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5th Annual PortfolioConstruction Conference

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Pillars for building better quality investor portfolios...

Global investing in the new world

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PortfolioConstruction Conference 2006

Deutsche Asset Management
Deutsche Bank Group

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“Habit rules the unreflecting herd”

William Wordsworth

Agenda

- The place of emerging markets in global equity portfolios
- Are benchmarks still relevant?
- The world has changed – History has repeated itself

  - Why we cannot avoid emerging market companies
- An alternative way to invest globally in the new world

  - A thematic approach to the problem
- Conclusion

Emerging markets

- Stellar returns last few years

  2003 56%*

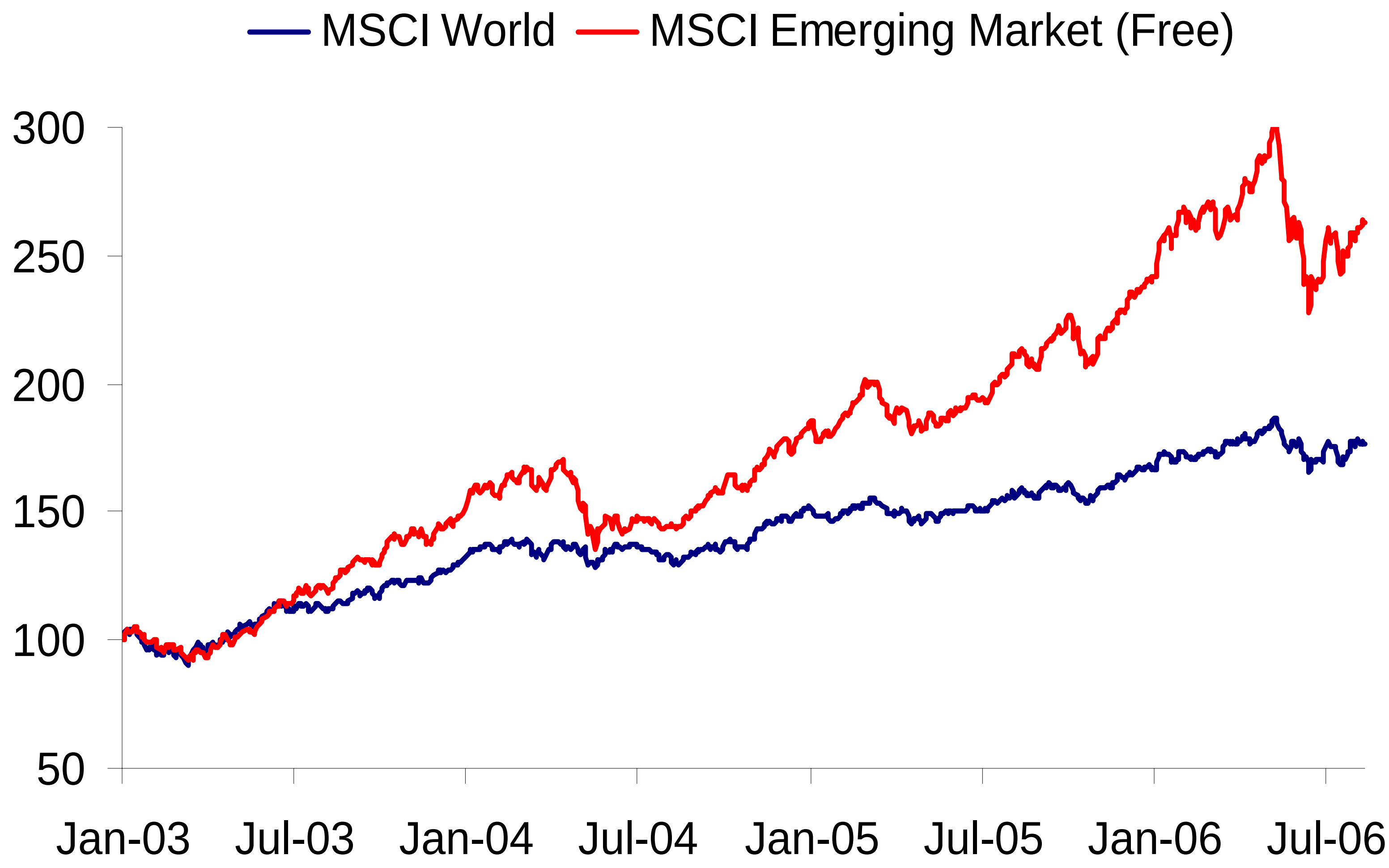
  2004 26%

  2005 35%

*US$ returns for years ending 31December for MSCI Emerging Markets (Free) Index

Source: MSCI

Common based returns from January 2003 (US$)



