In search of better Investment products for confused customers

Or

Lost on Wall Street

Background to the Paper

- Motive and opportunity to look at investment world

- Prompted to question how well our products have met customer needs in recent years

- And to ask: can we do better?

Important Disclaimer

- I don't have the perfect answer!

- Don't expect investment advice

- This paper is about products for ordinary customers who need above cash/inflation returns

- Admission: I was fully involved in selling the old products

The Managed Fund

"We normally recommend our Managed Fund because this fund invests in a well-balanced portfolio of equities, government stocks, property and cash deposits. Its aim is to produce strong capital growth without carrying an undue level of risk."

Irish Pension Managed Funds average returns
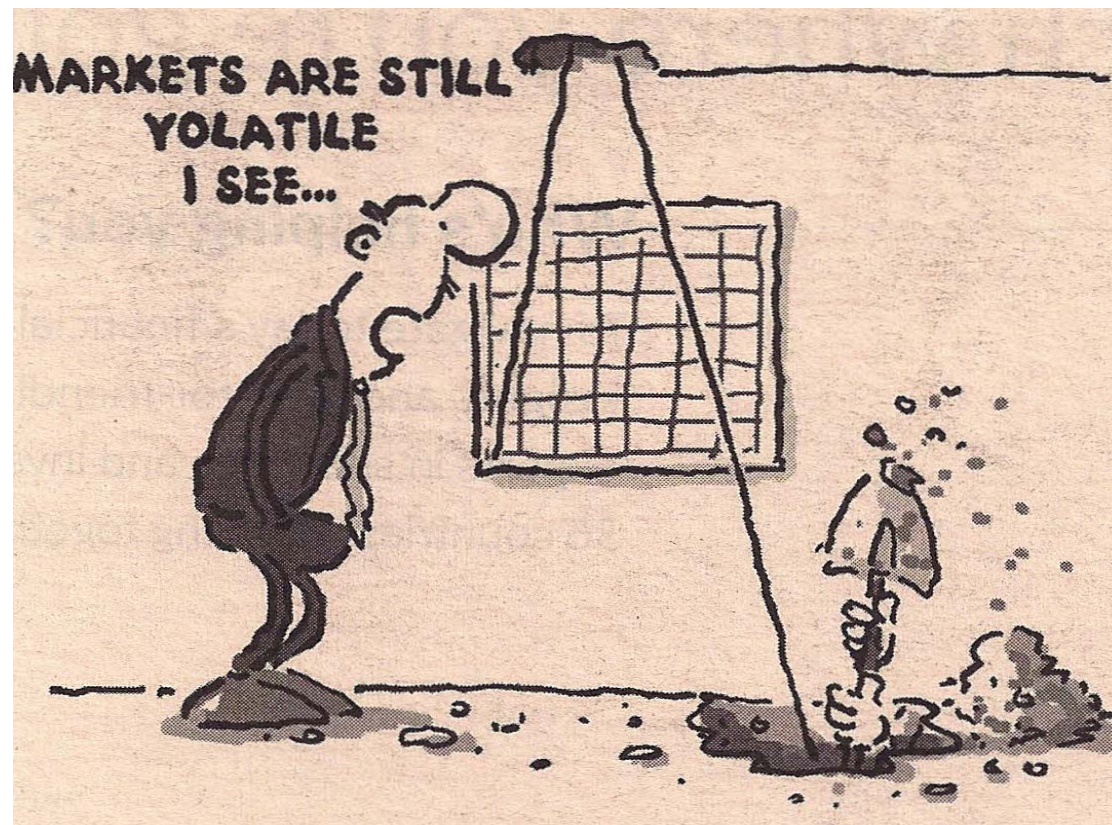
(Source: Mercers)

