Not All Emerging Markets Are Created Equal
Principal Global Investors is pleased to again partner with CREATE-Research, by sponsoring this, our sixth annual asset management research report. Professor Amin Rajan, chief executive of CREATE-Research, is one of the most respected commentators globally on the subject of asset management. Principal Global Investors’ participation in the annual report series is especially valuable in light of today’s rapidly changing markets across the globe. Fast-moving technology, increased market integration, broader globalization of asset managers and macroeconomic and regulatory changes help ensure that investment trends shift more quickly than ever. That makes an annual assessment, such as this report, even more timely and valuable.

This year’s report presents Professor Rajan’s most recent research findings, and examines whether emerging economies in the East and South and the developed economies in the West will converge or diverge over this decade. Over the last decade, emerging markets have experienced very rapid growth and investors have enjoyed attractive returns on their bond and equity investments, much of which was driven by growth in China. However, in this decade, emerging economies’ growth has slowed and asset values have been negatively impacted as foreign capital dissipated when the Federal Reserve decided to taper the quantitative easing program.

The study behind this report reveals a consensus that, during this decade, convergence between the East and West will become more prominent in two areas: market structures and investment approaches. Investors are becoming more discerning, changing the landscape of emerging markets investing. Additionally, the demographics of ageing populations with an eye toward retirement and those investors who are interested in a buy-and-hold approach lead a fundamental change in the way investors make asset allocation decisions.

Given today’s rapidly changing markets, we believe that it has never been more important to have a trusted investment partner, a long-term investment strategy, and disciplined execution to help navigate these demanding times.

Jim McCaughan
President of Global Asset Management
Principal Financial Group
Acknowledgements

This report presents the results of the 2014 global survey in the annual research series started by Principal Global Investors and CREATE-Research in 2009. The details of the previous reports are given at the end of this report.

My foremost thanks go to 704 pension plans, sovereign wealth funds, pension consultants, asset managers and fund distributors in 30 countries.

I would also like to warmly thank Principal Global Investors for sponsoring the publication of this report without influencing its findings in any way. Their arms-length support over the years has helped to create an impartial research platform that is widely used in all the key fund markets around the world.

Finally, I am very grateful to Lisa Terrett for directing the survey and helping with report writing; and to Dr. Elizabeth Goodhew for providing excellent editorial support. Their enthusiasm and can-do attitude enabled us to complete this project in record time.

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

Amin Rajan  
Project Leader  
CREATE-Research

The key theme this year is whether the emerging economies of the East and the developed ones of the West will converge or diverge over the rest of this decade.

In the 1990s, many emerging economies implemented significant reforms under the so-called ‘Washington Consensus’. It advocated the liberalisation of foreign trade, the privatisation of state-owned enterprises and the adoption of fiscal prudence in public finances.

As a result, their economies began to resemble their peers in the developed world in areas like living standards, industrial base and investment approaches. This report seeks to assess the extent to which this convergence will be affected in this decade in the wake of the recent setbacks.
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Introduction

Are emerging economies yesterday’s story or are they merely rebooting their growth engines before the next leap?

Their stellar growth in the last decade has no parallel.

Not only did emerging markets deliver outsized returns on their bonds and equities, they also sparked rapid convergence with developed markets.

Today, 500 million Asians enjoy middle class living standards. Never in human history have so many people been lifted out of absolute poverty so quickly; nor have so many economies gained traction in global finance so rapidly.

Most of them went into overdrive on the back of a supercycle fuelled by double-digit growth in China and a credit explosion in the US.

In this decade, they have switched into a lower gear. Their asset values have taken big hits: the last one from a massive flight of foreign capital, when the US Federal Reserve first decided to taper its monthly bond purchases last year.

The scale and speed of the resulting sell-offs in emerging economies have raised doubts about whether their convergence with the West will continue; and whether their financial markets have lost star appeal.

The associated risks can no longer be priced in at today’s low market valuations: especially when the global economy itself is marred by extreme uncertainty.

The worst of the post-Lehman crisis is over. But it is not in the rear-view mirror yet.

The US economy is on the mend. Europe is breathing a sigh of relief. Japan has kick-started its
Their stock markets have hit fresh highs. Confidence is reviving.

Still, big doubts persist on four unknowns with huge power to move global markets:

• The Fed’s exit strategy
• Slow deleveraging in Europe
• The ‘three-arrows’ initiative in Japan
• The credit explosion in China.

Their outcomes range between extremes: booming markets where fundamentals drive prices at one end, and prolonged turmoil where fear triggers periodic volatility spikes at the other. Investors have no precedents to guide them.

Against this backdrop, this report addresses four questions:

• Will emerging economies and developed economies continue to converge in this decade?
• Are investors’ perceptions of emerging markets changing due to heavy ‘sell-offs’?
• What will drive their asset valuations and those in the West?
• What asset classes are likely to be most in demand by different investor segments?

These questions were pursued in our 2014 Annual Survey, involving 704 pension plans, sovereign wealth funds, pension consultants, asset managers and fund distributors in 30 jurisdictions (see table).

To obtain deeper insights, the survey was followed up with structured interviews with 110 organisations. All the data presented in this report emerged from these two sources.

What follows are four key findings and four related themes that emerged from the research.

Key Findings

1. Emerging and developed economies will continue to converge

Long a core feature of the globalisation of the world economy, convergence between East and West will broaden and deepen in two key spheres over the rest of this decade (Figure 1.1).

In market structure (upper chart), 56% of the respondents expect further convergence, 11% expect divergence and 33% expect no change.

Separately, over half of our respondents also identified five areas that will be most affected: standard of living, regulatory framework for financial markets, industrial base, asset class correlations, and market depth and liquidity.

In investment approaches (Figure 1.1, lower chart), 32% expect further convergence, 12% divergence and 56% no change. These numbers mask a big divide between cognitive and intuitive aspects of investing.

Separately, over half of the respondents expect further convergence in six cognitive aspects of investing: risk management, performance measurement, strategic asset allocation, manager selection, portfolio construction and asset class diversification.

Such convergence has mainly stemmed from ever more asset managers from the West globalising their businesses by expanding their footprints in Asia Pacific and LATAM.
On the other hand, a minority expect further convergence in two key intuitive aspects of investing:

- **Retirement planning:** 40% expect convergence, 42% expect no change and 18% expect divergence;
- **Buy-and-hold investing:** 26% expect convergence, 52% expect no change and 22% expect divergence.

Notions of time premia, risk premia, dollar cost averaging and prime mover advantage are slow to take root across emerging economies. In the retail segment, there is unconscious bias towards trading, rather than investing; with a low tolerance for failure, a high time preference rate, a rent-seeking mentality, no tracking error, herd instinct and a quarterly ranking of managers. In the institutional segment, long-term investing is the goal, but short-term results are the focus. Even in absolute-return investing, quarterly peer benchmarks are the norm. The idea that risk generates return over time is easy to understand, but hard to accept. Hence investment convergence will be more evident in techniques than mindsets.

Overall, emerging economies with double deficits — trade and budget — will converge more slowly with the West than those with sound finances.

Those caught in the so-called ‘middle-income trap’ will advance more slowly than those migrating towards the top end of their value chain.

Those who are back-sliding on reforms are more likely to move more slowly than those seeking a fresh competitive edge to make a fresh leap.

Entrenched vested interests remain more powerful in some countries than others, as they develop the institutional strength and economic openness consistent with rising economic maturity.

Everywhere, the most noteworthy convergence is expected in financial markets.

First, the correlation between the emerging market and developed market equity indices has been rising over the past decade; and will continue to do so. It now stands around 0.9. In tandem, the ratio of average annualised volatility in emerging and developed markets has nearly halved from 1.9 to 1.1 over the past 30 years.

Second, the share of emerging economies in the MSCI All-Country World Index will rise, especially with the likely inclusion of mainland Chinese stocks (A-shares) over the next five years. The renminbi will emerge as one of the top three trade currencies, as China opens up its capital account and adopts a free float.

As for the frontier markets in Africa, Asia and LATAM, their population and growth outlook remains bright. Their market infrastructure has been extensively modernised, too.

But political risks and governance risks will loom large over the next three years.

2. **The emerging market story is being rewritten as investors become more discerning**

Investors have not lost faith in the emerging market story; they are simply questioning it. The scales have tilted somewhat from 2012 to 2014 (Figure 1.2, top panel).

The percentage of ‘believers’ has declined from 38% to 20% and ‘pragmatists’ from 23% to 21%.
At the other end of the scale, the percentage of ‘sceptics’ has risen from 18% to 28%, that of ‘cynics’ from 15% to 19% and that of ‘deserters’ from 6% to 12%.

This tilt is duly reflected in their asset allocation (Figure 1.2, bottom panel).

On the buy-and-hold side of the scale, the percentage favouring equities has risen from 43% to 49%; since they currently trade at 1.4 times their book value compared to 1.9 times for developed market equities. At the same time, those favouring bonds have fallen from 44% to 34%.

On the opportunistic side, the sentiment shift has been most pronounced. Those investors viewing emerging market assets as an opportunistic play has shot up: from 30% to 48% for equities; and from 15% to 51% for bonds.

This shift in sentiment marks yet another defining moment in investors’ learning curves.

In the 1990s, they underestimated the inherent risks when sovereign lending gained traction. This was duly confirmed when the ‘Tequila’ crisis in Mexico in 1994 sparked a contagion in Asian economies like Malaysia and Thailand; culminating in sovereign defaults by Argentina and Russia.

In the 2000s, in contrast, investors overestimated the inherent strengths of emerging markets, when their growth dynamics and population dividends hogged media headlines worldwide.

Having waxed and waned between these extremes, ‘wait and see’ appears to be the dominant investor sentiment and opportunism the dominant choice - for now.

### 3. The gravitational pull in key asset classes will guide investors West.

The scenarios of asset prices for emerging and developed economies will differ over the next three years.

#### Emerging Economies

For emerging economies, the two key drivers of asset prices will be:

- slower economic growth (cited by 62% of respondents)
- the Fed’s taper programme (53%).

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**FIGURE 1.2**

*How has investor sentiment changed towards emerging markets?*

**Investor Sentiment**

| Believers       | 38%  
|-----------------|------
| Pragmatists     | 23%  
| Sceptics        | 18%  
| Cynics          | 15%  
| Deserters       | 6%   

**Asset Allocation**

| EM equities     | 43%  
|-----------------|------
| EM bonds        | 34%  
| EM equities     | 30%  
| EM bonds        | 15%  
| 2012            | 49%  
| 2014            | 51%  

Source: The Principal®/CREATE-Research Survey 2014
Both are expected to increase volatility, hit returns and promote opportunism. Conspicuously, in most emerging economies, growth has already halved within its previous 3-13% range. Their equities have duly underperformed the aggregate world index by a stunning 25% in 2013; with Brazil and Russia leading the pack.

These negatives will be partially eased by medium-term positives, such as growing urbanisation, economic rebalancing and the dismantling of various business practices that act as a drag on economic efficiency.

Developed Economies
In contrast, the scenario for developed economies looks rosier. The top three drivers of their asset prices will be: improved growth prospects (74%), the Fed’s taper programme (60%) and the easing of the Euro crisis (40%).

There will be regional variability, though: continuing recovery in the US and weak recoveries in Europe and Japan, with an overall subpar growth across the West. Macro risks will continue to overshadow its financial markets. Besides, excess liquidity has seeped into cracks that investors are unaware of; nor are they aware of risks being stoked up by the current era of low rates. Over 70% of pension plans will have de-risking strategies in place to cope with more randomness and extreme events.

Yet, overall investor sentiment remains positive. It rests on the belief that the economic recovery and rising stock markets are now anchored in improving economic fundamentals; not just sugar highs from the Fed.

Over the next three years, the US recovery will not only drive the locomotive of the global economy, it will also deliver the best returns amongst all the key regions, according to 47% of our survey respondents (Figure 1.3).

Runners-up will include:
• Frontier markets (45%)
• Asia Pacific excluding China and India (41%)
• Western Europe (34%)
• China (34%)
• Japan (26%).

Significantly, the bloom will be off the BRICs rose, with Russia, India and Brazil at the bottom of the pile. However, emerging market equities will do well on relative valuations. Using the last 10 years as a benchmark, our consensus forecasts envisage a notable reduction on a 10-year forward look.

Illustrative reductions in returns are:
• Global equities going from 8% to a 5% return
• Global sovereigns, from 4% to 2%
• Real estate, from 9% to 7%
• High yield, from 8% to 5%
• Cash, from 2% to 1%
• Emerging market equities, from 14% to 9%
• Emerging market hard currency bonds, from 9% to 4%
• Emerging market local currency bonds, from 10% to 4%.

![Figure 1.3 Which regions are most likely to offer the best returns over the next three years?](image-url)

Source: The Principal®/CREATE-Research Survey 2014
There are five salient points behind these numbers.

