INNOVATION IN THE AGE OF VOLATILITY

U.S. Edition
We at Principal Global Investors are pleased to partner with CREATE-Research to publish this U.S.-focused report, *Innovation in the Age of Volatility*, authored by Professor Amin Rajan, one of the most respected commentators on the subject of asset management. As a linchpin in the global economy, the U.S. is in the limelight and as such, we are pleased to share this important research on innovation in this age of market volatility.

The report provides insights from nearly 300 asset managers about market conditions and their views of potential innovations that have been inspired by the amplified market cycles of the first decade of the millennium. In this era of prolonged volatility, investors and their asset managers are exploring new ways of investing and managing the asset management business to improve investment outcomes in the new reality of continuing turbulence.

An important outcome of the research conducted in preparation of this report, reveals that an increasing number of asset managers recognize the importance of becoming a trusted advisor to their clients. Investors’ views about investing are changing. This calls for active management by trusted advisors. We at Principal Global Investors believe in the value of actively managed, long-term investment strategy buoyed by longstanding client relationships.

Jim McCaughan
CEO
Principal Global Investors
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EXECUTIVE SUMMARY

Less constrained mandates are on the rise again.

- AN INTERVIEW QUOTE

INTRODUCTION

*Market Volatility: Friend or Foe?,* a 2012 Principal Global Investors/CREATE-Research report, highlighted how investors’ approaches to risk are changing and how asset managers can convert market volatility into an investment opportunity for their clients.

This follow-up report takes a deeper look into the importance of innovation, which was not a significant area of focus in the global edition of *Market Volatility: Friend or Foe?,* and goes much more in-depth into the U.S. market. In the wake of the 2008 credit crisis, prolonged volatility has enjoined investors and their managers alike to explore new ways of investing and managing the asset business to cope with the new reality.

Accordingly, this report highlights recent and prospective changes specific to four areas:

- Investment approaches
- Asset choices
- Diversification practices
- Business models

The underlying survey was carried out in the first half of 2012. It involved 289 asset managers, pension consultants and fund distributors in 29 countries around the world, with a combined AUM of $25.2 trillion. The survey was followed by 100 interviews, which included pension plans. Key findings from them are presented under the following five headlines.
1. Volatility will persist due to continuing turbulence in the global economy

The current crisis, which started in 2008, has found a second wind as public sector debt has spiralled out of control on both sides of the Atlantic after the rescue of beleaguered banks.

There are concerns whether the Euro will survive and whether America’s lawmakers will avoid the ‘fiscal cliff’: the simultaneous squeeze of tax hikes and spending cuts, scheduled for later this year.

As the linchpin of the global economy, the U.S. will continue to be in the limelight: The ‘fiscal cliff’ may create fresh global shock waves, similar to the downgrade in 2011. Equally, a recovery here could radically alter the market outlook worldwide.

For now, markets are already pricing in a double-dip recession, with falling corporate profits and rising defaults. Fears of policy errors will continue to overshadow good economic fundamentals.

2. Smart investing will rely on a high degree of pragmatism on the part of investors

Since 2008, price fluctuations of 4% or more in intra-day sessions have occurred six times more than in the previous 40 years. The conventional investment wisdom has been severely tested. A new approach is duly emerging.

Short term risk premia have become the target, as long-term premia have become unpredictable.

Risk management has come to the forefront, as the old-style diversification no longer provides a free lunch.

Exploiting price dislocations has gained traction, as barbell and style box investing have lost their effectiveness.

With these shifts, five trends will accelerate:

- Opportunistic investing will co-exist with buy-and-hold investing
- Strategic asset allocation will co-exist with dynamic asset allocation
- Capital conservation will co-exist with capital growth
- Top-down strategies will co-exist with bottom-up strategies
- Stock picking will co-exist with asset allocation

Clearly, flight or fight will not be the only choice. De-risking will occur alongside re-risking in all the client segments. Risks within an investment horizon will become just as important as risks at the end of it.

Hence, smart investing will rely on an eclectic approach that ramps up risks, squeezes more returns out of the existing risk budgets and immunizes the unrewarded risks.
EXECUTIVE SUMMARY continued

3. Asset choices will blend opportunism with caution

A key strand of the eclectic approach is gradually coming into view. It sees investors adopting a twin-track approach that engages in short-term opportunism and medium-term asset allocation. The former buys on the dips via market timing or portfolio rebalancing. The latter extracts intrinsic value via buy-and-hold investing.

For Defined Benefits (DB) plans, opportunism will center on credit products and exchange traded funds (ETFs). The latter will be morphing into a tactical asset allocation tool. In contrast, buy-and-hold investing will focus on equities that may well see a generational bull market, once the green light appears on the debt front.

For Defined Contribution (DC) plans, target date funds will become the preferred choice. Its glide path mechanism allows a contra-cyclical automatic re-risking and de-risking. So, they combine opportunism and buy-and-hold investing, with little need for discretionary rebalancing.

For retail investors, the appetite for opportunism will wane, as capital protection and tax efficient retirement funds top their agenda — driven by the ageing populations in the West.

For high net worth investors, similarly, interest in opportunism will weaken in the face of big losses in the last decade. Like their retail peers, their asset allocation choices will center on capital protection.

4. Two areas will see the most innovation: diversification and target date funds

DIVERSIFICATION

After being badly hit by the credit crisis in 2008, diversification has been staging a reinvention. Its new form is also coming into view. It seeks to manage risks more than returns. It chooses distinct asset classes to deliver a distinct set of goals, while seeking to minimize correlations at different phases of the market cycle. It also allocates assets dynamically, as events dictate. In the process, it draws a distinction between means and ends.

The means distinguish between alpha and beta returns, opportunistic assets and buy-and-hold assets, and re-risking and smart risking (i.e. more returns from existing risk budgets).

The outcomes typically target one or more of the following: capital growth, high income, cash flow, liquidity and inflation protection.

TARGET DATE FUNDS

Target date funds in the DC space are the second area that will see significant innovation. They will have a retirement income benchmark akin to liabilities in DB plans.

Asset allocation, thus, will aim to deliver a minimum acceptable level of income in retirement in relation to income earned in employment. This implied replacement ratio will effectively become the liability benchmark against which asset allocation will be adjusted.

Thus, the glide path will become dynamic and allow ‘LDI-lite’ structures that ring-fence the plan balances in the DC space.

5. Innovation will also permeate business models as managers seek to become ‘trusted advisors’

During these turbulent times, asset managers have to walk a fine line between product push and reputational risk. Their clients have to walk a fine line between value investing and value traps.

To achieve a balance in both cases, more and more asset managers will be striving to become a trusted advisor: somebody who is in the client’s inner circle of confidantes.

They are already doing this by a series of discrete improvements in three areas:

- Client engagement that minimizes ‘wrong time’ risk and ‘regret’ risk
- Investment capabilities that translate market disruptions into an investment opportunity
- Interest alignment that minimizes skewed incentives and herd behaviors

The above innovations aim to improve the old more than create the new. Incremental in nature, they have the tail windss to give the asset industry its biggest makeover since it went global in the 1990s.
A road to nowhere can be a road to riches, if history repeats itself.

- An Interview Quote
With yields at this low level, we’re between a rock and a hard place. – AN INTERVIEW QUOTE

2 | WITHERING OF OLD CERTAINTIES

WHY HAVE MARKETS DISCONNECTED FROM FUNDAMENTAL VALUE DRIVERS?

OVERVIEW

This section presents the reference scenarios of the Western culture economies and assesses their implications for the time honored investment approaches.

Four scenarios are identified. The two most likely ones envisage low growth at best and a muddle through at worst. Progress on the debt-front will be a key factor. Markets are already factoring in all possible bad news on the economic front.

In either case, the old investment certainties will continue to wither, forcing renewed pragmatism in five areas:

- Buy-and-hold investing
- Asset allocation
- Diversification
- Capital conservation
- Investment styles

Flight or fight will not be the only choices. For some investors it will be both, for others it will be neither. The response will vary by investor segments.

While investors in all segments are weary of new risks, they haven’t given up on chasing a bargain when they see it. Buying on the dips will increase.
Markets are in an era of prolonged volatility, according to our 2012 global survey on which this report is based. It shows that:

- 7% of respondents expect no more systemic crises over the rest of this decade
- 27% expect one crisis
- 35% expect two crises
- 21% expect three crises
- 10% expect four or more crises

This assessment, in turn, is influenced by three inter-related drivers operating at a macro level.

First, and most important, is the current sovereign debt crisis on both sides of the Atlantic. It started when governments were obliged to take over the debts of their stricken banks in the wake of the 2008 credit crunch. In the ensuing recession, the crisis had fresh momentum, when the public sector debt spiralled out of control. There is no place left to roll this crisis into, short of major reforms of government finances in the West. Lately, there has been a welcome development in Europe with the creation of a new banking fund to rescue beleaguered banks. But there are concerns whether America’s lawmakers will avoid the “fiscal cliff”: the near-simultaneous squeeze of tax hikes and expenditure cuts, equivalent to around 4% of gross domestic product (GDP), scheduled to occur at the end of 2012.

