

MyConsultant

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Duncan Smith
Head of Consulting

Duncan is the Head of Consulting, which involves ensuring our Consultants provide clients with the highest possible level of service. Duncan has previously been a senior member within the Australian Equities Research Team, former Head of our Property Research Team and a member of the JANA Research Committee.

Before joining JANA in 2007, Duncan spent 12 years with the NAB Superannuation Fund as Assistant Fund Secretary and Finance Manager, which included responsibility for the Investment Function of the Fund. Amongst other responsibilities the role involved managing a direct property portfolio and general oversight of the Fund's investments. Duncan has held positions on Investor Boards and Advisory Boards of both property and Infrastructure Funds.

Duncan has a Graduate Diploma in Applied Finance & Investments, Graduate Diploma in Financial Planning and a Bachelor of Business. Duncan is also a Fellow of the FINSIA and a member of CPA.

The JANA Study Tour

Investments Insights

JANA has recently completed a study tour to the US. The tour was an opportunity for a few of our clients to meet with some of the most experienced and informed investors in the world. It also provided another opportunity for JANA, through John Coombe (Executive Director) and Duncan Smith (Head of Consulting), to review JANA's investment strategy against the views of a broad range of investors. The following article highlights the main themes that emerged from the discussions with managers on the tour and some of the implications for our investment strategies.



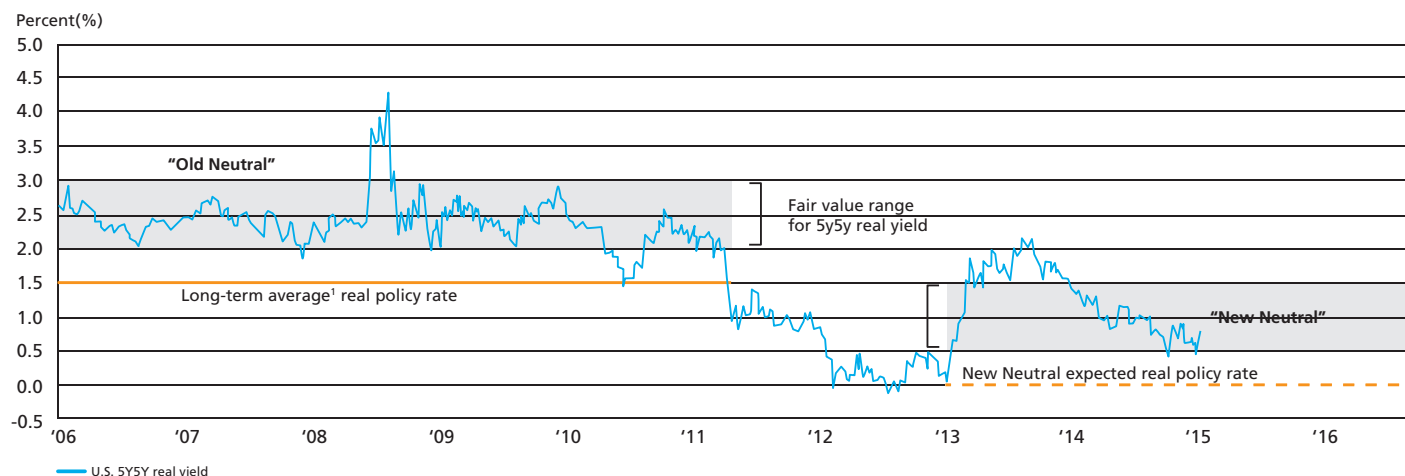
The Study Tour

In mid-June 2015, JANA hosted a study tour that covered Los Angeles, Baltimore, New York and Chicago. Attendees met with 31 investment managers across bonds, credit, equities, private equity, property, infrastructure and multi asset strategies and included discussions on broad economic and market issues. The purpose of the tour

was to provide our clients with financial market insights through direct exposure to experienced and well respected investors. The tour also provided an opportunity for JANA to review our recommended investment strategy against a broad range of informed opinions.



Chart 1: PIMCO's view of interest rates – the 'new normal' U.S real yield, 5y5y forward



As of April 2015. SOURCE: Bloomberg, PIMCO
Refer to Appendix for additional forecast and risk information.

What Were the Common Views Expressed by Managers?

Most of the common themes reflected by managers were relatively uncontroversial and are generally reflected in JANA's current and recent asset allocation papers. The main themes are summarised below.