1. **Within frontier markets**, sub-Saharan Africa is expected to deliver the best returns. Africa is the new energy hotspot. However, their critics contend that they are still 50% below the pre-crisis level.

2. **Within the rest of Asia Pacific**, Australia, Singapore, South Korea, Malaysia and Taiwan are expected to outshine the others. The last two will be breaking out of the ‘middle-income trap’.

3. **In Western Europe**, The Netherlands, the Nordics and the UK are likely to outshine France, Germany, Italy and the periphery. Europe will remain a tale of two continents.

4. **In China**, valuations will remain volatile until ambitious reforms get underway. It has grown too rich to sustain its stellar growth on low-cost manufacturing. Its annual wage inflation of 14% over the past decade has blunted its competitive edge.

5. **In Japan**, the entrenched deflationary bias will be hard to move, although it will no longer remain a backwater for investors.

In sum, notwithstanding the progress made since the 2008 crisis, the global economy will not return to rude health until its root causes are tackled via reforms – both in the East and the West. Principally, these need to reduce debt, strengthen public finances, promote growth and boost competitiveness.

Hence, emerging economies will no longer be distinct regional groups that can be described by catchy acronyms such as BRICS (Brazil, Russia, India, China and South Africa) and MINT (Mexico, Indonesia, Nigeria and Turkey). They will have as much that divides them as unites them; with just as many value opportunities as value traps. The gap between the best and the worst performers will widen.

Since 2008, BRICS has proved a clever marketing tool but a dumb investment strategy for most investors.

Pockets of under-valuation will prevail in all markets, while they are driven more by politics than economics. Stock picking will be the main source of alpha. Selectivity is vital due to wide dispersions in valuations of stocks, bonds and convertibles.

Investors will be far more discerning about countries and avenues, when investing in emerging markets and frontier markets. The days of blanket acceptance are over.

Passive funds have been one of the dominant avenues used by those investing in emerging market equities and bonds. Lately, the return dispersions within and between these markets have been getting bigger, thereby diluting the overall returns of the chosen indices. This trend will intensify as variable geometry characterise their growth pattern.

So much for our key findings.

The following four themes provide further details on how individual countries are likely to fare in their march towards reform and how different asset classes are likely to fare while macro risks overshadow the markets in the East and the West.

Their regional nuances appear at the end of sections 2 and 3.

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"The West is not out of the woods yet: it’s just in a better place." - AN INTERVIEW QUOTE

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\[\text{4. This could be the age of stock pickers as catchy acronyms become irrelevant.}\]

In the transitional phase, nations will not move in lock step, as they have done in the past under the toxic influence of cheap money from the West. Over the past ten years, such inflows have grown by 400% compared with nominal GDP growth of 200%. The double deficit countries remain especially vulnerable to violent outflows.
China will lead the pack on reforms in the East

The projected economic slowdown in emerging economies is more structural than cyclical. The decade-long boom created its own problems.

For example, the unused capacity in China’s steel industry now exceeds the total capacity in Japan and South Korea put together. Furthermore, China’s rebalancing towards consumption requires investment to grow slowly and disposable income to rise quickly; a very different structure of production; and market-driven interest rates.

The 2013 street fury in Brazil showed that the gap between the haves and have-nots has reached boiling point. In the past two years, Brazil’s stock market has tumbled by 53% before the recent bounce back. Inertia in Indonesia failed to create buffers against collapse in the global demand for its commodities. Inflationary expectations remain high among the so-called ‘Fragile Five’: Brazil, India, Indonesia, South Africa and Turkey. Worryingly, India’s inflationary expectations remain anchored in the 7-10% range.

While many emerging economies have accumulated large foreign reserves, they did not use the good years to reform their restrictive labour practices, opaque governance practices, protectionist trade policies and interventionist industrial policies. Now, they are switching from quantity to quality in their economic growth. This is easier said than done.

The winds of change are evident. Nations as diverse as Chile, Indonesia, Mexico, Nigeria, South Africa and Thailand recognise that, without further reforms, their growth engines will soon run out of steam.

There will be pain before gain. Hence, reforms now being implemented are gradual, piecemeal and incremental. While their pace will vary between nations, their central thrust is in the right direction (Figure 1.4).

Respondents are most positive about China (51%), followed by Brazil (27%); and most negative about Russia (61%), followed by frontier markets (34%) and India (32%).

Emerging economies are not created equal. Each will have its own narrative on what it stands for and what it can deliver.
The US will continue to drive positive sentiment in the West

Worries about the debt crisis, the collapse of the Eurozone and the political paralysis on both sides of the Atlantic have eased since our 2013 survey. Investors see light at the end of the tunnel and they no longer fear that it is an oncoming train.

The US is on the rebound, according to 64% of respondents (Figure 1.5). The housing market – the eye of the financial storm in 2008 – is on the mend. The budget deficit is being trimmed steadily; as is the trade deficit, due to energy self-sufficiency. Accordingly, an alternative view is gaining traction: the Fed tapering will bring a semblance of normality to markets, not roil them.

Tapering does not mean tightening. Policy rates are likely to remain zero-bound for the foreseeable future. With better growth, corporate earnings will get in sync with market valuations before long. Earning multiples may well expand.

In comparison, the economic outlook in Europe looks decidedly cloudy over the next three years, according to 30% of respondents.

Nations on the periphery are seeing a slow pick up: 75% of the necessary fiscal adjustment has already happened via austerity. But growth remains anaemic in the core economies of France, Germany and Italy. Isolated pockets of revival are evident only in Scandinavia and the UK.

Fears persist that Europe may not avoid a 20-year flat-line like Japan. In response, the European Central Bank is now contemplating its own version of quantitative easing, with all the attendant uncertainty.

Similarly with Japan, only 37% of respondents expect it to reboot its economy in the near future. For them, a gradual return of confidence is not a good measure of economic health. The jury is out on the impact of the ‘three-arrows’ initiative.

Doubling the monetary base in two years will devalue the yen and potentially trigger currency wars. The key reforms on deregulation and other supply-side obstacles have yet to see the light of day.

More worryingly, the proposed fiscal reforms will once again sidestep Japan’s biggest challenge: to re-engineer the welfare system, as its population falls from 127 million today to 86.7 million in 2060, when 40% of the population will be over 65.

Domestic investors have yet to be convinced that this time it will be different. Their psyche remains scarred by the losses after the Nikkei peaked in 1989 at nearly three times its current level.

FIGURE 1.5 Do you expect governments in developed markets to make significant progress in rebooting their economies over the next 3 years?

Source: The Principal©/CREATE-Research Survey 2014

“Excess liquidity has seeped into cracks we don’t know about. What risks are being stoked up by the current era of low rates?”

“For every critic who believes that central banks have done too little, there’s one that worries that they have done too much.”

“All developed economy indices are outgunning emerging economies.”
When selecting their asset classes, our respondents are drawing a distinction between opportunism for short-term portfolio rebalancing and asset allocation for medium-term value premia. The two categories of pension investors will pursue different goals.

For DB plans, ageing member demographics will be the key driver, as they transition from asset accumulation to liability matching (Figure 1.6, upper section). Four considerations will influence their asset choices.

First, emerging markets will no longer be seen as a buy-and-hold story. Its three key asset classes will become part of the opportunistic play.

Second, real assets and alternative credit appear to mimic the liability profile of DB plans. They are seen as hybrid assets with bond-type features and equity-like returns.

Third, traditional passive funds, fundamental indices, smart beta strategies and ETFs will be preferred, as alpha has proven ephemeral, elusive and expensive in the volatile setting of the past five years.

Fourth, quantitative easing has distorted the shape of the yield curve: all assets are mispriced. Yet, global equities will remain in favour, as their value drivers reassert themselves while the Fed continues to taper.

Turning to DC plans, the search for higher returns will be the key driver, as average plan balances are undershooting their targets during the accumulation phase. In the nascent DC markets of Europe and Asia, the undershoot is evident in the early stage. In the mature DC markets of Australia, the UK and the US, it is in the late stage. As a result, two considerations will influence the asset choices of DC plans (Figure 1.6, lower section).

The first one is cost and convenience, favouring overweight positions in passive funds. Cost is viewed as a key source of outperformance, when compounded over time.

The second consideration is the mitigation of career risks for plan trustees. Ever more of them will be adopting the set-it/forget-it lifecycle funds, listed in the southeast section of Figure 1.6. Ever more DC plans will be migrating to these advice-embedded funds.

INTERVIEW QUOTES:

“A lot of bad things are pulling in the same direction. So, if ever there was a golden age of stock picking, it is now.”

“Downgrades of earnings forecasts are outpacing upgrades by a ratio of three to two.”

“Australia provides an unsettling glimpse of the future. It shows how even a first-rate DC scheme is unable to deliver good outcomes.”

FIGURE 1.6 Which asset classes are pension investors likely to use for short-term opportunism and for medium-term asset allocation?

<table>
<thead>
<tr>
<th>DB INVESTORS</th>
<th>LIABILITY MATCHING</th>
</tr>
</thead>
<tbody>
<tr>
<td>High total returns</td>
<td>% of respondents</td>
</tr>
<tr>
<td>Distressed debt</td>
<td>55%</td>
</tr>
<tr>
<td>Emerging market equities</td>
<td>53%</td>
</tr>
<tr>
<td>Exchange traded funds (ETFs)</td>
<td>52%</td>
</tr>
<tr>
<td>EM corporate bonds</td>
<td>51%</td>
</tr>
<tr>
<td>EM government bonds</td>
<td>50%</td>
</tr>
<tr>
<td>Alternative credit</td>
<td>49%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>DC INVESTORS</th>
<th>ASSET ALLOCATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>High total returns</td>
<td>% of respondents</td>
</tr>
<tr>
<td>Exchange traded funds (ETFs)</td>
<td>46%</td>
</tr>
<tr>
<td>Actively managed equities/bonds</td>
<td>33%</td>
</tr>
<tr>
<td>Diversified growth funds</td>
<td>21%</td>
</tr>
<tr>
<td>Guaranteed insurance contracts/cash</td>
<td>20%</td>
</tr>
<tr>
<td>Customised investment plans</td>
<td>15%</td>
</tr>
</tbody>
</table>

Source: The Principal®/CREATE-Research Survey 2014
Retail investors will pursue regular income and high net worth investors will pursue a range of goals

Two universes will continue to evolve in the retail segment. In the first one, investors will become ultra cautious as they approach or reach retirement. In the second one, momentum investing will remain the norm. As such, caution will prevail in the West and opportunism in the East (Figure 1.7, upper section). Two key considerations will influence asset choices.

First, costs, convenience and regulatory pressures will favour passive funds. However, emerging market passives are less likely to be used, since their economies will no longer move in lock step.

Second, ageing populations will favour funds with an income focus in the West. Short-term concentrated bets will remain a feature of momentum investing in Asia; as exemplified by the so-called trust products and wealth management products in China. Elsewhere in Asia, household balance sheets will remain skewed towards real estate and low-yielding deposits, with periodic forays into equities.

But green shoots of change are evident. Asia is wealth rich and income poor. It has a savings ratio that varies from 25% to 50%. Its population is ageing very rapidly. Within a single generation, it will deliver what took 100 years in the West: fewer babies and longer lives. Those aged 65 and over will double in the next 15 years; raising the popularity of income funds. At any rate, as the population dynamic converges in the East and the West, a parallel convergence is expected in asset allocation of retail investors.

Turning to high net worth investors, the pursuit of multiple goals will drive asset choices, after the losses in the crisis. Opportunism will prevail alongside caution within a pragmatic approach (Figure 1.7, lower section). Four goals will influence their asset choices:

- Inflation protection and regular income via real assets such as real estate
- Capital growth via private public equities
- Lower costs and more nimbleness via passive investing
- Low volatility via balanced and capital protection funds.

However, wealthy investors in Asia will remain too impatient, making it hard to capture the full potential of money-in-motion. Mind space will remain more important than shelf space.

**“Financial repression will continue in the East and West due to low real yield, which is like a stealth tax on savers.”**

**“Asia’s population is ageing rapidly. India and Indonesia are the only countries that have not exhausted their demographic dividend.”**

**“Investors based in the Gulf states will remain overweight in real estate and private equity.”**
Issues

After a decade of stellar growth, emerging economies began to converge rapidly with developed economies by 2010. Since then, however, growth has faltered in emerging economies. Market valuations have plunged.

Against this background, this section pursues the following two questions:

• What will be the drivers of asset prices in emerging and developed economic camps?
• Will recent setbacks slow down the convergence between them?

2 Market Drivers

What will drive markets and their convergence?

Headlines

• Emerging economies are navigating a painful transition
• Developed economies are seeing a revival in confidence
• Economic convergence between emerging and developed economies will broaden and deepen
• Investment convergence will happen in techniques more than mindsets

“...
The Fed’s exit will be hugely consequential for the world economy as well as the US economy.

- AN INTERVIEW QUOTE

“...”
Summary Findings

Our findings on these questions are given separately below.

