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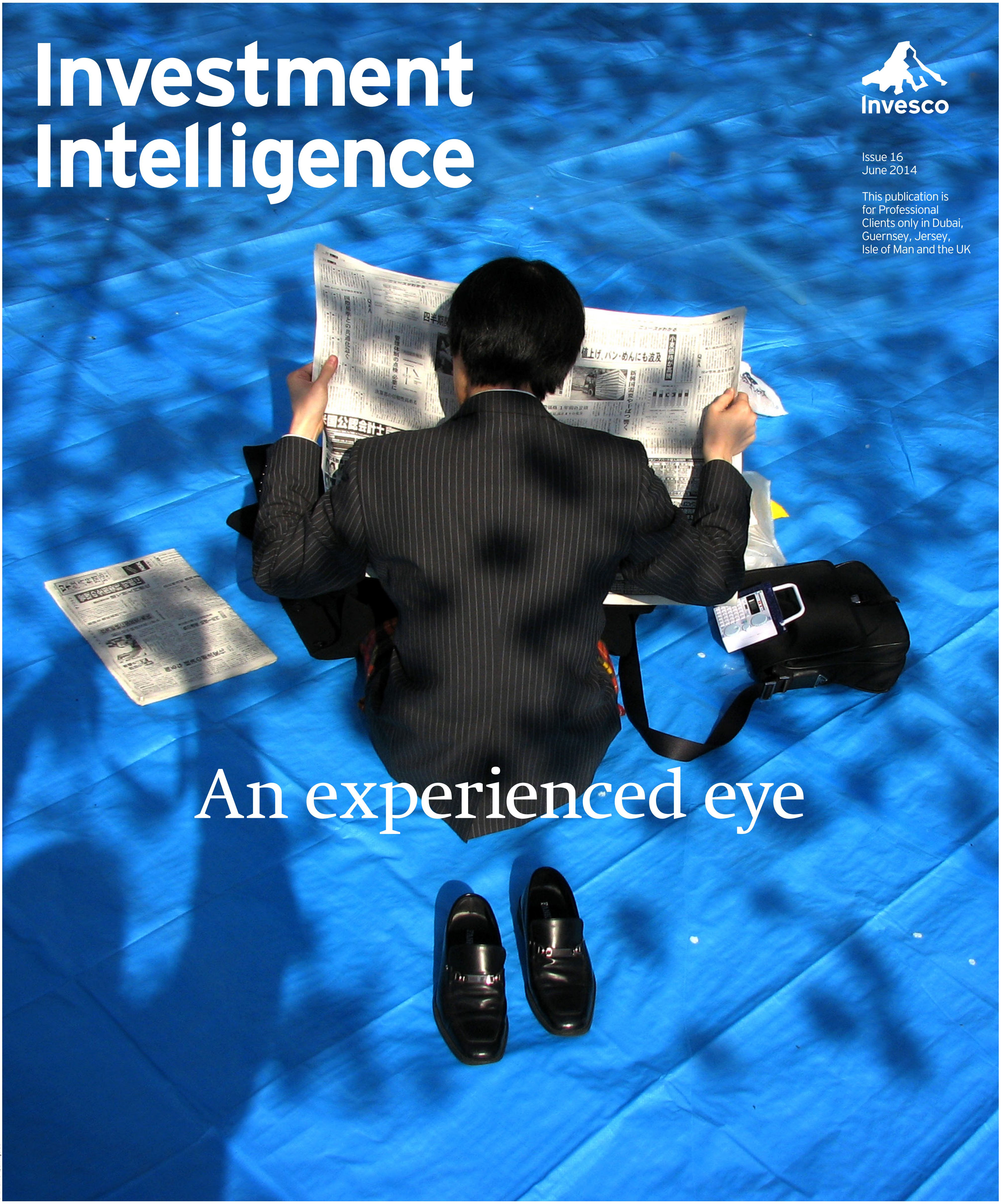

An experienced eye

Conviction, patience and experience

Mark Barnett, our new Head of UK Equities at Invesco Perpetual, offers his insight into the investment philosophy that guides his investment decisions.

Mark Barnett
Head of UK Equities
Invesco Perpetual

Mark Barnett has recently assumed the role of Head of UK Equities at Invesco Perpetual. Since joining Invesco in 1996, he has become one of our most experienced fund managers, managing a number of funds, specialising in UK equity income investing. We believe that successful active fund management should involve fund managers who are accountable for the performance of the companies they choose to invest in on behalf of a fund, and we think it's important for investors to understand what makes the fund managers tick and how they manage the funds they are responsible for.

> "So you come to understand patience is a key component for success. In fact, it is essential for positive long-term returns."

A wealth of investment experience
Mark has been managing funds at Invesco since 2006. In his 21 year investment career, 17 of them with Invesco, Mark has learned the lessons that only long service with a consistent investment approach can teach.

"When you have been managing funds for a long time," he says, "one of the things you learn is that events rarely turn out how you envisage. So you come to understand patience is a key component for success. In fact, it is essential for positive long-term returns.

"If, like me, you have a process, you have to be disciplined and stick to it when things are not going right."

Conviction investor
Conviction, backed by patience and experience, is the quality Mark is bringing with him into his new role. He has learned that even if there are periods when his performance lags the market – because the market is not favouring the sort of companies he believes in – it is essential to know when to stick to your guns.

> "The style that I represent is one I have evolved over the years."

"There will be periods when the stock market does not look at investment like you do. In these periods, the valuation discipline we focus on is deemed not relevant in the market's eyes. But we have learned that if you focus on high-quality businesses you will still do well in the long term."

Overall, Mark feels a great sense of responsibility in his new role, but also a lot of excitement.

"This is obviously a very prestigious job to be asked to do. I am very excited about it and I take my responsibilities to all the investors very seriously," he says.

"The style that I represent is one I have evolved over the years, managing income mandates with an unconstrained approach with a view to creating a total return from a combination of capital and income for our investors.

Mark has always had his own strong views and Invesco gives each fund manager the chance to apply them. For example, compared to his predecessor, Mark does not intend to hold as large single positions in companies.

"I've long taken the view that my own personal comfort zone is for individual holdings to be no more than 6% of the fund. So anything more than that may get trimmed back. My top ten has historically represented around 40-45% of the fund."

Cautious optimism
Of course, Mark takes on the position during a period when the UK economy itself is growing faster than it has for some time. He has for a number of years been cautious about UK growth, but is now cautiously optimistic.

"I don't share the huge wave of optimism we have seen from some of the more bullish commentators. I am realistic about what the UK economy can deliver. I think it will do okay, but nothing too spectacular.

"How that gets reflected in terms of revenue growth for companies is probably more crucial. My view is that it is likely to be in the low single-digit percentage growth area and that will affect how earnings growth develops in the market. I would say a lot of the domestically focused companies have performed very well and if we don't see further strong earnings growth, there could be some disappointment in those parts of the market."

Disappointments may come, but Mark believes that a disciplined, value-driven approach built on his many years of experience will be the right formula to deliver positive long-term performance for his key funds.

Cover image Bruno Quinquet's photograph from the Salarymen project, taken at Ueno park in Tokyo, Japan.

Welcome to the second issue of Investment Intelligence in 2014

Nick Tolchard
Managing Director
International Development Division
and Head of Invesco Middle East

The second quarter of 2014 saw Mark Barnett assume the role of Head of UK Equities at Invesco Perpetual. On this page, he shares his investment approach to managing UK equity portfolios.

Looking further afield to the US equities sphere, Simon Clinch, US Equities Fund Manager, discusses new research developments in the pharmaceutical and biotech industry, namely recent early-stage advances in immuno-oncology.

In European equities, Jeffrey Taylor, Head of European Equities and Stephanie Butcher, European Equities Fund Manager, shed light on whether we are seeing a sustained economic recovery in the region.

We're well used to the abundant use of abbreviations in the financial community. Dean Newman, Head of Emerging Market Equities, looks at whether economic groupings such as BRIC, CIVETS and MINT offer any investment insight. Also on the emerging markets front, Andrew Hall, Global Equities Fund Manager, examines the opportunities in Brazilian equities. Meanwhile, Shekhar Sambhshivan, Indian Equities Investment Director, looks at the key government proposals following the landslide election of the Bharatiya Janata Party.

With low inflation and new monetary policies driving investors into riskier assets, Paul Read, Co-Head of Fixed Interest, looks at the crucial importance of fundamental analysis in understanding the features of new debt instruments and new bond deals.

Moving onto our Multi Asset team, Dave Jubb and Richard Batty, Multi Asset Fund Managers, discuss the team's unconstrained approach to sourcing investment ideas combined with robust risk management.

We also hear from Joseph Tang, Greater Chinese Equities Investment Director, and Stuart Parks, Head of Asian Equities, about the major government and infrastructure reforms proposed in China. Tony Roberts, Japanese Equities Fund Manager presents his view on the current low valuations in Japanese equities.

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The return of M&A

Pfizer's bid for AstraZeneca may have been controversial, but it was just the latest potential deal in what is becoming an M&A boom.

David Prosser
Freelance Journalist

© Eric Vandeville/Gamma-Rapho via Getty Images

Britain's political classes got themselves worked up over the putative bid for British pharmaceuticals giant AstraZeneca by its US rival Pfizer this spring, but had they looked beyond the controversy, they would have seen the transaction as just part of a mergers and acquisitions (M&A) boom that has swept global markets during 2014 so far.

In the first four months of the year, M&A deals announced around the world totalled USD1.2 trillion according to research conducted by analyst Dealogic, more than in the same period of any year since 2007, just before the financial crisis struck, and 42% up on 2013.[1] These deals are taking place in markets all around the world and in every sector of the global economy.

Several factors explain the M&A boom, as well as the buoyant environment for IPOs in markets such as London, which has this year hosted high-profile flotations ranging from Poundland to Pets At Home.

For one thing, the improving global economic outlook is giving companies the confidence to do more deals. The International Monetary Fund now predicts that global growth in 2014 will come in at 3.6%, up from 3.0% in 2013, and rise to 3.9% in 2015.

Another driver is the record levels of cash on which many companies are sitting following several years in which they built up reserves in order to ride out the recession. The world's largest companies had a total of USD1.95 trillion in cash on their balance sheets by the end of 2012, 62% more than in 2008.[2] With confidence now returning, shareholders are understandably keen for these companies to spend some of that money on assets that will generate better returns than cash.

The final piece in the jigsaw is the strong performance posted by many stock markets in recent months – in the US, for example, the S&P 500 index rose 26% during 2013.[3] Higher share prices have given companies paying for deals partly with their own stock greater financial firepower – and encouraged unlisted businesses to come to market through IPOs.

However, while the alignment of these stars explains why M&A and new issues are suddenly so fashionable, there are those who see dark clouds gathering.

Not least, this is because the M&A recovery is more fragile than the figures at first suggest. The high total for the January to April 2014 period partly reflected an unusual number of very large deals – there have already been 13 transactions worth more than USD10 billion this year – but there have actually been fewer deals overall.[1] Were these large deals to fall through, or if large deals were to fall from fashion, the data for 2014 would begin to look less impressive.

Moreover, even where deals succeed, many investors are nervous about whether the businesses involved will prove capable of executing on the strategy they set out for the transaction. M&A activity has a nasty habit of destroying shareholder value – and a boom in M&A activity may suggest that companies are chasing deals because the market expects transactions, rather than because they make good strategic sense.

Against that, there is no evidence yet that the pace of M&A activity is slowing, or that the companies involved in this round of consolidation won't benefit from it.

In fact there are some reassuring data to cling to. For example, in the last M&A boom, it was noticeable that companies making acquisitions used a high proportion of cash – cheaply available from the banks – to fund their deals, but the Dealogic research reveals that transactions announced this year have been more likely to rely more heavily on the bidders' own stock. That implies a more considered approach to deal-making based on an assessment of the potential value for both sides rather than the availability of cheap debt.

"Another driver is the record levels of cash on which many companies are sitting following several years in which they built up reserves in order to ride out the recession."

No wonder – for many companies are in need of M&A in order to rise above the anaemic rates of organic growth that characterise many global markets, where the recovery may have been secured but growth remains low.

Strategic transactions can turn out badly too, of course, but one can understand why investors feel more positive about these deals than those constructed through clever financial engineering. This is one reason why Dealogic's figures show that in 2014 the market reaction to the announcement of deals saw a share price gain of 4.4% for the acquirer in the first four months of the year, whereas in previous years, prices have fallen on such news.[1]

[1] Source: Financial Times, 27 April 2014.
[2] Source: Financial Times, 21 January 2014.
[3] In US dollars, excluding dividend income.

>> **In Europe,** there was a notable increase in M&A activity over Q2 2014 across a broad range of sectors including telecoms, industrials and pharmaceuticals.

Healthcare in China

With a rising middle class, hands-on government reforms and an ageing society, China's healthcare sector is growing fast. Joseph Tang, Greater Chinese Equities Investment Director, Invesco Hong Kong, looks at the opportunities presented by this unique market.

Joseph Tang
Greater Chinese Equities
Investment Director
Invesco Hong Kong

The healthcare market in China has been growing fast. In just five years, the expenditure on healthcare has more than doubled, from US$156 billion in 2006 to US$357 billion in 2011^[1]. The rise in expenditure has been enjoyed by virtually every part of the sector including pharmaceuticals, medical devices and traditional Chinese medicine^[1]. That said, in comparison to the developed world, China's healthcare market is still at the nascent stage. China's total health expenditure as a percentage of GDP is 5.2%, well behind the Organisation for Economic Co-Operation and Development's (OECD) average of 9.5%.[2] We believe that China's healthcare market is at the beginning of a multi-year growth trajectory supported by favourable structural growth drivers.

Demands for better healthcare services

A recent study shows that healthcare, along with education and retirement, has become one of the top three focuses for China's middle class.[3] Instead of solely relying on China's government insurance programme, which provides basic healthcare coverage, the middle class is increasingly prepared to use private healthcare providers. These private companies typically provide a more comprehensive and faster service. With China's middle class expected to reach 1 billion people in 2030,[4] the demand for healthcare is set to increase and will likely further open up the overall market.