The second driver is the unintended consequences of the latest clutch of financial regulation. From the market perspective, for example, Basel III will enjoin banks to load up on ‘risk free’ debt just at the time when the AAA-rated ultra-safe sovereign debt pool has shrunk by 70% (in 2011 alone) — in response to the downgrades in America and Europe. Worse still, the risk-based rules under the Solvency II directive of the European Union (EU) will perversely turn its insurance companies and pension plans into forced sellers of securities in times of market turmoil, thereby accelerating its directional velocity.

The third driver is the ever-rising contagion susceptibility, as the global economy becomes ever more inter-connected. In this age of the 24-hour news cycle, globalization will amplify investor mood swings and compress their decision spans from calendar-time to real-time. The peaks and valleys of the last 10 years dwarf those of the previous 30 years when markets were less globalized.

Against the backdrop of these drivers, our survey identified four likely scenarios for the economies in the West over the next three years (Figure 2.1):
• None of the survey respondents expect the return to the golden age of high growth/low inflation that prevailed in the period 1982-2007. This scenario is predicated on an economic take-off in the U.S., a safe economic landing in China, a viable accord on the debt crisis in Europe and stable oil prices. Currently, there are no early signs that any of these conditions will prevail in the near future.

• 35% of respondents expect low inflationary growth, driven by a combination of more quantitative easing (QE) in America and Europe, a soft landing in China and a limited accord on the debt crisis in Europe. While QE will prime the pump of economic growth under this scenario, its inflationary consequences will be hard to avoid. Under this scenario, markets are expected to recover with a big early bounce at the first sign of credible progress on the debt front.

• 40% of respondents expect Western economies to muddle through, since it envisages no progress on the debt front in Europe and the near inevitability of the “fiscal cliff” in the U.S. It also anticipates a Greek exit from the Euro. As such, the fate of global financial markets will be driven more by political considerations than business fundamentals.

• 25% of respondents expect the current crisis to morph into global deflation, since it envisages a contagion effect from two key drivers: more exits from the Euro in the absence of a debt accord and a hard landing in China. It also envisages big upheavals in the Middle East. As a result, the West may have to brace itself for a five-year flat line a la Japan, after its property bubble popped in the early 1990s.

As always, the numbers are indicative, not definitive. But they serve to underscore an important point: with unusual economic uncertainty in the West, its markets will remain in a state of heightened volatility for the foreseeable future. As the linchpin of the global economy, the U.S. will continue to attract the limelight. Recovery in the U.S. can radically alter the market outlook worldwide. Equally, like the 2011 downgrade, the “fiscal cliff” may create global shock waves.

**INTERVIEW QUOTES:**

“The diffusion of power in the global economy has diluted the potency of traditional policy tools.”

“Long-term interest rates can remain low for a very long time.”

“Some of the biggest economies are doing fiscal tightening at the same time. That’s rare.”

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**A VIEW FROM THE TOP...**

Whether you live in San Francisco or Sydney, the old investment certainties are withering. In the last decade, risk failed to generate return. The U.S. pension plans, for example, averaged an annual negative real return of 1.8% in that period.

The primary cause was the credit crunch in 2008. Not only did it hit all asset classes indiscriminately, it also forced our governments to socialize the massive debts of their banking sectors. So far, the political consensus required to do that exists neither in Europe nor in the U.S.

Since 2007, gross government debt has increased by one-third in the Euro area, by two-thirds in the U.S. and by three-quarters in the U.K. Conventional fiscal options are mostly exhausted. Quantitative easing — redeeming public debt via freshly minted money — is the only option left.

But it’s not all gloom and doom. The U.S. economy may well avoid a double-dip recession. The latest data on jobs, labor earnings, house prices and corporate earnings point to a continuing modest recovery. Household debt has declined from 133% to 114% of income since 2007. The trade deficit has shrunk from 6% of GDP to 4% since 2006. Similar improvements are evident in parts of Europe.

Yet, the markets appear to have priced in a high probability of another recession with outright declines in corporate profits and a big hike in defaults. This is clear from the current yield on inflation-indexed Treasury bond (TIPS): it is negative over 15 years and only 60 basis points over 30 years, compared to 4% at the start of the millennium.

Such pessimism factors in another budgetary showdown with potentially even higher stakes — the so-called fiscal cliff at the end of 2012. Markets have become more tightly correlated and are more concerned about systemic risks than at any other time on record. Their response to news has been distinctly asymmetric: bad news makes the headlines, good news doesn’t. The recent monetary easing in China and the creation of a new breakthrough rescue fund to recapitalize European banks hardly scored on the Richter scale.

Many investment tools have been thrown out of the window while politics, more than economics, drives the markets. The price-earnings ratios have no sensible anchor points for now. Stocks are at their most attractive in 50 years.

— A GLOBAL ASSET MANAGER BASED IN THE U.S.
Implications for investment approaches

Since 2008, price fluctuations of 4% or more in intra-day sessions have occurred six times more than in the previous 40 years. In the process, investors have seen conventional investment wisdom sidelined.

Risk premia are neither stable nor predictable. Instead, they are volatile and accrue over a much longer period of time than in the past. Now, success is about exploiting the short-term premia as much as choosing the right medium-term strategies.

Popular approaches like barbell and style box investing only work when market cycles are driven by economic fundamentals. Now, success is about understanding the dynamics of price dislocations and devising appropriate strategies for different volatility regimes.

Diversification is no longer a free lunch, as correlation between historically lowly correlated asset classes has risen since 2004 — initially due to excessive leverage and most recently due to systemic forces. Success is about blending asset management with risk management.

Unsurprisingly, therefore, investors’ approaches have been changing and will continue to do so over the next three years (Figure 2.2).

**INTERVIEW QUOTES:**

“After a big shock, it takes years for markets to regain their sanity.”

“As in 2009, a lot of money is sitting on the sidelines, waiting to get back to work.”

“Investors are tiptoeing rather than hurtling towards more risk exposure.”

**FIGURE 2.2**

How will greater volatility change the importance of various investment approaches?

**APPROACHES:**

- Broad diversification
- Capital preservation
- Regular income
- Opportunistic investing
- Tactical asset allocation
- Top-down strategies
- Minimum or low variance equities
- Bottom-up strategies
- Trend funds that switch out of equities into cash when markets fall
- Strategic asset allocation
- Capital growth
- Buy-and-hold investing
- Core-satellite investing
- Quant-based strategies
- Style box investing

Source: Principal Global Investors/CREATE Survey 2012
The identified changes can be organized into four clusters. The first cluster of investors’ changing approaches covers *buy-and-hold investing*:

- 27% of respondents expect its importance to increase; 45% expect it to decrease

In the volatile environment of this decade, its appeal will be confined to those investors who want to exploit long-term premia or those who are not burdened by short-term funding pressures or those who treat volatility as ‘noise’ — here today, gone tomorrow. Either way, its appeal will be confined to those with a strong value bent and belief in mean reversion: buying stocks at a discount to their intrinsic value and holding them until markets are driven once again by economic fundamentals.

The second cluster covers strategic, tactical and opportunistic approaches to *asset allocation*:

- 44% of respondents expect the importance of strategic asset allocation to increase; 37% expect it to decrease
- 73% expect the importance of tactical asset allocation to increase; 15% expect it to decrease
- 70% expect the importance of opportunistic investing to increase; 9% expect it to decrease

These survey response results corroborate the observations on buy-and-hold investing. Strategic asset allocation will retain its hallowed place in the investment universe but it will increasingly incorporate a dynamic element to minimize the duration risk in the age of pronounced volatility. Now, investors are keen to minimize risks within their time horizon as much as at the end of it. Equally, they want to gain from momentum when it is working rather than sticking to the buy-and-hold story.

The third cluster covers *diversification*:

- 72% of respondents expect its importance to increase; 9% expect it to decrease

This big vote of confidence should not detract from an important shift, however. The old style asset-based diversification has not worked for many investors, so it is being refined. The evolving form of diversification will be more about risk-minimization than returns-maximization, involving more asset classes and tactical tilts, as we shall see in Section 4. It will have a larger impact in the institutional space than the retail space.

The fourth cluster covers *capital conservation*:

- 78% of respondents expect the importance of capital preservation to increase; 4% expect it to decrease
- 58% expect the importance of regular income to increase; 6% expect it to decrease
- 44% expect the importance of trend funds to increase; 17% expect them to decrease
- 15% expect the importance of capital growth to increase; 36% expect it to decrease

The shift towards capital conservation will be especially evident in the retail and high new worth investors (HNWI) space, as large cohorts of post-war baby boomers migrate in droves from accumulation to retirement mode over the next eight years.

