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ASSET MANAGEMENT

The Next 25 Years: Thoughts on the Future of Asset Management

A Special Report by the Investment Subsidiaries of Mellon Asset Management

Introduction

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What will the asset management profession be like 25 years from now?

Now seems like an appropriate time to ask that question, because despite the stock market's setbacks of 1987 and 1999/2000, we are in a long-term bull market that is almost 25 years old, with its start in August 1982. Since then, global capital markets have broadened and deepened in an unparalleled fashion. Investor participation has increased dramatically at both the institutional and retail levels, and has changed the scope and complexion of our industry.

We can look back at this unprecedented investment environment and identify some of the macro forces that helped ignite and sustain it – the breaking of inflationary expectations, falling interest rates and oil prices, the entering of the baby boom generation into its most productive years, and productivity enhancements driven by technology and global competition. Just trying to gauge the nature and extent of any one of those factors for more than a generation forward is an intimidating thought. As Yogi Berra observed, "predicting is hard, especially about the future."

But as another philosopher, Soren Kierkegaard, noted, we really have no choice: "Life can only be understood looking backwards, but it must be lived going forwards." All leaders and business managers need to look into the future, paying close attention to the factors most likely to affect their companies. For investment managers, our mandate as seers is broader because we are, collectively, professional generalists. It might be the prospects for student loan financing, drug manufacturers, oil drillers, retailers, or the timing of the ECB's next tightening cycle. If it has macro- or micro-economic impact, someone in our organization follows it closely, with a careful eye towards how events may affect future cash flows and current asset prices.

One of the major trends of the next 25 years can be stated with a high degree of certainty: the graying of western societies, plus Japan and China. The demographic tailwind that helped the markets in the previous 25 years will remain a primary investment theme, and likely become a headwind, in most countries for the next 25. But that relative certainty comes with a host of questions.

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For example, is demographic change already reflected in today's market prices? If so, have investors discounted that change correctly? How will changes in health care consumption and delivery affect economies and markets? Will seniors disinvest at a faster or slower rate than predicted? Will government change policy to boost savings? What is the impact on government spending as the demand for state-provided pensions and health care increases? Which countries, industries and sectors are best positioned to profit from the aging population? Successful investing will require a thoughtful evaluation of these questions and others.

In this special report, we give veteran investment professionals from Mellon Asset Management's investment boutiques a forum to leverage both the insights and the necessary humility we have gained as fiduciaries, focusing on the longer-term big picture. We hope you enjoy the perspective.

Neither the dramatic rise in inflation and interest rates nor the dramatic fall in inflation and interest rates is likely to be repeated.

Richard Hoey

The Next Quarter Century – Secular Neutral Trends

Richard Hoey
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What will the long-term secular trends be over the next quarter century?

We expect secular neutral trends for many economic variables and markets. Our rough definition of a secular trend is a long-term trend lasting a decade or more. Our outlook is for a "secular neutral inflation trend," a "secular neutral bond market" and a "secular neutral stock market." The dollar outlook is more mixed, as discussed below.

Over the course of U.S. history, there has been an alternation between uptrending secular inflation and downtrending secular inflation. A secular downtrend in inflation persisted from a peak at double-digit inflation in 1980 (when the Fed decided to stop the uptrend) through a secular low in 2003 at an inflation rate near 1% (when the Fed decided to stop the downtrend before it crossed into deflation).

With inflation likely to average higher than 1% in the future, some analysts will argue that the U.S. has entered a secular uptrend in inflation, a prolonged rise in the average rate of inflation. Political pressures for an easy monetary policy may rise as trend economic growth slows in response to slowing productivity and labor force growth, but we believe that the Fed should be able to resist them. A persistent inflation uptrend is conceivable but not probable. We expect a "secular neutral inflation trend" averaging near 2% to 2.5% rather than either a secular uptrend or a secular downtrend.

For the bond market, there has been an alternation of secular bear markets and secular bull markets. A "secular bond bull market" started in 1981 at 16% for 10-year Treasury bond yields and persisted for more than two decades. It ended in June 2003 at a low yield of 3.1% for 10-year Treasury bond yields. We now expect a "secular neutral bond market" with long-term yields cycling around current levels for the next quarter century rather than persistently rising or falling over time.