Key social priority

Although the government's healthcare insurance programme almost covers the entire population, the content still has a long way to go compared to programmes in developed markets. In light of this, the central government has launched a series of reforms to enhance the quality of the healthcare system. As a result, healthcare spending is expected to triple to an annual figure of US$1 trillion by 2020.[5] Reforms have already begun in earnest. For example, pilot medical insurance programmes covering major diseases have already been carried out in 28 provinces.[6] In particular, Beijing has completely removed the cap on the government contribution to major disease healthcare coverage. A further important reform aims to improve the geographical imbalance of healthcare provision. Currently the best medical resources are dominated by public hospitals in the big cities. The government has sought to redress the geographical imbalance by introducing favourable policies to enable private hospital operators that have already gained a foothold in second/third tier cities to expand.

Demographic changes

In line with many major countries, China is facing an ageing population. Inevitably, as the age profile of the population increases, so does demand for healthcare including hospital services, drugs and medical devices. However, China's medical coverage and technology are still playing catch-up in these areas compared to markets in developed countries. We believe that as China adapts to its changing demographic, demand will increase across the healthcare sector.

"Healthcare spending is expected to triple to an annual figure of US$1 trillion by 2020."

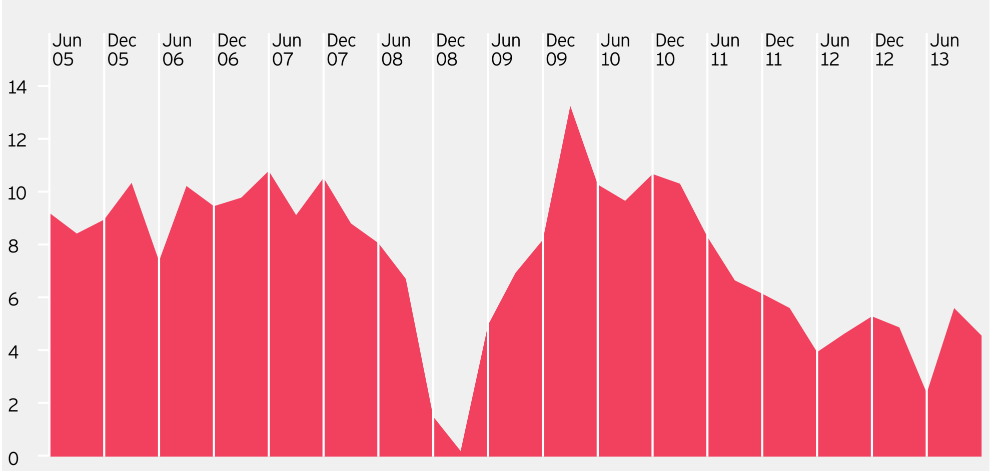
In summary, China has in place the key drivers for a continuation of strong growth in the healthcare sector (a rising middle class, the government's hands-on reforms, and an ageing society). However, much work needs to be done to address issues with the system: the multi-faceted reforms being undertaken by the Chinese government reflect the ambition and the scale of the potential transformation. Nevertheless, China's healthcare sector – a unique market that serves 1.3 billion people – will, we believe, continue to provide tremendous investment opportunities in the coming decades.

[1] Source: Ministry of Health yearbook, SFDA Southern Medicine Economic Institute, industry association, McKinsey analysis, September 2012.
[2] Source: J.P.Morgan Asia Pacific Equity Research, OECD Health data 2012, China Statistical Yearbook 2011.
[3] Source: CLSA, China Reality Research, "Mr & Mrs China" study of middle-class consumers, September 2013.
[4] Source: Ernst & Young, 2013.
[5] Source: McKinsey analysis, September 2012.
[6] Source: Premier Li Keqiang's report on the work of the government, delivered at the Second Session of the Twelfth National People's Congress on 5 March, 2014.

A landslide election brings hope to India

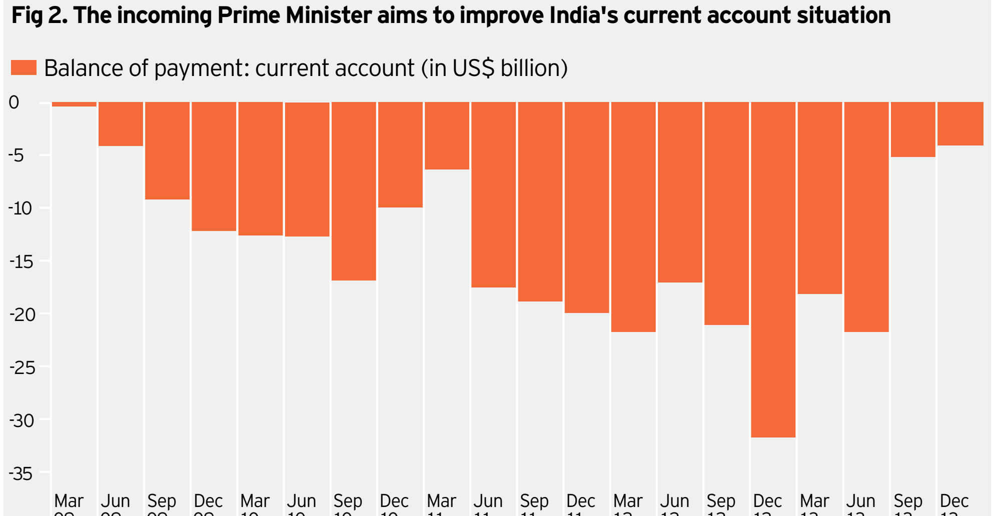
Will the landslide election of the Bharatiya Janata Party mark an end to India's era of stagflation? Shekhar Sambhshivan, Indian Equities Investment Director, looks at the key points from the election campaign.

Fig 1. Raising India's GDP is a goal of the new government



Source: CEIC, Invesco, as of 31 December 2013 (latest available data).

Fig 2. The incoming Prime Minister aims to improve India's current account situation



Source: CEIC, Invesco, as of 31 December 2013 (latest available data).

Shekhar Sambhshivan
Indian Equities
Investment Director
Invesco Hong Kong

A landslide election brings hope to India
Following the Bharatiya Janata Party's (BJP) decisive victory in the parliamentary elections India has, for the first time in 30 years, a government with an overall majority and a clear mandate for reform.

The landslide result should enable the BJP, under the leadership of incoming Prime Minister Narendra Modi, to push through its reform agenda without its policies being caught up in a political paralysis – a fate that has befallen previous administrations elected on optimistic agendas for reform.

In our view, this marks the end of India's era of stagflation. We are now at an inflexion point with growth, we believe, about to move structurally higher. The following are some of the key points of Mr Modi's campaign that we believe will enable India's new era of economic growth.

Reviving the overall economy
The BJP is committed to making India an economic superpower. Mr Modi's alliance aims to achieve high single-digit gross domestic product (GDP) growth on a sustainable basis over the next five years, as compared to the current 4.5% GDP growth rate.[1] One way of achieving this is by rebalancing the economy. Currently, two-thirds of the economy is skewed toward service industries, while the remainder is from manufacturing industry and agriculture. In light of this, the BJP campaigned to diversify the base of economic growth by rebalancing each sector of the economy to one-third. We believe this diversification can open up new business opportunities over the medium term.

In our view, Mr. Modi's strength and experience, together with his close ties with both state and central government, increase the chances that the government will focus on accelerating growth and other macro challenges looking ahead. His key economic policies include: controlling inflation as a priority; boosting exports; reviving domestic growth (see figure 1); and improving the current account situation (see figure 2).

Addressing infrastructure needs
With 1.3 billion people, India has an urgent need for basic infrastructure – 68% of the population still does not have access to safe water, and 34% has no access to electricity.[2] Mr Modi's campaign called for a "shining India" with nationwide infrastructure and improved road connectivity to various remote parts of the country (see figure 3 for infrastructure spending over the last decade). In our view, Mr Modi has a high chance of delivering his commitment, given his track record of improving the infrastructure of an urban state. During his 12 years as chief minister for his home state of Gujarat, he was dubbed the "development man", successfully transforming Gujarat from a less-developed state to one of India's most prosperous states that now enjoys good transportation and electricity.

Driving a capital expenditure and investment recovery
Looking ahead, we expect Mr Modi will promote policies to improve business sentiment, thereby lifting corporates' capital expenditure and incentivising a revival in both domestic and foreign investments – both of which have been held off in the recent years due to uncertainty over India's political direction. We believe Mr Modi, as a business-friendly and a strong pragmatic leader, should be able to instill confidence in investors. This was a skill he ably demonstrated during his time as chief minister of Gujarat, where he was able to woo investments from other states into his own.

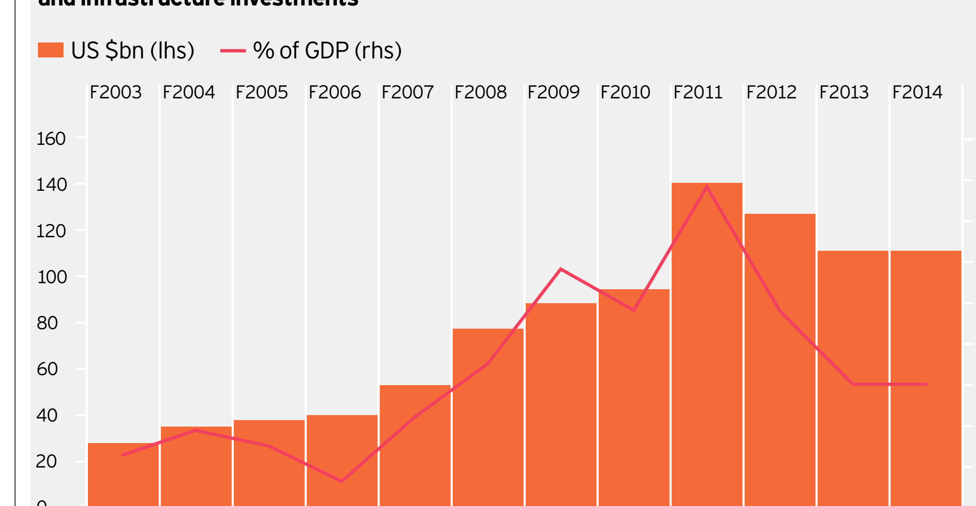
"Mr Modi's campaign called for a "shining India" with nationwide infrastructure..."

Conclusion
In our view the election of Mr Modi's government opens up a potentially new promising chapter for India. With a decisive government providing a positive backdrop, we expect corporate earnings and the cash flow of Indian companies to pick up thanks to an increase in government infrastructure spending.

Despite the recent strong performance of the Indian stock market, the valuation of MSCI India Index continues to be accommodative, with a trailing price-to-book ratio of 2.9 times, in line with the seven-year historical average.

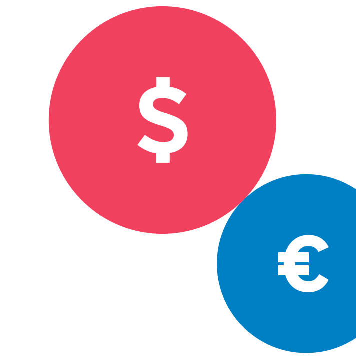
[1] Source: National Democratic Alliance party profile. GDP Growth rate is sourced from BofA – ML Global Research Estimates, RBI, CSO and refers to FY 2013 data as at 18 May 2014.
[2] Source: 2013 population data sourced from J.P Morgan Research, IMF, as of May 2014. Infrastructure-related data is sourced from CLSA research, as of November 2014.

Fig 3. The newly elected Prime Minister campaigned to increase infrastructure spending and infrastructure investments



Source: Planning Commission, Morgan Stanley Research estimates, as of 18 May 2014.

>> In the Emerging Markets, the general election in India proceeded with record turnout, while economic growth in China slowed.
Source: Bloomberg, as at 1 May 2014.



USD against EUR

The euro has been on a rising trend since 2012, but has it now started to look overvalued, particularly against the US dollar?

Stuart Edwards
Fixed Interest
Fund Manager
Invesco Perpetual

We are at a pivotal point in the global - and especially the US - economic cycle. A majority of investors entered 2014 with a relatively upbeat view on US economic growth. This was reflected in a positive outlook for the US dollar and an expectation that core bond market yields will rise, particularly in the US.

Since then, bond yields have in fact fallen and the US dollar is broadly speaking unchanged, especially against the euro and sterling. The fall in bond yields is in part due to geopolitical concerns surrounding the situation in Ukraine, but it can also be attributed to disappointing economic data in the US. If the slowdown proves temporary then the US dollar should benefit and bond yields could rise.

"Since mid-2012 the euro has been on a rising trend...."

The key US jobs report for March gave a better steer on post-winter trends but it could be several months before we get a fuller picture on whether the US economy can accelerate through the remainder of 2014. It is my expectation that it will do and the Invesco Global Bond Fund is positioned accordingly, with the interest rate sensitivity of the fund (its duration) low and the US dollar position high. This is mainly at the expense of positioning in the euro, which I have greatly reduced over recent months. Since mid-2012, the euro has been on a rising trend, benefiting from strong portfolio flows back into the eurozone after European Central Bank (ECB) President, Mario Draghi, famously declared that the ECB would do whatever it takes to save the euro. I would expect the strength of these flows to begin to subside.

The data appears to me to be showing that the level of the euro against the dollar has departed from the level that would be commensurate with their relative interest rates. In other words, the level of the euro seems too high. No wonder then that a number of ECB policymakers have begun to comment on the strength of the euro, especially in the context of the low inflation evident throughout much of the eurozone. Hence why there are hints of looser policy in some form, either via a further interest rate cut or even outright purchases of government debt (even if the probability of this still seems low). Taking into consideration these relative risks between the US and eurozone, it is my opinion that the euro has scope to fall from here, especially against the US dollar.

Will the green shoots of recovery be sustained?

Jeffrey Taylor
Head of European Equities
Invesco Perpetual

Stephanie Butcher
European Equities
Fund Manager
Invesco Perpetual

Live Q&A
9 April 2014

In our live event on 9 April 2014, Jeff Taylor (JT) and Stephanie Butcher (SB) answered questions from the intermediary community put to them by broadcaster and journalist Paul Burden.

Eurozone crisis

Do you believe that the eurozone crisis is over? What are the major obstacles that still exist?

JT I suppose you've got to preface everything along these lines with 'never say never'. However, the idea of systemic collapse is a long way away from where we are now. The European Central Bank (ECB) has played a very strong role over the last two years in particular. You've got a whole raft of structural reforms coming through in parts of the periphery and even France and Italy show a few more signs of doing more in this respect. You are seeing the cost of financing for peripheral governments and companies come down dramatically so, yes, things are healing.