Drivers of Asset Prices

Emerging Economies and Frontier Markets

Two principal factors will drive their asset prices over the next three years: the economic slowdown and the end of quantitative easing (QE) in the US.

Both will depress market valuations in the near-term.

The projected slowdown will be more structural than cyclical. The decade-long boom created its own problems. Economic and governance reforms are now in progress to create fresh traction. Pain will precede gain.

Over the next three years, asset valuations are unlikely to recover strongly after their last headlong plunge in 2013.

Challenges facing the frontier markets are no less daunting.

While their population and growth outlook remain bright, investors fear political risks and governance risks that show little sign of receding.

Developed Economies

The worst of the crisis seems to be over. Three factors will drive asset prices over the next three years: improved prospects for economic growth, the end of QE and the easing of the Euro crisis.

Confidence is reviving. Stock markets have touched their all time highs. But valuations remain out of sync with their fundamentals due to Fed action. They will synchronise, if the US recovery gathers speed.

In the background, however, doubts persist around four potentially big market-moving factors that can boost or roil the markets:

- The Fed’s exit strategy
- Anaemic growth and slow deleveraging by Europe’s banks and sovereigns
- The entrenched deflationary bias in Japan
- The credit explosion in the shadow banking sector in China.

The outcomes of each may be poles apart.

Growing Convergence

Convergence between emerging and developed economies has long been a key feature of the globalisation of the world economy. Being more secular than cyclical, it will broaden and deepen over the rest of this decade in two key spheres: economic and investment.

Economic Convergence

Three aspects will see the most convergence: standards of living, regulatory framework for financial markets and industrial structures.

The pace of convergence is unlikely to be uniform, however. Economies with the following features will have a slower convergence:

- Double deficits – trade and budget
- The so-called ‘middle-income trap’
- Backsliding on reforms.

Everywhere, the most noteworthy convergence is expected in financial markets.

First, the correlation between emerging market and developed market equity indices has been rising and will continue to do so; their volatility, too, will be converging.

Second, the share of emerging economies in the MSCI All-Country World Share Index will rise, especially with the likely inclusion of the mainland Chinese stocks (A-shares). The renminbi will emerge as one of the top three trade currencies.
As emerging economies transition from growth to maturity at a different pace, they are losing their homogeneity.

- AN INTERVIEW QUOTE

The common ones are:

- **North America**: the Fed’s exit strategy, the impact of rising market rates on the value of bonds and the potential loss of liquidity caused by the Volcker rule.

- **Europe**: a possible secular stagnation and a new package of measures from the European Central Bank.

- **Japan**: rising debt, the slow pace of reforms, and doubts about their impact.

- **Australia**: over-dependency on the Chinese economy and the ability to re-orient its exports towards new growth markets.

- **China**: a slow-down in the growth trajectory, while accelerating the reform agenda that may prevent a credit crunch.

- **Emerging economies**: doubts whether their growth engines can be revved up again via structural reforms.

- **Frontier markets**: their lack of size, depth, liquidity and maturity to attract foreign capital; and their governance and political risks.

**Regional Nuances**

As for market drivers, there are various common themes that run across all the regions as well as some regional-specific ones.

**Investment Convergence**

Specific aspects of investing, too, have been converging. The aspects that will come ever closer in this decade include: risk management, performance measurement and strategic asset allocation.

Notably, these are cognitive aspects of investing that have proved easier to adopt in emerging economies.

In contrast, its intuitive aspects are likely to see a much slower adoption. These include: buy-and-hold investing and retirement planning.

The main obstacles are:

- High volatility in local financial markets.
- A precautionary approach to savings.
- Doubts about whether value investing works in the long run.
- Limited tax incentives for retirement planning.

Even so, emerging economies are no longer a distinct homogeneous regional group. They have as much that divides them as unites them. Their growth pattern will have a variable geometry.

**Regional Nuances**

As for market drivers, there are various common themes that run across all the regions as well as some regional-specific ones.
Emerging economies need to create new sources of competitive advantage to maintain their high growth rates.
Emerging economies are navigating a painful transition that will depress market valuations in the short run

After headlong growth since 2000, emerging economies now face two uncomfortable realities. Having been the biggest beneficiaries of the US Federal Reserve’s loose monetary policy, their financial markets face unusual turbulence with the Fed eyeing an exit. Moreover, growth itself has halved lately from the 4% - 12% range. This is symptomatic of structural weaknesses in their economies that demand fresh reforms to stem the tide.

Unsurprisingly, in 2013 the emerging market equities underperformed the aggregate world index by a stunning 29 percentage points, as measured by their MSCI index components.

When asked to identify the factors that will drive asset prices in the key emerging and frontier markets, over a third of our survey respondents picked five of them (Figure 2.1):

- Slower economic growth (62%)
- The end of QE (53%)
- Growing urbanisation and the rise of the middle class (43%)
- Economic rebalancing (41%)
- Liberalisation of domestic controls and capital flows (34%).

When analysing these results, it is necessary to draw a distinction between emerging economies and frontier markets, which are at a more nascent stage. Taking them in turn, for emerging economies, these factors are inter-related, according to our post-survey interviews.

Previously, China has been a linchpin for all emerging economies. Its stellar performance has rubbed off on all its key trading partners. They have especially benefitted from China’s gigantic infrastructure investments that fuelled a supercycle in commodities and credit explosion; with the latter reinforced by the Fed’s QE programme. Emerging markets now face reversals on both fronts.

In the meantime, sustained growth has concealed various weaknesses, such as the misallocation of capital via generous subsidies to state-owned enterprises. These suffer from massive over-capacity that can only be supported.

INTERVIEW QUOTES:

“The emerging markets party is over. Their past successes concealed weaknesses that can’t be priced into today’s valuations.”

“Emerging markets’ fortunes are closely tied to those of China, which is changing irrevocably.”

“Sub-Saharan Africa has grown by 6% annually over 2002-2014. By 2016, it will be a US$2.3 trillion economy.”

Source: The Principal/CREATE-Research Survey 2014
by state subsidies that account for 30% of gross revenues, backed by a culture of inadequate governance.

These were priced into valuations only as long as stock markets rode high on the back of strong growth. Highly visible corporate debacles, such as OGX in Brazil, have now ignited worries about corporate governance and legal protection; as has political instability in places such as Thailand, Turkey and Ukraine.

Indonesia suffered most from the recent emerging market sell-off. After growing at an average rate of 6% since 2005, its policy makers turned complacent, failing to implement the reforms needed to provide a buffer against collapse in the demand for its commodities.

Moreover, with growth has come maturity: The rebalancing towards consumption in China, for example, requires investments to grow slowly and disposable incomes to rise fast, a very different structure of production and market-driven interest rates. These require reforms (see “Insights”). Emerging markets now have their share of ‘believers,’ ‘pragmatists,’ ‘sceptics,’ ‘cynics’ and ‘deserters’ (see p.5).

In contrast, the frontier markets are powering ahead, albeit from a small base. Their growth and population

In the meantime, inflation has taken off due to state-mandated pay rises for employees. India’s inflationary expectations are now anchored in the 7-10% range. The number of emerging countries with double deficits – in foreign trade and government finance – has been rising.

The resulting boom has served to divert attention from much-needed reforms essential for rebalancing their economies. While many emerging nations in Asia and LATAM have accumulated large foreign reserves and improved their balance sheets, they did not use the good years to reform their protectionist trade policies, interventionist industrial policies and opaque governance practices. Rising public debt is crowding out private investment and enterprise culture in India.

China is another case in point. A consumption-based economy requires the end of financial repression that subsidises state-owned enterprises at the expense of private savers. But giving a bigger role to markets at the expense of the state is hard when there are entrenched vested interests in business and politics. The winds of change are evident. Nations as diverse as Chile, China, Indonesia, Mexico, Malaysia and Thailand recognise that without further reforms, their growth engines will soon run out of steam.

The reforms announced at the Third Plenum in China last November were unprecedented. Not only do they recognise the primacy of markets, they also envisage an independent judicial system to uphold human rights and good governance for tackling corruption. China’s growth will be slower than in the past but it’ll be better quality.

The first generation reforms – e.g. opening up markets, attracting foreign direct investments, fixing the banking system, building up foreign currency reserves – relied on technocrats at central banks and finance ministries. The latest ones require strong political leadership. By their very nature, new reforms will be gradual, piecemeal and incremental. But their main thrust is in the right direction.

- A French Asset Manager Based Across Asia

“Insights”

The emerging economy growth engine is spluttering. Its high speed helped to stave off a global depression in the aftermath of the 2008 crisis.

In the process, however, credit growth outpaced economic growth in most emerging markets. For example, in China, corporate borrowing surged to 132% of GDP in 2013 from 103% in 2008. In Turkey, it jumped to 54% from 33%; and in Brazil to 68% from 53%.

To cope with rising defaults, governments have been forced to inject fresh capital into the banking industry. The Indian government has been obliged to inject US$4 billion into state-mandated banks.

Inflows of foreign capital still dwarf local money, eventually setting off the negative feedback loop from hell. Net inflows into emerging economies have risen by US$1.1 trillion since 2008.

The headline growth focused on top-line revenue via open and hidden subsidies to state-owned enterprises, causing a large-scale misallocation of capital. Without state support, many are unable to compete in the global marketplace.

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- A French Asset Manager Based Across Asia

“The 2013 street fury in Brazilian cities showed that the gap between the haves and the have-nots has reached the boiling point.”

“The sight of ‘tourist dollars’ fleeing their countries is one that national leaders are determined to avoid.”

“The biggest blockers of reforms in emerging markets are the entrenched vested interests who prefer the status quo.”
Developed economies are seeing a revival in confidence

In our 2013 global survey, the debt crisis was singled out as the number one driver of financial markets in the West, followed by the destabilising influence of monetary action by central banks.

This year, in contrast, the sentiment is more positive amongst our respondents. Around one in every three of them have identified four drivers:

- Improved growth prospects (74%)
- The end of the QE programme (60%)
- The easing of the Euro crisis (40%)
- Reforms of public finances (31%).

Previous concerns about the debt crisis, the collapse of the Eurozone and the accompanying political paralysis on both sides of the Atlantic have eased markedly.

This does not mean that the crisis sparked by the 2008 credit crunch is over — far from it.

What it does mean is that investors see the light at the end of the tunnel and they no longer feel that it is an oncoming train.

Only a tiny minority now envisage a 20-year flat-line, à la Japan.

A glimmer of hope is evident even in the worst affected periphery countries in Europe, such as Greece, Portugal and Ireland. Their sovereign debt spread against German bunds have halved in the last year.

Around 75% of the planned fiscal adjustment in the Eurozone has already happened. Growth is going from negative to positive. Although slow, some progress is evident on Banking Union and further fiscal integration.

Japan remains driven by its currency markets. Attempts to devalue the yen under the ‘three-arrows’ initiative have been successful so far. But the jury is out until significant reforms get underway.

The most likely scenario is for continuing recovery in the US, weak recovery in Europe and Japan and overall subpar growth in the developed world.

Record high profit margins in the US and sluggish sales trends lately suggest slower earnings growth. The bond yields are finally rising, reflecting improving economic confidence rather than rising inflationary expectations.

The Fed may soon take away the liquidity punch bowl. This speaks to a departure in the usual dynamics of equity markets.

In the past, market recovery at this phase has been driven by prospective earnings growth.

In contrast, earnings growth is expected to slow down, after recent record high profits and sluggish retail sales in America, Europe and Japan.

**INTERVIEW QUOTES:**

“Current frothy markets can turn choppy again. Is the storm over or are we still in the eye?”

“Whatever you say about the Fed’s QE programme is true – and its opposite.”

“Our biggest worry is either a very rapid rise or a rapid fall in interest rates. Both can be crippling.”

Source: The Principal®/CREATE-Research Survey 2014
Yet, markets now continue to set fresh records in these three regions, giving rise to the view that the primary driver of markets is a gradual revival in investor confidence. Having been temporarily disconnected from their value drivers, markets are reconnecting in stages. In the aftermath of the 2008 crisis, earnings soared while markets moved sideways. Now, earnings have flattened while markets have soared. The next phase will see more alignment between them.

On this argument, rising confidence will continue to create the ‘wealth effect’ that will trickle down in the real economy and bring earnings expectations in line with market valuations.

This view found strongest support in the US and the least support in Japan where the psychology of domestic investors has been scarred by two decades of losses. Many find it hard to believe that this time will be different. Today’s youngsters in Japan have seen neither inflation nor growth. Reportedly, 80% of pension plans have missed the latest rallies in the Nikkei and Topix in the belief that they are driven by the ‘carry trades’ of professional traders from the West. For them, confidence is not a good measure of economic health.

As for the QE by the US Fed, two points were often made in our post-survey interviews. First, it has done its bit and its tapered withdrawal may well do more good than harm. Second, the animal spirits it has uncaged are unlikely to wither, since central banks everywhere intend to keep policy rates down for as long as necessary to help their governments fund their deficits and households meet their debts.

