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Themes and Trends – March 2020

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 is only one topic of note for investors this quarter and it is the global pandemic COVID-19 that is affecting us all in so many ways. Previously we observed that investors were cautious given generally softer global economies, share markets supported more by interest rates than fundamentals and the coming US election. Highly priced listed equity and bond/credit markets were encouraging investors to look at a whole range of alternative assets.

While the pandemic driven sell-off will undoubtedly create some opportunities for investors with dry powder, many of the same issues have arisen as they did after the Global Financial Crisis. Member switching, funding of currency hedging overlay programs as forward contracts roll over, portfolio rebalancing as a result of sizeable falls in listed markets and revaluation of unlisted assets in order to maintain and protect equity between members are causing many super funds to focus on their portfolios before contemplating new investment ideas. A further level of complexity has been added by the Government's decision to enact an early super release scheme.

If markets ultimately recover in more a of a long 'U-shaped' rather than a 'V-shaped' fashion – which is the prevailing consensus view – investors should be able to rebalance their portfolios to strategic weights and still have time to contemplate opportunities to buy assets at lower prices.

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

- During the early stages of the correction, several investors were interested in repatriating funds from global to Australian equities. However, as the crisis continued and investors realised the economic recovery is likely to be an elongated U-shape, which is more usual, rather than V-shaped - and following the Government's early release super announcement - interest in this trade has subsided in favour of building up cash levels. As volatility has subsided, somewhat more nimble non-super investors are looking at listed developed market equity and REITs valuations and credit spreads with a view to selectively buying over the next few months. Notwithstanding some very problematic industry sectors such as travel and leisure, and oil, the current environment is considered very favourable for active managers focused on research and security selection;

- Super funds holding significant allocations to illiquid assets - notably private equity, private debt, property and infrastructure - have been criticised from a number of directions including Government, media and 'for profit' funds which have typically not been meaningfully invested in these assets. Although funds holding these higher exposures insist they will be able to satisfy switching and early release requirements, write-downs of valuations have encouraged commentators to be critical about the extent of holdings – portraying the funds as enjoying a free ride while not adequately considering the valuation and liquidity risks of these positions.

  Given these types of assets are particularly well suited to the needs of long term investors and, for that matter, long term investors are well suited to the needs of the capital raisers bringing these projects together, there is a risk some funds might become overly conservative allocators as a result of one-off circumstances such as those taking place currently; and

- We mentioned in the previous themes that Low Volatility and Dividend Income equity strategies had been attracting attention from investors cautious about market valuations. Low

Vol strategies on balance should have performed well in the recent past but, given the nature of the correction, dividend focused strategies may be in for a challenging period as many companies will struggle to pay dividends out of their reduced or non-existent earnings;

- In our previous Themes we commented on the APRA ‘heatmap’ and the implications and several criticisms thereof. One of the observations we made was that it is a point in time comparison (derived at least annually) and, depending on circumstances, outcomes could look quite different over relatively short timeframes. Even before COVID-19 escalated to a pandemic, APRA had stated that it would update the heatmap in the first half of 2020. It will be interesting to see how the rankings will have changed as a result of market movements by the time the results are published;

- Various commentators had been expressing concerns about the overly competitive tension created by the heatmap and the herding effect it potentially would have on investor behaviour. For instance, in respect of the ESG debate on divestment versus engagement, the observation has been made that, regardless of which approach would be more effective, divestment is a potentially big competitive risk given the proportion of the ASX that the mining sector comprises. Hence, decision making is likely to be skewed towards engagement. However, it’s possible the recent, and potentially ongoing, correction so soon after the release of the first heatmap may actually highlight that difference is a positive thing if those funds which led the pack see their rankings deteriorate markedly and if those funds which had been lagging resurface closer to the top of the list. The correction might be a bit of a circuit breaker on the push to have those ‘underperforming’ funds, particularly the smaller ones, merge or leave the industry;

- Senator Jane Hume (Federal Assistant Minister for Superannuation) during the period raised the question of whether some funds, particularly industry funds, were insufficiently diversified by member cohort. The logic being that, in the current circumstances, funds concentrated in single industries and dominated by younger members with lower salaries (and therefore lower balances) may be significantly impacted not only by the economic fallout in their specific industry but also by the Government’s recent decision to broaden early release of super hardship provisions for those adversely impacted by the current COVID-19 lockdown. A fund with an average member balance not much greater than the $20,000 early release limit may struggle to remain viable in the event the early release is taken up by a substantial proportion of members.

  Therefore, the argument has been made that, in order to avoid similar potential problems in future, such funds should be aggressively targeting a more diversified member base or seeking mergers that would result in that outcome.

  However, although this is a path some industry funds have taken, the argument is also made that as funds exist to serve their members they are better able to do this by focusing on the needs of a narrow cohort. A fund with investment options designed to cater to a broader mix of underlying members and holding, by necessity, more defensive and more liquid asset allocations (than for example investment options built for a younger member base with a potentially ~45 year investment horizon), might be better positioned from a portfolio management perspective to weather the ‘perfect storm’ currently underway but it may not be the best possible portfolio to maximise the retirement savings of the member base it might once have represented.