In terms of what has to happen next, there's an element of reverse engineering going on. Institutions are still being fitted into the construct, but there's very strong political and economic resolve to make things work better in the future.

For a lot of people, the eurozone crisis threw up the question of whether the euro itself was a viable concept. Has that debate completely gone away?

JT We've never believed in a collapse of the euro and that's one of the major themes that's been present in all our teams' portfolios over the last few years.

SB We spent a lot of time, particularly in the heat of the crisis, not just meeting companies, but also meeting politicians, central bankers and the ECB. The political will for this project to survive came across very clearly. That was the piece that was missing in a lot of the analysis at the time, so our view is, was and remains that the euro project will survive. Now it's a case of making sure that the institutions are fit for purpose in terms of moving forward with the reforms that are in place.

Economic recovery

Are the green shoots of economic recovery in Europe going to be sustained?

JT You've got to see Europe in a broader context and a global economic background where there is some growth going on is extremely helpful. What sometimes gets under-reported is the idea that there can be a self-sustaining element to what's going on in Europe. Private consumption in large parts of the eurozone crashed during the crisis, so you're recovering from a very, very low level. The same goes for capital investment by companies and there comes a point where you have to spend; you have to invest, because not doing so is going to cost you more money than doing so. You are now seeing the beginnings of a pickup in both consumption and in capex in a number of areas. If you couple that with the idea of less financial pressure and less austerity weighing on governments and individuals in a large part of continental Europe, that's got to help too.

Do you draw much comfort from the recent IMF forecasts?

SB I think economists' forecasts change quite rapidly. We spend a lot more time looking at bottom-up data points and some of those can be quite micro. One example is we look at light van registrations in Spain and they've picked up very aggressively (see figure 1). If you think about the people who are registering light vans, it is sole traders, small businesses and so on, so it gives you a good example of the fact that there is a building confidence coming through. There has also been a lot of reform, particularly in the labour area. That gives companies the impetus, both within and from outside Europe, to start investing in Europe again. For example, we've seen Ford move factories to Spain to take advantage of the cheaper labour rates, but also, if you look at the infrastructure in Spain, it is actually very, very strong.

There is still massive youth unemployment in Spain.

SB The quote of the famous 50% doesn't take into account that those in training or in university are counted as unemployed. It's more like 25%, but it does mean there's a lot of capacity that can be used to build factories and invest in the country.

Euro currency strength

Does the strong euro complicate the task of the ECB?

SB It's not helpful – it's been somewhat stronger than people expected. The question is partly if it's driven by euro factors or if it's a function of factors elsewhere. Our view is that we would expect the dollar to begin to strengthen; as tapering moves through, we would expect to see interest rates go up and that differential would start to favour the dollar over the euro. Also, if you look at the trade weighted basket, clearly emerging market currencies have come under more pressure. However, if you look at long-term relationships, it does look as though we're beginning to get to the end of that process. Again that sort of drag effect, which has led to the euro being stronger, we think we're towards the end of that.

Valuations

Are European equity markets still attractively valued?

JT Yes. One measure that I think has got a lot of validity at the moment is cyclically adjusted (Shiller) P/Es, which look backwards to see how things have been priced relative to where we are now. Looking at the eurozone overall, you see quite a big discount relative to history. If you were to use the same measure for the US, you'd see you're already trading at a premium. If you're looking forward at the 12 month average P/E, you're spot in line with a 10 year average now, which again doesn't scare me at a time when earnings growth should really start to accelerate in continental Europe.

If the markets remain attractive, why are investors holding back?

JT They are holding back less than they were. Bear in mind that the consensus view on Europe was that it was pretty close to a near-death experience in 2012. Markets had got obscenely cheap but we have moved on from there. It's a question of a steady building of confidence by investors, both within and from outside Europe, which will enable the market to be re rated further over time. The next stage on that I think will come as earnings growth is delivered by corporates.

SB If you look at the way a cycle develops – Goldman Sachs has done some good work on this – at the low point is the despair part of the cycle. You then move into the hope phase, which started when Draghi put the line in the sand with 'whatever it takes'. What happens there is you see P/E multiples expand. We've been through that process over the last 18 months. You then typically move into the growth phase, which is where we think we are now, and that's when the market tends to get driven by earnings rather than P/E multiple expansions.

"…if you look at the infrastructure in Spain, it is actually very, very strong."

We're not expecting a massive move on P/E multiples but, when you look at where earnings in aggregate are for Europe versus their history, we're around 33% off the peak level. From our point of view, we can find lots of companies, sectors and countries where we see a lot of room for that earnings recovery.

Are there still investment opportunities in the periphery of Europe?

JT Very much so. These are country markets that have tended to do very well over the last 18 months or so. We think that we're probably at the beginning of a multi year recovery from a very depressed level for large parts of the European periphery. If you look across our range of funds, you will typically see us overweight in peripheral markets, so our weightings will be higher than the benchmark index (the FTSE Europe ex UK) in peripheral Europe combined.

There are a range of things we like. There are plays on the domestic economy and the individual names will change a bit, but you'll find exposure to domestic banks in Spain and to media companies in Spain and Italy. Among the big international stocks that have had some image damage done by dint of having the wrong passport, as in being Spanish or being Italian, there are good things there too.

Sectors – cyclicals

How do you view the cyclical areas of the market currently?

SB There are some really interesting opportunities. Going back to our valuation point, it is areas like the financials where we see quite significant valuation opportunity and also within the cyclicals – for example media and so on.

In some of the more global growth cyclicals – which were favoured in the heat of the crisis – that's the one area we're still struggling with, but generally we are finding a lot of cyclicals which have run their businesses much better during this cycle than they have previously. We're finding companies with a lot of cash flow, a lot of potential to grow their dividends and good valuations. It is an area that we've quite liked and there is quite a wide range of cyclicals that we've favoured, although I'd say the financials are the largest element of the cyclicality we like.

Sectors – financials

What is your current stance towards the financial sector, and how does the ECB's asset quality review impact on that?

JT Financials are for us a very interesting area of cyclical exposure. Within the financials in our portfolios, you'll find exposure both to banks and insurers. The theme throughout all the holdings tends to be individual companies where the business model is intact and where the scope for earnings recovery looks credible, and also where you can trust the balance sheet.

AQR, or Asset Quality Review, is part of the preparation for banking union. It's working its way through the European banking sector now and it will then be linked to a stress test. It should be something that's very positive for the sector: the whole aim is to give more comfort and more confidence in bank balance sheets and, over the medium term, that's something that should help bring the cost of equity for the sector down. What you've seen ahead of AQR kicking off is capital raising by the stragglers. This is particularly the case in Italy and in Austria so far, quite a lot of banks have topped up to make sure they're going to be on the right side of where they need to be when the whole AQR and stress test takes place.

"We think that we're probably at the beginning of a multi year recovery from a very depressed level for large parts of the European periphery."

Sectors – consumer staples

Do you regard consumer staples as being expensive? If so, why?

SB In aggregate, yes. If you look at the qualities that these companies have, and in most cases they have very strong balance sheets; they have very robust top lines; they were exposed to emerging markets and to global growth. They weren't that exposed to domestic Europe. Therefore, they were very much favoured in the heat of the crisis as a 'safe' place to hide which meant that the valuations got pushed to levels beyond which we'd seen before, with very high premiums to the market and to their history.

Although we've begun to see that come off the top, in reality what's happened is that their earnings have been revised downwards faster than the rest of the market. All that is saying is, on the margin, emerging markets growth has been a little less strong than expected and also the currencies have weakened quite considerably. That's quite a major factor for these companies. From our point of view, what we'd need to see is, in absolute terms, those stocks come down further or to see evidence that that emerging markets drag has gone away.

JT We will keep on looking. We wouldn't be doing our job properly if we weren't reviewing things that have under-performed.

Dividends

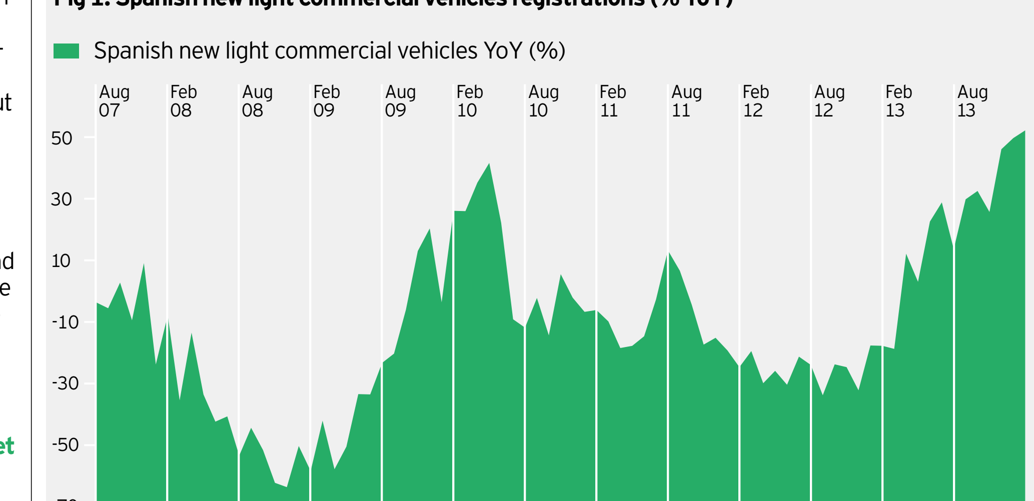
Are your funds focused on high-yielding stocks or more towards dividend growth?

SB It is very much the latter. Where we think you get the best result is finding companies that can really grow dividends over time. Going back to financials, it's one of the reasons we like that area so much. We're roughly at a market yield but, in a lot of cases, we're seeing the companies already talking about the fact that they're going to have excess capital and what are they going to do with it. A lot of that is going to come through in the form of dividends and buybacks, and we're seeing companies like BNP or UBS talking actively about that. Those are the areas we feel most strongly about. We want good-quality companies with lots of cash flow. Pharmaceuticals would be another good area, where the biggest problem that some of these guys have is they've just got so much cash coming through, which is a nice problem to have and yet the market is paying not aggressive multiples for them. That's what we're looking for and that's where we think we get not just the dividend growth, but also the capital element of a market rerating the potential for a company like that.

Are you seeing an improvement in the dividends being paid across Europe?

SB What was quite interesting in the last set of earnings results was the number of companies that were beginning to increase their payout ratios and surprised on the dividend side. Again, the financials were a good example of that. It is a classic cycle. What happens is, first of all, you get the multiple re rating, then you get increasing confidence from the corporates. Part of that is they have an awful lot of cash, and they are going to begin to need to do something with that cash otherwise they're going to have inefficient balance sheets. Part of that will come through in the form of capital expenditure. There may well be some more M&A activity, but I believe a big part of it will come through in the form of dividends and buybacks.

Fig 1. Spanish new light commercial vehicles registrations (% YoY)[1]



Source: Bloomberg, ACEA as at 26 February 2014.
[1]New light commercial vehicles registrations are subject to a one-quarter lag. Latest available data as at 31 January 2014

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Black gold on the Black Sea

Ukraine's reputation as the bread basket of Europe has deep implications for global commodity prices. But beyond the country's wheat exports, just how are gold and oil reacting to the political situation?

Hugo Greenhalgh
Special Reports Editor
Financial Times

Vladimir Putin speaks and the markets move. On the day the Russian president called on Ukrainian separatists to abandon their plans for a referendum on independence, the Micex, a Russian stock exchange, shot up by 3.4%.[1] Sceptics may be tempted to dismiss events in the Black Sea region as – to paraphrase the apocryphal newspaper headline – a "small war, not many dead", but the worsening situation between Ukraine and Russia has the potential to flare far beyond its borders.

The days when wars raging around the world did not affect the global economy are long gone. Globalisation and interconnected trade between nations mean the events unfolding rapidly in Ukraine are a growing cause for concern – not least for the commodity markets.

Bread basket

Ukraine has historically been known as the bread basket of Europe. Its 42m hectares of agricultural land – of 60m hectares in total – used to produce a quarter of the entire agricultural harvest of the former Soviet Union. The country's famously fertile black soil has seen Ukraine become an agricultural powerhouse, producing sugar, grain, sunflower oil and – crucially for the rest of Europe – wheat.[2]

> **"Yet despite the turmoil in eastern Ukraine, the oil price has resolutely refused to budge."**

When violence spread to the Black Sea city of Odessa, one of the country's main ports, wheat futures jumped to levels not seen for the past 13 months.[3]

Uncertainty over the region's prospects pushed the wheat price up by almost 15% in March[4] – and then a further 6% in April. Yet despite the recent spikes, on a historical basis, the price of wheat remains relatively inexpensive. Over the course of 2013, it actually dropped by almost 20%[4], and is nowhere near the heights of 2012 when US crops failed due to drought.

Factors other than the geopolitical meltdown in Ukraine are determining this year's price hike. The Australian Government Bureau of Meteorology has warned that "climate models surveyed by the Bureau" suggest that El Niño, which can be responsible for extreme global weather patterns, might be seen "as early as July".[5] And, structurally, the impact of global warming is likely to be more harmful to the industry over the long term. "Climate change has negatively affected wheat and maize yields for many regions," noted a recent report from the UN's Intergovernmental Panel on Climate Change.[6]

Place this in the wider context of the global wheat supplies, however, and the impact of events in Ukraine starts to diminish. According to the United States Department of Agriculture, "Global 2013-14 wheat supplies are raised 0.5m tons with higher projected beginning stocks, mostly because of reductions in European Union and Ukraine consumption for 2012-13. World production for 2013-14 is lowered 0.2m tons with mostly offsetting changes to several countries of 0.1m tons or less."

Morgan Stanley has warned that the price increase is unlikely to continue.[7] "While wheat prices have benefited from strong US export demand and geopolitical tensions in Ukraine, we expect that continued global feed substitution back to corn and adequate supply in the EU and the former Soviet Union should limit additional upside," the US investment bank said in a note published in May. "Declining global feed demand and adequate global supply should pressure wheat prices into MYE 13/14 and beyond."

> **"If the traditional 'safe haven' asset is relatively unaffected, surely the situation – worsening or not – in the country has been largely contained?"**

So if supply is remaining steady or increasing slightly, and demand and consumption are falling, can the recent moves in the wheat price be ascribed more to sentiment than fundamentals? Are the facts of the situation actually filtering through to investors? Or is it simply down to the media overplaying events?