The final cluster covers *investment styles*:

- 41% of respondents expect the importance of top-down strategies to increase; 15% expect it to decrease
- 29% expect the importance of bottom-up strategies to increase; 23% expect it to decrease

**INTERVIEW QUOTES:**

“*Systemic risks — from excessive leverage, globalization and debt crisis — have overwhelmed stock-related risks.*”

“*Ageing populations are forcing investors to rethink their approaches as there isn’t much time left to recoup their losses.*”

“*How you insulate your clients from volatility in today’s markets will be the defining differentiator in this decade.*”
• 50% of respondents expect the importance of minimum variance equities to grow; 9% expect it to decrease

• 27% expect the importance of core-satellite investing to increase; 36% expect it to decrease

• 18% expect the importance of quant-based strategies to increase; 37% expect it to decrease

• 8% expect the importance of style box investing to increase; 40% expect it to decrease

A number of salient points lie behind these numbers. First, macro or systemic risks are likely to dominate the markets, thereby favoring top down strategies and minimum variance equities. Second, certain styles such as quant and style box investing, will become popular only when momentum is working. Third, and most important, bottom-up stock picking will remain a dominant style, both for buy-and-hold investing and opportunistic investing. Picking the right stocks is seen to be as important as picking the right asset classes in periods of price dislocation and high correlation.

Overall, Figure 2.2 shows that investors will deploy a raft of tools while the markets remain wild. It also shows that having weathered many roller coaster rides since the start of 2000, investors have grown weary of new risks. But they haven’t given up on chasing a bargain when they see one. Investing will be influenced by short-term bargains as much as medium-term value bent.

**INTERVIEW QUOTES:**

“Recent history shows that the four most dangerous words in investment are “reversion to the mean.”

“Investors need to be nimble and adjust their asset weighting to reflect changing valuations.”

“Dynamic investing is a tall order. It requires a high degree of engagement between managers and their clients.”

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*A VIEW FROM THE TOP*

U.S. stocks have doubled in value since March 2009, yet most investors keep avoiding them. The overall trading volume has been trending down for three straight years, which has no precedence since the 1960s. That’s not all. The U.S. equity mutual funds have seen an outflow of over $400 billion for four straight years since 2007, compared to net inflow of $52 billion over the four preceding years. Evidently, volatility has driven out a swathe of frightened sellers. But it has not turned off hungry buyers. Investors can no longer bank on the economy or company earnings as key drivers of markets. Hence, many investors are dipping their toes in dynamic investing as and when opportunities arise.

Rising correlation and low returns have kick-started the search for different forms of investing. Average monthly correlations between the constituents of S&P 500 and their overall index went up from 0.01 to 0.53 between 2005 and 2012. For the FTSE 100, the correlation increased from 0.18 to 0.45 over the same period. Hence, our clients have discovered that a basket of assets with static weights will underperform in today’s volatile environment, just as it has in the last ten years, as markets have progressively disconnected from fundamental value drivers.

At a micro level, too, our clients have discovered that the concept of mean reversion has been getting far removed from the innovation dynamic. Some things don’t revert to mean, they simply go to zero due to disruptive forces like the Internet, smart phones and regulation that have been reshaping the contours of so many industries. What does it mean to be a buy-and-hold investor when corporate life cycles are getting shorter?

However, unlike the world of physics, paradigm shifts are rare in the world of investing, which is cyclical and self-correcting. Individual stocks may not revert to their mean, but the overall markets often do. The key is to spot opportunity in volatility. This is what active management is about.

— *A SWISS ASSET MANAGER*
Flight or fight are not the only choices

The regular media headlines about risk-on/risk-off trades are far removed from reality, according to our survey. It shows the response to volatility has been far from binary. Furthermore, the response has varied between individual investor segments as well as within them. Four investment permutations have been evident:

- De-risking
- Re-risking
- Both de-risking and re-risking
- Neither de-risking nor re-risking

De-Risking
While de-risking has been more prevalent, together the other three permutations are just as prevalent in each of the three investor segments, according to survey results.

In the future, those who de-risk are likely to rely on a variety of approaches. On the whole:

- Defined Benefit (DB) plans will use liability driven investing (LDI), diversification and investment outsourcing
- Defined Contribution (DC) plans will use advice-embedded products, diversification and capital protection strategies
- Retail investors, too, will rely on diversification, advice-embedded products and capital preservation tools

Re-Risking
Similarly, those who re-risk also expect to use a variety of avenues:

- DB investors will use absolute return strategies, unconstrained mandates and high conviction investing
- DC investors will use glide path strategies, absolute return approaches and unconstrained mandates
- Retail investors — especially those who use advise channels — will use active trading strategies, absolute return approaches and unconstrained mandates

The idea of re-risking is not so far-fetched, if history is any guide. According to survey respondents (Figure 2.3):

- 34% think it as a credible option
- 41% think it as a possible option
- 10% are unsure and 15% don’t rate it as a credible option

Nevertheless, the broad outlines of investor approaches are clear.

INTERVIEW QUOTES:

“Investors can no longer count on the economy or corporate earnings to drive the markets.”

“Our entire investment credo revolves around finding investments that sell for less than their intrinsic value.”

“Value investing has taken a disproportionate hit. It’ll bounce back so long as you avoid value traps.”

FIGURE 2.3
Overall, is re-risking a credible option for your clients over the next 3 years?

Source: Principal Global Investors/CREATE Survey 2012
Starting with DB investors, they are likely to adopt one or more of three options at any time. The first one is to dial up risk by venturing further out on the risk frontier via higher yielding assets. Saddled with big deficits, the state pension plans in the U.S. are likely to go down this route in the absence of fresh cash injections by their sponsors. The second option is the investors’ equivalent of the Holy Grail: getting more juice out of existing assets by getting additional alpha without taking on further beta risks. Fundamental indices will be increasingly used to create ‘smart betas’ that deliver cheap alpha, aided on occasions by tactical tilts. Private sector plans in the U.S. and Europe are already venturing down this route. The third avenue is LDI. It is used to immunize unrewarded risks and create a diversified returns-enhancing portfolio (see Section 4). Well established in Europe, LDI will gain traction amongst the U.S. private sector plans.

Moving on to retail investors, it is clear they became ultra-cautious in the wake of the losses sustained in the two bear markets of the last decade. The ageing population, holding the bulk of the retail assets now, has an especially low risk tolerance. Its preferred choice will be guaranteed income funds, with periodic bouts of opportunism when momentum is working.

In all investor segments, therefore, a variety of approaches will be used to cope with volatility. They will blend caution with opportunism. Their central thrust will be directed at one or more of the following:

- Hedging out risks that are not rewarded (e.g. inflation, interest rates)
- Being opportunistic via market timing and/or portfolio rebalancing as and when opportunities arise in the short-term
- Doing strategic allocation to extract intrinsic value in the medium-term

**INTERVIEW QUOTES:**

“If valuations return to the mean, the real return from U.S. equities will be 0.6% over the next ten years.”

“As liquidity dried up in 2008, so did the risk models.”

“Risk models should be used to frame questions, not provide definitive answers.”

**A VIEW FROM THE TOP...**

Historically, risk has been measured as the probability of a given loss or the amount that can be lost with a given probability at the end of a defined investment horizon. This measure only considers the final result. However, since the bear market of 2000-02, investors have been hit by waves of losses across their investment horizons. Such within-horizon losses have forced a big re-think on the traditional notions of risk premia, diversification and style box investing — in favor of dynamic investing. They have also done two other things.

First, they have put the prevailing risk models under scrutiny. Much of the losses have been attributed to fat-tail risks, which by their very nature can neither be modelled nor properly priced by the markets. They are the stuff of human judgement. MTM — maths, technology and models — cannot be ignored. But you have to subject their outcomes to reality checks via a robust overlay of human judgement. Over 90% of our investment calls are now based on judgement.

Second, the within-horizon losses often come from our clients’ own herd instinct. Many good products have not survived the panic selling of the past four years. The speed and scale of sell-offs in 2009 and then in 2011 have no precedent. The familiar fear-greed cycle overrode the fundamentals. In moments of panic, “wrong time” risk emerged like a bolt from the blue, only to be superseded by ‘regret’ risk when markets recovered sharply.

Any investing can be a road to hell if your clients act on a 24-hour news cycle without due regard to the intrinsic value of their investments.

We have re-engineered our client service organization with two aims: minimize the wrong time and regret risks and convert short-term punters into long-term investors. The alternative was to go on losing clients. Our view is that until there is substantial progress on sovereign debt and economic growth in the West, markets may well remain erratic. The S&P 500 earnings per share have increased 75% since 2000, while the index has remained virtually flat in that period.

However, a road to nowhere can be a road to riches, if history is any guide. The last comparable occasion when markets were so wild and moved so little happened between 1975 and 1982 when the legendary Warren Buffett achieved an annual average return of 34% due to good stock picking. During that period, an analysis of S&P 500 shows that in any one-year period, around 3% of stocks doubled in value. Over a three-year period, 18% of them doubled. Over a five-year period, 38% doubled. This is what has happened since 1999, with clear volatility regimes around flat markets. The latest bounces, starting in March 2009 and October 2011, show that the volatility can have an upside, if you know how to exploit it.”

— A U.S. INSTITUTIONAL MANAGER
Reports of the death of the equity cult have been exaggerated.

- AN INTERVIEW QUOTE

WHAT WILL BE THE FAVORED ASSET CLASSES?

OVERVIEW

Investors’ choice of asset classes will blend caution with opportunism within an evolving structure, while markets remain volatile.

With DB plans, equities are likely to feature high on the list of assets to be earmarked for medium-term asset allocation. Credit and ETFs will feature high on their list earmarked for short-term opportunism.

