



INVESTOR SERVICES

**thought**

3Q 2013

the *art*  
of investing

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The Art of Investing in Art

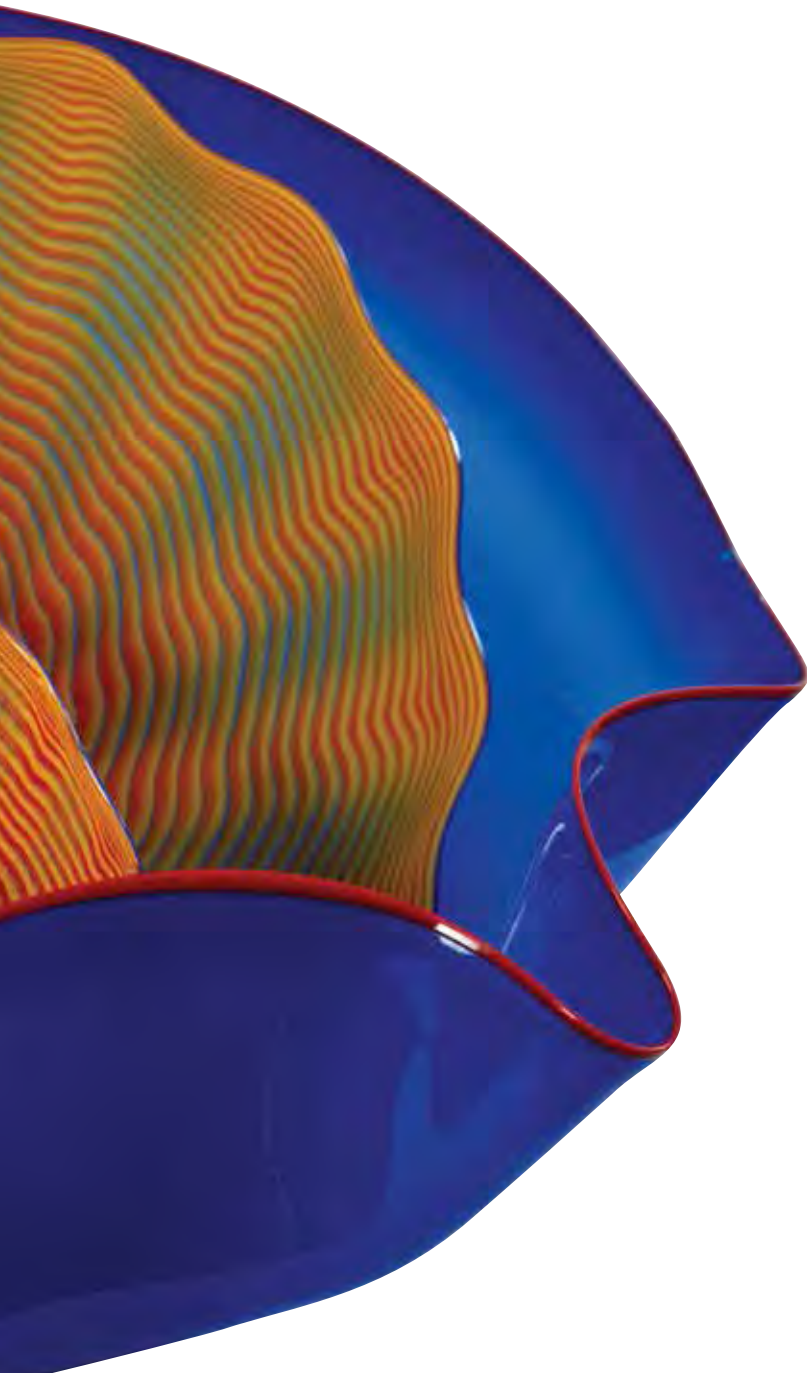
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Creating New Best Practices in  
Securities Lending for Cash and  
Non-cash Collateral Management

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Defined Benefit Plans and Hedge  
Funds: Enhancing Returns and  
Managing Volatility

J.P.Morgan





**Carlos Hernandez**

*Chief Executive Officer  
Investor Services*

“WE ARE HERE TO  
SUPPORT YOU AND YOUR  
BUSINESS OBJECTIVES.”

# Thinking OUT LOUD

It has been said that art has the power to inspire the human spirit. In this issue of *Thought*, we pursue a somewhat similar inspiration for the art of investing, with all of its risks and its many rewards.

Our first article, “The Art of Investing in Art,” takes a clear-eyed look at the proposition of collecting as an alternative investment. In relation to this topic, our firm can thank David Rockefeller, a legendary philanthropist and collector of art, as well as the former chairman of Chase Manhattan Bank. More than fifty years ago, Mr. Rockefeller started the JPMorgan Chase art collection, which has blossomed into one of the premier corporate repositories of artwork in the world—a few examples are presented in these pages. His vision has ensured that employees and visitors in JPMC offices around the globe enjoy exposure to these inspiring acquisitions.

Elsewhere in this issue you can read the first in a series of articles about the enormous potential for asset management in Asia. In other commentary, we examine the state of the hedge fund industry as seen through the lens of our clients, and we cite certain new best practices in securities lending.

This edition also features the launch of a section called “Ideas in Action,” where we’ll regularly sample solutions developed by J.P. Morgan in response to industry needs. For example, you’ll find there an overview of our unique global collateral management and optimization services, which were developed to provide you with critical asset-management tools.

The point I would like to make is that we are here to support you and your business objectives. We continue to work hard toward providing all of our clients with an integrated, single point of access to the broadest suite of middle and back office solutions available in the market today. Our clients truly are the inspiration.

Thank you for reading *Thought*. Please know that your questions and comments are always welcome and may be sent to [thought\\_magazine@jpmorgan.com](mailto:thought_magazine@jpmorgan.com).

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## Corporate & Investment Bank

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**Hassan Sharif**  
(Emirati, born 1951)  
*The Flying House #13, 2008*  
Oil on canvas  
JPMorgan Chase Art Collection

Courtesy of the Artist and  
The Flying House Gallery, Dubai

## The Art of Investing in Art

Art has long been considered an investment of passion, one that not only offers aesthetic pleasure but the potential for economic benefit. Only recently has art investing been viewed through the lens of modern portfolio theory and considered as a potential alternative investment in a portfolio of assets. Though research continues to shed more light on what has been historically an opaque market, studies show that art can offer long-term return potential that is uncorrelated with other asset classes.

Market paradigms have shifted dramatically over the last several

decades, as newly created wealth in emerging markets such as China, Russia and the Middle East has increased the number of participants in the art trade, giving the market greater resiliency. Undeterred by a rough economic environment in recent years, collectors globally are paying record sums for top works. Despite art's attractive upside as an investment, the lack of market transparency, illiquidity and high object costs have generally limited participation to a select class of wealthy individuals, leaving most institutional investors on the sidelines.



“NEWLY ACQUIRED WEALTH IN EMERGING ECONOMIES HAS GLOBALIZED THE ART MARKET IN MANY WAYS, GIVING IT MUCH-NEEDED DEPTH AND RESILIENCY.”

### Kyle Sommer

Product Manager  
Investment Information  
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### Global market overview

Given the murky nature of the art market, it is often misunderstood. Unlike traditional asset classes such as stocks or bonds, there is very little transparency associated with art trading. A large segment of the market is executed through private transactions, making it difficult for outsiders to gain insight. This overall lack of transparency also makes estimating the size of the market a true challenge.

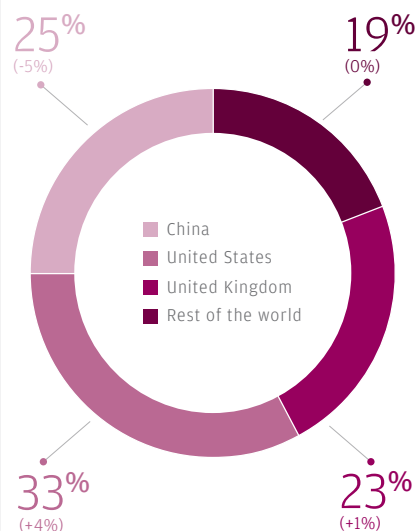
According to The European Fine Art Foundation (TEFAF), the size of the global art market is roughly US\$56 billion,<sup>1</sup> which reflects public auction data and an estimate of art gallery and private art dealer sales during 2012. That total represents a six-fold increase in size over the last 20 years.

As wealth has grown exponentially beyond North America and Europe in the last several decades, the art market has become more globally influenced than ever before. According to the 2012 RBC/Capgemini World Wealth Report, which analyzes economic factors that drive wealth creation,<sup>2</sup> Asia-Pacific surpassed North America in its high net worth individual (HNWI) population to become the largest HNWI region for the first time. With newly acquired wealth, the demand for luxury goods increases. Fueled by triple-digit growth in recent years, China (including Hong Kong) overtook the U.S. for the first time as the world's largest market for art and antiques in 2011. However, an economic slowdown in 2012 pared back art market participation, and China slipped to second place behind the U.S. in terms of global market share.

FIG-01

### 2012 Regional Art Market Share (change from 2011)

Source: TEFAF



## Performance and diversification potential

To understand what drives the art market, it is important to recognize the main motivations behind art buying. Art is unique as an investment in that there are many non-monetary investment reasons behind collecting. Surveys have shown on average only 10 percent of HNWIs own fine art and paintings purely as a financial investment, though other surveys suggest a much higher percentage.<sup>3</sup> Regardless, the actual non-financial value, though difficult to extract from overall value, shouldn't be ignored.

First, there are intangible values associated with having and enjoying a piece of art. Art provides collectors with social status and prestige—an outlet to signal their wealth or lifestyle to others. There are also the philanthropic benefits of purchasing art, from financing up-and-coming artists to building a collection to preserve cultural heritage. Chinese buyers, for example, have been repatriating cultural assets that have been in the hands of Western owners, which has contributed to a rise in values of Chinese works in recent years.<sup>4</sup> The obvious monetary benefit

is the opportunity to gain a return on investment, though investors also recognize art as a way to store value, to hedge inflation and to diversify their portfolio allocation.

### Measuring returns

Several studies have been conducted to measure the historical returns of art investments. The two main approaches involve analyzing repeat sales of the same object at auction and developing a hedonistic model, which takes into account characteristics and qualities of the individual works. Though calculation methodologies, sample data and time periods vary, most studies show that over long periods of time art prices have trended upwards, kept pace with inflation and, in several studies, have outperformed more traditional asset classes such as equities and bonds over certain time periods.<sup>5</sup>

There are, however, several limitations in measuring art performance. Typically, only auction records are used. Though auction data is large and represents a wide range of price points and collecting categories, much of the turnover in the market (i.e., private sales) is not captured. In addition,

transaction costs and other fees are not fully reflected. Auction fees for the buyer can exceed 10 to 20 percent of the hammer price. Other ongoing expenses such as storage, insurance, advisory and appraisal costs may also eat into returns.

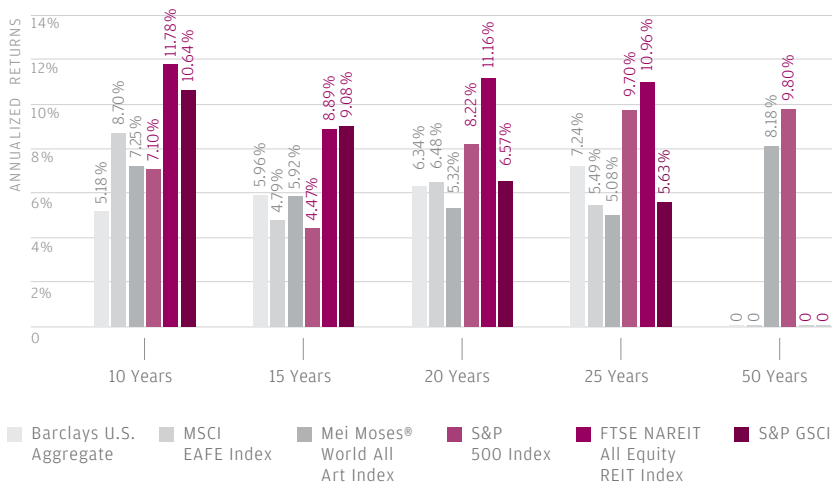
The Mei Moses® World All Art Index,<sup>6</sup> which is calculated annually and based on resale values of paintings sold multiple times at auction, shows positive returns over the last 50 years, albeit mixed relative to other asset classes. *Figure 2* illustrates that annualized returns on art as measured by the Index have done particularly well in recent years, outperforming U.S. equities and fixed income over the last 10 years and outpacing U.S. and international equities over the past 15 years. This is due in part to a relatively softer correction during the 2008 recession and a quicker recovery.

Volatility (standard deviation of annual returns) of art was lower than U.S. and international equities as well as commodities during the last 25 years. Art tends to move in slow and long-term cycles. The data show that when considering performance on a risk-adjusted basis (returns divided by standard deviation) over the last 50 years, art (0.51) looked comparable to

FIG-02

### Positive Art Returns Over the Long-term, Albeit Mixed Relative to Other Asset Classes (as of 2012)

Sources: Barclays Capital, Morgan Stanley Capital International, Standard & Poor's, Bloomberg FTSE International, Beautiful Asset Advisors® LLC



U.S. equities (0.58). On a 20-year basis, art (0.51) looked relatively strong, outpacing international equities (0.32) as well as U.S. equities (0.44).

Figure 3 shows that in the last 25 years, art had almost no correlation with U.S. equities and was negatively correlated with fixed income and REITs. The

analysis suggests that art may add diversification benefits within the context of an investment portfolio of assets.

FIG-03

Low or Negative Correlations of Art to Other Asset Classes (1988 to 2012)

Sources: Barclays Capital, Morgan Stanley Capital International, Standard & Poor's, Bloomberg, FTSE International, Beautiful Asset Advisors LLC

	S&P 500	MSCI EAFE	FTSE NAREIT All Equity REIT	Barclays Aggregate	S&P GSCI	Mei Moses World All Art
S&P 500	1.0000	-	-	-	-	-
MSCI EAFE	0.7367	1.0000	-	-	-	-
FTSE NAREIT All Equity REIT	0.4909	0.4898	1.0000	-	-	-
Barclays Aggregate	0.2137	-0.1783	0.0884	1.0000	-	-
S&P GSCI	0.1157	0.3593	0.1609	-0.2271	1.0000	-
Mei Moses World All Art	0.0270	0.0882	-0.1365	-0.0902	0.2440	1.0000

Selectivity a factor

It is worth noting that certain art genres do better than others for a number of reasons. Art can be an unpredictable investment in which returns may be heavily influenced by not only a number of macro-factors,

such as economic growth and inflation, but also micro-factors unique to the market, such as global interest in certain genres and changes in trends, tastes and culture.

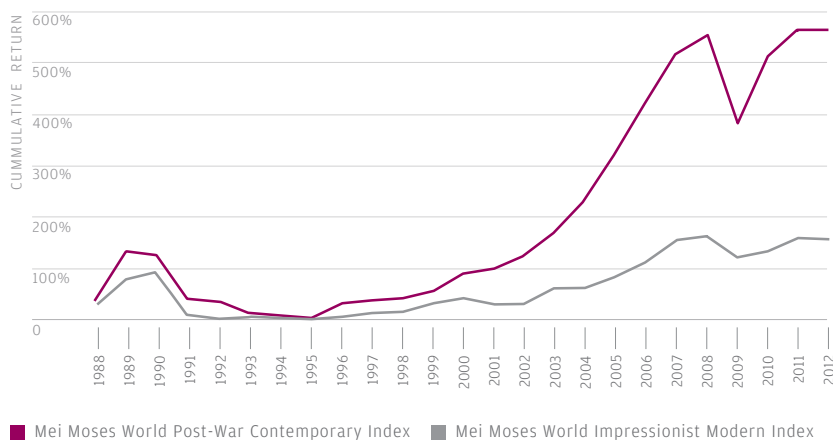
As figure 4 shows, the Mei Moses World Post-War Contemporary Index

has greatly outperformed the Mei Moses World Impressionist Modern Index, particularly over the last 10 years. As with other asset classes, investors should look to diversify their holdings to manage their exposure across different genres, artists or types of work.

FIG-04

Cumulative Returns for Contemporary and Impressionist Art

Source: Beautiful Asset Advisors LLC



## Hedging against inflation

As a store of value, art has shown to be an effective hedge against increasing prices when inflation rises. *Figure 5* shows the average yearly return for years when inflation (as measured by

the Consumer Price Index) is higher or lower than the 40-year median (3.3 percent) and rising or falling from one year prior. On average, art has performed significantly better over the last 40 years during periods when inflation is rising, particularly high

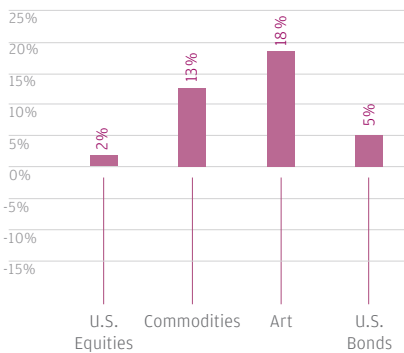
and rising. Returns on art appear weakest when inflation is falling. The analysis of art performance in various environments suggests that art can be used as an effective store of value in prolonged periods of rising prices.

FIG-05

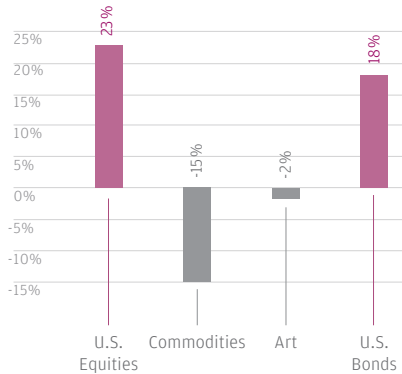
### Returns in Different Inflation Environments (from 1973 to 2012)

Sources: U.S. Equities—S&P 500 Index, Commodities—S&P GSCI, Art—Mei Moses World All Art Index, U.S. Bonds—Barclays U.S. Aggregate. High and low inflation distinction is relative to median CPI-U (source: BLS).

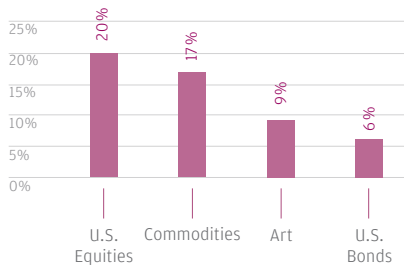
#### High and rising (14 times)



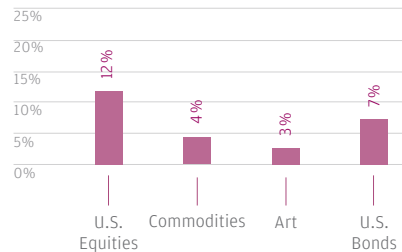
#### High and falling (6 times)



#### Low and rising (7 times)



#### Low and falling (13 times)



As emerging markets become wealthier, the art market is likely to continue to be comprised of a much more diverse set of art buyers. This is generally good news. When investors are concentrated in one geographic region, the art market as a whole is very sensitive to that region's economic environment. For example,

a steep decline in the art market in the early 1990s was in part attributable to the decline in the Japanese economy. During the highly inflationary 1980s, Japanese investors were investing heavily in art. As the Japanese real estate market started to collapse in the early 1990s, investors there pulled back and many segments of the art market

crashed. In theory, a more global market is more resilient. As *figure 6* shows, art prices took almost a decade to recover from that slump when the market was more concentrated geographically in a small number of wealthy countries, while the downturn during 2008 was short-lived in comparison.

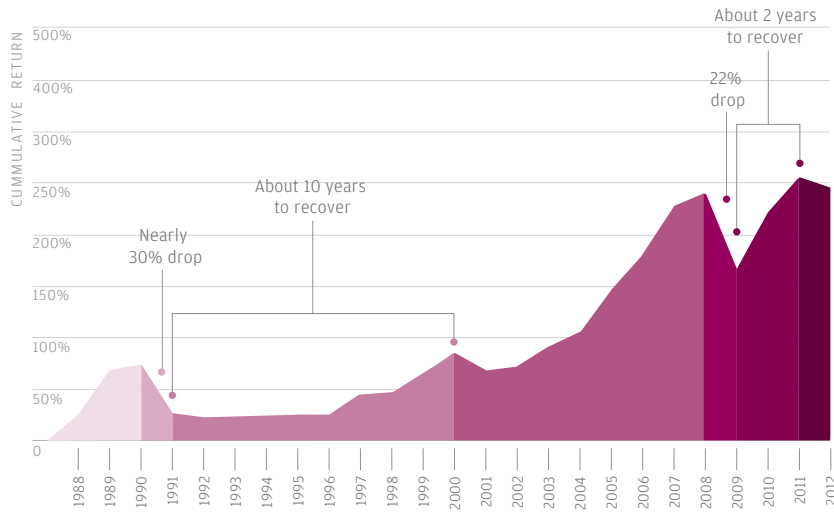


FIG-06

## Global Participation Has Added Depth to the Market

### Performance of the Mei Moses World All Art Index

Source: Beautiful Asset Advisors LLC



### An alternative for the institutional investor?

Despite the return potential, institutional investors, such as pensions and endowments, have historically been reluctant to invest in art or art funds. The British Rail Pension Fund (Railpen) is widely considered one of the first institutional investors to allocate money to a fund of art works. In the mid 1970s, about US\$70 million, or roughly three percent of Railpen's capital, was invested in approximately 2,500 works of art. This collection included a wide range of works including paintings, manuscripts, furniture and ceramics. Railpen was reportedly able to deliver an annualized return of 11.3 percent in its art allocation from 1974 to 1999. Critics, however, were quick to point out that most of the returns came from just a few works that were sold at a very good time in the market.

