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THE CHANGING LANDSCAPE OF THE ASSET MANAGEMENT INDUSTRY

Asset management companies need to rethink the fundamentals of their business model and change their basic thinking and intuition of what it means to be an asset manager because of the presence of “disruptive” forces, according to McKinsey’s Senior Advisor and Co-Lead for Asia Asset Management and Wealth Management Practice.

Anu Sahai says that the asset management industry faces new challenges in this era of disruption, which will affect financial performance if left unchecked.

“The industry is changing dramatically and we need to think about how we look at it today. We need to think about how we change our thinking and reset our intuition about this industry. We need to move away from the traditional model towards one that is more solutions-oriented.”

> ***“The industry is changing dramatically and we need to think about how we look at it today.”***

Clients are becoming increasingly sophisticated, she adds, and now have unsurpassed access to a variety of digital tools and online resources to help them make investing decisions on their own.

Asset managers, therefore, need to refocus on their unique value proposition to their clients, and to better manage their operations. The era of constructing a generic basket of products for a mass audience is quickly coming to an end.

"We need to move away from the model where we select securities, offer a basket of products to our consumers and pay distributors to market the fund."

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> ***"But, going forward, if we think about what we need to do, we also need to start thinking about branding because this is all about customers and end-customer engagement."***

"But, going forward, if we think about what we need to do, we also need to start thinking about branding because this is all about customers and end-customer engagement. What do they resonate with when they hear our brand? What is our differentiated product and service offering today?"

Spurring this step-change in the asset management industry are six distinct disruptive developments, Sahai explains:

i. The end of super-normal returns: Based on McKinsey's research, global returns over the last 30 years have averaged between 6.9% and 7.5%. However, in the next 20 years, average returns are expected to fall between 4% and 6.5%. Bond yields are also expected to fall between 0% and 2% from 1.7% and 5%. These significant changes in yields will require a reset of expectations of all future growth for the industry.

> ***"We need to think about how we change our thinking and reset our intuition about this industry. We need to move away from the traditional model towards one that is more solutions-oriented."***

ii. Growth of passives: Passives, or index-linked products, have seized hold in the Western world. Cheaper than actively managed funds, passives have taken a significant portion of equity capital, which will erode the premium of "benchmark-hugging" funds.

iii. The increasing sophistication of clients: Clients are becoming better educated and therefore they demand more from their financial advisors. The traditional way of selling is not in sync with what clients want today. This thus puts pressure on existing distribution models. The industry therefore needs to prioritise solutions-based selling, targeting key areas such as retirement funding and liability matching.

iv. Innovations and developments in data and technology: The tendency to think about technology as supportive of the back-end is prevalent although innovations have brought technology and data to be at the fingertips of the consumer. The rise in consumer applications and mobile technology has given consumers greater freedom and abilities to seek their own investing solutions.

v. Increased regulation: The increase in the number of existing regulations as well as the introduction of new regulations in Asia are changing the dynamics of the asset management industry. Regulators are targeting issues at the heart of this industry, namely consumer protection, such as transparency and fairness to the consumer. While there are positive developments, the increasing complexity of the regulatory structure entails greater costs, which the industry will have to manage.

vi. The competition for talent: There is an increasing competition for talents, both in the region as well as around the world. Recruitment and retention of skilled personnel are among the challenges for asset management companies. Nevertheless it is vital that talent remain part of the company's business philosophy and culture.

Collectively, these structural trends will have a substantial impact on net flows and bottomlines if the industry decides to not do anything about them.

"In the past, we tried to figure out best strategies to bring to the market, about streamlining our product offering, and optimising product pricing. The industry may try to defend the past but what we need to do is to start building for the future," she says.

> ***"The industry may try to defend the past but what we need to do is to start building for the future."***

Source: Morguefile

UTCs need to evolve into advisory role

Unit trust consultants (UTC) need to adapt to the changing landscape of the asset management industry if they are to remain relevant and sustainable, panellists at the FIMM Annual Convention 2016 say.

Discussing the topic "Accelerating the Future of Investment Planning", panellists Danny Wong Teck Meng, KL Tang, Chan Ai Mei and moderator Linnet Lee agreed that the demands and expectations of clients are changing rapidly. The increased usage of financial technology (FinTech) and alternative advisory services mean that clients are becoming more independent in making investing decisions, a result of the substantial growth of "robo-advisory" services.

Chan noted in her introductory comments that despite the rapid growth of FinTech service and the Wealthfront survey in the US that showed an increase from 40,000 to 90,000 FinTech investors over the last three years, the human approach is still much relevant in the industry.

"There is going to be a shift as more people start to believe in automated investments, but what's important is that we realise that we can continue to add value to our investors and that we build relationships," she says.

From this perspective, the role of UTCs has less to do with pushing or selling products, but more towards offering a solutions-oriented value proposition. The role of a UTC must therefore be centred on advising clients and tailoring portfolios to meet their specific investment needs while maintaining the highest levels of professionalism to build a relationship of trust and to provide clients with the necessary expertise.

"The first thing you need to manage is your reputation," Areca Capital Sdn Bhd's Wong says. "For UTCs, this means that in your service, you cannot engage in any misselling activity. At the same time, you must constantly enhance your products and industry knowledge. The second thing is you must manage risks, and thirdly you need to leverage on partners and your network."

