AustralianSuper’s Peter Curtis details his fund’s process to insource about AUD$30 billion of assets over the next three years. By 2016, the fund hopes to be saving $500 million a year in management fees.

REPORT PAGE 12.

For full conference presentations please visit: www.ioandc.com
The inaugural IO&C conference... and more next year

The inaugural Investment Operations & Custody conference at the Hyatt on the Bund, Shanghai, from April 28-30, 2013, had 143 attendees from across the Asia Pacific region – Australia, Malaysia, Korea, India, Taiwan, Cambodia, Hong Kong, Singapore and China. Speakers came in from the UK and US as well.

Pat and I are grateful for the contributions from speakers and attendees and for the contributions from sponsors who provided not only funding but also valuable assistance in inviting guests and speakers to make the conference a great success. We will be back in Shanghai next year: bigger and better. At the gala dinner on the last night, we raised AUD$14,500 for CereCare, the Shanghai facility which looks after children with cerebral palsy.

The main aim of the conference was to address operational and other inefficiencies impacting on cross-border investing throughout APAC. We don’t pretend that we can change things, but we can at least bring attention to them both within the industry and, to a certain extent, in the wider community.

The Asia Pacific region is the fastest growing institutional investment market in the world. But it is not without its issues, especially at the operational level. Costs for investment transactions are much higher in the region than in the US or Europe. Fees and commissions charged against investors are also considerably higher. Some regulators and governments impose additional costs for whatever reasons. These issues need to be addressed.

At the conference, Dr Yuanzheng Cao, the chief economist and director of the Bank of China, spoke about the movement to liberalize and internationalize the RMB. As he explained, this is not something that China can do on its own. It needs cooperation from other countries, which will hopefully be forthcoming in the interests of all international investors.

Other keynote speakers, such as Benjie Fraser from JP Morgan and Jeff Conway from State Street, spoke about the moves to improved governance and trends to lift outsourcing efficiencies. The boss of FNZ in Australia, Martin Jennings, spoke about the way big funds are looking to satisfy their membership base by giving the members far greater choice through new-style platforms. Stephen Wells, of National Australia Bank, tied this together under the worldwide implications of the Basel III regulations, which give individual investors an advantage over their institutional counterparts in banking products such as term deposits. This will accelerate the move to individual investment choice.

Lots of other issues were discussed, as we are covering in short-form in this special publication. And hopefully lots of private discussions, among people meeting for the first time, have led to more ideas about ways to improve how we do our jobs. That’s what conferences are all about – meeting people and picking up new ideas.

Pat and I are committed to producing this conference into the future and we hope that more and more people will join with us to ensure it’s a permanent event on the conference calendar. There is not another conference quite like it and our view, for what it’s worth, is that the asset servicing and investment operations part of the industry deserves more of a voice than it has had in the past.

See you in Shanghai in May next year.

Greg Bright and Patrick Liddy
Investment Operations & Custody Conference

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QIC
RMB band likely to be widened as RMB goes global

The band in which the Chinese RMB is allowed to float is likely to be increased from 1 per cent to 2 per cent this year as part of the liberalization of management and internationalization of the currency, according to Dr Yanzheng Cao of the Bank of China.

In a wide-ranging speech on the future of the RMB, Dr Cao, chief economist and a director of the government-owned bank, predicted at the IO&C conference that the current account would enter a stable period of development.

“It is expected that the full year trade settlement, for 2013, will exceed RMB 4 trillion (about US$645 billion), an increase of 25-30 per cent year-on-year, of which RMB 2.5 trillion will be in goods trade. Trade in services is expected to reach 1.1 trillion,’ he said.

There was “huge growth” potential for capital projects. RMB-denominated direct investment was expected to reach more than RMB 400 billion this year.

“On the solid foundation of Hong Kong’s offshore market, it is expected other offshore RMB markets will develop rapidly. By the end of 2013, total deposits in the offshore markets will reach RMB 1.25 trillion, divided equally between Hong Kong and other offshore markets,” Dr Cao said.

“Due to the huge market potential, competition between financial institutions will intensify, which will stimulate financial innovation and market development.”

