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Global small-cap: the best of both worlds?
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Crisis of confidence

Nick Mustoe
Chief Investment Officer
Invesco Perpetual



Global equity markets have moved to aggressively price in macroeconomic risks reflecting the slowing global economy, the spread of the Eurozone debt crisis into Italy

and Spain, and the fear that there will be a rerun of the banking crisis of 2008. We have known for some time that we are in a slow and prolonged economic recovery and that deleveraging will be a multi-year process. Equity markets are now pricing in a double-dip recession.

In the current low growth environment, we believe that there are certain types of companies across global equity markets that can thrive, delivering sustainable dividends and earnings growth. The fall in prices over the past few weeks has left many of these companies in a position where I believe they are fundamentally undervalued across a range of valuation measures. As long-term investors, this is where I believe the potential exists to make long-term gains.

" The market decline is being led by areas that are heavily owned by investors and which have done well. Investors are now taking profits "

A year of risk-on and risk-off

Since the first concerns about sovereign debt emerged in 2010, the market has moved between risk-on and risk-off. The end of 2010 bought the prospect of a US-led recovery as companies were showing an intention to hire and the US jobless rate started to fall. The rally lasted up to the earthquake and tsunami that devastated parts of Japan in March 2011.

Optimism soon turned to pessimism as the global supply chain, of which Japan is a vital component, was jolted, and the ripple effect on major industries, including automotive and IT, was significant. A slump in US employment in Q2 2011 and the forthcoming end of the expansionary quantitative easing policy in the US (QE2) at the end of June 2011 illuminated our concerns about the sustainability of this recovery.

As the markets moved to the end of July, the US budgetary process quickly grabbed the headlines as lawmakers in the US were unable to agree on an increase in borrowing - which the very same politicians had previously voted to approve. Whilst concerns about US debt are understandable, the less-than-statesman-like spectacle that the world witnessed has raised US political risk dramatically.

On the other side of the Atlantic, the world is gripped by the political and economic conundrum that is evident within Europe. There is a powerful discord between the economically powerful northern states and the weak southern states, where a decade of



profligacy has left them indebted and highly vulnerable.

The history to date has been that risk-off is soon followed by policy intervention which then energises the markets to allow risk-on to resume. However, as the cycle of intervention rolls on, its effect and power to influence markets is weakened.

" The current exceptional circumstances in financial markets make it a difficult time to be an investor. Markets are pricing in a prolonged recession which I believe is too extreme a scenario "

Global economy and implications for the equity markets

I see the market sell-off as a potential buying opportunity, as the correction that is rolling through the markets is largely indiscriminate. An indiscriminate sell-off is one that discounts the fortunes of all stocks, irrespective of their underlying dynamics.

The market decline is being led by areas that are heavily owned by investors and which have done well. Investors are now taking profits. Europe is in the eye of the storm and has taken the brunt of the market falls.

Year to date (9 September 2011), Europe is down -16.3% (MSCI Europe 350 index) compared to the US, for example, which is down -5.7% (S&P 500). Within Europe, the selling has been indiscriminate, with the German stockmarket down -22.0% (DAX), for example, and the Italian stockmarket down -27.6% (FTSE MIB).

Equity markets are barometers of sentiment, and fear is currently driving irrational decision-making. We believe that the current situation amounts to a crisis of confidence. Many of the companies that we are buying are in robust financial health, with strong levels of cashflow and earnings stability - and are being overlooked by the market.

Over the last few weeks, risk assets have been sold down. These have been primarily equities, although parts of the high-yield corporate bond market have also been affected. Risk aversion leading to panic selling of equities has pushed up volumes. Investors have instead been buying gold and other perceived safe assets such as core government bonds in the US and Germany. In my view, core government bonds offer little value and investors are paying a safety premium. Yields are now very low at around 2%.

Conclusion

The current exceptional circumstances in financial markets make it a difficult time to be an investor. Markets are pricing in a prolonged recession which, I believe, is too extreme a scenario. Indeed, 25% of companies within the

MSCI World index now trade below 10x P/E multiples, which represents a multi-decade low.

" I believe that this represents a clear buying opportunity in many high-quality companies which are well financed, with strong balance sheets and good levels of cashflow, and with a proven ability to sustain and grow dividends "

Many equities now also yield considerably more than government bonds. I believe that this represents a clear buying opportunity in many high-quality companies which are well financed, with strong balance sheets and good levels of cashflow, and with a proven ability to sustain and grow dividends. While equities on the whole are certainly undervalued now, I believe that in time, companies with dependable characteristics will be valued more sensibly. In difficult economic times, the 'quality premium' deserves to be even bigger than usual and I believe that, ultimately, this premium will be restored.

Dividend investing: a global enterprise

The long-term value of dividend yield and dividend growth to a portfolio's total returns should not be underestimated: sustainability of growth and dividends are central to total returns. So what are the benefits of a global approach to investing, and what criteria should investors be assessing?

Paul Boyne
Fund Manager, Global Equities
Invesco Perpetual



The long-term value of dividend yield and dividend growth to a portfolio's total returns should not be underestimated. Historical studies reveal that reinvested

dividends have been the primary driver of long-term total returns (see figure 1). We believe that evaluating the sustainability of dividends is a key factor in the overall assessment of equity investment opportunities. In our view, there are ample opportunities globally for investors seeking stocks that offer attractive and growing dividends.

A number of changes to the investment landscape over the past 30 years - including structurally declining interest rates - has seen dividend investing become a truly global enterprise. A global approach enables

us to seek the most attractive investment opportunities around the world that have dividend-generating characteristics which can potentially add value to a portfolio.

“ Historical studies reveal that reinvested dividends have been the primary driver of total returns over the past 30 years, and a key contributor to positive long-term performance ”

Investing globally has the additional benefit of increasing diversification through exposure to different industry sectors. Opportunities within some sectors are more prevalent in certain countries than in others. A global approach to investing not only broadens our opportunity set, but can also reduce volatility in a portfolio. Typically,

the wider the spread across various countries, sectors and stocks, the lower the correlation of their returns, and the lower the overall level of portfolio risk compared to investing in one particular country.

There are four main criteria that we consider when assessing the suitability of a company for our portfolios: the strength of a company's franchise; free cashflow generation; capital allocation discipline of management; and valuations.

“ Paying high and rising dividends is generally a reliable signal from management about its confidence in the sustainability of earnings ”

We evaluate the strength of a company's franchise with a particular focus on the sustainability of margins and returns, market share and free

cashflow generation. We also assess credit quality and balance sheet strength so as to gauge the company's ability to generate adequate future free cashflow to cover the payment of future dividends. Furthermore, we believe that financial strength leads to structural competitive advantages over more leveraged competitors.