Higher Interest Rates

Most managers believe higher interest rates are almost inevitable; however, the general expectation is for interest rates to stay lower than historical averages for longer (the 'lower for longer' theory). This position appears to be well supported by market participants and appears to be reflected in valuations across most asset classes. In regards to valuations, bonds appear the most susceptible from a slow increase in rates. Chart 1 illustrates PIMCO's view of the 'new normal' with respect to interest rates.

In addition to poor returns, there were also concerns that bonds have limited ability to protect portfolios during an equity market sell-off. Over the long term, the majority of protection from bonds in severe equity market corrections has come from bond yields falling from relatively high levels, creating capital gains. With yields at or near historically low levels, this protection is likely to be limited.

One counter view, that was particularly interesting, was that inflation in the developed world is a fairly recent outcome that has largely emanated from post war capacity destruction. Both World Wars

destroyed so much capacity that demand for goods outstripped supply, causing abnormal inflation. If we take previous centuries, the world experienced very little, if any, inflation. If the world returns to the low inflation rates of previous times, there would be no need for significantly higher interest rates.

US Federal Reserve Rate Rises

Janet Yellen, the US Federal Reserve (Fed) Chairperson, appears to have done a very good job in preparing the market for a rise in policy interest rates. There was a consistent view across almost all managers that predicted either September or December 2015 as the first 0.25% interest rate rise, and then a very conservative approach to raising rates thereafter. It is expected the Federal Reserve will be slow in raising rates over the next few years, preferring to see higher inflation, rather than impact the economic recovery. It appears that the Federal Reserve will be at pains not to surprise markets and create another 'taper tantrum' (like the one which caused substantial volatility in equity and bond markets in 2013).

Nothing Cheap

The general consensus was that the historically low interest rates had caused the valuations of all major asset classes to 're-rate'. Views varied between speakers and asset classes but in general the view was that most asset classes are somewhere between fair value to expensive. Most managers expected future returns to be challenged, with bonds

being the asset class that was consistently highlighted as the most tested. Some managers mentioned emerging markets, different forms of credit and the US Dollar as opportunities.

Alpha over Beta

A prevalent view is that the market return from major markets (beta) is likely to be relatively low in the future and, as such, a common theme is the need to be flexible in investing within and across asset classes. The ability to create value in addition to market returns (alpha) will be a key in determining the relative winners and losers.

Hidden Illiquidity

While markets continue to operate efficiently, this hides a potential lack of underlying liquidity, with the continued decline of investment bank proprietary trading desks (i.e. trading with the bank's balance sheet) due to regulatory controls. The absence of these 'market makers' makes a liquidity squeeze a risk to markets, particularly credit markets, where proprietary desks were previously most active. One manager noted that proprietary desks were holding approximately 4% of all US corporate debt on issue several years ago, while today it is closer to 0.4%. While this development may present shorter term risks, it can also provide an opportunity for investors with sufficient liquidity and longer term time frames. Exchange Traded Funds (ETFs) were also quoted as a potential issue where some redemption terms were shorter in nature than those of the underlying securities.

Australia

The only positive comments about Australia were in regard to a holiday (everyone is keen to come here!) or holding bonds. The general expectations are for Australia's economic growth to struggle, in large part due to a continued poor outlook for commodity prices. This also makes the Australian dollar less attractive. The commodity outlook reflected a general view that China's growth would continue to moderate as a natural evolution of an economy where the consumer is moving into the middle class (ie China is no longer the cheapest supplier of goods to the world) and services rather than manufacturing and construction become a more important driver of growth.

