Fortis Investments

BNP PARIBAS
INVESTMENT PARTNERS

fund expert

For professional investors

1st quarter 2010

Investing over the long term

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Editors
Nieck Ammerlaan
Stephen Henderson
Art director
Sandrine Rivière
Graphic designers
Claire Colombet, Joanne Sicre, Jeroen Sikkema
Production manager
Adriaan Kootstra

For more information, contact
fortisfunds@fortisinvestments.com

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Taking a longer view

We are proud to present the first edition of Fund Expert of 2010, the year that is due to see the legal merger of BNP Paribas Investment Partners and Fortis Investments. The future merger of our two asset management companies will combine complementary investment expertise and scale, so as to add long-term value for our clients.

Refocusing on a longer-term horizon and on the protection of one's assets can be seen as two of the lessons to be learnt in the wake of the turmoil in the markets and the global economy in 2008 and 2009. Volatility is an inherent part of investing and a phenomenon which investors should not shrug off despite an understandable temptation to do so when all is rosy. While the global economy appears to be recovering, upsets are never far away. Witness the spike in market worries about government debt levels, not just of certain European countries, but also of the triple-A rated US.

Change is inevitable. Dealing with the risks that may bring is equally possible, also for investors. A key theme for the outlook concerns the changing climate. In November 2009, we hosted a Climate Change Conference in Copenhagen with over 200 clients, covering a wide range of aspects. In this issue of Fund Expert, we examine some of the longer-term implications for investors.

We also look at a number of other themes associated with longer-term investing including capital preservation and some of the interesting alternatives, including those with guarantee features as well as those using derivatives to lock in gains. Capital preservation does not automatically entail risk aversion; rather, it can mean that the timing of investments should be smart and risks should be managed closely.

From a longer-term perspective, opportunities such as those presented in the emerging markets space can only be ignored at one's peril. As the global balance of power shifts eastwards, we think investors should continue to place greater emphasis on these appealing markets. We provide an overview of the main regions and the most prominent country in each of them.

What to expect from the climate change lottery

We take a look at SRI and the longer term, with the implications for large-cap equities and government bonds.

Peering into the next decade

In a roundtable discussion, we look at longer-term investing and risk.

"In many crucial areas, the world is getting better."

We investigate areas such as climate protection, growing urbanisation, ageing, renewable energy and spreading mobility.

Plain and simple: capital preservation

We discuss investing with built-in guarantees, locking in capital gains, tackling volatility and protecting against inflation.

Vincent Camerlynck
global head of institutional clients

Nicolas Faller
global head of distribution partners

Trend growth

The past two years have seen the global economy slide into recession and start to climb out again. Was lasting damage done? Are there any implications for growth further out? Joost van Leenders, investment specialist – investment strategy, looks at scenarios for the longer-term macroeconomic outlook.

Buds in the real economy

In 2008 and 2009, the global economy suffered the biggest financial crisis in decades and the deepest recession since at least World War II. The US economy shrank by 3.8% from its cyclical peak in the second quarter of 2008 to the trough one year later. The German economy contracted by 6.7% peak-to-trough and Japan's economy by 8.6%. Taiwan's economy, which is typically more cyclical, plunged by as much as 13.7%. By the summer of 2009, many economies had emerged from recession. While the strength and the sustainability of the recovery in many developed economies are still hotly debated, Asia is unmistakably going through a strong V-shaped recovery.

The proximity of a financial crisis and a recession raises questions about the longer-term growth prospects. Several scenarios are possible in our view. In an optimistic scenario, the output gap that opened up during the recession is quickly closed. This would mean that the global economy would grow above trend for a while. In a further scenario, the global economy returns to trend growth, but the activity lost during the recession would not be fully recovered. In a more pessimistic scenario, the global economy suffers in the coming year from an extended process of deleveraging.

US growing more slowly

Trend growth is the pace at which an economy can grow in the longer term. At this rate, unemployment does not rise or fall and inflationary pressures get no chance to build. The Congressional Budget Office estimates that before the crisis, from 2002 to 2009, US trend growth was 2.7%. A decade earlier it was 3.1%. The CBO now expects trend growth to slow to 2.2% in the coming 10 years. This slower pace reflects lower productivity growth after the collapse in investment during the recession and slower population growth.

Trend growth in the eurozone is generally about 1% lower than in the US, mainly due to lower population growth. In Japan, some observers see it as low as 0%. Emerging countries generally have much higher rates. Their populations tend to grow faster and productivity tends to grow strongly when subsistence farmers migrate to cities where they are typically employed much more productively. South Korea's economy, often seen as emerging but in fact highly developed, grew on average by 4.6% in the eight years before the crisis. Brazil's growth was more erratic but still 3.7% over this period. India grew by 7.4% on average, although this was probably above potential, since inflation was accelerating before the global recession affected the country. Growth in China averaged an impressive 10.4%. The government aims for an annual growth rate of 8%, which is also seen as the country's trend rate of growth.

I. The optimistic scenario: filling the gap

During recessions, actual output typically falls to below potential. This is reflected in rising unemployment rates and falling capacity utilisation in the manufacturing sector. In the second quarter of 2009 – the final quarter of the US recession – actual output was 7.4% below the level if the economy had continued growing at its trend rate of 2.7%.[1] If we assume optimistically that the economy makes up for the slack in the coming three years, growth should average 4.5%. This may seem high, but it is not impossible. History teaches us that the deeper the recession, the stronger the rebound, on average. After the deep recession in the early 1980s, the US economy grew for three quarters at near 9% quarter-on-quarter annualised. Growth in the fourth quarter of 2009 was actually a strong 5.7%.

For the optimistic scenario to come through, massive monetary and fiscal stimulus must spark a recovery which leads to an upward spiral of consumer demand, business investment and strong demand for labour so that workers who were laid off in the recession are hired again. On a global scale, demand from Asia should be supportive and even thrifty

slows

European and Japanese consumers would join in. Corporate profits would surge due to strong sales growth, advancing from a low cost base after aggressive cost-cutting in the recession. Monetary authorities would have to rein in liquidity quickly and hike interest rates to prevent a burst of inflation. Fiscal positions in developed economies would improve as taxes flowed in and social security payments receded.

World GDP growth (%)

	average 1991-2000	2007	2008	2009*	2010*	2014*
World	**3.1**	**5.2**	**3.0**	**-1.1**	**3.1**	**4.5**
United States	2.8	2.7	0.6	-3.4	1.3	2.4
Euro area	na	2.7	0.7	-4.2	0.3	2.1
Japan	1.2	2.3	-0.7	-5.4	1.7	1.8
Emerging economies	**3.6**	**8.3**	**6.0**	**1.7**	**5.1**	**6.6**
Central & eastern Europe	2.0	5.5	3.0	-5.0	1.8	4.0
Developing Asia	7.4	10.6	7.6	6.2	7.3	8.5
Middle East	4.0	6.2	5.4	2.0	4.2	4.8
Latin America & Caribbean	3.3	5.7	4.2	-2.5	2.9	4.0

* Estimates

Source: IMF, World Economic Outlook, November 2009

II. The intermediate scenario: back to trend at snail's pace

In this scenario, the global economy could return to trend growth after a relatively short period of inventory-driven strong growth. The output lost during the recession would only be made up after many years. This would mean that unemployment stays elevated, wage growth muted and pent-up demand built up during the recession met only slowly. Thus, monetary authorities in developed economies could be more patient with hiking interest rates. As for emerging countries, rates would be hiked more quickly in this part of the world.

III. The pessimistic scenario: muddling through

In the gloomy scenario, monetary and fiscal stimulus and inventory rebuilding would provide only temporary boosts to the global economy. Credit would fail to flow freely as banks remain pre-occupied with building up capital and trimming their balance sheets. Consumers in developed economies likewise would continue to focus on deleveraging. They would therefore not take up their usual role as "leaders of the recovery". Since emerging countries are not fully decoupled from the developed world, their growth would disappoint. Official interest rates would be kept at rock-bottom levels and "unconventional" measures such as unlimited liquidity provisioning by central banks or outright asset purchases could even be extended or reintroduced. Countries or even regions could suffer from deflation. Growth could stay slightly positive due to low interest rates, but fiscal policy would be a drag on growth since governments would have to address the high deficits resulting from fiscal stimulus. Overall, trend growth rates could be expected to be adjusted downwards.

