

## Themes and Trends – September 2012

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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.

Concerted central bank announcements in support of troubled sovereign bond markets helped to shore up investment markets more broadly and, from this perspective, the quarter was fairly uneventful. Several very large mandates by dollar amount were awarded during the quarter. However, mandate activity by number was comparatively light; possibly reflecting normal financial year end priorities.

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

- Backdated legislation providing capital gains tax relief (which will extend to 2017) for super funds seems to have renewed merger activity ahead of the January 2014 start date for MySuper. Although there are still over 350 super funds in Australia (including retail funds and master trusts but excluding the vast number of 'small' and 'self managed' funds) this number has fallen substantially in recent years (463 in June 2009). Conceivably, new funds established within the retail/master trust area might add to that number, but we are unlikely to experience a rise in the number of corporate, industry or public sector-sponsored funds.

Interestingly, the super funds have been steadily growing their internal resources regardless of size. It may be that there is, and will continue to be, an increasingly obvious dichotomy between the mega and large funds and the medium sized and smaller niche funds that have chosen to focus on their original member bases, rather than expanding via the public offer or merger route. In a hyper-competitive super environment, additional resources are enabling the large funds to be creative and innovative in product design and the breadth of their range of offerings. Smaller funds appear to be more focused on differentiating themselves by providing personalised member services. Interesting innovations from the larger end of town discussed in the past quarter include:

- Life Cycle investing has been much talked about in recent times and HESTA's "glide-path" concept ('HESTA Income Stream') is a more personalised approach to the topic. Members using this option are investing in a combination of balanced and defensive options. As members move from accumulation into drawdown, their income requirements are met from their balanced option (until that investment is exhausted). Thus, as they progressively draw on retirement savings, their overall exposure to risk assets is automatically and gradually decreasing; the more common age-based approaches involve funds being physically moved from riskier to more defensive options as members approach retirement;
- Further to the above, we think discussion of Life Cycle approaches is getting more interesting as greater personalisation is introduced at a member level. Industry participants are anticipating QSuper's "defined benefit approach to defined contribution" and seeing how "mass personalisation" will work in practise. It appears

the approach will take into account the current financial positions as well as retirement objectives of the members; and

- Towards the smaller end, Club Plus is taking AustralianSuper's direct investing option one step further by introducing not only Australian direct equities but also adding term deposits as a choice. In providing alternatives to members who might otherwise look for this level of customisation by opting for self managed super, this may be an effective retention tool. However, readily providing members the option of cash may potentially exacerbate the sort of liquidity issues experienced by many super funds in the immediate post-GFC period.
- The problems afflicting the Eurozone and the EU are attracting the attention of some of the more enterprising investors seeking to exploit the dislocation. Senior secured loans, high yield, mezzanine debt, and even distressed debt, are some of the sub-sectors investors are busily researching. A few determined investors have already committed capital. Although the headlines from the Eurozone seem dire, the reality is that in aggregate default rates have only edged up slightly and spreads remain below long term averages;
- The tumble back into recession in Europe, the United States' stuttering recovery and serious concerns over whether China will even be able to maintain growth at the previously unthinkable 7% - in spite of continued stimulus by central banking authorities - have impacted sentiment surrounding emerging market equities. Some institutional investors are delaying plans to increase their allocations. However, a smaller number are actually considering reducing their Asian regional allocations and shifting funds into broader emerging market strategies, reflecting heightened regional risks caused by an economic slowdown and possible geopolitical risks emanating from the South China Sea. Also, while the fundamentals for emerging market sovereign and quasi-sovereign debt yields generally seem attractive; interest has cooled as investors wait until the global macro story turns positive and the reward for risk becomes more compelling;
- Dynamic asset allocation has continued to be a topic of much discussion. Intuitively, it is appealing; however, we note that the downside potential does not seem to have entered the conversation. Obviously, shorter term decisions have as much potential to detract from, as to add to, total fund performance and for meaningful periods of time. However, because institutional investors or their outsourcing partners will have a greater role in determining asset allocation, members will judge them more harshly if they get it wrong. Funds incorporating dynamic allocation in-house will need to have very disciplined processes and funds outsourcing will want to be confident in their preferred providers; and
- We have observed a number of investors are continuing to shift to more active, higher conviction and unconstrained equities strategies. This suggests investors believe that equity prices are more likely to reflect fundamentals rather than sentiment. Notwithstanding cost driven decision-making in relation to MySuper, reports of purely passive indexing mandates seem to be fewer in number and spoken of more as interim parking arrangements rather than long term holds.

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