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INVESTOR SERVICES

Perspectives

April 2010

The global power shift

New directions for the world economy



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Perspectives is a publication of RBC Dexia Investor Services. Comments and questions are welcome and may be directed by email to marketingcommunications@rbcdexia.com.

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José Placido
Chief executive officer,
RBC Dexia Investor Services

Breaking Down Borders

Redefining the terms, the players and the rules

Based on the comments of managers that we feature in this issue of *Perspectives*, it may be necessary to drop “emerging markets” from the investment lexicon. That might be somewhat overstating the point, but it’s clear that markets traditionally thought of as “emerging” have arrived. Consider China and India — two economies that are burgeoning financial centres in the global investment world. As their populations rapidly develop savings pools and create new jobs, these nations are set to build a middle class that is in retreat throughout other parts of the world.

The theme of our current edition of *Perspectives* is globalisation — breaking down borders, building new global markets and rebalancing the centre of finance to new parts of the world. Not only do we examine the increasing role of China and India, we also look at Latin America, a region that has risen from fiscal turmoil to stability and growth. And we track the evolution of the asset management industry following the financial crisis. An era of consolidation and global expansion, combined with new regulatory and political challenges, could slow trends that have defined this industry in recent years.

We hope that you enjoy *Perspectives* and welcome your feedback.

A handwritten signature in black ink that reads "José Placido". The signature is fluid and cursive, with the first name "José" and last name "Placido" clearly legible.

Asia Rising

China and India are moving to centre stage in global markets

Just a few years ago, emerging markets played a small supporting role on the asset allocation stage, dwarfed by powerhouse economies in North America and Europe. Perceived as a risky niche investment, such markets can be hard to access. But this is changing dramatically. As so-called developed markets languish, countries like China and India stand at the centre of a major market and economic boom. Many believe these once-marginal economies will power a sluggish world economy back to life — and for good reason.



The best place to be in an era of depression-style economics is the emerging world. It's an essential risk reducer for worst-case scenarios. ”

China and India are experiencing rising savings rates and boast a growing middle class, two areas where other countries are quickly losing ground. Going forward, how will these countries change the face of global markets? And can they sustain the growth?

London-based Jerome Booth scoffs at the notion that Asian markets are risky, volatile or somehow difficult for investors to enter. Head of research at Ashmore Investment Management Ltd., Booth says those who think that China and India are any more risky for investors than Western countries could use a lesson in history — or current events.

Developed markets will continue to pay for what he calls the sins of the past. “The brutal truth is that we are in an enormous credit crunch that is affecting those countries with a huge amount

of leverage built up through a 20-year period of excessive financial engineering,” he says. The crisis has proved that markets once thought to be stable and well regulated are actually quite risky. In fact, Booth sees markets like China and India as a safe harbour

in a volatile world. “The best place to be in an era of depression-style economics is the emerging world. It's an essential risk reducer for worst-case scenarios.”

Paradigm shift

While market players are generally upbeat about prospects for emerging markets, such as China and India, some believe that real issues still surround market access. Vincent Strauss, vice-chairman of Comgest Asset Management International Ltd. in Paris, says it's still difficult for investors to gain entry to China or India. “Neither is very accessible for investors.” For example, he notes that, in China, all investors aren't treated equally. There are separate investments for foreign and domestic investors. Without a level playing field, both countries are tough to access. “It's not that easy to make money in these markets,” Strauss cautions.

Despite the high entry barriers, a major shift eastward is underway in the global investment landscape. N. Ganapathy Subramaniam sits in the midst of a huge tide of growth and transformation in India. As president of TCS Financial Solutions in Bangalore, he believes

that India has an opportunity to follow an economic strategy that will lead it along a similar path to the one followed by the US post-1945, creating a large and hard-working middle class that will one day make the country a global economic leader.

India, along with China, is attracting the attention of investors for very good reasons, Subramaniam says. The focus on Asia in the global economic scene constitutes a “paradigm shift” that is changing the face of international markets. “There is a growing realisation that the centre of gravity in the economic world is wobbling, moving eastward. And with it, there is a need to shift a larger portfolio of investments than has been done in the past,” he explains. China and India are growing out of their “emerging market” status and shining more brightly than developed markets.

Eduardo Repetto, co-chief executive officer and chief investment officer at Dimensional Fund Advisors in Austin, says you just need to look at the numbers to see the trend — seven of the 20 largest markets in the world are considered emerging: Brazil, China, India, Korea, Russia, South Africa and Taiwan. “Emerging markets used to be a satellite allocation,” Repetto explains. “Today, most globally diversified portfolios include allocations to emerging markets without raising any eyebrows. In fact, given the growing importance of emerging markets, it would be awkward not to have an allocation to them.”