Our position

We are not in the optimistic camp. We expect the aftermath of the financial crisis to prevent a lasting strong recovery. But we are not overly pessimistic either since the improvements in the global economy that we have seen in recent quarters appear to be for real. This leaves us between the intermediate and the pessimistic scenario. In our view, deleveraging and deflation are risks for the global economy and monetary policy will likely be a source of uncertainty for investors and markets. Although governments would like to continue to support growth, an increasing number of countries are being forced by bond markets to announce budget austerity programmes. This should be a drag on growth in the coming years. ■

[1] The actual output gap was probably lower, as some production capacity may have been destroyed permanently in the recession.

Contribution by:
Joost van Leenders
investment specialist – investment strategy

What to expect from the climate

Even though the Copenhagen Conference did not produce the global climate treaty that many people were hoping for, several countries have agreed that measures should be taken to prevent average global surfaces temperatures from rising by more then 2°C by 2050. In this article Eric Borremans, head of SRI development at BNP Paribas Investment Partners, discusses how climate change could affect the mainstream asset classes over the coming years.

Although December's UN summit failed to produce binding emission reduction targets, the major emitters agreed a number of emission control and adaptation measures. Moreover, national targets for reducing CO_2 emissions by 2020 were submitted at the end of January and further concrete measures are expected by November when the parties meet again in Mexico. However, many investors still believe that the impact of climate change on individual investments will be akin to a lottery – impossible to predict, and with many more losers than winners.

The impact of climate change has already become clear in carbon markets, in which CO_2 has become a tradable commodity – it has a price, and although the markets are still fragmented and extremely volatile, they are set to grow dramatically.

The universe of companies involved in the environmental sector has also grown dramatically over the last ten years: from as few as 200 firms in 2000, there are now more than 1500 listed companies worldwide operating in sectors such as renewable energy, energy efficiency and pollution control, and they could all benefit from efforts to reduce greenhouse gas emissions. The increased size of the universe is also making it possible to build environmental indices, Exchange Traded Funds and structured products.

These emerging asset classes offer good opportunities, but many remain niche areas, typically representing only a fraction of an investment portfolio. But what about the bulk of an investor's asset allocation – large-cap equities and sovereign bonds? Leaving aside moral considerations, below we explain how investors have a lot to gain from incorporating considerations of climate change into their day-to-day investment decisions.

Equities

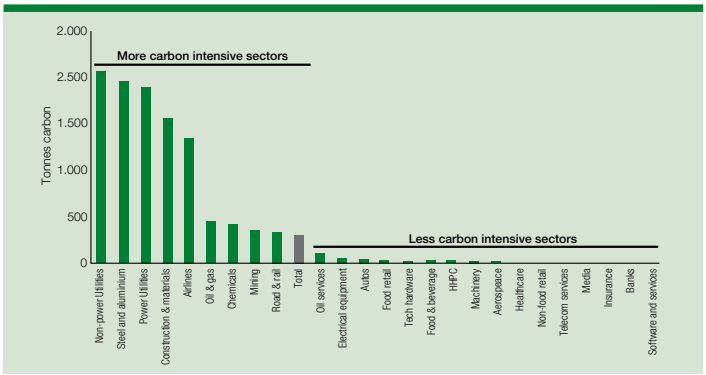
We need to ask ourselves three basic questions to better anticipate how climate change will affect large-cap equities. Which sectors and companies are likely to be most affected by the rising costs of greenhouse gas emissions? What is the likely impact of extreme weather events on firms' productive assets? And which companies are likely to take advantage of the fast growth of niche areas such as clean technologies?

Answering these questions is critical to properly understand all of the financial implications on individual companies. Paying for CO_2 emissions, for example, affects operating costs; building new, cleaner plants has a direct impact on capital expenditure; meeting consumer demand for cleaner products impacts turnover; and developing new products affects R&D expenditure. More fundamentally, we need to ask ourselves to what extent could climate change affect the very viability of some business models? Or will it favour the emergence of new ones?

If we plot the CO_2 emissions of industry sectors against their respective market capitalisation, we can easily rank them by their relative carbon intensity. Utilities, Steel & Aluminium, Construction & Materials and Airlines are some of the most carbon-intensive areas. These are followed by a long tail of sectors with much lower carbon intensity.

change lottery

Carbon intensity by sector



Source: Carbon Disclosure Project, Goldman Sachs Research estimates.

Power & Utilities

Electric Utilities are currently responsible for about 25% of greenhouse gas emissions in Europe. This is the single most important sector covered by the EU emissions trading scheme, which allocates allowances to emit a certain amount of CO_2, thereby forcing heavy emitters to buy emission allowances from those that reduce their emissions. This cap-and-trade system was launched in 2005 and was initially very generous. However, since 2008 it has been more stringent, and in 2013 the system is expected to be tightened again.

Studies show that projected CO_2 emission liabilities are set to account for a growing percentage of earnings. The differences are quite dramatic within the European Utilities sector and range from as little as 10% of earnings at risk to as much as 100% for those companies that are most reliant on coal or lignite to generate electricity. Winners and losers are clearly emerging.

Autos

The Autos sector has a relatively low carbon intensity compared to others, but this is misleading. Making a car produces one to two tonnes of CO_2 emissions. Over its lifetime, however, that car will emit 20-30 tonnes of CO_2, so the sector's indirect, product-related emissions are much higher than its direct emissions.

Regulation of vehicle emissions is becoming more stringent across the world, with Europe leading the way and China catching up quickly. Within Europe there are clear quantifiable differences between car manufacturers. An average Fiat car, for example, currently emits around 140g CO_2 / km, while a Porsche emits twice that level on average.

Financially, there are two ways of looking at this. First, the European Commission has set up a system of penalties for companies that exceed their emission targets. These can go up to EUR 95 per gram of CO_2 per vehicle, meaning that if a manufacturer misses its target by 10 grams then it would pay a fine approaching EUR 1000 per car sold. For a car manufacturer selling 2 million cars per year, this means a potential fine of EUR 2 billion.

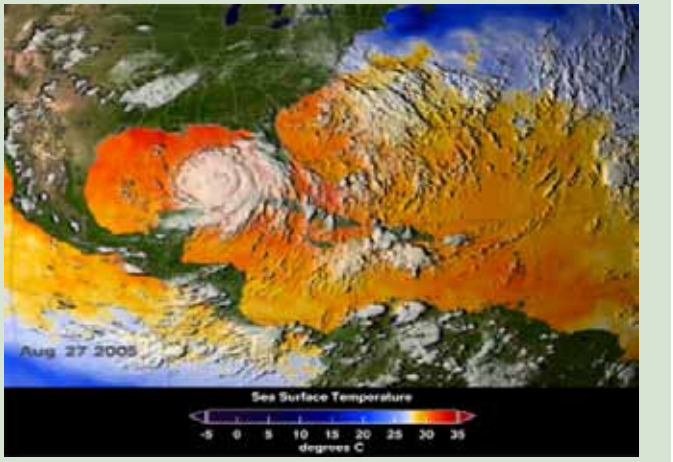
The other aspect that financial analysts need to consider is that some manufacturers are in a better position than others to meet consumer demand for clean vehicles. For example, Renault has embarked on an ambitious programme to launch commercial, fully-electric vehicles by 2012, which the company indicated could represent 10% of its sales by 2020. Meanwhile, several German manufacturers are pushing for hybrid vehicles, but some others have clearly come less far down the line. This is likely to lead to significant differences in revenues and earnings over the years to come.

Oil & Gas

Direct carbon emissions of the Oil & Gas sector arise from refineries, exploration, production and transportation. However, as with the Autos sector, product-related emissions can be ten times as high as direct emissions, such that the Oil & Gas sector by far exceeds all others in terms of carbon intensity.

What drives company valuations in the Oil & Gas sector? According to figures from Goldman Sachs, around half of a company's valuation is based on its proven reserves. We must also bear in mind that different fossil fuels contain varying levels of carbon – the carbon content of natural gas is around half that of coal and significantly lower than that of oil. The proportion of a company's reserves made up of natural gas rather than oil is therefore an important indicator for assessing hidden carbon liabilities in balance sheets. Some companies' reserves are made up of around 75% natural gas, going down to 30% for others. So the carbon liabilities of reserves, which themselves make up a significant chunk of a company's valuation, differ vastly. We believe this is something financial markets will increasingly have to take into account.

