

# f new frontiers

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WINTER 2014

INVESTING IN IDEAS



## PROFILE

### GEORGINA TAYLOR

The Product Director explains how the Invesco Perpetual Global Targeted Returns Fund has evolved over its debut year

## ADVISERS' VIEWS

### VOLATILITY

How advisers are coping with volatility spikes

## PLUS: INDEPENDENT VOICES

### FRANCES COPPOLA

The great Asian slowdown

### YOLANDE BARNES

Does property pricing distort the economy?

# One year on and we're exactly where we hoped to be

## The Invesco Perpetual Global Targeted Returns Fund

Our fund aims to deliver positive returns with less than half the volatility of global equities over a rolling, three-year period.<sup>1</sup> One year in and we're on course to achieve this.

How? By investing in ideas. Our Multi Asset team is free to consider any investment idea, anywhere in the world, without asset class constraints. It then blends them into a highly diversified, risk-managed portfolio, giving the potential to benefit from the upside and minimise the downside.

See the results at [invescoperpetual.co.uk/investinginideas](http://invescoperpetual.co.uk/investinginideas) or call us on 0800 028 2121 with any questions.



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<sup>1</sup>There is no guarantee that this will be achieved. Fund performance figures (Accumulation share class) are shown in sterling on a mid-to-mid basis, inclusive of net reinvested income and net of the Ongoing Charge and portfolio transaction costs from launch on 9 September 2013 to 30 September 2014. The figures do not reflect the entry charge paid by individual investors. Source: Lipper. Index performance is total return in sterling. Source: Datastream. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Where Invesco Perpetual has expressed views and opinions, these may change. The fund makes significant use of financial derivatives (complex instruments) which will result in the fund being leveraged and may result in large fluctuations in the value of the fund. Leverage on certain types of transactions including derivatives may impair the fund's liquidity, cause it to liquidate positions at unfavourable times or otherwise cause the fund not to achieve its intended objective. Leverage occurs when the economic exposure created by the use of derivatives is greater than the amount invested resulting in the fund being exposed to a greater loss than the initial investment. The fund may be exposed to counterparty risk should an entity with which the fund does business become insolvent resulting in financial loss. This counterparty risk is reduced by the Manager, through the use of collateral management. The securities that the fund invests in may not always make interest and other payments nor is the solvency of the issuers guaranteed. Market conditions, such as a decrease in market liquidity, may mean that it is not easy to buy or sell securities. These risks increase where the fund invests in high yield or lower credit quality bonds and where we use derivatives. For the most up to date information on our funds, please refer to the relevant fund and share class-specific Key Investor Information Documents, the Supplementary Information Document, the Annual or Interim Short Reports and the Prospectus, which are available using the contact details shown. Telephone calls may be recorded. Invesco Perpetual is a business name of Invesco Fund Managers Limited, Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire, RG9 1HH, UK. Authorised and regulated by the Financial Conduct Authority.



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## LEADER

This latest issue of New Frontiers focuses on the recent first anniversary of the Invesco Perpetual Global Targeted Returns Fund, and we are happy to be able to say so far, so good. As we head into 2015, we are exactly where we want to be at this point, but we also recognise we are only just over a third of the way into our first rolling three-year period against which our performance and volatility targets will be measured, and there are plenty of challenges ahead.

Now that we have a year under our belts, more investors want to hear about the fund, so communicating the process and the underlying ideas is a vital part of the overall strategy. Product Director Georgina Taylor plays a key part in that effort, and our profile this time focuses on her role and how it fits in with the rest of the team.

Elsewhere, after a fairly benign period in markets, volatility is at the forefront of investors' minds once again, following a spike in October. This edition of New Frontiers features a detailed look at the issue, including how New Model Adviser® readers cope with such spikes.

Overall, we welcomed the new bout of volatility as it gave the fund a stern test. When talking to advisers in recent months, one comment we have often heard has been that it would be interesting to see how the portfolio fared in tougher market conditions. We obviously model tougher markets all the time, but the spike in volatility gave the team a chance to show that its diversified, ideas-based strategy definitely works in real life.

A further fascinating theme from our interaction with advisers has been the range of different ways they are using the Global Targeted Returns Fund and integrating it into their client portfolios. We have always felt the fund can fulfil many roles for investors and are pleased that its flexibility is being recognised.

As ever, this issue also presents a number of current ideas from Head of Multi Asset David Millar and team, and we are delighted to include the views of three renowned economic commentators in the Independent Voices section.

We hope this publication proves a helpful read and thank you for your continued interest in the fund and our approach to multi asset investing.

#### Ian Trevers

Head of UK Retail  
Invesco Perpetual



## PROFILE

# GEORGINA TAYLOR

With the Invesco Perpetual Global Targeted Returns Fund having recently celebrated an important milestone – its first anniversary, Product Director Georgina Taylor is busy communicating how the portfolio works to investors. Here, Taylor and Head of Multi Asset David Millar outline how the fund has evolved over its debut year.



## PROFILE: GEORGINA TAYLOR

Product Director Georgina Taylor plays a key role in the Invesco Perpetual Global Targeted Returns Fund, communicating how the portfolio works to investors. In this profile, Taylor and Head of Multi Asset David Millar outline how this role, and the fund itself, have evolved over its debut year.

In September this year, the Invesco Perpetual Global Targeted Returns Fund celebrated an important milestone – its first anniversary.

'Now that we have that one-year track record, more people will be looking at what we've done and will want to know more about the fund. The obligation on us as an investment team in terms of explaining what we do to is incredibly important, and that's why the role of product director that Georgina fills for us in the UK is so important,' he says.

In addition to meeting clients, Taylor also makes sure Invesco Perpetual's internal salesforce, on both the retail and institutional side, is aware of what is happening in the portfolio.

But Taylor's role is far from just communication – she is also an active member of the investment team, helping to make decisions for the portfolio and carving out the team's economic outlook.

With a background in economics, her previous experience is primarily from working in the investment banking side of the industry. In her first role, she was part of HSBC's economics and strategy team, working alongside Richard Batty, now one of the fund managers of the Invesco Perpetual Global Targeted Returns Fund.

Taylor then moved on to work as an equity strategist for Goldman Sachs and State Street Global Markets.

Batty is not the only connection Taylor has with her current team. When she was head of equity strategy and asset allocation research at State Street, her current colleagues, who were running similar strategies elsewhere at the time, were among her clients.

'I used to feed investment ideas into the team, I used to help them with forming ideas over their three-year time horizons, and now it's great to be actually part of the team,' says Taylor.

'I used to go and talk to clients about my research and the outlook for financial markets. Now I focus on speaking to clients and helping them understand what we're doing in the team.'

Millar emphasises the importance of having Taylor work both within the investment team and with clients.

'With Georgina contributing to the research with her background as an equity strategist, and then going out and talking to people about what it is we do, it's an incredibly important role,' he says.

'We have monthly meetings where we review ideas and bring new ideas to the table, and it's not just the three fund managers – it's Georgina, it's our client portfolio manager in the US, our risk manager, analysts and our dealer.'

### A variety of perspectives

Taylor says it is very important to have different people with a variety of perspectives working on the fund.

'We can't have just one view of the world and expect to deliver our return and volatility targets



**The obligation on us as an investment team in terms of explaining what we do to is incredibly important, and that's why the role of product director that Georgina fills for us in the UK is so important**



over time. We have to be flexible, we have to know that markets can suddenly change very significantly and be able to cope with those changing market conditions,' she adds.

'If you look at the three fund managers, they have incredibly different personalities, different backgrounds and different views on financial markets. What I bring to the table is my economics background, a little bit of a valuation perspective, looking at different equity markets,' she says.

She says the three managers on the fund – Millar, Batty and Dave Jubb – all have particular biases, but have freedom to consider ideas across the board.

'We tend to have biases within what we look at sometimes, so David Millar might be a little bit more fixed income, Dave Jubb may be more derivatives or volatility focused, and Richard Batty might be a bit more equity and currencies focused, but we can all bring anything to the table. I am certainly slightly obsessed by sector themes within equity markets.'

An important part of the team's process is asking: what is the general economic outlook for the world? They put their two- to three-year outlook into what they call their central economic thesis, against which each idea in the portfolio must generate a positive return to justify its place.

Taylor says she tends to host and be very involved in the monthly meeting during which this thesis is debated.

'What's important is not being hostage to one economic view playing out, but you have to have a view against which you can test ideas and think about the minimum hurdle rate for every idea,' she adds.

The team uses a variety of sources for seeking out ideas. 'In terms of gathering ideas, we see ourselves almost as a funnel, gathering inputs from all around the firm, outside of the firm, and thinking about which ideas could work in this type of portfolio,' Taylor says.

'We are very lucky to be embedded on the Invesco Perpetual platform and we spend a lot of time listening to what the other asset class specialists are doing around us: what's going on in the fixed income world; what's going on in the equity world...'

Taylor also highlights the role of John Greenwood, Invesco Ltd.'s chief economist, who is a 'fantastic source of ideas' and a barometer for our own outlook on the world.

However, it is critical to filter those ideas. One team member will take responsibility for and champion each idea, writing a research note, putting together the drivers he/she believes will play out over the next two to three years and presenting that to the rest of the team.

'It is a repeatable process that we can continually refer back to,' says Taylor. 'Research notes are very structured, so if anything changes in an idea, or we feel the world is changing in some way, we can revisit the original note and verify whether the same drivers still apply. We review each idea at least once a quarter, we go through all of the drivers once again and take a view on whether we think the idea will work as we expect or whether actually things have changed



## PROFILE: GEORGINA TAYLOR

so much that we need to review whether that idea should be in the portfolio.'

Millar emphasises the benefit of having a thorough process and a settled philosophy, especially when faced with challenging markets.

'The thing that will get us through any year is a commitment to sticking to our philosophy and sticking to this process, it means that we're always looking out there on that two- to three-year horizon, we're trying not to get too distracted by the current noise in markets. The importance of this is even greater as we are entering a phase, potentially, when a lot could change,' he adds.

'The US Federal Reserve interest rate cycle could move for the first time in years. Nobody has any idea about what impact that might have on markets at a time when the volatility of some of those traditional assets like equities and bond yields are at historically low levels.'

The first year of managing the fund has taught the team a number of good lessons, adds Taylor.

She says that since inception, the investment process has not changed as this was carefully set up from the beginning.

'I think maybe what we've learned is how to communicate on the process, helping people understand what we're doing and how we're doing it,' she adds. 'The multi asset sector is growing by the day, it's a very popular sector right now, and we're working very hard on the transparency of what we're doing, being very open about how we have achieved our returns and volatility targets so far, but also how we plan to deliver those going forward.'