With DC plans, target date funds will become the preferred choice on account of their automatic rebalancing in the face of volatility. Retail investors will seek capital protection, with periodic bouts of opportunism when momentum is working. High net worth investors, too, will seek capital protection backed by a more cautious approach to opportunism.
Conventional investment wisdom has been sidelined by excessive volatility since 2008. But the outlines of the two key strands of the new approach are gradually coming into view.

First, investors are adopting a twin-track approach by drawing a distinction between short-term opportunism and medium-term asset allocation. The former relies on market timing or portfolio rebalancing to take advantage of emerging price anomalies. The latter relies on buy-and-hold investing to extract intrinsic value.

Second, after losing credibility in 2008, diversification is staging a reincarnation by deploying a wide array of asset classes to target multiple goals. This section focuses on the twin-track approach. The latter approach is discussed in Section 4.

Figure 3.1 shows the asset classes and generic products that are likely to be targeted by DB plans, as identified by our 2012 global survey.

**FIGURE 3.1**

Which asset classes and generic products are most likely to be chosen by your DB clients for short-term opportunism and which ones are likely to be chosen for medium-term asset allocation?

Six asset classes are likely to be targeted in the asset allocation track by at least two in five respondents:

- Global equities (58%)
- Global equities with emerging market revenue (54%)
- High income equities (46%)
- Emerging market bonds (44%)
- Emerging market equities (43%)
- Infrastructure (43%)

**INTERVIEW QUOTES:**

“The pendulum will swing towards equities, once the bond bubble bursts.”

“Corporate buy-backs may well fuel the equity markets.”

“Value stocks have been unduly hit by macro risks from China, Europe and the U.S.”

---

Source: Principal Global Investors/CREATE Survey 2012
INTERVIEW QUOTES:

“At today’s yield of 0.02% on three-month Treasury bills, one can double the money in 3,500 years.”

“For three decades, fixed income investors had strong tail winds. But times have changed.”

“A winding-up of the CLO sector is contributing to Europe’s high yield debt market.”

Six asset classes were identified as likely targets for the opportunism track by at least 20% of respondents:

- Distressed debt (43%)
- ETFs (37%)
- Emerging market equities (30%)
- High yield bonds (29%)
- Currency funds (29%)
- Hedge funds (27%)

Starting with the asset allocation track, value investing will retain its appeal, as investors wise up on value traps in this era of heightened volatility. Equities may experience a generational bull market, once there is a green light on the debt front in Europe and the U.S. However, there are some doubts whether the golden age for emerging market equities will continue, since their correlation with the developed markets has been inching towards 0.9. Besides, they have been four times as volatile as the S&P 500 since 2008. Finally, infrastructure will be favored as a source of illiquidity premia by investors with longer horizons.

Moving to the opportunism track, DB plans are likely to move up the risk frontier via opportunistic investing in search of yield in the credit space. Of particular interest will be high yield corporate debt, asset-backed securities, commercial mortgage-backed securities, private placements, senior loans, collateralized loan obligations (CLOs), project finance and ‘secondaries’ in private equity, to name a few.

Under Basel III rules, banks worldwide are expected to reduce their profile in this space by offloading chunks of their loan books to beef up their capital ratios by 2018. Besides, borrowers are now favoring loans over bonds due to favorable coupons, quicker deal processes and ample liquidity in bond markets. In Europe and the U.S., corporate balance sheets are stronger than they were in 2008 with lower leverage. If there is another recession, the default rates will peak at a much lower level than in the last cycle.

Plans in the U.S. are more likely to engage in opportunism and equity investing as a means of re-risking as well as de-risking their portfolios. Worldwide, risk aversion is on the rise. But the public sector plans in the U.S. will be forced to ramp up risk at some point since their current funding ratios assume around 8% annual return on the asset side and a discount rate of around 8% on the liability side. Such assumptions look untenable in the climate of this decade. Thus, some plans will ramp up risk, while some will aim to squeeze extra returns from their existing risk budgets. LDI is likely to gain traction with private sector plans, as they progressively move towards mark-to-market accounting rules.

INTERVIEW QUOTES:

“In emerging markets debt, main opportunities are at the long end of the yield curve.”

“High yield equities are closer to a risk-free asset than sovereign bonds.”

“Far from diversifying portfolios, alternatives have mainly served to concentrate them.”
Every good investment idea can turn into a bad idea once it attracts more inflows. The 2000-2002 bear market inflicted big losses on our 60:40 equity-bond mix. So we were advised to switch to alternatives only to discover, in hindsight, that their peak returns were history by the time we went in. We also discovered that many diversifiers like hedge funds, private equity and real estate could be fair-weather friends. They were not only correlated significantly with public equity. They also lacked liquidity and transparency.

Our funding ratio plummeted from 130% in 1999 to 73% in 2002. It rose to around 100% in 2006, as equities recovered. This was the time to lock in our funded status gains into an LDI structure. But we missed the boat in the belief that our 20% allocation to alternatives would soon raise our funding ratio. Besides, we had no formal plan for de-risking when markets were soaring. Now, we have one. It defines our target end game and a road map to get there. We have immunized the interest rate risk, which accounts for over 80% of annual changes in our liabilities under the mark-to-market rules.

Our returns-enhancing portfolio, too, is undergoing incremental changes. We are moving down the risk curve by replacing alternatives with low variance equities and high dividend equities. We now buy stocks of fundamentally strong companies with good balance sheets and free cash flow. Some of them are closer to a risk free rate than government bonds. The valuation gap between equities and bonds, rarely as wide as now, offers us a hope of prospective returns that are hard to ignore. At the lower end of the risk curve, we are moving up by replacing sovereign bonds with credit products. For example, returns on senior loans remain very attractive at around 9%. Their recovery rates remain around 80%, thus reducing downside risks. The same applies to various ‘secondaries’. Thus we’re de-risking and re-risking at the same time.

In our evolving portfolio, credit perspectives will play an ever larger role as banks in the West offload their assets by around $3.5 trillion to shore up their capital ratios ahead of Basel III in 2018. Furthermore, under an absolute return benchmark, the portfolio base is being expanded to cover emerging market assets, commodities and so-called shadow currencies like the Australian dollar, the Canadian dollar and the Japanese yen. Finally, we’ve become more nimble so as to adjust our asset weightings to reflect changes in valuations and market opportunities. We’ve capitalized on both temporal volatility via market timing and cross sectional volatility via portfolio rebalancing.

Time will tell whether this new approach will work. But we have to try it, since over the past 20 years, the real cost of our final salary pension has risen by 50% due to increased longevity and earnings. Around 60% of liabilities will start maturing over the next eight years as the post-war baby boomers head for retirement. Having already made one-off cash injections over the past 10 years, we can no longer rely on our sponsor. We have to make our assets sweat harder.

– A U.S. PRIVATE SECTOR DB PLAN
## Trends over time

Our current survey is the fourth in a series started in 2009 by Principal Global Investors and CREATE-Research. Here we present a snapshot of how investors’ expectations about their future asset choices have varied between 2009 and 2012 (Table A.1).

A small caveat first: the classification used in the two surveys is similar in most cases except that certain sub-categories were deemed important enough to be singled out in 2012 in a way that they were not in 2009. So, where comparable data are not available this is indicated in the table as n/a.

Four investor segments were covered by our surveys: DB plans, DC plans, retail investors and high net worth investors. As before, the data for each segment are presented separately below in two sets: one covering its likely choices for medium-term asset allocation and one covering its choices for short-term opportunism. For ease of presentation, the top 10 choices are listed for DB plans and top five for the remaining three segments.

### TABLE A.1 Which asset classes are most likely to be chosen by different investor segments for medium-term asset allocation and which ones are likely to be chosen for short-term opportunism?

