NAVIGATING THE NEW WORLD

Investment Strategies for the Low-Yield Environment

RED PAPER

NOVEMBER 2020

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QIC

Navigating the New World:

Investment Strategies for the Low-Yield Environment

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About QIC

Created in 1991 by the Queensland Government to serve its long-term investment responsibilities, we have grown into a long-term specialist manager in alternatives. We focus on our clients and their clients; first, last and only. Their objectives are our only objectives. We deliver to over 110 like-minded institutional investors in Australia and internationally.

Our investment capabilities are relevant for today's investment landscape. Our local and global networks give us access to quality alternative assets with a focus on infrastructure, real estate and private capital. We also specialise in liquid market solutions, providing multi-asset portfolios, liquid alternatives, active fixed interest and tailored overlay solutions for our clients.

Our heritage as an alternatives specialist with a long-term investor mindset informs everything we do and has enabled us to become the visionary asset manager we are today. It's in our DNA, embedded in our asset classes and delivered in our returns. It's what we pursue day in, day out for our clients and why over AU$79bn (US$54bn)[1] of people's dreams are entrusted with us.

1 As at 30 June, 2020

Foreword

Times are challenging for institutional investors around the world.

Headlines and boardroom discussions are currently dominated by the aftershocks of COVID-19 which has also ushered in global negative or zero percent interest rates, unprecedented stimulatory fiscal and monetary policies, a simmering trade war, significant socio-economic risks and ongoing digital and technological disruption.

Yet despite this maelstrom, at QIC we remain optimistic about our shared, long-term future.

In our latest QIC Red Paper, Navigating the New World: Investment Strategies for the Low-Yield Environment, we examine potential solutions *Across*, *Between* and *Within* portfolio asset classes which can help investors capture portfolio goals for both their stakeholders and the communities in which they operate.

At QIC, we generate investment outcomes by working closely with institutional investors to truly understand their needs and the needs of their members and customers. In this way, we create shared value together and enhance the standard of living for our communities.

As an experienced active asset-manager specialising in alternatives, we are pleased to share our unique insights into strategies across a range of asset classes to help build sustainable, future-focused investment outcomes.

In this paper we assess the value **across** asset classes which can be added by whole of portfolio overlay strategies.

We also explore the evolution **within** traditional asset classes as well as the growing interest in new assets referred to as occupying the White Space, falling **between** asset classes.

While these strategies and assets may not neatly fit in traditional asset class definitions, we believe they can deliver resilient investment outcomes, often with a shared societal value, for long-term institutional investors in a “Lower for Longer” world.

We are proud to share these latest insights and investment strategies with you, so that together we can set course towards an exciting future full of new, resilient and sustainable opportunities.

Damien Frawley
QIC Chief Executive Officer

Executive Summary

In the Old World, investors held on to the following as an absolute truth: that a model, balanced portfolio of 60 per cent equities and 40 per cent bonds would provide an attractive long-run equilibrium return above inflation. That was then. **This is now.**

Now is a New World.

COVID-19, demographic and digital disruptions are combining with geopolitical and economic trends to upend how and where returns are generated.

Making asset allocation decisions in liquid markets is now challenging, especially when trying to decipher recent movements: equity markets feel buoyant despite the long-term economic uncertainties; the ASX200 bounced almost two-thirds since its March lows with the S&P 500 and Nasdaq scaling record highs in August and September; bond yields driven by extreme policies, are low; and ICE Data Services[2] shows 86 per cent of the US$60tn global bond market has a yield of less than two per cent.

This is raising questions as to the traditional defensive characteristics of a sovereign bond index. At the height of COVID-19 market stress during March 2020, when margin calls and redemptions drove the extreme requirement for liquidity, liquid assets were the first cab off the rank for monetisation. The Bloomberg Barclays Global Aggregate Index fell 7.8 per cent from 9 March, 2020 to 23 March, 2020 while the MSCI ACWI global equity index lost 19.7 per cent in the same period. The requisite offset from bonds was just not apparent through the stress period.

With volatility in bond markets subdued and rates being held low, investors are looking for new ways to build defensive characteristics into their portfolios.

Now is an Age of Discovery.