"You can't imagine how stupid the whole world has grown nowadays," as writer Nikolai Gogol, born in Velyki Sorochyntsi in north-east Ukraine in 1809, wrote in his masterpiece Dead Souls. "The things these scribblers write!"

Indeed. This question becomes particularly pertinent when considering the impact on that perennial global economic bellwether, the gold price.

Golden opportunity?

Since the crisis in Ukraine began with demonstrations in Sevastopol in February 2013, the gold price has fluctuated wildly. But over the 12 months to 21 May this year, it actually declined by 5.6%, losing more than US$76 in value per ounce.

The price has increased in recent months. January and February both saw rises of 3.8% and 6.6% respectively. Indeed, there has been a "rebound in investor interest", according to the Thomson Reuters GFMS Gold Survey 2014, "in part due to escalating geopolitical tensions in Ukraine and renewed concerns about global economic weakness".

> **"When violence spread to the Black Sea city of Odessa, wheat futures jumped to levels not seen for the past 13 months."**

Yet in March, the price per ounce fell by 3.56% – and in April it remained steady with a slight upwards bump of 0.83%.[1]

What does this mean in terms of the markets' attitude towards what's happening in Ukraine? If the traditional 'safe haven' asset is relatively unaffected, surely the situation – worsening or not – in the country has been largely contained?

Not necessarily. The precious metal is not immune to events in Ukraine. On news of Putin's putative support for German chancellor Angela Merkel's proposal of further talks, the gold price shed US$17 over the course of the day.[1] Easing tensions in the region are not good news for gold investors.

Nor are they for those in the energy market. The elephant in the room is Russia's vast energy supplies, which it has used many times in the past – particularly with Ukraine – as a form of blunt diplomacy. The ability to turn off the taps – as Russia did in January 2006 and again in 2008…and again in 2009 – has long terrified energy experts and investors across western Europe. A tit-for-tat sanctions exchange could result in a "disruption in oil supplies [that] would tip western Europe into recession", Mohamed El-Erian, the former second-in-command at Pimco, the world's largest bond house, warned recently.[8]

Dependency dilemma

European energy dependency on Russia is high. Writing in the Financial Times, the Polish prime minister, Donald Tusk, called for an energy union to "end Russia's stranglehold".

"Regardless of how the stand-off over Ukraine develops," he wrote, "one lesson is clear: excessive dependence on Russian energy makes Europe weak. And Russia does not sell its resources cheap – at least, not to everyone."[9]

The situation is stark, he continued. "Today, at least 10 EU member states depend on a single supplier – Gazprom – for more than half of their consumption." Yet despite the turmoil in eastern Ukraine, the oil price has resolutely refused to budge.

Over the past 12 months, the price of a barrel of Brent Crude has slipped up by just under 4%, roughly nudging between the US$104-US$114 band. In January this year, it fell by just over 4%.[4]

Events in Libya, which saw a deal struck between the government and rebels to reopen a second port, would appear far more critical.

The question that the west is desperately seeking to answer is: what are President Putin's intentions? Does he intend to continue destabilising Ukraine – or stick by his call for the demonstrators to abandon their referendum?

Perhaps we should ask Nikolai Gogol. "Perfect nonsense goes on in the world," he wrote in his short story, The Nose, written in the 1830s. "Sometimes there is no plausibility at all."

[1] FT, as at 7 May 2014.
[2] Ukraine Digest website, as at May 2014.
[3] Bloomberg News, as at 5 May 2014.
[4] FT Markets Data, as at May 2014.
[5] Australian Government of Meteorology ENSO Wrap-Up as at 6 May 2014.
[6] IPCC, Climate Change 2014: Impacts, Adaptation, and Vulnerability, as at 31 March 2014.
[7] Business Week, as at 8 May 2014.
[8] FT Blogs, as at 29 April 2014.
[9] FT, as at 21 April 2014.

The world in numbers

9

The total phases of the Indian General Election, running from 7 April to 12 May 2014, making it the longest election in the country's history.[1]

66.4%

The average turnout for all nine phases of the Indian General Election, the highest ever for the country.[1]

37bn

The combined sales of Lafarge and Holcim, in US dollars, whose announced merger would create the largest building materials group in the world.

45bn

The monthly amount of US dollars that the US Federal Reserve cut its asset purchasing programme to, following a strong economic outlook.

1trn

The amount of US dollars that the Chinese government is expected to spend annually on healthcare by 2020.[2]

41

The number of years since business confidence among manufacturers in the UK has been this high, according to CBI's April survey.

30bn

Share buybacks in US dollars announced by Apple in April following strong share performance. The US technology giant also increased its dividends by 8%.

Data covers month of April 2014, and was correct as at 30 April 2014.
[1] The Electoral Commission of India, May 2014.
[2] McKinsey analysis, September 2012.

Optimism in oncology

As the potential for drugs to turn cancer to a manageable disease grows, so does the optimism in pharmaceutical and biotech companies.

Simon Clinch
US Equities
Fund Manager
Invesco Perpetual

I had the pleasure of attending a healthcare conference in New York recently where a number of exciting topics were bubbling through the crowds. Familiar themes of emerging market growth and the impact of Obamacare were touched upon, but the most tangible excitement was in oncology, where there was growing excitement amongst investors and companies alike over recent early-stage advances in immuno-oncology. In fact, many regard these advances as the first real chance to turn cancer from a killer disease into a manageable one, with comparisons being made to the treatment of Aids/HIV. As a generalist, I am always cautious when such claims are made, but so far the science is admittedly very eye-catching.

A new approach

Immuno-oncology is a new approach to tackling cancer. Historically, cancer treatments have been focused on destroying or shrinking tumours in the body through the use of highly toxic agents or radiotherapy, effectively tackling the outcome of cancer. Immuno-oncology is an attempt to tackle one of the biological loop-holes that allows cancer to occur, effectively trying to cut the disease at source. More specifically, cancer occurs in part because tumours have adapted so as to avoid detection by the body's immune system. Immuno-oncology seeks to unmask the tumours and allow the body's natural defences to take action against the disease. If this works, it will mean that the body can defend itself against the cancer well beyond the initial treatment phase.

This new approach is exciting in its own right, but it is made all the more so with an actual approved drug on the market. Yervoy was approved for late-stage metastatic melanoma in 2011, the first drug of its kind to demonstrate long-term survival in this cancer type, which otherwise has a median survival of only six months. Initial trials of Yervoy showed a 30% reduction to risk of death versus patients on another experimental drug, and impressively increased the percentage of patients alive after one and two years to 46% and 24% respectively, from 25% and 14%.[1] Late in 2013, more data was released showing a three-year survival rate of 22% in patients.[2] On the negative side, Yervoy is a highly toxic drug with plenty of side effects. But the fact is that we now have a treatment that is capable of significantly extending the life expectancy of a nearly a quarter of late-stage metastatic melanoma patients.

"This new approach is exciting in its own right, but it is made all the more so with an actual approved drug on the market."

Industry optimism

Needless to say, a lot of research is being focused on other drugs in the same class as Yervoy, across a broad range of indications. Furthermore, companies are researching biomarkers to help determine what makes a patient more or less likely to respond positively to the treatment of these drugs. At the healthcare conference, where many Heads of Research & Development presented, optimism was high. Indeed, the amount of data that could be released in 2014, starting with the American Society of Clinical Oncology Conference which was held in March, makes for an exciting year in the pharmaceutical sector.

What does this mean for the shares of pharmaceutical and biotech companies? Immuno-oncology has not gone unnoticed, primarily thanks to Citigroup research highlighting the opportunity in March 2013. The company behind Yervoy, which is the leader in immuno-oncology with the fullest pipeline of drugs in this class, has seen its price/earnings multiple expand from the high-teens in 2012, to the current forward multiple of above 30 times.[3] In fact, for 2013 the company's shares delivered a total return of nearly 70% versus the S&P 500 index's 32.4%.[3] This outperformance has occurred in the face of a consistent decline in earnings expectations for 2014 and 2015.[3] It is therefore hard to argue that immuno-oncology isn't already well anticipated by the market. Nonetheless, with many pharmaceutical companies investing in their own immuno-oncology pipelines, while actively looking to increase their exposure through licensing deals or M&A, we believe that this is a theme worth monitoring closely.

[1] yervoy.com, as at 31 March 2014.
[2] news.bms.com, as at 31 March 2014.
[3] Source: Bloomberg, as at 10 March 2014.

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Acronyms in the emerging world

BRIC. MINT. CIVETS. The use of such acronyms to group together countries first started in 2001. But can these groupings which, arguably, have little in common, offer any investment insight?

Dean Newman
Head of Emerging Market Equities
Invesco Perpetual

Ever since the acronym BRIC was conceived by Jim O'Neil of Goldman Sachs in 2001 to highlight the move in economic power away from the developed world towards emerging markets, we have seen a noticeable increase in the use of abbreviations across the financial community. What began as a BRIC family comprising Brazil, Russia, India and China has now grown to include acronyms including: MINT (Mexico, Indonesia, Nigeria, Turkey); MIST (Mexico, Indonesia, South Africa, Turkey); CIVETS (Colombia, Indonesia, Vietnam, Egypt, Turkey, South Africa) and more recently, the 'fragile five' consisting of India, South Africa, Brazil, Turkey and Indonesia.

The initial economic concept may have proved to be a useful marketing tool and successfully helped introduce global emerging markets to a wider audience, but not all of these acronyms take into account the difference in stages of development of each country and offer relatively little in investment insight. We believe it is far more important to look at each individual emerging country on its own merits as opposed to investing into a small grouping labelled under some catchy acronym.

We need to differentiate between the various economic systems that are in place in emerging countries. Some will lean closer to free market capitalism while others have a higher concentration of state-owned enterprises. While countries such as Brazil and China continue to strengthen commercial ties with each other, no bilateral trade agreement currently exists between India and China. Russia is a major exporter of resources, whereas China is the second largest importer of crude oil.

So what do we mean by an emerging market?

The term is usually associated with economies that have low to middle per capita income; it includes economic powerhouses such as China to much smaller and less developed countries in Africa. However, from an investment perspective we need to narrow the search to make it more relevant as not all of these places are fully investable and offer market liquidity. The need to differentiate and avoid generalities is also vital. Poland, for example, has far more in common with Germany than it has with Argentina.

Where can we invest?

The MSCI Emerging Markets Index covers 21 countries and more than 800 securities, representing approximately 11% of world stock market capitalisation.[1] While this may give additional scope for the formation of new acronyms, it also provides us with opportunities to pick high-quality companies that are attractively priced. Given that we are benchmark aware rather than being benchmark driven, we do cast our investment eye over a wider universe – although perhaps not as far as covering all 266 countries, dependent territories and areas of special sovereignty that we have in the world today.

In some cases, we come across well-managed businesses with strong fundamentals and exciting growth prospects in countries classified as frontier markets, for example Jordanian-based Hikma Pharmaceuticals. Thanks to its local presence and focus on quality, we believe that Hikma has positioned itself as one of the leading players in generic manufacturing within the Middle East region. As the company is UK listed and was founded in Jordan in 1978, it also provides us with an opportunity to conjure up our own light-hearted acronym JUSTICE (Jordan, UK, South Africa, Turkey, India, China, Egypt).

We believe other Middle Eastern companies with attractive prospects exist, but due to the region's frontier market status, analyst coverage here is limited. However, this may begin to change given that both Qatar and United Arab Emirates have recently left the MSCI frontier indices and moved to the MSCI Emerging Markets Index. This reflects the region's growing investment appeal and has little to do with the banding of countries around fashionable acronyms.

"We do cast our investment eye over a wider universe – although perhaps not as far as covering all 266 countries, dependent territories and areas of special sovereignty that we have in the world today."

Panama's population of just 3.5 million people ensures the economy has a relatively small presence on the global stage, but its central position between North and South America serves it with some natural advantages. Air travel in the region is on an upwards trend. Panama's strong strategic geographic position has been greatly utilised by Copa Holdings, the owner of Copa Airlines. This Panamanian airline is one of the most profitable operators of air travel in the world with consistently high operating margins. Using its dominant position at Tocumen airport, an international hub serving 68 destinations in the Americas, Copa Airlines has strong pricing power. Given that Panama is neither a constituent of the MSCI Emerging Markets Index nor a family member of an acronym club, many of its companies including Copa Airlines do not show up on investors' radar screens. We believe that to potentially reap the long-term benefits of emerging markets it is necessary to widen the investment search beyond the acronym world.

BRIC
Brazil
Russia
India
China

MINT
Mexico
Indonesia
Nigeria
Turkey

MIST
Mexico
Indonesia
South Africa
Turkey

CIVETS
Colombia
Indonesia
Vietnam
Egypt
Turkey
South Africa

FRAGILE FIVE
India
South Africa
Brazil
Turkey
Indonesia

"JUSTICE"
Jordan
UK
South Africa
Turkey
India
China
Egypt

[1] Source: MSCI Research, as at October 2013.

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The contrarian case for Brazil

Brazil's economic outlook is proving challenging, with slowing economic growth and a steep fall in the stock market. Andrew Hall examines the investment backdrop and asks if there are still opportunities to be found in the equity market.

Andrew Hall
Global Equities Fund Manager
Invesco Perpetual

In December 2013 I visited eight companies in four cities across Brazil. Although the economic outlook is very difficult, I returned slightly less cautious on the prospects for Brazil than when I went in. Nevertheless, Brazil is vulnerable to global liquidity flows and also runs the risk of an inflationary shock, which could have very damaging implications for a consumer sector that has just been through a fairly rapid credit expansion.

However, I was positively surprised by the quality of the companies I met and their approach to shareholders. Many of them are likely to emerge stronger from a period of economic weakness, assuming it is not an actual crisis. There appears to be some value emerging in the high-quality Brazilian stocks – and potentially significant value in the more cyclical parts of the market (those which are more sensitive to the economic cycle).

The investment backdrop

Brazil, as a potential investment destination, intrigues us presently. After an exceptional period of economic expansion between 2002 and 2009, driven by strong demand from China, a cheap and abundant labour force, expanding credit penetration and, more latterly, a strong inflow of liquidity from quantitative easing, economic growth has swiftly slowed and the Brazilian stock market has fallen sharply: a 58% fall relative to the UK's FTSE All-Share index since its relative peak in June 2010.[1] Combine this with the universally pessimistic sentiment surrounding not only Brazil but emerging markets in general and it appears to have the makings of a contrarian (or anti-consensus) investment.

