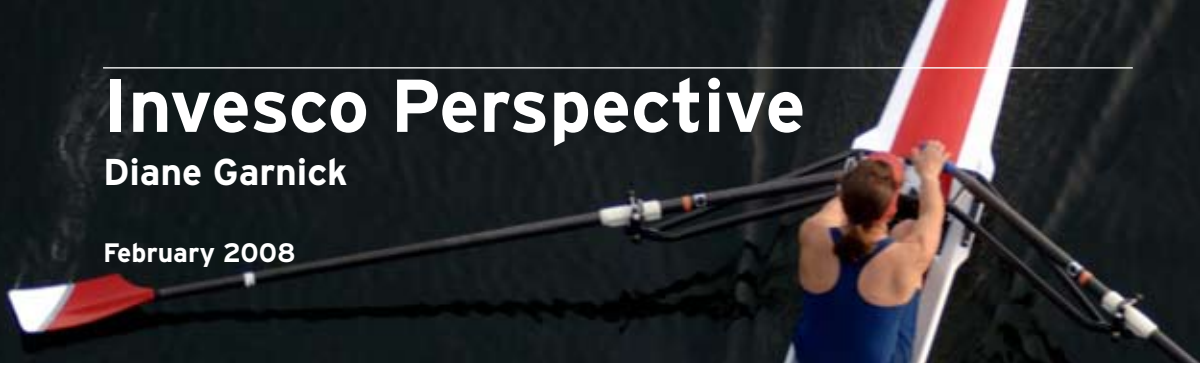




# Invesco Perspective

Diane Garnick

February 2008



---

## Investment Strategies to Bear in Mind

---

It was difficult, but we were finally able to identify a chart with an upward slope beginning in the summer of 2007 and continuing through today. Career risk. Plan sponsors, consultants, and trustees find themselves in an environment where tumultuous markets are coinciding with incremental transparency. During these periods of heightened uncertainty, careers are made (or lost) based on a few key decisions.

If it feels as if the entire environment has changed quickly, that's a good sign, because you're right. A mere 12 months ago there was ample liquidity chasing an abundance of readily accessible alpha promised by a quickly growing population of hedge funds. Those days are now long gone. Not only has liquidity dried up among wary investors, there is clear evidence that overall consumption is drying up as well. The three primary spenders in the US economy, consumers, corporates, and government, are all poised to spend significantly less.

Given this change in environment one must ask: have we identified all of the embedded risks in the market that in retrospect appear so hard to have missed? Which actions, or inactions, should now be considered as a career put? What are the keys to managing expectations when the one abundant 'asset' in the market is uncertainty? Should plan sponsors, consultants, and trustees adjust their view of the asset-liability equation given the twin risks of economic slow-down and rising inflation? Here are some of our thoughts.

---

### Cash on Hand

Cash should be allowed to grow as close to its targeted level as possible. For example, if a plan has a 5% targeted allocation towards cash, now would be a good time for plans to hold as close to 5% in cash as possible. The message here is to slowly accumulate cash positions rather than actively allocating positive cash flows into other asset classes. Market dislocations often provide liquidity premiums and investors with long term investment horizons might be well-served to attempt to capture those returns. When these opportunities do present themselves, having cash on hand will significantly reduce the time necessary to invest in these opportunities. Weighing this added flexibility against having to explain to beneficiaries why you experienced cash drag seems like a safe choice.

---

### Improving Returns Through Portable Alpha

The only thing more difficult than explaining poor performance is explaining poor performance coupled with high fees. Portable alpha strategies enable you to pay a premium for the stock selection prowess of your managers while minimizing your beta (or index) fees. Volatility continues to rise quickly, which can mean that the sources of positive returns will change rapidly, hence understanding and implementing portable alpha is key.

---

**Latest Lingo: Breaking the Buck**  
When money market funds, which traditionally invest in very liquid, safe assets have a net asset value of less than \$1 per unit. This can happen when rates are less than asset management fees.



# Invesco Perspective

## Investment Strategies to Bear in Mind

February 2008

---

### Latest Lingo: Liquidity Trap

This happens when traditional monetary tools fail to work. The macro events leading up to a liquidity trap include slowing GDP growth coupled with inflation.

---

### Latest Lingo: FASB 158, GASB 50, FRS 17 and IAS 19

These are the accounting rules in the United States (Private and Government), the United Kingdom, and internationally respectively that are now requiring companies and governments to report their funding ratio. Phase II of Accounting for Pensions is underway in the US and it just might be the only thing more political than the Presidential Election.

---

### Latest Lingo: Treasury Inflation Protected Security (TIPS)

Rather than payout a larger coupon rate, the principal balance of TIPS adjust to reflect inflation changes. For example, if the coupon rate is 3.5% and inflation is 4%, the stated rate of 3.5% is paid out and the principal adjusts to reflect the 0.50% differential. The increase in principal reduces rates in the secondary market. As of February 1, 2008 the yield on a 10 year TIP is 1.31%.