Meanwhile, extreme weather conditions could have a major impact on companies in the sector. For example, those with a high level of production in the Gulf of Mexico have already faced severe challenges from hurricanes, and this looks set to increase in the future. Companies with no presence in that region will be less exposed.



Source: National Oceanographic and Atmospheric Administration (NOAA)

Banks

Banks typically emit around three to four tonnes of CO_2 per employee per year, and this does not vary much between institutions. But if a bank finances, say, coal-fired power stations, its indirect CO_2 emissions would be much higher than a bank specialised in financing renewable energy infrastructure.

Therefore the most important factor in the banking sector is not direct emissions, but quantifying and assessing the exposure of individual institutions to carbon-intensive sectors on the one hand and "carbon-saving" ones on the other. Another critical issue is the assumptions that banks make about future carbon pricing when integrating carbon liabilities into their financial models. Reliable data here are lacking, but initial estimates suggest there are significant differences between European banks' exposure to fossil fuels and renewable energy projects.

Fixed income

Climate change is a source of risks and opportunities for companies, and we argue that this is also the case for sovereign bond issuers.

The Stern Review on the Economics of Climate Change in 2006 concluded that climate change, if left unchecked, could reduce global welfare per capita by 5% to 20% over the coming years. It also stated that if we act today to prevent climate change, the actual cost will be around 1% of GDP. So the global cost is expected to be between 1% and 20% of GDP – but this is an average figure as there are likely to be stark differences between nations. For example, Canada could benefit from higher crop yields as it gets warmer, whereas countries closer to the equator such as Brazil are likely to suffer. This is bound to have an impact on future economic growth and, therefore, states' creditworthiness.

However, if you do a search for "climate change" on S&P's sovereign credit rating methodology website you get no returns. So investors are faced with a fundamental problem when it comes to government debt: as yet there simply has not been enough research carried out to enable them to make an informed judgement about the impact climate change may have on individual countries and their future capacity to pay back their debt.

The way forward, in our view, is to develop a proper climate change assessment on a country-by-country basis that could be based on, for example, the degree of dependence on hydrocarbons, the proportion of renewables in energy production, and the socioeconomic effects of climate change (e.g. changing crop yields, public health impacts and catastrophic losses from extreme weather events).

How should the results of such research be applied? Consider two scenarios. A country with a strong credit rating but a very poor climate change assessment could see its rating downgraded. Similarly, a country with a poor credit rating but an extremely positive climate change assessment could see its rating upgraded. Again, further research is necessary to clarify and quantify the impact of climate on future economic growth and creditworthiness.

Conclusion

As investors search for climate change winners and losers, they might do well to consider a quote from Alfred Rappaport in 2005. "Financial analysts fixate on quarterly earnings at the expense of fundamental research… they believe that estimating distant cash flows is too time-consuming, costly, and speculative to be useful." Our major challenge is to reconcile our propensity to focus on the short term with the urgent need to focus on the bigger picture – the longer term. As we become more sophisticated we will be better equipped to ask the right questions and make the right investment decisions. At the start of this article we suggested climate change might be compared to a lottery: with unpredictable results and many losers. As it turns out, climate change opens up exciting opportunities for investors. And unlike a lottery, the outcome may be quite predictable for those who ask the right questions. There are reasons to be optimistic. ■

Contribution by:
Eric Borremans
head of SRI development

"In many crucial areas, the world is getting better."[1]

Fundamental shifts are taking place on technological, economic and sociological levels, which could profoundly alter existing industries and business models and lead to the emergence of new industries. For investors in the first group, change could be a threat. Equally, innovation could create investment opportunities.

From "emerging" to "emerged"

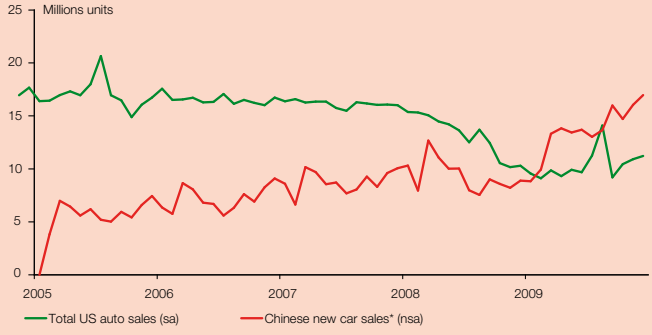
Every century has its dominating economic and political power: Great Britain in the 19th century and the US in the 20th century. The 21st century will likely see emerging markets come to the centre stage. This could be a source of challenges for developed countries and industries, but at the same time presents notable opportunities worldwide. Emerging markets have come through the 2008-2009 recession with surprising resilience. Their newly-found strength highlights the redistribution of the global economic power balance and has wide-ranging implications. Investors should take note of these promising trends.

- *Rising urbanisation:* emerging countries are experiencing a widespread move from rural areas to the cities, much in the way that was seen in developed markets in the first half of the 20th century. The challenges here include infrastructure investment as the rural population is absorbed. This involves a more equal distribution of state-led investments between cities and the countryside as is the case in China. Companies active in the infrastructure sector should benefit from this trend.

- *Developing a larger middle class:* economic development is driving the emergence of a middle class. As consumers adapt their eating habits towards more protein-rich foods, this should lead to a shift in agricultural production and retailing. New-found purchasing power means that sellers of consumer discretionary products such as cars and domestic appliances have bright days ahead of them. A clear sign of this trend is the fact that car sales in China have recently outpaced US sales (see chart below).

- *Environmental awareness:* as urbanisation rises and industrialisation advances, the pressure on the environment grows, but this is more and more accompanied by an awareness of the devastating effects of pollution. An emerging mentality change should allow companies active in areas such as waste management, water treatment and recycling to benefit from new market opportunities.

China/US car sales



* Passenger and commercial

Source: Bloomberg and Fortis Investments

[1] Bill Gates, remarks at the World Economic Forum, Davos; January 2008; www.microsoft.com

From "developed" to "mature"

Urbanisation, growing wealth and environmental issues feature in developed markets as well. In other areas, these countries are ahead, having to tackle structural developments and trends that will likely impact day-to-day life, but could yield investment opportunities of their own. We list a few prominent trends here.

- *Ageing population:* the baby-boomer generation is approaching retirement age in developed markets. This will have serious implications for the healthcare sector as well as related sectors such as adapted housing and leisure services.

- *Mobility:* road congestion issues and increased environmental awareness bode well for investments in transportation infrastructure. Mobile technologies are becoming an integral part of our day-to-day lives and significant advances are to be expected in this area including the greater use of eReaders and the spreading integration of GPS functionalities in devices such as mobile phones.

En route for greener and smarter

Technologically, the second half of the 20th century experienced a quantum leap. Only three decades ago, computers were in their infancy and developers could only dream of how "the magic of software" could change the world[2]. Fast-forward to the second decade of the 21st century and investors who spotted and acted on the promise of the PC and software industry then would now be celebrated as investment gurus. Below we highlight selected emerging industries and investment opportunities.

Light-emitting diodes (LED), smart grid technologies and clean batteries are already proving to be among the best-performing SRI investments. These technologies, and others like them, are vying to take over from mature industries. At the same time, within their own fields, there are battles about setting new industry standards. Many of these emerging technologies are in early commercialisation stages in a rapidly changing environment. However, as investment takes off and these solutions become better established, there should still be chances for investors to benefit.

SRI strategies – 2009 performance

Source: Fortis Investments

LED: TVs, lights and what next?

In April 2009, Samsung launched a range of cutting-edge and environmentally friendly LED TVs, leaving rivals such as Philips, Sharp and LG scrambling and kick-starting the mass production of LED chips. The continued development of LED technology paved the way for other advanced applications, such as LED lighting, to come to market. Although it is more energy-efficient, LED lighting is also still more expensive than conventional lighting. Still, recent results from Cree, a US-based leader in LEDs for lighting, have pointed to growing momentum. Organic light-emitting diodes are about to emerge. OLED screens can be used in mobile phones and other handheld devices. Compared to LCD screens, the OLED alternative is more energy-efficient. What's more, these screens are flexible. Kyocera's concept OLED cell phone can be folded like a wallet.

