

Investment market review

The credit crisis and implications for investment markets

Date: 21st October 2008

Executive summary

- Since the middle of 2007 the decline in US housing prices has morphed into a global credit crisis. The severity, scope and duration of the crisis have evolved beyond all expectations, culminating in a near-collapse of the financial system.
- The seeds of the crisis were sown in the macroeconomic environment that prevailed from 2003 to 2007. Increased capital flows from fast-growing emerging economies created imbalances in global capital markets, and supported low interest rates.
- This, in turn, encouraged widespread use of leverage across asset classes. This was most prevalent in the lower-risk asset classes such as (i) credit and other yield-based products; (ii) real assets such as residential property, due to its perceived low risk and capital appreciation prospects.
- The combination of increased product innovation and expanded use of leverage increased the level of systemic risk in financial markets. This lay dormant until the period of low interest rates and price appreciation in US residential property ended.
- As falling house prices became widespread, ratings agencies began to downgrade mortgage backed securities in July 2007, setting off a chain reaction of widespread losses in financial markets. This was the first phase of the credit crisis.
- Failure to restore market confidence saw the crisis enter a second, more critical phase characterised by liquidity concerns escalating into solvency concerns, greater government intervention in markets and negative feedback loops to the real economy.
- The end of the credit crisis will be characterised by the return of liquidity in international financial markets and a new equilibrium cost of capital determined by changing investor expectations about future returns. Its form and timing will be dependent upon the return of confidence to the global financial system.
- The post-crisis investment landscape is likely to change significantly. Total return expectations will moderate to reflect underlying asset returns instead of leveraged, financially engineered returns. Armed with a realistic appraisal of risk, investors will be better positioned to make investment decisions, providing the platform for more sustainable long-term growth.

1. Introduction

Since the middle of 2007 the decline in US housing prices has morphed into a global credit crisis. The severity, scope and duration of the crisis have evolved beyond all expectations, culminating in a near-collapse of the financial system.

This Investment Market Review provides a critical assessment of the crisis. Section 2 identifies the factors that led to the credit crisis, including the role of global growth and capital imbalances in creating large pools of capital, investor attitudes to risk, financial innovation and a resulting price bubble in US housing markets. The interplay of these factors embedded an unknown level of risk into the global financial system.

In Section 3, the credit crisis is divided into two distinct phases. In the first phase of the crisis, problems in US housing markets spread to global financial markets requiring co-ordinated efforts from global central banks to boost liquidity. The second phase of the crisis, characterised by escalating concerns over solvency in the financial system, triggered greater market intervention by government to limit the impact on the real economy.

Finally, the implications of the crisis are considered in Section 4. What will the impact on the macroeconomic environment be? How will the post-crisis investment product landscape change? Which products and asset classes are likely to perform well?

2. A background to the credit crisis

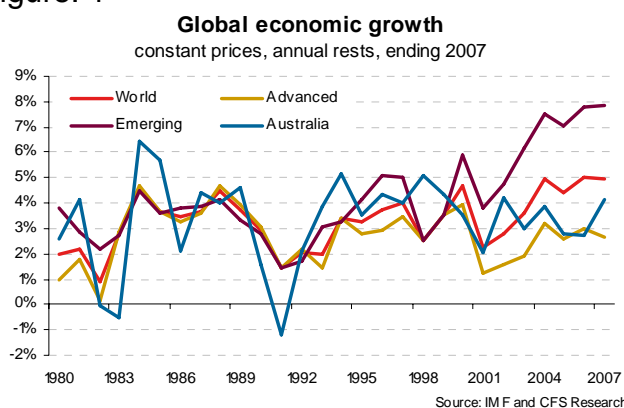
This section describes the elements that have contributed to the global credit crisis, including global growth and capital imbalances, financial innovation and leverage and changing attitudes to risk and return. These factors contributed to a US housing market bubble, which ultimately led to the credit crisis.

Global growth and capital imbalances

Global macro-economic conditions prior to the credit crisis and in the aftermath of the Tech Wreck in 2001, were uniquely expansionary. Between 2004 and 2007, global growth averaged 4.8% per annum - the fastest period

of expansion since at least 1980. This is observed in Figure 1.

Figure: 1

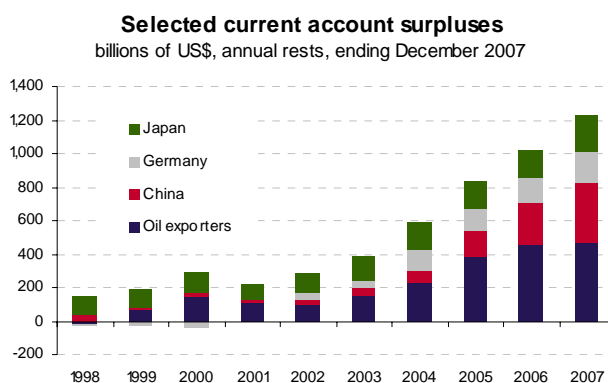


However, the figure also shows a divergence in the patterns of growth between emerging and advanced economies. Advanced economy growth fell behind growth in emerging economies from 2001. As a result the share of global GDP accounted for by advanced economies fell from 63% in 1999 to 56% in 2007.