There are several credible concerns about investing in Brazil just now. It is immediately clear, when you embark on travel across the country, that the infrastructure is woefully inadequate. There has been a 120% increase in the number of cars owned in Brazil over the past decade. Investment in roads simply has not kept pace. Major cities are gridlocked, airports are at capacity and rail infrastructure is non-existent. This strikes us as the key constraint on sustainable economic expansion from here.

"Can strong franchises be found that could actually benefit from a tough economic backdrop?"

Holding back structural reform

In my opinion, it is politics that is currently impeding much-needed structural reform. The ruling Workers Party has a strong following with the Brazilian working class and indications suggest that they will remain in power post the October general election. The primary fiscal surplus has fallen from 4% of GDP in 2011 to less than 1% today. The government appears intent on providing short-dated stimulus to the economy via consumption tax breaks and seems reluctant to implement the tough reforms of minimum wages and retirement benefits the economy requires. This is in sharp contrast to the (potentially positive) reforms that Mexico has implemented since its new government was formed in 2013.

With unemployment very low in Brazil, it is unsurprising that the working-class electorate remains supportive of the government. It's quite feasible that a much more severe economic backdrop could be required to force the government to make the tough decisions the struggling economy needs. The central bank is already raising interest rates, which currently stand at 11%,[2] to counter inflation. Combine these two structural issues with the more cyclical risks of international liquidity flows reversing, a more highly leveraged consumer sector and the potential for a rise in unemployment as the economy slows, and we can understand why investors are concerned about Brazil's economic prospects.

The contrarian case

Several judgements need to be made, in our opinion. How much of the above risk is reflected in current share prices? Can strong franchises be found that could actually benefit from a tough economic backdrop? Does the potential upside to share prices outweigh any potential currency risk? We think the answer to the above is yes, albeit selectively.

Finally, on a global level, can European and US listed stocks be found, that have similarly suffered due to their exposure to Brazil and other emerging markets, which offer better risk-adjusted returns? For high-quality franchises with strong long-term compound growth potential, that have de-rated as a result of their emerging markets exposure, our judgement would be that these companies have less direct currency risk, less political risk and less corporate governance risk. Compared to companies of similar quality in Brazil, for example, we find that valuation differentials at this stage are still quite small. However, if valuations of Brazilian listed stocks continue to contract, then the time may come to reconsider.

[1] Total returns, GBP, as at 30 April 2014.
[2] As at 3 April 2014.

>> In Asia Pacific, there was dispersion in the performance of Asian equity markets over Q2 2014 with positive performance in the ASEAN and Australian markets and negative performance in Japan and China.

Asia and the issue of China

China facts and figures

Source: cia.gov, The World Factbook, as at 1 May 2014.

Population	1,355,692,576
Unemployment	4.1%
Debt-to-GDP ratio	220%
Growth target	7.5%
Earnings growth expectations	10%

Asian equity markets have lagged their developed market peers over the last twelve months as China — its biggest and most significant economy — has disappointed. Here Stuart Parks looks at whether China is poised for transformational reform and observes some encouraging signs within the region.

Stuart Parks
Head of Asian Equities
Invesco Perpetual

Positive developments

This issue of China continues to dominate the Asian investment landscape. However, before looking at whether its economy is structurally flawed or poised for transformational reform, it is worth recognising some positive developments that have been taking place elsewhere in the region.

Last year there were worrying signs of overheating in several South Asian economies, with high wage increases, rising inflation and deteriorating current account positions. These pressures were most evident in India and Indonesia, where rising cost pressures saw a loss of competitiveness and deterioration in export performance. However, since then, monetary policy has been tightened, inflationary pressures have subsided and current account deficits have narrowed. The speed of adjustment has been encouraging, dispelling concerns of a repeat of the 1997/98 Asian crisis. Consumer demand has slowed, but its long-term structural growth drivers remain intact, and there have been improvements to export competitiveness across the region.

Another issue for us in recent years has been the generally over-optimistic nature of corporate earnings forecasts. For the last three years, expectations at the start of the year have been far too high, and actual earnings growth delivered has fallen short, which has been a headwind for equity markets. Current forecasts for 2014 are lower than they have been in recent years (see Figure 1), and are more realistic in our view – another significant and welcome adjustment.

China's reform agenda

However, China's economic and equity market performance have disappointed. This has largely been due to concerns over China's ability to move away from its unsustainable reliance on credit-fuelled investment, particularly in infrastructure and real estate. In the period since the global financial crisis, China's debt-to-GDP ratio has increased from around 120% to 220%, with much of the debt financing projects of questionable profitability. The Chinese government recognises the potential threats posed by a build-up of bad debts, and overall credit growth is coming down, but it is still much higher than nominal GDP growth.

Last November's announcement of an ambitious new reform agenda gave us grounds for optimism – particularly initiatives focused on allowing market forces a more 'decisive' role in the allocation of resources, improving capital allocation and shifting income towards households. The Party leadership appeared to go out of its way to explain why wide-ranging reform is needed, and we believe there is real potential for meaningful change in the medium term.

"Monetary policy has been tightened, inflationary pressures have subsided and current account deficits have narrowed."

If they are to succeed in implementing some of these reforms then we would expect to see a huge reallocation of capital to successful, profitable enterprises, particularly in the private sector. This could be revolutionary. It would leave undeserving companies, many of which are state-owned enterprises (SOEs), to be closed, with assets sold off and workers redeployed. There is no denying that this is a monumental challenge; but China has been here before with the successful restructuring overseen by Premier Zhu Rongji in the late 90s and early 2000s, when huge swathes of workers were laid off and reallocated to the export manufacturing sector. This time around, excess capacity needs to be shifted towards the services sector, where the private sector has greater involvement, and where profitability levels and investor returns tend to be higher.

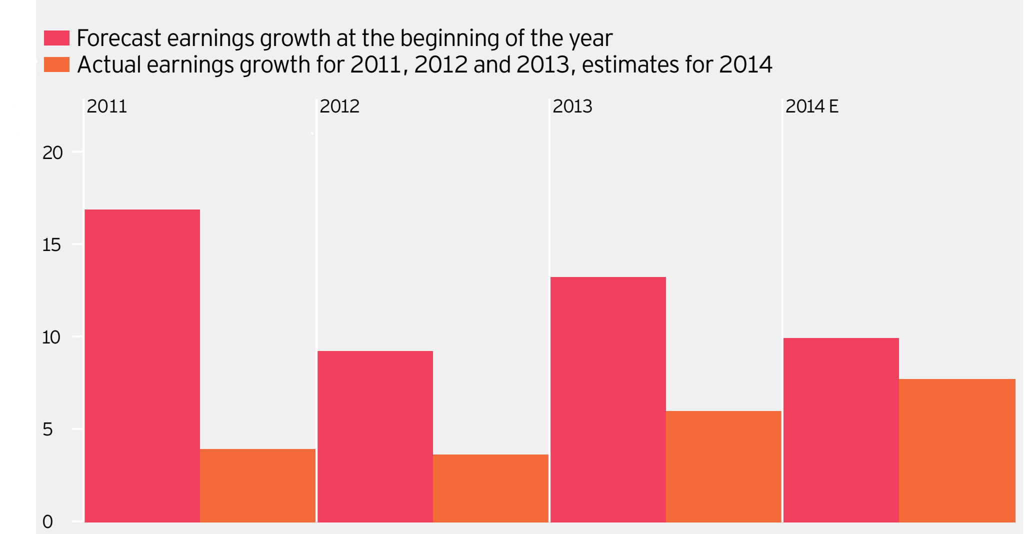
The critical question is whether the authorities are prepared to let growth drop below their 7.5% growth target as they try and implement reforms (see Figure 2). My chief concern is that they are not prepared to make this potentially painful adjustment, preferring instead to try and smooth the transition. Recent economic data has pointed towards a further slowdown in China's economy, but the authorities have resolutely stuck to their minimum growth target, raising expectations of further questionable investment spending.

Encouraging developments

Until we see evidence of reforms, scepticism over China's resolve to rebalance its economy and ability to control credit growth will remain a headwind for markets in the region. However, China has proven in the past that it can change quickly when challenged and there have been encouraging developments in other economies across the region. In our view, now is not the time to despair about China and the region in general as we believe that very little hope is being reflected in market valuations. Earnings growth expectations of 10% for the region in 2014 look achievable to us and we are still able to find what we consider to be good-quality companies at attractive valuations.

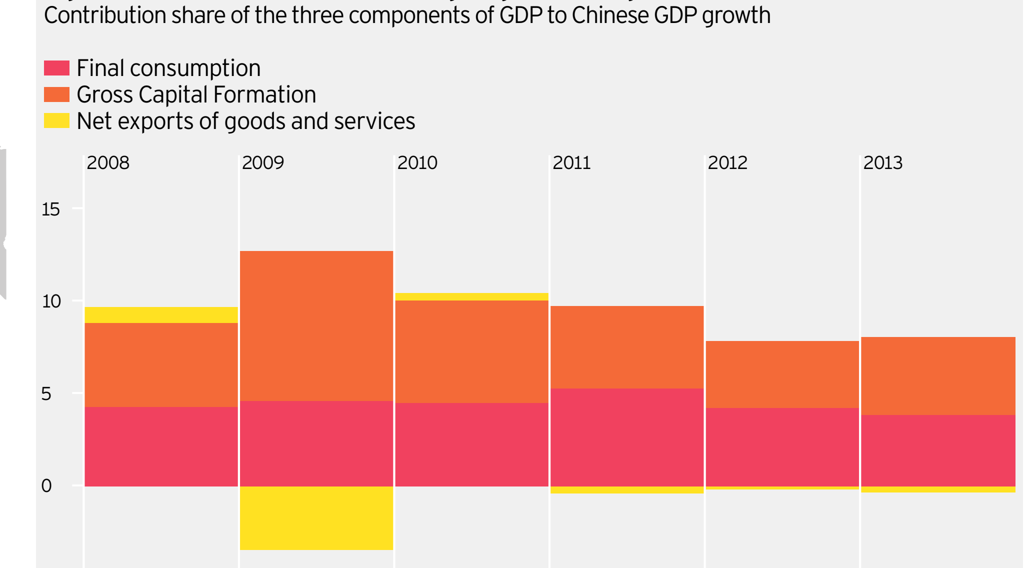
"This time around, excess capacity needs to be shifted towards the services sector...."

Fig 1. Earnings growth expectations look achievable



Source: Invesco, Goldman Sachs earnings forecast data for MSCI AC Asia Pacific ex Japan Index as at 28 February 2014.

Fig 2. Can reform be achieved whilst targeting 7.5% GDP growth?
Contribution share of the three components of GDP to Chinese GDP growth

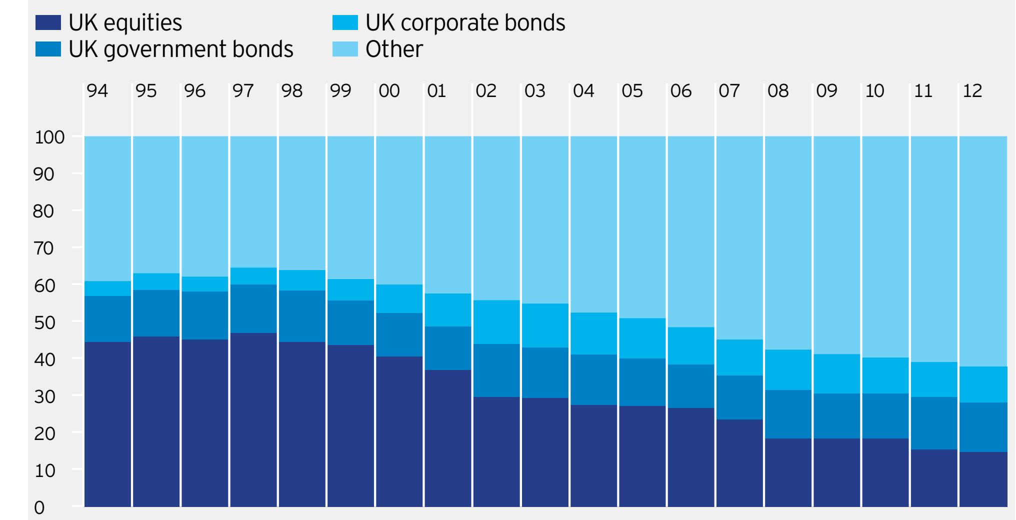


Source: CLSA, as at 31 March 2014.

The great rotation

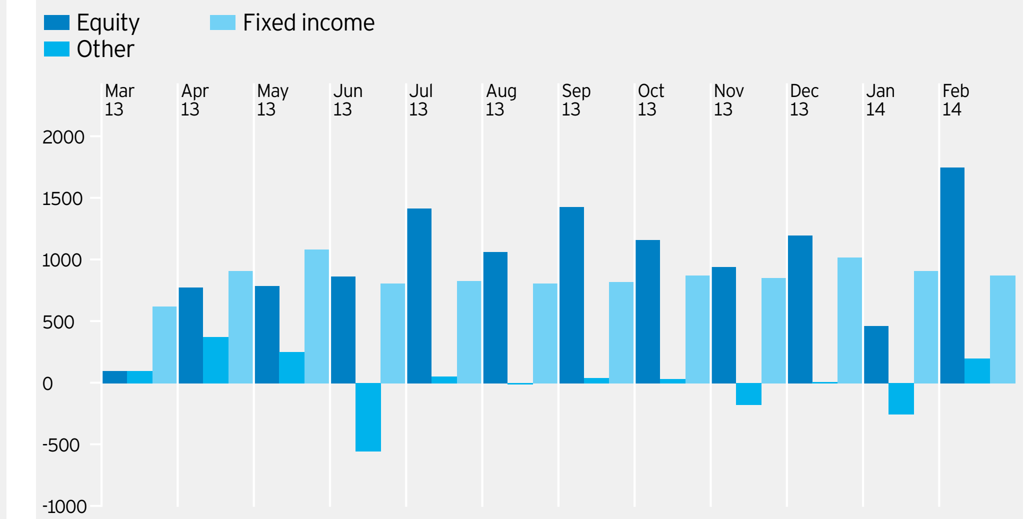
A potential driver for equity markets in 2014 could be a so-called 'Great Rotation' out of bonds and into equities. Martin Walker examines changes in asset class allocation over the last 30 years and the factors that could influence such a change.

