



# PERSPECTIVES



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## RRR investing: return at a reasonable risk

Financial markets this year have surprised even the most optimistic investors, thin on the ground at the end of 2011. Several factors explain the 'risk on' mentality: better US economic data, the January effect (with a full calendar year ahead many market participants view missing a rally as more costly than incurring a loss) and extra liquidity. It has taken the markets some time to fully assess the ECB's December long-term refinancing operation (LTRO) and the prospect of a similar three-year operation in February. Not only did it cause spreads against Bunds to narrow but, more importantly, it stopped the negative feedback loop from the peripheral bond markets to the banking sector. In the US, to avoid any doubt over interest rate direction, the Fed announced that its funds rate would remain unchanged until the end of 2014.

Both the ECB and the Fed sent the same message: nominal policy rates will stay very low for a long time and remain negative in real terms. Given that most investors seek positive real returns longer term, being too defensive for too long is costly unless risky assets (equities, corporate bonds) fall. Short term, uncertainties remain (Greece, the cyclical environment in Europe, elections), but the strong start to the year reinforces the investors' dilemma: should one jump on the wagon or wait until the train stops? We recommend either moving up gradually on the risk curve by seeking returns at a reasonable risk (as opposed to chasing 'high beta' strategies); or, given the quick switches between risk on/off environments, taking a longer investment horizon. This would make the entry point less important and thus, the decision to enter the market easier.

As always, do not hesitate to contact your Client Relationship Manager for further discussion.

Written 7 February 2012

**William De Vijlder**  
CIO Strategy and Partners





Nathalie Benatia  
Strategist - BNPP AM

## Eurozone: hard to imagine any bright scenarios

Last month, we concluded our US economic overview by outlining the upside risks to our expectations. For the eurozone, this month we have to resign ourselves to describing an unexciting core scenario that goes hand-in-hand with downside risks.

### The recession is here...

At the end of 2011 the first indicators came in showing that the economies of most leading European countries had contracted, even Germany. Indeed, economic momentum has been unfavourable since the autumn and has not improved since the start of 2012. That said, indicators watched very closely by investors, such as the PMI indices<sup>1</sup> reflecting purchasing managers' sentiment, have deteriorated no further since December. However, surveys by the European Commission and national statistics institutes continue to reflect a very gloomy economic situation. In France, for example, the index of business sentiment in the manufacturing industry established by INSEE<sup>2</sup> fell in January for the seventh month running and is now far below its long-run average. The economic sentiment index, measured by the European Commission each month, is sending the same signal for all the eurozone countries except Germany, where the index is still several points above its long-run average. It is close to the lows seen during the recession in Portugal and Greece and has continued to fall in large countries such as Italy and France. As for the INSEE survey, the most worrying factor is not so much manufacturers' sentiment on the general outlook for production – which may be influenced by the general environment – as the decline in the personal production outlook which generally goes hand-in-hand with a decline in activity in the following months.

Generally, the low levels of the leading indicators and the poor "hard" data (industrial output, consumption, employment) in December point to a contraction in activity in early 2012, except possibly in Germany where the economy seems more resilient. On this assumption, we consider the expectations of the consensus of private economists for the eurozone in 2012 to be still rather too optimistic. A 0.3% contraction in GDP is expected<sup>3</sup> on average, which implies growth returning in the second quarter at an annualised rate

of between 1% and 1.5%, i.e. above potential. Such an assumption seems strong given that fiscal policy is likely to adversely affect activity this year. According to estimates by the IMF<sup>4</sup>, the cyclically adjusted budget deficit as a percentage of potential GDP – i.e. the most pertinent measure of fiscal adjustment – is expected to be reduced from -3.5% in 2011 to -2.1% in 2012. Not only is the bar slightly higher than in 2011 (reduction of 1.25 percentage points), but the effort, which had concerned mainly Germany<sup>5</sup>, will this year be incurred by more vulnerable economies such as Italy and Spain, and will result in spending cuts and tighter tax policy, likely to adversely affect activity. The structural measures planned by Italy (especially in the labour market) should have a positive effect on growth, but only in the medium term.

### ...and the ECB too

Faced with this difficult economic situation, since last November the ECB has chosen to ease its monetary policy (via a reduction in its refi rate) and to ensure its good transmission by taking unconventional measures so as to provide the banking system with low-cost liquidity. The impact on financial markets was swift and sharp: the three-year refinancing operation (LTRO<sup>6</sup>) conducted at the end of December led, via various mechanisms, to an easing of bond yields in Spain and Italy and a normalisation of yield curves. However, according to the latest statistics on lending to private economic agents and the banks survey on lending conditions, the impact of the ECB's decisions on the real economy has so far been disappointing. To note, credit tightening<sup>7</sup> is at present the main factor that could exacerbate the recession in the eurozone. This reflects a complex situation: access to funding for banks, heightened prudential ratio requirements, and finally the state of demand. The next ECB LTRO scheduled for the end of February will facilitate refinancing. It remains to be seen whether this action will be sufficient to revive credit.

