

Themes and Trends – March 2018

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.

Stronger than expected US wages growth for January prompted the first meaningful US equity market correction of the last few years in early February (10%+ from peak to trough) and flowed through to most other stock and bond markets. Some of these falls have been clawed back but markets are still below their recent highs. Investors, for the most part, do not seem to have reacted by significantly increasing allocations. Even at lower levels many still see equity market valuations as quite tight and, despite expectations of a relatively benign global economic growth outlook, the stage of the cycle, inflationary uncertainty and flow through effects of inevitable cash rate hikes keep a lid on any near term bullish sentiment. Unknowable and unquantifiable geopolitical risks add to a generally cautious mood.

President Trump's announcement of the introduction of tariffs on steel and aluminium imports to the US in early March has also contributed to ongoing volatility; this is not because of the direct impact of the imposition (which is not great) but because of the message and the potential for any responses to potentially escalate to a global trade war.

Reflecting the above, investors continue to focus on adding assets which are relatively uncorrelated to traditional cash, bond and equity markets and to maximise diversification across these alternative investments.

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

- Private equity finally seems to be attracting some attention again but not at the old fee structures (including catch-up), not generally in fund of fund structures and frequently by means of direct investment (including co-investing alongside GPs). Venture capital seems to be of particular interest as it encompasses compelling growth areas such as technology (bio-tech, clean-tech, software), telecommunications, healthcare, fintech etc. Additionally, because these are new, numerous, small and consequently under-researched businesses, there is still potential to uncover value; demand is unlikely to push prices to levels that do not sufficiently reward risk for these investments - unlike for instance some larger more established businesses or infrastructure. Therefore, investors are more likely to be able to find projects that have the potential to provide adequate returns for the risks they are taking;
- Investors searching for both yield and diversification are becoming more familiar with and interested in frontier and emerging markets debt. However, most are still under-allocated if considered in the context of the proportion of global GDP or par-weighted issuance that these assets represent. The potential speed and scale of drawdowns resulting from investor outflows and/or emerging market currency fluctuations has been somewhat of an impediment in the past to a broader and deeper consideration of the asset class.

As a response, absolute or total return approaches to these markets have been developed to meet the demands of investors with a lower risk tolerance; such strategies typically access a wider opportunity set, build portfolios with higher conviction ideas, rely on more flexible trading methodologies, are largely blind to benchmark indices and seek to generate a greater proportion of return from skill/alpha rather than beta;

- For some time there has been an exodus from the upper echelons of the big name wealth management firms to smaller boutiques focused on meeting the needs of high net worth and ultra high net worth individuals. These firms seem to be relatively more open to new managers, new ideas and they can be early adopters of niche approaches; in fact these firms tend to steer clear of well established name brands that everyone is familiar with, as a point of distinction. While we have read that there has been a significant return of SMSF investors to the superannuation funds, as some find the required undertakings to be rather more onerous than expected, they appear to be increasingly well catered for at the higher wealth end of the spectrum;
- Several investors have commented that fund managers tend to road-show their wares primarily at times they believe opportune to win business. Thus, investors have not been seeing as many managers of traditional asset classes visiting the region whilst investor activity is relatively low. Yet this is the time investors may well be thinking of what to do when the time is right; fund managers who fly in and fly out primarily to raise capital, rather than to service investor needs in more difficult periods, may find investors less inclined to be accommodative with their time;
- There has been ongoing debate amongst investors about whether divestment is an effective strategy to discourage unwanted company behaviours, or to encourage wanted behaviours. The case against is that divestment just means that someone else gets to buy an asset more cheaply with no change to the targeted behaviour (e.g. reducing carbon emissions) and therefore engagement or lobbying is a far more effective means of driving change. However, some investors recognise that intransigent Governments opposed to such investor activism may actively encourage companies to stand their ground, even in the face of concerted and broadly-based lobbying efforts, and this can run counter to investor objectives.

We have observed previously that the sheer volume of funds managed currently by institutional investors (let alone the ongoing growth in funds), if harnessed effectively, can be influential even in the face of staunch opposition from vested interests. While a strong minority 'protest vote' can send a clear message to a company (and more broadly), arguably it is the threat of an equivalent divestment that can make the act of engagement more meaningful;

- During the quarter, an Australian superannuation fund joined forces with UK and Swedish pension funds to file a resolution calling for a multi-national mining and metals group to re-think its membership of several coal/mining lobby groups. Although the resolution is not expected to be successful in attracting a majority of votes it was still felt that a sizeable minority vote would send a strong signal. A similar motion coordinated by ACCR (Australian Centre for Corporate Responsibility) had some recent success with this strategy with a similar resolution put to the shareholders of a global resources company; and
- Investors who have reflected on the value of diversity (gender or otherwise) in their own decision-making structures are now focusing outwards and asking their service providers to provide information on their human resources and to elaborate on what they are doing to broaden their talent-base and, if nothing, why not. We anticipate much more discussion of this issue.

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