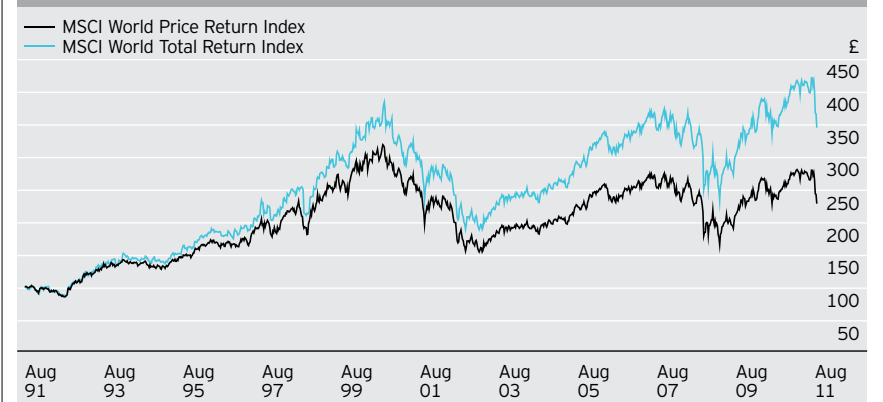
The attitude of management towards capital allocation is also key. We look for management teams who are focused on returning free cashflow to shareholders, after they make what we determine to be sensible investments in their businesses. We believe that our approach leads us to management teams who are less likely to

use surplus cash for other purposes such as unnecessary capital expenditure or, more commonly, expensive acquisitions. Paying high and rising dividends is generally a reliable signal from management about its confidence in the sustainability of earnings, regardless of where the company is listed. Finally, we assess absolute and relative value.

We believe that companies that are high quality, with attractive franchises and under-leveraged balance sheets, are more able to maintain profit margins through the business cycle and return cash to shareholders in the form of growing dividends. Sustainability and growth of dividends are key to total returns.

Fig 1. Income reinvestment: a significant contributor to total returns

Source: MSCI, Thomson DataStream as at 19 August 2011, rebased to 100 on 16 August 1991. MSCI World in £ terms.



Tony Wong
Head of Short-Term & Investment
Grade Municipal Research
Invesco Fixed Income



On 2 August, President Obama signed into law the Budget Control Act of 2011, which raises the US debt ceiling, reduces US government spending by up to US\$2.4 trillion over a 10-year

period, and establishes a Congressional 'super-committee' empowered to outline additional cost-cutting measures to lower the deficit and reduce the US debt burden. Investor relief from ending the Great Debt Ceiling Debate of 2011 was short-lived when on 5 August ratings agency Standard & Poor's (S&P) lowered its long-term sovereign credit rating on the US from AAA to AA+ with Outlook Negative.

“ The S&P downgrade sparked an episode of strong volatility in equity markets exacerbated by concern over European sovereign debt ”

The downgrade was not unexpected. S&P had made it clear well before 2 August that it would lower the long-term rating of US debt if it believed that the agreement reached on the debt ceiling was insufficient to stabilize medium-term US debt dynamics. S&P subsequently explained that this, along with concern about the political discord that surrounded the debt ceiling negotiations, was part of the rationale for the downgrade. At the same time, ratings agencies Moody's Investors Services and Fitch Ratings retained the triple-A long rating on US debt: Moody's confirmed the Aaa long-term US bond rating with a negative outlook, and Fitch affirmed on 16 August that the long-term US bond rating was commensurate with its AAA sovereign rating.

As it relates to money markets, S&P reaffirmed its highest rating (A-1+) for short-term US government debt, as did Moody's and Fitch, meaning that the ratings of money market funds would be "unaffected" by the downgrade of the long-term rating on US debt¹. In response to the S&P action, the US Federal Reserve (Fed) issued guidance that for its purposes, risk weights and treatment of US Treasury and Agency securities would be unaffected by the S&P downgrade².

As a result of the long-term downgrade of US sovereign debt, S&P³:
- lowered the long-term issuer credit ratings and related issue ratings on select government-related entities (GREs) -

US debt: the effect on money markets

The signature last month of the Budget Control Act was seen by many as a case of 'too little, too late' with Standard & Poor's leading Moody's and Fitch in a ratings agency re-examination of US debt. The ensuing volatility has had a material impact in many areas, the money market fund industry included.



including Fannie Mae and Freddie Mac - to AA+ from AAA;

- similarly lowered the AAA rating of five large insurance companies: Knights of Columbus, New York Life, Northwestern Mutual, Teachers Insurance & Annuity Association of America and the United Services Automobile Association;
- affirmed that the sovereign downgrade would not have an immediate

or direct impact on its ratings of US banks.

The S&P downgrade sparked an episode of strong volatility in equity markets, exacerbated by concern over European sovereign debt. Despite the downgrade, Treasuries rallied on strong investor flight to safety. Ten-year Treasuries fell to 2.1%⁴ on 10 August, revisiting lows last seen on 30 December 2008. A US\$24 billion auction of

10-year notes held on 10 August drew a high yield for the auction of 2.14%⁴, the lowest bid ever on record. In addition, some negative economic news, including that US GDP growth in the first quarter was revised down sharply to 0.4% from the previous estimate of 1.8%, fuelled concern of another economic downturn. GDP during the second quarter grew by an estimated 1.3%⁵.

In its 9 August statement, the Federal Open Market Committee echoed these sentiments, noting that economic growth has been slower than the Fed expected, highlighting the weak employment, consumer spending and housing market indicators. Coming on the heels of the downgrade and under pressure to do "something", the Fed took the largely unprecedented step of committing to keep the federal funds rate at exceptionally low levels - currently between 0% and 0.25% - "at least through mid-2013⁶." The statement also left the door open for future additional Fed action to promote economic recovery "as appropriate."

“ While we do not believe the S&P downgrade will have a material impact on the money market fund industry, we continue to monitor the potential impact of developments as they unfold ”

While we do not believe the S&P downgrade will have a material impact on the money market fund industry, we continue to monitor the potential impact of developments as they unfold. We are, of course, sensitive to shareholder concerns and headline risk and are typically holding higher levels of overnight and weekly liquidity in anticipation of potential adverse market volatility. As always, we continue to actively take positions that reflect our market views. As a central part of our investment process, we have been continuously stress-testing the net asset values (NAVs) for a 50% asset loss with a simultaneous 150 basis point increase in interest rates or credit spread widening; we are more than comfortable with the results these stress tests have been producing.

We've said it before: these are in many ways unprecedented economic times in which knowledge, experience, and a proven conservative investment philosophy make the difference in navigating these extraordinary events effectively.

¹ Standard & Poor's, "Principal Stability Fund Ratings Unaffected By US Sovereign Downgrade" 8 August 2011;

² Board of Governors of the US Federal Reserve System Joint Press Release, 5 August 2011;

³ Standard & Poor's, "Rating Actions Taken on 10 US-Based Insurance Groups Following Sovereign Downgrade," 8 August 2011 and "Ratings on Select GREs and FDIC- and NCUA-Guaranteed Debt Lowered After Sovereign Downgrade," 8 August 2011;

⁴ Bloomberg;

⁵ US Department of Commerce Bureau of Economic Analysis "National Income and Products Accounts Gross Domestic Product: Second Quarter 2011 (Advanced Estimate) Revised Estimates: 2003 through First Quarter 2011" 29 July 2011;

⁶ Board of Governors of the US Federal Reserve System Press Release, 9 August 2011.

