

inflection. points

VOL 2 N° 2 • FEBRUARY 2012

WORLD ECONOMIC FORUM

The view from Davos, 2012

by Matthew Kiernan mk@inflectionpointcm.com

Arguably the most notable aspect of this year's World Economic Forum (WEF) in Davos was in fact the snowfall: there was a 40-year high of 10 feet of snow and, consequently, positively divine skiing conditions. (Despite the allure, your faithful IPCM correspondent remained dedicated solely to bringing loyal readers a breathless, unexpurgated account of the Davos proceedings, so he forsook the slopes in favour of the requisite alcoholic beverages, canapés, and *bonhomie*. A thankless task, but...)

Overall, we can report a mood of cautious optimism at Davos. (Having said that, apart from several absentee ex-CEOs, there were relatively few unemployed folks or food stamp recipients at this year's conference; they might well have evinced a slightly less positive vibe...)

Martin Wolf, the esteemed senior economic writer for *The Economist*, pointedly observed that, in the 5-year period from 2007 to 2012, the overall GDP growth of the "emerging" markets had been roughly 35%, while the comparable rate for the OECD countries was, well, zero. Faithful readers of IPCM missives will perhaps recognize some resonance here.

Christine Lagarde, the new IMF head, pointedly emphasized the fact that, given the current level of global inter-connectedness (a much more modern and less perjorative term than "globalization"), no single country, region, or company was immune from the potential threat of European contagion, and therefore everyone had a vested interest in crafting a constructive solution. Of perhaps greater interest and novelty, however, was her emphasis on the importance of bolstering both economic growth and competitiveness within the Eurozone (your correspondent was unable to determine whether or not Ms Merkel was in the room at the time, and whether or not she had a printable response). Ms Lagarde also very astutely made the novel point that there should be no "one size fits all" prescriptions for Eurozone countries, and that individual, country-specific policy responses should be absolutely imperative.

Canadian central bank Governor Mark Carney, the newly-anointed chair of the International Financial Stability Board, quite rightly noted the ephemeral, self-reinforcing and self-destructive nature of investor confidence (or its absence), and argued that, by any objective measure, the global economy was in fact substantially more robust than it had been during the global financial meltdown/crisis of 2008. Significantly, he also pointedly observed

> *continued on next page*

DAVOS 2012

The Great Transformation?

It is perhaps ironic that the official theme of this year's WEF was "The Great Transformation": there was actually precious little transformational rhetoric (much less concrete calls for action) to be had in the official sessions. We are pleased to report that, by contrast, IPCM's annual dinner/"salon" was, as always, somewhat more "blue-sky" and transformational in both its objectives and its tone. The informal rules of the dinner preclude a detailed account of the discussion, but we can report at least three things:

- Climate change guru Lord Nick Stern confirmed that the most recent scientific findings were, if anything, even more alarming than preceding ones, and therefore that the economic, social, and environmental costs of inaction were escalating alarmingly;
- Microfinance pioneer and legend Muhammed Yunus has diversified his focus beyond his original concentration on providing financial capital to the poor to providing something which is arguably equally important: access to affordable energy; and
- Despite the apparent (and perhaps real) lack of progress in the "official" international, UN-sanctioned policy and program arena, back in the real world on Planet Earth there is a myriad of not merely encouraging but inspiring initiatives underway, ranging from the World Bank's increasingly successful "Green Bonds" program to the accelerating growth of the "impact investment" space, which are already leveraging the unparalleled power of the global capital markets to catalyze positive change.

Inflection Point Capital Management is pleased and privileged to be making a modest contribution to what is clearly an emerging and critical societal imperative: the tectonic shift from a global economy predicated on exponential consumption and exploitation of both natural and human resources to one capable of delivering sustainable economic, social, and environmental development for a world population expected to reach 9 billion by the time our grandchildren inherit the legacy we have all left.

that the current global financial malaise was more of a “global balance of payments crisis” than a banking one. (Skeptical wags in the audience may possibly have discounted that comment somewhat, given that one of Mr. Carney’s previous employers was Goldman Sachs, but we at IPCM could not possibly be so cynical...)

Perhaps the most sobering intervention at Davos came from Donald Tsang, the “Chief Executive” of Hong Kong (a deliciously ambiguous and ambivalent title). Mr Tsang began by observing that, despite Hong Kong’s own complete lack of debt and extremely low unemployment rate, he was actually extremely anxious and concerned about the prospects for the global economy in general. From IPCM’s perspective, what was perhaps most interesting about Mr Tsang’s remarks was his emphasis on the importance of addressing income inequality, and focussing policy responses and interventions on the poor. This, in our view, was one of the single most insightful and compelling statements made at the entire WEF, and we lament the fact that it failed to elicit much of a response. We suspect, however, that Mr Tsang was rather prescient with this observation...