### Consensus forecasts: Growth & Inflation

February 2012 M= Mean; H= High; L=Low	GDP YoY %									Inflation YoY %								
	2011			2012			2013			2011			2012			2013		
	M	H	L	-1M	M	H	L	-1M	M	H	L	-1M	M	H	L	-1M		
Developed Economies																		
USA	1.8	2.2	3.0	1.8	[2.1]	2.5	3.5	1.4	n.a.	3.2	1.9	2.9	1.1	[2.1]	1.9	4.0	0.5	n.a.
Canada	2.3	2.0	2.5	1.5	[2.0]	2.3	2.9	1.0	n.a.	2.9	2.0	2.9	1.3	[2.0]	2.0	2.6	1.4	n.a.
Eurozone	1.6	-0.3	0.6	-1.2	[-0.1]	1.0	1.9	-0.2	n.a.	2.7	1.9	2.4	1.5	[1.8]	1.7	2.7	1.1	n.a.
UK	0.9	0.5	1.7	-0.5	[0.7]	1.8	2.8	0.5	n.a.	4.4	2.7	4.5	1.9	[2.7]	2.0	3.5	0.8	n.a.
Switzerland	1.7	0.2	1.0	-0.5	[0.2]	1.3	1.9	0.6	n.a.	0.2	-0.3	0.4	-0.9	[-0.1]	0.7	2.0	-0.5	n.a.
Japan	-0.8	1.9	3.5	0.7	[2.0]	1.4	2.9	0.5	n.a.	-0.3	-0.2	0.1	-0.8	[-0.2]	0.0	0.4	-0.6	n.a.
Australia	2.0	3.4	4.5	2.5	[3.5]	3.3	4.0	2.7	n.a.	3.5	2.8	3.3	2.2	[2.8]	3.1	3.9	2.8	n.a.

Source: Consensus Forecasts as of 09/01/2012

1 Purchasing Managers Index

2 Institut National de la Statistique et des Etudes Economiques  
(French National Institute of Statistics and Economic Studies)

3 Consensus Forecasts on 9 January 2012, Consensus Economics Inc.

4 International Monetary Fund; Public Finance Monitor; update of 24 January 2012

5 With a 2.25 percentage point reduction in the deficit in 2011 made possible by a pickup in tax revenue

6 Long Term Refinancing Operation

7 As in the economic sphere, Germany seems to be a case apart, because demand there remains positive, including for housing loans, and the banks have not introduced more stringent lending conditions.



Vincent Treulet  
Head of Strategy - BNPP AM

## Reverting to normal – for now

January proved to be an excellent month for the markets, with risk appetite high. Do you think this might be the start of a more buoyant phase?

Risk appetite indeed rebounded sharply, following reassuring news regarding US growth, hopes of an improvement in the eurozone crisis – due to, among other things, the European Central Bank's LTRO – and hopes of further accommodative monetary policy in emerging countries. This rebound is probably a consequence of the deep pessimism that prevailed in the second half of 2011 and the resulting relative underexposure of investors. Medium-term, we remain rather cautious about this enthusiasm for risky assets. We do not believe in a lasting cyclical acceleration of the US economy, especially given the huge effort that the US will have to make to correct its fiscal deficit. We also think that, fundamentally, the European crisis has not yet been settled. The longer term refinancing operations had a most virtuous effect on sentiment in the short term and on banks' liquidity, but cannot settle problems springing from certain countries' solvency issues nor the defects in the design of the single currency – which require structural reforms. Shorter term, however, we believe that support factors will continue and this has led us to adopt a more risk-taking allocation. We have returned to a neutral position on developed equities, maintain a preference for emerging equities, and have also become slightly more positive on credit.

Despite economic fundamentals that are generally recognised as better, emerging markets have been struggling for the past year and a half. Doesn't this invalidate the idea that they should be preferred to developed markets?

It is true – and it's somewhat paradoxical – that the correlation between developed and emerging markets has not diminished,

Asset allocation

but rather increased, at a time when emerging countries are showing evidence of economic decoupling. We see this as being due to financial mechanisms which, for their part, are globalised i.e. the impact of risk appetite on institutional investor behaviour, easy circulation of global liquidity, etc. One probably should not expect the two groups of markets to decouple rapidly, and our short-term scenario is still that risk appetite in global markets will remain a crucial factor determining emerging market performance. Preferring them makes sense in the short term if you have a positive view on equity market direction. Emerging markets will probably expand or at least move in line with the global market's rise, as they did in January. In the medium term, they are likely to reflect profit growth differentials and any improvements in the risk profile of certain emerging countries relative to developed countries. This would be a more fundamental reason to assign them a significant allocation.

How can it be explained that government bonds and "safe haven" assets such as gold have also performed well since the start of the year?

Admittedly, this behaviour is atypical. Usually, spells of increased risk appetite see a pullback from the safest assets. This indicates the nature of the rise we are seeing at present, i.e. it is probably due more to across-the-board buying than to any normalisation in the environment. This is why we have not adopted negative positions on safe haven assets: the persistence of major underlying risks, and the need for certain investor categories to buy assets, should shore up valuations, even if they are stretched. We therefore remain positive on gold despite its recent rebound, and neutral on the sovereign bonds of developed countries.