Overall, the market outlook for developed economies is more favourable than their peers in emerging economies. However, the variability within each camp is likely to be just as pronounced as the variability between them.

The differences in their adaptive mechanism for responding to the crisis means two things: country-specific risks will be more important than macro risks; and stock selection will be more important than asset allocation. These differences do not detract from the fact that the East and the West will continue to converge on the larger scale.

“Due to geopolitical tensions, Japan is influenced more by what happens in China than the US.”

“The question is not if China will have a credit crunch, but when and how severe. Its banking system is unused to belt tightening.”

“This could be the age of stock pickers. There are big pockets of under-valuations in all the markets.”

We cannot see the crisis in the rear-view mirror yet but it does seem as if the worst is over.

After a torrid few years, the US economy is on the mend. The housing market – the eye of the financial storm in 2008 – is recovering as is the jobs market. As a result, the budget deficit is being steadily trimmed; as is the trade deficit due to energy self-sufficiency.

The US is once again the locomotive that is pulling growth in the global economy. Worries are also easing that Fed tapering will end the stock market party. But markets can still be derailed.

Until now, China was in the driving seat of global growth but it is facing a trade-off that is hard to resolve. On the one hand, it faces a growth crisis: the rate has reduced from 10% in the last decade to 7% now. The high rate had kept unemployment around 4% – the socially acceptable level in a population of 1.3 billion.

On the other hand, this target is unattainable without rampant growth in the shadow banking system which is now worth US$6.1 trillion (68% of GDP). If it blows up, mainstream banks will not be able to expand their balance sheets at will to contain the fall-out. That can be done only if Beijing mobilises its US$4 trillion FX reserves (44% of GDP). The chances are that it will, but only at the expense of slowing down the liberalisation of interest rates and the capital account.

There are two other sources of concern. The first is Europe. Its recovery remains tepid, its banks remain under-capitalised and its banking reforms remain slow. It is now planning to have its own version of QE – with all the attendant uncertainty.

The second source is Japan’s ‘three-arrows’ initiative designed to revive the economy after a long torpor. But doubts persist whether the envisaged deregulation of markets and labour force reforms (third arrow) will be implemented any time soon.

There are also worries that the devaluation of the yen caused by the doubling of the monetary base within two years (first arrow) could potentially spark “currency wars”, especially in Asia. Worst of all, Japan’s population is projected to fall from 127 million today to 86.7 million in 2060, when 40% of the population will be over 65. The essential welfare reforms are not there in the fiscal package (second arrow).

Domestic investors are sceptical – for now. Before the last War, one yen equalled one dollar. This shot up to 360 yen in the 1990s. Japanese investors have long memories.

But there is one ray of hope: investor sentiment is improving, especially in the US. Ever more of them believe that the economic recovery and rising stock markets are anchored in improving economic fundamentals; and not just sugar highs delivered by the Fed.

– A Global Asset Manager
Economic convergence will broaden and deepen to the point where catchy regional acronyms are meaningless

Since the 1980s, there has been gradual convergence between emerging and developed economies.

Initially, led by trade, aid and foreign direct investments, it embraced other aspects over time; thereby not only broadening the base of convergence but also deepening it. Looking ahead, this process will continue.

Our survey respondents identified eight aspects where they expect more convergence than divergence over the rest of this decade. Six of them were singled out by at least half of our respondents (Figure 2.3):

- Standards of living (67%)
- Regulatory framework for financial markets (60%)
- Industrial base (58%)
- Asset class correlations (56%)
- Market depth and liquidity (55%)
- Stature in global finance (49%).

A number of salient points emerged from our post-survey interviews.

The first point relates to living standards. These have been rising fast in the emerging economies to the point where the gap with the West has narrowed.

However, many emerging economies are now caught in the so-called ‘middle-income trap,’ caused by a seeming inability to create fresh comparative advantage to rise to the next level of economic maturity.

Factors that promoted the original economic take-off, like cheap labour, abundant raw materials or the abolition of controls no longer provide the edge.

For example, Singapore’s per capita income stands at a lofty $60,000, one of the highest in the world, compared with $16,000 for Malaysia (its neighbour) and $9,500 for Thailand.

FIGURE 2.3
What is likely to happen to various aspects of economies in emerging and developed countries in this decade?

<table>
<thead>
<tr>
<th>Aspect</th>
<th>DIVERGE</th>
<th>NO CHANGE</th>
<th>CONVERGE</th>
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</thead>
<tbody>
<tr>
<td>The regulatory framework around their financial markets</td>
<td>13</td>
<td>27</td>
<td>60</td>
</tr>
<tr>
<td>The conduct of their financial markets</td>
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<td>48</td>
</tr>
<tr>
<td>The correlation between their asset classes</td>
<td>16</td>
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<tr>
<td>Their stature in global finance</td>
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<td>49</td>
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<tr>
<td>The liquidity and depth of their financial markets</td>
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<td>Their standards of living</td>
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<td>15</td>
<td>67</td>
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<tr>
<td>Their industrial base</td>
<td>21</td>
<td>21</td>
<td>58</td>
</tr>
<tr>
<td>The volatility of their markets</td>
<td>22</td>
<td>33</td>
<td>45</td>
</tr>
</tbody>
</table>

Source: The Principal®/CREATE-Research Survey 2014

INTERVIEW QUOTES:

“The proposed Chinese reforms will have far-reaching consequences for all its emerging markets trading partners.”

“Is Samsung an emerging market stock?”

“EM investment is as much about stock picking as country selection.”
Singapore achieved this feat via purposive government action designing a regional financial hub that now caters for all value-added services in global finance.

Some countries are more able to break out of the trap than others through overt action that counters the unintended consequences of rapid growth.

Another salient point relates to the economic structure. Increasingly more and more raw material producers are seeking to move up the value chain and deliver value-added products. Ghana’s move into cocoa processing is an example. Furthermore, they are also moving into services – like education, healthcare, leisure, travel – demanded by their burgeoning middle class.

The third point relates to financial markets. Their regulatory framework, their conduct, their correlations and their volatility are converging. The correlation between the emerging market and developed market equity indices has been rising steadily in the last decade, standing at around 0.9 currently. Growing economic interdependency has been a key factor. Furthermore, at end-1980, the average annualised historical volatility of emerging market equities was 40%; by end-2013, it was 27%. This has nearly halved the ratio of emerging to developed market volatility: from 1.9 to 1.1.

The final point relates to the growing irrelevance of regional-centric labels like emerging markets or catchy acronyms like BRICS or MINT. As with developed economies, so with their emerging peers, nations are advancing at different rates. As we saw in Figure 1.3 (p. 6), their market outlooks are notably different. Given the uniqueness of their economic reform agendas, arbitrary groupings based on catchy acronyms are naïve at best and misleading at worst. Since 2007, for example, the gap in return on emerging market stocks with the highest sales growth versus the return on the slowest sales growth has been widening, now standing at 170%.

INSIGHTS

As a big investor in global companies, we follow their fortunes around the world. There is no doubt that there is growing convergence between developed economies and emerging economies.

The countries that are converging most rapidly are China, Mexico, Singapore, South Korea, Philippines and Taiwan. China’s pace has been exceptional. Over the past two years, its real consumer spending has contributed more to economic growth than has gross fixed capital formation; services oriented towards the middle classes have grown faster than export-led manufacturing.

This year, China will set up a system of insuring bank deposits, as part of steps to reduce the government’s role in setting interest rates.

But convergence has also slowed down among the so-called ‘Fragile Five’: Brazil, India, Indonesia, South Africa and Turkey. They are also the ones who suffered most from the US$40 billion outflow sparked by the Fed’s recent tapering of its bond-buying programme.

Their double deficits – budget and trade – have made them overly reliant on foreign inflows to the extent that their economic policies are more geared towards solving macro problems like inflation and growth rather than micro challenges such as inflexible labour laws, wasteful industrial subsidies and governance lapses. In 2010, for example, Brazil imposed ad hoc taxes on investors to make its exchange rate more competitive. It also imposed fuel subsidies that markedly slowed down the pace of offshore oil exploration. India is out of the woods but a long way from safe.

For their part, Argentina and Russia are, if anything, diverging from other emerging markets by back-sliding on reforms.

Many emerging economies remain vulnerable to foreign capital outflows. Over the past 10 years, the inflows have grown by 400%, compared with nominal GDP growth of 200%. Capital withdrawals have proved particularly painful during stress, especially for double-deficit countries. However, growing convergence from three sources will moderate such outflows in the future.

First, growth in foreign direct investment from the developed markets is making capital less mobile in times of stress. Japan increased its FDI in Asia by US$40 billion in 2013: fully 42% of its FDI is in South-East Asia now.

Second, as emerging economies increase their market capitalisation via new issuance, their share in the MSCI All-Country World Index will rise. Currently, emerging economies accounted for almost half of global GDP but less than 15% of the Index. Financial market investors, thus, do not face a big performance risk relative to their benchmark when they flee for home.

This will change also with the likely inclusion of the mainland Chinese stocks (A-shares) in the All-Share Index over the next five years. For example, their inclusion in the MSCI Emerging Markets Index will raise China’s current weighting of 20%, covering Hong Kong-based H-shares, to nearly 30%. This will trigger significant China-related investment from passive investors and other index huggers. China’s US$3.4 trillion equity market and US$4.7 trillion bond market will receive a major boost.

Third, there is greater financial integration happening via the rise of the Chinese renminbi as a reserve currency. China now has currency swap lines with 22 countries worldwide. Over the next five years, the renminbi will be one of the top three trade currencies. Fund centres such as London, Luxembourg, Paris, Singapore, have all been issued with the renminbi-based qualified foreign institutional investor (RQFII) quota to encourage more portfolio investment in Chinese currency. The renminbi era dawns as China’s financial clout grows.

– A Global Asset Manager

“In any acronym, lumping China with Russia is like lumping Germany with Greece. They are poles apart.”

“BRICS has been a clever marketing tool but a dumb investment strategy.”

“Neither China nor India need new rules. What they need is better execution of the existing rules.”
Investing is both a science and an art. Its ‘hard’ aspects – like Monte Carlo simulations, value at risk (VAR) analysis, risk-return features, portfolio construction and asset class correlations – can be learnt from books and classrooms. But not so its ‘soft’ aspects – like investment beliefs, herd mentality, gut instincts and first-mover advantage. They rely on learning by doing.

Unlike cognitive learning, experiential learning cannot be fast-forwarded. This has especially been the case in nations where the savings culture, based on capital preservation and income upside, has long prevailed. The idea that investing is a bet on an unknown future where risk generates return over time is easy to understand but hard to accept. Unsurprisingly, in investment matters, therefore, our survey respondents expect a growing convergence between emerging and developed economies to be more real in hard areas (Figure 2.4):

- Risk management (64%)
- Performance measurement (60%)
- Strategic asset allocation (53%)
- Manager selection (52%)
- Portfolio construction and stock selection (51%)
- Asset class diversification (51%).

At the other end, the lowest scores on convergence are confined to two soft areas:

- Buy-and-hold investing (26%)
- Retirement planning (40%).

These numbers suggest an important dichotomy. Asset managers from the West have established a strong presence in most emerging markets. With it has emerged a new professional infrastructure of skills, expertise and technology that emulates the best in the West. Indeed, they are driving convergence in the hard aspects of investing; as are indigenous professionals trained in America and Europe.

FIGURE 2.4 What is likely to happen to various aspects of investment approach in emerging and developed markets in this decade?

Source: The Principal®/CREATE-Research Survey 2014

INTERVIEW QUOTES:

“Notions of risk premia, prime mover advantage and time premia remain alien in the predominantly savings culture of Asia.”

“Across EM, there is a low tolerance for failure, a high time preference rate and quarterly ranking of managers.”

“Asian retail investors shoot for the stars, with no tracking error.”
Convergence in the soft areas, on the other hand, relies on investor behaviours on the ground. The path to buy-and-hold investing has been slow for two reasons.

First, investors have an understandable strong home bias. But with historically high volatility in local markets, trading has taken precedence over investing (see “Insights”). In most Asian and LATAM economies, products are sold, not bought. Independent advice channels remain the preserve of the ultra rich. Financial education remains confined to Brazil, Chile and Singapore. However, even their concepts, such as dollar-cost averaging, compound interest, market cycles and asset diversification are not widely recognised.

Elsewhere, the prevailing sales engines continue to thrive on high churn. New product launches attract the same hype as IPOs. Arguably, trading has one saving grace: it is part of experiential learning. Some see it as a way station on the path to buy-and-hold investing. After all, that is how it was with investors in the US before the 401(k) was introduced in the 1970s.

Large investors – like insurance companies and sovereign wealth funds in emerging economies – profess to subscribe to it. Yet, in their real-time world, many still focus on short-term results or peer benchmarks; always worrying whether risk premia will materialise over time. Career risk is always lurking in the background. To their credit, however, ever more of them are stepping up their engagement with external advisors and asset managers, as part of adaptive learning. The requisite DNA is developing gradually.

