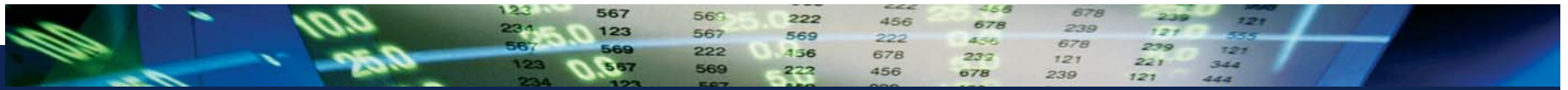


A presentation to: *The CFA Society of Minnesota*



# Challenges and Opportunities in the Current Financial Environment

Presented on  
November 16, 2009

Richard F. Lacaille  
Global Chief Investment Officer



# Introduction

- The inflation debate
- The US Dollar cyclical decline and secular outlook
- The diversification impact of divergent strategies



## There Is Global Economic Uncertainty Over Inflation Risk

- Opinions on inflation in the US and Eurozone are mixed

Short-term forecasts (next 12-18 months) see limited inflation risk\*\*

The drop in global inflation and deflation in most of the G10 will likely be temporary, and mild inflation will make a return in 2010\*\*

- 41% of National Association of Business Economists believe the Fed's actions will cause inflation in the next two years\*\*\*

Lagged effects of policies now in effect

Ineffective exit strategy, with significant concerns with the stimulus package

- Some institutional investors globally are now guarding portfolios from potential risk of both deflation and inflation\*\*\*\*

European pension funds have been early adopters of inflation-linked strategies because of pressure to tie pension payments to cost-of-living increases/inflation

In the US, large public funds have adopted an inflation-hedging asset class, or adding allocations to real assets – looking for uncorrelated returns

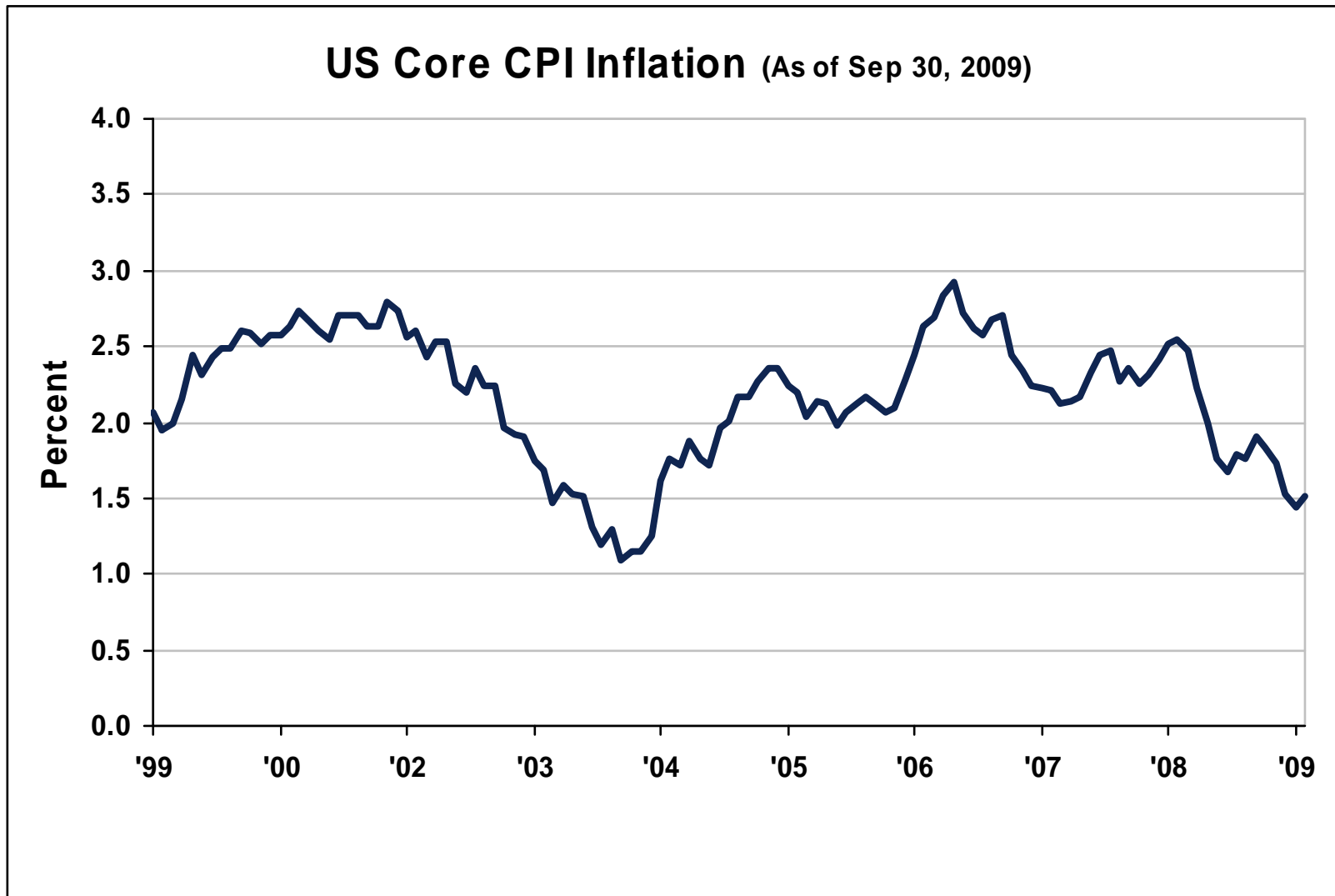
\* Morgan Stanley, April 20, 2009 – IMF's World Economic Outlook

\*\*I DD Magazine, 6/24/09: SIFMA: "Economists See Low Inflation Risk"

\*\*\* Economic Policy Survey: 266 members of National Association for Business Economics, August 13-18, 2009

\*\*\*\* P & I, June 15, 2009, "Inflation-deflation risk sparks portfolio changes"; Aug. 10, 2009 "Public Plans Barricade Doors, Fearing Inflation"