### Lessons learned

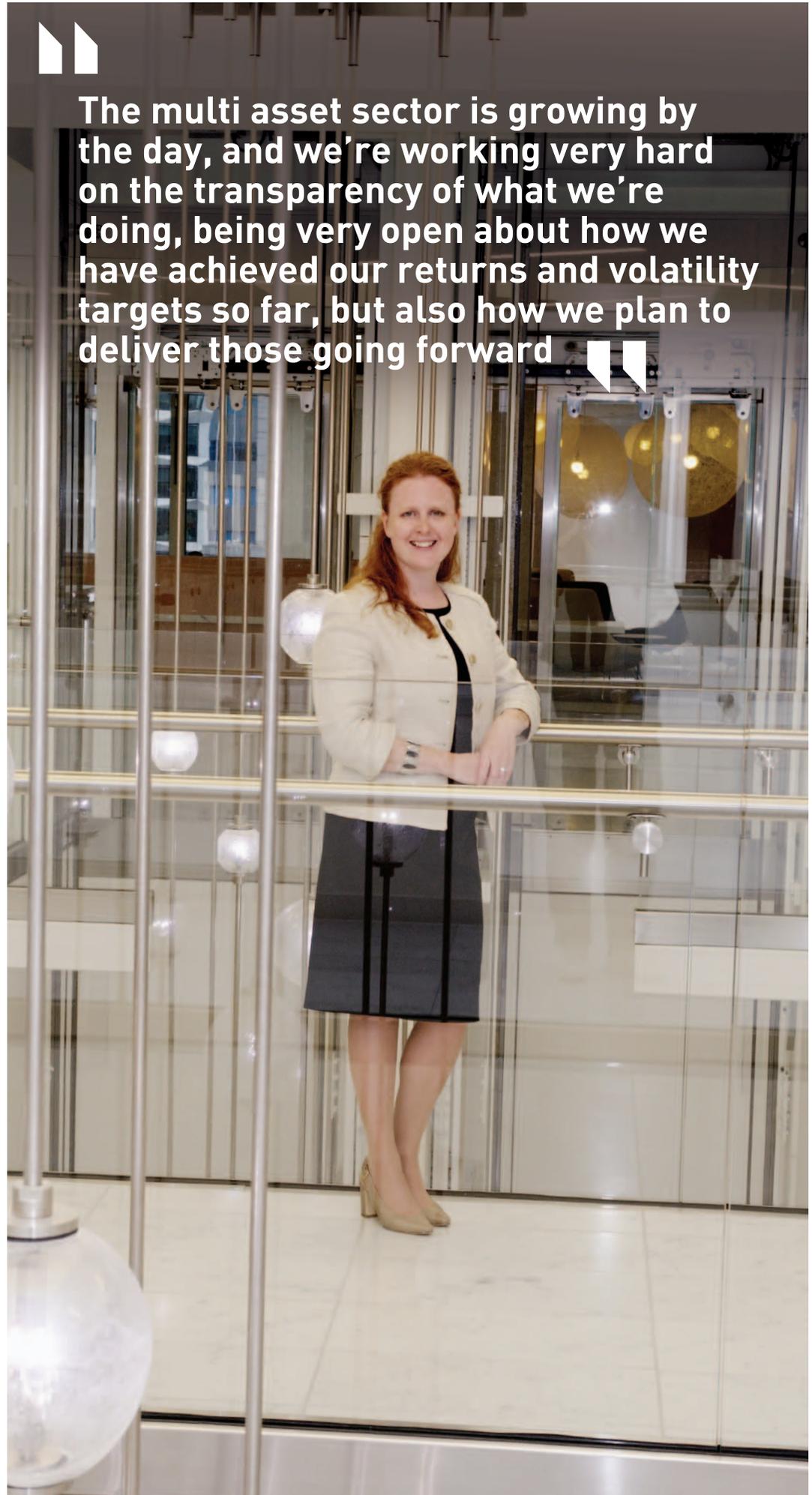
Taylor also thinks that due to the variety of scenarios faced during the first year, there have been a number of important lessons to learn from the financial markets. 'We've had geopolitical risk, we've had potential changes in policy by global central banks and we've had general risk-on, risk-off periods.

'Scenario testing, stress testing, always questioning: 'What if we're wrong?' – that's something we spend a lot of time doing, and the first year has underlined just how vital that part of the process is.'

She says the financial adviser market is very important to the team and she has spent a lot of time communicating with advisers not just directly, but also through educational materials such as white papers that lift the lid on areas like derivatives or volatility.

Taylor says the team wants clients to understand how it uses such investments but also to provide a breakdown of each investment idea in the portfolio. 'That has been incredibly important because when I've been speaking with clients, everyone grabs hold of something different: someone might be very interested in a view on a currency, such as the euro or sterling, for instance,' she says.

The team's knowledge is also passed on to the internal salespeople. 'We've had a lot of internal training sessions that I've run, and that knowledge base of our internal guys, to make sure we're then communicating that properly externally, has been a real investment by our team, and by me in particular,' says Taylor. ■



**The multi asset sector is growing by the day, and we're working very hard on the transparency of what we're doing, being very open about how we have achieved our returns and volatility targets so far, but also how we plan to deliver those going forward**

**INDEPENDENT VOICES**

**FRANCES COPPOLA**  
Economic commentator



# THE GREAT ASIAN SLOWDOWN

Over the past few years, exceptionally loose monetary policy by developed nations in the wake of the 2008 financial crisis has dominated market behaviour. As the US turns off the quantitative easing taps and thoughts turn to the first interest rate rises, investors are starting to pull capital from emerging markets.

Low interest rates have depressed bond yields, while quantitative easing (QE) has flooded the markets with liquidity. This has caused investors seeking yield to turn to emerging markets, creating an investment boom.

For emerging market countries the end of QE is bad news: it increases their borrowing costs and puts their currencies under pressure. Some people fear that there may be another Asian economic crisis, similar to that in 1997, when Asian countries suffered sudden capital outflows that crashed stock markets and caused runs on currencies and spiking bond yields. However, the reserves built up by many emerging market countries protect them against destabilising capital outflows, while the gradual tapering of QE by the US Federal Reserve (Fed) has allowed plenty of time for markets to adjust to less dollar liquidity and potentially higher interest rates. A 1997-style crisis seems unlikely.

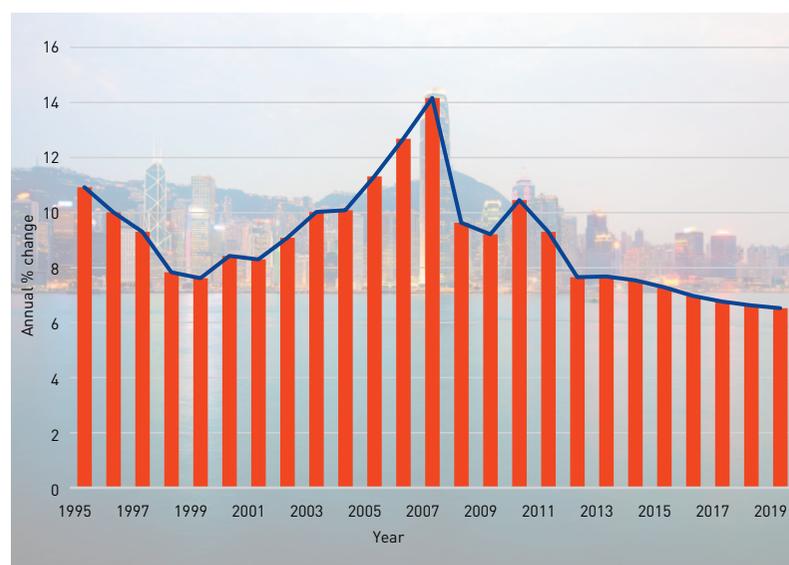
Indeed, just because the Fed has ended QE does not mean it is gone for good. Two days after the Fed announced that QE was over, the Bank of Japan doubled the size of its own QE programme and the Japanese government pension fund announced its intention to rebalance its portfolios away from government debt and towards higher-yielding equities. Japan now has by far the largest monetary easing programme in the world relative to the size of its economy. The effect on Asian economies remains to be seen, but other central banks may be forced to respond with easing of their own to protect exports. Competitive currency devaluation in Asia Pacific seems increasingly likely, possibly with inflationary consequences.

But the prospect of currency wars is not the main risk facing Asian emerging economies today. A bigger problem is the slowdown in China.

China's economy has grown fast in the last two decades and is now the powerhouse of the Asia-Pacific region. Smaller Asian economies use it as the 'hub' for their trading

**Figure 1: China GDP Growth**

Source: IMF



activities. But China's exceptional monetary and fiscal easing after the 2008 financial crisis, coupled with financial repression, has blown up a debt bubble of enormous proportions, much of it going to finance expensive and unnecessary construction projects. China's investment boom has seriously overstretched its banks, risking a financial meltdown of unknown proportions. The People's Bank of China is aware of the risk and has been attempting to remove incentives for banks to over-lend, though it has had to tread carefully to avoid precipitating a crash: recently it has actually loosened standards for mortgages due to risk of deflation in the housing market.

Partly because of its stagnant housing market, China's growth is now slowing significantly, falling from an average of 10% per annum to 7.3% in August 2014. The International Monetary Fund projects that it will continue to slow down over the next few years, eventually reaching a stable growth rate of 5-6%.

In many respects, China's growth moderation is a good sign. It has fast-tracked industrialisation on the back of enormous exports to the West, but this has come at the cost of pollution and ecological damage. Since the financial crisis, it has also

been achieved at the cost of high, and possibly unsustainable, public and private sector debt. Domestic consumption is a shockingly low proportion of GDP, largely due to artificial repression of wages to subsidise state investment projects. As is typical for countries with large trade surpluses, much of China's investment goes overseas, particularly to Africa and Europe. But many of its people remain poor, and it faces a serious demographic challenge due to its collapsing birth rate.

China's economy needs to rebalance away from investment and exports and towards domestic consumption and saving. To achieve this, wages must increase and living standards improve. The emergence of an urban middle class in China suggests this is already happening, but it also means that China will gradually cease to be a fast-growing, export-led industrial giant: as its middle classes become more prosperous, its economy will become more services-oriented, with lower productivity and slower growth. This is normal for a maturing economy, but it has consequences for other countries in the region. A slowing China drags down growth rates in its principal trading partners. Slower growth

should be expected across Asia in future years.