> ***"There is going to be a shift as more people start to believe in automated investment, but what's important is that we realise that we can continue to add value to our investors and that we build relationships."***

Source: Morguefile

In doing so, Wong adds, UTCs can transition their roles from being product pushers to trusted advisors, which will in turn build a lifelong relationship with clients for the mutual benefit of all parties. This has become more important, FA Advisory Sdn Bhd's Tang adds, because clients are now more financial savvy and have higher expectations of their financial advisors.

"Clients no longer just listen to you but they check online and with a few other people before making a decision," Tang says. "Staying relevant and useful to the client is important, which means you have to upgrade yourself and remain relevant to the industry."

"What is your business as a unit trust consultant or financial consultant? Are you in the business of selling unit trusts or in the business of building assets under management, that is helping people grow their money?"

While both are acceptable answers, the latter will have greater impact on the client and industry, and create "stickiness" within the relationship. This is especially important in line with the national aspiration for Malaysia to become a developed country by 2020. Industry and asset managers must therefore develop more sophisticated and complex products to cater to the mass affluent and high net-worth individuals, which in turn require developed and sophisticated UTCs.

In addition, UTCs also cannot ignore professional considerations.

New regulatory changes designed to improve consumer protection will likely create higher professional expectations of UTCs through the introduction of new benchmarks under a balanced scorecard. Malaysia is likely to introduce UTC benchmarking methods similar to Singapore that will assess the UTC on other factors aside from sales, which include the quality of advice as well as the bases of recommendations and disclaimers.

Both Wong and Tang agreed that technology, regardless of robo-advisory and FinTech, will play a key role in UTCs' interactions with clients. The efficiencies introduced by technology are essential

> ***"For UTCs, this means in your service, you cannot engage in any misselling activity and you must constantly enhance your products and industry knowledge."***

> ***"The industry and asset managers must develop more sophisticated and complex products to cater to the mass affluent and high net-worth individuals, which in turn require developed and sophisticated UTCs."***

Source: Stockvault

in helping UTCs conduct research and communicate with clients, and should be viewed as a tool to help UTCs better serve their clients. This is especially true for the new generation or the millennials who prefer to self-manage their portfolio via applications and are techno savvy to obtain information from online resources.

"The future of the industry will be a combination of expertise and technology—a combination of knowledge of constructing a portfolio for the client and of using technology to communicate to clients. If you are not equipped with expertise, you will be replaced by robo-advisory services."

Panellists at the session also discussed the possibility of a move away from a commission-based model in Malaysia, similar to some other developed markets. While there is no indication that this will happen in Malaysia anytime soon, the panellists were in consensus that a fee-based structure is not the end of the UTC industry in the country so long as the fees are fairly set.

> ***"The future of the industry will be a combination of expertise and technology—a combination of knowledge of constructing a portfolio for the client and of using technology to communicate to clients."***

Source: Stockvault

Investing responsibly with Shariah funds

Shariah-compliant unit trust funds and assets may be gaining traction within Malaysian borders but more needs to be done before they are accepted internationally.

However, growing investor interest in sustainably-run businesses may help the growth of Islamic assets, according to Najmuddin Mohd Lutfi, Chief Executive Officer of BIMB Investment Management Berhad.

He said that Shariah assets have natural synergies with interests driven by global concerns on socioeconomic issues. There is a global shift in business strategies where sustainability is being integrated into each component of the value chain. As a result, the world is witnessing a greater demand for stronger governance and ethics, not only in companies but also in financial institutions.

> ***"There is a global shift in business strategies where sustainability is being integrated into each component of the value chain. As a result, the world is witnessing a greater demand for stronger governance and ethics, not only in companies but also in financial institutions."***

Source: Stockvault

Shariah funds, governed by the principles of Islamic law, have long been identified as a subset of Socially Responsible Investing (SRI) funds, which are funds that invest only in socially and environmentally positive assets. In particular, Shariah funds share features similar to those of sustainability-focused funds, also known as Environmental, Social and Governance (ESG) funds.

In order for Shariah funds to become more appealing to investors, they (the funds) must be explained with more clarity for understanding more of their benefits. The Islamic investment products must be perceived as a genuine ethical business aimed at serving the needs of the market.

Eugene Lim, Vice President in the APAC Applied Research Team at MSCI, says that the close association between Shariah and ESG is one of the main international allures of Islamic assets.

> ***“If you’re running a Shariah fund now, you just have to add a few extra features and you will see a lot of demand from ESG asset owners with steady cash.”***

Source: pexels

Source: pexels

“Shariah and ESG funds share much in common with 70% of the overlapping features. If you’re running a Shariah fund now, you just have to add a few extra features and you will see a lot of demand from ESG asset owners with steady cash.”

In addition, Shariah funds have also established themselves to be somewhat resilient. Monem Abdul Salam, Chief Executive Officer of Saturna Sdn Bhd, explained that despite a fall in oil prices and a retreat in liquidity in the Gulf Cooperation Council (GCC) markets, total assets under management (AUM) for Islamic funds have remained stable.

“Considering that equity markets are down but the AUM of Islamic funds have remained stable, there’s an attraction for investors to invest in Shariah-compliant funds. As an advisor, it is your duty to let not only your Muslim clients know about Shariah funds but your non-Muslim clients as well because performance-wise, they have done just as well as conventional funds.”

Nevertheless, the 30-year performance of Islamic funds may still not be compelling enough of a historical record for investors and asset managers worldwide.

> ***“We have looked at the performance of Shariah funds against conventional funds and the periods of outperformance could be when there is greater financial uncertainty in the world.”***

"Looking at the evidence, the growth of Malaysian-managed Shariah-compliant funds hasn't exported very well," says Gerald Ambrose, CEO of Aberdeen Islamic Asset Management Sdn Bhd.

