



Invesco Perspective

Q&A with Invesco's Erik Granade, CFA®
CIO Invesco Global Equity

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Navigating Global Equity

Over the past 18 months, the broad financial market downturn yielded a wide spread of relative performance among highly leveraged, higher-risk stocks and those with strong balance sheets and more stable earnings. As a result, investor's risk tolerances have tended to decline creating a wide range of relative performance success among global equity asset managers. During 2008, the markets tended to favor companies with below average balance sheet leverage while companies with higher relative debt on their balance sheet were penalized.

As investors return to looking at traditional investment strategies following the current financial market downturn, global equity strategies may be an attractive opportunity at current market valuations. Erik Granade, CFA®, CIO of Invesco Global Equity, believes that while there are still significant risks in U.S. and international stocks in the near term, the current valuations of equities are quite favorable from a longer-term perspective. In this Q&A paper, Erik discusses the current investment environment for global equities, the long-term advantages of maintaining a conservative approach to risk, and his view for long-term opportunities in this asset class.

Q: Much has been written about the economic challenges facing the world, perhaps the greatest of a generation. What are the key factors, in your judgment, that will likely to lead to stabilization of the global economy and an eventual recovery in the stock market?

A: Late in an economic cycle, excesses in the system typically form the basis for the next contraction, resulting in a sell-off in equity markets. These excesses tend to differ over time, but in the most recent period, we believe the problems have emanated from three specific areas: over reliance on debt, the housing bubble (particularly in the U.S.), and the failure of many market participants to gauge risks effectively. Before an "all clear" signal can be given for the global economy and equity markets, we believe further progress is required on all fronts. An increase in the savings rate is the panacea for the indebted U.S. consumer. This takes time, however, and is likely to create a sustained headwind for the economy, which is 70% driven by personal consumption.

Global financial institutions, while far less leveraged than 18 months ago, have more limited options for additional balance-sheet repair due to the difficulties in raising private capital and the ongoing exposure to credit conditions and security prices. The U.S. housing market, which has endured roughly a 25% nationwide decline in values from the peak, remains under pressure due to the sizable inventory of unsold homes and rising unemployment. Many believe the government should consider even more tangible means of providing assistance to homeowners in making their monthly mortgage payments. On the risk front, the historic lows in credit spreads that were achieved in mid-2007 may never be seen again. Although we believe risky assets are priced much more appropriately at present, and perhaps even too cheaply in some cases, we believe a return to more normal levels of risk tolerance is a prerequisite to any sustained recovery in global equity markets.

Q: Global equity markets have declined sharply since October 2007, when the financial crisis began to impact the real economy. How has this bear market compared to other historic periods of substantial weakness in share prices?

A: Since the inception of the MSCI Indices in 1970, there have been five declines in excess of 20% or more. The low achieved in early March of 2009 by the MSCI World Index represented a 57% decline in price (excluding dividends) from the peak in 2007. This decline exceeded the 41% sell-off absorbed in the 1973-74 bear market, during the first energy crisis, and has been comparable to the 51% decline during the Technology, Media and Telecom (TMT)-related bear market of 2000-2002. The other corrections in the MSCI were more modest and lasted for simply a number of months, as they did not coincide with global recessionary climates. The current decline, which started 17 months ago, has been similar (thus far) in duration to the 18-month decline in 1973-74, and has been briefer than the 31-month decline in 2000 to 2002.

Q: Given your overall assessment of the macroeconomic backdrop, what are your expectations for global equity market returns over the next few years?

A: Given the magnitude of the sell-off over the past six months, with many market segments down well in excess of 50%, the recent rebound in equity markets in March could have further to go. It is typical to have intermittent rallies even in a severe bear market. This volatility was certainly the case in Japan during the 1990s, and the U.S. in the 1930s. We do expect, though, that additional time may be required before we experience a sustained recovery. Market valuations are at similar levels to those that existed from the mid-1970's to the 1982 market low, which could indicate that competitive long-term returns may be achieved from this starting point. The cost of participating in these returns, however, may be much higher embedded levels of volatility than has been customary. Due to the severity of the macroeconomic challenges, we certainly cannot rule out the possibility of further declines, perhaps even to new lows, in the interim.

Q: Returning to the big picture, what do you make of the recent announcements by the U.S. and U.K., among others, to purchase substantial amounts of government bonds?

A: This so-called adoption of quantitative easing, a strategy designed to sharply increase the money supply as a means of further stimulus, is desirable in our view. It prevented Japan in the 1990s from facing a depression scenario, though it was probably implemented a bit too late, and did not on its own lead to a substantial economic rebound. We believe this approach has a higher probability of boosting the economy than some of the earlier policy initiatives, which were designed in large part to support the fragility of the financial system. Other strategies, such as the term asset-backed securities loan facility (TALF), may also provide needed benefits for debt issuers and securitization markets. The cost of "printing money" to this degree, nonetheless, is a potentially weaker U.S. dollar and the risk of significantly higher inflation down the road.

Q: How would you advise your clients regarding asset allocation, particularly with respect to non-U.S. or global exposure?

A: A commitment to sound diversification strategies is probably the most important point to stress. As difficult as it may be at present, it means assessing the appropriate exposure to equities over the long term, and potentially taking a steady re-balancing approach as appropriate over time. From a U.S./ non-U.S. perspective, we fundamentally do not see any true safe havens among developed markets. Accordingly, we tend to favor many foreign stocks due to the materially lower valuations abroad, particularly in Europe and Japan. Our global equity portfolios remain underweight the U.S. market. We would also highlight emerging markets as attractive. In addition to diversification benefits, this asset class may provide highly scarce elements of growth potential that are desirable.

Q: How has the Invesco global equity strategy fared in this environment?

A: We've been fairly fortunate in that our portfolios have been relatively resilient compared to the precipitous declines of the broader indices. Our investment discipline has a good track record in times of market duress which is a function of (1) a stock selection approach that favors companies with demonstrated financial strength; and (2), a willingness to adhere to our methodology, even during more speculative market climates like we saw in 2006 and 2007.

The Chartered Financial Analyst® (CFA®) designation is a globally recognized standard for measuring the competence and integrity of investment professionals.

For more information on Invesco Global Equity, please visit www.institutional.invesco.com.

Sources: Barclays, Bloomberg, MSCI and Invesco

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