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Themes and Trends – June 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.

In the latter part of the June quarter, investor attention was focused on Greece and China. Although in respect of Greece it now appears a refinancing compromise has been hammered out, it remains to be seen how the tough austerity measures demanded will impact the Greek economy and what it may mean for an increasingly fragile Government. However, while defaulting on IMF and EU loans was potentially disastrous for Greece and inconvenient for the Eurozone, in the global scheme of things Greece is not a major economic force . the fallout would largely be contained within the Eurozone region.

On the other hand, a dramatic slowdown or collapse of Chinese economic growth would have far more serious consequences. The impact, both directly and via Australia¢s other major Asian export markets, would potentially be serious for Australian revenue, growth and the Australian sharemarket. The Chinese authorities still have a number of levers they can pull; however, Australian authorities have rather fewer options and a Chinese hard-landing would be a meaningful risk for the Australian economy and investors.

Taking into account eventual tightening of US interest rates and arguably stretched valuations, Australian investors are unsurprisingly rather gloomy in their forecasts for long term returns from most equity markets and, with interest rates and yields at low levels, for their funds overall.

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

- The rollercoaster ride provided by the Chinese sharemarkets in the last few months has resulted in some interesting numbers for high conviction emerging market managers. Managers with any meaningful underweight to China were significantly underwater in April, as the Chinese sharemarket rose by up to 20% (depending on market index), but have clawed much of that back in May and June. Reassuringly, not that they particularly enjoy the experience, investors are actually far more comfortable seeing expected underperformances than unexpected outperformances;

- With China becoming such a large part of the global emerging markets equity universe, some investors are starting to think differently about their exposures; in particular, whether to consider China and/or emerging Asia separate from their broader global emerging market exposure or whether in fact to go the other way and allocate to ACWI approaches with significant discretion across all countries and regions;

- Although investors always anticipate comparatively higher volatility in emerging market equities, they seem reasonably positive on the relative low valuation / high growth story for emerging market equities on a longer term view. Some large and very successful managers in this asset class are still making capacity available; investors will be conscious of capacity issues though if they feel their managers are becoming too big;

- With return expectations for the medium and long-term having come down, some investors contemplating whether they will be able to achieve their fund performance objectives are considering increasing allocations further along the risk curve while others, if they have the scope to do so, are doing the opposite and taking risk-off (holding more cash) in order to be able to invest when valuations are more attractive. However, peer

comparisons plaguing super funds mean they cannot simply focus on the horizon without also glancing sideways at their competitors; for super fund investors the concept of ±risk-offq may be illusory;

- As previously mentioned, some investors have been looking more actively for strategies that are less correlated to the direction of markets; meaning they have the potential to provide some return even in falling markets (long-short strategies for instance). Additionally, a number of funds are specifically looking at tail-risk and other hedging strategies; strategies designed to protect on the downside (particularly in the event of large market falls) but allowing investors to participate in the upside if markets rise.

  Of course nothing is for nothing and the cost of any hedging strategy will reduce the upside potential to some extent; however, reducing the size and frequency of negative returns lessens sequencing risk in a portfolio. Although difficult to quantify, lowering these risks may over time more than offset the additional costs involved. Such approaches may be of particular benefit to superannuants close to retirement; with interest rates as low as they currently are, retreating to cash and fixed income and living off those earnings may not be as palatable as it once was. Income focused equity strategies with a protective element may continue to attract greater attention as investors increasingly focus on the post-retirement market (as the Baby-Boomer surge works through) now that they have largely dealt with the implementation of MySuper. However, many income generating stocks, particularly those providing franked dividends such as banks, are seen to have had a strong run; they may be at risk given some mining projects are becoming less viable and there is speculation of a housing market correction;

- Investors and, particularly, their advisers continue to push fund managers on fees. Some managers have embraced this with reasonably convincing gusto; notably large multi-sector managers who anticipate replacing higher margins with greater scale. However, boutique managers, who often manage only a small number of frequently capacity constrained strategies, do not often have this flexibility. Independent of the financial backing of a larger parent or a broad product suite, they must work hard to retain and reward staff and principals as well as spending on research, resources and processes.

  Several studies have found that boutique managers have generally outperformed non-boutique managers in most equity categories over the last 20 years. This is not a secret to investors who, in many cases, favour boutiques precisely because of this expectation. However, it needs to be recognised that excessive fee pressures will make it much more difficult for boutiques to achieve these outcomes; and

- Research increasingly supports that ESG factors can contribute positively to portfolio performance. However, taking ESG apart and working out which aspects work most effectively and where, and therefore how best to use them, will be more challenging - the findings are not consistently positive across E, S and G and across different markets. For instance, ±Style Researchq has found that in developed sharemarkets environmental factors are positive for performance but social factors are actually negative and governance factors are unclear. The UN PRI Initiativeqs 2013 paper . ±Sovereign Bonds: Spotlight on ESG Risksq identifies that while social and governance factors impact performance, environmental factors are less clear cut. Understanding the logic behind the differing impacts of ESG factors and how their influence may change over time will be critical if managers are to confidently incorporate these as investment factors.

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