Russia - reform continues

Russia appears to be in an enviable position, with a strong macro framework, a current account surplus, negligible external financing requirements and foreign exchange reserves. With a current P/E ratio below its 10-year historic average, it is also the cheapest of the Emerging Markets.

Liesbeth Rubinstein
Fund Manager, Emerging Market Equities, Invesco Perpetual



Whilst macro storm clouds in the US and Eurozone have dominated recent headlines, Russia continues to consolidate its gains and look to the future. The country has a strong macro

framework, runs a current account surplus with negligible external financing requirements and boasts foreign exchange reserves of US\$544bn¹. During a period when many Western countries are being downgraded due to widening budgetary deficits, it is worth noting that government debt in Russia is only 10% of GDP². With the economic recovery broadening, inflationary pressures easing and companies in good financial health,

we believe that Russia is well positioned to deal with the uncertainties coming from other regions of the world.

“ At a time when developed-world consumers continue to repair their personal balance sheets, domestic demand trends in Russia remain robust [and] the untapped consumer potential... over the long term is huge ”

At a time when developed-world consumers continue to repair their personal balance sheets, domestic demand trends in Russia

remain robust. Consumers are relatively debt-free and becoming more affluent. Many basic product categories have low penetration levels by Western standards.

The untapped consumer potential in Russia over the long term is huge (see figure 1). We believe that we can capture this multi-year investment theme, by investing over the long term in good-quality companies that are likely to prosper from the growing importance of the consumer sector.

Indeed, there are other exciting developments in Russia that we believe are adding to its investment appeal. Further liberalisation of the economy through reform and modernisation programmes should improve the investment conditions for foreign companies. Russia's eagerness to embrace Western oil and gas technology in the development of the Arctic has been highlighted by the strategic alliance reached between Exxon Mobil and Rosneft in August 2011. It is no coincidence that the US\$3.2bn deal

follows the Russian government's recent reform of energy sector taxation and should herald a massive increase in direct investment over the next decade - already up by 30% to US\$7bn over the first half of this year³. This latest deal is another vote of confidence in the country, in addition to hosting major events such as the Sochi 2014 Winter Olympics and the 2018 FIFA World Cup.

Russia's investment climate is also likely to be broadened by President Medvedev's recently announced privatisation plans, estimated to raise US\$150bn in coming years. We believe this privatisation drive will ultimately be positive for the market, stimulating foreign investor appetite for the market. It should also encourage better allocation of capital and improve corporate governance. A targeted reduction of government stakes in industrial enterprises will broaden and deepen the market. This process will help improve economic efficiency and encourage investment in productive assets.

Privatisation supports the government's strategy to diversify the economy. Technology transfer and multinational involvement in Russian industry can provide a boost to the earnings profile as companies adopt Western productivity techniques. We have seen this already with Renault's involvement with AvtoVAZ in the auto sector. The Russian merger and acquisition market has also recovered. The explicit blessing of PepsiCo's acquisition of Wimm-Bill-Dann by PM Putin last year sent a further positive signal to would-be overseas investors eyeing investment opportunities in the country. An open door to foreign investment will allow Russia to better capture its enormous potential in terms of natural and human resources. Increasing the country's integration into the global economy should also have a positive

impact on the perceptions of Russian investments abroad.

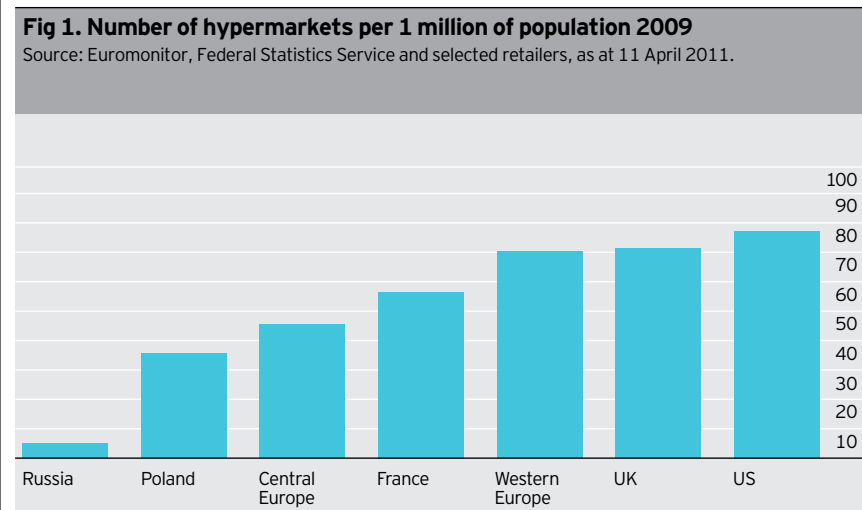
Furthermore, additional incentives are likely to be offered to foreign companies investing in Russian businesses and greenfield development projects. This commitment to a modern and innovative economy is likely to be consolidated after the presidential election in March 2012.

“ If Russia does gain membership of the World Trade Organisation - and both the US and Europe are now in favour of Russia's application to join - this could represent a springboard to growth ”

Indeed, a Medvedev victory could possibly see the reform process fast-tracked. If Russia does gain membership of the World Trade Organisation - and both the US and Europe are now in favour of Russia's application to join - this could represent a springboard to growth.

We believe that the fundamental strengths of Russia are not reflected in current valuations. This is the cheapest of the emerging markets, with a current P/E ratio below its 10-year historic average. In our view, the country's strengths and unique advantages are not being truly reflected by the financial markets.

¹ Source: Source: Bloomberg, 19 August 2011.
² Source: Citigroup, August 2011.
³ Source: State Statistics Service, August 2011.



Ray Clancy
Editor
Investment International



Those who were away in the second week of August and checked the latest stockmarket figures on their return might have been wondering what all the fuss was about, having missed one of the

most turbulent weeks in the financial markets since 2008.

In just five days the speed of the market decline, including the biggest one-day fall in stocks since the collapse of Lehman Brothers, was astonishing. The markets had recovered by the end of the week but the events of that extraordinary period offered an important reminder to investors that the stakes are high.

It is clear that current economic conditions call for greater attention to risk management than ever before, and commentary is rightly full of the need to diversify on one hand, and the need to seize opportunities on the other. Such volatility is also expected to produce increased interest in hybrid funds as they allow the investor to invest in a mixture of different types of securities. Typically comprising either an international or a domestic blend of bonds and stocks, these funds are generally considered

Hybrid funds: the balance of risk and reward

The summer storm that hit global markets has turned the spotlight on the pursuit of balance.

less risky, reducing the volatility involved in investing exclusively in stocks while expecting to beat bond funds over the long term.

Hybrid funds could prove attractive for investors who may now be reducing their risk appetite in the wake of such a turbulent summer, helped by the fact that they are naturally diversified and can be bought by those with limited capital available to invest.

You have to question whether many investors choosing so-called 'balanced' funds understand what they are getting. For some of these funds, asset allocation goes little further than simply dividing the portfolio between equities and bonds. Such a simplistic approach can leave a massive concentration of risk in the

equity part of the portfolio, which can mean that stockmarket shocks trigger greater falls than an investor may have been expecting from a fund claiming to be balanced.