Power up for electrical vehicles

If it is to survive, the car industry must adopt stringent regulations on fuel efficiency. Electrical motors are emerging as a potential solution. These can convert around four times more available energy into motive power than traditional engines can. But to establish them in the car industry and among consumers, manufacturers need highly efficient batteries. Lithium ion batteries provide up to twice the power of nickel metal hybrid batteries and are cheaper to run. A few developers have already won contracts by major carmakers, including Samsung SDI of South Korea; Sanyo and Hitachi of Japan; A123 Systems of the US; and Johnson Controls/Saft, a US-French joint venture. Lithium ion batteries could be used in areas such as storing energy, opening up new markets. A Danish e-car charging network by utility Dong Energy and Silicon Valley start-up Project Better Place aims to store wind turbine energy at night within the network and use it during the day. Lithium ion batteries could be the answer here.

Smart grid and intelligent energy

The energy industry is on the eve of its next comprehensive infrastructure upgrade. Demand response, the two-way flow of electricity and information, is seen as one of the main goals. Smart grids need new devices and technologies such as smart meters, high-voltage cables and superconductors. US-based Comverge has already won a contact for its smart grid programme, shortly after securing USD 130 mln of government stimulus funding to roll out this technology across its entire service territory. Other examples include Itron of the US and Hong Kong-headquartered Wasion, which both supply advanced energy metering products. American Superconductor's technologies can enhance grid reliability, efficiency and capacity and include superconductor power cables. It has won its first orders from the US, China and Korea. ■

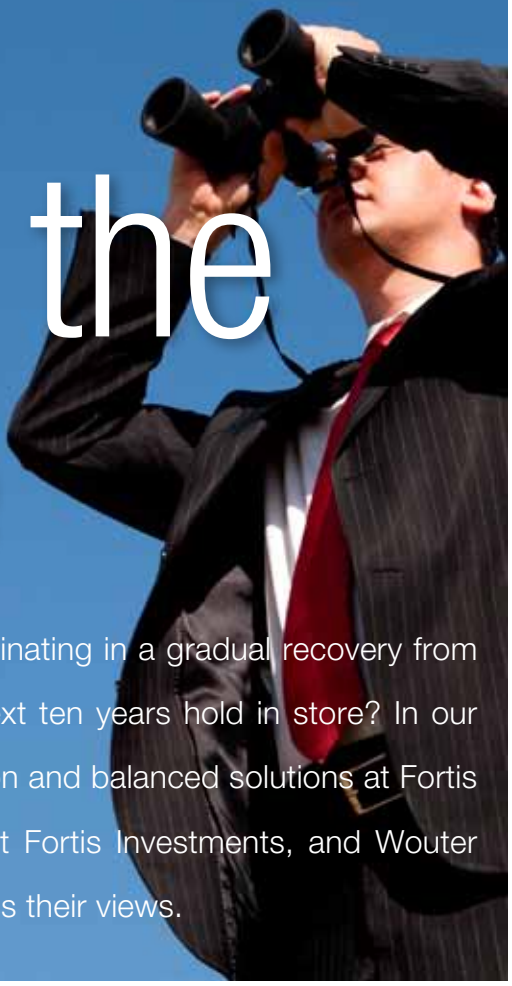
[2] Bill Gates, remarks at the World Economic Forum, Davos; January 2008; www.microsoft.com

Contributions by:

Charles-Henri Kerkhove
investment specialist

Stewart Armer
CIO, head of SRI

Peering into the next decade



The past decade has witnessed a number of ups and downs, culminating in a gradual recovery from the worst economic crisis in living memory. But what might the next ten years hold in store? In our latest roundtable Emiel van den Heiligenberg, head of asset allocation and balanced solutions at Fortis Investments, Gabriel Wallach, head of emerging market equities at Fortis Investments, and Wouter Weijand, head of high dividend equities at Fortis Investments, discuss their views.

Will growth continue to be driven by the emerging world? What will this mean for the global balance of economic and political power?

EvdH: The clear answer here is yes! I believe that emerging market growth and emerging market investments will be the theme for the coming decade. And we can say with some pride that we started pitching this idea early on (7-8 years ago) when not everyone was in agreement. There are several reasons for this. Emerging market balance sheets have never been better. Over the coming decades these countries will become much greater forces in the global economy as their growth will continue to outpace developed world growth. Rising commodity prices are supportive of emerging markets and vice versa, while deflationary pressures in the developed world are not necessarily bad for emerging growth. We expect long-term capital flows in favour of these regions, prompting major currency realignments. Current emerging equity valuations are not cheap but they still do not reflect how positive fundamentals are. In the end we believe that emerging assets will end up in a bubble, with extreme valuations, extreme positive positioning and very strong capital flows. Eventually, they will correct. However, we believe we are not at that point yet or even close to it. Emerging valuations are only neutral and, yes, bullishness about emerging markets is consensus, but there has been no extreme build-up of positions (like there was in the TMT bubble).

Weijand: The economic rebound in the Western world will continue, but structurally, global economic growth will increasingly be led by the emerging world and, gradually, political power will become more evenly spread. I see this as a positive as it could reduce frustration within the emerging world and lead to more balanced decisions by global governing bodies.

Wallach: The emerging world, particularly China, will certainly grow at a faster pace than the developed world and consume more resources and durable goods than in the past, offsetting some of the current weakness in the US and Europe. However, the USD 14.2 trillion US economy remains a major contributor to global GDP and growth, and has recently expanded at an annual rate of 5.7%, leading to a sharp rebound in exports from Asia. This is certainly a reminder that the world is better off with two growth engines than one. The global balance of economic and political power will continue to evolve as having one superpower and one reserve currency is not ideal. The United States inherited this status, first with the collapse of the British Empire and then of the Soviet Union. This is partly the reason for the severe economic imbalances since the early 1990s and the recent credit crisis. The creation and recognition of the G-20 as an economic bloc is a move in the right direction.

Are commodity prices going to continue to trend upwards? Are they a good long-term investment?

EvdH: This is actually two different questions. Yes, we do believe that commodity prices are generally trending upwards, for the following reasons: there is high demand for commodities from emerging markets (where GDP growth is much more commodity-intensive than in the developed world), high investor demand for commodities, underinvestment in commodity supply (mining, oil extraction), the rate of depletion of existing oil fields is higher than expected, and there are rising geopolitical tensions, increasing the marginal production cost of commodities, many of which are mainly to be found in the more "difficult" countries. But whether this will lead to strong returns for a buy-and-hold investor is debatable. The commodity indices are mostly in contango – a negative roll yield – which means it costs money to hold these futures over time. This will mitigate the positive spot return on commodities. So timing investments – both buying and selling – will be important to benefit from the rally.

Wallach: Commodity prices will remain strong as China maintains its insatiable appetite for resources. It is growing rapidly, urbanising and moving up the value chain – all at the same time. Commodity stocks should generate decent returns over the next few years as supply constraints lead to stable or rising prices.

Weijand: Commodities themselves are not a good investment in my view as they are highly volatile and do not provide a yield or an income. Commodity stocks are a better way to gain exposure to raw materials, although we should not generalise. Supply and demand conditions vary greatly amongst the various commodities. The concentration of a number of rare metals in China and of cheap oil and gas in countries that do not always seem friendly or stable is worrying. Agricultural commodity prices could be volatile because of changing climate conditions, and fresh water will be more scarce in the future.

Is inflation or deflation likely to be dominant? Does all the monetary expansion we've seen make inflation the more likely outcome?

Weijand: Inflation can result from rising demand for labour or higher capacity utilisation rates, as well as rising input (commodity prices) costs. While I don't exclude the possibility of deflation, inflation is unlikely in the short term given high and still-rising unemployment in the Western world and economic activity that generally isn't particularly buoyant. Inflation is more likely to occur in the emerging world, especially China. Elsewhere, deflation should generally make way for modest inflation given the expansionary monetary environment.