The second factor behind this gradual process is the orientation of the newly emerging retirement systems in countries such as Brazil, Chile, China, Hong Kong Malaysia and Singapore. In this phase of their evolution, trustee boards are overcautious to the point where the systems are promoted as a supplemental element of retirement savings, not the principal one. The required tax breaks are limited.

**INSIGHTS**

*In emerging economies, the arrival of asset managers from the West has helped to create a professional overlay of skills and infrastructure. This has been reinforced by the indigenous pension plans and sovereign wealth funds that, until recently, were strongly bond biased, peer biased and home biased. Now, they are diversifying on a scale that is planting the seeds of a buy-and-hold culture. But this is not easy.*

Retail investors have an unconscious bias towards trading, rather than investing. They demand proof that riding out short-term volatility can be rewarding in the long-term. In countries as diverse as China, India, South Korea and Taiwan, the average holding period for mutual funds is less than a year. Investors prefer high volatility stocks in the belief that they can make a quick buck by market timing. 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 market conditions and intrinsic value.

The first requisite for a buy-and-hold culture is the introduction of retirement planning systems that put the onus on the individual and/or the employer, backed by tax incentives. In the past 15 years, these have been introduced, mostly as a supplemental, rather than mainstream, device to deliver retirement income. Individuals are still enjoined to accumulate private savings separately as a principal source of retirement income. The national welfare safety net is very limited, that’s why the savings rate in a country like China is over 40%. Most Asian countries are wealth-rich, income-poor: they accumulate savings but do not earn good returns in the conventional savings channels.

The second requisite is an advice infrastructure that minimises herd behaviour. Compared to the West, such a platform is in its infancy in almost all emerging economies. Where it exists, it is targeted at ultra-high net worth individuals. Even then, investors favour concentrated portfolios. In Hong Kong, for example, diversified funds have attracted significant interest only since the 2008 crisis. An average portfolio of retail investors still has six stocks and a 100% turnover.

In emerging markets, the art of investing will develop gradually. Even large investors such as insurance companies and sovereign wealth funds worry whether they can wait for an extended period to get risk premia. Having been brought up in a saving culture, their top executives want capital protection and a regular income upside as baseline outcomes. Investing has to do better than that. Many of them are also political appointees with a strong “rent”-seeking mentality. Long-term investing is their mantra. Yet they are over-focused on short-term market or peer benchmarks.

> “In their real-time world, large investors in Asia take a long-term view but have a short-term focus on outcomes.”

> “Our board members are from different ministries, with little investment experience. The urge to follow the herd is powerful.”

> “There has been a lot of skills and technology transfer from the West to the East.”

> An Asian Sovereign Wealth Fund
The last four subsections have set out the market drivers within emerging and developed economies. They also identified those aspects that will mark convergence between them.

This subsection first highlights the themes that are common to all of them. It then singles out those that are also unique to them, as identified in our 110 interviews across the key fund markets around the globe. They are covered separately below.

**Common Themes**

First, the reference scenarios of global financial markets over the next three years will be driven by four macro factors: the phasing out of the QE programme in the US; the anaemic growth in Europe; the credit bubble in China; and the ‘three-arrows’ initiative in Japan.

However, so uncertain are their outcomes that each one acting alone can spark violent market swings in either direction.

**FIGURE 2.5 What avenues are being used to do smart risking?**

Source: The Principal®/CREATE-Research Survey 2014

Second, although the investor sentiment has improved, risk remains a persistent feature of the post-crisis world; forcing smart risking to the fore in all regions. It involves the use of one or more of nine tools to protect against big drawdowns of the sort that have ravaged investor portfolios since the 2008 crisis (Figure 2.5):

- Uncorrelated alpha, using a small part of risk budget
- Risk budgets, using risk factors to allocate assets
- Asset diversification, blending inversely correlated exposures
- Implicit hedges, tackling specific risk like duration
- Explicit hedges, using options and swaps
- Risk barbell, mixing low-risk and very high-risk assets
- Dynamic risking, benefiting from risk-on/risk-off cycles
- Investment vehicles, providing good hedges
- Regular rebalancing, capturing momentum.

With the macro risk ever present, investors are seeking to minimise panic buying and panic selling by adopting one or more of these tools.

In the pension space, risks within a time horizon have become more important than risks at the end of it. Plans already in the run-off phase especially worry about the time it can take for their portfolios to recover after a big drawdown. The same applies to retirees or near-retirees in the retail space.

Macro risks now attract far more attention than in the past. Overt hedges against "fat tail" risk remain expensive. They also impose a significant drag on performance.

Investors are thus exploring cost-effective alternatives to cope with more random and more extreme events. It means planning less and preparing more.

**INTERVIEW QUOTES:**

“Forget the taper effects. China’s credit binge is a bigger risk.”

“Despite proliferating regulation, risk is as prevalent as ever and hard to detect. Over 70% of DB plans are de-risking.”

“Bond markets remain in a state of fear due to worries about big changes in interest rates in either direction.”
North America

Three concerns preoccupy investors in the US. To start with, the positive fallout from the Fed actions is widely applauded. It has prevented a global depression and created or saved around five million jobs in the US alone. But few expect a smooth transition towards monetary tightening when the Fed slows its bond buying. Its intention to keep policy rates low for a long time will also ensure that market prices will remain disconnected from their value drivers. The era of cheap money has to end, but it may cause transitional pain as investors come to terms with new notions of fair value via trial and error.

Fears lurk in the background that what has been a source of stability on its way in could flip into a source of instability on its way out. The degree of potential pain from the Fed actions will be minimal, if the US economy returns to its long-term growth trajectory of around 3% over the next two years or so.

Furthermore, the Fed’s scaling back of bond buying could wipe out as much as US$2.3 trillion on the value of bonds, should the long-term market rates rise by a full percentage point. The US sets the price of debt everywhere.

Finally, these losses could be exacerbated by the potential loss of liquidity. Since 2008, the inventory of various assets have shrunk by over 70% due to the introduction of the Volcker rule which restricts proprietary trading and increases capital charges for banks who hold risky assets.

The ability of banks to warehouse risk is greatly diminished. Asset managers have to price in liquidity in a world without the market maker of last resort.

These concerns in the US are shared by its closest neighbour, Canada. Canadian investors are also closely watching developments in China, one of its biggest markets.

Europe

It faces the prospect of a secular stagnation that has afflicted Japan for the past 20 years. Austerity has done its bit; yet neither Europe’s banks nor its sovereigns have been able to deleverage significantly. The European Central Bank now plans to implement its own QE programme.

The effect of slowdown in China is being felt notably in hitherto strong exporting nations like France, Germany, Sweden, the Netherlands and the UK. While growth has picked up in 2013, it remains subpar. An even stronger showing in Germany and the UK are not big enough to make a dent in the rising deficit in total demand. Youth unemployment is over 65% in Greece and 56% in Spain. Corporates have been squirrelling away cash rather than investing. Yet market sentiment is picking up as investors around the world eye Europe’s underpriced assets.

Over the next three years, two factors will drive Europe’s market outlook: the scope of the proposed ECB package and the fate of the US economy.

Japan

Confidence is returning but it remains fragile.

The ‘three-arrows’ initiative has been widely welcomed. The bond purchase programme and doubling the money supply over two years (the First Arrow) are on track. Fiscal reforms that envisage a rise in sales tax (the Second Arrow) are on track, too. But agricultural, industrial and employment reforms (the Third Arrow) are slow to materialise.

Past debts (especially the public one) are being rolled forward without the magic of rising prices to erode them.

While listed companies more than doubled net profits last year, their dividends have barely budged. The ‘wait and see’ attitude is palpable.

The government’s target of 2% annual growth appears ambitious due to a shrinking population, the devastating tsunami and the suspension of nuclear capacity. Yet Japan is no longer a backwater for investors.

Australia

As a mega raw material producer, Australia rode high on the back of the double digit growth of the Chinese economy for the best part of 20 years. The slowdown in China will have a disproportionate impact. Directly, it will reduce the demand for raw materials from Australia. Indirectly, it will favour consumer goods industries in other parts of the world. Australia will have to re-orient its economy in this decade. China’s slowdown from 10% to 7% over this decade will reduce Australian exports by 3.5% of GDP: second only to Mongolia in terms of its knock-on effect.

“America is on the mend. Its twin deficits are shrinking. The Fed’s exit strategy may do more good than harm to asset values.”

“Europe has a mountain to climb before its problems are over. Its growth will remain subpar.”

“Together, China’s state-owned enterprises have delivered a negative return on capital in the last decade.”
The Regional Nuances

**CONTINUED**

With its acknowledged expertise in extractive industries such as coal and copper, it is repositioning itself to serve other markets around the globe.

**China**

Stellar growth does not last forever. China’s average annual wage increase of 14% has eroded its competitive edge in low-cost manufacturing.

It faces three momentous tasks: how to achieve 7.5% growth to meet the needs of its 1.3 billion people; how to maintain this target without refuelling its money supply, which has tripled since 2006; and how to rebalance its economy from exports and investment to domestic consumption.

Although bold and necessary, its latest programme of reforms may markedly slow down growth. Its plan to liberalise interest rates and capital account may backfire too, without root-and-branch reform of its state-owned enterprises, which is not on the current reform agenda. Their investment spending is yielding sharply diminishing returns and only survives on subsidies equal to 30% of their gross revenues. They have grown at the expense of private businesses and ordinary savers. On balance, there is optimism that the proposed reforms will unleash a fresh impetus to growth.

On the investment side, the prospective liberalisation of capital account can potentially result in a significant two-way flow of capital. By 2020, foreigners are predicted to hold Chinese securities worth a minimum of 2% of its GDP (about US$170 billion); and Chinese investors to hold foreign assets worth 15% of GDP (US$1.3 trillion).

Add to that, the likely inclusion of Chinese A-shares in the MSCI All-Country World Index, the MSCI Emerging Market Index and the FTSE World Index will catapult China into the ranks of the top five places for foreign investors. That is the aim behind the recent creation of the Shanghai Free Trade Zone.

**Emerging Economies**

The scale and speed of the sell-off after the Fed announced its taper plan in May 2013 was striking: US$40 billion flowed out of the 10 largest emerging economies, excluding China.

The outflows rekindled an old debate: was their stellar growth in the last decade solely fuelled by a worldwide liquidity boom or was it fired by an economic miracle? The answer is both.

To start with, after rapid growth in the last decade on the back of the Chinese boom, these economies are seeking to develop new growth engines via microeconomic reforms. Companies with at least 30% state ownership account for roughly one third of market capitalisation of US$5 trillion in emerging economies. Since 2008, their value has dropped by a stunning 40%.

Additionally, macro reforms are also being adopted to cope with twin deficits in countries such as Brazil, India, Indonesia, South Africa and Turkey, the so-called ‘Fragile Five’. The resulting hikes in interest rates will further dampen their growth prospects.

On the other hand those like Chile, Mexico, Poland, Singapore, South Korea, the Philippines and Taiwan are rebalancing their economies.

The upshot is clear. Nations in the emerging camp face different prospects. They are also acquiring unique identities that work against simple geographical acronyms. For example, Brazil is emerging as a strong player in off-shore oil, Dubai in global aviation, India in defence equipment, Malaysia in Islamic finance, the Philippines in call centres, South Korea in consumer electronics, Saudi Arabia in petrochemicals and Thailand in tourism. These countries have as much that divides them as unites them. Each is being integrated into the global economy at varying rates.

The crisis in Ukraine has shown how fragile politics in emerging economies can be.

The outlook for frontier markets is favourable, so long as they implement governance reforms.

Frontier markets have a lot going for them and a lot against them.”

- ANNE RIBANQIOE
Accordingly, investor perceptions are changing. Stock-specific risk and country-specific risk feature higher than regional risks. Emerging countries will follow different trajectories over the rest of this decade, as each develops a more unique identity.

**Frontier Markets**

Similar to emerging economies 10 years ago, frontier markets are at a nascent stage of economic take-off. They lack size, depth and maturity. Yet, for investors, they are attractive on three counts: they have favourable economic and demographic dynamics; they have outperformed emerging market equities by some 20% lately; and they have a very low correlation with asset classes in the West.

The lack of liquidity has been a bigger factor in insulating their debt markets. Some bonds are difficult to sell even at deep discount: they are held to maturity.

Their critics contend that these markets are still nearly 50% below their pre-crisis level: their recent performance is merely clawing back losses incurred during the crisis.

Their supporters argue that not all frontier markets are created equal. Those in sub-Saharan Africa have supercycle characteristics: at 7% compound annual growth rate (CAGR), they are doubling in size every 10 years. Africa is the next energy hot spot.

They are resource rich, accounting for more than 20% of world output in platinum (82%), cocoa (66%), coltan, used in cell phones (57%), diamonds (57%), palladium (43%) and gold (20%). They also have a strong demographic dividend. Their per capita incomes are expected to double by 2020.

