Themes – March 2011

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.

Investment markets proved surprisingly resilient in the face of local, regional and global natural disasters and political upheaval across East Asia, North and sub-Saharan Africa the Middle East and Eastern Europe. Investors tended to be more focused on the relatively mundane economic policy settings of the developed and emerging worlds – the former still focused on recovery and the latter now more concerned about the inflationary repercussions of continuing strong economic growth levels. However, renewed interest in non-market directional investment approaches and strategies uncorrelated to traditional bond and equity markets may, at least in part, reflect a level of ongoing global uncertainty, both natural and anthropogenic.

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

- Interest in hedge funds continues to increase; globally, and amongst Australian investors also. Some still favour broadly diversified hedge fund-of-fund offerings but the trend is towards building exposures using single manager strategies. A number of investors are seeking a reliable single manager multi-alpha source approach (quite difficult to find) as a core strategy and later adding single-manager, single-strategy approaches as satellites. In doing so, they are increasingly relying upon specialists for advice in building their exposure. In fact, several are appointing hedge fund-of-fund managers in an advisory capacity to assist in building tailored solutions for their portfolios;

- While the political debate over climate change (whether it is man-made and how best to address it) continues to rage, it seems institutional investors and their advisors are getting on with the job of planning for the opportunities and mitigating the risks that may arise under various scenarios. Mercer, in particular, argue that a retreat to traditional defensive asset classes such as cash and fixed income may not be an effective hedge against the non-traditional economic and investment impacts of harmful climate change. Further, with estimates of low-carbon technology investment requirements in the trillions of dollars, the return-seeking opportunities may also be immense. Mercer suggest that funds should be considering meaningful exposure to climate sensitive assets in areas such as infrastructure, real property, private equity, timber and agricultural land, green bonds etc. as a diversifier of risk and return. We have previously highlighted similar themes in articles linked from our website;

- We mentioned in previous Themes that flows to emerging markets equities had been rather subdued given expectations for growth and the opportunities for alpha. In fact, there has been some tactical rotation (not necessarily by superannuation fund investors) out of emerging markets to developed market equities recently as Governments focus on providing stimulus in the developed economies and on the spectre of rising inflation in the emerging economies. However, the maturation of emerging economies; particularly across Asia, will continue. As Government policies unfold, these tactical flows are likely to revert (and in fact this appears to have begun). However, many institutional investors are close to their long-term strategic allocations so any new wave of substantial flows to emerging market equities may depend on a review of those weights. Regardless, member contributions will continue to flow – particularly with an eventual increase in the SGC to 12% - and good managers with capacity will be sought after;

- As recognised previously, superannuation fund mergers continue apace. However, there have also been a number of super funds that are equally keen to stay small/medium, with the flexibility that implies, but that will pursue economies of scale by seeking to cooperate/collaborate with funds where there is some consistency of purpose or significant structural overlap;

- In private markets, infrastructure (debt and equity) continues to be a sought after asset sector; and reflecting this, investors and their advisors are building their resources in this area with a number of key hires during the period. Increasingly, specialist offshore advisors, across alternative asset classes, are establishing a presence in our market and in order to continue to be credible full service advisers, consultants are beefing up their in-house expertise. Previously, we have identified this trend but in the most recent period we have noticed the focus has particularly been on infrastructure experience. KPMG also launched a specialist private markets advisory business during the quarter;

- Still on private markets, "opportunity" is the buzz-word. Niche, differentiated approaches are attracting greater attention than broadly diversified generalist buyout and fund-of-fund strategies. GP's offering broadly diversified approaches to relatively efficient markets (e.g. the US and Western Europe) will need to tell a convincing story in order to raise capital from hardened investors still feeling pain from earlier forays into private equity. The value proposition in more targeted approaches may be rather easier to convey, assuming a compelling underlying logic;

- With the increasing interest in private markets more generally, hedge fund managers that have held private equity in side-pockets following the enforced selling of their more liquid assets (as a result of GFC-related redemption activity) are now coming to market to off-load these assets. Private equity secondaries managers, and some institutional investors, are looking to snap up attractively priced deals. This should be good news as well for investors who have been tied up in these side-pocket investments waiting for their redemptions to be realised; and

- Finally, given the muted outlook on domestic short term interest rates and the increasing talk over increases in US short term interest rates, several consultants and advisors are now recommending that their clients reduce their currency hedging ratios in favour of the US dollar versus the Australian dollar exposure.