The trajectory between the two cultures will be anything but a straight line. India may well be the next gold rush for wealth managers—but later rather than sooner.

– AN INDIAN WEALTH MANAGER
WHAT DO ASSET MANAGERS NEED TO DO?

OVERVIEW

Section 2 identified the differing perspectives of clients. Many believe in the U.S. story and may well re-risk their portfolios; as would the ‘adventurists’, the ‘pragmatists’ and, to a much lesser extent, the ‘purists’.

However, their perception of volatility as an investment opportunity is far from unconditional.

The 2000s was a ‘lost decade’ for them. They don’t want to suffer the same fate in this decade. If this is an era of prolonged volatility, they would consider taking advantage of the periodic dislocations, so long as they are convinced that their asset managers can up the ante.
Accordingly, this section turns the spotlight on the changes that asset managers think that they need to make to raise their clients’ confidence level.

It covers two specific issues:

- What are the main external and internal hurdles that asset managers face when capitalising on volatility?
- What actions do asset managers need to take to overcome these hurdles?

**KEY FINDINGS**

**External and Internal Hurdles**

Over the past decade, as asset management has morphed into a mass market industry with a global reach and a broad client base, it has lost much of its craft heritage that was conducive to riding the volatility wave.

The unintended outcome has been a vicious cycle, where external and internal factors have reinforced one another to create a high degree of disintermediation and skewed incentives. After the ‘lost decade,’ there is a lumpy legacy of mistrust.

The key factors on the external side are: clients’ behavioural biases, their risk aversion, and with institutional clients, their restrictive policy guidelines. These have been reinforced by the mediocre track record of active management.

The key factors that are internal to individual asset managers include: lack of a credible track record on volatility trading, lack of tactical asset allocation capabilities, the entrenched buy-and-hold mentality and the adherence to style box investing.

**Required Actions**

To break this cycle, a number of mutually-reinforcing changes are essential. They fall into four clusters.

The first cluster aims to improve investment capabilities in specific areas, like price dislocations and high conviction investing.

The second one aims to improve the alignment of interest via co-investing and more symmetrical incentives.

The third cluster aims to promote nimbleness, free thinking and high conviction investing.

The final cluster aims to enhance client engagement via better understanding of their needs and avoidance of unrealistic claims about returns.

**Each Cluster Underscores a Distinct Imperative**

First, alpha is in the eye of the beholder. Clients are increasingly drawing a distinction between product alpha and solutions alpha: one is about beating the markets, the other about meeting their identified needs—like consistency of returns or customised benchmarks. For both types of alpha, greater proximity to clients is essential in setting and managing expectations.

Second, asset businesses need a lot of resilience. Improving investment capabilities extends beyond skills. It covers a raft of other areas that provide the essential shock absorbers in this age of turbulence.

Third, investment professionals must put their money where their mouths are. The asymmetric rewards inspire neither trust nor motivation.

“There’s a big gap between what clients need and what we give them.”

- AN INTERVIEW QUOTE
Key hurdles remain to be crossed before volatility can be turned into an opportunity

If there was one recurring theme in our post-survey interviews, it was that the industrialisation of the investment business has created a vicious cycle that makes it hard to profit from volatility. The cycle is reinforced by a mix of external and internal hurdles that asset managers face when dealing with volatility (Figure 4.1).

External Constraints
Starting with the principal external constraints, 59% of asset managers cite clients’ behavioural biases that often ignore conventional wisdom to buy low/sell high. Driven by the greed-fear cycle, clients often make choices that are contrary to their best interest.

53% cite risk aversion in the aftermath of the seismic shocks unleashed by the Lehman collapse (2008) and the sovereign debt crisis (2011).

47% cite the overall mediocre track record of active management in beating the markets. Long fed on the dubious virtues of peer and market benchmarks, most clients don’t recognise their inherent limitations.

39% cite investors’ rules and guidelines that restrict their risk parameters.

Internal Constraints
As for the internal constraints, 51% of asset managers cite the lack of a good track record on volatility investing.