There was a "secular bear stock market" of disappointing returns from a peak in the 1966-1968 period to a low in 1982 as inflation and interest rates soared. From the summer of 1982 to the spring of 2000, there was a "secular super bull stock market" as inflation and interest rates dropped sharply while profits rose. Neither the dramatic rise in inflation and interest rates nor the dramatic fall in inflation and interest rates is likely to be repeated. As a result, we expect a "secular neutral stock market" to generate a trend of moderate positive returns in coming years. This should occur because U.S. economic policy and fundamentals are relatively

favorable but the profit share of GDP is already high and inflation and interest rates are already moderate.

The secular outlook for the dollar is mixed. With good economic policy, external financing for current account deficits should be sustained long enough to permit an orderly downward drift in the U.S. external deficit as consumption growth and import growth moderate. If poor economic policy erodes the appeal of investing in U.S. assets, there would be a greater risk of a major secular downtrend in the dollar. We believe that non-Asian currencies, including the dollar, should trend downward against the undervalued Asian currencies for the first decade of the next quarter century. Against the other major currencies, the dollar should cycle around a neutral trend over the next quarter century.

New Risks Create New Opportunities

Robert A. Jaeger, Ph.D.
Vice Chairman
EACM Advisors LLC

It's been a good 25 years. The inflation of the 1970's gave way to a prolonged period of disinflation. The end of the Cold War triggered a massive "peace dividend." The former Soviet Union and a host of other "developing countries" transformed themselves into full-fledged members of the global economy. Globalization was accelerated by the technology boom of the 1990's, which unfortunately evolved into a stock market bubble. And then the mood darkened: the tech bubble burst in 2000 and the attacks of September 2001 ushered in a new era of geopolitical anxiety.

Current anxieties revolve around three main themes: globalization, retirement and climate. (1) Globalization has created immense wealth, but this wealth is very unevenly distributed. Further progress requires that the winners treat the losers in such a way that the losers do not derail the process altogether. This issue lies at the heart of current debates about income inequality, immigration, free trade, and even the terrorist threat. (2) The retirement problem is that individuals must take responsibility for their own financial security. The defined benefit plan is dead, and Social Security might as well be dead. Some people worry that as retirees shift away from "risky assets" their collective behavior will produce a run on the global bank. (3) Climate change is no longer an academic problem. Many people continue to worry about costs, but others are growing increasingly excited about the rewards of finding solutions.

The shape of the next 25 years will be determined by how smart we are in confronting these challenges. The key requirement is smart policy, but policy problems typically involve "asymmetrical warfare," where one or two mistakes can destroy years of progress.

The boundary between hedge funds and long-only investing will continue to blur as major institutions reach deeper into the hedge fund tool kit.

Robert A. Jaeger, Ph.D.

The last 25 years have transformed the very idea of a diversified portfolio. The primitive "U.S.-centric" stock/bond portfolio has become more global and more exposed to "alternative assets and strategies." The pace of transformation will accelerate over the next 25 years. For example, the boundary between hedge funds and long-only investing will continue to blur as major institutions reach deeper into the hedge fund tool kit. Already we have 130/30 strategies, portable alpha, and related approaches: there is more of that to come, both in the institutional market and in the retail market.

Even the line between active and passive investing may become blurred as investors focus on the "alternative betas" that are partially responsible for hedge fund return and risk. Some of these betas may be delivered in passive form. For example, we may see

exchange-traded funds that own volatility, or momentum, or own various types of hedged positions (long value vs. short growth, long corporates vs. short Treasuries, etc.).

As individuals assume greater responsibility for their own financial welfare, they will need an insurance-like product to address the risk of failure. If there's life insurance and disability insurance, why not insurance against the failure of your lifetime retirement program? Social Security plays that role now, but we need something better.

Diversification in 2032 will be nothing like diversification in 2007, which suggests that the "run on the bank" problem may be overblown. Retirees have already learned not to switch entirely from stocks to bonds at retirement. As the "risk portfolio" becomes more robustly diversified, the need to shift away from it diminishes. And if globalization advances along the right path, then there are lots of young people in Afghanistan who will eventually want to buy U.S. stocks.