MULTI-ASSET CLASS			EQUITIES DEVELOPED COUNTRIES				EQUITIES EMERGING COUNTRIES			
	CURRENT	PREVIOUS		CURRENT	PREVIOUS		CURRENT	PREVIOUS		
EQUITIES			US	=	=	Brazil	+	+		
Developed Equities	=	-	Canada	-	-	China	+	+		
Emerging Equities	+	=	Eurozone	=	-	India	-	-		
FIXED INCOME			Japan	=	=	South-Korea	=	=		
Government Bonds	=	=	UK	+	+	Taiwan	-	-		
Corporate Bonds	+	=	Switzerland	=	=	Russia	=	+		
High Yield	+	=	Australia	-	-	South Africa	=	=		
COMMODITIES						Turkey	-	-		
Brent Oil	=	=	BONDS COUNTRIES SOVEREIGN							
Base Metals	=	=		CURRENT	PREVIOUS					
Gold	+	+	US	-	-					
Agricultural	=	=	Eurozone	+	=					
CASH			Japan	=	=					
	-	-	UK	+	+					
			Switzerland	=	=					

Notes: The indications in the tables reflect views not weights, whereby the "+", "-" and "=" signs respectively represent positive, negative and neutral views. Two different types of views are expressed in the tables. Those in the Multi-Asset Class Module are absolute returns views, or more precisely views on excess returns versus cash. Those in the equities and bond modules are relative return views. Here we assess relative excess returns amongst different countries. These views can of course be translated into portfolio weights. Their size will heavily depend on portfolio constraints and the specific risk budgets.



**Martin Fridson**  
Global Credit Strategist - BNPP IP

## Can default rates stay low?

Brokerage firms and rating agencies predict a third consecutive year of below-average default rates on high yield bonds<sup>1</sup>. This may surprise some investors, given the consensus expectation of sluggish GDP growth in the US and recession in Europe. Several different analyses, however, support the view that defaults will remain low in 2012.

### A sound methodology

Moody's Investors Service forecasts 2012 rates of 2.8% in the US and 3.7% in Europe. Those figures compare with averages (since 2000) of 5.2% and 5.8%, respectively. Unlike some forecasters who rely heavily on subjective components, the rating agency derives its projected rates from a rigorous and transparent model. Moody's statistically relates the ratings mix and economic outlook to the default rate, drawing on its vast historical database.

In January last year, Moody's projected a 1.4% global default rate for 2011. The rate came in at 1.7%. That represents a negligible difference in the world of econometric forecasting.

Moody's current forecasts do not overlook the sombre economic outlook. For instance, the European projection assumes the 9.8% European unemployment rate will climb to 11%. If the recession proves more severe, the default rate will probably exceed the current projection, but Moody's forecast is realistic in view of the present outlook.

### A strong credit profile

Today's universe of outstanding high yield issues promises to hold up well even under adverse conditions. Moody's figures show that at the beginning of 2012, just 11% of global issuers were in the most default-prone category, with ratings below B. Prior to the financial crisis, the comparable figure was 16%.

This quality improvement is easily explained. Many of the weakest credits defaulted during the 2008/9 financial crisis. Too little time has elapsed since then for the new-issue market to reach the point in the cycle at which large numbers of very low-rated companies float debt. As a result, the current universe is concentrated in companies less likely to fail in hard times.

High yield companies have further strengthened themselves by refinancing a large portion of their near-term debt maturities. For example, at the end of 2008 US issuers faced USD 22 billion of 2012 maturities, according to Credit Suisse. By the end of 2011, all but USD 9 billion had been eliminated. Thanks to an aggressive extension of maturities, we should expect few companies to fail this year through being unable to roll over debt as it comes due.

### Taking comfort from history

One more analysis supports the view that although default rates will probably rise in 2012, they should remain below average. Historically, the default rate has not risen from its cyclical trough to its cyclical peak in a single year. When conditions start to deteriorate, companies typically have liquid assets that enable them to continue to meet their obligations for a while. It takes time for the companies to deplete their stores of liquidity, so defaults escalate gradually, rather than all at once.

Let us first consider the US, where economists surveyed by the Wall Street Journal perceived only a 16% probability of recession in 2012. For all non-recession years since 1983 in which the US default rate rose, the average increase was 1.3 percentage points. An average increase this year would produce a rate of 3.1%. That is not far above Moody's 2.8% forecast. Even a 2.2-percentage-point rise, equivalent to the largest observed (in 1989), would result in a below-average rate of 4.0%.

The high yield market has a shorter history in Europe than in the US, so it is more difficult to make reliable statistical inferences for that region. It is noteworthy, however, that in 2008, the default rate increased by just 1.0 percentage point. If the rate were to climb by the same amount in 2012, it would reach 3.7%, right in line with Moody's forecast.

### How much does it matter?

No forecast of default rates is likely to achieve absolute precision, even if the economic assumptions prove highly accurate. Determining the optimal high yield allocation, however, does not depend on a perfect default rate prediction. The one-year total return on the high yield index is not equivalent to Yield - Default Rate + Recovery Rate. Factors such as changes in risk-free rates and yield spreads, early retirements and tender offers also affect returns. Still, it is encouraging to investors with exposure to high yield to know that forecasts of a third year of below-average default rates look realistic from several angles.