Modern investors are searching for yield in an environment where returns are going to be "Lower for Longer".

Yet there are opportunities arising out of these unchartered waters, ones that will require investors to think and act differently, and more quickly.

In this Red Paper, Navigating the New World: Investment Strategies for a Low-Yield Environment, we attempt to answer the question which is top of mind for institutional investors: How can I extract value and maximise portfolio defensiveness and liquidity in this New World?

We believe investors face several options. They can: accept a lower investment return; move up the risk curve in traditional approaches; or look for ways to enhance returns by taking non-traditional forms of risk or managing portfolios more efficiently.

This Red Paper tackles these opportunities under the guise of looking for risk adjusted returns **across**, **between** and **within** traditional asset classes and in doing so, present investors with our views on how to maximise value in a low-yield environment.

2 Smith, C. (27 July, 2020) "Desperate hunt for yield forces investors to take 'extreme risk'" published in Financial Times: https://www.ft.com/content/b44281c0-2ddb-46ae-83e2-150461faed65

While our base case is that cash rates will eventually rise again, they will not return to historical long-run averages in the foreseeable future; a forecast which has long-run implications for returns. As such, we believe investors now need to consider their investment objectives and position their portfolios differently to extract value in the New World.

Across the asset classes:

Rethinking the levers at the top to enhance defensiveness and liquidity

Creating efficient defensiveness: Portfolio hedging

In the New World, investors are recasting for tools which can rally and protect portfolios as sovereign bonds near their lower bound. We see portfolio hedging emerging as a permanent tool to not only adjust asset allocation, but secure downside protection for the short and long-term and enhance portfolio diversity.

An evolving SAA: Creating liquidity with derivatives

Strategic Asset Allocation (SAA) is a long-standing and well-tested portfolio strategy. In a low-return environment such as the current COVID-19 reality investors now face, being able to control SAA deviation leakage is more important than ever before. We believe a considered rebalancing framework that utilises derivatives can be a cost-effective way to reduce risk and enhance portfolio liquidity.

Total Portfolio Approach (TPA): Greater flexibility to capture opportunities

While SAA will continue to play a major role in asset management, investors requiring even greater flexibility may consider tilting towards TPA which may offer a more streamlined approach for portfolio construction. While regulatory requirements may preclude full adoption of a TPA approach for Australian superannuation funds, we believe there is a spectrum of approaches between TPA and SAA that can be considered.

Between the asset classes:

Netting opportunities in the White Space

The boundaries between asset class definitions are becoming porous in the New World, creating opportunities between the silos which are worth exploring. These are opportunities that do not meet traditional asset class definitions, escaping the majority of institutional investors' searchlights to potentially offer attractive risk and return prospects for portfolios.

