

Themes and Trends – March 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.

Investment markets performed strongly in the March quarter, regaining the underperformance from the end of the previous quarter and then some. As markets have generally continued to rise and investors have achieved returns above long term averages, or as implied by normalised valuations, they recognise expected returns are falling and will be accompanied by periods of higher volatility and/or rising exogenous risks. Geopolitical issues remain a concern and, eventually, monetary policy settings must return to more normal levels. As investment markets become more volatile, investors are considering asset allocations and manager selections that may be better suited to a quite different market environment than has been experienced for quite some time.

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

- Diversified fixed income strategies (which can include a broad array of assets e.g. developed markets and emerging/frontier markets sovereign, semi-sovereign, non-investment grade credit, structured credit, asset backed, private markets debt, cash and currency) have been in demand by investors searching for yield who still like their managers to have the option of retreating to relatively safe haven fixed income assets and/or the ability to dial up or down duration or floating rate exposure;
- Further to the above, multi-asset approaches within some of the debt/credit sub-sectors named above (e.g. multi-asset credit, hard/local sovereign/credit emerging markets debt) have also attracted attention where premiums in a particular market are identified as relatively attractive and/or as the risk of long-only exposure in certain sub-sectors are being less rewarded after a period of strong returns. The ability to increase risk-adjusted returns by diversifying across sub-sectors and perhaps eke out some value add from active allocation across sub-markets is viewed highly;
- While some investors believe skilled active management (concentrated high conviction portfolios) is the best approach to investing through challenging market conditions, others are inclined towards cheap and simple smart beta strategies. Purely passive approaches, although cheap, are not attracting as much interest in the face of possible volatile headwinds. However, genuinely smart beta is anything but simple. Basic premia strategies have been with us for decades now and newer smart beta is often far more complex than fundamental approaches relying upon deep understanding of companies, markets and human behaviour. That is not a criticism of smart beta – it is simply an observation that 'smart beta' is not particularly simple;
- Not a recent development at all, but we note that investors increasingly are using asset consultants on an 'as needed' basis. The days when most or many investors were heavily dependent on consultant advice in order to satisfy their obligations under the SIS Act are well in the past. Although some smaller funds, and a few medium sized funds, will defer in large part to their advisors in relation to allocation and manager decisions, many others are relying primarily on in-house expertise and using their generalist advisors for oversight. Having said that, specialist advice (e.g. for private markets or alternatives) is being increasingly used to complement internal teams;

- Superannuation fund providers continue to focus on the development of retirement fund products (Comprehensive Income Products for Retirement) in anticipation of a retirement income covenant, as announced by the Government in the May 2018 Budget, being inserted into the Superannuation Industry (Supervision) Act 1993.

However, it has been observed that while the provision of the products will be mandated the use of them will be entirely voluntary. So, in the absence of compulsion, the challenge will be in convincing retirees exiting the superannuation system to transfer savings into the CIPR products. For those retirees whose savings are not enough to provide them a reasonably comfortable income for the rest of their lives, there will be a real temptation to take their savings as a lump sum and 'live a little' before falling back on the aged pension;

- There have been some interesting observations regarding dissatisfaction with the performance of Australian infrastructure assets held by superannuation funds and the rise of populism globally. It has been all very well for Governments – State and Federal – to maximise sale proceeds in order to bolster budget positions and for Supers to acquire long term stable income producing assets that meet the needs of their members. However, members are also consumers and disgruntled consumers are frequently unhappy with the charges being levied upon them for the roads, the carparks, the utilities etc. that once belonged to them.

While the concept of asset recycling is not questioned, it has been suggested the answer may lie in Supers accepting lower returns from these assets going forward. However, perhaps the solution goes back further than that. If Governments worked more closely with Supers, if asset sale negotiations were less concerned with immediate revenue maximisation and were more focused on long term mutual advantage, then perhaps the various transaction counterparties could all accept that a lower return to all stakeholders may be necessary in the best interests of the end-user;

- Investors, particularly those with a strong ESG charter, focused again on Facebook. Previously this related to dissemination of questionable 'information' that may have influenced US election outcomes. More recently, live-streaming of the massacre in Christchurch drew universal condemnation. With such breadth and depth of coverage and services it may be difficult for a social media company to predict the next conflagration, but many believe they will have to work harder to anticipate and address such reputational risks or face the potential wrath of shareholders;
- Further to the introductory comments, investors anticipating a more difficult and more volatile investment environment in the years ahead are working hard to better engage and educate members so that these outcomes when they occur are better understood and less likely to be a cause of consternation and potentially result in knee-jerk reactions to significant negative market moves; and
- Money continues to flow into fixed income exchange traded funds (ETFs). Although this can result in market distortions and thus impact performance for active managers, active managers also recognise and can take advantage of the opportunities this creates.

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