2011: A Mixed Forecast

The Calm Before the Storm?

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With another year in the books, many of the major questions introduced by the financial crisis have been answered, or at least partially so. While neither the global economy nor the global financial system are thriving, financial markets are again functioning, thanks in part to efforts on the part of central banks across the globe to pump more liquidity into the system.

Successful IPOs by firms such as LPL Financial, General Motors and Petrobras, as well as the recovery of the commercial paper market, are evidence of functioning capital markets. Meanwhile, in spite of lowered return expectations, the MSCI Barra All-Country World Index has plowed ahead almost 10% YTD through the first week of December.

Yet, if the patient is out of the operating room, there are still serious risks of complications from surgery. The U.S. housing market, one of the largest villains of the global crisis, is still unstable, as sales of existing homes declined more than forecast in October, even as pending (but not yet completed) sales rose by 10%, according to the National Association of Realtors. Unemployment rose from 9.6% to 9.8% according to the Bureau of Labor Statistics, with 42% of that total being jobless for 27 weeks or more, which should continue to constrain the growth in consumption that typically accounts for two thirds of overall spending.

Pension markets are far from healthy, with tough decisions to be made across the globe. In the U.S., 48 states face funding shortfalls totaling a record $192 billion, representing 29% of total state budgets, according to research from the Center on Budget and Policy Priorities. In France, as many as 2.7 million people took to the streets to protest the potential raising of the retirement age from 60 to 62, though government officials insist that it will have to happen. Experts predict that without reforms in the not too distant future, even the esteemed German Bund could be relegated to junk status by year 2038. In Hungary, the retirement predicament takes a different spin, as the government has moved to shore up its budget by seizing pension assets, enacting a devastating 70% penalty for investors who elect to maintain private pensions.

The predicament of pension funding, particularly in the public market, is highly interdependent with economic and fiscal policy. Ironically, pension consulting firm Mercer notes that the Federal Reserve's second round of quantitative easing could actually inflate pension liabilities as discount rates decline.

Strong Investment Opportunities

If the global economy remains on the watch list, this does not necessarily translate into lack of opportunities for investment managers. Some portfolio managers have been vocal about the need for investors to separate economic and stock market performance, arguing that American corporations are very lean, making even modest improvements in top-line growth highly leverageable into bottom-line results. Data from Bloomberg reveals that for the sixth straight quarter, 70% of S&P companies have beaten their consensus earnings estimates. Similarly, Standard & Poor's notes that S&P 500 companies hold about 10.6% of their market value in cash, increasing the potential of stock buybacks, mergers and acquisitions, or capital expenditure, all of which could foster additional economic growth.

Even if the U.S. economy should prove challenging, many believe that U.S. stocks could benefit from growth in other regions. Standard & Poor's reported in August that of the large-cap companies in the S&P 500 that disclose the data, 47% of 2009 sales (roughly $2,000bn) came from outside the U.S. This plays well with the almost universal belief that BRIC countries will drive global GDP growth in the near, if not long-term, future.

In a recent interview with online news service Citywire, Jim O'Neil, chairman and economist at Goldman Sachs, who coined the term "BRIC," stated his belief that these countries should no longer be thought of as "emerging" economies. The fact that many of these economies are healthy from a budgetary perspective is also encouraging, as excessive borrowing on the part of the consumer is a nonissue.

New Distribution Opportunities, New Challenges

The same growth in Asia and Latin America, which managers have identified for investment opportunities, offers tremendous distribution potential as well. For example, Mark Fetting, chairman and chief executive of Baltimore-based Legg Mason, told *The Wall Street Journal* in October of his firm's goal of increasing non-U.S. client assets to 50% in the next few years from 35% today. In Asia, much of the low-hanging fruit has been picked via the UCITS framework, as the European standard has been exported to offshore centers such as Hong Kong and Singapore. In spite of the balance of transparency and functionality offered by UCITS, the next stage of distribution in Asia and Latin America is likely to rely on onshore distribution, using local structures denominated in the local currency.

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But for Western managers, onshoring comes with a series of challenges. Acquiring a local footprint does not come easily, whether by acquisition, joint venture or building from scratch. In any region, acquirers should pay careful attention to valuation and potential synergies; however, in Asia, standard Western assumptions regarding savings behavior, asset persistency, consumer tastes and product preferences may not apply. Driven perhaps equally by investor tastes and heavy reliance on a commission model, investors tend to chase the "hot dot," which works fine for the local bank, but less so for the asset manager attempting to increase distribution.

At a more basic level, obtaining the right to conduct business in local markets, such as China, can be difficult. Qualified Foreign Institutional Investor licenses are meted out quite slowly and methodically and joint ventures can be equally complicated. Moreover, some of the best potential distribution partners may have already inked exclusive deals. Experiences will vary across the continent: while one could argue that neither Europe nor Latin America is homogeneous, the differences between China and Japan, or India and Australia, are much more pronounced.

Despite these myriad factors, global distribution is not necessarily a pipe dream. Some of the early entrants from the U.S. and Europe have been disappointed with their results in Asia and Latin America. Part of the solution may lie simply in resetting expectations, and realizing that expanding into growth markets is a long-term play, requiring tremendous upfront due diligence and a long-term commitment from senior management and shareholders.

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