During another session at the conference, Susan Lin of Citi predicted that Taiwan would become another offshore RMB centre. Lin, Citi’s managing director and regional head of Yield Book/Citi Fixed Income Indices, said the new ”Dim Sum” bond market was good for RMB exposure. That market started, in 2011 with US$25 billion; it was now worth US$160 billion.

Lin said a high proportion of the Dim Sum market was unrated because there was little incentive for the issuers to pay for ratings since demand was very high. Therefore, the bonds were not necessarily “high yield”.

Dr Cao said, in his keynote address, that since the RMB was officially used for cross-border trade settlements, in July 2009, it had grown rapidly. Currently, more than 10 per cent of the trade with China has been settled with RMB, but this is still bilateral.

“Further RMB internationalization depends on the multilateral process… This depends on the use of the RMB in international investment and financing,” he said.

Dr Cao said non-residents’ holdings of RMB would speed up as the currency moved towards full convertibility and attain a reserve currency functionality.
As back-office providers to fund managers and pension funds provide more and more services in the middle and front office areas, the question of data quality and delivery is growing in importance. Jeff Conway, the State Street asset servicing veteran, says the term “outsourcing” needs to be replaced.

Addressing the IO&C conference in Shanghai last week, Conway, who was appointed last month to head up State Street’s new Global Exchange division – the fourth pillar of the company – asked the following questions:

1. “The internalization of investment management is a global trend – when do the benefits outweigh the costs for a manager?
2. “The explosion of data and the need for more sophisticated data and analytical insights (alpha generation, trading strategies, loss prevention) are driving increased complexity. What techniques are you using to incorporate real-time data and insights to manage risk and generate alpha?
3. “Assets continue to flow into opaque alternatives in search of returns. How do you get the transparency and analytics to provide comfort in your allocations?
4. “Regulatory changes are creating increased compliance and capital adequacy requirements and rapidly evolving markets structures (e.g. central clearing). How do you ensure compliance in a dynamic regulatory environment?
5. “The digitalization of markets is an ongoing trend. How should firms play in an increasingly electronified market to minimize trading and operating costs?”

State Street has set up Global Exchange to gather in under one roof a number of data-generating parts of the business. It complements the other three pillars of asset servicing, funds management and foreign exchange and transactions services.

Addressing the industry trends, Conway said: State Street would launch the next generation of fixed income and derivative execution and clearing services; provide new benchmarks and indices, and an analytics platform with each becoming the industry standard; be a market innovator and leader for integrated analytic solutions across multiple asset classes with a focus on portfolio construction and risk; leverage State Street Associates’ innovation and the STT Digital Enterprise to develop timely benchmarks, indices, insight, and information products.
Mass customization taking hold as FNZ expands in Asia

FNZ, the investment platforms systems and administration provider, is expanding into Asia with the decision to open a Singapore office, according to the chief executive for Australia, Martin Jennings.

Jennings told the Investment Operations & Custody “Best Practice” conference in Shanghai last week that the Singapore office would be opened soon following receipt of the various approvals. He was speaking about the worldwide trend to “mass customization” for investors, which is particularly strong in Australia with the move by super funds to introduce their own member-directed platforms under the funds’ trustee umbrellas.

FNZ, together with partner UBS, supplied Australia’s first member-directed system, which was developed for the $A64 billion Australian Super in 2011. It subsequently won Telstra Super, a part of the Challenger International business, and several other fund contracts.

FNZ has offices in New Zealand, where it was founded, the UK and Australia. The New Zealand business includes a full administration and call-centre service, while the UK is concentrated in the life insurance industry.

Jennings told the IO&C conference that investors’ preference for more control, flexibility and perceived ability to outperform were the main reasons for establishing a do-it-yourself (SMSF) fund.

Compounding the issue for big super funds, which are losing their high-balance members to the SMSF market, is the demographic shift of an ageing population, a lack of retirement solutions and an under-investment in administration systems.

“Members should not have to ‘self manage’ to receive the choice they want,” he said. “And choice doesn’t have to mean increased cost. The technology is out there to deliver individualization and deliver on the product possibilities.”