The different patterns of global economic growth contributed to the emergence of imbalances in global capital markets.

Emerging economies that enjoyed high growth generated excess savings, which were added to the surplus savings of some developed countries, such as Germany and Japan and are evident in rising current account surpluses, as shown in Figure 2. China, Germany and Japan, in addition to the principal oil exporters, accounted for over 60% of global current account surpluses in 2007.

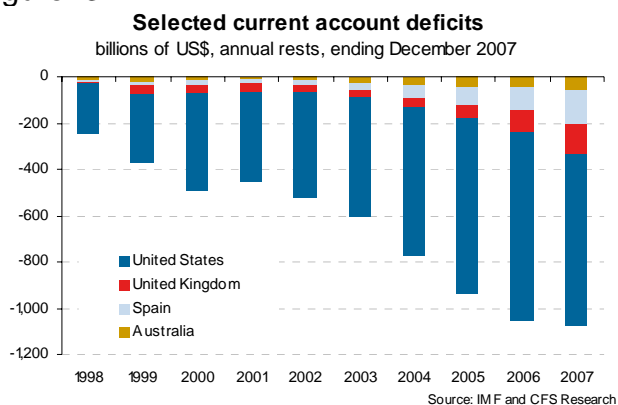
Figure: 2



With limited access to suitable domestic investment markets, these excess savings were exported primarily to the US, UK, Spain and Australia; where financial markets were

characterised by a greater depth of capital, a broader range of investment products, and more transparent regulation. These four markets were the recipients of 70% of global capital imports in 2007, creating a situation where the destination of capital was concentrated relative to the source of capital. This is shown in Figure 3.

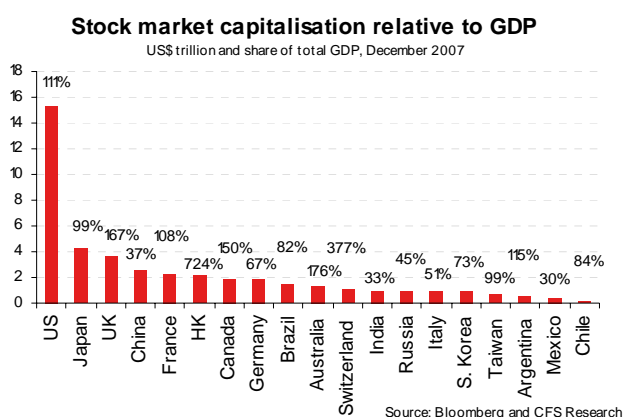
Figure: 3



The US was the largest recipient of this excess capital. In 2007, 50% of global surpluses ended up in US markets, largely as financial assets. The scale of capital deposited meant market interest rates in the US were effectively subsidised by the excess savings of other economies.

Excess savings created imbalances in global capital markets and a concentration of funds in US financial markets. While globalisation of trade had created diversification benefits for the global economy, the globalisation of finance concentrated capital and financial risk in the US. With the largest financial markets, the US was a natural destination for capital from countries where markets are small relative to GDP, such as Germany and China. The size of equity markets relative to GDP is shown in Figure 4.

Figure: 4



The surplus of savings, exported to the US, led to lower market interest rates and a concentration of funds in US financial markets, creating conditions for price bubbles.

Financial innovation and leverage

Growth in capital imbalances coincided with the recovery in financial markets from the Tech Wreck of 2000 to 2003 that had changed investor preferences to risk. Immediately after the Tech Wreck, risk aversion increased as investors sought to preserve capital through yield based products, such as debt and real assets.

However, as macroeconomic stability continued, investors began to seek higher returns. In particular, the desire for 'alpha' led to a raft of new products, which often relied on leverage to achieve the desired return.

Financial innovation

This period of expanded demand for yield spurred growth in securitised products such as asset backed securities, as well as the proliferation of new, more complex products such as collateralised debt obligations (CDOs)¹ and credit default swaps (CDSs)². These products flourished in financial markets that were lightly regulated with strong management incentives to increase product volume.

These innovations were, initially, designed as risk management tools, intended to spread and dilute the risk of default across the financial system. For instance, the securitisation of mortgage lending aimed to diversify risk by pooling individual mortgages and on-selling them as financial market securities. Securitisation lowered entry costs, enabled the entry of a wider range of mortgage originators, enhanced competition and cut mortgage borrowing costs for the consumer.