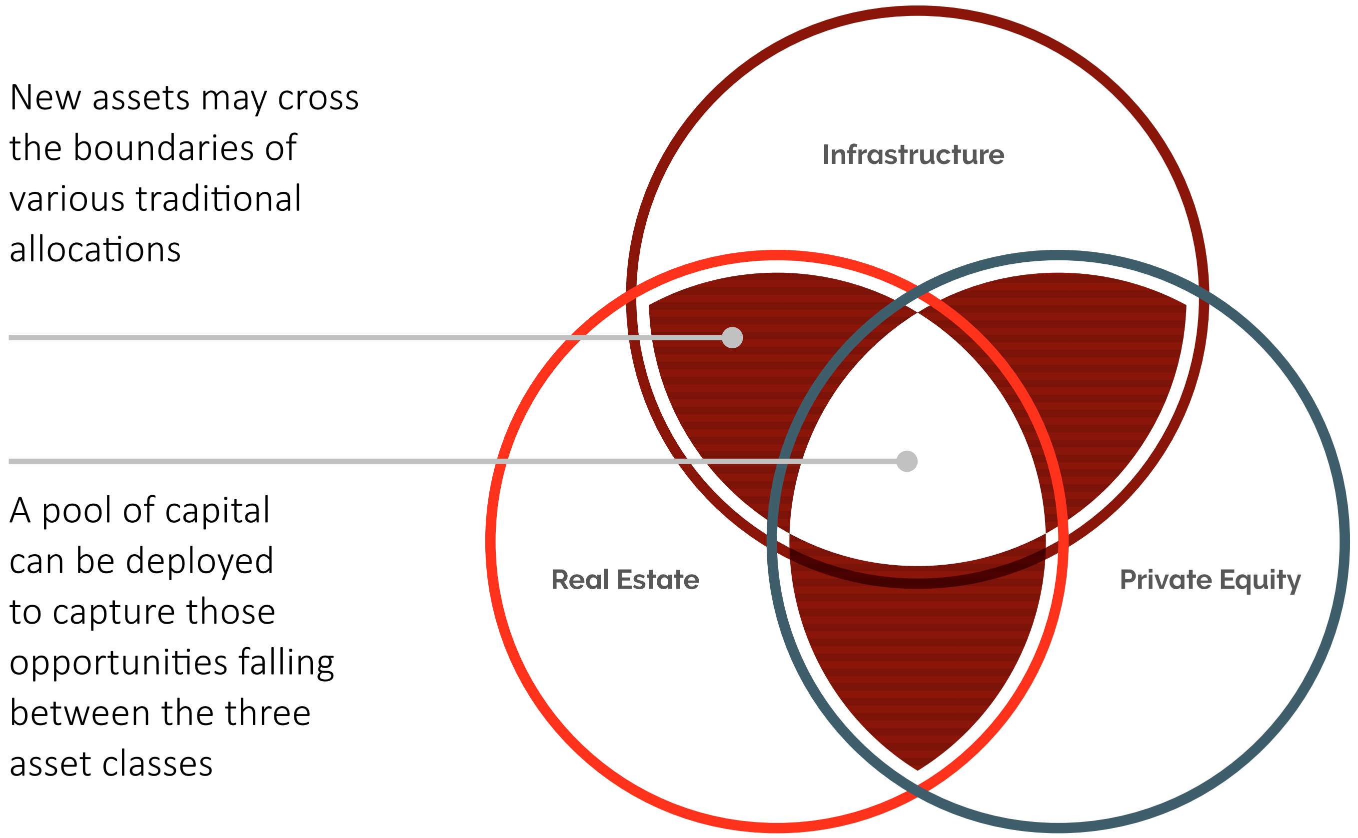

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Figure 1: The risk-return spectrum can be enhanced with hybrid assets occupying the "White Space". Source: QIC

The drive towards these hybrid assets – which live in the "White Space" – is not a cyclical phenomenon. It is structural; and is part of the future of the investment landscape. It will operate alongside traditional vertical asset allocations, all of which will continue to deliver value to institutional investors.

This White Space is highly customisable to create bespoke value matching individual investor needs. Within the White Space lie assets which disregard traditional definitions and customise new risk and return opportunities to generate cash flow or capital growth.

This trend is prompting asset managers to infuse and leverage greater active management skills like never before to deliver additional value components alongside quality, long-term assets and with returns generated from strong cashflows.

By harnessing these opportunities – the 'Efficient Frontier' or return for given risk on the spectrum – can be extended.