At another session at the conference, Patrick Liddy, principal of consultancy MSI Group, said that custodians needed to be aware of the trend for super funds to establish member-directed platforms, otherwise they would miss out on a big opportunity.

In Australia, for instance, Macquarie Bank is offering to provide super funds with access to its retail platform for high-balance members at negligible prices, including “free” custody.

As super funds “move up the value chain with these platforms” there were also implications for fund managers, he said. Managers would need to market to the member as well as the fund.

Liddy said that this was not just an Australian phenomenon – the trend would spread throughout Asia because of the fundamental demographic drivers of ageing populations and people wanting to take more control of their retirement savings.

In a panel session at the conference, Liddy labeled his presentation: “Your Customers Are Now Driving You”. Addressing the custodians, fund managers and other service providers in the room, he likened their attitudes to those of the early railroad proprietors who ignored the encroachment of trucks and cars about 100 years ago.

“They said ‘we are in the railroad business’ and they stuck to their trains. They should have realised they were in the people and freight transport business and diversified accordingly,” he said. “I challenge the master custodians to answer: what business are you in?”

Liddy listed seven super funds and one multi-manager which have introduced member-directed platforms under their trusteeship directorship to take advantage of the mass customization trend. They are: AustralianSuper, Telstra Super, HostPlus, ING Direct, Care Super, EquipSuper, Legal Super and Club Plus.

He said there were many others looking to follow suit.

“The announcement that FNZ is setting up in Singapore shows you that the trend is not confined to Australia,” he said. FNZ, together with its partner UBS, is the platform provider for AustralianSuper, which was the first super fund to introduce member-directed choice for its high-balance members, and several other funds.
Broker panels the way to save money in foreign exchange

For big funds with a lot of international assets, the currency decision will often be the most important. And it is a decision you cannot avoid making. Hedging, or not hedging, or opting for active currency management – with or without cross-country actions – are decisions which have to be made.

And, according to Jonathan Green, the head of investment management for the NSW Government’s US$12 billion Treasury Corporation fund, foreign exchange can be managed a lot better from the investor’s perspective.

For the most part, also, he is not talking about making a call on the direction of your home currency. He is talking about, rather, saving a lot of money from improved efficiencies and price tension among a fund’s service providers.

In revealing presentation based on the evidence from his own fund, Green told the conference that moving funds managers away from their traditional practices and towards the use of a panel – third-party broker panels - of FX providers can more than halve transaction costs. In T-Corp’s case, between 2009 and 2012, overall average FX transaction costs dropped from 7.2bps to 3.4bps after adopting the panel approach.

He said: “Inefficient FX execution is a real cost and vigilance starts at the service provider appointment, usually the manager but also the custodian. You need to understand your managers’ and custodian’s FX execution process and ensure it is the best you can achieve.”

His tips included: encourage the managers and custodian to collect time and date-stamp data, which is still relatively rare; conduct regular reviews of the FX execution outcomes; and consider using a third party for verification and benchmarking.

In emerging markets the gap between good and poor FX execution was far greater, he said. Emerging market currencies are subject to a variety of trading rules and there are 11 “restricted currency” markets. Typically, in emerging markets, the FX execution is undertaken by a custodian. Due diligence around the custodian and manager’s process in restricted currencies is recommended, he said.

Some of the challenges in trading emerging market currencies include: pre-funding requirements; non allowance of overdrafts; different restrictions on purchasing and selling local currency; FX having to be matched to underlying securities; local agents being required and onshore trading only being allowed during local market hours.
State Street’s Jerry Cristoforo and Jean Xu

Li Na, deputy finance and accounting director for China’s US$180b SSF, with Northern Trust regional head, Teresa Parker, and JP Morgan’s Jin Lee

Sandy Morgan and Sheridan Lee of Shed Enterprises

The traditionalist and fabulous musicians for NAB cocktails

Suzanne Smith (l) working the room, before we interrupted, at the NAB cocktails

Laurence Bailey of JP Morgan at work

Benjie Fraser of JP Morgan and Dave Edwards of Citi

Greg Bright, the organiser, and Laurence Bailey of JP, again
The CereCare charity folk: Glen Deutscher, Windy Fang and Tim Hardy

