

Themes and Trends – June 2012

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.

If anything the quarter was characterised by a paucity of new or overarching themes. This may reflect that world investment markets continue to muddle along without any clear direction or resolution to economic woes. It may also be the case that, locally, investors are focused on their own priorities such as MySuper implementation and financial year end considerations.

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

- Although the connection can be tenuous, the convergence of the ratios of total market cap to GDP between emerging and developed markets suggests the obvious beta play that existed when investors were new to global emerging markets equities may have disappeared and emerging markets have become a mainstream asset class. Increasing financialisation as companies seek equity and debt capital from markets, rather than banks and other stakeholders, also contributes to this convergence. Although there are likely to be tactical opportunities to allocate to the asset class or to specific emerging countries (as these markets overreact to developed market weakness or country, industry or stock specific GEM news), from a strategic perspective investors looking for returns in excess of developed markets are increasingly looking for managers, philosophies or approaches with potential to add alpha to the asset class return; passive or very broadly diversified active strategies, closely focused on benchmark relative outcomes, seem to be attracting less attention;
- In our December 2011 *Themes and Trends* we drew attention to AustralianSuper's new offering to fund members; providing them the opportunity to invest directly in individual Australian stocks, deposits or ETFs without having to set up their own SMSF. We think this is an interesting response to growth in the SMSF sector and an obvious demand from amongst the more engaged of the fund membership. Subsequently, we note a service provider has rolled out a platform to other institutional super funds that will enable them to provide a similar offer to their members. We will watch the uptake of this product with interest. Further, we wonder if AustralianSuper's determination to compete broadly in the retail space (rather than simply defending territory) may be followed by other of the 'mega' funds;
- Superannuation funds have been enthusiastic investors in infrastructure for some time; particularly attracted to the relatively high and mostly regulated long-term cash flow available from more mature brown-field assets. The Australian public on the other hand is yearning for new and/or upgraded infrastructure, which is far more green-field in nature. The demand for the former, and the lack of supply, has pushed investors to look beyond our shores for suitable projects; notwithstanding that State Governments are harnessing this demand to a limited extent by raising capital from asset sales. In theory, the proceeds of asset sales could be used to finance spending in much needed greenfields projects; however, the reality is budget bottom lines tend to obscure the longer term view. Clearly, there is benefit in finding

ways to bridge this brown/green chasm in order to encourage Australian investors (at face value, keen to invest locally) to fund new infrastructure at home. While Governments may not themselves have the fortitude to invest for the long-term (given the electoral pain they may feel for some future Government's electoral gain), if they can work closely with superannuation fund investors to structure new projects offering stable income streams this may be more palatable to the general public than the undertakings/underwritings Governments have relied upon to secure private sector involvement in the past. We note the increasing discussion now underway between Governments and funds on this topic;

- Emerging markets debt is an area of considerable interest to investors and consultants, although many investors are still thinking about their preferred approaches. With the balance sheets of many emerging economies in better shape than those of their developed market counterparts, some view sovereign emerging market debt as a generally higher yielding and arguably more secure alternative to developed markets sovereign debt. Others may look to broaden their exposure to high yielding corporate credit opportunities; utilising emerging market debt specialists capable of the deep credit research required to find the best opportunities and to avoid the many pitfalls in these markets. Investors also have different views as to whether currency management should be specifically included or excluded as a contributor to outcomes. There is also the question of hard versus soft currency denominated debt and whether to adopt any one of these approaches or some combination of them all;
- Investors and consultants continue to apply pressure in respect of management fees, particularly in relation to beta and alternative beta type approaches. Given alternative or smart beta can be every bit as valuable as 'bells and whistles' alpha, we think innovation still needs to be recognised and any hint of beta should not automatically imply management fees should be knocked down to bargain basement levels. Systematic and quantitative fund managers spend years developing their investment strategies, and the better ones are continually refining them; therefore, their compensation should reflect this; and
- As more employees will spend their entire careers within the superannuation system, the discussion regarding life cycle/life stage investing is ongoing and gradually becoming more interesting. Age appropriate investment strategies continue to be talked about (i.e. gradually reducing exposure to 'risky' growth assets as members approach retirement). Clearly there is sense in reducing the risk of a substantial fall in retirement savings shortly before intended retirement. However, the observation has also been made that reducing investment in growth assets following a period of protracted weakness will not help a member already lagging their retirement savings objectives. We note both retail (e.g. Zurich Financial) and corporate super (e.g. Telstra Super) funds have been developing income focused offerings; these somewhat more defensive, cash generative approaches may represent an alternative way to temper risk without systematically reducing growth exposures and blindly increasing exposure to certain types of 'defensive' assets (e.g. sovereign bonds) that may actually be expected to perform poorly depending on market environments. Additionally, there has been some talk of accommodating the progress towards objectives of individual members; for example, by reducing risk if and when savings are ahead of objectives rather than purely based on age.

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