But China's slowdown is not the whole story either. Global trade has reduced significantly since the 2008 financial crisis. The Great Expansion in the East was made possible by the consumer boom in the West, which we now know was largely funded by unsustainable credit expansion. Demand for consumer goods in Western countries fell sharply after the crisis and remains depressed due to high unemployment, stagnant wages and overstretched household budgets. Regulatory pressure keeps credit conditions tight: but perhaps more importantly, demand for credit is low. Firms remain unwilling to invest either at home or abroad. And as wages fall in Western countries, Asian countries gradually lose their cheap labour advantage in manufacturing: as the gap narrows, supply-chain risk encourages re-shoring of jobs from East to West. Firms also have the possibility of replacing cheap labour with even cheaper machines, supported by a skeleton crew of highly skilled technicians. Large amounts of low-paid workers are no longer a source of competitive advantage for emerging markets.

Growth rates in emerging markets would have fallen sooner had it not been for China's investment boom, high commodity prices benefitting exporters, and Western QE. But China's credit-driven investment boom has now peaked, and its commodity-hungry expansion has slowed. No wonder emerging markets are worried about the end of QE. Their export-led growth models have depended on Western support of global aggregate demand. Without it, they will be forced to develop domestic and local markets and compete on equal terms with the large Western economies. The Great Expansion is over. ■

**Frances Coppola** is an economist and author, and currently associate editor of financial website *Pieria*. Before this, she had a long career in the banking industry, working largely on the risk management side.

## INDEPENDENT VOICES



PAUL CRAVEN

Investment specialist in behavioural economics



# SEVEN BIASES FOR SEVEN GOALS

Behavioural economics has overturned traditional economic models in recent years, because it relates better to real people in the real world.

This summer's World Cup semi-final between Brazil and Germany would surely refute Hassim Taleb's comment, although he might counter with the observation that the result was a 'black swan' event. The fact is that most rational commentators and football experts could never have conceived in their wildest dreams that Brazil would concede seven goals.

Yet it happened. Conventional wisdom was overturned.

In like manner, behavioural economics has overturned traditional economic models – although not because of extraordinary exceptions, but because it relates better to real people in the real world. Traditional models assume people are always rational decision makers who fully analyse data and act logically before they reach conscious decisions. Behavioural economics refutes this by demonstrating that human beings have hardwired biases and also make mental shortcuts.

Nowhere are mental shortcuts more evident than in people's attitude towards wealth, savings and investment. This article highlights seven common cognitive biases.

It is always interesting to see how investors approach unrealised book losses on a stock they have previously purchased. Do they still believe in a particular stock that has disappointed? Will they buy more, and risk succumbing to the **sunk cost fallacy**? Or do they particularly dislike crystallising losses – **loss aversion** – and start to hope for, as opposed to honestly anticipate, price improvement? And if they were setting up a new portfolio, would they buy the same stock. If not, why not? There are a lot of potential biases and heuristics possible in these circumstances.

Human beings have an instinctive, hard-wired reactive way of thinking, as well as a more recently evolved rational, analytical side – what Nobel Prize winner Daniel Kahneman

calls System 1 and System 2. We all like to think that we are constantly using System 2. But the hard-wired, emotive and unconscious System 1 can never be switched off and we accordingly rely on it far more than we believe. This can sometimes lead investors and savers to make decisions that are irrational at worst and sub-optimal at best.

Having worked in the investment industry for 27 years and witnessed a variety of financial bubbles and credit crunches, I am convinced insights from psychology are equally, if not more, important than economics in understanding how financial market participants act, individually and in aggregate.

Partly as a result of the global credit crisis, and partly because of a growing interest in the psychology of investments, a lot of private investors, as well as institutional pension funds and their consultants, are increasingly interested in the



**Watching soccer is punishingly boring unless you root for one side. Without an emotional draw it is literally impossible to follow the game**

fresh perspective it offers.

Psychologists estimate the human brain is potentially subject to over 150 different biases, and other examples include **base rate neglect** (ignoring the statistical facts and figures, often in favour of an emotionally appealing or attractive story – a real-life example is the popularity of some 'pseudosciences', such as astrology or homeopathy, despite minimal supporting evidence), or **anchoring**, whereby we might consciously or subconsciously latch on to a number as a reference point.



Germany beat hosts Brazil 7-1 in the 2014 FIFA World Cup semi-final

Photo: AGF s.r.l./REX

Another psychological insight relating to money and savings is **confirmatory bias** – a common feature in our industry. We often come to an investment conclusion quite quickly. But then we tend to find reasons to back it up and we often filter out things that do not quite fit our story or our argument.

There are perfectly good evolutionary reasons to be confident and even optimistic. Without

often people will reject something that does not agree with their view rather than genuinely re-evaluate the situation.

I have always liked the John Maynard Keynes comment: 'When the facts change, I change my mind.' We need to question our assumptions.

As a historian, I am particularly interested in booms, bubbles, and busts in market cycles. These are often viewed simply in terms of fear and greed, but in reality, they reflect many underlying behavioural biases, such as the **bandwagon effect**, that were just as prevalent in the tulipomania bubble in 17<sup>th</sup> century Holland as they were during the 1990s' dotcom boom.

Behavioural economics in the business world is becoming increasingly important, providing individuals and firms with a competitive advantage. Above all, it emphasises the importance of challenging our in-built biases, in order to optimise our chances of reaching better conclusions. ■

<sup>1</sup>Tali Sharot, *The Optimism Bias* (2012)

Hassim Taleb



optimism, a form of 'mental time travel', as Tali Sharot notes: 'Our ancestors might never have ventured far from their tribes and we might all be cave dwellers still, huddled together and dreaming of light and heat.'<sup>1</sup>

But the **optimism bias** and confirmatory bias can lead to mistakes, not least overconfidence. You could imagine a situation in which an optimistic investor has lots of good reasons to own a stock, having done the research. Now what happens if that person is faced with contradictory evidence or opinion?

**Paul Craven** is specialist in the area of behavioural economics and founder of Paul Craven Partners. He retired from Goldman Sachs Asset Management at the end of 2013 after six years with the firm, where he was a managing director and latterly head of European Institutional Business. Prior to Goldman Sachs, he worked at PIMCO Europe.

## INDEPENDENT VOICES



**YOLANDE BARNES**  
Director, Savills World Research



# DOES PROPERTY PRICING DISTORT THE ECONOMY?

Land price cycles remain an under-researched and misunderstood element of broader economic conditions.

Back in the depths of the Great Depression of the early 1930s, a hitherto obscure American academic named Homer Hoyt published a book called *One Hundred Years of Land Values in Chicago*. It has influenced several generations of economists since with its description of successive economic booms and busts in the city during the late 19<sup>th</sup> and early 20<sup>th</sup> century.

Hoyt's book is influential because it shows how land speculation and its attendant finance seems to have played a big part in these cycles.

Land price cycles are nothing new, but they remain relatively under-researched – let alone understood – by many mainstream economists.

Little has been mentioned of the possible role of land price cycles in the economy and the impact of speculative bubbles since the time of the British Edwardian economist Henry George, who saw land speculation as a deeply malign economic force and advocated the abolition of income tax and its replacement with land and property taxes.

More recently, a new player, French economist Thomas Piketty, has entered the fray and described the concentration of capital globally. It is in real estate that much of the private capital he describes is stored.

This phenomenon, coupled with the recent property-led recession in the US is leading more people to see if property taxes may be a way of curbing future cycles. So the role of real estate in recessions has risen to the fore again. Is a new speculative land price bubble threatening to destroy western economies?

The OECD seems to think so. It has been warning some countries for the past year or so that their housing markets are overheated, are a threat to economic health and need to be curbed.

This may seem strange given these warnings have been issued so soon after many member countries have experienced severe real estate crashes in recent years. The financial crisis of 2007/08 was triggered by an excess of sub-prime mortgage lending in the US and the subsequent mispricing of bond risk associated with it.

Most Georgist economists reckon real estate cycles take about 18 years to get from one trough to the next, so if the OECD thinks real estates are already in danger territory, this would look like one of the shortest real estate cycles in history.

Strange too is the data upon which the OECD bases its assertions. In the absence of widespread land price data, they are using house price data instead. Distinguishing between the

two may seem like semantics, but it is nonetheless important.

Hoyt drew the conclusion that it was speculation in land and the willingness of financial institutions to lend at scale on the back of it that was at the root of the economic problems in the US in the late 19<sup>th</sup> and early 20<sup>th</sup> century.

The OECD is not looking at levels of speculative purchase, development and lending in land markets, but rather the levels of recent growth in housing markets and overall pricing of housing in relation to incomes. This is subtly different and, although excessive mortgage lending and speculation in housing has caused economic malaise in the past, there is insufficient evidence it was a widespread issue across all the OECD nations in the recent cycle.

For example, in the UK at present, development land prices are still well below their 2008 peak, having dropped by about a third after 2008 and barely exceeding their millennium level in real terms.

House prices in the UK have only just regained their 2008 levels in real terms – unlike, say, Germany's which are now 22% above their 2008 levels. What the OECD sees as significant is average owner-occupied house prices as a multiple of average earnings. This, it thinks, is a measure of how 'overheated' real estate

markets have become in different countries.

Ironically, however, in many countries this very high multiple is the result of excessive lender prudence rather than profligate land speculation and lending of the type that Hoyt associated with economic crashes.

Because lending is constrained and limited in so many countries, the only people able to participate in real estate markets are the cash rich. Mortgage funds, lending and homebuying activity remain at record low levels in many jurisdictions.

The OECD is not only missing the indicators of a dangerous bubble, but probably measuring the symptoms or consequences of exactly the opposite phenomenon: undersupply and insufficient credit and liquidity.

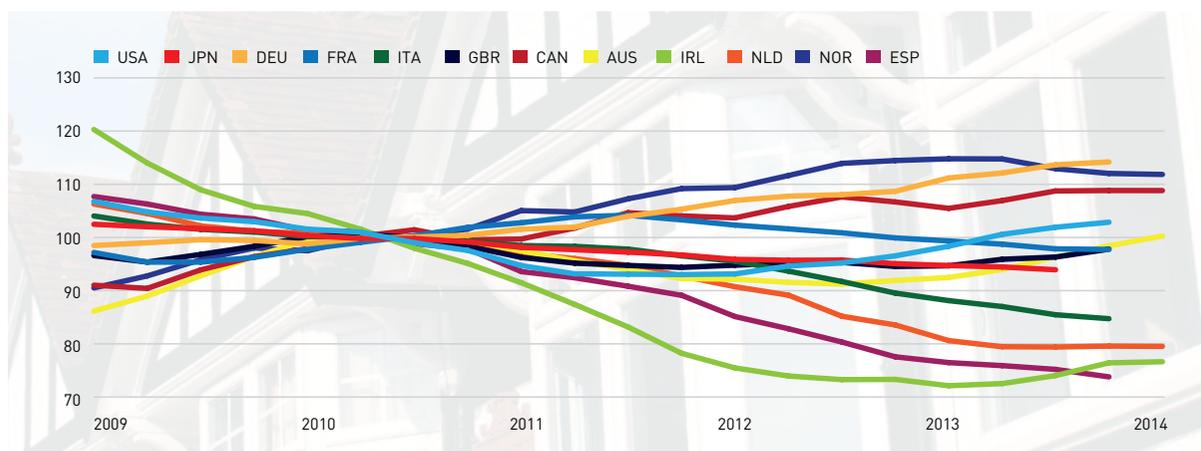
While the US, Ireland and Spain were notable instances of classic housing and land price bubbles during the early 2000s, it is the economic consequences of these countries mistakes with which most of the Western world is now dealing. Other OECD countries seem to have suffered more from the financial aftermath of the US and the world financial crises than a land price cycle of their own.