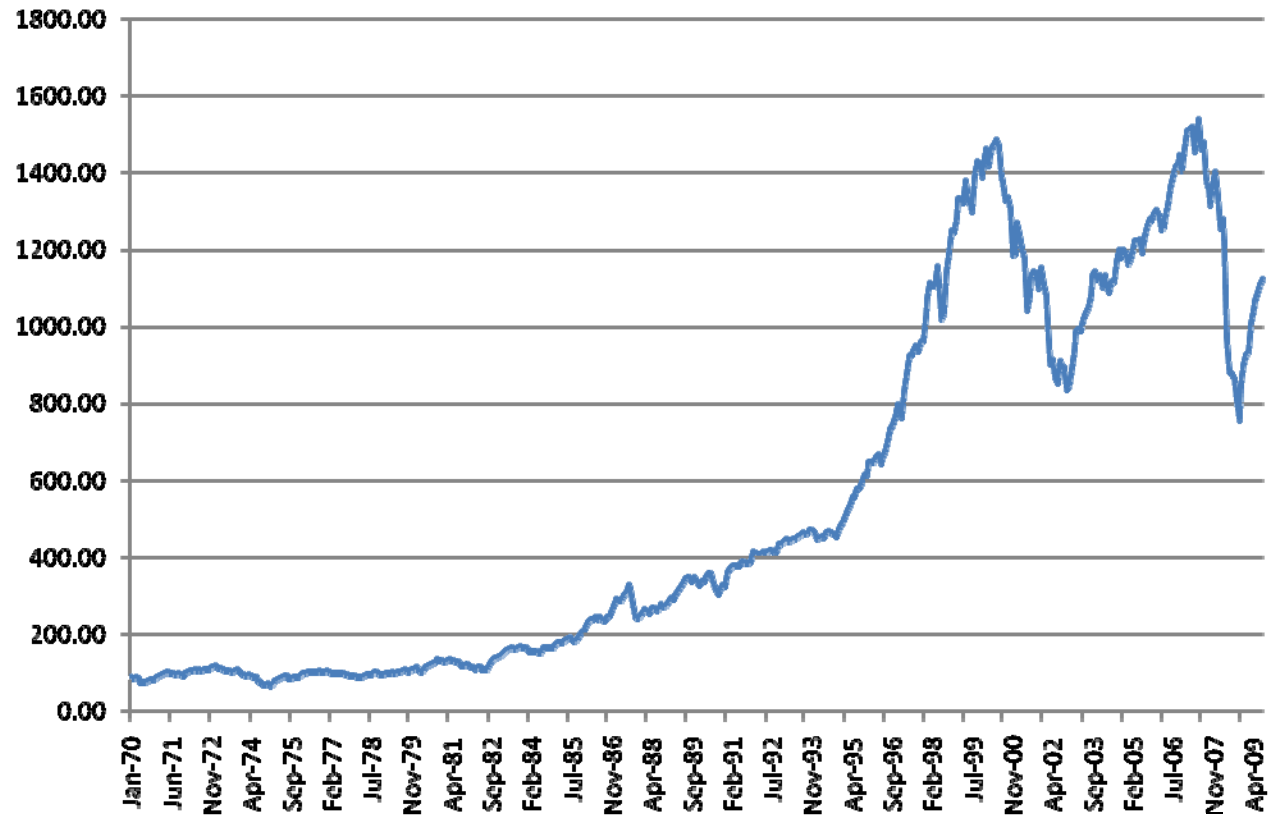| Period	to July 2009	to Nov 2010
1 year	-19.3%	+12.7%
3 years	- 9.5%	- 5.5%
5 years	- 1.0%	- 0.8%
10 years	- 0.1%	+ 0.6%

Q. Do you invest in shares?

A. Through a managed portfolio. I should have bought more Manolo Blahnik shoes instead.

(Author Sheila Flanagan in an interview in the Irish Times, 20th September 2010)

Possible reason for reduced popularity of Managed Funds!
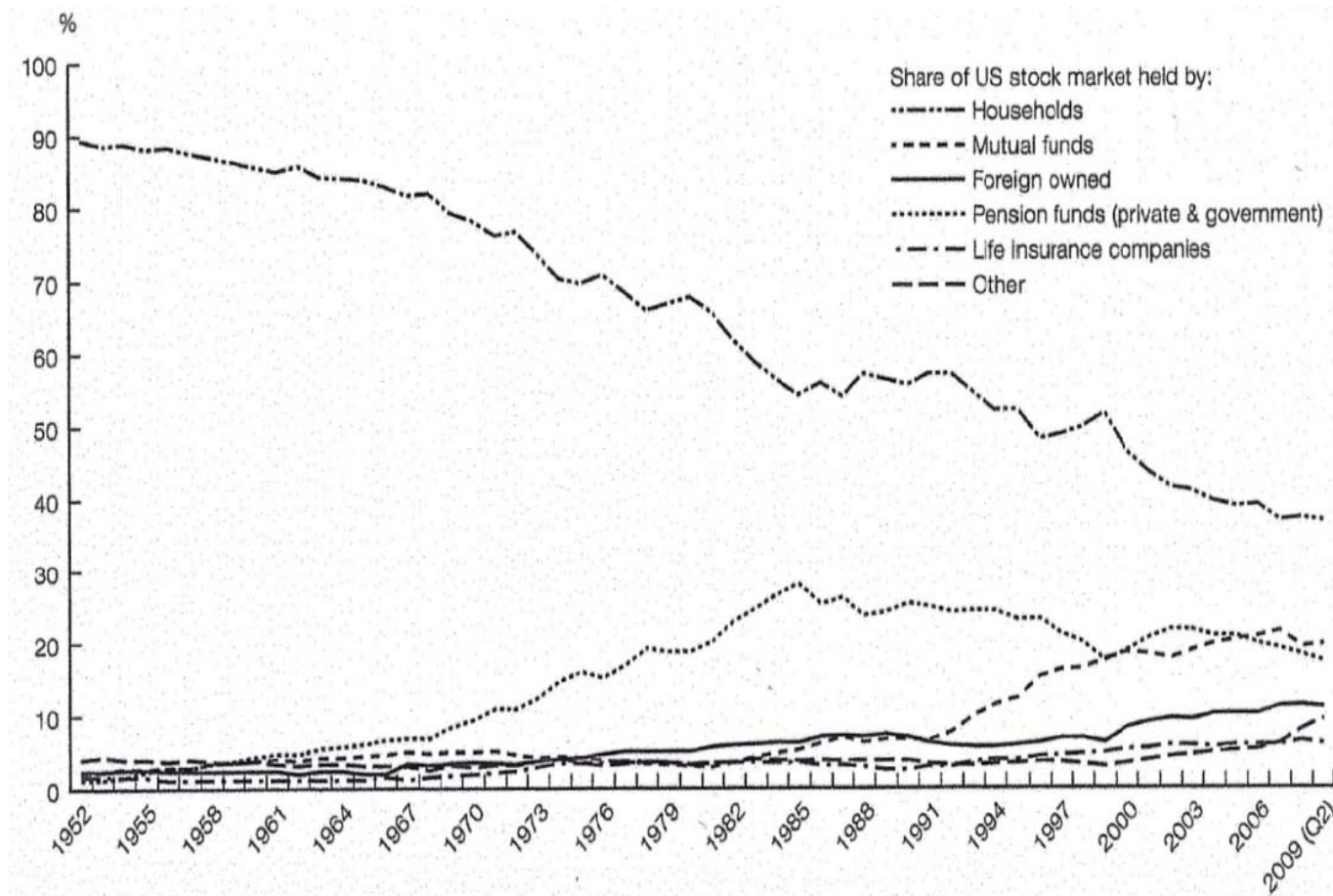
S&P 500 Index 1970-2010