Wallach: The primary purpose of the massive monetary and fiscal stimulus in 2008-09 was to generate inflation – and the headlines are certainly pointing to concerns of rising prices. Central bankers have been successful in achieving some pricing power in the economy and preventing a 1930s-style deflationary bust. The unwinding of this stimulus in 2010 will be difficult, and risks plunging developed economies back into recession and asset deflation. Hence, I don't believe they will be quick to change direction. Inflation will probably be more of a dominant theme in Asia and Brazil as economic growth rebounds.

EvdH: We firmly believe that inflation is not so much a monetary phenomenon as a business cycle phenomenon. Deflation will remain the main issue as there will be loads of slack in the system and spare capacity will keep inflation low. The impact of economic slack is becoming most clearly visible in the labour market, where average weekly earnings growth has slipped to an all-time low. With unemployment at its highest level since the 1980s, downward pressure on wages is set to continue. As Mervyn King, Governor of the Bank of England, said early last year, recovery will have no immediate impact on inflation. The massive monetary expansion we have seen will push up real yields at some point, especially when corporates want to lend money as well (as governments will then have to compete for money).

What will be the long-term effects of government debt and deficits?

EvdH: Public debt to GDP ratios are set to surge higher over the next four years, with structural problems most acute in Japan, the UK and Ireland. To get debt ratios back to 60% by 2030 will require a decade of tightening by 1% of GDP per year, followed by another decade of primary surpluses at around 4% of GDP. This needs to be corrected over time. In my view this will mean lower long-term growth, higher risk premiums and higher real interest rates.

Weijand: The longer-term effects will be tax increases and cuts in government expenditure to restore the fiscal balance. We will all have to pay for this huge intervention, so longer-term growth may indeed be held back by this.

Wallach: Developed market currencies, particularly the euro and sterling, will remain under pressure as debt levels and spreads rise.

What will be the long-term effects of stricter regulation of the financial sector?

Wallach: Higher transaction costs. Since 1981, the deregulation of the financial sector and globalisation of capital have resulted in lower costs for businesses, governments and consumers. Higher taxes and stricter regulations on sources of funding and the types of activities that financial institutions can engage in will inevitably result in higher costs for all types of transactions, including hedging and mortgages.

EvdH: This is a difficult question as at this time there is still limited visibility on what kind of regulation will come out. The good news is that the world will become a somewhat safer place, with smaller banks, lower risk of contagion, more regulation and better solvency. The bad news is that this will decrease profitability, long-term growth, credit creation and, therefore, it will mean lower investment returns in the years to come.

Weijand: Stricter regulation, I hope, will come in the form of higher core tier 1 requirements, reducing the leverage of financial institutions but not necessarily forbidding certain activities by banks or splitting them up.


"Emerging market investments will be the theme for the coming decade"
"Commodity stocks should generate decent returns over the next few years"
"By adapting a long-term view, we can focus on misvaluations and return opportunities."

Which assets do you think are going to prosper over the next ten years?

Weijand: Bonds might not prosper from these low yield levels, and neither will cash. Equities, and dividend stocks in particular, with their superior yield to bonds (which is an exceptional characteristic) are likely to outperform over time, also given their scope to raise the "coupon" and show capital growth from current levels. Hence convertibles should also be expected to deliver reasonable returns. Property could suffer a bit longer from the weak cycle and the rebound in stock prices may have come slightly too quick. As a late cycle play, the sector may need more time to digest the adverse trading conditions of the underlying bricks and mortar. Investment-grade corporate bond spreads may have some more room to narrow, as do those of high-yield credit, but the majority of the contraction from the peak a year ago must now be behind us.

EvdH: Our Smart Benchmark research is quite clear on this. Risk premiums will be lower than average because the valuations of developed equities are above average. The exception is emerging equities, emerging fixed income and emerging currencies for the reasons I discussed earlier. High yield should produce an average return over the long run as spreads are average fair value and rising real yields should have a limited impact on them. Bond returns will be low as real yields will rise. So alpha, hedge funds and absolute return strategies will become relatively more interesting (compared to beta).

Wallach: In short, Chinese equities.

Is it even worthwhile attempting to predict the long term?

EvdH: Definitely! We believe and have shown that long-term returns can be substantially improved by adopting a dynamic approach to strategic allocation. The main idea is that strategic allocations should not be completely static, but should depend on the medium-term return and risk expectations of different asset classes. Over the medium to long term, valuations matter. Expected returns of assets differ according to whether you buy them when they are cheap or expensive. We believe valuations mean-revert over a business cycle. By adapting a long-term view, as we do with our Smart Benchmark Model, we can focus on these misvaluations and return opportunities. These are opportunities that most investors do not exploit as they have too short a time horizon.

Weijand: It never hurts to think over the longer term, but then often, like in the equity market, things happen quickly and you have to act on that. Still, there are a lot of subjects that require longer-term thoughts and discussion. For example, the stability of the euro – I believe the euro will change its current format at some stage (maybe it will split into a northern euro and a southern euro), although that could be many years away. Which countries should be part of Europe, culturally and economically? Could the US be downgraded to single A in five years? Will the renminbi again trade at 4 to the dollar, like in 1994? ■

Contributions by:

Wouter Weijand
head of high dividend equities
at Fortis Investments

Emiel van den Heiligenberg
head of asset allocation and balanced solutions
at Fortis Investments

Gabriel Wallach
head of emerging markets equities
at Fortis Investments

Plain and simple: targeting capital preservation

The financial crisis, the global economic slowdown, and the market volatility that accompanied these developments, have sparked a review of asset allocation approaches, putting the spotlight on investment characteristics such as quality and liquidity. Transparent, low-risk investments, closer risk management and capital preservation feature more prominently in discussions about the world of more risk-aware investing after the Great Recession. The reassessment appears to favour putting alternative investments on the backburner to the benefit of products typically seen as liquid, such as money market funds or even deposits. Closely regulated and well-defined products look to have a newly found lustre.

In prudent investment management, considering market volatility and the risk of investment loss could cause investors to give a higher weighting to protecting assets as a strategy, paying more attention to, for instance, unleveraged products. With aggregate risk hard to grasp, risk budgeting could make sense: looking at the individual risk components, setting limits on acceptable risk levels and allocating the individual investments accordingly. Thus, risk becomes the key driver of the targeted capital preservation, determining the exposure investors are willing to take to earn returns, rather than return targets being pursued at the expense of risk.

Targeting capital preservation need not entail a broad retrenchment. Instead of avoiding volatility, investors can opt for strategies managing volatility. Below, we discuss volatility as a "hidden asset class" and one such strategy. While among alternative investments, absolute return products suffered from converging correlations in the financial crisis and the downturn, lessons were learnt. We discuss the improvements made. A more classical approach can include seeking to preserve capital through inflation-linked products: below, we discuss the simplicity and clarity of inflation-linked bonds. Finally, we highlight the attractions of products offering downside protection such as the increasingly popular target-date or target-click funds.

Volatility: a hidden asset class

Volatility as an asset class is underexplored and can offer attractive risk premiums. The buyer of volatility (i.e. in the form of options and variance swaps) buys protection, paying a relatively small premium and thus putting only a small amount at risk. The seller is willing to take the risk, setting aside significant capital as collateral to meet capital requirements. Typically, the investor will be a seller of volatility, while the end-buyer will be a hedger. For an investor to capture the volatility risk premium, he needs a liquid volatility-linked instrument such as an option. The closest to an ideal "clean" volatility product is a variance swap. A prudent investment in volatility should be dynamic to "normalise" the distribution of returns, paying attention to diversification. This follows traditional lines: a larger pool of exposures that are as uncorrelated as possible. Alternatively, one could opt for investing in the volatility of an index such as the S&P 500 or the EuroStoxx 50, i.e. targeting the volatility of the constituents and their correlations.

By running a well diversified portfolio of short positions in plain vanilla stock options, an investor can earn premium income as a seller, at the same time holding long positions in variance swaps to have downside protection. Since a long position in a variance swap profits more from an increase in volatility than it loses from a decrease in volatility, there is protection in adverse market scenarios. To contain portfolio risk, there can be limits on the exposure to any single stock, investments should be diversified geographically and over sectors and currency exposures should be hedged as much as possible. A well diversified portfolio of volatility positions can thus offer attractive returns, while being transparent and liquid.

