Themes and Trends – September 2022

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.

Several investors, buoyed by the RBA's and some other G10 central bank's recent dovish forward guidance regarding interest rates, are thinking about what their next move will be after the first signs of a Fed 'pivot'. This has prompted research and due diligence into so-called risk-on trades and strategies ranging from global developed market equites, emerging market equities, developed market leveraged loans/high yield bonds, convertible bonds, and emerging market sovereign and corporate debt.

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

What we are hearing

Australian super fund asset allocations tend to be growth-orientated compared to the rest of the world and they will generally re-allocate their liquid holdings back into equities; more than likely, growth company equities given many believe they are oversold following the bear market of the last 12 months. The potential for lower discount rates will make their long-duration earnings profiles even more attractive. There is another school of thought that 'big tech' earnings will disappoint over the next 12 months or so and so these investors are seeking quality growth earnings beyond this group of companies.

However, some investors believe that any rally is likely to be muted given ongoing energy shortages, supply chain issues, and geopolitical risks, prompting interest in perhaps allocating some liquid holdings into sub-investment grade credit. Currently, the Yield to Worst of US high yield is higher than the levels recorded during the first month of the COVID-19 pandemic in March 2020 while at the same time default rates remain below historic averages. Even quality convertible bonds, given their cheap optionality and 'equity-like' returns typically delivered in a recovery phase of the cycle, without similar levels of volatility as equities, are garnering the attention of investors.

Stressed and special situation credit is also seeing an uptick in interest as a potential home for risk capital in a post-pivot environment in recognition that some lowly-rated corporates will have liquidity issues or may face challenges rolling over their debt.

Emerging market sovereign and corporate debt is also garnering interest again after a long period of declines as investors assume the US dollar will weaken and realise that some emerging market economies are healthier than many of their developed market counterparts. Surprisingly, some have even concluded the domestic political risks, in some cases stemming from higher external energy dependence, are higher in developed markets than major emerging markets, with the chaos in the United Kingdom being a harbinger of things to come.

Even emerging market equities have piqued the interest of investors as valuations are seen as very attractive compared to developed markets; but most remain wary about allocating a part of their active risk budget until there is clarity from the pending Your Future, Your Super review (see below). Relatively volatile sub-asset classes tend to be penalised in the current YFYS regime.

Interest in active management in the above public markets has made a comeback as investors anticipate greater idiosyncratic risk as companies grapple with somewhat unfamiliar challenges such as persistently high inflation, weakening consumer demand, supply chain blockages, energy shortages and geopolitical risks.

Based on our understanding, institutional and wholesale investor adoption of digital assets is likely to remain elusive for a while yet as super funds wait for regulatory clarity from APRA and ASIC - APRA has signalled strict adherence to prudential standards and ASIC has hinted at considering crypto-currencies as financial products. The recent high correlation to technology companies and lack of any perceptible inflation hedging properties has probably also contributed.

However, there are some encouraging signs overseas with BlackRock announcing a deal with Coinbase, a crypto exchange and custody provider, where it would provide connectivity to its investment technology platform to initially facilitate access to Bitcoin. Additionally, Fidelity has added to its digital asset offering with the Ethereum Index Fund.

Scope 3 carbon emissions

How managers deal with scope 3 carbon emissions remains a topic of interest for consultants and their investor clients. Some concerns relate to the potential double counting of emissions that are covered under scope 1 and the quality and availability of scope 3 emission data provided by companies. Third-party data vendors have tried to step into the breach but their data is considered somewhat problematic.

Your Future, Your Super reforms

We have commented on the implications of the Your Future Your Super (YFYS) requirements in previous quarterly themes and trends. With the change in Government and a pending review of the YFYS measures, invested industry participants have become more vocal in relation to unintended detrimental outcomes. A common criticism is that the benchmarking assumptions, requirements, and ultimately the repercussions of underperformance are changing investor behaviour in terms of shortening time horizons and reducing relative benchmark risk; this will impact the asset sectors and investment styles that will be allocated to. Incorporating ESG considerations into portfolios will also potentially be impacted which creates challenges given that super funds have net zero targets to meet.

Those funds that have a meaningful performance buffer relative to benchmark are in a strong position to continue to manage innovatively and in line with long-term performance objectives. All others are, to some degree, hamstrung by the risks associated with deviating from the neutral position. For those funds that fail the performance test, portfolio management will become even more difficult as they will no longer be able to rely upon member inflows to assist with liquidity management and/or to be available to fund new investments.

It will be interesting to see the findings of the review and whether the regulations may be significantly modified or even just tweaked at the margin.

About Clearway Capital Solutions:

Clearway Capital Solutions, based in Sydney, Australia, provides ongoing business development and product advice and assists in gaining access to the institutional, wholesale, and sophisticated investor markets of Australia and New Zealand for local and offshore-based fund managers. Clearway Capital represents a small diverse group of funds managers, covering alternative and traditional asset classes. In addition, Clearway Capital conducts marketing research on a project basis.

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