US



# US Treasury Inflation Protected Securities

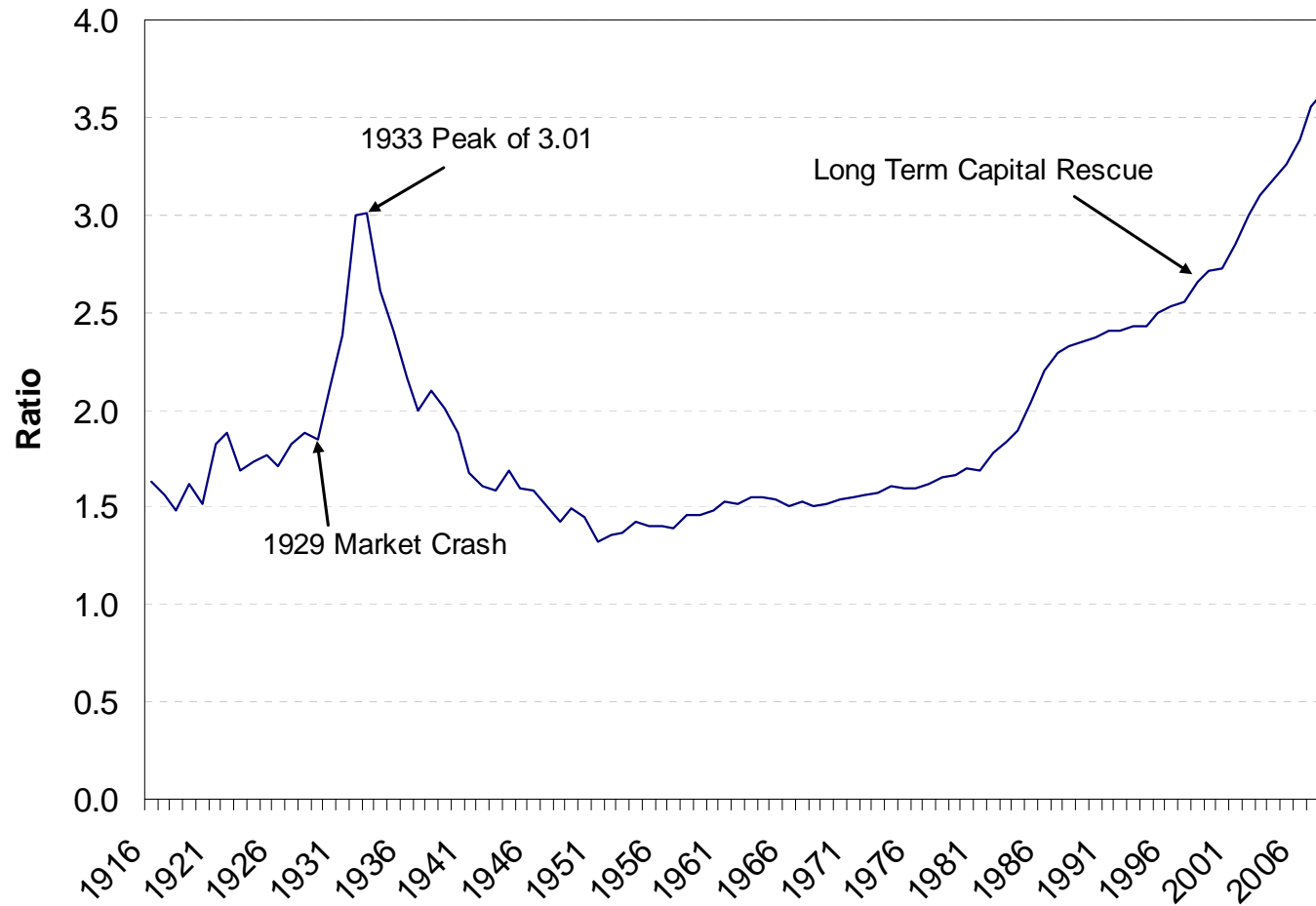
Market still not fearful of inflation over next 10 years



# Key Risk: Deleveraging

## US Total Private and Public Sector Debt to GDP

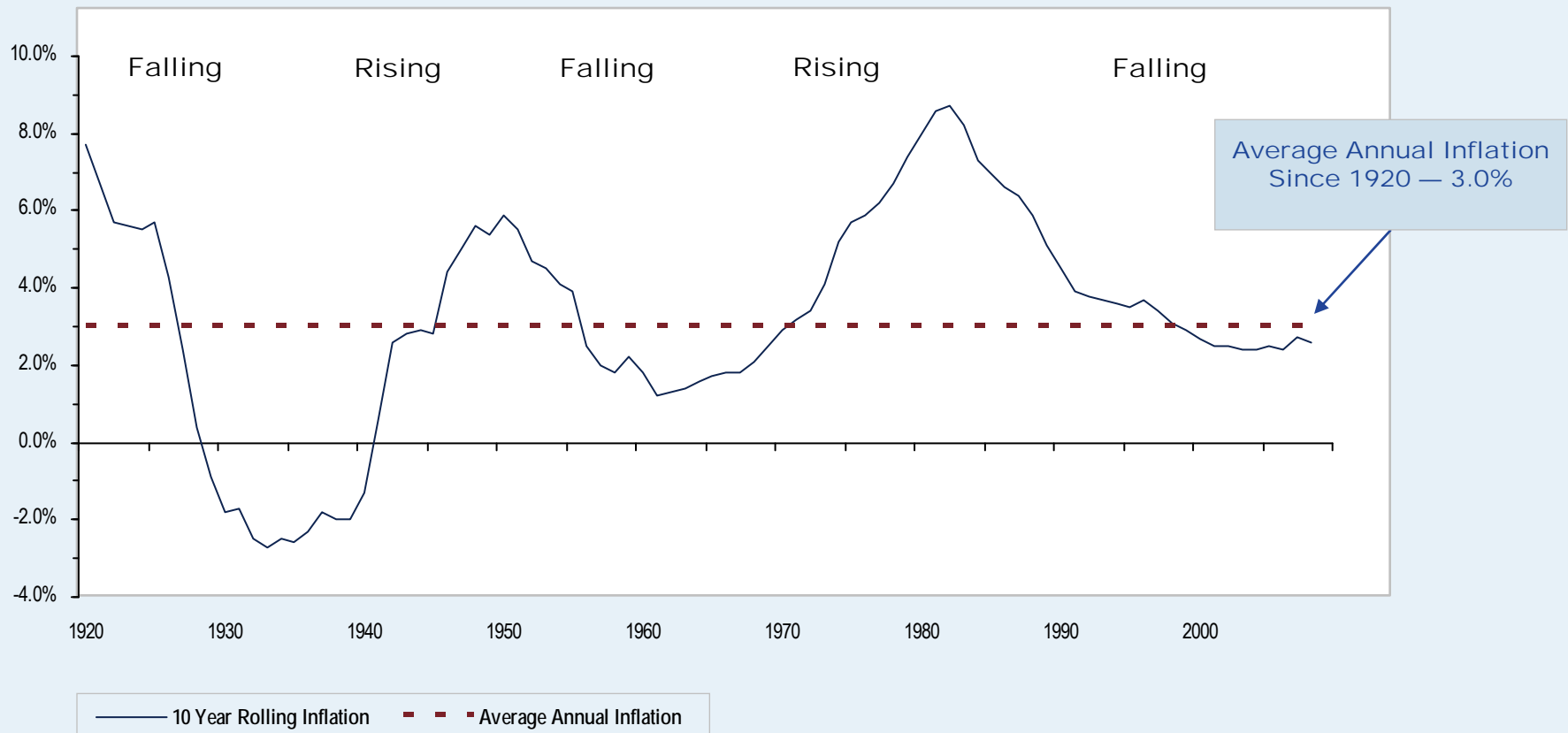
1916 - 2009 Q2



Source: Federal Reserve, Bureau of Economic Analysis, Census Bureau

# The Cyclical Nature of Inflation Requires a Hedging Strategy

- It has been 30 years since the US last experienced rising inflation
- Portfolios should be positioned to withstand the next cycle

