November 2012

Special Report
INCOME 2012

Focus on high income

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FOREWORD

When we talk about "investing for income" we are referring to an invest-ment with the potential to pay out a regular dividend or return. There are several different ways of investing for income and they work in quite different ways but all aim to deliver a regular return. Similarly, investors have a number of choices about the ways they receive their income and what they do with it.

The hunt for income by individual investors since late 2011 has seemed relentless. The need for income generation is becoming increasingly important due to an ageing population demographic. The UN forecasts that the number of retirees will increase from 737 million in 2012 to 2 billion by 2050. Individuals retiring at the age 65 today need to save for 27 years of retirement (Society of Actuaries).

Historically-low interest rates mean that the usual safe-havens for income investors such as deposits and bonds are not currently generating sufficient returns.

Investors are seeking alternative sources of income distribution for their portfolios. High-dividend stocks and real estate investment trusts (REITs) have been the recipients of much renewed interest by Asian investors over the past 12 months or so.

Equities offer an attractive option for income seekers in the current low-growth inflationary environment. Dividends are a major driver of overall total returns. Equity income funds have performed particularly strongly recently and this has generated considerable publicity, while there have also been a number of new products launched. However, equity income-focused strategies are not just a short-term fad, but rather a valuable long-term strategy that advisers should be including within their clients' portfolios.

It is important at this juncture – especially given the continued uncertain market outlook and relatively high cost of some income-generating products – for advisers to understand the nature of these opportunities, to be able to assess each type of asset and determine decision-making criteria for individual investors, and to be aware of risks and yield traps such as inflation or conditions linked to coupon payments.

On behalf of Threadneedle Investments, we're delighted to partner with Hubbis to provide further thought-leadership on the topic of generating income for portfolios.

Gerard Clancy
Executive Director, Wholesale Distribution, Asia Pacific
Threadneedle Investments

CONTENTS

02
Q&A
ACCESSING INCOME OPPORTUNITIES
As the importance of income looks set to stay, Charles Chui, director, asset management at Falcon Private Bank, looks at some of the current opportunities and considerations for investors.

04
Feature article
INCOME STRATEGIES FOR A NEW INVESTMENT LANDSCAPE
The search for yield in today's low interest-rate environment has made the focus on different types of income-generating products and strategies sharper than ever before.

12
Co-published article
CATERING TO THE APPETITE FOR INCOME
Investors seeking income have a range of opportunities and instruments to choose from, depending on their risk appetite. But they need to be cognisant of the various risks which come from market volatility and the economic cycle to ensure they build sustainable portfolios, say Jonathan Lowe and Brian Tan of J.P. Morgan Asset Management.

16
Q&A
UNDERSTANDING THE SEARCH FOR YIELD ASSETS
Eleanor Wan, chief executive officer of BEA Union Investment Management, explains some of the trends in relation to the strong investor appetite for yield, and outlines some buying considerations in today's environment.

18
Co-published article
WHY INVEST FOR INCOME?
The need for income has been brought starkly into focus following the fall out of the credit crunch and the continuing challenging economic conditions in which we find ourselves, says Stephen Thornber, fund Manager - global equity income, Threadneedle Investments.

22
Q&A
THE ROLE OF DIVIDEND-PAYING STOCKS IN THE HUNT FOR YIELD
Mark Vanderkolk, investment specialist at BNP Paribas Investment Partners in Asia, explains the importance and application of dividend-paying stocks as part of any investor's income strategy.

WHEN A FIXED INCOME INVESTOR SENDS OUT AN SOS SIGNAL, IT SHOULDN'T FALL ON DEAF EARS.

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24
Feature article
MAKING THE RIGHT BUYING DECISIONS
As investors have gotten swept up in the rush to access various income-related opportunities, they need to make sure to bear in mind various characteristics of the products they are buying, and to not fall prey to common misconceptions.

34
Co-published article
FORGET ABOUT GARP, IT'S ALL ABOUT YARP
According to Michael Kerley of Henderson Global Investors, investors should be focusing on names that have a value bias – that is they are fundamentally under-valued, providing room for capital growth – and at the same time are expected to grow their dividends in the years to come.

38
Q&A
THE NEED FOR A MORE BALANCED APPROACH TO INCOME
Eddy Tsoi, head of fixed income advisory at BNP Paribas Wealth Management in Asia, discusses key considerations for investors to manage and fully understand the exposure in their portfolios to income-generating products.

40
Co-published article
MAKING THE RIGHT ALLOCATION
As investors take an increasingly-tactical approach to their fixed income allocations, Lemuel Lee and Chan Ahn of J.P. Morgan say it is challenging for anyone to know the best time to switch from high yield to emerging markets to investment grade debt, especially given the ever-shorter market cycles.

44
Q&A
A HIGH-YIELD PERSPECTIVE
As investors search for yield in a very low nominal interest rate environment, there are few options available to capture high current income. One of the most compelling investment opportunities is the global high-yield sector, says Betsy Hofman, CFA, vice president and portfolio manager in the Franklin Templeton fixed income group.

46
Co-published article
FINDING YIELD IN ALTERNATIVE INCOME SOLUTIONS
In the current low-yield environment, investors are looking for defensive alternative income solutions which generate higher yields. Innovative issuers are able to offer such products which meet these requirements and more, says David Schmid of the EFG Financial Products Division within EFG Bank.

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52
Comment
DOES FINANCIAL HISTORY RHYME?
Paul Stefansson, head of investment funds at UBS Wealth Management in Singapore, explains why it is vital for investors to think long term and move out the risk spectrum by focusing on assets which have historically provided "real" returns.

56
Co-published article
COMPLACENCY IN THE DEBT SUPER-CYCLE
The aftermath of the burst of the debt super-cycle causes low to no growth, no inflation and hardly any job growth. This makes the healing process painful since the choice is between austerity now or restructuring over time. By Sander Bus, head of high-yield credits, and Victor Verberk, head of investment-grade credits, at Robeco.

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Q&A

ACCESSING INCOME OPPORTUNITIES

As the importance of income looks set to stay, Charles Chui, director, asset management at Falcon Private Bank, looks at some of the current opportunities and considerations for investors.

Why is income important, especially in today's environment?

Interest rates are at historical lows. Deposits are earning dismal returns in the banks. On the other hand, inflation pressure is high, which could eat away most of an individual's purchasing power.

At the same time, with the unsettled global economic and political climate, equity returns in recent years have been quite disappointing.

As a result, a stable Income stream is becoming more important to our clients.

What are some of the current opportunities in Asia in terms of income-enhancing products?

In Asia, there are a variety of options for investors to choose from in high-yield corporate bonds.

With careful research and due diligence by investment advisers, clients can find attractive yield pick-up opportunities in this region.

In addition, real estate investment trusts (REITs) have been a relatively new development in Asia with dividend yields in the area of 6%-plus. Both Hong Kong and Singapore offer a wide selection of REITs.

In Hong Kong, we favour retail-oriented REITs as local employment levels remain strong and tourists from mainland China should continue to use retail shopping malls.

We also like REITs which show upgrade potential, for example in the East Kowloon industrial district [in Hong Kong] with the new Kai Tak re-development potential.

What are some of the main vehicles and strategies to gain access to different asset classes?

Bonds are usually traded over-the-counter and denominations could have minimums of US$100,000 or higher. In Hong Kong, retail clients can subscribe to certain Chinese sovereign bonds and HKSAR Government iBonds in lower denominations.

A few of these bonds are listed on the stock exchanges which can be easily accessed by end-clients.

Other than buying corporate bonds, bond ETFs are available. There are also certain income-oriented / index-tracking fixed income funds which are available from fund management companies.

What differentiates dividend-paying stocks?

Clients should pay attention to the sustainability of dividend payments. We try to look for companies with a long-term track record of payment, not just one-off extraordinary events that cannot be sustained.

Clients also need to pay attention to the capital needs, asset quality (for example, non-performing loans) and cash-flow requirements of the companies.

While they may offer high yields now, potential capital raising and rights issues could more than offset the dividend that investors earn.

Companies which have a lower dividend now, but for which there could be potential for a higher payment in the future – for example after a CAPEX peak, new market opportunities, or successful product development – should also be considered by investors.

Charles Chui
Falcon Private Bank

> "REITs could be better positioned in an inflation environment since positive rental reversion and higher business activities usually lead to higher dividend payouts."

What other considerations are important when looking at different income-enhancing products?

Inflation could eat away the purchasing power of bond investors. This is because their capital is redeemed at par several years later.

Higher inflation usually leads to higher interest rate expectations, and hence negatively impacts bond prices.

REITs could be better positioned in an inflation environment since positive rental reversion and higher business activities usually lead to higher dividend payouts.

Possible land-use upgrades and re-development potential of the REIT properties could lead to a leap in the dividend potential as well. ■

Feature article

INCOME STRATEGIES FOR A NEW INVESTMENT LANDSCAPE

The search for yield in today's low interest-rate environment has made the focus on different types of income-generating products and strategies sharper than ever before.

At times in the market and macro-economic cycle when there is so much uncertainty, investors realise the need for income. The greater difficulty to make capital gain has meant investors have had to look at other options for their portfolio. And Asian investors have embraced this hunt for yield with full force since late 2011.

"Higher political and economic uncertainty has led investors to look at something more stable and certain," says Richard Mak, managing director, head of advisory services for Pictet & Cie in Asia, "which translates to sustainable cashflow."

With real interest rates in markets like Singapore being negative, given zero deposit rates and inflation of between 4% and 5%, this creates a problem for all investors, explains Dennis Harhalakis, head of products & services, pri-

> "The greater difficulty to make capital gain has meant investors have had to look at other options for their portfolio."

vate banking, Chinatrust Commercial Bank. "Thus, discussions about asset allocation and investment become skewed by the need to generate some form of fixed income stream."

Predicts Mak: "A larger and larger portion of total returns will come from income going forward."

Richard Mak

Pictet & Cie

"A larger and larger portion of total returns will come from income going forward"

PIN-POINTING THE APPETITE FOR YIELD

"The last 12 months has seen good opportunities in fixed income," says Bill Tsang, managing director, regional head of product, wealth management for Nomura in Asia ex-Japan.

"There is a lot of appetite for new issues and secondary bond trading. Clients want to go back to basics because of bad experiences during the financial crisis."

Essentially, investors are seeking products which provide a stability of relatively higher-yielding income – which in today's environment typically means products with a high component of equity exposure, says Stephen Grundlingh, co-chief executive officer, Templeton Asset Management, Singapore, and regional head, South-east Asia, Franklin Templeton Investments.

Good levels of current income in equity investments clearly need to be viewed in the context of the risks around capital losses and general volatility, adds Danny Howell, head of wealth management for Towers Watson in Asia.

"Notwithstanding this, many in the market talk about finding investment opportunities with good price-growth potential when the market becomes more positive, but with current good yield – effectively being 'paid to wait'," he explains.

Property, in the form of REITs, for example, also offers good income opportunities as well as offering added diversification, he adds.

"The opportunity is clear: to collect a decent rental income (net of tax), whilst benefitting from the US Federal Reserve's accommodative policies towards stimulating the housing market," according to Nick Hoar, managing director and head of Asia Pacific at Neuberger Berman.

The US real estate market is highly-transparent and well-regulated, he adds, which comforts Asian investors looking to diversify their property exposure away from their home markets.

"Well-managed mutual funds with experienced teams that invest in US REITs appear to be the preferred choice for this exposure."

Other ways clients can generate income is through mutual funds rather than buying single bonds.

"Investors are increasingly focused on mutual funds rather than purely trading," says Tsang at Nomura. "For some clients who have previously traded a lot of individual bonds and other fixed income instruments, it has been

Stephen Grundlingh

Franklin Templeton Investments

"Some of the most successful recent fund launches have been funds that focus on providing regular income"

more difficult for them over the past 12 months to generate similar income with the same risks."

Adds Grundlingh: "Some of the most successful recent fund launches [we have seen] have been funds that focus on providing regular income in today's low-rate environment."

This has led to banks tailor-making some bond fund portfolios for these clients, which can achieve similar volatility with a more consistent income and dividend yield.

Bond funds are top-sellers and passive funds have generated more interest from investors in recent months, says Andrew Fung, executive director, head of global banking and markets, at Hang Seng Bank.

"Index products are increasingly popular for investors because fees are lower than for actively-managed funds, and index funds typically perform better than many active managers," he explains. "Active managers tend to pick high-beta stocks to beat the index, yet these types of stocks have under-performed in the last year or so."

There is also a growing desire to invest closer to home.

"Over the last few years, there has been a growing discomfort with going too far away geographically in terms of investing, as a result of a fear of the unknown," says Ajai Kaul, chief executive officer and head of sales at AllianceBernstein in Asia ex-Japan. "There is more concern than ever before about where money is being invested and the fact that it is difficult to understand what is happening in certain markets."

At the same time, Asia is dominating the economic landscape as the world's growth engine, says Kaul. As a result, this is re-enforcing the views of investors that the opportunity set in the region is more attractive.

Meanwhile, Hoar at Neuberger Berman says high yield is offering the most value within credit. "Over the next two years, interest rates are forecast to remain extremely low, and we expect default rates to be 2% to 3% rather than the 5% level in which the market is currently pricing."

In terms of new products attracting client attention, Hoar says the NB Short Duration High Yield bond fund has proven to appeal to clients who like high yield as an asset class but who prefer to have a slightly higher quality portfolio with less duration risk. "We like to call it a 'sleep at night' high yield bond fund. The yield is lower than a full market high yield exposure but investors seem to be comfortable with that trade off."

According to Matthew Barron, managing director and head of fixed income sales for TD Securities in Asia Pacific, due to the current low yields of the more traditional investor currencies of the region, appetite for higher-yielding niche and developing currencies grow over recent years.

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"Locally this has seen our EMTN offering grow in attraction when compared to Singapore-, Hong Kong- and US-dollar products, where moving down the credit curve is the only way to add yield," he explains.

GETTING THE RIGHT ADVICE ON INCOME

It isn't all about just getting access to income, however.

Investors must create income at appropriate risk levels.

In particular, the rush into high yield in the past 12 months raises concerns among private banks in relation to concentration risks for their clients, because many Asian investors are now over-exposed, says Lionel Florentin, head of distribution for Amundi in South-east Asia.