Rising innovation in financial markets required rapid adaptation by other parts of the financial system's infrastructure. For instance, ratings

¹ A CDO is a type of asset-backed security where various forms of debt are bundled together. They often divide the credit risk into tranches, each with a different credit rating which is known as a subordinated structure.

² A CDS is a contract in which a buyer pays a series of payments to a seller, and in exchange receives the right to a payoff if a credit instrument goes into default.

agencies were challenged to provide an assessment of the ability of securities to pay principal, interest or dividends. As MBS and other securities evolved, these agencies were required to provide ratings for securities about which there was limited information or historic performance.

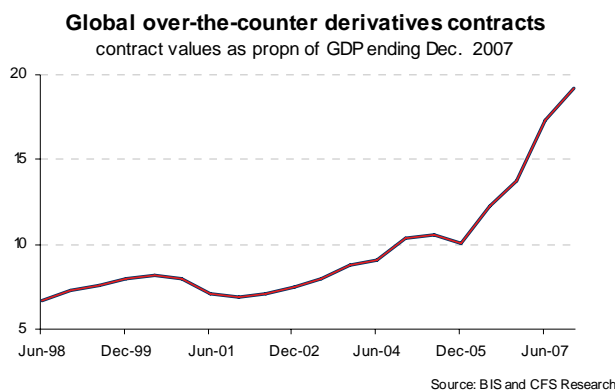
Leverage

The creation of seemingly robust risk management tools allowed investors to seek alpha returns. Alpha refers to above normal returns on investment, returns that are in excess of what should be expected from a particular asset or asset class. However, this concept was not well understood by investors, whose desire for alpha fuelled the use of leverage in the form of debt and derivatives.

The falling price of credit due to excess savings and official monetary policy enabled greater use of debt by investors. In the US between July 2003 and June 2004 the Federal Funds rate was just 1.0% as inflation fell to 1.7% in 2004. This allowed credit to expand rapidly. The extremely low cost of debt encouraged the use of leverage across many asset classes but was most prevalent in the lower-risk asset classes such as credit and real estate.

Growth in the use of derivatives was also rapid and is reflected in Figure 5, showing global over-the-counter derivatives contracts relative to GDP, in Figure 5.

Figure: 5



Derivatives were originally introduced as a risk management tool. In the mortgage lending industry, it allowed lenders to remove some new lending from their balance sheets. This enabled significant growth in lending portfolios that further enhanced competition, particularly

in mortgage markets. Many investors, however, saw derivatives as a means of enhancing returns.

A new risk-return environment

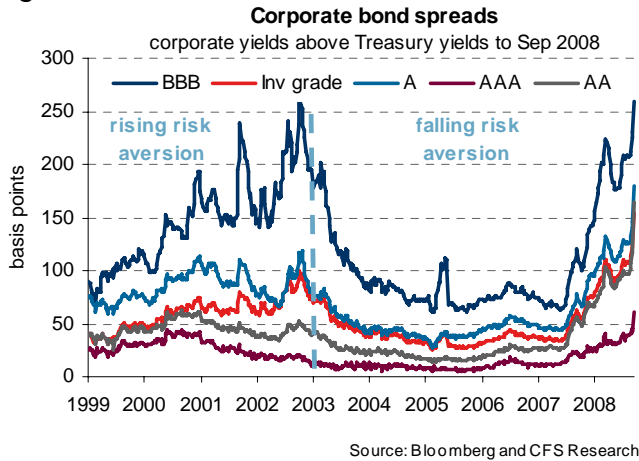
The combination of product innovation and leverage boosted asset returns enhanced competition and lowered prices for consumers. However, it also embedded systemic risk in financial markets due to the rapid expansion in products and falling transparency, leading to a mispricing of risk.

Securitisation and derivatives supported competition and growth in financial services, but created systemic risk. Securitisation divorced originators from the owners of loans. Where banks had once controlled a mortgage from beginning to end, mortgage brokers now originated loans that were sold to financial markets. The short-term incentives of mortgage brokers encouraged growth in loan portfolios but discouraged proper assessment of the default risk that would be borne by the end owner of the asset.

Innovation and leverage also removed transparency from financial markets. Derivatives and other off-balance-sheet assets are, by nature, relatively opaque leaving market participants with only a limited understanding of the relationships between underlying assets and the various products' associated risk. This was further compounded by the inability of rating agencies to properly understand the risk due to the relative immaturity of the market for these products.

The increase in innovation and leverage coincided with an increase in risk appetite. This was reflected in the dramatic fall and compression in bond spreads observed across the risk spectrum in the period from 2003, highlighted in Figure 6.