"What you need to do to break into international markets, even the Middle East, is performance, and quite often the performance track record of Shariah funds hasn't been that long. I would like to say Shariah-compliant funds always outperform conventional funds, but that wouldn't be true."

However, Shariah funds do possess a unique selling point, namely their resilient performance during times of duress: "We have looked at the performance of Shariah funds against conventional funds and the periods of outperformance could be when there is greater financial uncertainty in the world."

"Right now, nobody knows whether interest rates are going up or down. There are doubts about the solvency of some of the biggest banks in the world. We are in a very uncertain time. So I think we may be entering a period of outperformance for Shariah-compliant funds."

Source: Stockvault

Meanwhile, Islamic assets are enjoying greater popularity in Malaysia following the decision by the Employees Provident Fund (EPF) to launch the Shariah Savings Scheme. Since opening for registration on 8 August 2016, a whole half of the RM100 billion allocated to the scheme has been taken up by members, Ja'afar Rihan, EPF Head of the Shariah Savings Department, says.

"As at December 2015, there were 329 funds offered in Malaysia, out of which 206 are conventional and 123 are Islamic funds."

"But if you look in terms of market value, it's the other way around. In terms of value, total investment in Islamic and conventional funds were RM27 billion and RM11.8 billion respectively. Such is a clear indication that EPF members prefer Islamic funds over conventional funds."

The panellists agreed that the strong interest shown by Malaysian investors in Islamic funds was driven by several factors including the large Muslim population in the country, and the presence of a well-developed Islamic finance infrastructure and ecosystem. From this perspective, the association of Shariah funds with SRI or ESG may not be as important in Malaysia, but will continue to play a crucial role in marketing these funds overseas.

> ***"What you need to do to break into international markets, even the Middle East, is performance, and quite often the performance track record of Shariah funds hasn't been that long. I would like to say Shariah-compliant funds always outperform conventional funds, but that wouldn't be true."***

Embracing FinTech
to secure a new generation of investors

Source: freestocks.org

The digital revolution continues to transform the financial industry throughout the world. The Malaysian Financial Industry must therefore know how to embrace the new development, according to Securities Commission (SC) Malaysia's Senior Manager of the Digital Department Chan Zhong Yang.

The SC views the digital revolution as inevitable. Resistance would be ineffective given the way financial technology (FinTech) innovations have already gripped the rest of the world. Therefore, time and resources would be better spent on managing the adoption of digital technology in the country.

"Digital Fintech revolution is part of a megatrend and the sooner we embrace it, the sooner we can exploit it in our market. The SC has taken a proactive stance in embracing the digital revolution and is already looking at the regulatory frameworks for equity crowd funding (ECF) and peer-to-peer funding (P2P). It is actively engaging the industry in terms of affinity, and, as a regulator, looking hard at the potential risks in order to mitigate them."

One of the key changes brought about by the digital revolution in the financial industry is the way in which it has "disrupted" traditional market access channels. While market participants would in the past have had to rely on expensive intermediaries and advisors for access to the market and research information, the advent of FinTech is now providing participants with cheap, efficient and reliable access to both market and information.

This so-called "democratisation" of the financial market is the factor of FinTech's popularity among the digital generation—what Chan calls the Generation D. They are the technologically savvy users who like to take a do-it-yourself approach to investing.

> ***"Generation D is always hungry for more information and opportunities, so the question is how we can best tap and serve this segment of customers."***

"Generation D is always hungry for more information and opportunities, so the question is how we can best tap and serve this segment of customers. While the industry is generally good at coming up with technological innovations, this time, the digital revolution is being mainly driven by changing customer behaviour. Usage of smartphones, apps and tablets is changing expectations. Examples of on-demand products such as Netflix, Amazon and PayPal, and shared services such as Uber and AirBnb, are changing the way consumers think, act and behave."

> ***"While the industry is generally good at coming up with technological innovations, this time, the digital revolution is being mainly driven by changing customer behaviour."***

"If you look at Malaysian investors today, the average age of our investor is 45 years old. Less than 5% of the working population aged below 30 years are investing. One can argue that this maybe due to certain factors including the absence of disposable income. But the fact remains that youths today are no longer interested in investment products purchased by their parents. There has to be a way to attract these investors into our market."

The same is true for the financial industry, with FinTech start-ups already eating into every market space of every component in the supply chain. From robo-advisors to P2P financing, the traditional financial marketplace, and by corollary traditional financial intermediaries, is steadily losing market share to these technological alternatives.

"Robo-advisors are becoming prominent in digital investment management. While they are still investment planning firms which provide the same services, recommendations and advisory work as traditional firms, they are completely automated with solutions generated through algorithms."

Currently robo-advisors represent a small proportion of the overall market. However, robo-advisors collectively have about US$26 billion in AUM. This number is expected to grow exponentially and hit the US$2.3 trillion AUM mark by 2020. The allure of robo-advisors is their simplicity, and their low fees and low barrier of entry. Their convenient 24/7 access and commitment to transparency are also contributing to their overall popularity with investors.

Source: Stockvault

Source: Morguefile

It is thus only right and timely for fund managers and financial advisors to embrace the new technology and think about how they can put FinTech to that advantage. FinTech will help increase retail participation in digital investment services in order to attract the younger demographic and provide important data and analytics services to institutional investors.