A lot could go wrong, but, with a little luck, it's astonishing how much could go right. As the founder of our firm periodically reminds us, in the long run the optimists do better than the pessimists.

The combination of higher wages, inadequate savings and improved health will lead many of the baby boomers to remain in the workforce longer than the previous generation.

Charles Jacklin, Ph.D.

4 Forces of Change: Demography, Labor, Emerging Economies and Climate

Charles Jacklin, Ph.D.
President and CEO
Mellon Capital Management

During the next 25 years the global economy will be dominated by four inter-related phenomena: demographic shifts, labor shortages, rapidly emerging economies and risks related to global climate change. The aging of the populations of the developed countries will have dramatic impacts. First, with population expanding at a rate faster than the workforce there will be an ever increasing demand for labor as well as technological improvements, given the increasing real cost of labor. The combination of higher wages, inadequate savings and improved health will lead many of the baby boomers to remain in the workforce longer than the previous generation. Nonetheless, the workforce as a percentage of the total population will decline steadily leading to higher wages. At the same time, investment capital will become scarce as the baby boomers shift from being middle-aged investors to retired consumers.

The shortage of labor in the developed countries will continue to fuel the shifting of jobs to the emerging/developing countries. Nonetheless, there will continue to be significant shortages of service workers, particularly in health care, in the developed countries. As employment rises in the developing countries, so will wages, standards of living and ultimately energy consumption – a trend toward more greenhouse gases and the potential for global climate change. This risk will spur investment in research and development focused on green energy.

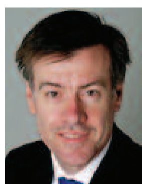
As government Social Security programs prove to be inadequate and corporate defined benefit plans disappear, retirees will struggle to manage both investment and longevity risk. Navigating the changing economic environment will prove to be daunting. Rising wages will result in higher living costs for retirees. To the extent higher wage costs lead to increased inflation and higher bond yields, safe bond investments may prove riskier than expected. At the same time, climate-driven technological changes may lead to increased market volatility as the old technologies are replaced with new. Moreover, the scarcity of investment capital due to older investors reducing their equity holdings and to the middle-aged investing population shrinking may prove to be a headwind for equity markets. Of course, falling prices should increase the forward-looking expected return on equities for the investors who weather the initial storm. The vast majority of the baby boom generation will have only marginally adequate savings and thus be unable to afford sufficient investments in annuities to manage their longevity risk.

Demand for professional investment services will be great. The investment management industry will respond by offering tiered services. High net worth clients will have a full array of personal services at their disposal. The mass affluent will have a nearly comparable array of offerings, but with a more automated interface. The remainder of the investing public will be on their own in many ways. However, they will have a broad array of "one-stop" investment solutions offers in the form of products that package professional investment with annuity characteristics.

One of the great uncertainties will be whether the societies act early enough to mitigate the impact of increasing dependency ratios and inadequate personal savings. Some, like the Australians, have already made strides in the right direction through the development of their mandatory savings via superannuation schemes. Others, most notably the Americans, have taken steps in the wrong direction by allowing the demise of defined benefit plans with no adequate substitute. Without doubt, the future will be shaped by the decisions being made today.

A lot of the wealth that has been created in the last few decades has been generated by transformational events.

Phil Collins



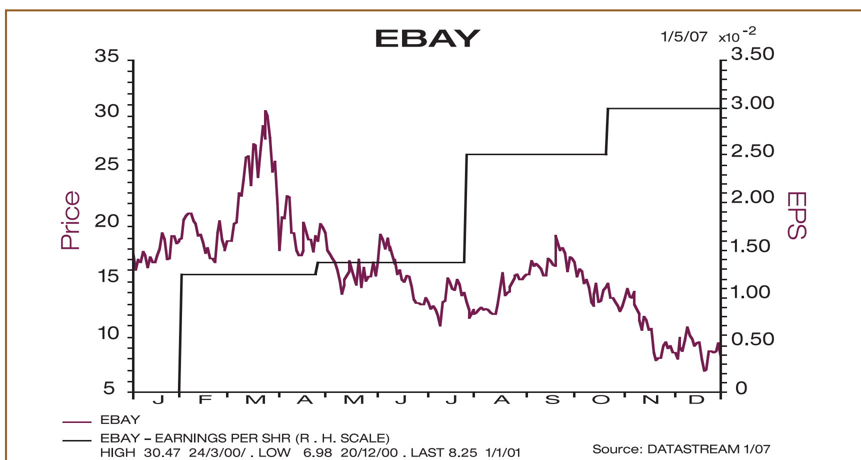
Looking Ahead 25 Years: The Chance to Profit From Change

