

## Themes – December 2009

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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.

In previous commentaries we have described a “GFC cycle” of sorts whereby investors initially restructured portfolios in order to adjust for the adverse liquidity and asset allocation impacts of falling equity markets, realised currency losses and member transfers; they then rationalised manager line-ups (generally allocating those funds across the remaining managers) and more recently have re-focused on the business of looking for new ideas and better performing investment managers. Note, for some investors fund consolidation has slowed this process. In parallel, it appears a number of investors have also taken stock of their asset consulting arrangements (whether implemented or tailored) and consequently we have seen a number of changes made recently. Presumably full strategic reviews will ensue prior to any significant portfolio changes being implemented where this has occurred. Given the events of the past 18 months, there may be some element of catch-up in the first half of 2010 but all in all it looks like a return to a (relatively) more normal investment environment.

Some themes we have identified since our previous update are as follows:

- Non-investment grade credit continues to attract strong interest (and increasingly passive and active distressed) due to the high income yields on offer, but the possibility of easy gains has disappeared. The less than sanguine outlook for the US and Europe suggests the high income yields will persist – an attractive proposition for risk averse investors such as super funds. However, investors are likely to prefer managers with a history of avoiding the high level of defaults still prevalent in this recovering market. Yields may even increase if the banks are slow to clean up their balance sheets and the above regions tilt back into negative growth. Furthermore, some investors are considering the establishment of a strategic allocation to non-investment grade credit to boost fixed income returns and lower sensitivity to inflation, whilst being less dependent on economic growth to drive returns like public equity;
- The little private equity activity undertaken during the course of 2009 tended to be amongst the larger investors, and commitments were generally made directly to funds, if not directly to the underlying deals. More recently, there seems to be activity amongst smaller and medium sized investors and in relation to more diversified offerings (e.g. fund of funds or co-investment vehicles). While there also seems to be good interest in secondaries on the buy side, few sellers have been prepared to exit at the discounts buyers are demanding; therefore, not much is happening. More positively, the IPO markets have improved and M&A deals are occurring again which bodes well for this sub-sector going forward;
- Regarding global emerging market equity, we previously identified that most investors now have a strategic allocation to GEMS, whether it be via a specialist manager or included in the mandate of broader global equities managers (either within their benchmark or within their universe). Many investors believe that a concentrated approach makes sense for these markets. At the same time, there are

concerns that appointed manager(s) may choose (possibly for all the right reasons) not to be in the markets that run hardest at any point in time. Thus, there has been some tendency for investors to partially hedge their high conviction managers by also appointing passive managers. The recent strong rally has dampened enthusiasm but investors may invest in increments to reduce risk but still participate in these rapidly evolving markets. Emerging market private equity is also garnering interest (see above); particularly, Asia-Pacific;

- Many investors are encouraging managers to incorporate ESG (environmental, social, governance) considerations into their investment processes. We have previously commented that ESG approaches continue to evolve (see our article “ESG - where to next for Australian and New Zealand investors”). However, it is also the case that ESG may need to be applied in different ways to different asset classes and strategies. For instance, “by exception” approaches (sin-screens or worst of breed screens) may be particularly appropriate for broadly based passive equity or fixed income strategies. Active quantitative managers may also be able to add the use of ESG factors as an alpha source. More concentrated, conviction driven fundamental managers may adopt shareholder activism/proxy voting approaches in seeking to address negative corporate behaviours. Conversely, there are some markets, e.g. emerging and frontier markets, where it may be rather more important that a manager knows their market well and is like-minded with the investor in their approach;
- Investors continue to discuss low correlation strategies (preferably low correlation to equity markets) such as insurance linked products (cat bonds, weather derivatives, life settlements), real assets (timber, commodities), alternative debt strategies (aircraft leasing and other forms of mezzanine debt) and volatility arbitrage; but, they remain concerned about liquidity, pricing, valuation and adequately reducing diversifiable risks;
- The fallout from the various hedge fund scandals has prompted some investors to further incorporate risk management principles and practices across aspects of their fund's operations including hiring more investment and governance/operational resources, investing in systems to better monitor risk exposures and embedding risk management into their culture;
- Investors are also re-focusing their attention on fund terms and conditions and how to better align their interests with managers. For example, there has been a push towards flat management fees and longer term performance fee calculations; and
- Finally, we have been following with interest submissions to the Cooper review into Australia's Superannuation System. The Phase One Preliminary Report released in mid-December makes interesting reading and we very much look forward to the Phase Two, Phase Three Preliminary Recommendations and ultimately the final recommendations in June. We anticipate some spirited debate and some fresh ideas over the next 6 months.

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