

Themes and Trends – September 2015

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 Chinese growth remains a concern, most commentators are not predicting a hard landing and there is a general belief that China can do more to stimulate its economy if the situation looks dire. However, with the IMF flagging downward revisions to global growth forecasts and the US Federal Reserve holding off on the much anticipated rate rise, reflecting concerns about the fragility of their domestic economy, there was a significant and broad based sell-off across global equity markets. Notwithstanding concerns about global economic growth rates, investors are now somewhat in two minds about US monetary policy; firstly, they do not want the Fed to move too quickly and risk stalling their economy (with the potential flow-on effects to other countries); but secondly, they are getting impatient for the first rate rise at the same time . if only to see how markets will respond. However, there has been a general expectation that Yellen will manage cash rates very cautiously and the latest non-move supports that contention.

Sovereign bonds benefitted from their safe haven status and somehow most markets found a way to rally quite strongly from not much yield to even less. On the bright side, some equity and credit markets now look considerably better value and investors will perhaps use this opportunity to spend some of the cash they are holding and/or reallocate in line with longer term objectives.

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

- Given the recent paucity of clear value propositions, some of the largest funds in Australia have built up substantial cash holdings over time; while it is handy to have a dry-powder in order to take advantage of opportunities as they arise, these funds also acknowledge the dilutionary effect these low yielding allocations will have at a total fund level. To some extent these large funds are a microcosm of the industry . investors by and large have allowed their cash holdings to increase rather than fully allocate in the current markets. Although recent weakness has possibly increased the attractiveness of many asset classes, the shortage of single sector long-only opportunities seems to have driven the surge of interest in multi-directional strategies such as absolute return and other hedge fund type approaches, particularly where they offer reasonable liquidity;
- Measured by their respective MSCI indices, global emerging market equities have dramatically underperformed developed market equities over the 1, 3 and 5 years to 30 September 2015. Although not as cheap in an absolute sense as they have been towards the end of previous bear markets (if we are, in fact, at the end of a bear market) their relative value compared to developed markets is much improved. Reflecting this, there has been greater interest in global emerging markets equities over the past quarter;
- The shift to global equities, from Australian equities, has been an ongoing theme for at least 18 months. However, a very small number of investors have bravely decided that all the bad news such as the end of the mining boom, a China growth slowdown, the peak in housing market and so on has been largely priced and are starting to reduce their global equity allocations in favour of local stocks. Admittedly, this trade is in its early phase and may not develop into a broad theme as the overall trend is for investors to reduce their home bias given the paucity of quality companies outside of the Financial and Material sectors;

- We note there has been less selling of growth assets by super fund members than during previous periods of significant market volatility; however, we should bear in mind this latest bout of volatility has been relatively short-lived and mild when compared to 2007-2008 and even mid-late 2011. If this behaviour reflects a better educated membership due to coherent and consistent member communications over time, life may become easier for asset allocators who have to second guess member responses in such circumstances;
- Discussion of manager fees continues. Managers with large amounts of capacity across multiple product lines may have scope to significantly cut fees. However, many high conviction quality boutique firms enter the market knowing, due to the nature of their strategies, they will only ever be able to manage capacity at a fraction of the size of their less constrained counterparts. Some of these businesses may not be viable if required to reduce fees to the levels being flagged. Buyers can certainly walk away from fee negotiations but it should be kept in mind that sellers, particularly those managing non-Australian assets, may also pursue more lucrative markets if they think they cannot be profitable in Australia. Active fund managers are not homogenous; investors cannot necessarily buy another similar manager at the price they want to pay;
- The recent market volatility may provide a fillip to active management. When stocks and markets go up in unison, and in a relatively orderly fashion, it is challenging for active stock-pickers or active allocators to add value; passive management is likely to outperform active management on a net of fees basis. Extended bull markets therefore tend to support the truism that active managers underperform (the periods when they do not tend to get forgotten at such times). Although, passive management will continue to grow (for reasons unrelated to performance), in the near term investor attention is likely to be more directed towards active managers - in anticipation of continuing volatility;
- Responses to recent divestments by a number of funds, at a company level and more broadly (e.g. across mining or fossil fuels), have not been unambiguously positive; questions have been asked as to whether such actions meet the sole purpose test and the interests of members. While many investors have chosen to incorporate considerations of ESG risks and opportunities into the investment process, some observers question whether divestment of a company, let alone an entire industry, would necessarily meet this hurdle. However, the UNPRI also states that responsible investment requires that investors pay attention to the wider contextual factors, including the stability and health of economic and environmental systems and the evolving values and expectations of the societies of which they are part. Given the number, and funds under management, of the Australian asset owners who are signatories to the UNPRI, it is fair to say the sole purpose test as it currently stands is somewhat incongruent with the UNPRI; and
- Some investors are encouraging managers of passive strategies to be more involved in relation to ESG issues. Obviously, passive managers cannot sell companies in response to perceived ESG risks; however, they are long term equity holders and, in theory, can represent a very substantial proxy voting bloc. Therefore, their potential to engage with firms in relation to governance and other issues should not be underestimated. Several of the largest global managers of passive assets have indicated willingness to engage with companies on matters of corporate governance.

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