

# MyConsultant

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## Investing in a world gone MED



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Every year we gather some of the best minds from around the world to share their strategic insights and forward thinking at the MLC Implemented Consulting Conference.

Our Conference in September was no exception, with topics ranging from the complex geopolitical forces jolting markets to how we can exploit innovation and manage culture as a competitive advantage in turbulent times. The speakers seemed to have hit the mark based on the positive feedback we received from those attending.

In this article we draw out four key themes from the Conference, and explore how these insights can be applied to our clients' portfolios and our approach going forward.

### From MAD to MED

The theory of MAD (Mutually Assured Destruction) came into prominence during the Cold War when the US and Soviet Union eyed each other warily, knowing that a nuclear attack by either

side would be followed by swift retaliation and mutual annihilation. The tensions in the Middle East involving Israel and Iran, and North Korea and its neighbours, echo the characteristics of modern MAD theory.

David Gordon (former Director of Policy Planning under US Secretary of State Condoleezza Rice and our keynote speaker) extended this military game theory not only to nuclear, but also to economic, geopolitical risks. Unlike a military situation, the common thread in some key global power relationships is that they commenced with mutual benefits for those involved, leading to a growing financial interdependence which was expected to culminate in global economic stability. Instead potential breaking points have been reached in the US-China relationship as well as within the Eurozone, replacing the global threat of MAD during the Cold War with the global threat of MED (Mutual Economic Destruction) in the aftermath of the GFC.

The US gained greater ability to finance its debt and increase leverage through China's purchase of US Treasuries, whilst China fueled its growth by exporting to US consumers bloated by the resulting liquidity and easy credit. Now this seemingly virtuous cycle has turned vicious. Similarly, the creation of the European Union provided benefits initially for all its member countries, including shielding the credit status of weaker economies through the common

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currency. However a breaking point could be reached with Greece (and others) on the path of severe austerity measures, a banking crisis and rising civil unrest, whilst Germany and France grapple with bailout packages and the threats of contagion.

David felt that as the risk of MED increases, so does the need for strong political leadership to bring us back from the brink.

## A failure of imagination

Brian Parker, Investment Strategist at MLC, agreed with David that the global lack of political leadership is now one of the greatest contributors to geopolitical and economic risk. He spoke about how this is also symptomatic of a failure of imagination in both the public and private sectors.

The GFC was a stark reminder that investment returns are not normally distributed, with Brian remarking that extreme events deemed to occur once every 100 years seem to have a horrible habit of occurring more frequently. Many people saw the warning signs and predicted a crisis, however few predicted the sheer magnitude of the GFC, and probably almost none the timing of it. Brian therefore believes one of the key learnings from the GFC is to recognise as investors our individual and collective failure to imagine extreme events.

Brian reminded us that a failure of imagination is not restricted to the GFC. He asked who would have thought in the early nineties, when the Japanese 10 year government yield was at 8%, that 20 years later the yield would be close to

1%? And who would have thought that one Australian dollar would recently have purchased as much as 110 US cents?

Brian therefore feels that investment professionals should be paid to worry, and to imagine. And an integral part of his job at MLC is to imagine a range of scenarios, especially worrying ones, in order to devise strategies to help reduce their potential damage to our clients' portfolios.

## Sorting leaders from imposters

Frank Sands Jr defined innovation as the creation of better, more effective, more convenient, less expensive products, services, processes, technologies or ideas, and that innovation leadership is the ability to convert these ideas into wealth. As CEO of Sands Capital Management, he heads a firm actively seeking out true leaders that not only develop innovative solutions but can also turn them into revenue with strong growth. There is a clear distinction between these two concepts and Frank defines a company that cannot convert ideas into wealth as an 'imposter'.

The graphical user interface (drop down menus, point and click etc) was invented by Xerox in 1975 but they didn't know what to do with it. After touring Xerox and seeing the idea, Steve Jobs found a mainstream use in the launch of the Macintosh in 1984. However, it was Microsoft Windows that reaped the richest rewards by scaling up the technology. Thus if one had invested in the inventor (Xerox), or the first mover (Apple), one would have missed out on the wealth generated by the true innovation leader for the graphical user interface (Microsoft).