#### A. DB INVESTORS

<table>
<thead>
<tr>
<th>ASSSET ALLOCATION</th>
<th>% of respondents</th>
<th>OPPORTUNISM:</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2012</td>
<td>2009</td>
<td></td>
</tr>
<tr>
<td>Global equities</td>
<td>58</td>
<td>61</td>
<td>Distressed debt</td>
</tr>
<tr>
<td>Global equities with emerging market revenues</td>
<td>54</td>
<td>n/a</td>
<td>Exchange traded funds</td>
</tr>
<tr>
<td>High income equities</td>
<td>46</td>
<td>n/a</td>
<td>Emerging market equities</td>
</tr>
<tr>
<td>Emerging market bonds</td>
<td>44</td>
<td>n/a</td>
<td>High yield bonds</td>
</tr>
<tr>
<td>Emerging market equities</td>
<td>43</td>
<td>40</td>
<td>Currency funds</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>43</td>
<td>n/a</td>
<td>Hedge funds</td>
</tr>
<tr>
<td>Real estate (inc. CMBS nearing redemption)</td>
<td>40</td>
<td>48</td>
<td>Commodity funds</td>
</tr>
<tr>
<td>Global tactical asset allocation products</td>
<td>38</td>
<td>42</td>
<td>Global equities with emerging market revenues</td>
</tr>
<tr>
<td>Investment grade bonds</td>
<td>37</td>
<td>53</td>
<td>Global tactical asset allocation products</td>
</tr>
<tr>
<td>Government bonds</td>
<td>35</td>
<td>40</td>
<td>Global equities</td>
</tr>
</tbody>
</table>

#### B. DC INVESTORS

<table>
<thead>
<tr>
<th>ASSSET ALLOCATION</th>
<th>% of respondents</th>
<th>OPPORTUNISM:</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2012</td>
<td>2009</td>
<td></td>
</tr>
<tr>
<td>Target date retirement funds</td>
<td>52</td>
<td>62</td>
<td>Equities</td>
</tr>
<tr>
<td>Equities</td>
<td>49</td>
<td>62</td>
<td>Cash-like products</td>
</tr>
<tr>
<td>Diversified growth funds</td>
<td>43</td>
<td>n/a</td>
<td>Diversified growth funds</td>
</tr>
<tr>
<td>Bonds</td>
<td>37</td>
<td>56</td>
<td>Customized investment / self managed plans</td>
</tr>
<tr>
<td>Target risk retirement funds</td>
<td>36</td>
<td>52</td>
<td>Bonds</td>
</tr>
</tbody>
</table>

#### C. RETAIL INVESTORS

<table>
<thead>
<tr>
<th>ASSSET ALLOCATION</th>
<th>% of respondents</th>
<th>OPPORTUNISM:</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2012</td>
<td>2009</td>
<td></td>
</tr>
<tr>
<td>Capital protection funds</td>
<td>46</td>
<td>55</td>
<td>Indexed funds</td>
</tr>
<tr>
<td>Tax efficient retirement funds (e.g. IRAs in the USA)</td>
<td>34</td>
<td>53</td>
<td>Actively managed equities and / or bonds</td>
</tr>
<tr>
<td>Actively managed equities and / or bonds</td>
<td>32</td>
<td>49</td>
<td>Theme funds (e.g. Shari’ah, SRI, environment)</td>
</tr>
<tr>
<td>Mutual funds using hedging tools (e.g. Newcits)</td>
<td>30</td>
<td>n/a</td>
<td>Mutual funds using hedging tools (e.g. Newcits)</td>
</tr>
<tr>
<td>Indexed funds</td>
<td>28</td>
<td>46</td>
<td>Capital protection funds</td>
</tr>
</tbody>
</table>

#### D. HIGH NET WORTH INVESTORS

<table>
<thead>
<tr>
<th>ASSSET ALLOCATION</th>
<th>% of respondents</th>
<th>OPPORTUNISM:</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2012</td>
<td>2009</td>
<td></td>
</tr>
<tr>
<td>Capital protection funds</td>
<td>55</td>
<td>40</td>
<td>Commodity funds (inc. gold)</td>
</tr>
<tr>
<td>Absolute / real return funds</td>
<td>42</td>
<td>50</td>
<td>Indexed equities</td>
</tr>
<tr>
<td>Real estate</td>
<td>37</td>
<td>46</td>
<td>Currency funds</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>30</td>
<td>31</td>
<td>Absolute / real return funds</td>
</tr>
<tr>
<td>Active equities and bonds</td>
<td>29</td>
<td>51</td>
<td>Hedge funds</td>
</tr>
</tbody>
</table>

Source: Principal Global Investors/CREATE Survey 2012 and 2009

n/a = not applicable
INTERVIEW QUOTES:

“Minimum variance equities have discredited the idea that higher risks mean higher returns.”

“Among asset classes, equities may be the best of a bad bunch.”

“With ETFs, innovation breeds more risks.”

A. DB PLANS
i. Asset allocation
Key message: equities bounce is overdue whereas bond prices defy logic.

Over the period 2009-2012, equities ranked high in the top ten forward choices favored by DB investors in the asset allocation set. Since the onset of the current crisis, value stocks have been hit disproportionately by the absence of progress on the debt front on both sides of the Atlantic. The crisis has yet to weaken the central credo of most DB investors: invest in assets that are sold for less than their intrinsic value and sell when the time is right.

At the same time, these investors also believe that the 30-year bull market in fixed income is over, with interest rates edging towards their lowest levels for a generation. The powerful tail winds from falling rates have eased markedly. So, investors expect to move up the risk curve in pursuit of higher yield.

ii. Opportunism
Key message: ETFs will be an important component in the opportunistic bucket.

In the 2009 survey, opportunism was centered on distressed debt, emerging market equities and high yield bonds. These will retain their relevance, alongside the emergence of ETFs, currency funds and hedge funds.

The inclusion of these classes in the opportunistic bucket is indicative of growing interest in opportunism and expected emergence of bargains in ever more asset classes presented by continuing volatility.

B. DC PLANS
i. Asset allocation
Key message: target date funds remain the most preferred choice.

In both surveys, they ranked number one on the list of top five choices favored by DC investors in the asset allocation set. Their two merits are propelling their popularity inside and outside the U.S.: their embedded advice features which deliver sensible asset allocation choices; and their glide path mechanism, which adjusts allocation in line with members’ age profiles.

With the ascendency of advice-embedded asset allocation products, single asset classes like equities and bonds have lost their popularity between the two surveys. The same applies to target risk funds, as we shall see in Section 4.

ii. Opportunism
Key message: The appetite for overt opportunism will diminish.

The reason is obvious: in advice-embedded products there is automatic re-risking and de-risking via the glide path mechanism that sets the asset weights. As markets fluctuate, price falls trigger buy-orders and price rises trigger sell-signals. Such products are also likely to see further innovation that will enhance their design features, as we shall see in Section 4.

C. RETAIL INVESTORS
i. Asset allocation
Key message: Capital protection will top the investor agenda.

The ageing populations in the West, holding the bulk of retail assets now, have a low tolerance for losses. They have been de-risking their portfolios and will continue to do so. The pronounced hemorrhaging in the mutual funds sector in Europe and the U.S. may be indicative of a new downward secular trend.

As a result, interest in traditional asset classes like equities and bonds that have long dominated the choices of retail investors have waned between the two surveys as the unfolding demographic dynamics shift attention from investment to savings.

INTERVIEW QUOTES:

“The process that determines share prices today is arbitrary. This could be the golden age for savvy investors.”

“We’re probably at the end of the high correlation period and fundamentals are set to re-assert themselves.”

“Market-cap weighted indexes overweight expensive stocks and underweight cheap stocks.”
Risk as we know it was rarely factored into returns historically. Its dynamic nature did not figure in its conventional metrics. That’s not for want of trying. Black Swans, by their very nature, are hard to predict. But they do argue against rigid asset allocation when markets move in fits and starts. Our clients are venturing into dynamic investing. So far, one of their main vehicles has been ETFs. As artificial pools of equities, bonds and derivatives, ETFs have been around since the early 1990s. They trade throughout the day like stocks. But they have taken off since 2006 — initially, as a reaction to the mediocre track record of active management; and most recently, as a tool of tactical asset allocation in the face of volatility. They are cheaper to run, since they generally track indices rather than attempt to outperform them. They also slice and dice the investment landscape to make sector calls at different phases of the market cycle. Leveraged ETFs seek to maximise performance by borrowing to bet: they use derivatives such as options and futures to deliver a multiple of the daily return of an index. In contrast, inverse ETFs seek to give a multiple of the opposite return for an investor wishing to bet against the market.

Our clients see them as a cost effective tax advantaged method of investing. Indexed funds account for around 10% of global pension assets of $28 trillion. We expect this number to more than double by 2020, with ETFs spearheading the growth. However, we have some immediate concerns.

**D. HIGH NET WORTH INVESTORS**

**i. Asset allocation**

*Key message: capital protection will dominate the portfolio but not to the exclusion of risky assets.*

As with retail investors, demographics are a factor here. But that is not all. Having sustained heavy losses in their alternative investments in the last decade, HNWI have become decidedly risk averse in their asset allocation choices between the two surveys. Interest in capital protection has grown notably since the 2009 survey — from 40% to 55%. At the same time interest in absolute return funds and active funds has waned, as has the tolerance for losses.

**ii. Opportunism**

*Key message: The appetite for opportunism will wane somewhat.*

While retail investors in the West will be mostly de-risking, they are expected to engage in opportunism when momentum is working, using exchange traded funds (ETFs) or active funds. No investor segment wants to miss the next rally, when it comes.

**A VIEW FROM THE TOP...**

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**ii. Opportunism**

*Key message: interest in opportunism has diminished somewhat but not markedly.*

As markets have displayed periods of revival since 2008, opportunism has returned to the table. However, big bets have been conspicuous by their absence.

HNWI want to be convinced that their asset managers can convert market volatility into investment opportunity before making big calls.

**INTERVIEW QUOTES:**

“Market cap indices overweight expensive stocks and underweight cheap ones.”

“The long-term investor should exercise caution in venturing beyond traditional ETFs.”

“Value is a matter of opinion.”

---

**Notes:**

“Market cap indices overweight expensive stocks and underweight cheap ones.”

“The long-term investor should exercise caution in venturing beyond traditional ETFs.”

“Value is a matter of opinion.”

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**A GLOBAL PENSION CONSULTANCY**
Successful innovations must reinforce investment basics, not ignore them.