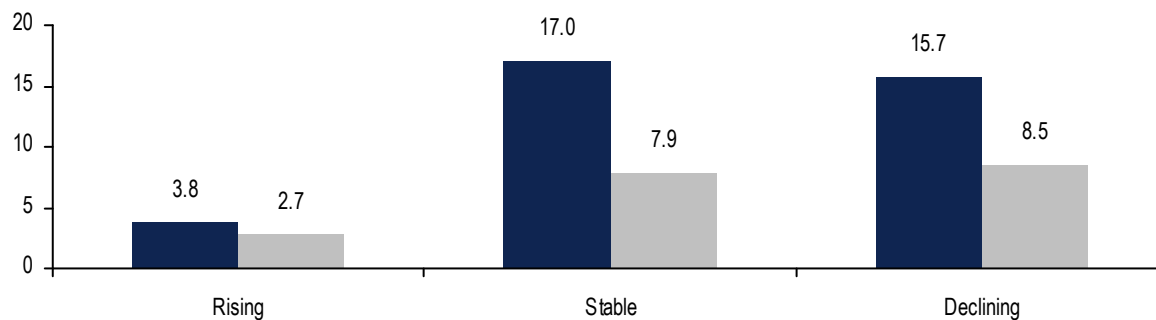


US Consumer Price Index (CPI-U) through December 2008  
Source Robert J. Shiller, *Irrational Exuberance*, April 2001 and Ibbotson Associates

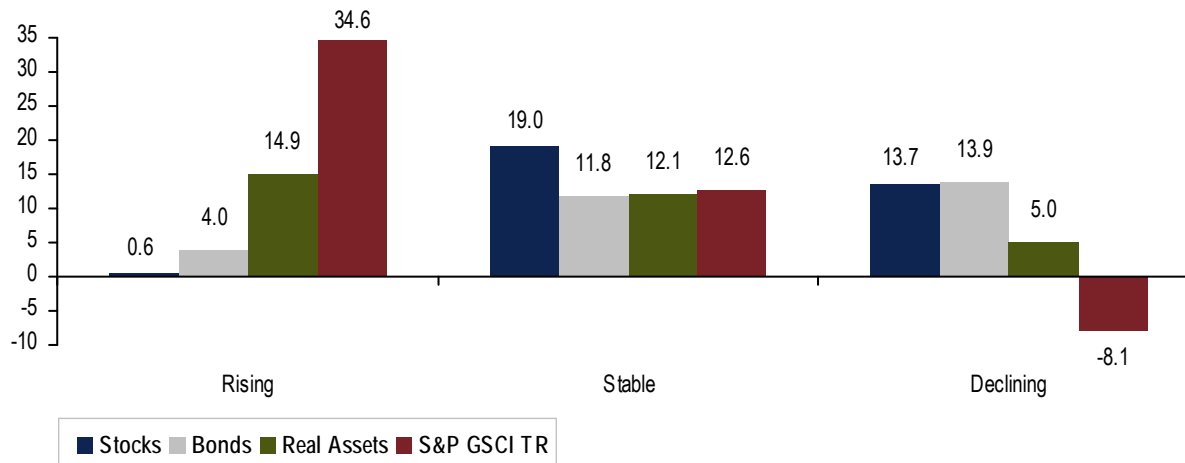
# Inflation Protection: Stocks and Bonds have Historically Underperformed in Periods of Rising Inflation

Nominal stock and bond returns  
During rising, stable, and declining inflation environments

Period: 1930–2008



Period: 1970–2008



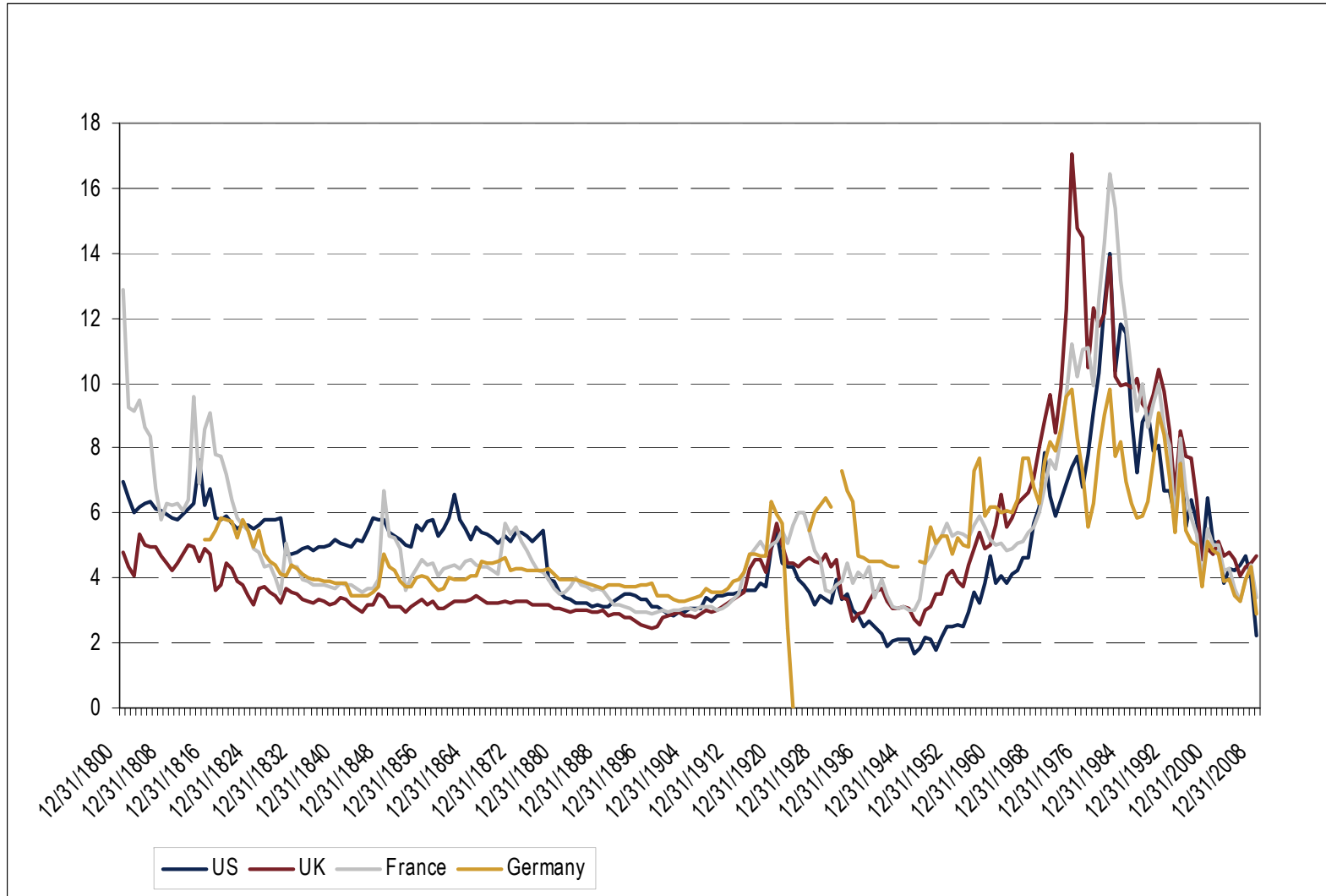
Asset Classes are represented by the S&P 500 Index, Ibbotson's US Long-Term Govt. Bond Index, Simulated Real Asset Strategy, S&P GSCI TR and US Inflation (CPI-U). Based on annual calendar year returns with quarterly data.  
Source: SSgA and Morningstar  
Past performance is not a guarantee of future results.