<sup>1</sup> Moody's Investors Service reported US percentage-of-issuers default rates of 3.4% in 2010 and 2.7% in 2011. The corresponding European rates were 2.3% and 2.7%.



Chi Lo

CEO - HFT Investment Management (HK) Ltd

## RMB to challenge USD dominance in Asia

Rumours that the internationalisation of the renminbi is stalling are untrue. We believe the process is simply evolving at a slower, more sustainable pace and that the Chinese government's initiatives to broaden the demand base for the currency will see it erode the US dollar's dominance in foreign trade in Asia.

### Is RMB internationalisation stalling?

It's true that since Q3 2011, renminbi (RMB) trade settlements have fallen. Similarly yuan deposits in Hong Kong have declined and the CNY-CNH bond yield spread has fallen into negative territory. However, the latter is indicative of a fall in the speculative demand for RMB due to fading expectations of currency appreciation. This led to there being less RMB in circulation and weak demand offshore. Those who had bullishly predicted early last year that RMB deposits in Hong Kong would top RMB 1 trn within a year have quietly cut their forecast by a third. What's more, bankers in Hong Kong say that only a small portion of the RMB 2.04 trn of RMB trade settlement since 2009 involves companies outside Hong Kong and China. The bulk of the settlements are phony transactions, driven by mainland Chinese companies transacting with their subsidiaries in Hong Kong so as to arbitrage the interest rate differential between the onshore and offshore markets. This partly explains the decline in RMB trade settlement since Q3 2011.

### The next steps

Trade settlement is only the first step for internationalising the RMB. Hong Kong obviously uses the currency in trade with China and is Beijing's designated test centre for offshore RMB development. To expand the RMB's role, China must attract more foreign banks and traders but this will not be easy because foreign incentives are constrained by a RMB that is not fully convertible. Additionally, the Chinese capital market is inadequate and lacks transparency and hedging tools, plus there are complex rules governing the use of RMB.

For the RMB truly to become an international currency, Beijing must create incentives for China's trading partners and foreigners to hold and use RMB as an investment and reserve currency. It will have to simplify the RMB trading rules, introduce transparency, liberalise its capital markets by sanctioning the development of more RMB products and hedging tools, and to upgrade the onshore banking system to handle international portfolio flows. All this will take a long time to achieve. Further, developing large offshore RMB centres carries the risk of losing monetary control and inviting external volatility into the local system.

1 In this move, China will allow Japan to make FDI in China in RMB, develop a RMB/yen FX market to promote trade settlement in RMB in Japan and encourage Japanese entities to issue RMB bonds in Tokyo and other offshore markets. Japan will invest in Chinese sovereign debts as reserve assets. But no timetable had been agreed yet at the time of writing

### New initiatives

Beijing implemented a series of new initiatives in Q4 2011: approving the use of RMB for foreign direct investment (FDI) in China; allowing more Chinese entities to issue RMB bonds in Hong Kong; trading Australian and Canadian dollars against the RMB onshore and sanctioning the so called RQFII (RMB-QFII) scheme (which allows offshore RMB to be invested in China's capital markets through a quota system). These were designed to create a two-way trading mechanism for the RMB between onshore and offshore markets and encourage RMB asset creation offshore. Of particular importance is the Sino-Japanese collaboration, announced late last December, of using the RMB for trade and non-trade transactions<sup>1</sup>. This is a major step towards expanding the foreign demand base for RMB. Japan's decision to buy Chinese bonds will for the first time mean that RMB assets form part of the reserves (though very small) of a G7 economy, and it could be the start of a long-term process for accepting the RMB as a reserve currency.

### Potential challenges

From a policy perspective, rapid growth of the RMB offshore markets will pose regulatory challenges for China. Despite reforms, Beijing's monetary policy is quantitative-based, with market forces via credit-pricing mostly absent. But the growth of offshore RMB markets will erode China's quantitative monetary control. Already, the CNH market in Hong Kong has allowed some Chinese borrowers to skirt onshore liquidity tightening by raising funds offshore. This regulatory challenge will only grow with deepening RMB internationalisation, putting pressure on Beijing to improve its monetary management in the long term.



**Olivier Rudez**  
Senior Portfolio Manager - THEAM

## Currencies: a value-creating asset class

With daily traded volumes of some USD 4 trillion, the foreign exchange market offers investors a broad, liquid and diversified asset class which is increasingly being used by fund managers to create alpha.

The foreign exchange market has expanded rapidly in the past decade, with daily volume currently estimated at USD 4 000 bn<sup>1</sup> versus USD 1 500 bn in the early 2000s. It is the biggest financial market in the world. This colossal volume, traded round-the-clock, ensures appreciable liquidity for investors who are increasingly anxious to have the means to manage their currency risk, especially in periods when volatility can change swiftly and dramatically.

Beyond strictly passive management strategies, which usually involve hedging the entire currency risk exposure of international equities portfolios, the foreign exchange market is increasingly used in active management as a source of alpha creation in its own right. This, notably, is the approach adopted by the Absolute Return team of THEAM.