This makes sense, he notes, given that just five years ago emerging markets represented less than 6% of global market capitalisation. Today, that figure has doubled to 12%.

There’s another way to look at the growth of emerging markets, especially as other countries seek to serve the needs of these new parts of the world. Michael Boychuk is a Canadian pension plan sponsor, who is eyeing growth on his home turf. As president and chief executive officer of Bimcor Inc. in Montreal, he says countries like Canada, that serve the emerging market appetite for commodities, will do well in the years ahead. “One would consider Canada a developed nation, but it’s also a much safer proxy for emerging market investment. That’s because emerging markets are looking for commodities — oil, materials and copper — to fuel the growth. Where will that come from?” Commodity-rich countries like Canada and Australia offer investors indirect exposure to Asian growth, but with more evolved regulatory and legal systems, he says.

Grizzly grows up

But can this pace of growth be maintained? And is it realistic to expect China and India to power the rest of the world out of the economic doldrums? Kelvin Lau, regional economist with Standard Chartered Bank in Hong Kong, expects China and China-related investments to continue to grow at impressive rates, especially as this country carries on the gradual opening-up of its financial



Jerome Booth

Head of research,
Ashmore Investment
Management Ltd.
LONDON

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Michael Boychuk

President and
chief executive officer,
Bimcor Inc.
MONTREAL

.....



Kelvin Lau

Regional economist,
Standard Chartered Bank
HONG KONG

Asia Rising

markets to overseas investors. But Subramaniam isn't as sure about the pace of growth. "China is like a grizzly bear growing up. It is on a fast path and is huge." But it has to stop somewhere. "For example, fourth-quarter growth was running at 10.7% annually. December industrial production

“

As creditor nations, these countries have all the bargaining power. They can decide the pace of rebalancing and the terms of trade for the global economies.

”

was up 18.5% year-over-year, while fixed-asset investment grew by 30.5%." And when the slow-down finally does happen, Subramaniam says the transition could be tough.

Political and policy risk, less liquidity, more volatile economic cycles — these are risks that Lau points to. And in the short-term, they are the emerging market characteristics that, he says, still hold such markets back. However, in the future, Asia stands poised to assume far more economic and financial power. As populations in India and China grow in wealth and influence, an entirely new populace of investors will emerge. "This population is increasingly wealthy and has plenty of untapped savings," says Lau. "Its demand for investment products and financial services could only become greater and more sophisticated over time."

Provided China and India can keep growing, Lau says the financial crisis is going to be a "catalyst for a shift in economic and financial power from the West to the East." However, he notes, the West still accounts for a huge portion of the world economy. "China's domestic consumption is only

one-eighth of that in the US," Lau explains, adding that "China's GDP per capita is still slightly over USD 3,000 and India's is even less. Chances are that these gaps between the West and the East will take a long time — certainly more than 10 years — to fully close up."

Jerome Booth believes that global rebalancing is going to happen on a massive scale. The seeds for that shift are being sown right now. "Global rebalancing means that these currencies will rise versus old currencies," he says. "The average reserve-to-GDP ratio is about 30% in the emerging world. That is massive. As creditor nations, these countries have all the bargaining power. They can decide the pace of rebalancing and the terms of trade for the global economies,"



Eduardo Repetto

Co-chief executive officer and chief investment officer, Dimensional Fund Advisors AUSTIN



Vincent Strauss

Vice-chairman, Comgest Asset Management International Ltd. PARIS

he explains. Emerging markets like China and India are also set to shift to more of a consumption model of growth. "There will be an increased need to absorb high levels of domestic savings in these countries and other emerging market economies." Booth expects investment booms in capital-intensive sectors like infrastructure. And this is going to happen for a long time, he says.

Latin America Q&A

From volatility to positive growth potential

Hard times have taught Latin American countries some important economic lessons over the last 30 years. From the oil shocks of 1979 to the debt crises that spread across the region in the 1980s, Latin America was paralysed by poor monetary policy and political volatility. Today, many countries in the region are reaping the benefits of efforts by monetary authorities in countries like Brazil, Chile, Colombia, Mexico and Peru to rebuild the region's credibility, stabilise inflation and attract new investment.



WHO

Charles Ferraz

Chief investment officer,
Itaú Private Bank Brazil

WHERE

São Paulo

FACTS

- Largest private bank in Brazil
- Best private bank in Brazil and Chile (*Euromoney*, February 2010)
- www.itauprivatebank.com

What's going to drive growth in Latin America going forward?