49% cite scarcity of tactical asset allocation capabilities.

47% cite entrenched buy-and-hold mentality that misses opportunities in periods of price dislocation.

43% cite adherence to style box despite high asset class correlations and uncertain risk premia.

INTERVIEW QUOTES:
“What we need from our clients is patience. The 24-hour news cycle has distorted clients’ investment time horizons.”

“We can’t cope with volatility because there is no mindset of contrarian investing in our firm.”

“The long-term relationship between us and our clients gave way to brief affairs in this world of fast finance.”

FIGURE 4.1 What will be the main external and internal constraints that asset managers face when capitalising on volatility?

<table>
<thead>
<tr>
<th>EXTERNAL CONSTRAINTS:</th>
<th>% of respondents</th>
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<tbody>
<tr>
<td>Clients’ behavioural biases leading to herd mentality</td>
<td>60</td>
</tr>
<tr>
<td>Clients’ risk aversion due to economic uncertainty</td>
<td>57</td>
</tr>
<tr>
<td>Overall mediocre track record of active management</td>
<td>53</td>
</tr>
<tr>
<td>Institutional investors’ rules and guidelines</td>
<td>51</td>
</tr>
<tr>
<td>Low funding levels that promote risk aversion</td>
<td>47</td>
</tr>
<tr>
<td>Scary headlines on volatility in the mass media</td>
<td>43</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>INTERNAL CONSTRAINTS:</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of a good track record on volatility investing</td>
<td>51</td>
</tr>
<tr>
<td>Scarcity of tactical asset allocation capabilities</td>
<td>50</td>
</tr>
<tr>
<td>Prevalence of entrenched buy-and-hold mentality</td>
<td>49</td>
</tr>
<tr>
<td>Adherence to style box investing</td>
<td>47</td>
</tr>
<tr>
<td>Over-reliance on backward looking risk models</td>
<td>45</td>
</tr>
<tr>
<td>Internal bureaucracy that slows things down in asset houses</td>
<td>43</td>
</tr>
</tbody>
</table>

Source: Principal Global Investors/CREATE Survey 2012
A number of factors are at play behind these numbers. The key one is disintermediation by pension consultants and fund distributors. It has unduly inflated return expectations and created a legacy of mistrust, especially in the volatile environment of the last decade. For their part, without sufficient knowledge about clients’ overall needs, asset managers have resorted to a big product push, notably in Europe and Asia.

That has ignored an essential pre-condition for success in turbulent times: client patience is just as important as the intrinsic merits of their choices. In bad times, clients instinctively head for the exit, because in good times they were rarely advised to cash out.

Disintermediation has exacerbated the familiar principal-agency problem as well as peer herding among advisers and managers alike ("A view from the top"). It has also amplified the ‘regret’ risk and ‘wrong time’ risk.

The current arrangement needs step improvements to convince the clients that volatility is an opportunity in practice as much as in principle. Such changes will not instantly convince them to re-risk. But they will raise the probability of it.

INTERVIEW QUOTES:

“Industrialisation has suppressed the skills that translate market ructions into investment opportunities.”

“Like their clients, many asset managers follow the herd to manage the peer risk.”

“Peer benchmarks are subtly powerful. It takes courage to step away from them. Herding helps to manage the career risk.”

A VIEW FROM THE TOP...

As asset management became a mass market industry on a global scale, it has industrialised to the extent where it lost its cottage industry heritage. Most of its current practices work against capitalising on volatility. Quite frankly, we’re no longer close enough to our clients to inspire the necessary trust or motivation.

Our industry has gone from art to science, from craft to scale, from judgment calls to complex models far removed from reality. Some of the key innovations, e.g. shorting, leverage, portable alpha, high frequency trading, were conceived as clever mouse traps. But quite often, they failed to extract value, when there was none to start with. Systemic risks, product complexity and higher charges have been the main outcomes.

