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Overcoming the Follow-on Effects of the Global Financial Crisis (GFC)

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31 July, 2009

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Crisis

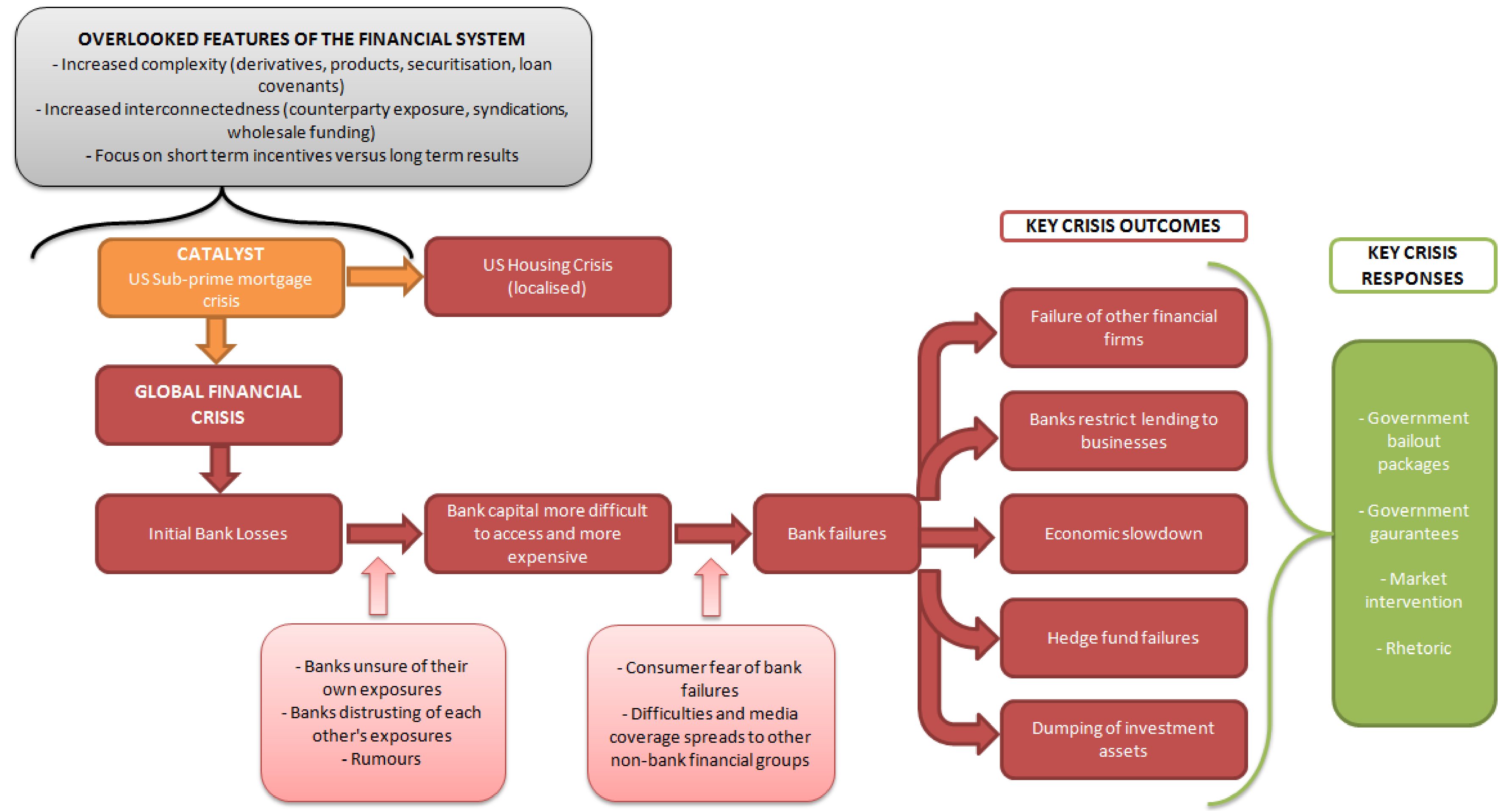
- 1. a stage in a sequence of events at which the trend of all future events, esp. for better or for worse, is determined; turning point.
- 2. a condition of instability or danger, as in social, economic, political, or international affairs, leading to a decisive change.