Weighting each asset class so they each contribute a relatively equal amount of risk to the portfolio will limit the effect of underperformance of any single asset class.

Short-term stockmarket fluctuations are not the only risk faced by long-term investors. An asset allocation model that works, whatever the economic weather, is also key. The events of the last three years have shown us that anyone who thinks they can predict with any certainty what the economy will look like even one year from now, let alone three or five

years down the line, is overestimating their powers of foresight. Unfortunately, we only know the economic environment we are in when we are actually in it, which is why it may be beneficial to have an asset allocation model that can derive and protect returns whether inflation is high or low, through growth or recession.

Funds that can balance equities, bonds and commodities should reduce risk over the long term as the economy evolves. Those that can find tactical opportunities in these various asset classes will do even better. And if there is an upside to the recent volatility in the markets, it is that stock valuations across the board are significantly lower than they have been.

“ It is clear that current economic conditions call for greater attention to risk management than ever before ”

In these uncertain times, the fundamentals of investing in a balanced fund holding a diversified range of assets, with an asset manager carefully controlling those assets full-time, may seem increasingly attractive.

While global markets will continue to be volatile in the short term, many are looking for comfort in longer-term growth stories. Some investors are talking about

a two-speed market where the sovereign debt-saddled Western markets are overtaken by emerging markets in South America and Asia, who are arguably in better financial health. But others warn that even in developing economies, stockmarkets are likely to remain volatile in the short term.

With many eyes on hybrid fund opportunities in the coming months, the spotlight is likely to move to the long-term potential on offer in emerging markets, particularly Asia. Even those who have been cautious about Asia are beginning to see the region as an opportunity to spread risk away from Europe.

There have been those who have historically viewed China as too much of a risk, but the Middle Kingdom has rapidly shed the inefficiencies that its economy suffered from in previous decades, and current inflation and monetary tightening concerns may be dissipating. Many professional investors believe the justification for long-term investment there is increasingly compelling, and China now forms a part of many asset allocations. Meanwhile, India's GDP growth is widely expected to outstrip, for example, the UK's for the next 20 years.

But alongside such growth, there are significant opportunities in post-shake-out developed markets that would be foolish to overlook. Indeed, investors could well look back on this period as a point in time where healthy, well-funded companies in Europe and the US were underappreciated by the market.

Paul Chesson
Fund Manager, Head of Japanese Equities, Invesco Perpetual



With share prices having fallen sharply in the days immediately after the earthquake, Japanese equities reached their lows in mid-March. Since then they have outperformed

both the world and the rest of Asia, as can be seen in figure 1. Japan was not immune from the recent volatility to hit global equity markets, but on a relative basis Japan continues to outperform.

A number of positive surprises have helped drive this outperformance. These include the earlier-than-expected resolution of supply chain disruptions, resilient domestic consumption and property market trends, signs of improvement in capital spending by Japanese companies and generally positive momentum in earnings revisions.

Initial estimates failed to anticipate the negative impact and reach of supply chain disruptions caused by the Tohoku earthquake and tsunami. Both the US Federal Reserve and UK Treasury have cited the negative impact of supply chain disruption as a contributing factor to lower economic growth forecasts, while economists at Goldman Sachs estimate the negative impact to US GDP will be around 1/3 to 1/2 a percentage point.

“ The immediate post-earthquake reaction... was one of self-restraint, as expected. However, this... was only temporary, and... the disaster has actually spurred an acceleration of consumption ”

Following the events of March 11, many Japanese manufacturers were unable to give accurate guidance as to when they expected normal production to resume, especially given the lack of visibility on the power supply situation at the time. Since then, the pace of recovery has been quicker than anticipated. For example, Toyota announced in May that it would be able to restart its domestic production in June rather than July. Renesas Electronics, the worlds leading supplier of microcontrollers, announced that its factory in Naka - which was hit hard by the earthquake - would return to pre-earthquake production levels a month ahead of its initial late October estimate. Canon meanwhile, has recently revised up its forecasts for copier and printer production due to the faster-than-expected supply-chain improvement.

The impressive recovery of Japanese manufacturing can also be seen at a



Catching up with Japan

Japanese equities tumbled in the aftermath of the devastating earthquake and tsunami that hit the Tohoku region of Japan on 11 March 2011. However, since April, Japanese equities have outperformed their developed market peers. What has driven this recovery? What risks remain, and what does the future hold for Japan?

macro level, with a strong turnaround in industrial production and the manufacturing PMI shown in figure 2. Furthermore, the recovery is expected to be sustained, with some analysts now forecasting that domestic auto production could actually exceed last year's levels.

The immediate post-earthquake reaction of consumers in Japan was one of self-restraint, as expected. However, this period of restraint was only temporary, and to the surprise of many, the disaster has actually spurred an acceleration of consumption. This was partly attributable to aftershocks, rolling blackouts and radiation fears leading consumers to clear shelves of supplies. However, consumption levels have been healthy, exceeding the initial expectations of retailers such as Seven & I, who now see robust sales continuing to grow into the summer. Electronics retailers such as K's Denki and Yamada Denki have seen sales for the most recent quarter rise by as much as 29% year-on-year (y-o-y) and 7% y-o-y, respectively, driven by demand for white goods (especially air conditioners ahead of the summer period, and energy-saving appliances).

At the macro level, the data further supports the evidence coming from companies themselves, as the most recent retail sales figures, shown in figure 3, exceeded analysts' expectations; and as conditions continue to normalise consumer confidence should be maintained, which can only be positive for the domestic economy.

The real estate market has also been resilient. Housing starts have continued their upward trend following their most recent trough in August 2009, and condo sales in Tokyo are picking up. One impact

of the earthquake appears to be that demand, both residential and commercial, for higher-quality earthquake-proof buildings has increased.

Since April, the relative outperformance of Japanese equities in comparison to their developed market peers, has also been partly underpinned by a turnaround in earnings revisions. Initial concerns over supply chain disruption and power supplies saw large cuts to earnings expectations, but in many cases these concerns have proved temporary, and overly cautious downgrades have now given way to upward revisions such as those made recently by Canon, Honda and Toyota. With positive revisions and largely robust first-quarter results seen so far, investors have good reason to have greater confidence in the valuation of Japanese companies, which - trading at a price/book ratio of just below 1.0 and around 13 times 2012 expected earnings - do not appear demanding.

“ Any further sharp strengthening of the yen would challenge the profitability of exporters. However, gradual appreciation, which they have capably dealt with for many years, is more manageable ”

Another feature of the Japanese market's recovery has been the activity of cash-rich corporates taking advantage of market weakness to repurchase shares, with buy-back announcements during the period March-May totalling ¥415 billion, up 113% y-o-y, according to data from the Tokyo Stock Exchange. Meanwhile, the Bank of Japan's recent Tankan survey showed that large firms are planning to increase capital spending more than initially expected in the financial year to March 2012. This is partly explained by a shift among Japanese companies away from just-in-time to just-in-case inventory management. The yen's strength has also seen a pick-up in overseas acquisitions by Japanese companies as they take advantage of relatively cheaper opportunities.