Figure: 6

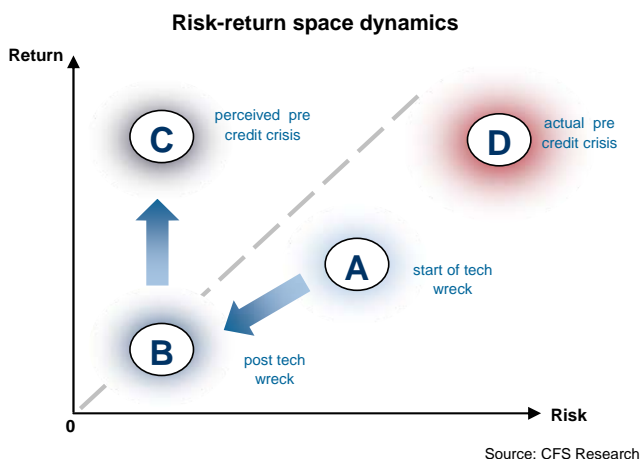


The shift in the risk-return trade-off is highlighted thematically in Figure 7. Point A reflects the Tech Wreck trade-off. In risk-adjusted return (RAR) terms investors were not receiving adequate returns for the level of risk they were bearing. As prices reached their peak, the level of assumed risk was substantially greater than any future return.

As prices of growth-equities fell steeply, risk-aversion increased, prompting a flight to lower-risk asset classes such as yield-based products, denoted by point B.

Over time, investors used low interest rates to apply leverage to these lower risk asset classes, in the search for “alpha”. The higher returns, combined with macro-economic stability (stable market interest rates and low inflation) meant investors believed they had achieved “alpha” (represented by point C). However, the true level of risk, including the embedded risk created by greater leverage and complexity, was severely underestimated, and investors were instead at point D.

Figure: 7



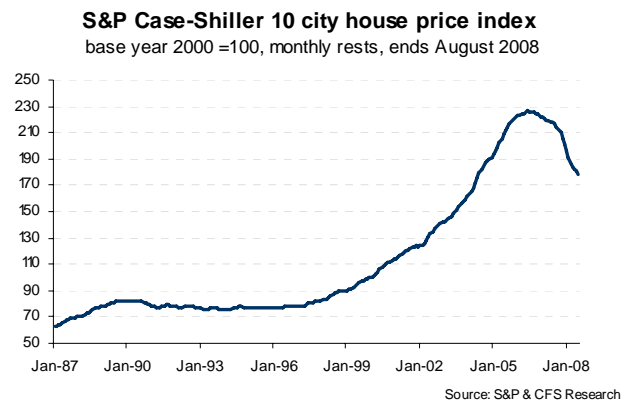
The increased level of innovation and leverage, combined with lower transparency and greater complexity, left the financial system vulnerable to even small falls in the prices of assets.

US housing markets

The confluence of these factors was observed in the US housing market, which was a prime candidate for an asset price bubble due to its perceived low risk, capital appreciation potential, ability to support high levels of leverage, and strong political incentives promoting growth in the sector.

The US housing market enjoyed a boom, with national house prices rising by 12.4% per annum from December 2001 to December 2006 compared to an historical average of 4.6%. The market’s growth seemed to match the belief of perpetually rising house prices. This is shown in Figure 8.

Figure: 8



The US saw particular growth in the mortgage market. Rising house prices and competition led lenders to increase their exposure to sub-prime lending. Sub-prime lending refers to loans to people with limited ability to repay. Instead, both lender and borrower are dependent upon perpetually low interest rates and rising house prices to make the transaction profitable.

Adjustable Rate Mortgages (ARMs) also became popular. ARMs allowed borrowers to fix interest rates at the low prevailing market interest rates between 2000 and 2004. They would reset after a specified period of time to the prevailing market rate.

By June 2006, house prices were falling in the US. By this stage, the Federal Funds rate had risen from 1.0% in June 2004 to 5.25% in July 2006. This endangered ARMs that began to re-set at significantly higher interest rates and led to increasing defaults. The interplay between rising interest rates, re-setting ARMs and falling house prices became a vicious circle and homeowners began to default triggering the credit crisis.

3. The credit crisis

The previous section discusses the elements contributing to the credit crisis: excess capital flows to the US, changing attitudes to risk, financial innovation, excess leverage and the US housing market downturn. This section analyses the credit crisis in two distinct phases, before considering its potential resolution.