# Inflation Hedging Alternatives for Investors

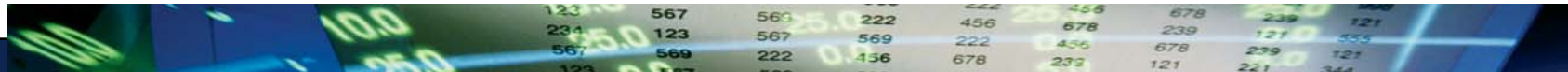
| Asset Class                 | Inflation Sensitivity | Return Characteristics  | Observations   |
|-----------------------------|-----------------------|---|--|
| <b>TIPS/Global Linkers*</b> | <b>High</b>           | Principal and Interest amounts rise/fall with inflation<br>Low volatility/high liquidity<br>Various durations<br>Global linkers/TIPS combo increases inflation-hedging capability | US TIPS pegged to US CPI; may not capture all inflation<br>Returns also reflect inflation expectations   |
| <b>Commodities*</b>         | <b>High</b>           | Tied to global economy (emerging markets growth)<br>High volatility/high liquidity  | Strongest correlation to inflation<br>Opportunities for active management<br>Use of natural resources as a commodity play                          |
| <b>Real Estate* (REITS)</b> | <b>Moderate</b>       | Dividend potential<br>High liquidity  | Correlations benefit strongest over longer periods<br>Moderate correlation to traditional asset classes  |
| <b>Timber</b>               | <b>Moderate</b>       | Illiquid<br>Long-term investment  | Historically outperformed inflation, returns competitive with stocks over long-term<br>Long-term cyclical hedges                                   |
| <b>Infrastructure</b>       | <b>Moderate</b>       | Similar to long-duration fixed income<br>Illiquid<br>Direct/indirect and listed (public) opportunities  | Global, regional and national opportunity set, investing opportunities range from public to private, liquid-illiquid.<br>Long-term cyclical hedges |

Source: SSgA, 2009

# Long Term Government Bond Yields



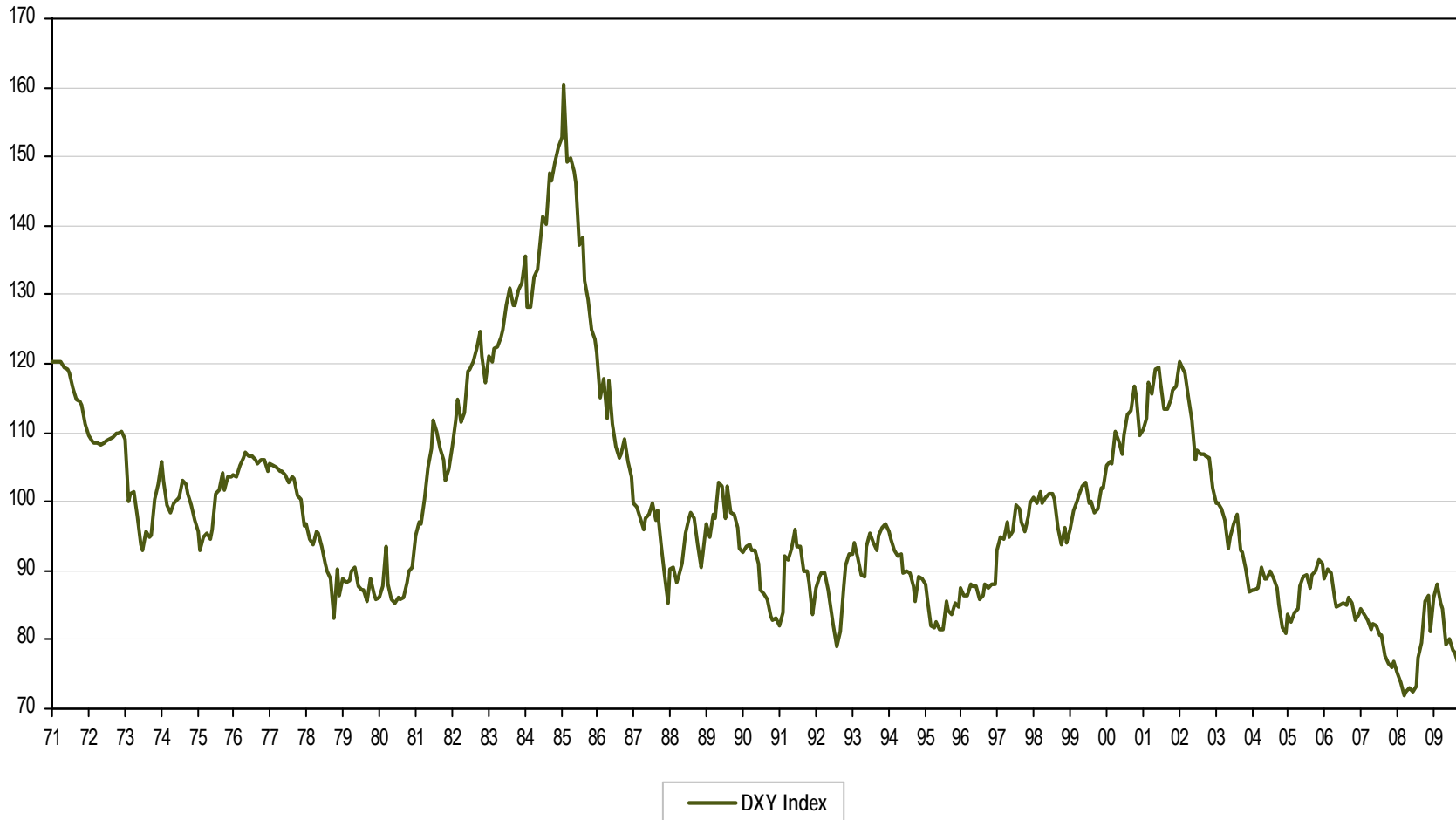
Source: Bloomberg  
As of December 31, 2008, updated annually