Introduced in 1986, the Dow Jones Industrial Average was simply a market proxy, not an investment idea. It was never designed to evaluate manager performance or promote a beat-the-market mentality. However, over time, as it became apparent that markets were hard to beat, enterprising managers saw an opportunity to deliver market representative returns at rock-bottom costs, never mind their intrinsic value. The big picture understanding of investing was lost when specialist mandates replaced the balanced ones. Few managers understand the real drivers of correlation or TAA.

Clients want certainty in a world full of uncertainty. There’s a big gap between what they need and what we give them. So we’ve created new concepts like risk premia, bar-belling and relative benchmarks. We’ve also created new advice infrastructure via pension consultants and fund distributors. Thus, we have moved away from our original mission to deliver absolute returns via high conviction investing based on skills.

The disintermediation has forced us to provide products, not solutions. We don’t know what clients’ overall goals are, so we’re forced to exaggerate the virtues of our products. These intermediaries think they know better than clients or managers. But they don’t. The result is an entrenched blame culture in which career risk and reputation risk take precedence over investment risk. The principal-agency problem is as acute now as it’s ever been. Skewed incentives have encouraged herding.

Like clients, their advisers and managers stay within the ‘pack’ with no outliers. Everyone’s scared to stick their necks out. More often than not, they rely on client inertia and market recovery to bail them out. After all, clients were rarely advised to cash out when markets were peaking. Why would they trust us when we ask them to invest when markets are so volatile?

If volatility persists over this decade, this industry will need a big makeover. We can’t roll back industrialisation but we can inject a big dose of realism in areas that can make a difference to investment outcomes. The market turmoil of the last 10 years has forced us to revisit our original mission within a new form of engagement that is free of dogmas, fads and clichés. We have to learn to lean against the crowd and focus on the fundamentals.

– A GERMAN ASSET MANAGER
To overcome the hurdles, a range of investment-related and business-related changes were identified in our survey (Figure 4.2). Further analysis suggests four neat clusters.

The first cluster covers clients. 66% of respondents cite the need to develop a better understanding of clients’ goals and challenges. 66% also single out the importance of greater client engagement. 59% caution against making unrealistic claims about returns.

The second cluster relates to investment capabilities. 54% see the need to improve the track-record of active management. 53% see the need to develop deeper expertise in anticipating price dislocations.

The third cluster covers business nimbleness. 49% cite the importance of a work environment conducive to high conviction investing.

The final cluster covers alignment of interests. 50% see the need for co-investing that ensures that investment professionals also have a personal stake in the funds they manage. 44% see the need for low charges plus high watermark fees. 42% favour low charge plus profit sharing.

These percentages underscore three imperatives. First, without greater client engagement, continuing volatility risks turning even more investors into ‘pessimists’ (p.19). Increasingly, clients are distinguishing between product alpha that is time-dependent and solution alpha that is need dependent.

**INTERVIEW QUOTES:**

“Even our best products could not survive the panic selling seen since 2008.”

“Is volatility an opportunity or a disaster? We need skills to answer this question.”

“If a volatility trade goes pear-shaped, it needs to hurt the manager.”

**FIGURE 4.2** Which capabilities do asset managers need to develop, if their clients are to benefit from volatility?

Source: Principal Global Investors/CREATE Survey 2012
One is about beating the markets, the other about meeting clients’ identified needs. Each requires greater client engagement. The current disintermediation in the industry needs to be tempered by new avenues of engagement that go beyond the regular reporting.

Second, if the era of prolonged volatility is here, it is essential to develop better shock absorbers in the existing business models which have been severely tested since the 2008 crisis. To its credit, the industry has made progress. The adoption of the multi-boutique model is an important step towards nimbleness and a small company mindset in a large company environment, as our 2010 CREATE Report showed. Adoption of meritocratic staff incentives is also a step in the right direction (our 2009 CREATE Report).

However, the asset industry is still perceived as a bastion of entitlements, as evidenced by recent political hostility and regulatory creep. This perception needs to be countered by practical examples of good practices.

