Themes – September 2009

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.

Equity markets and local currency cross-rates continued to strengthen over the quarter. As a result, investors are much better placed from a liquidity perspective and many are now taking the opportunity to review portfolios (or already have). However, changes to asset allocation and manager line-ups are usually being made with a view to the liquidity of the overall portfolio. Our observation is that there have probably been more terminations than appointments over the quarter, with investors acting decisively in relation to under-performing managers but deliberating for longer on manager additions and significant asset allocation decisions. Incumbents therefore have tended to experience additional portfolio inflows over the period. Asset consultants have not been immune from investor reviews, with a number of funds making changes recently.

With portfolios in better shape, with somewhat reduced manager line-ups, indications are that investors are now in the process of adding managers and changing strategic asset allocations as appropriate. Alternative asset classes are now being reviewed more broadly.

Some themes we have identified since our previous update are as follows:

- Yield spreads on corporate debt have fallen from unsustainably high-levels to within longer-term ranges. The appeal of the sector (particularly non-investment grade) is now not so much based upon a "once in a lifetime" opportunity; but more on high-income yields, that may persist for some time (given a still fairly moribund medium term global economic outlook). While investment grade corporate debt is now more likely to be impacted by inflation and future monetary policy direction, at current yields non-investment grade debt still has the potential to offer equity like returns. Arguably, at this stage in the cycle, a conservative approach to non-investment grade debt (given still high levels of default) represents an attractive investment opportunity (even without significant further capital gains), despite the strength of the recent rally. The risk though is of governments globally failing to co-ordinate the un-winding of their corporate rescue packages, in the wake of the GFC, extending the duration of, and increasing the severity of, the current global slowdown. This could lead to a further spike in default rates and another widening in high-yield spreads;

- With global economic influence recently shifting from the developed to the emerging economies (particularly emerging Asia), global emerging markets (GEMs) are increasingly being thought of as a mainstream portfolio allocation (on a medium to long-term view). Opinion varies in respect of the best means of constructing portfolios with GEMs exposure. Some funds include GEMs in their international equity mandates, either through the use of All Country benchmarks or by allowing managers to tactically allocate against developed world benchmarks. However, others believe that managing emerging markets (particularly at the mid and small cap end of the spectrum) requires a very specialist skill set, and therefore they are opting for specialist GEM mandates. Most are opting for global rather than region or country specific mandates, as they are not confident that they, or their asset consultants, are in a position to market time shifts in geographic allocation;

- Similarly, commodities are generating some interest coinciding with the Asia growth story (and as a diversifier and inflation hedge). Active strategies seem to be of greater interest than passive, given investor concerns regarding index biases. Commodities remain a niche asset class though, reflecting at least in part that many investors believe Australian equities already provide sufficient exposure to commodities markets - despite Australian resource company's being somewhat insensitive to commodity price changes;

- Apprehension over valuation and liquidity of private equity has discouraged further commitments recently. In the absence of fund realisations, investors have been more inclined; although reluctantly, to honour existing private equity commitments, rather than exiting via secondary markets (LPs are reticent to exit existing holdings at substantial discounts) and committing to new partnerships. This has created a challenging capital raising environment for private equity firms, at a stage in the cycle that is generally recognised as being supportive of investment in this area. Nonetheless, deals are being completed at low valuations and investors are starting to consider their 2010 programs. However, heightened liquidity concerns and a perceived lack of transparency in private equity and hedge funds has triggered renewed investor interest in buying similar risk premiums in more liquid asset classes such as listed equity and traditional fixed income. Some investors are even seeking a compromise in buying listed private equity;

- Disappointment associated with some recent unlisted infrastructure investments that relied on optimistic forecasts; and hence, were highly levered and struggled to arrange refinancing, has encouraged investors to think about more realistic risk/return expectations, appropriate investment structures and portfolio construction issues;

- Investors largely remain on the sidelines with regards to further investments in real estate. Australian banks are begrudgingly rolling over facilities; and in some cases, refuse new debt financing. In Europe, some banks are even refusing to roll over facilities;

- Sustainable investing has remained a hot topic of discussion. Other priorities however, have preoccupied investors and we have not observed significant new activity in this area. Having said that, where activity has occurred it has tilled some new ground – notably a sustainable farming venture. Regional investors are likely to further pursue sustainable investment and they will also increasingly search beyond listed markets to other approaches (e.g. agribusiness, water, carbon management, remediation and redevelopment, clean energy etc.);

- As portfolio reviews progress and changes are made to traditional asset class exposures, it is likely that other lowly correlated niche and alternative strategies will also become more of a focus. Single strategy hedge funds are attracting some interest, although multi-strategy funds and anything remotely opaque are approached with a great deal of caution. Insurance-linked strategies are attracting some interest – such as catastrophe bonds, weather derivatives, life policies; and

- A number of funds have created specific alternatives allocations – alternative growth, alternative defensive. Arguably, this is a simpler and cleaner way of segregating illiquid and/or volatile assets - such that exposures and impact on the overall portfolio can be closely monitored and constrained in order to avoid some of the issues of the recent past. We anticipate this trend will continue.