It is worth noting, however, that views on alternatives have evolved significantly over the last several decades and will continue to evolve. What most fiduciaries today consider mainstream alternatives—namely, hedge funds, private equity and real estate—were not always considered so. Today, more than 22 percent of institutional investors' portfolios are allocated to such investments, a significant increase from just a few years ago.<sup>7</sup> Whether or not art will be accepted as a viable alternative asset remains to be seen. However, given a low interest rate environment, unease about the global equity and bond markets and chronic pension funding shortfalls, less mainstream assets such as art may draw more attention among institutional investors seeking greater return and diversification potential.

**thought**

Studies have shown relatively strong returns for art over extended periods of time, and recent risk-adjusted performance looks comparable to other traditional asset classes. Low and even negative correlations with equities and fixed income suggest an allocation to art can potentially diversify one's portfolio.

*Special thanks to Michael Moses, co-founder of the Mei Moses family of fine art indexes and Beautiful Asset Advisors LLC, for his contributions to this article.*



**Lisa K. Erf**  
*Director and Chief Curator  
JPMorgan Chase Art Program*

## The JPMorgan Chase Art Collection

Established by David Rockefeller more than fifty years ago, the JPMorgan Chase Art Collection is one of the world's most celebrated corporate collections. Over 450 locations display pieces from the collection, true to Rockefeller's original vision of "art at work." Today, Lisa K. Erf oversees the collection as director and chief curator.

***Thought: What is your role as director and chief curator?***

LE: My job is to manage a collection of around 30,000 pieces in 450 corporate locations worldwide. The firm sees this collection primarily as a cultural investment, not a financial one. When Rockefeller started the collection, he envisioned it as a way of bringing art and creativity to the workplace. We seek out works that are high quality, innovative and inspirational, and ultimately contribute to our corporate culture. We also look for good value.

***Thought: Can the public view the collection?***

LE: The JPMorgan Chase Art Program curates travelling public exhibitions as an ongoing component of its dedication to share the collection with audiences and communities around the world. From 2007 to 2009, Collected Visions: Modern and Contemporary Works from the JPMorgan Chase Art Collection, an exhibition of more than 70 highlights, travelled to Istanbul, Dubai and New York City. Other exhibitions have toured Argentina, Brazil, Chile, Japan, France, Venezuela and throughout the United States. We also have a full agenda of loans with many museums all over the world—an average of 12 works are on loan to different museums every year.

***Thought: What types of works are included in the collection?***

LE: The collection has a variety of art forms and styles. It includes

paintings, photographs, prints, sculptures, indigenous objects, textiles, such as African cloths and American quilts, and even utilitarian objects, such as maps and weathervanes. More than 8,000 artists and 100 nationalities are represented.

***Thought: What are some of your favorite pieces?***

LE: I love some of our earliest acquisitions—a mobile by Alexander Calder, a mural by Sam Francis and a 1959 oil painting by Joan Mitchell. I love them because they're magnificent works that are highly collectible and museum quality now, but at the time they were acquired, the artists were relatively unknown. Part of our vision is to discover original and innovative artists and their works to inspire future generations, not necessarily to follow current trends.

***Thought: Do you work much with clients who may be interested in collecting or investing?***

LE: We share our passion, exchange information and network with clients, but my department does not work directly with clients to buy or sell their art.

***Thought: To which artists are you looking with interest at the moment?***

LE: Latin-American artists, particularly those from Colombia, Argentina, Peru and Brazil, are interesting. Miguel Angel Rojas and Oscar Munoz are two examples of mature artists whose art is still undervalued, in my opinion.





**Alexander Calder**

(American, 1898 - 1976)

*Untitled (Mobile), 1959*

Painted iron

JPMorgan Chase Art Collection

© 2013 Calder Foundation / Artists Rights Society (ARS) New York

- 1 [www.tefaf.com](http://www.tefaf.com).
- 2 [www.capgemini.com](http://www.capgemini.com).
- 3 In the 2011 RBC/Capgemini Global Wealth Management Financial Advisor Survey, 42 percent of advisors believe their HNW clients invest in art primarily for its potential to gain in value.
- 4 Patrick Mathurin, "Gold feels weight of Paulson Curse," *Financial Times*, 8 January, 2012, [www.ft.com](http://www.ft.com).
- 5 Orley Ashenfelter and Kathryn Graddy, "Auctions and the Price of Art," *Journal of Economic Literature*, Volume 41, Issue 3, September 2003, [www.aeaweb.org/jel](http://www.aeaweb.org/jel).
- 6 Used with permission; more information about the Mei Moses Art Indexes may be found at [www.artasanasset.com](http://www.artasanasset.com).
- 7 2012 Russell Investments' global survey of 144 large institutions, cited by Mark Cogley in "Pension Funds Embrace Alternatives," [www.efinancialnews.com](http://www.efinancialnews.com).

# Creating New Best Practices in Securities Lending for Cash and Non-cash Collateral Management



**Josh Galper**  
*Managing Principal*  
*Finadium LLC*

Securities lending is experiencing a marked change in 2013, as lending and the collateral it generates are becoming more integrated than ever with other parts of financial markets. This is most readily apparent as banks adjust their balance sheets to optimize Basel III capital ratios and as other market participants begin to identify the collateral they need for OTC derivatives transactions that clear on CCPs. Regardless of how beneficial owners manage portfolios, participation in the securities lending market means engagement with a diversity of other market actors. The willingness of beneficial owners to accept cash or non-cash collateral, and how they choose to manage collateral once they have it, has started a new conversation with agent lenders and counterparties.

Data drawn from recent Finadium surveys of institutional investors, mutual funds and insurance companies help to identify trends that beneficial owners in securities lending programs will want to pay attention to going forward. While we find no “one size fits all” model in securities lending collateral management, there are some lessons that apply across the market.

“AS BANKS AND OTC DERIVATIVES END-USERS WORK TO MANAGE THEIR BALANCE SHEETS AND AVAILABLE COLLATERAL, SECURITIES LENDING HAS BECOME AN IMPORTANT PART OF HOW RISK CAN BE MANAGED AND ASSETS DISTRIBUTED IN FINANCIAL MARKETS.”

## Institutional investors and cash collateral

The majority of the institutional investor world, including pension plans and sovereign wealth funds, has gravitated to the most secure collateral for their securities lending programs. Cash has gone into government-backed repo or money market mutual funds, and government bonds are the most highly desired form of non-cash collateral. However, sophisticated investors recognize that these collateral types may introduce constraints to their lending programs and make mandates more difficult to achieve, even as cracks appear on the edges of what collateral institutions

will accept. While still in the early stages, institutions recognize that the old order is changing, and that to run successful lending programs they too must evolve. The challenge now is in maintaining the safest possible risk parameters as cash collateral reinvestment opportunities expand and contract along with regulatory requirements and market conditions.

When it comes to cash collateral reinvestment strategies, following the herd is a safe policy but not necessarily the best policy, according to the executives at large global pension plans and sovereign wealth funds we spoke with for our January 2013 institutional investor survey.<sup>1</sup> In our interviews with institutions

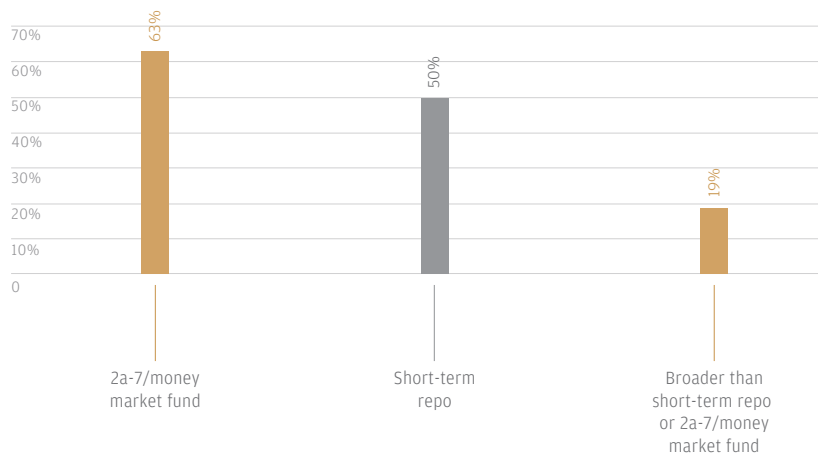
accepting cash collateral, we found 63 percent putting cash into money market accounts that follow U.S. Rule 2a-7 or similar guidelines. These include money market funds as well as separately managed accounts that may extend in term or hold less liquid investments. In addition, 50 percent of respondents put cash into short-term repo and 19 percent invest for greater returns than these other two pools offer (see *figure 1*). Many institutions reported more than one option.

Some institutions with more aggressive collateral pools than 2a-7 funds discussed the idea of accepting term repo past 30 days, although this strategy is still in the planning stages. Institutions are most interested in

FIG-01

### Securities Lending Cash Collateral Vehicles for Large Institutional Investors

Source: Finadium



Note: institutions may invest in multiple cash collateral types.

overnight repo to limit their risks whether they are providing cash against government bond, agency, equity or corporate bond repo. However, very low returns and a periodic or potentially permanent lack of liquidity mean that some institutions are looking at longer term repo options.

## Institutional investors on non-cash collateral

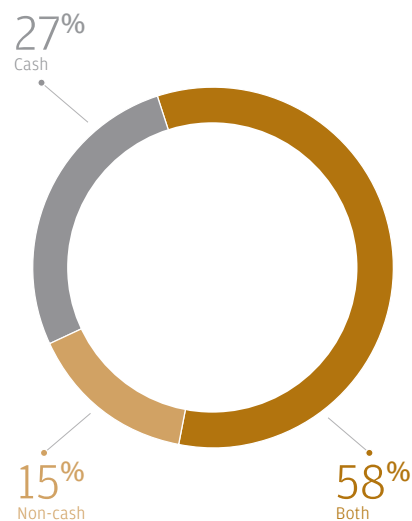
Among non-U.S. investors where non-cash collateral is the norm

for securities lending programs, there is a similar conversation on risk versus reward regarding acceptance of securities other than government bonds as collateral. Government bonds are undoubtedly preferred but investors recognize the growing scarcity of those assets in the market. The alternatives are to accept a planned decrease in securities lending revenues or to take other asset classes, with higher margin levels. For example, equities may be accepted with up to 110 percent collateralization.

FIG-02

### Large Institutions Accepting Cash Collateral, Non-cash or Both

Source: Finadium



A small portion of U.S. institutional lenders see demands for cash in other areas and believe that non-cash will be the most viable collateral option for borrowers going forward. This is not entirely welcome as most U.S. funds either do not accept non-cash or do not like to advertise the fact. Several large funds that we interviewed said that they had not been asked to accept non-cash for loans lately, and U.S. borrowers were cash-rich in the first half of 2013. However, the expectation from our interviews is that non-cash use will grow as the U.S. economy enjoys a stronger economic recovery.

Across the sample of large institutional investors globally that we interviewed, 27 percent accept cash collateral only, 15 percent accept only non-cash and 58 percent accept both (see *figure 2*).

### Mutual funds and insurance companies on cash collateral

In Finadium’s August 2013 survey of the largest mutual funds and insurance companies in securities lending, we saw little change in cash collateral management practices since 2011.<sup>2</sup> This year, 78 percent of our sample managed their own collateral internally while another 11 percent used an affiliated custodian, and several funds had more than one cash reinvestment vehicle (see *figure 3*). Only 19 percent of firms chose to have their cash collateral managed by an unaffiliated custodian.

We saw consistent interest in overnight repo only as a cash collateral reinvestment strategy; 41 percent of our sample used overnight repo alone or as one of two cash collateral reinvestment vehicles (see *figure 4*).

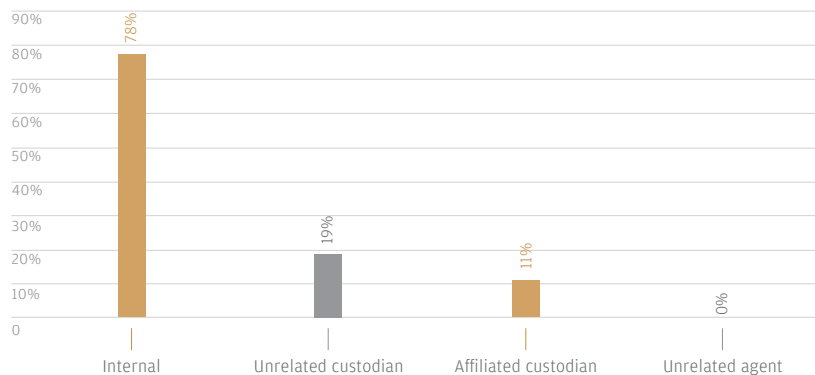
At the same time, 68 percent of our sample used a money market fund or separately managed account including U.S.-style 2a-7 funds. We see an increasing emphasis on leaving the strict 2a-7 confines and more attention on separately managed accounts. The 5 percent with collateral strategies that were longer in duration than a conservative money market fund remained an anomaly, but we see the potential for adding new categories in our data tables as U.S. money market reforms continue to constrict the definition of 2a-7 itself. We would expect then to expand our data choices to include an Old or Highly Flexible 2a-7 category that encompasses greater duration and more flexible credit qualities.

Whether in overnight repo or increasingly strict definitions of money markets, risk-averse mutual funds and insurance companies accepting cash in securities lending may be challenged in identifying reinvestment vehicles that provide enough supply to meet their needs. This is not chasing for yield; rather, this is finding investments that make sense in a conservative environment and for which there is

FIG-03

### Managers of Securities Lending Collateral for Asset Managers

Source: Finadium

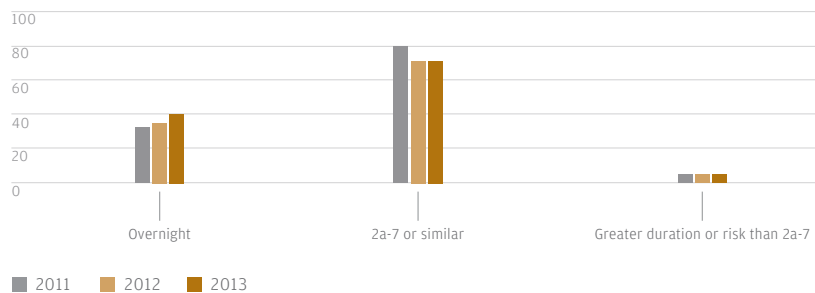


Note: multiple choice question.

FIG-04

### Securities Lending Cash Collateral Investments of Asset Managers (%)

Source: Finadium



Note: asset managers may have assets in more than one type of cash collateral account.



- 1 “Institutional Investors on Securities Lending and Collateral Management in 2013: A Finadium Survey,” Finadium, January 2013.
- 2 “Leading Asset Managers on Securities Lending and Collateral Management 2013: A Finadium Survey,” Finadium, August 2013.

sufficient supply relative to the risk tolerances of investors. In the end, not everyone really wants to hold bank certificates of deposit or government bonds that may dip into negative interest rate territory on occasion. Further changes in money market regulations may encourage the trend toward a relaxed or older 2a-7 style of money market fund guidelines for securities lending cash collateral investments.

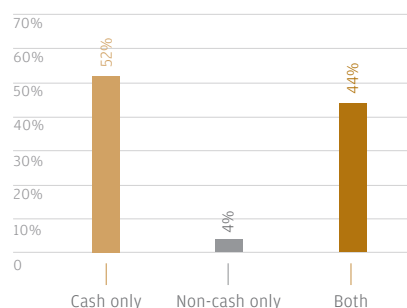
### Mutual funds and insurance companies on non-cash collateral

Mutual funds and insurance companies continued to expand their thinking about cash and non-cash collateral options in our 2013 survey. While U.S. mutual funds are limited in their acceptance criteria, European investment funds and insurance companies worldwide can engage in a broader conversation about collateral safety, returns and diversification. In our 2013 survey, we found 52 percent of our funds accepting cash only, and these were largely U.S. mutual funds (see figure 5). The 4 percent accepting non-cash only were European based. Where regulations are not a factor,

FIG-05

#### Asset Manager Use of Cash and Non-cash as Securities Lending Collateral

Source: Finadium



we see the general industry preference as accepting both cash and non-cash depending on the circumstances.

### Questions to ask for beneficial owners

Institutional investors, asset managers and insurance companies understand that the old world has changed. Cash collateral reinvestment vehicles can no longer rely on an unlimited supply of government-bond backed repo to produce returns, and increasingly tighter money market fund guidelines mean reduced risk but also lower returns. Beneficial owners looking to find supply and perhaps increase yield are looking at longer terms and lower credit qualities. Is this a safe option for investors? This is an important conversation to have in today's securities lending market in order to chart out strategies going forward.

In non-cash, the acceptance of equities or even corporate bonds creates new opportunities for beneficial owners. Borrowers are eager to provide blue chip equities as collateral because these securities are less desirable for bank Basel III Liquidity Coverage Ratios when compared to cash or government bonds. While beneficial owners accepting equities report right-way risk versus the correlation of their portfolios, ongoing sensitivities remain over how risky equities really are. There are also uncertainties about margin levels: is 105 percent to 110 percent the right margin or should black swan types of market events that could drop equity market values by 20 percent in a day be taken into account? For mutual funds and insurance companies, will investors view equities as too risky or do they make good sense?

A scarcity of government bonds as non-cash collateral, as well as government bond backed repo and similar investments in cash collateral, is as much a question of competition

Whether in overnight repo or increasingly strict definitions of money markets, risk-averse mutual funds and insurance companies accepting cash in securities lending may be challenged in identifying reinvestment vehicles that provide enough supply to meet their needs.

between beneficial owners and other market participants as it is about the assets of borrowers to pledge as collateral. If all beneficial owners insist on government bonds as collateral then borrowers will be forced to oblige, albeit at lower lending volumes than today. On the other hand, if enough beneficial owners are willing to take corporate bonds and equities then lending revenues will flow to those institutions at the expense of others. This is the flip side of the challenge faced by cash collateral holders in securities lending; more risk may result in higher revenues, but insisting on current exposure levels may reduce revenues to undesirable low points.

As banks and OTC derivatives end-users work to manage their balance sheets and available collateral, securities lending has become an important part of how risk can be managed and assets distributed in financial markets. While the potential of the collateral transformation trade both in securities loans and collateral reinvestments remains either out of reach or out of mandate for most beneficial owners, current participants report strong returns with acceptable risk parameters. Going forward, beneficial owners in securities lending may want to consider these options as important risk-managed opportunities for yield enhancement to their portfolios. The right first step however is knowing the questions to ask to ensure strong oversight and risk reduction in the lending program. **thought**

# Hedge Funds Seek Critical Mass While Sustaining Profitable Margins

Insights from J.P. Morgan's Annual Benchmarking Survey of the Hedge Fund Industry



“AS A WHOLE, THE HEDGE FUNDS PARTICIPATING IN OUR SURVEY REPORT THAT THEY ARE GROWING STEADILY. BEYOND A NOTABLE FALL-OFF IN DISTRESSED DEBT, MOST ARE CONTINUING WITH THE SAME STRATEGIES USING THE SAME INSTRUMENTS. WHAT HAS CHANGED IS THE COST OF DOING BUSINESS AND THE ABILITY TO PASS THOSE COSTS ALONG TO THEIR CLIENTS.”

Rapidly developing cycles of obstacles and opportunities continue to play a dynamic role in the operational direction of hedge funds. J.P. Morgan's Prime Brokerage Consulting Group recently completed analysis of a four-month survey of hedge fund clients, aggregating key insights concerning the industry's expansion and factors influencing growth. “Our clients' feedback conveys some of the response to regulatory change and toward new efficiency trends,” says Kumar Panja, Global head of Prime Brokerage Consulting. “The cumulative data we've built provides some unique insights into directional shifts over time as well as certain continuing patterns for the industry as a whole.”

Now in its third year, the survey examines diverse elements of hedge fund structures and strategies. Key findings include the growth of separately managed accounts, changes in staffing and the adjustment of performance fees, among others. “With institutional investors pushing back on fees, we expected to find that smaller to mid-sized hedge funds would be reducing headcount,” said John Cotronis, NA head of Prime Brokerage Consulting. “Instead we found that they were adding staff, holding the line on administrative fees and compromising largely on their performance incentives.”

## Fund strategies and asset allocation

### Key Findings

Strategies employed by hedge funds remained largely unchanged from 2010 through 2012 with the notable exception of credit/distressed. Among those strategies, allocations to commodities have decreased sharply.

Overall, the strategies employed by hedge fund respondents were fairly consistent from 2010 through 2012 with the exception of credit/distressed, which declined from 55 percent in 2010 to 48 percent in 2012. This decrease may reflect what hedge funds view as a diminishing opportunity set in the credit arena since little room may be left for price appreciation.





**Kumar Panja**  
Global Head of Prime Brokerage Consulting



**John L. Cotronis**  
NA Head of Prime Brokerage Consulting

## Study Methodology

J.P. Morgan's Prime Brokerage Consulting Group annually produces its *Prime Brokerage Hedge Fund Survey*, which is designed to assist clients in benchmarking various facets of their businesses relative to industry peers. Each participating fund is provided with a customized report containing bespoke content that illustrates their individual factors measured against the overall industry while offering insight into best practices.

The 2012 survey reflects data from 174 participants representing \$581 billion in assets under management (AUM). The 174 funds were then segmented based on AUM, strategy and security types traded into nine peer groups for further analysis.

Among the strategies employed by respondents, the AUM allocated to each also has remained fairly stable with two notable exceptions: commodities/CTA fell from 27 percent of AUM in 2010 to only 13 percent in 2012. Correspondingly, the number of firms that have ceased trading in commodities rose from 17 percent in 2011 to 25 percent last year. These declines correspond with what many view as the end of the commodities super-cycle and poor performance among managers with material commodities exposure. By contrast, allocations to statistical arbitrage surged from 14 percent in 2010 to 38 percent in 2012.

