## Themes and Trends – March 2014

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.

There were not really any significant economic events in the quarter. Geopolitical events in emerging markets, notably Ukraine, probably focused attention more than anything. Emerging market equities for the most part were flat to down while developed markets were reasonably strong and credit markets across the board finished slightly higher (yields down).

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

- Continuing high demand and investment in Smart Beta strategies has drawn warnings to be cautious in relation to the plethora of new strategies describing themselves as such. For instance, comments suggesting that some so called óbetasô such as momentum may be stretching the definition and that investors should not see these strategies as a free ride. They need to understand the risks they are exposed to and where they may be duplicating existing exposures in their portfolios;

- Infrastructure investors have much to think about at the moment. A few observations follow but without any clear conclusions:

    - Australian investors will watch the May Federal budget with interest as the Federal Treasurer, Joe Hockey, has indicated measures will be introduced to encourage State Governments to sell remaining infrastructure assets with a view to reinvestment in new infrastructure projects;

    - The Productivity Commission has provided qualified support to Gary Weaven, from IFM, and his óinverted bidô infrastructure model whereby the long term investor (e.g. a superannuation fund) in a new project is involved much earlier in the process, possibly in place of the investment bank that might otherwise fill that role and ahead of the various parties involved in construction;

    - Comment was made on the back of the recent Free Trade Agreement reached with South Korea, and potential opening up of investment between Australia and Korea, that Korean retirement funds could be invested heavily into key Australian infrastructure such as ports, roads and rail;

    - Global investors prepared to invest in Australian infrastructure to earn relatively lower returns, than those sought by Australian superannuation funds, are encouraging some tactical profit-taking; and

    - There is likely to be resistance to any legislated requirements or Government suasion designed to require superannuation funds to invest in domestic infrastructure.

  Although there is much happening in this area, it does not seem clear yet that Australian super funds seeking infrastructure at the right price and with the right characteristics will necessarily have a framework delivered to them in the very near future;

- Investors continue to consider alternatives to investment grade and sovereign and semi-sovereign fixed income. We have previously mentioned the increasing demand for diversified approaches to non-investment grade credit, focused on diversification and limited rotation across sub-asset classes, aiming to deliver positive absolute levels of return rather than relative to benchmark returns. This quarter we have noticed more investors seeking alternative and sometimes less liquid forms of fixed income, including: convertibles, emerging market debt (and regional e.g. Asian debt as a subset), infrastructure and mezzanine/private debt, hedge fund variations (e.g. including leverage, long-short and market neutral) etc.;

- Developed market equities have, by and large, performed strongly in the recent past. This reflects expectations that the major economies are on the mend, despite indicators not being unambiguously positive. Australian investors are not uncomfortable with the strength in the market; however, they would like to see higher earnings recorded such that the P/E multiples decline slightly. There is still strong demand for new strategies, given the growing superannuation pool and the falling by the wayside of some well-known managers. However, super and non-super investors and their consultants require greater convincing of the efficacy of various investment approaches in an already crowded marketplace. Cheaper alternatives like ETFs are also making it more difficult to state the case. There also appears to be some scepticism over managers previously focused on domestic equities expanding their opportunity set. For those managers deemed to be óglobalö, flexibility is sometimes being given to seek opportunities in emerging market large and mega caps;

- Interestingly, emerging markets equities have not kept pace with rising developed market equities. Regional and country concerns in emerging markets are holding investors back a little but some are venturing back in. Further confirmation of higher earnings in developed markets, brighter prospects for some larger emerging economies, meaningful structural and fiscal reform in Brazil, Turkey, South Africa and a cessation of some of the alarming political developments in Ukraine and elsewhere would provide comfort to a greater number of investors currently under-allocated to emerging markets. Having said that, current circumstances do tend to favour high conviction, high concentration approaches that can avoid as far as possible the countries and regions affected;

- As superannuation funds and product providers have crafted ever more considered responses to MySuper, particularly in relation to more tailored offerings such as óglide pathö, ólife-stageô and ócohortô type structures, one of the out-workings of MySuper has also been a greater focus on post-retirement savings. Recent and ongoing discussions regarding a possible increase in the pension age and the superannuation access age (reflecting the budgetary pressures of an aging population and lengthening life expectancies) will likely keep this topic front of mind for superannuation funds looking to provide services to their membership in the post-accumulation period. Expect annuities and longevity risk insurance, for instance, to continue to generate much discussion; and

- Further to the above, we note the observation that MySuper, designed to provide simpler, more cost effective solutions for disengaged superannuants has actually resulted in quite an unprecedented flurry of new product design and innovation. While this can only be a good thing, it can be argued that the offerings are now more diverse, numerous and complicated than ever. Thatös not an issue for members who default into MySuper funds; however, it makes comparisons more difficult, across funds, for employers looking to decide on providers.