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Themes and Trends – September 2014

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.

Notwithstanding some concern over equity market valuations, surveys indicated most investors were actually reasonably bullish at the beginning of the quarter given expectations of solid economic growth rates. However, the Australian equity market had given ground late in the quarter on concerns over the rate of Chinese growth. US equities had held up quite strongly in the face of global events (Israel/Palestine, Ukraine, Iraq and Syria), perhaps reflecting expectations that Yellen will keep Fed rates lower for longer. This will help to support other developed market economies. Having regard to the geopolitical state of play though, investors appreciate there are any number of triggers that can result in heightened volatility and at least a short term correction. The fall in the Australian dollar late in the period provided a slight performance buffer for unhedged overseas assets.

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

- Rainmaker data released during the quarter, for the year to 31 March 2014, showed a big increase in the proportion of funds invested in index strategies; now 19% of the market based on data sourced from fund managers, including ETF providers. Presumably, some of this reflects investors building or restructuring default funds in line with MySuper requirements. The increased focus on passive management seems to have reinvigorated the whole passive versus active debate. The Grattan Institute in particular has been pushing the line that higher cost active management on average does not outperform the market and has posited that MySuper could simply have compelled default funds to invest in passive strategies in order to bring cost structures down.

  There is great interest amongst both investors and consultants in ±smart betaqapproaches - this seems to have gained momentum recently. Smart Beta strategies potentially add value over cap-weighted benchmarks but are offered at fees much closer to passive management. While Towers Watson stole a march in this area many years ago now, it seems most asset consultants are now considering how best to integrate such strategies into client portfolios;

- Recent high profile departures at fund managers with significant Australian businesses has resulted in speculation about whether there will be significant redemptions, and if there are, where those flows are likely to go. It is probably too early to gauge the impact of these departures just yet and these processes usually take a long time to play out. However, it highlights the ongoing problem of continuity in investment management; particularly in relation to active management, as it is a business enterprise largely dependent on human capital which can quite easily walk out the door;

- More Australian super funds are joining the regional (NZ seems to have led the charge) move to limit or reduce fossil fuel exposures in their portfolios. HESTA and UniSuper have made announcements on this issue in the past quarter and Simon Sheikh (of GetUp fame) has recently launched Future Super which will specifically exclude these exposures, amongst others. Total %esponsible+investment has grown strongly in the last year and is reported to be over $150bn. It appears that an increasing number of superannuation investors genuinely believe these exposures represent a real performance risk for their funds. Although adherents to the logic of considering ESG issues from a portfolio risk and

return perspective have been around for decades, it has taken some time for this to become the widely held view. Data supporting that ±responsibleqAustralian equities funds have actually outperformed over short and longer time frames suggest that such exclusions are not being introduced for the purpose of ±feel goodqmarketing to members; it may become the more conservative approach;

- Comments have been made that the rate of growth of the SMSF market may be close to a peak or plateau. We have frequently commented on the innovative efforts of superannuation funds to defend their membership base by providing options allowing members to pursue strategies otherwise sought elsewhere (such as direct investment in Australian shares). This quarter we note CareSuperqs partnership with Crowe Horwath to offer services to CareSuper members - who for one reason or another have decided not to persevere with SMSFs - to assist them in managing the complexities of terminating an SMSF. There appears to be no clear impediment to the service being offered beyond their own membership; therefore, there may well be first mover advantages should superannuants be inclined to join a fund offering such a service. Other funds may follow their lead;

- Super funds also increasingly have to compete with banks and other financial institutions that have subsidiary superannuation businesses. During the quarter we note a couple of the industry funds are returning the favour by offering branded debit cards supported by their own bank . ME Bank. As the funds grow, behave more commercially and as innovation becomes second nature, super funds are likely to progressively expand their operations as more broadly based providers of financial services to their members;

- With the ongoing proliferation of MySuper default approaches and strategies, some larger funds have questioned the relevance of peer comparisons focusing on short term performance. In particular, QSuper (although they have not specifically referenced MySuper) have suggested it would make more sense to look at the consistency and reliability of performance relative to investment objectives over time. This would seem to be a fairly logical outworking of MySuper, given we have cheaper, more explicable but frequently less comparable offerings. MySuper was specifically set-up to cater for disengaged superannuants so it is the employers making the default fund decisions that would need to get their heads around the concept.

  Perhaps the industry may take some initial steps away from the short-termism that has dogged the ability of the funds to make clear long term decisions, matching the liability horizons of their membership. Funds like NZ Super and Future Fund bask in their ability to implement long term decisions unencumbered by short term peer comparisons. Having said that, super funds will not ever have quite their degree of flexibility, given the liquidity that will always have to be factored into their decision making; and

- Several large direct property deals were closed during the quarter by super and non-super institutional investors. Although interest in infrastructure continues to be very strong, high prices and the dwindling of premiums ordinarily expected due to the illiquidity of the infrastructure asset class may focus attention on other unlisted markets where selective value is a little easier to find. However, given the long lead times on these deals this might be a bit speculative.

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