FIG-01

### Assets Under Management for 174 Funds

Source: J.P. Morgan's 2012 Prime Brokerage Hedge Fund Survey

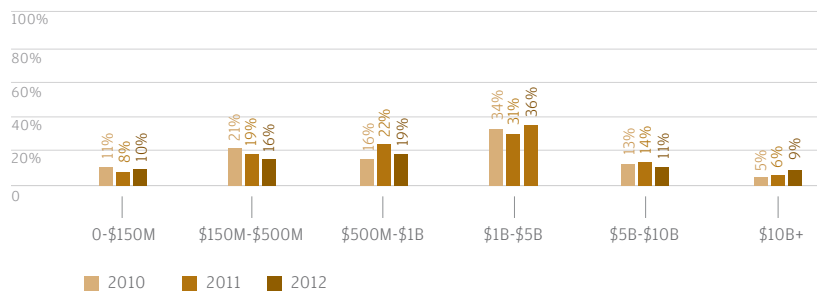
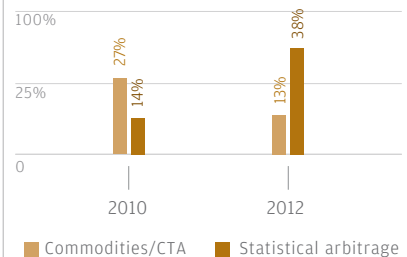


FIG-02

### Evolution in AUM Allocated to Strategies

Source: J.P. Morgan's 2012 Prime Brokerage Hedge Fund Survey



## Separately managed accounts

### Key Findings

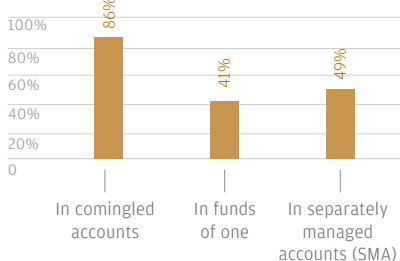
Separately managed accounts have grown steadily in recent years, reflecting the rising demand for customized, bespoke solutions in lieu of broad, commingled vehicles.

Not surprisingly, the survey revealed that separately managed accounts (SMAs) have grown steadily in recent years in response to rising demand for customized fund solutions. Firms that manage SMAs rose from 59 percent in 2010 to 63 percent in 2012. The survey also showed a willingness to raise assets in vehicles other than commingled partnerships. Almost half of the participants would consider the use of funds of one and SMAs to raise assets.

FIG-03

### In What Type of Accounts are You Raising Capital?

Source: J.P. Morgan's 2012 Prime Brokerage Hedge Fund Survey



## Asset classes used

The survey measured the types of asset classes that respondents use for trading and investments, ranging from equities to FX and ABS. Notable changes included CFDs, which shot up from 31 percent in 2011 to 48 percent last year; commodities, which fell by two percentage points; and sovereign debt, which rose from 24 percent in 2011 to 34 percent in 2012. The dramatic increase in the use of sovereign debt likely reflects receding tail risk among eurozone countries.

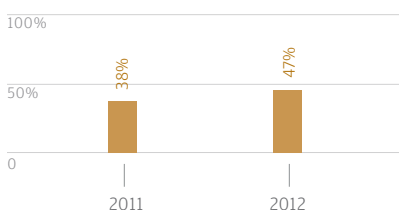
## Country exposure

Year-to-year country exposures among respondents were largely unchanged with the exception of Japan, to which hedge funds increased their exposure from 38 percent in 2011 to 47 percent in 2012. This increase reflects greater short exposure to the JPY trade and to Japanese equities as a result of "Abenomics."

FIG-04

### Exposure to Japan

Source: J.P. Morgan's 2012 Prime Brokerage Hedge Fund Survey



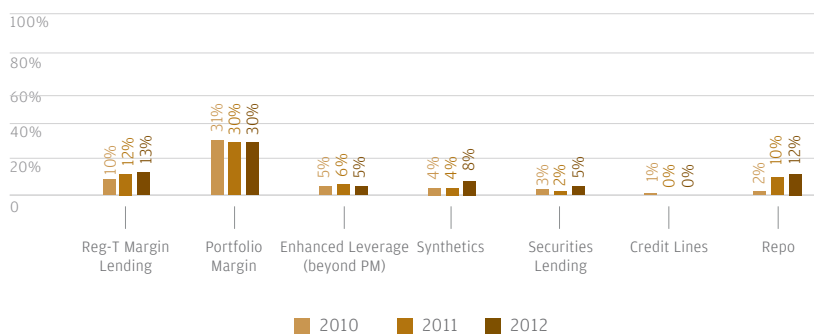
## Financing sources

Within different peer groups in the survey there has been movement on financing sources. Specifically, equity-centric funds with \$500M to \$1B in AUM have moved dramatically away from Reg-T margin finance towards portfolio margin, which could afford higher leverage levels across a broader spectrum of securities.

FIG-05

### What Percent of your AUM is Financed by the Following Sources?

Source: J.P. Morgan's 2012 Prime Brokerage Hedge Fund Survey



## Performance fees

### Key Findings

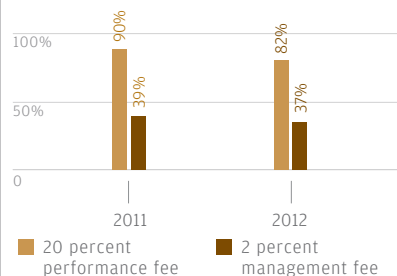
In response to fee pressure from investors, hedge funds have adjusted performance fees more while management fees have remained stable.

Our many conversations and meetings with clients confirm that the fee pressure from investors remains very real. Consequently, the survey revealed a decline in the number of hedge funds charging a 20 percent performance fee (90 percent in 2011 versus 82 percent in 2012) and a slight increase in the number of funds charging a 15 percent performance fee (three percent in 2011 versus six percent last year).

FIG-06

### Changes to Fee Structures

Source: J.P. Morgan's 2012 Prime Brokerage Hedge Fund Survey



## Management fees

Despite fee pressures, the number of hedge funds charging a two percent management fee has remained quite stable. While 39 percent of respondents charged a two percent fee in 2011, 37 percent did so in 2012.

## Regulation

### UCITS

At the time of the survey's completion, 18 percent of U.S.-based survey respondents indicated that they planned to look into onshore European fund regimes, although 65 percent of that number will examine opportunities through UCITS, as alternative UCITS funds and AUM continue to grow.

### AIFMD

Somewhat counter-intuitively, 57 percent of the respondents expressed no concern over the Alternative Investment Fund Managers Directive (AIFMD), which took effect in July 2013. Such responses may reflect the lack of consensus among legal practitioners regarding the compliance measures required with respect to the AIFMD. Since the survey date, there has been increasing interest in understanding the various facets of AIFMD and the impact on the way hedge fund managers conduct business going forward.

## Operations

### Key Findings

There has been a steady uptick in the number of firms planning incremental increases in headcount, reflecting ongoing growth in the industry.

There was an incremental uptick in the number of funds planning to increase headcount; 48 percent indicated such plans in 2011 and 49 percent indicated such plans in 2012. While the increase is slight, it reflects continued growth in the hedge fund industry despite the headwinds faced last year. The one notable exception has been the dramatic decrease in traders employed at funds. The average number of traders across all fund managers dropped from eight in 2010 to just over two in 2012.

### Technology

The survey revealed a slight year-over-year increase in the percentage of firms' technology budgets devoted to services and data (plus one percent) and a corresponding decline in the allocation to software investment (minus one percent). This pattern reflects hedge funds' growing use of cloud, ASP and SAAS solutions.

## Capital-raising

### Key Findings

A growing number of allocators are investing directly in hedge funds, thus circumventing hedge funds of funds.

### Direct hedge fund investments

According to the survey, the number of investor relationships among respondents increased from 90 in 2010 to nearly 160 in 2012. That trend is indicative of the fact that, increasingly, investors are allocating directly to hedge funds, thus disintermediating funds of funds.

### Institutionalization

Nearly 60 percent of the respondents indicated that the composition of their investor base has become increasingly more institutional. That pattern reflects the ongoing institutionalization of the hedge fund investor base, which once was comprised mainly of family offices and ultra high net worth individuals but increasingly is made up of pensions, endowments and foundations, and sovereign wealth funds.



## The bottom line

As a whole, the hedge funds participating in our survey report that they are growing steadily. Beyond a notable fall-off in distressed debt, most are continuing with the same strategies using the same instruments. What has changed is the cost of doing business and the ability to pass those costs along to their clients. As hedge funds, particularly smaller funds, strive to keep up with new regulatory and market demands, they are planning to increase headcount or otherwise increase operating costs. Achieving critical mass becomes a paramount

concern, as efficiencies of scale may well be needed to sustain a profitable fund. In the face of increasing competitive pressure, however, many funds must compromise on fees, particularly performance fees, to attract new assets. We believe that this delicate balancing act, between the need to grow and the ability to sustain a profitable pricing model will define the agenda for many funds for years to come. We look forward to exploring these issues further in our next survey. **thought**



# Maturing Market, Emerging Opportunity—the Transformation of Asia

“WE’RE SEEING A LOT MORE FUND MANAGERS SETTING UP OFFICES, LARGER NUMBERS OF EMPLOYEES RELOCATING TO ASIA, AND A NUMBER OF FUNCTIONS PREVIOUSLY MANAGED OUT OF NEW YORK OR LONDON TRANSPLANTING TO ASIA TO BETTER REPRESENT THE SIGNIFICANT GROWTH IN BOTH INWARD INVESTMENT INTO THE REGION AND ASSET-GATHERING WITHIN ASIA.”



**John Murphy**

*Custody and Fund Services  
Product Executive, Asia*



**Andrew Lawson**

*Global Custody  
Product Manager, Asia*

## The Staggering Potential of Asia's Retail Investors and How Asset Managers are Responding

[Editor's note: This article is the first in a series of special reports regarding the asset management industry in Asia.]

Asset management is ripening in Asia. Asset managers must rapidly evolve their strategies to address wealth accumulation and an amassing pool of investible assets within the region, combined with the emergence of retail investors with diverse needs. In parallel, the long-term move toward integrating Asia's markets, with an emerging regional superstructure and infrastructure, is reshaping the face of Asia's asset management industry with global implications.

It is difficult to generalize about Asia's investors and asset management industry. Asset managers themselves have distinct areas of focus within institutional and retail investment. Data can be challenging to come by and inconsistent. Still, through a review of market developments affecting onshore retail investors—supported by statistics and anecdotal evidence—a picture emerges of an industry landscape undergoing transformation.

### Asia's investor community—bigger, wealthier and underpenetrated

Regional wealth is increasing both among high net worth individuals (HNWIs) and the middle class, but as an investment community, the Asian retail market is underpenetrated. According to The Boston Consulting Group's *Global Wealth* 2013 report, Asia-Pacific will surpass North America as the world's largest wealth region by 2017.<sup>1</sup>

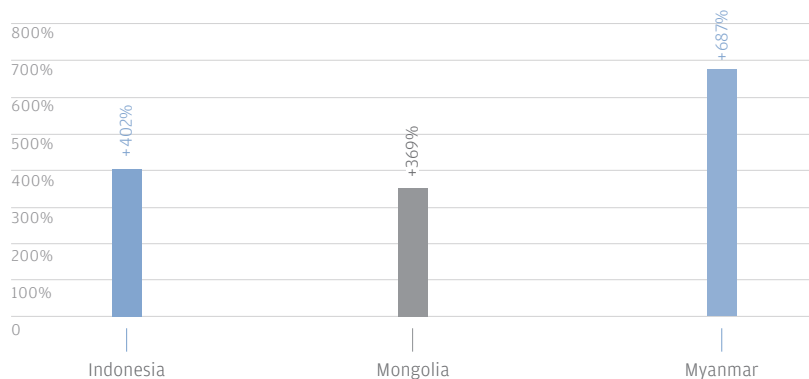
China is said to be a key driver of this growth with a projected gain in wealth of 104 percent by 2017 that would place it as the world's second wealthiest country, ahead of Japan. The same report predicts that India's wealth will jump 127 percent.

Growth in the middle class is contributing to regional wealth. By 2030, two-thirds of the world's

FIG-01

### Predicted Explosive Growth of HNWIs by 2022 in Three Emerging Economies

Sources: *The Wealth Report 2013*, Knight Frank



middle class will live in Asia-Pacific, with China's middle class reaching one billion, according to a report by Ernst & Young/SKOLKOVO Institute for Emerging Markets Studies.<sup>2</sup> A consumer-oriented and young middle class is expected to drive growth, especially in the sectors of consumer finance, healthcare, education, green business and infrastructure.<sup>3</sup> Economic growth in turn drives investor confidence.

### A diverse, burgeoning middle class

Asia's middle class is not uniform; it comprises multiple segments with varied income levels and purchasing power. Estimates vary by country and are challenging due to a range of issues, including data quality. Silk Road Associates numbers emerging Asia's middle class at 501 million based on an annual per capita income of US\$5,000. The estimate changes to 286 million when annual income adjusts to US\$7,500.<sup>4</sup>

Asia-Pacific has more HNWIs than any other region. In 2011 Asia-Pacific's population of HNWIs grew by 1.6 percent to 3.37 million individuals, compared to a 0.8 percent gain in the rest of the world.<sup>5</sup> *The Wealth Report* 2013 by Knight Frank expects the biggest growth rates in HNWIs to occur in Asia's emerging economies. For example, the report predicts a 687 percent growth in Myanmar's HNWIs, followed by growth rates of 402 percent and 369 percent for Indonesia

and Mongolia, respectively, between 2012 and 2022.

The accumulation of wealth is also becoming inter-generational. Wealth succession is emerging as a top discussion point among many rich families in Asia, despite a reluctance and cultural taboo around the topic in some circles. At the same time, wealth remains concentrated within the HNWI category. In 2011, according to Capgemini's *Wealth Report*, wealth increased by 1.5 percent for Asia-Pacific's so-called "millionaires next door"—or those with US\$1 million to US\$5 million in investable wealth.<sup>5</sup> Seventeen percent of Singapore's citizens are worth more than \$1 million, the most in the world.<sup>6</sup>

- 1 Diana Britton, "The Future of Wealth? Look to the East," May 30, 2013, [wealthmanagement.com](http://wealthmanagement.com).
- 2 Ernst & Young, "By 2030 two-thirds of global middle class will be in Asia-Pacific," 25 April 2013, [www.ey.com](http://www.ey.com).
- 3 World Economic Forum, "Asian middle-class to drive growth," 18 June 2009, [www.weforum.org](http://www.weforum.org).
- 4 Silk Road Associates, "The Rise of Asia's Middle-Class: The world's new growth driver," May 2, 2013, [www.silkroadassoc.com](http://www.silkroadassoc.com).
- 5 Capgemini and RBC Wealth Management, "Asia-Pacific Wealth Report 2012," September 19, 2012, [www.capgemini.com](http://www.capgemini.com).
- 6 Myriam Robin, *Property Observer*, "Rich turn to Asia as exclusive wealth management firms park money in Singapore," 23 April 2013, [www.propertyobserver.com.au](http://www.propertyobserver.com.au).

## Drivers of wealth

In Asia, economic growth is closely tied to wealth accumulation due to the prevalence of family businesses. Family businesses comprise 50 percent of all listed companies and 32 percent of Asia's total market capitalization according to one study.<sup>7</sup>

High and rising savings rates are another contributor. It is difficult to account for the higher savings rates in Asian economics, and savings levels vary by country. China's household savings rate, which now exceeds 50 percent of GDP, is noteworthy. As a whole, domestic savings rates in the developing economies of Asia are forecasted to remain steady over the next 20 years.<sup>8</sup>

The Towers Watson Savings Attitude Survey, conducted among 4,701 young, wealthier-than-average, working-class male employees in China and India, found that motivations for saving include housing, children's expenses, medical expenses, retirement and general savings.<sup>9</sup> Without thinking much about retirement, the study finds, many have adequate savings, but there is a need to change the culture of saving from short- to long-term. According to Andrew Lawson, global custody product manager at J.P. Morgan, "Along with a growing middle class, there is an increased expectation for quality of life and the associated need to take ownership of one's own investments."

According to The Boston Consulting Group's *Global Wealth 2013* report, Asia-Pacific will surpass North America as the world's largest wealth region by 2017.

## Underpenetrated, not diversified

But how aggressively has all this wealth been invested? There are a number of indicators of low penetration of investment products. For example, discretionary products make up approximately five percent to 10 percent of all products, versus about 30 percent in traditional wealth centers.<sup>10</sup> Investments from Asia compose only 13 percent of the mutual fund industry's global AUM, as compared to 52 percent and 35 percent for the Americas and Europe, respectively.<sup>11</sup>

Overall, there is a lack of investment diversification behind AUM inflows. Alternatives, such as property, gold, insurance products and bank deposits—for a variety of reasons—siphon off investment dollars. In looking at Asia in comparison to the West there are some fundamental differences in views around areas such as investment risk and property investment. Accordingly, the ratio of traditional to alternative investments seen in the West may not be the correct benchmark when looking East. A study by Fitch Ratings found that domestic funds are weighted toward fixed income, and investment flows

in 2012 showed continued preference for bond and money market funds.<sup>12</sup> In a number of markets, concentration in onshore fund products persists; for example, onshore mutual funds constituted 88.9 percent of regional AUM in 2012, excluding Japan.<sup>13</sup>

## Emerging regional superstructure and infrastructure

Exacerbating investor concentration in onshore products is the cost inefficiency, and in some cases, impossibility, for asset managers to operate across the region. Regional funds management remains fragmented; each jurisdiction has its own domestic funds market with varying degrees of restrictions around cross-border funds.

But the superstructure and infrastructure of Asia's asset management industry are evolving. The Asia region Collective Investment Vehicle Passport, or Asia Region Funds Passport, aims to support the cross-border distribution of Asia-based funds. A passport could support the creation of a regional superstructure or the integration of the funds management industry across the region.



Longer term, the promise of a passport implies lower fees for investors through greater efficiencies and increased competition, enabling, among other things, direct access to offshore funds and the distribution of single funds across multiple markets. It also potentiates greater investor choice through direct access to more funds, markets and expertise. In the short- to medium-term, challenges to achieving a passport include varied levels of fund market development, the continuation of captive distribution in many markets, investor predilection toward locally invested products, and differences in many key areas, including legislative and tax regimes.<sup>14</sup>

In southeast Asia, progress on the ASEAN funds passport—initially involving Singapore, Malaysia and Thailand—has been slow to develop, but continued dialog and activity evidences the long-term trajectory toward market integration. Perhaps closer on the horizon is the Greater China passport, beginning with the January 2013 announcement that consultations are underway on the mutual recognition of funds between Mainland China and Hong Kong. Explains John Murphy, custody and

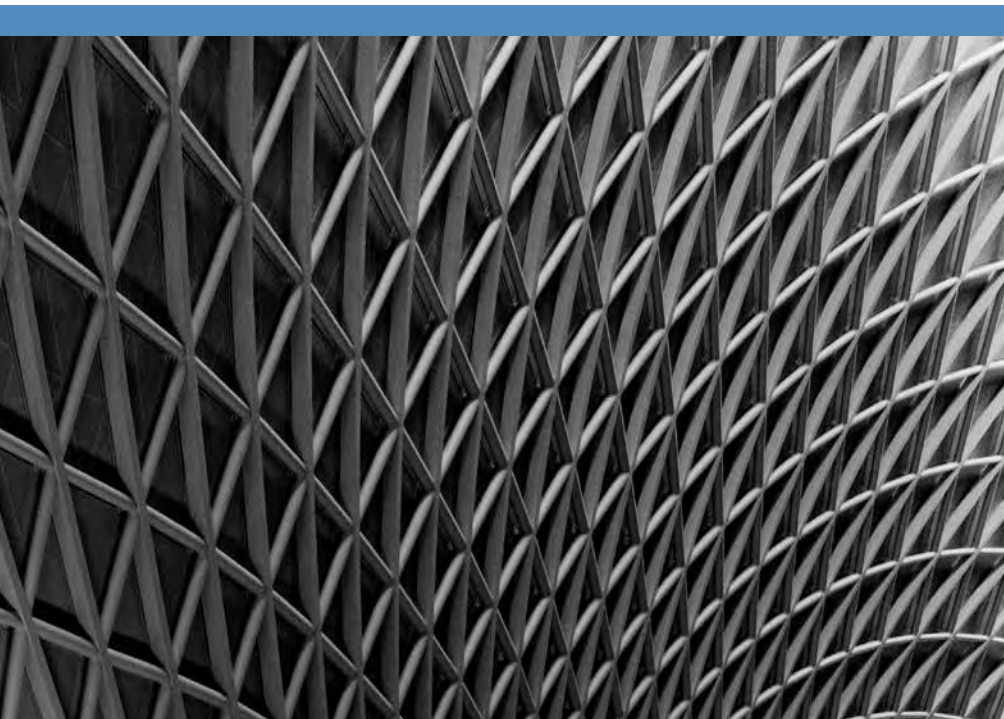
fund services product executive at J.P. Morgan, “If implemented, funds managers will be able to register and sell Hong Kong-domiciled products in China to retail investors and vice versa. There is a lot of press coverage and dialog around whether a China passport could become a Greater China Passport that includes Taiwan.”

### Supporting trend—RMB internationalization

RMB internationalization, and the RMB’s long-term trajectory toward being a major on par with USD and EUR as a global currency, is a lynchpin in the development of the Greater China Passport. “We are witnessing a huge build-up of RMB balances in Hong Kong and moving into Taiwan, with the trend continuing in Singapore and increased interest in RMB-based products,” says Lawson. “The general populace believes that the RMB will be a strong currency that will appreciate over time. The first day that I went to a cash machine in Hong Kong and had the option to withdraw HKD and RMB from the same machine was a clear signal to me of the extent to which the RMB is internationalizing.”