"This is where it is all about good advice," explains Tony Edwards at Robeco. "Investors need to create income through a variety of sources and risks, not just through buying a bond. Diversification is key to long-term investment success."

Tony Edwards
Robeco

"Investors need to create income through a variety of sources and risks, not just through buying a bond"

> Investors must create income at appropriate risk levels.

It is possible to put a diversified portfolio together to spread risk and provide income, he explains, adding that, in fact, the dividends from equities look a lot more attractive than buying government bonds.

As a result, some private banks are transferring some of the high-yield allocations to corporate bonds, which are lower risk and help to protect clients' portfolios, adds Florentin.

"Yet investors are still looking for income," he adds, "driving demand within product structuring for monthly and quarterly coupons via dedicated share classes to provide this. The challenge is to generate sufficient yield to provide these coupons."

Edwards at Robeco says the hedge fund and alternative spaces also offer interesting income-generating opportunities for investors.

Ajai Kaul
AllianceBernstein

"Over the last few years, there has been a growing discomfort with going too far away geographically in terms of investing"

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Gary Dugan
Coutts

"Returns from bonds have historically become negative when bond markets returns are as high and yields as low as they currently are"

Further, second-generation wealth is more likely to be interested in capital value retention than growth.

"Hence the prospective development of more diversification and also new approaches like our Conservative Equity service, which is an enhanced low-volatility investment strategy," says Edwards.

A CONTINUED "BULL" RUN

Henry Wong, head of fixed income of BEA Union Investment Management Limited, says that despite the good run, year-to-date, in both domestic and hard currency markets, the so-called "bull market" will continue.

"Since the European financial crisis has not yet stabilised, or been resolved," he adds, "money is still coming to Asia in search of diversification as well as alternative investment."

While the surge in fixed income might look like being over-done from a global perspective, with a lot of money coming out of Europe and the US looking for diversification, Wong says liquidity is still plentiful.

So investors are generally looking for better returns and diversification out of developed markets.

However, adds Gary Dugan, chief investment officer, Asia and the Middle East at Coutts, the flow of macro-economic data has more recently been increasingly in favour of equities and against investment-grade bonds.

"Equity markets remain out of favour with many investors despite the rises seen in many markets this year, while the search for yield in bond markets appears to be an overcrowded trade," he says.

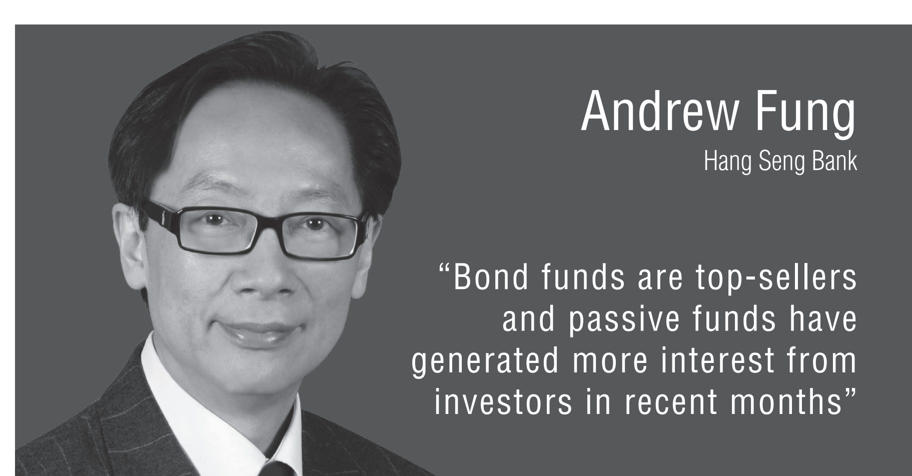
Although many investors believe bonds provide a safe haven, in the current volatile economic environment there is a higher-than-understood probability of there being negative returns from bonds in the future.

Explains Dugan: "While there is no guarantee of future performance, returns from bonds have historically become negative when bond markets returns are as high and yields as low as they currently are."

The greatest risk to bonds is that investors become more confident about the outlook for equities.

If the positive global economic data flow builds momentum, and Spain accepts help from the ECB and the US politicians manage to avoid the fiscal cliff, equities could do very well.

"Indeed, many equities yield more than their respective bond markets and corporate bonds." ■



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2009	4.61%
2010	5.94%
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Co-published article

CATERING TO THE APPETITE FOR INCOME

Investors seeking income have a range of opportunities and instruments to choose from, depending on their risk appetite. But they need to be cognisant of the various risks which come from market volatility and the economic cycle to ensure they build sustainable portfolios, say Jonathan Lowe and Brian Tan of J.P. Morgan Asset Management.

Looking across the investment landscape in Asia, there are many attractive opportunities for investors who seek a potentially attractive income stream from the region's fast-growing economies.

These range from high-dividend stocks and real estate investment trusts (REITs) to high-yield and investment-grade sovereign and corporates bonds.

High-dividend yield Asia ex-Japan stocks, for example, have not only delivered robust total returns; they now yield even more than US Treasuries and are catching up with high-yield bonds. Dividends are also crucial from a total return perspective, and are the second-largest contributor to total returns after earnings.

The case for Asian bonds is also well supported. Asian companies are generally less leveraged, with stronger balance sheets compared with their European and US counterparts. Asian high-yield bonds are also good for diversification purposes.

MEETING DEMAND

While fixed income funds have garnered the majority of investor inflows to capture these opportunities, investors who seek income are increasingly looking beyond bonds to diversify their portfolios and broaden opportunity set.

For example, funds - such as the JP Morgan Funds - JF Asia Pacific Income Fund - which invest primarily in income-generating securities in Asia Pacific (excluding Japan) can offer a single solution to maximise potential income return and to capture long-term capital growth opportunities.

Further, there has also been demand for multi-asset income funds - such as

the JPM Multi Income Fund and the JPMorgan Investment Funds - Global Income Fund - which aim to tap a broader global opportunity set and provide share classes that offer regular potential payouts.

DIVIDEND OPPORTUNITIES

Compared with their history, the dividend yields on most equity markets are attractive.

The highest yields are available in the most out-of-favour markets, for example continental Europe. And even markets not generally known for their yield potential, such as emerging markets and Japan, are offering historically-attractive yields.

However, in terms of generating future returns, investors should focus less on the starting level of yield, and more on the potential for dividend growth.

Over time, the strongest returns will come about as a result of the ability for dividends to grow.

Many high-yielding companies, for instance telecoms and utility companies, have a high yield because they have limited growth prospects.

Their ability to sustain their yields, however, may come into question if they fail to invest in their businesses for the long term.

Unless there are good bottom-up reasons for doing so, it is probably best to avoid investing in the highest of high-yielding companies.

Brian Tan

J.P. Morgan Asset Management

"Investors who seek income are increasingly looking beyond bonds to diversify their portfolios and broaden opportunity set"

However, a combination of yield and potential dividend growth is generally a good recipe for success.

At the same time, it doesn't make sense to avoid a particular geographical region just because of short-term issues. Although the outlook for many European economies will remain difficult in the short term, there are many European companies with international businesses trading on 4% to 6% yields with the reasonable prospects for growth over the medium term.

Sometimes, the best opportunities can be found where the short-term prospects are the darkest.

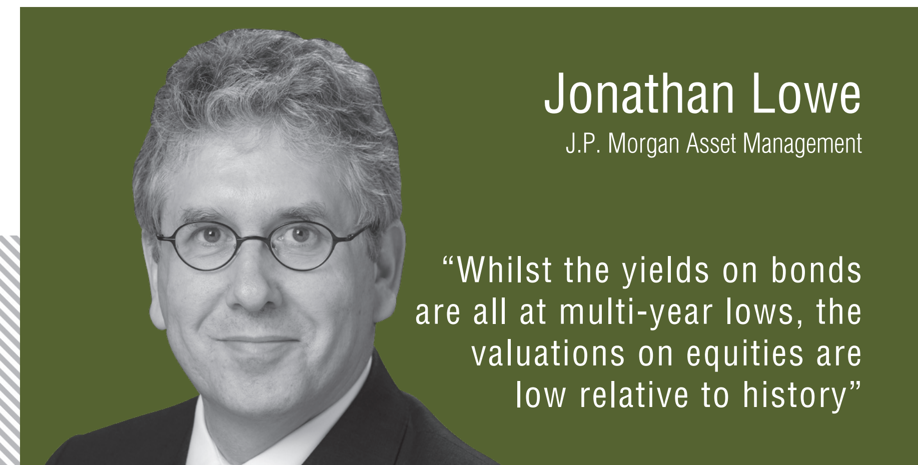
FINDING VALUE IN CREDIT

When it comes to the credit mar-kets, there is less absolute value in all segments than 12 months ago.

Yield compression has occurred throughout the spectrum of opportunity as investors have rushed in to take the yields on offer.

Interestingly, spreads relative to risk-free assets have compressed less significantly but even here there is less value on offer.

"Sometimes, the best opportunities can be found where the short-term prospects are the darkest."



Therefore, any perceived value is a relative judgement call. Given low levels of economic volatility and the low level of defaults, there is still some attraction in the US high-yield sector although the prospect of further spread compression seems limited.

However, a yield of around 6.5% is attractive relative to a five year Treasury yield of 0.7% and a five-year high quality investment-grade corporate bond yields of just under 2%.

GETTING THE BALANCE RIGHT

The extraordinary demand for income-orientated products is a direct consequence of the unconventional monetary policies being pursued in the developed world.

With the low interest rate guidance by the US Federal Reserve being extended out to 2015, and with quantitative easing forcing investors to effectively take on more risk to satisfy their income objectives, it is not surprising that the current appetite for yield products is strong.

Is this overdone? This can only ever be known in retrospect. Current yields across all fixed income asset classes are certainly low but there is no iron law to suggest that they cannot move lower. With two-year Swiss government bond yields still negative, and having been continuously so since April, even the zero-yield boundary can no longer be taken for granted.

Given the current historically-low interest rate environment, the extent to which clients should be better balanced depends on their investment objectives and risk tolerance.

If clients have a zero or limited appetite for risk then clearly they should only consider investment in the safest of safe havens. It is difficult for investment advisers to determine this for clients; clients should determine it for themselves.

Whilst the volatility of all asset classes at the moment is low – as a direct outcome of various central bank policies – this will rise at some point and clients need to factor this into their risk/reward assessments.

That said, if clients can tolerate more potential volatility in their investment choices, they should consider putting some of their wealth in higher risk asset classes.

Whilst the yields on bonds – be they government, investment grade, high-yield or emerging market – are all at multi-year lows, the valuations on equities are low relative to history. Most equity markets provide a reasonable trade-off between return and risk at this point.

> “One of the benefits of a multi-asset fund is that it does give an element of inflation protection through investments made in equities and REITs.”

PROTECTION FROM INFLATION

Inflation expectations should be a critical variable in any investment decision, with the return on the investment over a reasonable time horizon at least being able to compensate for any erosion of purchasing power through inflation.

The problem at the moment is that inflation rates differ significantly depending on the location of the investor. Inflation (and inflation expectations) are materially higher in the developing world than they are in the developed world. However, nominal yields are largely driven by monetary policies that a conducted in the developed world.

As a result, inflation protection strategies are of the utmost importance for investors located in the developing world. But this is easier said than done. Yield products are not typically designed with inflation protection in mind particularly given the mismatch in the inflation experience that exists between the developed and developing world.

One of the benefits of a multi-asset fund is that it does give an element of inflation protection through investments made in equities and REITs. REITs, in particular, provide direct inflation protection since rents received over time will adjust to changes in price levels as will underlying capital values. The linkages between equity returns and inflation are less direct but since equities are a claim on asset values as well as earnings stream, there is some inflation sensitivity.

However, yield strategies can only offer so much inflation protection. Investors seriously concerned about inflation should also seek protection through indexed-linked bonds (where available) and commodities. Given the unconventional nature of current monetary policies, some insurance in gold would also be desirable.

RISKS AND YIELD TRAPS TO AVOID

Since multi-asset funds invest in a wider range of instruments than single asset funds, there is the benefit of diversification across different asset classes. Yet there are more risks to consider.

For investment in non-investment grade bonds, for example, the risks are largely credit-related and depend on the vagaries of the economic cycle. Anything which impacts the economic cycle negatively – higher interest rates, deteriorating balance of payments positions, inflation, recession, etc – will impact the price of such bonds accordingly. Equities and REITs are also impacted by many of the same factors, but the volatility of returns are higher.

Possibly the most significant risks to be aware of occur during times of financial turbulence and dislocation.

In normal conditions, different asset classes should perform differently in line with the perceived risks they embed – bonds (even low-grade bonds) should be less volatile than equities. This generally provides diversification benefits of multi-asset investment.

However, during periods of turbulence, the diversification benefits tend to reduce. During short periods of time all asset classes can come under pressure and see an increase in volatility. Fortunately these periods tend to be relatively short lived, and this does give rise to profitable opportunities as market conditions normalise. However, investors must of course be able to tolerate the potential volatility.

Another important consideration is to resist the temptation of focusing solely on the absolute level of yield.

For bonds, this means thinking about credit quality in relation to the economic cycle – not just chasing the headline nominal yield.

Leverage works in both directions and the absolute prerogative for credit investors is to make sure the coupon can be sustained and the principal can be repaid.

The more highly-geared the structure the less certainty there will be on both of these issues.

For equities, factoring in dividend growth as a return driver should be a key consideration.

Should dividends be cut the equity price will suffer, so concentrating on dividend sustainability and ultimately growth, should turn out to be a better protection against such adverse investment outcomes. ■

For more information on J.P. Morgan Income Funds, visit:
www.jpmorganam.com.sg/income.

Find out more about J.P. Morgan Asset Management at:
www.jpmorganam.com.sg

Q&A

UNDERSTANDING THE SEARCH FOR YIELD ASSETS

Eleanor Wan, chief executive officer of BEA Union Investment Management, explains some of the trends in relation to the strong investor appetite for yield, and outlines some buying considerations in today's environment.

What are some of the ways that investors are generating income for their portfolios at the moment?

There are still some stocks which offer good dividends, but many clients and advisers are looking for purely high-yielding product. They need to be careful as this is just focused on one side of the story.

