

## Themes and Trends – June 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.

The June quarter was relatively uneventful. Equity markets continued to rise with occasional and limited bouts of volatility. Yields on sovereign and investment grade fixed income securities stayed low and spreads remained tight. Investors largely tinkered around outside their core exposures and focused internally on year end and adjusting to the latest superannuation reforms imposed on them by Government.

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

- The quarter again was notable for merger activity between super funds. It is becoming clearer that the industry will increasingly be divided between a relatively small number of small funds who believe they have something to offer, by virtue of their size and their targeted offerings, and everyone else. And 'everyone else' is moving rapidly towards proving the pundits correct in their predictions that in future the industry will be serviced by a small number mega-funds;
- Notwithstanding ongoing Government enquiries in the Senate, merging funds have mostly embraced the logic of economies of scale and accepted they will be subject to increasing peer competitive pressures because of the heatmap and the Your Future, Your Super reforms. Industry observers already note a trend of funds reducing fees in response;
- Investors were relieved the final iteration of the Your Future, Your Super reforms were passed without the proposed Ministerial discretionary 'veto' power to prevent investments not in the national interest. However, concerns remain about 'stapling' provisions that could semi-permanently attach members to first-time funds (often funds with a history and focus on retail and hospitality), or to underperforming funds, and also insurance implications in the event an employee changes careers but is stapled to a fund with unsuitable insurance (e.g. a retail employee moving to building/construction);
- With the superannuation landscape now rapidly and substantially transitioning to one of a small number of mega-funds and a smattering of 'boutiques', the latest round of questioning from Government will revolve around whether super funds, by virtue of their increasing size, are now becoming too dominant and too influential in relation to the listed Australian companies they invest in; they ask if smaller, non-institutional, investors are able to have any meaningful impact on share prices and whether their voting rights give them any say in relation to the management of Australian listed companies? It is difficult to see what possible outcomes could be arrived at from this topic of conversation; even if the mega-funds were entirely indexed and voiceless (i.e. not exercising voting rights) this would not resolve the issue of whether mum and dad investors are being heard;
- The issues mentioned in the bullet points above have preoccupied investors over the quarter and many have focused internally rather than considering adding or reducing manager numbers or replacing incumbents. In order to express a view e.g. whether to add to emerging market equities or tradeable non-investment grade credit, many super funds are using incumbents, sometimes even requesting alterations in their mandates, rather than seeking new managers. The inability to conduct overseas research trips has also

contributed to a reduction in hirings (and firings). Financial year end is generally somewhat of a distraction but, even so, we think investor activity has been quite subdued compared to previous June quarters;

- Where we have seen interest, given developed market sovereign bonds and investment grade corporate credit still offer little yield and equity markets are highly valued, investors are generally expending their energies in other areas. Strategies investors have shown interest in include:
  - Multi-asset credit, Australian direct lending/private credit;
  - Industry and sector specific global equities (healthcare, information technology), global and regional small caps, Asia ex-Japan, China;
  - Real assets; primarily property and infrastructure and less enthusiasm for private equity;
  - Passive Australian and global equities, with a view to managing risk (and fees) around the 'heatmap' and Your Future, Your Super reforms; and
  - Investors are also/always keen to hear about anything new, niche or differentiated. New ways of incorporating E, S and/or G into equity investing, strategies driven by artificial intelligence, genuinely diversifying alternatives;
- Specifically regarding credit, investors continue to strongly favour relatively liquid multi-asset credit or even broader approaches, depending on the risk/return objectives, with significant discretion given to the teams managing the allocations and sub-sectors. Traditional long-only sub-sectors are less interesting given spreads have largely returned to pre-COVID levels. But again, most super funds prefer to utilise the broader capabilities of an incumbent fund manager rather than select entirely new managers for this task;
- Regarding equities, potentially higher inflation, Chinese government regulatory interference, geopolitical risks and COVID-related impacts on emerging markets are weighing on investor's minds; although, they remain very interested. Value stocks bounced back but many are doubtful this will continue; and
- As funds become fewer and larger, some mobility may be lost, at least at the mega-fund level. \$50bn+ or \$100bn+ funds will still be able to change allocations incrementally as their long-term outlooks evolve and/or, at the margin, adjust exposures tactically or dynamically on a shorter-term view. However, it is unlikely they will be able to adjust positions both quickly and substantially. Consequently, they may prioritise investing in people, processes and systems that will allow them to dig deeper to identify investment opportunities that will enable them to meet their benchmark objectives and remain competitive with their peers. Therefore, they may become less reliant upon asset allocation moves and more focused on identifying investments in which they have reasonable conviction of beating static passive benchmarks. Beyond choosing managers and weighing up the benefits of sector sub-asset categories (e.g. loans vs bonds, value vs growth, broad markets vs regional vs industry sectors), larger investors are increasingly getting closer to the underlying real assets – property, infrastructure, private equity, direct lending – and investing directly or co-investing rather than via funds. Additionally, cost savings resulting from internalisation of some investment functions may allow larger funds to free up their fee budgets in order to access higher conviction alpha strategies.

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