Dim sum bonds are becoming available in Hong Kong, Singapore, Taiwan and London, and companies are launching RMB-denominated bonds. Investor demand for RMB bonds is driving asset managers to develop new products to satisfy client desire to invest in these bonds and maintain exposure to RMB. The growth of multi-currency mutual funds in Taiwan, tied to changes in Taiwan regulations related to offshore RMB, exemplifies this trend.

On the other side of the coin are infrastructure developments like the ASEAN+3 Bond Market Forum and Asian Bond Markets Initiative. Such initiatives are laying the groundwork for more integrated capital markets across the region by building the underlying mechanics necessary for more efficient markets. A flurry of initiatives this year—including the rollout of the ASEAN Trading Link across Singapore, Thailand and Malaysia and the Invest Asia 2013 Investment Roadshow are coalescing to build momentum around infrastructure developments and investor education as to the value of regional investment.



- 7 Credit Suisse, “Asian Family Businesses Report 2011,” October 2011, [www.efiko.org](http://www.efiko.org).
- 8 Eswar S. Prasad, National Bureau of Economic Research, NBER Reporter 2013 Number 1: Research Summary, “Saving in Developing Countries,” [www.nber.org](http://www.nber.org).
- 9 Bob Charles, Towers Watson, “Private Pensions in Asia: Challenges and opportunities in a post-crisis world,” January 2013, [www.imf.org](http://www.imf.org).
- 10 Capgemini and RBC Wealth Management, “Asia-Pacific Wealth Report 2012,” September 19, 2012, [www.capgemini.com](http://www.capgemini.com).
- 11 Justin Ong, PwC, “Distributing funds in Asia’s growth market,” [www.pwc.com](http://www.pwc.com).
- 12 Richard Newell, *Investment & Pensions Asia*, “Fixed Income funds key to China market growth,” 22 May 2013, [www.ipe.com](http://www.ipe.com).
- 13 Cerulli Associates, “The Cerulli Report: Asian Distribution Dynamics 2013,” June 7, 2013, [www.cerulli.com](http://www.cerulli.com).
- 14 Andrew Wilson, PwC, “Asia Region Funds Passport: The future of the funds management industry in Asia,” November 11, 2010, [www.pwc.com.au](http://www.pwc.com.au).

Regional funds management remains fragmented; each jurisdiction has its own domestic funds market with varying degrees of restrictions around cross-border funds.



## Moving offshore onshore

In parallel, Singapore and Hong Kong are emerging as hubs for offshore wealth management within the region as Asia's HNWIs increasingly seek offshore solutions closer to home than traditional centers, such as Switzerland.<sup>15</sup> Research by WealthInsight indicates that Singapore will surpass Switzerland as the largest offshore wealth center as measured by AUM by 2020.<sup>16</sup> Singapore's AUM has grown to US\$550 billion from US\$50 billion in 2000, with about US\$450 million attributed to offshore wealth.<sup>17</sup> Hong Kong is also a recipient of funds transplanted from Europe's historical private banking locations.<sup>18</sup>

## Asset managers respond

Key to the maturation process within Asia is the ability of asset managers to satisfy investor demand amid changing dynamics. Toward this end, they are shifting their approaches within Asia's diverse context—including fine-tuning their strategies to service changing client needs.

Depending on their focus, they are adopting a range of strategies. For those foreign players operating in the offshore wealth management hubs, to compete against entrenched local firms and grow profitably in the midst of high operating costs, it is imperative to properly target AUM and to understand the cultural and behavioral nuances of investors and

the operating context of the offshore wealth centers.<sup>19</sup> Whether to establish a local presence through branches or partnerships and which products and services to provide are cited among the critical decisions.

Offshore asset managers with a mass retail focus often sell products through institutions or wholesale distributors in and around the region to retail investors, given that distribution is challenging in countries where distribution is captive or there are dominant players, among other factors. Those engaged in onshore asset management for retail investors are preoccupied with where to launch local domiciled products in and around Asia and what, when and how to do this.



## Redefining their presence

According to Murphy, “We’re seeing a lot more fund managers setting up offices, larger numbers of employees relocating to Asia, and a number of functions previously managed out of New York or London transplanting to Asia to better represent the significant growth in both inward investment into the region and asset-gathering within Asia. They are doing so to better service clients or make decisions that are more relevant to the region and the assets being based here.”

In the HNWI space, for example, Coutts, a private bank under the Royal Bank of Scotland, plans to double its client-facing employees in Asia within the next two to three years, and Julius Baer reported plans to more than double its on-the-ground staff by 2015.<sup>20</sup>

Asia’s middle class is not uniform; it comprises multiple segments with varied income levels and purchasing power.

The influx of expatriates and the creation of a pipeline for their long-term displacement by local talent are additional indicators of a maturing Asian asset management industry. For example, efforts are underway to train locals in private wealth management and encourage employee retention. A scarcity of local skills and expertise is leading to the establishment of training programs in private banking and wealth management at local universities. As a case in point, the Hong Kong Institute of Bankers will add two new streams to its Postgraduate Diploma in Wealth Management in 2013.<sup>21</sup>

## A strategic focus

Asset managers are choosing their market presence strategically. Emerging Asia has 274 cities with populations greater than 750,000 inhabitants.<sup>22</sup> It is not possible to be in all markets from a cost and logistics perspective let alone to compete everywhere effectively against entrenched players. Some firms have a strong presence in one

By 2030, two-thirds of the world’s middle class will live in Asia-Pacific, with China’s middle class reaching one billion.

or two countries only and choose where to invest based on their core capabilities or investment sweet spots. Others are entering selective markets opportunistically, for example, establishing a presence in Hong Kong in anticipation of eventual broader access through the establishment of a Greater China Passport.

“The successful asset management players in Asia have clarity around their targets that involves a country-driven investment strategy and offerings sharply attuned to market nuances and investor demands,” says Lawson.

“Investor needs vary significantly due in part to cultural and demographic differences,” he adds. “Asset managers must distinguish among investor bases by country and tailor their offerings accordingly to understand client interest and salability.” For example, says Lawson, “the income needs of aging Japanese pensioners vary greatly from the investment growth demands of younger generations in the Philippines or Vietnam.” Further, there is industry-

Seventeen percent of Singapore’s citizens are worth more than \$1 million, the most in the world.

wide recognition of the need for continued investor education to encourage private retirement savings in Asia.

Investor demand and changing market dynamics require a nuanced understanding and fine-grained approach for those looking to capitalize on Asia’s emerging regional wealth and investment appetite. The ripening of Asia is underway—and while much development lies ahead for the region’s asset management industry—asset managers are looking with a sense of urgency on how to capitalize on the opportunity today. **thought**

15 Capgemini and RBC Wealth Management, “Asia-Pacific Wealth Report 2012,” September 19, 2012, [www.capgemini.com](http://www.capgemini.com).

16 Sarah Krouse and Mike Foster, *Financial News*, “Wealth managers flock to Singapore as Switzerland suffers,” 7 May 2013, [www.efinancialnews.com](http://www.efinancialnews.com).

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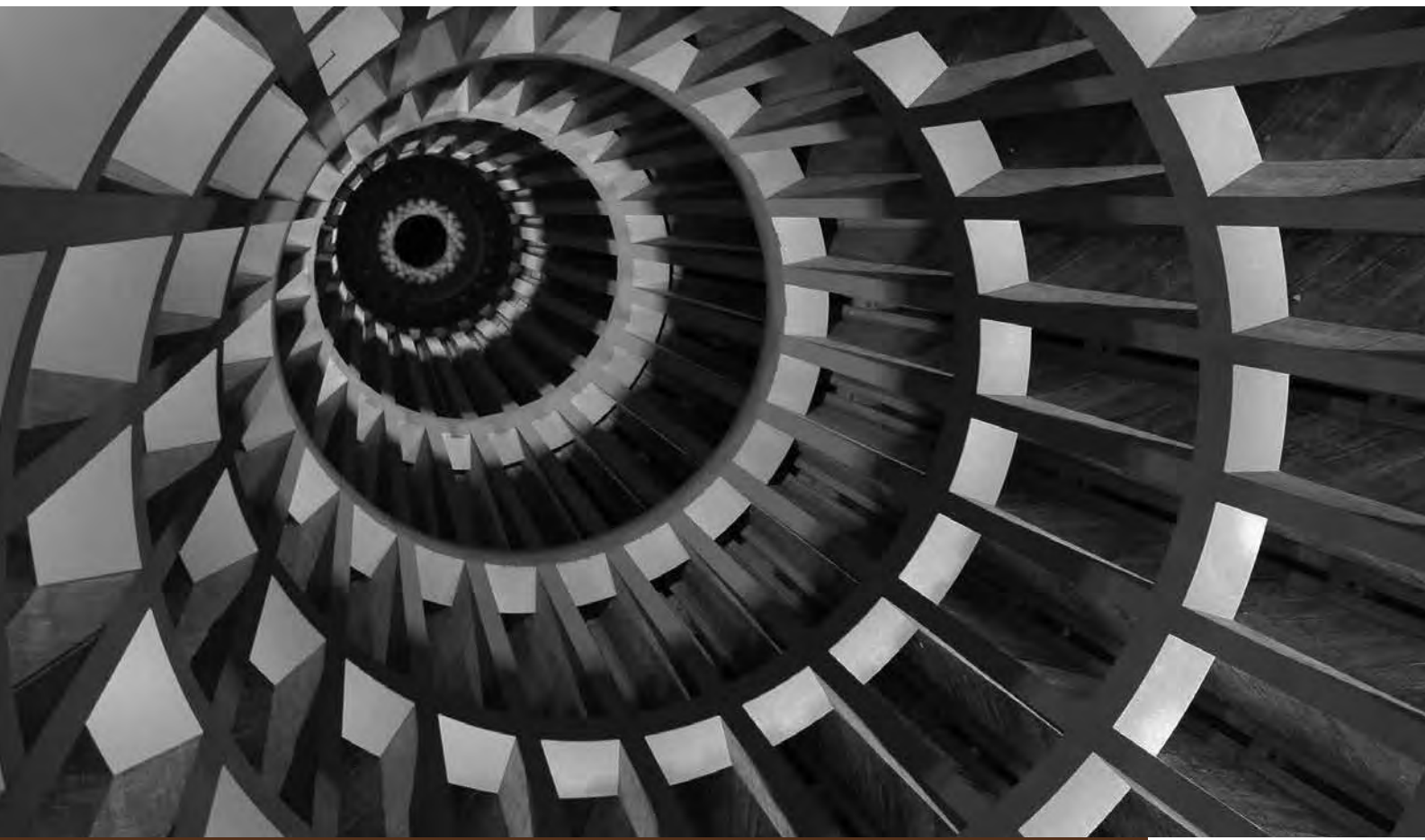
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# Perspectives on the Economic Evolution of Brazil



**Cedrick Reynolds**  
*Executive Director  
Latin America*

“INASMUCH AS THE BRAZILIAN GOVERNMENT HAS TAKEN AN AGGRESSIVE STANCE TO COMBAT INFLATION WHILE PROVIDING STIMULI NECESSARY TO JUMPSTART ITS ECONOMY, INVESTORS NEED TO DETERMINE WHETHER THE RISK/REWARD PROFILE OF A HIGHLY CONCENTRATED PORTFOLIO OF BRAZILIAN ASSETS CAN BE JUSTIFIED ON A RISK-ADJUSTED BASIS.”



**A**fter an extended period of solid economic performance and equity market returns, headwinds are pushing Brazil into a challenging phase of its global emergence. From 2003 to 2010, growth in Brazil was fueled in large part by rising commodities prices for core exports, including soybeans, sugar, coffee, crude oil and iron ore. Demand from key downstream markets such as China and Europe base-loaded Brazil's economy, and when coupled with smart fiscal policies, Brazil paved the way for strong economic growth and an increase in the size of its middle class.

Following the global financial crisis, Brazil was one of the first major economies to post a strong recovery. Brazil's dip during the crisis was not as severe as other markets, with growth of 6.1 percent in 2007 and 5.2 percent in 2008, compared to 1.9 percent in 2007 and -0.3 percent in 2008 for the

United States. Its recovery in 2009 and 2010 exceeded most other leading economies, with growth of -0.3 percent in 2009 and 7.5 percent in 2010, compared to -3.1 percent in 2009 and 3.0 percent in 2010 for the U.S.

Since 2010, Brazil has been dealing with a number of economic issues—some are the result of its success. Heightened investor demand strengthened the Brazilian Real and at the same time made Brazil less competitive in global commodities markets. Largely through the use of taxes, interest rates and currency controls, the Brazilian government took steps to cool the economy following 2010. Today, a number of factors are clouding the investment landscape in Brazil and, when viewed collectively, may influence investors to consider other options as part of an overall diversification and risk mitigation strategy.

### **Inflation and real rates of return**

Since the adoption of the Real Plan and the introduction of the Real in 1994, inflation management has been a central component of Brazil's economic policies. The government communicates inflation target ranges and uses its available tools to keep inflation within that range. The current target is 2.5 percent to 6.5 percent.<sup>1</sup> Reported inflation rates are currently beyond the upper end of the

target (6.7 percent through June of this year), and this limits the government's ability to use its full panoply of tools to stimulate the economy.

Beginning in 3Q11, Brazil began aggressively reducing its benchmark risk-free rate (SELIC) to help stimulate economic growth. Rates decreased from 12.5 percent in 3Q11 to 7.25 percent in 4Q12. This policy required inflation to stay within the target range. However by 1Q13, inflation

levels had become intolerable and the government began to reverse course and raise interest rates. In 1Q13, the spread between SELIC and actual inflation declined to its lowest level since the introduction of the Real (see *figure 1*). Declining real rates of return limit the government's ability to fully use the stimulus provided by lower interest rates. The SELIC rate is currently at 8.5 percent and the government has a stated year-end target of 9.25 percent to 9.5 percent.

## Equity market performance

Aside from stellar performance during the recovery of 2009, Brazilian equity markets have been negative and/or have underperformed other global markets (see figure 3). Prior to 2010, Brazilian investors had grown accustomed to higher than average volatility and higher than average equity returns. Subsequent volatility has remained high, but absolute returns have lagged broader global indices. Recent interest rate reductions and broader economic stimulus have not provided significant lift to the Bovespa. Historically, rising inflation has served as a leading indicator of downward pressure on equity market valuations (see figure 4).

Equity market capitalization remains at historically high levels, at 54.6 as percent of GDP in 2012 (see figure 5 for historical data). Brazil is also the world's sixth largest investment funds market with approximately \$1.1 trillion of assets under management.

FIG-01

### Trajectory of Brazilian Inflation

Sources: IBGE and Brazilian Ministry of Finance

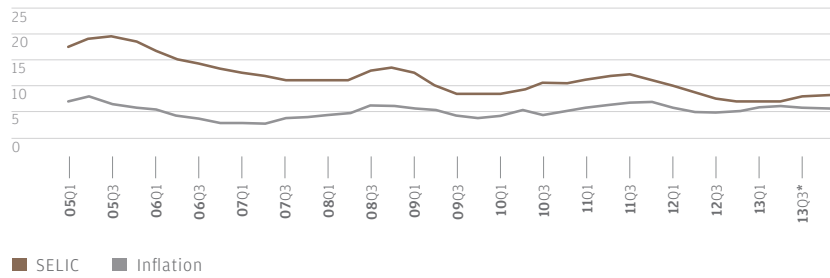


FIG-02

### Forecasts

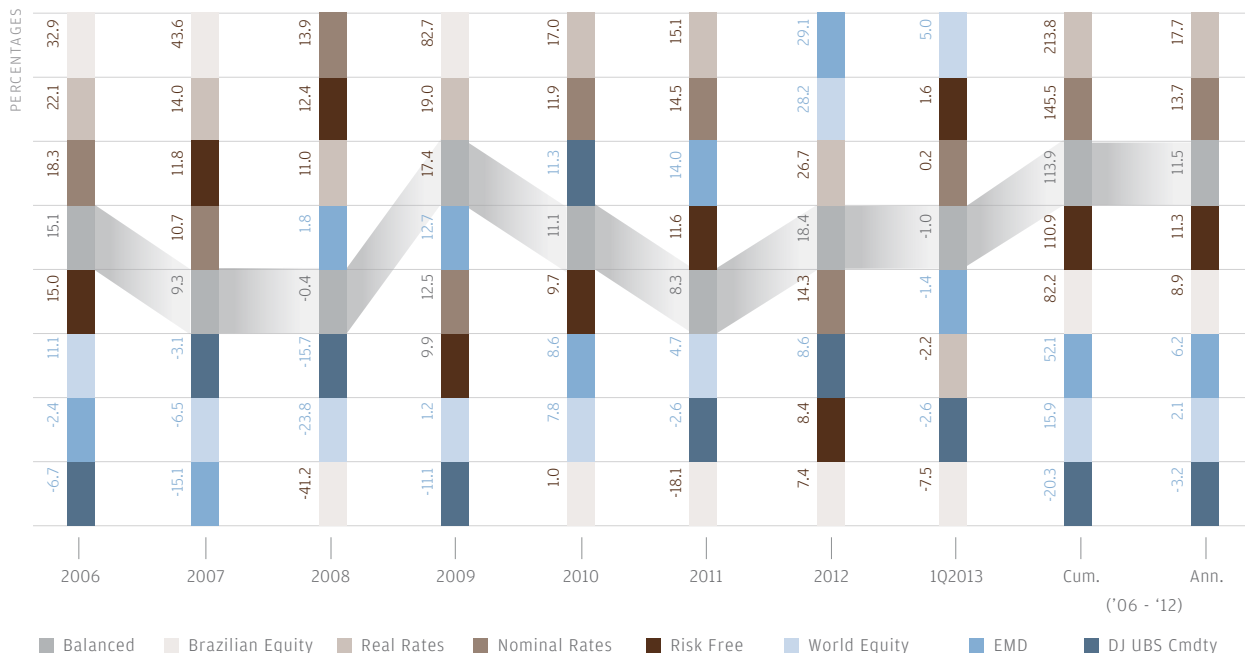
Sources: J.P. Morgan Research and Banco Central do Brasil

2013	SELIC	IPCA <sup>2</sup> (JPM)	IPCA (BCB) <sup>3</sup>
July	8.5	6.22	6.49
August	9.0	6.02	6.39
September	9.0	5.92	6.22
October	9.5	5.92	6.10
November	9.5	5.94	6.04
December	9.5	5.85	5.82

FIG-03

### Brazilian Equity Markets against Other Global Markets<sup>4</sup>

Sources: J.P. Morgan Asset Management, BM&FBovespa, ANBIMA (Brazilian Association of Financial and Capital Markets Entities), Cetip, BDS, MSCI, Dow Jones, Barclays Capital, FactSet. Brazilian Equities, Real Rates, Nominal Rates, Risk Free, World Equities, EMD (Emerging Market Debt) and Commodities returns are Ibovespa, IMA-B, IRF-M, CDI Cetip, MSCI All Country World Index, Barclays EM Corporates and DJUBS Commodity Index returns, respectively.



## Commodities prices

Agricultural products, metals and crude oil are leading Brazilian exports and approximately 40 percent of all exports are concentrated across five commodities:<sup>5</sup>

1. Soybeans represent 6.4 percent
2. Sugar is approximately 5.9 percent
3. Coffee is 2.4 percent
4. Iron ore and related products constitute 16.3 percent
5. Crude oil represents an additional 10 percent

The overall commodity price index has slumped approximately 13 percent since peaking in April 2011. Although the index is elevated when compared to historic levels, this will nonetheless present a challenge to Brazil as the economy adjusts to more normalized pricing and reduced global demand. From 2003 to 2012, the Real appreciated along with investor demand for Brazil. As the Real appreciated, Brazil's pricing advantages for global commodities deteriorated. To combat this, the government has allowed the Real to weaken over the past six quarters. The country's currency strategy has shifted to provide support for Brazilian exports and attract investment to modernize the country's infrastructure. The challenge for the government will be controlling inflation through rate increases that will potentially provide lift to the Real while managing to an overall need for a weaker currency to support local industry growth.

