Asset Management: Plotting New Directions
(As History Repeats Itself)

Joseph Cherian
November 2, 2010

FT Business and The Banker’s 4th Annual ERM
Thought Leadership Series 2010
Big Banks’ US$ Outlook for 2010:

- US$ has limited downside with respect to Yen and Euro. Cyclical near-term weakness followed by gradual dollar recovery further out
- If global economic growth disappoints, US$ will strengthen
- US$ will remain weak but strengthen in late 2010
- US$ downside limited, in fact likely to rally significantly against Euro, especially given the US$-funded carry trade is probably overdone

Forecasts dated Jan 2010

BIG BANKS’ FX FORECASTS A LITTLE OFF THE “MARK”
Deep Dive: Year-to-Date Empirical Evidence
Euro | Yen | SG$ versus US$

Source: Bloomberg
Deep Dive 2: Comparing Stock Index Price Returns (in USD)

• On a Year-to-Date basis, up until May 25, 2010 low, S&P 500 was down the least
  Order: S&P 500, Nikkei 225, Straits Times Index, MSCI Asia Apex 50

• Flip side: The STI is the best performing on a 1YR basis (as of Oct 21, 2010)
  Order: Straits Times Index (30.3%), MSCI Asia Apex 50 (14.2%), S&P 500 (10.2%), Nikkei 225 (4.2%)
Comparing Valuations

Source: Bloomberg

3YR Median: 11.8
10YR Median: 17.7
10YR Median: 15.0
10YR Median: 14.0
10YR Median: 25.4
Factor Performance & Rotation – US Equities

- Returns for an equal-weighted top quintile versus bottom quintile L/S factor portfolio – high correlation during GFC
- Some recovery since

Top 1500 US stocks based on market capitalization (02/1996 – 10/2010)

Global Financial Crisis 2007 - 2009
Factor Performance & Rotation – Japanese Equities

- Returns for an equal-weighted top quintile versus bottom quintile L/S factor portfolio – high correlation during GFC
- No sustained recovery but heightened volatility since

Nikkei 500 stocks (02/1996 – 10/2010)

Global Financial Crisis 2007-2009
The New Asian Headlines

Source: AsianInvestor, October 22, 2010

- Asian real estate careening towards ‘inevitable correction’
- Rush into emerging market equities raises alarm
- Regulations hurting India’s mutual fund industry
- The rise and fall (and return?) of hedge funds
- Risk management models are always wrong, the question is by how much (so says a global financial institution CEO as quoted in The Business Times)

As a consequence, risk managers now worry about:

- recent Euro zone sovereign debt crisis, continued weakness in the U.S. economy
- hot money and asset price bubbles in Asia
- counterparties
- financial regulations and the attendant compliance issues
- Asian inflationary and currency spirals
ERM Redux

- RM’s role post-crisis has increased significantly – needs requisite experience, training, real powers, and appropriate incentive scheme. Being well-intentioned not good enough
- Liquidity, transparency, and downside risk control & management
- Counterparty, operational, reputation, political/regulatory, hot money… the list goes on
- Renewed focus on risk allocation, attribution & analysis
- Prudent risk management: blending good quant models with qualitative insights such as financial market intuition, common sense & experience to create more “balanced” risk views and portfolios
  - Search for “black holes” in quant model assumptions
  - Stress tests have to go on – get stressed by the latent and unknown risks
  - Create early warning systems
  - To avoid concentration risk in portfolios, use risk parity over risk budgets
Role of Industry Associations in Asset Management and Investor Education

• CFA Institute – Certification program for analysts & money managers. 91,555 charterholders. Strong commitment to professional excellence, ethical standards, financial market integrity. Censures, reprimands, revokes. 13 suspensions YTD, highest in 10 years!

• AIMA – represents all practitioners in the alternative investment management industry. CAIA designation. Excellent AIMA due diligence questionnaire

• Continuing education – being well-intentioned not good enough, have to be well-trained and well-informed. Both CFA Institute and AIMA have university co-sponsorship programs

• However, be aware of conflicts of interest, self-serving and/or plain bad advice:
  
  ➢ According to FINRA: Long term investing (more than ten years) means earning a return that outpaces inflation and allows one’s principal investment to grow over time to ensure a financially secure retirement. This implies allocating a larger percentage of one’s portfolio to stocks and equity mutual funds in the early stages of one’s life (www.finra.org)
  
  ➢ Saving is for the short run, investing for the long run (Fact: Saving is income minus consumption; investing means selecting your portfolio of assets!)
  
  ➢ Stocks are safe in the long run due to “time diversification” (and boy, do I have a snake oil liniment for you!)
Role and Impact of Regulators

- Soft touch, laissez-faire regulatory system created a behemoth *too-big-to-fail* financial industry ex Asia, which is now trying to be corrected by the Dodd-Frank Act, EU “passport regime” law, UCITS IV, Basel III, etc.

- While some of these laws have made it more difficult to offer Asian funds and investment services in foreign jurisdictions, it also opens up new opportunities for us
  
  ➢ Derivatives and clearinghouses under Dodd-Frank? Singapore ideally-suited from the technology, know-how, financial stability points of view to serve as a warehousing hub for derivatives / swaps, in providing central clearing, netting & settlement arrangements, handling transactions in various currencies, etc. (Think a “booking center” equivalent of the private banking sector)

- Expeditiously partnering / cooperating with foreign regulators to ensure their laws are complied with, hence ensuring domestic fund managers aren’t unfairly penalized

- Drawing up sensible rules & regulations post GFC – e.g., recent MAS licensing rules proposal for domestic fund managers (Notified vs. Licensed–Qualified vs. Licensed–Retail)

RISK TAKING HARD TO LEGISLATE. PRUDENCE AND GOVERNANCE SHOULD RULE
Risk management an **integral** part of the asset management business. As important as “alpha generation” (the front office)

As a consequence, risk managers must be **empowered** with real powers, incentivized to do the right thing, and compensated in a commensurate manner (with appropriate claw backs)

The fervent hope is **prudent risk management** won’t suffer the same fate as prudent Wall Street compensation, which appears to have died a natural death

**Balance** traditional quantitative risk management models with more qualitative financial market intuition, common sense & experience

Empower **arms-length** risk oversight committees to **identify enterprise-wide portfolio risk concentrations**, to institute controls and meaningful “stops / limits”

Provide **full holdings transparency** to your risk managers so they can make fully-informed decisions at both the portfolio and firm levels, just as a CIO would

Growing importance of **liquidity risk management**, both from the point of view of investment strategy and as a source of funding, and **downside risk management**

Last, proper **risk governance**, sound supervisory and regulatory oversight are key ingredients in avoiding blowups – both of the singular and systemic kinds. Regulators should pay attention to **correlation risks**