Other advantages include:

- optimising existing sales and service channels, products and operations;
- helping investment managers achieve a higher level of automation to reduce costs;
- providing an open platform through social media for investment managers and agents to build their online presence; and
- using smartphones and tablets as new channels to engage, research and transact with customers.

> ***"Less than 5% of the working population aged below 30 years are investing. One can argue that this maybe due to certain factors including the absence of disposable income. But the fact remains that youths today are no longer interested in investment products purchased by their parents. There has to be a way to attract these investors into our market."***

> ***"While they are still investment planning firms which provide the same services, recommendations and advisory work as traditional firms, they are completely automated with solutions generated through algorithms."***

Financial providers can thus cater to the emergence of a more sophisticated and tech-savvy generation, which in turn demands new business models and channels. In Malaysia, millennials or Generation D represent a viable future investor base. However, they are more entrepreneurial and independent, and financial providers must be able to fill this need by going digital.

Urgent

need for PRS to solve retirement crisis

The country's Private Retirement Scheme (PRS) continues to face hurdles despite having recently celebrated its four-year anniversary, and must be rethought if it is to solve Malaysians' retirement woes, says CIMB-Principal Asset Management Berhad CEO Munirah Khairuddin.

Munirah cited worrying figures regarding the preparedness of Malaysians to retire. According to her, one in three Malaysians does not have a savings account and 90% of rural households have no savings, while 86% of their urban counterparts are in the same situation.

"Malaysians are still at a very basic level of retirement savings."

With the rising inflation rate, most Malaysians simply cannot afford to retire, and will be forced to work through their retirement days. There simply isn't sufficient mandatory savings in the form of EPF contributions to ensure that the average Malaysian will be able to afford retirement, according to Munirah.

> ***"With the rising inflation rate, most Malaysians simply cannot afford to retire, and will be forced to work through their retirement days."***

The average life expectancy of a Malaysian male is 75 years old, and the average amount of retirement savings they possess by retirement is RM194,000. However, the amount required is RM345,000.

The problem is further compounded by the statistic that Malaysia will have an aging population by 2035, adding additional pressure on social institutions and the demand for post-retirement jobs if the majority of retirement-age persons cannot afford to retire.

> ***"There simply isn't sufficient mandatory savings in the form of EPF contributions to ensure that the average Malaysian will be able to afford retirement."***

Source: Morguefile

The government introduced the Private Retirement Scheme (PRS) to help Malaysians better save for retirement. However, there are some fundamental issues with the scheme which prevent it from gaining traction. She identifies four key problems:

1. Distribution issues: PRS is not as lucrative a product to sell for consultants compared to other financial products.
2. Complexity of the enrolment process: Signing up for PRS needs to be greatly simplified to allow interested individuals to enrol on the spot through their smartphones or mobile devices.
3. The "social cost" of PRS: Retirement has a social dimension that makes it difficult to sell to employers and other individuals.
4. The existing model of the financial industry: The traditional model used in Malaysia is rigid and prevents innovative selling.

With respect to the first issue, Munirah says that consultants need to reassess their roles in their customers' lives. Retirement is a key part of their customers' future and consultants need to embrace their roles as comprehensive financial advisors to help their clients plan for this stage of life.

> ***"If you build your customers' portfolio systematically, each and every financial advisor is a mini-EPF. Distribution is the key thing."***

> ***"We talk about digital services, but before we go digital we need to simplify how we do things."***

"All of us need to think again. If you build your customers' portfolio systematically, each and every financial advisor is a mini-EPF. Distribution, to me, is the key thing. Perhaps we need to better incentivise the consultants to grow the portfolios better."

Additionally, the enrolment process could be simplified. Whereas potential customers now need to fill 12 forms, the process needs to be streamlined such that interested clients should be able to sign up immediately.

"We talk about digital services, such as Betterment and WealthFront, but before we go digital we need to simplify how we do things. This is my call to regulators here and also to asset management companies. Forget Betterment, forget WealthFront; let's try to do things more simply. If I'm at a company presenting on PRS, let people be able to enrol on their phones during the presentation."

"I am worried not because I'm not ready for the digital revolution, I'm worried because we are so late to go up the value chain, so late to prepare for IT platforms, so late to educate our financial consultants, so late to do many things."

Source: Morguefile

As for practical advice for consultants, Munirah says that consultants need to constantly talk about retirement with their clients, particularly during bad times. There is a pressing need to reach out to the millennials and Gen Y, who tend not to be interested in retirement when things are going well, so a down cycle in the market gives them an opportunity to sell PRS.

Finally, consultants must use PRS and retirement planning as a value-add to keep them relevant to both their clients and customers in this age of technological disruption.

"We are all disrupted by technology. Fees are going to come down. We will all be disrupted and only the best will survive, and the best are the people who can value-add on advice, in this case, on retirement planning. If you're still not convinced on why you should sell PRS, think again."