US Stock Market Turnover

(Source: John C Bogle)

- 1951: 25%

- 1998: 100%

- 2008: 215% (284% incl. ETFs)

Institutionalisation of the US stock market

(Source: Authers)

Outline of Paper

Part I: What drives markets? Is there an ERP? Do equities have a fundamental value to which they revert?

Part II: What is a sensible strategy for the ordinary investor? How well do current products help him/her?

Challenges for industry & suggestions

Part I: How markets behave

- Huge amount of data and experience available

- How well do we use it?

- Focus on equities – the special ingredient of funds

Typical Irish Pension Fund 1980

Asset Class	1980 Allocation
Equities	35-40%
Bonds	25-30%
Property	25-30%
Cash	5-10%

Irish Pension Funds now

(Source: IAPF)

Asset Class	2007 Allocation	2008 Allocation
Equities	66.30%	52.30%
Bonds	18.50%	26.10%
Property	9.10%	8.40%
Cash	3.80%	10.90%
Other	2.30%	2.40%

Life Companies

(Source: IIF)

Asset Class	2008 Allocation	2009 Allocation
Equities	43.4%	50.3%
Bonds	29.8%	26.8%
Property	8.7%	5.7%
Cash	11.4%	11.0%
Other	6.7%	6.2%

Equity Risk Premium for US

(Source: Smithers)

	1800-2000	1800-1900	1900-2000
US real equity returns %p.a.	7.0	7.5	6.5
US real bond returns % p.a.	3.4	5.0	1.8
ERP (ex post) % p.a.	3.6	2.5	4.7
ERP (ex post) % p.a. deducting 0.5%p.a. for higher equity costs	3.1	2.0	4.2

UK and US real equity minus real bond returns

(Source: Smithers)
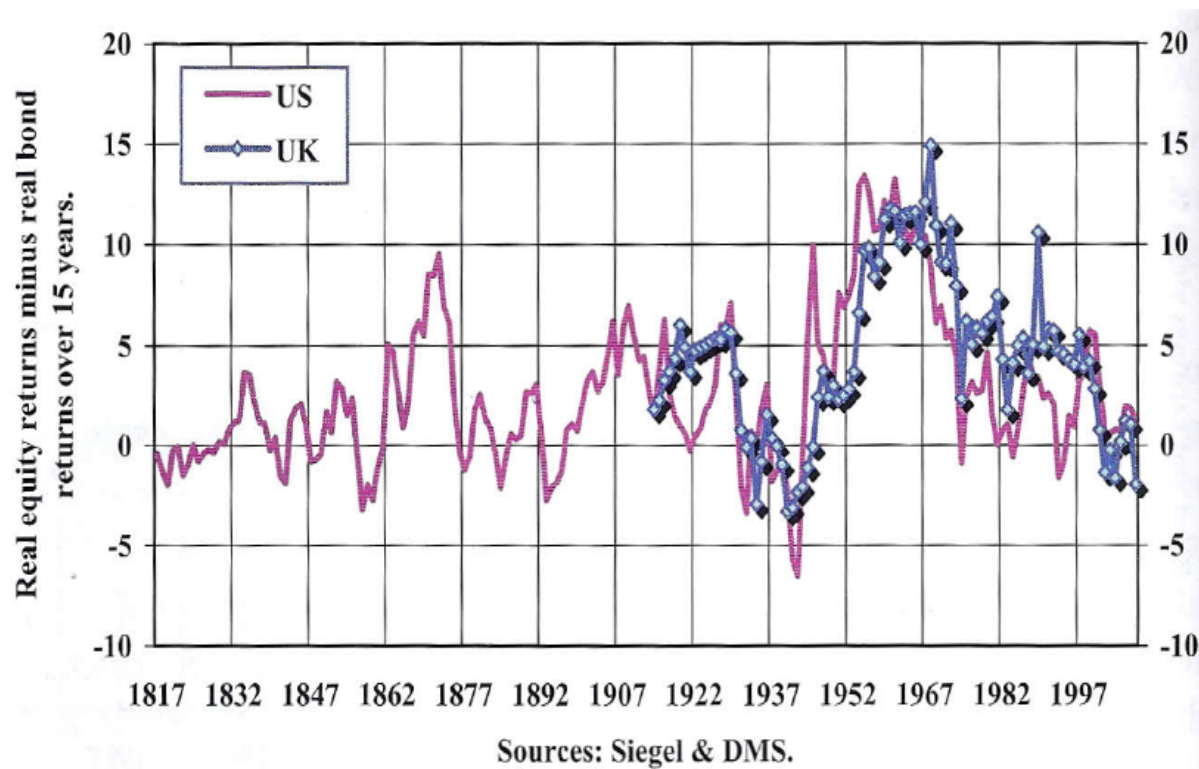
R. Shiller (Irrational Exuberance)

