

Themes and Trends – March 2012

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.

The deleveraging that began in 2008 across most advanced economies is proving painful. Generally, investors believe we are early in the process; although, there is significant variability in the size of the problem and the stage of recovery across countries. Driven by rising government debt, the ratio of debt to GDP has actually grown amongst the largest developed economies; however, private sector debt has fallen. In the United States, as in Europe, policy makers have maintained negative real interest rates as a measure to liquidate debt, which is acting as a disincentive for holders of sovereign bond and depositors.

In response, investors have been reducing their government issued debt exposure in favour of credit, particularly to US non-investment grade corporates. Although credit spreads are wider than historical averages, defaults remain low and refinancing has resulted in healthier balance sheets. However, many investors believe that developed market equities are unlikely to be beneficiaries from this “financial repression”. Despite recent encouraging economic data from the United States, this reluctance reflects that after US households finish deleveraging, home refinancing - which provided such a strong stimulus by increasing consumption before the crisis - will not be available, as house prices have declined significantly, equity is lower and lending standards have tightened. A change in the Federal Reserve’s stance on interest rates or money printing in 2013-2014 will further reduce growth. Also, the recovery in Europe has been tepid at best; as the main growth engine, Germany has been weighed down by the periphery and, increasingly, core countries such as the Netherlands and France. Even the recent mainstay of global growth, China is showing signs of slowing; albeit from high levels.

Some investors are considering reducing developed markets equity exposure in favour of high yield and bank loans due to their attractive risk/return characteristics. The question for them is whether they opt for high yield bonds or floating rate bank loans, to hedge against rising inflation.

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

- Alternative beta, smart beta, beta prime, minimum volatility and/or fundamental beta are epithets describing various systematic portfolio construction approaches deliberately avoiding traditional capitalisation weighted benchmarks in seeking to exploit reliable, observable market premiums. These strategies have attracted a lot of attention from institutional investors although, as yet, funding has been miniscule compared to the pool of available capital. Many investors are still more focused on better understanding the liquidity implications of tail risk events and the impact of serial correlation on portfolio volatility. They are also trying to determine whether their current portfolio configurations may already be providing them with some exposure to these premiums;
- Interest in emerging market equities and debt has improved since the second half of 2011. Valuations and currency fluctuations across a number of markets have improved their return

potential. However, investors remain wary of potential technical sell-offs; as developments in advanced economies may significantly impact the prospects of BRIC economies such as China, Brazil and even India. Of course, investors clearly recognise that the secular story remains attractive as emerging economies continue to urbanise, fixed asset investment and consumer spending is increasing, fiscal positions remain robust and inflation seems to be getting under control;

- The demand for domestic utilities and infrastructure assets remains as strong as ever. In fact, some investors bemoan the lack of deal flow. However, wholesale institutional investors remain wary of projects with significant Greenfield risk. Smaller investors such as family offices and high net worth investors are taking up the challenge;
- Collier Capital, a private equity secondaries manager, has identified that Australian LP commitments to private equity have stagnated since 2008/2009, while many of their offshore counterparts have largely recovered. They cite very high levels of activity immediately preceding 2008 as part of the reason for reluctance to re-enter these markets now. Our discussions with Australian LPs support these findings; LPs also continue to express reservations about valuations, transparency, pricing and liquidity. Additionally, fund governance required to adequately assess, and thence to monitor, GPs likely to comprise only a relatively small proportion of a multi-asset portfolio has been seen as inefficient; particularly if LPs lack conviction in the GP's target return IRRs. Despite this, a few Australian LPs have recently re-commenced their programs; however, we are not assuming a lemming-like rush in the very short term;
- In our December commentary we mentioned the newly established NSW Government body – Infrastructure NSW. Although the authority is more about out-sourcing than in-sourcing, we note one of the NSW Government's early initiatives in this area has been to buy Metro Transport Sydney. This will allow the Government to dismantle the Sydney monorail and to take action on their election promises in relation to extension of the Sydney and inner-west light rail loop. Although unlikely to be one of the larger infrastructure deals this year it is encouraging to see innovative activity in this area; and
- From 2013, signatories to the UN PRI will be required to complete an on-line survey in relation to their responsible investment activities and responses will be publicly disclosed. If institutional investors are obliged to provide ever greater levels of reporting, service providers will be similarly obligated. We are seeing this already and it has been increasingly the case that new business opportunities are prefaced with enquiries regarding a fund manager's approach to incorporating ESG issues into their decision making. Some managers who previously have not identified themselves as ESG-sensitive have on reflection realised (at least on the risk side) that they are already having regard to many issues that are readily identified as E, S or G in nature. So, broadening their thinking and analysis in this regard may not be as onerous as imagined.

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