> ***"We are all disrupted by technology. Fees are going to come down. We will all be disrupted and only the best will survive, and the best are the people who can value-add on advice, in this case, on retirement planning."***

Source: Morguefile

2017
Economic Outlook and Key Investment Themes

While stock markets faced a turbulent 2016 with volatility stemming from China, Brexit and the initial reaction to Donald Trump's victory, many equity markets have ended the year higher (see Figure 1). Within the fixed income space, accommodative monetary policy, along with the "seek-of-yield" behaviours, have led to more funds flowing into riskier fixed income segments (high yield, Asian bond, EM debt, etc.). This has led to the continual declines in yields, contributing to the outperformance of these riskier bond segments in 2016. The further depreciation of Malaysian Ringgit,

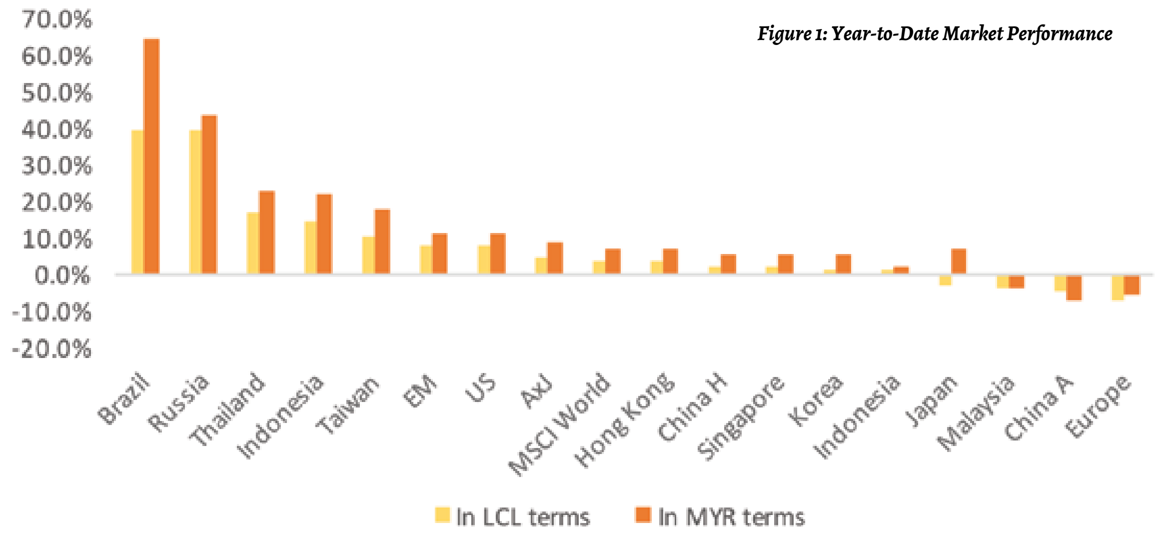


Figure 1: Year-to-Date Market Performance

Source: Bloomberg, Fundsupermart compilations as at end-November 2016.
LCL = local currency
fundsupermart.com

which was down by -4.0% against the USD year-to-date (as at end-November 2016), has also compounded the returns from these markets. Investors who have taken the opportunities to gain exposure in these markets have been rewarded handsomely.

Following our decision in 2016 to go neutral equities vis-à-vis bonds for the first time in eight years, we have decided to overweight equities relative to bonds in 2017. Market wise, we remain positive on the Asia ex-Japan region as compared to its developed counterparts, while preferring some of the equity markets within the Asia ex-Japan region that have relatively attractive valuations such as China. In the fixed income space, we reckon that there is a lack of exciting opportunities at this juncture, and thus, have shifted towards a more defensive stance for capital preservation purposes. In the current environment, we prefer the safer segments of fixed income such as short duration bonds over credit spreads such as high yield and emerging market debt due to historically-low yield levels and the risk of faster-than-anticipated rise in yields and rates going forward.

With 2017 on the horizon, we will present our outlook and some of our key investment themes in the following section:

Source: Morguefile

2017 Economic Outlook

- **Global economic expansion to accelerate**
  - Following a year of slowing economic growth in 2016, we expect global economic growth to accelerate in 2017, reaching a 3.1% year-on-year expansion (see Figure 2). For the US, the prospect of fiscal stimulus is expected to directly boost the nation's economic growth, with an expectation of 2.2% in 2017. The European markets might also see a potential possibility of fiscal stimulus that will lead to future improvements in their economies, although the more probable case is that most of the recovery within the regional market will still be stemming from the continued monetary policy easing by the central bank. Within the emerging market space, China's deceleration in growth could have possibly ceased, and the nation's multiyear rebalancing act should bring forth a sustainable level of growth over the long term, which should also have some positive spill-over effect to other Asian countries. As such, we expect to see economic expansion accelerate into 2017, for both developed and developing economies, albeit at varying paces for different regions.

- **Easy monetary policy to ease off**
  - We think that central banks across the world have done a lot in the past few years. Although we are expecting global growth to accelerate in 2017, it is unlikely to see a hard reversal of loose monetary policies implemented by major central banks given that the growth rates continue to remain moderate as compared to historical figures. For the US, the Federal Reserve's current stance is towards a gradual normalisation of monetary policy amid benign inflationary environment and moderate growth. Nonetheless, no policy stance is set in stone given that the Fed will remain to be data-dependent in their policy actions going forward.
  - As for the Bank of Japan (BoJ) and the European Central Bank (ECB), they have been amongst the major central banks that are on an increasing easing trajectory in the past few years. However, for the year 2017, we could see a directional shift in their trajectory. Instead of further easing measures, we believe that the BoJ and the ECB will more likely to be making refinements and fine tuning on their existing measures.

- **Inflation to begin its comeback**
  - Another major trend that investors should expect will be the return of inflation. While low energy prices have remained a prominent theme since 2015 and early 2016; energy prices have stabilised in 2016 as per our expectations. In 2017, investors are likely to witness further stabilisation as the rebalancing between supply and demand dynamics continues with a new equilibrium to be found in the year ahead. The low base effect due to low commodity prices should also contribute to higher inflation rates in 2017.