Their capital markets are developing rapidly, too. Currently, 29 countries are covered by a domestic or regional stock exchange that complies with global standards in trading, execution and administration.

Their future success is crucially predicated on the adoption of corporate governance standards that are acceptable to foreign investors. Progress is gradual.
Section 2 highlighted the macro risks that overshadow emerging and developed economies while they continue to converge.

This section completes the picture by focusing on the resulting asset allocation choices by four key investor segments: DB, DC, retail and high net worth investors.

It pursues the following questions:

- Which asset classes will be most favoured by investors over the next three years?
- What specific nuances will characterise the similarities and differences across the broad regions?

### Headlines

- DB plans are transitioning to liability management
- DC plans are seeking to boost their credibility
- Retail investors are splitting into separate universes
- High net worth investors are chasing a variety of goals

### Issues

How will investors respond to market drivers?
Summary Findings

When allocating assets, investors are drawing a distinction between opportunism for short-term portfolio rebalancing and asset allocation for medium-term value premia.

Under these headings, our survey identified the following choices for four key segments:

**Defined Benefit Plans**

Ageing member demographics is driving the transition from asset accumulation to liability matching.

For opportunism, the key choices will include: distressed debt, emerging market equities, ETFs and emerging market corporate bonds.

For asset allocation, the key choices will include: traditional passive funds, real estate, infrastructure, global equities and alternative credit.

The salient points behind these choices are:

- Emerging markets are no longer a buy-and-hold story; ever more investors also see them as an opportunistic play
- Real assets and alternative credit can potentially mimic the liability profile of DB plans
- Traditional passive funds, fundamental indices and smart beta strategies rank high on consultant recommendations, since alpha has proved ephemeral, elusive and expensive for many.

**Defined Contribution Plans**

Below-target plan balances at the early and late stages during the accumulation phase are intensifying the search for higher returns to gain more credibility.

For opportunism, only two asset classes will matter: ETFs and active equities and bonds.

For asset allocation, four asset classes will matter most: traditional passive funds, balanced funds, target-date funds and target income funds.

The salient drivers behind these choices are:

- Cost and convenience associated with passives
- Mitigation of career risks for trustees via set-it/forget-it retirement funds
- The rising overlap in the period to-retirement and through-retirement.

In the nascent DC markets of Continental Europe and Asia, plan balances are a matter of concern in the early stage of asset accumulation. In the mature DC markets of Australia, the UK and the US, they are a matter of concern in the last stage.

Low balances are the outcome of low contribution rates and/or suboptimal asset allocation.

**Retail Investors**

Two distinctive universes will continue to evolve. In the first one, investors will become ultra cautious as they approach or reach retirement; in the second universe, momentum investing will remain the norm. Those in the developed economies are more likely to be in the first universe; those in the emerging economies in the second.

For opportunism, retail investors’ choices will include: ETFs, theme funds and actively managed funds.

For asset allocation, their top choices will include: traditional passive funds, funds with income focus, mutual funds and capital protection funds.

The key drivers of these choices include:

- Costs, convenience and regulatory pressures for passive funds in both universes
- Preference for momentum investing via active funds in one universe
- Preference for capital conservation due to ageing populations in the other universe.

As the population dynamics converge in emerging and developed markets, there will be a parallel convergence in asset allocation of retail investors.
High Net Worth Investors

After big losses in the 2008 crisis, the HNWI segment will continue to shift the emphasis from high returns to a variety of goals via institutional-quality tools.

The shift will be reinforced by worries around the Fed’s exit strategy and the ultra low yield for the foreseeable future.

Asia is wealth rich, income poor. Global convergence in asset allocation has started to restore the balance. - An interview quote

For opportunism, their choices will include: ETFs, commodity funds, especially gold, currency funds and hedge funds.

For asset allocation, they will include: real estate, traditional passive funds, private equity, balanced funds and funds with income focus.

Together, they will target a multiplicity of goals:
- Inflation protection and regular income via real assets
- Capital growth via private and public equities
- Low cost and nimbleness via passive investing
- Low volatility via balanced funds and capital protection funds.

In the developed economies, capital protection will remain the dominant theme; in the emerging economies, it will be capital growth.

Regional Nuances

In the asset allocation context, there are various common themes across all the regions as well as the regional-specific ones.

The common ones are:
- Investors will be far more discerning about countries and avenues, when investing in emerging markets and frontier markets
- Investors’ 10-year forward return expectations envisage a near halving for most classes, with emerging market equities still retaining pride of place.

The regional-specific themes are:
- **North America**: the uncertainty around the Fed’s exit strategy and the contraction in the pool of triple A-rated bonds needed in LDI programmes
- **Europe**: gaps in skill sets and governance practices to assist the transition from asset accumulation to liability matching in DB plans; and below target balances in nascent DC plans
- **Japan**: gaps in the requisite in-house skills and governance to manage a transition to risky assets by government-controlled pension assets
- **Australia**: low plan balances in mature DC plans; and the risks involved in holding overweight positions in domestic equities
- **China**: the sevenfold increase in the renminbi-denominated QFII quotas; and the formal endorsement of long-term investing by China Investment Corporation
- **Emerging and frontier markets**: improving financial education to deliver better economic returns and corporate governance to replace ‘hot money’ by ‘sticky money’.
“Worldwide, target-date funds hold just over US$650 billion – a figure likely to grow at a compound rate of 15% over the rest of this decade.”
DB investors are transitioning to liability management

Having identified the macro risks that currently overshadow the financial markets, our survey respondents went on to identify the asset classes that are likely to be chosen by DB investors.

In so doing, they separated those that would be targeted for short-term opportunism and those for medium-term asset allocation (Figure 3.1).

For opportunism, six asset classes were singled out: distressed debt (55%), emerging market equities (53%), ETFs (52%), emerging market corporate bonds (51%), emerging market government bonds (50%) and alternative credit (48%).

For asset allocation, a further six were also identified: traditional passive funds (66%), real estate (66%), infrastructure (66%), global equities (66%), alternative credit (56%) and developed market government bonds (56%).

Our post-survey interviews unearthed a number of points.

First, investors’ views about emerging markets have changed perceptibly since our previous surveys. They are seen as much as an opportunistic play as a buy-and-hold story, as we saw in the Executive Summary.

Most emerging economies need to create fresh momentum via reforms. Currently emerging market equities trade at 1.4 times their book value compared to 1.9 times for developed markets. Investors are becoming more discerning.

Second, investors’ appetite for real assets – infrastructure and real estate – will remain undiminished. The appetite is far higher now than in any of our previous six surveys. As the global pool of triple A-rated bonds has contracted by some 70% since 2011, investors are looking for substitutes in their hedging portfolio – substitutes with additional kickers like inflation protection and regular income.

In the last year, notably, the biggest property deals - involving premier trophy assets in London, New York, Tokyo, Sydney and Zurich - were snapped up by pension plans and sovereign wealth funds.

While advancing in their run-off phase, pension plans are moving from an asset-based diversification to one based on liability matching. In it, both real estate and infrastructure feature high in the early stage (“Insights” segment on next page).

INTERVIEW QUOTES:

“Equities are neither cheap nor over-extended. They are a little ahead of themselves but earning growth will catch up.”

“Tapering doesn’t mean tightening. The Fed has pledged to keep policy rates near zero until US unemployment falls to 6.5%.”

“Once the darling of investors in the 2000s, Brazilian equities have fallen by 53% in the past two years.”

Source: The Principal®/CREATE-Research Survey 2014
Third, as in last year’s survey, alternative credit also features high on the list. They have four perceived merits at this juncture in the liability cycle of pension plans. They are an ideal asset class in the early stage of the run-off; they are less volatile than equities; they deliver better yield with lower default rates; and they offer new opportunity sets as European banks deleverage. Thus, both real assets and alternative credit have features that mimic the liability profile of pension plans in their run-off phase.

Fourth, as in our last year’s survey, passives feature high, too. DB plans see traditional indexing as an asset allocation device and ETFs as an opportunistic device. Alpha has proved elusive and expensive for them, when investing in developed market equities and bonds. As a result, they have nearly doubled their allocation to passives since 2008, from 18% to 34%, in order to get low-cost exposure to these markets. Both smart beta and fundamental indices are on the rise. ETFs are seen as ideal for tactical changes, transitional management, cash equitisation and periodic rebalancing. The overall thrust behind the passives comes from their most vocal supporters: pension consultants.

On the other hand, passives are less likely to be favoured when investing in emerging markets. There, market indices are seeing an ever larger dispersion in the constituent returns, as emerging economies no longer move in lock step. Finally, equities face mixed fortunes. Large public sector plans in the West with big deficits are likely to raise equity allocations, as recently announced by the Government Pension Investment Fund in Japan – the largest in the world. It’s the only means for them to support their liability phase, a phased diversification is gaining upper hand over asset maximisation.

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Finally, equities face mixed fortunes. Large public sector plans in the West with big deficits are likely to raise equity allocations, as recently announced by the Government Pension Investment Fund in Japan – the largest in the world. It’s the only means for them to improve their deficits. Besides, they also see pockets of undervaluation in places like Japan, even after attracting a record $125 billion in the past 12 months. On the other hand, in the private sector, most plans are reducing their equity allocations as part of the time-based approach. Having weathered old macro risks, they fear new ones buffeting their portfolios.

The implications are clear: as DB plans are advancing in their liability phase, a phased diversification is gaining the upper hand over asset maximisation.

**INSIGHTS**

Currently, some 15% of our members are retired, rising to 35% by 2020 and generating an ever rising negative cash flow.

So, we are moving from an asset-based diversification to a liability-based one by segmenting the run-off phase into three stages: early, middle and late, with each stage getting ever shorter over time, as the post-War baby boomers retire in ever larger cohorts.

Currently we’re in the first stage, in which the bulk of our assets are invested in four broad asset groups.

The first one targets high total returns mainly via high dividend equities, which remain our main source of returns and capital growth. Some 45% of our assets are allocated to this group of which 10% is allocated to emerging markets. Of the latter, 7% has actually been invested – either in the subsidiaries of global companies listed in the emerging markets or in global companies with significant emerging market exposure. As and when we increase this allocation, we will invest directly in local companies. We will do that once the dust has settled after the second market carnage earlier this year.

Emerging economies are not submerging but retooling for the next wave of growth. We anticipate a variable geometry where economies will advance at more varying speeds than in the past. The difference between the best and the worst performers will get bigger over time with as many value opportunities as value traps. This argues against investing via indices. It also means that stock picking and country risk will be the key avenue of alpha.

Our second asset group seeks to provide high yield via alternative credit. Some 15% of assets are invested in investment-grade credit, high yield bonds, senior loans, mezzanine finance, CLOs and private equity “secondaries.” The default rates of these assets are unusually low in today’s low-interest environment. Additionally, these assets provide regular income that helps as our cash flow needs rise over time.

The third group targets inflation protection via real estate and infrastructure. Some 10% of our assets are allocated to this group with most of it in real estate.

The fourth group targets capital conservation via sovereign debt and investment-grade credit. Some 30% of our assets are allocated to this group.

This approach is dictated by two imperatives.

First, we have to leave some risk on the table in the early stage and progressively reduce it so as to boost our funding levels in anticipation of rate hikes, as the Fed takes away the punchbowl. That also means buying on dips.

Second, as ever more of our members retire, our assets will migrate towards stages, since our funding ratio is still 80% after the recent market bounce.

- A US Private Sector Plan

“New money will flow into real assets and alternative credit, because of their income and cash flow characteristics.”

“Pension consultants will favour passive investing when it comes to the deep liquid markets of the West.”

“High dispersions in returns of the index components will not favour passive investing in emerging markets.”
Worldwide, diversity characterises defined contribution plans, as shown in our 2012 survey. There are employee-managed plans in Hong Kong, Japan, the UK and the US. There are trustee-led plans in Australia, Brazil, Chile, Continental Europe and South Africa. There are state-supervised plans in China, India, Malaysia and Singapore.

This diversity will be reflected in the choice of asset classes, duly separating short-term opportunism from medium-term asset allocation (Figure 3.2).

For opportunism, only two asset classes were singled out in our survey:

- ETFs (46%)
- Active equities and bonds (33%).

For asset allocation, in contrast, six were singled out by around half of the respondent sample:

- Traditional passive funds (70%)
- Balanced funds (69%)
- Target-date funds (64%)
- Target income funds (56%)
- Diversified growth funds (54%)
- Target-risk funds (50%)
- Actively managed equities and bonds (50%).

This batting order has not changed much from last year. Our post-survey interviews shed light on these numbers.

First, as in the DB segment, the widespread interest in traditional passive funds rests on two factors: the elusiveness of alpha and its fees, in an age of high volatility. More and more investors also see charges as a key source of returns, when compounded over time. Moreover, trustee-based plans on the Continent have become overly cautious. Those in the UK have also opted for passive indexing in their target-date funds. Cost is one factor. The other is career risk – an enduring legacy of the 2008 crisis. In these markets, passives and insurance contracts will remain popular while trustees have become over-zealous when discharging their fiduciary role.