Phil Collins
Investment Director
Newton Investment Management

For many people, change is uncomfortable. But the one certainty is that in 25 years' time, things will be different. It is important to choose whether you see that as an opportunity or a threat. As a money manager I view that as a good thing, because change generates significant investment opportunities. A lot of the wealth that has been created in the last few decades has been generated by transformational events: technology-driven change and ownership transference in the former Soviet Union are two reasonably obvious examples. The number of billionaires created by these two examples is impressive.

If an investor can spot these changes early enough, there are attractive gains to be made. However, investors also need to be aware of valuations. The share price of e-Bay halved in 2000 despite both profits and sales increasing in that year – the start of a strong growth period.

While changes in economic growth, interest rates, inflation etc., are important, they are also more difficult to forecast than (for example) demographic changes or the continued shift of workforces to lower-cost centers.



The identification of change, the ability to analyze appropriate valuation levels and a good awareness of the economic background is an attractive starting point for investors.

What investments might investors use to take advantage of that thought process? Some investors have specific mandates that include only certain assets, others are less clear about which assets are appropriate. It seems illogical to restrict the range of assets without good reason – valuations of all assets will tend to wax and wane as greed and fear drive valuations too high and too low. Thus, a portfolio comprising of a wide range of assets with different risk and reward profiles seems entirely logical. The mix of those assets would depend upon the investor's risk profile.

It also seems illogical to restrict the geographic range of assets. According to Lehman Brothers, U.S. companies earn around a quarter of their revenues overseas and European companies more than 40%. To invest only in those companies that have chosen to base their headquarters in one country or list their investments in one country seems overly restrictive.

All of these facets suggest that a multi-asset portfolio invested on a global basis with investment ideas driven by the identification of change and an appropriate valuation would be a good way for investors to increase their wealth.

In terms of specific predictions, I suspect that in 25 years' time the stock market will be higher than its current level (probably considerably higher). Unless someone finds more land somewhere on the globe, the price of property is also likely to be higher. A lot of hedge funds will have been launched and a lot will have gone bust, but in the aggregate they will probably provide a return above cash. Finally, the majority of U.S. and European government bonds will have redeemed at 100 causing a capital loss if you buy them today. However, they will generate a reliable income stream.

Necessarily, I have made a number of generalizations (space is limited), but the best investment methods are simple at heart and long term in nature. The hard part is making the choices in all the short terms that go to make up the long term.

Free markets have a surprising way of solving even the most challenging problems.

Ronald G. Layard-Liesching

How Technology Will Drive Change in Asset Management

Ronald G. Layard-Liesching
Chairman
Pareto New York LLC

Technology is driving a global revolution in institutional asset management. While this may seem self-evident, a quick survey shows the surprising extent of its impact.

- Demographic change yields important information in estimating fair expected returns and constructing investment strategies.
- Human lifespans are increasing while corporate life spans are decreasing.
- Assets and liabilities can be marked to market in real time, heightening the visibility of short-term results.
- Alpha and beta are increasingly being separated, meaning that investors can unbundle the services provided by their investment managers.
- Global investment barriers are disappearing, allowing money to flow to the highest return opportunities.

Let's examine how these inexorable trends are likely to affect institutional investors – pension plans in particular – in the coming years. First, underfunded pension plans must "de-risk" their portfolios. Traditional immunization is too expensive, given the low returns on bonds. At the same time, returns on direct equity beta will be sharply lower than we've experienced in recent decades.