Chris Taylor of State Street (standing, left) gathers up Table 3 for formalities

Some weird entertainment

Nagendra Bhatnagar, boss of of the national Indian fund, with Northern’s George Hindmarsh and ex-JP executive Roger Harrold

Steve Baron of Z-Ben and Denis Carroll of Check-Risk

More weird entertainment

Software smoothie Darren Stevens with Super Communications’ Martina Tuohey

Alicia Tuohey
How Basel III is benefitting fund members

Basel III is having ramifications through the pension fund and banking sectors of economies around the world. For the end investors, or members of pension funds, this is a good thing. For the funds themselves, this represents a new challenge.

The voluntary worldwide banking code for collateral, which comes into force this year, favours retail investors. Stephen Wells, managing director, Financial Institutions Group, at National Australia Bank, told the IO&C conference that pension funds were regarded as financial institutions under the code and therefore were treated less well than individuals.

What this means is that self-managed super funds (SMSFs) will get a better rate for their cash and term deposit accounts than the big super funds can get. Given the evidence that SMSFs are skewing their asset allocation heavily towards cash and fixed interest, Basel III will exacerbate the trend.

Wells said that the banks and funds were working on presenting “look-through deposits” to allow members to get the better rates due to retail investors. This also required disaggregated information needs, he said.

Under Basel III, there were higher minimums required from “financial institution” clients, as well as additional buffers.

For the average member of an Australian super fund the difference could be as much as 80-100bps due to the new regulations.

Different countries responded to Basel III in different ways, he said.

How the Future Fund built its investment operations

Gordon McKellar and the investment operations team at the Future Fund had a rare opportunity to build their management and operational systems from the ground up. They also had the time to study the market and the operations of some other big funds.

“Our observations of some of the others we looked at were that their operations can be a bit tactical in making sure that they’re supporting the investment decisions,” he said. “There sometimes seemed to be a mad scramble to get things done. Sometimes, people do a really ordinary job.”

McKellar said the main key performance indicator for the Future Fund’s operations group was to “never constrain the investment team”. He said the group wanted to be ahead of the game – “it’s the concept of seeing around the corner”.

Under its Act of Parliament, the Fund is required to outsource investment management. So, it didn’t need to consider trade execution and decided to outsource custody, to Northern Trust, which had a few years earlier picked up the neighboring sovereign wealth fund, New Zealand Super.

Timing was also fortuitous in another way. The Fund started to invest in June 2007, just before the first cracks appeared in the global financial system. It took its time as professional investors were hired to oversee the fund managers and was still, therefore, sitting on a lot of cash when the crisis hit.

McKellar said: “We still needed experts in their field, even though we had an outsource model … The cultural fit was also extremely important.”

The governance model and the manner by which the operations team made the proper decisions set out the objectives, structures and governance committees.

“The results are proven and effective practices, engaged staff and business unit initiatives being achieved,” he said.

The Fund developed processes to work with its board, who are all appointees of the Federal Government, as well as the Government and colleagues.

“To have stakeholder confidence we needed to engage with them in a certain way. Operations need to understand them and keep them briefed … We adopted a consultative approach. We have as our strapline: ‘One team, one portfolio’.”
Now the whole fund is getting in on the outsourcing act

The convergence of middle and front-office for outsourcing has also meant a move to enterprise-wide responsibility for the outsourcing process. Once the domain of the investment operations department, more senior staff across a fund or fund manager are now getting involved in custody and fund administration decisions.

In a panel session at the conference Teresa Parker, the head of the APAC region for Northern Trust, said middle-office reviews had been driven by the push for growth, capability, profitability and governance. The selection of a partner needed to be based on enabling the client’s business and advancing its strategy.

Both Brett Elvish, the principal of consultancy Financial Viewpoint, and Ric Stevens, the head of investment operations for Queensland Investment Corporation, mentioned the move to enterprise-based decision making.

Elvish also warned, however, that the “final decision maker”, such as the CEO, should be kept away from the engagement team because “greater concessions are made to a ‘faceless’ party”.