Brazil supplies approximately:



**41 percent**  
of the world's soybeans



**and one-third**  
of the world's coffee

FIG-04

### SELIC and Inflation

Sources: IBGE, Banco Central do Brasil, BM&FBovespa, J.P. Morgan Research forecasts

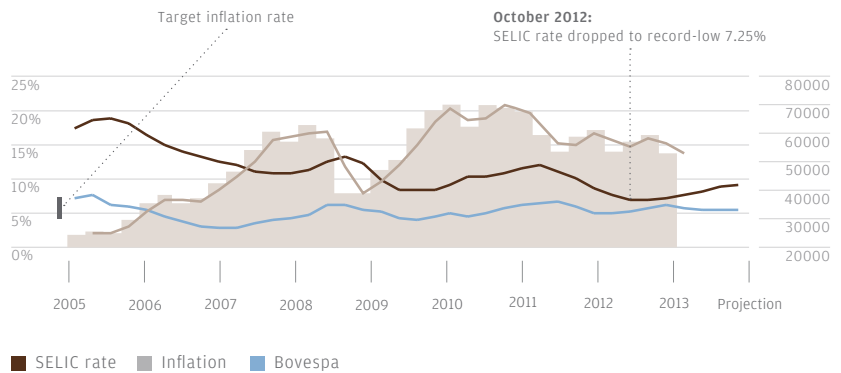


FIG-05

### Market Capitalization (% of GDP)

Sources: World Bank and IMF

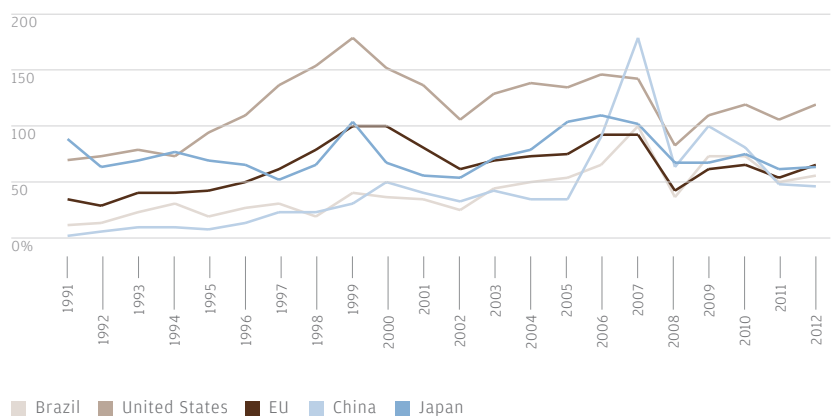
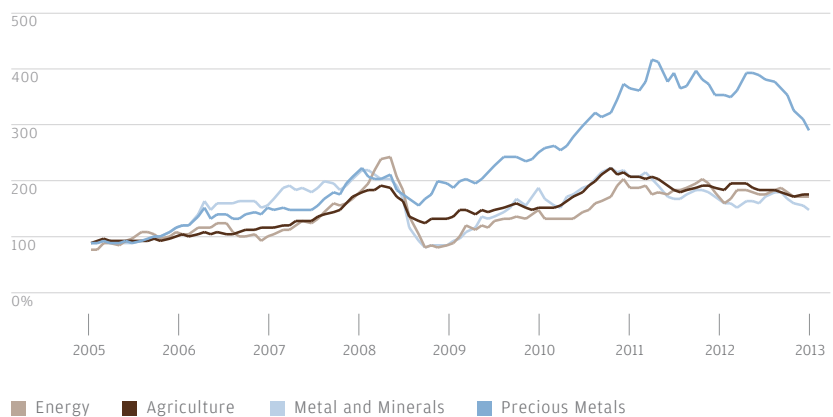


FIG-06

### Commodity Price Data

(Monthly indices based on nominal U.S. dollars, 2005=100, 1960 to present)

Source: World Bank



## GDP growth and broader fiscal policy

Brazil is a highly regulated market and the government uses a variety of tools to control demand and market activity. An array of taxes on imports, domestic manufactured goods, capital inflows and energy production are used at varying times throughout the economic cycle. Over the past several quarters, Brazil has significantly reduced taxes on capital inflows to provide additional incentives for investors focused on infrastructure projects. The government has also removed capital inflow taxes focused on “hot money” (defined as foreign capital chasing high, short-term interest rates). It has converted a sizeable payroll tax to a smaller domestic sales tax. The government has also implemented a 20 percent tariff reduction on electricity prices.

Although a number of measures have been installed to attract capital to critical areas of the economy, reduce employment costs and reign in prices, Brazil’s economic performance will reflect the performance of its key trading partners. Further slowdowns and muted recoveries among the countries listed in *figure 8* will have an adverse impact. Government policies and fiscal strategies can position the country for a recovery, but downstream linkages to certain key countries mustn’t be overlooked.

## Diversification through globalization

Inasmuch as the Brazilian government has taken an aggressive stance to combat inflation while providing stimuli necessary to jumpstart its economy, investors need to determine whether the risk/reward profile of a highly concentrated portfolio of Brazilian assets can be justified on a risk-adjusted basis. Key drivers of local economic performance and GDP growth have recently been under pressure. Rising interest rates will offset previous government efforts to inject capital into the economy

FIG-07

### Historic Exchange Rates

Source: J.P. Morgan (Brazil)

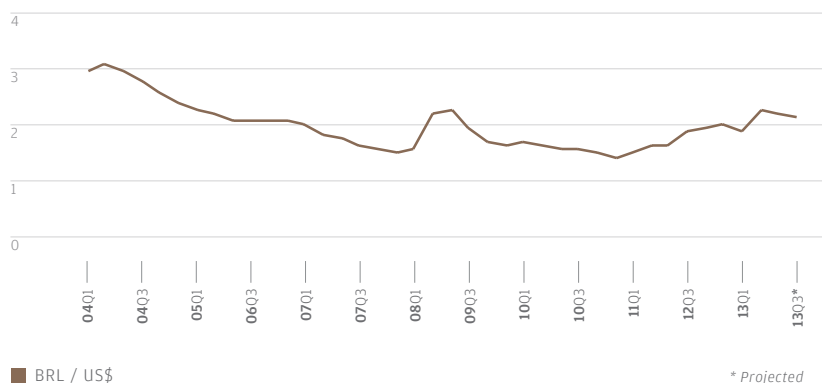


FIG-08

### Brazilian Export Partners

Sources: IMF and World Bank

	GDP Annual Growth (percent)				Percentage of Total Exports (2012)
	2011	2012	2013	2014*	
EU	1.6	-0.4	-0.1	1.4	18.6
China	9.3	7.8	8.0	8.2	15.7
U.S.	1.8	2.2	1.9	3.0	10.2
Argentina	8.9	1.9	2.8	3.5	6.8
Japan	-0.6	1.9	1.6	1.4	3.0
Russia	4.3	3.4	3.4	3.8	1.2

and stimulate demand. Relatively high tariffs on imports put additional inflationary pressures on consumer goods and higher inflation will negatively impact real rates of return. Falling commodities prices will impact important agricultural and mining segments of the economy. Several complex economic issues need to be addressed and the government is using its available tools to balance these moving parts.

Global markets and indices have outperformed Brazilian equity markets in each of the previous three years. Major asset owners in Brazil have significant pools of capital that

have been largely invested within the country’s borders. The nearly \$2 trillion of capital held by Brazilian insurance companies, pension funds and investment managers is minimally invested offshore. Part of this is due to regulatory restrictions that limit the amount that can be invested outside of the country.

Another driver is lack of experience and unfamiliarity with structuring vehicles and strategies necessary in providing diversification while safeguarding investments. Properly structured vehicles domiciled in jurisdictions with transparent investment fund regulations allow

## Trade and Exports



- Accounting for only 6.7 percent of Brazil's exports in 2007, trade with China has grown significantly in recent years.
- China consumes 45 percent of Brazil's iron ore and related products exports, as well as 66 percent of grains, seeds and fruits, of which soy is the largest component.



- Roughly 22 percent of mineral fuels and oils exports and 28 percent of iron and steel exports are destined for the U.S.
- Russia takes in a large portion of Brazil's meat and sugar exports, at 11.3 percent and 12.3 percent respectively.



asset owners to efficiently execute global investment strategies that will help them offset “Brazil-only” country risk. Whether individually (single participant in a single vehicle) or collectively (multiple participants in a single vehicle), Brazilian asset-owners should explore offshore investment strategies as a complement to their overall asset management goals. Following a full Brazilian recovery, offshore investment strategies should continue to receive allocations as part of overall diversification.

### thought

*Special thanks to Julia Harrigan for research contributions.*

- 1 Banco Central do Brasil.
- 2 IPCA: Inflation rate, standing for Índice Nacional de Preços ao Consumidor Amplo = Brazilian Consumer Price Index.
- 3 BCB: Denotes median of Central Bank of Brazil survey on inflation expectations.
- 4 The “asset allocation” portfolio assumes the following weights: 25 percent in Real Rates, 25 percent in Nominal Rates, 10 percent in Brazilian Equities, 10 percent in World Equities, 10 percent in Risk Free, 10 percent in Commodities and 10 percent in EM Debt. All asset class returns are in BRL currency. Past performance is not indicative of future returns.
- 5 International Trade Center, USDA, GlobalData, Brazilian Ministry of Development, Industry, and Foreign Trade, National Petroleum Agency.
- 6 Forecasted.

# Changing Dynamics of Global Distribution

A report from J.P. Morgan's roundtable

UCITS have become synonymous with global distribution as a means for asset managers to reach international investors. Recent directives and planned regulatory changes to cross-border products sold from Europe have therefore become a major topic of interest among international asset and alternative managers. In a panel discussion held on May 1, 2013, Patrick O'Brien of J.P. Morgan, with partners from PwC and Dechert, discussed the likely impact of these changes and other factors affecting the global distribution of cross-border funds.



**Patrick O'Brien**

*European Fund Services Executive  
J.P. Morgan (Dublin)*

Patrick is responsible for profiling and presenting J.P. Morgan's European Fund Services capabilities. He acts as a key liaison for J.P. Morgan's clients, designing and implementing appropriate fund structures to meet investors' needs across Luxembourg, Ireland and the Channel Islands.



**O'BRIEN:** *The international funds industry has largely developed through domestic products tailored for a local investor base. However, over the past 20 years we've seen the emergence of true cross-border funds distributing to in excess of 75 countries worldwide. There are now more than 500 fund managers running portfolio strategies with in excess of US\$4 trillion in products classified as cross-border. I'm joined by industry experts from PwC and Dechert to discuss the growth of these cross-border funds and how the changing regulatory landscape may impact the global distribution model.*



**Mark Evans**

*Partner  
PwC (Luxembourg)*

Mark leads the Global Fund Distribution service at PwC in Luxembourg where he specializes in distribution, regulatory and tax issues impacting cross-border investment funds.



**Andrew O'Callaghan**

*Partner  
PwC (Dublin)*

Andrew is an audit partner in the Asset Management group and Deputy Leader of Foreign Direct Investment in PwC Ireland, specializing in asset management/mutual funds. He also leads PwC's ETF group across EMEA.



**Christopher Christian**

*Partner  
Dechert LLP (Boston)*

Christopher is a partner in Dechert's Financial Services Practice Group in Boston where he advises offshore funds on compliance with U.S. regulatory requirements. Christopher also routinely counsels European retail and institutional funds on organization, registration, corporate governance and global distribution issues.



**Declan O'Sullivan**

*Partner  
Dechert LLP (Dublin)*

Declan is a partner in Dechert's Financial Services Practice Group in Dublin where he advises domestic and international clients in the establishment and authorization of all types of investment funds.

## Strong growth of cross-border funds to date

**O'BRIEN:** The UCITS funds' vehicle allows for a single fund to register for sale across multiple countries and has become synonymous with cross-border distribution. What's behind its success?

**O'CALLAGHAN:** The entire UCITS framework began in the mid-1980s with a simple concept to facilitate cross-border investment and the

free movement of capital within the European Union. Europe embraced this new initiative, opening the doors to allow the selling of products from other member states. In turn, this led to international recognition of UCITS vehicles. Other countries have since recognized UCITS as an appropriate vehicle for their investors. UCITS provide the benefits of global and segmental diversification to a broad

range of investors across Europe, Asia, Latin America and the Middle East.

"UCITS remain the most efficient way to access multiple local markets across the globe."

**Mark Evans**  
PwC

UCITS have managed to strike an effective balance between product efficiency and investor protection to support the growth and needs of an international investor base.

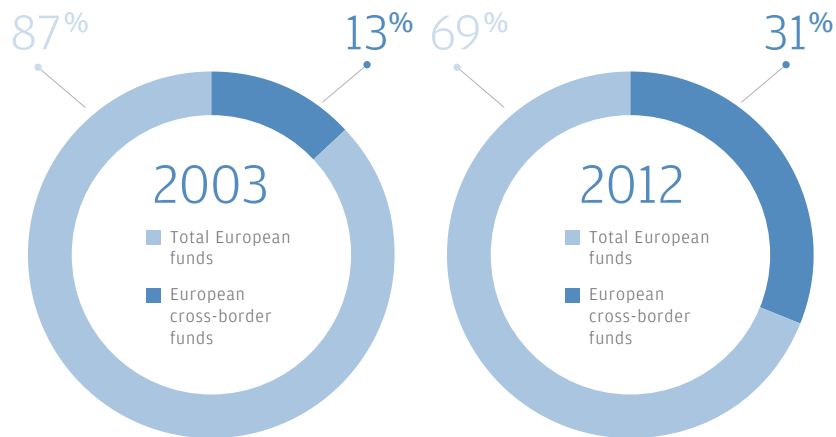
**O'BRIEN:** You can set up UCITS in every European country. So why have Ireland and Luxembourg become the domicile for true cross-border funds?

**EVANS:** The success of Ireland and Luxembourg as UCITS cross-border fund hubs is due to a combination of factors. The starting point is that their own domestic markets are very small, which means they can be totally focused on creating an industry framework to support and foster international funds distribution. The Irish and Luxembourg domiciles have been able to concentrate on creating product strategies and service models to support cross-border fund sales and meet the desires of investors in multiple countries. This is not the case in larger countries such as the UK, Germany or France, where the local fund industry must operate within more restrictive domestic parameters and focus on domestic investors' needs. It's very difficult for a jurisdiction to have both a domestic and international focus as these objectives can be in conflict. Moreover, there continues to be no real effective

FIG-01

Growth of the Cross-border Fund Industry: Assets under Management

Source: EFAMA International Statistical Release Q4 2012



competition to cross-border UCITS that are now sold across multiple regions. In fact the dominance of UCITS cross-border products has grown strongly over the past ten years. UCITS remain the most efficient way to access multiple local markets across the globe through a single fund structure with the potential to access global distribution volumes and achieve significant economies of scale. Of course, the question is whether this dominance will continue in the future.

“Ultimately, the key to AIFMD’s success, and any impact on the global distribution market, will be whether an AIFMD passport emerges and brings more product efficiency for alternative strategies.”

Andrew O’Callaghan  
PwC

FIG-02 A

Cross-border Fund Distribution  
Evolution of host country registrations held by cross-border funds

Sources: Lipper LIM and PwC analysis, December 2012

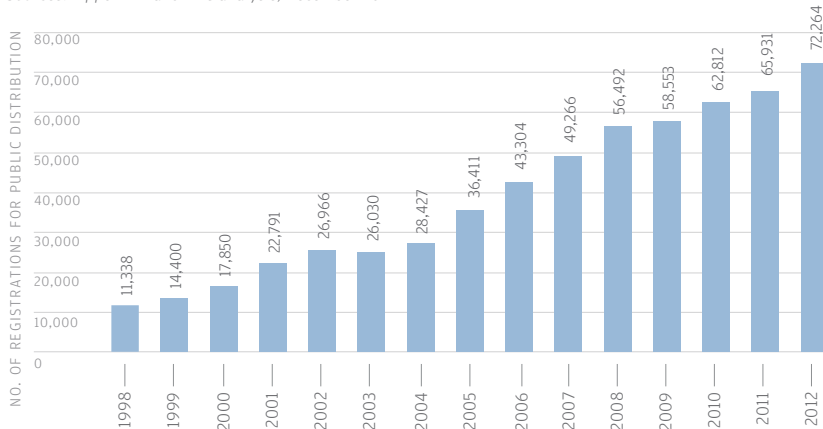
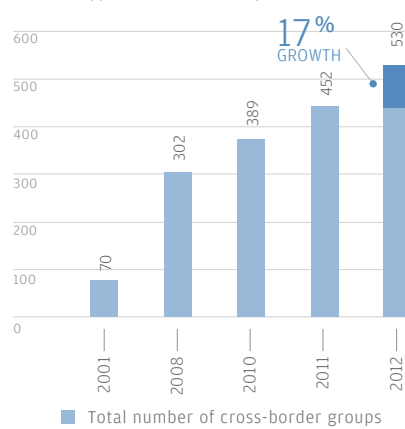


FIG-02 B

Evolution of Cross-border Fund Groups  
Very strong growth in total number of cross-border groups during 2012

Sources: Lipper LIM and PwC analysis, December 2012



# Evolution

**O'BRIEN:** UCITS are now celebrating 25 years in existence. During this time, we've seen a number of changes, some product enhancements and some regulatory requirements. Although the Alternative Investment Fund Managers Directive (AIFMD) relates to non-UCITS, it's also a key consideration for UCITS V and for global distribution in general. Why?

**O'SULLIVAN:** The upcoming UCITS V proposals are part of a drive to enhance investor protection around financial products. Further questions are raised by UCITS VI, which aims to look at the product anew and see whether retail product boundaries have been pushed too far with respect to product strategies. This might constrain the investment options within a portfolio that could use UCITS. We'd hope AIFMD could offset this in terms of having a passport for alternative products.

"AIFMD is more likely to create a brand in five to ten years' time."

**Christopher Christian**  
Dechert LLP

**O'CALLAGHAN:** Ultimately, the key to AIFMD's success, and any impact on the global distribution market, will be whether an AIFMD passport emerges and brings more product efficiency for alternative strategies.

**O'SULLIVAN:** But managers now need to consider AIFMD as part of their global distribution strategies when targeting Europe.

"The Retail Distribution Review has been hailed as the biggest shake-up within the UK financial services' history."

**Christopher Christian**  
Dechert LLP

"Managers now need to consider AIFMD as part of their global distribution strategies when targeting Europe."

**Declan O'Sullivan**  
Dechert LLP

**O'BRIEN:** So are we questioning whether AIFMD's passport benefit is a forgone conclusion? Surely it will be an enabler of cross-border distribution for alternative funds, making them more accessible to European investors?

**O'SULLIVAN:** I think the concept of passporting an alternative fund is already impacting distribution to European investors. The whole idea behind AIFMD is that regulated alternative funds should have the benefits of an EU passport. Over the past five to six years there's been an increasing number of funds launched as regulated alternative funds using the QIF fund structures in Ireland and SIF in Luxembourg. Whilst most alternative funds continue to be launched in locations like the Cayman Islands, there is growing institutional demand from European institutional investors for EU-regulated managers running QIFs and SIFs.

**O'CALLAGHAN:** I think the AIFMD passport will eventually emerge, but it could take five to ten years to mature.

**CHRISTIAN:** I agree—AIFMD is more likely to create a brand in five to ten years' time. There are 6,000 hedge funds out there; each one is different, so managers might be more attracted

to the differentiating benefits of having an AIFMD-branded fund than the passportability benefits.

**O'BRIEN:** This raises the question about the alternative methods available for managers to access their investor base—passporting versus private placement. What are the complexities around private placement and why is this important from the perspective of the global cross-border distribution model?

**CHRISTIAN:** Private placement refers to a private, non-public sale between an investment fund and individual investor. The way that private placement rules work depends on the type of fund wrapper and the country the investor is based in.

Whereas UCITS can be sold under national law subject to the public offering laws of the country, many countries don't allow for private placement of UCITS to retail clients on an offered basis—for example, France, Italy and, since July 2013, Germany.

So in over three of the largest markets, you can no longer privately sell UCITS to private investors. For Germany, this is a huge change as private placement has existed there for over 60 years. Until 2015 when AIFMD comes into force at the national level, the regime governing marketing to EU investors will depend on where the manager and the AIF are based.

Most countries in the EU are going to have to change their national regulation to incorporate AIFMD and will most likely close down private placement after a transitional period

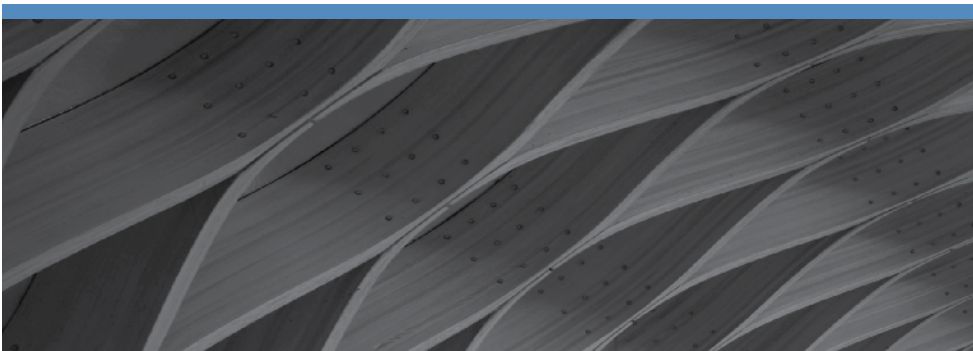
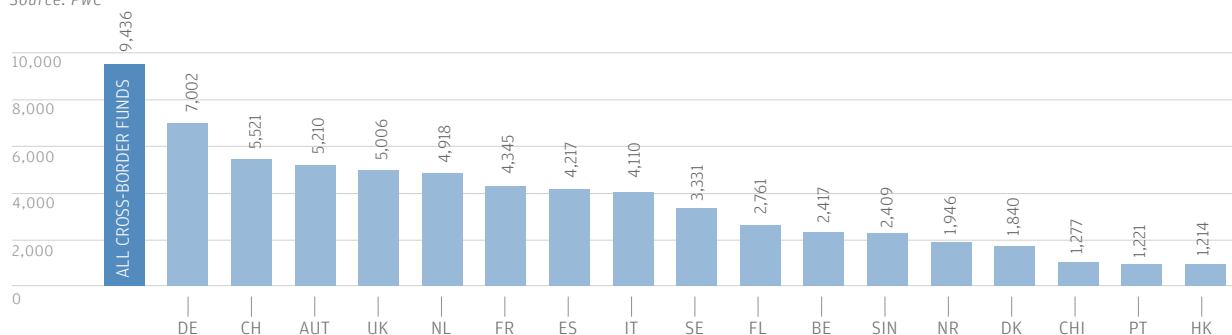


FIG-03

## Cross-border Fund Distribution

17 most popular target destinations (as of March 2013)

Source: PwC



between 2015 and when the EU can get the passport. There's going to be a maze of regulation which managers in the EU or outside will need help in interpreting. This will present challenges and will certainly change the dynamics of the global distribution model.