Source: MSCI and Bloomberg

Emerging markets

- Performance has produced a host of new products:

  Brazil

  Russia

  India

  China

- Market still under the influence of benchmarks despite all the academic work done on failings and shortcomings of Modern Portfolio Theory

"Has everyone constructed the wrong portfolio"

James Dick

- The Markowitz model is simply an observation between two points in time.
- It is not a dynamic model that can be used to predict from a real world starting point.

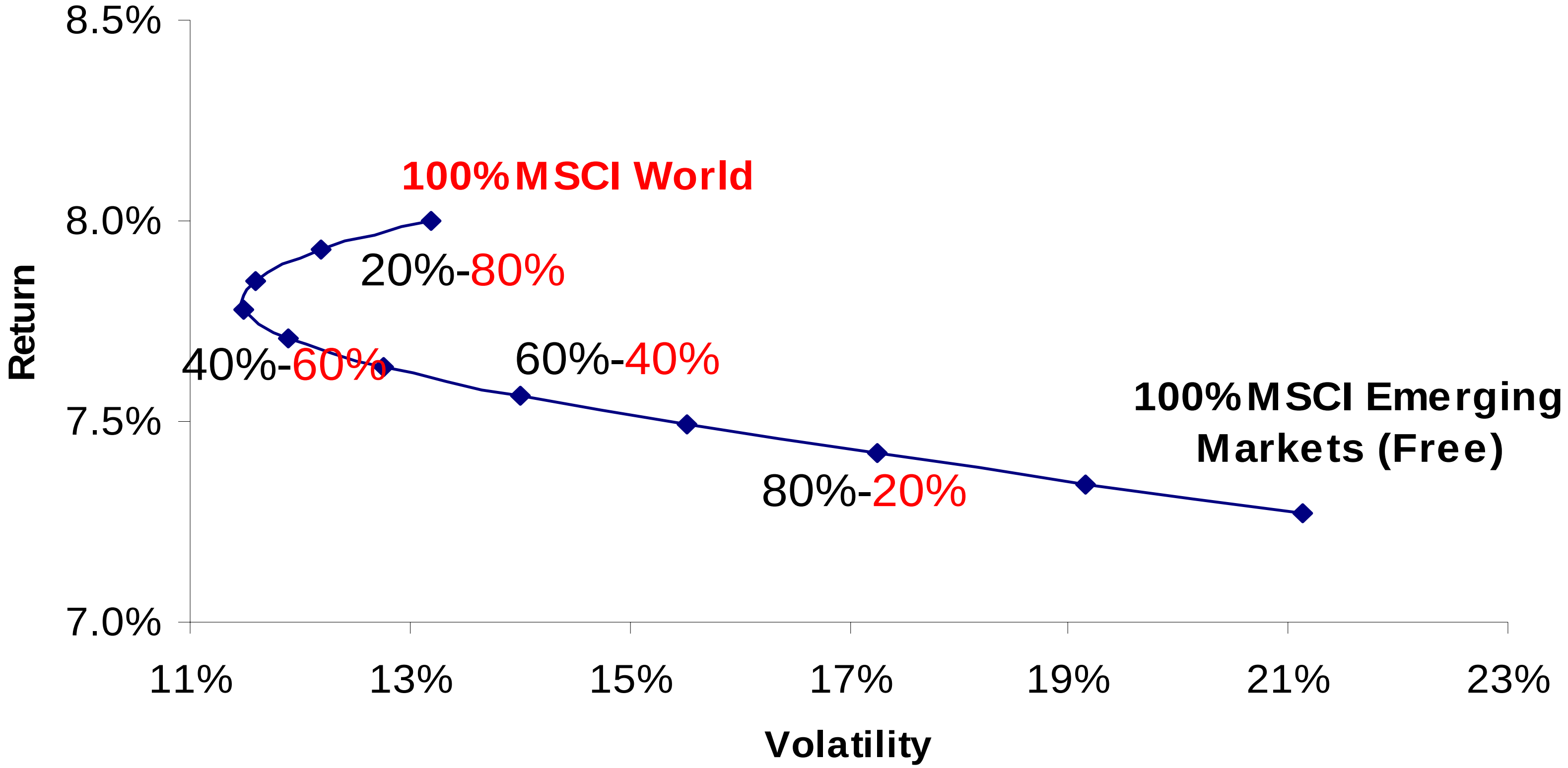
Emerging markets

- Performance has spurred new debate -

  How to invest in emerging markets?

- Is history our best guide?

10 year risk and return
MSCI Emerging Markets (Free) vs MSCI World Index
Annualised portfolio outcomes