Stevens said the shift to enterprise-based decision making was a key issue for QIC. Others were the importance of accurate and reliable delivery of data and other value-added services by the outsource partner, along with cultural alignment.

Elvish provided several tips, including:

- maintain a collaborative process and avoid adversarial relationships
- keep fees and service standards close to market to avoid a shock at review time - be careful of “innovative” fee structures
- be careful with the final negotiations because they tend to shape future behavior - “keep a small win which can be given to the other party near the end of the process
- keep the engagement team small – larger teams tend to be more adversarial
- avoid overly prescribed processes – don’t focus on micro details.

Peter Curtis, head of investment operations at AustralianSuper, also emphasized the greater demand for accurate daily data to help decision making in strategic asset allocation, tilts within asset classes and assessing manager performance.

Strong growth in funds under management meant a partner that could support the growth trajectory in areas such as new products and services, direct investments and new implementation techniques.

Academia’s work offers data ‘vizualization’

Links with academia are important for big technology-dependent companies, such as global banks and fund managers. Jerry Cristoforo, the former Boston academic who set up State Street’s Hangzhou office as a global IT Center of Excellence, described the importance of the work with Zhejiang University, in Hangzhou, a city of about six million people which was a favorite summer holiday destination for Mao Zedong and remains a popular spot today.

Cristoforo, who speaks fluent Mandarin, is State Street’s chief technology officer. He provided a recent example of collaboration - a data visualization project called “Prometheus”. The project, which is designed to better portray the shape and structure of China’s growing funds management industry, involved several PhDs and other academics working with technicians. The result, previewed at the conference, is a galactic spherical image surround by data-point “stars” which represents about 800 funds in the Chinese universe.
AussieSuper to save $500m a year in fees from insourcing

The AUD$64 billion AustralianSuper believes it will save about $500 million a year in fees across its portfolio by the time it hits $100 billion in funds under management in 2016 from insourcing 30 per cent of assets.

In a case study presented to the conference, the fund’s head of investment operations, Peter Curtis, said that the rule of thumb, according to benchmarking work done over the past six years, a fund of our size could be expected to save 4bps in costs for every 10 per cent of assets insourced. “We were running at about 60bps and would expect this to drop to the mid-40s. This allowed us to set our strategy,” he said.

The fund worked with a group called the Global Projects Centre, which is a collaboration between Stamford and Oxford Universities, who set out 10 factors from their research of what should be done for successful internal management.

Because of its size, AustralianSuper was having difficulty getting its cashflow invested. It found that, with four or five Australian equities managers, for instance, it was paying active fees but getting close-to index returns. “Traditionally, industry funds have had a cost advantage over the bank-owned funds, but in recent years this had been eaten away... This was our strategy to move our fund down the cost curve.”

Frameworks have been put in place to protect the intellectual property of ongoing external managers. The fund decided to treat its internal team the same as external managers, with management agreements, monitoring and external scrutiny – “we still want the views and insights of other managers”.

Curtis said the fund was concerned about the impact on its culture of having different people with different skillsets joining in significant numbers. “We want to maintain our member-first ethos... A possible issue is that there will be an increase in the number of things which go wrong. There will inevitably be some losses and won’t be able to blame the fund managers.”

In deciding on which asset classes for the insourcing, the fund looked at capacity constraints, high costs, alignment with ESG policy and whether the process would help with insights. This threw up, in order they will be insourced: Australian equities, direct property, infrastructure, emerging markets, fixed interest and cash.

Phase 1 will see the internal Australian equities being managed about September this year, followed by direct property and infrastructure. Phase 2 will build on the equities capability and roll this out across Asian equities – our idea was stand this up around September 2014 but this may be reassessed”. Phase 3 involves fixed interest in cash. Although the savings are smaller, there will be more demand for pension products in the future and therefore those asset classes will be more important. Phase 4 is for developed market equities.

“We feel there is no sense in us doing private equity internally,” he said.
Asian growth prospects – it’s not just China

While the growth in financial services in China is undeniable, what is being lost is what is happening in the rest of Asia, according to Andrew Inwood, principal of research firm CoreData.

