

Themes and Trends – March 2016

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.

Institutional investors generally seem more confident about investment markets than they were in 2015. Possibly they are becoming medium/long term bullish (recognising there is now value across any number of asset classes) but are still cautious in the short term, given previous concerns still linger regarding US growth (and the recent rate tightening), flow through effects to emerging markets, slowing China growth and falling resource and commodity prices. At this stage, this is reflected more in words than actions; cash holdings still remain high historically.

In the very short term investors are likely to be focused on the imminent release of the 2016 Federal Budget, particularly the implications for superannuation funds and superannuants, and the Prime Minister's assumed visit to the Governor General shortly thereafter.

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

- Notwithstanding the ongoing trend to higher strategic international equity weights, reflecting the more limited opportunities and diversification of Australian equities, a small number of investors currently favour Australian equities on a valuation basis. As yet, there are few signs this will turn into a broad trend given some of the uncertainties surrounding commodity prices, the credibility and sustainability of Chinese growth and local banks;
- Some investors are a little cautious about adding to growth equity exposures given current valuations for quality growth stocks and given that growth has generally outperformed value over the last 5 years or so. However, much of this outperformance has been in the last 18 months rather than sustained throughout the period. Further, investors recognise that good managers of growth equities who are cognisant of buying at the right price, rather than any price, and who are selective in buying only the stocks they have the highest conviction in will have the potential to outperform the broad market index, if not the value index, even if growth/value performance shifts for an extended period;
- Although private equity is a topic of interest we continue to see limited activity in this area. In addition, the downward trend in the Australian dollar over the last two years has increased the dollar value of calls of international private equity programs, limiting further commitments. Within the broader private markets it seems property and infrastructure are preferred (particularly direct exposure), probably because investors are more familiar and comfortable with the underlying investment cases;
- The Responsible Investment Association Australia's 2015 Benchmark Report identifies \$630bn of Australian money invested in funds incorporating ESG considerations, \$32bn in core responsible funds and also finds that the performance for this latter group has been particularly strong relative to benchmark indices. In the same report RIAA also identifies that 30 super funds have removed tobacco stocks across their entire portfolios in the past 2 years. Interestingly, CalPERS recently considered a review of their decision to disinvest from tobacco stocks, reacting to a report showing the decision (made 15 years ago) has cost \$2bn to \$3bn in returns. However, pressure from a number of health associations may be strengthening their resolve; the possible review is itself now under review. We assume this would be a relief to Australian funds with a strong responsible investing

outlook as a move by CalPERS to reinvest in the sector for purely return driven (fiduciary) motivations would send a strong signal that could create ructions elsewhere;

- Some investors recognise that overreaction to bad news can present opportunities to exploit short term contagion effects. In late 2015 there were two well publicised implosions of credit funds particularly exposed to highly levered companies in the already weakened oil and gas sectors. This then flowed through to further weakness across the oil and gas sectors and more broadly to credit generally as broad-based concerns set in; some investors feared this was a portent that could become much more widespread. Credit markets experienced a significant pull-back in early 2016 as a result. However, a relatively small number of Australian investors saw this as an opportunity to invest in the safer of the oil and gas names and a rather larger number are thinking about increasing exposures to credit with little exposure to the troubled names/sectors;
- Investors anticipate a greater divergence of returns across asset classes and this is likely to be reflected in more meaningful shifts in allocation than has been the case in recent times (relatively high cash holdings notwithstanding). However, this is likely to be undertaken with a view to downside risk. Reflecting this, interest in multi-strategy approaches continues to grow. Whereas many investors previously believed that everything is expensive they can perceive value now and some are prepared to delegate allocation decisions to managers they are confident can adjust exposures in order to add value or reduce risk at the appropriate times;
- Additionally, although investors seem more comfortable with the outlook for markets on a medium term view, they are still conscious of recent weakness and ongoing volatility and are increasing exposure to strategies that have some scope to protect against or benefit from downside by including tools that have the scope to make money from falling markets (for instance, long short strategies have been receiving greater attention);
- Although emerging market equities performed very strongly in March, returns over the past 5 years have been negative in an absolute sense and also relative to developed markets. However, investors are starting to think more positively and are looking to the longer term. Reversals in emerging market equities are no longer finding new lows and perhaps reflect optimism more generally about global growth. Having said that, investors are not labouring under any misapprehensions regarding the potential for further bouts of weakness or volatility in the short term; this may be staying their hands but we anticipate there will be more activity in this asset class over the coming period;
- Similarly, in emerging markets debt (an asset class that is becoming more mainstream) investors recognise value and increased liquidity; particularly in relation to local currency debt, but are looking for a catalyst for a sustained turn-around in order to have greater confidence there will not be further significant weakness. Despite this there is an awareness that certain sovereign issuers will not perform as well as others and investors are becoming more discriminating of risk than they were before the recent sell-off; and
- A number of emerging market equity managers have experienced significant outflows in the recent past and are marketing aggressively with a view to building out their Australian businesses (seeing Australia as important from an investor diversification perspective). It seems there may be a brief window for investors to access a few brand name managers (assuming they are comfortable with the circumstances of the outflows) who have been closed to new business for some time.

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