

The Australian and global investment landscape

Opportunities, challenges, and what lies ahead

Carl Hess, Global Head of Investment chats about big picture local and global investment issues with Sonja Lee, Head of Marketing Australia. He considers the global economic outlook, the impact this might have on Australia, and the big challenges facing institutional investors. He then discusses areas he would focus on to achieve long-term sustained returns if he were the CIO or CEO of an Australian super fund. Carl wraps up with upcoming research his team is working on and the outlook for the Towers Watson Investment business.



Carl Hess
Global Head of Investment



Sonja Lee
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Sydney, 5 August 2010

Q Sonja: Carl welcome back to Australia. Last time you were here in May, the global equities markets were falling on the back of the debt crisis in Greece. A few months later, the EU and the markets have had time to digest things and more economic data has trickled out from Europe and the US—not all of it good news. What's your view on the state of health of the major economies of the world?

A Carl: While the patient isn't acutely ill, there are certainly some chronic issues that will require sorting out. First is the immense amount of debt we've seen created through various stimulus efforts by most of the G20. This only partially represents a transfer of debt from the private sector, and working our way out of these IOUs is one of the major issues for perhaps a decade to come. There are many ways this can be worked out. Some are benign, as in good economic growth, and some are destructive, as in default. While I think it's possible that we might see a relatively benign outcome it's certainly possible that amongst all of the developed economies we won't. That's clearly a major issue facing investors.

Tied to that, of course, are worries about growth. There is a reasonably accepted economic theory which indicates that when debt levels get to 90 per cent of GDP or greater, that debts will function as a drag on economic growth, which again indicates that the less benign outcomes as to how the debt gets worked out, whether it's through deflation or currency devaluation, might be more likely.

Lastly I'd also identify the fact that while we may have righted the ship through concerted actions by the G20, there are certainly a large number of imbalances that still remain. Whether we're talking about the US and China trade relationship or the continued leakage of dollars to the gulf economies through the high use of petrol, these just aren't sustainable over the long-term.

Q Your outlook sounds pretty gloomy.

A It's easier sometimes to focus on the gloomy, but that's not to say that there aren't potentially propitious routes ahead. Nevertheless, we haven't quite figured out how it's going to work out just yet. I would say there's uncertainty rather than gloom.

Q You mentioned the issues of sovereign debt and a weaker outlook for the global economy. How do you think this will affect Australia and do you think the Australian economy will differ in its performance relative to other G20 countries?

A Well, Australia is dealing from a position of relative fiscal strength. While we might soon be looking at sovereign debt to GDP ratios of 100 per cent or more amongst many of the G20, for Australia that number is under 20 per cent, your fiscal position has been relatively balanced up until now—a small surplus now a small deficit. So that's quite good. It almost runs a bit of concern whether the relative strengths and relative prospects of Australia might lead to significant capital inflows which could potentially create problems and that's something we need to keep our eye on. And if the world does slow down, Australia as an exporter of raw materials, will be affected.

Q The investment environment has become highly globalised and interconnected in recent years. How is Towers Watson responding to this change?

A I'd like to think that we actually anticipated that environment. We've very much taken a global approach for years in terms of thinking about these issues—"think globally, act locally" is how we look at things. Now, that being said, just having recognised the interconnectedness doesn't make it easy to analyse, so part of what we try to do is make sure we're well equipped with a large global team that can look at the myriad of issues that might affect our clients' portfolios. Whether those are political issues, economic issues or pertaining to a particular investment, it's important that we're well resourced and can research them.

The fact is the world is our oyster and the next great opportunity may be in Australia or it may be in Azerbaijan. If you don't have a global team you will not be able to distinguish between them.

Q What do you think are the biggest challenges facing Australian institutional investors?

A I do think that the economic issues I spoke about earlier are utterly critical. Developing a good road map to navigate amongst what could be some fairly interesting bumps is critical. The bumps are large—and they move, which makes navigation more difficult—but they don't necessarily move all that fast.

More particularly, though, are the challenges of dealing with the increased complexity and the increased competition in the investment landscape. We've reached a point over the last decade where someone has an idea and suddenly a hundred products spring up

to exploit it. Distinguishing between what's actually good and what's just copied, I think is an immense challenge for us all, and it's compounded by the fact that business as usual probably won't see us out. If, in fact, the world has reached a point where someone sneezing in Laos causes a market crash in London, you have to be adaptable, and that takes quite a lot of effort. So that's complicating all our lives.

The other thing I'd point out, is that we are highly likely to have increased regulation in most jurisdictions—whether that's Dodd-Frank in the United States or coming out of the Cooper or Henry Reviews in Australia—it's going to impact how the industry does business and we should anticipate that, not just react to it.

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Q It's interesting you mention the reviews in Australia. If Cooper's recommendations are implemented, what impact do you think this will have on the institutional space here?

A The transition has the potential to be disruptive indeed and that's certainly a cautionary note we have to worry about on behalf of our clients and the industry in general. Nonetheless, to the extent that funds, as consumers of investment products, can strike a better deal—whether that's through harder negotiation, clubbing together to form buying syndicates, or through amalgamation—this does strike us as one way of curing some of the leakage that's come out of the system in terms of fees.

Q If you were the CIO of an Australian super fund, what areas would you be looking to invest in over the next 10 years?