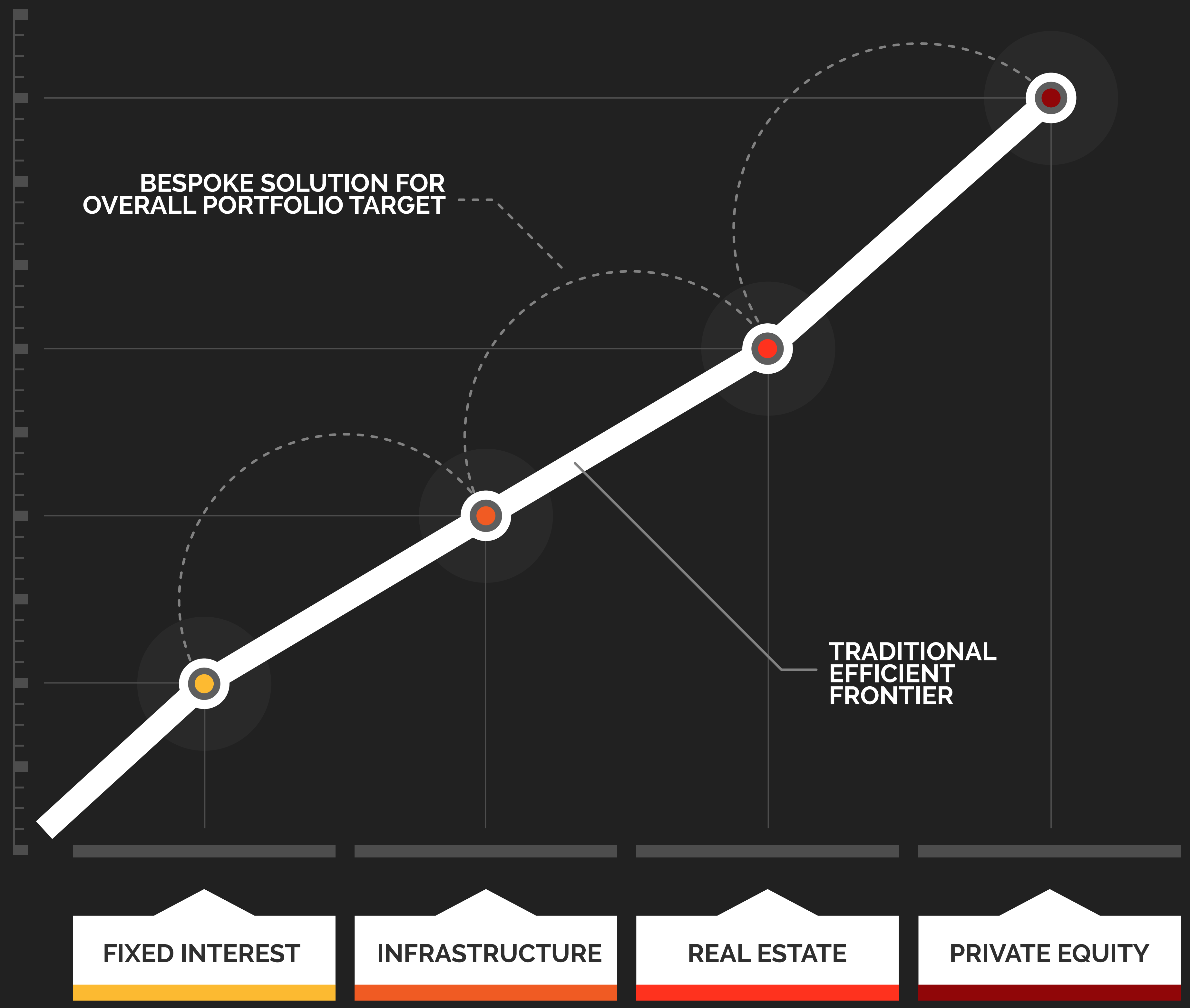

Figure 2: Extending the Efficient Frontier to capture new, untapped returns. Source: QIC

Within the asset classes:

Recasting nets to capture value

As long-term, active managers of alternative assets and fixed income, we remain strong advocates of their value for investors while also constantly innovating within these classes to increase risk adjusted returns for our clients.

Infrastructure: The rising importance of business planning

COVID-19 has ushered in a New World for infrastructure investors, with the pandemic acting as both the biggest disruptor, and generator of opportunities. We see the current raft of fiscal stimulus packages as a key influence in defining this sector's future.

Technology and the rising power of the consumer is also evolving the delivery of essential services, leading to increased risks for some traditional monopolistic utilities which are being replaced by decentralised customer-driven solutions.

The hunt for yield in the New World has also tipped the balance to favour the value being derived from growth-orientated infrastructure assets compared to yield-orientated ones.

And while we continue to believe in core infrastructure assets, we foresee an even greater role for active management to extract maximum value from an asset. In this way, stringent business planning for infrastructure has never been as important as it is in this low rate environment and post-COVID landscape, where the long-term impacts of the pandemic over a 30- to 50-year time horizon are still unknown.

Real estate: Transforming the traditional

Even before the advent of COVID-19 reshaped a new socially-distanced reality, the following drivers were affecting structural changes in real estate: human behaviour and consumption patterns; changing business models; demographic trends; falling interest rates; and technology.