Source : MSCI World Accumulation and MSCI Emerging Market (Free) Accumulation indices as at 30 June 2006 in Australian Dollars. Volatility is annualised standard deviation. All returns are annualised.

Are benchmarks still relevant?

- Most investors use the MSCI World index as the basis for constructing a global portfolio and for asset allocation between asset classes.
- This approach is flawed for a number of reasons

Are benchmarks still relevant?

Throughout history:

“Markets have emerged, submerged and re-emerged”

William Goetzmann, Yale University – Re-Emerging Markets

Are benchmarks still relevant?

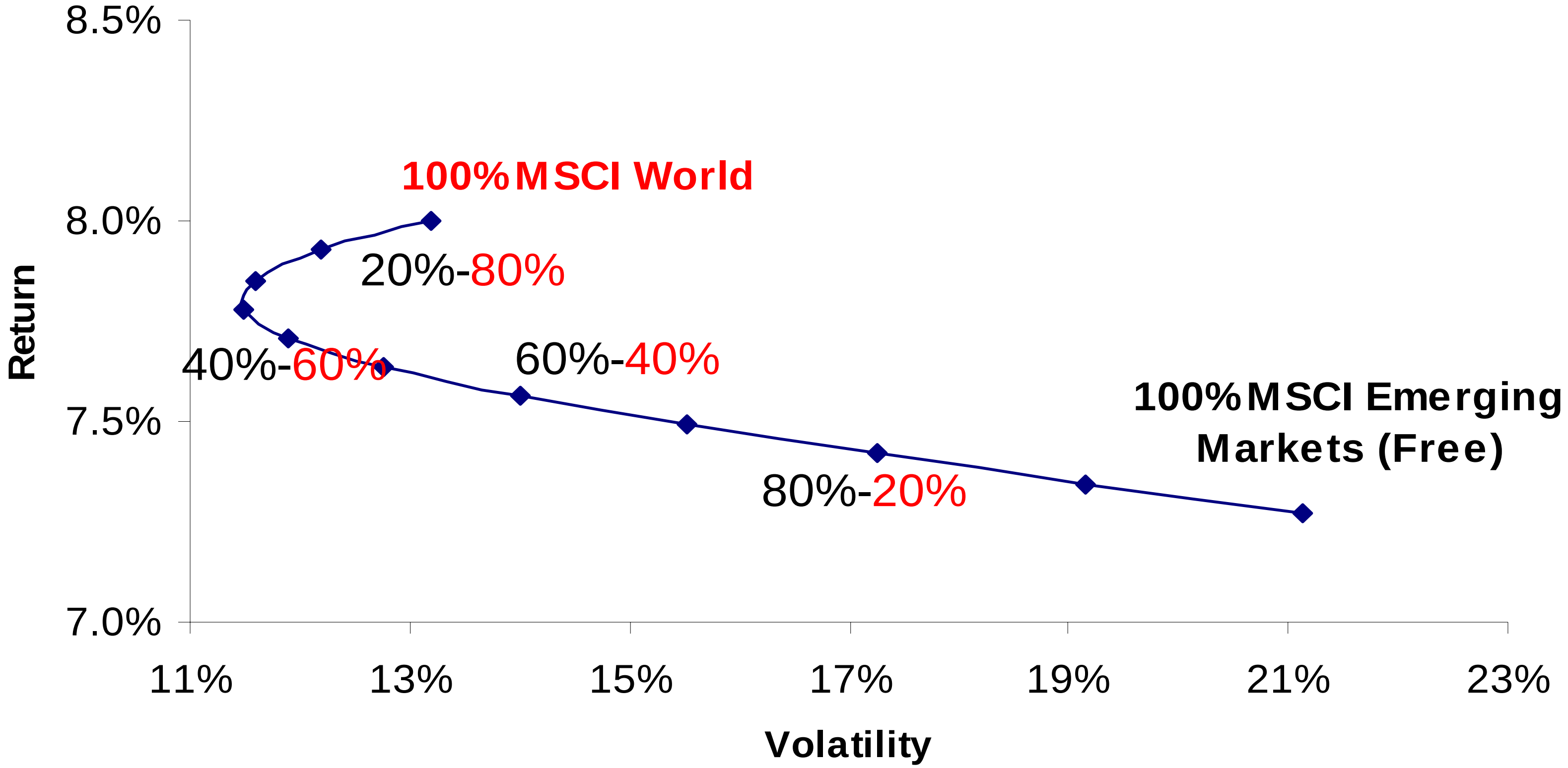
- Fama and French have made numerous studies that illustrate the limitations of using historical time period analysis to adequately describe the future.