Second, interest is growing in target date, target income and target-risk funds in many markets. For example,

**FIGURE 3.2 Which asset classes and investment vehicles are most likely to be chosen by DC investors worldwide for short-term opportunism and which ones for medium-term asset allocation over the next 3 years?**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>% of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Traditional passive bonds/equity funds</strong></td>
<td>13</td>
</tr>
<tr>
<td>Balanced funds</td>
<td>6</td>
</tr>
<tr>
<td>Target date retirement funds</td>
<td>7</td>
</tr>
<tr>
<td>Target income retirement funds</td>
<td>8</td>
</tr>
<tr>
<td>Diversified growth funds</td>
<td>21</td>
</tr>
<tr>
<td>Target risk retirement funds</td>
<td>11</td>
</tr>
<tr>
<td>Actively managed equities and/or bonds</td>
<td>33</td>
</tr>
<tr>
<td>Customised investment plans (including self-managed plans)</td>
<td>15</td>
</tr>
<tr>
<td>Exchange traded funds</td>
<td>46</td>
</tr>
<tr>
<td>Insurance contracts/cash plus</td>
<td>41</td>
</tr>
</tbody>
</table>

Source: The Principal®/CREATE-Research Survey 2014

**INTERVIEW QUOTES:**

“Plan trustees prefer low-cost options to minimise their own career risks.”

“Life-cycle funds are becoming popular outside the US. Their embedded advice and asset allocation are big pluses.”

“DC plans are having early life crises in many markets owing to lower than expected balances.”
Currently, Australia is the fourth largest pension market after the US, the UK and Japan. Its DC assets stand at around 100% of GDP and are forecast to rise to 180% by 2033.

Participation is mandatory and the contribution rate is projected to rise from 9% to 12% in 2020, higher than most DC markets around the world. As Australia avoided the 2000-02 bear market while riding on the back of the China boom, double digit returns were the norm until the Global Financial Crash (GFC) in 2008.

Since then a combination of low returns and an ageing population is creating a credibility gap for the superannuation system.

To start with, double digit returns are history. During the period 2004-2008, a 9% return was the norm across all the supers. Since the GFC, this has more than halved to 3.9%.

There is a lot of talk about consolidation that would reduce overall costs. But that will not improve performance: the largest pension deficits in other countries prevail amongst the largest plans. Scale creates bureaucracy that stifles performance.

Low returns apart, plan balances are too low to permit a decent retirement. For men, they average US$66k for the age band 16-59, and US$184k for the band 60-64. For women the numbers are even lower: US$37k for the 16-59 band and US$105k for the 60-64 band.

On the population side, the number of Australians over the age of 65 is expected to increase by 75% over the next 20 years. The bulk of that will occur over the next eight years when the largest post-War Baby Boomer cohort reaches retirement age. Two problems have come to the fore.

First, growth in post-retirement assets has been less than predicted at a time when the longevity rate is rising. Currently, 81% are forced to rely on the government pension to supplement their income.

Second, there is no asset pooling to tackle the longevity risk. Life-time annuities remain unpopular on account of their unattractive charges and returns. The chances of most Aussies outliving their retirement nest eggs are very high.

In order to improve the plan balances, two changes are being implemented: the introduction of life-cycle funds that target a retirement income benchmark; and the diversification into alternatives, especially real estate and infrastructure.

The changes are incremental, however. Aussie equities continue to retain their attraction as a result of tax incentives.

Elsewhere in the DC world, the pressure to perform stems from the need to build credibility for DC plans while they are still in their formative years. In contrast, in Australia, this pressure stems from the need to build credibility in the post-retirement phase. Without better returns, DC plans face credibility problems.

- An Australian Pension Consultant

“Even in mature DC markets like Australia, the UK and the US, plan balances remain a matter of concern.”

“Even if the US economy was rock solid, DC plans would still be a problem. Their balances are too low.”

“Plan members are now more willing to have a conversation about retirement matters.”
According to our 2013 report, *Investing in a Debt-Fuelled World*, over the next five years, up to 75% of retail assets will be held by baby boomers born in the period 1945-65. Many of them do not belong to any retirement plans. As this decade progresses, the retail and the retirement segments will converge.

This is duly reflected in investment choices over the next three years. For opportunism, only three asset classes were singled out by at least a third of respondents (Figure 3.3):

- ETF (54%)
- Theme funds (37%)
- Actively managed funds (36%).

For asset allocation, five funds were singled out by at least two in every five respondents:

- Traditional passive funds (62%)
- Funds with income focus (62%)
- Mutual funds (61%)
- Capital protection funds (46%)
- Actively managed funds (46%).

Interest in traditional passive funds and ETFs will continue on account of costs. But regulation will be an even bigger factor.

Starting in India and the UK, the Retail Distribution Review has aroused regulatory interest in almost all retail markets around the world. The shape of the regulation may be hazy at the moment but its intent is clear: to attack conflicts of interest, high fees, high rate of churn and poor investment choices. In anticipation of the abolition of front-end, trail and exit commissions, fund distributors are implementing advice-based fees. They are also segmenting clients: those with lower balances – the majority – are being channelled into passives; leaving ETFs to capture momentum when it is working.

Three other observations emerged from our interviews.

The first one concerns income funds. Bond-based funds will remain in the ascendancy with retirees and near retirees holding the bulk of the retail assets.

In the US, however, they are coming in the form of managed drawdown accounts. As the name implies, some pay out a percent of principal each year, ranging from 3% to 7%, depending upon the investor’s risk profile. Some seek to liquidate principal over a specified timeframe: typically 10 years or 20 years. Such funds address the investor’s reluctance to give up control of his/her savings and meet a desire to leave residual savings to heirs. Of course, by their very nature, these accounts do not offer guarantees: investors could well outlive their savings.

**FIGURE 3.3 Which asset classes and investment vehicles are most likely to be chosen by retail investors worldwide for short-term opportunism and which ones for medium-term asset allocation over the next 3 years?**

<table>
<thead>
<tr>
<th>Category</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional passive bonds/equity funds</td>
<td>18</td>
</tr>
<tr>
<td>Funds with income focus</td>
<td>21</td>
</tr>
<tr>
<td>Regulated mutual funds</td>
<td>21</td>
</tr>
<tr>
<td>Capital protection funds</td>
<td>23</td>
</tr>
<tr>
<td>Actively managed equities and/or bonds</td>
<td>36</td>
</tr>
<tr>
<td>Exchange traded funds</td>
<td>54</td>
</tr>
<tr>
<td>Theme funds (e.g. Shari’ah, SRI, environment)</td>
<td>37</td>
</tr>
</tbody>
</table>

Source: The Principal®/CREATE-Research Survey 2014
In the UK, such products will increasingly become popular once compulsory annuitisation ends in 2015.

Second, at the other extreme, active funds and theme funds will remain popular in Asia. Most retail investors will continue to hold concentrated portfolios with a high churn. In China, in search of yield, they will also continue to invest in the so-called wealth management products and trust products. They are typically invested in property and infrastructure development on a short-term basis via the shadow banking system. Their growth has been explosive and has all the hallmarks of the subprime debt in the US which sparked a global disaster in 2008. In China and elsewhere, as the search for yield has intensified, retail investors will be tempted into speculative ventures.

Third and most important, ageing demographics will continue to reshape the retail sector – long characterised by a feast and famine mentality.

At its periphery, herd mentality will be the norm, in both emerging as well as developing economies. The chase for the next rainbow will remain ever prevalent and dominate media headlines.

At their core, however, investors are wising up on their approach to retirement. They worry about the Fed’s declared intention to keep policy rates near zero for a long time. On the other hand, they are unwilling to go for risky assets due to the sequence of returns risk; the inordinate time it may take for their portfolio to recover in the event of another market crash. In the face of the macro risks identified on Section 2, capital conservation will be the key goal at the core of the retail segment.

"The wealth management products in China are as toxic as the subprime bonds in the US".

"Pension systems in Asia are not yet up to scratch to cope with its fast greying populations."

"Capital conservation and income upside will top the agenda of core retail investors."

INSIGHTS

Contrary to general perception, Asia is ageing fast. India and Indonesia are the only nations left with a demographic dividend. It is most evident in the ASEAN (Association of Southeast Asian Nations): Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

Those aged 65 or over account for about 7% of the combined population currently. The number will double by 2030; as will the number of retirees, with the fastest increase occurring in Singapore on account of its favourable fertility and longevity rates.

Within a single generation, their population dynamic will create the same phenomenon that took a century in developed economies: fewer babies and longer lives.

Pension systems have duly emerged in the ASEAN group and elsewhere in Asia. But they face a double challenge. On retirement, lump sums are the norm and annuitisation the exception. They also target a high replacement ratio – the value of the pension paid as a proportion of final year salary. In Vietnam and the Philippines, the rates are 77% and 65% - well above the OECD average of 40%.

As a result, the required contribution rate (as % of income) needed to sustain the current schemes is very high: 49% in China, 43% in Vietnam, 33% in Pakistan, 28% in the Philippines – in contrast to 13% in Japan. Of course, actual rates are well below the required rates, casting doubts about the viability of the pension systems. They also have a comparatively low coverage rate, benefiting around 30% of the working population. Retirement age is low, too. Reforms are in the air.

In the meantime, these countries have an abnormally high savings ratio – currently ranging from 51% in China to 31% in South Korea and 30% in Malaysia. Most of it is invested in bank savings, earning a meagre return in today’s low-yield environment. This is yet another example of the misallocation of capital on a large scale. Asia is asset rich, income poor.

Still, there are two positive straws in the wind. First, across non-OECD Asia, life insurance penetration (as % GDP) has risen from 1.4 % in 2001 to 3% currently. Household savings have formed their assets into long-term channels. Second, the mutual fund industry is expanding rapidly, albeit from a small base. The most pronounced growth has been in Singapore where the total assets handled by Singapore-based managers have risen at an annual rate of 16% since the crisis to US$1.7 trillion.

However, rising prosperity alone cannot deliver more retirement savings. You also need developed capital markets and the right incentives. As the Asian population ages, we envisage fixed income products taking off. But this will take a while to materialise without financial education. Asian investors expect quick returns. The mindset change will remain slow.

As the population dynamics converge in emerging and developed economies, we can see a parallel convergence in the asset allocation of retail investors.

- A US Asset Manager Based Across Asia
High net worth investors are chasing a variety of goals

Being overweight in risky assets before the 2008 crisis, the HNWI segment was the biggest loser in the crash that followed the Lehman collapse. At the time, for example, it accounted for 60% of hedge fund assets and 85% of withdrawals.

Since then, it has become more discerning, with a pronounced regional bias: ultra-cautious in the developed markets and ultra-demanding in the emerging markets. In both areas, the search for high alpha has proved costly. The return expectations are now more realistic and the investment approaches more measured.

When asked to identify the asset classes that the HNWI segment is likely to use for opportunism over the next three years, more than a third of our respondents identified four (Figure 3.4):

- ETFs (50%)
- Commodity funds (47%)
- Currency funds (44%)
- Hedge funds (38%).

For medium-term asset allocation, at least half of them singled out the following:

- Real estate (61%)
- Traditional passive funds (59%)
- Private equity (55%)
- Balanced funds (54%)
- Actively managed equities/bonds (54%)
- Funds with income focus (52%).

There are regional similarities and differences.

In developed as well as emerging economies, the popularity of real estate, passive funds and ETFs will grow – for reasons similar to the ones cited for DB investors.

For the first time in our annual global trends survey since 2009, real estate has emerged at the top of the list. It is seen as a hybrid asset class with bond-type features and equity-like returns. It has the potential to deliver capital growth, income upside and inflation protection.

The new emphasis on the multiplicity of goals marks a decisive shift from our previous surveys, which singled out alpha returns as the be-all and end-all that can accommodate other goals. Since the bear market

FIGURE 3.4 Which asset classes and investment vehicles are most likely to be chosen by high net worth investors worldwide for short-term opportunism and which ones for medium-term asset allocation over the next 3 years?

<table>
<thead>
<tr>
<th>Asset Class / Investment Vehicle</th>
<th>Opportunism</th>
<th>Asset Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate</td>
<td>61%</td>
<td>28%</td>
</tr>
<tr>
<td>Traditional passive bonds/equity funds</td>
<td>59%</td>
<td>13%</td>
</tr>
<tr>
<td>Private equity</td>
<td>55%</td>
<td>27%</td>
</tr>
<tr>
<td>Balanced funds</td>
<td>54%</td>
<td>13%</td>
</tr>
<tr>
<td>Actively managed equities and/or bonds</td>
<td>54%</td>
<td>31%</td>
</tr>
<tr>
<td>Funds with income focus</td>
<td>52%</td>
<td>16%</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>48%</td>
<td>38%</td>
</tr>
<tr>
<td>Capital protection funds</td>
<td>45%</td>
<td>18%</td>
</tr>
<tr>
<td>Exchange traded funds</td>
<td>39%</td>
<td>50%</td>
</tr>
<tr>
<td>Commodity funds (including gold)</td>
<td>20%</td>
<td>47%</td>
</tr>
<tr>
<td>Currency funds</td>
<td>15%</td>
<td>44%</td>
</tr>
</tbody>
</table>

60 50 40 30 20 10 0 10 20 30 40 50 60 70
% of respondents

Source: The Principal®/CREATE-Research Survey 2014

INTERVIEW QUOTES:

“High net worth investors are too impatient. It is becoming harder to capture the full potential of money-in-motion.”