Second, as a result, plan sponsors will increase allocations to absolute return strategies and diversify radically, including global investments. Just as it is hard to imagine a large company today with a set policy of 83% domestic sourcing, in the future investors will seek the best returns relative to risk wherever it can be sourced. The average of 17% held by large U.S. funds in non-U.S. equities should move closer to 30% over the next five years.

Third, the search for returns at lower risk will drive a move away from the classic policy of *passive* strategic asset allocation into *dynamic* strategy investing. There will be an explosion in new investment classes, such as the market for risk transfer, which – unlike alpha generation – is not a zero sum game. The explosive growth in credit derivatives will continue to include plain vanilla risk transfer markets, through to the yet-to-be-developed market for extension risk.

We have been in a dream environment of falling volatility, falling risk premia and rising equity markets, but this cannot continue.

Large U.S. funds have long term return assumptions of 8% and higher, but everyone knows this is unrealistic. This is why a wall of money has gone into private equity, infrastructure, hedge funds, international REITs, new alternatives, etc. We are seeing the triumph of hope over experience. Successful private equity firms are past masters of when to take firms private and when to take them public. The fact that they themselves are now going public is a very clear message to investors.

As we saw with the Club of Rome report, free markets have a surprising way of solving even the most challenging problems. Around the world, risk is being better priced and moved to the correct portfolios. The classic academic separation theorem says that investors should hold a combination of cash and the market portfolio, which now is global. It includes risk markets and strategies as well as assets. Funds cannot manage returns, they can only manage risks. And the two ways to manage risks are aggressive diversification globally and into new alternatives, and via direct active management of risk. Technology makes these trends inevitable.

With acceleration in the speed of transmission of information and the shortening of time horizons, patient contrary investing will remain an eternal virtue. It will uncover the biggest inefficiencies and thus exploit the greatest opportunities.

Edward H. Ladd

Pronounced Economic Shifts and Continuing Investment Truths

Edward H. Ladd
Chairman Emeritus
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Having been a practicing investment manager for about 45 years, I hope I have learned a few things, including being very humble in making predictions, especially those based on extrapolating the recent past into the future. Having said that, here are what appear to me to be seven pretty likely outcomes for investment management over the next 25 years:

- The demographics will change dramatically, and the vast majority of the current developed economies plus China will be older and grayer. This will drive down savings rates, expand markets for retirement or life-cycle products, further stress governmental budgets, and arguably raise real interest rates.

- Notwithstanding the graying of the developed world (unless there is some sort of apocalypse or plague), there will be a lot more people on the face of the earth, say another couple of billion! This means we need and hopefully will have strong economic growth, bigger markets, more crowding, huge environmental impact, and enormous social challenges to accommodate the population increase.

- The greater perception and reality of climate change will reflect the combination of population growth, rising economic activity and expectations, and greater industrial activity. Unfortunately, countries will focus on their short-term national vs. long-term global interests. Hopefully there will be some technical fixes but, in a world of generally open markets, we will also require some price signals to spur climate change mitigation.

- Pronounced shifts will occur in the national allocation of world economic output reflecting population growth and especially competitive advantage. The "emerging markets" have current momentum and substantial competitive advantages. The economic winners will have the attributes of an increasingly well-educated workforce, improving hard and soft infrastructure, and relatively low costs in a world of increasing cross-border activity in goods and services.

- The enhancement of technology, continuing strong productivity, and more rapid communication is likely. In the financial world, integrated markets, cross-border capital flows, and the speed of transmission of events will be increasingly dramatic (and potentially disruptive).

- Life, economics, and financial markets are cyclical. Shocks, disruptions, occasional excess complacency, and systemic financial problems are inevitable as markets get carried to extremes and then revert. This is particularly true given current abnormally low volatility and risk premiums. The next 25 years will have periods, maybe long periods, when financial volatility and risk premiums will be considerably greater than at present.

- Despite these forecasts, there are some continuing investment truths: Disciplined investors who can identify their competitive advantage, process information effectively, and avoid being sucked into momentum-driven markets seem likely to be long-term winners. With acceleration in the speed of transmission of information and the shortening of time horizons, patient contrary investing will remain an eternal virtue. It will uncover the biggest inefficiencies and thus exploit the greatest opportunities.

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