A I think the need for continued diversification remains paramount. Although many alternatives didn't deliver huge positive returns during the GFC, they delivered returns better than equity through it, and so the search for good diversifying ideas remains incredibly important for super funds.

I think there are a few opportunities we might see in particular today—recognising that opportunities come and go. Whether it's trying to get access to the insurance risk premium through catastrophe bonds or other vehicles, as well as thinking about the fact that the emerging economies seem to have weathered the GFC better than developed economies and, looking forward, the former are going to show economic strength relative to the latter—there are ways of accessing that theme and we are working with our clients to look at various ways they can take advantage—whether through equities, bonds, currencies or other investments.

The next challenge that I would identify for the industry in general is that, the world moves rather quickly, opportunities that look very attractive today may not be so tomorrow. The first mover advantage is more important than ever.

In addition, valuations really do matter. We would argue that while the strategic asset allocation remains an important part of defining a fund's mission, many funds will have to be more nimble to deliver the returns that they'd like for their members. So we believe a dynamic strategic asset allocation alongside the long-term strategic asset allocation has the potential to provide tremendous value-add, as well as controlling risk for funds willing to devote the time and effort to implement it.

Q Carl if you were the CIO of the fund in the US, would you be looking at different opportunities or doing things differently?

A Well with respect to decumulation, the US isn't getting any younger either, so it's an issue not just for the US or Australia. Rather, it's a universal issue and particularly critical as we see the transition from DB to DC globally. I think if we look at the US, I would suggest that risk return profiles do vary especially since we've got many frozen or closed DB funds who are looking to lower their risk profile over time and perhaps even exit the business of being a fund, and that will affect what they do. Your opportunity set when you have say 80 per cent of a fund devoted to growth assets is, I think, a bit different in implementation than when you have say 10 to 15 per cent.

Q What incremental things do you think CIOs can you do in order to minimise risks both locally and overseas?

A I think it's critical to begin by inventorying the risks.

Q You mean identifying the risks?

A Right. And some of these risks may be investment risks, some of them may be operational risks, some of them may be reputational risks, etc. So I think you need to take a fairly holistic view of this. Once you have catalogued them, the next thing you're going to realise is you're going to have to spend more time on risk. This may be the responsibility of the governing body, or there may be a specialised resource to pay attention to risk such as a CRO—which might be a very appropriate position to consider filling. Finally once you've identified those risks and decide what's important and what's not, make sure you're being compensated for the risks you're taking, otherwise get rid of them.

Q Is this something that Towers Watson typically does for clients?

A We have tried to help our clients with their risks for many years and we look forward to helping them to do so in the future.

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Q Changing hats now, imagine you were the CEO of an Australian super fund. What three areas would you identify as being the most important to focus on in order to achieve sustainable long-term returns for investors?

A Devoting the right amount of human resource to managing the fund in line with its mission has to be a top priority for any CEO. We would see that really as getting the right talent in the decision-making process, the right delegations and the right organisations. All three of those are important for good governance.

Secondly, risk management remains utterly critical. Given the maturity of the pensions industry, it's really unusual how nascent risk management is as a discipline specific to pensions. This is going to take a higher priority, because if the industry doesn't give it a higher priority, the regulators will, and we suggest that voluntary is preferable to involuntary in this respect.

Thirdly we have to look toward what I call sustainability of the industry. We are talking about long-term investment accumulation towards people's retirement and the decumulation in their retirement years by definition is very long-term period. But within the system we have a lot of short-termism, whether it's competing returns on a quarterly basis or whether it's having too much turnover in investment portfolios, which of course raises the level of expense in the system. There are ways we can do much better here and there are ways we should do much better.

Q Looking ahead, are you able to tell us what themes Towers Watson is thinking about?

A Two in particular come to mind. First of all we are swinging back from an era of under regulation to an era of regulation and possibly one of over regulation. This is going to have a huge impact on investment portfolios so we believe one of the largest issues out there is public policy. We will be issuing a white paper shortly on the effect public policy could have looking forward and it's well worth the time for fund boards to be contemplating this.

Second is the governance research that Roger Urwin has been doing with Professor Gordon Clark. The fourth piece in their series, this one will focus on better governance for DC funds. This is a very global issue, with different markets in different states of development. We aren't sure if anyone has got it 100 per cent right just yet, so I think in some ways we can advance this, and it's critical for the pensions industry.

Q Do you know where the funds are located in the world that Roger Urwin and Gordon Clark have spoken to for this survey?

A They interviewed funds throughout the world—Australia, UK, Europe, North America and Africa.

Q And Carl six months post-merger, how are things going with the integration of the legacy teams in Investment across the world?

A We're six months in and we're functioning as one team before I thought we'd be, so that's a very exciting thing to be able to say. People are working jointly on engagements all around the world and we've become a "one firm" firm.

Q It sounds like things are going very well. Where then do you see the opportunities for your business?

A The opportunities are just fine doing what we've been doing, thank you, but I'd highlight in particular that Towers Watson is a stronger investment and insurance firm than we were as individual companies and the opportunity for us to look at how we can help the insurance industry with their asset management issues, seems particularly intriguing.

Carl Hess was in Sydney for the Towers Watson Ideas Exchange Conference held 3 August 2010.

About Towers Watson

Towers Watson is a leading global professional services company that helps organisations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.

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