Absolute return lessons – closer tabs on risk and exposure

The concept of absolute return is returning to the fore again as investors grapple with low interest rates and search for alpha, in particular within the fixed income asset class. Many lessons have been learnt over the course of the recent cycle that should ensure that the evolution of this investment style continues from strength to strength. The style is characterised by the ability to operate in an unconstrained, i.e. benchmark-free, fashion, further cemented by the liquidity of fixed income derivatives, both within the Treasury futures market and the ever expanding CDS market. This makes it easier to not only capture opportunities for alpha investment returns, but also helps to ensure access to the necessary liquidity in managing the risks of such typically active positions. The flexibility of the approach and the use of highly liquid instruments should allow for the smooth management of performance drawdowns, which is essential to preserve capital.

Our top-down risk budgeting style has evolved. It now includes the expected shortfall, or 'tail event', within the allocation to specific risks. This makes it easier to identify low-volatility high-tail risk trades. We believe one should also include the maximum expected shortfall in the overall calculation of expected risk. This maximum is arrived at through a series of stress tests. The approach ensures a process whereby one can clearly distinguish and manage between types of trade: carry, mean reversion or trend-following, and the expected alpha. This helps in avoiding unintentional directional bets in the overall portfolio, allowing for improved control and optimisation of the correlations of the various risk positions.

Clear and simple: inflation-linked bonds

Offering a coupon and nominal value tied to inflation, inflation-linked bonds (linkers) can help investors deal with capital preservation issues such as wealth erosion. Over time, they have been shown to entail lower risk for a given level of expected return than traditional bonds.

The difference between nominal and expected inflation is one of the main drivers of return for linkers. When real, inflation-adjusted rates are expected to decline – for instance when GDP growth expectations are cut – and/or inflation is expected to accelerate significantly, linkers have been seen to outperform traditional sovereign bonds. Timing the investment in linkers is important. This is obvious when we consider that real rates on 10-year AAA-rated euro sovereigns in the eurozone have moved between 1% and 3.5% over the last 10 years. The entry point is a key element for optimised expected performance. When 10-year real rates rise to 2% -- not expected in the next 12 months for German linkers where the yield is 1.45% now – we would recommend using linkers for capital preservation purposes. Diversification of a bond portfolio by adding linkers can also make sense because of their low correlation with traditional bonds.

Linkers could be suitable for investors seeking to protect their long-term purchasing power; companies whose revenues are tied to price indices; bond portfolio managers looking for tactical diversification; and long-term investors, such as pension funds and insurance companies, whose payments are linked to price indices.

Lifecycle: returns and limited downside

Increasingly individuals are faced with the challenge of making sound investment decisions for their financial future themselves as they realise that they cannot rely entirely on state and employer pensions anymore to support their desired lifestyle after retirement. Institutions are seeking to provide customers with capital guaranteed products with the potential for attractive returns, particularly in light of the 18% drop in the value of pension assets globally in 2008[1]. Thus, for those doing their own provisioning and for those such as pension funds who are striving to ensure that the future financial needs of a group can be met collectively, capital protection has become a central theme.

Lifecycle products can help meet these needs, offering capital protection and attractive potential returns in a single package. Such products are becoming more popular, in particular in the US. Their structure means that investment risk is adjusted as the maturity date approaches: the focus shifts to typically more risk-averse instruments such as bonds, scaling back the exposure to risky assets. Lifecycle investing is suitable for investors who want to build up capital in a straightforward way to meet future financial needs such as pensions. It can also play a role in the post-retirement market for investors who want to remain active in the equity market, while providing an income stream in their retirement. These “decumulation” solutions are emerging as a key area in the lifecycle space.

Lifecycle and in particular guaranteed target date products can allow institutions to align their fiduciary duties by explicitly safeguarding clients’ assets. We distinguish between three types lifecycle investing: target risk (self managed), target date (automatic risk reduction) and guaranteed target date (automatic risk reduction with a built-in guarantee). The benefits of the guaranteed target date funds in protecting capital were clearly demonstrated in the market downturn of 2000-2002 and again in 2008, both in terms of the development of the guarantee and the net asset value.

Contributions by:

Dominique Mousset
senior fixed income specialist

Daniel James
product CIO absolute return fixed income

Ronan O’Riordan
investment speciailist TCF

Nail Shamsutdinov
investment manager volatility

[1] Source: International Financial Services London: Pension Markets 2009

Emerging markets in 2010 – a

The last decade has rightly been named as the decade of emerging markets, as evidenced by strong growth in their equity market capitalisation. From less than 5% of the MSCI World index in 2000, the proportion of emerging markets has risen to 13% of the index today (as at 31 December 2009). More impressive however has been emerging markets' growing weight and influence in the global economy: as a group, they account for more than a third of total global gross domestic product (GDP) in US dollars today.

Emerging markets can be difficult to define. In investment circles, the term refers to a group of 'investable' countries outside the G7 industrialised nations, in which investment returns are expected to be higher in line with their purportedly higher risk premium. But in fact, it is a disparate group. While giant economies in the group are approaching the industrialised nations in many ways, some emerging markets remain more "emerging" than others.

Definitions may vary per index provider. MSCI uses three criteria: economic, development, size and liquidity to determine whether a market is "emerging" or "developed". Emerging markets are defined as those whose GNI per capita is less than a 25% premium to the World Bank threshold (2007: USD 11,456).

The MSCI Emerging Markets index is a free-float adjusted market capitalisation index designed to measure equity market performance of emerging markets. As of June 2009, the index consisted of 22 emerging markets country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, South Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

Source: www.mscibarra.com

Going forward, as the largest emerging countries confirm their seat at the table of global negotiations and policy-setting, we expect investors to focus more on individual or thematic opportunities as emerging markets become a structural part of a portfolio. To guide investors, we are providing this overview, focusing on the three major emerging market regions and highlighting the largest emerging market by equity market capitalisation and GDP.

The Americas – samba!

Latin America was for a long time the quintessential emerging market region and one in which, until last decade, investors had endured a roller coaster ride due to relatively high economic volatility. However, their patience is now being rewarded. As the stand-out emerging market in the region, Brazil dominates in economic, societal and stock market terms. For many years, the country was plagued by high inflation and frequent currency devaluations. However, the situation has turned around dramatically in the last five years. Good economic management, including strict inflation targeting by the independent central bank, stable politics with the nation rallying around the popular President Lula and the good fortune of having some of the world's largest raw material reserves have helped. Brazil's GDP has grown to USD 1.64 trillion and is expected to grow at 5% next year, while debt as a proportion of GDP has shrunk, with external debt becoming negative, net of currency reserves.

The virtuous cycle of economic management has bolstered confidence and laid the foundation for sustainable economic growth, leading to an investment and credit boom. GDP per capita in Brazil is set to become one of the highest in Latin America, as Brazilians have become richer and

new cycle begins

high wealth disparity is now starting to decrease. An urban middle class is focusing on aspirational needs – buying new homes, consumer goods and travel. The commodity cycle – a long-term structural driver for emerging markets as a whole – is expected to contribute to steady economic growth over the next few years. The discovery of oil reserves by the national champion Petrobras should turn Brazil into a net exporter of oil in two to three years' time and support infrastructure projects. The icing on the cake will be the 2014 Football World Cup as well as the 2016 Olympic Games, which are expected to drive infrastructure spending and retail sales. Elections in October 2010 could, however, be a catalyst for market volatility.

Brazil

Facts:

- **Market capitalisation: USD 534 bln**
- **Earnings growth 2010E, 2011E: 25.7%, 20.2% (source: Credit Suisse, IBES)**
- **P/E 2010E, 2011E: 12.9x, 10.8x (source: Credit Suisse, IBES)**
- **Top-5 listed companies: Petrobras, CVRD, Banco Bradesco, Itau Banco, Ambev**

Countries	Population (million)	GDP (USD bln)
Brazil	186	1,637
Mexico	106	1,085
Colombia	48	243
Argentina	41	328
Peru	28	128
Venezuela	28	332
Chile	16	245
Ecuador	14	108
Bolivia	10	43
Paraguay	7	29
Uruguay	4	43
Central America	75	615
Caribbean	40	396
Other	2	20
LatAm	**605**	**5,253**

Source: IMF; November 2009

Emerging Europe – recovering from deep recession

EMEA has been viewed as the laggard in recent years and underperformed the other emerging regions in 2009 as contagion effects from the West held the region in their grip. However, growth should improve substantially in the wake of a large amount of global de-leveraging, with a significant part of the global economy committed to fiscal stimulus and global interest rates forecast to stay low. However, there are likely to be large differences within the region; only Russia is seen as having the potential to grow faster than the consensus.

