Themes – June 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.

Many of the themes addressed in previous issues remain so we are focusing on a smaller number of topics that we think may be of some interest; the tenor of this quarter's *themes* is perhaps a little more focused on private markets. Whilst there has not actually been a significant amount of activity in these areas thus far; we have observed that, with liquidity issues having largely been addressed, institutional investors are now more focused on their next moves. Where money has been put to work in private markets it has tended to be on behalf of the larger superannuation funds, with significant in-house investment and governance resources. The investments themselves have generally been quite niche, and this perhaps reflects that investors are looking for value in less commonly accessed sub-sectors, countries or regions as well as recognising there has been over-commitment in some of the more traditional or more diversified sub-sectors.

Some themes we have identified since our previous update are as follows:

- Previously, we noted a trend away from Fund-of-funds to direct investing in private equity funds. Interestingly, some private equity markets attracting interest overseas, such as regional or country specific emerging markets, have gone largely unloved in Australia and New Zealand, reflecting that many institutional investors and generalist consultants do not believe they have sufficient insight to make calls on a particular GP. However, for some the macroeconomic case is sufficiently compelling that, in contrast to developed markets, a more diversified Fund-of-funds or multi-strategy (private and public markets) offering may help to alleviate the aforementioned concerns. Given the smaller deal sizes in India and China, a fund of a relatively modest size may still offer sufficiently broad diversification to provide comfort to somewhat unfamiliar investors. We have also observed that emerging markets GPs are becoming more enthusiastic about promoting their funds in this region;

- Specifically, in respect of greater China and Indian private equity, investors and consultants recognise these relatively new markets pose unique problems. Hence, the experience and longevity of the team, the number and type of realisations and a proper alignment of GP/LP interests will be scrutinised more closely. A local presence with local sponsors is seen to be very important in developing a strong deal pipeline; however, global sponsors of local teams will also be considered;

- Terms and conditions are likely to come under increasing examination across all private markets. There is a level of cynicism in respect of promised target returns for new capital raisings (often 20%+ for private equity offerings) given the paucity of debt financing and underlying growth. On the other hand, there are also murmurings from investors in relation to the preferred return hurdles – 8% may no longer be sacrosanct. Management fees are likely to come under pressure; while talk of deal fees being split 80/20 or even 100% of deal fees being reimbursed to LPs is becoming more common. Finally, there are concerns over GP stability given the almost non-existent carry earned since 2007, so investors are more focused on key man provisions;

- Broadly, market volatility continues; reflecting the risk of European debt contagion and fears of a double-dip US recession. The potential implications are perhaps discouraging investors from making changes to strategic asset allocations. However, investors are taking another look at sectors such as high yield and bank loans which performed so strongly in 2009 - spreads over Treasuries have widened considerably with no commensurate deterioration in free cash flows to debt ratios. Indeed, the annual default rate continues to decline;

- Another such sector is emerging market listed equities. Most investors agree about the long term secular shift towards emerging markets but have been cautious – believing valuations are stretched or technical factors are primarily driving prices. Some investors prefer their managers invest in developed market companies with significant operations in emerging markets;

- A number of investors have also dipped into core, particularly domestic, real estate believing capitalisation rates have stabilised. A modest recovery in rental growth and debt finance will slow cap rate compression; particularly overseas, reducing interest in value added strategies;

- Flaws inherent in market cap weighted benchmarks are well understood. Increasingly, non-superannuation investors (for instance charitable, insurance related, family office and Fund-of-funds) are indicating a willingness to invest in passive or active strategies that deliberately move away from the cap-weights. Fixed weight and alternative beta starting points, as well as benchmark unaware approaches, attract attention. Whilst subject to their own competitive pressures, presumably these investors are a little freer from the short term peer comparisons for superannuation Trustees; and

- We are seeing more and more overseas managers developing strategies with a sustainability "hook" of some description or they are simply incorporating ESG into their investment processes. However, whilst environmental, social and/or governance elements to a strategy will attract attention, Australian and New Zealand investors are unlikely to commit to an approach that is not also compelling in its own right.