- Stocks underperformed bonds in 10 years following 1929 and 1966 peaks

- Stocks underperformed bonds in 20 years following 1901 peak

- In 39 other countries real growth only 0.8%pa for 1926-96 compared with 4.3% pa in US

- "The evidence that stocks will *always* outperform bonds over long time intervals simply does not exist"

- Clearly helpful if we can make an informed assessment of current market levels

Methods for assessing market levels

- Markets always correctly priced (Efficient Markets Theory)

- Comparison of PE ratio with bond yield (Fed Model)

- Comparison of PE ratio with its average

- Comparison with the market "trend value"

- Q ratio

- Cyclically Adjusted Price Earnings (CAPE) ratio

Q Ratio

(Tobin 1969)

• Ratio of value of stock market to net worth of component companies at replacement cost

• Usually limited to non-financial sector

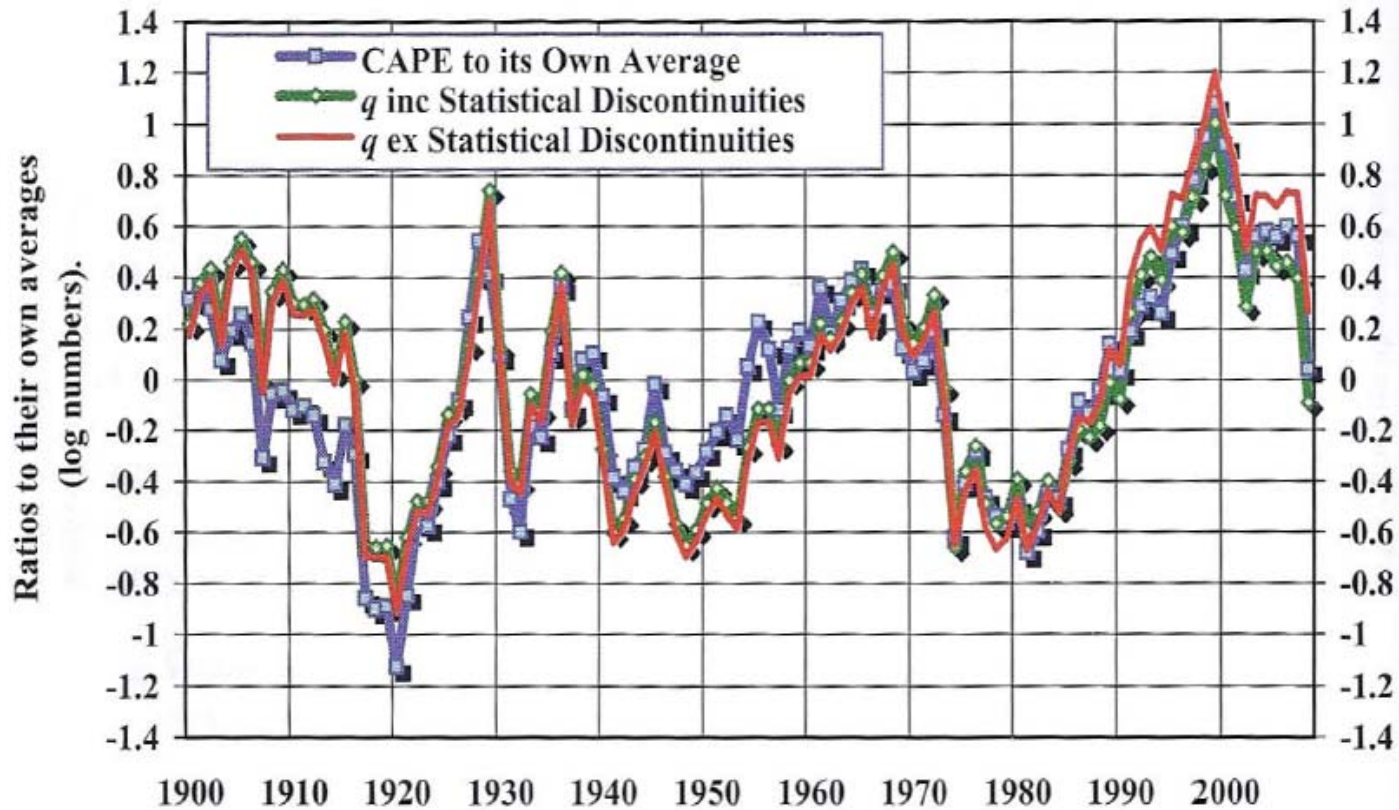• Averages at 0.63 due to persistent overstatement of profits/net worth

CAPE ratio

(Shiller/Graham&Dodd)

•PE ratio where earnings averaged over the previous 10 years and adjusted for inflation

•Choice of 10 years arbitrary but smoothes cycles in earnings

•Average CAPE approx. 16.5

US CAPE and Q

(Source: Smithers)

Sources: Shiller, Wright & Z1 Tables B.102 & R.102.