### Main features of the FX market

There are some obvious features that make the foreign exchange market an indispensable asset class in multi-strategy and multi-asset investment management. It offers a broad, liquid and diversified investment universe that provides an effective source of statistical diversification and reduces the overall volatility of a portfolio. Also, it can be a source of alpha that is not cash-consuming and is easily to carry. However, its main quality is the diversity of its investors. The FX market attracts operators with different investment motives and investment horizons, including, primarily: central banks (which do not pursue a profit or return target), traditional investment managers and hedge funds (which increasingly use this asset class as a source of alpha), commercial and merchant banks, and finally, multinational firms (which hedge commercial transactions or repatriate profits from abroad). The heterogeneous nature of these operators makes this market inefficient as defined by financial theory, and thus creates numerous arbitrage opportunities that can be exploited as part of a discretionary and/or model-driven active management strategy.

### A decisive source of value creation

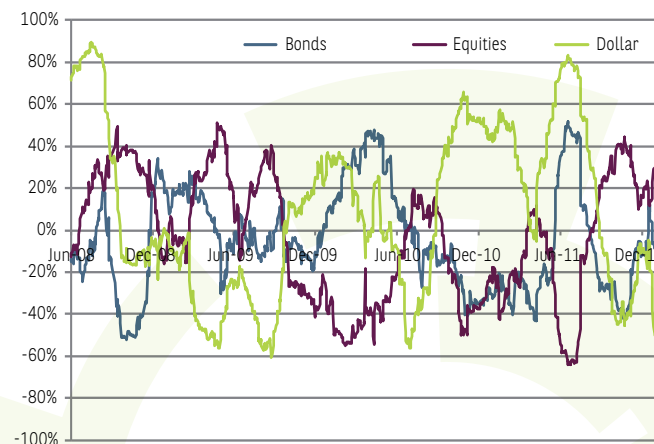
With a risk level somewhere between bonds and equities, the currency market fits in perfectly with an absolute return management strategy. As it is, this market can be traded to exploit investment themes simply and efficiently and within strictly controlled risk budgets, due to the correlation of certain exchange rates with 'global macro' themes. For example, a portfolio can be exposed to commodities markets by purchasing

currencies such as the Canadian dollar or the Norwegian krone (strongly correlated to oil), or the Australian dollar (strongly correlated to precious metals).

Likewise, the major so-called 'emerging' currencies of Latin America such as the Mexican peso and the Brazilian real – whose liquidity has greatly increased in recent years in line with the growing weight of these countries in international trade, and which offer far higher interest rates than other currencies – could be used in carry trading strategies, highly correlated to risky asset markets. Risk aversion indicators can very usefully be combined with this type of strategy to avoid the repercussions of a sudden sharp increase in underlying volatility. Conversely, short positions in these emerging currencies (e.g. by buying put options) could represent an effective hedge during risky asset deleveraging phases.

As the chart illustrates, dynamic currency management makes it possible, via correlations, to exploit a broad variety of investment themes. We apply this in our absolute return management via either discretionary or model-driven inputs and have even devoted one of the five alpha strategies to it. We believe, the currency market is an excellent source of diversification and therefore enables investors to optimise their risk/reward ratio, particularly for absolute return investment management.

FX Active moving correlation



Source: THEAM.

<sup>1</sup> 2010 estimates by the Bank for International Settlements (BIS)



Bruce Jenkyn-Jones

Director of Listed Equity - Impax Asset Management

## When growth is scarce, look to the resource scarcity and environmental markets

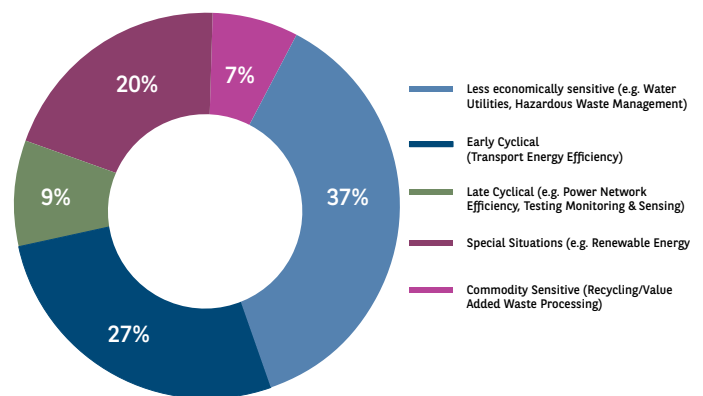
With unstable market conditions leaving many institutional investors concerned about lack of growth, poor returns and rising liabilities, they are increasingly turning to investment strategies based on long-term, uncorrelated growth themes that are advancing despite the economic environment.