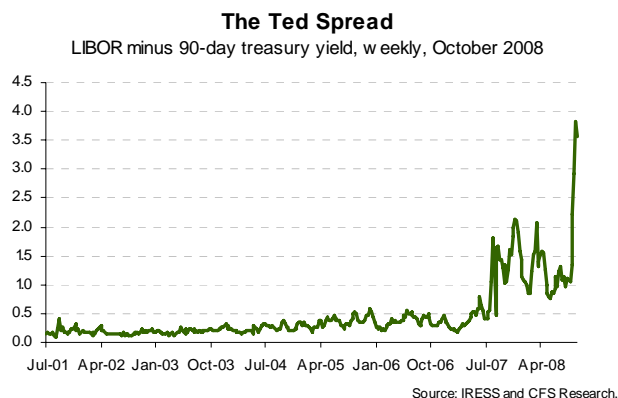
The first phase of the credit crisis

Price declines in housing accelerated in 2007, as observed in Figure 7. As losses worsened, house purchases fell precipitously and liquidity in mortgage security markets evaporated.

In the realisation that house price falls were now widespread, ratings agencies began to downgrade mortgage backed securities in July 2007. Sharp falls in the prices of mortgage backed products led to margin calls, requiring institutions to sell higher-quality assets at heavily discounted prices. Balance sheet losses at major banks rose due to mark-to-market valuation techniques (see “Credit crunch: implications for property and infrastructure,” CFS Research, 2007)

The uncertainty surrounding the exposure of counterparties to the sub-prime mortgage market meant that financial institutions became wary of transacting with each other. Hence, liquidity problems in the mortgage security market spread to the general debt market, particularly the inter-bank markets. The flight to quality saw an increase in spread for non-government debt and falling market liquidity. This is shown in Figure 9.

Figure: 9

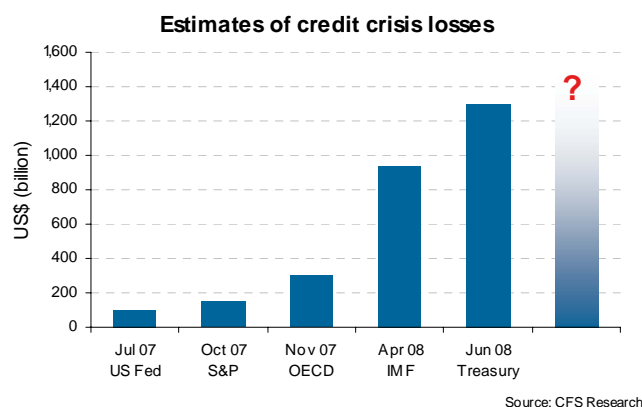


Increased uncertainty led to a general increase in volatility within global equity markets. In the Australian equity market, volatility tripled over the period of the credit crisis. Implicitly, this increases the cost of capital and, in turn, creates a negative feedback loop of higher risk premia that further adds to the cost of capital.

In response, policy makers around the world, but particularly in the US, took large steps to improve liquidity in financial markets. These steps included the use of central bank balance sheets to improve liquidity in inter-bank markets and cuts to official interest rates from August 2007. The US Federal Reserve (“Fed”) cut its Fed Funds³ rate from 5.25% in 2007 to 1.50% in 2008, and also reduced the discount rate⁴ to ease pressure.

As Figure 10 shows, the initial estimate of these losses by the Fed of US\$100bn, proved inadequate. By September 2008 total losses on bank balance sheets had reached US\$600bn.

Figure: 10



³ The Fed Funds rate is the rate banks charge each other on overnight borrowings.

⁴ The discount rate is the rate banks pay the Federal Reserve on overnight borrowings.

The second phase of the credit crisis

The initial policy response from monetary authorities proved ineffective. Vast amounts of liquidity pumped into the system failed to ease the uncertainty and heightened risk aversion amongst market participants as the crisis dragged on. Investor confidence, which was necessary to ensure the normal functioning of financial markets, was extraordinarily low.

The failure to restore market confidence meant that the crisis entered a second, more critical phase characterised by:-

- Liquidity concerns escalating into **solvency** concerns
- Greater market **intervention**, including a greater role played by governments, as well as greater global coordination
- Market conditions being exacerbated by **negative feedback loops** from the real economy

These are discussed in turn, noting the important role that confidence played in each aspect of the crisis.

From liquidity to solvency

Liquidity, the ability of a bank to convert its assets to cash, fell as banks refused to transact with each other as confidence fell and counterparty risk rose. Liquidity is essential for banks borrowing short-term, through customer deposits and inter-bank markets, to fund long-term assets. A lack of liquidity in inter-bank markets threatens their ability to meet short-term debt obligations and can lead to insolvency.

As liquidity problems persisted and confidence deteriorated, these developed into solvency problems. As the IMF has noted, this is particularly the case in an environment of financial integration and innovation.

In the credit crisis, access to short-term liquidity was restricted and the ability to meet obligations limited. As a result some Wall Street investment banks, with no access to deposits, rising funding costs and falling asset values, were left insolvent. These large failures threatened the global financial system's existence.