“Private banks are promoting smart-beta strategies in Europe.”

“Gold will retain its appeal in the East as a store of value.”
of 2008-09, however, high returns have proved elusive, ephemeral and expensive.

Besides, the monetary action by the Fed is expected to sustain a property price boom for years to come, both in the commercial and residential segments.

Growth in passives, on the other hand, reflects the desire to remain nimble when markets are driven more by politics than economics. Besides, alpha has proved hard to harvest in the volatile markets of the past five years.

That said, there are regional differences as well.

In Asia in general and the Middle East in particular, three asset classes will dominate asset allocation: real estate, private equity and actively managed funds. ETFs will also be a popular device to pursue special themes when momentum is working.

In India and China, gold will retain its lustre. There and elsewhere in emerging economies, investors will retain a low tolerance for subpar performance.

In the developed markets, on the other hand, balanced funds, hedge funds, income and capital protection funds will be popular. De-risking will be the main theme.

If and when it happens, the predicted rotation from equities to bonds will be somewhat muted for one key reason. Everywhere investors are moving away from the old-style equity-bond mix by deploying other asset classes to deliver a multiplicity of goals in what is expected to be a low-return environment (see “Insights”). Indeed, in this respect, the HNWI segment in the developed economies is importing institutional-quality tools and techniques from the DB segment.

This shift reflects two worries: the Fed’s exit strategy may potentially roil the markets again big time; and the current era of low returns may well last for at least another five years, until the global economy is no longer over-stalked by big macro risks.

As the ranks of billionaires grow in Asia, Singapore is emerging as a global hub in wealth management, with assets in excess of US$1.6 trillion. There is a big difference between the wealthy in the East and the West. In the East, wealth is largely earned. In the West it is mainly inherited. This in turn influences their asset allocation approaches.

Before the 2008 crisis, our Asian clients’ wealth was mainly invested in equities, bonds, hedge funds and real estate. Their key aim was to earn shoot-the-light-out-type returns with low tolerance for under-performance. Their churn rate for wealth managers was high. The differentiation between them was miniscule.

After heavy losses in 2008, two changes have been evident amongst a growing number of wealth managers: their client engagement has become deeper and their asset allocation more discerning.

Taking them in turn, wealth managers have invested a lot in people and technology to improve their CRM function. The onus is as much on education and guidance as on reporting and housekeeping. They are also upgrading their asset allocation capabilities. The mentality of high-returns-at-any-price is being gradually replaced by the twin notions of risk-adjusted returns and a multiplicity of goals.

In the process, our clients are taking baby steps towards an approach in which there is a clear hierarchy of goals, depending upon the age and the personal circumstances of the investor.

The first goal is capital protection, attracting around 35% of assets, with most of it invested in cash plus products locally and sovereign bonds in America and Europe.

The second goal is income upside, attracting around 15% of assets, with most of it invested in investment grade bonds and senior credit in Europe.

The third goal is inflation protection, attracting around 25% of assets, with most of it invested in gold and property.

The fourth goal is alpha, attracting the remaining 25%, with most of it invested in emerging market equities – private and public – and US equities.

Within this overall allocation, there is a strong bias towards smart beta strategies or traditional passive funds.

We are adopting institutional quality tools and goals in our asset allocation, which aim to minimise correlation while seeking a multiplicity of goals.

But we still have to contend with one big drawback: our Asian clients tend to be highly secretive and spread their assets among so many different managers which aim to minimise correlation while seeking a multiplicity of goals.

The advance of the buy-and-hold culture in Asia will follow a jagged path. It requires a long bull market like the one in the West during 1983-2000. Our clients take a lot of convincing that intrinsic value comes through in the end. The necessary investment beliefs are slow to evolve.

Singapore is turning into a global centre. We have the skills, processes and technology you will find in London, New York and Paris. But the investor mindset is still mired in short-term results.

- A Swiss Wealth Manager Based in Singapore

“Private banks are showing an interest in smart-beta strategies for their ultra-rich clients in the Middle East.”

“Demand for capital protection products will grow in the West.”

“With the Asian ultra-rich, mind space is more important than shelf space.”
A Regional Snapshot

The previous four subsections have highlighted the salient aspects of asset allocation by four key investor segments, in the light of the identified market drivers.

This subsection now turns the spotlight on the key asset allocation themes that emerged from our post-survey interviews. Some are common across our sampled regions; some are region specific. They are considered separately here.

Common Themes

The first one concerns the changing emphasis on avenues of investing in emerging economies, after experiencing two severe downdrafts in the space of eight months – June 2013 and February 2014.

While accepting that the days of stellar growth are over, most investors still believe that emerging economies will remain the main growth engine of the global economy for the foreseeable future – if they implement reforms that tackle the deep-seated barriers holding back their next take-off.

Hence, investors see emerging markets as an opportunistic play as much as a buy-and-hold story (Fig 3.1).

Hitherto, investors had relied on five distinct avenues to invest in emerging market equities – indirectly at one end and directly at the other (going from right to left in Figure 3.5). In the wake of the recent big drawdowns, investors will turn more discerning.

Specifically, the two avenues at the two extremes are less likely to be used: passives, because the return dispersions within and between the markets are getting bigger, thereby dumbing down overall returns; and direct, because country-specific risks will be high during the transition to the next phase of growth.

The second common issue concerns return expectations, in the light of the four market-moving unknowns (p.3). Using the last 10 years as a benchmark, the consensus envisages a substantial reduction on a 10-year forward look.

Illustrative reductions are:
- Global equities, going from an 8% to a 5% return
- Global sovereigns, from 4% to 2%
- Real estate, from 9% to 7%
- High yield, from 8% to 5%
- Cash, from 2% to 1%
- Emerging market equities, from 14% to 9%
- Emerging market hard currency bonds, from 9% to 4%
- Emerging market local currency bonds, from 10% to 4%

In sum, while emerging markets will remain attractive on relative valuations, investors will be far more discerning, both about countries and avenues.
The Regional Nuances

North America
Three themes will dominate asset allocation decisions. The main one will be the Fed’s taper programme: will it derail the stock rally and send markets into a tailspin? Will the Fed hold its over US$4 trillion asset mountain to maturity or sell it? Will its exit path turn what has been a stabilising force into a destabilising one? What will be ‘fair value’ after the exit when the dust settles?

The second theme concerns liability driven investing. Nearly 17% of baby boomers now report that they are retired, compared to 10% in 2010. The number is set to rise rapidly by the end of this decade. In response, as ever more DB plans in the US adopt immunisation glide paths, two impediments will emerge.

The first one stems from the contraction in the global pool of triple A-rated bonds used in the hedging portfolio. Unlike their European counterparts, the US plans are less keen to use synthetics such as swaps and options because of counter party risk exemplified by the Lehman collapse.

The second impediment is the time-varying risk premia for assets in the return-enhancing portfolio.

Both impediments are already slowing down the journey along the glide path to full immunisation.

The third theme concerns low average balances in DC plans, around US$60k currently. At around 8%, the average deferral rates remain well below the recommended prudent level of 17%.

As a result, the spotlight has turned on how to improve asset allocation via target-date funds. Holding some $600 billion in assets currently, they are likely to grow at a compound annual growth of between 15% and 20% over the rest of this decade.

This is corroborated by the recent decision by The Federal Retirement Thrift Investment Board to rebrand its ‘L Funds’ as ‘lifecycle strategies,’ based on target-date funds. Managing US$330 billion, the Board is seeking a new conversation with its 4.6 million members about worry-free asset allocation so as to stimulate more interest in target-date funds.

Europe
The two US themes apply to Europe, too, plus two additional ones.

First, as ever more DB plans advance in the run-off phase, they have to acquire the new skills and governance expertise to go from asset accumulation to liability management: a whole new game for most of them.

Second, DC plans have yet to build up a track record – in assets and returns – that inspires trust and motivation. Assets are building up gradually mainly by regulatory behest. But constant media scrutiny will invite more regulatory intervention and dumb down the asset allocation choices even more. As it is, on the Continent, investment choices are fairly cautious. For example, in 2000, the state pension system accounted for 78% of retirement income in Germany. Thanks to the so-called Riester Reforms in 2002, this was reduced to 70%. But few believe that the German DC plans will be able to bridge the gap, due to their heavy reliance on low-yield stable value insurance contracts.

Japan
As part of the ‘three-arrows’ initiative, the biggest change in asset allocation will come from the recent far-reaching reforms to boost returns at the giant US$1.25 trillion Government Pension Investment Fund.

Rather than being overweight in Japanese Government Bonds (55%) and foreign bonds (13%), the Fund is now...
mandated to invest far more in equities, infrastructure, real estate and venture capital. Its asset allocation may change markedly over the next three years.

The timing is propitious: the Bank of Japan is buying JGB in large volumes as part of the ‘three-arrows’ initiative. So, the Fund is in a seller’s market while readjusting its portfolio. The allocation to global equities is expected to double from 20% currently.

However, a large part of the portfolio changes will be implemented initially via smart-beta strategies and passive funds, until the Fund has build up the requisite in-house capabilities and governance to manage overseas investments on an enlarged scale.

**China**

Two recent measures are expected to have a significant impact on asset allocation.

The first one concerns the seven-fold rise in the RQFII quotas. This will allow overseas investors to increase their holdings of Chinese equities and bonds.

Over time, Hong Kong, London, Paris, Luxembourg and Singapore will become hubs for inflows into the Chinese markets. When, as seems likely over the next five years, the Chinese A-shares are included in the MSCI All-Country World Index, the RQFII quotas will rise to enable the ensuing automatic portfolio rebalancing across the globe.

The second measure concerns the adoption of the so-called Santiago Principles by the China Investment Corporation (CIC), the nation’s main sovereign wealth fund.

Under the auspices of the International Forum of Sovereign Wealth Funds established in 2009, the CIC has signed up to the principles of long-term investing and full transparency in asset allocation.

The significance is two-fold: it publicly supports the ethos of buy-and-hold investing: and if all the sovereign wealth funds did that, their influence on the global financial markets could be substantial. Together, they hold US$4.5 trillion currently; this is projected to rise to US$10 trillion by 2020.

**Emerging Economies and Frontier Markets**

Two themes will impact asset allocation in these regions. The first concerns the need to nurture a buy-and-hold culture, as they generate huge wealth. Currently, much of it ends up in real estate and bank deposits, with the rest in speculative trading. Their capital is not channelled to ventures that deliver the best economic returns. Without financial education and advice-embedded products, investing will continue to verge on speculative trading. Across these regions, financial flows have preceded financial education.

**INTERVIEW QUOTES:**

“While the locals in Asia struggle with the idea of long-term investing, asset allocation remains a hit-and-miss affair.”

“Each month, a million new Indian youngsters enter the workforce, with bleak job prospects while corruption paralyses their economy.”

“Allocations to frontier markets remain low. Governance holds the key to future growth.”
On the education side, they need a basic understanding of how their chosen investment options work; what risks are embedded into their portfolios; the virtues of buy-and-hold investing; the perils of panic buying and panic selling; the futility of chasing the next rainbow created by regular fund ratings and new launches; and the power of compound interest rates and dollar-cost-averaging.

The aim of such an educational effort is not to produce investment experts. Rather, it is to promote a basic grasp of what their portfolio aims to do and cognitive capabilities to ask intelligent questions, seek advice and make decisions. Above all, it is to get across the message that investing is not a rent-seeking activity but a growth-promoting device.

The second theme relates to corporate governance, which falls well short of international standards in areas like financial transparency, board composition, independent non-executives, separation of the role of chairman and chief executive, and annual and shareholder meetings.

Where the standards prevail, they are honoured more in the breach than in the observance. Family-owned businesses predominate. Public officials are often "on the make".

Reportedly, China and India have many admirable principles to guide their governance practices. But there remains a big gap between principles and practices.

The advent of foreign capital has done a lot to bridge it, in emerging and frontier markets alike.

When their markets were riding high, the gap was easy to price into the valuations. Now, the gap has not only affected the size of inflows but also rendered it more volatile in times of stress.

Without better investor education and corporate governance, these regions will continue to attract ‘hot money’ far in excess of sticky money.
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CONTACT DETAILS:

Prof. Amin Rajan
amin.rajan@create-research.co.uk
Telephone: +44 (0) 1892 52 67 57
Mobile/Cell: +44 (0) 7703 44 47 70
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