**O'BRIEN:** What impact is AIFMD likely to have outside of Europe and what is the future of UCITS outside of Europe?

**EVANS:** AIFMD may pose an underlying challenge to UCITS in some regions, especially in Asia if the AIFMD brand develops and becomes an attractive proposition for both asset managers and investors who may otherwise have contemplated a UCITS. Moreover, the tremendous success of UCITS in Asia could also be a challenge to its future market penetration and long-term sales success. We know that a number of Asian countries are

looking to strengthen their local fund industry, in part because they need to make their funds more competitive versus foreign products such as UCITS. Interestingly, some of them may seek to replicate parts of the UCITS model within their own investment funds' regulatory framework.

Moreover, with the potential of an Asian "fund passport" we're also seeing the emergence of bilateral reciprocal agreements among Asian countries to sell Asian-domiciled funds. These arrangements are also replicating parts of the investor protection and diversification rules that UCITS offer and potentially pose a long-term threat to the UCITS model.

Another potential challenge to UCITS distribution into Asia is the growing discussion around mutual recognition coming from a number of Asian countries. There's increasing pressure on the EU to look at some sort of reciprocal arrangements with Asian regulators. The EU

Commission is aware of this issue and considering how it can grant some kind of reciprocal UCITS distribution arrangement with key Asian markets. In the medium to long-term, it's unrealistic to think UCITS can keep coming to Asia and generating billions of euros of net sales from Asian investors into UCITS that are managed in Europe or the U.S. if Asian funds are excluded from the European investment market as a result of AIFMD. This is a very important point.

**O'CALLAGHAN:** It's difficult to assess what impact AIFMD will have outside of Europe. We've seen redomiciliation of some funds from non-EU domiciles to Ireland and Luxembourg. The mutual recognition agreement between Hong Kong and China is very interesting. UCITS currently account for over 80 percent of the funds sold in Hong Kong. In the future we're likely to see increased demand for both UCITS and Hong Kong-domiciled unit trusts.

## Retrocessions

**O'BRIEN:** The introduction of the Retail Distribution Review (RDR) in the UK also requires fund managers to adjust their sales channels and products for that region but is likely to spread across Europe. Is this a positive development for investor transparency or a threat to the open architecture?

**CHRISTIAN:** It's possibly too early to tell. The Retail Distribution Review has been hailed as the biggest shake-up within the UK financial services' history because it affects remuneration—how distributors, advisers, in particular, get paid. The RDR regime has brought massive

changes in that UK financial advisers can no longer get paid or earn commission from the product manufacturer for the sales of third-party or proprietary products. Financial advisers now have to charge their end consumers, which means that the best-of-breed products offered

at the lowest price are increasingly attractive. This is a positive impact for investors.

The UK RDR regime will probably spread throughout Europe as a result of MiFID II's provision governing the payment of retrocessions. This would then impact the retail bank distribution chain, the primary route in Europe for selling UCITS products. This is a key watch item for the future distribution model and main selling channels for European investors.

**EVANS:** I'm not convinced the UK RDR rules will spread across Europe, at least in their current form, as I think there's still a general reluctance to ban outright distribution retrocessions across Europe. Instead there seems to be a preference for increased transparency and disclosure around distributor remuneration. This is going to be one of the big issues over the next few years, especially with MiFID II and various local regulatory changes, for example in the Netherlands. The EU Commission is focused on getting retail

investors' confidence back into UCITS and fund products generally, so they're going to continue to look to either ban distribution retrocessions in various circumstances or modify disclosure rules of distribution remuneration.

"Ultimately the objective is to provide appropriate products to investors."

**Patrick O'Brien**  
J.P. Morgan

## The immediate future

**O'BRIEN:** What are the key considerations managers should think about when assessing their distribution plans?

**EVANS:** Currently UCITS remain more expensive to establish and run than alternatives funds. However, with AIFMD, this cost differential, at least for EU-based alternative funds, will be reduced. As an asset manager, if your investment strategy could fit in either structure you need to consider whether one structure is better than the other, the type of investors you want to target, where they reside and what the most efficient way of reaching them is. Let's face it; three quarters of cross-border funds are only sold in half a dozen countries and only about a third are sold in 20 to 30 countries. As such, it's essential to determine who you're going to sell to and how. Selling is going to become even more challenging in the future. I think it's going to remain difficult to get on fund platforms and engage third-party distributors.

"The EU Commission is focused on getting retail investors' confidence back into UCITS and fund products generally."

**Mark Evans**  
PwC

**O'CALLAGHAN:** I'd echo that. You shouldn't build a product and expect the investors to come. All products should be investor-focused. Understand the impact of global regulation and the opportunities to build a product for distribution and ultimate sale. Focus on what your competitive strengths are, where your connections are, your product and distribution channels—then put all your efforts behind them.

"You shouldn't build a product and expect the investors to come."

**Andrew O'Callaghan**  
PwC

**CHRISTIAN:** Before you consider your distribution, you need to review your investment strategy and performance and determine whether there's an appetite for your product and a distribution channel that works for you in that country.

You also need to decide whether you've got a product that can be successful from a cross-border perspective. The EU is a very difficult market to penetrate, so having a UCITS product doesn't automatically mean you'll be successful.

**O'SULLIVAN:** We're already beginning to see some implementation of AIFMD with the first AIFMs. Hopefully the larger managers are embracing AIFMD and the opportunities it offers.

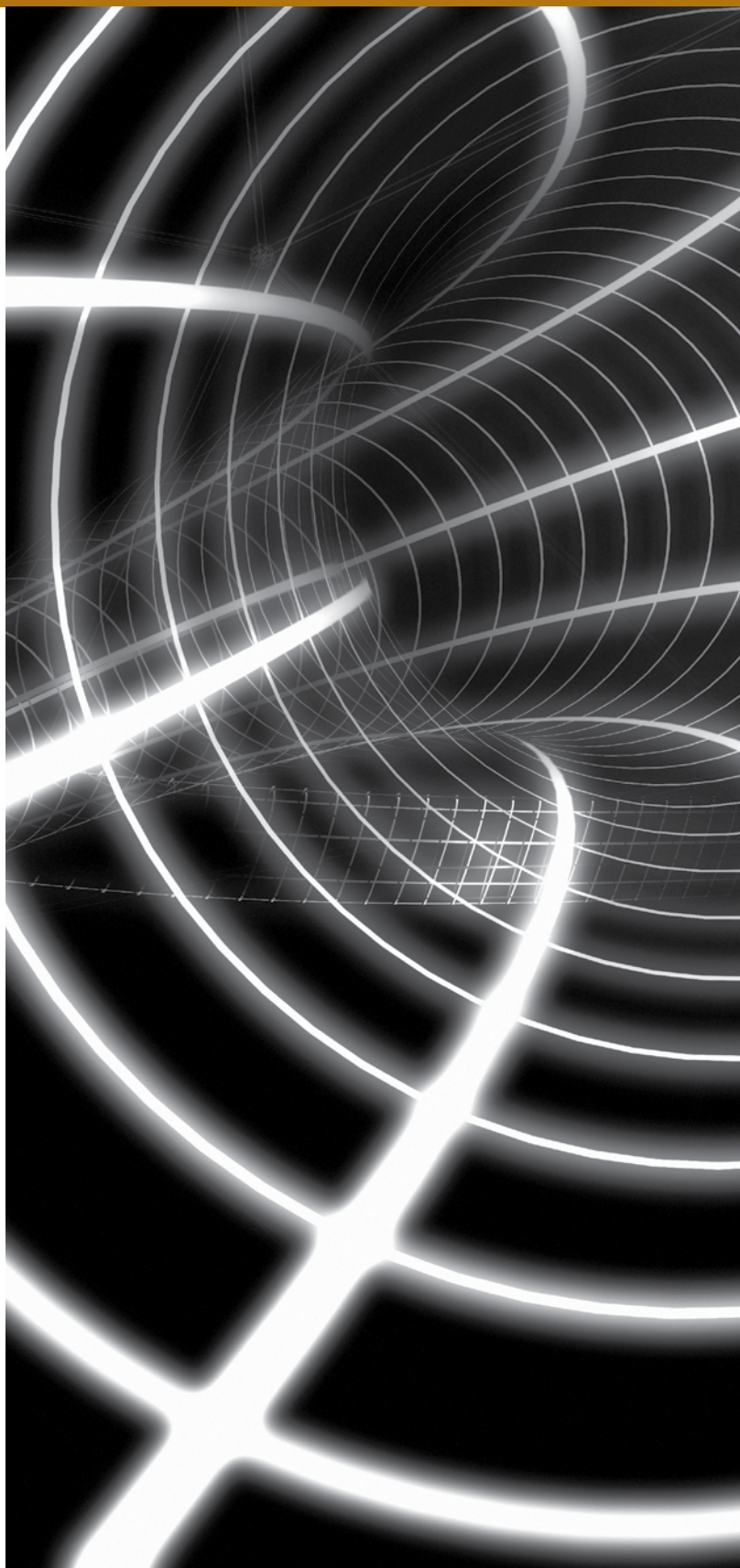
**O'BRIEN:** So in summary, managers need to consider many factors whether they're seeking to establish or are already providing cross-border distributing funds. In the longer-term, the establishment of an AIFMD sales channel is a possibility. However, in the short-term, product design and amendments to the UCITS framework appear to be at the forefront of managers' minds. Ultimately, the objective is to provide appropriate products to investors. As an industry, we need to monitor and adapt to all the imminent changes in the global distribution model to ensure we see the continued success of the UCITS brand. **thought**

“BY INTRODUCING A HEDGE FUND ALLOCATION TO THEIR PORTFOLIOS, DB PLANS MAY BE ABLE TO REDUCE VOLATILITY AND INCREASE DOWNSIDE PROTECTION.”



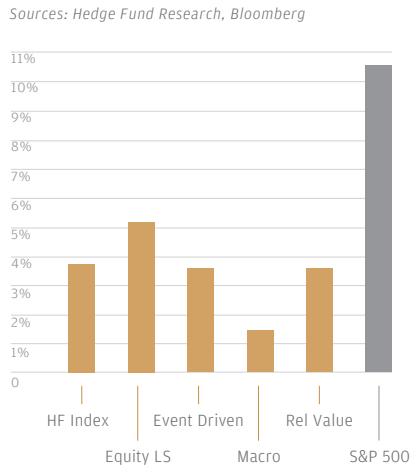
**Alessandra Tocco**  
*Global Head  
of Capital Introduction*

## Defined Benefit Plans and Hedge Funds: Enhancing Returns and Managing Volatility



In recent times, hedge funds have come under criticism because of their underperformance relative to the broader equity markets. In the first quarter of 2013, the major hedge fund strategies—equity hedge, relative value, event driven and global macro—lagged the S&P 500 Index by an average of 7 percent (see figure 1). In the aggregate, hedge funds trailed the S&P 500 Index by 6.74 percent during the quarter.<sup>1</sup>

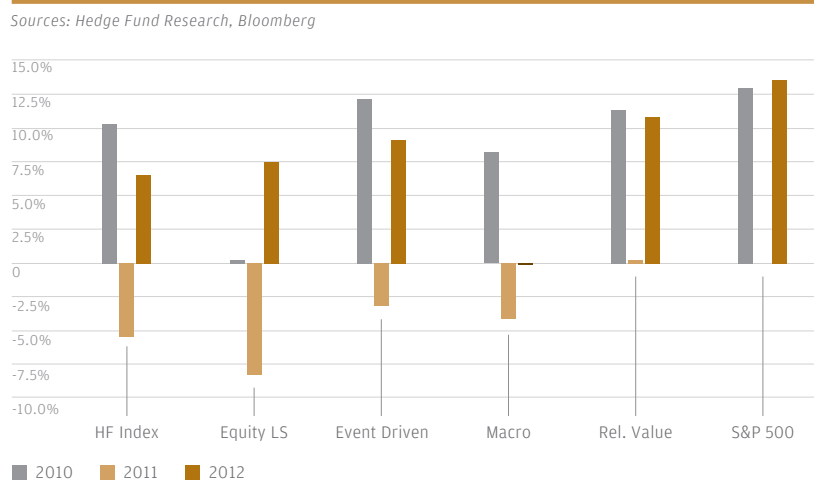
**FIG-01**  
S&P 500 Index vs. Hedge Fund Performance, 1Q 2013



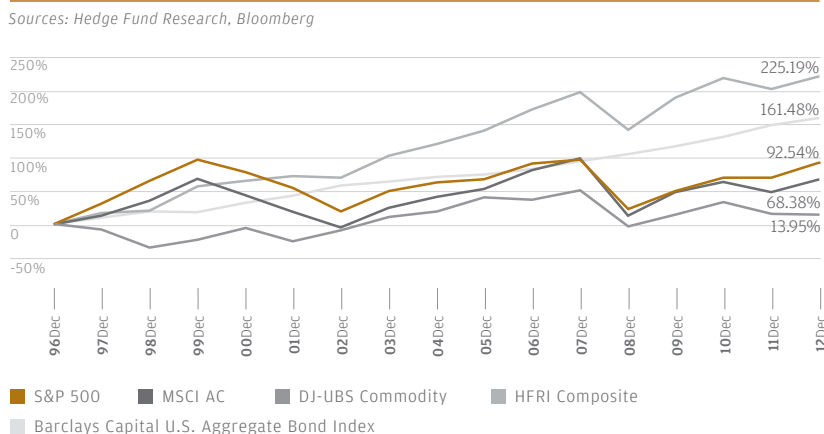
That pattern was not limited to the first quarter of 2013. The HFRI Fund Weighted Composite Index underperformed the S&P 500 Index by nearly 5 percent annually from 2010 through 2012 (see figure 2). This pattern reflects the run-up in equity markets as they rebounded from their post-crisis lows, receding tail risk as the sovereign crisis in Europe eased and gradual improvements in economic data.

Over a longer period, however, a different picture emerges. During the 16 years from 1997 through 2012, hedge funds delivered superior cumulative returns to domestic and international equities, commodities and fixed income by substantial margins (see figure 3).

**FIG-02**  
Equities vs. Hedge Fund Performance, 2010-2012



**FIG-03**  
Cumulative Hedge Fund and Other Risk Asset Returns, 1997-2012



### For Defined Benefit (DB) Pension Plans Considering or Re-evaluating Hedge Fund Allocations

1. Hedge funds historically have provided superior risk-adjusted returns over the long term relative to conventional asset classes despite their recent underperformance to traditional risk assets such as equities.
2. They offer lower volatility than long-only managers and may provide greater downside protection during times of market stress.
3. By adding hedge funds to their portfolios, pensions may be able to meaningfully reduce portfolio volatility over time and increase their Sharpe ratios across the market cycle. Hedge funds can also help pension plans mitigate steep drawdowns and, therefore, interruptions to the rate at which their portfolios compound.

During that same 16-year period, each of the major hedge fund strategy indices delivered higher annualized returns than the S&P 500 (see figure 4). In fact, over that time, hedge funds delivered superior annualized returns in comparison to conventional asset classes, including equities (see figure 5).

FIG-04

Annualized Hedge Fund Strategy Returns vs. S&P 500 Index, 1997 to 2012

Sources: Hedge Fund Research, Bloomberg

	Equity Hedge (%)	Event Driven (%)	Relative Value (%)	Global Macro (%)	S&P 500 (%)
Annualized Returns	9.80	9.51	8.36	7.75	6.08
Cumulative Returns	279.10	284.58	240.77	220.81	92.54

FIG-05

Annualized Hedge Fund Returns vs. Other Risk Assets, 1997 to 2012

Sources: Hedge Fund Research, Bloomberg

	Hedge Funds (%)	Bonds (%)	S&P 500 (%)	MSCI AC (%)	Commodities (%)
Annualized Returns	8.24	6.24	6.08	5.60	2.88
Cumulative Returns	225.19	161.48	93	68.38	13.95

Increasing returns with hedge fund allocations

Accordingly, adding a hedge fund allocation to a hypothetical portfolio consisting of 60 percent equities and 40 percent bonds would have meaningfully increased returns during those 16 years (see figure 6). A 25 percent hedge fund allocation would have increased the portfolio's annualized returns by 0.53 percent; adding a 50 percent allocation to the portfolio would have increased its annualized returns by 1.08 percent; and reducing the 60 percent/40 percent

equities/bonds allocation to 25 percent of the portfolio while increasing the hedge fund allocation to 75 percent would have increased the portfolio's annual returns by 1.64 percent. A portfolio comprised solely of hedge funds would have higher annualized returns of 2.21 percent.

Many pension plans understandably are focused primarily on hedge fund performance in the years subsequent to the financial crisis, believing the industry has changed fundamentally as a result of stricter oversight and increased conservatism among managers.

FIG-06

Hedge Fund and Traditional Asset Allocation Performance, 1997 to 2012

Sources: Hedge Fund Research, Bloomberg

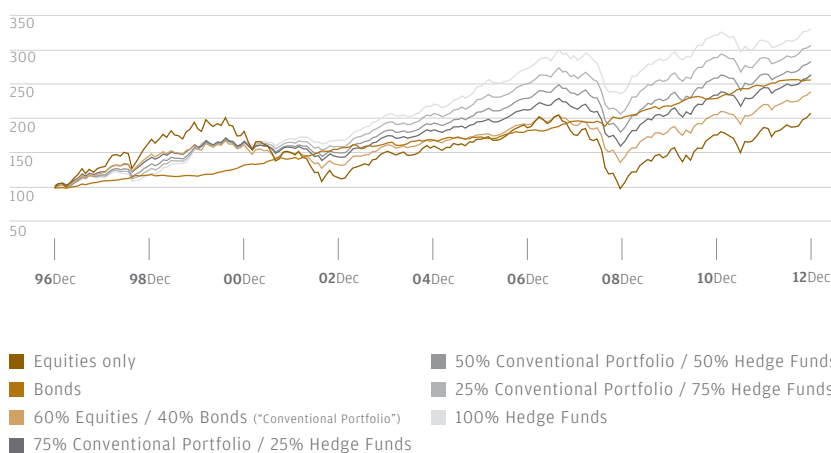


FIG-07

Hedge Funds' Asymmetric Return Profile in Comparison to Equities, 2009 to 2012<sup>3</sup>

Sources: Hedge Fund Research, Bloomberg

Strategies	Market Up	Market Down	Market Up	Market Down
	Avg Ret %	Avg Ret%	% Captured	% Captured
HFRI Composite	1.6%	-1.3%	41%	29%
Equity Hedge	2.1%	-2.1%	54%	48%
Event Driven	1.8%	-1.0%	46%	23%
Macro	0.6%	-0.6%	14%	13%
Relative Value	1.4%	0.0%	36%	0%
Short Bias	-3.4%	2.9%	-88%	-64%
Sys Diversified	0.3%	-0.4%	8%	10%
Distressed	1.7%	-0.7%	45%	15%
Merge Arbitrage	0.7%	-0.2%	19%	4%
Convertible Arbitrage	2.2%	-0.4%	58%	10%
Equity Neutral	0.5%	-0.6%	12%	14%
<b>S&amp;P</b>	<b>3.8%</b>	<b>-4.5%</b>	<b>32%</b>	<b>15%</b>



Accordingly, the remainder of this analysis centers largely on the post-crisis period.

During that time, from 2009 through 2012, introducing a hedge fund allocation to the hypothetical portfolio comprised 60 percent of equities and 40 percent of bonds would not have been additive. Adding a 25 percent hedge fund allocation to the portfolio would have reduced its annualized returns by -0.24 percent; adding a 50 percent allocation to the portfolio would have decreased its annual returns by -0.48 percent; and reducing the 60 percent/40 percent equities/bonds allocation to 25 percent of the portfolio while increasing the hedge fund allocation to 75 percent would have reduced the portfolio's annual returns by -0.72 percent. These results are partly the consequence of equities having rallied from their post-crisis nadir along with current central bank easing, which has pushed investors into riskier assets such as equities as they search for yield.

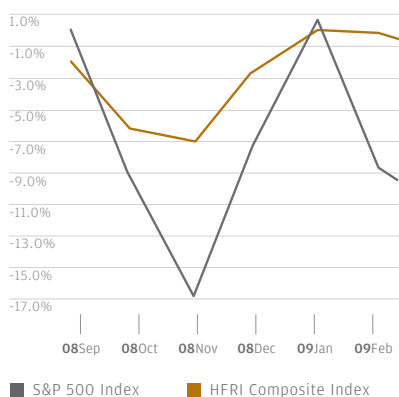
However, hedge funds still delivered superior risk-adjusted returns over the same time period with higher Sharpe ratios, lower volatility and steadier rates of compounding.

It should be noted, also, that over time hedge funds are able to avoid sharp drawdowns because, unlike conventional asset classes, they have an asymmetric return profile. This means they capture upside in rising markets, albeit to a lesser extent than equities, but they have smaller losses than equities during market declines (see figure 7). Hence, from 2009 through 2012, equities outperformed hedge funds by 2.3 percent on average when the market was up but were down by an average of -3.2 percent in excess of hedge funds when the market declined. Stated differently, hedge funds captured 41 percent of the upside during months when equity markets showed positive returns but only 29 percent of downside during months when equity markets produced negative returns.

FIG-08

S&P 500 and HFRI Composite Rolling Returns, September 2008 to February 2009 (Lehman Brothers crisis)

Sources: Hedge Fund Research, Bloomberg



### Volatility

Historic data show that hedge funds offer investors lower volatility than long-only managers<sup>4</sup> at different points in the market cycle and provide greater downside protection during times of stress. In 2012, for instance, the S&P 500 Index had 11 percent volatility in 2012 as measured by the standard deviation, whereas hedge fund volatility was only 5 percent. Moreover, while the S&P 500 experienced a maximum month-to-month drawdown of -6.3 percent in 2012, hedge funds recorded a maximum month-to-month drawdown of only -2.6 percent.