Shiller's precipitating factors for high market values

1. The capitalist explosion and the ownership society
2. Cultural and political changes favouring business success
3. New information technology
4. Supportive monetary policy and the Greenspan "put"
5. The baby boom and bust
6. An expansion in media reporting of business news
7. Analysts' optimistic forecasts
8. The expansion of defined contribution schemes
9. The growth of mutual funds
10. The decline of inflation and the effects of money illusion
11. The expansion of the volume of trade: discount brokers, day traders and twenty- four hour trading
12. The rise of gambling opportunities

Secular Bull and Bear Cycles

(Source: Crestmont Research)

| Market Cycle	Total Years	Market	P/E Ratio Beg	P/E Ratio End	Inflation Beg	Inflation End
1901-1920	20	Bear	23	5	-2%	16%
1921-1928	8	Bull	5	22	-11%	-2%
1929-1932	4	Bear	28	8	0%	-10%
1933-1936	4	Bull	11	19	-5%	1%
1937-1941	5	Bear	18	12	4%	5%
1942-1965	24	Bull	9	23	11%	2%
1966-1981	16	Bear	21	8	3%	10%
1982-1999	18	Bull	7	42	6%	2%
2000-		Bear	42		3%	

Demographics and CAPE

(Source: Barclays Capital Equity Gilt Study 2010)
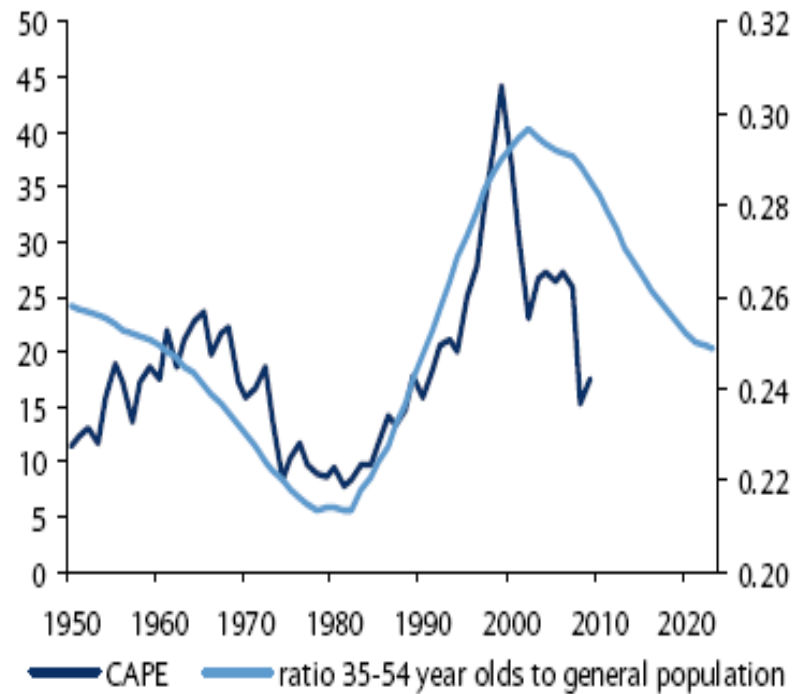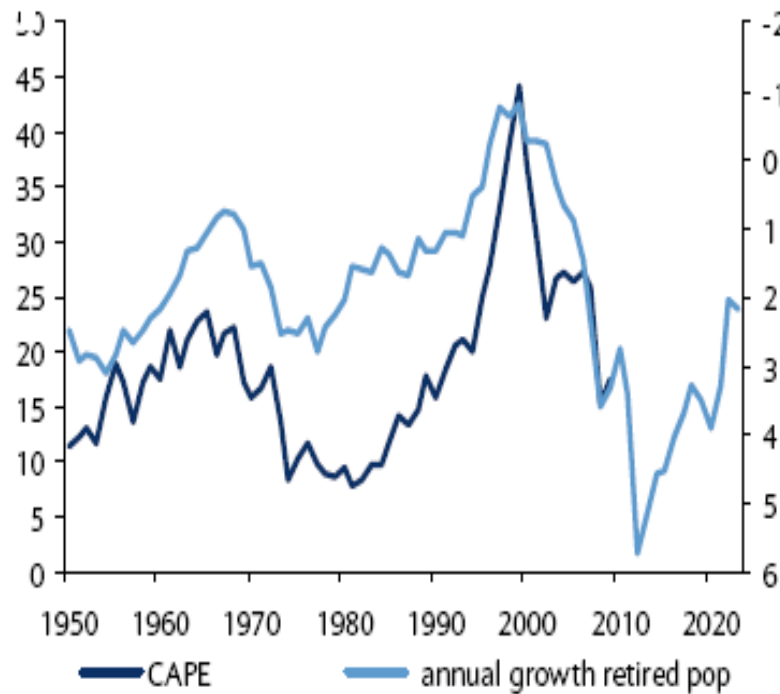
Note: CAPE is calculated from 10y moving average of earnings. Source: Haver