- AN INTERVIEW QUOTE

WHAT NOTABLE INNOVATIONS ARE IN THE PIPELINE?

OVERVIEW

The first decade of the new millennium is remembered as a ‘lost decade’. On the flip side, it has inspired a number of innovations, of which two are especially noteworthy: asset diversification in the DB space and target date funds in the DC space. Both are expected to morph for the better.

In its new form, diversification will target capital conservation by going beyond the traditional risk factors and allowing for various contingent events. It will also target a blend of goals.

In their new form, target date funds will morph into a holistic retirement product that blends the ‘to-retirement’ phase with the ‘through-retirement’ phase. They will embody new features such as retirement income benchmark and ‘LDI-lite’ mechanism.

Incremental in their orientation, these innovations have the potential to improve investment outcomes against the background of too many wild variables in the global economy.
Diversification is staging a reinvention. Its evolving form seeks to manage risks more than returns. Its core aim is capital conservation, with either an absolute return or a total return target.

The emphasis on risks is dictated by the fact that risks can often emerge from unfamiliar sources that are hard to model. The term ‘market risk’ now embraces all the things that can go wrong. The fact that four standard deviation events have occurred has changed the subjective probabilities commonly assigned to tail risks. That means going beyond the traditional risk factors to allow for various contingent events. These may or may not happen. But if they do, they can nullify the historical risk-premia and ravage any portfolio. By focusing on risk events rather than asset classes, diversification is taking a new form compared to the recent past.

The second point of departure is the new focus on the end-goals. While seeking to minimize correlations at different phases of the market cycle, the new approach chooses asset classes to deliver a distinct blend of goals: e.g. capital growth, high income, steady cash flow, high liquidity and inflation protection. The old focus on returns per se is now being augmented by other distinct end-outcomes within a more dynamic approach that changes allocations, as and when events dictate.

The new approach has evolved from the previous ones, as shown by the stylized version in Figure 4.1 which currently applies to DB plans in the U.K. and the U.S. In the 1990s, their asset allocation followed a formulaic approach that favored overweight positions in equities (first box). After the losses in the 2000-2002 equity bear market, there was a significant switch to alternatives and exotic beta — the latter targeted risk premia in new areas like commodities, forestry, currency and ETFs (second box). However, the losses in 2008, once again, led to a fundamental rethink.

**INTERVIEW QUOTES:**

“To be fully funded within 25 years, sponsors’ contribution to the U.S. public sector plans will have to double.”

“Traditional diversification has hit a brick wall for now. It has failed to shield clients from volatility or losses.”

“Asset classes are far more correlated than we thought.”

**FIGURE 4.1**

How are DB plans likely to change their asset allocation approaches?

Source: Principal Global Investors/CREATE Survey 2012
As a result, by the beginning of this decade (third box), three clear distinctions emerged in the portfolio: between alpha and beta; between opportunistic investing and buy-and-hold investing; and between re-risking and smart risking.

While the first two distinctions had been evolving in the last decade, the third one has come rapidly to the forefront lately, as pension plans have been left with three options to cut their deficits.

The first involves dialling up the risk by venturing further out on the risk curve in search of higher yielding assets. Some of the plans with big deficits have been obliged to go down this route. The second option involves squeezing more juice out of existing assets: getting more returns from the existing risk budgets. Such smart-risking has been done by using market indices and a more diverse asset base to create ‘smart beta’ that deliver cheap alpha. The third option involves going down the LDI route by hedging out the unrewarded risks and using a variety of assets in the returns-enhancing portfolio. European plans have been active adopters of LDI.

In contrast, their U.S. peers have focused more on re-risking and smart risking. Either way, there is a clear distinction between means (third box) and ends (fourth box). One is about the principles guiding asset allocation, the other about their outcomes. The outcomes in question include: inflation protection, high liquidity, cash flow, high income and capital growth. Such multi-outcome funds in the U.S. bear strong resemblance to diversified growth funds in Europe, which also have a broader palate and, in most cases, daily liquidity to meet the needs of DC investors.

The percentages in each box are indicative, not definitive; being based on a sample of large plans in the U.K. and the U.S. They vary with the circumstances of the plan in question. But they do show that, in the face of wild variables that cannot be modelled on a spreadsheet, pension plans have been exploring a new approach consistent with new realities. Currently, interest in this form of diversification is centred on large plans with the necessary skills and governance structures. If markets remain volatile, however, medium and small plans are expected to adopt variations of it.

**INTERVIEW QUOTES:**

“Nothing is an opportunity, unless you understand the sources of risks, their likelihood, their potential impact and their mitigating tools.”

“The fact that four standard deviation events have occurred has changed investors’ perception of risk.”

“Most institutional investors need new skills and nimble governance to thrive in today’s environment.”

**A VIEW FROM THE TOP...**

Our funding levels had a double whammy. The S&P 500 index returned 2.7% p.a. over the past decade, including re-invested dividends, compared with our target rate of 12%. We had assumed a discount rate of 8% for calculating our liabilities, which also turned out to be too optimistic. This was before the big losses in 2011. Our funding ratio is now so low that we would need a 30-year recovery period in the absence of big changes. So we’ve changed our asset allocation approach. To start with, we no longer believe that volatility and correlations among asset classes will follow their historical norms. We’ve gone from asset diversification to risk diversification by adopting five risk buckets.

The first one covers assets that provide ready liquidity in times of extreme volatility. They include cash and Treasuries. The second bucket covers inflation-proof assets like commodities and infrastructure. The third bucket covers fixed income assets that provide a steady cash flow. The fourth one covers real assets like property and forestry that deliver high illiquidity premia. The final bucket includes growth assets like equities. A large chunk of our assets are now in this growth bucket because we believe that the U.S. economy may well be on the verge of a come-back. It may experience an unusual second recovery over the next three years, after a weak one in the last three years. We also see potential in the credit space as banks retreat to beef up their balance sheets under Basel III.

This form of diversification also incorporates a time element, since the markets can turn on a dime. So, within the buckets, we have a mix of short-term assets like cash and Treasuries; medium-term assets such as stocks with safe and rising dividend payouts; and long-term assets with a deep value bent.

Finally, our diversification is significant within as well as between the buckets. It involves both single and multi-asset class strategies. It involves risk parity portfolios that include gold and leverage on low-risk assets. It also permits opportunistic rebalancing within and between the buckets. In the immediate aftermath of the Lehman debacle, we became ultra-cautious. As events have unfolded, we’ve learnt that volatility is here to stay and we have to make a virtue out of necessity. We’re replacing benchmark-related measures, e.g. tracking error and information ratio, with measures that focus on absolute risk.

— A U.S. STATE PENSION PLAN
Another area of significant innovation is target date funds. DC products have come a long way in the U.S. in the past decade with the introduction of target date and target risk funds. Before then, most buyers of 401(k) funds largely relied on top Morningstar funds, both for initial investments and their periodic rebalancing. This pursuit of the next rainbow was just as prevalent in other DC markets where asset allocation choices rested with the individual member. The arrival of target date and target risk funds was a welcome development. Their inherent ‘set-it/forget-it’ feature mitigates against the buy-high/sell-low mentality in pursuit of ‘hot’ stocks.

These funds are expected to morph into a holistic solution, with unique features in its two distinct phases (Figure 4.2). The previous two distinct phases, ‘to-retirement’ and ‘through-retirement’ are expected to coalesce. In the first phase, two improvements are likely to be on offer for those who want them. First, the glide path will go dynamic and target a retirement income benchmark, instead of a target date. Target income will effectively become a liability benchmark akin to one in DB plans. Second, such a benchmark will permit the deployment of LDI-lite structures that will seek to ring-fence the balances as they build up.

That apart, currently there is a lot of talk about using either overt stop-loss mechanisms that are activated when a pre-determined loss threshold is breached; or option contracts with asymmetric bets that offer limited downside and unlimited upside. Not much progress is likely on either front, however, due to technical reasons.

**INTERVIEW QUOTES:**

“Target date funds are a big improvement on what prevailed before.”

“What matters is the plan balance upon which the risk is taken, not the age at which the risk is taken.”

“Stop-loss mechanisms are simple. But simplicity means trading on stale prices or incomplete information.”

---

**FIGURE 4.2**

What innovations are likely in target date funds?

<table>
<thead>
<tr>
<th>INNOVATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>To retirement</strong></td>
</tr>
<tr>
<td>• A pragmatic risk profile with periodic switches between equities and bonds in both directions</td>
</tr>
<tr>
<td>• Focus on target income as a liability benchmark</td>
</tr>
<tr>
<td>• Protection against big market events</td>
</tr>
<tr>
<td>• Accumulated gains ring-fenced over time to permit liability matching</td>
</tr>
<tr>
<td><strong>Through retirement</strong></td>
</tr>
<tr>
<td>• Part of the accumulated pension pot to be used to buy an annuity</td>
</tr>
<tr>
<td>• Remaining pot to be reinvested to deliver an income draw down</td>
</tr>
<tr>
<td>• Life insurance</td>
</tr>
<tr>
<td>• Health insurance</td>
</tr>
<tr>
<td>• Residual wealth transfer on death</td>
</tr>
</tbody>
</table>

Stop-loss mechanisms operate on stale or incomplete information, as evidenced by the ‘flash crash’ on May 6, 2010, when the Dow Jones Industrial Average plummeted by 990 points in a matter of minutes only to recover most of the losses just as quickly. But the initial fall triggered numerous ‘false’ stop-outs that could not tell ‘noise’ from ‘signal’. Similarly with options: the benefits of asymmetry begin to wash out as one goes from a single security to the whole portfolio.