The resource scarcity and environmental markets are driven by numerous themes: changing demographics, urbanisation, greater affluence and consumption, natural resource depletion and rising air and water pollution. Increasingly, they threaten sustainable economic growth and prompt large capital allocations towards the development of cleaner, more efficient infrastructure and technologies. Thus, in 2011 the Chinese government confirmed an investment of USD 770 bn in low carbon energy and USD 780 bn in water management and treatment. Similarly, the Australian government adopted a carbon tax and, in light of Japan's Fukushima reactors disaster, Germany, Belgium and Switzerland are abandoning nuclear power generation and increasing renewable energy sources. This favourable political backdrop is complemented by rapid technological developments such as smart grids, light-emitting diodes and thin-film solar. Forward-thinking energy, water and waste businesses are capitalising on these trends with innovations in managing resources, improving efficiency and reducing risk, and are thus generating superior earnings growth. Leading companies are capitalising on these mispriced opportunities by making acquisitions at full market valuation, such as Total's 2011 purchase of 60% of Sunpower at around 15x forward earnings. This interaction of corporate activity, technological innovation and legislative momentum makes the resource scarcity and environmental markets complex to understand and challenging to navigate, leading to frequent mispricing and alpha generation opportunities.

### Attractive valuations but re-rating possible in 2012

2011 was challenging for investors in these markets, with Asian and renewable energy companies de-rated. As a result, many stocks are trading at exceptionally low valuations making it a highly opportune time at which to make an allocation: our Environmental Specialists portfolios are on 14x - versus 18-22x historically - despite earnings growth of 17%. So far, 2012 has seen mixed news, with improving US economic data, receding Asian inflationary pressure and positive earnings momentum set against the continuing sovereign debt crisis in Europe. Though market volatility could continue short term, a number of catalysts could generate the re-rating of some sectors over the next 12 months. Investors in these markets have a wide range of both defensive and cyclical stocks (see chart) to select from to capitalise on opportunities.

Example Environmental Specialists portfolio in early 2012:  
A well-balanced range of cyclical and defensive stocks



### Catalysts and investment options

Should European leaders find a solution to the sovereign debt crises, we would expect economic growth, and thus spending, to improve. With a better short-term outlook for cyclicals, we would selectively increase exposure to the energy efficiency, water infrastructure and recycling sectors.

A sustained recovery in US gas prices would improve the relative economic attractiveness of solar, wind and geothermal power production globally. In this case, we would selectively increase exposure to independent renewable energy power producers, which benefit from falling equipment prices and stable revenue streams. Finally, signs that recent falls in Asian inflation are set to continue would provide us with an impetus to increase exposure to over-sold stocks in China and India, such as Jain Irrigation (micro-irrigation, India) and Lee & Man Paper (paper recycling, China).

### A compelling proposition for 2012

Given all the recent market turbulence, investors should seek portfolios offering sustainable, long-term outperformance. The resource scarcity and environmental markets, whose growth is underpinned by a consistent stream of technological and legislative developments, and is advancing independently of economic conditions, is a good option. In 2012, the key will be to ensure portfolios are robust enough to withstand short-term market headwinds but still take full advantage of the above catalysts. Therefore it remains crucial to identify those mispriced companies poised to generate above-average profits. As a recent de-rating of many of these has resulted in historically low valuations, the timing seems right for those willing to take a medium to long perspective.



Andrew King

Head of European Equities team – BNPP IP

## Investing for the long term pays

Despite the difficult market conditions in Europe over the past year, Andrew King's European equities team has held its course: since taking over four years ago, King has steered BNPP IP's funds through volatile market conditions that have seen prices fall, rally, rise moderately, then fall again. It seems that regardless of the market trend, the European equities team manages to outperform its benchmark while keeping volatility contained. *Perspectives* (P) asked Andrew King (AK) to explain how this was achieved.

**P:** *How have you been able to consistently beat the benchmark in such different market environments?*

**AK:** The reason we have been able to do consistently well in a wide range of market conditions is a function of three things. Firstly, we have a very disciplined risk management process based on the belief that the key to outperformance is to know your limitations and not to try to add value to all aspects of the investment equation. Thus, we concentrate on our core competencies which are industry analysis and stock selection and ensure that the risk/return profile of our funds is driven by stock specific factors and not macro views or top-down strategies and themes. Secondly, we are long-term investors and have designed a process that aims to perform at all stages of a cycle. This is achieved by ensuring there are no top-down biases to drive risk or returns. The key to this second aspect of our performance is to know and understand the key drivers of our stocks very well. Thirdly, we would add that our stock-picking technique, which uses the Herfindahl-Hirschman Index (HHI), is at the core of our success. This index, also used by the US Department of Justice to help "properly define and measure industry concentration", enables us to assess the degree of pricing power that exists for all the companies we examine. Basically, we favour industries with high barriers to entry and limited competition as we believe this permits companies to produce above market rates of return and to do so with less risk. Thus, we only invest in companies that operate with a strong competitive position in well-structured industries – in our view, the two key attributes that allow company management to better control their destiny.

**P:** *How have you taken advantage of the industry knowledge gained from using the HHI?*

**AK:** We have found that analysts' initial earnings estimates often have to be lowered as the year unfolds reflecting our view that market participants are by nature optimists and that external influences detrimental to a company's income stream are often not taken into account. So profit estimates tend to fall as the official earnings announcement date approaches, negatively impacting share prices. We use the HHI to assess the degree of pricing power that should exist in an industry. This enables

us to identify – and only invest in – those companies that are best placed to take corrective action (e.g. through higher pricing) when external shocks occur. The key is their relative pricing power within their industry.