Projected US CAPE

(Source: Barclays Capital Gilt Equity Study 2010)
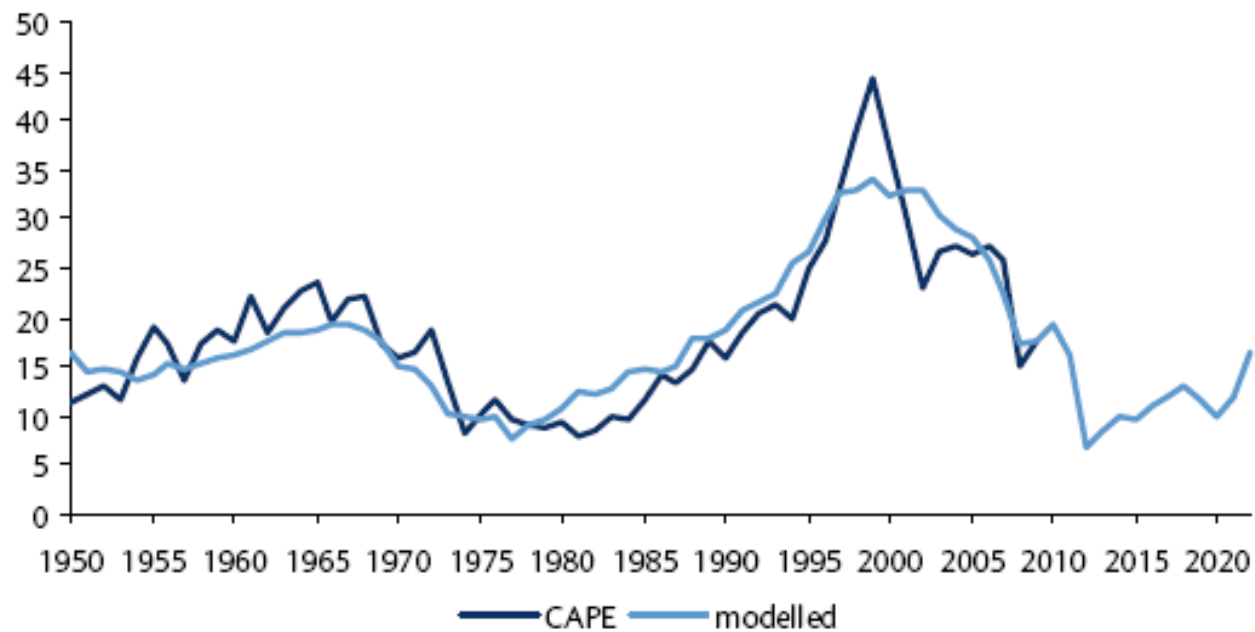
Source: Haver, Barclays Capital

Summary so far

- Market levels fluctuate around a fundamental value

- Cycles are not regular but driven by factors such as inflation or demographics

- It should be possible to identify times of significant over or under-valuation

- We don't seem to make much use of that information

Single Premium flows into the Irish life assurance industry

(Source: IIF)

| Year	Single Premium (€m)	Equity content %
2009	5424	50.3
2008	5615	43.4
2007	10032	58.4
2006	7848	63.0
2005	5612	58.4
2004	3957	52.6
2003	3806	58.1
2002	3674	55.5
2001	4215	60.1
2000	5222	53.6
1999	3898	56.5
1998	2419	51.0
1997	1637	54.0

Investor underperformance is international

- For the 20-year period to December 2009, equity fund investors averaged 3.17% compared to 8.20% for buy-and-hold stock investors (S&P 500).

- The gap between investors and the buy-and-hold data has narrowed from 10.65% in 1998 to just 5.03% in 2009.

(Source: Dalbar Inc.)