These structural changes have seen a growing prominence of alternative real estate assets with sub-categories including: student accommodation; residential; build-to-rent; industrial buildings; logistics centres; health-care facilities; and data centres. The common theme binding the growth of the alternative real estate sector is the focus on the customer.

As such, asset managers need to embrace a greater spectrum of specialisation to secure returns for clients, encompassing a broader range of risk. The core assets in real estate are also undergoing a transformation, with the retail sector the most visible.

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Private equity:
A leader in constant motion

Superior private equity strategies focused on capturing value arising from consumer, enterprise and industrial trends – particularly in a post-COVID landscape – will benefit institutional investors. Private equity's focus on infusing strategic and operational improvements into investments also makes this asset class well-placed to harness the digital transformations global economies are undergoing.

Investors have the option to now increase their allocation to secondaries and co-investment opportunities in order to increase their pace to market, minimise the J-curve impact and lower their average fee burden.

We are also seeing some investor preference for pursuing longer time structures rather than the traditional three to seven-year hold period.

Fixed income:
An alternative take for a traditional class

Traditional fixed income was typically regarded as a ballast in the late-cycle economy as it provided investors with defensive income. But as bonds comes under scrutiny – with over 20 per cent now trading with a negative yield[3] – new benchmarks are needed to keep pace with structural changes.

This change could take the form of strengthening the focus on income generation, the jettisoning of negative yield assets from traditional benchmarks or finding new markets such as the Chinese corporate bond market. As such, this traditional class is seeing a rise in alternative approaches to seek improved risk and return outcomes from the sector.

Read on

This paper will look at the opportunities which can be harvested by exploring overlays and options as whole of portfolio tools. It it will then investigate the potential benefits available from broadening asset class definitions to encompass the "White Space". Finally it will explore the ongoing opportunities floating to the top as alternative asset classes evolve in the New World where Lower for (Even) Longer is the norm.

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3 Bloomberg Barclays Global Agg Index (27 July, 2020)

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Welcome to the New World

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Welcome to the New World

While institutional investors have always keenly watched public markets, they have been distracted during the COVID-19 pandemic by volatility, low-yielding bonds and unprecedented monetary and fiscal policy regimes.

As a result, investors are incentivised to look for new opportunities and risk management tools in a bid to protect their portfolios and continue their hunt for yield in the New World.

COVID-19 markets have challenged our traditional understanding of both **liquidity** and **defensiveness**. For instance, traditional fixed income allocations are no longer seen as the ballast that portfolios need.

In the proceeding section, **Across Asset Classes**, we explore how risk management and whole of portfolio thinking is evolving to offer defensive, and potentially, more liquid characteristics in this low return world.

Following sections will then examine changes **Between Asset Classes**, and finally consider **Within Asset Classes** changes and how alternative assets and new thinking in fixed income are going to play an important role in a New World landscape.

We note already global alternative AUM has more than tripled in just over a decade: from US$3.1tn in 2008 to US$10.3tn at the end of 2019.[4] The implications of this step change **across**, **between** and **within** asset classes will be of immense interest to the institutional investor.

Alternatives AUM have increased more than three-fold over the past decade to reach US$10.3tn AUM as of December 2019[5]