- MSCI World Index is not constructed rationally

Is the MSCI Emerging Market (Free) Index appropriate for optimal asset allocation?

- Emerging market data is highly non-normal
- Risk parameters change through time and are non-stationary
- These markets are not integrated into world capital markets
- This is a problem – Financial market integration is critical for the CAPM to function.

10 year risk and return
MSCI Emerging Markets (Free) vs MSCI World Index
Annualised portfolio outcomes



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History has repeated itself

Barge Haulers on the Volga. 1870-1873. By Ilya Repin. Oil on canvas.
The Russian Museum, St. Petersburg, Russia

Geographical attack of industrial advantage

Look to Asia for the new giants

FRANCESCO GUERRERA
ON ASIA

When I was 16 my parents gave me a Goldstar stereo for my birthday. I was devastated. My friends had cool, well-known brands such as Sony and Pioneer and here I was stuck with a bulky, dull looking black thing from a company no one had ever heard of (teenagers, like journalists, like to exaggerate).

Today, I wish my parents had bought me some Goldstar shares together with the stereo. Since that purchase, shares in the South Korean company, which went through a name change, a spin-off and a stock split, have risen more than 300 per cent.

You may have heard of Goldstar's latest incarnation. It goes by the name LG Electronics, a group with global turnover of $22bn profits of $1.3bn and one of only two Asian companies outside Japan to be part of the world's top 100 by market capitalisation. The other is its arch-rival, Samsung Electronics.

Unless they want to end up like me – with high sound quality but low investment returns – investors should be looking for the next Goldstars, especially in Asia.

McKinsey, the management consultancy, this week predicted that half the top 100 companies by market capitalisation would hail from emerging markets, particularly Asia, in 10 to 15 years.

That call, in itself, is hardly surprising. After all, if current macroeconomic growth continues, China and India alone are forecast to account for 50 per cent of global gross domestic product by 2025.

The real lucrative call would be to separate the Asian companies that will make it to the top 100 from those that will fall by the wayside. And, given pension fund trustees' fascination with quarterly returns, to choose stocks that provide value and returns in the short term while they work their way to greatness.

Some of the stars of the future are easy to identify. Companies such as India's Infosys Technologies, a leader in information technology outsourcing, and Ranbaxy Laboratories, a drugmaker, look as though they are in a good position to build on their strengths.

Similarly, China's Lenovo and Haier, manufacturers of computers and white goods respectively, are strong candidates to repeat the world-conquering feats of Samsung and LG.

Whether these companies graduate from their current status – emerging, low-cost, focused providers of in-demand goods and services – to the big league of the truly global multinationals will depend on a myriad of factors, not all within their control.