Another way that we use the HHI index is to identify which industries are consolidating, because as the number of participants reduces, pricing power and profitability increase while earnings risk should decrease. We can then focus on selecting those companies most likely to benefit from this. A good example is Siemens's exit from the radiology machines business. Elekta from Sweden, which we have in our portfolio, and Varian, a US company, are market leaders in this area whereas Siemens is actually a challenger in a growing market that requires high investment. Siemens has announced it will withdraw from this market, which will clearly benefit the leaders. Similarly, Technip in France, an oil services company, has seen two of its competitors in the sub-sea construction market merge turning a four-player market into one with only three participants. These consolidation situations are what we look for, not just as a source of profit, but also because it means that we take on less risk. Finally, thanks to the HHI scoring, we avoid fragmenting industries where we believe earnings will come under pressure as competition increases and pricing discipline erodes.

**P:** *You mentioned that you are also long-term investors, can you explain this further?*

**AK:** We think that the growing market short-termism can negatively impact stock pickers. Over the last 40-50 years, there has been a reduction in the average holding period of stocks from around five years down to less than 12 months\*. We think the market pays too much attention to current events and or 'noise' - focusing on factors we think aren't relevant to a company's longer term fundamental value. As we are long-term investors, we had to find a way to adjust to this timeframe discrepancy so that our fund's performance would not unduly suffer from 'noise'. This is done through the risk management process – reducing common factor risk and allowing risk and return to be driven by stock specific risks, which should be largely independent of each other if we do our job correctly.

\*For the FTSE and Dow Jones indices.

*P: How do you minimise or neutralise other factors that influence stocks besides buying for the long term?*

**AK:** As long-term stock pickers, we do not build our portfolios with biases to shares that are expected to do well in a rising or falling economy. Unfortunately, this has been a major feature of recent market performance where the market has been driven by this 'risk on' or 'risk off' mentality. The market's almost binary fixation on this point does lead to much volatility in returns, but we aim to counterbalance this by managing out the top down biases. For example, if we need a defensive stock exposed to euros with a value tilt, we will seek the best companies among our favourites that will give us these attributes. Thus, while making no concessions to short-term market trends, we reduce the volatility.

We also make sure we have no unintentional exposure or deficiency in exposure. For instance, we don't take a view on where the oil price is going, but we do look at which industry can give us this energy exposure while scoring well on the HHI, and then pick the companies we think will best perform – thus our exposure to Technip. We are not merely attempting to be sector neutral: our underweight stance to telecom companies and utilities stocks introduces a bias away from cheap, utility-like income streams. To counterbalance, we looked elsewhere and found this negative bias could be somewhat offset by two holdings within industrials: Experian - a UK credit bureau with a highly stable annuity-like income stream - and ADP, the French airport operator with similar risk characteristics but with a better longer term growth profile.

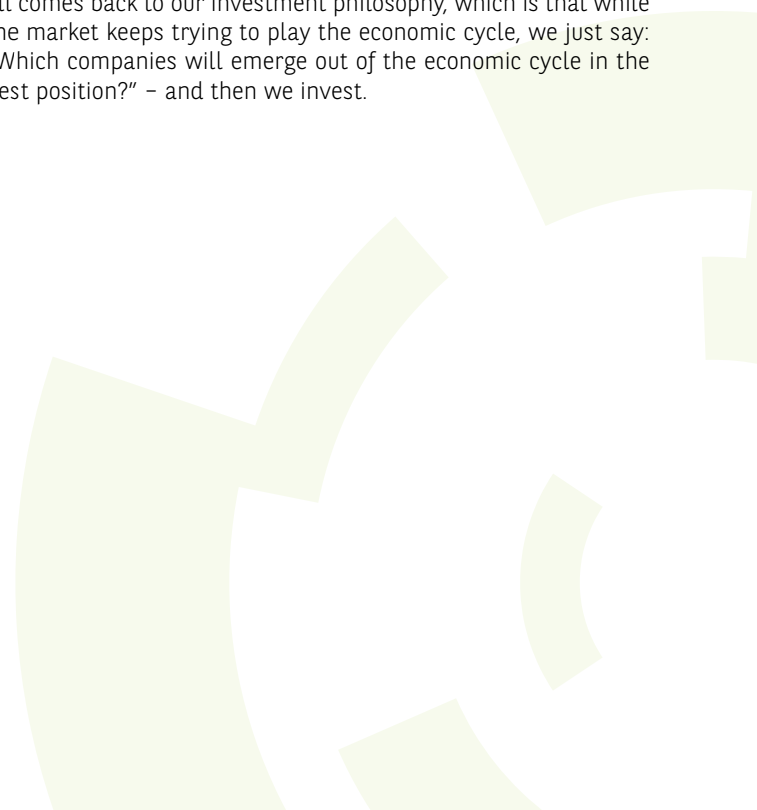
*P: Your success has led to a double A rating from Citywire. Does that mean you work fairly independently or more as a team?*

**AK:** I find that quite embarrassing as I strongly disagree with the star fund manager model - a well-focused team will always add value over any individual in my view. Further, we are very clear about the fact that our results are due to teamwork: each of our eight portfolio managers has an equal vote and everyone's view counts. We have a daily conference call where the team heatedly debates the merits of each proposed stock and reviews those in

the portfolio. Competition to have a stock included is ruthless. This is complemented by a weekly risk management review to ensure the portfolio is sufficiently diversified.

