Themes – December 2010

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.

In the December quarter most investors, and their advisors, largely focused on strategic planning for the new year rather than starting new manager discussions or progressing due diligence. We anticipate that in 2011 there will be much greater activity in asset classes (e.g. illiquids, emerging markets, hedge funds) that may have been given a lower priority by many over the last year or two.

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

- We have seen considerable activity in alternative asset classes over the last six months reflecting: firstly, modest return expectations in traditional asset classes such as Treasuries, sovereign and investment grade bonds and perhaps even listed equities; and secondly, a shifting focus from a macro to a micro perspective i.e. with macroeconomic concerns having dissipated somewhat in the period since the financial crisis investors are now looking for ways to implement more targeted and, in some cases, more niche approaches in order to position portfolios optimally;

- Debt strategies potentially offering "equity-like" returns, such as distressed and high yield first mortgages and private equity mezzanine debt, are attracting renewed interest as a real estate funding gap and increased LBO activity creates opportunities. Income streams are only as reliable as the underlying assets and businesses; therefore quality, stable teams with compelling track-record only need apply;

- Investors are building their familiarity with private markets investing in emerging economies; diversified offerings managed by local teams and with a focus on due diligence (at a manager, fund and underlying business level) are generating enthusiasm. In particular, due diligence is very much a key selling point in these somewhat opaque markets; access to deals and/or funds (much relied upon in developed markets fund-raising) may be a close second;

- Interest in global emerging market equities continues to be very strong but, surprisingly, allocation to these markets has been quite muted due to a number of factors:

    - In China, strong growth rates, higher wages and inflationary fears point to rising interest rates and a stronger currency. However, China's announcement that it will allow the Yuan to drift higher has been met with scepticism, given this could potentially damage China's export competitiveness. While the implications for the region (and the globe) of this uncertainty are difficult to gauge, the significance of Chinese growth suggests that doubts about how they react may be a deterrent to some investors;

    - Emerging markets have performed strongly over the last two years and some investors believe that valuations are stretched - the somewhat common belief that economic growth largely determines equity markets return has been questioned by a number of studies. Investors would be more comfortable investing following a pause or a correction. However, if developed markets continue to recover; albeit slowly, any meaningful emerging market correction may be from significantly higher levels; and

  - Some investors believe that Australian equities are sufficiently correlated to emerging markets that they are already benefiting from the key themes. Similarly, some believe they can access emerging market returns of developing economies by investing in broader developed market funds specifically targeting global resources/commodities. Still others have chosen to adopt ACWI benchmarks or to expand developed market mandates to allow managers to tactically allocate to GEMs. These approaches, in common, focus on market beta and while they will capture some of the directional moves of emerging markets, specialist experience is necessary to reliably capture alpha and avoid the potentially significant downside risks within these markets.

  With emerging market economies now comprising approximately 30% of global GDP (and forecast to grow) but a much smaller percentage of the market benchmark, we anticipate that in time, and as investors become more familiar with these markets, the headwinds will dissipate and more substantial flows will be observed;

- Following public comments in recent years Frontier and JANA, jointly, released six "Principles for the Establishment of Fees" in November. Amongst these was a suggestion that performance fees relating to illiquid investments should, preferably, be based on realisation of the investments. Calls for a greater emphasis on realisations rather than estimated valuations (regardless of the level of diligence applied) are not just a local, or recent, phenomenon. We know that sceptical US LPs are also pushing primary fund GPs on this issue and some GPs have been prepared to sell minority interests in order to generate cash on cash returns and to justify valuations ahead of exit. We appreciate that Frontier and JANA are not advocating GPs prematurely exit portfolio holdings but this may be a trend that will help to address the issue in relation to performance fees charged against unrealised investments. Additionally, this is a trend which could create opportunities for secondaries players or for primary funds incorporating some allocation to secondaries (for the reduction of the J-curve);

- Investors are clearly differentiating between infrastructure assets delivering mostly regulated and stabilised cash flows with longer debt repayment schedules and those that are targeting some development risk and which are more dependent on GDP growth; terms/conditions and structures will vary accordingly; although, consensus is largely lacking; and

- On the staffing side, we've mentioned previously that consultants and funds have been building up their manager and sector research capabilities (particularly in relation to alternatives). This has continued over the past quarter but we have also noticed a few movements back in the other direction i.e. investment specialists previously from the funds management side returning to their roots. With investment markets looking rather more buoyant than they have for some time we wonder if this may continue.