Some experts argue some of these Asian corporates could make the leap in as little as five years if they expand geographically, acquire wisely and attract international talent into their top management.

Apart from being easier said than done, these "globalisation accelerators" in McKinsey-speak (why resort to plain language when you can have jargon?) are not very specific.

Sure, HSBC turned itself from a Hong Kong-based lender into a global powerhouse through acquisition and aggressive organic growth, but how do investors know whether Infosys or Ranbaxy is more likely to follow that route?

And Samsung did hone its sales and production skills in the tech-savvy South Korean market before taking it abroad, but what implications does that have for export-oriented companies such as Lenovo and Haier?

I am afraid fund managers looking for success and growth in Asia will have to rely on old-fashioned financial figures and valuations.

The first piece of advice is to think big, simply because large companies have a greater impact on stock market: the top 100 companies by market capitalisation, for example, account for more than half of the benchmark index for emerging markets.

Moreover, there is evidence that these companies tend to be cheaper and more profitable than their peers in the US.

According to a study by JPMorgan, the emerging market's top 100 trade at an average discount of 30 per cent to the US market based on next year's earnings forecast. Their return on equity – a measure of profitability – is also above their western counterparts.

That is good news for foreign investors, as they prize both a discount (to Wall Street's valuations) and a premium (to US profits) to compensate for the higher risks and volatility of Asia's developing economies.

And, given the likelihood that the next Samsung – or even the next General Electric or Microsoft – is currently hiding in this group of would-be global players, investing in those companies looks like an even better bet.

It's time to sell your Goldstar stereo, if you still have one, and buy Asian shares.

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"McKinsey, the management consultancy, this week predicted that half the top 100 companies by market capitalisation would hail from emerging markets, particularly Asia, in 10 to 15 years."

Source: *Financial Times*, November 19/20, 2005

Geographical attack of industrial advantage

Emerging markets

Cement
Chemicals
Generic Pharmaceuticals
DRAM/Microchips
IT Services
Metals and Mining
Oil and Gas
Steel
Personal Computers