- Dictionary.com

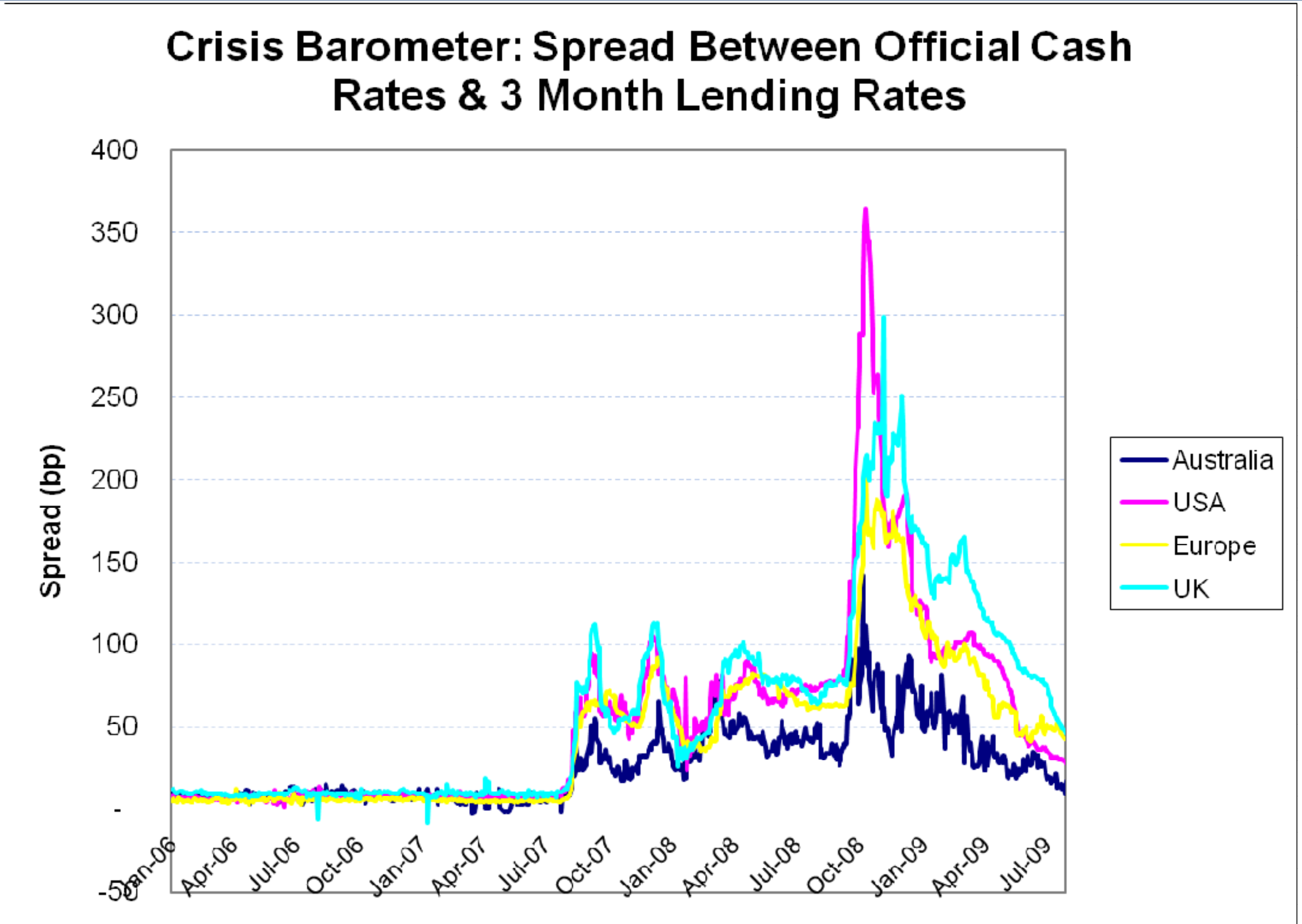
There are many crises occurring everyday throughout the world

- It is all in the eye of the beholder and the breadth of who is affected that makes it a global crisis

GFC in Detail



The GFC is Over?



Could the GFC Reignite?

