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Themes and Trends – March 2013

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.

For much of the quarter the superannuation industry speculated about Government %raids+ on the super system; who would be targeted, for how much and whether the savings of superannuants would be impacted retrospectively. The Government eventually brought forward the release of its policy proposal for super. Notwithstanding additional complexity in an already complex system, at this point the industry in general does not seem overly concerned about the impact. The increase in tax for super balances and earnings above the threshold suggest the changes will impact a relatively small and affluent group. There is still some debate about this.

In terms of investment activity, low bond yields, a high Australian dollar and strong performance from the Australian sharemarket further encouraged investors to contemplate other asset classes and regions.

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

- Although long-term government bond yields and developed equity markets were higher over the quarter, enthusiasm for Australian equities and even global equities by institutional investors was more muted. This suggests the increase was primarily driven by retail investors unwinding cash positions in favour of riskier assets. Institutional investors continue to baulk at rushing headlong into risk assets due to concerns over US fiscal consolidation and economic growth, seemingly never-ending Eurozone problems and potentially inflation inducing policies by central banks of the US, Japan and other important economic centres;

- Given the contraction in spreads, the high level of issuance and even the emergence of a number of covenant-lite deals, some institutional investors are considering rotating into bank loans to benefit from their interest rate hedging characteristics and, more recently, some are considering broadening their exposure by allocating to multi-strategy credit strategies with an absolute return approach. The shift towards further diversifying credit portfolios, rather than reducing or eliminating exposures, suggests that credit is now accepted as a strategic exposure in portfolios;

- Interest in establishing a strategic exposure to emerging market debt is also increasing; however, investors are unsure about whether there is sufficient reward for the expected levels of risk. Therefore, some are considering active multi-strategy approaches that include hard and local currency, FX and emerging market corporate credit;

- There is a growing realisation that ±conventionalq emerging market equity mandates do not really provide an exposure to emerging market risk due to their high exposure to large BRIC companies which are either highly dependent on developed market economies or the state. Therefore, investors are seeking approaches that are better placed to find mid and small cap companies in domestically-orientated sectors such as consumer staples and discretionary and healthcare. Furthermore, emerging market equity strategies with off-benchmark allocations to companies in frontier markets are also being sought after;

- SuperRatingsqresearch identifies a trend amongst funds to move away from offering stand alone SRI options and towards incorporating ESG considerations at a total fund level. This has certainly been our recent experience and itqs now almost unheard of that a manager will not have regard to these factors in some way. Increasingly we see funds adopting policies in line with UN PRI guidelines; essentially expecting managers to have regard to both the risks and opportunities associated with ESG issues. This approach puts the onus on managers in two ways; firstly, ESG considerations cannot be used as a justification for underperformance and secondly, managers may still invest in firms with demonstrably poor performance in relation to E, S or G but they will have to be able to justify their decision to invest. Interestingly, the more this type of approach is adopted the more ESG simply becomes just another factor in a managerqs analysis. If we get to a position where ESG considerations are a given in most portfolios the concept of an ±ESG strategyqmay become largely irrelevant;

- Notwithstanding MySuper has encouraged merger activity and consolidation in the number of funds, we note that Victorian Teachers Mutual Bank has taken the opportunity to enter the market. Although that is not hugely significant as a stand-alone observation, some wonder whether there might not be an influx of non-super players with capacity to offer low cost, low service, simplified investment product in the default superannuation market;

- A number of investors have been establishing increasingly personalised default options for their members who choose not to choose and HESTAqs de-risking %Super Stream+ innovation, designed for the draw-down phase, is one that we have mentioned previously. HESTA point out that members are actively choosing this default de-risking option, suggesting that even though they donq want to make active decisions on their portfolio they can appreciate the logic of the approach and are prepared to default to a strategy that will change allocations on a predetermined basis;

- Nick Sherry, formerly Minister for Superannuation, made a rather bold prediction that all (APRA regulated) super funds will offer direct investment options within 5 years. Interestingly, research undertaken by CoreData suggests the opposite; that direct investment options are well down the list of wants of superannuants and are not having a meaningful impact on the flow of money to SMSFs. Intuitively, that does not seem quite right; although, perhaps for new entrants to the SMSF market, much of the appeal has been the ability to invest directly into real assets (such as leveraged property) and not just to select individual stocks, term deposits or money market investments. It is possible that a larger number of superannuants may in future choose to utilise SMSFs, for their real asset investments, as well as maintaining a substantial portion of their retirement savings within the super system for their traditional financial asset needs; and

- Personalisation of member accounts is becoming an important trend. As a counterpoint though, Peter Lambert makes an interesting observation when he points out that most of todayqs retirees will have been in the super system for perhaps 20 years. Regardless of asset/liability matching (i.e. risk reduction), contribution rates and ability to top-up, most of these people will be retiring without sufficient final balances to sustain them outside of the pension system. Therefore, some believe more of the discussion needs to be focused on how best the current crop of retirees should be able to access their savings, post-retirement and pre-pension, in order to sustain their standard of living for longer.

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