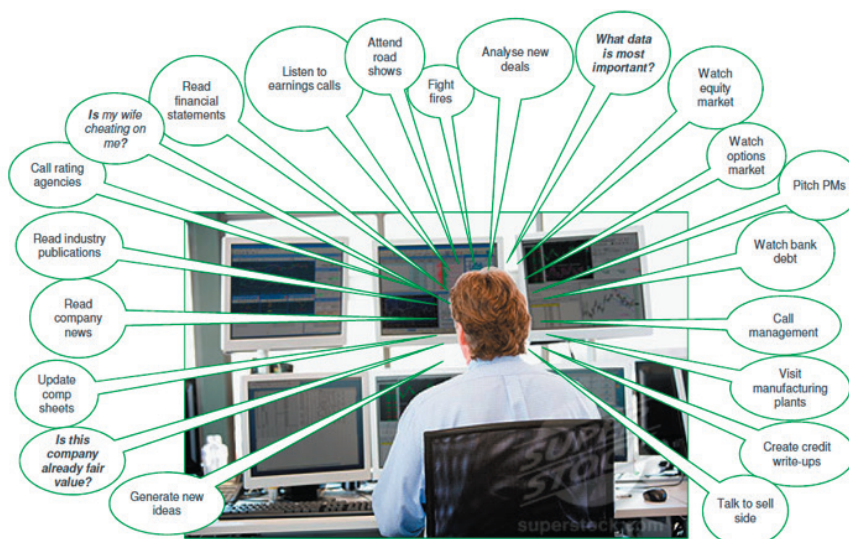
Greece

The tour finished before the real action started in Greece. However, two key views were expressed. The first was that the European Central Bank and governments have had five years to plan for the worst case, being a Greek exit from the eurozone. They now have tools to manage this risk without large scale contagion, which they did not have five years ago. However, the consensus view was that Greece cannot repay its debt as it stands today; so at some point some level of debt forgiveness will be required if Greece is to remain in the eurozone.

Less a theme but an Insight – Big Data

One of the most interesting sessions of the tour was from a quantitative manager who covered a lot of intriguing areas, particularly 'Big Data'. Big Data is a broad term for data sets so large or complex that traditional data processing applications are inadequate to process the data. The fact that more data has been created in the last three years than in the entire history of mankind is both hard to fathom and understand (do not ask me how they calculate that!). The question from an investment perspective is: "So what, how do I use this data? It is information we seek, not data". However, new technologies can provide greater insights into different areas of the market. For example, by searching all social media and filtering the data effectively you can obtain an understanding of brand recognition, customer preferences and changing trends. Another example is the common traits in CEO commentaries that can consistently track the reliability of statements (call it the 'truth meter').

Too much information, too little time, and finite limits on the ability of analysts to process so much information



SOURCE: BlackRock

A great quote attributed to Bill Gates was (loosely translated), "We tend to overestimate change over 2 years and underestimate change over 10". Where this technology will take us in another decade will be something to watch.

Implications for Investment Strategies

This article has focused on the most commonly expressed investment themes, as over the two weeks of our tour, many divergent and conflicting views were highlighted. We must also recognise that we have a human bias to hear what we want to hear; however, in recognising these limitations the below summarises the key themes and their relationship with JANA's recommended investment strategies.

Overall, the majority of the common views from the study tour are supported by JANA's investment strategies, in particular:

- Interest rates to slowly increase, but remain well below long term averages for longer, is reflected in our benchmark weight to 'growth' assets and underweight to bonds.
- The fact that the Fed's interest rate policy is well understood, reduces the risk of another 'taper tantrum' and supports the 'lower for longer' rates thesis.
- JANA has been advocating the view that no asset class has looked particularly cheap for some time, and we've consequently been recommending high levels of

diversification in order to provide some defensive characteristics for portfolios in light of our recommended underweight position in bonds. This includes a preference for overweighting 'mid risk' assets including credit, infrastructure, property, currency, and alpha-based strategies.

- The preference for alpha-based strategies including Hedge Funds, 'Cash Plus' strategies in Fixed Interest and more flexible investment mandates is a reflection of a desire to generate greater alpha. A downside of this strategy is that these portfolios and strategies tend to be higher cost.
- If a volatility event does hit financial markets, the first priority is not to be a seller at distressed pricing. The second priority is to be in a position to take advantage of the dislocation, by buying cheap. To allow for this, a higher level of cash may be appropriate, especially in light of underweight positions in bonds.
- The outlook for Australia was typically down beat, although, to be fair, it was not a major focus for many of the managers. Given some of the risks, JANA still supports an underweight to Australian equities and an overweight to foreign currency exposure.

Conclusion

Although this article has focused on prevalent themes, opposing and conflicting views on various topics were common, and again reminded us of the uncertainties of investing. Not surprisingly, the biggest investment anomaly identified was abnormally low interest rates, and the risks and opportunities this presented. The pricing in bond markets today is in part being set by key players that are not driven by investment risk or returns, in particular by Central Banks. This has created an environment where bonds offer both poor prospective returns and also less protection in an equity market correction.

John and I would like to thank the clients who joined us on the tour, and their contribution to the discussions with managers was both valuable and appreciated.

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