The threat first emerged in March 2008; Bear Stearns was the first of the Wall Street investment banks to be threatened with insolvency. As a result the Fed arranged a sale to JP Morgan Chase. In addition, the Fed used its own balance sheet to guarantee US\$29 billion of Bear Stearns assets.

However, the tipping point for a deepening of the crisis came in September when Lehman Brothers filed for bankruptcy and Merrill Lynch was purchased by Bank of America⁵. Goldman Sachs and Morgan Stanley, the remaining independent Wall Street investment banks, sought to avoid a similar fate by converting to bank holding companies. This status allows them to access deposits as a source of funding but places restrictions on the level of risk they may now undertake.

Insolvency spread beyond Wall Street investment banks. American Insurance Group (AIG), the largest US insurer, Countrywide Financial, the largest US mortgage lender, and Washington Mutual, the US's fourth largest commercial bank, were among a number of organisations unable to continue independent of external support. In the UK, the government forced a merger between two banks; the struggling HBOS and Lloyds TSB. This was after it had nationalised mortgage bank Northern Rock in February 2008.

These events exacerbated the contagion in financial markets. Lehman's default on its debt caused some large money market funds, the safest of all investments, to 'break-the-buck'⁶ prompting further panicked selling. At one point, 90-day Treasuries traded at negative yields. This was a dramatic manifestation of the flight to safe assets and highlighted the need for increased market intervention by authorities.

Greater market intervention

The escalation of the financial crisis prompted a substantial change in policy leadership from central banks to government. The increasingly global nature of the crisis also necessitated greater coordination between countries.

⁵ Which had earlier purchased Countrywide Financial, the largest US mortgage lender

⁶ A term used to describe a situation where money market investors receive less than their initial investment.

In the US, whereas the Fed has previously led efforts to combat the financial crisis, Treasury was also required to intervene in response to the deteriorating situation.

In September, US Treasury announced that it would nationalise Fannie Mae and Freddie Mac, the two largest mortgage lenders, which were also Government Sponsored Entities (GSEs). Insurance giant AIG was also bailed out, with 80% of the company placed under government ownership, as part of a US\$121 billion rescue loan from the Fed.

This was followed by the US Treasury's US\$700 billion Emergency Economic Stability Act (EESA). Initially, the act was designed to purchase troubled mortgage-backed securities from financial institutions, meaning the US government would assume default risk on these assets to lower counterparty risk in the financial system.

However, in October, the British government announced further measures that were more positively received by the market. It used £39 billion to purchase stakes in three of the largest UK banks prompting other nations to do the same. The US Treasury purchased equity stakes in US banks. This accounted for approximately US\$250 billion of the US\$700 billion available to it in the EESA and amounted to approximately 25-30% of the total capitalisation of US banks.

The motivation for direct control of these institutions is threefold. Firstly, government ownership of banks at this time improves public confidence in the health of the banking system. Secondly, government control over bank policy, should promote greater liquidity in lending markets. In the case of the UK, board representation is part of the government nationalisation arrangement. Finally, as discussed in the next section, interim government ownership of banks ensures bank viability prior to the introduction of a new regulatory regime for the financial sector.

Global action was also evident in the coordinated move by governments and central banks to guarantee bank deposits and cut interest rates.

This unprecedented level of intervention and coordination amongst policymakers was necessary to prevent a systemic failure of the

global financial system with dire consequences for the global economy.

Negative feedback loops and the real economy

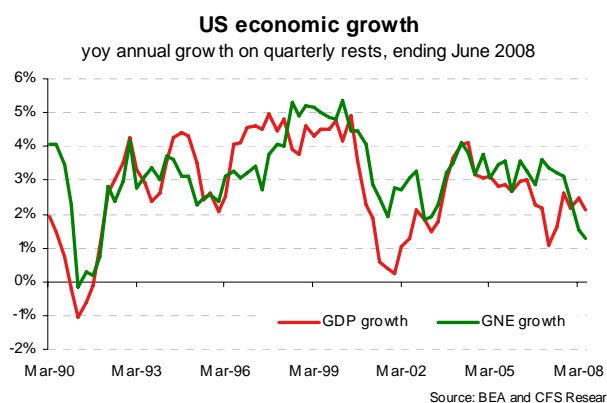
In the year since the credit crisis began, a significant deterioration in US economic conditions has become apparent. This has been most evident in the labour market, where the unemployment rate has risen from 4.4% in early 2007 to 6.1% in August 2008. As a result, the US economy is expected to experience a recession in at least the second half of 2008.

The deterioration in economic conditions reflects the existence of a negative 'feedback loop' between financial markets and the real economy, identified by the Fed early 2008. In particular, the Fed was concerned that restrictive credit availability, arising from financial market dislocation, would negatively impact the economic outlook, prompting further tightening in credit conditions.