- Yes, but unlikely. Key catalysts could be:
  - Bad debt cycle – this is a cyclical event that banks have dealt with successfully before. However, if it interacts with shaken market confidence, or comes as a surprise (poor transparency) there could be problems
  - Surprise losses – examples could be European banks' exposure to Eastern Europe emerging markets. If this resulted in loss of confidence and suggests banks have not been transparent then the crisis could re-start
  - Other potential catalysts could be credit insurance group collapses, insurance company failures etc

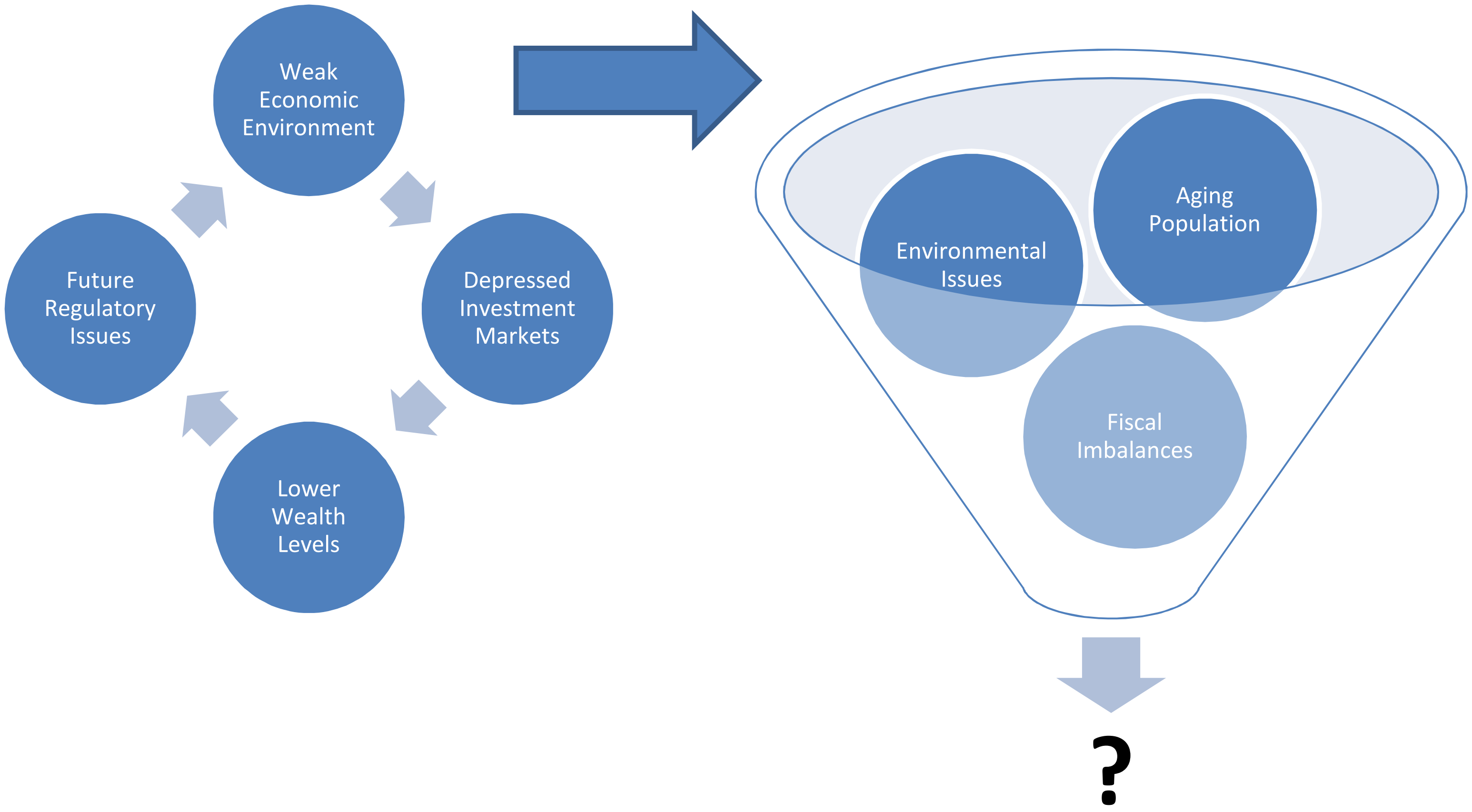
What we are left with?

- A weak economic environment
  - Reduced growth (negative in most developed markets)
  - Rising unemployment
  - Reduced consumer confidence
  - Large fiscal stimulus packages / government debt
- Depressed investment markets
- Lower wealth levels and lower value of retirement savings
- Questions over the future regulation of markets

Existing / Looming Problems in the World?

- Aging population
  - Living longer
  - Higher old age costs of living - more healthcare
  - Insufficient retirement savings
- Environment
  - Global warming
  - Fossil fuels v. alternative energy development
  - Water shortages
  - Food shortages
- Existing fiscal imbalances
  - Huge US debt
  - Huge and growing surplus of China etc

How do the GFC Ramifications Blend with the Key Future Issues?



