

Themes and Trends – June 2018

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.

Solid global economic growth generally, supported by the fiscal stimulus of US tax cuts and planned infrastructure spending, has continued to buoy equity markets. This is despite the potential to overheat the US economy and, thereby, push up inflation, leading to increased risk of interest rates rising faster than might otherwise have been the case. Talk of a US/China trade war (and the risk of this becoming global) escalated early in the quarter, and then subsided in mid-May with a seemingly mutually agreeable last-minute compromise arrived at between the two countries. This somewhat settled investor nerves as it appeared likely President Trump would 'take the win' and move on. However, the President's unpredictability seems to be the most certain thing in an uncertain world and he has again dialled up the rhetoric in relation to China and other US trading partners.

Reflecting the above, a US and resultant global recession is now seen in some quarters as a genuine risk; albeit, a deep recession does not seem to be the base case scenario.

Simultaneously, the President's 'diplomatic' overtures to various world leaders, although self-described as great successes, are ensuring investor anxiety is maintained at a constant level. Although they appreciate entreaties to focus on what the President does rather than what he says, not everyone is finding this to be entirely reassuring.

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

- Some investors are increasingly adopting 'all country' global equity mandates rather than separating developed and emerging/frontier; this reflects a view that the opportunity set is across these markets and not just within them. Markets are not as clearly delineated as they once were, and some markets are also seen as being too big and significant (e.g. China) to be constrained by a typically lower maximum weight to emerging markets;
- For some time, investors have been pursuing fixed income opportunities in relatively illiquid forms such as direct lending and mezzanine debt. However, there has been some re-consideration of whether there is still sufficient premium in yield, once adjusted for the reduced liquidity and increased complexity. Tight investment grade spreads and some increase in emerging market debt yield, compared to that of developed markets, has encouraged investors towards emerging markets debt (primarily local currency or a blend of local/hard currency). Investors interested in EMD do not seem overly concerned that recent US dollar strength is a longer-term market phenomenon, and some are viewing this as a possible entry point to the market;
- For those investors who have an EMD exposure, or who are looking at the sector, concerns about these markets tend to be country specific (e.g. Turkey, Argentina), so generally they prefer macro-driven research and benchmark agnostic approaches. ESG issues are often more of a focus than purely economic factors (governance and human rights issues being key worries). Reflecting this, total and absolute return approaches are quite compelling, but passive is somewhat unloved in this asset class;
- Responsible Investment Association Australasia's (RIAA) Investment Benchmark Report 2017 indicates that approximately 44% of Australian professionally managed funds were

invested under a responsible investment approach by the end of 2016 (which is likely to have increased since then). Approximately 90% of these assets were invested under broad 'ESG integration' approaches (involving 'systematic integration of ESG factors into traditional financial analysis and investment decision making...'). This category dominates core (specifically ESG strategies, including positive and negative screening, sustainability themes and impact investing etc); although core approaches are attracting more attention also. Within core ESG approaches, our experience suggests that relatively simple exclusion strategies (with the exception of clear-cut exclusions like tobacco, slavery and controversial weapons), based on data provided by external data providers, are seen as simplistic and incapable of objectively targeting risk-return outcomes for their clients;

The Report shows that integration of ESG analysis into portfolios has become largely mainstream.

The RIAA's Super Fund Responsible Investment Benchmark Report 2018 draws on these observations and highlights the growing commitment and stronger stewardship super funds are taking in relation to their members assets.

This Report also recognises that members increasingly expect their super and/or other investments to be invested responsibly and ethically. It is difficult to know to what extent members are driving the behaviour of the funds or whether their expectations are being fuelled by the words and actions of the custodians of their retirement savings. It seems likely that each will continue to influence the other regardless of who was the instigator;

- Passage of the Modern Slavery Bill 2018 through the NSW Parliament and progress of an equivalent Bill through the Federal Parliament has focused investor attention on the social component of company behaviours. The objective of the Federal Bill is to "assist the business community in Australia to take proactive and effective actions to address modern slavery. This will help mitigate the risk of modern slavery practices occurring in the supply chains of goods and services in the Australian market."

Notwithstanding some political noise-making, the Bill is anticipated to be passed largely unamended. The Bill is based upon a similar Act passed by the UK Parliament in 2015. Australian investors have expressed support for the Bill; particularly in light of a number of recent scandals, mostly involving franchise businesses, where it appears operating models encouraged franchisees to breach Australian labour laws in order to achieve profitability. To date, ESG discussions at an institutional investor level have tended to be focused more (but not entirely) on environmental and governance issues so this may somewhat tilt the conversation towards the social aspects of business behaviour (such as working conditions, health and safety, diversity etc.);

- Several larger investors have adopted or are moving away from the traditional 'sequential investing' model and towards 'total portfolio' approaches. These investors are of the view that the two-stage process of asset allocation and then investment selection limits the ability to effectively manage a portfolio on a holistic and internally consistent basis; and
- Investors were initially surprised when widespread calls for a Royal Commission into the banking and financial services industry ultimately resulted in the inquiry being broadened to include the superannuation sector; now that the Commission's focus has turned to super, investors will be watching the direction this takes with some trepidation.

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