*P: Why should investors buy one of your funds today?*

**AK:** We are convinced the outlook for the European stocks in our portfolio is attractive. The European market valuations are very cheap relative to global markets, other asset classes and past data. That's clearly a result of the problems Europe currently faces but a lot of the companies we hold are multi-nationals that happen to have their headquarters in Europe for historic reasons or because that is where the board chooses to meet. For example, one of our biggest overweights is Jeronimo Martins, a Portuguese food retailer which makes the bulk of its profits in Poland. Similarly, the most significant markets of the big European beer companies are South Africa, Colombia, Russia or Brazil. Another example is Fresenius Medical – a kidney dialysis company based in Germany but with most of its profits coming from the US. It all comes back to our investment philosophy, which is that while the market keeps trying to play the economic cycle, we just say: "Which companies will emerge out of the economic cycle in the best position?" – and then we invest.





Gary Smith

Global Head of Official Institutions - BNPP IP

## Central banks' shifting investment approach

With yields on US treasuries and other developed market government bonds now so low, central banks and other official institutions face a real challenge to find investments that fit their low risk criteria while yielding some positive return. They are thus exploring other investment possibilities and, as these strategic shifts might impact on markets, we provide here an overview of the current trends.

Central banks' reserve managers are being challenged on several fronts. As foreign exchange reserves grow steadily in many emerging countries, reserve managers are struggling to find appropriate investments for the funds. The current environment of heightened concern over the creditworthiness of US debt instruments and the future value of the US dollar make their job particularly difficult. As central banks have historically invested most of their funds in low-risk, low-yielding investments, they face high negative carry costs – where the cost of financing the position via the issuance of domestic debt exceeds the yield earned on US treasury debt. This situation is not soon likely to improve. On top of this cost is the reality that the chance of negative returns on a traditional US Treasury portfolio has never been higher, simply because yields have never been lower. Yet many central banks still hold US dollar assets because the dollar is the dominant reserve currency, although this position is being slowly eroded. Central banks are now debating whether low yields on traditional investment will fundamentally change the way they invest.

### Move to renminbi

One area where it's clear this is already making an impact is in the choice of reserve currency that central banks use: witness the declared intention to invest in the Chinese renminbi (RMB). That numerous Asian central banks want to invest in RMB might be expected, not least for trade-related reasons, but that African central banks would express equal enthusiasm is somewhat of a surprise. The renminbi story can perhaps be best summarised by describing the position of the Central Bank of Nigeria (CBN). The governor of the CBN surprised markets late last summer by publicly announcing an intention to target a 10% allocation to RMB in its reserves, approximately USD 2.5 billion. The justification for the move was trade and trade finance-related. It is worth noting that this would be a move into a currency that currently fails to meet several of the criteria normally required of reserve currencies (e.g. full convertibility, deep and liquid bond market, rule of law, etc.) and is being undertaken in anticipation of those requirements eventually being met. This type of "front running" is of course unusual for a central bank.

### Trend towards local, emerging market, investments

While enthusiasm for the RMB is obviously an emerging market theme, it should be viewed as slightly separate from the demand for broad-based emerging market investments that we have seen from central banks in recent quarters. This local-to-local theme

is well established in Asia, but is now growing in popularity in Africa where there is increasing demand for African investments from local central banks. Furthermore, the demand for Africa-to-Africa investing is over and above the weight of African nations in traditional indices. While there are impediments to this story in Africa (not least because of existing investment guidelines on sovereign credit ratings and the low ratings currently attached to most African nations) there is enthusiasm for the theme, and the African Development Bank is expected to provide political and practical leadership.

### Diversification into other asset classes

Since the S&P downgrade of the US last summer, central banks have been debating precisely what constitutes a risk-free investment. The current investment environment could actually accelerate the pace of diversification into other asset classes. As the whole concept of risk-free assets has been eroded, this could provide some impetus to a changed approach. Some central banks might consider new fixed income asset classes such as Australian bonds, MBS, and emerging market bonds... and perhaps even equities. At a recent conference for central banks organised by Institutional Investor, 37% of central banks and other official institutions, when quizzed on their risk appetite over the next 12 months, said they would exhibit a higher risk appetite. This compares with only 18% who anticipated lower risk appetite and 45% who saw no change. When the optimists were pressed on where they saw this risk appetite being played out, 22% cited emerging market debt, 21% emerging market equity, and 21% illiquid investments (predominantly infrastructure). When asked what might be cut so as to facilitate this, the top response was sovereign debt, with 44% of the votes.

### The old system is ending

Another topical issue is how the natural 'space' for central banks has shifted. The old system of just investing blindly in short-duration treasuries is ending, and this is helping to shape and improve the governance structure of reserve managers. In other words, the pressure to justify strategy, to explain risk and return, and to be generally more professional in approach has been growing and should not relent. Central banks are facing pressures on many fronts and grappling with record low yields on their favoured traditional sovereign investments. A seminal change in their approach to investment allocation may well be the consequence.

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