He said that China was probably the most attractive for foreign firms but it was also the most complex – "the rest of the region is just as interesting".

According to CoreData research, which rated eight countries for both attractiveness and ease to do business in, China came out first for attractiveness and last for ease; Malaysia was second for attractiveness but second-last for ease; the Philippines third for attractiveness and fourth-last for ease; Indonesia fourth for attractiveness and fifth-last for ease. Hong Kong was considered the least attractive and third-last for ease to do business. Australia was the second-easiest place to do business but also the second-least attractive. The US was most attractive of the eight and mid-range for ease.

Steve Baron, of Shanghai-based research firm Z-Ben Advisors, said that Chinese retail investors were generally "fairly fickle". While the mutual fund industry was growing, it was only expected to reach RMB 7 trillion (US$1.15 trillion) by 2016, compared with RMB 40 trillion in bank deposits.

But a big jump in the number of high net worth (HNW) investors over the next few years will have a "huge impact" on the growth of the mutual fund industry in China, Baron said.

"High Net Worth investors are the holy grail for fund managers. There are about 2.5 million in China, with assets of more than RMB 6 million excluding their property. They have total assets of about RMB 15 trillion," he said. "We anticipate that there will be about 4.2 million HNWs by 2015."

About 60 per cent of mutual fund distribution goes through the Chinese banks, with only a small proportion going through independent financial advisors. But the licensing body, the CSRC, is to allow foreign banks to distribute mutual funds from later this year.

"Standard Chartered may be the first to get approval," Baron said, "and there are several others. The process seems to be taking only about two months which suggests that the authorities are keen to encourage the entry of foreign banks."

The foreigners will struggle to get distribution scale, though. China’s largest bank, ICBC, has more than 17,000 branches. A joint-venture ICBC and Credit Suisse mutual fund launched recently raised RMB 40 billion in a month.

"It makes more sense for the Chinese banks to distribute their own funds management company products (ones in which they have an ownership stake)," Baron said.

Harvest Funds, which is majority Chinese-owned but 30 per cent owned by Deutsche Bank, is the only distributor which has been set up exclusively for its own product.

One bright spot for foreigners is the use of internet marketing, with Chinese investors showing a tendency to this medium.

"Online financial shops and e-marketing will be a crucial battleground," Baron predicted. "The Shanghai Stock Exchange has already flagged a possible fund platform with no trail fees."
Regulatory uncertainty the constant in securities lending market

If there is one area of the institutional financial services industry which has undergone significant change since the global financial crisis hit home in 2008, it is securities lending. These are some of the events which happened in quick succession: Lehman Bros default; cash reinvestment losses, short-selling bans in many countries; hedge fund de-leverage; and regulatory uncertainty over the responses.

Some bans, such as “naked” short-selling – where the borrower sells the stock before he has borrowed it – remain in many countries. Some deleveraging is continuing, not just among hedge funds. Notwithstanding many more regulations introduced to follow various single-country bailouts of banks and other companies, one suspects that that trend is still being played out.

According to Simon Lee, senior vice president of securities lending specialist eSecLending, based in London, there have been many positives which have come out of the mess of 2008. He said that, in 2013 compared with five years earlier:

- risk is better managed and better understood
- the focus is on intrinsic returns
- cash reinvestment has been deleveraged too
- performance benchmarking is ubiquitous.

But regulatory uncertainty remained, he said.

Nick McDonald, the Hong Kong-based principal of Mercer Sentinel, said that a lot of lenders – mainly big pension funds – withdrew their programs in the immediate aftermath of 2008 but many have come back into the market once they were more confident of the risk controls being in place.

In most major markets, supply is not the problem. The shrinking of the hedge fund industry and deleveraging through replacement strategies for shorting stocks, in particular, has left an oversupply in aggregate.

Lee said that there was an estimated US$13 trillion in lendable assets (supply) compared with $1.8 trillion of on-loan balances (demand). The latest annual aggregate revenue for securities lending was $10.5 billion in 2012, according to Markit Securities Finance.

Is Asia the answer to developed market bond yields?