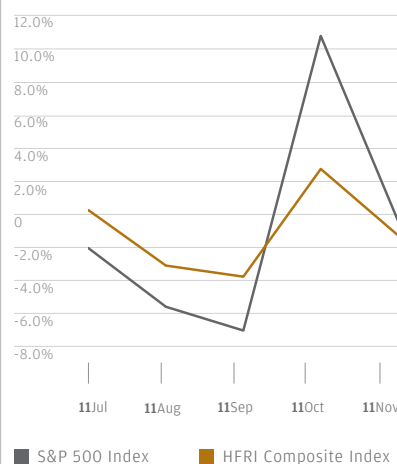
A similar pattern holds true during the years since the financial crisis. From 2009 through 2012, hedge funds delivered consistently less volatility than equities and provided greater downside protection to mitigate losses. Further, hedge funds had a maximum month-to-month drawdown of -3.9 percent as compared with -11.0 percent for the S&P 500.

Historic data suggests that hedge funds also provide investors with greater downside protection during acute periods of market stress. For instance, from September 2008 through February 2009, the period surrounding the collapse of Lehman Brothers, the S&P 500 Index had a maximum month-to-month drawdown of -16.9 percent. Hedge funds, by contrast, had a maximum month-

FIG-09

S&P 500 and HFRI Composite Rolling Returns, July to October 2011 (U.S. downgrade and EU debt crisis)

Sources: Hedge Fund Research, Bloomberg



to-month drawdown of -6.8 percent (see figure 8).

Moreover, throughout that period, during which the VIX monthly average was 43.77, the monthly volatility of the S&P 500 was 19.19 percent whereas hedge funds had month-over-month volatility of only 9.21 percent.

Similarly, from July through October of 2011, amidst the U.S. downgrade and the EU debt crisis, the S&P 500 and the HFRI Fund Weighted Composite had maximum month-to-month drawdowns of -7.18 percent and -3.89 percent, respectively (see figure 9). Hedge fund volatility (5.79 percent) was again materially lower than equity volatility (17.79 percent).

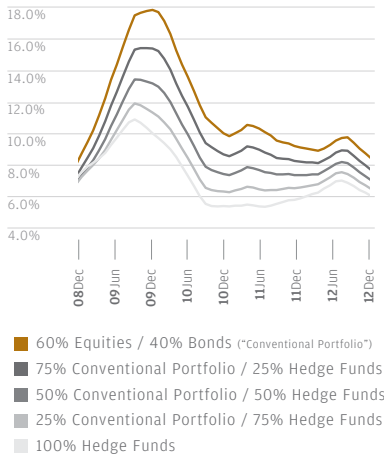
### Managing volatility with hedge fund allocations

Because hedge funds provide stable returns on a relative basis, investors can use hedge fund allocations to reduce the volatility of their overall portfolios. As figure 10 demonstrates, adding hedge funds to a hypothetical equity portfolio would have meaningfully reduced its volatility during the period from 2009 through 2012. Adding a 25 percent hedge fund allocation to a hypothetical 60 percent/40 percent equities/bonds

FIG-10

Portfolio Composition and Volatility

Sources: Hedge Fund Research, Bloomberg



portfolio would have reduced its month-over-month volatility by -1.11 percent; reducing the 60 percent/40 percent portion to 50 percent while raising the hedge fund allocation to 50 percent would have decreased volatility by -2.06 percent; reducing the 60 percent/40 percent allocation to 25 percent while raising the hedge fund allocation to 75 percent would have decreased monthly volatility by -2.81 percent; and a portfolio comprised solely of hedge funds would have had -3.29 percent less volatility.

Over time, lower volatility along with downside protection may allow for fewer and less pronounced interruptions to the rate at which a portfolio compounds. In sum, hedge funds can help pensions to achieve “steadier state” investing.

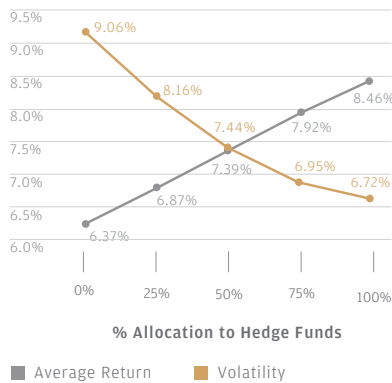
Risk-return

With stable returns and low volatility, hedge funds have produced an attractive risk-return profile over time. As figure 11 illustrates, introducing a hedge fund allocation to a hypothetical portfolio consisting initially of 60 percent/40 percent equities and bonds not only curtails volatility but also adds incrementally to returns.

FIG-11

Risk-return Profile of Conventional Portfolio with Addition of Hedge Funds

Sources: Hedge Fund Research, Bloomberg



Given their risk-return profile, hedge funds have yielded superior overall Sharpe ratios to equities in the years subsequent to the financial crisis. Over that period, hedge funds had higher Sharpe ratios than equities in two of the four years while equities had superior Sharpe ratios during the other two years. During that time, though, hedge funds had an average Sharpe ratio of 0.89 compared with 0.58 for equities. Over a longer horizon, from 1997 through 2012, hedge funds delivered higher Sharpe ratios than equities 68.8 percent of the time. During that extended period, hedge funds had a Sharpe ratio of 0.9 versus 0.3 for equities.

Enhancing investment returns

Institutional investors face the twin pressures of needing returns while avoiding significant volatility. Pensions are therefore under pressure to target investments that can meet their targeted rates of return without taking undue risk. Hedge funds certainly offer no silver bullets but they may be able to help pension plans enhance investment returns over the intermediate and long term. Additionally, by introducing a hedge fund allocation to their portfolios, DB plans may be able to reduce volatility and increase downside protection.

Less volatility and smaller drawdowns will meaningfully boost the rate at which pensions’ portfolios compound. Over time, hedge funds can enable pensions to increase the risk-return profile of their portfolios. Steadier compounding will better prepare pension plans to meet their funding obligations to current and future retirees. **thought**

- 1 As measured according to the HFRI Fund Weighted Composite Index.
- 2 HFRI Equity Hedge Index, HFRI Event Driven Index, HFRI Relative Value index and HFRI Macro (Total) Index.
- 3 It should be noted that the capture ratio averages shown in figure 7 do not include short bias or the HFRI Composite.



Rachel C. Sykes, CFA

*Product Executive  
Americas Fund Services*

“IT SEEMS REASONABLE FOR BOARDS TO EXPECT CONTINUED ATTENTION FROM REGULATORS. AS SUCH, POLICIES AND PROCEDURES SHOULD BE THOUGHTFULLY REVIEWED AND VALIDATED REGULARLY.”

## Board Governance— Ever Raising the Bar



Board members at U.S. mutual fund companies may be feeling under pressure these days. With recent high-profile SEC enforcement actions and the resulting news headlines, fund directors have come under increasing scrutiny. There is interest from regulators for greater clarity on valuation, disclosure of fees, adherence to policies and procedures, and concerns about delegation of duties.

### **Aftermath of the financial crisis**

Many retail investors in registered funds experienced significant losses during 2008 and 2009. In fact, some investors claimed they were not aware that their fund investments were so risky and subject to such large declines in value, given the types of securities in which they were invested and the strategies employed. Some of these claims have been investigated by regulators to see if investment firms, advisors or boards of directors were liable for breaches of law and fiduciary duties.

## Fee disclosures

It appears to be a regulatory priority to improve and clarify the disclosure of all fees and/or expenses for the investing public. In addition, academic research has shown that investors, as a broad class, may be underperforming on an after-fees' basis, and that investors may not have all the information necessary to assess actual investment performance.

For example, in an article by Charles Ellis,<sup>1</sup> the argument is made that there are no other services that charge such a high premium for the value of the service provided, particularly for actively managed funds. Explicit disclosure of section 12b-1 distribution fees—those fees paid by the fund out of fund assets to cover distribution expenses and sometimes shareholder service expenses—was made mandatory in 2010, and pressure continues to favor increasing clarity.

In addition, the investing public is aware that mutual funds charge higher fees to retail investors than to large institutions. In a 2012 study, authors Richard Evans and Rüdiger Falhenbrach found that retail funds with an “institutional twin” (where advisors offer multiple versions of a fund) underperform their institutional counterparts by 1.5 percent on a risk-adjusted annual basis. In addition, these authors found that when a retail fund gains an institutional twin, the fund's expenses decrease and measures of managerial effort increase.

## Lack of transparency on director pay

Investors do not appear to have a clear understanding of the work that directors perform on behalf of the fund, and how that ties to director compensation. This lack of clarity becomes even more concerning during periods of underperformance. In addition, many directors serve on multiple boards, particularly within the same fund complex. The investing public may not understand how a director can perform the appropriate level of due diligence for multiple funds. Providing insight into the responsibilities borne by directors and the actual burden of work may serve to put things in perspective.



## SEC Exam Priorities

Last February, the SEC issued their examination priorities for 2013 for the National Exam Program's Office of Compliance Inspections and Examinations. This fourteen-page publication clearly documents some major issues of concern and highlights fund governance as a focus. The following is noted as an ongoing risk in the Investment Adviser/Investment Company Examination program:

*Fund governance and assessing the “tone at the top” is a key component in assessing risk during any investment company examination. The staff will confirm that advisers are making full and accurate disclosures to fund boards and that fund directors are conducting reasonable reviews of such information in connection with contract approvals, oversight of service providers, valuation of fund assets, and assessment of expenses or viability.*

## A few best practices in board governance

**Valuation**—Against the backdrop of recent enforcement actions (see *figure 1*), valuation continues to be an area of focus for regulators. It seems clear that directors need to be actively involved with setting appropriate practices and policies. It is not sufficient to outsource this responsibility to others, although other professionals may be involved in the execution of these duties. Not only may funds be held responsible, but the board may be liable as well.

**Conflicts of interest**—One important policy to address regards conflicts of interest. Boards should put in place a solid and thoughtful process to identify and monitor potential and actual conflicts of interests. This review should not simply be a once-off occurrence but rather incorporated as part of an ongoing process. Boards should also ensure that these issues are then rigorously and regularly documented and disclosed.

**Policies and procedures**—Boards should have an oversight process in place that outlines the policies applicable to the fund, its managers and the board.

**Delegation of duties**—If a particular expertise is required that is not present in the board's composition, it can often be appropriate to engage with a subject-matter expert to assess, and even perform, some of the oversight work. However, while one may delegate the task, the board retains responsibility for the actual practices and their execution. As such, directors must be able to document the decision-making process, policies and procedures and also demonstrate that the appropriate level of oversight is performed. As noted in the Morgan Keegan case, *figure 1*, valuation remains a key function and a high priority to the SEC. Specifically, while boards may employ experts to perform the required valuations, they should possess or obtain the requisite knowledge in the subject area and demonstrate regular and reasonable oversight.

Boards should put in place a solid and thoughtful process to identify and monitor potential and actual conflicts of interests.

FIG-01

## Three Recent SEC Cases Involving Valuation

### Morgan Keegan:<sup>4</sup>

Eight former fund directors of Morgan Keegan were charged by the SEC on a number of valuation-related charges in December 2012. It was alleged that the board delegated the responsibility for determining valuations without providing direction or retaining oversight. It was further alleged that the directors made no efforts to understand the fair value process and relied on a valuation committee and the firm's fund accountants.

### Yorkville Advisors:<sup>5</sup>

In October 2012, hedge fund adviser Yorkville Advisors was charged with fraud related to suspicious fund performance. The regulator alleged that the hedge fund misrepresented the characteristics of the fund and its related valuation methodology and charged excessive fees based on over-inflated performance returns, among other charges.

### Oppenheimer:<sup>6</sup>

On March 11, 2013, the SEC found that Oppenheimer provided misleading valuation and performance information. The actual valuation practices were not consistent with the stated policies, resulting in overstated performance results. The regulator also found that the policies and procedures were not reasonably designed to ensure valuations were presented as stated. The firm settled with the regulator for \$2,800,000 and was similarly penalized by the Commonwealth of Massachusetts for approximately \$130,000.

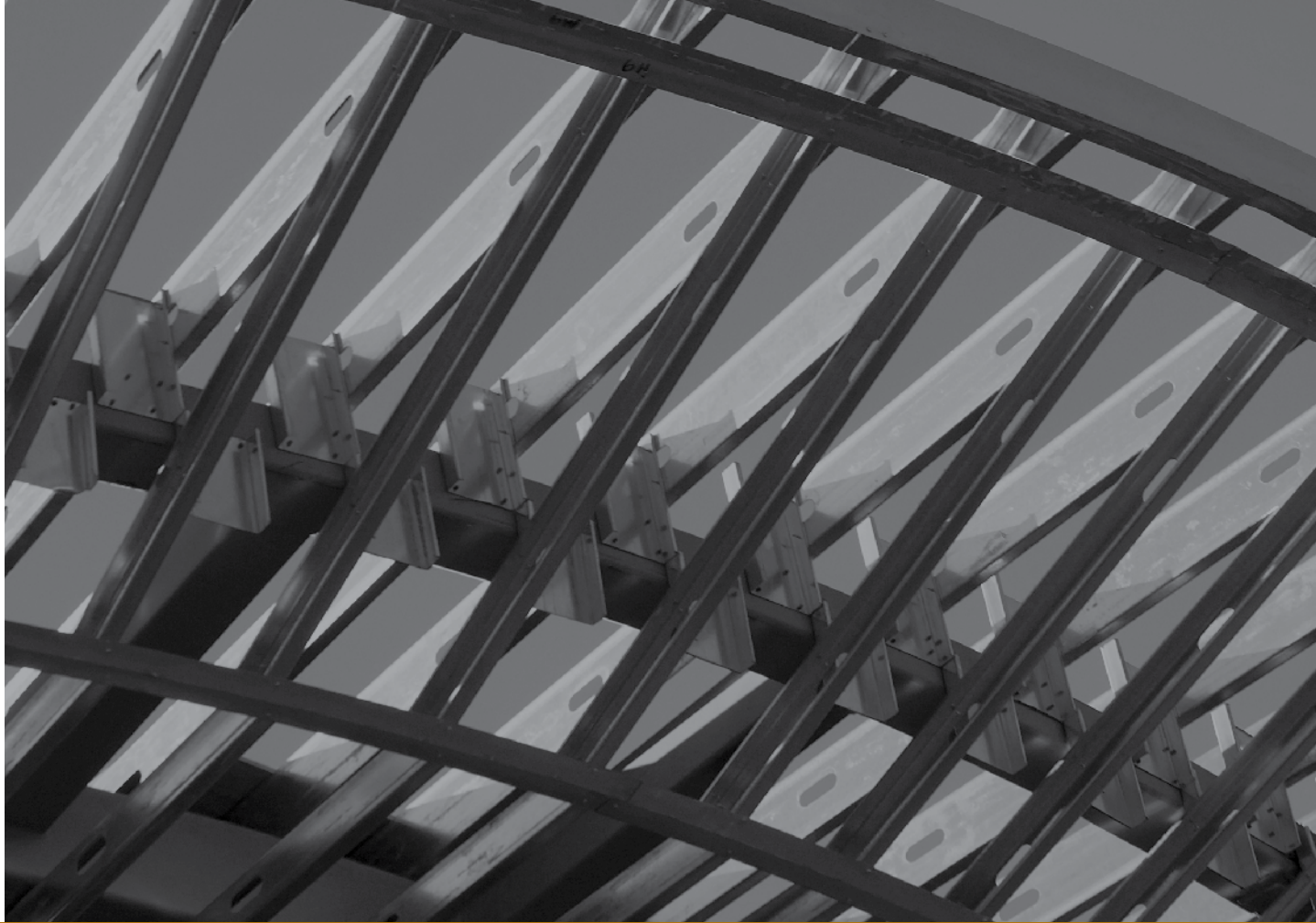
**Board composition**—Investors are seeking qualified, independent directors with minimal conflicts of interest. Boards are responsible for a broad range of functions, including the assessment of fund manager performance, review of manager contracts, oversight of manager adherence to fund registration and investment guidelines, and reviews of prospectus documentation, regulatory filings and compliance results. The composition of a board should be reviewed, and it should be considered if it is appropriate to enhance the diversity of experience represented in its composition.

**Transparency of fees**—Investors should be provided with access to simple, clear data regarding all fees for which they may be responsible. Investors also should feel confident that they are paying a reasonable fee for the benefits received in terms of investment returns. Ensure that fees are in keeping with current standards and are clearly communicated. Investors should be permitted to see the impact of these fees on their total absolute and relative returns to allow for fair comparisons. The pay structure should be disclosed for both board members and investment managers, demonstrating the performance-based components and/or incentives.

In conclusion, it seems reasonable for boards to expect continued attention from regulators. As such, policies and procedures should be thoughtfully reviewed and validated regularly.

Diligent compliance practices should be visible in all parts of the organization and demonstrate a clear understanding of client needs. Regulators have clearly documented their priorities, and funds should be prepared to meet them. **thought**

- 1 Charles D. Ellis, CFA, *Financial Analysts Journal*, vol. 68, no.3, "Investment Management Fees Are (Much) Higher Than You Think," May/June 2012, [www.cfainstitute.org](http://www.cfainstitute.org).
- 2 Richard B. Evans and Rüdiger Fahlenbrach, *CFA Digest*, vol. 43, no. 2, "Institutional Investors and Mutual Fund Governance: Evidence from Retail-Institutional Fund Twins," May 2013, [www.cfainstitute.org](http://www.cfainstitute.org).
- 3 National Examination Program, Office of Compliance Inspections and Examinations, "Examination Priorities for 2013," February 21, 2013, page 4, [www.sec.gov](http://www.sec.gov).
- 4 United States of America Before the Securities and Exchange Commission In the matter of J. Kenneth Alderman, CPA; Jack R. Blair; Albert C. Johnson, CPA; James Stillman R. McFadden; Allen B. Morgan Jr.; W. Randall Pittman, CPA; Mary S. Stone, CPA; and Archie W. Willis III, respondents, Release No. 30300/ December 10, 2012, [www.sec.gov](http://www.sec.gov).
- 5 United States District Court Southern District of New York Securities and Exchange Commission, Plaintiff, against Yorkville Advisors, LLC, Mark Angelo, and Edward Schinik, [www.sec.gov](http://www.sec.gov).
- 6 United States of America Before the Securities and Exchange Commission In the matter of Oppenheimer Asset Management and Oppenheimer Alternative Investment Management, respondents, March 11, 2013, [www.sec.gov](http://www.sec.gov).



# The Securities Lending Industry in 2013 –Turning Crisis into Opportunity

In 1959 John F. Kennedy said, “In the Chinese language, the word ‘crisis’ is composed of two characters, one representing danger and the other, opportunity.”<sup>1</sup>

For the securities lending business, both aspects of that statement are significant. Market participants need to be attuned to the challenges and risks to their activities. However, they also need to be able to navigate these to exploit the opportunities that exist in a climate that might otherwise only be viewed as negative. The financial crisis of 2008 and its immediate aftermath are behind us, and while some participants have fallen by the wayside or have completely

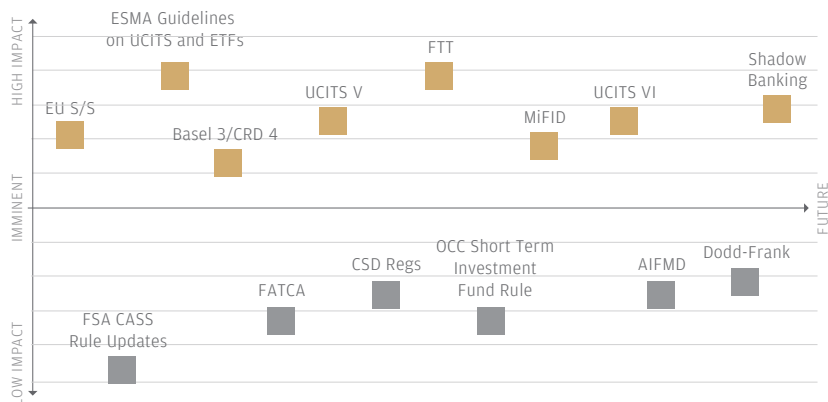
disappeared, others have survived, recalibrated their business models and even thrived.

These themes are under constant scrutiny within organisations, as the regulatory environment relating to the securities lending business continues to develop while multiple jurisdictions and regulators propose and implement new regulations. The potential impact of these regulatory measures on the securities lending business is illustrated in *figure 1*.

FIG-01

## Impact of Regulatory Measures on the Securities Lending Industry

Source: J.P. Morgan Investor Services, July 2013



### A sounder footing for securities lending

Notwithstanding the regulatory backdrop, the securities lending business has clearly evolved. At J.P. Morgan's inaugural Securities Lending Forum held in February, Kevin McNulty, CEO of the International Securities Lending Association (ISLA) commented that "the securities lending industry has developed onto a sounder footing and can adapt to the new environment in which regulatory reform is at the epicentre of events."

Market data clearly shows that between 2010 and 2013 there has been a significant increase in the lendable inventory that is available in the market, even allowing for market lift. Our own experience at J.P. Morgan during 2012 confirms this trend—we saw a number of new beneficial owners joining our programme, particularly from the Nordic region. So there are a greater number of lenders in the business today and more supply is being made available.

But the real story remains the depressed state of the demand side of the supply-demand equation with loan volumes being, at best, flat in real terms. McNulty also described how the relationship between loans conducted against cash and non-cash collateral has inverted. Sixty percent of the business is now being

transacted against securities or non-cash collateral as beneficial owners have been attracted to the most secure forms of collateral in the wake of the financial crisis. McNulty went on to speculate whether the much-vaunted collateral shortfall, predicted in the light of the clearing reforms envisaged under Dodd-Frank and EMIR, would create new opportunities for growth. Hundreds of billions of dollars' worth of CCP-eligible securities remain available but un-lent in global securities lending programmes, as agents and beneficial owners alike weigh the risks and rewards associated with lending these highly rated securities against more diversified and lower quality collateral.