The shift from liquidity concerns to solvency concerns parallels the evolution of the crisis from a financial market phenomenon to a real economy event (or 'Wall Street to Main Street'). In both cases, deteriorating expectations and confidence is playing a significant role in the crisis worsening.

The deterioration in domestic conditions in the US can be observed in the sharp fall in gross national expenditure (GNE) growth in the latest national accounts. Annual GNE growth, for the year to June 2008, fell to 1.3% yoy. Alternatively, GDP growth, reflecting strong exports, has remained stable to date. This is shown in Figure 11.

Figure: 11



Resolution of the crisis

The end to the credit crisis will be characterised by liquidity returning to financial markets and a new cost of capital, determined by changing investor expectations about future returns, as government interventions begin to work. Its form and timing will be dependent upon the return of confidence to the global financial system.

The role that falling confidence has played in the credit crisis so far has been emphasised. Indeed, it is at the heart of why the crisis has persisted and escalated in the manner it has. It is the necessary precondition for any recovery. To re-create confidence in the financial system, government, market participants and households have considerable roles to play.

The first goal for authorities in the US and around the world is to ensure greater **stability**. One move has been a ban on short-selling with the aim of protecting financial services firms from selling attacks. However, the ban potentially prevents markets from reaching equilibrium prices and may have exaggerated the current level of volatility in markets.

The second goal for authorities has been to improve the balance sheets of banks so as to limit **counterparty risk**. The first phase in this process has already begun and has created an environment in which an orderly de-leveraging process and transition to the new equilibrium can occur. Markets have responded positively to these measures with the spread between the rates in inter-bank lending and treasury markets narrowing.

The final goal of authorities will be to outline a new **regulatory framework** for financial markets. The new framework is likely to be more restrictive and costly than its predecessor, as well as global in scope. Its tougher stance will increase the cost of credit and limit the scale and scope of banking operations, but improve transparency. This should improve risk management practices and increase confidence in the system as a whole.

The involvement of Treasury and taxpayer-funded policy measures introduces a political dimension to the crisis' resolution. Issues

being debated include ensuring sufficient upside for taxpayers, limits on compensation for those who benefit from the fund, executive remuneration, incentive structures and the broader problem of moral hazard. These issues need to be addressed to limit the risk of a repeat of the credit crisis, as well as ensuring the burden of the crisis is distributed equitably and fairly. The direct equity stakes governments have taken in banks, has afforded them greater control over these issues.

The cost of debt will rise relative to equity as the re-pricing of risk occurs, requiring market participants, particularly banks, to de-leverage. The process will include raising capital through external investors, retained earnings, lower dividends, asset sales, removing bad assets from balance sheets and a more conservative approach to balance sheet expansion.

Many households will also need to de-leverage. In extreme cases this will be through asset sales and defaults. However, most households will use increased re-payments on accumulated debts as the most common method of de-leveraging. De-leveraging will not be easy in a time of falling asset prices and rising unemployment. This highlights the importance of increasing liquidity in US house markets. As buyers return to the market, prices will stabilise, providing borrowers and lenders with greater price certainty.

4. Investment implications

This section outlines the implications from the credit crisis as it eases and a new environment in the global economy and investment markets prevails.

Macroeconomic climate

The credit crisis marks an inflection point from a period of rapid credit expansion (supported by low interest rates and relaxed lending standards), to a period of much more moderate credit growth as de-leveraging occurs. This is already occurring, largely as a result of a restricted supply of credit. However, as supply increases, credit growth will remain slow as a result of lower demand.

Because capital markets are global in nature, the increased **cost of credit** and decline in lending growth will be felt across the globe. In addition, the decline in **US consumer spending** will affect export growth in other economies, further dampening their growth prospects.

Economic growth, therefore, is likely to be significantly lower than the levels seen over the past five years – which were strong by historical standards. From 2003 to 2007, real GDP growth averaged 4.6% globally, compared to an average of 3.3% for the twenty years prior. The strength of global growth will be dependent upon the ability of emerging markets to achieve strong domestic growth without the stimulus of high export demand.

Australia

Australia's status as a small open economy would ordinarily leave it highly vulnerable to the ripples emanating from the US; however, there are four broad points which suggest the effects here are likely to be more moderate than in the US and Europe.

Firstly, the **financial system** in Australia is in a more fundamentally sound position. Banks have been more prudent. This was highlighted in an IMF study showing that of the 28 banks with AA credit ratings or higher globally, 8 are Australian owned or controlled. Indeed, the Australian banking regulation model may be used internationally in the wake of the crisis.

Secondly, Australia continues to enjoy the stimulus provided by Asia's structural economic development (see "Asian Infrastructure Sector Review, CFS Research, 2008). The **resources boom** has contributed to the largest terms of trade shock in Australia's history.