Institutional Investors Experienced Risk Process Failure

- Losses for the last two years were collectively outside what they thought possible
- Some institutions invested their cash options in income funds / growth assets and experienced returns far below cash
- Most institutional investors experienced stress (but no one had to freeze redemptions or issue side pockets) from a liquidity perspective
- Some corporate defined benefit schemes required employer top ups
- Potential for defined benefit members' benefits to be reduced
- Found fx hedging a larger demand on cashflow than thought possible
- Experienced underlying product manager defaults on process

What Mistakes Were Made?

- The majority of institutional investors:
  - Do not have a dedicated risk manager
  - Rely on risk management as a consultant provided service
  - Rely heavily on historical data analysis
  - Do not actively manage liquidity risk
  - Didn't envisage that liquid exposures could become illiquid
  - Relied on contractual obligations (eg. Liquidity rules)

Bank Example - UBS

- UBS
  - VaR Model (1 day, 99%), as reported in Annual Reports
    - 1998 to 2006: zero VaR breaches recorded
    - 2007: 29 VaR breaches
    - 2008: 50 VaR breaches
  - UBS experienced a $50b loss during this period
- Did UBS's VaR modelling ever work?
- Did management, the Board, the Auditor or even the Regulator do their job properly?

* Credit and thanks to Dr. Frank Ashe for this illuminating example

Hedge Funds - Lightning Can Strike Twice!

LTCM
Closed in 1998
and lost USD4b

John W Meriwether
and others

Myron Scholes
and others

JWM Partners

- Approx USD2b
- Froze redemptions early last year having lost approximately 30% in first quarter of 2008

Platinum Grove

- Approx USD4b
- Froze redemptions late last year, having lost nearly 40% in first 10 months of 2008

Modelling Alone is Not The Solution

- Imagine if a group (bank, hedge fund etc) had a VaR model that works well (measures VaR accurately):
  - This means the model may adjust quickly to a changing risk environment
  - Would they be able to react to risk as it increases?
  - What if everyone reacted quickly?

➔ You can only react to observed risk if markets are liquid

So What Is The Solution?

- A blend of:
  - Technical risk management skills
  - Strong qualitative input – “What if...”
  - A risk aware culture: asking questions, answering questions etc

Challenging Issues Ahead for Institutional Investors

- Determining the appropriate asset allocation: fiduciary duty v business risk in an era of choice of fund
- Interpretation of ESG issues: Is it acceptable for investment returns to be lower?
- Explaining return and risk potential to investors without purely relying on historical analysis (the 'safe' approach)
- Not reacting to past performance influencing future investment decisions
- Key liquidity assumptions (how much switching risk etc) and the allocation to illiquid assets

Challenging Issues Ahead for Institutional Investors

- Focus on fees versus return (and service?) net of fees
- Spending on resourcing such as risk management, which may not deliver near term tangible benefits
- Managing return / risk within the constraints of no leverage, limited use of derivatives etc
- Trustee education in an increasingly complex environment

Necessary Improvements

- Improve the (create a) culture of risk management
  - Dedicated risk manager
  - Greater trustee awareness, questioning and discussion
  - Investment decision making process – should it be trustee-driven or delegated to an investment team (with mandate and rules)?
  - Risk management is not compliance – risk management is far more creative – compliance is an outcome
- Portfolio management systems
  - Many institutional investors do not have them
  - More than just portfolio reporting – these systems help you size and assess potential trades and look at return and risk across the portfolio
- Trustee education

Necessary Improvements

- Risk management
  - Tick all the boxes (acknowledging that they generally look backwards)
    - VaR, risk contributions, stress testing etc
  - Then assess forward looking risk
    - What scenarios may occur?
    - Forecast risk rather than just use historical
    - Consider systemic risks
    - Don’t rely on ‘normal’ assumptions
- Establish a clear view on the balance between outright performance versus relative performance objectives
  - Mixed opinion amongst trustees
  - There is an interaction – if you deviate too far away from peer group and underperform ➔ flows out ➔ dangerous for a portfolio with illiquid assets etc

Summary

- The GFC is technically over
- The ramifications of the GFC are significant and the way they blend with looming problems is crucial
- Many groups from many different parts of the industry were affected, including institutional investors
- There are many problematic issues ahead
- The industry can learn that by focusing on risk management practices as a whole (modelling, qualitative overlay, risk culture) they will be better placed to manage the different sets of risks that will emerge