### Industry response to regulatory changes

These are challenging times for an industry body such as ISLA. The volume of work associated with representing its members' interests is rapidly multiplying. While the dialogue between the industry and regulators is positive and constructive, it is clear that more beneficial owner involvement would be desirable. One has only to look at ESMA's website and the lack of beneficial owner responses lodged to the consultation on ESMA's regulatory guidelines for ETFs and other UCITS issues, to see that collectively the industry needs to invest more time



Paul Wilson

Global Head of Agent Lending Product and Portfolio Analysis

“WHILST THE SECURITIES LENDING INDUSTRY CONTINUES TO EXPERIENCE SIGNIFICANT CHANGE, OPPORTUNITIES ARE ALSO APPARENT.”

in supporting the work of its trade association.<sup>2</sup> Beneficial owners and stakeholders clearly have an important role to play in augmenting the work of ISLA and helping to shape the way the industry develops.

The market consensus now seems to be that the proposed EU short-selling rules and Financial Transaction Taxes (FTT) on repo, securities lending and collateral movements are likely

to negatively impact borrowing, financing and repo. These regulations are also likely to affect the securities lending market in general, producing important revenue streams for long-term investors (notwithstanding the critical role that securities lending is acknowledged to play in the provision of liquidity to secondary markets for bonds and equities). Since ISLA calculates that more than 65 percent

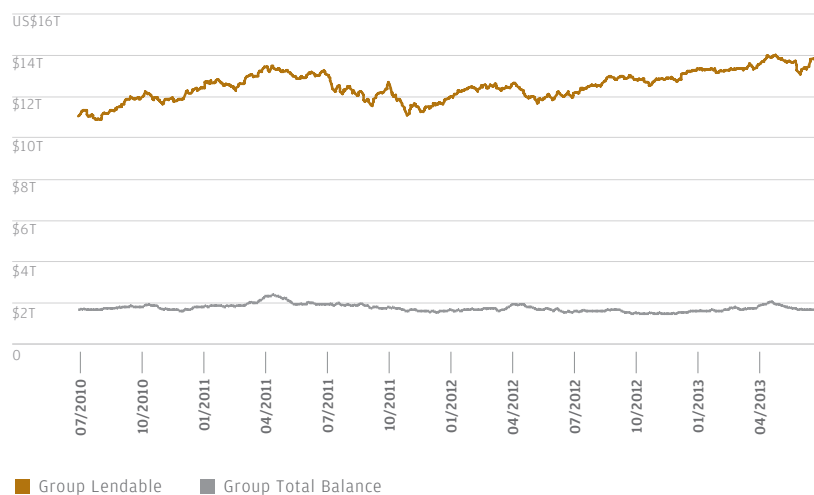
of the European securities lending market would be directly impacted by FTT, it is clear that a consistent approach is required to introduce these measures in a coordinated and sensible way.

The development of CCPs is another area where market participants, driven by risk considerations and regulatory sentiment, remain divided. This divergence of views was again illustrated at J.P. Morgan's Securities Lending Forum. When polled, 46 percent of the audience felt that the mandatory introduction of CCPs for securities lending was unlikely and a further 68 percent felt that the use of CCPs for securities lending is undesirable. Commenting on these results, a representative from the Bank of England said, "this doesn't surprise me at all. The challenge of getting CCPs to work in such a heterogeneous market is huge."

FIG-02

### All Securities: Lendable versus Total Balance

Source: Markit Group Limited, July 2013

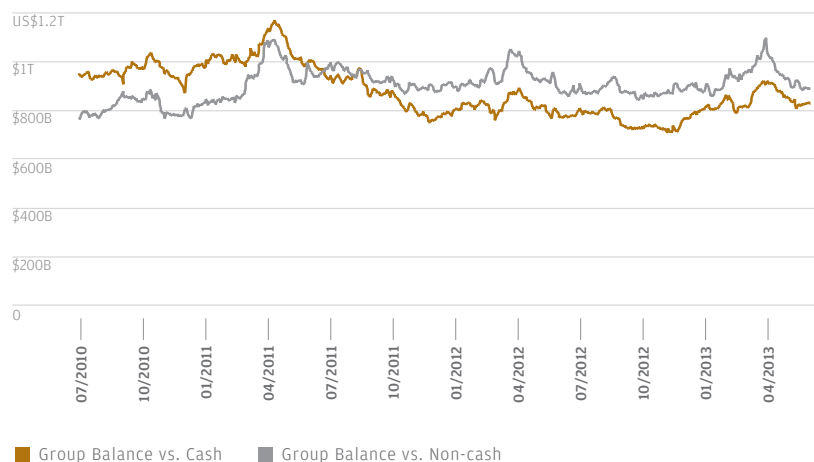


Market data clearly shows that between 2010 and 2013 there has been a significant increase in the lendable inventory that is available in the market, even allowing for market lift.

FIG-03

### All Securities: Cash versus Non-cash Balances

Source: Markit Group Limited, July 2013



In contrast, enhanced transparency is generally seen as a good thing for securities lending, a business that has long been viewed as niche, secretive and opaque. The post-crisis world has evolved, and it is generally recognized that service providers have made great strides in providing not only more information, but relevant information that can be rapidly accessed in at-a-glance, dashboard-style formats. A healthy 74 percent of those polled at J.P. Morgan's Securities Lending Forum felt that more disclosure to investors will help to build lenders' confidence in the stock loan market and thereby help it grow.



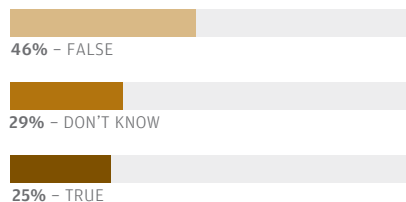
FIG-04

## Sampling the Mood of the Industry: J.P. Morgan's European Securities Lending Forum

February 2013

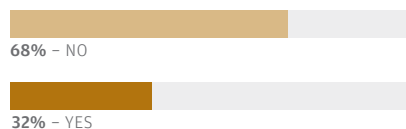
### Question 1

True or false? The mandatory use of CCPs for securities lending is inevitable.



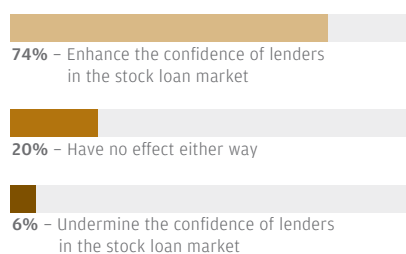
### Question 2.

Is the use of CCPs for securities lending desirable?



### Question 3.

Increased transparency (i.e., disclosure to investors) will:



## Opportunities ahead

So although the regulatory and macro-economic environment remains challenging, we agree with ISLA's view that the securities lending industry has moved onto a sounder footing and believe that attractive opportunities can be found within selective areas. Calendar year 2012 was certainly characterised by beneficial owners displaying a healthier appetite for securities lending than at any time since 2008. Whilst none of them are in the business of taking on inappropriate risks, they are willing to investigate the re-calibration of their programmes to capture the available incremental revenue. Specific areas of focus are:

#### 1) Yield enhancement—

Notwithstanding a challenging and volatile market, opportunities remain in Japan, Australia (DRIP trading) and the traditional European markets of Germany, France, Sweden, Switzerland and Finland.

#### 2) Flexible collateral strategies—

As beneficial owners review their securities lending programmes, they are increasingly considering alternative forms of collateral to the highest grade and safest forms of government assets, such as equity indices. Recognizing that managing a diversified pool of collateral is not in itself an additional risk creates opportunities to work with agents and borrowers alike to extract value within closely managed and appropriate client-defined guidelines. Some of this activity is related to the collateral transformation debate, whereby beneficial owners are not now just asking "can I lend my securities?" but are increasingly posing questions around the ability of their investment portfolios to generate collateral that can be used to pledge against CCPs and derivative transactions.

"Securities lending provides useful fee income to USS that helps to offset operational costs and provides a vital source of liquidity to financial markets."

**Leandros Kalisperas**  
Universities Investment Management Limited (USS), July 2013

#### 3) Emerging markets—

Securities lending traditionally follows demand-driven flows, which in the last three or four years have been into emerging markets, both in bonds and equities. Asian securities lending markets, such as Taiwan, Korea and Malaysia, continue to provide lucrative revenue streams, and in Latin America, Brazil offers good value. Additionally, there are a number of markets that remain under review, including Russia, Indonesia, India and China.

These frontier markets are often structured very differently to European and U.S. markets and frequently have operational hurdles that need to be overcome so that agency lending can take place. Nonetheless, a first-mover advantage undoubtedly reaps premium fees. Our clients are therefore pushing us to aggressively capture these revenues by pursuing a "first to market" strategy.

Whilst the securities lending industry continues to experience significant change and intense scrutiny from all quarters, opportunities are also apparent. The overarching sentiment is that the situation in which the market now finds itself is Darwinian, in that it is not the strongest of the species nor the most intelligent that survives. It is the one that is the most adaptable to change. **thought**

- 1 John F. Kennedy, speech given at the convocation of the United Negro College Fund, Indianapolis, Indiana, 12 April 1959, [www.jfklibrary.org](http://www.jfklibrary.org).
- 2 [www.esma.europa.eu/consultation/Consultation-ESMA-guidelines-regulatory-framework-ETFs-and-other-UCITS-issues](http://www.esma.europa.eu/consultation/Consultation-ESMA-guidelines-regulatory-framework-ETFs-and-other-UCITS-issues).

Notes from J.P. Morgan's pension blog...

# Forever Young!



**Benjie Fraser**  
*Global Pensions Executive*

A recent posting on our blog offered some unconventional thoughts from guest Adjiedj Bakas, a renowned trend-watcher, author and speaker. Adjiedj will be a featured speaker at the J.P. Morgan Multinational Pensions Forum in Paris on 3-4 October 2013, an annual gathering for senior leaders to discuss challenges and strategies facing corporate sponsors.

In a recent article on research by the Cambridge Institute of Public Health and the University of Southern Denmark, *The New York Times* reported that, “dementia rates among people 65 and older in England and Wales have plummeted by 25 percent over the past two decades, to 6.2 percent from 8.3 percent, a trend that researchers say is probably occurring across developed countries and that could have major social and economic implications for families and societies.”<sup>1</sup>

It is, therefore, not unrealistic to suggest that many of us can expect to live until we are 100 years old and that our children have the prospect of living to 120. Immortality is now conceivable!

Scientists have warned that the cost of healthcare could explode as people live longer and could even become unaffordable. But guess what? This doom scenario is unlikely to become a reality. Not only are dementia rates falling, but using a 3-D printer, we will soon be able print a new heart, liver or maybe even a brain. We will be happy and healthy when old: forever young!

Am I saying there is no problem here? Well, for the healthcare industry, it is not as much of a problem as you

might think. For the pension funds the story is different. You do not have to be a whizz kid to understand that the funds can never pay the pensions of all these people who are refusing to die.

So what needs to happen is to open the discussion about our working life. Currently we work until our sixties and then we retire. This model is not sustainable. Why don't we work as long as we feel well, but on a more flexible basis than we do now? Why wait until we are old to enjoy life and then die of boredom because we have very little to do? This arrangement is just not right. **thought**

Excerpt from a recent posting.  
To learn more or to  
comment, please visit  
[www.jpmpensionblog.com](http://www.jpmpensionblog.com)

Note: the J.P. Morgan Pension Blog is a secure, online community for pension fund trustees and managers.

1 Gina Kolata, *The New York Times*, “Dementia Rate Is Found to Drop Sharply, as Forecast,” July 16, 2013, [www.nytimes.com](http://www.nytimes.com).

# Complete Collateral Portfolio Solutions

## A clear view that cuts through the complexity

Global regulations and prudent business practices are driving buy- and sell-side institutions to deploy more collateral, against more counterparties and transactions, than ever before.

Increased demand for collateral, plus a heightened focus on quality and liquidity, challenge institutions to fully understand the assets they hold, how to best leverage them, and the true cost of collateral.

J.P. Morgan offers new ways to understand and assess collateral needs, including advanced tools and analytics to support informed decision-making and help reduce financing costs.

## Global view of assets and obligations

First, institutions must fully understand the assets available for use and the obligations that need to be collateralized. This view can be restricted when assets are held at multiple custodians and obligations are due to multiple clearing/prime brokers or central clearinghouses. Clients who manage collateral against multiple initiating transactions or in multiple regions face an even more fragmented view.

J.P. Morgan's unique global solution is clearing broker- and custodian-agnostic, providing a central view of your assets, whether held with J.P. Morgan or with other custodians. Similarly, transaction data is sourced from your brokers, with permission, providing a comprehensive view of margin requirements and obligations requiring collateralization. Data is synthesized in the virtual global longbox.

## Collateral optimization

As demand for collateral increases, it's critical to put the right asset in the right place at the right time, fully utilizing your assets to reduce financing costs.

Using data in the virtual global longbox, you can model and run comprehensive projections using actual or hypothetical portfolios to understand the impact of different decisions. For example, you could assess the cost of sourcing a particular piece of collateral in the market or the potential economic benefit of lending a desirable asset rather than using it as collateral.

Then, sophisticated optimization algorithms combine with rigorous eligibility testing to recommend scenarios for consideration. Current advanced waterfall algorithms will be supplemented with a linear, multi-factor optimization algorithm, creating greater flexibility in defining conditions for collateral usage and identifying opportunities.

Optimally deploying collateral will reduce the need for, and cost of, transformation services. Should a mismatch occur, collateral upgrade trades or other time-tested financing and liquidity strategies are available from J.P. Morgan.

## Data-driven decisions

Holistically managing collateral extends beyond the efficient deployment of collateral to understanding its true cost. Increasingly, clients are factoring the cost of collateral into the cost of the trade.

J.P. Morgan's advanced data and analytics support informed decision-making. What will be the margin impact of an incremental trade? Which futures commission merchant should I use? Can I gain portfolio margining benefits? Does a trade give me an asset that's valuable as collateral? Does the collateral required to support a trade affect its value?

## Collateral portfolio management

Managing collateral well can positively affect the institutional bottom line, particularly as central clearing increases demand for high quality, highly liquid collateral. This is likely to limit supply and inflate costs. Concurrently, a more operationally complex market model is driving a shift from traditional collateral servicing models.

J.P. Morgan's integrated end-to-end solution cuts through the complexity to help you make the most of increasingly critical collateral assets. We can help you manage trading activities with a sharp eye on your collateral bottom line.

### thought

"We believe that collateral has become so business-critical that it should be treated as a new asset class, subject to the same portfolio management and analysis as other crucial trading decisions."

#### Mark Trivedi

Global Product Head for Collateral Management, J.P. Morgan

# Finish Line in Sight—Achieving the Target End State for U.S. Tri-Party Repo Market Reforms

J.P. Morgan significantly reduced the credit extended to dealers in its U.S. Tri-Party Repo business during the second quarter. New tools enable dealers to process the settlement of their repo transactions in an operationally efficient manner, reducing the need for clearing bank credit extension by:

- **Eliminating the unwind for trades that roll.** Maturing trades that are replaced with a new trade with the same profile (same counterparty, terms and amount) no longer require credit. By settling rolling trades throughout the day using J.P. Morgan’s technology, dealers can focus on maturing other trades after 3:30 p.m.
- **Netting General Collateral Finance (GCF) repo transactions.** These transactions had previously unwound on a gross basis, requiring an extension of credit for the full amount until new funding was in place. Now, maturing and new trades are netted, reducing credit requirements to correspond to the difference between the maturing trade and anticipated new funding.

Together, these changes have reduced the need for intraday credit by 70 percent, or hundreds of billions of dollars. Eliminating the uncommitted credit extended by the clearing banks is a key goal of the Federal Reserve Bank of New York-sponsored Tri-Party Repo Infrastructure Reform Task Force.

## The final steps

J.P. Morgan aims to implement the last deliverables to achieve the Target End State by year end. Three linked initiatives will virtually eliminate J.P. Morgan’s extension of uncommitted credit for tri-party:

- **Rolling settlement** will allow dealers to initiate the maturation and settlement process of repos after 3:30 p.m., expediting the return of cash for maturing trades.
- **Simultaneous exchange** of cash and collateral will keep transactions fully collateralized.
- A new **secured committed credit advance facility** will allow dealers to obtain secured financing from J.P. Morgan at competitive rates, up to pre-negotiated limits, to cover short-term financing shortfalls.

J.P. Morgan continues to work closely with dealers and cash investors to prepare them for upcoming deliverables and changes. Once the Target End State is met, we will continue to introduce additional GCF repo functionality and other capabilities to support our clients’ need for complete collateral portfolio solutions. **thought**

## High Marks from Clients

Citing commitment and “marketplace innovation to meet regulatory requirements,” clients rated J.P. Morgan #1 by reform delivery and leadership (and #1 in the Americas and globally) in 2013 industry surveys conducted by *Global Custodian* and by *Global Investor/ISF*.

# New Industry Recommendations to Margin Forwarding-Settling Agency MBS Transactions in the U.S.

Late in 2012, the Federal Reserve Bank of New York-sponsored Treasury Market Practices Group (TMPG) recommended new margining practices, similar to those used for OTC derivatives trades, for forward-settling U.S. agency mortgage-backed securities transactions (including TBA bonds).

The TMPG recommends that counterparties:

- Regularly exchange two-way variation margin in an amount equal to the mark-to-market change of the net value of the unsettled forward transaction (for TBA bonds with a trade/contractual settlement date difference of more than one day).
- Secure written agreement to terms, using documentation such as the Master Securities Forward Transaction Agreement. Such terms include collateral eligibility, valuation of exposures and collateral, timing and frequency of margin calls, thresholds, minimum transfer amounts and liquidation procedures.

Originally recommended for June 2013, the TMPG recognized operational and legal complexities and now recommends “substantially complete” implementation by year-end. Margining forward-settling agency MBS exposures can help reduce the credit risk inherent to forward-settling trades, enhance financial system stability, and support market function during periods of market stress.

## Effectively managing new collateral and margin requirements

With US\$750 billion to \$1.5 trillion of unsettled transactions on a daily basis and scores of active dealers, the size and fragmentation of the MBS market makes the year-end timeframe challenging—even for market participants who already collateralize other transactions. In preparation for year-end, clients will need to agree on terms, finalize agreements, and prepare systems to handle daily variation margin flows across custodians and CSDs. On an ongoing basis, before moving collateral, participants will need to reconcile positions, manage haircuts, asset allocation preferences, eligibility schedules and concentration limits.

In today’s collateral environment, simply meeting a margin call is no longer enough. As collateral becomes an increasingly valuable asset, institutions must be able to rapidly assess over- or under-collateralization and optimize the use of their collateral portfolio. As one of the world’s leading collateral agents, J.P. Morgan supports Agency MBS and TBA Bond transactions as part of its comprehensive collateral portfolio solution. **thought**

**Editor’s note:** this article references detail from the Treasury Market Practices Group’s “Margining in Agency MBS Trading,” November 14, 2012, and “TMPG Releases Updates to Agency MBS Margining Recommendation,” March 27, 2013, [www.newyorkfed.org/tmpg](http://www.newyorkfed.org/tmpg).

# The Pathway from Frontier to Emerging: Middle East Markets

With the recent MSCI upgrade of Qatar and U.A.E. from Frontier Markets to Emerging Markets Index<sup>1</sup> status, one can see evidence that certain Middle East capital markets have made visible progress in making the improvements and changes to align with the views and practices of the international investment community. For a growing Frontier Market, acquiring the status of MSCI Emerging Market could open doors to a larger investor base of not only the institutional pool of global assets but also to other investors who might enter the market as well. While Saudi Arabia has a longer journey ahead, particularly in respect to market liberalization efforts, there are positive indicators suggesting it might well follow suit.

In consultation with our clients, J.P. Morgan’s ongoing market advocacy initiatives attempt to reduce the many structural issues and local market complexities that have acted as barriers to cross-border investments. To assist clients who are considering entry into Middle East markets, we offer access to global investment through one of the largest and most experienced custody and trade settlement services in the industry. Our Network Management professionals understand Middle Eastern market regulations and operational requirements to support portfolio investment in the Middle East. Through

interactions with local regulators, stock exchanges, central depositories and other market participants, our experts actively advocate for change in the local markets on behalf of foreign investors worldwide and closely monitor market developments to help our clients make informed decisions as they deal with rapidly evolving economic and market environments. **thought**

“The upgrade of Qatar and UAE to the MSCI Emerging Market index is an exciting development for the markets and foreign investors alike. We now look forward to continued improvement in Qatar and UAE that are in line with international best practice and for other markets in the GCC region to follow.”

**Alan Taylor**

Cluster Head for Middle East and Africa  
J.P. Morgan Network Market Management

1 With effect from May 2014.

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Figures 2 and 4 of "Perspectives on the Economic Evolution of Brazil," pages 24 through 29, cite forecasts from a Latin America Emerging Markets Research report issued by J.P. Morgan: "Brazil: Fear about growth to limit policy tightening," by Cassiana Fernandez and Fabio Akira, available at [www.jpmorganmarkets.com](http://www.jpmorganmarkets.com). Brazil: Banco J.P. Morgan S.A. is regulated by the Central Bank of Brazil and by the Securities and Exchange Commission of Brazil (CVM). J.P. Morgan CVM S.A. is a member of the Brazilian Stock Exchange (BM&FBovespa) and regulated by the Securities and Exchange Commission of Brazil (CVM). Ombudsman J.P. Morgan: 0800-7700847 / [ouvidoria.jp.morgan@jpmorgan.com](mailto:ouvidoria.jp.morgan@jpmorgan.com).

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