I think that investors also need to be careful about distributions of dividends with higher-yielding products. I think that those dividends should in some cases be put back into the fund to invest for further growth.

Part of the problem in these cases, however, is that investors don't always know what they are buying, which comes back to the need for more investor education.

In terms of fixed income, there are still some corporate bonds in Asia which offer much higher yields than the Western bonds. This might include property companies in China, as well as REITs which provide consistent dividends, especially in Australia. This is leading some portfolio managers in Asia ex-Japan to broaden their focus to Asia Pacific ex-Japan in order to find these higher-yielding opportunities.

> Investors need to be careful about distributions of dividends with higher-yielding products.

What have you been offering recently which gives investors higher yields?

We launched an Asia Pacific Multi Income fund in May 2012, which includes Australia, to offer high-yielding stocks as well as some corporate bonds to make up the portfolio.

Our target is to distribute a 7% yield per annum, as well as a monthly dividend. The fund raised over US$100 million from Hong Kong investors during its IPO.

This shows that we are working hard to ensure we are producing a product that the client wants, including working

Eleanor Wan

BEA Union Investment Management

hard with the distributor – which in this case was exclusively the Bank of East Asia – to understand what the local investor-base needs.

Are there not a lot of risks with such a fund, given the underlying assets?

If we were to offer this product in Europe, for instance, the investor response would be very different. They don't know the assets as well as the local investors do, and there are of course higher risks than investing in government bonds. But Asia Pacific is a very different economic environment.

At the same time, local investors know the names of the companies in which they are investing, and have a lot of trust in them.

How important is RMB product at the moment?

This is the dominant topic at the moment as investors are expecting RMB appreciation and the higher yield. However, these conversations are limited to Asia for the time being, and the investment world in the region is very different from what it is in Europe and the US.

So have most investors given up on traditional investment products?

I don't think so. Regulations are tightened towards complicated structures, particularly those involving extensive use of derivatives. Simple and traditional investment products remain in the supply.

For an equity fund manager, they can still find growth opportunities in some companies to invest, but of course, the performance expectations are now different – it is no longer about double-digit growth.

Also, good investments will be impacted by sudden changes in economic development.

This means creating a diversified portfolio is a challenge.

Further, time horizons are now different. So while there are still some good opportunities in global equities, for example, advisers cannot go to investors and expect them to be open to investing in global equities with a 10-year outlook.

Investors can generally only see what is happening at the moment, rather than being forward-looking in the same way as the investment managers are, even if this is only three years in the future.

What are some of your priorities at the moment, given the lull in activity in the markets generally?

BEA Union is only five years old, so I am focused on how our infrastructure and resources might be able to handle growth in assets and the overall business going forward.

I am using this period to revisit all these strategic issues to ensure that when the time comes, we are well-positioned to grow sustainably. I won't have time to do that once the market recovers.

The current market environment in fact gives me a good opportunity to look internally, increase efficiency and invest in technology. When the market recovers, BEA Union will be ready to grow. ■

Co-published article

WHY INVEST FOR INCOME?

The need for income has been brought starkly into focus following the fall out of the credit crunch and the continuing challenging economic conditions in which we find ourselves, says Stephen Thornber, fund Manager - global equity income, Threadneedle Investments.

More and more investors are seeking ways to invest that will pay them regular income.

This is due to various factors:

- As economic growth continues to be subdued, many investors have become increasingly aware of the potential for re-investing income, enhancing the total returns from their portfolios. In other words, if you re-invest the income that an investment pays out back into that investment, the investment capital increases and you may also hope to see greater potential growth

- The rising costs of fuel and food had also prompted many investors to look for a regular return on their investments that will help them meet their household bills

- Investors who are currently retirees face different challenges from those of previous generations. Older investors may now find themselves looking forward to a longer retirement. Their search for income is dominated by greater longevity and uncertainty about the costs of living into an advanced age

THE ECONOMIC ARGUMENT

Economic circumstances are altering investors' search for income-generating investments.

Historically, income-seekers have favored lower-risk investments such as deposits and government bonds. Those investors seeking income during their retirement are not currently getting a good return on either of these traditional lower-risk investments. The rates of interest paid by high street banks have fallen commensurately, damaging the income-generating ca-

pacity of deposit accounts for millions of savers.

Government bond investors are facing a similar problem. The risk-averse conditions of the past few years have driven yields to historic lows.

It is increasingly difficult for investors to achieve meaningful returns. With such uncertainties surrounding the assets traditionally favoured by income seekers, it is necessary that investors look for alternative solutions.

EQUITY INCOME OPPORTUNITY

In such an environment, dividends from equity (the investor's share of a company's profits) are proving to be extremely attractive to investors searching for income.

Whilst not providing a capital guarantee, equity income investing has moved to the top of many investors' agendas. Equity markets are very well-placed to fill investors' needs, delivering very attractive yields that are typically superior to those found in bond markets.

Not only do some equity dividends exceed the yields of developed market government debt, but they also outstrip those of bonds with comparatively higher interest rates such as emerging market debt and investment grade bonds.

EQUITIES HISTORICALLY A GOOD SOURCE OF INCOME

Equities have historically been a very good source of income for investors because well-managed companies have been able to raise their dividends faster than the rate of inflation, providing real income growth that is hard to achieve in other asset classes.

The income stream generated by equities grows over time, while income from fixed income (bonds) is exactly that – fixed, thus an investor's purchasing power is eroded over time by inflation. This is particularly important for pensions and longer-term savers. Dividend growth has outstripped inflation over the past 20 years, thus supporting purchasing power.

Dividends are a prominent component of total return. In fact, over the past 40 years, dividends have been the most significant component of returns, and returns linked to changes in stock prices (multiple expansion) have been comparatively small and in some cases have been negative.

The combination of dividend yield and dividend growth has been a major contributor to overall performance.

What makes the equity income strategy even more attractive is that it not only captures income but, with the high exposure to quality companies, it can provide significant scope for capital appreciation over the longer term. Companies that pay dividends tend to be established, well managed and fairly large and secure, making them more resilient to unexpected shocks in the market. Dividend-paying stocks represent a relatively conservative subset of the equity market, offering investors lower volatility with more consistent performance.

A CASH-RICH MARKET

Throughout the financial crisis of the past few years, companies have focused on cutting costs and strengthening balance sheets to remain competitive. They have emerged more efficient and rich with cash – non-financial US companies, for example, held a record US$1.24 trillion in cash as of February 2012, up by 3% from the year before (Moody's: US Non-Financial Companies Hit New Cash Stockpile Record. March 14, 2012. www.wsj.com)

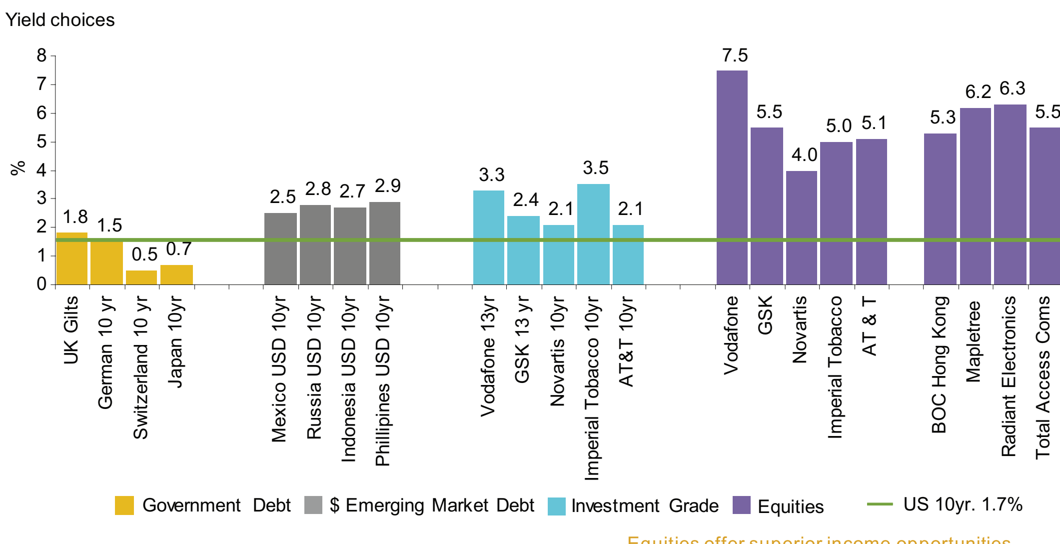
With abundant supplies of cash and current dividend pay-out ratios below the historical average companies are in a better position than ever to initiate or raise dividend payments.

Stephen Thornber

Threadneedle Investments

"Dividends from equity are proving to be extremely attractive to investors searching for income"

Equity income yields compared with yields from other asset classes – Equities offer superior income opportunities



Source: Bloomberg as at 16 October 2012, equity yields are estimated 2013 yields.

Asian companies have generated impressive earnings in recent years as a result of strong economic growth in the region.

At the same time, there is a growing trend for Asian businesses to distribute excess cash to shareholders.

Today, Asian yields are not far behind those on offer in the UK, and there is every chance that the gap will narrow in the coming years as Asia's relatively strong economic fundamentals continue to feed through to higher earnings and dividends.

A FAD OR A LONG-TERM STRATEGY?

Equity income funds have performed particularly strongly recently and this has generated considerable publicity. However, they are not just a short-term fad, but rather a valuable long-term strategy that should form part of a balanced portfolio.

Indeed, there is a good body of research, comparing the performance of high-yield stocks against the overall market, which supports our view that high-dividend strategies consistently perform well or indeed outperform.

Looking at the performance of markets over the past 20 years shows, while on a year-on-year basis income strategies can underperform, on a rolling three-year return basis there is no period over the past 20 years when a high-dividend strategy has underperformed the world market.

There are a number of advantages of taking a global approach to equity income investing. An investor can gain exposure to underlying economies, which may be growing much faster than their own domestic economy.

> "There is a growing trend for Asian businesses to distribute excess cash to shareholders."

Threadneedle's Global Equity Income strategy holds a global telecoms company, for example, that is an excellent business. However, 70% of its revenues are generated in Europe with just 30% emanating from the rest of the world, including the rapidly-growing emerging markets.

But as a result of our global strategy, we are able to invest in telecoms businesses with direct exposure to surging economic growth.

Thus we include telecoms stocks in Malaysia, Singapore and Thailand, all of which are benefiting from booming demand for mobile telecoms services in their domestic markets.

Selecting companies on a global basis provides a much wider set of opportunities than otherwise true and it also enables the construction of a much more efficiently diversified portfolio.

INCOME SUMMARY

Over the longer term, the income component of total return on equities is significant enough for investors to think of this asset class when they are considering how to meet their income requirements.

Threadneedle Investments believe that equity income strategies have a very important role to play within a balanced portfolio.

The diversification benefits offered by an international approach mean that global income funds are likely to become increasingly popular.

Threadneedle's Global Equity Income strategy is versatile and focuses on delivering long-term capital growth with the additional benefit of an above average level of income distribution. The strategy is plain vanilla, using no dividend capture, derivatives or hedging. The strategy targets "quality income" rather than High Income, with an emphasis of free cash-flow and dividend growth. ■

For more information, contact:

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Executive Director
Wholesale Distribution, Asia Pacific
Threadneedle Investments
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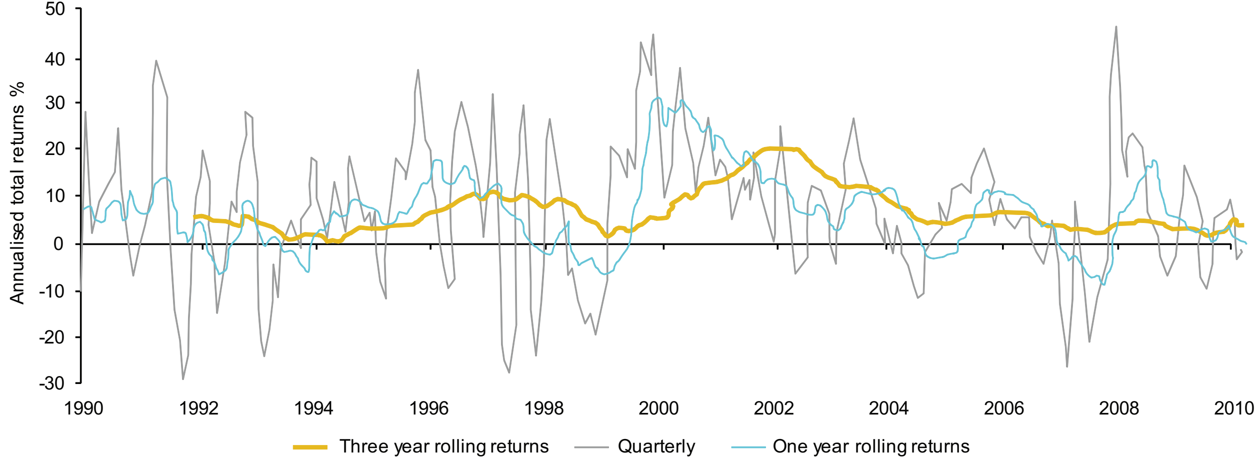
E gerard.clancy@threadneedle.com

Income strategies have consistently out-performed the market

- Using rolling 1 or 3 years periods, the strategy has rarely underperformed during the last 20 years

Short-term low beta characteristics become compounding outperformance in the longer-term: Relative total returns of a global high dividend yield strategy



Source: SG Cross Asset Research

THE ROLE OF DIVIDEND-PAYING STOCKS IN THE HUNT FOR YIELD

Mark Vanderkolk, investment specialist at BNP Paribas Investment Partners in Asia, explains the importance and application of dividend-paying stocks as part of any investor's income strategy.

In the rush to provide income funds and products, how can you differentiate your offering?

A good example of our differentiation is the BNP Paribas L1 Equity High Dividend Pacific Fund. The objective of owning financially-healthy companies that reward shareholders with potential income every year is certainly attractive.

Ideally, we look for businesses that stand apart from their competitors because they invest shareholder capital wisely, minimise borrowings, grow revenue streams through smart expansion, and retain cash generating assets such as patents or other intellectual property. We also look for unique thematic investments which may be overlooked by the broader market.

With so many clients sitting in cash, and a lot of money going into different types of fixed income, do you think this is over-done?