PENSION INNOVATION

The coming revolution

by Matthew Kiernan mk@inflectionpointcm.com
and Gordon Noble gn@inflectionpointcm.com

In our last edition, we made the statement that we need to accept that institutional investors have played a significant role in digging the economic hole in which we have found ourselves globally. While Governments can be justly criticized for their unsustainable debt levels, it is really the investors who must ultimately accept responsibility for investing without questioning the long-term ability of a country to actually pay off its debts.

IPCM believes that in 2012 we will continue to see significant global financial volatility; this is scarcely a breathtakingly bold prophecy. What is perhaps even more important, however, is the question of what this means for the most significant group of international investors in the world – the pension funds.

We don’t make this statement lightly. Pension funds ARE the most significant institutional investors – although few have yet realised that power. The size of the global pension fund sector is in itself an indicator of its importance. According to the OECD, at the end of 2010 fully USD 19.3 trillion were held in pension funds of both OECD and non-OECD countries combined.

But it is not just FUM that counts when it comes to the importance of pension funds. Their real importance lies in demographics.

IPCM and others have long ago identified changing demographics as one of the defining global megatrends of our time. A narrow analysis of demography would suggest that the ageing of western society (and China) is significant because of the opportunity that it creates for health sector

> continued on next page

EMERGING MARKETS

The challenge for pension trustees

The World Bank’s report Global Development Horizons 2011 argues that three major international economic trends are occurring: the shift in the balance of global growth from developed to emerging economies, the rise of emerging-market firms as a force in global business, and the evolution of the international monetary system toward a multicurrency regime.

According to the World Bank by 2025, a multi-polar world will emerge in which economic clout is spread across developed and emerging economies. Emerging economies are likely to grow an average of 4.7% a year through 2025, more than double the 2.3% forecast for advanced economies.

These sobering facts should cause every trustee of pension fund assets to ask a fundamental question: is the pension fund on whose board I sit equipped for this change? And if not, what do I need to do?

In a complex world, merely knowing where investments are domiciled tells us little about where the underlying assets are being deployed. Simply investing in emerging-market investment managers will not in itself provide the pension fund with the

> continued on next page

and related companies. Whilst this is important, the investment opportunity is just one (relatively small) part of why demography is important. Whilst we could reel off a string of implications of ageing, the truth is that we are coming up to a time that civilisation has never known before, where there are more people retired than working.

This in turn raises one of the most important socio-economic and political questions of our time: can pension funds actually deliver on their promises?

IPCM suspects that the structure of pension funds, intertwined with government regulations and organizational cultures that enshrine existing ways of doing things, is going to make it difficult for many pension funds to innovate to the extent that is going to be required in the current investment environment. Their challenge becomes particularly acute when, as is the case today, the toxic combination of market volatility and depressed asset values on the one hand with historically low interest rates and yields on the other simultaneously decreases the funds' asset base while increasing their liabilities. The resulting gap is unlikely to be bridged by business-as-usual approaches.

The challenge for pension funds is that they are wedded to asset allocation strategies that are well past their use-by date.

According to the OECD, the dominant asset class globally for pension funds is bonds – consisting of 50% of total assets on average. It should, therefore, be no surprise as to why we currently have a sovereign bond debt crisis. As pension funds accumulated assets as baby boomer moved into middle age, pension funds with their fixed asset allocation strategies bought more and more sovereign bonds, mistakenly assuming them to be essentially “risk-free” assets.

In good times the structural problems with pension fund investment were not as evident, but in the continuing global financial crisis, which we must regard as the new normal, the deficiencies are becoming increasingly apparent.

The challenge for pension funds is how to wean themselves off their addiction to bonds at a time when pension fund trustees, pension fund members and politicians that oversee pension systems are hungering for the kind of low volatility that bonds are supposed to represent.

The news from the World Economic Forum is that if pension funds don't start the process now, then the future is bleak. According to the World Economic Forum's 6th edition of its Global Risks report, almost all advanced economies will require significant fiscal adjustments given the magnitude of uncovered future pension liabilities. What this means is that if we think that times are tough now, demographics in the western world are going to put even more pressure on government budgets going forward. Governments are not going to be able to issue new bonds to finance their needs, at least not at rates which do not themselves threaten the financial viability of the issuing countries. At the very least, this should imply that that new money coming into the pension funds should not be massively invested in sovereign bonds.

Continuing fiscal crises across western economies will also create one further dilemma for pension funds. As cash-strapped politicians search for ways to solve a myriad of social problems, there will inevitably be a new focus on looking deeper at existing and future pension fund assets as an important part of the solution. As a result, we should look for (and encourage)

exposure to emerging markets that they could achieve if they looked at their whole equities portfolio.