While the positive surprises described here have helped recover some of Japan's post-earthquake losses, when considering whether recent outperformance is sustainable we must consider a number of issues that investors in Japanese companies are faced with, several of which are general headwinds facing global markets.

These external headwinds include the ongoing sovereign debt crisis in the Eurozone periphery, and what appears to be a slowdown in the US economic recovery. Considering the importance of exporters in driving Japan's economic recovery, the soft patch in the US economy will need to be closely monitored, but we believe this is a temporary pause in the recovery and not the start of a reversal. While of less significance to Japan as an export destination, the Eurozone's debt concerns are likely to remain an issue

for the foreseeable future, albeit that the European authorities are making some progress towards a more sustainable solution.

There are also domestic issues, both short and long-term, that need to be addressed. These include current political uncertainty which is encumbering domestic policy developments and the ongoing concerns surrounding electricity supplies. The level of the yen also remains an area of concern.

The issue of power supplies, and specifically the outlook for nuclear power provision, is a key issue. Companies have so far coped with power restrictions at peak times through measures such as shifting production to weekends, reducing general levels of consumption and using in-house power generation. However, there is a risk that opposition to nuclear power plants being restarted after recent inspections could lead to a longer term supply shortfall, a situation exacerbated by a lack of political clarity on the issue. If alternatives need to be introduced in the longer-term then increases in energy bills would be expected as substitutes such as coal, oil and liquefied natural gas are sourced. This would clearly impact corporate profitability and disposable household income. However, with nuclear power accounting for more than 25% of total electricity generation prior to the earthquake, it is likely that it will remain part of the solution in the medium term.

Political uncertainty continues to grip Japan at the current time, much to the chagrin of those who had hoped a spirit of solidarity might unite weak and disparate factions within the government and opposition parties. Prime Minister Naoto Kan resigned after just 15 months in office, to be replaced at the end of August by Yoshihiko Noda. Japan's sixth new prime minister in five years. Noda inherits a number of key pieces of legislation which still need to be passed, including approval to the issuance of reconstruction bonds and reform of Japan's energy policy.

In early August, with global stockmarkets in turmoil, the yen's status as a safe-haven was reinforced as the currency approached its previous record high set in March. The Japanese government intervened, as it did five months earlier, to try and drive the currency lower. It is impossible to know whether we will see a further intervention, but any excessive and rapid currency move will put more pressure on the Ministry of Finance to help ease currency concerns.

Any further sharp strengthening of the yen would challenge the profitability of exporters. However, gradual appreciation, which they have capably dealt with for many years, is more manageable. Japanese companies have ably demonstrated their ability to restructure over the past decade, particularly since the global financial crisis; and, where necessary, they can move lower-value-added manufacturing offshore while keeping the higher-value-added activities in Japan. Japan's exporters have achieved a great deal in recent years, with profitability levels close to the peak of the last cycle, before the collapse of Lehman Brothers, when the yen was much weaker, clearly demonstrating their ability to deal with the situation.

The relative outperformance of Japan's equity markets, since they reached their March lows, has been driven by positive surprises, with indicators suggesting that the recovery is sustainable given further reconstruction demand and the on-going global economic recovery. With corporate profitability recovering, Japanese companies are well placed to resume earnings growth, capitalising on demand from Asia, as well as a pick-up in conditions in the developed world, which are likely to be supportive of a strong rebound in Japan's domestic economy.

“ The impressive recovery of Japanese manufacturing can also be seen at a macro level, with a strong turnaround in industrial production and the manufacturing PMI ”

Considering these factors, what continues to surprise us is that Japanese equities remain so undervalued versus historic levels - trading around the value of their net assets and on an estimated price/earnings ratio of around 13 times 2012 expected earnings. In our view, these valuation levels do not adequately reflect the profitability and earnings growth potential of many Japanese companies.

Furthermore, the post-earthquake recovery is proving sustainable, and further positive data can be expected after production fully normalises and reconstruction efforts provide the economy with an additional boost. While Japanese companies have undergone significant structural change in recent years, certain aspects of Japan's conservative business culture remain, and this could include their forecasts for lower profits in the current fiscal year. If improvements continue at their current pace, these expectations may prove overly cautious and could further highlight the value in Japanese stocks.

Japan has come a long way since the devastating events in March, but has further to go. The Japanese equity market currently offers a compelling long-term investment opportunity, in our opinion, with low valuations suggesting potentially less downside risk relative to other more highly valued equity markets, combined with an earnings recovery that indicates projected upside potential.

Fig 1. Topix relative to World ex Japan and Asia Pac ex Japan

Source: Datastream (in Sterling terms, rebased to 100 at 1 October 2010, to 12 August 2011).

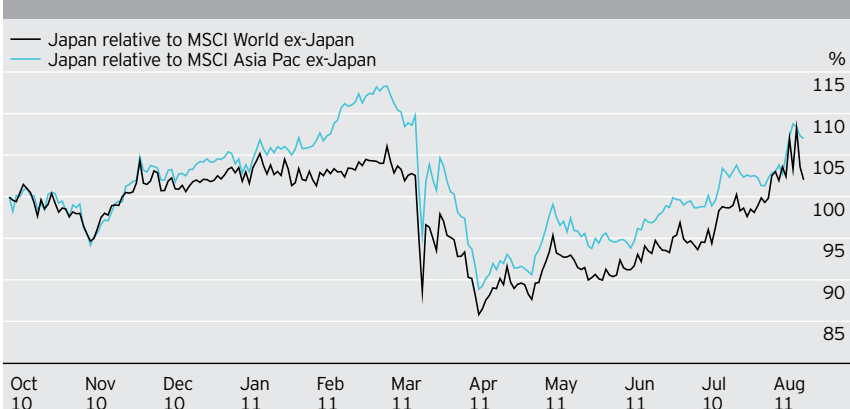


Fig 2. Industrial production and business sentiment recover

Source: Bloomberg, as at 31 July 2011.

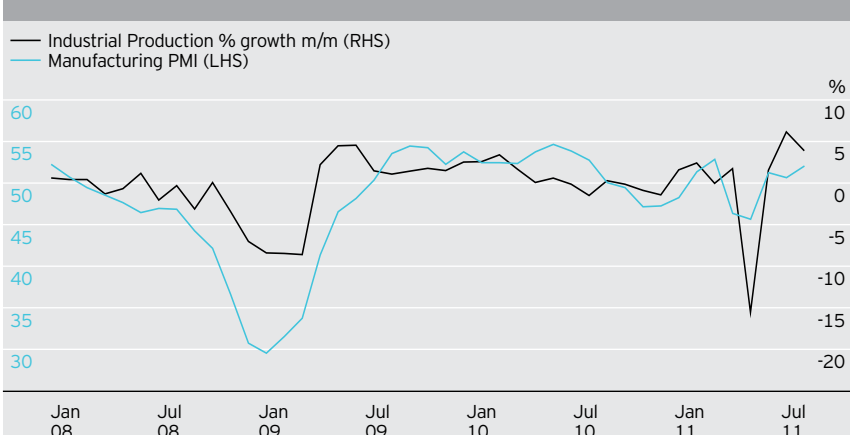


Fig 3 Retail trade rebounds strongly

Source: Bloomberg, as at 31 July 2011.



