Investing in the Future

by Tom McIntosh, Product Specialist – Pensions, Dalton Strategic Partnership LLP

Traditionally, UK pension funds have had an asset allocation skewed towards equities, both domestic and overseas and, although in recent times, the exposure to bonds has risen, equity investment remains the asset class with the potential to deliver the best real returns in the medium and long term.

Many studies have shown that asset allocation is responsible for up to 90% of the return on a diversified portfolio. For fund managers who describe themselves as having an active approach to investment, that description should surely apply to asset allocation as well as stock selection. Andrew Dalton, Head of the Global Team at Dalton Strategic Partnership LLP, certainly takes that view and drawing on the knowledge and experience of his fund managers and strategic partners, as well as his own extensive experience, he is willing to take positions far removed from traditional benchmarks in order to access the potential for higher returns. Traditional benchmarks lag the reality of the global economy.

The fundamental shift in economic power which continues to develop in the world economy, suggests that pension funds (and other investors) should allocate a significantly higher proportion of long term equity investment to emerging markets. The global economy will continue to grow but that growth will be heavily concentrated in regions such as Asia, the Middle East, Latin America, Emerging Europe and Africa.

The driver of these changes is a single underlying fact. The world population has increased by a factor of 2.6 times since 1950 and continues to grow. At that time, developed countries represented a third of the population of the world, but by the end of 2005, that proportion had fallen to a quarter. This relative diminution of the percentage of the global population represented by the developed world will continue. The growth in the population of the developing world combined with increased urbanisation and growing per capita incomes is already leading to rapidly improving standards of living in many of the countries which are defined as "emerging" and this rising standard of living will have enormous implications for regional economic activity, demand for resources, such as energy and metals, and individual consumption. GDP growth in the developing world will continue to outstrip that of the developed economies.

This secular change in outlook for these countries is already being reflected in the performance of local capital markets. The following table demonstrates this.

Performance	3 year (% pa)	5 year (% pa)
Broad Market Index Global	19.38	16.55
Broad Market Index Global ex US	25.86	21.06
Broad Market Index World (Developed Markets)	18.26	15.76
Broad Market Index Emerging Markets	38.95	31.56

Source: S&P/Citigroup Global Equity Indices – USD

The market capitalisation of emerging market countries more than doubled over the decade to 2005. From less than \$2 trillion in 1995 it is now calculated to be in the region of \$5 trillion. As a percentage of the overall world market capitalisation, emerging markets are growing steadily. The scope for these markets to develop in the context of the overall economies of their countries is also enormous. Adjusting market capitalisation by GDP shows the relative size of stock markets. Comparing this ratio reveals the substantial potential of the emerging markets. For low and middle income economies the ratio is 38%, but for high income economies (the developed world) the ratio is 113%.

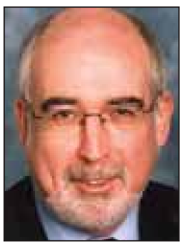
It is certainly still the case that the breadth and depth of some of these markets remains constrained, but many markets are perfectly accessible to international investors, either directly or via the increasingly wide range of funds quoted on the developed markets. Dalton Strategic Partnership already has an established range of funds which reflect its view of the future significance of the region in terms of growth and investment opportunities, including specialist funds for Asia, India and Canada. These funds are managed by regional partners, to benefit from the best local knowledge. Further specialist emerging market funds will follow as opportunities present themselves.

At the end of September 2007, the weighted average UK Balanced Pension Fund equity investment was as follows:

UK	42.8%
US	9.7%
Canada	0.7%
Europe	15.9%
Japan	5.4%
Pacific ex Japan	6.1%
Emerging Markets	4.3%
Others	15.1%
Total	100.0%

Source: CAPS

What is striking about these figures is that out of the overall equity exposure of 84.9%, only 10.4% is invested in the markets which represent the fastest growing regions of the global economy i.e. Pacific ex Japan and Emerging Markets. Over 40% is invested in the UK which over the seven years to December 2007 only rose by 3.77% as measured by the FTSE 100 Index. It could be argued that within the developed markets like the US and the UK there are many companies which allow participation in the growth of these regions by virtue of the global spread of their activities, but an investment in such companies only offers a diluted exposure at best. Many of the indices in the developing countries have delivered returns in the hundreds of percent in sterling terms over the same period. It is definitely time for UK pension funds to look again at the relative importance they give to investment in the developing world, irrespective of what the benchmarks say.



Tom McIntosh
Product Specialist – Pensions