But with the two likely improvements identified above, outcomes in the accumulation phase can be potentially more favorable. The same with the planned improvements in the decumulation stage where plan balances are expected to roll-over into a ‘cafeteria’ plan with a range of choices. For example, part of the accumulated pot may be invested in an annuity to provide regular income and longevity hedge; and the rest re-invested to generate income and capital growth during the draw down phase. The plan may also cater for insurance covers and residual wealth transfer upon death. The aim is to counter the key disadvantage of investing the entire pot in annuities: namely, their all-or-nothing nature that ensures zero wealth transfer upon death.

However, there is one drawback that will slow down the pace of innovation: no insurance company in the world today has the balance sheet to underwrite the volume of annuities envisaged under such a product. It is not inconceivable that governments may step into the breach. In all likelihood, the bulk of the retirement income may come from the draw-down portfolio.

Currently, DC plans account for 43% of the global pension pot estimated at $28 trillion. Powerful tail winds will drive the proportion north of 60% before the decade is out. DC products will doubtless morph under the sheer weight of new money.

### INTERVIEW QUOTES:

“Options markets are less liquid and have higher transaction costs than markets for the underlying securities.”

“Dynamic life cycle strategies that incorporate both account balance and age do better than the fixed glide path.”

“The appeal of diversified growth funds might be a sign of the times, in the absence of an equity bull market.”

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**A VIEW FROM THE TOP...**

A DC plan is very different from a DB plan in who bears the investment risk. That does not mean that it can’t borrow innovations from its older cousin.

The target date DC funds, based on a pre-set glide path, have proved superior to the traditional approach, where individuals make their own asset allocation decisions. Its ‘set-it/forget-it’ mechanism adapts investors’ risk profile to their age — starting out with aggressive equities and switching to cautious bonds nearer the retirement date. This has prevented poor asset allocation choices, driven by a herd instinct that was rife in the 1990s.

From the volatility standpoint, these funds have also had another spin-off. Their pre-set allocation formula buys equities when markets are down and sells them when they are up. Such automatic re-risking and de-risking has proved beneficial in the aftermath of the 2008 market collapse.

They are now likely to witness further improvements. The glide path is perceived as overly oriented towards the target retirement date rather than the target retirement pot. The latter is implicit. Furthermore, the path has no automatic mechanism to ring-fence the accumulated gains at the time of big market upheavals.

Accordingly, two innovations are likely over the next three years, both of which will improve the risk approaches implicit in the glide path strategies.

First, the current target date funds will also have a clear retirement income benchmark, akin to liabilities in DB plans. Asset allocation will be outcome driven. It will aim to deliver a minimum acceptable level of income in retirement relative to the income earned in employment. This implied replacement ratio will become the de facto liability benchmark against which asset allocation will be adjusted on a discretionary basis.

Second, the resulting dynamic glide path will bring LDI-lite structures into the DC space. They will move growth assets into cash and use the collateral to buy interest rate swaps. The current method of using growth assets to buy bonds prevents the pot size from getting bigger on approach to retirement.

The automatic re-risking mechanism in the current glide path strategies will embody a discretionary element to boost the returns and target a pre-set income ratio.

— A 401(k) U.S. ASSET MANAGER
The trusted advisor role will seek to put clients first. Perseverence with them in the face of continuing market traumas has the potential to create businesses of enduring value in the years to come.

- AN INTERVIEW QUOTE
DEVELOPING NEW SHOCK ABSORBERS FOR A NEW AGE

You can’t predict the future, you have to invent it.

- AN INTERVIEW Quote

HOW ARE BUSINESS MODELS BECOMING MORE RESILIENT?

OVERVIEW

Business model innovation will focus on two related areas:

• Better shock absorbers that increase business resilience
• Trusted advisor role that minimize herd instinct to deliver better outcomes

Shock absorbers in question will focus on costs, investment capabilities, risk management, client engagement and a culture of leadership.

The trusted advisor role will strive to improve client proximity, investment capabilities and interest alignment.

Changes in both areas seek to put clients first. Perseverance with them in the face of continuing market traumas has the potential to create businesses of enduring value in the years to come.

“...
**Shock absorbers**

Clarity of beliefs and courage of convictions are vital attributes for good investment outcomes. But they are not sufficient. Asset managers also need a business model that enables them to see beyond 3% daily market fluctuations and provides the necessary business resilience.

In this context, our survey has singled out five likely improvements (Figure 5.1):

- 58% of the respondents expect to develop better 'shock absorbers’
- 41% will restructure the skill sets of the talent pool
- 40% will enhance execution capabilities
- 38% will revamp their corporate culture
- 35% will hire or develop leaders who can embrace volatility

These factors are not mutually exclusive. The notion of shock absorbers embraces all of them, since they collectively aim to deliver an all-weather business model that works in good times and bad.

In previous market cycles, downturns have been short and rallies have lifted all boats. In contrast, the periodic bouts of risk-on/-risk-off cycles have called for new shock absorbers that are embedded in the fabric of the business. Such shock absorbers are emerging in five areas.

**Costs**

The first of these covers costs. As our 2009 survey showed, nearly one in two managers is moving towards a variable cost business model where the bulk of the costs, especially compensation, are linked to the level of activity. The old entitlements are being replaced by meritocratic incentives.

**INTERVIEW QUOTES:**

“The volatility dynamic requires much more business resilience.”

“Costs in this business are hydra-headed. They have a life of their own.”

“Clients want to see track record and co-investing before taking on new risks.”

---

**FIGURE 5.1**

How will asset managers reboot their business models to develop the resilience required by prolonged volatility?

<table>
<thead>
<tr>
<th>SOLUTIONS:</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building the necessary ‘shock absorbers’ in the operating model</td>
<td>60</td>
</tr>
<tr>
<td>Restructuring the skill sets of the talent pool</td>
<td>50</td>
</tr>
<tr>
<td>Enhancing execution capabilities</td>
<td>45</td>
</tr>
<tr>
<td>Revamping the corporate culture</td>
<td>40</td>
</tr>
<tr>
<td>Building corporate leadership teams that can embrace volatility</td>
<td>35</td>
</tr>
</tbody>
</table>

Source: Principal Global Investors/CREATE Survey 2012
**Investment Capabilities**

The second shock absorber covers investment capabilities. These are being revamped by honing gut instincts about geo-political events that cause regular market disruptions. In particular, investment professionals are enjoined to develop a strategic understanding of clients’ liabilities on the one hand and cross-correlations in a multi-asset environment on the other. They are also discouraged from being dogmatic about their own views by constantly stress testing the strength of their own convictions and the validity of their time horizons.

**Risk Management**

The third area covers risk management. The new mantra is simple: everything is a risk until one knows its origin, its likelihood, and its potential impact. For now, past is no longer seen as a good guide to the future; nor are there any magical metrics that can substitute human judgment. Value drivers are subjected to stress tests that factor in four standard deviation events in global economy and geo-politics. In addition, there is a growing trend toward identifying and managing enterprise-wide risks as they apply to individual asset businesses.

**Client Service Models**

The fourth shock absorber covers client service models. These are being upgraded in approximately 40% of asset houses in order to enhance client proximity. We return to this point in the following “Critical Success Factors” section.

**Culture and Leadership**

The final area refers to culture and leadership. These aim to put clients at the heart of the business. The executive bandwidth is being upgraded via coaching, mentoring and stretch assignments that allow senior executives to sharpen their business skills in general and execution skills in particular.

Senior executives are enjoined to ‘set the tone at the top’ by emphasizing what is important, why it is so and how it will be implemented. In the past, many good business ideas were implemented with the best of intentions but delivered sub-optimal outcomes due to inadequate change management capabilities. Such ideas focused on creating high performance teams and business re-engineering. Lessons have been learned.

**A VIEW FROM THE TOP...**

What if the next 10 years are the same as the last 10 years? What if good times aren’t around the corner? Currently, cost pressures are intense, clients want more for less and recovery is not in sight. The asset industry is at an inflection point: we have to prepare for a future that is different from the past when market recovery always bailed us out. Now, it would be unwise to count on it.

On the other side of the equation, it is clear that the crisis can be turned into an opportunity as markets are throwing up bargains from time to time. We have a two-fold challenge: how to survive this era of prolonged uncertainty and how can we make a virtue out of necessity?

Once the initial market bounce in 2009 ran out of steam, we knew that deleveraging would be a long haul, fraught with policy errors and social turbulence. We needed shock absorbers to cushion the exceptional ups and downs in gross revenue. So, we’re taking actions on a wide front.

