Aussie super funds shift to emerging markets

The superannuation funds industry will become a major investor in emerging markets, particularly Asia.

By Mark Story

For the past two decades, institutional investors put less emphasis on the importance of asset allocation as a driver of returns. Most asset classes delivered high overall returns, and correlations increased between bonds and shares.

Asset consultants have long stressed the fact that asset allocation can account for the lion's share of portfolio performance, but institutional investors still preferred to spend an inordinate amount of time on selecting managers within an asset class.

The Lehman Brothers collapse in September 2008 saw asset classes correlate almost completely – all downward. Since then, however, asset classes have diverged, both in terms of their risk characteristics, as well as in performance.

For Australian superannuation funds, the post-crisis realisation is their overexposure to commodities, an asset class now at the heart of global booms and busts. This exposure is having a material impact on superannuation funds' asset allocation, says Shane Oliver, head of investment strategy at AMP Capital Investors.

He says the realisation that a passive 'sit-on-your-hands' approach is no longer going to deliver the goods is affecting not only what super funds invest in, but where and for how long.

Making readjustments

Oliver maintains that increasingly wild swings in share markets, and the return to shorter and more volatile economic cycles, is forcing super funds to readjust their investment rationale around heightened unpredictability.

The crisis led super funds, like other investors around the world, first to the safety of fixed income. This year they have returned to equities. But the old reflexive, programmed rebalancing tactics are no longer accepted. Rather than 'set and forget', Oliver says CIOs now recognise the need to move investments around more frequently than when markets where more stable.

One reason why investors used to disdain such tactical moves was because they were considered short-term and subject to emotional overreactions; in other words, too retail-like.

However, there is a new appreciation for the need to capitalise on opportunities created by extreme swings in share markets. This can create one- to three-year investment decisions that are tactical, but not necessarily short term.

To avoid over exposing themselves to excessive market risk or missing out on short-term market opportunities, super funds are now reviewing and rebalancing their asset allocation at more regular turning points, says Tim Schroeders, fund manager at Pengana Capital.

Meanwhile, in an attempt to respond faster to the next macroeconomic scare, and capitalise on alternative asset classes now begging for their attention, consultants are pushing super funds to incorporate dynamic strategic asset allocation (DSAA).

With the accent on shorter time frames (typically one to three years), DSAA is designed to discover what are known as ‘unsustainable pricing anomalies’ and other opportunities that might deliver good returns within a prevailing economic environment. Towers Watson predicts funds could receive between 1% and 1.5% long-term outperformance by allocating 10-15% of total risk to a DSAA strategy.

Instead of continuing to entrust asset allocation to a handful of asset consultants that have struggled to add value for the fees they charge, trustees of the larger super funds may bring asset allocation in-house, says Tim Unger, head of investment strategy at Towers Watson.

“When investment consultants became specialists in asset allocation, it was progressively removed from the hands of fund managers on the basis that not too many were good at it,” says Unger. “But given the increased scale and greater depth within asset classes, super funds can now justify the costs associated with developing internal expertise for asset allocation.”

Understanding diversification

That’s all fine, but tactical rebalancing raises the question of how diversification is really supposed to work.

Australian super funds have been major proponents of diversification. This position didn’t necessarily serve them well during the carnage following the collapse of Lehman Brothers.

Investors are taking a closer look at third-party fund managers’ products and what actually drives returns among asset classes, says Towers Watson’s Unger.

This is leading super funds to look beyond the basic choices of stocks, bonds and cash. “Fund managers are investing in a growing number of asset classes in an attempt to diversify ongoing risk,” he notes.

A major beneficiary is emerging markets. Aussie super funds see their traditional global destinations face stunted prospects of growth, as consumers in America, Europe and Japan continue to deleverage and pay off debts, thereby stifling credit creation.

Australian super funds have tended to view investments as either domestic or global, but they are now paying more attention to emerging markets, particularly the strong growth in China and India.

Catching up

Asia ex-Japan now comprises 65% of the MSCI Global Emerging Markets Index, and most of these countries are transitioning their economies to be more focused on services, thanks to their burgeoning middle classes.

While savings rates have been around zero in the US and gross national saving at around 15% of GDP, Asia’s household savings rates are typically 20-30%, with gross national saving running at around 40% of GDP. There are some not-so-attractive reasons for this, such as the

paucity of Asian governments’ welfare nets, but overall these are creditor nations with mostly sound fundamentals.

Oliver expects a continued skewing by super funds towards emerging markets in an attempt to both to maximise returns as well as justify the fees associated with active funds management. “It’s easier for super funds to add value through Asian markets than via developed economies,” says Oliver.

This suggests a big shift is coming. Aussie super funds’ typical exposure to emerging equity markets has been 5-15%, usually accessed via broad global equity mandates. But now emerging markets account for 49% of global economic growth (though not market cap).

Oliver expects super funds to hike their EM exposure to 25% over the next few years.

This leads to a question of valuations. Investors worldwide, including within Asia, have made dramatic tilts into emerging markets since 2007, and the United States monetary policy of printing money to buy its own bonds, thus driving down interest rates, is adding fuel to the fire.

Moreover, the natural growth of superannuation funds’ assets under management, given their captive membership, will also lead to their putting more money to work in emerging markets and across the board.

Plans by the Labor government to incrementally raise the current 9% super guarantee contribution to 12% is expected to tip an extra A$500 billion into Australia’s pension pool by 2035.

According to research by the Association of Superannuation Funds of Australia (ASFA), international shares currently comprise around 22% of the A$1.3 trillion in assets within Australia’s pension system, and are quickly catching up to Australian equities, which account for 29% of aggregate exposure.

With the biggest super funds receiving monthly contributions as high as A$150 million, there’s more pressure on CIOs to look beyond Australia for performance, says Joanna Davison, regional managing director at Colonial First State Global Asset Management.

The greatest focus of this shift is emerging markets, although this may not take the form of direct exposure. For example, US and European blue-chip companies with sizeable revenues in emerging markets are now in Australian sights, says Brian Parker, investment strategist at MLC Investment Management.

“As the super pool continues to growth in size, more exotic asset allocations will become more feasible,” says Unger. “Interest in emerging markets will eventually diversify into property, debt instruments, emerging technologies, hedge funds, commodities and infrastructure assets.”

The development of emerging capital markets will also make it easier for Australian institutions to invest. For example, the outstanding universe of emerging-market debt instruments will jump by 50% over the next few years, as more issuers take advantage of US-led low interest rates, predicts Aberdeen Asset Management.

Unger also expects the sheer momentum of Australian baby-boomers transitioning into retirement over the next 15 years to see super funds pay closer attention to asset classes like fixed interest and sovereign debt that provide greater downside protection.

He expects a much greater focus on the ‘retirement-phase’ that will see super funds provide more products offering a trade-off between capital growth/protection and certainty of inxcome. To ensure reliable income streams, expect more returns to come from emerging markets. ■

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