Certain investments that are overlooked. For investors seeking steady income that dividend-paying stocks provide, and the potential for capital gains, high-yielding equity funds are a viable solution to achieve the best of both worlds.In the hunt for yield, this asset class is often passed over in favour of lower-yielding fixed income products.

Where specifically should be investors looking in terms of dividend opportunities?

Dividend-paying stocks are a practical investment for several reasons. First, they ensure that management's interests are more closely aligned with investors' interests. They are also an effective starting point in that a company requires profits in order to pay dividends. As an investment theme which has been largely overlooked in the past, especially in Asia, valuations amongst dividend-paying stocks remain attractive.

Increasingly, more stocks in Asia are offering the best of both worlds; paying a sustainable yield and providing growth potential.

Whilst it seems to be a reasonable conclusion that dividend-yielding stocks should be a common investment theme, in Asia ex-Japan there are relatively few equity funds that have an income theme.

In fixed income, capital appreciation and interest income through investing in Asia ex-Japan transferable debt securities denominated in hard and Asian local currencies also provide opportunities. Given that Asian bonds are available in both hard currency and local currency, we see different benefits arising from investing in each of them.

Mark Vanderkolk

BNP Paribas Investment Partners

> Increasingly, more stocks in Asia are offering the best of both worlds; paying a sustainable yield and providing growth potential.

Hard currency Asian bonds enable investors to benefit from the global interest rate and credit cycle, whilst local currency Asian bonds allow investors to exploit Asian interest rates and FX.

Where should investors look for value in the credit markets?

Capital appreciation and interest income may be achieved by investing in non-Japan Asian fixed income securities denominated in US dollars or other major currencies and local Asia Pacific currencies, with medium- to long-term maturity. This allows investors to participate in Asian economic and financial developments via an active, systematic, fundamentally-driven and quantitatively-enhanced multidimensional investment approach to unlock opportunities.

What products are you offering to capture some of these opportunities?

For example, the BNP Paribas L1 Equity High Dividend Pacific Fund invests in the shares of Asian small-, mid- and large-sized companies, with a top-down thematic approach and bottom-up analysis.

The Asia Pacific high dividend team screens all investible Asian stocks based on each company's financial health, sustainability of the dividend, and valuation.

The majority of our investment approach is fundamental with research based on regular company meetings, which leads to a detailed understanding of each company's business model.

Industry decisions reflect bottom-up opportunities within a top-down assessment of industry themes.

What misconceptions exist around income and yield?

Investment in high-dividend stocks is often seen as a defensive play. However, we see it as a smarter starting point and a long-term investment for all seasons.

Asian net gearing is the lowest compared with other regions, whilst cash-flow growth remains strong. Even during the global financial crisis, Asia had more dividend increases than cuts.

Corporate gearing in Asia remains low and well below historic averages. Capex to sales is set to hit a 22-year low in 2012, which leaves significant free cash-flow and the ability to pay dividends. ■

Feature article

MAKING THE RIGHT BUYING DECISIONS

As investors have gotten swept up in the rush to access various income-related opportunities, they need to make sure to bear in mind various characteristics of the products they are buying, and to not fall prey to common misconceptions.

In general, as investors look for yield and income, it is inevitable that there is some confusion about what this means.

For example, does it mean getting a coupon being distributed on a monthly or quarterly basis? Or does it mean buying into an income theme as part

> There are a lot more interesting names on the supply side of the fixed income space. However, investors shouldn't simply chase yield by going down the credit curve and therefore force themselves into a trap.

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< GAIN FROM OUR PERSPECTIVE >

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of the style of the way in which the assets are managed?

Product providers say they can design products with a regular coupon, but do private clients really need or want this? It would seem to be the case that many investors would prefer out-performance as a result of through good-quality stocks delivering income.

Either way, this highlights the need for investors to fully understand what they are buying, and the various potential impacts on returns, to ensure there are no unexpected surprises along the way.

Sandro Steiner

OLZ Wealth Management

"The more equity clients have in their portfolios, the higher the fluctuation of the returns. The same is true for currency risk"

IMPACT OF INFLATION

As an important part of making the right decisions when investing in income, clients need to think about inflation – especially as many central banks continue to print money.

According to Henry Wong of BEA Union Investment Management Limited, for example, different types of inflation impact investors' yield strategies and mentality in different ways.

For example, in a deflationary environment, investors look for yield enhancement, he explains. Meanwhile, a stagflation outlook, which is expected going forward, will also affect investor mentality, with more focus on bonds.

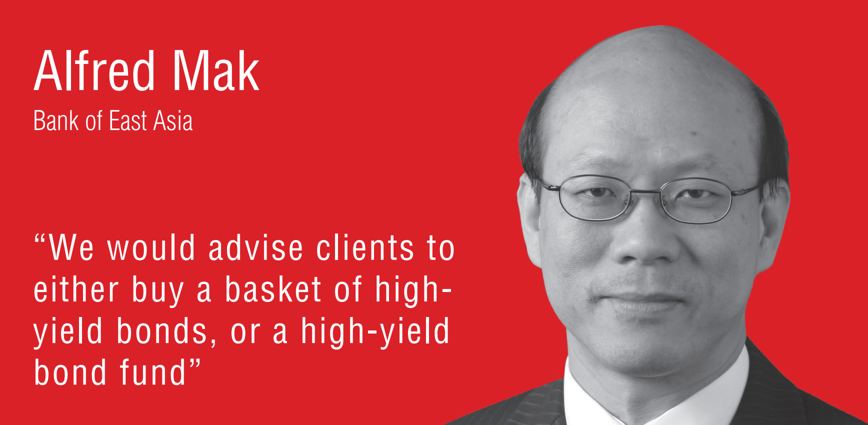
For the time being, however, most investors don't really see much inflation, so are not putting it as a priority from a capital preservation perspective.

"While clients are conscious of inflation, they don't tend to factor this into the equation of the returns they are looking for," explains Alfred Mak, head of investment products and advisory at Bank of East Asia. "In general, many investors just look at the nominal return. That is helpful given how volatile inflation can be and the external influences that are beyond our control."

Instead, advises Sen Sui, senior director and head of markets and investment solutions for Credit Agricole Private Banking in Asia, they should buy what they know and what they are comfortable with.

While Wong says he expects to see higher inflation, there is likely to be less economic growth globally. This means that corporate earnings will be under a lot of pressure, he explains, so rather than looking for dividend payments, investors will look for coupons from bond issuers.

In general, investors will allocate more to bonds to get stable returns as well as higher coupons for their overall portfolio, he adds.



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Serious Investing®

Nick Hoar

Neuberger Berman

"CCC-rated securities look expensive... we don't think investors are being rewarded for the risk they are taking"

> Investors need to be aware of dividend yields which are at risk of decline.

"In general, there are a lot more interesting names on the supply side of the fixed income space," says Sui at Credit Agricole Private Banking. "However, investors shouldn't simply chase yield by going down the credit curve and therefore be forcing themselves into a trap."

Getting yield without taking excessive risk is certainly the key when it comes to currency plays.

"Most Asian-based investors have to look for yield by investing in other currencies, but they are then subject to the currency risks," says Sandro Steiner, partner and managing director of independent asset manager OLZ Wealth Management in Singapore.

Whether the return of a portfolio fluctuates more or less depends on the asset allocation, meaning the weights in cash/bond and equity. In fact, asset allocation accounts for about 90% of the "ups and downs" of a portfolio, explains Steiner. "The more equity clients have in their portfolios, the higher the fluctuation of the returns. The same is true for currency risk."

The current situation, where (nominal) interest rates are lower than inflation rates, meaning negative real rates, is not easy for many wealth management clients to understand.

"Clients often have difficulties in understanding what this really means, namely losing money (purchasing power) every day," says Steiner.

"In such a situation, clients are often tempted to buy products promising (relatively) high returns without seeing the (hidden) risks."

It is in these types of situations where they make investment mistakes.

However, adds Steiner, these can be prevented by the investor properly understanding the situation and impact of negative real returns, and investing in a systematic way.

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FOCUS ON QUALITY

In terms of other influences on appetite for income products, Wong says many investors might first opt for high-grade investments when buying income products.

This is because these will give them more comfort in relation to the issuer, due to the credit fundamentals.

For investors with a higher risk appetite, the high-yield sector, through careful selection, could give them greater compensation from the level of risk they take on through a higher coupon, explains Wong.

Yet with high-yield bonds in particular, Mak at Bank of East Asia says he wouldn't recommend clients to invest in only a single bond because of the exposure they would have to a single issuer's credit risks.

"Instead, we would advise clients to either buy a basket of high-yield bonds, or a high-yield bond fund," he explains. "They can then take leverage on this and be more comfortable with the risks."

Marc Lansonneur

Societe Generale Private Banking

"More and more banks are looking to develop their own core systems which are 80% to 90% defined"

For example, says Marc Lansonneur, regional head of investment teams and market solutions, Asia Pacific, at Societe Generale Private Banking, the European high-yield sector is considered to be risky.

"So while people will invest in it, they will do so only for a certain percentage of their assets. In Asia, however, some investors consider some high-yield paper to be as safe as US or European government bonds."

It is therefore important to reassess investors' risks in terms of their portfolios, in terms of liquidity and counterparty risks, he explains.

Within high yield, Nick Hoar at Neuberger Berman says CCC-rated securities look expensive. "And we don't think investors are being rewarded for the risk they are taking."

Investors often forget the yield on these bonds is high for a reason.

"We think it is a better strategy to overweight BB-rated securities, many of which have been identified by our team of credit analysts as prime candidates to be upgraded to investment grade," says Hoar.

> Investors should also make a projection about whether an issuer will have the ability to make the payment in a timely manner against the current market conditions.

CONSISTENCY

With dividend-paying products, investors should look for consistency in the payments.

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Selecting and investing in bond funds

Henry Wong of BEA Union Investment Management Limited says investors must have clear decision-making processes and criteria when they buy bond funds, to avoid some of the common pitfalls.

The starting point for investors is deciding to use a bond fund manager to take care of the returns, rather than investing directly in single-name bonds. "The main reason," says Wong, "is that if investors don't have time, it is better to assign a fund manager."

In addition, and especially during difficult market conditions, many investors don't have the experience to properly understand the credit risk or the fundamental risks, he adds.

When choosing between fund managers, Wong says track record is the first thing for investors to assess. Secondly, it is important to know how long the fund has been managed by the same managers, particularly in the current environment. "A mature fund manager with a full economic cycle of experience is very valuable in today's environment because we are now in unchartered waters." For example, says Wong, never before in history have so many governments been printing money at the same time, "and the consequences of this might go beyond our understanding, as well as our market timing".

When investing in the fund, Wong points out some commonly-overlooked issues. For example, as investors look for a higher coupon to find a more stable return, they need to ask themselves what risk appetite they have, he says. "If they have a higher risk appetite, for instance, then they can allocate more into higher-yielding sectors. But if they are more risk adverse, then they should stick to investment-grade products," explains Wong.

Also, the investment horizon for fixed income should be longer than for other asset classes, so investors in bond funds shouldn't be looking to trade out in three months' time, adds Wong. "Otherwise the transaction costs will be too high, plus it is unlikely they will make the right pick according to their risk appetite."

Wong says the most important question advisers need to ask investors to ensure the most appropriate fund selection relates to their risk appetite. "Given that markets can change very quickly, unless investors understand how much downside they can bear, they should think twice before going into specific asset classes," he says.

"When they buy into the asset, they want a stable payment stream to avoid the need to change their investment," says Wong.

Investors should also make a projection about whether an issuer will have the ability to make the payment in a timely manner against the current market conditions, he adds.

According to Joshua Crabb, director and fund manager for the BlackRock Asia Pacific Equity Income Fund, studies in the US have looked at dividend-payout ratios and subsequent 10-year earnings growth in order to see the trends over time.

The reality, he says, is that dividend-payout ratios don't necessarily imply slower growth.

His premise comes down to capital allocation, he explains.

For example, if a company has US$100 to spend on capital, its first US$20 or US$30 will probably go to the highest-returning assets, and then gradually down to lower-returning assets.

"For those companies paying dividends to shareholders, if they have good opportunities to come to market to raise additional capital for good buying opportunities – and they explain this to investors – then the market is happy to provide them with the required funding," says Crabb.

At the same time, investors need to be aware of dividend yields which are at risk of decline.

Says Crabb: "Some companies will be paying out more than they should be, for example, which will affect their sustainability." ■

Important:
- The BEA Union Investment Asia Pacific Multi Income Fund (the "Fund") seeks to achieve income and long-term capital growth by investing in an actively managed portfolio of debt securities, listed REITs, and other listed securities in the Asia Pacific region.
- The Fund invests in emerging markets and may be subject to higher liquidity and volatility risks.
- The Fund invests directly in listed REITs, equities and interests in trusts, and is thus subject to the risks generally associated with such asset classes, including but not limited to liquidity of the asset class, changes in investment sentiment, political environment, economic, business and social conditions in local and global marketplace.
- The Fund may invest in lower-rated fixed income instruments, including below investment grade and non-rated debt securities, which are subject to greater credit and liquidity risks than higher-rated securities.
- The Fund may enter into futures contracts for hedging and investment purposes. Given the leverage effect embedded in futures contracts, the Fund may be exposed to significant losses.
- Investors should not make an investment decision based solely on this material.
- Issuer: BEA Union Investment Management Limited

In pursuit of high-yielding assets from a diversified source of investment opportunities in Asia Pacific

BEA Union Investment
Asia Pacific Multi Income Fund ("APM")

- Searching for higher yields amid "zero" interest rates
- A dedicated investment team with an average of 14 years' experience in Asian equities and fixed income
- A portfolio mainly consisting of Asian high yield bonds, high dividend stocks, and REITS, aiming to generate an above-average stream of income
- HKD and USD unit classes with monthly dividends^

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1. Source: BEA Union Investment Management Limited. The quoted annualised dividend yield is for APM – USD Class A (Distributing) for the month of July 2012. Annualised dividend yield = (Dividend x 12) / last month-end NAV x 100%. Positive dividend yields do not indicate positive returns. ^ The dividend of the Fund is subject to the Manager's discretion and is not guaranteed. The Manager may make distributions from income and/or capital in respect of the distributing classes of the Fund. Investors should note that the payment of distributions out of capital represents a withdrawal of part of the amount they originally invested. Distributions in general will result in an immediate decrease in the net asset value of the Units of the relevant distributing classes. Charging all or part of the fees and expenses to the capital will result in income being increased for distribution, however, the capital that the Fund has available for investment in the future and capital growth may be reduced. All fees and expenses in respect of this Fund are charged to capital.