For Russia, the largest of the EMEA markets, 2010 looks promising with GDP growth estimated at around 5%. Both consumption and investment are likely to be supported by "spillover effects" from higher oil revenues, improving confidence and easing financial conditions. The corporate sector is expected to enjoy better access to external financing, while domestic banks, after a sharp phase of deleveraging, are expected to restart lending from early 2010. With the central bank of Russia having cut the benchmark rate by 400 basis points in 2009 and with liquidity continuing to improve, leveraged sectors and industries such as materials, telecommunication services and developers should feel major relief from lower interest expenses. Earnings estimates for 2010 are expected to rise by around 40% and this momentum should extend into 2011.

Russia

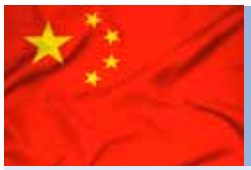
Facts:

- **Market capitalisation: USD 223 bln**
- **Earnings growth 2010E, 2011E: 34.9%, 47.4% (source: Credit Suisse, IBES)**
- **P/E 2010E, 2011E: 5.7x, 8.4x (source: Credit Suisse, IBES)**
- **Top-5 listed companies: Gazprom, Lukoil Holdings, Sberbank, Norilsk Nickel, Rosneft**

Asia-Pacific – the dragon's back

Asia is the largest of the emerging regions in market capitalisation terms and has had its fair share of boom-bust cycles, culminating in the Asian financial crisis of 1998. Asia learned its lesson well, not least the world's most populous country, China, which embarked on a period of economic reform from as early as 1979. China's success at manufacturing goods for export around the globe has seen its currency reserves balloon to over USD 2.25 trillion. For many years, these have been used to modernise the vast country from North to South and more recently from East to West. This is most noticeable in urbanisation. At around 40%, the proportion of China's population living in urban areas is lower than developed economies of a similar size, although it is growing at a rate of more than 2%. This translates into about 20 million people moving to cities each year, creating demand for new housing, appliances, transport infrastructure and sustainable power generation.

Fixed asset investment, a major contributor to China's GDP growth (but not exports, as is commonly thought) is forecast to rise by 24% in 2010. GDP has grown by 10% on average over the last 10 years. After a period of weaker growth in 2009, it is expected to rebound in 2010 and 2011, with strong domestic demand to continue as the main driver. The focus going forward should be on moving up the value chain in manufacturing – China is already producing Airbus jets under licence – and on sustainable development. In fact, 30 years after Deng Xiaoping's pragmatic reforms opened the country up to the world, China is apparently succeeding in its attempt to change its 'growth mode' towards a modern consumer economy. The prize will likely be the no.2 ranking in world economic terms ahead of Japan by the end of this year.

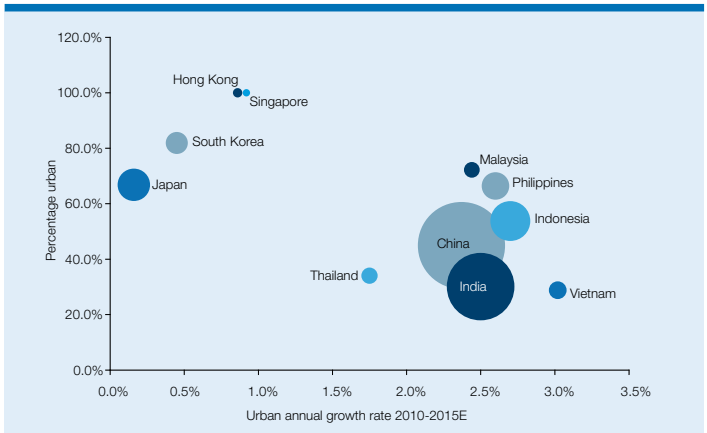


China

Facts:

- **Market capitalisation: USD 540 bln**
- **Earnings growth 2010, 2011: 22.2%, 16.8% (source: Credit Suisse, IBES)**
- **P/E 2010, 2011: 13.4x, 11.4x (source: Credit Suisse, IBES)**
- **Top-5 listed companies: China Mobile, China Construction Bank, Industrial and Commercial Bank of China, China Life Insurance, Bank of China Ltd.**

Urbanisation projections for 2010-2015 (bubble = total pop.)



Source: UN Population Division; end 2007

Must-haves and potentials

The emerging markets are a diverse set of countries at different stages of economic development. However in each region, one country stands out as the dominant force driving future development and acting as a magnet for foreign investment, with its success often rubbing off on its neighbours. The giants in the emerging market universe – Brazil, Russia and China – have already developed to such an extent that "emerging" could arguably have become inaccurate.

We expect long-term structural trends to continue to favour their development and attract even more financial flows in 2010, so investors that are not exposed to these countries in their portfolios could miss out on a rich source of returns. As the emerging giants increasingly modernise, these investment destinations are clearly far too big to ignore. They should form a commensurate part of equity allocations in portfolios. Meanwhile, as the driving economic force in their respective regions, their success may be repeated and enable peripheral countries to enjoy their time in the sun as well. ■

Contribution by:
Simon Godfrey
investment specialist - emerging markets

Local perspectives

From Singapore

With low interest rates, appreciating currencies and spiking property prices, what are Asian investors currently looking for? Real assets such as gold and property were popular last year, but investor sentiment has improved since then and interest in mutual funds has gradually picked up, especially in Hong Kong and Singapore.

After the collapse of Lehman Brothers, demand for structured equity products fell in the region. From an asset allocation perspective, global financial institutions have a mixed view on the direction of the markets. There is renewed interest in US and European equities, but the rally in Asian equities has not stopped Asian investors from seeking opportunistic investments in the region. Given recent performance, countries such as Japan and Indonesia are drawing particular attention, while there has been some profit taking in Russian and Latin American equities.

Asia seems to be moving quicker than developed countries in terms of hiking interest rates, and there has been a great deal of speculation about Asian currencies appreciating. Bonds denominated in local currency are currently popular with Asian investors. Rather than chasing high commodity prices, Australian and Indonesian equities are also popular as they are highly correlated with commodity returns. Meanwhile, non-resident Indian investors still see the attractiveness of local convertibles, even though their yield has dropped slightly compared with last year. Historically-low interest rates and expected volatility in the stock markets mean that investment-grade credit is still on the radar, but investors are taking a somewhat more cautious stance on this asset class.

Like elsewhere in the world, Asian investors continue to look for yield and for ways to hedge expected inflation. High income products are gaining in popularity having lagged for some time.

Finally, Asian investors have never forgotten China due to its increasingly important global role. Renminbi-denominated bonds – either short-dated or medium-term – are experiencing high demand due to the potential appreciation of the Chinese currency. Meanwhile, the high demand for a recently-launched Chinese environmental equities fund in Japan has shown that Chinese equities are also an attractive option.

Contribution by:
Mabel Chan
Singapore

From the UK

After 2009 – a year that turned out to be one of the best on record for risky assets – UK institutional investors are expecting a return to a more "normal" market environment in 2010. Despite something of a recovery in asset values, particularly in the second half of last year, liabilities have continued to rise, leaving a funding gap that remains a major concern for UK pension schemes. Although many schemes have implemented some form of LDI solution to mitigate this problem, the fall in yields on AA-corporate bonds (one of the key measures for pension liabilities in the UK) has had a significant impact on liabilities.

As we move into 2010, UK pension schemes are likely to focus on the return-seeking assets in their portfolios, driven by an increased awareness of the need to diversify both within and between asset classes and for a greater focus on risk management. For many schemes, this will manifest itself in an appetite for absolute return funds – particularly in areas such as Dynamic Asset Allocation or Diversified Growth Funds, in which managers allocate between different asset classes to generate a return in excess of cash.

