

Themes and Trends – September 2013

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.

Surprisingly, given the ructions in the US regarding the short term partial Government closure, the very real prospect of a debt default and the ongoing question-mark over the timing of tapering, markets for the most part performed quite strongly over the quarter. Other than a change of Government locally, which arguably has provided a short term bounce in terms of consumer confidence and investor sentiment, there was not much that stood out over the period. Investors focused on financial year-end, MySuper and where they might find some income producing assets offering a little more return than investment grade bonds without a lot more volatility. This is reflected in some of the trends we have identified over the recent period.

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

- There seems to be moderately strong interest in emerging market debt (EMD) (including in relation to ~~frontier~~- i.e. not yet emerging - markets), thus far most investors seem most comfortable leaving the asset allocation decisions to a manager with the ability to shift money across a diverse range of fixed income markets and with reasonably modest maximum allocations for this asset class. However, this is changing as investors recognise the investment case and become more interested in and more familiar with the asset class. They also recognise that specialist skills and resources differ from those required to manage developed sovereign bonds and non-investment grade credit portfolios. The comments we have received, adjusting for fluctuations in valuations, suggest allocations to EMD on a stand-alone basis will increase over time;
- With many investors now having ticked their MySuper boxes and with the GFC hangover receding to a dull throb, greater attention is being focused on areas that may not have been highest on investors' priority lists for some time. The trend to increasing allocations to international investments has gained some momentum. Additionally, specific types of multi-strategy hedge funds are being considered increasingly and ~~we~~ even heard private equity mentioned a few times in a good way;
- The OECD released a report early in the quarter highlighting that Australian and Canadian superannuation and pension funds are leading the world in relation to investing in infrastructure projects. The Canadian model is somewhat different from ours in that it is dominated by DB funds rather than DC funds; and therefore, its ability to invest for the long term is rather simpler than our own. Given that critical difference, Australia's effort is laudable though arguably more problematic given the level of choice in our system. Another key point of differentiation highlighted in the report is that the Canadian model strongly favours direct investment in infrastructure whereas Australian funds are predominantly investing via the vehicles of specialist General Partners. However, although it is early days yet, the trend to building out internal investment teams in Australia is continuing, including in the area of infrastructure. This should allow superannuation funds to be more involved; and, importantly for infrastructure projects to receive the support they need, to be involved earlier in the process. The OECD report highlights several advantages of investing directly in infrastructure projects; lower cost than investing via external funds, direct control over the assets (including time horizon and entry/exit decisions), alignment of interests with other project partners and a longer term focus on

value in line with the fund's liability profile rather than the terms of a GP's carried interest. We expect this trend to internalising expertise to continue amongst the larger funds and/or in partnership of some description with relatively smaller funds;

- There is genuine interest in convertible bonds; however, one of the questions investors will need to deal with is where to house this asset class; this is an asset that not only has characteristics of both debt and equity but which also behaves more like one than the other at different stages of the cycle. This may make an allocation challenging for some funds whose equity and debt responsibilities are clearly demarcated, unless converts are separately identified and placed within an ~~alternatives~~ allocation;
- Still on the topic of non-investment grade credit, we also note the evolution of interest in the various sub sectors of the asset class. Investors took note of high yield bonds at the peak of the GFC when spreads to Government-issued bonds blew out to well over 1000 basis points. Few took advantage at those levels; given a lack of familiarity with the asset class and the very real possibility that spreads were justified at these levels. However, quite a number of funds did allocate when both the spreads and risks were lower and have found this to be an attractive investment from a risk and return perspective. As high-yield bond spreads reduced and the returns became more bond like than equity like, a number of investors gravitated towards bank loans, as a floating rate instrument less susceptible to the impact of rising inflation and interest rates, or shorter duration high yield bonds. As we move through the cycle, we are now seeing increasing interest in active diversified approaches to stand-alone non-investment grade credit.

We suggest this reflects a growing understanding of the asset class and a willingness to allow non-investment grade specialists to make the asset allocation call. Previously, diversified approaches have been very broad ranging; encompassing sovereign, investment grade, non-investment grade, possibly emerging markets and private markets debt (mezzanine private equity, infrastructure etc) and even currency. However, as knowledge and familiarity increases, investors and their advisers may become more comfortable taking the overarching asset allocation decision themselves but allowing the non-investment grade specialists to make the relative value decisions at a sub-sector level as they recognise that non-investment grade market shifts are highly dependent on the credit quality of the underlying issuers/issues. Most investors and consultants readily accept they do not have the sufficient skills and resources to monitor at this level of granularity; and

- Roll-out of direct investment options continue apace in response to the growth of the self managed super fund market. However, some commentators are appending warning labels (not literally) to this trend. At the ASI Conference in September, polling of the audience indicated most were keen for their funds to be able to offer a DIO; however, an even larger number of that same audience were of the opinion that members who took up the option would in general underperform the professionals. While choice has been assumed to be an objective in itself by many for a long time, the ultimate out-workings of choice may actually not always be beneficial to the majority of superannuants. If this issue is given greater credence, questions may need to be asked in respect of the fiduciary duties of Trustees if they are in fact facilitating the ability of members to reduce their retirement savings and, if so, is that appropriate simply as a defensive measure against fund outflows.

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