

Themes and Trends – December 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.

For a time on 3 November, it appeared President Trump would be returned for a second term. However, as counting continued key swing States fell to Biden. Ultimately, the college vote was formally counted on 15 December and Biden was inaugurated as President on 20 January.

The other key development was the commencement of the COVID19 vaccines roll-out. Currently, it is estimated that more than 131 million shots have been administered globally. However, investors are not assuming the worst is behind us as vaccinations remain a small percentage of the global population; there are still uncertainties about the efficacies and risks of the vaccines and the scale of the second and third infection waves rolling around the world are unclear.

Thus, despite some greater certainty, than was perhaps the case 3 months ago, investors are making no assumptions about a return to normal in the short term. With interest rates on anything investment grade and above still at historical lows, they are challenged to find any meaningful yield for the defensive proportions of their portfolios. On the other hand, listed equities valuations are considered stretched, supported by low interest rates and stimulatory economic measures implemented by Governments. Further, Australian investors are having to consider the portfolio implications of proposed Government policy initiatives designed to identify and address underperformance in the superannuation sector.

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

- Investors searching for yield for the defensive elements of their portfolios are considering, amongst other things, private debt issued by private equity sponsors. As there is a greater information asymmetry in understanding and negotiating the terms of the debt compared to publicly traded debt of a big mining company or a bank, specialised skills are required. Relatively few investors are sufficiently internally resourced to undertake this work but, for those that are, there are purported benefits to be had in terms of diversification as well as yield. Most of the interest appears to be for mid-market deals;
- Various sub-asset classes of non-investment grade credit also continue to be of interest to investors; however, there is less interest in leveraged loans and high yield by highly active investors given the contraction in spreads although managers with strong credit selection skills remain highly sought after by patient investors. There is strong demand in opportunistic credit strategies where managers have greater leeway to selectively consider stressed opportunities in beaten down industry sectors such as energy, retail, leisure and tourism or stressed opportunities triggered by company specific events. The idiosyncratic nature of these strategies can be attractive to investors who recognise the drawn-out nature of this credit cycle – unusual in that it is unlikely investors will experience a broad-based dislocation in credit markets but somewhat heightened default rates. This is also the reason that closed-end distressed debt funds have garnered as much attention as they have; however, investors are questioning whether sufficient opportunities will arise in this sub-sector given the more compressed cycle. For example, the latest distressed cycle, associated with COVID-19, began and ended in three quarters;
- The search for yield in a relatively liquid form has also engendered heightened interest in emerging market sovereign debt and corporate credit in discrete mandates despite a

strong recovery from the lows in March 2020 and heightened tail risks if the vaccines are not as effective as expected. The demand has tended to be selective, with greater interest in local currency debt, but in a blended format that also includes some hard currency debt hedged back to Australian dollars. Frontier debt is also recognised as a sub-asset class with attractive diversification and yield levels which investors are increasingly thinking about including in a blended emerging market debt portfolio;

- Annual performance tests proposed under the Government's 'Your Future, Your Super' initiative will compare a fund's performance against a benchmark comprised of various listed asset indices. Funds underperforming their benchmark by 0.5% p.a. over the previous 8 years will be required to advise members; those that underperform again in the following year will be frozen to new members. Although investors have expressed that they are supportive of the Government's demands for greater transparency and accountability, the current policy iteration has attracted considerable criticism because it is felt the consequences have the potential to influence investment behaviour in ways that are not ultimately beneficial to members. Criticisms include:
 - It is one dimensional and, beyond the setting of the benchmark, has no regard for the objectives of individual funds or their risk adjusted outcomes;
 - Given the consequences of underperformance, it has the potential to encourage funds towards benchmark allocations and passive index holdings and conversely away from less active, less liquid assets that have the potential to significantly outperform over the medium to long term but which come with greater risk of underperformance in the short term; some have described this as a 'recipe for mediocrity';
 - Alternatively, it may encourage some funds to 'game' their benchmarks by introducing risk purely for a perceived 'free ride' (e.g. appointing a credit manager against a Government bond benchmark allocation because there should in theory be a risk premium that will accrue over time);
 - Because the consequence of failing to outperform a simplified benchmark is so dire, investment market risks, competitor risks and even member retirement objectives would be subjugated to this requirement. Some question whether this should be the primary motivation for superannuation fund investors;
 - While an 8-year aggregate underperformance of 4% is not particularly substantial, if that underperformance was delivered in the year or two immediately preceding the commencement of the proposed test, it is an underperformance that potentially carries forward for another 6 to 7 years. It would also be particularly challenging to turn that around in a single year in order to avoid the consequences of having 2 consecutive years of rolling 8-year underperformance; and
- A new climate initiative – Climate League 2030 – was launched during the quarter backed by Australian investors, representing over \$850m of collective assets, and coordinated by the IGCC. The initiative has an objective of reducing (Australian) emissions by at least 230 million tonnes over current projections for the end of the decade. Participants will be able to determine their own actions towards achieving this goal but will be held accountable for reporting on progress. It is intended that the initiative will be broadened beyond the superannuation sector.

Disclaimer

The information contained in this document is for general information purposes only. It should not be construed as advice of any kind. Clearway Capital Solutions is not liable for any loss suffered as a result of reliance on this information. All investing involves various types of risk and you should seek independent advice prior to making any investment decisions.

The information is subject to change and Clearway Capital Solutions may not and is under no obligation to update the information or correct any inaccuracy of which it may subsequently become aware. You must not alter, reproduce or distribute any of the information in this document without the prior written consent of Clearway Capital Solutions.