The companies that will benefit from the growth of emerging market economies will be both companies from countries in emerging markets with strong, growing and stable economies and multi-national companies that understand the forces of global change and who are actively transitioning their businesses.

Exposure to emerging markets can therefore be generated within an existing equities portfolio, as well as through targeted investment in companies in emerging markets that can generate sustainable returns.

There is no doubt that there will be companies that will rise from nothing to become household names in emerging markets. We are just as sure that multinational companies will use the strength of their balance sheets to enter emerging markets.

For pension fund trustees the challenge will be to build skills and capacity within their funds around emerging markets. The first step for pension fund trustees on their emerging markets investment journey does not need to be the placing of a bet on the success of a particular emerging market economy. Taking a holistic approach, through developing a deep understanding of who will benefit from the growth of emerging markets, provides trustees with the capacity to generate long-term sustainable returns from what will be the shifting of the world's tectonic plates.

> continued on next page

pension funds to break from their historical patterns and mobilize their capital in ways that contribute to economic and social development.

Strategic infrastructure investment, green investment, and social impact investment are all going to increasingly become part of the debate on the way in which pension funds invest. This change may not happen quickly, but as fiscal pressures tighten we fully expect that it will indeed happen.

All of this means that pension funds, and pension fund systems, face some fundamental challenges and changes, and a concomitant need to achieve unprecedented levels of innovation. This will not be easy, given the enormous inertia built into the current structures and mindsets. But if it cannot be achieved, the odds against the fulfilment of pension promises worldwide will be prohibitive, and the social, economic, and even environmental consequences will be exceedingly grim.

IPCM expects that the pension fund of tomorrow will look a lot different from that of today. We hope that that will mean at least four things: an unprecedented commitment to long-term investing that goes beyond mere rhetoric; substantially different asset allocations, with much less emphasis on sovereign bonds and much less homogeneity and herding in allocations; different geographic emphases, reflecting the structural megatrend which has already shifted the locus of economic growth to emerging markets; and dramatically improved pension fund governance structures.

Arguably the most important of these revolutionary changes will be adopting a genuinely long-term investment perspective. Bond-like returns are manifestly unable to meet pension funds' (or society's) future requirements. Allocation to equities (and other "risk" assets such as real estate, infrastructure, real assets, and hedge funds) must absolutely be increased; simple arithmetic demands it. Countless studies have confirmed that, in the long run, equities and other risk assets do indeed deliver superior returns. The problem with those returns, however, is that they are inherently volatile; impatient, short-term investors who cannot stomach this volatility are almost certain to experience sub-optimal results.

So here's the dilemma in a nutshell: pension funds can only achieve their required returns through a substantial allocation to equities (and other non-fixed-income asset classes). But short-term equity returns are (increasingly) volatile, so the only way to achieve the necessary returns is to accept short-term volatility as the necessary trade-off for superior long-term results. Sounds simple, but this is of course devilishly difficult to accomplish in practice. The traditional quarterly scrutiny of returns, and hair-trigger investment committee decisions to fire "under-performing" managers are scarcely a recipe for the type of long-term, universal owner orientation that is clearly required.

The challenge is for pension funds to innovate in ways that enable funds to uncover assets that diversify their portfolios and deliver stable returns. This is not an easy job, and will involve pension funds having to build deep, skilled investment teams. An average asset allocation of 50% to bonds is simply not going to deliver that. Nor will investment strategies which fail to explicitly acknowledge and respond to the series of secular global megatrends which are literally re-shaping the competitive environment for both companies and their investors.

The implications for the global funds management industry, which has grown off the back of the USD19 trillion of FUM managed by pension funds, are significant; there too, Business-As-Usual will simply not cut it.

ABOUT US

Inflection Point Capital Management

is a new, sustainability-driven asset management boutique. A research-driven organization, IPCM builds on the knowledge base and networks of its predecessor company, Innovest Strategic Value Advisors. Innovest was ranked by the Thomson Extel survey of institutional investors as the #1 research firm in the world in the sustainability space. IPCM has offices in London, New York, Toronto, and Melbourne.

www.inflectionpointcm.com

DISCLAIMER

The information contained herein has been prepared solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any financial product, security or to participate in any trading strategy. Content contained herein may not be reproduced or disseminated in whole or part without the prior written consent of Inflection Point Capital Management (IPCM). While every effort has been made to ensure the accuracy of information contained in this newsletter we cannot provide guarantees. IPCM disclaim liability for any loss or damage which may arise as a consequence of any person relying on information contained herein. Before relying on any information in this newsletter please independently verify its accuracy, currency and completeness.

inflection.
point
CAPITAL MANAGEMENT

Inflection Point Capital Management
100 King Street West, Suite 5700
Toronto, ON M5X 1C7, Canada
+1 416 399 2861
info@inflectionpointcm.com
www.inflectionpointcm.com