The fiscal discipline of the last few years has meant that we weathered the financial crisis much better than other countries. For example, Brazil is set to grow its economy by 6% this year. Latin American countries in general are forecast to grow more than other regions in the world because of the reforms that have been put in place. We also have a strong tradition of entrepreneurship. This tradition, combined with a push for democracy in the region, is going to create a good environment for business going forward.

What are some of the challenges?

Right now, we face high interest rates — 8.75% a year is the base rate in Brazil and that is going to increase in the near-term. But

I believe that interest rates are going to be substantially lower in the next five years. Decreasing interest rates will mean companies can take on new projects as the cost of the opportunity decreases. That will boost economic growth.

On the investment side, we anticipate new opportunities in private equity and fixed income. We also enjoy highly sophisticated and developed financial markets, as well as a solid futures and exchange market in the region.

What are the risks?

I think the main risk to Latin American markets is short-termism on the fiscal side. Employment rates are sound and inflation is under control, but if governments get complacent and decide not to follow through with needed reforms, that could jeopardise the region.

There are still some socio-economic gaps. Much investment is required on the education front. And there is a need for infrastructure; without it, we can't grow. But that is also an opportunity and, given the current microeconomic policies, I think the region can attract resources to build infrastructure.

Reversal of Fortune

Regulators could push the consolidation trend back a few years

World leaders in Davos, Switzerland, started 2010 by taking aim at the financial services sector. While French President Nicolas Sarkozy labelled the financial crunch a “crisis in globalisation,” US President Barack Obama tapped into public anger over the situation by saying that big banks would never hold US citizens hostage again. Given that consolidation and globalisation have been the biggest drivers of growth in the asset management industry over the past decade, these comments struck the heart of the business.

Asset managers have been working on initiatives like the Undertakings for Collective Investment in Transferable Securities (UCITS), generating new products that break down regulatory barriers among regions. However, as regulators struggle to deal with the aftermath of the financial crisis, some of those barriers could be resurrected.

The financial crisis laid bare some major flaws in the financial system and, according to Susan Mangiero, chief executive officer, Investment Governance Inc. in Fairfield County, Connecticut, it has also created huge pressure for regulators to do something. “Large-scale losses and negative headlines

have put immense pressure on regulators and politicians to address regulatory gaps as a way to further protect investors,” she explains. “Bad times beget more regulation because no one wants to be held responsible for the average employee not being able to retire with a reasonable amount of income, children not having funded sports and arts programs due to budget cuts, or hospitals not getting certain programs funded because an endowment’s portfolio has plummeted in value.”

One of the big areas that policy-makers seem to be focusing on is the size of financial institutions. If financial institutions become too big to fail, the risk is that governments — and taxpayers — will be forced to bail them out in the future. The solution, for now, appears to lie in efforts to break up institutions that are deemed to be too large. Just what effect this is going to have on asset managers, particularly bank-owned firms, remains to be seen.

Trend in reverse

According to some managers, however, breaking up large firms could slow down an expansion phase that has helped create economies of scale for an industry under pressure to cut costs and

achieve global reach. “There is a lot of pressure on organisations to contain costs,” Mangiero explains. “This means that sales and marketing teams are being cut back at the same time that competition is increasing for buy-side assets. Some buy-side executives are moving their business in-house, and mandatory regulatory compliance is increasing costs that cannot be reduced.”

While consolidation is necessary for survival, the regulatory pendulum could soon reverse the trend, causing financial institutions to carve up their businesses. “Politicians and regulators are looking at the cause of the crisis,” explains Alain Picquet, partner, KPMG Advisory in Luxembourg. “They are asking banks to decrease their size, carve up some of their activities and sell them off.” This will have a knock-on effect for many managers who could lose access to vital distribution and some of the back-office functions that they enjoyed as part of a major institution. Picquet says that an asset manager cut loose from a bank will then have to find new distribution networks. “That’s a big question mark,” he warns. “More managers could be forced to find new alignments with other banks — it will be challenging.”

While there is a threat to some managers, Picquet thinks most big banks and institutions still need to finish the consolidation job to better serve investors. “We see many managers who, after mergers, have not yet integrated all the components and parts they have been taking on. This is continuing,” he says.

