

Themes and Trends – September 2017

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.

Global economic growth continued to be modest, stable and reasonably broad-based. Share-markets continued to rise even though, arguably, quite fully valued. Most bond and credit markets (with some exceptions) produced a return somewhere close to their coupons and running yields. As a result, investors still find it difficult to find much value in 'vanilla' asset classes.

China has focused investor attention: Chinese debt levels continue to be a cause for concern (reflected in Moody's cutting the sovereign debt rating in the previous quarter), in late June MSCI announced they will begin adding China A-shares to their emerging markets indices for the first time from 2018 (meaning the exclusion, rather than the inclusion, of Chinese shares will become a risk consideration for portfolios) and Xi Jinping was recently re-elected as head of the Communist Party of China - his name and ideas will be written into the constitution of the Party (effectively elevating him to the same status as Mao Zedong). This will be closely watched.

Some observers describe the seemingly inexorable rise of equity markets as complacency; they speculate about the possibility of major corrections arising from unexpected negative economic or political events. However, long term investors are reluctant to allow too much cash to accumulate as markets continue to move ahead of them. It is also important to note that many still maintain overweight allocations to cash, which they can at least put to work in the event of a major fall.

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

- FTSE Russell's 2017 Smart Beta survey identified an ongoing global trend of asset owners incorporating some element of smart beta in their portfolios. The survey (covering assets of US\$2 trillion plus), found that 46% of participating funds had exposure to smart beta approaches and, of those, almost 70% plan to increase their allocation. Further, of the 46%, 64% are utilising multi-strategy rather than stand-alone factor approaches. Additionally, 41% anticipate applying ESG considerations to their smart beta investments – for reasons of (in descending order) "avoid long term risk", "societal good", "performance", "regulatory requirement" and "other". The responses are not absolute i.e. people have chosen more than one reason. Interestingly, while 69% of the 41% include avoidance of risk in their reasons for incorporating ESG, only 31% of the 41% are motivated by performance. The survey was primarily in respect of investor intentions, as opposed to identifying the means to achieve investment related goals (which it identifies as the primary motivator for incorporating ESG considerations) or whether and how ESG would be incorporated as a factor, in and of itself;
- As an aside to the above, in some cases super and non-super investors are planning, or have already undertaken, considerable work to reduce the environmental (carbon) footprints in their portfolios. Therefore, investment strategies which purport to reduce this footprint as their primary objective are unlikely to be as compelling as they might once have been. Generally, investors are more interested in finding a unique source of alpha, with the reduction of the said footprints being a consequent but not targeted outcome.

There is interest in whether an alpha signal, associated with a reduction in environmental footprint, might be a distinct new proxy for quality of management – a factor which has been dominant for a long time. However, investors are naturally cautious about committing

to further research as some have speculated that their multi-asset portfolios may already be exposed to this factor - given the strong bias to quality in most equity portfolios;

- Social impact investing again seemed to be a focus for investors during the quarter, or perhaps it is just that it gets talked about more while there is less focus on liquid equity/debt markets. Worthy of note: FSS investing in a retirement village business, CBUS stating their intention to be more involved in affordable housing and HESTA's partnership investment in a unique dementia care facility in Tasmania. Under the same broad social impact heading, Christian Super announced they will be investing in a fund providing financing to small/medium sized businesses in developing economies;
- The latest headline-grabbing 'crowded trade' phenomenon, recently given the moniker of FANG (Facebook, Amazon, Netflix and Google's parent, Alphabet Google's parent - plus sometimes Apple), continues to concern equity investors; particularly those exposed to the growth factor or even simply the index – the FANG companies (and Apple) constitute more than 10% of the market cap of the S&P500 - representing a considerable risk if they were to be sold-off rapidly. Although concern is justified when seen as a group, many investors recognise there is considerable differentiation between these companies in terms of valuations and earnings - some are comfortable with active managers holding one or two, such as Facebook and Alphabet, if the earnings are expected to justify above-market but not steep valuations. The Chinese tech rally, with the most representative companies being Alibaba and Tencent, is related to the FANG trade; however, earnings and valuations are generally seen as being more supportive. Again, many investors are comfortable investing in active managers that can expertly discern the quality of the earnings of these companies and avoid paying too much for them;
- Peter Costello, Chairman of the Australian Future Fund, raised the idea of the Future Fund managing outsourced money on behalf of super funds. He later took the concept a step further by suggesting a Government agency could become the default super provider for Australia's compulsory super system. He argued such an agency would benefit from huge economies of scale, would end the fighting between industry and retail funds and that Government should rightly have an interest in managing the system it established. It has been suggested the idea will be considered as part of the Productivity Commission's review of the competitiveness and efficiency of the super system.

Accurate numbers on the size of the default fund sector are difficult to estimate, but it seems likely it is above \$500 billion (and growing) – a sizeable chunk of the \$2 trillion plus of Australia's super pool. It would be a behemoth compared to any Australian super fund and would also be one of the top half dozen pension/retirement funds in the world. However, one wonders how the default fund providers who have done so much recently to deliver their MySuper offerings may respond. Additionally, super industry bodies seeking to leverage the influence of the weight of money to promote progressive reforms and changes may be somewhat concerned if Governments, perhaps less committed to such agendas, seek to significantly in-source non-public monies. Further, in the current environment, it would be difficult to see bipartisan political support for such a move.

Such a fund could be productive if utilised effectively to help satisfy Australia's future infrastructure needs or if directed towards essential services (e.g. aged care, dementia care) that super funds are increasingly focused on. However, the flexibility and manoeuvrability of a fund of this size would also obviously be a first order issue.

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