Figure 2: Forecasted GDP Growth (YoY, %)

Source: Morguefile

Investment Themes

- **Bye bye earnings recession, hello earnings growth**
  - While earnings revisions came down in 1H 2016, 2H 2016 saw the exact opposite with strong positive earnings revisions. We expect positive earnings growth in 2017 for the markets under our coverage. With commodity prices having seemingly found a floor and inflation expectations rising, the cyclical sectors of the stock market are expected to see strong earnings growth in 2017, alongside markets which heavily exposed to energy and material sectors. Following an 'earnings recession' in 2015 and 2016, the developed markets of US and Europe are each expected to post over 11% earnings growth in 2017, the strongest growth rates since 2010 and 2013 respectively.
  - Outside of the developed markets, earnings momentum has been fairly weak across various markets in 1H 2016, but the positive earnings revisions in 2H 2016 are most acute in the Asia ex Japan and emerging markets. While much has been made of China's rebalancing, few have talked about the anticipated 11% earnings growth being projected for the market in 2017 and the positive effects it will have on the Asia ex Japan which is forecast to grow its earnings by a strong 12.5%. Emerging markets such as Brazil and Russia which have seemingly turned a page in 2016 are expected to post double digit earnings growth rates in 2017, alongside improving economic fundamentals and without the energy and material sectors providing the headwinds they have done in 2015.

- **Stocks to head higher, but expect volatility**
  - An environment of accelerating economic growth, alongside modest inflation and still easy monetary policy by central banks should continue to be a positive for earnings, and hence, stocks. We expect most of the markets to head higher in 2017, propelled by strong earnings growth. For Asian equities, a turnaround in the earnings revision cycle should be a key catalyst for valuations to mean-revert from their low current levels – the North Asian markets are expected to do most of the heavy-lifting to allow the Asian benchmark index to head back towards its 2007 highs.
  - The continued normalisation of monetary policy in the US is expected to continue to remove some of the excess liquidity in the financial system, which could lead to relatively higher levels of volatility. Volatility levels have been historically low over the past few years (thanks to the monetary policies of the various major central banks) and a return to a normalised volatility regime in the US in 2017 and beyond should not catch investors unaware. Don't fear volatility in 2017; use it to your advantage.

- **Return expectations tampered**
  - Returns for developed markets like the US and Europe over the past few years have outpaced the rate of earnings growth, with valuations having already more than normalised to fair levels and beyond, that see it trading at premiums to our estimates of their fair values. While a modest rate of return for investors looks likely for investors hence our 2.5 star - Neutral rating for the US and 3.0 star – Attractive rating for Europe, high double digit returns for either market would be really stretching their respective valuations.
  - As in our 2016 outlook, investors looking for strong double digit returns in 2017 from a well-diversified portfolio of global equities (with a fairly large allocation to developed markets) are more than likely to be disappointed given the valuation premiums attached to these markets today. If it's strong double digit returns investors seek, the Asian and Emerging market equity markets should be their focus in 2017.
  - In the fixed income space, historically-low yields mean return expectations are low. Rising risk-free rates mean investors could see higher yields in credit spreads that might affect Asian bonds as well as Emerging market debt.

- **Don't underestimate the value of active management**
  - Strong returns for both stock and bond markets over the past few years, investors have gravitated towards passively-managed investments such as Exchange Traded Funds (ETFs), with Morningstar data suggesting that passive mutual funds in the US have continued to see inflows on a one-year basis while actively managed funds have seen net redemptions (as of end September 2016). With bond yields at still low levels and selected equity markets trading at premiums, we think actively-managed investments are more appropriate, with active stock-pickers able to shun more expensive stocks in favour of more attractive ones, while an era of rising interest rates coupled with historically-low rates means credit selection, currency expertise and a more flexible positioning should aid in driving fixed income strategy returns to a greater degree going forward.
  - While ETFs have their benefits such as taking advantage of intraday volatility to capture low prices and avoiding the potential of underperformance by an active fund manager, strong active management is likely to provide investors with stronger returns over the long term.

- **A stronger USD likely ahead**
  - Following the direction of higher bond yields and tighter monetary policy via anticipated rate hikes for 2017, the USD has strengthened by 3.5% as measured by the Dollar Index since Donald Trump won the Presidential election in November to hit a 13-year high.

- **...but investors should be wary of chasing the fastest rising currency**
  - However, investors should note that forecasting currency movements is an incredibly difficult art as fundamentals for currencies such as interest rate differentials, balance of payments and fiscal balances can take years to play out or on the market's whim.
  - Just as importantly, we would caution against mounting expectations of an ever-strengthening USD (or ever-depreciating EUR or GBP or JPY) – the currency has already posted strong gains since 2011 (the Dollar Index has gained approximately 90% since May 2011, as of 30 November 2016) while many developed market, Asian and EM currencies are already trading at multi-year lows against the greenback.

What Should Investors Do?

- **Overweight equities vis-à-vis bonds**
  - Following our decision last year to go neutral equities vis-à-vis bonds for the first time in eight years, we have decided to overweight equities relative to bonds in 2017. Given the stronger earnings forecasts, diminishing prospects of new aggressive measures by major central banks as well as the current lack of attractive opportunities in the fixed income landscape, we believe that equities warrant an overweight in 2017

  - Given that we expect the global economic expansion to accelerate, higher rates of earnings growth are expected and these should help the Western developed markets offset any contraction of the valuation multiple that could detract from healthy earnings growth and anticipated dividends. Given that a well-diversified global equity portfolio would still have substantial exposure to the developed markets that are above our estimated fair value, an underweight allocation to developed markets at best is warranted.

