

Distinguished guests, Ladies and Gentlemen, Da Jia Hao (Hello everyone in Mandarin)

On behalf of Aberdeen Asset Management, may I thank the organisers of today's conference, for the invitation to speak.

We live in turbulent times; according to some, the worst financial market conditions for 60 years. Today I will give you my thoughts on what is happening.

I am going to start by comparing the situation of barely a year ago with the one we have today, and then ask "What has gone wrong?" "What needs to be done?", and finally comment on who is strong enough to ride through the crisis, and who is not.

The situation last year

Until last summer, we lived in the Goldilocks economy, not too hot and not too cold, a kind of financial Nirvana, where every player in the capitalist system was a winner, because everyone was making money and lots of it, and it was great. Thanks to low commodity prices, low transportation costs and globalisation, wages were kept low, so inflation was low, so Central Banks around the world could slash interest rates, to stimulate non-inflationary growth. We had the "conundrum" of very low long term interest rates. Investors, whose expectations of what was a "normal" rate of return did NOT fall as the risk-free rate fell, piled into the carry trade. Credit spreads for corporate, securitised, emerging market and high yield bonds fell to record low levels, compared to risk-free government bonds. Leverage was everywhere and asset prices soared. So great was the pressure from investment bankers on Wall Street to generate assets to

sell to investors, that you could walk into any Commercial bank in the US and get a NINJA mortgage. No income, no job and no assets? No worries; just fill out a form, and the American dream was yours; you had a free option on a housing market that had been going up every year for over 50 years! And if it went wrong, you just handed back the keys. But wait, it got even better: why not take out a second mortgage? As property values soared across the United States, banks even wanted to lend you money against the unrealised gains in your property, so called Home Equity Loans. More assets for the boys on Wall Street meant more fees for the commercial bankers. Yippee!

Your home became your nest egg. No wonder Americans concluded there was no need to save and no need to complain about stagnant wages, assuming of course that you had one foot on the property ladder. Your home was your savings plan and your pension plan rolled into one!

The ratings agencies obliged by putting a AAA rating on just about anything as long as it was called a CDO, and were paid handsome fees for doing so. Their fee income went up, so their share prices went up.

Investors piled into these wonderful new assets that were somehow high yielding and cheap and risk-less and AAA rated all at the same time. They didn't have a clue what they were buying, but that didn't matter because it was all AAA.

Fannie Mae and Freddie Mac decided to rev their engines too: they moved on from their main role of providing guarantees on conforming mortgages to actually investing in mortgage backed securities themselves, funded by cheap debt issued with an implicit government guarantee, and minimal regulatory capital requirements. With house prices going up, the value of their collateral was going up, so who needed capital anyway?

Franklin Raines was the darling of the stock market as Fannie Mae's share price soared.

Hedge funds used investment banks as prime brokers, as a source of leverage. All you needed to finance a \$100mm pool of Alt-A Mortgage Backed Securities was to cough up \$3mm of cash (in technical jargon a haircut of 3%). Leverage of 30 times was not only common but entirely possible, so keen were investment banks to trade with hedge funds.

Even commercial bankers started pushing the envelope to try and boost their share prices by creating an entire shadow banking system, away from the eyes of regulators, a world of off-balance sheet vehicles called SIVs, where assets could be parked without the need for regulatory capital, funded by short term loans from the commercial paper market. So great and successful was their disguise that Halifax plc, one of the largest banks in the UK, had by 2007 amassed some 18.6bn pounds of assets in its SIV called Grampian; and they didn't even mention the words Grampian or SIV in their 2006 annual report. Indeed, Anthony Bolton, Fidelity's famous UK fund manager, admitted in 2007 that he had never heard of a SIV, and had no idea what it was.

Asian Central banks played their role too in making sure that the music never stopped, keeping their currencies artificially weak to boost exports to kick-start growth after the 1997 debacle, building up enormous foreign exchange reserves in the process, which were then re-cycled into the US, financing both the housing bubble and the war in Iraq. With abundant domestic liquidity, equity markets in China and other emerging economies soared.

Governments at the Federal, State and Municipal levels were happy as tax receipts soared on the back of record profits from the financial services sector, and rising house prices.

Regulators around the world couldn't see a problem, because everyone was making money.

Common shareholders were happy too, because share prices kept on going up. The US Federal Reserve had an asymmetric approach to dealing with bubbles. If share prices ever wobbled, there was everyone's friend Alan Greenspan with his famous put, ready to bail you out by slashing interest rates and pumping in even more liquidity at the first hint of trouble. And Uncle Ben has kept the tradition going.

