

## Themes and Trends – December 2021

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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.

Our comments this quarter are somewhat dominated by discussion of the new 'Your Future Your Super' (YFYS) benchmarking requirements. This is not because superannuation investor thinking is entirely focused on this issue but more because investors must now consider all their decisions in the context of the implications and restrictions imposed under the new regime.

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

- Superannuation investors who, due to past performance outcomes, are required to carefully manage risk budgets under the new YFYS benchmarking regime, may find it difficult to incorporate responsible, sustainable, or other ESG considerations (such as carbon reduction) in their portfolios. Funds that are forced to be more benchmark-like are not only avoiding active concentrated approaches that would create significant risk from a YFYS perspective but also more broadly diversified approaches that naively reduce ESG exposures/footprints without focusing on benchmark risk implications.

Passive enhanced or Smart Beta management approaches that focus on the risk and alpha, with the improved behaviour or reduced footprint being a necessary but untargeted outcome, are seen as compelling by some and are attracting attention from investors;

- Investors are increasingly of the view that inflation is turning up and yields on cash and high-grade fixed income will be rising soon. They expect volatility to continue in developed market listed equities for the time being. One asset class we are seeing much greater interest in recently because of the potential to achieve higher rates of return, albeit with greater illiquidity, is private markets and, specifically, private equity. Increasingly, private equity has become a more important means of participating in economic growth than it once was as new companies are staying private for longer and thus creating greater value before listing.

Unsurprisingly, it's a smaller group that can now consider investing in the private markets space. Super fund investors whose historical performance leaves them vulnerable to underperforming YFYS benchmarks are unlikely to be prepared to take the risk of investing in a longer-term and relatively illiquid asset class against what has become, for them, a short-term benchmark mismatched to their long-term liabilities. Such investors, if they are being cautious, have little opportunity to get themselves ahead of the curve again and presumably, if they are not pursuing mergers, will commit themselves to the efficient provision of low-cost near benchmark returns to their members.

Reflecting the above, the greatest interest we have seen in private equity has tended to be from investors not bound by the YFYS requirements (e.g. family offices, Future Fund, state investment authorities, endowments/foundations) or who have some reasonable historical outperformance buffer allowing them to have a longer term horizon;

- On a similar theme, conversely, there is a view that those investors who enjoy a substantial historical margin of outperformance over the YFYS benchmark may be

encouraged to take more active positions to differentiate in an increasingly competitive landscape. There is strong interest in private debt (both global and domestic), where traditional lenders such as banks now have a very much reduced role. Some argue that investing in this asset class over a 4-, 5- or 6-year horizon with a manager that deeply understands the nature of the businesses to which they lend, and that can potentially be actively involved in providing advice regarding the structure of a balance sheet, may be quite compelling when compared to the benchmark alternative of composite all maturities or global aggregate indices;

- Institutional investors are tentatively giving thought to investing in cryptocurrencies; REST Super have indicated they may, in the medium term, consider crypto for their members' savings – which would make them one of the first APRA regulated supers to do so. Others are much more cautious at this stage including ASIC, which has said that the crypto-assets underlying investment products will need to satisfy a range of criteria including in relation to institutional support, service providers, regulated futures markets and transparency of pricing.

However, some believe the underlying technology – blockchain – is sound even though the currencies that are based upon it are insufficiently regulated at this stage;

- Predictably, many long-duration growth companies have witnessed a savage sell-off as the reality of higher inflation and short-term rates dawned upon investors. However, in some cases, these companies maintain very strong market positions and free cashflows. This has caused some investors to begin thinking about entry levels which have not been available over the last few years;
- Although non-investment grade credit spreads remain tight, investors are still interested in the asset class given easy access to capital continues to put downward pressure on spreads whilst simultaneously creating a benign environment with defaults at historic lows and the ability for corporates to roll forward or restructure debt. The main risks to the current scenario appear to be supply chain and labour shortages feeding inflation; and
- We mentioned in our June 'Themes' that the Government was questioning whether large super fund investors were becoming too influential on the behaviour of companies, by virtue of their voting rights relative to smaller non-institutional investors. However, Rainmaker Information reports that the percentage of market capitalisation of the ASX held by local investors fell in the 4 years to June 2021. This is not particularly surprising as Australian investors have long-held a hometown bias in their portfolios which has been gradually diversified away over the years.

Having said that, the absolute size of super fund investment has increased over that period, just not at the same rate as the ASX has grown. Alex Dunnin, of Rainmaker, suggests that Government policymakers should pay heed to this trend and “work harder to make investing in the Australian share market more attractive”.

The Government instead passed regulation just prior to Christmas requiring proxy advice firms to apply for new financial services licences, by 7 February, to provide their services to super funds under more onerous and impractical considerations (any breach of which will come with substantial penalties). There has not been a great deal of commentary on this topic but as Parliament has only recently begun sitting, we expect to hear much more in this election year.

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