Finally, if clients are to re-risk on a notable scale, they want to be sure that their managers put their money where their mouths are. They want managers to eat their own cooking. The current skewed fees structure is akin to a call option, which makes little sense, after millions of clients have lost billions of dollars. Whereas industrialisation is irreversible, it does not preclude progress in these clusters to restore the best features of its craft heritage.

INTERVIEW QUOTES:

“Clients want to see track record and co-investing before taking on new risks.”

“Costs in this business are hydra-headed. They have a life of their own.”

“The volatility dynamic requires new corporate shock absorbers.”

A VIEW FROM THE TOP...

Investing during volatile times is scary. Our clients are a heterogeneous group: some with a strong risk appetite, some with none. In between, are the majority, who tend to blow with the wind. After the wreckage of 2008, there were lots of bargains. But the level of engagement needed to persuade our clients to see them as bargains was just not there. We did a number of client perception studies and focus groups. One thing was clear: clients want a solution to specific needs, which can require a multi-asset class or a stand-alone product. They want good returns as a part of this solution. But they also judge us by how we develop a strategic understanding of their needs and how we meet them.

This was a light bulb moment. We realised that no matter how good our products are, they can fare badly, unless clients have some understanding of their intrinsic worth and time horizons. Our products can’t survive panic buying and panic selling of the past four years. For our part, we also need a more rounded picture of client needs before launching new products.

We have initiated regular pulse surveys and face-to-face contacts with key clients in order to solicit new ideas, manage expectations, minimise ‘wrong’ time risks, communicate bespoke research, deliver products that are fit for purpose and highlight proactive buying opportunities. Clients like this approach, since it helps to establish common beliefs and investment horizons, to learn what works and what doesn’t at different stages of the cycle, and to understand the ‘health warnings’ that are usually lost in the fine print of legal agreements.

We believe that markets will remain jittery for a long time. Absolute returns and unconstrained mandates will grow in popularity. 35% of our clients use their liabilities as a benchmark. Our task is two-fold: via greater engagement, to raise clients’ comfort levels during turbulent phases; and to deliver decent returns by upgrading our own investment capabilities. Our portfolio managers and research analysts are enjoined to develop new skills that focus on asset correlations, risk premia, geo-politics, systemic risks, balance sheet dynamics, behavioural biases and many others. Our investment processes incorporate a variety of perspectives, including risk management and client needs. New products are stress tested against extreme macro-economic and geo-political environments.

All investment professionals are enjoined to invest their bonus into the funds they manage. Some hold as much as 80% of their net worth in the funds they manage.

– A SWISS ASSET MANAGER
APPENDIX

The Principal Global Investors/CREATE annual survey started in 2009. Items that are comparable over time in our surveys are covered in this appendix to facilitate a time comparison. They relate to clients’ choices of different asset classes. Four client segments have been covered: Defined Benefit (DB) plans, Defined Contribution (DC) plans, retail clients and high net worth clients, in Tables A.1, A.2, A.3 and A.4, respectively.

Our classification of asset classes has evolved over time, such that a minority of items covered here do not have comparable data. These have been identified as “not applicable” (n/a).

<table>
<thead>
<tr>
<th>TABLE A.1</th>
<th>Which asset classes are most likely to be chosen by your DB clients for medium-term asset allocation and which ones are likely to be chosen for short-term opportunism?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSET ALLOCATION:</strong></td>
<td><strong>% of respondents</strong></td>
</tr>
<tr>
<td></td>
<td><strong>2012</strong></td>
</tr>
<tr>
<td>Global equities</td>
<td>58</td>
</tr>
<tr>
<td>Global equities with emerging market revenues</td>
<td>54</td>
</tr>
<tr>
<td>High income equities</td>
<td>46</td>
</tr>
<tr>
<td>Emerging market bonds</td>
<td>44</td>
</tr>
<tr>
<td>Emerging market equities</td>
<td>43</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>43</td>
</tr>
<tr>
<td>Real estate (inc. CMBS nearing redemption)</td>
<td>40</td>
</tr>
<tr>
<td>Global tactical asset allocation products</td>
<td>38</td>
</tr>
<tr>
<td>Investment grade bonds</td>
<td>37</td>
</tr>
<tr>
<td>Government bonds</td>
<td>35</td>
</tr>
<tr>
<td>Indexed / enhanced indexed equities</td>
<td>34</td>
</tr>
<tr>
<td>Private equity</td>
<td>29</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>29</td>
</tr>
<tr>
<td>High yield bonds</td>
<td>23</td>
</tr>
<tr>
<td>Commodity funds</td>
<td>18</td>
</tr>
<tr>
<td>Exchange traded funds</td>
<td>16</td>
</tr>
<tr>
<td>Currency funds</td>
<td>10</td>
</tr>
<tr>
<td>Distressed debt</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: Principal Global Investors/CREATE Survey 2012 and 2009
n/a = not applicable