Everyone was happy. The financial system was literally on drugs (of which more later).

What a party!

And then, BANG! Whilst many commentators date the start of the crisis to July 2007 when Bear Stearns announced that 2 of its hedge funds were in trouble, or to August 9th when the ECB surprised everyone with a massive liquidity injection, for me the most important date was the 21st August. That day Standard and Poor's downgraded 2 bonds from AAA to CCC overnight. AAA means you are 99.9% certain to get your money back. CCC means you won't. How could a bond go from AAA to CCC overnight? What could possibly change in 24 hours? There were no terrorist attacks that day. No bombs. No stock market collapse. Imagine going home one night with nothing to worry about.

The situation today could not be more different.

Major stock markets are down 20%, bank shares 40%; Chinese stocks 60%, whilst Fannie Mae and Freddie Mac's share prices are down a staggering 90% from the highs. They have just over \$10bn of capital to support a \$5trillion book of mortgage assets at a time when US house prices are falling. Indymac, Bear Stearns, Northern Rock and IKB are now gone, as are the CEOs of UBS, Citibank, Wachovia and Merrill Lynch to name but 4. The Federal Deposit Insurance Corporation, which guarantees bank deposits in the US, has just \$52bn of cash to handle failure at any one of the 8,500 banks in the US, where people have deposited \$6.8 trillion. The IndyMac failure is expected to use \$4-8bn of those funds and the FDIC have another 120 un-named banks on their watch list. Some independent researchers like Chris Whalen have identified 700 "troubled" institutions. As a reference point, 1500 banks failed in the S+L crisis of the early 1990s. No surprise then that bank lending has ground to a halt, credit spreads have exploded and securitised markets have seized up. July and August 2008 were terrible months for credit markets. Spreads ballooned and issuance stalled. Agency Mortgage issuance declined to \$85bn in July from \$117bn in June and non agency Mortgage issuance fell to just \$743mm in July from \$10bn in June. Some corporate bond issues did get away recently, but at spreads that were unimaginable a year ago. Citigroup had to pay 337 bps over 5 year US treasuries, American Express 425bps and AIG 433 bps. A year ago, those issues would have fallen into the High Yield category. Yet these are the best and biggest names in the US financial system.

Remember that 3% haircut on a mortgage portfolio of a year ago? Well today it's more like 30%. A year ago, \$10mm of capital would have funded a \$300mm portfolio. Today,

it finances a portfolio of just \$30mm. Last year's hedge funds today need either to sell \$270mm of assets into a falling market, or raise another \$90mm of capital. No wonder everyone is so desperate to de-leverage.

Faith in the credit ratings agencies for structured products is non-existent, because AAA doesn't mean AAA any more. Some investment banks are now beginning to use Credit Default swaps as the basis for lending decisions, rather than a credit rating. This is very significant, especially for one of today's sponsors, as the derivatives market is beginning to replace the ratings agencies as the final word on credit worthiness.

States and municipalities in the US are in crisis, because their revenue depends on property taxes and in the case of New York City taxes on bank profits which have now turned to losses. California Governor Schwarzenegger has just tried to fire 20,000 employees to try to balance his books; and governments outside the US are suffering too; UBS won't be paying much tax in Switzerland this year, and by some estimates Merrill won't be paying any tax in the UK for the next decade.

Outside the USA, house prices are falling in the UK Ireland Spain and New Zealand and Australia is following. Commodity prices, despite the recent correction, have soared, and inflation is amok in many Emerging economies, especially in Asia. We in Asia are being hit by the triple whammy of being forced to save because there is virtually no social security system; then seeing the value of our savings plummet because stock markets are going down; and what's left is being eaten away by inflation. Asia is unique in that its governments refuse to offer savers an inflation hedge in the form of inflation linked bonds that pay a positive real rate of return. Asia may have recovered from the

1997 financial crisis but current exchange rate and monetary policies may be sowing the seeds for the next crisis. Inflation is as much a political issue as it is an economic problem. With the G7 economies moving into recession, there is not going to be an export led solution to Asia's problems this time. Indeed Asia's mercantilist export-led model is under threat for another reason; it relies on low energy and transportation costs to move goods around a region where distances are enormous, for final assembly in China, from where they are shipped to the US and Europe. Final demand issues aside, this model may be broken: the anecdotes are of globalisation in reverse, of manufacturing moving back to, or closer to, the end customer. **What a hangover!**

What caused the crisis? GREED.