On the financial side, they aim to create a variable cost model by reducing fixed costs, converting as many costs as possible into variable costs and ensuring that such costs move in line with gross revenue as far as possible. Compensation is set in line with business performance and personal merit.

On the investment side, they seek to widen and deepen the capabilities to create the right product sets for different volatility regimes as well as cater for multi-asset class offerings. Far from bending with the wind, our new capabilities aim to prepare us for an investment landscape that we are not used to in any sense of the word.

On the risk side, there is no substitute for human judgement. The old models encouraged Main Street to play Wall Street, with disastrous results. We can’t predict a Black Swan event. But we can blend our risk analytics and risk protocols with judgement calls in all our investments. Risk management is now embedded into the investment process as well as the interest alignment.

Finally, on the culture side, we are becoming nimble by moving towards the multi-boutique model that permits high conviction investing and a strong interest alignment between us and our clients, and between us and our staff.

It all amounts to a big work-out. If our industry is at an inflection point, which we believe it is, we need capabilities to exploit the resulting opportunities. In any event, business as usual is not an option.

> – A U.S. MUTUAL FUND MANAGER

**INTERVIEW QUOTES:**

“This is about return of capital, more than return on capital.”

“What makes a good manager? Common sense and gut instincts.”

“You have to constantly stress test your convictions. Hope is not a strategy.”

Notes:

“This is about return of capital, more than return on capital.”

“What makes a good manager? Common sense and gut instincts.”

“You have to constantly stress test your convictions. Hope is not a strategy.”
**Critical success factors**

Designed to reboot business models, the shock absorbers described above are also vital, if asset managers are to convert the current volatility into an investment opportunity for their end clients. For example, in our 2012 survey, when asked whether high volatility offers a great opportunity to active managers, the responses were:

- 71% ‘yes’
- 22% ‘possibly’
- 7% ‘no’

There is no doubt that the volatility cloud has a silver lining. However, when asked whether active managers can capitalize on it by delivering good returns net of fees, the replies were:

- 13% ‘yes’
- 54% ‘possibly’
- 20% ‘no’
- 13% ‘unsure’

The reported gap between opportunity and outcome is due to two hurdles. The first is the rapid ‘industrialization’ of asset management. Over the past two decades, as it has morphed into a mass market industry, with a broad client base and global reach, it has lost much of its craft heritage that was conducive to riding the volatility wave. The skills that translate market disruptions into investment opportunity have become scarce.

The second hurdle is clients’ own herd instinct that often ignores the cardinal investment rule: buy-low/sell-high. Driven by greed/fear cycle, they often make choices contrary to their own best interests. Hence, investing during turbulent times can be scary. Clients have to walk a fine line between value investing and value traps. Similarly, asset managers have to walk a fine line between product push and reputational risk.

To strike a balance in both camps, more and more asset managers are striving to become a trusted advisor: somebody who is in the client’s inner circle of confidants; somebody who is open about the five factors that matter most when deciding whether to capitalize on volatility:

- The time period over which returns can materialize
- The nature of risks involved both within the period and at the end of it

**INTERVIEW QUOTES:**

“**Investors are always looking in the rear view mirror.**”

“**By working with a trusted advisor, the long-term investor can mitigate the stress of investing and make wise choices.**”

“**Alpha is in the eye of the beholder.**”

**FIGURE 5.2**

What do asset managers need to do to become trusted advisors of their clients in an era of prolonged volatility?

**CLIENT FOCUS**

- Understand client needs, liabilities and risk tolerances
- Separate out within-horizon risk from end-horizon risk
- Deliver solution alpha via products that are fit for purpose
- Conduct regular client pulse checks and act on feedback
- Create client protection panels to champion client interests
- Avoid unrealistic claims about returns

**INVESTMENT CAPABILITIES**

- Understand the geo-politics of the debt dynamic and its market impact
- Know the return drivers and their vulnerability to untoward events
- Detect correlations and risk premia at different market phases
- Spot value opportunities and value traps arising from herd behaviours
- Blend quant background with fundamental analysis, using a variety of perspectives
- Use trained intuition as much as MTM – models, technology and math

**INTEREST ALIGNMENT**

- Promote co-investing and share pain and gain with clients
- Have meritocratic incentives for investment professionals
- Avoid me-too products and only provide ones that are fit for purpose
- Deliver proactive investment ideas and customized research
- Minimize ‘wrong time’ risk and ‘regret’ risk
- Avoid peer herding

Source: Principal Global Investors/CREATE Survey 2012
The fitness of products with respect to end goals
The scalability of strategies that attract new money
The transparency around charges

Using these guiding principles, asset managers are implementing changes in three specific clusters, according to our survey (Figure 5.2).

**Client Proximity**
The first cluster seeks to improve client proximity. Its key aims are: to understand clients’ dreams and nightmares; to sell products that the client needs; to elicit regular client feedback and act on it; to avoid unrealistic claims about returns; and to create in-house panels that protect client interests. Such panels provide the necessary checks and balances on client needs.

Our 2011 report, *Investment Innovations: Raising the Bar* found that the degree of client engagement was a major factor in innovation outcomes. Such engagement typically solicits new ideas, manages expectations, raises awareness and minimizes ‘wrong time’ risk and ‘regret’ risk.

**Improved Investment Capabilities**
The second cluster seeks to improve investment capabilities. Its aims are: to develop fresh insights into the complex interaction between geo-politics and market dynamics; to identify return drivers during volatility phases; to blend quants with fundamental analysis; to develop a trained intuition about what works, what doesn’t and why; and to spot good buying opportunities.

**Alignment of interests**
The third cluster seeks to promote a better alignment of interests. Its aims are: to have meritocratic incentives; to avoid me-too products; to offer proactive investment ideas; and to minimise herd behaviours.

The CREATE-Research program dates back to the 1990s. It has tracked the key changes in global asset management annually. It is fair to say that the industry is now undergoing its biggest makeover since our surveys began. There are signs that many asset managers are now creating businesses of enduring value in the face of recent traumas.

**Interview Quotes:**

“We incubate new products with our own funds. We don’t succumb to fads.”

“Change management is not what it used to be.”

“Is this the magic moment to remake the asset industry?”

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Our ethos is ‘our clients’ business is our business’. So, the concept of trusted advisor is not new to us. It has evolved out of example and achievement.

Most of our business is in the institutional space and most of it comes via pension consultants and fund intermediaries. Although that has created a distance between us and our clients, we strive to transcend it by getting various business basics right. The key is to develop close client proximity where a series of small steps deliver big gains over time, as success begets success.

We jettisoned the old sales culture, where clients were sold what we had, and replaced it with an investment culture where clients were sold what they needed. We got rid of products with high churn rates, high fees and low returns.

Since then, via a variety of channels, we have developed useful insights into our clients’ short, medium and long term goals, along with their accounting and regulatory challenges. This has enabled us to understand their asset allocation approach, durational risks and their associated tolerances.

Our clients are increasingly drawing a distinction between product alpha and solutions alpha: one is about excess returns over a market benchmark, the other about meeting specific needs. At one time, solutions alpha relied on clever financial engineering from investment banks. Now, clients want returns to flow from the intrinsic value of their assets rather than any bells and whistles around them. So, solutions alpha now centers on products that are fit for purpose.

For our top tier clients, we do regular reviews that highlight deviations from benchmarks, offer explanations and agree corrective actions. We also do regular pulse surveys of all clients to get their feedback on key areas like returns, advice and administration. This kind of focus has generated external pressures for internal change. Our investment capabilities have come under sharp scrutiny. For us, smart investing today is about understanding the return drivers that operate at a geo-political level as well as the fund level. It is also about spotting value opportunities and their hidden traps.

Last, but not least, alignment of interest sits at the heart of our trusted advisor role. We share the pain and gain with our clients via meritocratic fee structures that seek to minimise the heads-I-win vs tails-you-lose fee situations. That translates into meritocratic incentives for our staff as well. We seek to avoid conflicts of interest, artificial distortion of prices and artificial distortion of trading volume. We often do joint seeding which has been a source of symbiotic branding.

— A U.K. ASSET MANAGER
Other publications from CREATE-Research

The following reports and numerous articles and papers on the emerging trends in global investments are available free at [www.create-research.co.uk](http://www.create-research.co.uk).

- Investment Innovations: Raising the Bar (2011)
- Exploiting Uncertainty in Investment Markets (2010)
- DB & DC plans: Strengthening their delivery (2008)
- Global fund distribution: Bridging new frontiers (2008)
- Globalisation of Funds: Challenges and Opportunities (2007)
- Convergence and divergence between alternatives and long only funds (2007)
- Towards enhanced business governance (2006)
- Tomorrow's products for tomorrow's clients (2006)
- Hedge funds: a catalyst reshaping global investment (2005)
- Raising the performance bar (2004)
- Revolutionary shifts, evolutionary responses (2003)
- Harnessing creativity to improve the bottom line (2001)
- Tomorrow’s organisation: new mindsets, new skills (2001)
- Fund management: new skills for a new age (2000)
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- Leading People (1996)

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CREATE-Research is an independent think tank specializing in strategic change and the newly emerging business models in global asset management. It undertakes major research assignments from prominent financial institutions and global companies.

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