Recent OECD warnings have gone out to countries as diverse as Norway, New Zealand and the UK, on the basis of price growth or house price-to-income ratio data. Using either as a measure of a land price bubble misses the real dangers of world real estate markets today: namely, the disenfranchisement of the millennial generation and the, sometimes dire supply shortage of decent, affordable rental housing.

The sociopolitical consequences of these may make the prospect of a mere boom-bust economic cycle seem much easier to politicians and policymakers by comparison. ■

## Real house prices since 2009: little sign of a speculative boom – even in the highest growth countries

Source: OECD. Data from Q1 2009 to Q1 2014, seasonally adjusted, index rebased in 2010



Yolande Barnes has worked at Savills since the late 1980s, analysing and commenting on UK real estate for three decades.

## INVESCO PERPETUAL'S IDEAS

## FIRST YEAR OF PERFORMANCE

While the Invesco Perpetual Global Targeted Returns Fund has enjoyed a strong debut year in terms of both its risk and return targets, resting on their laurels is the last thing on the portfolio team's mind.



**To meet our targets, we are judging every single idea on a two- to three-year investment horizon, constantly scanning across asset classes and geographies for new ideas**



Product Director Georgina Taylor says while the team is pleased with how the first year has gone, the challenge is ongoing.

'We are only one year into our rolling three years of performance and volatility targets,' she says.

'The next year is going to be full of challenges: when will interest rates start rising and how will markets react? Can volatility stay this low? Can the European Central Bank defeat deflation? Is Japan's recovery for real? No-one has the answers, but we believe each idea in the fund's portfolio has the potential to provide a positive return over the next two to three years.'

#### A defined strategy

David Millar, Head of Multi Asset at Invesco Perpetual, highlights getting a defined process and philosophy in place early as a key part of the team's success.

'In difficult investment conditions, process can keep you on track,' he says. 'To meet our targets, we are judging every single idea on a two- to three-year investment horizon,

constantly scanning across asset classes and geographies for new ideas. It is a lesson we thought we knew, but definitely one we have been reminded about through some difficult market conditions in our first year.'

Obviously, there are no guarantees of the fund's targets, but it seeks a gross return of 3-month Libor plus 5% over a rolling, three-year period with less than half the volatility of global equities. The fund was on track for both of these targets over its first 12 months, keeping pace with global equities, but limiting the downside amid some sentiment-driven sell-offs.

Taylor says having a number of ideas across a variety of asset types and geographies has been vital: from 22 ideas at launch, the team has 26 in place at the end of October, and around two-thirds of these have contributed positively to performance.

'At an asset class level, it has been difficult to establish where there is value in equities or bonds, for example, but if you go one layer beneath the surface, we can find anomalies and opportunities in one market versus another or even within the same market,' she adds.

'Very few investors would have thought a year ago that buying bonds would have been a good idea. Everyone was focusing on the risks, but when we looked at certain parts of the market, we realised 30-year bonds were pricing in a very typical economic recovery and we are in anything but that.'

#### Bond exposure

Having some bond duration within the fund has therefore been positive for performance, as has select equity exposure in Asia, for example.

'With equities in aggregate, people are starting to say they look expensive, but, for us, it is not about the asset class, but rather which markets within it are offering opportunities,' adds Taylor.

Millar says a 'lower for longer' bond yields argument has consistently been part of the team's central economic thesis, against which each idea is judged.

'I have referred to our central thesis for some months as cautious optimism and one of the key points

## FUND VOLATILITY

# 3.45%

## MSCI WORLD VOLATILITY

# 10.00%

**INVESCO PERPETUAL'S IDEAS**

was a view that the interest rate cycle would be longer and more drawn out than many believed, and inflation would stay under control and, if anything, there was potential for the deflation scares we have now seen in Europe,' he adds.

'Now, we are keeping a close eye on how much good news is priced into risk assets and that is a constant debate within the team. Some of our volatility ideas have not worked so far, but if you look at it on a two- to three-year view, the same central banks that have been responsible for suppressing volatility across asset classes may ultimately cause it to return when interest rate cycles change.'

**Volatility plays**

Taylor says that although the volatility plays struggled during the first year, the team is confident levels will normalize, and having these more defensive ideas in place has allowed the fund managers to take risk elsewhere.

'Looking at where equity volatility is today, we would say that under-represents some of the risk over the next few years and spikes in volatility like we saw in October are a good reminder of this,' she adds.

'We are entering a period where there are a number of policy changes ahead, and that is something we have not had to deal with post-financial crisis. One theme running through markets at present is interest rate policy: what are central banks doing around the world now they are no longer coordinated. In the crisis, they were cutting interest rates together and then trying to increase them together. Now they are firing in different directions, and that is providing great opportunities, particularly at currency level.'

**Real vs peso**

Taylor says identifying how best to implement ideas is as important as the ideas themselves, and currency positions have proved a major performance driver over the first year.

A standout performer for the portfolio has been pairing a long position in the Brazilian real with a short position in the Chilean peso.

'If we go back 18 months to when we started looking at building a portfolio, we were not keen on emerging markets at all, largely due to policy risk,' says Taylor.

'But while that was our core view, we are always keen to look beyond that in order to find opportunities. Within emerging markets, we saw Brazil and Chile firing on very different cylinders. In Brazil, inflation was high and it looked as though the country needed to start raising interest rates to get it under control. In Chile, meanwhile, growth was weakening and inflation was well below target, meaning the central bank could potentially turn to rate cuts.'

With that in mind, the team put the pair trade idea in place and benefitted as its expectations of policy divergence came to pass, with Brazil raising interest rates and Chile cutting them.

'After a year, we have taken this idea out of the portfolio as we feel the drivers are potentially changing, particularly with the Brazilian election results,' says Taylor.

'This is a good example of an idea where if we had just followed our core view, where we were nervous on emerging markets, we would have ignored a major opportunity.'

Millar stresses that ideas do not have to be complex to find a place in the portfolio and many are fairly traditional equity plays.

'Having a core allocation to equities as they have reached new highs has been incredibly important,' he says.

'Our favoured market has been Asia, which has done well since the turn of the year, and we also see a valuation opportunity in the UK. We think it is one of the cheapest markets, so one of our ideas is as straightforward as having a holding in UK equities via a couple of Invesco Perpetual funds.' ■

**Invesco Perpetual Global Targeted Returns Fund performance since launch**

Source: Lipper, data from 9 September 2013 to 30 October 2014



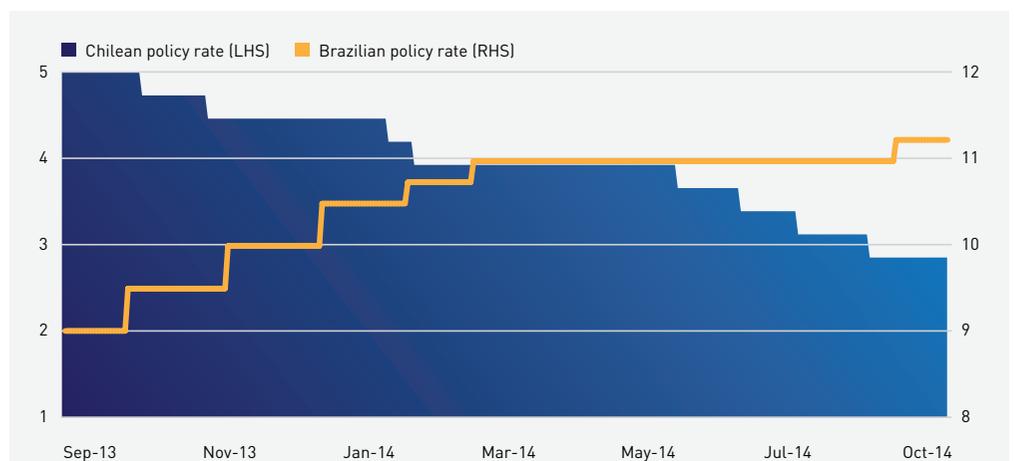
**The Brazilian real/Chilean peso idea was removed in September 2014**

Source: Bloomberg, as at 30 October 2014



**Rising interest rates in Brazil and falling rates in Chile supported the real vs peso**

Source: Bloomberg, as at 30 October 2014



## INVESCO PERPETUAL'S IDEAS

# ABENOMICS AND JAPAN: A THATCHERITE-STYLE REVOLUTION

Following a research trip to Japan, Multi Asset fund manager Richard Batty was wary about the possible success of Abenomics, however the team found an idea in the bond markets that should work in a number of different scenarios.

Japan is likely to undergo a transformational shift as a nation if Abenomics succeeds in its aims of reforming, modernising and globalising the economy and, eventually, reversing the 'shrinking mindset' engrained within the nation. This may sound like a grand statement, however, the proposed scale of both the economic and social reforms must be the largest ever of any democratic nation outside an immediate post-war period.

'Speaking to politicians and policy makers, it was clear many have a reformist zeal akin to that of Margaret Thatcher and her followers seen in the UK in the late 1970s/early 1980s. In contrast to the UK 35 years ago, Japan's inclusiveness as a nation – similar to, say, Sweden's or Switzerland's – seems, at first glance, to be helping marshal the changes in the country,' says Batty.

In addition, Prime Minister Shinzo Abe appears to enjoy significant continued support: a Jiji Press opinion poll showed public approval of his cabinet running at around 60% in June.

Officials believe the economy can stay on track after the consumption tax hike. The Bank of Japan's (BoJ) argument is with markets, not the government. Policy remains growth, inflation and profit-friendly by any measure and relatively activist in comparison with Western governments.

'The problem lies in that by having accomplished the achievable, everything left over is less achievable. This exposes the issues where internal divisions cannot be papered over and the targets that lack

credibility. Both are ammunition for die-hard Japan sceptics,' adds Batty.

The policy pitch is now for measures to facilitate a more bottom-up improvement in corporate profits and investment. What equity multiple do you put on a corporate tax cut?

The bottom line is everyone's biases are reinforced. Those looking for a revolution to avoid a negative endgame will likely be disappointed. Those happy with an evolutionary shift from bad to less bad can draw comfort from moving more in the right than the wrong direction. In the end, however, the 'right' direction may not be enough to overcome the huge obstacles needed to change Japan for the better.