Contested industries

Automobiles
Consumer Electronics
Financials
Leisure
Software
Telecommunications

Developed markets

Capital Goods
Luxury Brands
Biotechnology
Retail

Source: Deutsche Asset Management

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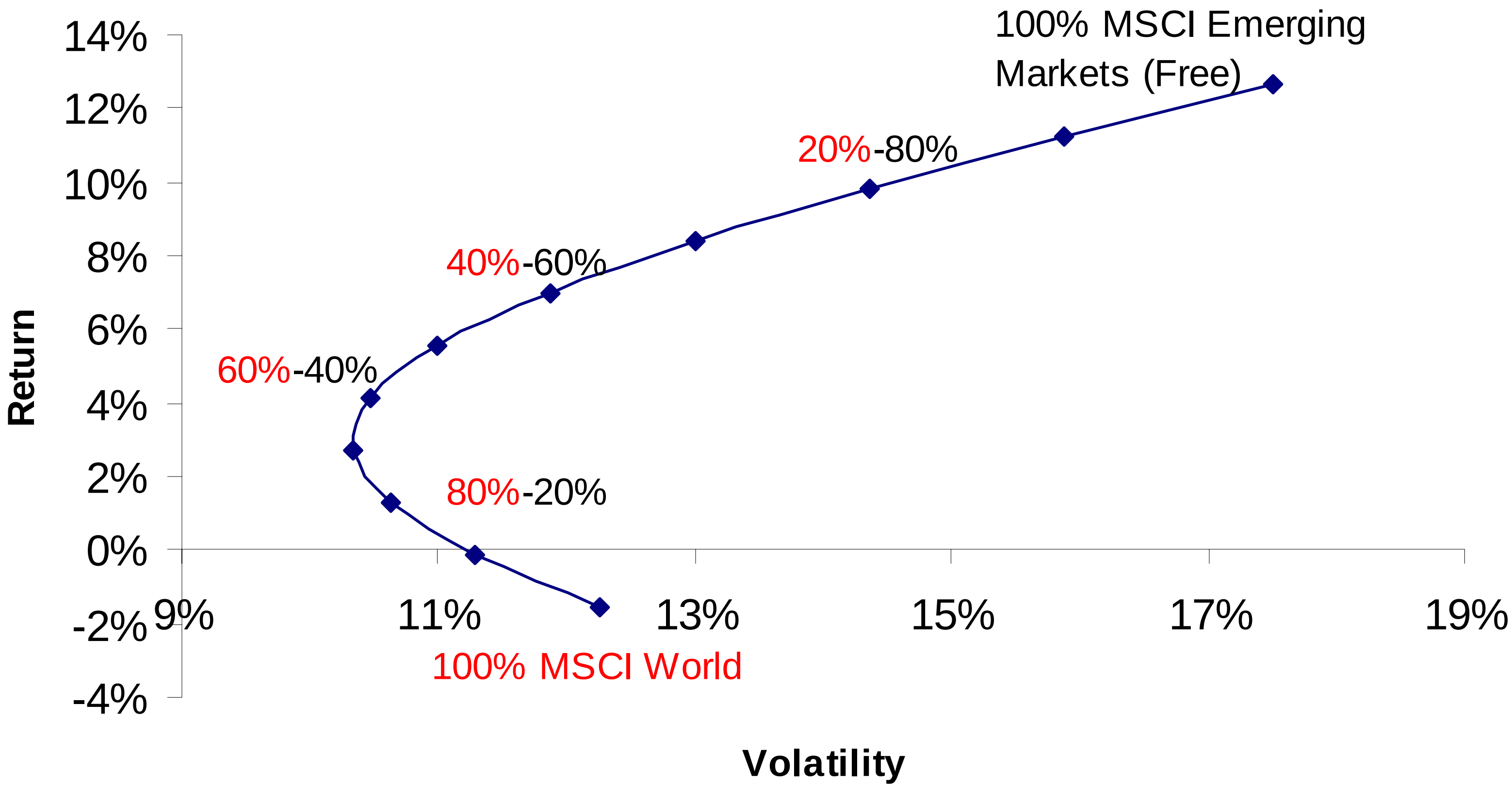


Source : MSCI World Accumulation and MSCI Emerging Market (Free) Accumulation indices as at 30 June 2006 in Australian Dollars. Volatility is annualised standard deviation. All returns are annualised.

An alternative way to invest globally

Our philosophy

“One increasingly integrated global market”

An alternative way to invest globally

- The world is one economy, one market
- Companies must react to secular change not just to survive but to profit and grow
- It therefore makes sense to construct a portfolio based around the themes that are driving long term secular change rather than a flawed benchmark
- We find 8 to 12 themes that have low correlations between them but have high correlations between the stocks that make up each thematic cluster
- We populate the portfolio with the most attractively priced securities that fit each theme optimised by expected upside

