Themes and Trends – December 2013

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.

Despite widespread concerns the commencement of the tapering by the US Federal Reserve would cause market ructions similarly experienced during the middle of 2013, investors have been surprised at how muted the impact has been. Perhaps, confirmation that the US economy is on firmer ground; although, not humming along, is tempering their concerns. A greater fillip might be provided if the economic recovery becomes broader based and the American middle class begins to feel genuinely wealthier.

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

- In terms of investment activity, global equities; particularly managers using highly active approaches, has continued to attract new money and interest. Several larger institutional investors have shown the way, indicating they find current valuations to be fair despite an increase in Treasury yields and strong multiple expansion - implying they believe corporate profitability will improve. In particular, value in emerging markets has been identified (notwithstanding the unique risks) given these markets have significantly underperformed developed markets. Real property and infrastructure continue to be of interest to investors looking for relatively stable and predictable returns, who can accomodate the lack of liquidity. Cash and sovereign issued fixed income generally are not offering attractive returns and the likelihood of rising short, and long, term interest rates is a deterrent. However, multi-asset absolute return type approaches (i.e. strategies actively allocating across fixed income asset classes to achieve an absolute return) are receiving attention both on a broad global aggregate basis and also more narrowly within the credit markets;

- The Treasurer, Joe Hockey, has been talking with global institutions and counterparts about the capacity of Governments to fund infrastructure. The possibility of Government guarantees being applied to infrastructure debt, in order to encourage institutional investment in much needed greenfield projects, has been flagged (which will need to have regard to the rating agency perceptions thereof) and no doubt will be followed closely by investors keen to increase exposure to the asset class but in a way that is closer to their objectives; namely, the relatively stable returns they would normally seek from more predictable brownfield opportunities;

- There has been increasing interest in dynamic asset allocation as superannuation funds grapple with the practical issues of life-cycle investing (which a significant number of funds have adopted in respect of their MySuper offerings) and risks inherent in de-risking member portfolios, when they are close to their peak balances, irrespective of market circumstances. Approaches to life-cycle vary from the simplest approach of de-risking portfolios by age bracket through to much more tailored approaches that may also consider member balances or salaries, gender and even risk preferences. There is probably scope for improved awareness of the market circumstances at the time of de-risking. For example, genuinely dynamic asset allocation, around longer term strategic allocations, may help funds to manage this risk. For instance, if de-risking involves moving all or a proportion of a member's funds from higher to lower risk profiles, then dynamic asset allocation has the potential to avoid significantly disinvesting from óriskierô assets at that particular moment in time; especially, if the more conservative options have wider ranges around the strategic mix. Conceivably, the Trustee or outsourced manager could have a strong view that equity markets are undervalued and a higher weighting (relative to benchmarks) across all options is warranted. The more conservative option could therefore still have a relatively high weight to equities and the member would not be at such risk of ónaivelyô selling at the worst possible time;

- Internalisation of investment expertise and management continues apace. Some funds are doing this in order to have the necessary expertise to get closer to complex underlying deals and projects in private markets (notably infrastructure and real property); however, others are in-sourcing entire investment capabilities in order to generate anticipated cost savings, improved performance, greater accountability and/or efficiencies of one kind or another. There has been some reported defensiveness from fund managers in respect of this latter trend but funds are pointing out to them that the ópieô continues to grow and the better managers will continue to see plenty of opportunities. Notwithstanding this, in light of APRA warnings regarding Trustee obligations (see comment below), superannuation funds and their Trustee Boards will need to be very confident in the capabilities of the internal teams, and the internal resources allocated to support them, and that due diligence has been conducted to the same extent as if an external appointment had been made. In the medium term it will be interesting to see if these internal óboutiquesô are suitably and sufficiently incentivised;

- We note over the last quarter a number of smaller and medium sized funds appointing dedicated CIOs for the first time. It seems this may be in response to APRA warnings regarding the prudential obligations and the liabilities of superannuation fund trustees in respect of the investment decisions being made on behalf of their members. APRA has made it clear Trustees will not be able to simply apportion blame to investment consultants in the event that things go wrong. Greater engagement with consultants and deeper questioning and understanding of their recommendations may be required of smaller funds. Larger funds will mostly already have had the resources required to drill deeper with consultants. The APRA warnings may also encourage funds to give further thought to the Cooper Review recommendations regarding the appointment of independent expert Trustees to Boards; and

- More and more funds are making available direct investment offerings, largely as a defensive measure to offer an alternative to members who might otherwise leave for SMSFs in order to pursue their desired investment strategy. For the most part, the offerings are encompassing Australian listed shares, a selection of exchange traded funds and term deposits. However, some funds are already moving beyond defending their territory and looking at the opportunities presented. Notably, Catholic Super has indicated interest in making these options available to non-superannuation investments and HostPlus are talking about creating PSTs (including for direct infrastructure) to lure money back from SMSF investors.