Themes and Trends – September 2020

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.

Unsurprisingly, the US election, COVID-19 and its impact on the economy and climate change, as well as the interplay between those three 'themes', continued to be the focus of investor thinking. While Australia's response to COVID appears, for the moment, to have been effective nobody is taking for granted that second or third waves, like those in other parts of the world, may not happen here. Reflecting this, investors are not yet investing for a post-COVID landscape. Additionally, the pending US election may one way or the other impact the global response to climate change, depending on whether Trump or Biden wins the day and what the next steps will be in relation to driving or derailing coordinated global efforts.

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

- The 'COVID-crash', from late February to late March, has since prompted much research and analysis, and discussion and debate, into whether or not ESG or elements of ESG have had a material impact on the relative share price performance of companies during that period. Conclusions, reflecting in part how broadly ESG has been defined, vary from 'not at all' to 'undeniably'. Where the conclusion *has* been reached that companies exhibiting sustainable behaviours or characteristics generally outperformed during this period, the question has been asked as to whether these companies outperformed because their approach to ESG contributes to value or whether they are outperforming companies who happen to incorporate positive ESG behaviours because it is the right thing to do as good corporate citizens.

  One fund manager's study observed that companies exhibiting resource efficient characteristics (in relation to their consumption of scarce resources and their creation of waste) performed better than inefficient companies. However, the same study also recognised such companies often also rate highly on traditional measures of resilience and flexibility (which can be identified by Fama-French profitability and investment factors) and therefore could be expected to do relatively well in a period of stress. The study then considered whether resource efficiency measures simply identified quality in another guise or whether in fact they independently contributed to performance during the sell-off. Using regression analysis, the study concluded that resource efficiency independently added alpha during the 'COVID-crash'. The same regression analysis, covering the period from late March to late May, found that resource efficiency was not a significant alpha source during the 'recovery' period. No doubt the dramatic market fall and subsequent rise will be used to test many other investment hypotheses;

- Although spreads have narrowed somewhat, credit remains a strong area of interest for investors. Distressed credit managers have been prominent again but investors remain wary given the period following the Global Financial Crisis when managers raised large amounts of capital and then some handed it back as the expected volume of distressed opportunities did not eventuate. Also, many investors are wondering how long the US central bank stimulus, and any US government fiscal stimulus, will remain and what impact this may have on the level of defaults. Most believe central expansionary policies will help to cushion defaults, with the exception of industry sectors such as oil and gas and travel and leisure. Therefore, most investors seem to be thinking about expanding their existing mandates to allow managers to exploit stressed opportunities or they are seeking specialists in this part of the market;

- The old 'growth versus value' argument was also prominent among non-super allocators - they remain sceptical that growth can continue to outperform given its strong run over the last 5-7 years. However, central banks across the developed world have been very clear about being supportive - prepared to use various levers such as ultra-low interest rates and quantitative easing - for the foreseeable future which bodes well for so-called growth companies. Although increasing concerns regarding Big Tech's dominance and ethical practices, and the US-Chinese trade spat, might weigh on this high-flying sector;

- There has been much commentary about the attractiveness of various real and listed property assets relative to each other and also to other asset classes; this was particularly the case at the time funds were being critiqued in relation to their ability to fund early release redemption requests. Many types of real property will be badly impacted in the short term (e.g. retail, hotel, tourism etc.) but are anticipated to substantially recover once some sort of solution is arrived at. However, others, such as office property, may require a wholesale reassessment of the nature of the work environment.

  Some investors are of the view that falls in valuations are large enough that, even in the riskier segments of the market, they represent a reasonable opportunity over the long-term. For instance, some argue that REITs are trading at a sizeable discount to NAV and must be a good long-term investment even if, in the worst case, they might require some repurposing to realise their potential. Others however are much more cautious and will wait till there is a clearer picture of how we will emerge from the current crisis.

  Interestingly, some forms of property investment falling under the heading of impact investing have attracted attention. For investors willing to accept a somewhat lower yield but attached to high certainty of tenancy, impact investments such as affordable / low income housing, specialist disability / aged care / dementia accommodation etc. are being considered; and

- Talk that the Federal Government would defer or cancel the next round of SGC increase, previously denied, solidified during the quarter with the PM and Jane Hume, the Assistant Minister for Superannuation, making clear this course of action is now being considered. The argument is made that the COVID crisis means employees cannot afford to have near term wage rises traded off for an increase in their superannuation that will benefit them at retirement. Further, flat wages will reduce current spending by lower income earners which will in turn be a negative factor for jobs and growth in the economy.

  Industry bodies counter that contributions do not simply disappear into an unproductive ether for the duration of a member's working life but those savings are invested, amongst other things, in Australian businesses and jobs and help support the economy.

  Further, they argue that super can be a key plank in Australia's economic recovery. For instance, Industry Funds Management (IFM) is proposing a new infrastructure model (the Building Australia Model) whereby a private infrastructure investor (not *necessarily* a consortium of superannuation funds) would work closely with Government from an early stage to generate efficiencies, lower taxpayer risk, achieve greater transparency and transfer risk effectively to the private sector.