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Themes and Trends – December 2019

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.

One year ago, after sizeable falls on equity markets over the later months of 2018, investors were cautious and more focused on risk than return; while equity markets were not seen as overly expensive**,** a slowing of the rate of Chinese growth, ongoing US/China trade tensions and the increasingly messy path to Britain exiting the EU were all areas of concern. 12 months later, equity markets have hit new highs and fixed income yields plumbed new lows. Combined with a generally weaker Australian dollar, many super and non-super funds will likely have achieved mid-double digit returns for the calendar year.

Although Brexit has now concluded, the outcomes are far from clear-cut. And while the US has announced phase one of a US/China trade deal, this is not necessarily adding a great deal of certainty either. Hence, investors remain cautious given generally softer global economies, share markets supported by interest rates rather than fundamentals and a looming US election.

GDP growth in Australia continues to fail to meet expectations and, combined with the impact of the current devastating bushfire season, many forecasters are now calling for another two cuts to official cash rates in coming months. More recently, the spread of the coronavirus is likely to further take the edge off both domestic and global growth.

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

- The first iteration of APRA's MySuper 'Heatmap' was published on 10 December and this has caused some consternation. APRA has made clear it expects trustees to address areas of underperformance and, if not, they may be "subject to more intense supervisory actions". APRA has been contacting trustees of the 'worst' performing funds and letting them know there will be consequences if there are not signs of improvement in a reasonable time frame. Several investors have been outspoken about possible pitfalls of this peer comparison; criticisms include:
    - Return numbers do not have sufficient regard for individual fund risk and return objectives. It's quite conceivable that a defensively positioned fund (reflecting its particular member characteristics) could be meeting return targets over all periods but underperforming the peer group over an extended bull market. Arguably, peer comparison should be almost completely irrelevant if a fund is meeting the retirement objectives of its members;
    - Peer comparisons can have a 'herding' effect if they encourage funds to focus on performance relative to each other rather than performance focused on meeting fund investment objectives and the retirement needs of their members. It has been suggested that this could stifle innovation;
    - Although returns are quoted on a net of fees and costs basis, fees are also emphasised on a stand-alone basis; this may tend to push funds collectively towards lower cost investment options regardless of outcome;

   - The comparison is a single point in time; although updated periodically (at least annually), outcomes may look meaningfully different in relatively short timeframes**.**

  Cleary the Heatmap is intended to be considered in its entirety. Too much information cannot be a bad thing but perhaps this information is more useful as a pointer to review of the management and trusteeship of funds that, at face value, are not stacking up. Unfortunately, elements of the media may be more inclined to focus on raw numbers which can in turn feed through to the perceptions of fund members or employers;

- Reflecting the above, there are calls for a greater focus on risk-adjusted returns. This is not something currently included in the Heatmap. Some funds scoring poorly on both fees and net investment returns are amongst the strongest performers when considered on a risk adjusted basis;

- Some investors, cautious about the extended bull market in equities (both locally and globally), are showing interest in strategies they anticipate will perform better in the event of a meaningful correction – Low Volatility as well as dividend focused strategies are included in that mix;

- Additionally, investors continue to seek yield from non-traditional fixed income asset classes. Emerging and frontier markets debt is an area of growing interest. However, many still contemplate where best to house such an allocation. The observation has been made that funding EMD from defensive allocations adds risk whereas funding from equity de-risks, at a total portfolio level. An interesting observation and perhaps it is the case that such assets can find different homes at different stages of the investment cycle.

  Another question that is often asked is about timing an allocation towards the various EMD sub-asset classes and Frontier markets debt. Many investors are concerned about being on the wrong side of perceived hot money flows and bouts of dramatic market volatility. The more sophisticated investors know the finances of many emerging market economies are quite sound, which helps reduce the risk of tourist dollar flows. Also, a blended approach to the asset class including hard currency, local currency, and maybe even Frontier and corporate debt, may help to smooth returns. Some of the more forward-thinking investors anticipate that EMD will become as ubiquitous in portfolios as investment and non-investment grade bonds and loans and they are less concerned about an entry point; instead they are working towards building a strategic exposure to EMD;

- There have been several stories about the inexorable rise of ESG investing globally. We have noticed the demand for ESG and impact-related product is strengthening; particularly in non-super channels such as wealth advisory firms, who are in the early stages of developing policy and investment recommendations. One investor we spoke with believes we have hit ‘peak ESG, although we are not entirely sure we have reached that peak yet or if we will – perhaps the peak will keep moving ahead of us. However, some consultants/investors are increasingly sceptical that the claims made by investment managers can be universally taken at face value. Greater scrutiny is being applied to ensure managers are genuinely responsible in their investing and not just in their marketing material. They are also interested in the scope of ESG integration away from narrow definitions of ESG. This requires greater consideration of issues surrounding climate change, privacy/ethical issues and so on.

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