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Themes and Trends – September 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.

Economic indicators for major developed economies, including Australia, on balance seem mildly positive although not unambiguously so. However, it seems cautious investors remain wary given valuations, current interest rate settings and the risk of tail events. The culmination of the seemingly endless US election process is now within sight and, depending on the outcome, should allow investors to take stock and think about longer term portfolio plans.

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

- Despite cash and high quality debt yielding low or negative real returns a number of investors remain significantly allocated. This is either to defensively protect against falls in possibly overvalued growth asset classes or, more actively, to keep their ópowder dryô in order to take advantage of opportunities in other asset classes. Some are positioned for both contingencies. These investors are not focused primarily on the nominal return; although they recognise the risk of rising inflation, some hold the view that yields on fixed income securities are unlikely to rise dramatically and result in substantial capital losses;

- Conversely, many others are as reluctant to hold these assets given the potential dilutionary effect on returns and the long term horizons of their members; particularly for funds where their average age is lower. These investors are not necessarily overweighting ógrowthô assets but are often considering fixed income in other forms. Either opportunistically in private markets debt / direct lending, where the role of banks and financial institutions have been reduced as a result of regulatory requirements. Or, where they can find a significant risk or liquidity premium relative to traditional fixed income (e.g. non-investment grade credit, emerging markets debt, infrastructure debt etc.);

- Investors are also somewhat cautious about REITs. They are worried about possibly stretched valuations and the risk of a tail event arising from any of a number of global circumstances currently playing out. A steep step-up increase on long dated government bond yields is usually the primary concern of REIT investors. At current valuations, some investors think they may be able to find better risk/return outcomes elsewhere;

- A number of investors have been reducing exposure to Australian equities relative to international equities for some time. They are doing this because Australia is still generally over-represented in portfolios and because Australia represents not only a smaller opportunity set but also an opportunity set concentrated in a relatively small number of very large companies and industry sectors. Regarding global equities, there has been some talk of a possible switch from growth to value since the beginning of the year. Note, growth has dominated value for a number of years. However, it will take some time for a potential secular trend to develop and be recognised. There are some investors who believe lagging growth performance has been mostly because US presidential candidates routinely bash the healthcare and biotechnology industry sectors during their campaigns ï and often are unable to follow through once elected;

- Emerging market equities have continued to focus investor attention, driven by relatively attractive valuations, significantly lower currencies and economic growth rates that are more appealing than developed markets. Investors are also beginning to recognise that necessary structural and fiscal reforms have been undertaken in some of the most important countries and they are now hoping to exploit the opportunity this represents. However, significant geopolitical risks remain; particularly, in Turkey. And Chinese debt concerns continue to mount as well as worries about a possible yuan devaluation. Overhanging all of this is investor wariness about the possible interest rate path the US Federal Reserve is likely to adhere to. A rapid increase will place a lot of pressure on emerging market currencies but this is generally seen as less likely than a gradual path;

- Emerging market debt has rallied strongly since the end of last year. Interestingly, investors have sought refuge in the relatively more attractive yields on offer compared to many developed market sovereign bonds. However, the relatively easy beta play is probably over and investors are focusing on managers who are more discriminating when selecting countries and securities. Again, all eyes are on the US Federal Reserve;

- However, on balance, illiquid private markets and real assets have probably been the areas of strongest interest for investors. This has tended to overlap ESG considerations and help turbo-charge interest in the current hot topic of impact investing;

- On the topic of impact investing, we note QIC (on behalf of Future Fund and limited partners in a QIC infrastructure fund) will partner with AGL to potentially invest $800m in an Australian renewables platform. This will initially comprise existing solar power assets in NSW and their intention is to then develop new wind assets in NSW and Queensland.

  Given the enthusiasm of investors to be involved in the construction of essential public infrastructure, the recent political stoush over renewable power generation targets in South Australia has not been viewed as productive. Investors inclined to commit the sums required to get these projects off the ground are likely to hope for more constructive input and less political point-scoring given they will presumably be expected to reach for their wallets in future;

- Government encouragement of enterprise and innovation has renewed interest in venture capital and, in particular, underlying businesses focused on potentially ógame changingô disruptive technologies. Investors recognise the sector is high risk and high return but some also identify that ódisruptiveô businesses can represent competitive threats to some of the large and relatively staid businesses in their existing portfolios; therefore selective exposures to VC are also being seen as potentially having defensive benefit for portfolios;

- The NSW Government recently announced the partial sale of Ausgrid to IFM and AustralianSuper. While the sale price is less than if the FIRB had not blocked two competing Chinese bidders, having the assets stay in Australian hands will take some of the heat out of the foreign ownership argument; particularly if the proceeds are at least partially invested into new infrastructure rather than simply paying down debt; and

- The óGlobal Statement on Investor Obligations and Dutiesô was launched in late June of this year. The Statement encourages international and supranational and national policymakers to provide further clarity and consistency in relation to investor obligations integrating ESG considerations into investment practice. The 74 signatories to date (26 October) include CBUS, HESTA, Local Government Super and NZ Super, as well as a handful of Australian/NZ funds management firms. We assume momentum will build as the initiative receives greater coverage.