

## Themes – March 2010

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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.

As noted in our previous *Themes*, it appears we have returned to a more normal institutional investment market-place. With portfolio returns improving, investors are increasingly focused on introducing managers and strategies that will improve portfolio risk / return and, in some cases, downside and liquidity risk. Previously, we observed that investors had been more preoccupied with portfolio rebuilding; dealing with liquidity issues arising out of the GFC and terminating poorly performing managers. Our understanding is that, by default, these redeemed funds were mostly allocated across surviving managers.

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

- The influence of specialist alternative asset consultants continues to rise in this region; we also note that generalist consultants are building upon their alternative asset capabilities by making senior level appointments or by re-configuring their teams to more efficiently and accurately assess managers and strategies and provide targeted advice across all asset classes. We suggest there may be a causal relationship;
- Some investors profess to be wary of quantitative strategies as a whole; others recognise quant is not a one-size fits all categorisation. Our conversations suggest that logical, internally coherent systematic approaches (with predictable outcomes in given market environments and the ability to adapt during changing market environments) are likely to be increasingly of interest to investors. However, opaque strategies, whether quant or fundamental, are unlikely to attract significant attention going forward;
- Sovereign bonds seem to be out of favour. The capital losses potentially arising in a higher inflation and rising interest rate environment, coupled with increased supply – and even the spectre of default - are encouraging investors to look elsewhere (most obviously cash). With corporate default rates falling and issuance quality improving, investors are looking at high yield / bank loans, to boost yields, and are also considering the turnaround potential in traded and non-traded distressed credit; although, the extent of the capital overhang for distressed appears to have worsened;
- Investors continue to search for managers providing exposure to emerging market equities and debt; although, investors remain wary of a technical pullback or a reallocation of capital flows back into certain improving developed markets. Nevertheless, investors believe their strategic exposure to emerging markets should rise over the long term;
- In private markets, there has been a continuation of the trend towards making commitments exclusively to funds (rather than relying to some extent on Fund of

Funds); in fact, more investors are looking to directly invest or co-invest in underlying deals. By going direct to funds, investors are able to be more targeted in terms of their exposures to themes and sectors, and also to remove a layer of fees from the equation. This increased specialisation is generally being matched by an increase in resources and internal governance capabilities of the superannuation funds;

- Broadly diversified investment offerings will always have their place but we note that investors are increasingly comfortable with higher conviction / higher concentration strategies in certain asset classes. Whilst introducing greater levels of “risk” when compared to a market benchmark there is recognition that these strategies may actually reduce risk if considered in an “absolute” sense because they are not forced by structural constraints to hold exposures to stocks, sectors, countries, regions and even themes they expect to underperform;
- Investors are increasingly seeking domestic real estate opportunities; such as fully leased assets or partially leased and to a lesser extent distressed assets, to exploit the re-rating of risk/return (higher capitalisation rates) that has occurred over the last 18 months. Offshore real estate investment remains off the agenda with the exception of traditional well known fund of fund structures;
- Fees are not likely to go away as an issue and consultants continue to push for flexibility in structures for active strategies; our experience indicates that managers are likely to accept lower base fees if accommodated by increases in performance fee potential. Fixed dollar based fees are an interesting concept; but investors need to be comfortable that if their asset size decreases they will still be paying the same level of fees. If not, perhaps the concept needs to be redrawn with the fixed dollar fee being a cap and reverting to a % base fee below a given level of assets. However, managers would probably expect to be compensated, under that scenario, either by setting the cap at a higher level than the fixed dollar fee would otherwise be or by increasing the % base fee below the cap;
- A general malaise seems to have descended on the general public in relation to environmental issues; responding to this, some superannuation funds and their advisers seem to have been ramping up their efforts and taking up some of the slack in terms of keeping ESG issues front and centre with superannuants; and
- Historically, regional investors have been early adopters of certain innovative investment concepts and strategies. However, we have observed some caution on the part of investors in relation to support for new investment concepts offering real diversification benefits. Although questions regarding pricing, valuation and liquidity remain to be addressed, we think this probably also reflects portfolio issues of the recent past and the difficulties arising from unanticipated portfolio outcomes of the global financial crisis.

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