Macrobites

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Ian Kernohan, RLAM's Economist, discusses the need for a catalyst to boost markets and shares his thoughts on the future of the Eurozone.

Robert Talbut, RLAM's Chief Investment Officer, tells how the historic asset management model needs to be rethought with an emphasis on reduced fees, more transparent products and increased shareholder engagement.

Tom Meade, Investment Director at Royal London Cash Management examines the value of segregated cash management in times of market uncertainty.

Ian Kernohan

Economist

History suggests that, while low valuations can matter a great deal in the long run, they are a necessary, rather than a sufficient condition for outperformance. Indeed, often they are not even a necessary condition, as markets can move higher even when expensive. As Keynes reminded us, the market can remain irrational for quite a long time.

The recent sell off in share prices means that equity markets are now discounting a mild global recession, though not a 2008/9 type event, which was after all the deepest global recession since the 1930s. In short, if a recession duly materialises over the next few months, this should no longer come as a great surprise as it's now in the price. If, on the other hand, a recession does not materialise and global growth is supported by continued rapid growth in emerging economies, then there is considerable upside from current levels over the longer term. But as I said, for portfolio managers conscious of the need to churn out performance on a monthly and quarterly basis, valuation is not enough, we need some other catalyst.

Possible catalysts include an improvement in the economic data: perhaps we have just had a short term pause, largely driven by the transitory effect of the Japan earthquake and the steep rise in the oil price during the first half of the year. China could give a strong signal that it will boost GDP growth, having dealt with its little inflation problem. Share buy backs and/or M&A could pick up, as companies see good value in their own stock and that of other companies.

One area where I find it difficult to be optimistic is the thorny issue of Euro sovereign debt. At the heart of this problem is the question of whether the Eurozone is ready for central control of national budgets. There is a huge democratic deficit here, as the European Parliament is not seen by many people as a legitimate expression of popular sovereignty. Many, I should say most, people do not even know the name of their MEP. The differences between countries in terms of language, culture and attitude to debt appear too great when compared with the differences within other monetary unions, such as the UK or US. Perhaps I'm wrong and there is a solution which lies somewhere between full fat super state fiscal union and euro break-up, however it is difficult to see the possible outcomes as anything other than binary.

Robert Talbut

CIO

Recent events in financial markets, and in particular gilt yields falling to almost unprecedented lows should have convinced everyone that the post financial crisis world is going to be a very different place. My view is that this new environment will last for many years to come and that much, if not all, of conventional views on markets need to be significantly redrafted. As major investors in these markets it should be challenging the asset management industry to reframe much of what we've done before and chart a changed future model. I set out below some initial thoughts on what some of those changes need to be. Overall the industry needs to find ways of providing more for less than has been the case hitherto.

The overall background is that the standard recommendation to retail type clients of holding bonds for income and building equity portfolios to provide capital growth has been unsuccessful for some time. However a yield now at a little over 2% on gilts is unlikely to provide an exciting return and equities have gone nowhere for ten years. For the overall health of the economy we need investment in risk assets and in particular equities.

Firstly, given that financial market returns overall are highly likely to be lower than have been experienced over the 80's and 90's, the industry needs to lower the fees that are charged. The headline fees charged to retail clients will be taking a far greater share of the lower return and that is before we start to clearly provide a real 'all-in fee' basis. Therefore the industry needs to provide lower fee products so clients can re-engage in the markets, believing that they are getting value for money.

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Secondly, the industry needs to desist from its general trend of taking relatively simple concepts and then making them increasingly complex. Rebuilding trust in investment requires that the funds and products provided are relatively simple and transparent rather than complex and opaque. As a recent example, the financial industry has taken straightforward ETFs and produced increasingly complex, and untested products.

Thirdly, as a way of giving clients more for their money, I believe that shareholder engagement has to become embedded in what every fund manager does as part of their job. Simply deciding to buy and sell based upon some valuation basis, or worse still because a computer has required it, cannot be the right way for us to convince clients that we are taking the management of their money seriously and that we take a genuine interest in the companies in which we invest.

This list is not exhaustive but it signposts the way in which I believe the industry needs to respond to the last ten years of disappointing returns with high volatility. Ploughing on with the historical mantra cannot be the best way to re-encourage new and existing investors back into financial markets. I believe we need to demonstrate more candour and responsibility in building sensible expectations and how these might be achieved.

As for the current crisis, I believe that again we need very different thinking. Ultra low bond yields are not to be celebrated but instead need to be reversed in order that the countries' growth strategy is supported by the capital allocation process. Hence I believe that the authorities need to target a higher rate of inflation - both as a way to reduce debt burdens but also to encourage expenditure. In combination with this we need ways to write off unsustainable debts and measures to boost structural growth. Thirdly, Europe needs jointly issued bonds and all central banks need to engage in expansionary monetary policy. While many of these will seem anathema to conventional wisdom, we need greater recognition that we are not dealing with a conventional situation and therefore we need to embrace unconventional remedies.

Tom Meade

Investment Director, RLCM

Bank Rate in the UK has been unchanged at 0.50% since March 2009, but over the past year money market rates have gradually risen, with three month LIBOR moving from 0.64% to 0.86% and twelve month LIBOR from 1.31% to 1.63%. Most of this movement occurred during 2011. It is now unlikely that Bank Rate will increase until late 2012 at the earliest but we may still see market rates moving higher, reflecting increased competition for deposits from banks. We expect Bank Rate to remain at historically low levels for a considerable period, thanks to a combination of the pressure of fiscal restraint and continued fragility in the banking sector.

Our investment policy means that we continue to only lend to banks that are highly rated in their own right and who additionally have the potential backing of credible governments. We remain conscious that the apparent stability of the money market could change very quickly particularly in response to the perception of increased sovereign risk.

In an environment where there is still a great deal of uncertainty, we will continue to manage cash funds so that they provide security and liquidity as well as investment performance.

Our experience of managing cash during the financial crisis has strengthened our belief that a segregated cash management service provides clients with a sustainable model for managing their cash balances through the creation of a partnership between the client and fund manager. By working together, cash portfolios can be created that exactly reflect the client's treasury policy while allowing the client to benefit from experienced fund managers who are committed to ensuring that the policy remains relevant and adaptable in a changing environment.

Source: rlam as at 22 August 2011 unless otherwise stated.