Elsewhere, there is likely to be demand for "alternatives" such as currency, Global Tactical Asset Allocation and hedge funds, as well as real assets such as infrastructure, property and commodities, which offer long-term real return potential. Within equities, the trend of reducing allocations to domestic stocks in favour of global equities looks set to continue for the foreseeable future. Typically in a global equity portfolio, investors are looking for returns in excess of 2% over the MSCI World index, but they are willing to adopt a more "unconstrained" approach for part of their portfolio. We are also seeing a significantly greater focus on emerging markets, with UK institutional investors actively considering allocations to both emerging market equity and debt in their return-seeking portfolios.

Finally, from a structural perspective, one of the key trends in the UK pensions market is the closure of Defined Benefit (DB) schemes, and a shift towards Defined Contribution (DC) schemes. There is considerable scope for innovative solutions and the opportunity to make "DB-like" investment capabilities available for investment by DC scheme members. Funds in the diversified growth universe as well as target-date vehicles are likely to be of increasing interest as they address some of the needs of the DC market.

Contribution by:
Deborah Harris
London

What are investors around the world interested in for the year ahead? We canvas the opinions of four representatives from Fortis Investments around the world to find out what is popular in their locality.

From Turkey

Like almost all other economies, Turkey was affected by the global financial crisis in 2009. The economy contracted by an estimated 5-6%, while interest rates and inflation fell sharply to their lowest levels in 30 years as a result of contracting domestic demand. Turkey has recently enjoyed a rating upgrade from Fitch and Moody's thanks to its relative resilience during the global financial crisis, and this year Turkey is expected to post higher growth than the other eastern European economies.

Against this backdrop we will be focusing on structured products and pension funds in 2010. The Turkish mutual fund market is currently highly concentrated in money market funds rather than equity funds, mainly due to historically relatively high interest rates, which offered investors sufficient returns with limited risk.

However, money market funds no longer look so attractive due to lower interest rates. After the negative sentiment in the markets between 2007 and 2009, many investors are now looking for ways to invest in financial markets with less potential downside and a capital protection mechanism. Structured products are seen by many as the perfect solution to this demand. The first structured product in Turkey appeared in 2007, and since then several more have been launched such that the market has reached around EUR 200 million in size. We believe there is high potential for these products to grow strongly in popularity in 2010, and we plan to launch around ten new vehicles this year to help satisfy investor demand.

We also expect the pension fund market to expand in 2010. The Turkish population is relatively young, with over half of people under the age of 35, and the number of contributors to pension schemes is increasing rapidly. Total assets in the system now exceed EUR 4.5 billion. We expect investment solutions for the pensions market (such as lifecycle funds) to be popular this year.

From Russia

Despite the stellar performance of the Russian market in 2009 (the MSCI Russia was up 104.91% last year), valuations remain attractive and Russian equities are still among the cheapest in the emerging world. This has led to a strong preference for the domestic stock market among the majority of Russian investors, although certain institutions are choosing to limit their exposure to equities. Fixed income is not really on the menu at the moment as inflation is likely to rise later in the year and the central bank has cut rates fairly aggressively recently. The derivatives market is still in its infancy and is a long way off becoming a staple asset class for mainstream investors, whereas real estate is slowly but surely becoming more fashionable.

Russian investors incurred major losses in late 2008 and early 2009, but since the middle of last year they have been asking us to increase their exposure to equities as they attempt to recoup their losses. Investor appetite for Russian equities is increasing for good reason. Macroeconomic conditions are favourable, commodity prices strong, domestic demand recovering and the US dollar weak. Meanwhile, Russia's risk spreads relative to its emerging market peers have contracted sharply, boosting performance.

Investors seeking exposure to Russia believe that they will be rewarded for the risk that investing in an emerging market involves. Such countries are better poised for post-crisis growth than developed markets, with GDP and output figures already demonstrating this point. Large consumer bases underpin growth in domestic demand, even as government stimulus measures are withdrawn. In Russia, investor optimism stems from the significant growth in trade with China as well as its abundant natural resources, such as some of the world's largest reserves of oil, natural gas, nickel and palladium. ■

Contribution by:
Burak Altinsac
Istanbul

Contribution by:
Vladimir Vladimirov
Saint Petersburg

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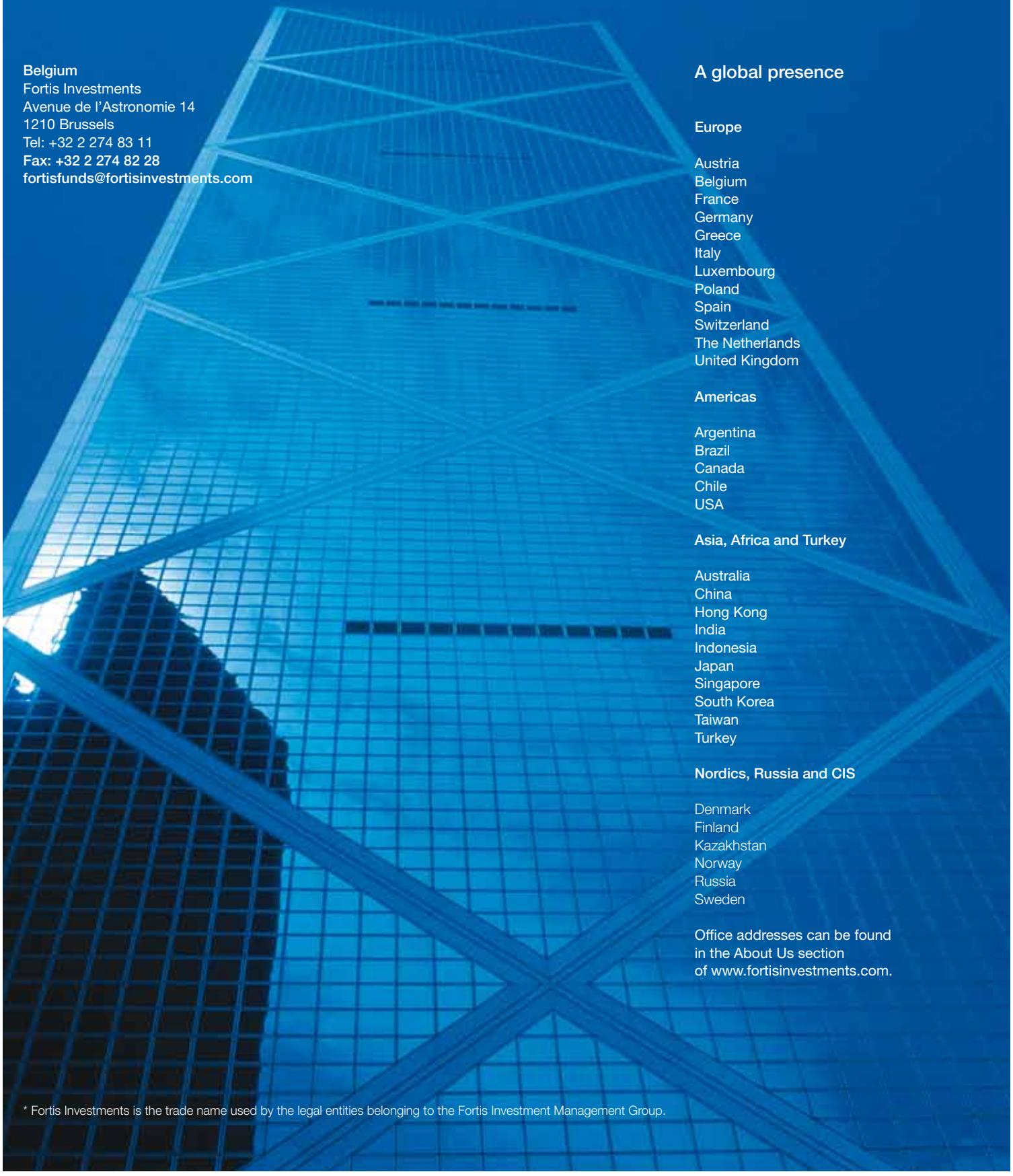

Belgium
Fortis Investments
Avenue de l'Astronomie 14
1210 Brussels
Tel: +32 2 274 83 11
Fax: +32 2 274 82 28
fortisfunds@fortisinvestments.com

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South Korea
Taiwan
Turkey

Nordics, Russia and CIS

Denmark
Finland
Kazakhstan
Norway
Russia
Sweden

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