# USD Currency

# US Dollar in Demise or Just Back to the 1990's

After the credit crisis induced flight to quality, the DXY Index resumed falling



Source: Bloomberg, as at 30 September 2009

CMINST-0836



# Is the Decline Structural or Cyclical: it's About the Economy, Stupid<sup>1</sup>

## Structural Factors

- Emergence of a new reserve currency such as the euro, Renminbi or a new IMF Special Drawing Rights (SDR)
- Diversification of official foreign exchange reserves into non-US dollars

## Cyclical Factors

- High current account deficit and budget deficit i.e. net funding deficit
  - British pound has appreciated against the US dollar despite having the highest forecast public debt as percent of GDP in the OECD
- Low US interest rate compared with the rest of the world
  - Japanese yen has appreciated against the US dollar despite interest rates in Japan having been below those in the US for the past decade
- Risk appetite for carry trades
  - Australian and New Zealand dollars and Norwegian krone have been the strongest performing currencies against the US dollar

1. James Carville, slogan from Bill Clinton's 1992 presidential campaign



## Are Officials Worried about the Depreciation of the US Dollar?

### US officials say they want a strong dollar... maybe not

- US Treasury Secretary Tim Geithner: a “strong dollar” is in “America’s interests” but “open” to “increase the use of the IMF’s special drawing rights”

### G-10 officials just want a weaker domestic currency i.e. a stronger US dollar

- Bank of Canada Governor Carney: the strong Canadian dollar is a major risk to the Canadian economy<sup>1</sup>
- European Central Bank Governor Trichet: the world needs a strong US dollar<sup>1</sup>

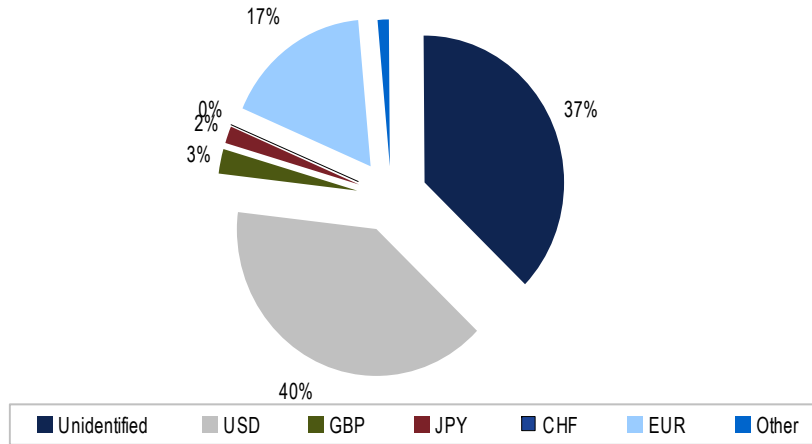
### Largest holders of US dollar assets call for a new reserve currency<sup>2</sup>

- Russian President Medved: wants a “new reserve currency” to replace the US dollar
- Peoples Bank of China Zhou: wants a new reserve currency “disconnected from individual nations”

1. Bloomberg, 12 October 2009  
2. Bloomberg, 3 April 2009

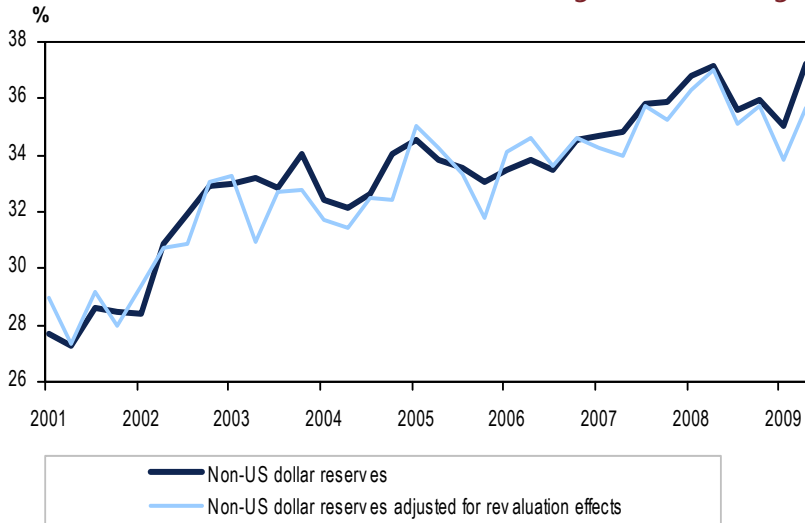
# Reserve Diversification: are Central Banks Walking the Talk?

## Currency composition of US\$6.8 trillion official foreign exchange reserves<sup>1</sup>



- Currency composition of 37% of official reserves – most of which is held by the Chinese – are “not identified”
- 40% of identified reserve assets are held in US dollars

## Officials have been steadily diversifying out of US dollars for the past decade<sup>2</sup>



- Share of non US dollar reserves has been steadily rising for a decade
- Rise in US dollar holdings in late 2008 was probably due to a tactical “flight to quality” during the credit crisis rather than strategic re-allocation to the US dollar

1. IMF & COEF estimate for Q2 2009, 15 October 2009  
 2. IMF & RBC Capital Markets, 15 October 2009



## Selection Criteria for Reserve Currencies

### Opening for new reserve currency: general selection criteria

- Convertibility and liquidity

Convertibility is essential and liquidity is highly desirable

- Deep financial markets

Growth in active currency management by reserve managers has made currencies that in which a larger variety of financial instruments are denominated, more attractive candidates as a reserve currency

- Common usage as the medium of exchange

Common usage as the medium of exchange i.e. basis of invoicing of trade in goods and services typically reduces transaction costs

- Credible store of value

US dollar's broadly based depreciation is a source of concern to emerging market officials, especially Brazil, Russia, India and China nations

# Euro is More Ready Than the SDR to Take Over the US Dollar's Mantle

- Pre-requisite of use of the SDR as a currency, let alone a reserve currency, is the development of settlement and clearing systems and a market for SDR denominated securities<sup>1</sup>

Convertibility and liquidity: turnover in the euro is the highest after the US dollar

