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Themes and Trends – June 2014

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.

Australian super funds, on average, enjoyed double digit investment returns over the 2013/14 financial year. Most asset classes performed strongly despite concerns over valuations and the pace of global economic growth. Many investors now view equities with the same trepidation as they have had for Government and high quality corporate debt in recent times (note, there is still reasonably good interest in lower quality debt). Overweighting one and underweighting the other is therefore not as clear an asset allocation decision as it might be in more normal market cycles. While there has been some meaningful activity in equities over the quarter, our understanding is this has reflected manager, style or even cost considerations rather than asset allocation. Instead, some investors have focused more on either hedge fund assets of one kind or another where they can find opportunities to ratchet up returns or protect the downside, or private market assets (infrastructure, property, private equity and mezzanine/private debt) that potentially offer higher returns; albeit over the longer term, given their lack of liquidity.

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

- Interest in non-investment grade credit continues; reflecting a view that the current cycle may be protracted and, even at current spreads, decent risk-adjusted returns are on offer. However, some investors are looking at strategies that are diversified and have the ability to adjust allocations across the capital structure and sectors as the cycle rolls forward, perceiving this to be a somewhat defensive approach to credit. Conversely, or perhaps even complementarily, some investors are searching further along the non-investment grade spectrum for more risk; seeking more bang for their buck from stand-alone credit sub-sectors that may still offer outsize returns (with outsize risk) at this stage of the cycle. They are tending to pair this with more conservative strategies to bring the overall risk back.

  Despite the above, areas of concern include the increased level of covenant-lite bank loan issuance, the inflow of retail money into the sector and the general levels of spreads. While it is arguably the better names which are able to issue cov-lite loans, and hence may be safer than their heavier counterparts, it is still very important for investors to be comfortable their manager knows the portfolio names intimately. In relation to the rapid growth of retail, this still comprises a relatively small proportion of the overall market. Fund managers and institutional investors may well see any sizable retail investor outflows as an opportunity to top up at more attractive levels if and when markets become dislocated;

- Interest in emerging market debt continues to broaden. To date a number of investors have sought exposure within broadly diversified fixed income or slightly narrower credit mandates; we have been seeing greater interest in emerging markets debt as a stand-alone. Investors are getting to know the sector better and are increasingly of the view that the skill set is unique and these exposures are best managed by specialists; therefore, the asset allocation decision would be returned to the investor and their advisor;

- The development and proliferation of savings and retirement products continues apace, reflecting both increased competition for members from the Self Managed Superannuation Fund industry (and each other) as well as the fact that more superannuants are retiring

with larger balances. The post retirement savings sector could garner similar levels of attention and innovation as has the pre-retirement sector over recent years;

- ESG seems to have been generating greater attention in the very recent past; perhaps this also reflects growing member balances and greater engagement of those members with their investments. Possibly, superannuation funds have found a little more time to consider such issues as they get on top of various regulatory issues (any reprieve may be temporary at best). Portfolio level disclosure legislation, which has been pushed out a year, will likely encourage engaged investors to speak their minds so if the push is coming from members, it is likely this will ramp up;

- Low interest rates, and the risk of rates rising, have encouraged investors (globally) to look for alternative sources of yield for their portfolios. In turn, this has driven valuations higher for income/yield driven real assets such as brownfields infrastructure. Previously we mentioned valuations have increased to levels at which local investors have become somewhat cautious; however, it appears offshore investors (faced with even lower yields) are still prepared to buy these long term assets placing further pressure on yield. Although we possibly face an extended period of relatively low interest rates, they must go up eventually; when they do, the realisation value of these assets bought for yield will fall. This is exacerbating investor concerns about the market.

  Having said that, Australiaœ self-declared infrastructure Prime Minister, Tony Abbott, has flagged that %an infrastructure boom unmatched in our history is shortly to begin+ and the Treasurer, Joe Hockey, included measures in the May budget to encourage a State based infrastructure recycling program (whereby existing brownfield assets are sold to fund new greenfield projects which, on becoming brownfield, are sold again to fund new infrastructure and so the cycle continues) as well as investing in infrastructure directly (e.g. committing funds towards the second Sydney airport to be built by the NSW Government). However, Australian investors hoping the promise of greater supply will take pressure off valuations and yields, thereby making the sector more attractive from a risk/return perspective, may be thwarted by the ongoing and increasing interest of overseas investors and also by Government efforts to build upon this.

  Given State and Federal Governments may well be focused on maximising sale prices (and thereby the funding available for future projects), rather than making available suitably attractive assets for the portfolios of domestic super funds, investors may continue to struggle to find the right assets at the right prices. Perhaps Governments need to consider further whether it might be in the longer term interests of Australia to provide greater incentive/encouragement to likely long term local super holders of these assets, rather than maximising short term sale proceeds from overseas pension funds who may be satisfied with lower yields or private investors who will be more focused on restructuring in order to generate greater profits; and

- On a related note, the observation has been made that, unless we are to have a comprehensive system of road-pricing, roads do not easily lend themselves to the recycling model described above. Once built, roads require tolls to generate an income stream necessary to attract investors. Based on precedent, toll roads have been problematic investments because the patronage forecasts have almost always been over-estimated. In respect of the recycling model, brownfields infrastructure can be sold to fund roads but road-pricing will need to be carefully considered if the cycle is to continue and the ±roads of the 21st centuryqare to be included in this initiative.

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