REPORT –BACK ON CFA INSTITUTE ANNUAL CONFERENCE HELD AT HILTON HOTEL, NEW YORK, 30TH APRIL – 2ND MAY 2007

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1. BACKGROUND

This was the 60th Annual CFA Institute Conference, and the diamond anniversary was the focus of a number of celebratory events.

The Conference was attended by over 1600 delegates from 60 different countries. Less than 3% of the audience was from Africa, but there was a good (close to 30 people) attendance from South Africa.

The Conference lasted over three days and included a number of general or plenary sessions, interspersed with roundtable seminars, concurrent workshops and corporate presentations. The corporate presentations kicked off at 07h30 in the morning, running until 18h30, when the plenary sessions were not underway, and there were normally 6-8 seminars running concurrently, which made the choice of which seminar to attend often a difficult exercise.

An exhibition was part of the conference, and nearly all major financial service providers were represented. The exhibition hall was dominated by three broad providers of products:

- **Information technology**. As well as the well known companies, such as Reuters, Bloombergs, etc., there are now a multiplication of companies providing data, all with some innovative quirk to measure performance or to identify alpha, risk or trends.

- **Indexation**. A growing number of companies are providing index based products, not only on so called "exotic" markets or sectors, but also on fundamental indexation or other ways of compiling indices other than purely on market capitalisation.

- **Alternative Markets**. There appears to be a growing need to identify, measure and monitor investment opportunities and performance in these alternative markets, be they hedge funds, private equity, direct investment or emerging markets.

2. BRIEF SYNOPSIS OF SOME OF THE PAPERS PRESENTED AT THE CONFERENCE

a) Capital Ideas: Past, Present and Future – Peter Bernstein, President, Peter L Bernstein Inc.

Peter Bernstein, one of the doyennes of the US financial industry is now over 80 years old, but he still remains articulate and very much in touch with the markets and current thinking. His talk ranged through a number of topics and thoughts, but some of the focus areas were:

- **Alpha/beta debate**. Alpha and beta need to be regarded and priced differently. Beta was a commodity and could be managed and paid for cheaply. Alpha was increasingly elusive and has no relationship with beta, i.e. alpha is portable.

- **Risk and volatility**. He questioned if volatility was the right measurement for risk. Volatility forced investors to focus on the short-term, but risk and performance were often long-term phenomenon. It was extremely dangerous to think of **risk as a number**; this questioned whether the concept of measuring beta by numbers was correct.

- **Investment analysis**. Most analysis is done by analysts sitting alone in the room with a computer, whereas markets are driven by competition and contact. Often then the stock selection of analysts is done independently of the market messages and of market risk.

- **Dividend yield**. Over time, the best device to determine market timing is to transact based on current and expected dividend yields – buy when dividend yields are high and sell when dividend yields are low.

- **Market models** – are based on historical market performance, but do they take into account current market risks and events. For instance, the growth of heavily leveraged hedge funds and globalisation brings new risks not measured by historically based market models.

- **Derivatives**. Shift risk, but they are not normally regulated, so can actually add risk. The derivative contracts of today are not the same as those catered for in the Black/Scholes models and market liquidity can be dangerous to derivative strategies (Long Term Capital Markets for instance).

- **Fundamental Indexation**. The measurement of companies by their actual performance and size rather than their price (market capitalisation) was the most promising new development in financial markets.

b) Asset Allocation Strategies to Meet Long-Term Portfolio Objectives – Paul Dyer, Chief Investment Officer, New Zealand Superannuation Fund

The New Zealand Superannuation Fund was investing with a 20 year time horizon, as this was the period when the fund would need to deliver maximum performance in order to meet its funding liabilities. They invested worldwide and appeared to have a conservative stance to market and stock selection. One area, however, which stood out and drew plenty of remarks was a 10% asset allocation exposure to commodities, which had helped their recent performance.

Over time they were looking for 2,5% return above the Treasury Bill rate. The "information ratio", i.e. the return above benchmark was acceptable at 0,25% allowing for the standard deviation.

They looked for alpha returns and were not passive investors.

The Strategy which drew the most response from the audience was to leave their global exposure unhedged. They believed that – and this had proved correct over the past 10-15 years – that the New Zealand dollar would be a generally strong currency against the global currency basket. This appeared to be a long-term view on commodity producing nations and he mentioned the Australian example as well. This may have some implications for the rand which falls into the same category.

c) Roundtable Discussion on the Evolution of the Portfolio Management Process

The panellists for this debate were all US based and were all contributors to the CFA Institute's new edition of Managing Investment Portfolios, which had just been published and formed part of the material and curriculum for the CFA Institute Course.

