

Themes and Trends – September 2021

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.

The implications of the newly implemented performance tests under Your Future Your Super have been a focus for investors over the most recent quarter. Those implications differ greatly for investors depending on how they have performed over the past seven years and depending on the pattern of that performance. Investors whose funds have substantially underperformed over the period will have known their situation was irredeemable and will have been working on measures to seek to address the reasons for that underperformance or are contemplating merging with other funds that have done better. Those who have substantially outperformed will have a buffer that allows them some real flexibility in determining how to position portfolios away from their benchmark and will have reasonable time for those positions to play out. In between there will be many investors whose funds have performed much closer to the benchmark and/or who will be dropping off early years of outperformance; for these investors decisions to deviate from benchmark in terms of either allocation or investment style will have potentially greater consequences in the near term. Given past performance has long been held not to be a reliable indicator of future performance, carrying forward seven years of performance does not really establish a level playing field in an increasingly competitive marketplace.

Investor concerns over recent Chinese Government intervention in Chinese listed companies (e.g. New Oriental and Evergrande) are somewhat mixed. Some take the view that the interventions, in the rear-view mirror, are explicable in relation to the impacted companies and are not necessarily a warning sign of further surprises. They believe the Chinese Government will be keen to settle the market so as not to discourage future foreign investment. However, others are more wary of President Xi's hold over the Government and less confident in predicting his next moves; they may be more inclined to watch from the sidelines until they have greater clarity.

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

- Many investors believe interest rates at historically low levels mean fixed income and long duration equities are, generally, expensive in an environment where there is a perceived risk of inflationary pressures in the relatively near future. Unsurprisingly, Rainmaker data shows most mandates, by number, awarded over the period were in alternatives of some description. Clearway's experience is largely aligned with this. At the same time, many investors are waiting to see if those long duration equities will continue to deliver their strong earnings going forward and thereby offset higher discount rates. If so, then it is likely there will be renewed demand for global and emerging market equities;
- Investment grade credit and cash currently offer very little yield and are being used solely for defensive purposes. In the case of investment grade credit, that positioning might be riskier than assumed given their interest rate sensitivity. Investors continue to look for yield in alternative credit asset classes such as non-investment grade, emerging and frontier markets and private debt. However, given concerns about inflation and rising interest rates, there seems to be little interest in taking on longer duration assets despite the higher yields on offer, unless a strategy has scope to tactically and strategically allocate around its benchmark to exploit opportunities in other debt asset classes or sub-classes.

With traditional lenders such as banks being much less active in private markets, opportunistic, stressed or distressed private credit with limited duration can offer attractive

returns, particularly if there is some opportunity to participate in the upside of the investee companies' equity via warrants or options. Investors are looking for deep credit knowledge, comprehensive understanding of the nature of the underlying businesses and the purpose of the debt-raise as well as seniority in the capital structure when considering managers of this asset class;

- Superannuation funds whose members may be drawn from, amongst others, first time job market participants will, all things being equal, benefit from new stapling requirements. These are typically those funds with retail member bases. Those who have also emerged unscathed from the initial Your Future Your Super performance tests and whose recent years' performance suggest they will continue to do so in the near term are likely to find themselves in demand as potential merger partners. This is not so much purely from the perspective of likely fund growth but, more importantly, funds with net inflows are better placed from a liquidity perspective and more able to invest in less liquid asset classes, should they choose to do so;
- Investment strategies that have an ongoing, and possibly significant, cost but which have a very much asymmetric payoff, e.g. tail risk protection strategies, are likely to experience reduced interest and demand in a YFYS world. Although the payoff and the benefit to members in the event of, for instance, another Covid or GFC driven sell-off would be great, the new benchmarking requirements make this a risky position purely from a benchmarking perspective. However, and to the previous points, those investors with the insurance of strong historical outperformance and net inflow are in a much better position to consider such strategies;
- Further to our introductory comments about the Your Future Your Super benchmarking provisions, investors are of the view that traditional 60/40 growth/defensive strategies are less likely to deliver the returns they have over the past decades. Even new job market entrants who will accumulate superannuation savings for their entire working lives may well struggle to earn similar retirement incomes to those who have been in the system to this point. Arguably, this is not the ideal time to have investors gravitating towards a generic benchmark comprised of passive asset sector exposures.

If one of the outcomes of Your Future Your Super is a more engaged superannuation membership, it would seem those funds with a historical outperformance buffer and strong net cash inflow (due to the nature of their membership) will have the opportunity to actively differentiate (i.e. market) themselves from more constrained investors by virtue of a broader and deeper set of investment opportunities; and

- With net-zero by 2050 increasingly being accepted as the necessary global emissions target required to ward off the negative impacts of climate change, investors have been adopting similar targets at a total portfolio level. However, some funds have also set even more ambitious net-zero targets by 2030. Some are also, hypothetically, considering the impact on portfolio holdings if carbon pollution prices of some description were to be imposed more broadly on companies across the globe. Some investors (notably Unisuper), and fund managers, are incorporating shadow carbon prices into their analysis of the balance sheets of the companies they invest in so they can identify how exposed they are to this risk across their portfolio. Regardless of whether an actual carbon price is imposed as a solution, this will provide an indication of which portfolio companies will have to work harder to achieve the reduced emissions that will be required of them as we move to a substantially lower carbon world.

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