Themes – September 2010

The following comments are based on our discussions with investors and investment managers over the last quarter. We have referred to investors in the comments below but in most instances investors will be working closely with their consultants and you can infer that a reference to one is a reference to the other also.

We identified in our June report that private markets strategies were garnering more investor attention after their post-GFC hiatus; although that had not yet translated into a flurry of activity. If nothing else, the GFC has drawn attention not only to liquidity but also to the correlated nature of reputedly uncorrelated asset classes. Investment strategies that are genuine diversifiers and that will protect against tail risk will have strong appeal to investors.

The Australian Federal election focused attention, amongst other things, on the Superannuation industry in the past quarter. The hung Parliament election outcome and subsequent minority Government somewhat clouds the outlook in relation to stated policy positions.

Themes we have identified since our previous update are as follows:

- There has been significant interest in non-traditional debt and credit strategies of one sort or another. This reflects several key considerations. First, yields on Government and investment grade debt are low and investors are seeking higher yielding opportunities. There is also the potential for a rise in yields, making investors somewhat cautious about duration risk. Second, with spreads narrowing, and some loans and bonds trading above par, the market is becoming more traditional in nature - credit selection is viewed as more important than macro bets. Third, with a wall of loan refinancing across various asset sectors; despite the proliferation of “amend and extend” loan extensions, expected over the next three to five years, and banks having curtailed their lending activities somewhat, in the wake of the GFC, the supply/demand equation has shifted somewhat in favour of alternative lenders - even large institutional superannuation funds. As a result, investors are seeing opportunities that might not otherwise have been available to them and risk/return outcomes that they might ordinarily have sought from equity. Strategies invested in over the past quarter include: bank loan and high-yield; distressed; emerging market debt; CMBS; private equity mezzanine; infrastructure debt, structured credit, insurance-related debt and various diversified mixes of some of the above;

- Proposals to increase the Superannuation Guarantee Charge from 9% to 12% have generated a renewed focus on the adequacy of Australian retirement savings and related issues such as life-stage investing, post-retirement annuity streams, differentiation between advice for DB and DC funds etc. It will be interesting to follow the direction of these discussions. Perhaps there will be a shift away from the idea of age-based retirement strategies to rather more dynamic approaches based upon achieved portfolio outcomes and progress towards individuals’ desired retirement objectives;

- Income and dividend focused strategies are not new; they have tended to be the domain of non-super institutional investors (such as charitable organisations) and retail investors. Interest seems to be broadening though as many investors believe income based strategies have the potential to outperform in falling markets and also offer more reliable liquidity streams (still front of mind in the post GFC environment); allowing investors to pursue opportunities that inevitably arise under such circumstances;

- The debate during the recent Federal election regarding the sustainability of continuing Australian population growth focused attention on investment in Australian infrastructure. Inactivity at a State Government level (arguably there needs to be greater Federal Government involvement) has created a backlog of much needed infrastructure investment. However, enthusiasm for Australian infrastructure is somewhat tempered by recent disappointing projects (e.g. the Cross-City and Lane Cove tunnels in Sydney), unexpectedly large downward valuations during the GFC and unsuitable fund fee structures;

- There is strong interest in emerging markets; particularly India and China. However, investors and a few consultants are uncertain as to how to gain exposure resulting in quite disparate positions. Some prefer the private equity route, but intermediated by an experienced and well incentivised manager focused on the country or region, eschewing the volatility wrought by institutional capital flows on listed markets. Within this group there are certain investors; particularly larger ones, that prefer the manager has more of an advisory role. Others prefer pan-Asian public equity strategies, believing the greater liquidity acts as a safety valve during times of stress. However, investors may be underestimating market downside risks and the costs of servicing redemptions during crisis;

- During the most recent period we have seen a reasonable level of activity in relation to Australian equities managers; we think in part this was and is a catch up on normal review cycles – substantial restructuring of global equities line-ups had occurred in previous periods;

- The growth of the high net worth sector in Australia has again received much attention over the last six months. The mining boom and Australia's relatively strong performance throughout the GFC has helped Australia's super rich grow compared to the rest of the world. Some of the private banks servicing the sector are beginning to recommend alternative strategies, becoming more comfortable with offshore vehicles, lower liquidity, periodic pricing and redemption frequencies;

- Consultants are continuing to build their alternatives research capabilities; although we have mentioned this before there has been significant hiring activity in this area over the past quarter; and

- Fund merger activity continues; some along industry lines and some more on the basis of complementarity (e.g. same consultant, custodian, some commonality in Board membership).