---

### Improving Returns Through Portable Alpha (cont.)

Many plans already have (at least a few) managers with a consistent alpha generating investment process. For example, you might have a manager who delivers returns in excess of the S&P 500. If your view on the S&P 500 becomes negative and you believe the Russell 2000 small cap will have better performance, alpha transport might be a viable solution for you. Rather than terminate the S&P 500 manager, then identify and hire a Russell 2000 manager, alpha transport enables plans to continue their relationship with the S&P 500 manager and simultaneously sell the S&P 500 index and buy the Russell 2000 index. This strategy enables plans to shift the alpha they have identified over to any index, hence the term 'portable alpha'.

This is a particularly attractive strategy now because it eliminates the traditional process of vetting out new managers which might be a long, cumbersome process that could cost you the opportunity to capture returns. Given the ease of use, portable alpha also enables plans to implement asset allocation decisions without having to hire new managers.

---

### Liability Driven Investing (LDI)

So far much of the discussion and implementation surrounding LDI has been focused on recent accounting changes requiring companies to report the ratio of plan assets they have to meet their pension fund liabilities. In this environment, even we have to admit there is a force more powerful than accounting changes. Lower forecasted returns for most major asset classes means that simply delivering market returns will not allow plan assets to grow as quickly as necessary. Actuarial assumptions of roughly 7% returns are unforgiving if a plan sponsor delivers 3% returns in a 1% market. If you focus most of your energy on the asset side of the equation, you're in good company. Most of us tend to. However, you also need to recognize that the falling rate environment will require a larger pool of assets to meet future liabilities. Hence, funding ratios are deteriorating as rates continue to decline. This shift in focus will continue to drive investment policy and asset allocation decisions throughout the year.

---

### Inflation

After debating back and forth, it is difficult to determine which investor base will be hit the hardest by the growing level of inflation the US has been experiencing. Certainly contenders include Healthcare and Educational foundations. Defined benefit plans, however, might be the most dramatically impacted as payouts are usually based on the compensation levels attained during the last few years of employment and wage inflation is a large source of the current inflationary pressures.

Developing and shifting into inflation sensitive asset classes has quickly moved to the forefront of most CIO's minds. Traditionally these allocations include commodities, TIPS, timber, infrastructure and real estate. Shifting into these and other inflation sensitive strategies makes a lot of sense now. Real estate might prove to be the most difficult decision given the current environment, but remembering that the typical plan's investment horizon is quite long might help to mitigate concerns raised by the current real estate market.



# Invesco Perspective

## Investment Strategies to Bear in Mind

February 2008

---

### Latest Lingo: 1X0/X0

The term 130/30 means selling 30% of the securities short then using those proceeds to buy 130% of the securities. There have been more marketing dollars associated with the value than research. As many plan sponsors have questioned the accuracy of the '30' or the need for the two amounts to be equal, the term '1X0/X0' has been coined.

---

### The New Core Equity

The opportunity to identify and capture alpha using long only investment strategies is becoming increasingly scarce. Envision for a moment how a negative market outlook could make the task of hiring those coveted managers even more difficult. Often times asset management fees are used to conduct research that enable portfolio managers to develop views on the best and worst performing companies they cover. Unfortunately, plan sponsors are willing to pay the management fees necessary to develop those views but simultaneously give mandates to managers that prohibit them from utilizing all of their best ideas by requiring them to have long only portfolios. Bringing these two ideas together it's easy to understand the allure to active extension, or '130/30'. We caution, however, that the ability to identify and sell stocks short is not simply an extension of the research and infrastructure necessary for success. We cannot stress the importance of identifying managers with a long track record of shorting stocks successfully and a consistent, deep research team.

A straightforward approach might include breaking the core equity component into a few sub-categories; pure beta, enhanced long only, and active extension. Proactively shifting into active extension strategies might provide a first mover advantage as the best in breed managers with experience shorting are frequently the first to discuss capacity constraints. In a similar vein, rebalancing pure beta allocations into a risk controlled enhanced strategy might prove beneficial in a higher volatility market.

**Career Puts** are not easy to capture and frequently the premiums paid for them are in intellectual sweat equity. In the past, market downturns have had the luxury of being offset by the long term average of 7% returns. However, as baby boomers retire we can no longer rely on time alone to offset market declines. Luckily, the necessary characteristics for success are consistent; insight, due diligence, and solution-oriented investment policy.

---

**Diane Garnick**  
**Investment Strategist**  
**1166 Avenue of the Americas**  
**New York, NY 10036**  
**212-278-9404**  
[www.institutional.invesco.com](http://www.institutional.invesco.com)

---

For Institutional Investor Use.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. This is not to be construed as an offer to buy or sell any financial instruments and should not be relied upon as the sole factor in an investment making decision. As with all investments there are associated inherent risks. Please obtain and review all financial material carefully before investing. This does not constitute a recommendation of the suitability of any investment strategy for a particular investor. The opinions expressed herein are based on current market conditions and are subject to change without notice.

4433-02/08