Greed exists in almost every single corner of today's financial system. Most players have been acting logically, responding to the carrots and sticks that have been offered. It is a system where risk and return for many are completely asymmetric. Risk takers, backed ultimately by the US Federal Reserve, have all the upside of large bonuses when they take a lot of risk, and make a lot of money: but shareholders and taxpayers have all the downside when things go wrong. The big hitters literally walk away scot-free, or if you happen to be the former CEO of FNMA, Merrill Lynch or Citibank, you walk out the door laden with gold. The system is absurd. What is worse is that shareholders have put up with all this nonsense for so long.

I asked my colleagues on the equity desk why they (shareholders) had allowed this all to happen. Partly greed; why bother to ask questions when share prices keep on going up? Surely that's a sign that everything is just fine?

They also mentioned the role that passive investors play in today's markets. Many investors are so fed up with paying fees to under-performing fund managers that they have switched to passive investing, investing in Exchange Traded Funds or tracker funds. Buying these funds is cheap. You just choose an index, and you get whatever is in the index. But is there a catch? Well yes there is, because you are forced to own whatever is in the index. So, the higher a company's share price the greater the company's weight in the index. So you buy more shares in the most expensive companies: great. Let me give you an example of how stupid this is. Remember the MSCI World Equity Index back in Dec 1989, when the Nikkei was at almost 40,000? If you had invested in that index on that day then you would have had a 42% allocation to the Nikkei and less than 1% in the Hang Seng. Since that time, the Nikkei has fallen 70% and the Hang Seng is up 12 fold. Bond indices have similar issues. They force you to lend more money to the most indebted countries and companies. This is madness! Indices are a valid tool to measure performance, not to make asset allocation decisions. Yet that is how they are being used today. There are now trillions of dollars that are invested passively. Its irresponsible, yet people do it. Why?

Well, many decisions are made using models, around which today's financial system revolves. Everyone uses them. Every model is based on historical data, so is backward looking. Models are great -until they blow up. It's like driving a car using the rear view mirror. I don't care how good a driver you are, if you drive like that, it's only a matter of time until you crash. Long Term Capital, run by people with Nobel Prize winning brains blew up. Even Goldman Sachs saw its flagship global equity fund lose 30% in a week, because of "problems with its trading strategies created by computer models". David

Viniar, Goldman's CFO, said: "We are seeing things that were 25 standard deviation events". Well a 25 standard deviation event is one that happens once every 100,000 years. He continued that they were seeing these 25 SD events "several days in a row". If a 25 SD event happens 5 days in a row, that is a once in every 10 octillion years event! (That's 10 with 25 zeroes after it, I think) Now I know that Goldman people are smart, butDavid, the model is probably wrong.

The list of problems goes on. Suffice to say, Ladies and gentlemen the system, capitalism, is broken. It's also absurd. It's absurd that surplus savings from the Emerging World, countries like China, where hundreds of millions of people still live below the poverty line, working ludicrous hours for little pay in appalling conditions to make goods for export, that their savings are invested in assets in the developed world, like houses in Florida and California. The heart of capitalism being financed by the heart of communism! What would Chairman Mao, have to say about that?

Calling capitalism a giant Ponzi scheme may be harsh on some players, but it's not far from the truth. The system has worked on the basis of continually rising asset prices. But asset prices, especially US real estate prices, residential and commercial, the collateral that underpins so much debt, are falling. The risk now is that the sub prime problem becomes a prime problem. The financial sector is witnessing huge losses and write-offs; as of 13th August, Bloomberg reports \$501bn of announced bank losses and write-downsand \$352bn of new capital raised. Taxpayers are beginning to question this system where profit is privatised and losses are socialised (i.e. the taxpayer picks up the tab).

The real economy implications of this financial bust are just beginning to be seen, in terms of unemployment in the US. Recently, the data coming out of Japan, Australia, New Zealand, UK and Europe, has been awful. As we move from a financial crisis to an economic crisis, we are likely to see another wave of write-downs and losses, triggering a vicious cycle in which economic weakness hits an already fragile financial system, leading to even tighter financial restrictions on lending, leading to yet another economic lurch down, and so forth. Losses ultimately will be in trillions of dollars. Banks may need to be nationalised. Fannie Mae and Freddie Mac certainly need to be. US treasuries will not be rated AAA for much longer.

As humans need water, so economies need credit. The financial system, that is supposed to do that, needs to be rebuilt. The market for sub prime mortgages is the proverbial butterfly that flapped its wings. Because the system is global, we need a global solution. This is a problem because the fixers, governments, are national and regulators are local, and balkanised, in the case of insurance companies in the USA. "We" will not all survive the crisis.