Fig 1. Holding as % of total assets by insurance companies, pension funds and investment trusts



Source: ASR Ltd/ONS, as at 31 December 2013.

Fig 2. Sales of investment products to the UK retail market



Source: IMA, as at 31 March 2014.

Martin Walker
UK Equities Fund Manager
Invesco Perpetual

The 'Great Rotation' is a phrase often used by investment commentators to refer generally to the practice of switching invested money from one asset class to another. The two asset classes to which this switching most commonly refers are equities and bonds, and the idea is that an investor buys one of these asset types when it looks relatively good value and sells the other when it looks relatively poor value. As this buying and selling is most likely to happen more than once over a period of years, you have an impression of rotating invested money between asset classes.

Getting this rotation right, i.e. buying equities at a low price and selling the bonds at a high price, and vice versa, is one of the most challenging and keenly debated subjects amongst investors. The reason being, of course, the potential for investors to maximise investment returns upon any success.

Moving in opposite directions

One way to think about this is that the value of these two assets often moves in opposite directions. The main reason for this is the difference in the risk profile of equities and bonds and investors' attitudes to and appetites for risk.

The investment performance of an equity is dependent on the performance of its share price (and the dividends paid by the company), which in turn is dependent on a range of factors, including the performance and the prospects of the company itself and what the marketplace determines its value to be. Investing in such an asset is therefore, by definition, risky.

Contrast this with the risk profile of a bond. Some elements of a bond's return are fixed: the rate of interest that will be paid and the date that the issuer will repay the nominal value of the bond. However, just as for an equity, the price of a bond fluctuates. The bond price is dependent on a range of factors, including the prevailing interest rate, the rate of inflation and the market supply and demand for bonds, as well as the interest paid by the issuer and the credit quality of the issuer. However, compared to an equity, the future returns on a bond are relatively fixed and limited. Also, these interest and principal payments on a bond are obligatory, with any failure deemed a default. Due to these differences, bond prices have historically been less volatile than equity prices and, hence, bonds are deemed less 'risky' than equities.

A preference for bonds?

The risk attached to the timing of when to buy and sell equities versus bonds has proven to be a significant reality for many investors. As concerns over shortfalls in the value of funds accumulated for retirement has increased, so an increasing school of thought has emerged concluding that bonds should have a higher allocation in an investment portfolio than they had in previous decades (see Figure 1).

Combine this with the volatility in equity markets in the periods 2000-2003 and 2008-2009, as well as the ten years plus required to see equity markets (in the UK and US) regain their pre 'dot-com era' levels, and it is easy to understand the reasons why many investors have preferred to invest in bonds during much of the last decade. Such has been the debate on this subject that some investment managers have wondered whether we have seen the death of the cult of equity investing. Figure 1, which indicates UK institutional fund asset allocation, puts this in context as it shows that the allocation to equities has fallen from a peak allocation in 1997 of almost 47% to about 15% by mid-2012.

To look at this in monetary terms, the Office for National Statistics reveals that over the same time period, the UK institutional net investment in UK ordinary shares has fallen by over £200bn.[1]

> "Taken together, these factors might suggest that a change in the preference between bonds and equities has emerged."

Reversal of fortune

Such descriptions of the 'death' of equity investing, and dramatic shifts in patterns of behaviour in areas such as asset allocation, will often signal that all energy connected to such a trend has been spent. Indeed, there are now some tentative signs that equity investing has been increasing so that once again we can see that the preference between the two asset classes could start to rotate (see Figure 2). One of the most important factors to consider in relation to this possible change is the difference in total returns. For the 10 year period ending 31 December 2010, the UK equity market, as represented by the FTSE All-Share index, returned a total of 35%, whereas the benchmark UK government bond (UK gilt) returned 96%.[2] However, since the low of the equity index in the spring of 2009 there has been a reversal of fortune, with the equity index providing a total return of 122% versus a return for the UK gilts of 27%.[2] We believe this was primarily related to the perceived better value in equities, as evidenced by the dividend yield of the UK equity market in March 2009 of about 5% versus the yield on the UK 10 year gilt, which was about 3.3%.[2]

Potential to rotate

In addition to the ideas on the relative value of the two asset classes, there has been an increasingly pro-growth stance in the policy of the central bankers of the developed world. In the US this became most obvious on 12 December 2012, when the US Federal Reserve made 'maximum employment' an objective as revealed in the minutes of the related committee meeting. Such a policy was emulated in Japan when their Prime Minister, Shinzo Abe, launched his own version of reflating the economy by setting a specific target of 2% for domestic inflation as well as a target of 2% growth in GDP.

Subsequent to this action in Japan, the governor of the Bank of England, Mark Carney, tied the likelihood of UK interest rates staying low for the foreseeable future to a UK unemployment rate remaining below 7%. With such potentially reflationary policies being adopted internationally, it can be seen why an asset such as an equity, which helps to avoid the impact of inflation on the nominal interest rate of bonds, has regained some interest. This could then mean that the allocation between the two assets, bonds and equities, has the potential to rotate again.

In the last five years we have seen significant changes in performance of the two asset classes and an obvious pro-growth stance of western governments. Taken together, these factors might suggest that a change in the preference between bonds and equities has emerged. However, as can be seen from the data on sales of investment products to the UK retail market for the year to 31 March 2014 (see Figure 2), despite the near 15-year decline in UK institutional equity fund allocation, the decrease in global bond yields and the strong recent performance of global equities, there have been only three months of significant bond outflows. It must therefore be observed that any sign of a rotation back into equities may be a rather tentative one.

Whether any trend to rotate from bonds into equities will take hold or not will depend on the collective conclusions of investors as to the greater likelihood of inflation or deflation persisting, whether equities or bonds look the more attractive on valuation grounds, and individual risk preferences.

[1] As at 30 September 2013.
[2] Source: Thomson Reuters Datastream as at 14 February 2014.

> "The risk attached to the timing of when to buy and sell equities versus bonds has proven to be a significant reality for many investors."

Demographic trends

With the global population now at the seven billion mark and showing no signs of slowing, Paul Temperton looks at the crucial importance of demographic trends to economic, social and political development.

Paul Temperton
Consultant to Invesco

Billions and billions of people...
The world's population hit the seven billion mark in 2011; another billion is expected to be added to that figure by 2025 but after that population growth is expected to slow. Subsequent increases of one billion are set to take longer and longer: it will take 18 years to get to nine billion and another 40 years after that to get to ten billion, by which time there is a reasonable chance of the global population levelling off.[1]

Some may think that there has always been a trend towards an increasingly more populated planet but that is not true. In pre-industrial times the global population grew slowly, if at all. It was little higher in the year 1000 than it was in year zero – 300 million people. It was not until the 18th century when Western industrialisation began that population started to rise strongly. Even then it was slow to take off: it only reached one billion in 1804 and took a further 123 years to reach two billion in 1927.

...many of them older...
Japan is the most notable exception to this global trend. Its population has been declining since 2004. In 2013 it dropped by a record 244,000. A report compiled with the government's co-operation two years ago warned that by 2060 the Japanese population will have fallen from 127 million to about 87 million, of which almost 40% will be 65 or older.[2] Measures aimed to prevent such a fall and stabilise the population at around 100 million are reportedly being considered. To achieve that, the fertility rate (the number of children born per woman) would need to rise from its current 1.39, one of the lowest in the world, to 2.07 and there would need to be mass immigration – 200,000 foreigners a year. Without raising the fertility rate, an immigration level of 650,000 per year would be required. The extent of that challenge is highlighted by the fact that the country's annual net immigration ran at just 70,000 per year between 2007 and 2012.[3]

Across the developed world life expectancy has continued to increase in recent years, with the 'population pyramid' of the 1950s – a small, old population supported by a larger population of working age – transforming into one with a middle-aged bulge and a growing number of old people. Some of the projections on this ageing trend may seem surprising.

...and some very old.
In the UK, the Office for National Statistics recently estimated that one in three babies born in the UK in 2013 will celebrate their 100th birthday.[4] Considering that there are currently only 13,500 centenarians in the UK, that projection may, to some people, seem fanciful. Remember, however, that in 1900 the average life expectancy for white and black Americans was 47 and 33 years, respectively.[5]

"In the UK, the Office for National Statistics recently estimated that one in three babies born in the UK in 2013 will celebrate their 100th birthday."

US: immigration and participation
The US is in a relatively good position to avoid a 'Japan-like' outcome of a shrinking population. Indeed it still has, and is expected to continue to have, a growing population. That in turn is due largely to continued immigration, which has provided a consistent boost to the US population of around 0.3% p.a. for the last four decades.[6] The participation rate – the proportion of people within the population that are working or actively seeking work – is also less of a concern in the US than in Japan. One important driver is that the participation rate of older – particularly skilled, professional – workers has increased in recent years. In 2009-10, 65% of men aged 62-74 with a professional degree or doctorate were employed or actively seeking employment.[7]

Cities and clusters
The trend towards greater urbanisation is an important demographic trend and one which is of potential benefit to economic growth. Urbanisation generally tends to boost economic growth. This is typically explained by the facilitation of production, trade and services when companies in similar industries cluster together. Banking centres in cities such as London and New York have thrived for centuries. In early industrialised England urban clusters were common. The benefits of clustering seem no less important now, even though many think that location should no longer be a source of competitive advantage in a 'flat world' with high levels of interconnectedness. This apparent paradox has been explained by several factors[8]: the important spillover benefits enjoyed by small, supplier firms when they locate close to a large customer (the phenomenon is seen around Toyota factories around the world); the benefits of being near research-based universities (such as Silicon Valley and Silicon Fen); and the advantages brought by a shared infrastructure.

The benefits to economic growth from urbanisation were highlighted in a recent study by McKinsey, contrasting the USA and the eurozone. Despite similar total populations, the USA's 50 largest cities have over 164 million people compared to the eurozone's 102 million. McKinsey estimates that three quarters of the lead that the US has over the eurozone in per capita GDP can be explained by this greater urbanisation.[9]

Conclusions
Demographic trends are, by their very nature, slow-moving and often attract little interest. Yet they are of crucial importance to economic, social and indeed political developments. In the developed world, slowly growing or shrinking populations which, with increased life expectancy, are also ageing, are now the key challenges.

[1] United Nations, World Population Prospects: the 2012 Revision.
[2] The Economist, 25th March 2014.
[3] Source: United Nations as at 1 May 2014.
[4] Office for National Statistics website, as at 1 May 2014.
[5] George Magnus 'The Age of Ageing', John Wiley and Sons 2009.
[6] US net immigration has been running at an average of 0.3% of the population per year for most of the last four decades, with the five years from 1993-97, when the rate doubled, as the main exception. Source: World Bank and Thomson Reuters Datastream, as at 1 May 2014.
[7] The Economist, 26th April 2014.
[8] See Michael Porter, "Clusters and the New Economics of Competition", Harvard Business Review, November-December 1998.
[9] McKinsey Global Institute "Urban America: US cities in the global economy", 2012.

>> **In the UK,** industrial production rose 0.9% in February, with CBI quarterly business optimism rising to a 41-year high.

Taking care in a seller's market

Low inflation and accommodative monetary policies are driving income-seeking investors into riskier assets. Yields and spreads on European corporate bonds have been testing or even breaking historical lows.

Paul Read
Co-Head of Fixed Interest
Invesco Perpetual

The universe of corporate debt investments, which is currently being supported by a strong tide of demand, is changing. New types of debt instrument are being issued and the structures of new bond deals are also shifting – often to the disadvantage of the investor.

We believe that in more challenging market conditions, the features of individual bonds can drive greater price variance. This increases the importance of fundamental analysis of these new types of debt and of the particular features of each bond.

Buoyant markets

Corporate bond markets have rallied a long way from the lows of 2009 and 2011 and yields on both investment grade and non-investment grade bonds in the euro market are near all-time lows (Figures 1 and 2). In part, this has been driven by falling bund yields.

Credit spreads, though they have still not reached the low levels seen in the years before the financial crisis, are tight (Figure 3 opposite and Figure 4 on page 24, overleaf). It appears unrealistic to expect much further tightening from here.

There is support for these valuations. The level of income available from bank deposits and lower risk assets such as money market instruments and short-dated government bonds has plummeted since 2007. This has increased demand for higher-yielding debt assets and this demand is an important factor in the tightening of credit spreads. Current low levels of inflation and the continuing commitment of major central banks to low interest rates support this trend. Furthermore, the default rate is low (Figure 5, overleaf). Even including a number of defaults related to last year's Cypriot banking crisis, the rate remains near pre-2008 levels.

But as Figure 5 overleaf shows, the default rate is not a good predictor of yields. In 2000, 2007-08 and in 2011, defaults lagged rising yields as the market began to discount deteriorating credit conditions before they were confirmed by credit defaults. There is an intuitive argument for default rates to lag yields. Strong demand for credit allows corporate treasurers to lengthen the maturity of their debt, reducing the likelihood of default by extending the period to principal repayment and reducing debt-servicing cost. Rising yields discourage such refinancing.

Issuer-friendly conditions

Current market conditions certainly favour the issuer, in our opinion. New bond deals, many

"Supply has been strong across the bond markets. Current low yields are a strong incentive to corporate treasurers to borrow..."

with historically low levels of coupon, are being met with strong demand. Table 1: Lower coupons (page 25, overleaf) shows examples of the reduction in coupons on bonds from the same issuer over the past few years.

The reduction of coupon is only one way in which the terms of bond deals are becoming less beneficial for the lender and more advantageous for the borrower. We are seeing some typical cyclical trends developing in the terms of newly-issued bonds, which are affecting the quality of the market, particularly in high yield.

Call protection (the period between issuance and the first date at which the bond can be called) is falling. The average period from issuance to call in the European high yield market[1] is now 5.0 years, compared to 7.9 years in March 2010^[2]. The less favourable market conditions of 2008-2010 had seen this measure rise from 5.2 to this peak of 7.9.