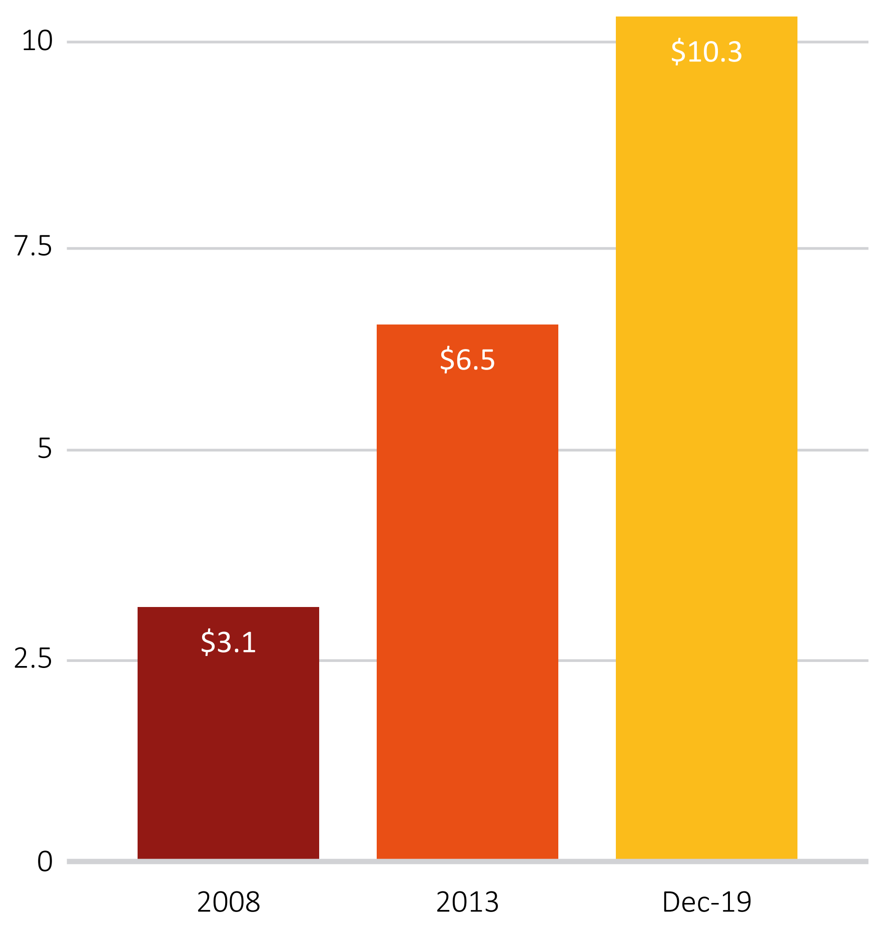

Figure 3: Allocation Alternatives

4 Preqin Alternatives in 2020 Report. Retrieved from: https://docs.preqin.com/reports/Preqin-Alternatives-in-2020-Report.pdf
5 ibid

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Across Asset Classes

Across Asset Classes

When returns were higher, small leakages from portfolio allocation drift or currency mismatches could be forgiven and absorbed by abundant returns.

However, these detractions are more nefarious when returns are lower as they can equate to a much more substantial piece of the pie. These detractions can also be persistent, meaning the annuity value of several basis points (bps) of loss is meaningful.

Whole of portfolio management tools, which have heightened in importance in this low return environment, include:

1. Both direct and indirect options to protect for equity downside risk while also potentially to allow for more asymmetric upside risk
2. Strategic management of currency risk
3. Systematic Strategic Asset Allocation (SAA) rebalancing

Even the traditional approach to asset allocation, SAA, is coming under the microscope as a growing number of investors move further towards Total Portfolio Allocation (TPA) to extract value in the New World.

Creating efficient defensiveness: Portfolio hedging

With sovereign bonds potentially at their lower bound, the opportunity for them to rally and protect portfolios is now seen to have less utility than in the past. Investors in the New World are looking for ways to diversify portfolios efficiently, which may not be so reliant on traditional allocations to sovereign bonds.

We see portfolio hedging as a permanent tool to make either short or long-term adjustments to asset allocation. In most multi-asset class portfolios, it is equity risk that investors often use to diversify and/or hedge. After all, diversification is often quoted as the one free lunch in finance.

Portfolio hedges can be further dissected based on the type of hedge they offer.

Types of portfolio hedges

— Buying or selling *futures* or *physical assets* which offer a one-for-one or linear payoff.

— Buying *options* offers a non-linear payoff whereby the maximum loss is known.

— *Indirect hedges* are those where the hedge instrument is not directly the same as the risk that is hedged. In implementing these hedges, “*proxy assets*” are selected that combine the concepts of both portfolio diversification and portfolio hedges to deliver a portfolio hedge which has a higher expected return.

An ideal indirect hedging framework for equities has three key criteria:

1. **Does it diversify during normal times?**

   The asset ideally should have a low/negative correlation during normal times to provide some diversification benefits and offset the cost.

2. **How does it act during stress periods?**

   In stress times the asset should have a large negative correlation/beta with global equities to provide an effective hedge with global equities.