  - Comparatively, Asian and EM equity markets have material room for valuations to mean-revert and provide outsized gains than their developed market peers. Healthy earnings growth and stable dividends will aid in delivering a higher total return for Asian and EMs. We are projecting returns of over 40% by the end of 2018 for both Asia ex Japan and the Global Emerging Markets.

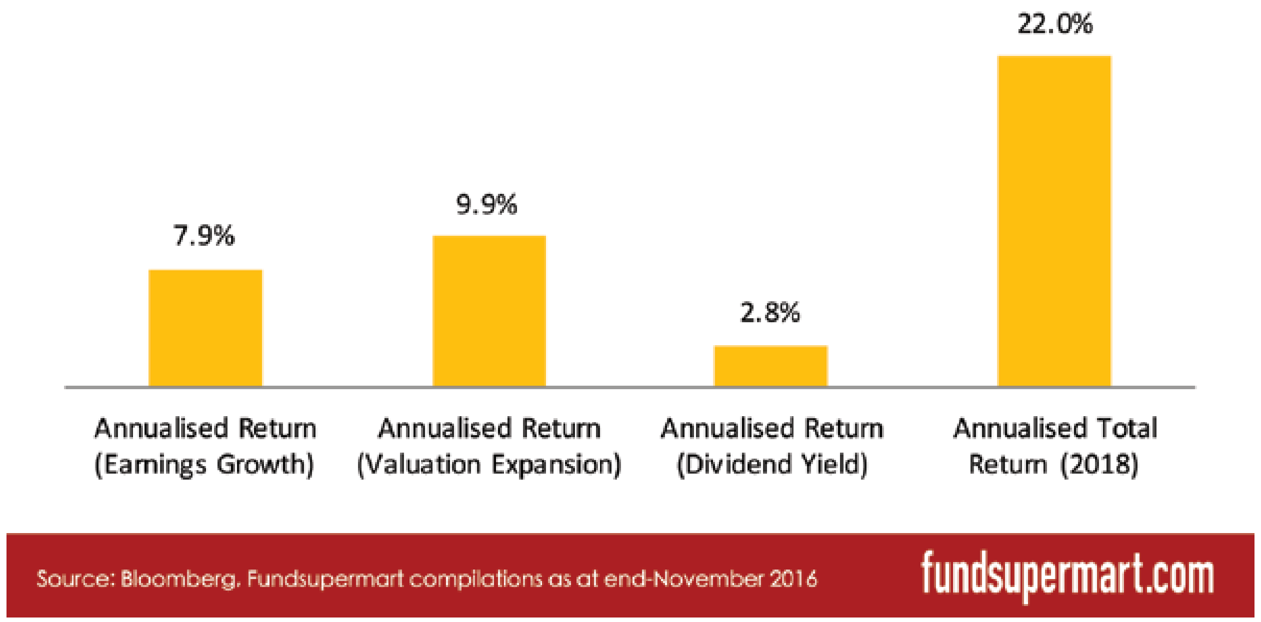
  - Given some of the risks facing bonds in 2017 with interest rates yet to normalise, the dangers of rising bond yields should see investors be on the defensive for fixed income.

- **Continue to favour Asia ex-Japan equities**
  - Corporate earnings disappointments have been a feature of Asian equity markets since 2011, which has weighed on stock performance in the region. The stabilisation in China's economic growth alongside improvements in developed market growth rates should promote a recovery in Asian earnings and forecasts; the upward-revisions seen for Asian earnings in 2H 2016 could be the start of great things to come in 2017 for Asian equities.

  - At just 14.0X 2016 earnings, Asian equities remain undervalued at this juncture, and we believe that a recovery in the earnings revisions cycle for Asia ex-Japan equities will be a key catalyst for Asian equity valuations to mean-revert higher. We are targeting a 16.0X PE for Asian equities which would see the market deliver a 22% annualised return by end-2018 (including dividends), with the North Asian markets accounting for most of the potential returns (see Figure 3).

- **Developed markets still necessary for portfolio diversification**
  - Our forecasted returns for developed markets like the US and Europe have risen slightly for 2017 on the back of upward-revisions to earnings growth.

Figure 3: Potential upside for Asia ex-Japan (by end-2018)



The main detractor of their potential upside for both markets are the likelihood of a contraction in valuation multiples, which could be reset via a correction in the stock market.

  - For 2017, we still expect both markets to deliver fairly reasonable (single-digit) returns for investors and continue to advocate an allocation (albeit underweight) to developed markets for portfolio diversification purposes, with the expectation that 2017 should be another year of positive earnings growth for developed market companies.