Prior to 1972, portfolio return was measured by actual return of the entire portfolio, where performance was largely derived by the asset allocation between debit and equities.

Since 1972, there has been greater focus on diversification and the measurement of risk. Until 1990, the typical institutional fund (in the US) had 90% of its portfolio invested in stocks (i.e. equities or bonds). Now some one-third of all assets are in alternative investments. The bigger the portfolio, the greater the allocation to alternative investments. Private equity is now 11% on average of the asset allocation of portfolios of the larger endowment funds in the US.

The reason for this shift to alternative investments was that traditional investments were not providing the returns necessary to support the long-term liabilities of the funds. Hedge funds were adding some impetus to performance as they could take on leverage and go either long or short. The 30/130 strategy of gearing 30% of the portfolio and shorting 30% of the portfolio appeared to add considerable value.

In planning for future retirement, the distinction between human capital and saved capital was becoming increasingly important. Human capital was basically the concept of how long an individual or group of individuals could support themselves by earning an income stream. The ageing demographics of most of the developed world population, were focusing on how long people could continue to work before they finally retire and have to depend on their financial portfolios (savings) to support themselves. Actuarial models, based on past demographics, were of little use in looking at the future models of segmentation between human and financial capital.

d) Fundamentally Weighted Indices

Three of the corporate presentations taking place in the early mornings of the Conference were on this subject and were all well attended, indicating the general investor interest on this topic.

Normal indexation takes place on the basis of weighting the index by market capitalisation, i.e. largely the price of shares, although liquidity and free float were also taken into account. The supposed problem with this methodology is the "noisy market hypothesis", i.e. part of the price of shares on the market is "noise" and take-over frenzies or other market hype can push up the value of shares in a mark cap weighted index, well above their fundamental value.

The market cap method can lead to the overvalued shares being overweighted in the index and the undervalued shares being underweighted.

Fundamental Indices value companies in an index based on their company size, or performance, i.e. dividends, earnings or a ratio such as a price earnings ratio, etc. A concept mentioned more than once was "MARP" – the market at a reasonable price. By looking to establish higher weighting for stocks based on value, fundamental indices give a "value lift" to the investors and compete more directly with active managers who are also looking for value.

Most fundamental indexation focuses on earnings and dividends. **Dividend weighted** indices are becoming particularly popular and are widely available for US, European and increasingly world markets. Rating companies on dividends has the benefit of: providing investors with high yield products; high dividend paying companies are often re-rated and this could help a dividend based portfolio to outperform the general market; and provides some protection on the downside, i.e. the yield absorbs some of the loss of capital.

Earnings based fundamental indices, typically focus on "core earnings" and not on once off earnings and can look, not only at ratios, such as price/earnings, etc., but also can index companies on book value, cash flows, net earnings, etc., or a combination of all of these, which are called wealth weighted fundamental indices.

Multi-function indices, contain both dividend and earnings yield criteria in the constitution of the index and are also becoming more popular.

The case for fundamental indexation is generally made on the basis of:

- Markets are not truly efficient. Value can be found by quantitative methods used in fundamental indexation. The Warren Buffet quote "I would be a bum on the streets with a tin cup, if the market were truly efficient" was used more than once.

- Costs are low – fundamental indexation is more expensive than old fashioned market capitalisation indices, but is cheaper than most actively managed portfolios.

- Performance is often better than active managed portfolios – at least on a historical basis.

e) The Role of Alternative Assets in a Well-Diversified Portfolio – David Swenson, Chief Investment Officer, Yale University

The top performing endowment fund over extended periods of time in the US has been the Yale University endowment fund. The fund was operated with two simple investment principles – these were: that equities outperform bonds over time; and that holdings need to be fully diversified.

Between 1925 and 2007, bonds had provided a multiple growth of 96 times, equities 3077 times (but equity small caps had provided a 15922 multiple).

The long-term York University portfolio asset allocation was as follows:

12%	US equities
11%	Foreign equities
10%	Bonds
33%	**Traditional asset allocation**
21%	Real assets (property, direct investment)
30%	Private equity
16%	Alternative assets
67%	**Diversified and non-traditional assets**
100%	**Total**

This type of diversified approach had given the Yale fund a 15,4% annual return over a 30 year period.

