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Themes and Trends – December 2018

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.

We said at the beginning of 2018 that investors seemed relatively comfortable with the sustainability of world economic growth; although, monetary policy settings would gradually become less accommodating. Investors at the time were mostly focused on asset valuations, with geopolitical risks put to one side - on the basis not much that can be done to defend against them other than to retreat from the market. 12 months later, with equity markets lower across the board, investors seem more focused on risks than opportunities and are generally cautious on the investment outlook. Although investors believe equity valuations are not overly expensive, a slow-down of Chinese economic expansion, ongoing US-China trade tensions and the increasingly messy UK exit from the European Union are the specific themes causing investor consternation.

US trade sanctions imposed on China (and retaliatory sanctions against the US) are now starting to be felt in the US. Given Trump's focus on trade and jobs, it will be imperative that he negotiate an outcome or at least extend the 'truce' with China expiring at the end of February (possibly a more likely short-term fix). If a longer-term beneficial outcome (or at least the appearance of a beneficial outcome) can be negotiated in America's favour it will be a huge PR coup for Trump. Despite all the other noise, this may give him a chance of being returned in 2020. In theory, investors acknowledge China can further stimulate their economy to offset weak business, consumer and investor confidence but authorities will be wary of doing too much given their existing debt levels. Currently, it is difficult to see how an orderly Brexit can be achieved; particularly, given looming deadlines.

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

- Although wary of overweighting equity exposures, investors are reluctant to build up cash levels too far. While they are comfortable holding some cash, to top up on market declines or to invest as other opportunities reveal themselves, most activity over the quarter seems to have been in various permutations of fixed income. Although a small number of sovereign or investment grade mandates were awarded, for the most part fixed income alternatives offering some yield over a risk-free rate (e.g. private debt, property debt, stressed and distressed debt, absolute return and emerging markets debt), and with some scope to avoid capital losses associated with rising inflation and interest rates, were favoured.

  With respect to the above, investors are also aware that these fixed income sub-asset classes exhibit varying degrees of equity market beta and they are factoring that into their considerations;

- Passive, and smart beta, investing has continued to grow as investors (both Australian and global) seek to reduce costs; particularly in sectors where it is believed manager skill is harder to find. However, reflecting ongoing caution towards equity markets, some investors are currently more inclined to active management; they believe genuine active managers will be capable of exploiting volatile or falling markets. In this current environment, they believe this makes more sense than being exposed to the entire market or being passively weighted to specific equity betas;

- If developed markets can muddle along, there is a view that emerging market equities appear compelling given they have underperformed developed markets for so long and they offer diversification benefits due to the number of countries and their different points on the economic cycle. As above, genuinely active approaches are likely to be favoured;

- Although China is becoming, from a practical perspective, increasingly investable, some investors are wary of business practices under a CCP-controlled state. However, managers with substantial stakes in Chinese equities recognise the end game for China is to have the world's most successful companies contributing to the wealth of the nation and ultimately for China to become the wealthiest country in the world. Government manipulation of the market or company managements engaging in unprofessional or illegal conduct (for which the consequences can be dire) would damage investor confidence and would not be conducive to this outcome. Therefore, they argue not only are there great opportunities for investment, but also that China is a particularly safe and stable country to invest in;

- Investors with exposure to the FAANG stocks (Facebook, Apple, Amazon, Netflix, Google/Alphabet), who have watched prices rising since the GFC, experienced meaningful corrections from peaks in or around the third quarter of 2018. These stocks seem to have found a floor just before Christmas (although Apple has fallen a little further in early January). While some investors are now cautious on these names (perhaps viewing the FAANGs as a largely amorphous mass), others recognise that these firms are not tech companies as much as they are product distributors, advertisers, entertainment providers who use the internet as their distribution vehicle (Apple is a manufacturer also). Therefore, their business models and earnings potential vary greatly, and, despite their amusing acronym, investors believe they should be unpacked and analysed independently; and

- Having emerged, thus far, relatively unscathed from the inquiries of the Financial Services Royal Commission, super funds are currently absorbing recommendations from the Australian Government Productivity Commission's review into the efficiency and competitiveness of the Australian superannuation system. While many of these seem to have been generally well received, probably the most contentious is 'Recommendation 2A 'Best in Show' Shortlist'. Essentially the recommendation is that an expert panel should determine a top-10 list of superannuation products to be presented to any members new to the workforce or who do not have a superannuation account. The 'default' under this arrangement (for those who do not make a choice from this list) will be determined on a sequential basis from the funds on the top-10 list. Although members will be able to choose products outside this list, it is likely that many will not.

  Concerns in relation to this recommendation include: the necessary reliance on past performance to predict future top performers and the difficulty of comparing like with like, the exclusion of many well managed funds arguably deserving of default fund status, the potential for competitive pressures to change the way funds are managed and to distract from long term objectives, the selection of panel members and how their decisions will be made, the potential for this to be politically influenced, the potential creation of mega-funds, the management of mega-flows and how this will of itself impact the performance of the chosen funds. This is nowhere near an exhaustive list. We suspect that, while many of the recommendations of the Commission will be implemented, this may well be a bridge too far.

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