% of investors who expect the market to rise in the following twelve months

(Source: Yale Management School)
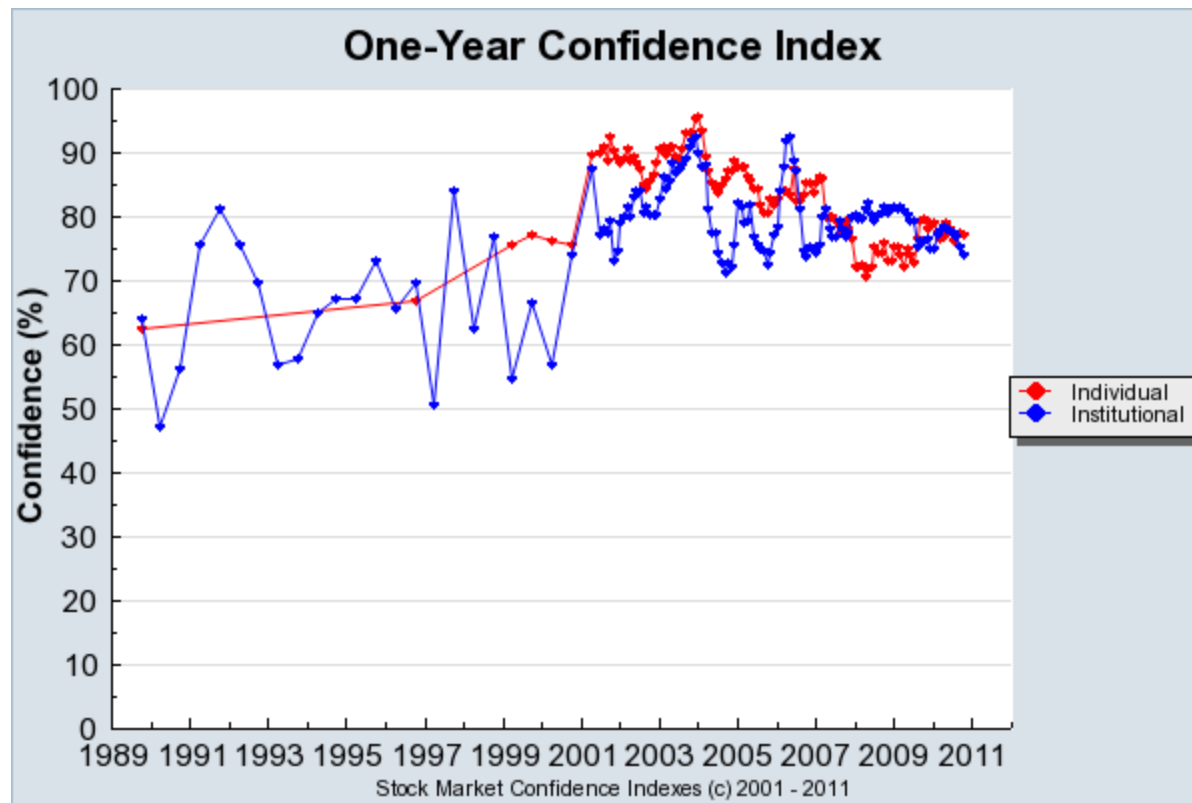
Do we adjust our behaviour to market levels?

- Financial advisors sell on performance or guarantees

- Pensions actuaries don't seem to change assumptions, or surpluses or deficits

- Insurance companies sell what they can – do better after good performance. Decline of RP sales creates a bias for underperformance. Customers take care!

But the need for good products and advice has never been greater!

Conclusions of Part I

- There is an average CAPE of around 16.5 to which markets revert

- More use should be made of this and CAPEs should be available for every market

- Similar measures should be developed for commercial property and house prices

- Industry should sell on cheapness not dearness

- Role for actuarial profession?

Part II: Intelligent Investment

John Kay: "Guide to finance and investment for normally intelligent people who are not in the industry"

- Mind your own portfolio

- Set a target (10% gross = 6% net of tax & inflation)

- Keep fees down (use ETFs & on-line stockbrokers)

- Invest regularly (pound cost averaging)

- Be contrarian

- Diversify

Diversification

- Conventional investor diversifies by asset class & geography. He picks individual holdings based on expectations

- Intelligent investor thinks in terms of probabilities. He looks for uncorrelated assets

- CAPM formula: $E(R_i)=R_f+\beta_i(E(R_m)-R_f)$

- Look for industries that have cycles of their own; overseas companies oriented to their domestic economies rather than international market

In search of uncorrelated assets

- Falling interest rates and booming equities in US since 1980s have led investors to look further afield for investments

- Emerging markets begin to correlate with world markets (Source: Authers)

MSCI Emerging Markets Index correlation with MSCI World Index
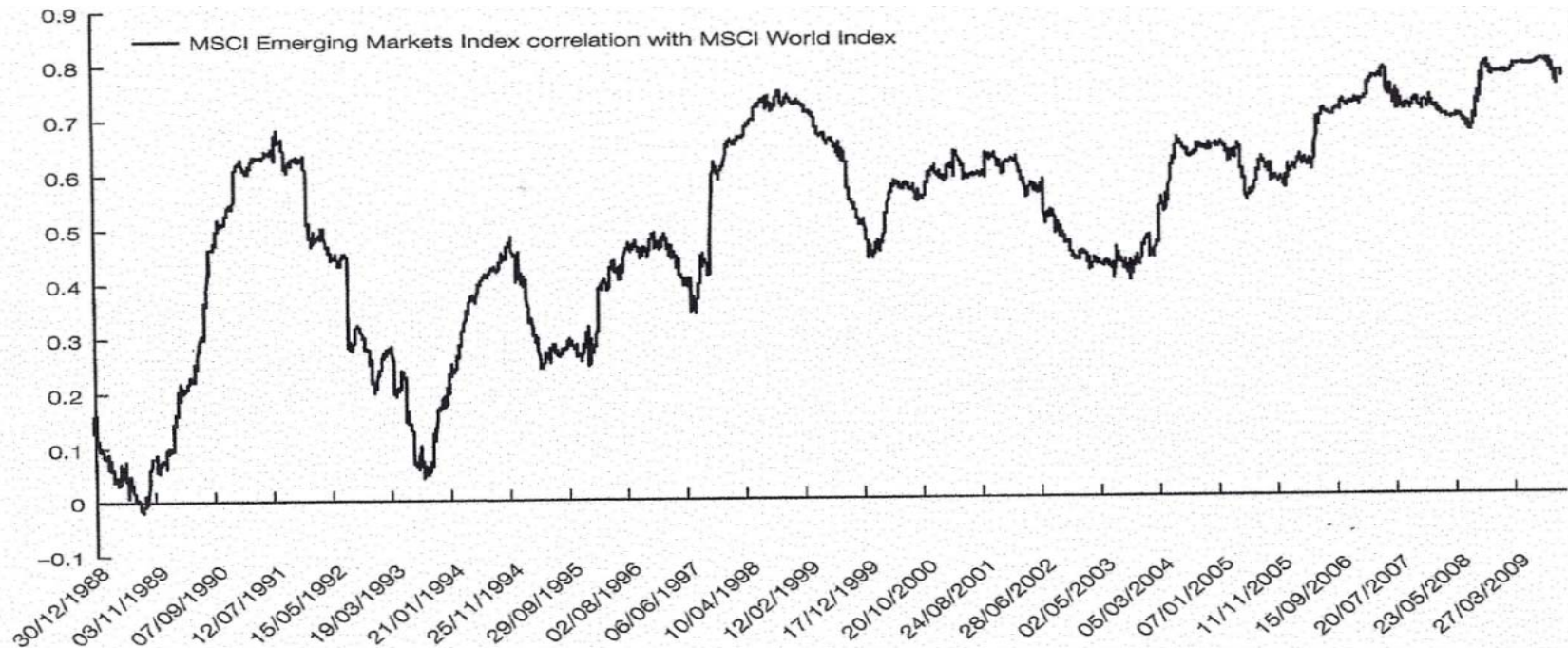
In search of uncorrelated assets (2)