Investments are subject to investment risks. Past performance is not indicative of future performance. For full details and risk factors, please refer to the Explanatory Memorandum of the Fund. The Fund has been authorised by the Securities and Futures Commission ("SFC") in Hong Kong. SFC authorisation is not a recommendation or endorsement of a scheme nor does it guarantee the commercial merits of a scheme or its performance. It does not mean the scheme is suitable for all investors nor is it an endorsement of its suitability for any particular investor or class of investors. This material has not been reviewed by the SFC in Hong Kong.

Co-published article

FORGET ABOUT GARP, IT'S ALL ABOUT YARP

According to Michael Kerley of Henderson Global Investors, investors should be focusing on names that have a value bias – that is they are fundamentally undervalued, providing room for capital growth – and at the same time are expected to grow their dividends in the years to come.

Growth at a reasonable price (GARP) is a good philosophy when screening equities for investment – striking a balance between strong, consistent earnings and good value. But the hunger for yield, in Asia as elsewhere, means investors risk investing in high-yielding companies with limited growth and high multiples. Yield at any price is as illogical as it sounds; better investment decisions are made seeking yield at a reasonable price (YARP).

The prolonged low levels of interest rates in the developed world over the last few years, together with the flight by investors towards safe havens, has pushed up the price of many income-producing assets and has also depressed yields.

This is particularly true of core government bonds, but it has also spilt over into the corporate credit markets. Although equities still have a significant yield advantage over government bonds and cash, there are some sectors where equity yield is becoming expensive as investors risk the situation of overlooking valuations in the quest for distribution.

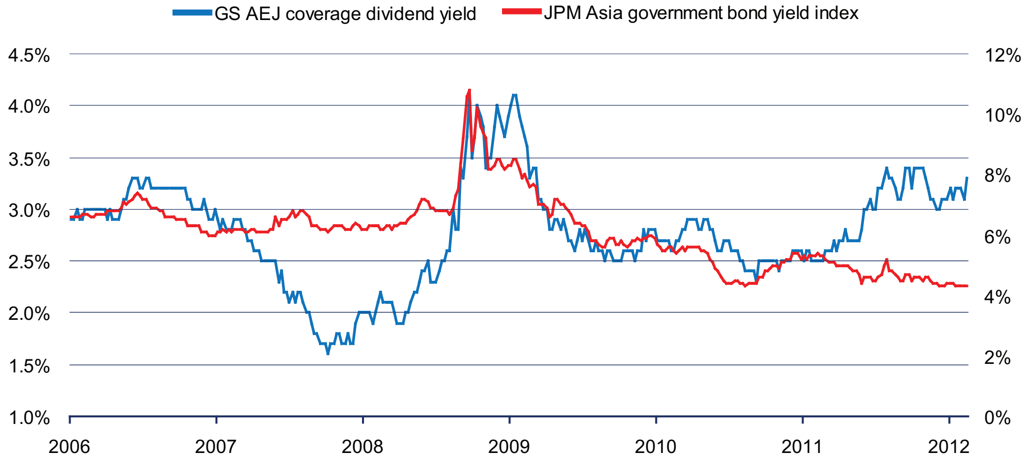
There are areas of the Asian equity markets that exhibit this tendency: companies within the consumer staple and utility sectors are currently trading at multi-year highs despite a fairly pedestrian earnings outlook.

THE NEED TO BE SELECTIVE

We take the view that one should not overpay for income and our strategy is to try and incorporate the yield payers of the future into the portfolio.

While we believe that dividend-paying companies are a good defensive tool against turmoil in the markets (dividend stocks are historically less volatile than the broader market), our

Divergence continues between dividend and bond yields



Source: Bloomberg, Goldman Sachs research estimates, as at 9 May 2012

focus remains on sustainably high-yielding names that have valuation support. We also dedicate a proportion of the portfolio to companies that we believe will be the high-yielding names of the future.

This should allow for superior dividend growth going forward but also provide greater capital upside should market sentiment turn more positive.

The technical backdrop has not changed in Asia. Equity valuations are still not excessive, and divergence continues to exist between dividend and bond yields.

Asian markets currently trade below their average 10-year price-to-earnings (PE) ratios at the lower end of their historical ranges, and look attractive relative to other asset markets – especially local and global bonds.

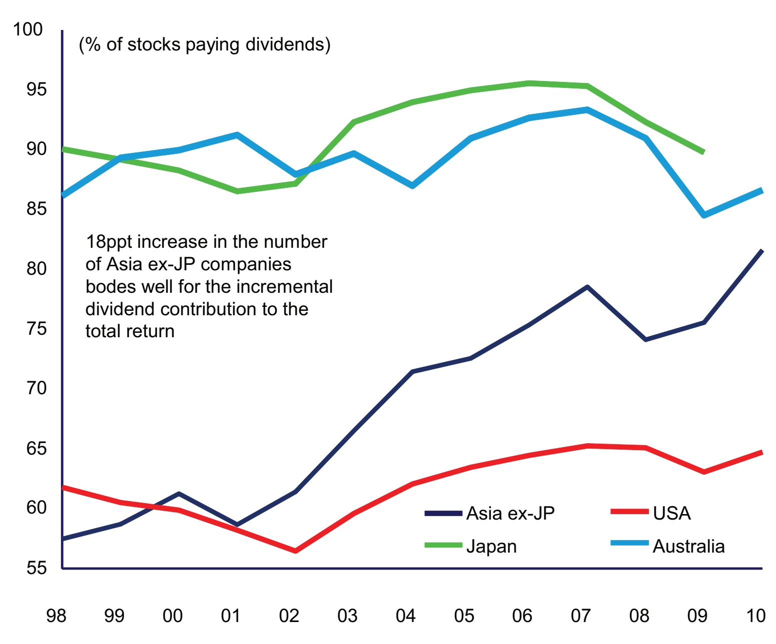
Although earnings numbers have been revised down in recent months, especially in the more cyclical areas, many companies are still awash with cash as cash-flow generation has remained healthy while gearing levels are low.

Despite a slowdown in dividend growth, dividends continue to be a growing part of total returns in Asia.

Back in 1998, less than 60% of stocks in the region (ex-Japan) paid dividends; that figure has since risen to around 80% by 2011.

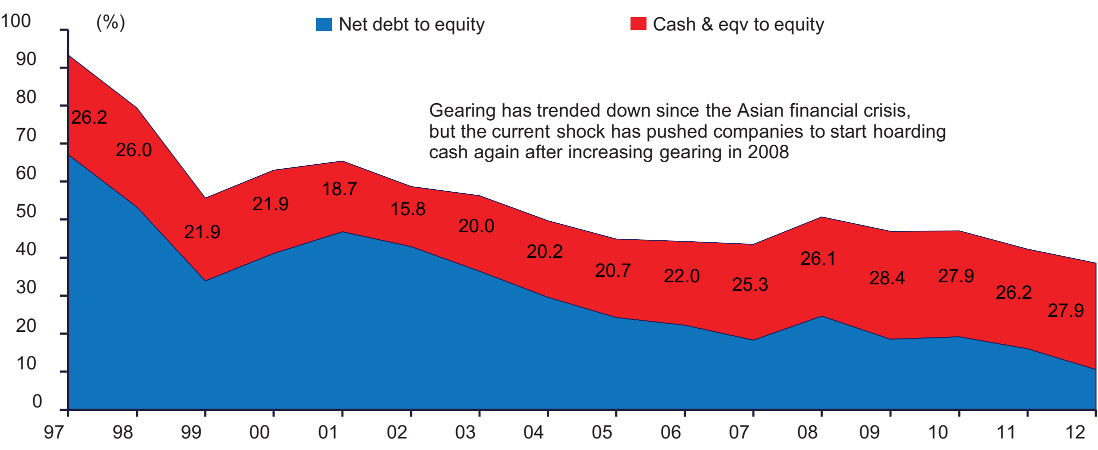
Importantly, following the changes at the company level in recent years, Asian companies have the ability to

Asia ex-JP witnessing improvement in number of companies paying dividends



Source: CLSA Asia-Pacific Markets
Note: MSCI universe, May 2011

Asia ex Japan net debt-to-equity



Source: Worldscope, MSCI, Citi Investment Research estimates, May 2011

continue to generate strong cash-flows. This is reflected in the lower debt and higher margins of Asian companies. The extra cash, we believe, will be put towards increasing dividend payments.

Sustainable dividend yield is in plentiful supply across Asia.

In that year, those Asian markets less exposed to the global cyclical cycle had increasing levels of dividend payment. And yet average pay-out ratios (percentage of net profit paid out as dividend) are at the low end of their historical range in Asia.

This will have to rise given the arguments above.

ASIA IN STRONG RELATIVE SHAPE

On the economic front, the west-ern world's uncertain growth outlook contrasts to that of the relatively robust Asian economies.

While GDP growth has slowed, mainly from export weakness but also from restrictive government policy, underlying trends remain healthy in Asia, especially in those areas related to consumer demand.

More importantly, inflationary pressure has abated, which has allowed interest rates to be cut in China, Australia and South Korea, and overall fiscal and monetary policy to be much more accommodative in the region. The measures to contain property price appreciation have been relaxed and infrastructure projects, which had been put on hold due to fears of overheating, have been restarted.

This is not to say Asia is completely immune to the woes of the west. Asian economies may display an element of decoupling from their western peers but the same cannot be said for the stock markets. In the last 12 months, heightened economic and political uncertainty resonating from Europe and weaker-than-expected growth from the US have been the cause of much weakness in Asia, leaving markets range-bound, weighed down by a moribund growth outlook and political uncertainty in both Europe and the US.

The good news, however, is that investment opportunities still abound in Asia. Finding them requires a selective philosophy; one that looks to markets with less susceptibility to global economic growth and more focus on domestic names, and then combines it with a bottom-up approach to find stocks that have a real investment appeal rather than just a high yield.

This means focusing on names that have a value bias – that is they are fundamentally undervalued, providing room for capital growth – and at the same time are expected to grow their dividends in the years to come: YARP.

There are plenty of income opportunities. Dividends-per-share paid in Asian countries are estimated to grow. Indonesia and Thailand, for example, top the board with 19.4% and 15.0% respectively.

Sixty percent of Asian companies' shares currently yield more than 10-year US Treasury bonds, and 39% yield

Dividend yield

MSCI Markets	Dividend yield (%) 2012	Dividend yield (%) 2013	Dividends per share CAGR 2011-2013 (%)
Australia*	5.1	5.4	5.8
China	3.4	3.6	3.9
Hong Kong	2.9	3.1	1.7
Indonesia	2.7	3.0	19.4
India	1.6	1.8	11.4
Korea	1.2	1.3	7.7
Malaysia	3.3	3.6	8.1
Philippines	2.3	2.5	2.4
Singapore	3.5	3.7	4.0
Taiwan	3.3	3.6	2.5
Thailand	3.4	4.0	15.0
Asia Pac ex Jp	3.2	3.5	5.1

Source: Datastream, CLSA Asia Pacific Markets, 21 Sep 2012
Note: For Australia, 2012 and 2013 represents FY13 and FY14

more than their 10-year local bonds. The proviso is that while we wait for the decoupling of Asian stock markets from the west, likely a protracted process, one has to take a medium to long-term view on investments.

THEMES THAT PAY DIVIDENDS

We remain confident in the key investment themes in the portfolio, which remain mostly unchanged: banks, property, infrastructure, telecoms and China:

- Banks are favoured as they remain well capitalised, liquid and undervalued – reduced overseas competition should also enable them to increase profitability
- Lower interest rates and high savings ratios bode well for the property sector
- Government infrastructure spending should stay strong across the region to offset some dampening of export growth
- Telecommunications continues to offer strong cash-flow generation and sustainable yields, as well as providing exposure to increased data usage across the region
- China offers the best combination of value and income in the region, and is best-placed to respond to global economic volatility because demand for goods and services, such as bank accounts, mortgages, mobile phones, etc still have the potential to grow rapidly, bolstered by significant increases in disposable income

Elsewhere at the country level, Thailand is area where the fund has been overweight and is reaping the benefits of growing consumer demand and a more benign political environment.

The greater growth potential in under-penetrated markets such as Indonesia in the telecoms sector versus the more developed markets in Asia, is also proving beneficial to performance.

THROUGH THE LOOKING GLASS

We remain positive on the outlook for Asian equities in the medium to long term but expect volatility to continue while Europe debates its future and the US struggles to maintain an economic recovery.

We believe Asian fundamentals remain intact and will use opportunities from global uncertainty to acquire solid franchises at attractive prices given resilient corporate balance sheets, earnings and dividend yields. ■

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THE NEED FOR A MORE BALANCED APPROACH TO INCOME

Eddy Tsoi, head of fixed income advisory at BNP Paribas Wealth Management in Asia, discusses key considerations for investors to manage and fully understand the exposure in their portfolios to income-generating products.

With so many clients sitting in cash, and a lot of money going into different types of fixed income, is this over-done?

Long-dated, high-grade bonds appear quite expensive as most of them offer tiny real returns, or even negative real returns, after adjusting for inflation.

However, technicals remain favourable as the central banks of developed markets are likely to keep rates low for another two to three years.

The carry trade is still the dominant theme for the time being. Nonetheless, we monitor clients' leverage closely and will suggest them to reduce gearing accordingly.

While it's over-done from a long-term view, but short-term momentum is still there.

So given the current historically-low interest rate environment, how should clients be better balanced?

Asset allocation remains the key for investments. We closely monitor clients' exposure to interest-rate risks and will make appropriate recommendations to clients accordingly, including hedging to trim down long-dated bonds when we expect the interest-rate market is turning around.

On the other hand, more investors are willing to take risk in high-yield bonds. We closely monitor clients' portfolios which have a large exposure to sub-investment grade bonds or emerging market bonds.

Other than bonds or structured notes, investors can achieve better risk-reward ratios by investing in high-quality stocks with stable dividend policies over the long run.

