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Themes and Trends – December 2014

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.

Generally, there has been a lack of conviction amongst investors about which asset classes to redirect or allocate flows towards. Developed market sovereign and quasi-sovereign bonds are seen as having more downside than upside and have little appeal unless investors have taken a very dim view of risk. Global developed market equities are perceived as being fairly to slightly overvalued; they may be up-weighted or down-weighted based on currency moves. Emerging market equities are seen as more interesting from a valuation perspective after a poor showing in 2014, as central banks have generally been pro-active, necessary reforms are being implemented and concerns over the end of the QE have been largely priced in. However, China may be a drag on these markets. Infrastructure and property continue to be of interest for their income producing characteristics but there is nervousness over valuations here as well; particularly, if interest rates rise sharply.

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

- Non-investment grade credit, such as high yield, senior secured loans (bank loans) and multi-asset approaches are attracting more interest after a difficult 2014 when investors perceived heightened risks due to lower quality issuance and mispricing of risk. Yield spreads have widened somewhat and some investors, particularly those nervous about equity valuations, are contemplating entering these sectors. Although valuations are not as cheap as a few years ago, they recognise that default rates remain low and fundamentals are solid. However, there are emerging problems amongst non-rated energy issuers and the volume of senior secured issuance due to regulatory changes;

- Emerging and frontier market debt are sectors which may at face value appear problematic; however, they may also offer interesting opportunities for enterprising investors. As stated above, investors are acknowledging that many emerging market sovereigns have implemented necessary reforms and the risks surrounding the end of the QE have largely been priced in. However, an active manager who can allocate between oil and gas exporters and importers is likely to be critical given the decline in the oil price;

- The Final Report of the Financial System Inquiry was delivered in December. It is worth noting that some commentators feel the Report perhaps overemphasises the lack of progress on costs since MySuper. Amongst other things, the Report flags “a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.+ A number of factors are identified as having hindered anticipated savings benefits, including %costly asset management and active investment strategies+. Fortunately, the Report acknowledges higher costs and fees may sometimes be of benefit to members; an example being alternative investments such as infrastructure.

  Investors have laboured to bring down the cost structures of their default MySuper offerings; we know many funds already restrict their use of higher fee active managers and constrain their investment in higher cost asset classes in order to work within tight fee budgets adopted for their MySuper products. The risk of ever increasing competitive pressures, particularly in the event of an open tender process, is that our default fund

landscape ultimately may comprise a relatively small number of cheap, big and simple offerings delivering modest but somewhat predictable long-term returns.

However, there is a contrarian view that default funds (managed for disengaged investors) could/should actually have more discretion to invest for the long term, in assets and strategies with lower liquidity, greater short term volatility and potential for higher returns. As previously noted, funds such as Future Fund and NZ Super have the ability to invest for the long-term precisely because they do not have to worry about competitive pressures and they can focus almost entirely on their objectives;

- Asset consultants have suggested onsite visits to fund managersq offices will assume greater emphasis as many firms are approaching their second and third decades and the likelihood of retirement of key people is increasing. Two critical factors regarding transition have been identified; team responsibilities and ownership. The first, although subjective, is relatively straightforward; you kick the tires, slam the doors, check for rust and make a judgment call as to whether the car is still roadworthy. Transferring equity stakes is rather more complicated; firm founders and key investment personnel potentially hold substantial equity worth a lot of money. The more valuable the stake the less likely the successors are to be able to buy the stake and even less likely again are the owners of the stakes to give them away. However, it is probably not necessary to make hiring and firing decisions today in relation to something that may be a problem in the future i.e. if the team and structure are sound the decision to terminate can be acted upon relatively quickly at the appropriate time. If research has been previously conducted to identify a pool of reserve managers, then the change should be relatively painless;

- The Melbourne East-West Link recently joined the NBN as the latest infrastructure project to become subject to the whims of political fortune. One reason these projects predictably resulted in political battles was the lack of public information and scrutiny. Long-term infrastructure projects will not always be justifiable on the strength of a narrow profitability analysis. However, in the absence of a clear business case, Governments either need to bring the public or the Opposition (possibly with reluctance) along with them. The Victorian Government will be liable to the parties involved, in the event the East West Link project is ultimately abandoned. Beyond the costs involved, the resulting uncertainty will be unhelpful as Governments seek the support of the private sector to fund later projects. These contracts are signed not with the ±Government of the dayqbut with the ±sovereignq (and the people of the State). Governments also need to accept they are accountable and perhaps there should be a process consistently adhered to, ahead of putting pen to paper, that will discourage political opportunism. Nobody expects our major parties to be ±as oneq on all projects but at least there could be an understanding that if the boxes have been ticked the project will not later be dismantled; and

- With commentators predicting the AUD could go as low as $0.70 in the relatively near term, some investors are contemplating selling the AUD to take advantage. Conversely, others who have benefitted from overweight unhedged international equity allocations are thinking the prudent thing to do may be to increase AUD positions to neutral levels by the time the above stated levels are reached. However, with many thinking international shares are a more attractive proposition than Australian this may be done by increasing AUD hedge levels rather than adjusting equity positions.

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