Scott Wolle
CIO
Invesco Global Asset Allocation



Sometimes the simplest questions are the most revealing. After experiencing deep losses for the second time in a decade, many investors are reconsidering how they should

construct their portfolios. Investment advisers have devised a number of enhancements to the classic mean-variance optimised structure, but few address the key underlying issue - uncertainty.

The Invesco Global Strategies team first considers the primary economic outcomes that investors are likely to face, and then identifies assets that should benefit from each outcome. Next, they equalise the risk associated with each set of assets.

“ The balanced-risk portfolio... holds assets that should perform well in a variety of environments ”

Finally, the team makes tactical shifts around the balanced core, allowing the portfolio to adapt to the near-term environment. Each of these steps is considered in turn below.

The team considers three major economic outcomes: non-inflationary growth, inflationary growth and

Asset allocation: a question of balance

In the last issue, we investigated why, in times of uncertainty, it's important to balance risk equally among the assets, rather than having equities account for the majority of portfolio risk. In this issue, we review the process that Invesco's Global Asset Allocation team uses to manage portfolios.

recession. One or more assets can be identified as beneficiaries of each outcome (figure 1). For example, non-inflationary growth tends to benefit equities, due to generally brisk real growth and controlled inflation.

Certain bonds, such as high yield, also benefit in such times. Long-term government bonds perform best in periods of recession, as short-term interest rates, real growth and inflation fall. Inflationary growth supports the returns of real assets, such as commodities and inflation-linked bonds.

In order to maintain a high degree of liquidity and low counterparty risk, the team focuses on the most readily traded assets in each economic category: equities, government bonds and commodities. The allocation process is best understood in contrast to traditional balanced portfolios.

While the stock/bond mix varies widely by country, in this article, we follow the convention of considering 60% stocks and 40% bonds as a balanced portfolio. Different allocations

will differ in magnitude from the examples below, but not in basic character.

As shown at the top right side of figure 2, a traditional balanced portfolio is dominated by equity risk - over 90% of total risk in most cases. This means that the total portfolio - like equities - will typically perform well in non-inflationary growth, but will struggle during periods of inflation or recession.

“ The answer to the question of what to balance appears quite clear: investors should balance the risk of economic outcomes ”

The bottom-half of the figure shows an alternative approach, where risk is balanced equally among the assets. This leads to a quite different asset allocation, but one that may better cope with equity-unfriendly outcomes.

Finally, the team assesses the attractiveness of each asset relative to cash. This creates an opportunity for modest shifts in the mix of risk, as well as the total amount of risk taken. Each asset class will typically represent 16%-50% of the total risk of the portfolio, while total expected volatility of the portfolio will generally range from 6%-10% with a neutral target of 8% (for comparison, the traditional balanced portfolio referenced above has an estimated volatility of approximately 10%).

Taken together, the balanced-risk portfolio should have more defensive qualities than a traditional portfolio, since it holds assets that should perform well in a variety of environments. As

the history for the strategy begins at the end of September 2008, investors have an eventful period over which to evaluate its effectiveness in limiting downside exposure, while participating in more attractive environments. The mathematics of compound returns - that losses harm portfolios more than the equivalent gains help - supports the philosophy and explains the source of the strategy's results.

Conclusion

The answer to the question of what to balance appears quite clear: investors should balance the risks of the various possible economic outcomes. In our view, this sits well alongside today's uncertainty and places investors in a position where material portions of their portfolios may benefit from a wide range of environments.

Fig 1. Economic outcomes and select asset classes

Source: Invesco analysis. For illustrative purposes only.

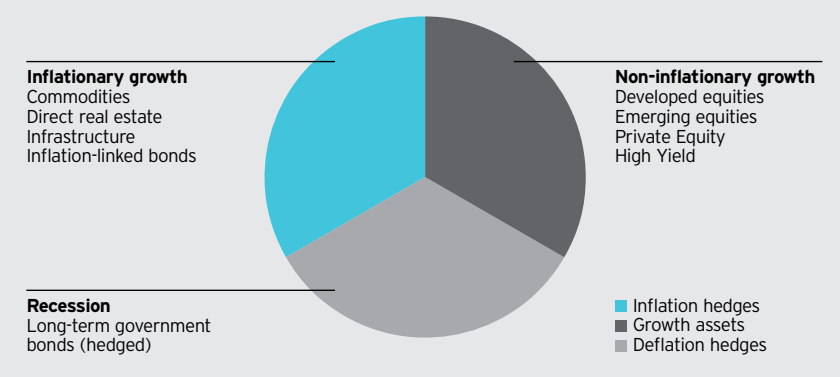
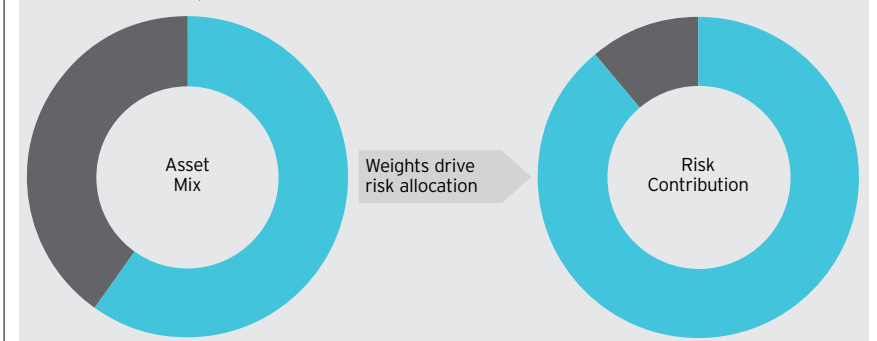


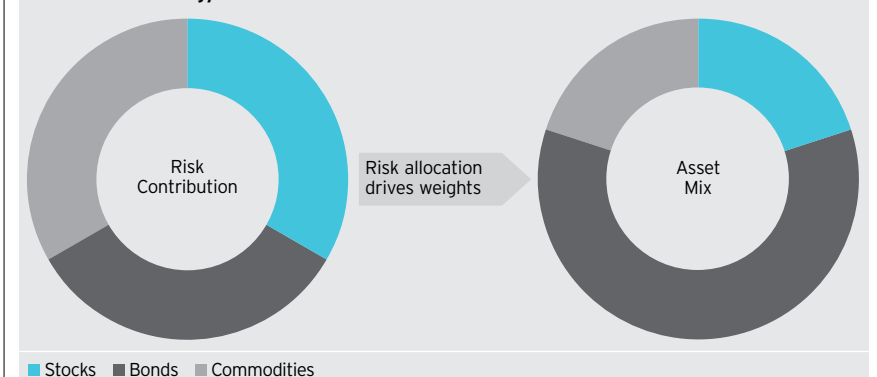
Fig 2. Asset mix and risk contribution

Sources: Invesco analysis and Datastream. Commodities are represented by the S&P Goldman Sachs Commodity Index. Bonds are represented by the Barclays Capital Treasury Index. Stocks are represented by the S&P 500 Index. For illustrative purposes only.