Given what we already know and how much policy detail and actions have happened, making a call on Japan is fraught with danger in the years ahead. To that extent, the 'modestly successful' outcome appears priced in: USD/JPY up, stockmarket up and Japanese government bond (JGB) yields down on BoJ policy action.

'Ironically though, and as demonstrated at the end of September when the announcement of extra stimulus surprised markets, it's the potential for short-term failure of policies that may actually be a better catalyst for financial markets. The BoJ will feel forced to step in again with further quantitative and qualitative easing (QQE) and expansionary policies to weaken the yen,' says Batty.

The Multi Asset team decided that a safer way to play the Japan theme was through the interest rate market, taking advantage of the steepness in the long-dated yield curve.



**Speaking to politicians and policy makers, it was clear many have a reformist zeal akin to that of Margaret Thatcher and her followers seen in the UK in the late 1970s/early 1980s. In contrast to the UK 35 years ago, Japan's inclusiveness as a nation – similar to, say, Sweden's or Switzerland's – seems, at first glance, to be helping marshal the changes in the country**



'It is very much a standalone idea that the Japanese yield curve will flatten. The difference between the 10-year bond and the 20-year bond is very steep and you could think of a number of different scenarios why that curve should flatten,' says Millar.

**The team believes the super-steep curve could flatten under a number of possible scenarios including:**

- 1. Abenomics is successful and BoJ taper causes the front end of the curve to sell off more than the back end.**
- 2. Abenomics is mildly successful causing BoJ to halt QQE, causing 10-year yields to drift up quicker than 20-year yields.**
- 3. Abenomics is unsuccessful and BoJ is forced to buy bonds further out the yield curve (as the low level of 10-year yields means buying them would have limited monetary impact on growth).**

It implements the idea through buying the 10-year interest swap in 10 years' time and selling the 10-year interest rate swap, and will therefore profit if the difference between the two narrows over time. ■

# PUTTING FAITH IN US GROWTH DYNAMICS

Invesco Perpetual's Multi Asset team believes the long-term growth outlook in the US looks rosier than in Europe and this will be reflected in the exchange rate.

Currency ideas have played an important role in the construction of the Invesco Perpetual Global Targeted Returns Fund, but Georgina Taylor, Product Director, explains it is not just the economics and valuations that play a part.

'One of the more recent ideas that has gone into the portfolio is buying the US dollar versus the euro and, I think, this is quite an interesting one for showing how we don't just purely focus on the economics or even valuations,' she says.

Looking at the euro, the economics have been in place for the euro to weaken for quite a long time. It has been fairly obvious that the eurozone area has had weaker economic growth and that authorities there had not grabbed the nettle in quite the same way as the US or even the UK when charged with fighting off the last financial crisis.

However, the performance of the euro has not reflected this. 'If you look at what the euro was doing last year, it was actually strengthening, it was rising versus the US dollar and that was making no sense because the economics were all saying that the euro should be a lot weaker,' says Taylor.

This made the team uncomfortable as although the euro looked expensive, it was not behaving as perhaps it should. 'We looked at the currency very closely last year, but the timing just wasn't right, as we simply didn't understand the dynamics.'

This year, the economics were again very much in place and the European Central Bank (ECB) was coming under increasing pressure to address lacklustre growth and deflation by using policy tools. However, despite an ECB interest rate cut at the end of 2013 and increasing speculation of quantitative easing, the euro continued to



strengthen in the early months of 2014.

'We felt that the economics were not driving the euro and did some other work, fund manager Dave Jubb in particular, who focuses on flows and behavioural indicators alongside all of his valuation work,' adds Taylor.

'We noticed that a couple of the drivers that really supported the euro last year were starting to change.'

The team saw that last year, a lot of overseas investors were investing in Europe and buying European assets, which meant there was a lot of demand for the euro as they needed to buy the currency to facilitate that.

'Also central banks, particularly in Asia, have been diversifying their currency holdings away from dollars over the last few years and the euro was a big part of that. So, again there was demand for the euro from that side as well,' explains Taylor.

However, at the beginning of this year, those indicators started to change so, demand for European assets started to roll over, not collapse, but just peter out a little bit and also flows from those central banks just started to level off.

'So, we put everything together and thought, the economics is there, the ECB is changing policy again, but



**One of the more recent ideas that has gone into the portfolio is buying the US dollar versus the euro and, I think, this is quite an interesting one for showing how we don't just purely focus on the economics or even valuations**



also those flows indicators, which had been supporting the euro last year are also starting to shift. So, back in the beginning of May, we decided to look at the exchange rate,' says Taylor.

At this time, the level was hovering around 1.40 US dollars to the euro and having understood better the previous drivers of the currency, and that things were possibly about to change, the team took this opportunity to add the idea to the portfolio.

'And it's been working very well, so well, in fact, that we have had to review the idea regularly to make sure our targets are still justifiable in terms of the returns we expect. However, it's a very good example, I think, of an idea not just being about the economics, there are other factors at play when you think about the drivers of financial markets and we try and incorporate those as well,' concludes Taylor. ■

## INVESCO PERPETUAL'S IDEAS

# CROSSING ASSET CLASS BOUNDARIES

Volatility has been at depressed levels over the past few years, largely due to the extremely loose monetary policy of the leading central banks. The Invesco Perpetual Multi Asset team is confident that volatility will increase over its two- to three-year investment horizon and describes one idea that crosses the traditional asset class boundaries.

The Invesco Perpetual Global Targeted Returns Fund's volatility ideas have struggled to generate returns since launch but have proved invaluable to the balance and diversification within the portfolio.

'We do have some volatility ideas in this fund. They haven't delivered in the first year, but by having those ideas, they create balance for the fund and it means we can take risk elsewhere because those volatility ideas are typically slightly more defensive,' says Product Director, Georgina Taylor.

If the world is a more negative place than the team expects, volatility should start to rise and that could potentially offset some of the risk being taken in equities or in credit markets.

In addition, with global financial markets facing a period of potential change, in the shape of rising interest rates and divergent monetary policies globally, the future is increasingly unpredictable.

'Policy change, interest rate rises – we haven't had to deal with those for over half a decade, post-financial crisis – that is a fundamental change for markets we think could be a risk and could then start to come through in the shape of volatility,' says Taylor.

And volatility plays aren't in the portfolio simply for these 'just-in-case' scenarios: every single idea is reviewed at least once a quarter, and volatility ideas do not escape this scrutiny.

'Every single idea has to get reviewed at least once a quarter, and the macro thesis, which includes a view as to whether volatility

will return to markets, is reviewed monthly.

We fundamentally do believe that on our two- to three-year time horizon, there will be more



**In any traditional asset allocation approach to investing, would you even be able to have an expression of where you think volatility will go? The benefit of having an unconstrained agenda allows us to look at less traditional asset types such as volatility**



volatility in markets than has been experienced over the past 12 to 18 months,' adds head of Multi Asset, David Millar.

He says volatility ideas themselves are quite interesting because it goes back to having an unconstrained research agenda: 'In any traditional asset allocation approach to investing, would you even be able to have an expression of where you think volatility will go? The benefit of having an unconstrained agenda allows us to look at less traditional asset types such as volatility.'

Indeed, volatility allows the team even greater flexibility than traditional balanced portfolios as the team is able to take views on how volatility may move across different asset types. One idea in the portfolio pairs a long position in UK equity volatility with a short position in UK interest rates volatility.

This idea in particular crosses those asset class boundaries further because it is an idea where the team is looking at the differences or the potential move between the volatility in two different asset classes.

'Now, there is a common thread,' says Millar. 'There always has to be a theme, there always has to be an idea, which we're expressing here.'

The idea looks to take advantage of the currently very low difference between the volatility in UK equities and UK interest rates. Recent tapering and rates normalisation fears in the UK, and in the rest of the world, have left interest rate volatility at reasonably high levels. Equity volatility on the other hand has stayed low, even after the blip in October.

Millar says: 'If you look at a chart of where UK equity volatility is, we know it's very low and we look at the volatility of UK interest rate volatilities, more so in the forward space, and they are still fairly elevated.'

What Millar is keen to stress is that, ultimately, central banks have firm control of interest rates volatility, but not that of equities.

'Ultimately, central banks are able to directly control the interest rates market, but not equities. Equity markets will be driven by underlying profitability, which may not persist on our multi-year time horizon. It makes sense to take advantage of this situation,' concludes Millar. ■



**INVESCO PERPETUAL'S IDEAS**

# BEWARE THE LOW VOLATILITY TRAP

The implied level of volatility for equities and realised volatility across a number of asset types is currently incredibly low, writes Product Director Georgina Taylor. However, the low level of volatility is perhaps being driven by the supply-demand dynamics across asset classes, rather than an outright complacency by investors. Complacency is perhaps being revealed in preferences for credit and bond-like equities as investors search for income, but when we scratch beneath the surface, volatility is, in fact, already rising.

Since the global financial crisis, central banks have had to introduce extraordinary measures to prop up the global economy. There are intended and unintended consequences to these actions. The intended consequences are centred on the avoidance (or attempted avoidance) of another broad-based recession around the world. The unintended consequences are related to the misallocation of resources and a potential complacency based on the belief that central banks around the world will provide a backstop for financial markets. The misallocation of resources is arguably underway and has been for some time. Because central banks have bought assets directly, primarily fixed income, the supply of yield assets has in effect decreased. This increase in demand has forced

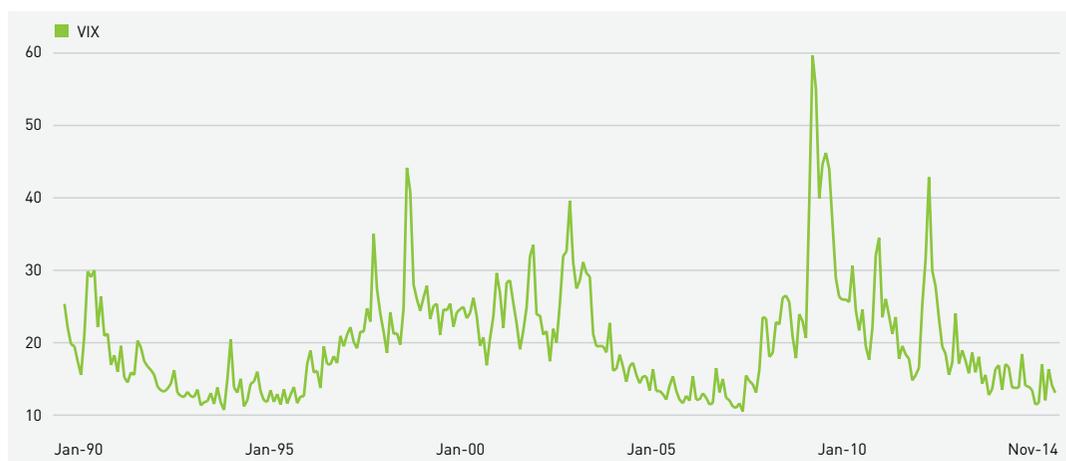
global bond yields to very low levels. Investors who need to hold fixed income assets have been forced to accept an incredibly low level of yield on their investments. Another unintended consequence of central bank action is complacency, an important driver of investor behaviour. It has been argued that complacency over central bank actions is being reflected in the low levels of volatility we can observe across financial markets. The volatility index VIX reflects the implied level of 30-day volatility for the US options market, based on call and put options on the S&P 500 index. If the VIX index starts to rise, it reflects a belief by investors that volatility going forward is going to rise because it shows an increase in the market price of volatility, implied by the equity options