So what can be done?

If the cause of the crisis is "GREED", then the solution to the crisis is "CONFIDENCE".

For confidence to be restored, two main things need to happen. The first thing we need is for real estate markets to stabilise. Thanks to securitisation of real estate assets, these are now the collateral supporting trillions of dollars of assets held by the financial system in general, and the banking system in particular.

In the property markets where there are more sellers than buyers, we need to find buyers, and to do that, property prices have to fall so the market can clear. The supply of buyers is dependent on people's ability to get a mortgage. But mortgages are now more difficult to get and more expensive, as banks tighten their lending standards. It's almost impossible today to get a non-conforming mortgage and Fannie and Freddie have just doubled the fee that they charge banks to guarantee conforming mortgages. The latest quarterly US Federal Reserve Senior Loan Officer Survey shows an intensifying credit crunch as lending standards are being tightened across the board, for all types of loans, big and small.

The supply of buyers is also dependent on people having jobs and an income to pay off the mortgage. With job losses mounting as the crisis on Wall Street hits Main Street, it looks like its going to be a while yet until the housing market stabilises, let alone begins to rally.

The **second** thing we need to restore confidence is to get banks to start lending again, especially to each other. It's actually this reluctance of banks to lend even to each other, as evidenced by the dislocations in the global inter-bank money markets, that many find most unnerving. What exactly do these bankers know that we all don't know? They won't start lending to each other until they have cleaned up their own balance sheets, and have confidence that other banks have cleaned up their balance sheets too. Many US banks still have billions of dollars of off-balance sheet assets that they need to bring back onto their balance sheets. FASB has just given them an extra year's grace (til January 2010) to do that because if they had to do it today, banks would be so

undercapitalised that they would have to raise billions more dollars of equity capital, which the market simply could not handle. If banks are unable to raise fresh equity capital, they will have to either wait until their assets or loans mature, or try and sell them. Until these assets are sold there is the issue of how to value them. Banks have assets that are classified Level 1 (observable market prices), Level 2 (assets that don't have observable asset prices but they have inputs that are based upon them) and Level 3 assets where one or more of the inputs do not have observable asset prices. The value of Level 3 assets relies on management estimates, often based on computer modelling. In other words banks do their own "no doc" valuation. As Warren Buffet quipped, "Mark to model? Its more like mark to myth". Of course selling these assets would be a lot easier if the value of the underlying collateral is rising not falling. One reason why there are so many more sellers than buyers of assets is that most sellers are leveraged, in the typical case of investment banks, 30 times leveraged. The buyers we need to find are real money buyers, ie non-leveraged buyers. So you need 30 real money buyers for every one leveraged seller. That's going to take time. There are some private equity houses who are "buying", but then that is only with money they have borrowed from the bank that's selling them the asset in the first place, and even that money is often borrowed at below market interest rates; AND the buyer has the option to put the assets back to the seller if the price of the assets falls below a certain level. Recent attempts by houses like Merrill Lynch and others to put the past behind them, are nothing more than a game of smoke and mirrors. Banks have yet to come clean and until they do, the crisis will get worse, because no one will have confidence in the

system. Ultimately, it's entirely possible that governments will have to step in, and then we will have to see who picks up the tab: shareholders or taxpayers?

There is a very long shopping list of other things that need to be done to sort this mess out. Transparency would be next on the list. This applies as much to the derivatives market as it does to banks and sovereign wealth funds. If you want an example of how transparent a sovereign wealth fund can be, take a look at www.nbim.no. It's the website of Norway's Norges Bank Investment Management. It's an outstanding website, the ultimate standard in terms of democratic accountability.

Also high on the list is the issue of the ratings agencies, which is now being addressed by the European Union and others.

Despite, maybe because of, all this chaos, there is some good news out there. Can we survive the crisis? Well it depends on who "we" are. There will be winners and losers, some will survive, many will not.

The winners broadly will be people, companies, and countries whose balance sheets are cash rich; the losers are those who are in debt, those who need to re-finance, those who are highly leveraged, those who need to sell. Cash is very much King.