Where specifically should investors look in terms of dividend opportunities?

High-dividend stocks is one category. Private banking clients are also looking at corporate hybrids which offer more stable coupons/dividends when compared with stocks.

Corporate hybrids are usually subordinated and have either very long or no maturities.

These are good investment opportunities into companies with solid fundamentals and assigned investment grade ratings as opposed to investors buying lower-beta, emerging market debt.

In the rush to provide income funds and products – how can you differentiate your offering?

In the current landscape, the product offering by most private banks to clients is similar.

However, BNP Paribas Wealth Management differentiates itself from other competitors as it offers more tailored solutions to clients by considering their risk profile and risk tolerance levels. Clients can sometimes take riskier products as long as they can limit the total exposure.

How do your advisers ensure that products offered are suitable for investors?

We have a risk-score system in place for all bonds, structured notes, equities, funds and other products to match a client's risk profile – including conservative, balanced, dynamic and very dynamic groups.

Clients in the conservative group are not recommended to invest in products with high risk scores. Most importantly, our consultants will highlight the risk of the instrument to clients to ensure they understand the risk of the product before investing.

To what extent do inflation expectations impact advisers' advice and investors' investment decisions with respect to yield-enhancement products and strategies?

Inflation is the major risk for income products. It does not only reduce the real return for investors, but also puts investors under mark-to-market risks.

Even floating-rate notes cannot eliminate inflation risks because central banks can artificially cap the short-term rates at very low levels.

The floating-rate coupons may offer negative real return if adjusted by inflation. Nonetheless, inflation should have less impact on high-dividend stocks of which nominal earnings will benefit from inflation.

What are the yield traps to avoid?

Investors should be fully apprised of the risks associated with any income products. For example, some structured products can offer decent yield pick-up, but there could be a number of conditions linked to the coupon payments.

Eddy Tsoi

BNP Paribas Wealth Management

Moreover, investors should also understand the credit risk they are taking, because this may have an impact on the principal invested.

What misconceptions exist around income and yield?

Expected return does not equal to yield.

For example, long-dated US Treasuries delivered 10%-plus returns in the second half of last year, while some high-yield bonds fell more than 20% during the same period.

Yield-to-maturity can only materialise if the client holds to maturity and the issuer can repay the principal. ■

Co-published article

MAKING THE RIGHT ALLOCATION

As investors take an increasingly-tactical approach to their fixed income allocations, Lemuel Lee and Chan Ahn of J.P. Morgan say it is challenging for anyone to know the best time to switch from high yield to emerging markets to investment grade debt, especially given the ever-shorter market cycles.

The rush into high-yielding assets since 2011 has left many investors fairly heavily skewed towards investments such as high-yield corporate bonds. This has led them to start to assess their concentration risk.

While rates remain low and markets uncertain, investors are now contemplating whether to make the switch into investment-grade names.

However, the yields aren't quite attractive enough for most, halting sweeping shifts in their asset allocation. Plus, when is the best time to switch? And which assets should they look to invest in at this point in time?

Offering clients a way to allocate their investments between high yield, emerging market and investment-grade debt, therefore, seems to meet current appetite. And doing it via a portfolio of funds with a rules-based approach to allocation enables investors to detach themselves from the decision-making process. This approach

> Investors are now contemplating whether to make the switch into investment-grade names.

prevents investors from subjecting their investment strategy to emotions or behavioural bias.

CHANGING INVESTOR MINDSET

Before the 2008 financial crisis, investors of all types tended to just look at performance track-record to determine their investment strategy.

However, the immediate aftermath of the crisis saw many questions being raised, given that some of such strategies performed poorly and didn't deliver their expected returns.

In particular, many investors now have four key requirements:

- They expect stable returns as a source for meeting their yield requirements with volatility levels set as low as possible
- They expect to have efficient access to income. Instead of direct investments, which can be expensive and illiquid, funds can provide such access efficiently for many investors
- Their scrutiny of fund managers is much greater than in previous years – especially with ever-higher correlation – so they prefer managers who are well-known and have good track records
- Despite their thirst for yield, they believe that there is no single asset class which can serve as an all-weather investment. This has steered them towards more diverse exposure

As a result, investors are now taking into account how asset classes will react to a changing environment. The macro-economic backdrop shows that market cycles are shorter than ever before, and investors are now seeking

products which can capture the opportunities as macro conditions change.

OPTING FOR BOND FUNDS

A diverse range of bond names could ensure a well-diversified portfolio. The most effective way for many investors to achieve this is via a bond fund that is actively managed by well-respected fund management teams that employ various investment strategies – both fundamental and quantitative. Bond funds also provide higher liquidity when compared with direct bond investments.

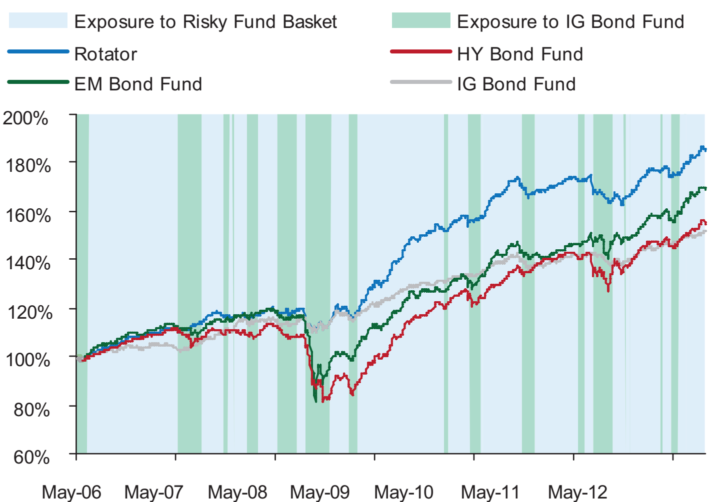
Some of the key attractions of different types of bond funds include:

Investment grade

- Relatively safer with lower default rates
- Likely to be more defensive and less volatile than high-yield bonds, equities and commodities in case of economic downturn,

> The macro-economic backdrop shows that market cycles are shorter than ever before, and investors are now seeking products to capture opportunities as macro conditions change.

Simulated performance



	Rotator	HY Bond Fund	EM Bond Fund	IG Bond Fund
Ann. Returns	10.20%	7.14%	8.65%	6.81%
Ann. Volatility	4.54%	6.00%	7.16%	4.45%
Info Ratio	2.25	1.19	1.21	1.53

Source: J.P.Morgan. Data: May 06 – Sep 12
For the above illustration, HY Bond Fund: PIMCO Global HY Bond Fund (BBG: PIMGHYB ID), EM Bond Fund: PIMCO Emerging Market Bond Fund (BBG: PIMEMBA ID), IG Bond Fund: PIMCO IG Bond Fund (BBG: PTRBDFE ID)

ideally suited for the current environment of uncertainty

High yield

- High rate of current income associated with their high coupons
- Higher potential of capital appreciation (and depreciation), compared with investment grade
- Correlated to equities yet more defensive given the typically positive carry earned from the difference between the implied default rate and the realised

Emerging markets

- Emerging market macro-economic indicators stronger than in developed countries
- Global diversification of the portfolio and potentially lower volatility compared with investing only in US debt
- Inflation rates have been trending down lately

It is important to recognise that high-yield and emerging market bond funds have historically shown a high correlation to market trends.

In a bull market, they tend to give a high return on investments and outperform other asset classes.

By contrast, in a bear market, they show a significant drawdown in fund value, as seen in 2008.

A STRATEGY FOR UNCERTAIN MARKETS

Being able to rotate between riskier bond funds, such as high-yield and emerging markets, and more stable investment-grade names is an ideal option to enable investors to manage their portfolios through stressed market environments. This also could minimise any losses they would have incurred if they would have stayed invested in high yield or emerging market funds.

The J.P. Morgan Bond Funds Rotator invests in a risky bond fund basket or

an investment grade bond fund, based on momentum signals of the risky bond fund basket. The basket consists of an equally-weighted basket of a high-yield bond fund and an emerging markets bond fund.

The mechanics are straightforward and the logics are simple. Each day, the 10-days moving average of the risky bond fund basket is compared with the 40-days moving average. If the 10-days moving average is greater than the 40-days moving average, it indicates a bull trend and the Rotator invests in the risky bond fund basket. The Rotator invests in the investment-grade bond fund when the 10-days moving average is less than the 40-days moving average. Positions can also potentially be rebalanced daily.

Since many Asian investors tend to find it difficult to make certain changes in their strategy, a feature to rotate between assets has the benefit of removing any decision-making burden for investors.

LOCAL CURRENCY EXPOSURE

There is also a growing interest among investors in retaining local currency exposure. However, investors need to be careful not to leave their portfolios exposed to FX risk, as this will significantly increase their portfolio volatility.

To address this, the Bond Funds Rotator can be offered as a total return swap. This creates several benefits: minimising exposure to currency movements; offering a potential yield pick-up via access to local money markets; and settling payments in the local currency.

To achieve this, J.P. Morgan enters into an unfunded total return swap with the investor on the Rotator.

So, it borrows the US dollar amount equivalent to the local currency notional, and invests in the Rotator. The investor posts J.P. Morgan a fraction of the notional as collateral and invests the remaining notional in the local money market.

As a result, during the life of the trade, currency exposure is only on the excess returns of the Rotator (returns of the Rotator in excess of the borrow cost). Also, the end-investor gains the money market rate differential – meaning the difference between the local money market rate and the US dollar funding cost. ■

Chan Ahn

J.P. Morgan

“The end-investor gains the money market rate differential”

For investors who prefer sticking with investment-grade bond funds, they can get two-, three- or four-times leverage through buying a J.P. Morgan-issued note linked to such funds.

This meets the desire of many investors for higher yields than are available on investment-grade bonds at a time when they cannot borrow as much from their banks as previously, or if they lack capital.

J.P.Morgan

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Q&A

A HIGH-YIELD PERSPECTIVE

As investors search for yield in a very low nominal interest rate environment, there are few options available to capture high current income. One of the most compelling investment opportunities is the global high-yield sector, says Betsy Hofman, CFA, vice president and portfolio manager in the Franklin Templeton fixed income group.

Why do you favour the global high-yield sector, especially compared with other fixed income options?

Currently, the benign outlook for defaults and the healthy US corporate environment have continued to make the high-yield sector an attractive option for investors, particularly in relation to the government bonds of many developed countries.

> Over the past few years many corporations have sought to raise their liquidity buffers and deleverage their balance sheets.

Considering the historically-low rates being offered in many developed-market government bond markets – such as those of Japan, the US, Germany and Canada – investors are being paid little to invest in these countries' bonds.

Although we expect inflationary pressures to remain subdued over the near term, the potential longer-term impact of government debt funding needs from these countries, combined with very low current yields, does not make these fixed income sectors very compelling longer-term investments, in our view.

So why is the high-yield sector the place for investors to look?

Over the past few years many corporations have sought to raise their liquidity buffers and also to deleverage their balance sheets.

This generally-conservative approach to financial management, combined with earnings growth over this period, has reduced the inherent financial risk in the corporate sector, at least over the near term, in our view.

In addition, accommodative public debt markets have allowed many companies to issue bonds and to push out their debt maturities, further reducing refinancing risk.

In which sectors specifically do you see opportunities?

Currently, we continue to overweight the energy sector where we feel there are strong assets supporting the various issuers.

In addition, we also see the potential for positive event risk for these names as there have been a number of recent buyouts by cash-rich, higher-rated energy companies looking for strategic acquisitions.

What might derail the potential you foresee in the global high-yield sector?

Despite these supportive fundamentals, security prices in the credit markets have largely moved up and down this year based on headlines from the Eurozone and the US, as well as from moves in the global equity markets.

We recognise that the high-yield sector may be vulnerable in the event of volatility related to the Eurozone sovereign debt crisis.

However, with our sovereign and local asset management analysts continuing to identify select opportunities, attractive valuations on a risk-adjusted basis and below average default rates, we believe the asset class can provide lower financial market correlation relative to equities while typically offering a higher-than-average yield.

Are there any other positive indicators for the high-yield sector?

We also view this as an exciting time for the high-yield asset class as it continues to globalise.

Recently, we've seen Yankee issuance from Europe as well as Asia and Latin America. While the market remains modest, we believe this trend will likely continue and we expect this will continue to be an area of growth.

What are the general risks for fixed income investors to bear in mind?

When speaking about risk in the context of fixed income investing, there really are two basic types: credit and interest rate. Of the two, many investors focus on credit risk, or the risk of not getting your coupons paid and/or your principal back.

However, when longer-term interest rates rise, the price for government bonds will generally move lower – and the longer the maturity of a bond, typically the greater the downward price move. ■

Betsy Hofman
Franklin Templeton Investments

> We believe the asset class can provide lower financial market correlation relative to equities while typically offering a higher-than-average yield.

Co-published article

FINDING YIELD IN ALTERNATIVE INCOME SOLUTIONS

In the current low-yield environment, investors are looking for defensive alternative income solutions which generate higher yields. Innovative issuers are able to offer such products which meet these requirements and more, says David Schmid of the EFG Financial Products Division within EFG Bank.

Today's US Federal Reserve (Fed) monetary policy has resulted in historically-low interest rates and high inflation rates.

As recently as five years ago, 1-year Treasuries offered a yield which was higher than 5%. This is much more than today's 1-year Treasuries at 0.165% and is still greater than today's 30-year Treasury yield.

It is expected that the Fed is maintaining its low-rate policy to help cope with the current environment. The Fed has stated its intention to keep rates at zero at least through the middle of 2013, and possibly longer if need be.

Taking into account an expected inflation rate of 3.9% in Singapore (1.7% in the US), for instance, the real interest rate is negative.

"As a result of the near-zero short-term rates, rising inflation and decreasing corporate's credit spreads, investors are looking for alternatives."

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Structure:	Low Strike Autocallable
Underlying:	iShares FTSE China 25 Index Fund (FXI UP)
Currency:	USD
Maturity:	Max. 18 months
Autocall Trigger:	100%
Coupon Frequency:	Quarterly
Strike Level:	70%
Coupon Type:	Guaranteed Coupon
Coupon Level:	5.00% p.a.
Collateralization:	Yes (COSI)

Source: EFG Financial Products, 2012 (illustrative example only)

In such an environment, investors often take on significantly more risk with corporate bonds for higher yields.

