

## Themes and Trends – September 2019

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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.

The on again off again trade war between the US and China was on again and then off again. Brexit looked for a moment like it might be resolved – and then it was not. The Australian economy continues to be soft and interest rates were reduced once more. Global economic growth continues to be slow and interest rates in Europe and Japan turned negative. Periodic bouts of equity and bond market volatility seem to snap back relatively quickly, as risk-seeking investors and those searching for yield underpin both equity and credit markets. We understand investors generally are neutral to slightly underweight equities which provides somewhat of a support against a dramatic fall in equity market levels.

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

- As mentioned above, investors are generally neutral to slightly underweight equities; the latest round of interest rate cuts and possible quantitative easing in Australia and overseas may support the asset class despite enduring investor concerns about overvaluation and downside risks. Global ACWI equity managers have also benefited greatly from a handful of Chinese companies; some investors question whether this is repeatable given the regulatory, growth, trade dispute and even ethical headwinds these companies might be facing going forward. This is not to mention the influence of first order China-related factors Australian investors are already exposed to in their domestic portfolios;
- Investors are also wary about some forms of traded credit, despite delivering solid returns year to date. Regarding non-investment grade credit, ongoing concerns over the growth of covenant-lite deals endure but almost all investors accept this is the new normal - a secular trend - and not necessarily a sign of the end of the credit cycle. However, they continue to be worried about the impact on recovery rates if the next recession is particularly deep, even though this scenario is deemed improbable. Specifically, some are worrying about whether private equity sponsors will be more scrupulous in exploiting covenant-lite deals. The divergence between BB and CCC performance and industry sector divergence such as oil/gas, chemicals and retail has also been a common topic of discussion. Most investors accept though that lowly or non-rated securities and 'problematic' industry sectors can be largely avoided by an active manager;
- Inevitably, after such a long credit cycle, distressed debt managers have been doing the rounds; however, investors continue to struggle with recent memories of distressed managers raising capital with subsequently few opportunities to put the money to work while still charging fees on committed capital. The era of ultra-low interest rates and quantitative easing is making investors even more circumspect about the depth of the distressed cycle - whenever it happens. More well-rounded strategies that can exploit opportunities from stressed traded credit to distressed seem to be preferred;
- Emerging market debt and, specifically, blended approaches across local and hard currency, and even Frontier debt, continue to garner interest among investors seeking yield and diversification - notwithstanding negative headlines about Argentina and Turkey - but uneasy about the rush for illiquid forms of credit. The genuine value add of

incorporating ESG in the asset class, as Frontier and emerging economies transition to developed market levels of governance, is also another attraction;

- There has been much ongoing discussion about the benefits of scale and the survivorship of smaller superannuation funds - smaller funds are having to increasingly justify their ongoing existence. Therefore, the common refrain is that small funds must differentiate themselves by niche (e.g. having a very particular focus on ethical investments or bias to investments in industries of relevance to the member base) or by having exceptional and personalised service standards. However, the corollary to large funds having access to large deals is that smaller funds can participate meaningfully in opportunities that would not move the needle for larger funds.

Super Ratings data (to 31 March 2019) is inconclusive on that score and shows that the median return for the Balanced investment options they track varies relatively little by fund size – although the median for larger funds has outperformed modestly over the longest measurement periods. This is not consistent across fund types though and they find that net returns positively correlate to fund size for ‘not for profit’ funds;

- It is perhaps not surprising in this somewhat uncertain investment environment that ‘alternatives’ managers were being awarded the lion’s share of new mandates (44% in the 12 months to March 2019 according to Rainmaker). Interestingly, Rainmaker also observed that “if mandates appointed by superannuation funds to themselves are treated as a single manager, these self-mandates would have come in second”.

ASIC has flagged that in-house managed funds will be subject to their scrutiny given concerns about vertical integration and the potential for conflicts of interest to arise. Presumably, fund Trustees will be required to exercise the same oversight in relation to internal fund managers as to externals and to act accordingly where problems are identified. The implications of terminating an in-house manager are rather more encompassing than simply parting ways with an external manager. Therefore, the bar must be set high when first deciding to pursue this option and the commitment sustained. No fund will want to be the first to shut down an underperforming internal manager; and

- Following the outcomes of the Royal Commission, there have been any number of articles written (some quite scathing) about the return differences between top and bottom performing funds and the possible dollar impact on retirement savings if extrapolated over the course of a 40 year plus career. Notwithstanding assumptions about being able to accurately predict the ongoing top performers and underperformers, frequently comments are made relating purely to absolute return outcomes rather than risk adjusted returns and/or with a view to the objectives and investment horizon of the funds in question. For example, one ‘very poor performer’ based on absolute returns is one of the best performers when considered on a volatility basis in line with the investment objectives targeted for its close to retirement membership base. Some industry commentators are urging context be considered if we want funds to be focused on their members rather than their competitors.

Another issue that is increasingly being discussed is the exposure to unlisted assets in mostly industry-sponsored super funds. Some commentators believe the risks, and the methodologies used to value these assets - namely assuming very low discount rates - are under-appreciated and problems might become even more stark in the event of another GFC.

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