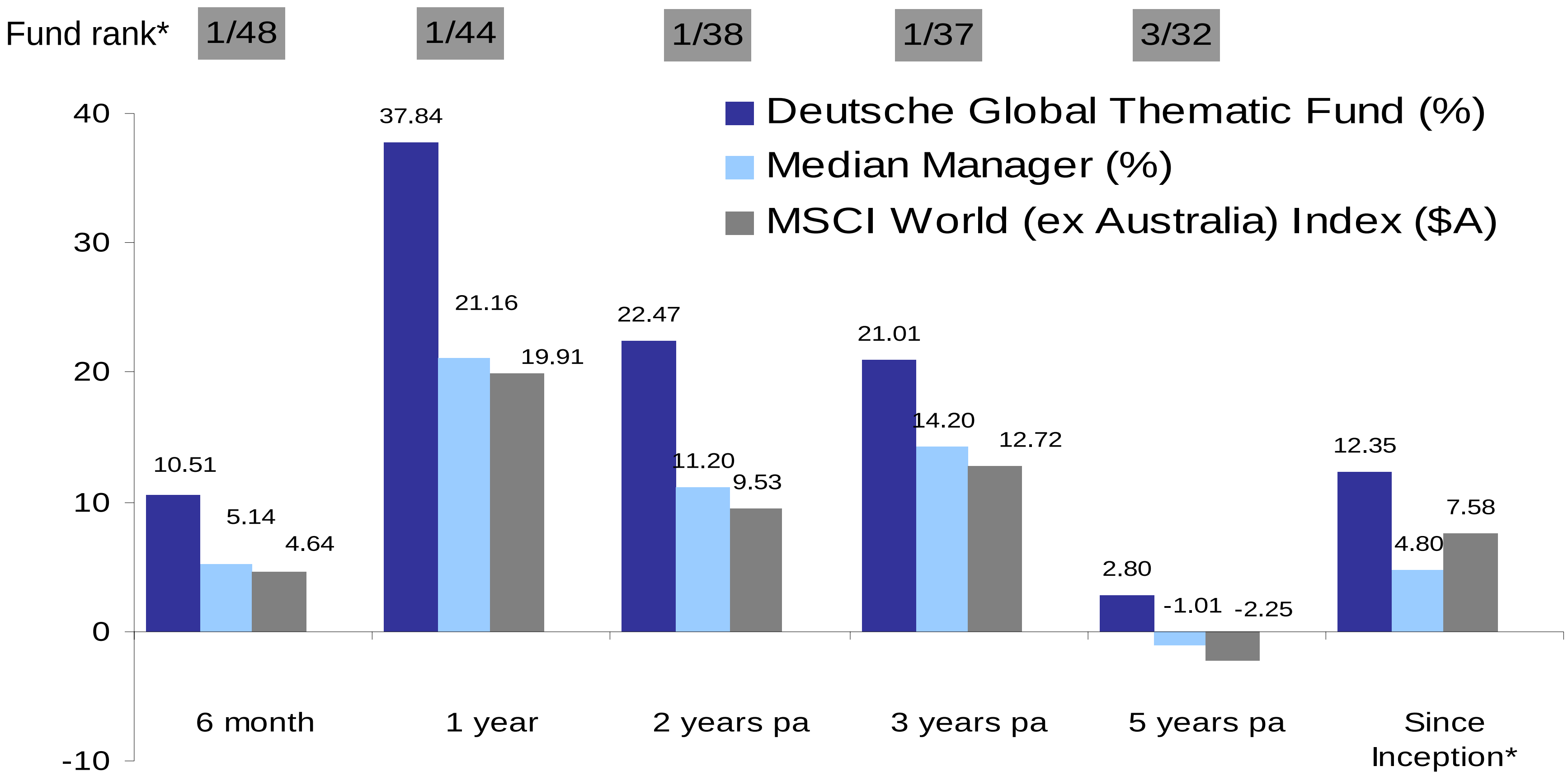
An alternative way to invest globally

- Country and sector weightings are a residual of the process
- We are benchmark agnostic although we do measure tracking error and are aware of our common factor risks
- The process has delivered portfolios that are well diversified across sectors and geographically
- The process has delivered out performance across all market conditions

