## Themes and Trends – December 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.

Although the US fiscal cliff loomed as a risk for much of the quarter, institutional investors were reasonably active, particularly in respect of their listed equity portfolios. While the recent tendency to political brinkmanship may mean we have not heard the last of this issue, at least for the time being equity markets appear to have responded quite positively to the 11th hour compromise. Unrelated to these concerns, a number of institutional investors went into lockdown mode over the period in order to grapple with MySuper or to focus on regular strategic and/or manager reviews.

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

- With short term interest rates falling over the last 12 months, and with many expecting the Reserve Bank of Australia to continue their cuts to at least mid-2013, the shift from cash to higher yielding assets is likely to gain momentum over the next 12 months. Although spreads on investment grade and non-investment grade credit have narrowed, bank loans are still seen as a solid investment as default rates are expected to remain low (there is an enormous amount of cash on US corporate balance sheets), spreads remain healthy and their floating rate nature provides an attractive hedge. Convertible bonds, which have low correlation to traditional bonds and defensive characteristics relative to equities, are on the radar screen of a few investors  Some investors have also reduced their cash allocations in favour of high dividend paying stocks;

- Given persistent global economic uncertainty, investors have favoured global equity strategies offering some downside protection; there has been a premium on large and mega capitalisation high quality, dividend paying companies. However, there is a small minority opinion that valuations in this sub-sector of the market have become stretched, which may reduce the interest in these types of managers. Gains from labour force reductions have largely occurred so, in order for margins to remain high, investors are seeking companies with strong franchises which command pricing power. Comparatively concentrated portfolio approaches are preferred and potentially divergent company profit and macro-economic performance is driving a preference for active management if it can be justified by the management fees. The developing consensus that Australian economic growth will slow because of a decline in the resources boom, impacting the performance of local equities, is also causing investors to reconsider their exposures relative to global equities.

- The uncertainty mentioned above contributed to emerging market equity performance lagging developed markets last year. In addition, valuations were considered to be historically high. Therefore, deliberations for emerging market equity managers amongst institutional and sophisticated investors slowed. Many had also reached, or even exceeded, their strategic allocations to emerging markets. However, valuations are generally considered to have improved, and earnings growth is expected to resume on a stronger path as the global economic recovery slowly improves. This is likely to boost the search for managers buying high quality emerging market companies;

- Notwithstanding the above, smart/alternative/creative beta approaches (which tend to be quite broadly diversified at a stock level) are also continuing to focus attention. These can be relatively traditional value or size focused approaches that move away from traditional market cap weighted benchmarks but can extend to more esoteric strategies such as reinsurance and volatility. Cost considerations are often cited but that will not always be the driving force;

- With MySuper legislation now through the House of Representatives and capital gains tax relief extended, merger activity is continuing and likely to persist. Note, not all funds are embracing mergers as a means to greater efficiencies and outcomes. Some smaller and medium sized funds will work collaboratively in seeking to generate competitive advantages otherwise accruing to scale. Fewer funds and an ever more competitive playing field are driving funds, and providing the opportunity, to increase their in-house resources. This is not a new observation but it is perhaps worth noting the different ways these additional resources are being applied:

    - Establishing in-house portfolio management teams. Some funds believe they can generate cost savings relative to external management in certain asset classes and thereby reduce total costs in their funds;

    - Building in-house manager research and/or asset allocation (including dynamic) capabilities. Funds may believe they can better tailor their macro decision making to their particular circumstances or this will enable them to achieve better outcomes when working closely with their external advisers. This may accompany a move towards specialist advice or a core plus satellites approach to external advice;

    - Increasing in-house operational capabilities in order to improve portfolio management efficiencies at a total portfolio level; for instance, to reduce slippage in currency overlay management or during the process of transitioning assets;

    - Expansion of customer services, quality and range of offerings. Some innovations are at least in part a response to the growth of the SMSF market (over 35,000 new SMSFs were established in 2012). We also note some early discussion about whether super funds may have the ability to provide SMSF infrastructure (enabling members to build their SMSFs within the super system).

- Increased competition has also flowed through to consultants. Funds with greater resources will not necessarily rely less upon consultants but they may use them in differently. A greater proportion of the work done by consultants may be focused on specialised areas other than asset allocation and manager selection; and

- Not surprisingly, infrastructure was much discussed again. We note HostPlus providing equity funding for the redevelopment of the entertainment, exhibition and convention precinct at Darling Harbour alongside Lend Lease and also REST partnering with Cintra on Australian toll-roads. Industry funds were cited as supportive of Government infrastructure sales if the proceeds are used for new infrastructure development and particularly if super funds (rather than just the private sector) are directly involved in these projects. This is something we have flagged previously and most industry participants believe this is a positive step.