N. Ganapathy Subramaniam, president of TCS Financial Solutions in Bangalore, agrees that a lot more work must be done to effectively integrate firms that have consolidated. “The ultimate goal of consolidation is to take out cost and that has to happen fast,” he explains. “The industry still has a big job to do in terms of cost elimination. It isn’t sufficient just to execute a simple merger of investment teams. Rather, consolidation needs to find benefits from economies of scale in administrative functions, client service, technology infrastructure and distribution. It should also focus on broadening sales channels and geographic reach.” The goal of consolidation can’t just be cost-cutting — it must lead to greater mutual value and a better client experience, Subramaniam adds.

While the push to consolidate operations is driven in large part by increasing pressure to reduce costs in the wake of smaller margins, large firms still haven’t figured out the biggest piece of the merger puzzle: will size enable them to have better performance? For Picquet, this means finding ways to ensure that a merger leads to integrated products and consolidation in the back office.

New barriers

Subramaniam believes that consolidation should and will continue — it’s the key to meeting evolving investor needs. Investors want products that meet high regulatory requirements, so they will look to those that come from developed markets. UCITS is an excellent example of this. “Global demand has only increased for stable and well-regulated investment products,” he explains. “UCITS sales outside the EU, especially in South America and Asia, are on the increase. In Hong Kong, Singapore and Taiwan, significant traction is being seen for UCITS-compliant funds.”

And it’s not just Western firms that will benefit from global demand for products. As emerging markets continue to expand and grow, so too will their banks, potentially resulting in a host of new players on the global stage. Jerome Booth, head of research with London-based Ashmore Investment Management Ltd., says this trend could also change where people do business. “Financing will go to emerging market banks,” he says. “Why can’t Asian banks, for example, expand into Europe?” Booth says that, on the regulatory front, there will be far more cross-border business with emerging markets and Asia — not just as consumers of Western products, but also as service providers in a changing financial services landscape.

For now, however, asset managers face a threat to globalisation. Kelvin Lau, regional economist with Standard Chartered Bank in



Alain Picquet
Partner,
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LUXEMBOURG



N. Ganapathy Subramaniam
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Hong Kong, agrees. “Since the financial crisis, the risk is for the globalisation trend to stall or even reverse. This is evident in the rise of trade protectionism tendencies, and there is divergence in views over the banking sector debate, resulting in certain nations pursuing their own populist measures.” Where all this ends up will determine the future of the global financial industry, he says. “We have yet to see the new definition of ‘banks’ in the post-crisis world, and that will, in turn, influence the shape and form of the investment industry.”

Risk Management Q&A

Risk is a four-letter word



WHO

Susan Mangiero

Chief executive officer and founder, Investment Governance Inc.

WHERE

Fairfield County, Connecticut

FACTS

- Author of *Risk Management for Pensions, Endowments and Foundations*
- Creator of PensionRiskMatters.com and FiduciaryX.com

Is globalisation making risk management tougher for institutional investors?

Globalisation reflects a much faster information flow than ever before. This requires institutional investors to stay abreast of current economic, regulatory and geopolitical happenings around the world. Something that occurs in a seemingly remote corner of

As regulators struggle to fill the gaps that created the financial crisis, money managers and investors are coming to grips with risk within their own organisations. Susan Mangiero believes that many new risk management challenges lie ahead for the industry.

the globe may turn out to have a material impact on prices and volume. Managers must now pay close attention to value drivers in multiple countries and currencies, while acknowledging that correlations might change quickly.

Has the financial crisis led to any meaningful changes on the risk management front?

Investors have come to terms with the reality that liquidity is illusory for some types of assets. Additionally, there are a lot more questions about risk-taking and internal controls. Some asset managers have hired chief risk officers or, if they had one already, increased the size of the risk management team. And I don't think anyone wants to see their name in headlines over a big loss. In the aftermath of financial scandals and turmoil, risk is a four-letter word in every sense. We are all risk managers now.

What is your view on the role of policymakers in the wake of the bailouts and stimulus packages?

As an ardent free marketer, I am disturbed by so much heavy-

handed regulation. "One size fits all" mandates almost always result in unintended consequences. The last thing anyone should want is for risk-taking where some bear the consequences of the bad actions of others. On the other hand, freedom comes with responsibilities. It's in everyone's best interest to have robust industry self-regulation that rewards advocates of best practices and penalises bad stewards of other people's money.

What are the common misconceptions when it comes to the role of leverage?

There is no magic answer in terms of what level of leverage is optimal for a given institution. A fundamental problem is that there is no consensus in the industry on how to measure leverage. If you can't quantify something properly, how do you manage the risks? All leverage is not created equal. A short position in an actively-traded instrument has a different risk-return profile than taking on debt or synthesising exposure with puts or a combination of derivatives.

