

Themes and Trends – June 2019

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.

There seems to be a general perception that we are now late in the cycle for both equities and bonds; therefore, many investors are considering how best to position their portfolios for the inevitable turning point. Having said that, some are of the view that geopolitical risks have eased, and low cash and bond rates (expected to remain low) are supportive of the relative value in asset classes such as equities, property and 'alternative' debt; they are happy to be allocated at close to strategic weights for growth assets. Yet others are awaiting the turning point with considerable enthusiasm, looking forward to putting their 'dry powder' to work at lower valuations.

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

- A frequent line of inquiry recently from investors is how global and emerging market equity, global credit and emerging market debt managers (and presumably fund managers in other asset classes) plan to deal with the fallout from a continuation, and perhaps even a worsening, of the China-US trade war/disagreement resulting in higher tariffs and other measures. One common response that the dispute will endure for a long-time has been perceived as pragmatic and has helped to deflate short-term concerns - generally investors accept they will just have to adjust to a different market environment;
- The late 2018 weakness and subsequent rapid rebound early in 2019, and how managers responded, was raised several times during the quarter. Given there have been so few dips over the last few years it was thought this period of market volatility might provide a good opportunity for investors to gauge the efficacy of managers' stock and credit selection, portfolio construction and risk management approaches. Ultimately, the market slump was too short-lived to draw any meaningful conclusions;
- A lack of enthusiasm for traditional equity and fixed income markets has encouraged some investors to spend time looking beyond the mainstream for value that may not have been tapped by their peers. For instance, certain wealth firms are looking for less well-known managers of niche approaches in order to take unique and compelling offerings to their client base. Super funds with good connections and/or deep resources are prepared to seek additional return wherever they can find it - sometimes purposely seeking complexity in the belief there is a premium available. Essentially, anything with a price that can go up is an investment opportunity and worthy of consideration.

Our observation is simply that the landscape will continue to broaden as investors strive to differentiate themselves from competitors; for instance, stand-alone Russian equities, medicinal cannabis, litigation funding, digital infrastructure, Romanian supermarkets and the 'Internet of Things' were some of the opportunities pursued during the quarter;

- Mergers, or contemplation of mergers, continued during the quarter. Although driven by the desire for efficiencies and economies of scale – and the tax concessions offered by the Government may be enticing - there is a counterargument that smaller can be beneficial too. Opportunities that are too small to move the needle for a medium or large fund can be very meaningful for a fund of a few billion or less. Smaller funds can look for attractive investments in a pool entirely inaccessible to many of the larger funds. Some of

these smaller funds are amongst the stronger performers, in terms of both returns and service, in the industry;

Conversely, as larger funds merge and become mega-funds and as mega-funds become 'behemoths' they must modify their approach to managing portfolios in order to remain relevant. Although Australian investors have been gradually increasing allocations to overseas markets over a long period of time, most still retain a substantial domestic bias (compared to Australia's weight in global equity indices). As the Australian superannuation pool increases and as the larger funds grow even further, this bias becomes less of an option as the relative size of their opportunity set diminishes. Unsurprisingly, investors (particularly large investors) are increasingly allocating offshore and some are even establishing or building out offshore based teams in order to have an advantage/head-start in the search for compelling assets;

- We have previously highlighted the potential pitfalls some in the industry have identified of the 'best in show' recommendation arising from the Productivity Commission's review into the efficiency and competitiveness of the Australian superannuation system. Frontier Advisors' research released during the quarter supports that size should not of itself push funds toward mergers; larger funds do not always perform better on a net return basis - smaller funds potentially have unique advantages. They also found the movement of funds in and out of a top-10 of performers is difficult to predict. The general industry view seems to be that the top-10 list recommendation is not sufficiently compelling to proceed to implementation;
- In April, Mercer released 'Investing in a Time of Climate Change'; a sequel to a 2015 report analysing possible return impacts of climate change under various hypothetical global warming outcomes. Their 'aggressive climate action' scenario delivers a 50% chance of limiting temperature increase to 2°C, their 'some climate action but not transformative' scenario delivers a ~2°C increase by 2050 and 3°C+ by 2100 and their 'business as usual' scenario arrives at 2°C by 2050 and ~4°C by 2100 (and rising). Their research forecasts return outcomes for a 'growth' portfolio and for a 'sustainable growth' portfolio (with explicit allocations to sustainability-themed investments across multiple asset classes) under the 3 scenarios. Their results show a positive impact as a result of a sub-2°C outcome on the 'growth portfolio' returns to 2030 but negative thereafter (and negative impacts over all periods for 3°C and 4°C increases). More interestingly, and the key finding of the report, the results show a premium for the 'sustainable growth' portfolio compared to the 'growth' portfolio, over all periods, if the sub 2°C scenario eventuates (but no meaningful difference under the warmer scenarios).

The paper suggests that investors should be adopting sustainable approaches not only to save the planet from the damaging aspects of global warming but also from a fiduciary perspective with a view to maximising retirement outcomes for their members; and

- Gender diversity has been frequently discussed in recent times; fund managers are being questioned not only in relation to their own hiring intentions but also about whether consideration is given in relation to the companies in which they invest. Interestingly, one of the recent disruptors in the superannuation field, Future Super, announced in May that they have divested from every company in their portfolio with an all-male Board; they argue that this makes sound investment sense as "there's plenty of research that shows that companies with diverse boards perform better".

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