Themes and Trends – June 2016

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.

Australian and New Zealand investors have had much to think about over the past quarter. The somewhat unexpected outcome of the UK ±Brexitq vote on 23 June spooked global equity markets and resulted in substantial falls taking place over subsequent days. Markets began to recover by the Monday of the following week and many are now back above the levels they were before the vote. Having said that, the machinations of Britainqs withdrawal from the EU will take considerable time to play out and the uncertainty will hang over the markets for the time being.

Additionally, the Australian federal election dragged out while we waited to see if the LNP Government would be returned and, if so, whether with a majority or in a hung Parliament. Although this has been resolved, investors have yet to see how effectively Turnbull will be able to govern with the barest of margins and a Senate cross-bench as ±colourfulq as the one it replaced. Reflecting this, Australiaqs current sovereign credit rating will be under pressure (S&P have already flagged their negative outlook) if the LNP Government is unable to make progress towards reducing deficits and debt. Some respected economists are of the view that downgrades are likely and that there could be significant ramifications in respect of foreign investment in Australia.

As if this was not enough, investors are also watching the run-up to the US election closely; particularly as many commentators are currently not ruling out what at one stage seemed unthinkable, namely that Donald Trump could actually become Americaqs next President.

More recent events such as the attempted coup in Turkey and the findings of the Permanent Court of Arbitration in The Hague, in relation to Chinaqs territorial activities in the South China Sea, remind us that globally the only certainty is uncertainty.

Finally, the World Bank, in June, reduced its forecasts for world growth to 2.4% (down from 2.9% in January).

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

- ±Impact investingq continued to be much talked about (and acted upon). Some of this activity relates to old fashioned infrastructure being, quite reasonably, re-labelled reflecting its public benefit. However, we note the NSW State Government looking to tap into this broad concept; ±On Traccq will fund a program to reduce re-incarceration rates amongst NSW parolees - investor returns will reflect the measurable success of the program. On Tracc joins the Newpin Social Benefit Bond and the Benevolent Society Social Benefit Bond initiatives. These programs are probably not yet, individually, of an institutional scale for many superannuation funds; however, the securitisation of social outcomes (which have a definite dollar cost) as offerings to private investors can potentially, at the margin, open up something new in this space;

- There is an increasingly greater focus on post-retirement services/solutions (for example the recent acquisition of StatePlus by First State Super). As more and more superannuants transition to retirement, and as the superannuation system matures, the relative size of superannuation versus retirement savings is changing. Therefore, the resources devoted to the ±administrationq of retirement savings will likely increase in order

that the superannuation funds of today can evolve to also become the retirement saving fund providers of tomorrow. Over time, the super funds are likely to become developers and producers of a proliferation of more complex retirement products;

- In June the Queensland Treasurer announced that two of the larger Queensland Government funds . QSuper and LGIA Super . would become ±public offerq from June 2017. The observation was made (by Rice Warner) that this could put significant pressure on other public funds (particularly in Queensland). Although this may well be the case, some commentators observe that as more and more ±not for profitq funds become public offer, they would anticipate one of the outcomes would be a greater focus on product range and service provision and therefore such moves are, over time, as likely to put greater pressure on the ±for profitq providers;

- Emerging markets equities and debt continue to focus attention as there is perceived to be reasonable value, notwithstanding the risk, in these markets relative to developed markets (volatility has actually been lower for emerging markets asset classes in the recent past). However, with respect to emerging markets debt it seems many investors still prefer to leave that decision in the hands of managers of broad fixed income strategies rather than themselves making the decision to invest in stand-alone emerging market debt strategies. It is anticipated this will change; particularly, for sovereign and semi-sovereign debt, as investors become more familiar with the asset class, recognise it as a quite separate fixed income asset class and allocate the resources necessary to take the decision out of the hands of the generalist asset managers;

- Investors are watching their healthcare exposures closely. In the US, Hillary Clinton has made no secret of the fact that she would like to see the cost of healthcare and pharmaceuticals decrease . thus squeezing margins throughout the pharma, biotech and healthcare industries. On the other hand, Donald Trump has indicated he will repeal and replace the Affordable Healthcare Act (i.e. ±Obamacareq) with a platform based on free market principles. Uncertainty associated with either election outcome will cast a shadow over these industries in the short term, impacting global equity and credit managers;

- As commodity prices have recovered meaningfully, non-investment grade credit asset classes have generally performed strongly since the oil and gas driven weakness, and related fund blow-ups, of late last year and early this year. Weaker credits, i.e. more highly geared companies, have kept pace during this modest rally meaning the ±spreadq for leverage is still attractive but there is not as much reward for taking on risk as there was earlier in the year. Although spreads on the loans and bonds of companies with stronger balance sheets are closer to their longer term averages, they still look attractive on an absolute yield basis compared to other fixed income asset classes and given default rates have not increased significantly amongst names outside the energy, metals and mining industry sectors. Some investors and consultants concerned about valuations in equities are also continuing to place money in this asset class. If there is a correction after this run it may be the more levered names that bear the brunt; and

- Notwithstanding the distractions mentioned in the introduction above, investors were quite active in the quarter in relation to Australian and also global equities. Selective allocations to infrastructure and real property continued as investors seem happy to invest in quality real assets offering stable, albeit not necessarily stellar, returns.

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