Themes

The following is 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 consultant and you can infer that a reference to one is a reference to the other.

Following our December 2008 themes, we'd like to be able to say that investors are in a better position to deal with their portfolio issues; and therefore, better placed to contemplate a meaningful review of their asset sector allocations and managers. Unfortunately, listed equity markets continued to fall over the March quarter.

However, there have been some more positive signs recently:

- Equity markets have recovered somewhat since early March;
- The AUD was only marginally weaker versus the USD and was marginally stronger against other currencies over the quarter, taking pressure off portfolio hedging programs; and
- There have been some private asset write-downs (although there is probably more to come).

There is a wide divergence of opinions about whether the recent market strength is the start of a sustainable upward trend or whether this is just a bear market rally and the downward trend will continue. Doomsayers take strength from the increasingly dire predictions of the OECD, the World Bank, the Asian Development Bank and the IMF. Perhaps these increasingly pessimistic outlooks portend that the end is in sight, in which case equity markets generally recover ahead of an improvement in the global economy.

As stated above, most of the themes identified in our previous paper remain in place. However, we have some additional observations:

- Investors are increasingly considering more risk-based approaches to managing currency hedging, rather than adopting what often seems to be a "position of least regret". The AUD/USD reached 25 year plus highs in July 2008 and spent almost 6 months during 2008 above USD0.90. Yet, not a lot of action was taken - admittedly the direction of currency is notoriously difficult to predict - some investors now believe hedges could have been reduced around these levels simply in order to reduce total portfolio risk (as opposed to more profit seeking motivations). Also, funds with significant allocations to private assets were faced with finding sufficient liquidity to fund losses from their hedging programs;

- Over the course of 2009 funds will begin to focus again on the pursuit of alpha by exploiting attractive valuations and higher cross sectional volatility; but, in response to recent circumstances there may still be a preference for yield over strategies with a prominent J-curve; despite, very attractive opportunities in private equity;

- Credit strategies remain in demand. However, some investors are uncertain whether to reduce their investment grade debt allocations in favour of non-investment grade debt and how. Some investors may opt for giving existing managers additional flexibility in their mandates but others are realising that non-investment grade debt requires specialist skills;

- Investors are likely to increasingly focus their due diligence on the credentials of service providers and their independence from hedge fund managers, following several hedge fund scandals. Single strategy hedge funds must communicate their business structures, financing arrangements, governance, risk management procedures and relationship to service providers as clearly as possible;

- Investors are also likely to focus more closely on further reducing agency risks. They have been demanding performance fee structures to achieve this recently; but, managers must be prepared to help in designing increasingly longer and complex mandates (possibly with option features) and work towards becoming more client-centric;

- Once the current portfolio issues have resolved themselves (whether through market movements or internal restructuring) funds are likely to spend more time considering alternative ways to manage liquidity - holding higher cash levels and/or obtaining synthetic market exposure may be the simplest but not the most efficient method. Innovative funds management firms may direct resources towards "building better mousetraps";

- Related to the previous point, investors have been thinking about whether there is scope to develop a more efficient secondaries market (or create a service) for private assets. Again, this may be an opportunity for an innovative service provider;

- As member statements for 2008 are being distributed member switching activity seems to have been mixed across funds, with some indicating significant moves to cash and others not. This is a curious phenomenon as, presumably, most superannuants are hearing similar messages from their respective fund Trustee (in respect of the long term nature of superannuation and unforseen market volatility). There may be some interesting conclusions to be drawn from follow-up research into this behaviour;

- Valuations for listed infrastructure have fallen dramatically relative to the unlisted infrastructure. Investor's views are mixed on the sector in general at this stage. But governments are throwing a "wall of money" at infrastructure projects and there will be an abundance of global projects and no doubt some failures. Given the illiquidity inherent in the underlying private markets it will be important to be in and out of the right projects. Furthermore, current valuations for selected listed securities are arguably compelling;

- The boutique fund manager model is under some distress - some are seeking capital injections from institutional managers or seeking restructuring assistance. Some of them are very likely to close. New boutique managers in any asset sector will have to clearly demonstrate they have the financial resources to survive a potentially difficult 12-24 months; and

- A number of funds are hiring from investment banks and funds management firms - adding to their intellectual capital in order to deal with increasingly complex portfolio issues. Managers have to be vigilant in improving their skill sets and adjusting their business development efforts accordingly.