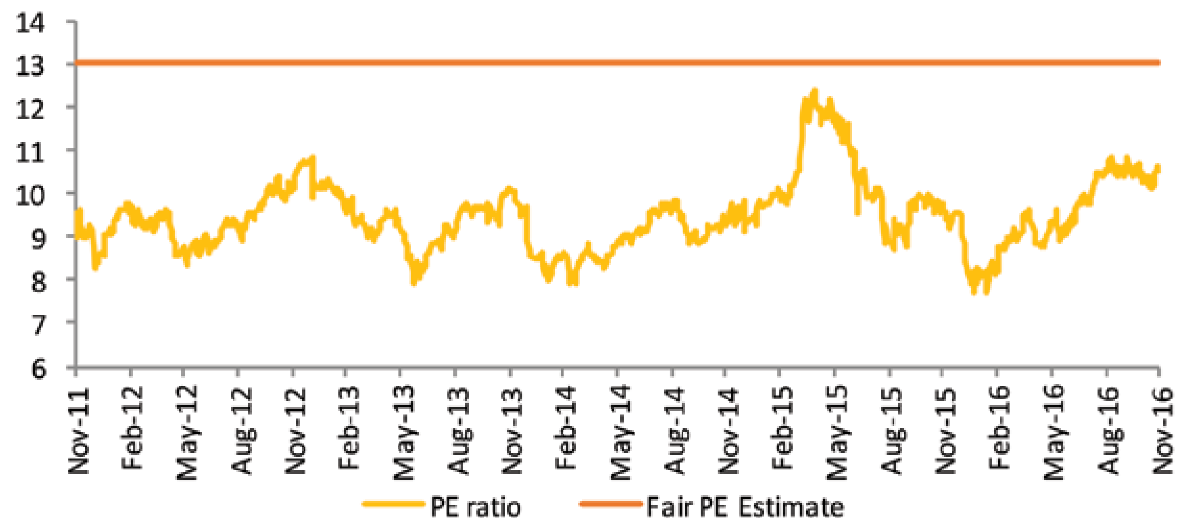
- **China is cheap and ready to outperform**
  - Seemingly in a state of continuous "rebalancing", the world's second largest economy remains in a transition phase towards a consumption-led economy. Guiding for a growth rate of 6.5% in 2017, China's economy has moderated from the double-digit growth rates seen in the 2000s. The ongoing anti-corruption crackdown has continued to impact the corporate sector, with the earnings of Chinese equities continuing its trend of disappointment. That having been said, we think the worst of the Chinese economy appears to be behind us, with no meltdown. Domestic consumption remains robust and growing

  - For the "old economy", the industrial sector could be poised for a rebound given that the current 22-month long industrial destocking may be over soon; allowing a restocking cycle to begin. The acceleration of industrial profits growth also point to better times ahead as estimated earnings for 2016 were revised upwards by 0.4% in September 2016 after being cut 7% by analysts on a year-to-date basis.

  - While monetary policy has been easy in 2016, we expect a tightening bias to it in 2017 given the sharp rise in property prices in certain cities, with the intent of controlling run-away home prices. Valuations remain very undemanding at this juncture having undergone a momentous correction in the middle of the year; China equities trade at just 10.6X 2016 earnings (see Figure 4), a long distance away from the 13X fair PE we attribute to the market. On our estimates, the China equity market is on track to deliver a 26.3% annualised return by end-2018, driven primarily by an expansion of the market's PE ratio.

- **Chinese financials – the dark horse for 2017**
  - The Chinese financial system has been the subject of intense pessimism in recent years. Be it due to concerns of a property bubble, wealth management products or fears of bond defaults and a rise in non-performing loans, the Chinese banking sector has been very much unloved by markets. We think that a systemic banking crisis is unlikely to unfold, given that Chinese banks are adequately capitalised with their capital adequacy ratios well above the Basel III requirements of 8% as well as the stricter ratio of 10% that is imposed on Singapore banks by the Monetary Authority of Singapore.
  - While a further rise in soured loans over the next few quarters that could reduce their profitability is a possibility, it is important to note that most debt defaults stem from state owned enterprises; with the Chinese government retaining control over these state owned enterprises and banks, foreign exchange and capital flows, the government is in a position to contain this debt burden and limit the risk of a systemic financial crisis.
  - The Chinese banking sector is expected to post positive earnings growth in 2017, despite several purported headwinds. Sporting valuations based on 2017 estimates that are at a significant discount with sufficient negative sentiment to make the sector a contrarian call, the sector could be poised to outperform in 2017 against market expectations.

Figure 4: China's PE valuation (HSML 100 Index)



Source: Bloomberg, Fundsupermart compilations as at end-November 2016 fundsupermart.com

- **Seek out safer bonds for capital preservation in fixed income**
  - Part of our decision to overweight in equities is due to a lack of attractive opportunities for fixed income as a whole at this juncture, which sees us shifting our portfolios towards a more defensive stance for capital preservation. We expect the fixed income landscape to be lively in 2017, which should provide us with tactical opportunities.
  - While interest rates in the US are still on its up-cycle, the current stance adopted by the Federal Reserve has been a gradual normalisation in monetary policy due to a benign inflationary environment and moderate growth. Should inflationary pressures accelerate, policy-makers could normalise interest rates faster than expected which could lead to volatility in bond yields in 2017. While there is currently a lack of opportunities in the fixed income space that are attractive from a risk-return basis, we maintain that fixed income remains an integral and relevant part of an investor's portfolio, and should be seen as a portfolio stabiliser.
  - Given that yields on safer fixed income instruments like G7 sovereign bonds remain unattractive at this juncture (and are also expected to be hurt more should the Fed hike rates quicker-than-anticipated) despite having risen recently, investors might think that the riskier segments of fixed income are more attractive. However, in the current environment, we prefer the safer segments of fixed income such as short duration bonds over credit spreads such as high yield and emerging market debt due to the risk of rising risk-free rates which will send yields rising for credit spread related instruments.
  - While our long-standing preference for short duration bond does not offer yield hungry investors a mouth-watering return, we believe the segment is best placed to offer investors capital preservation, especially if bond yields or rates rise quicker than anticipated.

Quiz

1. What is PRS?

2. What are the benefits of PRS?

3. What are the benefits for resellers of PRS?

Notes

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