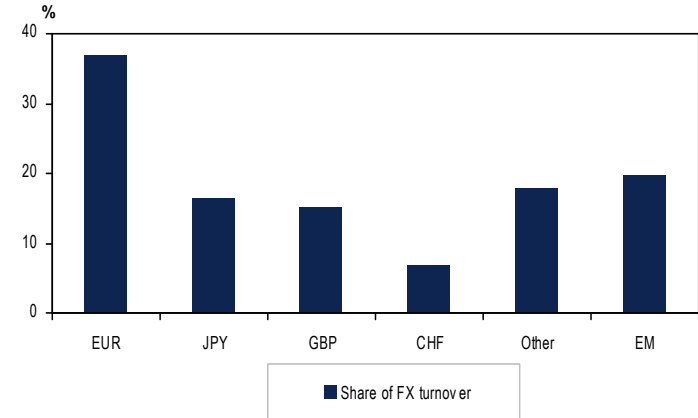
Size, liquidity and depth of financial markets: euro denominated securities is second only to the US dollar markets<sup>2</sup>

Common use as medium of exchange: euro denominated transactions have grown strongly although transactions invoiced in RMB are growing<sup>3</sup>

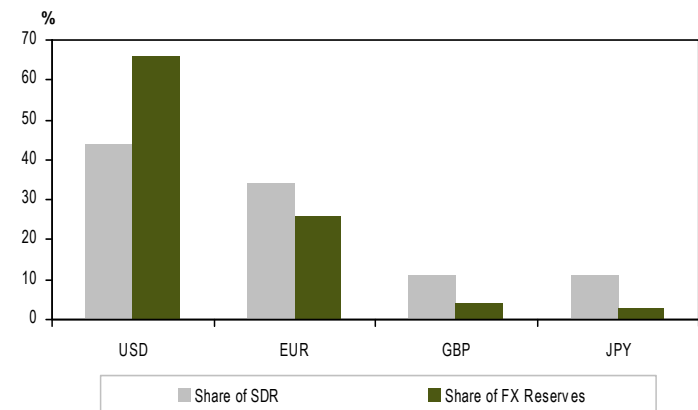
Credible store of value: euro is the largest known source of reserve assets

- Composition of the SDR will be reviewed in December 2010<sup>1</sup>

euro leads non-US dollar FX turnover<sup>4</sup>



Reserve assets overweight the US dollar versus SDR weights<sup>1</sup>



- Cole. A "Towards a new global reserve currency", RBC Capital Markets, 9 July 2009
- BIS "The euro as a reserve currency: a challenge to the pre-eminence of the US dollar" October 2006
- Bottelier P. "Zhou Xiaochuan's Proposal and Future of the RMB", *China Stakes*, 15 October 2009
- BIS, Triennial Survey of FX turnover, 2007, Only non-USD side of FX transaction shown, will not sum to 100%



## Impact of Further Depreciation in the US Dollar for US Investors

Apart from more holidays to Jamaica...

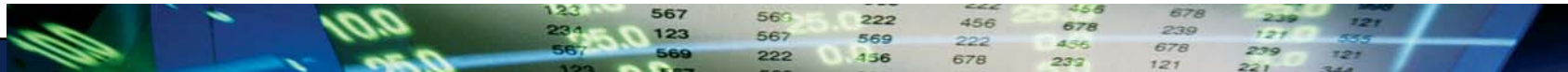
- Increased volatility in the USD-exchange rates resulting from speculation regarding the future of the US dollar as a reserve currency will increase inefficiencies in the currency market and increasing opportunities to add excess returns
- Continued growth of non-US dollar denominated financial instruments is expected to:
  - Increase investment opportunities outside the US in equities, fixed income, currencies and alternative assets
  - Increase the need to manage larger, and more diverse, foreign currency risks from growing allocations to non-US markets



## Why Active Currency Management Now?

- Currency offers diversification due to its low and unstable correlation with other asset classes over the long term
- Opportunities for excess returns in the currency market emanate from:
  - Conflicting investment objectives of participants in the currency market
    - Central banks seek to stabilise currency markets, importers/exporters engage in commercial transactions and investors seek to maximise profits
    - Lack of consensus among investors about ways to add excess returns from currency
- Potential sources of inefficiencies that can be exploited<sup>1</sup> include the tendencies of:
  - Currencies to trend over the long term
  - Currencies to revert to their fair value over the long term
  - High (low) yielding currencies to not depreciate (appreciate) to the extent implied by uncovered interest rate parity
- Excess returns from currencies is an especially valuable source of portfolio diversification now that
  - Liquidity is a priority: the currency market is extremely liquid with average daily turnover of \$3.2 trillion<sup>2</sup>
  - Potential excess return from equities and bonds is subdued

1. Binny, J. "Currency Management Style Through The Ages", *Journal of Alternative Investments*, Winter 2005  
2. BIS, 2007 Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity Report, BIS, 2007