**It has been argued that complacency over central bank actions is being reflected in the low levels of volatility we can observe across financial markets**

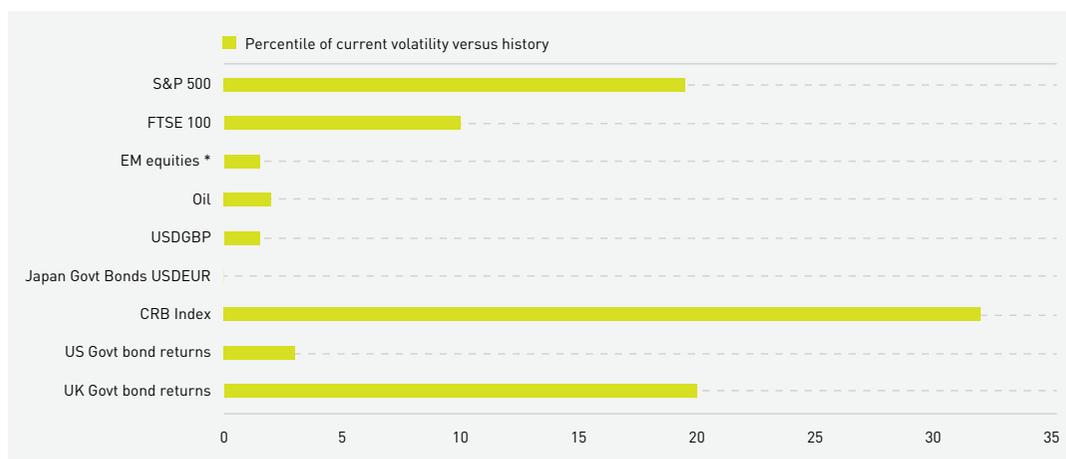


**Figure 1: 30-day implied volatility of S&P 500 index** Source: Bloomberg, as of 13 November 2014



**Figure 2: Percentile of realised volatility January 1990 to 26 October 2014**

Source: Thomson Datastream, as of 26 October 2014. \* Datastream Emerging Market index



market. The VIX is currently very low as shown in figure 1, despite a spike in October. However, this is a very near-term measure of volatility, and implied volatility markets themselves are impacted by investors' search for yield. Because yields are so low in traditional fixed income markets, investors are searching for income from alternative instruments. This is particularly prevalent in Asia, where structured products have been created, and ultimately means the local investor base is selling volatility by selling options. This increased supply of options is pushing the 'price' of volatility lower and lower, which is showing at the aggregate index level for Asian equity indices. Given some of these distortions, it may be better to focus on what we can ascertain from realised volatility – the actual standard deviation of asset class returns over the past few years. On this basis volatility also looks very low. But, importantly, it shows that the current level of realised volatility is not unprecedented. Realised volatility was at a similar level during the early to mid-1990s and pre-crisis from 2004-06 – two periods of time when interest rates were rising, not falling, so a very different monetary policy backdrop to today. However, what is different is that realised volatility is currently low across a number of different asset types. In figure 2 we show the percentile of realised volatility relative to the period January 1990 to 26 October 2014. This shows that across these 10 different asset types, volatility is in, or very close to, the bottom quartile for all of them, based on one-year volatility using weekly data. For oil, the USDGBP and USDEUR currency rate, and for Japanese government bonds, the level of one-year realised volatility is the lowest it has been since 1990.



**INVESCO PERPETUAL'S IDEAS****Q&A**

WE'VE PUT YOUR TOP QUESTIONS ABOUT THE INVESCO PERPETUAL GLOBAL TARGETED RETURNS FUND TO

**GEORGINA TAYLOR,**

PRODUCT DIRECTOR FOR THE MULTI ASSET TEAM AT INVESCO PERPETUAL.

**MARK ROGERS**

Managing director, Clay Rogers & Partners

**Q) In light of flat equity markets over the past year and significant geopolitical volatility, has the one-year performance met your expectations?**

The first year of the fund has been relatively challenging. Markets have been faced with a number of issues, from geopolitical turmoil to concerns over policy changes by central banks around the world. We are pleased with performance over the first year given those challenges, and feel that even though it is a short time frame relative to our three-year rolling measurement period, we have managed to deliver in excess of three-month Libor plus 5%, with less than half the volatility of global equities\*. In particular, we have managed to go relatively sideways when equities have fallen because we have worked hard to try and get the right blend of ideas which can cope if market dynamics change over the short term. We believe all of our ideas have the potential to generate positive returns over our two- to three-year time horizon, but it is important to have a mix of defensive as well as risk-on ideas selected from across a range of different asset types to cope with short-term changes in market dynamics.

**IAN BROOKES**

Financial planner, Critchleys

**Q) How successful or not have the fund managers been in managing currency risk over the past 12 months, particularly in relation to the US dollar and Japanese yen?**

We automatically hedge all of our positions back to sterling, unless we want to take an active view on a particular currency. We currently have two ideas where we have a long view on the US dollar: versus the euro and the Canadian dollar. These two ideas have contributed positively to fund performance in the first year.

In relation to the Japanese yen, we had an active view in the portfolio for the first eight months of the life of the fund. We did not have an outright negative view, which in hindsight would have worked very well. But we did implement a view through options, which benefitted from the yen weakening and contributed positively to fund performance until we removed it from the fund in May.



**We currently have two ideas where we have a long view on the US dollar: versus the euro and the Canadian dollar**



\*These targets are not guaranteed.

## INVESCO PERPETUAL'S IDEAS

**CARL LAMB**

Managing director, Almary Green Investments

**Q) The fund has performed well during the first 12 months in absolute and relative terms. Has it been advantageous to start with a clean slate, and now that the fund has been running for 12 months, do you still feel that you have sufficient ideas to continue this good performance?**

I think the biggest benefit of starting with a clean slate is reviewing the process and ensuring we had everything in place to run the Invesco Perpetual Global Targeted Returns Fund in the most efficient way for our clients. In terms of the portfolio, it is always a good discipline to step back and take a fresh look at markets and we certainly took that opportunity last year.

The majority of ideas are still in the portfolio that we launched with and we expect a number of them to be in the portfolio for quite a long time to come. We are constantly studying financial markets and talking to colleagues here in Henley and in Invesco's global network in the search for new ideas. We also have a number of investment banks and research boutiques who will contact us regularly suggesting new ideas for the fund. If we believe an idea has legs, one of the team will present it at our monthly ideas meeting. We probably discuss about seven or eight new ideas each month, so we certainly don't feel that we are struggling to find new ideas for the fund.

**Q) The level of volatility displayed by the fund has been higher than those of several peers within the IMA Targeted Absolute Return sector. Why has the volatility been at this level and what controls do you employ to ensure it is kept within target levels?**

We have an explicit volatility target. We aim for the fund to have less than half the volatility of global equities (as measured by the MSCI World index) over a rolling, three-year period\*. It is still early days, but at the end of the first year, for example, the fund's one-year realised volatility was 3.31%, comfortably less than half the realised volatility of the MSCI World index over the same period, which measured 9.10%. Risk management is an essential part of our fund management process and Gwilym Satchell, the team's risk manager, is an important member of the investment team. Each month we publish the independent risk numbers for each idea and also the expected risk

of the portfolio when the ideas are combined – it is important that the total independent risk (we target between two-thirds and four-thirds of global equity risk) is sufficient to achieve the targeted return and the expected fund risk is less than half that of global equities. The difference between the two is the diversification benefit of the different ideas working together. These risk levels are tested on a daily basis and whenever a new idea is considered for the portfolio, it will have its risk assessed both individually and in combination with the ideas that are already in the fund.

**DAVID MITCHELL**

Head of wealth management, Astute Financial Management

**Q) According to FE Analytics, your correlation with other competitor funds was surprisingly low (around 0.4). Can we expect the fund to continue to offer significant diversification away from other similar funds?**

A number of different funds have similar targets based on returns and volatility. However, all of these funds are taking a slightly different approach to achieving these outcomes. Some funds will look at asset classes, some will focus on strategies and because of this the themes and ideas expressed will be different. Importantly, implementation within these funds will also be different, so their sources of return should remain uncorrelated.



# Q & A

**LEE FISHER**

Director, Burton &amp; Fisher Financial Services

**Q) How do the fund managers plan to navigate through what is expected to be a difficult and volatile upcoming year, especially with the recent global sell-off in equities and continuing unrest in the Middle East, Ukraine and Africa?**

Flexibility is key to being able to navigate difficult market conditions. It is also why we don't think about the world in asset classes because sometimes it is difficult to take a very directional view on equities, bonds and commodities. Instead, our unconstrained approach means we can pinpoint other opportunities within and across asset classes. So, we can look at one equity index versus another, one currency versus another, or one bond market versus another bond market, or, we can look within the same market and take positions that express views on, for example, how a yield curve may develop. This is critical for being able to deliver consistent returns even against a challenging market backdrop. Volatility is also incredibly important. We can implement ideas, which take a view on volatility rising in particular markets going forward, which is very helpful if we go through a volatile period for financial markets.

\*These targets are not guaranteed.

**ANALYSIS BY** *cityWire*

# HARNESSING VOLATILITY

Citywire examines how investor views of volatility are changing as it continues to develop as an asset class in its own right.

**O**f many misconceptions about investing, the idea risk and volatility are essentially synonymous is among the most damaging – at least when it comes to people committing capital to markets for the long term.

For most professional investors, some volatility is to be embraced, as without it there would be very little profit opportunity in markets.

Writing back in 2007, economic commentator James K. Glassman said: 'Imagine a world in which stock investments performed the same year after year. A stock would be like a certificate of deposit. It would have no volatility – except for the effects of inflation – but it wouldn't put much money in your pocket either. Stocks have returned an annual average of more than 10% over the past 80 years because they are volatile. To put it another way: a higher return is your reward for investing in a riskier asset.'