| **OPPORTUNISM:** | **% of respondents** |
| | **2012** | **2009** |
| Distressed debt | 43 | 59 |
| Exchange traded funds | 37 | 18 |
| Emerging market equities | 30 | 34 |
| High yield bonds | 29 | 51 |
| Currency funds | 29 | 25 |
| Hedge funds | 27 | 21 |
| Commodity funds | 25 | 31 |
| Global equities with emerging market revenues | 21 | n/a |
| Global tactical asset allocation products | 20 | 21 |
| Global equities | 18 | 23 |
| High income equities | 17 | n/a |
| Emerging market bonds | 15 | n/a |
| Indexed / enhanced indexed equities | 12 | 17 |
| Investment grade bonds | 11 | 27 |
| Private equity | 9 | 18 |
| Real estate (inc. CMBS nearing redemption) | 7 | 20 |
| Infrastructure | 6 | n/a |
| Government bonds | 6 | 13 |

Source: Principal Global Investors/CREATE Survey 2012 and 2009
n/a = not applicable

<table>
<thead>
<tr>
<th>TABLE A.2</th>
<th>Which asset classes are most likely to be chosen by your DC clients for medium-term asset allocation and which ones are likely to be chosen for short-term opportunism?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSET ALLOCATION:</strong></td>
<td><strong>% of respondents</strong></td>
</tr>
<tr>
<td></td>
<td><strong>2012</strong></td>
</tr>
<tr>
<td>Target date retirement funds</td>
<td>52</td>
</tr>
<tr>
<td>Equities</td>
<td>49</td>
</tr>
<tr>
<td>Diversified growth funds</td>
<td>43</td>
</tr>
<tr>
<td>Bonds</td>
<td>37</td>
</tr>
<tr>
<td>Target risk retirement funds</td>
<td>36</td>
</tr>
<tr>
<td>Customised investment / self managed plans</td>
<td>34</td>
</tr>
<tr>
<td>Target income retirement funds</td>
<td>34</td>
</tr>
<tr>
<td>Guaranteed insurance contracts</td>
<td>23</td>
</tr>
<tr>
<td>Deferred annuities</td>
<td>23</td>
</tr>
<tr>
<td>Cash-like products</td>
<td>18</td>
</tr>
</tbody>
</table>

Source: Principal Global Investors/CREATE Survey 2012 and 2009
n/a = not applicable

| **OPPORTUNISM:** | **% of respondents** |
| | **2012** | **2009** |
| Equities | 20 | 30 |
| Cash-like products | 18 | 25 |
| Diversified growth funds | 7 | n/a |
| Customised investment / self managed plans | 7 | 10 |
| Bonds | 6 | 13 |
| Target risk retirement funds | 5 | 15 |
| Guaranteed insurance contracts | 5 | 16 |
| Deferred annuities | 4 | 13 |
| Target date retirement funds | 3 | 7 |
| Target income retirement funds | 3 | 19 |

Source: Principal Global Investors/CREATE Survey 2012 and 2009
n/a = not applicable
### Table A.3 Which asset classes are most likely to be chosen by your retail clients for medium-term asset allocation and which ones are likely to be chosen for short-term opportunism?