# Divergent Investing



# The Key to Diversification

- Examples of convergent strategies

- Many value driven equity and credit strategies

- Currency and interest rate carry strategies

- Many arbitrage strategies : fixed income, convertible, M & A, Statistical

- Selling Volatility

- Volatility capture style country selection

- Examples of divergent strategies

- Global macro CTA

- Commodities trend following

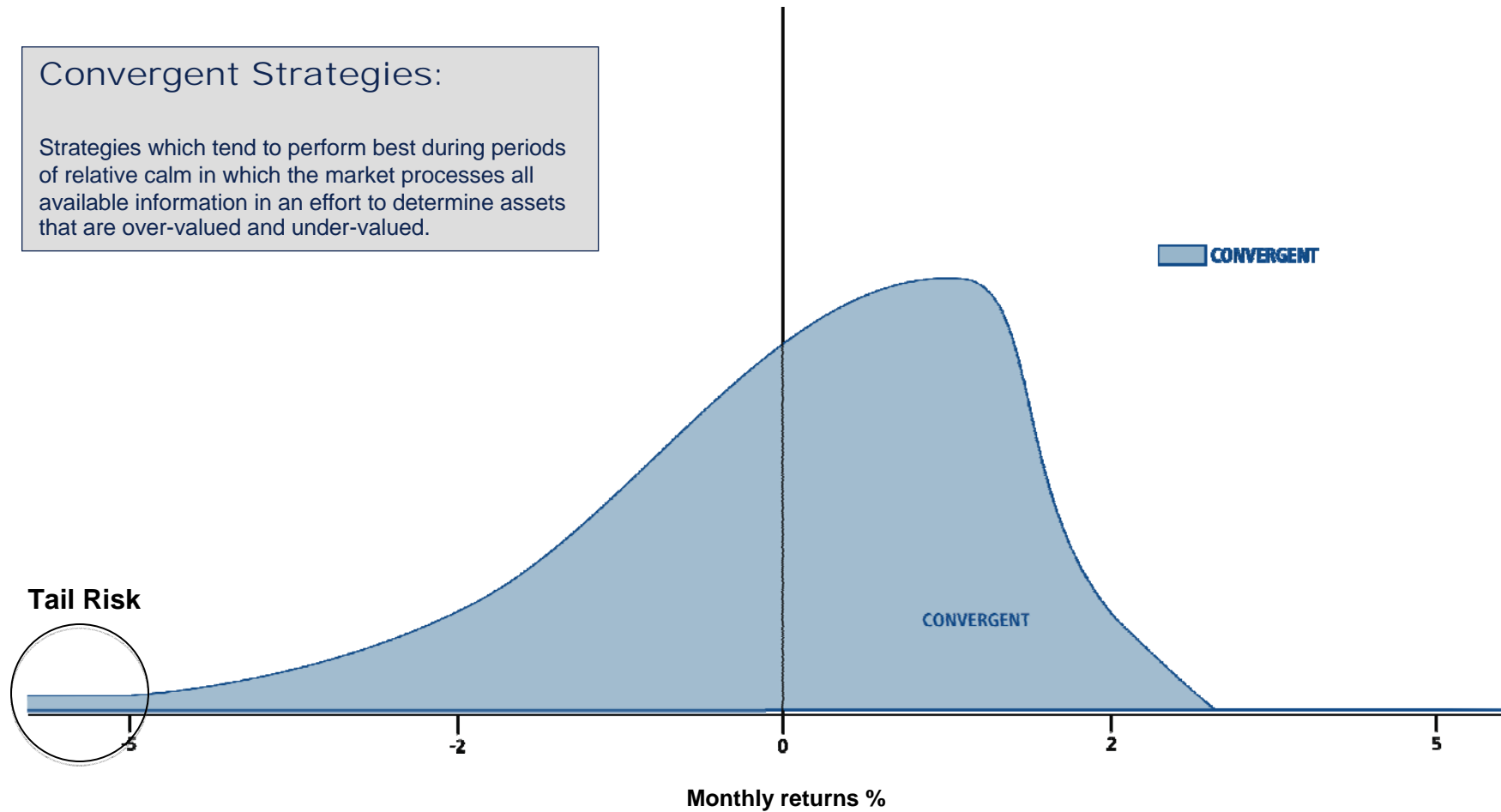
- Lookback straddles

- Many momentum strategies

# The Traditional Value Proposition

## Convergent Strategies:

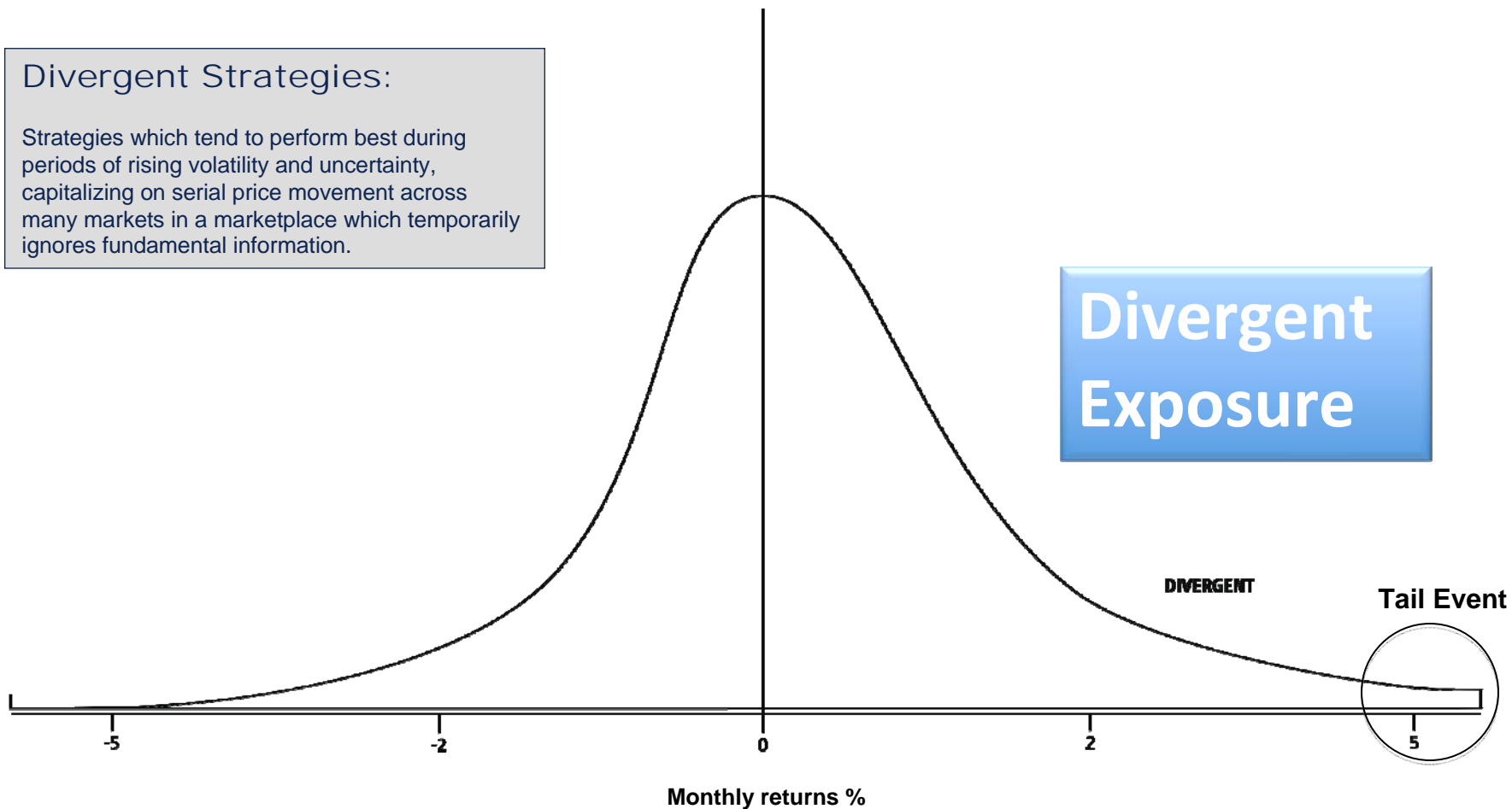
Strategies which tend to perform best during periods of relative calm in which the market processes all available information in an effort to determine assets that are over-valued and under-valued.