The good news is that we are all sitting out here in Asia, where at the personal, company and government level, leverage is much lower on average than in the rest of the world. It's interesting that my colleagues at Aberdeen whether from our currency teams, our fixed income credit teams, our equity teams, or our property teams, are all optimistic on Asia broadly relative to other parts of the world. Asian stocks should

outperform, especially the regions banks. Asian currencies are broadly cheap, especially versus the Euro, Sterling and Swiss Franc. Asian credit spreads look very good on a relative value basis. And Asian property probably has less to fall than property in the highly leveraged Anglo Saxon economies. Of course there are exceptions; countries like Australia, Korea and India come to mind with their large current account deficits. It's also not to say that Asia is problem free: inflation is THE issue, but the difference between the lowly leveraged economies of Asia and the highly leveraged Anglo Saxon economies is that Asian governments have all the tools at their disposal to rectify that particular issue. These may involve cooling their economies, but it doesn't necessitate causing a recession. Interest rates probably need to rise, and so do currencies. That's not too hard.

Many investors still think of the world in terms of developed economies and emerging economies. I don't think that is particularly helpful anymore. The distinction that is relevant today, whether you are developing or emerging, is between those who are highly leveraged and those who are less leveraged. So, the positive conclusion is that we, being in Asia, should fare a lot better in these difficult times than our more highly leveraged Anglo-Saxon friends. And as I mentioned earlier, the other advantage is that the main problem in Asia, inflation, is pretty easy to fix, and governments and central banks in the region have plenty of flexibility.

From our point of view as asset managers, there are other positives that we can take from the situation today.

1. At last, people are starting to ask questions, the right questions. Literally every aspect of the global capital system is now under the microscope. Questions are being asked of

banks, investment banks, investors, shareholders, pension funds, trustees, ratings agencies, regulators, consultants, governments, central banks.....there are no sacred cows today. That questions are being asked is a sign that issues are being addressed. It's not a guarantee that the right conclusions will be reached, but it is a sign that past excess will not be tolerated.

2. The sell off in financial markets creates opportunity for long term investors to buy quality assets at more reasonable prices. In the liquidity fuelled bubbles of the last couple of years, the valuations accorded to many assets reached absurd levels, whether in equity markets like China, Vietnam and India, or in credit markets globally where spreads were just too tight. In the de-leveraging process that we are beginning to go through, leveraged investors are having to take profit on their good investments to make up for losses on their bad investments. As I mentioned before there are literally babies being thrown out with the bathwater. The bad news for those who are leveraged is great news for those with cash, those like Warren Buffet.

3. It's also good news because it should reduce clients' expectations about what is possible to achieve in terms of a normal rate of return on an investment portfolio. Double digit rates of return are just not normal. In a sense what has really been happening over the last decade is that people have tried to invent the ultimate high yielding AAA rated risk-less asset. That's what our clients want in a utopian sense. The realisation that it's just a dream, and not a reality, is healthy.

4. Investor reliance on tools and techniques that are basically substitutes for hard work and doing your own homework will diminish. The use of computer models, ratings

agencies, indices and consultants will not disappear overnight, but it's unlikely that they will continue to play the same role as before. There is a greater understanding of their limitations, and the extent to which they have been abused. People will actually have to start thinking for themselves, and thinking forward, rather than outsourcing thinking to others...whether to backward looking humans (broadly sell-side research) or to computers (and their models based on historical data).

I will end with a quote from the world's most famous investor, Warren Buffet. What did he have to say on the main theme of my speech today, on "Greed"?

He says: "Be fearful when others are greedy and greedy only when others are fearful."

Finally, may I take this opportunity to briefly introduce Aberdeen Asset Management, where I am working for. Aberdeen is a UK-based independent asset management company managing approx USD250 billion assets on equity, fixed income and property. Aberdeen was founded in 1983 and was listed on London Stock Exchange in 1991, today we have 25 offices around the world, with key investment centres in London, Philadelphia, Singapore and Sydney. In Asia, we are one of the best resourced and most respected names in regional asset management. We have been investing in Asia for over twenty years. Currently we manage over US\$45.1 bn, making us one of the largest managers of regional equities globally. We also have a dedicated regional bond team. Assets are invested in a variety of country and regional funds, as well as specialist products, for leading institutions, other asset managers and retail investors. In addition to Singapore, we have fund managers in Hong Kong, Thailand, Malaysia and Australia, plus representation in Korea and an upcoming office in Shanghai. Our

research-led, long-term investment approach has resulted in many awards for investment performance.

I hope to meet as many of you as possible over the course of this seminar in conjunction with my colleague Mr Kevin Liu, our Chief Representative in Shanghai. Perhaps we can exchange ideas, discuss current issues and maybe combine our energies for a positive future.

Ladies and gentlemen, Xie Xie (thank you)!