

Themes and Trends – June 2017

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.

Global political tensions notwithstanding, the investment horizon did not change dramatically over the quarter. Investors still think developed market equity valuations are tight, investment and some non-investment grade spreads are too narrow and private market investments offering decent risk/reward trade-offs are hard to find. There has not been an exodus from traditional markets (although some funds have actively or passively increased their allocations to cash) but there is more of a focus on sub-asset classes that are seen to potentially offer greater value.

Emerging market equities are still seen as attractive, Asia particularly; although, it is assumed they will fall together in the event of a major correction in developed equity markets. Emerging and frontier markets debt is of growing interest to many investors, as yields have not been driven to historic lows by investor demand. However, any sharp rise in bond yields globally is likely to have a detrimental effect on these markets. 'Impact' investments of various kinds (although still a very niche 'asset class') are attracting growing interest, particularly if and where Governments are involved and structuring them with attractive but not necessarily 'outsize' return potential.

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

- In an environment where it is increasingly difficult to target returns in line with retirement objectives by managing around long term strategic asset weights, more investors are focusing on absolute rather than relative return objectives and adopting the 'one portfolio' approach initially championed by several of the larger, less benchmark focused and less peer conscious Australian funds. Investment specialists are less likely to be locked in silos, instead they are freed to participate in outcomes at a total portfolio level by voicing opinions both positive and negative about the asset classes in which they have expertise.

This also seems to be encouraging investors to consider higher allocations to non-traditional and sometimes less liquid asset classes, such as private and direct investments, which may be very suitable to long term objectives. Such approaches should lead to better outcomes over time albeit with presumably greater disparity in the short and medium term. Reflecting this, industry leaders suggests peer comparisons should be focused on risk adjusted returns rather than absolute performance outcomes. That makes sense but may be difficult for funds competing in a MySuper constrained default universe;

- In debt markets, investors recognise that while there is not much value in developed market Government or corporate bond yields, and the balance of risk lies on the upside in terms of yield, other debt markets may still offer a reasonable return, even though there may be limited scope for capital gains. Many investors in non-investment grade debt are positioning themselves for a rising interest rate environment; they assume that as official interest rates rise from historically low levels, particularly as 3-month Libor is now above floors, longer term yields on non-investment grade bonds will also rise. Leveraged (bank) loans, short duration high yield and diversified strategies (with scope to allocate both strategically and opportunistically) have frequently been the beneficiaries.

Notwithstanding the above, some bold investors with the ability to take on risk, and to move quickly, are keen to look at opportunities to allocate on dips or significant intra-market dislocations (such as occurred in the energy sector from early/mid-2015).

However, in respect of energy, dedicated funds still have money waiting patiently to be put to work. Additionally, many non-investment grade companies have taken advantage of lower interest rates and a somewhat stronger global economy to improve their balance sheets. Finally, investors (and managers) with a strategic allocation to credit are also aware that markets have had a good run and they will be keen to add a little value over and above coupon so will be enthusiastic buyers on dips, if seen as aberrations rather than genuine market corrections or 'crises'. For these reasons, 'opportunities' may be fewer, shallower and shorter lived.

While it is safe to assume yields will rise generally as economic growth eventually drives inflation higher, a number of those non-investment grade companies which have re-structured balance sheets and become better credits have enjoyed ratings upgrades and issuance across the markets has consequently been higher on average. In a rising rates environment, credit spreads could still have some room to tighten, thus negating some of the impact that may be felt in the investment grade world;

- In March, we observed there had been a shift of investor interest to value in global equities but that growth equities had done better in the period to March; therefore, it was not yet evident whether this had been the beginning of a value market or more a search for yield (rather than capital gain) given the market as a whole had performed so strongly in recent years. In the latest quarter, growth continued to outperform value and for the full year to June value was only a percent or so in front after another strong year for equity markets. Some growth managers argue strong forward earnings in certain sectors, such as those driven primarily by informational technology disruption, may still justify P/Es at current or even higher levels.

More broadly, reflecting views that equity markets overall are quite highly valued, there has been a determined trend towards buying cheap long-only exposure (passive/enhanced/smart beta) and pairing with strategies pursuing pure alpha i.e. long short beta/market neutral approaches; and

- Donald Trump announced in June that the US would withdraw from the Paris Climate Agreement. Whilst the message this sent to the other signatory countries and to the world at large was worrying, many US States have indicated they will continue to pursue climate change mitigation anyway. Regardless of the ideologies of individual world leaders, the reality is that investors and State Governments are unlikely to invest in technologies and assets they believe will decline not only in value but in productive purpose and that may ultimately become stranded and largely worthless.

In fact, in early May an open letter was penned to the leaders of the G20 Governments urging them to stay the course; this letter was signed by 282 investors representing over US\$17 trillion of assets (by 3 July these numbers stood at 389 investors representing more than US\$22 trillion of assets). By contrast, US GDP for the 2016 calendar year was approximately US\$18.5 trillion and budget revenue and expenditure for the same period was US\$3.3 trillion and US\$3.9 trillion respectively.

In our previous 'Themes' we suggested the Australian superannuation savings pool is sufficiently large (\$2 trillion+) as to conceivably have an influence on the framing of Government policy. The observation may hold true internationally also, if and where investors may be motivated to act collectively.

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