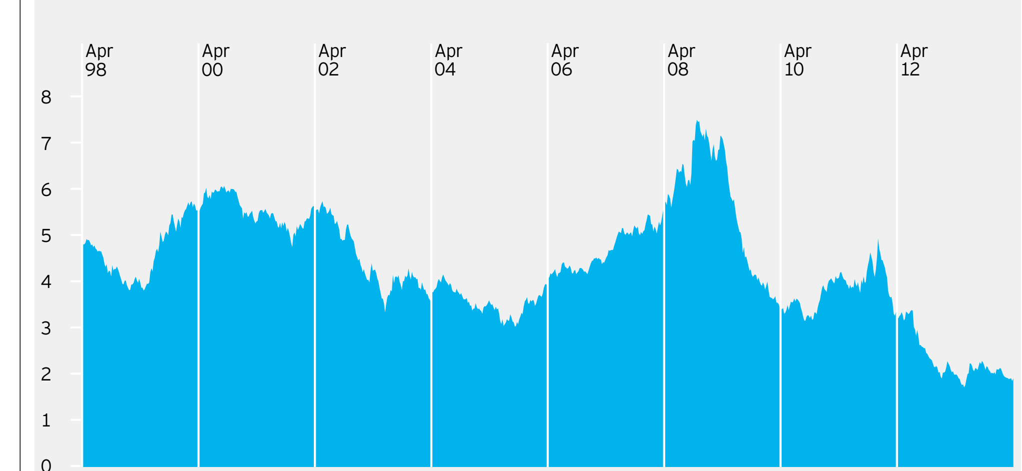
Although bond holders don't lose when a bond is called, an earlier call date has value as an option for the issuer. If market yields are falling, the issuer can call and refinance at a lower rate of interest, reducing returns for the creditor. If market yields have risen, the bond need not be called.

Other trends in the high yield market include a rise in the leverage of issuing companies[3], a large rise in the proportion of high yield supply rated B, relative to BB[3], and a rise in the percentage of high yield supply being issued for purposes not normally considered creditor-supportive, such as for leveraged buyouts and the payment of dividends^[3].

Many investment grade issuers have increased issuance of hybrid debt instruments. These securities typically allow the issuer to skip coupon payments without defaulting.

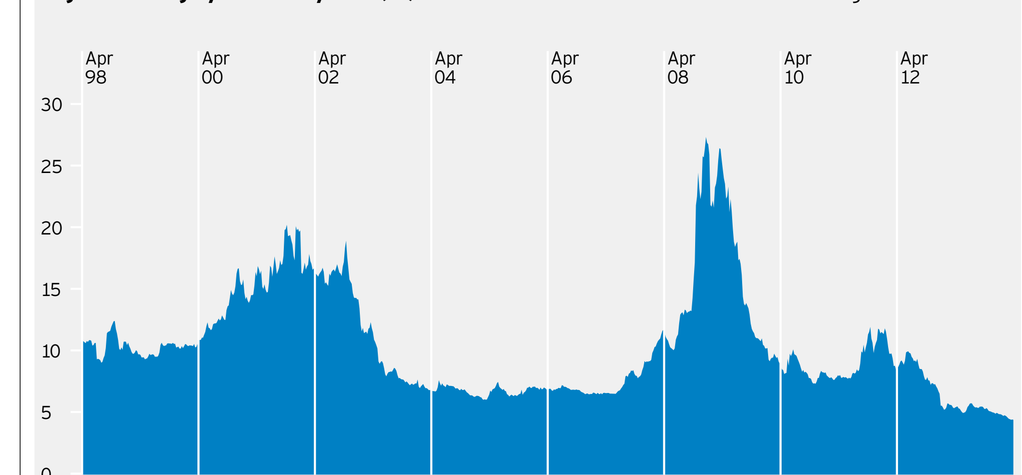
Continue on page 24

Fig 1. Euro investment grade bond yields (%)



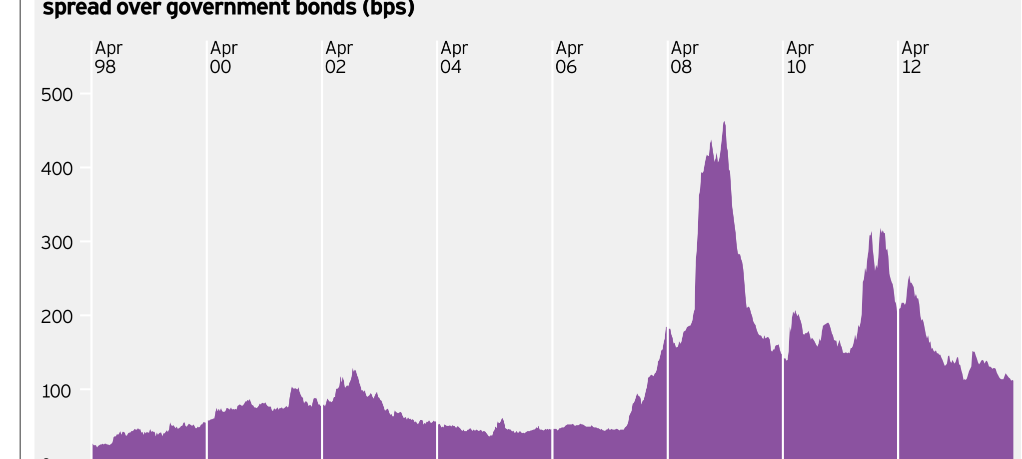
Source: Merrill Lynch, as at 21 March 2014.

Fig 2. Euro high yield bond yields (%)



Source: Merrill Lynch, as at 21 March 2014.

Fig 3. Euro investment grade bond spread over government bonds (bps)



Source: Merrill Lynch, as at 21 March 2014.

Continued from page 23

A portion of the capital raised is also considered equity by rating agencies, so protecting the issuer's rating.

While these trends can be observed at the market level, bond managers can address them at the security level. Fundamental analysis of new bond issues can take into account all of these particular features of the bond in its valuation.

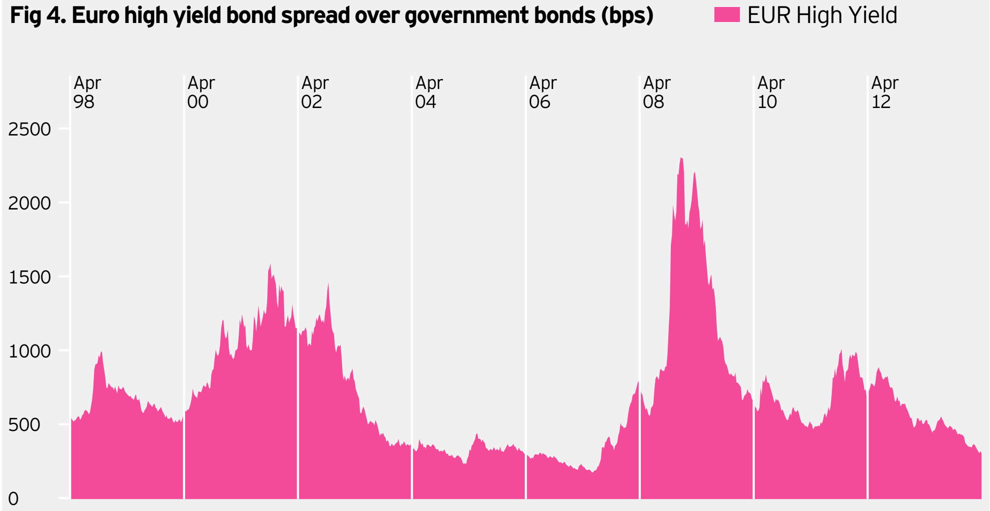
New trends in supply

Supply has been strong across the bond markets. Current low yields are a strong incentive to corporate treasurers to borrow – whether to raise new capital or to refinance existing debt. 2013 was a record year for European high yield issuance, with €83.3bn across currencies[*4]. Investment grade issuance has begun 2014 strongly and is expected to reach €700bn in the euro and sterling markets combined (Figure 6).

The rise in issuance in recent months has been driven by the financial sector (Figure 7). This sector is expected to return to positive net issuance this year after several years of heavily negative net issuance as firms have acted to reduce leverage on their balance sheets since the financial crisis.

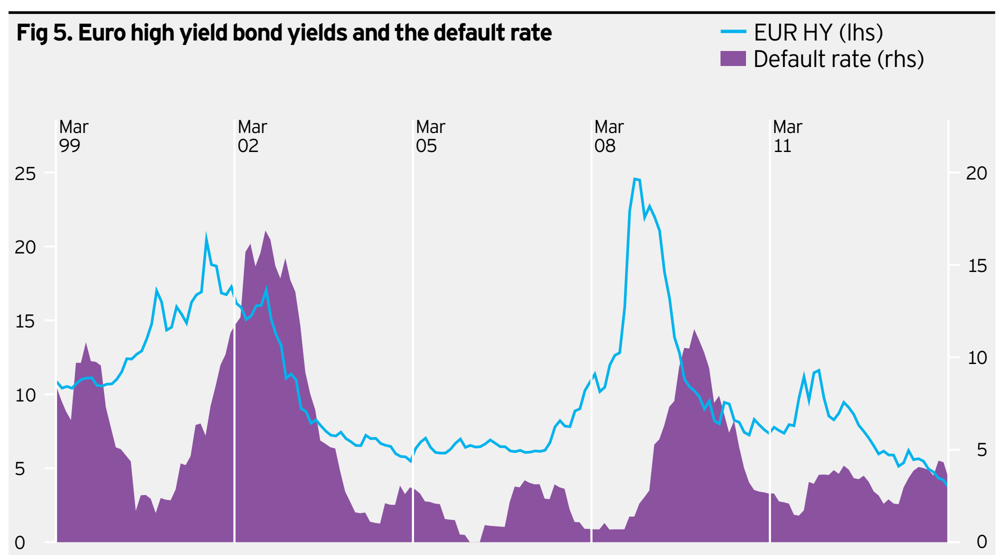
This increase in financial sector issuance reflects an important development in the market. The recommendations on the reform and strengthening of bank capital made by the Basel Committee on Banking Supervision in the years following the crisis (known collectively as Basel III) are now being enacted in legislation across Europe and elsewhere. While requirements vary by jurisdiction, with some states legislating for higher capital requirements than set out in Basel III, all require an increase in the amount of capital banks must hold and there is a common definition of the nature of capital instruments which

Fig 4. Euro high yield bond spread over government bonds (bps)



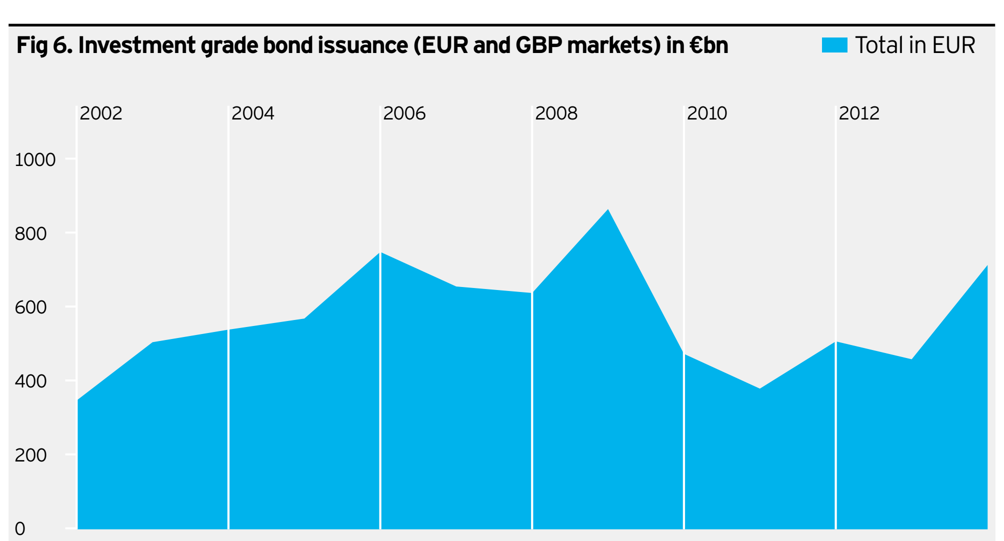
Source: Merrill Lynch, as at 21 March 2014.

Fig 5. Euro high yield bond yields and the default rate



Source: Merrill Lynch, Moody's Trailing 12-Month Speculative Grade Default Rate – Europe, as at 28 February 2014.

Fig 6. Investment grade bond issuance (EUR and GBP markets) in €bn



Source: Barclays, as at 31 March 2014 (2014 data is estimated).

"New bond deals, many with historically low levels of coupon, are being met with strong demand."

qualify as regulatory capital. The minimum level of Core Tier 1 capital is 6% of risk-weighted assets. There are further requirements for Tier 2 capital and for other, supplementary capital buffers.

Each section of the new capital requirements has specific qualifying criteria. Take, for example, Additional Tier 1 (AT1) capital. This debt can be used to meet 1.5% of the 6% target for Core Tier 1 capital. The coupons on AT1 instruments must be fully discretionary and step-ups in coupon levels (a common feature of pre-Basel III Tier 1 instruments which gave the issuer an incentive to call bonds) are not permitted. AT1 instruments must also be fully loss-absorbing, either through conversion into equity or principal writedown. Debt instruments with this sort of loss-absorbing feature, both debt qualifying as AT1 and other capital categories, are commonly referred to as Contingent Convertibles or CoCos. A number of CoCos have been issued in recent months and it is expected that this trend will continue as banks seek to adapt to the new regulatory environment[*5]. Morgan Stanley has recently estimated the European CoCo market could eventually reach €250bn.

Need for fundamental research

This pool of new debt investments is not uniform. These instruments are being issued to meet a variety of capital requirements across a number of jurisdictions with different regulations. These regulations are also new. Each bank is having to work out the best way to reach the new goals it has been set. This is leading to a great deal of variety. As Société Générale recently commented: "Standardisation of issuance remains remote in the CoCo market. Despite attempts to raise the consistency of bank capital, national discretion in interpreting the Basel Committee proposals has created non-standardised and non-homogenous CoCo debt instruments… This has led to almost every issuer adding a new aspect to their bonds."

The most important distinctions between these different instruments have to do with the conversion triggers and the treatment of creditors post-trigger. For example, the BBVA 7% Tier 1 instrument issued in February 2014 allows for conversion of the bond to equity in the event that the bank's Common Equity Tier 1 ratio falls below 5.125%. On the other hand, holders of the Credit Suisse 7.5% Tier 1 (issued in December 2013) face a full writedown if Credit Suisse hits that same trigger capital ratio. Further variation comes from the level at which any equity conversion will be enacted and whether the capital ratio trigger is defined under Basel II definitions or Basel III, along with variants of any set of bonds, such as coupon, maturity, call features, etc.