Gross performance

Deutsche Global Equity Thematic Fund

As at 30 June 2006

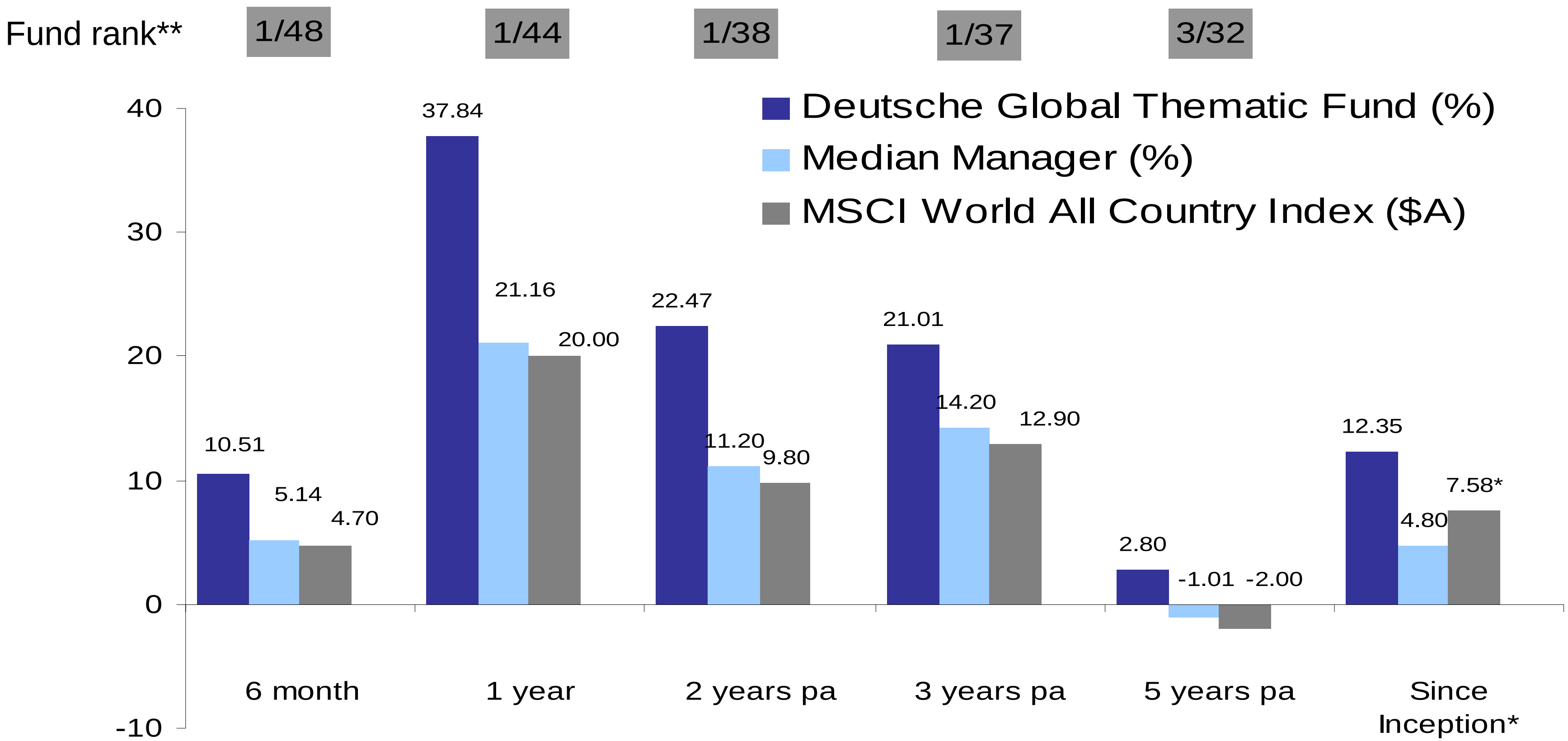


Source: Deutsche Asset Management. *Since inception 4 October 1996
Gross: shows performance gross of management fees, net of performance fees.
*Fund ranking from the Mercer Overseas shares – Core Managers Survey

Gross performance

Deutsche Global Equity Thematic Fund

As at 30 June 2006



Source: Deutsche Asset Management. *Since inception 4 October 1996. The benchmark used for the since inception number only is the MSCI (ex Australia) Index. Gross: shows performance gross of management fees, net of performance fees.

**Fund ranking from the Mercer Overseas shares – Core Managers Survey

Conclusions

- Combining developed and emerging market portfolios is inefficient in a simple linear combination

  View the world as one entity and construct a portfolio accordingly

- Market capatalisation weighted benchmarks have been challenged over the last few years

  New products (eg Deutsche and Intech) exploit these inefficiencies

- The original CAPM made no assumptions about benchmarks – A “market portfolio” was defined to cover all investable assets

  Applying the original theory allows us to construct portfolios that will provide superior future returns

 Source: Deutsche Asset Management

“Habit rules the unreflecting herd”

William Wordsworth

Thank you…… Questions?

Deutsche Asset Management
Deutsche Bank Group

Gizmo time

Which session are you in?

1. PIMCO
2. Principal Global Investors
3. Colonial First State
4. Deutsche Asset Management
5. Challenger Financial Services

Gizmo time

Please rate the overall quality of this session...

1. awful
2. Poor
3. Mediocre
4. Good
5. Very good
6. Great!

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