However, the credit spread – the additional yield to the risk-free rate an investor earns in exchange for the higher risk he takes – decreases.

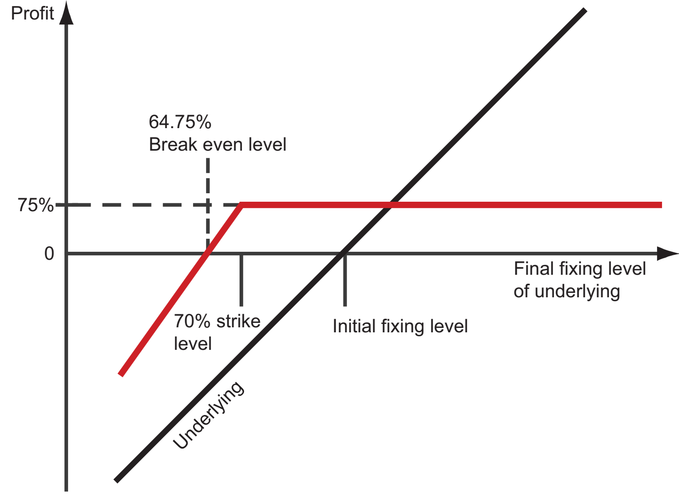
This means that an investor receives a lower compensation for the higher risk of corporate bonds than a few months or years ago.

As a result of the near-zero short-term rates, rising inflation and decreasing corporate's credit spreads, investors are looking for alternatives.

Low Strike Autocallables (LSAs) are defensive financial products which have many advantages over traditional investments. Based on current market conditions, it is possible to structure LSAs which offer a guaranteed coupon of 5% p.a. with a maximum tenor of 18 months.

As illustrated in the above table, the underlying is a broadly-diversified ETF with 25 constituents which represent the performance of the largest companies of China's equity market. Addi-

Payoff at maturity (if no early redemption occurred)



Source: EFG Financial Products, 2012 (illustrative example only)

tionally, the LSA is quarterly autocallable if the underlying closes above the initial level. Further, the low strike at 70% offers a decent downside protection against falling prices of the underlying ETF.

HOW LSAs WORK

The mechanism of an LSA is simple:

- **Coupon mechanism:** the coupon of 5% pa is paid independently of the performance of the underlying, on a quarterly basis (assuming no early redemption)
- **Redemption mechanism:** every quarter, if the underlying is above the respective autocall trigger level of 100% of the initial fixing level, the product will be early redeemed and the investor will receive 100% of the denomination plus any payable coupon
- **At maturity (if the product has not been early redeemed):** if the underlying is at or above the strike level of 70%, the investor will receive 100% of the denomination. If the underlying is below the strike level, the investor will receive the denomination reduced by an amount proportional to the negative performance of the underlying below the strike level. The investor cannot lose more than the initial investment

BENEFITS OF AN LSA

1. Less risk due to diversification

Compared with US corporate BBB bonds which yield about 3.50% pa, the illustrated LSA is not only an attractive alternative because of the 1.50% pa higher yield.

Whereas the investor of a BBB bond bears the risk of a single corporation, the investor of an LSA is exposed to the market risk of a diversified and well-known ETF. The investor faces a trade-off between the probability of a default of a BBB corporation and the market risk that an ETF will decrease by more than 30%.

2. Enhanced payout thanks to low strike level

The low strike of 70% makes the product very defensive. It means that the investor's capital is preserved until the underlying decreases by more than 30%. From this point, the investor will start losing money. Hence, there is no digital risk such as a barrier where the payout falls to the level of the barrier once breached.

Redemption at maturity (if no early redemption occurred)

Final level of the underlying	Final redemption (including all coupons)
120%	107.50%
110%	107.50%
105%	107.50%
100%	107.50%
95%	107.50%
90%	107.50%
80%	107.50%
70%	**107.50%**
69%	106.07%
64.75%	**100.00%**
60%	93.21%
50%	78.93%
50%	78.93%
40%	64.64%
30%	50.36%
20%	36.07%
10%	21.79%
0%	7.50%

Source: EFG Financial Products, 2012 (illustrative example only)

Source: EFG Financial Products and Bloomberg, 2012

The table illustrates the final redemption amount (assuming no early redemption) depending on the underlying performance.

Even if the underlying decreases by 35.25%, the investor still receives his initial invested amount (break-even level). From the performance of the iShares FTSE China 25 Index Fund, as depicted in the chart, one can see that the ETF has never traded below the strike of 70% in the last 3 years.

3. Auto-call feature offers more flexibility

The autocall feature allows the investor to get early redeemed if the underlying closes on the quarterly observation day above 100% of the initial level.

This enhances the investor's flexibility in a sideways trending or slightly increasing market environment to reinvest their capital at the prevailing market conditions.

GENERAL RISKS

As with all financial instruments, there is also risk associated with an LSA. If the underlying closes below the break-even point of 64.75% (-35.25% in 18 months), the investor receives less than their initial investment.

Hence, the product is not capital protected and the investor may lose part or all of the invested capital.

In addition, the investor usually bears the credit risk of the issuer. However the issuer risk can be minimised through the COSI® feature.

Because structured products in the form of certificates are bearer debt instruments (claims), the investor who purchases a certificate assumes a default risk that varies according to the creditworthiness of the issuer. The insolvency of the issuer could therefore result in a total loss for the investor.

COSI®, meanwhile, are structured products with a minimal counterparty risk. This protection is provided by means of a collateral pledge. Investors thus profit from increased protection on the invested capital.

This unique service is offered by SIX Swiss Exchange Ltd in collaboration with SIX Securities Services and Eurex Zurich Ltd. ■

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DOES FINANCIAL HISTORY RHYME?

Paul Stefansson, head of investment funds at UBS Wealth Management in Singapore, explains why it is vital for investors to think long term and move out the risk spectrum by focusing on assets which have historically provided "real" returns.

Imagine that you are the president of a large country with high public debt. Elections are around the corner and you want to get re-elected. The bond market is demanding that you repay the debt and prevent the massive chaos of an economic collapse. Your economic advisers tell you that you have five options:

1. Economic growth
2. Default on the debt
3. Hyper-inflation
4. Austerity
5. Inflation and financial repression

Which option is most likely to get you re-elected?

ASSESSING THE OPTIONS

Option 1, economic growth, will definitely get you re-elected, but is it a viable solution? After all, no country has ever grown itself out of a significant debt crisis with the exception of England, and it was a long time ago. After the Napoleonic Wars, the UK's debt exceeded 200% of GDP. After the wars were over with, the UK met its debt obligations and thus the debt/GDP ratio steadily declined until 1915. This was possible because the UK was the financial centre of the world and British sterling was also the world's reserve currency.

While you must try to get growth, it's a long shot and has not worked often in the past. In fact, according to Reinhart and Rogoff (2010), when debt/GDP exceeds 90%, growth declines. Over the past two centuries, debt in excess of 90% has typically been associated with mean growth of 1.7% versus 3.7% when debt is low.

Option 2, default, is viable, but you won't get re-elected. In 2002, Argentina defaulted on US$100 billion of debt. After the default, hundreds were killed

> The only workable solution you have is inflation and financial repression.

through riots and outbursts, protests outside banks have taken place and there have been three governments and five presidents.

Businesses were severely disrupted; banks froze assets and limited withdrawals. Together with the default, President Duhalde brought an end to the "convertibility" system of the previous system which had tied the Argentine peso to the US dollar. The peso was subsequently floated, leading to its rapid devaluation.

Argentina suffered a -14.7% GDP growth rate with 37% of its population living below the poverty line. Inflation was at 4% and the unemployment rate was at a high 25%. Would voters re-elect you?

Hyper-inflation, option 3, is next to consider. After the signing of the Treaty of Versailles, Germany couldn't repay its debt to the Allied forces and chose a combination default and hyper-inflation. Prices went up quicker than people could spend their money.

In 1922, a loaf of bread cost 163 Deutsche marks. By September 1923, this figure had reached 1.5 million Deutsche marks and at the peak of hyper-inflation, November 1923, a loaf of bread cost 200 billion Deutsche marks. People were paid by the hour and rushed to spend money before it became worthless. Bartering became common practice. Pensioners on fixed income suffered as pensions became worthless. The middle class suffered the most as their savings disappeared overnight and had no wealth or land to fall back on, having to sell their family heirlooms to survive. Voters and Germans don't like hyper-inflation. However, it wasn't just Germans that chose this option. Yugoslavia also chose hyper-inflation in 1993 and so did Zimbabwe in 2008.

So how about austerity, option four? Cutting back on government spending for welfare benefits and public services will reduce debt, and coupled with increases in taxes to demonstrate long-term fiscal solvency may solve your problems, but it won't be pretty. Although in the long term it can change future expectations to encourage private consumption and result in economic expansion, in the short term such policies are counter-productive as it would reduce your country's GDP and the poor will have nothing to live on. Without schools, hospitals, pensions and welfare benefits, people will riot on the streets.

Nicolas Sarkozy got replaced by Francois Hollande when he wanted to implement austerity measures. So did Italy's Silvio Berlusconi, Greece's Nikos Nikolopoulos and Netherland's Mark Rutte. You won't get elected.

	Public debt/GDP			Annual average: 1946-1955	
Country	1945	1955 (actual)	1955 without repression savings (est.)	"financial repression revenue "/GDP	inflation
Australia	143.8	66.3	199.8	6.2	3.8
Belgium[1]	112.6	63.3	132.2	4.6	8.7
Italy[2]	66.9	38.1	81.9	3.7	10.8
Sweden	52.0	29.6	59.1	1.8	5.0
United Kingdom[3]	215.6	138.2	246.9	4.5	5.9
United States	116.0	66.2	141.4	6.3	4.2

Source: Carmen M. Reinhart and M. Belen Sbrancia, "The Liquidation of Government Debt", National Bureau of Economic Research Working Paper 16893 (2011); 61

Government revenues (interest cost savings) from the "Liquidation Effect" per year

Country	Period	Benchmark Measure "Liquidation effect revenues"		Alternative Measure of "Liquidation effect revenues"	
		%GDP	%Tax Revenues	%GDP	%Tax Revenues
Argentina	1944-1974	3.2	19.5	3.0	16.6
Australia	1945-1968, 1971,1978	5.1	20.3	n.a.	n.a .
Belgium	1945-1974	2.5	18.6	3.5	23.9
India	1949-1980	1.5	27.2	1.5	27.2
Ireland	1965-1990	2.0	10.3	n.a.	n.a.
Italy	1945-1970	5.3	127.5	5.9	143.5
South Africa	1945-1974	1.2	8.9	n.a.	n.a.
Sweden	1945-1965, 1984-1990	0.9	6.5	1.6	10.9
United Kingdom1	1945-1980	3.6	26.0	2.4	17.3
United States	1945-1980	3.2	18.9	2.5	14.8

Source: Carmen M. Reinhart and M. Belen Sbrancia, "The Liquidation of Government Debt", National Bureau of Economic Research Working Paper 16893 (2011); 61

THE SOLUTION

The only workable solution you have, therefore, is inflation and financial repression, option five.

Financial repression is defined as negative real returns on deposits.

The nominal interest rate is lower than the rate of inflation. Real returns on deposits and treasury bonds are negative. In 1945, the US government required that US banks buy its debt through government bonds and treasuries when their debt was over 100% of GDP.

To repay the debt, fast, they chose to implement financial repression. Financial repression kept real returns on fixed deposits at -1.94% for 35 years.

The government heavily regulated cross-border capital movements and put an explicit cap on interest rates. Binding interest rate ceilings on deposits kept the real deposit rates negative. The real rates on treasury bills were at -1.6% per year.

The emergence of leakages in search for higher yields, apart from prevailing capital controls, was delayed because of negative returns on government bonds and deposits were a universal phenomenon at the time.

The people had no choice but to direct their lending to the government by purchasing government bonds and also treasuries.

Depositing their money in the bank would effectively tax the people's financial savings as their money became devalued.

Low real interest rates were consistently and substantially below the real rate of GDP growth. As observed by Elmendorf and Mankiw in 1999, "an important factor behind the drop in US public debt between 1945-1975 is the growth rate of GNP exceeded the interest rate on government debt for most of that period."

As a result of growth inflation and financial repression, in just 10 years, the US reduced debt by 49.8%.

The government was able to liquidate its debt when interest rates were unable to respond to inflation and inflationary expectations in the future.

This situation is also known was "the liquidation effect".

Historically, the annual liquidation via negative real interest rates were about

3% to 4% of GDP each year, causing debt to shrink each year, as the government was able to collect 3.2% of GDP through the liquidation effect.

THE SITUATION TODAY

Government debt and financial repression is not a just phenomenon of the past. It is happening right here, right now.

As the sub-prime crisis of 2008 produced a surge in private debt, we face the consequences of what is known as the second great contraction.

Its effects are much more pronounced now as the globalised world faces near zero nominal interest rates. National debt is rising. We are at the historical high of World War II debt levels.

Governments in advanced economies have taken many steps in recent years to grow demand for public debt. In 2010, France converted a pension reserve fund to be a captive buyer of French official debt, with the Fonds de Reserve Pour Les Retraites (FRR) being a large captive buyer.

Ireland has used the national pension reserve to recapitalise banks by up to €17.5 billion.

Japan has reversed privatisation of Japan Post and increased deposit ceilings to increase the capacity of captive customers for Japanese government debt. The UK has increased the required holdings of government bonds and privatized Royal Mail.

Many emerging countries, such as Brazil, Indonesia, Peru, Russia, South Africa and Thailand, have followed suit, taking steps to control the flow of foreign capital into their economies. Financial repression is real.

While the European crisis scares investors out of securities, financial repression should scare investors out of fixed deposits. In the US, the fixed deposit rate is at 0.5% but inflation is at 2.6%. Assuming that there are no changes, in 20 years, you can stand to lose up to one-third of your purchasing power if you do not invest your money elsewhere. The case in Singapore is even worse. With as high an inflation rate as 5.2%, you will lose almost 60% of your purchasing power in the next 20 years.

It's time that you think long term and move out the risk spectrum. Interest rates aren't likely to climb for some time, so focus on assets that have historically provided "real" returns, namely corporate bonds, emerging market bonds and high dividend-paying stocks. Make sure that your balance sheet remains healthy.