<table>
<thead>
<tr>
<th>ASSET ALLOCATION</th>
<th>% of respondents 2012</th>
<th>% of respondents 2009</th>
<th>OPPORTUNISM</th>
<th>% of respondents 2012</th>
<th>% of respondents 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital protection funds</td>
<td>46</td>
<td>55</td>
<td>Indexed funds</td>
<td>23</td>
<td>23</td>
</tr>
<tr>
<td>Tax efficient retirement funds (e.g. IRAs in the USA)</td>
<td>34</td>
<td>53</td>
<td>Actively managed equities and / or bonds</td>
<td>22</td>
<td>39</td>
</tr>
<tr>
<td>Actively managed equities and / or bonds</td>
<td>32</td>
<td>49</td>
<td>Theme funds (e.g. Shari’ah, SRI, environment)</td>
<td>22</td>
<td>n/a</td>
</tr>
<tr>
<td>Mutual funds using hedging tools (e.g. Newcits)</td>
<td>30</td>
<td>n/a</td>
<td>Mutual funds using hedging tools (e.g. Newcits)</td>
<td>19</td>
<td>n/a</td>
</tr>
<tr>
<td>Indexed funds</td>
<td>28</td>
<td>46</td>
<td>Capital protection funds</td>
<td>14</td>
<td>29</td>
</tr>
<tr>
<td>Theme funds (e.g. Shari’ah, SRI, environment)</td>
<td>28</td>
<td>n/a</td>
<td>Tax efficient retirement funds (e.g. IRAs in the USA)</td>
<td>6</td>
<td>13</td>
</tr>
</tbody>
</table>

Source: Principal Global Investors/CREATE Survey 2012 and 2009  
\( n/a = \text{not applicable} \)

### Table A.4 Which asset classes are most likely to be chosen by your high net worth clients for medium-term asset allocation and which ones are likely to be chosen for short-term opportunism?

<table>
<thead>
<tr>
<th>ASSET ALLOCATION</th>
<th>% of respondents 2012</th>
<th>% of respondents 2009</th>
<th>OPPORTUNISM</th>
<th>% of respondents 2012</th>
<th>% of respondents 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital protection funds</td>
<td>55</td>
<td>40</td>
<td>Commodity funds (inc. gold)</td>
<td>31</td>
<td>39</td>
</tr>
<tr>
<td>Absolute / real return funds</td>
<td>42</td>
<td>50</td>
<td>Indexed equities</td>
<td>28</td>
<td>23</td>
</tr>
<tr>
<td>Real estate</td>
<td>37</td>
<td>46</td>
<td>Currency funds</td>
<td>28</td>
<td>39</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>30</td>
<td>31</td>
<td>Absolute / real return funds</td>
<td>26</td>
<td>28</td>
</tr>
<tr>
<td>Active equities and bonds</td>
<td>29</td>
<td>51</td>
<td>Hedge funds</td>
<td>24</td>
<td>30</td>
</tr>
<tr>
<td>Indexed equities</td>
<td>27</td>
<td>47</td>
<td>Capital protection funds</td>
<td>13</td>
<td>25</td>
</tr>
<tr>
<td>Commodity funds (inc. gold)</td>
<td>20</td>
<td>32</td>
<td>Active equities and bonds</td>
<td>12</td>
<td>28</td>
</tr>
<tr>
<td>Currency funds</td>
<td>11</td>
<td>32</td>
<td>Real estate</td>
<td>9</td>
<td>26</td>
</tr>
<tr>
<td>Private equity</td>
<td>9</td>
<td>32</td>
<td>Private equity</td>
<td>5</td>
<td>27</td>
</tr>
<tr>
<td>Indexed bonds</td>
<td>6</td>
<td>32</td>
<td>Indexed bonds</td>
<td>3</td>
<td>18</td>
</tr>
</tbody>
</table>

Source: Principal Global Investors/CREATE Survey 2012 and 2009  
\( n/a = \text{not applicable} \)
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