Frank presented five key identifiers which Sands Capital uses to sort the innovation leaders from the imposters, as shown in **Exhibit 1**.

### Exhibit 1: Innovation leader identifiers

- 1. Leadership** position in a promising business space
- 2. Recurring revenues** rather than a once-off sale
- 3. Platform** to provide relevant services to a wide range of businesses (e.g. Visa)
- 4. Network Effects**, which rely on a growing customer base and increased traffic to lower costs and prices and increase product range (e.g. Amazon)
- 5. User Built Content** (e.g. Facebook).

These identifiers appear to have served Sands Capital well in the past. Ever since MLC seeded Sands Capital's first global shares mandate and included it in the MLC Global Shares strategy, the manager has outperformed the benchmark by 17.4% pa on average. Looking ahead, Frank emphasised that turbulent times can help increase the performance differential between leaders and imposters, and that actively selecting stocks which are innovation leaders is a way of growing wealth in the face of a volatile investment environment.

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## Culture as competitive advantage

Jim Ware, founder of Focus Consulting Group, defined culture as the beliefs, values and behaviours that differentiate one organisation from another. Whilst some may not immediately think of culture as a competitive advantage in the investment management industry, it can be viewed as an essential ingredient in achieving superior innovation and productivity. Australia's productivity has been under the spotlight due to the debate around the 'two speed economy'. Indeed, for companies operating in any industry, a challenging economic environment means that companies cannot afford to neglect maximising the value from their employees; hence culture becomes an important lever to separate winning companies from the losers.

Jim introduced the concept of the 'Red X', which is also not unique to the investment management industry. The Red X is an individual within an organisation who tends to think outside the box and therefore can exhibit behaviours and attitudes that do not conform with the firm's 'mainstream'. However, Jim felt that if Red Xs are properly managed, and appropriately situated within the company (even to the extent of ringfencing them!), they can add significant value through their creative thinking and challenging of the status quo.

It's not surprising then that the heads of leading innovation companies mentioned earlier by Frank, such as Bill Gates of Microsoft and Steve Jobs of Apple, could be characterised as 'Red X' personalities.

## Investment intelligence for turbulent times

The four speakers at our Conference provided valuable insights into the volatile and uncertain environment we face and different angles on how to approach it.

Firstly, we need to stretch our imaginations and imagine a wider range of possible economic and investment outcomes. Our Strategic Overlay process is well suited to help us imagine, identify and understand scenarios that could play out in the medium term and adjust the balance between risk and reward.

Secondly, we need to worry about the downside. In particular, we need to factor in the heightened political risk around the world. Accordingly our medium term thinking explicitly considers scenarios such as a disorderly European sovereign default or a Chinese policy mistake. This has led to more defensive positioning of currency exposures as well as a reduction in exposure to longer dated global sovereign bonds (with almost nil sovereign bond exposure to the PIIGS\* of Europe).

Thirdly, we must recognize that periods of financial market distress and turbulence often provide us with the best investment opportunities. Hence the appointment of managers like Sands Capital can add exposure to this upside through their highly selective stock picking process.

In addition, our culture as an investment organization must continue to foster innovations that improve our clients' investment outcomes. A recent example is the Low Correlation Real Return

strategy which targets returns with low correlation to equity markets to help reduce volatility in these turbulent times.

The world has gone from MAD to MED, which is beyond our control. What we can control, however, is what we imagine and worry about, and how we innovatively adapt.

\* PIIGS refers to Portugal, Italy, Ireland, Greece & Spain.

*“What we can control, however, is what we imagine and worry about, and how we innovatively adapt.”*

If there are any topics you would like us to cover or if you have comments or questions about any of the articles, please contact us on (02) 9936 4505 or email [myconsultant@mlc.com.au](mailto:myconsultant@mlc.com.au)

For additional news and upcoming events please visit our website at [mlc.com.au/institutional](http://mlc.com.au/institutional)

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