As Mark Twain said: "History doesn't repeat itself, but it does rhyme."

Interest rates are likely to remain low for a long time, and its time you look ahead and protect your wealth. Who will win: You? Or financial repression and inflation? ■

Financial repression calculator

	SGD	USD
Fixed deposit rate	0.5%	0.5%
Inflation	5.2%	2.6%
Loss in purchasing power over		
1 year	-4.5%	-2.0%
5 year	-20.4%	-9.8%
10 years	-36.7%	-18.7%
20 years	-59.9%	-33.9%

Source: Carmen M. Reinhart and M. Belen Sbrancia, "The Liquidation of Government Debt", National Bureau of Economic Research Working Paper 16893 (2011); 61

Co-published article

COMPLACENCY IN THE DEBT SUPER-CYCLE

The aftermath of the burst of the debt super-cycle causes low to no growth, no inflation and hardly any job growth. This makes the healing process painful since the choice is between austerity now or restructuring over time. By Sander Bus, head of high-yield credits, and Victor Verberk, head of investment-grade credits, at Robeco.

The pressure will remain on politicians for many years to come. The CRIC-cycle (Crisis, Response, Improvement, Complacency) clearly has reached the improvement phase thanks to the European Central Bank (ECB) and the latest EU summit in which good plans were issued. The next phase is complacency though.

It is critical that policymakers continue the good work via a banking union and further fiscal and economic integration. Otherwise, in the long term there is no euro.

If we are correct that tail risks have become smaller, peripheral spreads and financials should trade tighter and with lower volatility. Core European (German cyclical) credit has become more expensive, especially on the long end. Steep government and credit curves make the roll down the curve effect a big contributor to total return. In high yield we overweight the European versus US market. For US high yield, investors start to "pay up for risk". For emerging credit we find valuations only just fair.

Technically we see negative net supply of financials, which is a clear positive. Tail risks have dropped since central banks around the world took the lead and keep pumping unlimited liquidity in the system – QE squared! The consequences of this will be a distant future problem. For now, this supports asset price reflation.

For investment-grade credit we see more spread tightening than for high yield and maintain overweight beta up to 25% of the maximum, while being close to neutral for the periphery.

For global high yield we feel more comfortable with a small overall negative position, while being overweight Europe. For emerging market credits we will run a neutral beta at best.

FUNDAMENTALS

The economy is in dire straits. It does not matter where one looks. Europe is in a recession. The southern part of the eurozone is in a real slump with unemployment still rising. On top of that, Germany clearly shows signs of moderating growth. This means the locomotive of the European economy is showing signs of weakness too.

In the meantime, the ECB put a temporary floor under the market with the potential unlimited purchases of peripheral government bonds. This has given the politicians some more time to continue rebuilding the European house. Building new institutions like the ESM and central oversight on banks is critical. A banking union and some kind of deposit guarantee system needs to be drafted. We fear that the politicians need another crisis before they will be urged to finish the draft of a banking union.

In the meantime, some countries need deep reforms of their economy. We think lowering pension ages, increasing taxes and skipping labour market reforms, like what is happening in France (although for a small selected amount of people) is not the correct way forward. It sets a wrong example to the Southern part of Europe.

Other problems are on the horizon in the US. A lower participation rate in the labour market hides a standstill in total employed American workers. A fiscal cliff is in sight.

The US really needs to start to get its public finances under control.

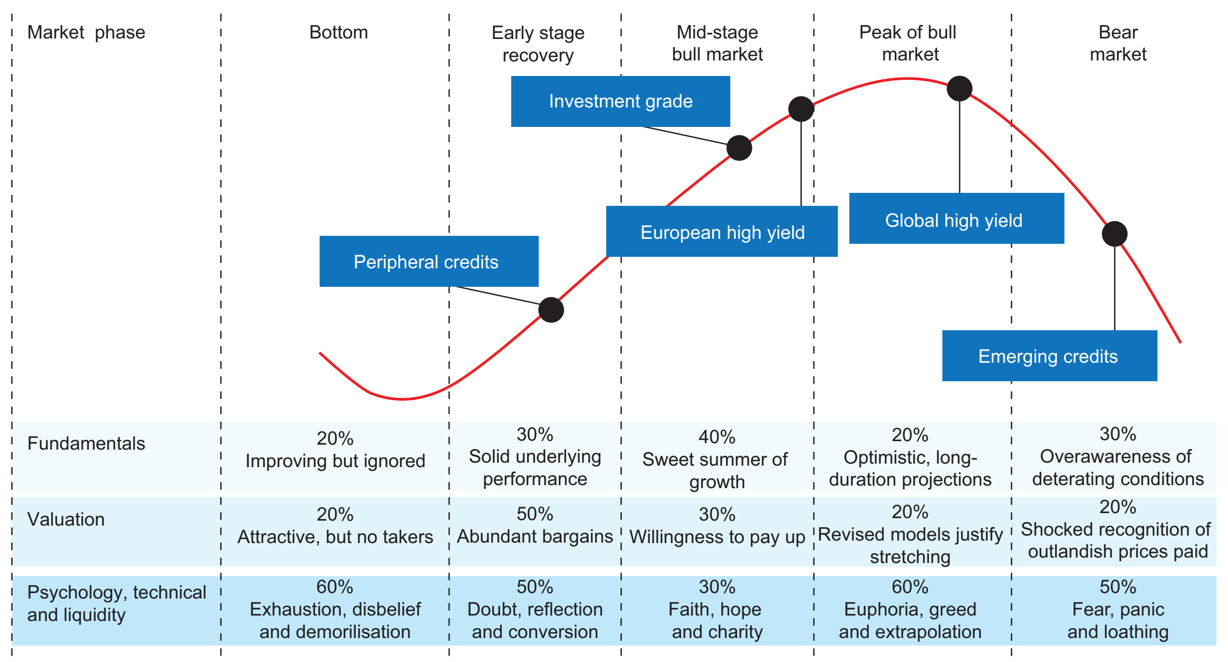
It can cost the US economy more than 1% potential output if it succeeds, but potentially even more if it does not reach a sustainable debt level.

In the US, there are also some positive signs. The inventory cycle is marginally better. That makes the quality of growth a bit better. The housing market has really started to recover. If house prices keep rising that is good news for banks and potentially for the construction sector.

More good news for the financial sector comes from the drop in delinquencies and foreclosures.

Debt forbearance has lowered household debt-to-GDP. This deleveraging trend has caused US household debt levels to look more sustainable (and back to trend). This might cause a surprisingly strong US consumer. We have had a long debate about the upward trend in leverage for the US economy since the 1980s. Many economists

Mapping our view on market segments



Market phase	Bottom	Early stage recovery	Mid-stage bull market	Peak of bull market	Bear market
Fundamentals	20% Improving but ignored	30% Solid underlying performance	40% Sweet summer of growth	20% Optimistic, long-duration projections	30% Overawareness of deterating conditions
Valuation	20% Attractive, but no takers	50% Abundant bargains	30% Willingness to pay up	20% Revised models justify stretching	20% Shocked recognition of outlandish prices paid
Psychology, technical and liquidity	60% Exhaustion, disbelief and demorilisation	50% Doubt, reflection and conversion	30% Faith, hope and charity	60% Euphoria, greed and extrapolation	50% Fear, panic and loathing

Source: Robeco

> The conclusion on fundamentals is not positive.... However, it seems that technical factors matter more now and these are very supportive.

question this upward trend to be sustainable. In any case we believe total debt levels will have to come down.

The situation for emerging markets has not improved either. The Chinese construction sector threatens to cool down too much, pushing China into a new and much lower growth era. In the meantime there are geopolitical tensions with Japan and a switch of political powers that seems not to go smoothly. The trade balance (exports) of its Asian trading partners is worsening, a clear sign of slowing growth in China. There are also geopolitical risks around Israel/Iran and Syria that might be overlooked.

The conclusion on fundamentals is not positive. Hardly any growth, the risk of deflation falling away and questionable outcomes of central bank interventions are not things to be excited about. However, it seems that technical factors matter more now and these are very supportive.

VALUATION

In general, credit markets have rallied and spreads have compressed by 30% over the last few months. Clearly this makes credit less attractive. The US high-yield market is even entering the phase we call "paying up for risk". The bright spots are peripheral credit and financial credit.

We follow the peripheral to non-peripheral spread ratio to estimate value. This ratio has traded up from 1.6 to 2.6 in the last 12 months and is currently back at 2.1. If we are correct that volatility stays a bit lower for now, this market should benefit more. With respect to financials, spreads are still cheap, fundamentals continue to improve, capital levels increase and funding gets better. Return on capital is currently low, but we are in business for return of capital and that is getting more certain every day.

Another topic is credit curves. Government, swap but also credit spread curves are very steep, making break-even levels high.

This means that the roll down the curve effect is a big part of total return on a 1-year horizon. Several 5-year corporate bonds generate returns from rolling down the curve as high as their yield-to-maturity. On the other side we notice expensive cyclical core (German) European issuers taking advantage of strong markets to issue longer term (10-year) debt. At current tight spreads one is vulnerable for even just a small spread widening. Of course this all assumes that curves remain unchanged for the next 12 months.

For high yield, it is worth noting that the leveraged loan market now trades at a wider spread than the public market. The biggest part of US high yield now trades above par prices. Also, 70% of the market trades to the call price. This means upside is limited. There are strong signals that high-yield issuance is getting more covenant-lite. Within covenant-lite, there is a trend to more issuance of the really weak covenant packages. If this trend continues, it is a negative sign.

The conclusion for valuation is that it clearly got less attractive. We favour financials, Europe and peripheral risk for a bit longer, but with less outspoken positions.

We are fully aware that if we end up in a complete Japanese situation spreads can go much tighter. It is just a scenario we take into account and makes us wary to put on short positions.

TECHNICALS

We had an in-depth discussion on the consequences of a Greek exit. Although this event might have been pushed to the background for now, it is a very interesting technical case to study tail risks.

In summary, a Greek exit would have the following consequences: imploding exports due to lack of export credit, failing banks, a further falling apart of public tax collection and institutions, deposit flight, introduction of IOUs, social unrest and maybe even

geopolitical risks when Russia or other countries take up financing Greece.

In the end, it might cause a humanitarian disaster. In that case Europe needs to help after all. So, whether one likes it or not, in all likelihood Europe keeps paying for Greece for much longer. The chances of a second Lehman Brothers-type event are just too big to take. In this situation, contagion and potential capital controls for Spain and Italy would complete the created mess.

This discussion is almost a theoretical exercise, but we do hope the politicians will not take this route. Primarily, we would fear an unknown technical contagion.

The biggest beneficiary of lower tail risks will be the financial sector.

The sector is already enjoying a nine-quarter strike of solid earnings in the US. More tailwind is coming from lower provisioning, better and cheaper funding and maybe a bit better demand for loans (in US).

Last year the Northern European banks offloaded peripheral exposure a lot (to central bank funding).

Already we see a continued trend of buybacks of wholesale debt (both senior and subordinated). This will further enhance scarcities of opportunities and decent yields for investors.

In many aspects, the last months have shown that an investor needs to be contrarian and be very aware of positioning and flow of funds.

Opposite to expectations, European credit outperformed US credit, the basis got positive, French government bonds rallied and credit market reactions to sovereign stress seem to soften. The market's pain trade is a continued tightening for peripheral credit driven by the market's underweight positioning. We are wary of that and therefore do not want to be short. However, we do search for signals that the consensus has turned and shorts have been covered.

Finally, if one takes a helicopter view, it is clear that most central banks are flooding the system with liquidity.

It takes on different forms (direct quant easing or LTRO) but the result is a huge expansion of central bank balance sheets.

The US Federal Reserve (Fed), UK Monetary Policy Committee (MPC) ECB and Bank of Japan (BOJ) all try to reflate financial assets.

Bernanke, in what could be seen as a historical comment, even explicitly said that a 1930s deflationary scenario needs to be circumvented.

This enormous execution of quant easing and interest repression is supporting financial assets in all forms; this is quant easing squared.

The conclusion for technicals is that while our central case for now is more fiscal integration and at least a less volatile period, there are enough potential tail events remaining.

Chinese imbalances, the US fiscal cliff, European leaders disappointing, German recession or geopolitical stress all have the ability to scare markets.

THE NEXT CHAPTER

The next chapter in the saga of the debt super-cycle is more of the same. Around the world, the economy is weak or weakening.

Labour participation is dropping and all kinds of bearish scenarios are possible (fiscal cliff, China and peripheral recessions). Still it does not matter for now. The market is in a delicate equilibrium between fundamentals and technicals.

The Fed, ECB, MPC and BOJ are really pushing liquidity in the system to generate asset-price inflation, quant easing squared.

For now this works, negative consequences are a concern for later.

Tail risks have come down a bit in Europe but complacency looms. In the near future further recovery in peripheral and financial spreads will lead indices tighter. ■

> "The market is in a delicate equilibrium between fundamentals and technicals."

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Threadneedle Investments is an international investment manager with a strong track record of out-performance across asset classes.

Established in London in 1994, but now with a presence in 16 countries, Threadneedle Investments manages US$116.5 billion* of assets on behalf of individuals, family offices, pension funds, insurers, and corporations.

We are the international asset management arm of Ameriprise Financial (NYSE: AMP), a leading US diversified financial services company and one of the 30 largest asset management firms globally, managing and administrating US$655 billion.*

Our success has been built on our distinctive investment approach based on creative thinking, the sharing of ideas, and rigorous debate. By combining the different views of our specialist teams, we gain a perspective advantage which enables us to generate better returns for clients across asset classes.

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Important information *Source: Threadneedle and Ameriprise, as at 30 June 2012 Past performance of the funds and their managers and any forecasts or information on the economic trends are not necessarily indicative of the future or likely performance of the fund or its manager or a guarantee of future trends. The price of shares and the income accruing to those shares, if any, may fall or rise and an investor may not get back the amount invested. Issued in Singapore by Threadneedle Investments Singapore (Pte.) Limited, 3 Killiney Road, #07-07, Winsland House 1, Singapore 239519. Regulated in Singapore by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289). License number: CMS100182-1Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies. **threadneedle.sg**

AD110