Themes and Trends – March 2015

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.

US equity markets rose in the March quarter; economic growth data was generally positive. EAFE and emerging markets also rose, responding positively to the European Central Bank's quantitative easing program, and rebounding from mostly negative performances in 2014. Fixed income asset classes were more mixed as attention continues to focus on the next moves by the US Federal Reserve in respect of the unwinding of QE and also European discussions in relation to Greek debt. Falling oil and gas prices impacted different countries in different ways. Obviously, the tumbling iron ore price impacts the economies of raw mineral exporters like Australia. While investors have come to expect the unexpected, in the absence of major surprises, they are anticipating moderately positive returns over 2015, albeit with some divergence expected between domestic and global equities.

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

- Although investors seem somewhat less concerned about the possibility of major market corrections in traditional asset classes, they are still struggling to identify investments that are not fully or over-priced. In this environment even isolated bouts of market weakness in sub-sectors of broader asset classes may represent more attractive entry levels. For example, credit spreads on oil, gas and related companies widened considerably in late 2014 (this negative sentiment flowed through to broader asset classes). Notwithstanding credit markets are not as tightly priced as some other markets (given spreads are close to long term averages but default rates are much lower), some larger investors have contemplated investing directly into credit pools established to specifically exploit this 'dislocation' on a tactical basis. However, many investors may not be able to move quickly enough to act on such opportunities before they disappear. Reflecting this, we continue to see interest in active diversified approaches within or across asset classes; whereby investors are prepared to allow fund managers varying degrees of discretion to exploit opportunities they would be unable to move on themselves;

- Notwithstanding the above comment, global emerging market equities are increasingly on the agenda for reviews later this year. Although GEMs performed reasonably well on a currency unhedged basis for Australian investors in 2014, in local currency terms the broad market was down. While some investors may opt for passive solutions to keep costs down or for convenience (while deliberating on the most appropriate solution) many will prefer to invest through active approaches, believing that particularly in this asset class there can be a very great divergence of outcomes at each of stock, industry, country and even regional levels. For instance, the recent fall in oil, gas and commodity prices will negatively impact oil exporting countries but will be very positive for other emerging economies highly dependent on commodity imports. India is a strong case in point;

- Strategies perceived to be lowly correlated to bond and/or equity markets, with the potential to achieve a positive return in up and down markets - or that may have the potential to evade the worst of the next GFC type event - are also of interest. Some investors are considering global macro hedge funds or similar approaches, with multiple moving parts, and approaches that have the ability to substantially hedge out long exposures are also being thought about. The problem with the latter though is that investors have in the past not always shown great perseverance in the event of early, late or wrong calls and consequently being out of the market at inconvenient times;

- There has been much talk of the growth of exchange traded funds (ETFs) both locally and globally as the measured assets under management have reached record levels. ETFs because of their (generally) passive nature will be cheaper than active strategies in the same asset class. However, they are not universally a cheaper solution than other passive investment solutions (although they may be in certain instances). Institutional investors believe they do have advantages in terms of liquidity and ease of use; therefore, they have been perceived as a useful portfolio management tool rather than necessarily a permanent fixture. As a long-term hold they are probably most useful to retail and/or SMSF investors who can use them to access offshore markets or more niche exposures than they might otherwise be able to. Related to this, there has been renewed discussion about how the growth of ETFs might be impacting the creation of asset price bubbles and subsequent crashes and the ability of active managers to exploit these opportunities;

- Superannuation funds continue to build their in-house investment expertise. While a number of large investors are in-sourcing investment management, this has not universally been the objective. Some funds rely upon their highly experienced investment teams to manage and monitor outsourced funds management, in line with their needs and objectives, to an extent not possible when relying solely upon consultants. More recently, some larger funds are using this expertise to facilitate external bespoke solutions they have effectively engineered in-house; rather than in-sourcing funds management they are using their skilled resources to design solutions that meet their needs but that can be implemented by external funds managers. They can then shop around for managers who can incorporate these design elements with their own investment styles and philosophies;

- On a related note, a number of super and non-super funds have built, sometimes substantial, real asset (infrastructure, property) teams; this enables them to invest directly into projects or to co-invest with firms who are real asset specialists (and to participate actively at Board level in relation to the assets). Additionally, larger investors are becoming more reluctant, if investing via funds, to simply invest as relatively silent LPs and have their involvement limited to asset allocation rather than having some influence in, or at least about, the selection of underlying deals. Infrastructure investment firms have become accustomed to superannuation fund investors become more demanding including in respect of fees and fee structures and access; and

- As previously observed, superannuation funds have in recent times focused upon relatively stable income generating brownfield assets (particularly infrastructure). Demand for local infrastructure assets and a shortage of supply has pushed valuations to very high levels. Local investors, including superannuation funds, had anticipated some degree of relief as existing Queensland and Victorian assets came up for sale and new road, rail and other projects were commenced as part of the Federal Government's asset recycling program. However, as it now appears unlikely these transactions and projects will proceed, pent up demand may be redirected towards NSW with the result being even higher prices and lower IRRs. Notwithstanding that superannuation (and non-superannuation) funds have already been looking beyond our shores for quality assets (several very significant deals were announced over the past quarter), the suggestion has been made that greenfield infrastructure may again attract greater attention. However, if so, investors are likely to be very particular about the type of projects they will consider.