- The success of the 1992 attack on sterling created interest in currencies as an asset class

- Institutions increase their holdings in hedge funds

- Academic study of commodities encouraged investors to pile in

- Credit also became an asset class with issuance of CDSs

- Amount of leverage meant everything was now correlated - when one market implodes de-leveraging requires selling anything that can be sold

- Is this a permanent or unusual phenomenon?

What can we learn from hedge funds?
(Source: Ibbotson, Chen and Zhu)

- 1990: 530 funds with $50 billion
  2009: 8000+ funds with $1.6 trillion

- TASS database shows they earned 14.26% pa from 1995 to 2009

- Excluding FofFs, 8421 funds in TASS database of which 5013 dead and 3408 still alive

- Excluding back-filled data and including dead funds returns reduce to 7.63%

- Equities 8.04% pa, Bonds 6.43%pa and cash 3.4%pa in same period

- Be careful when reviewing hedge fund data

But hedge funds give positive returns most years

Year	Post-fee return %	Alpha %
1998	-2.38	-14.07
1999	25.19	7.20
2000	1.90	6.89
2001	1.95	10.27
2002	1.17	10.08
2003	17.62	12.06
2004	7.77	3.06
2005	8.96	5.14
2006	11.75	2.65
2007	10.02	3.38
2008	-16.08	6.65
2009	16.38	5.93

Most strategies giving good returns

	Pre-fee Return %	Post-fee Return %	Alpha %
CV Arbitrage	11.01	7.31	2,76
Emerging markets	13.23	9.09	5.00
Equity Market Neutral	10.05	6.54	2.38
Event Driven	12.00	8.10	3.73
Fixed Interest Arbitrage	9.57	6.16	2.39
Global Macro	10.72	7.08	2.10
Long/Short Equity	14.73	10.29	5.16
Managed Futures	8.83	5.56	1.17
Short	1.32	-.045	1.74
Overall Equally Weighted	11.42	7.63	3.01

Hedge funds (conclusion)

- Big fund flows may make it harder to make such good returns in future. 2010 reported as difficult.

- Institutional interest remains strong:

  29% plan to increase holdings in next year

  46% plan to increase holdings in next 3 years

  (Preqin survey 2010)

- Fees very high 1.5% to 2% p.a. plus 20% incentive fee

- Some hedge fund techniques could be useful for life companies

Current Irish funds by risk category

(Source: Moneymate)

Risk Category	Number of funds	% of funds
Very high risk	308	57.9
High risk	123	23.1
Moderate risk	44	8.3
Low risk	24	4.5
Very low risk	33	6.2
Total	532	100.0

Features of funds available in Ireland (1)

- Most are "conventional" investors

- All clear about level of risk – up to 7 categories of volatility

- No reference to level of risk depending on current market levels

- Importance of starting early mentioned but not pound cost averaging

- Most companies offering some form of protected fund on CPPI lines

Features of funds available in Ireland (1)

- All offer "lifestyle" option

- Growing number of "Diversified" funds

- Some companies also offering "Absolute Return" funds

- Investment consultants active in these areas

- Wide range of specialist funds but often with high charges

Conclusions of Part II

- Set target returns – avoid benchmarking

- Keep fees down

- Avoid expensive "protection"

- Be contrarian

- Encourage regular investment

- Seek uncorrelated returns

- Learn from hedge funds

- Develop "Diversified" and "Absolute Return concepts" further

Discussion Topics?

- Use CAPE or similar measures more
    - in asset allocation?
    - in customer information?
    - in pension funding?

- Move to target returns rather than benchmarking?

- What is the replacement for the Managed Fund?

- Should Actuaries take a more leading role?