These variations, and all the others which exist across the growing universe of 'post crisis' bank capital instruments, create different risks. These risks can be hard to understand but the variety of risks and the particular circumstances of each issuing bank mean that this set of instruments cannot easily be valued using a single, formulaic approach.

The valuation of these investments will be decided by the market. At present, most are being well received, with many deals heavily oversubscribed. Rabobank recently estimated that there had been €80bn of orders for the €8bn of European CoCo issuance in the first quarter of 2014[*4]. Over time, as investors become more accustomed to the different risk elements, we think that the price variation will grow. This may be driven by a deterioration in market conditions which could test the likelihood of conversion triggers being reached and the relative benefit of equity conversion to writedown.

Conclusion

At present strong demand is supporting valuations right across the bond market. This is an environment that favours issuers, not investors. Yields are relatively low. The quality of some new issuance is falling while new capital instruments are adding new risks that are not straightforward to assess. We believe that pockets of value remain but we also think that it is sensible in these conditions to build liquidity and not to stretch for yield. The market may well become far more discerning about the valuation of different bonds when this positive tide recedes and investors must be equipped to analyse the fundamental value of each individual bond to find the best fundamental value.

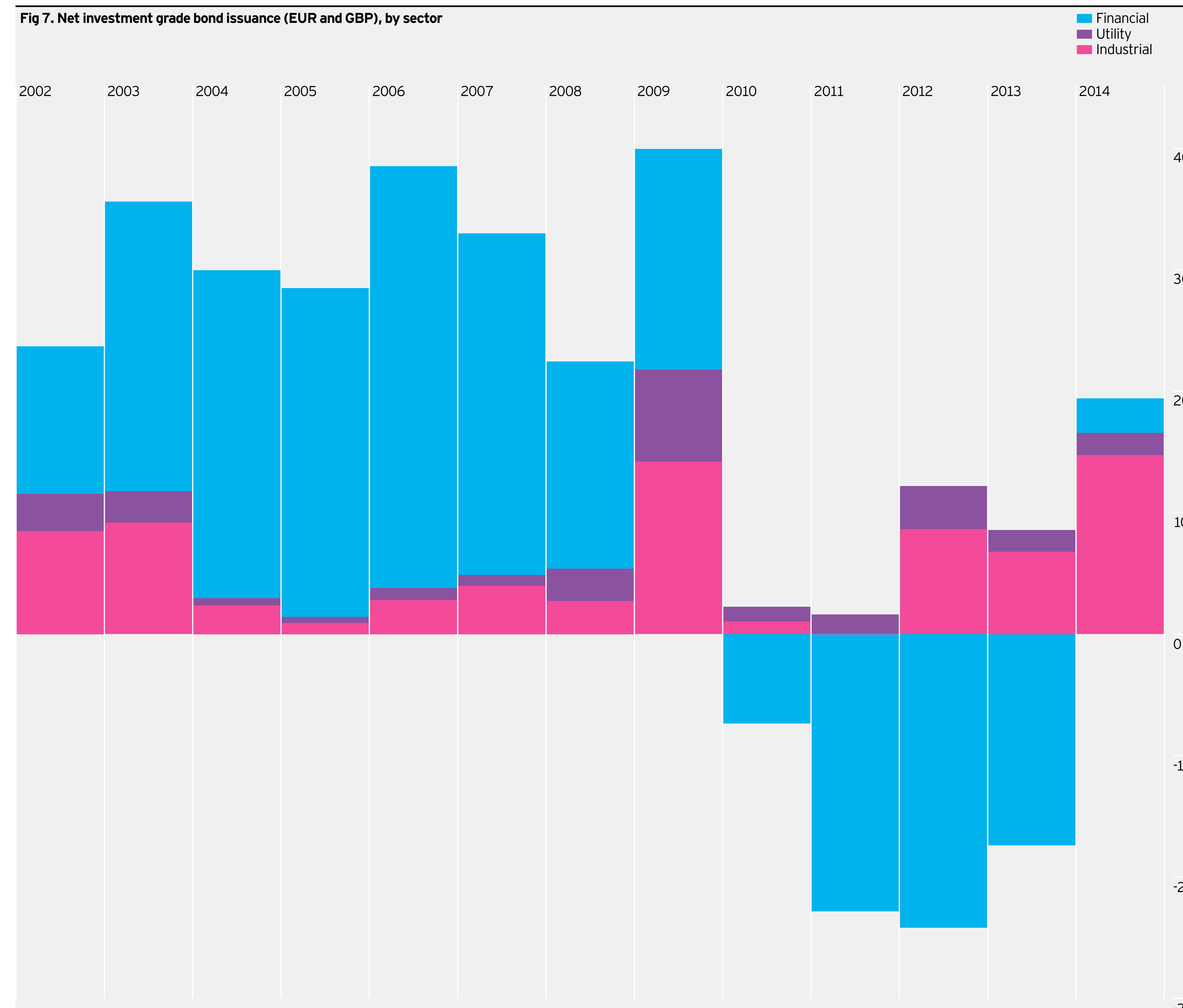
[1] BofA Merrill Lynch European Currency High Yield Index.
[2] Source: Merrill Lynch, Bloomberg, as at 31 March 2014.
[3] Source: JP Morgan, Credit Strategy, 8 November 2013.
[4] Source: Barclays, January 2014.
[5] Barclays, Euro/Sterling High Grade Supply Update, March 2014.

Table 1. Lower coupons

Issuer	Rating	Issue date	Tenor	Currency	Coupon
Heineken	BBB+	25.03.09	5yrs	EUR	7.125%
	BBB+	23.01.14	5yrs	EUR	3.500%
Coca-Cola	A+	03.03.09	10yrs	USD	4.875%
	A+	29.10.13	10yrs	USD	3.200%
BASF	A+	26.06.09	8yrs	EUR	4.625%
	A+	13.01.14	10yrs	EUR	2.500%
Jaguar Land Rover	BB-	11.05.11	7yrs	USD	7.750%
	BB-	10.12.13	5yrs	USD	4.125%

Source: Bloomberg, as at 8 April 2014.

Fig 7. Net investment grade bond issuance (EUR and GBP), by sector



Source: Barclays, as at 31 March 2014 (2014 data is estimated).

"Whilst macro concerns have so far dominated investor sentiment this year, Japanese companies generally enjoy healthy balance sheets and rising profitability."

The ultimate value play?

With strong company fundamentals and an improving global economy, Tony Roberts, Japanese Equities Fund Manager, Invesco Perpetual, looks at the reasons why, in his view, the current low valuations in Japan present a long-term opportunity.

Tony Roberts
Japanese Equities
Fund Manager
Invesco Perpetual

As some investors rotate from growth to value stock, the one stand-out value market that appears to have fallen out of favour recently is Japan. The valuations of Japanese equities are low on both a historical comparison and relative to other equity markets. Of course, 'cheap' assets do not always translate into high returns, but in our view there are a number of sound reasons that lead us to believe that low valuations in Japan present a long-term opportunity. Firstly, we believe current valuations reflect the impact of macro factors and not a deterioration of company fundamentals – in aggregate Japanese companies are in very good shape and in our view are likely to experience healthy profit growth through 2014; secondly, the global economy continues to improve and as it does the demand for Japan's exports is expected to increase, providing a boost to earnings.

After the extraordinary returns of last year, so far 2014 has been a more sobering experience for investors in Japanese equities with the Topix index down around 10% year-to-date (local currency price return to the end of April). The market has weakened amid slowing economic growth in China, US Federal Reserve tapering, the uncertain political situation in Ukraine and domestic concerns over April's consumption tax increase. The true impact of the tax hike is difficult to predict, but what is clear is that its implementation has had a short-term distortive effect on the Japanese economy with demand brought forward into Q1. This is clearly illustrated by the surge in retail sales seen during March 2014 - month-on-month sales increased to 6.3% compared to a monthly average for the prior 10 years of less than 1%. We think the consensus view that growth will now slow through Q2 is broadly correct. However, the extent of any pullback is more difficult to predict with the market likely to remain data dependent and, therefore, volatile in the near term as the extent and duration of the reactionary fall becomes clearer.

Ahead of the tax hike the market's expectation was that the fiscal tightening would be offset by further monetary easing by the Bank of Japan (BoJ). The decision therefore by the BoJ not to increase QE as inflation was rising in line with the bank's target was seen as a disappointment and equities sold off. It is worth reflecting that Japan's monetary base is still being increased at an annual pace of 60-70 trillion yen and that the governor did not rule out further easing if needed. Indeed, all things being equal, as the impact of last year's sharp fall in the yen drops out of inflation indices the pressure to provide further stimulus could well increase. Furthermore, it is somewhat ironic that after suffering nearly 15 years of deflation, a statement by the bank's governor that inflation is increasing in line with its objective has been met with disappointment. Clearly a normalisation of Japan's inflation rate is a long-term positive for the country and indeed equity markets.

Whilst macro concerns have so far dominated investor sentiment this year, Japanese companies generally enjoy healthy balance sheets and rising profitability. Looking ahead, the weak Japanese yen should continue to support earnings at Japanese exporters, while economic conditions globally are improving. As a result of the macro driven sell-off in 2014 so far, valuations have become more attractive, with the Topix currently trading at around 13 times forecast earnings for the year to March 2015. Meanwhile, the S&P 500 trades on 15 times earnings and both the Euro Stoxx 50 and the FTSE 100 at 14 times. At these levels we believe that the downside risks are largely already in the price of Japanese equities and we maintain our positive outlook for the asset class, which should benefit from greater clarity on both the economic and earnings outlook as the year progresses.

Building the portfolio

Our Multi Asset team combines an unconstrained approach to sourcing ideas for the Invesco Global Targeted Returns Fund with robust risk management. Here we talk to Dave Jubb and Richard Batty, two of the fund's managers, about how the team sources ideas for the fund and how each of the managers' different specialisms can be reflected in the ideas they bring to the table.

Dave Jubb
Multi Asset Fund Manager
Invesco Perpetual

Richard Batty
Multi Asset Fund Manager
Invesco Perpetual

When Dave Jubb says that investment ideas for the Invesco Global Targeted Returns Fund "can come from anywhere", he is not overstating the point.

Dave and Richard Batty, together with their co-fund manager and Head of Multi Asset, David Millar, have an unconstrained investment approach in managing the fund, which is mirrored in the way they source ideas. Each has different specialisms, which can be reflected in the sort of ideas they will bring for discussion. David Millar's background in fixed income means he will often look at the bond markets for ideas, while a number of the volatility trades in the portfolio are the brainchild of Dave, due to his background in derivatives. But with all three sharing a background in multi asset investing, none of them has a monopoly on a particular asset class.

"One of the things we've all done is to bring in ideas from the major asset classes. We've all had bond ideas, we've all had equity ideas and we've all had foreign exchange ideas," says Dave. "The differences between us are more about the approach to the process, whether it's an analytical one, or about identifying the economic backdrop to the investments, rather than about the asset classes."

Ideas from peers

The team also draws on the ideas of their fellow fund managers in Invesco Perpetual's Henley headquarters, together with those of the global Invesco group. External sources, such as investment banks and research boutiques, also play their part.

Any idea that gets into the fund has to go through the same three-step process during which they are approved, tested in combination with the rest of the portfolio and then implemented.

The four-part TEAM (Thematic, Economic, Analytic, Managers) research process comes first. An idea has to reflect a core macro theme which can be articulated in words; the team will then examine the particular economic drivers that will make that idea work. Richard Batty will typically focus on that part, while Dave's specialism is in the third stage of the process, which involves model building and analysing the sort of valuations that would help the idea perform. Finally, the team will canvas the opinions of their Invesco Perpetual and Invesco colleagues to discover their views and opinions on the themes behind the idea and how it might best be implemented.

Then comes the rigorous testing of the idea on its own and in combination with the rest of the portfolio. Does the idea offer sufficient return for the risk taken (can it outperform 3-month EURIBOR on a two- to three-year view)? Does it correlate with other ideas in the portfolio or have specific diversification qualities? How will it behave in the different scenarios that the fund is tested against on an ongoing basis? And is it sufficiently liquid that it can be traded effectively even for a fund many times the size of today's portfolio?

Only once an idea has been through these phases will it move onto the implementation stage where an idea will be added to the fund in conjunction with Invesco Perpetual's global trading desk and its dedicated multi asset specialist.

Of course, once in the portfolio, the processes outlined above will be repeated on a regular basis on a fund and idea level to ensure that all the research behind an idea is still relevant and that it still merits its position in the fund.

"As the fund grows, these ideas are scalable and we can add to them.."

Scalable strategy

The team can hold from five up to around 50 ideas within the fund at any one time, although typically there will be between 20 and 30 in the portfolio. The ideas currently held in the portfolio are in liquid asset classes and instruments, meaning a growth in fund size will not present an issue.

"As the fund grows, these ideas are scalable and we can add to them," says Richard. "Fifty ideas is an upper limit from a practical point of view. We don't really want to be having more than that number of ideas in the portfolio. Also, we don't need to have that many even if the fund was multiples of the size it is now as 20 to 30 ideas would typically provide the diversification necessary to achieve the fund's goals. It's really just dependent on the ideas that we think are appropriate for the portfolio and if there are more ideas that we want to put in the portfolio, we can do that."

Typically, one of the three fund managers will act as the sponsor of a particular idea, and present it to the rest of the team. The team will then put the idea through its paces, a process that can take some time.

A number of ideas will not make it beyond the discussion table. "Sometimes an idea just gets thrown out. If we can't agree on an implementation of a particular idea that is satisfactory then it doesn't go in the fund," says Dave. "We have got to all agree that it's a good idea in the form that it's finally brought to the table. Also, it's important to note that we try to build the best portfolio to achieve our twin targets of returns and volatility; so consequently the fund is not a fund of best ideas."

However, sometimes an idea may eventually be admitted into the fund, but not as it was first proposed. "It may go through iterations – the idea may get thrown out and get brought back in again in a slightly different form," says Dave.

"It can take a while sometimes," he adds. "A lot of discussion takes place, it never happens quickly, but it is about ironing out the issues that the others bring, given that they've got a different perspective on it."

"I think it's important for us to have creative tension in the team," adds Richard. "If you accept an idea too readily, too easily, then maybe you've missed something and to have that wider, more detailed discussion about an idea is absolutely critical to the process of accepting it."

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