

Themes and Trends – September 2011

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.

After big falls in early August, global share markets for the most part moved sideways for the remainder of the quarter; albeit, with significant intra-day volatility. Bank loan and high-yield spreads widened during August and September; offering some value to investors who decided against investing when spreads were closer to long term averages. This volatility is causing some investors to put on hold any significant changes to strategic allocations, risk budgets or manager line-ups until such time as the markets are more settled and they have greater clarity regarding relative value across asset classes. However, with domestic cash rates expected to be reduced, the outlook for traditional 'vanilla' asset classes a little uncertain and signs of overheating in some emerging market economies, a few investors are focusing on alternative strategies, such as global macro and event driven hedge funds or specific private equity opportunities such as mezzanine debt which, in theory, are less correlated to traditional asset classes.

The number of mandates awarded during the period seemed quite low, with Australian equities (unhampered by currency concerns) probably dominating; there were a small number of global emerging markets equities mandates awarded and some specialised infrastructure/private equity deals entered into.

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

- Within private markets, interest and activity in infrastructure and property continues to dominate. Investors perceive these asset classes can provide some protection from the risks inherent in listed equity markets. That the return streams are often linked to inflation is also attractive given the nature of the liabilities of superannuation funds and worries over central bank stimulatory measures. Private equity buyout cannot offer these characteristics but arguably certain forms of private equity debt may; particularly given the greater opportunities on offer to institutional investors as bank lending has significantly dried up;
- Some institutional investors view recent financial market volatility as an opportunity to increase their allocations to emerging market equities at more attractive levels, perceiving that the most dynamic and fiscally sound economies can be found here; and despite the sell-off, the fundamentals remain solid. However, a few recognise that all is not well with several emerging markets economies in danger of overheating - inflation is rising and credit is expanding at a rapid rate - endangering the current account balances of those which are overly reliant on external capital. Governments are being challenged to slow down their economies without disrupting the wealth transfers to their constituencies. Other investors are uncertain about whether markets may fall further and are holding back on adding to emerging market strategic allocations. Regardless, it is becoming apparent to many that country and stock selection skills are critical in order to benefit from the dynamism of emerging markets and also to cushion investors from the significant economic and geopolitical risks that are likely to appear;
- Discussion of ESG/sustainability in investing has been a feature of our landscape for some time. Interest in incorporating sustainability risks and opportunities in portfolios has certainly been strong (as reflected in the rollcall of signatories to the UNPRI for instance) but some

commentators question whether this has been matched by action. It is anticipated that passage of the carbon-price legislation through the Lower and Upper Houses may serve to draw a line in the sand whence investors, and investment managers (particularly of Australian equities), will have more certainty and will be better placed to actively integrate these themes into their portfolios;

- On a related theme, whilst there continues to be uncertainty locally and hence a reluctance to invest in new clean technology, venture capitalists globally have continued to invest. While the level of investment has fallen from record highs set in the first quarter of 2011 a further US\$1.83billion was invested in the second quarter. In the clean tech sector, energy efficiency, particularly alternative fuels (e.g. algae, ethanol and electricity), attracted most investment (US\$428 million in 38 deals) according to Knowledge@Wharton. The weight of money pursuing opportunities indicates investors are 'walking the walk' and not just 'talking the talk'. It will be interesting to see if Australian institutional investors increasingly pursue such opportunities now that the carbon-price legislation has passed through the Lower House;
- Two observations hardly signal a trend but we note QIC's hiring of Geoff Raby, former Australian Ambassador to China as part of a push to raise capital from the Chinese sovereign wealth market, where they feel they have some obvious alignment. We also note Acumen, the corporate services division of REST Super, picking up a mandate for superannuation services for the Australian staff of AkzoNobel (a global paint and chemicals firm). We have previously identified that asset consultants have been broadening their horizons in terms of the clients they are seeking to provide services to; although QIC and REST/Acumen are fundamentally very different organisations perhaps it is the case that institutional investors, in an increasingly competitive market place, may also start to look beyond their traditional client bases;
- On the topic of competitiveness, growing popularity of self managed super funds (SMSF) is also putting pressure on funds as superannuants, somewhat disillusioned with past returns, take matters into their own hands. This is creating strong demand for domestic direct equities and ETFs often via managed account services. Managed funds are in demand for international equities. Most notably, many SMSFs are holding high levels of cash which is likely to start finding a home when confidence returns to markets; and
- Institutional investors continue to separate their pension and superannuation pools as 'Baby Boomers' begin to retire en masse and require higher income and capital protection, compared to superannuants. Many investors realise that they must not only alter their strategic allocations and risk budgets but also populate their pools with somewhat different investments. Generally, portfolios comprised of high levels of domestic and international equities, sovereign debt and investment grade credit are increasingly including a complex range of products and strategies from relatively liquid non-investment grade credit such as high yield, emerging market debt and bank loans, to alternative private credit such as distressed control and non-control credit, real estate and infrastructure debt and mezzanine private equity debt.

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