Traditional balanced portfolio



Balanced risk strategy



Smaller Asia fights for attention

India and China dominate the thoughts of investors interested in Asia, but the region's smaller investment markets should not be dismissed.

Chris Newlands
Managing Editor
Ignites Europe, Financial Times



Overlooked, underexplored and all too often ignored - that is how many experts describe the smaller investment markets in Asia.

And it is no surprise. For countries like Indonesia, Thailand and the Philippines, trying to compete for attention with the Asian powerhouses of China and India is like trying to be heard over a pair of very loud and boisterous teenagers.

China and India dominate the attention of those investors interested in the Asian investment story, and the pair's neighbouring countries can suffer as a result.

Economic growth in China is expected to hit 9% this year - almost two and a half times that of Thailand - while the World Bank's forecast for GDP growth in India is 8%.

Both India and China carry concerns of inflation but investors, it seems, are growing increasingly comfortable with what has become a relatively well-trodden investment path.

The same cannot be said of Asia's smaller investment markets, but this should not hide the fact there are some compelling stories to be told.

Indonesia's narrative, in my view, is perhaps the most compelling. Its economy has been expanding at an average of close to 6% a year for the past four years, helped by soaring prices of its natural resources.

This growth has spread beyond the urban centres of Java and Bali to far-flung spots across the 17,000-island archipelago, including the coal mines of Kalimantan and the palm-oil and rubber plantations of Sumatra.

As a result, rubber tappers, cocoa pickers, and coal miners have in some cases seen their incomes more than triple in the past three years, making such workers wealthier than some city residents.

In the 10 years to 2009, the size of Indonesia's middle class also more than doubled to 93 million people, according to the Asian Development Bank, and Nomura Research projects that this could grow to more than 150 million people over the next four years.

World Bank Chief Economist Justin Yifu Lin says: "Indonesia is a country of many advantages, among other things: it has an abundance of resources, a large and relatively well-educated labour force, a large domestic market, and a vibrant domestic business community."

But it does not come without its problems. The country's lacklustre infrastructure continues to be an obstacle due to a decade of underinvestment. Traffic remains a nagging issue, with the length of road increasing by just a third in the last 10 years while the number of vehicles has nearly quadrupled.

"Despite rapid infrastructure development in large urban areas, traffic

congestion continues to hamper large cities like Jakarta, Bandung, and Medan... Car ownership is increasing, following the liberalization of import motor vehicle rules. At least three million locally assembled motorcycles are added each year," says the World Bank in a report about Transport in Indonesia.

But I believe the advantage that comes with Indonesia being a soft commodities exporter seems to outweigh this and is also a boon to other nations in the region, notably Thailand.

“ There are... compelling stories to be told [in Asia's smaller investment markets] ”

Rising food prices can cripple many countries' poor rural population but in Thailand, which has attractive oil reserves and is a big exporter of rice, the purchasing power of the population remains pretty much intact.

"It is forecasted that Indonesia will be a major growth pole by 2025 - being one of six emerging economies accounting for more than half of all global growth," says Mr Lin.

Thailand and Indonesia share another attractive trait. The two - along with India to some extent - have extremely low mortgage penetration, and credit cards are literally non-existent.

As interest rate hikes go hand in hand with inflation, Thailand's low levels of personal debt add to the Thai investment story with experts advising against investment in economies in which the indebtedness of people is high during periods of rate increases. Korea and Taiwan are cited as examples.

in a bid to anchor inflation expectations. "Members judged that the risk of inflation outweighed the risks to growth, especially in light of continued fiscal stimuli that could add to inflationary pressure," according to the minutes of the meeting.

And it is likely there will be more rises to come. "There are three more MPC meetings this year and the policy rate hikes will probably continue," according to Assistant Governor of the Bank of Thailand, Paiboon Kittisrikangwan.

Interest rates in Indonesia, meanwhile, were held at 6.75% in August after being raised by 25 basis points in February. "The rate is still consistent with the efforts to maintain macroeconomic stability and support stronger economic growth," Bank Indonesia said in a statement. "[We are] confident that the impact of the recent turmoil in the global financial markets due to the downgrade of the US credit rating is limited, and can be contained with continuous monitoring of market development and co-ordination with the government."



Nick Hamilton
Head of Global Equity Products
Invesco Perpetual



Global smaller companies is a well-established asset class. It belongs to the domain of traditional equity investing and there is significant evidence of outperformance

of smaller companies versus larger companies. MSCI data for global smaller company markets dates back to 1993, and the outperformance since then of smaller companies versus large companies is shown in figure 1.

If we take the world's largest equity market (the US), then the evidence of smaller company outperformance over longer periods is significant. An asset class study by Choi et al. (2010)¹ looked at returns from 1926 to 2007, a period of over 80 years and spanning a world war and the Great Depression, and concluded that smaller company outperformance is around 1.7% per annum, after removing inflation. This is a significant premium when you consider the impact of compounding returns. Smaller companies have the highest return of the asset classes examined in the study - government bonds (intermediate and long-term), corporate bonds, large-cap and small-cap equities - and what is significant is that their volatility has been no greater than investing in larger companies. The conclusion we can draw is that for the same amount of long-term risk, you receive a return premium. This is why as an asset class they have the highest Sharpe ratio by a significant margin (the greater a portfolio's Sharpe ratio, the better its risk-adjusted performance).

Small-caps can diversify and reduce risk

When investors are constructing portfolios, they often seek to hold a basket of assets that have low correlation and which therefore behave differently to one another. Smaller companies are noteworthy in that long-term evidence validates the notion that they offer substantial diversification benefits to a bond portfolio and to a large-cap equity portfolio.

“ Smaller companies are noteworthy in that long-term evidence validates the notion that they offer substantial diversification benefits to a bond portfolio and to a large-cap equity portfolio ”

Smaller companies have a negative correlation to bond markets, and this has been maintained even in recent years when the correlation between large-cap equities and bonds has risen. In the long-term asset study by Choi et al., smaller companies were shown to have a powerful diversifying effect with bonds; and today, with investors heavily exposed to the bond market, long-term evidence would support smaller companies as a potential diversifying asset class.

We believe that smaller company returns are driven primarily by local and company-specific factors, whereas larger-company performance is driven by more global factors. For investors who hold portfolios with predominately larger company exposure, smaller companies can reduce the level of risk, as measured by portfolio variance dramatically. This means that a diversified global smaller company portfolio has the potential to reduce risk through diversification.

A study of small-cap returns and risk undertaken by Eun, C et al. (2008)² concluded that a fully diversified global large-and small-cap portfolio is significantly less risky (two-thirds by portfolio variance) than a diversified large-cap portfolio: “International diversification with large-and small-cap stocks will be substantially more effective in reducing the portfolio risk than diversification with large-cap stocks alone”.

Global small-cap benefits

The last 10 years in particular have seen an increasing appetite for emerging



Global small-cap: the best of both worlds?