The general comment of conference participants in discussions afterwards was that the Yale strategy had proved successful, but they had the advantage of being shown alternative asset allocation strategies first and such assets were hard to come by for most other investment funds.

f) The Impact of an Aging Population on the Global Economy – Jeremy Siegel, Wharton School, University of Pennsylvania

The general thrust of Professor Siegel's talk was that people are living longer and the need to finance their extended retirement is becoming a critical problem. In the 1950s, people in the US retired at age 68 (on average) and lived 1,6 years in retirement before reaching the end of their lives. In 2005, the average retirement age was 62 and the average life expectancy after retirement 15,9 years.

As the US population ages, less and less people are working to support the growing population that is in retirement. In 1950, there were 7 workers for every retiree, by 2020, there will only be 2½ employed workers per retiree.

The general acceptable solution to this dilemma was that retirement ages should rise, and it is expected by 2050 that the general retirement age in the US would have to rise to over 70 years of age. However, by that stage, life expectancy would have risen to the extent that an average of 11,6 years of retirement would still need to be funded.

The other generally accepted solutions were also faulty:

- Productivity growth would not solve the problems as wages rise with productivity improvements and so the funding of higher retirement expectancy wages remains constant.

- Immigration does not help – to keep US retirement ages in the mid-1960s would require some one and half billion new immigrants to enter the US over the next 45 years – that was far in excess of the current US population.

The solution, or a big part of it, was that the developing world would need to finance the pensions of the older developed world.

Currently, 53,3% of world GDP is produced by the developed nations, who only make up 15,2% of world population. By 2050, it was projected that the developed world would only produce 22,9% of world GDP. The US which currently produces 21% of world GDP, would have dropped to 10% by 2050. The big increases on world GDP output will take place in China (currently 14%, by 2050 19%); India (6% to 18% by 2050).

The solution to the dilemma as to how to finance the retirement of the aging first world population is to rely on the savings and capital accumulation of the developing nations. By mid-21st century, developing nations will own most of the world's capital. In 2006, the developed world stockmarkets accounted for 92,7% of world stockmarket capitalisation, by 2050, this will have dropped to 33%. So the developing world stockmarkets will have jumped from about 7% to some 70% of world stockmarket capitalisation.

What this means is that:
- Growth in the developing world will offset slowing growth in the developed world and will be able to absorb some, if not most, of the financing requirements for the pensions of the aging developed world population.
- This growth in developing nations will support future equity prices. The savings of the developing nations will be channelled into equities, to provide the required capital returns.
- Pension fund assets in the US and Europe will need to be channelled more and more into developing world equity markets. Jeremy Siegel believes this asset allocation should be 40% in international markets.

- Equity returns will far exceed bonds and real estate returns in future.

g) The Market, The Economy and Politics – Lawrence Kudlow, CEO, Kudlow & Company

"Everything good in the world is a bubble"

Kudlow does not believe that there are bubble conditions in the US, in either equity or property markets.

- US assets are still growing at three times the pace of liabilities, i.e. gearing and leverage are not growing at a faster rate than the value of assets, so there cannot be a debt financial bubble – either in property or equities.

In the US over the past 25 years, there have only been 5 quarters of negative growth. 95% of the time, the US economy is expanding and only 5% of the time is it in recession, this differs from the previous 30 years, when the US was in recessionary conditions 30% of the time. This more stable economic performance significantly accounts for the good performance by the stockmarkets.

He believed there were three broad reasons for the improved and more stable performance of stockmarkets and economies:

- The global rise of capitalism had not only increased the world growth rate, but made it more sustainable and supported markets.
- The anti-inflationary stance of all major world central banks had provided strong support for financial markets.
- Low tax rates across the globe significantly boosted the incentive for businesses to grow their assets and to re-invest in capital assets.

h) Panel on Future of Retirement Funds

The key issue identified by all speakers on this panel was the need for the return to focus on defined benefit (DB) funds. Defined contribution (DC) funds were not able to cope with the challenges of funding the retirement of an aging population, who would provide a tremendous future burden on the State and on the retirement fund industry.

It was also believed that the contributions to retirement funds should become compulsory; that the new generation DB funds should be transparent (present values must be known and should be published regularly); transferability was key; there should be less participant choice and the exposure to equities should increase substantially.

It was pointed out that only 22% of US workforce was correctly covered by DB funds.

3. Copies of the plenary session and certain other papers are available on the CFA website: www.cfainstitute.org

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