Themes and Trends – December 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.

There have been some early indications of a sustained improvement in the US economy but any announced progress in European discussions in relation to debt, deficits and currencies seems to receive mixed reviews from one day to the next. Question marks over a soft or hard landing in China and flow-ons thereof also impacted investor intentions. As a result, while investors can identify and appreciate there are opportunities to be had as a result of the market upheavals of recent years; many are still approaching growth markets with a good deal of caution. At the same time, current and future levels of return for Australian cash and sovereign debt (more broadly) mean they retain defensive characteristics but not much in the way of return potential.

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

- As above, we are all aware of the ongoing debt, deficit and currency issues across Europe. Many investors appreciate the opportunities the turmoil is creating; restoring value to previously overpriced liquid markets and throwing up new investment possibilities resulting from reduced bank lending for private equity, infrastructure and real estate projects. Paradoxically, even though they recognise the opportunity, many are still cautious about committing, anticipating opportunities may become more numerous or fearing risks of further dislocation;

- Having said that, overall interest in alternatives continues to improve; albeit, not yet matched by activity/commitments. However, while some investors may be chasing outsize returns from niche growth strategies, many are very deliberately focusing on what they perceive to be more modest and reliable nominal return targets and outcomes. Hence, in accordance with comments in our previous Themes and Trends, high grade property with secure rental streams, income producing 'brown-field' infrastructure and private equity debt are all areas that continue to be considered. Additionally, investors are likely to be more comfortable with hedge fund strategies they believe will produce more consistent outcomes and provide some protection in down markets even though they may forego some of the outperformance targeted by more aggressive approaches;

- Regarding more traditional asset classes, investors have continued to position themselves for comparatively stable but sub-par developed market economic growth and the liquidation of government debt, by seeking senior debt, high yield bonds and bank loans. A few investors have been exploiting the apparent disconnect between heightened spreads, modest default rates and strong refinancing activity, to time their entry into these asset classes. Some have endeavoured to substitute a portion of their equity allocation with high yield given its strong risk-adjusted return history. Non-investment grade credit with adjustable coupons such as bank loans continues to be sought after;

- The search for growth assets has become more challenging as subdued, or even recessionary, developed market economic growth begins to impact the real economies of emerging markets. Unconventional monetary policies and heightened geopolitical risks in strategically important locations are also making investors nervous. Arguably, the share prices of emerging market companies are already reflecting this. Consequently, some investors are seeking to take advantage of this by signalling their intention to increase their emerging market exposure;

- On the theme of infrastructure again, the NSW Government's appointment of former Premier Nick Greiner as Chair of the newly established (July 2011) Infrastructure NSW (INSW) is worthy of mention. INSW has been charged with developing a 20 year strategy to address major infrastructure requirements across areas such as transport, water, energy and communications. Importantly, Greiner is making clear that the authority will be cognisant of investor requirements in terms of risk and return and structuring projects to be attractive to institutional investors. Although still early days, some industry participants are encouraging other State Governments and the Federal Government to follow NSW's lead in developing a more coordinated approach to building out much needed regional and national infrastructure. In light of a number of about-turns and investor and political headaches overseas, this may be welcomed by GPs and LPs focused on our market;

- Some private equity GPs are innovating to accommodate LP preferences also; we have become aware of hybrid structures whereby LPs commit to a traditional 'blind' pooled fund but then have significant discretion regarding acquisitions, divestments etc. If the GP seeks out deals within their area of focus but the LPs ultimately are responsible for the decision to proceed, this will raise some interesting questions regarding accountability and also whether due diligence needs to be focused as much on fellow LPs as those nominally managing the investments;

- We note Australian Super's new product offering allowing members to construct their own portfolios from the bottom up using S&P/ASX 300 stocks, ETFs and term deposits. This is an interesting response to the growth of the SMSF market (research undertaken by KPMG and ACFS indicates the SMSF market has grown by over 461% since 2000; this compares to 410%, 177% and 100% for industry, retail and public sector funds respectively) and provides options in a number of areas in which individual investors may wish to have greater ability to make their own decisions. We will be interested to hear of the uptake and whether other funds follow this lead; and

- Discussion regarding Cooper Review recommendations on standard disclosures for super funds (encompassing performance, costs and taxes, portfolio holdings etc.) has broadened to calls for 'complete' transparency and accountability, in line with corporate governance requirements for listed public companies. However, many industry participants are questioning the overall benefit to investors.