Coming back to basic descriptions, the volatility of an investment is defined as the standard deviation of its returns over a certain period of time; risk, on the other hand, is essentially

the potential for permanent capital loss.

Mistaking periodic bouts of volatility to mean an immediate rise in risk can often lead to some very poor decisions.

Volatility is what basically drives markets up or down, and the higher the level, the greater the profit opportunity for investors able to harness it.

Conversely, when there is little or no volatility, there tends to be little profit opportunity and markets tend to drift sideways.

This has not been the case more recently, with many equity markets around the world hitting fresh highs during a period of low volatility (before a spike in October). But this has been one of many norms subverted post-credit crunch, with loose monetary policy playing a key role in keeping volatility depressed and driving equities higher.

Perhaps a more useful way of defining risk in an investment context is unmanaged volatility – if harnessed and made to work for you, volatility can provide another source of alpha.

When it comes to limiting the downside, managing volatility is often as simple as identifying

potential issues and finding ways to offset them: some investors use stop-losses, for example, ending a trade automatically at a certain point if it goes against them.

## Ways to benefit

But there are also ways to profit from volatility.

On the simple side, this typically involves finding a good stock-picking investment manager and there are many ways of identifying these.

We discussed a number of risk measures in the previous edition of *New Frontiers*, but another one to throw into the mix is active share, which basically shows how much stock-specific risk an investment manager is taking.

Meanwhile, there are also a growing number of funds – Invesco Perpetual's Global Targeted Returns among them – looking to invest in volatility as an asset type in its own right.

This is an obvious example of fund managers starting to break away from traditional asset allocation restraints in the hunt for better risk-adjusted returns.

Investing in volatility can also be a useful tool for diversification, particularly with bond markets not necessarily providing the uncorrelated returns they have done in the past. Somewhat counter-intuitively, investing in volatility can help

ANALYSIS BY **cityWire**

reduce your overall portfolio volatility.

This is because volatility behaves independently of underlying asset prices – a valuable characteristic amid the spikes in correlation that have characterised recent years.

As highlighted earlier, the Invesco Perpetual Multi Asset team's volatility ideas have been among the weaker performers over the fund's debut year as loose monetary policy globally has kept levels low.

But with the recent spike and signs of a return to more normalised levels, there should be opportunities over the coming years.

An example from the Invesco Perpetual Global Targeted Returns Fund highlights the principles of investing in volatility.

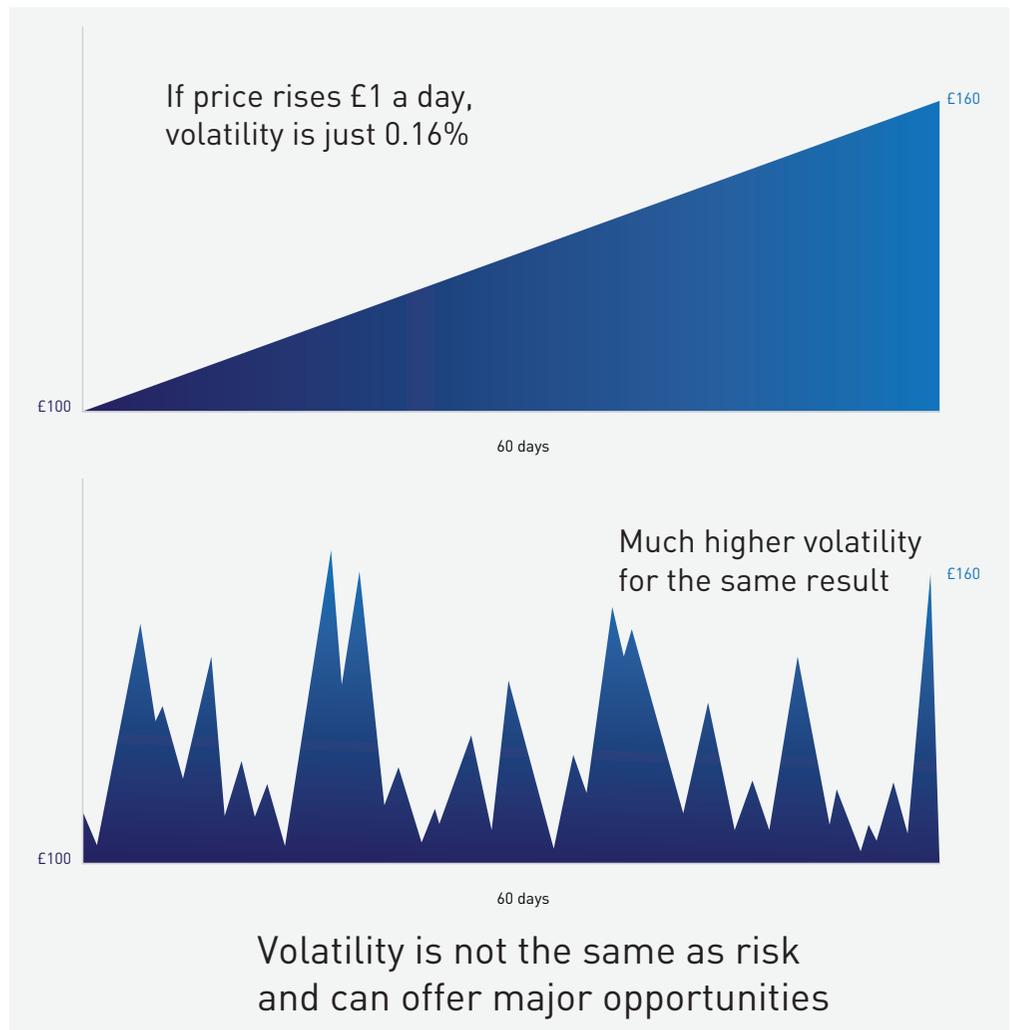
One idea has been to exploit what the team sees as the cheap volatility of the Australian dollar versus its US counterpart.

According to fund manager Dave Jubb, the idea has its roots in the idea that the US dollar is naturally a less volatile currency than the Australian dollar, with the latter being commodity-dependent and also serving a much smaller economy.

Jubb believes this has not been reflected in pricing, with the volatility of the Australian dollar only at a small premium to that of the greenback.

To exploit this, the team bought the volatility of the Australian dollar and sold volatility of the US dollar.

Provided managers have the expertise and remit to find such opportunities, there are many ways to harness volatility that could potentially boost returns.



## DEFINING VOLATILITY

There are two types of volatility to consider, statistical/historical and implied.

The first of these is calculated by determining the average deviation from the average price of a financial instrument over the given time period and standard deviation is the most common way of expressing this.

Statistical volatility is a simple descriptive measure, but the assumptions underlying it form the basis of implied volatility, a predictive measure. In short, implied volatility is a calculation based on what has been happening to the underlying asset recently, and what is projected for the near term.

From an investment perspective, there are some major weaknesses in using statistical volatility when it comes to predicting price movements.

Think about a stock priced at £100, where volatility over the next 60 days is going to be close to 0% per annum.

At the end of that period, few people would expect that company to be trading at £160, but if the price rises by £1 a day, it is exactly where we end up. In such a case, the volatility measure would be 0.16%.

However, another company could go through that same £100 to £160 journey with much greater ups and downs on the way, and the 'volatility' of that would be much higher, despite the end investor getting the same result.

What this shows is that statistical volatility of a stock is not directly related to the increase or decrease in price, but only to the amount of daily variation in that price – and is therefore a poor indicator of risk as most investors would describe it.

**ADVISERS' VIEWS BY** *cityWire*



# Adviser views: coping with volatility spikes

**ANDREW MERRICKS**  
Head of investments, Skerritts



The low volatility environment this year led to many lamenting 'the death of volatility', but its sudden return in October has stirred the markets.

Both the CBOE volatility index (VIX), which measures the implied volatility of the S&P 500, and the EuroStoxx 50 Volatility (Vstoxx) reached their highest point in the past year in October, hitting a level not seen since 2012.

This change in backdrop poses a challenge to investors, who need their asset allocations to work in different market environments. Here, some leading financial advisers share their views on volatility and its effect on their decisions.

Andrew Merricks believes a conglomeration of events led to the recent hike in volatility.

He illustrates this with an analogy: 'You're driving along the motorway and the traffic comes to a halt for no reason. You only need one person to set off a chain of events – they could drive into the wrong lane or make a wrong turn – that slows everything down. Then you stop, you reset, and then you get momentum.'

He points out that investors tend to look for returns whenever there is a dip in the markets, but the dips have been shallower lately in the low interest rate environment.

Merricks sees similarities between the current environment and the 1990s.

'For the first time since the 1990s, I have invested in a couple of American funds – there are very strong similarities between the late 1990s and today,' he says.

'In the late 1990s, the US was the market to be in. Now, with the development of shale gas and lower dependency on Middle

Eastern oil, the economy is stronger than it has been in many years, and that means the dollar could strengthen.'

The shift in focus to the US has been at the expense of Europe and emerging markets, he adds.

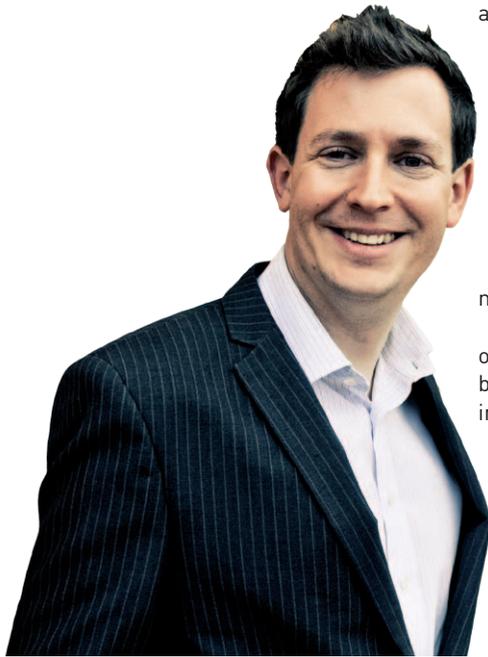
Merricks hopes volatility is here to stay for the longer term, pointing to a number of potential risks, including the upcoming UK general election.

'I expect volatility to increase within the UK market,' he says. 'On the European side, we have potential splits coming up due to the Greek election: we could have an issue raise its head again in Europe.'

Overall, Merricks' view is tentative. Although he sees positive movement from company fundamentals, he thinks investors should always have one eye on worst-case scenarios.

'You'd be mad to think about things with confidence, with the number of risks out there,' he says, pointing out the stand-off between protesters and the Chinese government in Hong Kong as an example.

'This risk hasn't really come onto the radar but it could erupt quite quickly if Chinese authorities overreact,' he adds.

