Themes and Trends – June 2013

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.

Uncertainty seemed to be the overriding theme of the June quarter. MySuper, and the possibility of last minute changes, has for many super funds continued to be a distraction from the ordinary day-to-day business of managing investments. There has also been uncertainty regarding the superannuation policies of our major political Parties and there is considerable doubt over which Party will shortly form our next Government. There has been uncertainty over US quantitative easing, when it will stop and, when it does, how much it will hurt. Following on from that, there have been reservations about investment markets and much talk of bubbles. Are we in a bond bubble, a credit bubble, an equity bubble, a housing bubble or some combination of these? None of these issues have been overly conducive to investment activity over the quarter.

In terms of mandate movements, there was reasonable activity in listed equities of various descriptions but most of the focus seems to have been in respect of an asset class that hopefully is relatively immune from short term noise; namely, direct infrastructure. In large part, our comments below reflect this. Our previous Themes and Trends have been rather infrastructure heavy - this is a theme we think will continue to dominate discussions for the foreseeable future.

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

- Some time ago we observed that superannuation funds are hungry for the stable and reliable cash-flows anticipated from mature brown-field infrastructure assets. The recycling of Government investment in infrastructure via asset sales (assuming proceeds are reinvested in new infrastructure projects) will help address our ongoing infrastructure shortfall but if Governments can encourage super funds to invest in new projects that has the potential to be a game-changer. Finsia shared some of the outcomes of an infrastructure forum of leading industry experts; one of the interesting perspectives was that super funds (of course this could also apply to non-super institutional investors) could be more involved earlier in the process; that they could be involved ahead of the construction companies and financiers; and could be having a say in how these deals are brought together and how the assumptions underlying them are determined. The result should be more conservative funding structures relying upon more conservative forecasts. If these investors are involved at an earlier stage, the projects may hopefully be more likely to satisfy their needs;

- Unsurprisingly, we note that super funds continue to build out their internal resources in this area. As mergers and the SGC creates larger funds, and funds are becoming asset owners as opposed to investors, a deep understanding of the characteristics of individual projects will be required; particularly, if the gap is to be bridged for investors from consideration primarily of brown-field assets to more risky green-field projects;

- The extent to which Australia's retirement funds are now predominantly defined contribution is also an issue - investment in very long term projects conflicts with the possible need to liquidate investments in the short term. In Canada, which is dominated by defined benefit schemes, funds on average have a significantly higher weighting to infrastructure assets. Comments have been made of the potential for greater Government involvement by virtue of the creation of a longer bond market and conceivably

Governments standing as buyers of last resort (to provide liquidity). Governments providing or facilitating debt funding at lower borrowing rates would increase the viability of any given project;

- Given that infrastructure will be an important investment theme for the indefinite future, Industry Funds Management - one of the biggest Australian investors in this asset class - was active over the period. IFM invested in a major deal (Ports Kembla and Botany), together with AustralianSuper, HESTA, CBUS, HostPlus and Tawreed Investments (a subsidiary of ADIA) and have since indicated their interest in the next one (Port of Newcastle), they hired a number of private equity and credit specialists, they opened a new office in Berlin and are considering opening a sales office in Asia, they won new client business and they will apparently shortly be advising the date of an across the board fee reduction for their clients;

- There was some discussion of social infrastructure during the quarter, in respect of opportunities represented by investment in private hospitals, retirement living and aged care. These types of infrastructure/property projects probably do not attract as much attention as some other types of infrastructure because they are less well understood and arguably more complex than say the energy, transport or telecommunications projects more commonly discussed. However, there is a growing demand for a greater number of quality facilities and services in this area. The demand is also of a long term nature and largely non-cyclical. The challenge, as above, will be to match the demand for this infrastructure with the investment requirements of super and non-super investors;

- Although many funds have adopted the UNPRI guidelines and encourage/instruct managers to consider risks and opportunities presented by ESG, direct action staged a bit of a resurgence with a number of large funds cutting tobacco from their portfolios ï notably (in no particular order) VicSuper, HESTA, Future Fund, Sunsuper, State Super and GESB. NZ Super also continues to walk the walk, cutting a number of companies involved in nuclear weaponry and on a more positive note adding back some previously screened companies who have severed connections with cluster munitions manufacture;

- Given the significant divergence in performance between developed and emerging market equities (approximately 18% over the 12 months to 30 June, depending on which currency the numbers are being quoted in), some investors are starting to think about tactical shifts or strategic rebalances in favour of global emerging markets as they believe the longï term fundamentals remain sound. Significant further divergence will prompt a number of investors to fast-track considerations of the asset class in light of the value this may represent. Similar comments have been made in respect of emerging market debt; and

- US and Australian long-term bond yields increased sharply from the beginning of May following news that US Federal Reserve quantitative easing was coming to an end. Investors were left wondering whether this was the long awaited beginning of the bear market in sovereign bonds. Although yields eased somewhat and the yield curve flattened slightly towards the end of the quarter, there remained a high level of uncertainty whether investors should reduce risk or move further along the risk curve in various asset classes. Regardless, this is propelling forward research into alternative/smart beta, volatility, short duration and interest rate hedging strategies.