Thirdly, **policy settings** going into the crisis are sufficiently tight to allow the government and the Reserve Bank of Australia (RBA) to add substantial stimulus to the economy. This is evident in the two rate cuts by the RBA, first 25 bps in September 2008, followed by a 100 bps cut in early October. It is also seen in the government's fiscal stimulus package of \$10.4 billion aimed at families, pensioners and first home-buyers.

Finally, Australian households have been more prudent in their behaviour since 2003, meaning much of the de-leveraging required is already taking place through slower credit growth and faster debt retirement. The cut to interest rates, government stimulus and falling petrol prices will further help households survive the crisis.

The greatest risk to the Australian economy is a substantial rise in unemployment. An unemployment rate above 5.0% would further depress economic sentiment and prolong the period of economic weakness. Avoiding a significant decline in employment will be dependent upon an improved flow of credit to businesses and households and a relatively limited impact on the domestic economy from the global downturn now taking place.

Investment landscape

Changing market dynamics

For investment markets, the de-leveraging process across asset markets is likely to see prices remain volatile.

The composition of total returns is also likely to change, with investors discriminating between underlying **asset returns** and **financially engineered** investment return. 'Artificial yields,' which rely on financial engineering, are likely to fall from favour, with cash flows from the underlying asset regaining prominence.

In a similar vein, there will be a re-emphasis on active funds management to deliver out-performance, instead of a reliance on general market momentum driven by capital flows.

Product offering

Products heavily reliant on **leverage** will become less popular in the post-credit crisis environment. These include certain styles of hedge funds, long/short funds, and the leveraged buyout end of the private equity spectrum.

More complex products, such as structured products, asset-backed securities and other derivative products will not enjoy rapid growth. Instead, investors will be attracted to **simpler, more transparent products**.

A closely related point revolves around the **regulation** of products. Certain asset classes such as private equity and hedge funds have been largely unregulated. The prospect of greater regulation is a negative for these asset classes. The proposed disclosure of short positions may be a source of competitive disadvantage for a hedge fund.

In terms of investor demand for **yield-based** products, we see this intensifying, rather than diminishing. This reflects the investment objectives of major sources of capital such as pension funds, which have liability matching needs and prefer yield-based asset classes and products. This will favour bonds and other asset classes at the 'core' end of the spectrum.

As the pattern and distribution of capital flows becomes more aligned with the changing world economic order, the **geographic exposure** of products will play an important role in investor preferences. Emerging markets may be seen as offering better relative value, becoming a destination as well as origin of capital.

Capital flows are likely to favour **real assets**, such as property, infrastructure and other alternatives such as commodities. This trend will reflect the desire to own tangible assets and the inflation-hedging properties of these asset classes.

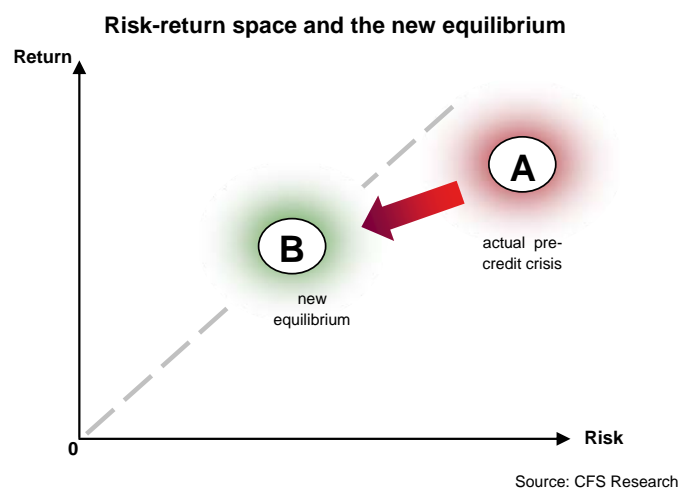
For less risk-averse investors, **equity valuations** will become more attractive as prices fall. Rather than broad based momentum returning to the equity market, however, we are likely to see active, concentrated portfolio managers taking the lead as they identify value in specific stocks or sectors.

Risk and return

Across all asset classes, the re-pricing of risk will also see greater **differentiation** between different grades of assets within each asset class, with a flight to quality increasing the premium for higher quality assets. This implies a reversal of the narrowing spreads seen over the recent period of falling risk-aversion as highlighted in Figure 6.

From a risk-return perspective, the move to a higher cost of credit and associated de-leveraging will represent a 'return to normality'. As Figure 12 demonstrates, even if total return expectations moderate (moving from Point A to Point B), the reduction in risk should imply an improvement in risk-adjusted return for investors.

Figure: 12



Armed with a realistic appraisal of risk, investors will be positioned to make better investment decisions, providing the platform for more sustainable long-term growth.

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