ADVISERS' VIEWS BY **cityWire****MIKE DEVERELL**Investment manager,  
Equilibrium Asset Management

Mike Deverell says the very long period of very low volatility was unusual.

However, he believes there is a 10% correction in the markets in most calendar years, so there will always be some volatility.

He believes newly returned volatility may carry on for a little while, but markets will likely find some comfort and settle down.

In the meantime, Deverell says investors should be making use of the volatile environment. 'You make volatility into an opportunity: you should be buying when markets are lower and selling when markets are higher,' he adds.

In terms of opportunities, he points to emerging markets.

'Emerging markets look really cheap relative to others. They started to do well, but have been coming back down since September. The current valuations in emerging markets are lower than in the US or Europe,' he says.

The low-volatility environment that ruled markets until the beginning of October coincided with an underweight to equities and a larger holding in cash in Equilibrium's client portfolios. In equities, this environment led Deverell to look to value-driven funds in areas like emerging markets.

A sizeable part of the portfolios is also in property funds, which Deverell says continued to deliver throughout the low volatility environment. ■



**You make volatility into an opportunity: you should be buying when markets are lower and selling when markets are higher**

**PETER LOWMAN**

Chief investment officer, Investment Quorum

Peter Lowman says the hike in volatility has been significant, however, in terms of the bigger picture, it is still not particularly high.

'If we look back to 2007, prior to the Lehman Brothers collapse and the credit crunch in the developed world, which overflowed to other markets, VIX spiked up to 80,' he says. 'More recently, it has been as low as 10. But over the past couple of months, it has been rising up to around 20: a 100% rise.'

Lowman points out myriad reasons for the hike in volatility, including the eurozone crisis along with the standoff between the European Central Bank and German Bundesbank over the former's suggested government bond-buying programme, and the unrest in Syria and Ukraine.

'The International Monetary Fund has lowered expectations for global growth and there are worries about China slowing. There is a lot of noise out there that has pushed the volatility rate up,' he adds.

'You get peaks and troughs, but once that noise starts to evaporate, the volatility will fall again. Once this happens, people start looking at fundamentals: for example, well over 60 companies in the US have announced better-than-expected results.'

He believes inflation remains a worry, but



volatility is likely to drop back in the next two months.

Once again, Lowman adds investors should take advantage of uncertain and volatile market environments.

'As investors we need to take advantage of it,' he says. 'As we have a longer-term view, at these troughs, we see opportunities to buy good-quality investments.' ■



**You get peaks and troughs, but once that noise starts to evaporate, the volatility will fall again.**

**COLIN LOW**

Managing director, Kingsfleet Wealth

Colin Low says it is impossible to predict where volatility will go next, but what really matters is diversification.

'We have no idea what the market is going to do: the market may double or halve, all we can do is diversify,' he says. 'If you'd asked anybody in the summer, no-one would have seen this coming.'

Low adds that the hike in volatility has not had a significant effect on Kingsfleet Wealth's client portfolios.

'This change isolated one or two managers who could have done better, but we had relatively small allocations to them. We need to have another close look at those funds,' he says.

In terms of possible asset allocation changes, he points out the need to look at what difference higher volatility makes and, also, the risk on each of the portfolios.

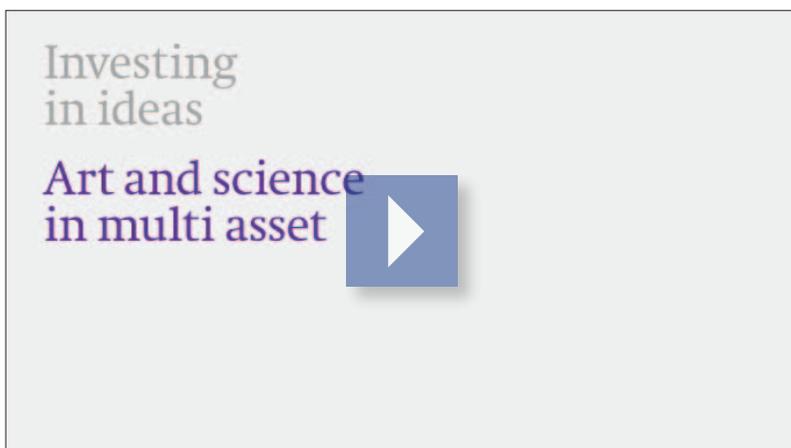
Low says his clients have not been disturbed by the recent news: 'So far we haven't had so much contact from clients, but I was concerned, so I sent out a little market update, thinking they must be worried. All I had back was: "Thanks very much, that's really helpful."'

'I had a client review meeting where the client admitted they were concerned, but their portfolio had gone down only a fraction, so they were quite relieved.' ■

**ONLINE LEARNING**

# FIND OUT MORE ABOUT OUR MULTI ASSET APPROACH

As part of Invesco Perpetual’s commitment to providing continuous professional development, we are offering online training to help you gain a greater understanding of our approach to multi asset investing, in particular, the Invesco Perpetual Global Targeted Returns Fund. We have put together four videos that take you through:



**Idea: Buy the USD versus the CAD**  
Research

Inputs	Thematic T	Economic E	Analytic A	Managers M
Multi Asset team	Initial justification for the idea - why it should work in our central economic scenario	Economic and corporate drivers that should make the idea work	Valuation metrics - industry standard and proprietary - to assess each idea	The views of Invesco asset class specialists when assessing potential ideas
Invesco Eats Chief Economist				
Chief Investment Officer challenge process				
Henley based fund managers				
	Favour the US dollar which in our view is a cheap defensive currency, relative to the Canadian Dollar which is a cyclical expensive commodity currency.	Growth in Canada is under pressure and the housing market is slowing. Canada is also sensitive to commodity prices which could weaken given growth risks in emerging markets.	The Canadian dollar looks expensive relative to the US dollar based on our valuation metrics. This investment idea should work well in the portfolio as the US/CAD has a negative correlation with risk assets such as equities.	Our Chief Economist John Greenwood is concerned about consumer leverage and the housing market in Canada. He expects weaker growth in Canada versus consensus.

Source: Invesco Perpetual as at 28 June 2013. For illustrative purposes only.

**Proposition basics** - includes exploring the target return and target volatility.

**Idea generation** - we look at what is meant by an idea and illustrate the concept with a number of examples.

**Ideas working together to reduce volatility**

Fund Ideas	Central	Equities rally	Equities fall
A Risk on	+1%	+3%	-1%
B Risk on	+1%	+3%	-1%
C Risk neutral	+1%	+1%	+1%
D Risk off	+1%	-1%	+3%
E Risk off	+1%	-1%	+3%
<b>Fund</b>	<b>+5%</b>	<b>+5%</b>	<b>+5%</b>

How might the ideas perform if the global economy grows more slowly than expected and equities fall?

For illustrative purposes only.



**Idea combination** - shows how ideas will work together in the fund and how they contribute to the fund’s return and volatility targets.

**Idea implementation** - how ideas can be implemented through direct or indirect investment.

**To view the videos go to: [www.invescopetperual.co.uk/GTRtraining](http://www.invescopetperual.co.uk/GTRtraining)**  
**Once you have viewed all four modules you will be able to complete the questionnaire and earn your CPD.**

**The key learning outcomes are:**

- The three key stages in our multi asset portfolio management process
- What is meant by an investment idea rather than an asset or an asset class
- How our ideas are combined to produce a risk managed portfolio
- How our ideas can be structured and implemented in the portfolio
- Our use of derivatives for risk reduction and efficient portfolio management

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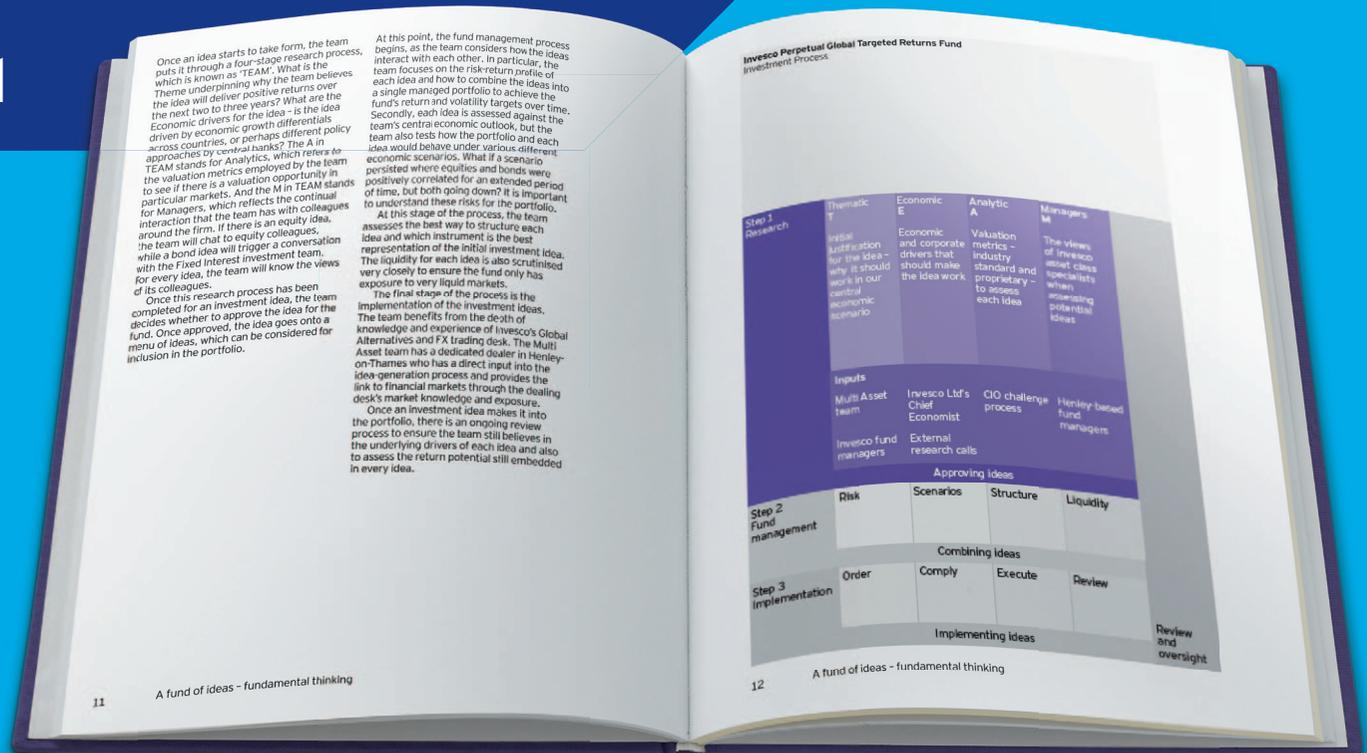
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