# What Went Right in 2008?

## Divergent Strategies:

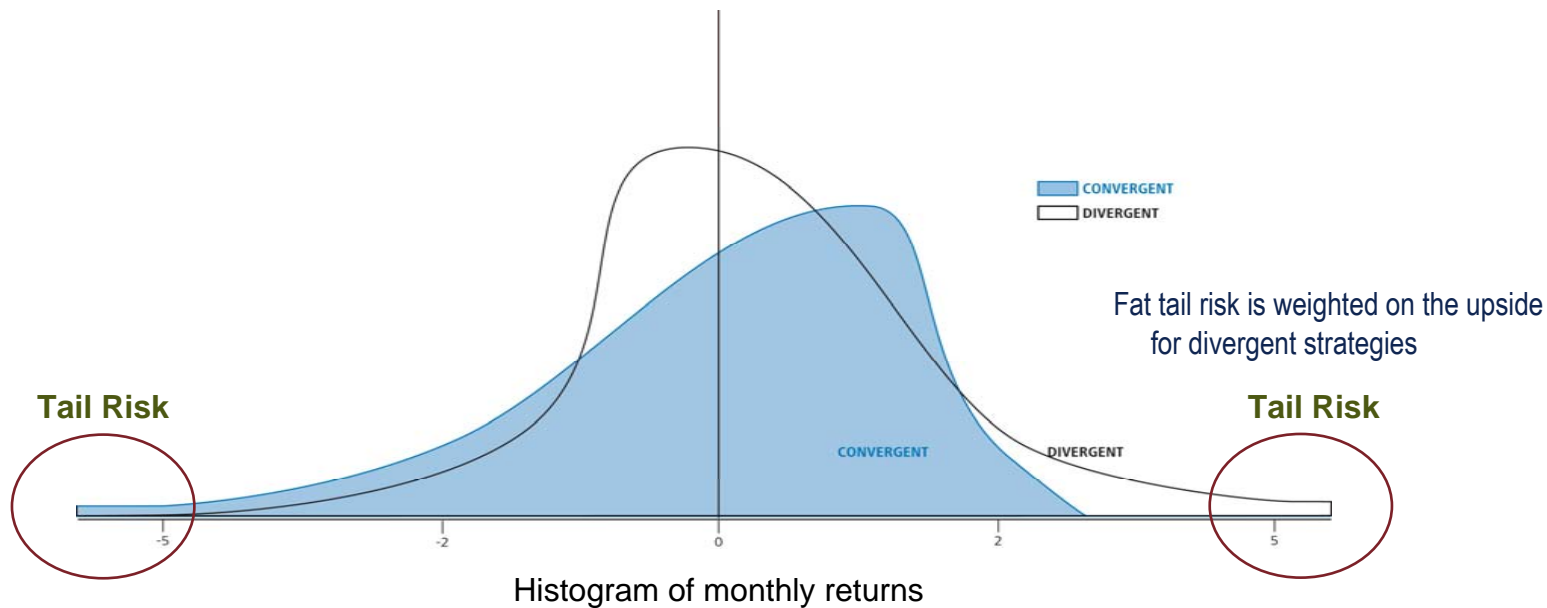
Strategies which tend to perform best during periods of rising volatility and uncertainty, capitalizing on serial price movement across many markets in a marketplace which temporarily ignores fundamental information.



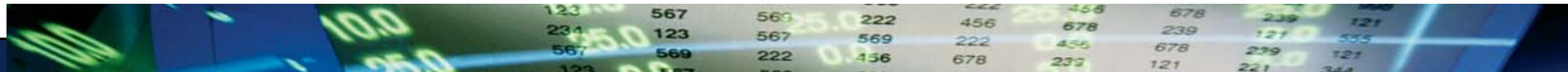
# True Portfolio Diversification

Combining convergent and divergent strategies to create true portfolio diversification and risk management

- Convergent strategies focus on undervalued/overvalued assets and tend to perform well in relatively stable markets
- Divergent strategies capitalize on continuous price movement during periods of rising volatility, while limiting exposure to significant downside risk



The information outlined above is intended for illustrative purposes only. The information is not intended to be investment advice.



# Financial Market Outlook



# Financial Markets Outlook

- Financial markets are healing as signs of recovery emerge and risk appetites revive:

- Equities have rebounded

- Emerging market equities have outperformed

- Oil prices have recovered

- The US dollar has sold off

- Credit spreads have narrowed

- Sovereign yields are off their lows but have not continued to rise

- Prospects for further disinflation and a prolonged period of low policy interest rates are mitigating the recovery trade



## Financial Markets in the Short Term — Equities

- Third quarter earnings reflected economic data, confidence
  - Earnings not just powered by cost cutting
  - Productivity growth high, so operational leverage high
- Expectations for growth have begun to ratchet upwards
  - Fourth quarter could see disappointment
  - Some elements of growth were a one-off
- Management are turning their attention from bond holders to equity investors
  - Hence revival of merger activity as recipe for growth
- Bottom-up valuation metrics are beginning to work again
  - And earnings growth forecasts (management and analyst) becoming more believable and now influencing stock prices



## Financial Markets in the Short Term — Fixed Income

- Long end determining shape as short end anchored for now
- Occasional two year opportunities

### Canada, fleetingly

- We expect range-bound markets as participants balance reality of short term deflation against longer term government funding and inflation worries
- Breakevens a little more expensive in UK/Europe than USA
- Forward/Forward inflation rates have offered (fleeting) anomalies



# Financial Markets

- Based on our economic scenario:

Barring another shock, equities should continue to improve. The timing seems right and valuations are fair.

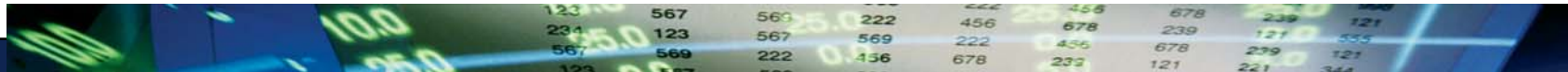
Emerging market outperformance should continue and perhaps even accelerate as signs of global recovery emerge

Oil prices should continue to rise. We expect them to get back to \$90 within two years, and they could overshoot.

The dollar should continue to weaken as the flight to quality bid evaporates and investor stretch for yield across the globe

Credit spreads should continue to narrow making corporate bonds an attractive asset class

If we are right about inflation, namely that it will decelerate to low levels, sovereign bond yields should not continue to rise



# Appendix



## Disclosures

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# Biography



Richard Lacaille

Rick is Global Chief Investment Officer (CIO) of State Street Global Advisors and a member of the firm's Executive Management Group. In his role as Chief Investment Officer Rick has responsibility for all investment management activity at SSgA, including research and trading. Prior to his current role, Rick was Head of Global Active Equities, and previously European CIO. Rick is a Board member of SSgA Limited, and also serves on the European and International Executive Committees and the SSgA Investment Committee. Before joining SSgA in 2000, he held a wide variety of posts in quantitative fund management and research at Gartmore Investment Management, including periods as Head of Quantitative Research and Head of Structured Equities.

Rick has a BSc (Hons) in Operational Research from Lancaster University and MSc in Econometrics from London Guildhall University. He is Chairman of the Board of Inquire (UK) a non-profit body devoted to the research and promotion of quantitative techniques in investment management, a member of the FTSE Policy Committee and he sits on the Asset Management Committee of the Investment Management Association. He is a regular writer and broadcaster on investment issues and speaks frequently at industry conferences.