Investor attitudes to sovereign bond markets also changed as the global crisis unfolded and whole countries needed to be bailed out, and are still being bailed out. Yields remain at record lows.

According to Susan Lin, of Citigroup Global Markets, based in Taiwan, some sovereign bond markets in Europe have been behaving like corporate bond markets.

And, while emerging bond markets and other fixed income asset types may seem to be good investment targets, there are many challenges.

Susan Lin is regional head for Asia Pacific for The Yield Book and Citi Fixed Income Indices. She spoke about the growing importance of analytics in such a changing market.

“When managing fixed income portfolios, risk management should be a discipline throughout the portfolio management process,” she said.

While the low-yield environment and European sovereign crisis have led to strong interest in higher-yielding emerging markets bonds, some countries limit access and more countries have various taxes – such as withholding taxes, capital gains tax and interest income tax - acting as a form of capital control.

On the other hand, the non-investment-grade status of some Asian bonds may not mean they are actually of a lower grade. Lin said that demand was such that the issuers may not have any incentive to have their bonds rated by the ratings agencies.
Narrowing down the likelihood of the next Black Swan

Human beings can recognize and remember about 7,500 human faces – an amazing feat. But the pattern of recognition does not seem to translate to the notion of risk. Our recognition systems become incredibly unreliable.

Nick Bullman, founder and chair of the specialist investment risk research and consulting firm CheckRisk, told the conference that various behavioral factors affect the way we think about the past and, therefore, the future, such as over-confidence and extrapolation of recent conditions, or ‘recency bias.’

‘Black Swan’ events are impossible to predict by their nature, but, Bullman said, we can narrow down the points in time when they are more likely to occur – just not when they will occur.

The main characteristics of a Black Swan event are:

- A rare event that is extremely hard to predict beyond the realm of normal expectations in history, science, finance and technology
- Very small probabilities of occurrence mean traditional models are inadequate
- Psychological biases make us blind to uncertainty and unaware of risk
- Perception of risk and actual risk are usually different - Black Swan Events have a disproportionate impact Cygnets (young swans) are what we usually have to deal with.

Work by CheckRisk and the University of Bath, with which it is linked, and University of Bristol has shown that risk can develop in clusters, where there are multiple events within a group of risks, such as with the occasional behavior of equities. The clusters can infect other clusters by spreading around the system. They can also ‘bridge’ or jump across the system to other clusters. This can occur when there are universal correlations of volatility and may mean rapid spread across the system.

Alarminglly, Bullman said that we haven’t arrived, yet, at the end of the 2008 risk cluster because Quantitative Easing (QE) is being extended - “So, we should be extending risk budgets”.

Japan presented a high risk in the event of its recent stimulus package failing to lift inflation. This will be very serious for financial markets, Bullman said.

CheckRisk analysis since 2011 has consistently thrown up Asia as the best risk-adjusted region in the world, especially China. Counter-intuitively, the Japanese QE has also lifted that country’s risk-adjusted outlook.

“But you shouldn’t generalize across the region,” Bullman said, “because some markets are quite pricey.'

Government funds’ bond allocations for all reasons

Fiduciary funds often look to emulate other types of funds from time to time following periods of outperformance. This happened after the big US endowments led the way with alternatives in the 1990s and outperformed most pension funds.

It may be happening again by funds looking to emulate those which have traditionally had big allocations to bonds and have therefore outperformed since 2008.

But government pension funds, in particular, may have those bond allocations for their own reasons. Take the nascent Indian National Pension System as an example.

Nagendra Bhatnagar, the CEO and trustee of the NPS Trust, said the NPS’s asset allocation had been nearly 50 per cent government bonds, 37.5 per cent corporate bonds, 7.6 per cent equities and 5.3 per cent other.

But the scheme had introduced to India the concept of unbundled management and portability under a common brand umbrella. The trustees wanted a simple product investing in three main asset classes, with no alternatives.

NPS was not allowed to invest offshore but the depth of the Indian corporate debt market meant a diversity of instruments, such as inflation linked and long-dated securities. The NPS also had higher limits on its equities allocation than the commercial market.
SEE YOU IN SHANGHAI IN MAY 2014.