Smaller companies can play an important role in a globally-diversified portfolio, challenging the assumption that they are inherently more risky than larger companies and highlighting their potential for outperformance.

country exposure, and investors have diversified by shifting their geographic exposure to emerging economies, as opposed to diversifying by market capitalisation.

We believe a logical approach to smaller company investing is to harness the opportunities within both developed and emerging economies. For investors into emerging markets, smaller companies provide a powerful means to access many of the companies that are genuinely exposed to the dynamics of those economies, rather than the large-cap names that today are similarly correlated to developed markets stocks.

A feature we find in emerging markets are smaller companies with a strong level of earnings growth, especially companies exposed to rapid growth in consumption and industrial activity.

Long-term analysis of the earnings growth of larger companies and smaller companies supports the notion that smaller companies have higher structural earnings growth³. It is with this knowledge that we can understand why smaller companies have historically outperformed larger companies.

What supports structurally faster growth?

Management interests are generally closely aligned with shareholder interests in smaller companies. The management of smaller companies tend to hold a significant amount of their own shares, so have a real incentive to succeed. Importantly, the incentive to succeed isn't driven by profits alone but by an entrepreneurial spirit. While the role of owner-manager changes as a company grows, individuals who have been with a company from the beginning tend to have a collective ambition for it to succeed. In our view, this dynamism is a compelling force. Studies have shown that managerial ownership improves company performance. Empirical research points to an improvement in corporate performance when managerial ownership rises from zero to 5%. Performance continues to rise as managerial ownership grows to an inflection point of 25%⁴.

As investors, we also like the ability for smaller companies to identify growth opportunities and to execute more quickly than larger companies. In a telling recent comment from Hewlett Packard's CEO, he admitted that the size of his company was effectively limiting its ability to respond to product cycles in the global economy. Large companies become complex and dynamism is often forsaken for process which may limit growth opportunities.

Finally, it is becoming apparent that large global companies - some of which are today sitting on large cash hoards -

are looking to acquire innovation and growth through acquisition, and that is a positive for smaller companies, which are likely to become targets as we move through this economic cycle.

Market performance and valuation

The recent setback in global equity markets has reduced the value of all equity markets. Smaller companies have been no exception.

We have studied how markets perform as they recover from recession-driven market lows to post-recession recoveries. As can be seen from figure 2, smaller companies - which are normally more economically sensitive and generally fall further - tend to bounce back stronger and typically outperform larger companies in post-recessionary periods. The current market fall has brought the outperformance they had experienced back below historic recovery averages.

Whilst there is clearly much uncertainty and reason for due care across the global economy, we remain positive about the long-term opportunity in this asset class today, especially following the recent market declines.

“ It is becoming apparent that large global companies - some of which are today sitting on large cash hoards - are looking to acquire innovation and growth through acquisition, and that is a positive for smaller companies ”

Conclusion

Global smaller companies is a well-established asset class and belongs to the domain of traditional equity investing. Exposure to global smaller companies within a global equity portfolio offers investors potential diversification benefits and the potential

Fig 1. Global smaller company performance
MSCI World Small Cap vs MSCI World Large Cap since inception of the MSCI World Small Cap Index January 1993. Source: Thomson Reuters Datastream, as at 6 September 2011.

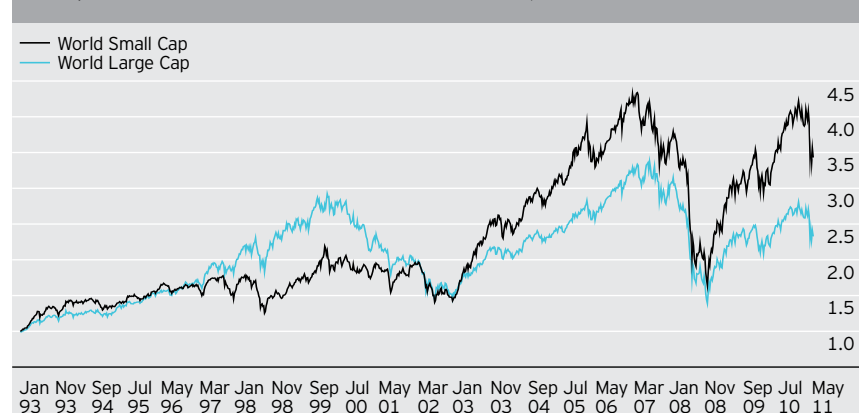
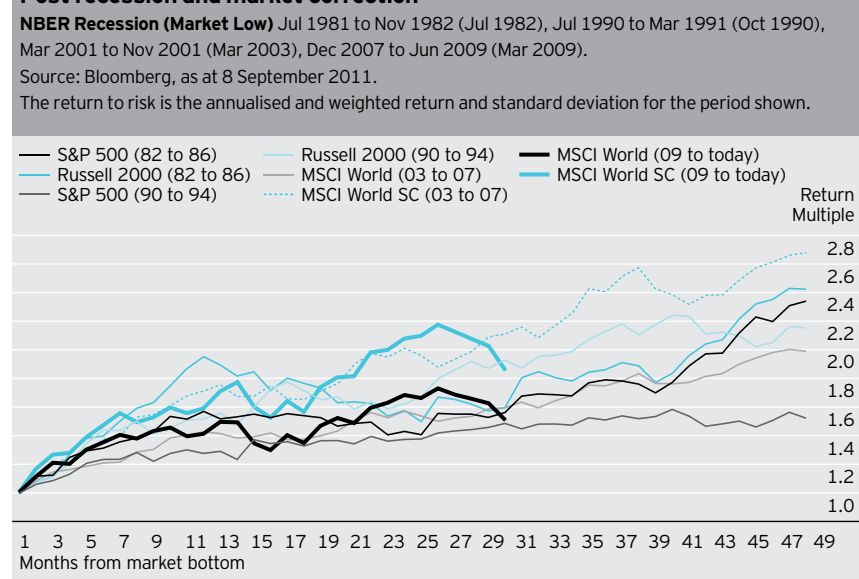


Fig 2. Smaller company returns and larger company returns
Post recession and market correction
NBER Recession (Market Low) Jul 1981 to Nov 1982 (Jul 1982), Jul 1990 to Mar 1991 (Oct 1990), Mar 2001 to Nov 2001 (Mar 2003), Dec 2007 to Jun 2009 (Mar 2009). Source: Bloomberg, as at 8 September 2011.



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¹Choi, B.P. & Mukherji, S. (2010). Optimal Portfolios for Different Holding Periods. Journal of Business & Economics Research, 8(10) (October 2010).
²Eun, CS; Huang, W. & Lai, S. (2008) International Diversification with Large- and Small-Cap Stocks. Journal of Financial & Quantitative Analysis, 43: 489-524 (June 2008).
³Bloomberg. MSCI World Index/MSCI World Small Cap index - trailing 12 month Earnings per Share (EPS) for the period 30 January 1998 to 31 August 2011.
⁴Morck, R., Shleifer, A. & Vishny, R. (1988). Management Ownership and Market Valuation: An Empirical Analysis, Journal of Financial Economics, 20: 293-315 (March 1988).

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