3. **Is the indirect hedge cheap to implement?**

   The indirect hedge will come at a cost; ideally, the asset should be cheap from both an expected return perspective and basis risk.

A range of tools can be evaluated depending upon the entry point levels of volatility, spot prices and required payoffs over different market events.

For example, to hedge equity risk, hedges such as put options and put spreads, and proxy assets such as VIX call options and currency hedges like AUDJPY, can be tested.

We have proxied this study over the COVID-19 stress period between March to April 2020, assuming various hedges were entered into at the end of January 2020. The ex-ante assumptions for the normal beta, stress beta and leverage are summarised in Table 1.

	Base Asset	Proxy Asset	Proxy Asset
Name	'SPX'	'VIX'	'AUDJPY'
NormalBeta	1	-75.4	0.5
StressBeta	1	-66.1	0.4
Leverage	100.00%	1.51%	244.90%

Table 1: Ex ante assumptions for equity hedges over the COVID stress period: 31 January to middle April 2020
Source: QIC

Our analysis found the below:

- All correlations and volatilities increased in March 2020, which was the "stressed state".
- Yet the beta of the proxy assets actually fell when moving from the normal state to the stressed state – meaning the proxy assets became less of a hedge during a stressed equity market than a normal market.
- Each structure expired in the money.
- In this example, the S&P put option was the cheapest by expiry but the speed of retracement across the different underlying markets differed greatly.

In doing this analysis and assessing both direct and indirect hedges, we believe there are two guidelines to create the best solution for the New World:

1. **It is vital that a true like-for-like comparison is made between the alternatives; and**
2. **An understanding of the broader portfolio objectives and risk tolerances is key.**

A better currency mix

Exposure to foreign currency is another example of an indirect hedge. For example, USD and JPY are often cited as safe haven currencies versus more pro-cyclical currencies like the AUD or CAD. Holding these cross rates is a complementary strategy to option protection for helping protect against portfolio downside risk.

Aussie dollar hitched to fluctuations in equity markets during Global Financial Crisis (GFC)

The example from the 2008/09 GFC provides a case in point. The eight months leading up to the heart of the crisis *(see Figure 4)* was one where the AUD and global stocks were positively correlated but could easily be defined as 'loose'. The apparent breakdown in the relationship between June and August 2008 would have tested any investor's conviction that the traditional relationship would hold up during adversity.

During the Incendiary part of the crisis – from September 2008 to when equities put in a floor in March 2009 – it is hard to distinguish between the movements of the AUD and equities, at least from a directional perspective *(see Figure 5)*. The currency was practically hitched to the oscillations in global stocks.

During this period, a higher exposure to foreign currencies provided a massive relief to Australian investors, both from a return and liquidity perspective. While it remains an extreme example of what happens under stressed conditions, recent market movements provide comfort that the defensive qualities of foreign currencies remain intact.

The impact magnitude of the hedging decision is far from inconsequential. At the height of the GFC, there was a 59-day period where the difference between fully-hedged and unhedged international equity returns was a monumental 30 per cent. In that environment, even modest changes in hedge ratio between competing funds produced significant differences across the industry.

For further insights on currency policy, particuarly its impactfulness through the extreme moves at the beginning of COVID-19 please see *Five Crucial Currency Themes 2020.*

AUD/USD & MSCI World ex Australia:

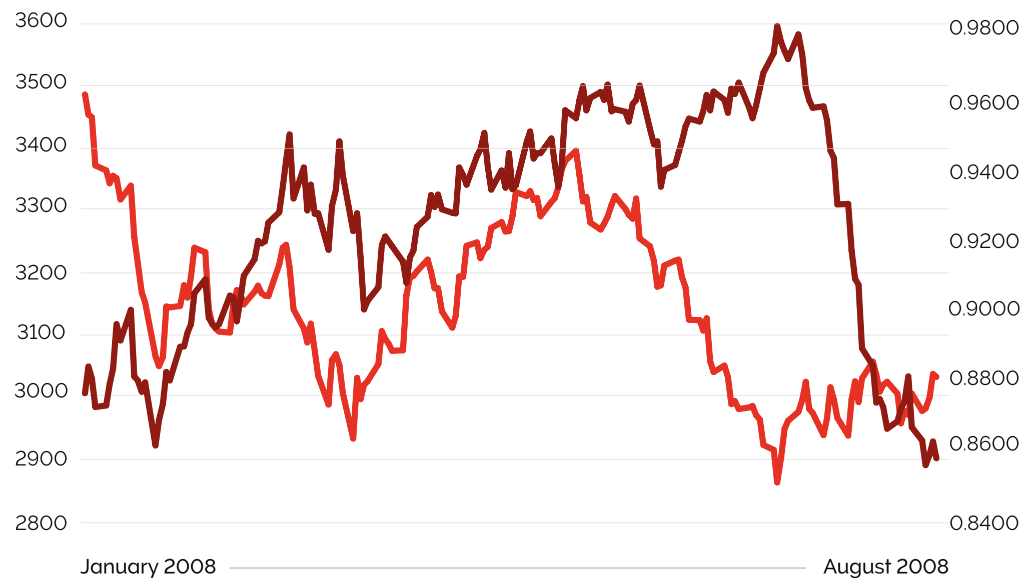


Figure 4. January 2008 to August 2008. Source: Bloomberg and MSCI.

September 2008-March 2009

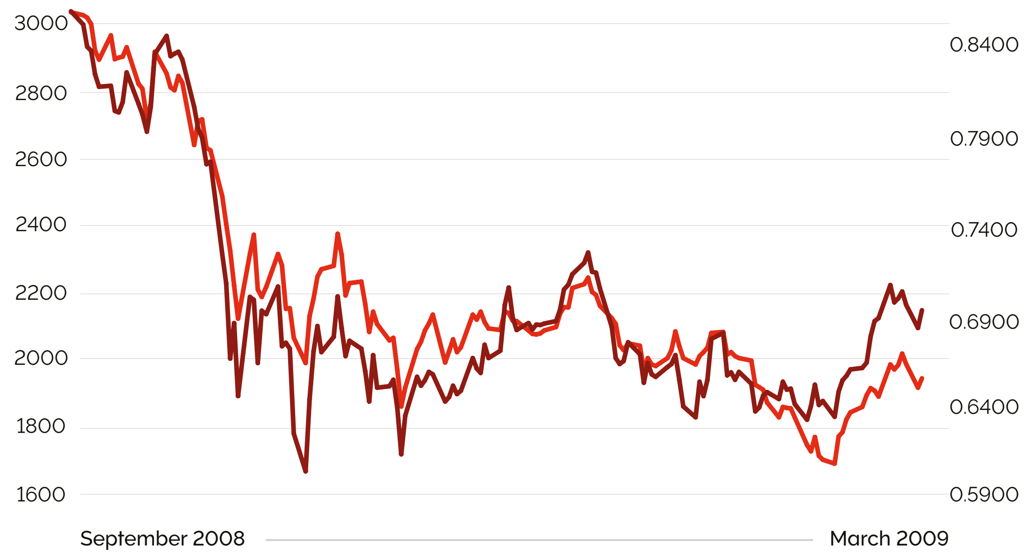


Figure 5. September 2008 to March 2009. Source: Bloomberg and MSCI.

MSCI WORLD – LOCAL AUD/USD (RHS)

An evolving SAA: Creating liquidity with derivatives

The SAA approach is a long-standing portfolio strategy founded in Modern Portfolio Theory (MPT) and which involves set, targeted allocations for asset classes based on investors' profiles.

To plot the allocation, managers assess the investors' risk appetite, investment timeline and their end objectives. This approach is popular as it is easy and bespoke to the investors' needs.

Institutional investors such as superannuation and pension funds, insurers and other liability managers continuously wrestle with drift from SAA settings, largely due to cash inflows/outflows, market moves and difficulties in managing committed, but not called, capital. If unmanaged, SAA drift creates active risk with a real impact on risk adjusted returns over time. With equity market and bond markets swinging wildly in March and April 2020, coupled with calls being made by members to switch to cash, SAA management was significantly difficult for many Australian institutional investors.

Having spent the time to establish SAA, systematically rebalancing exposures back to target weights is critically important for a number of reasons. At the basic level, ongoing cashflows both in and out, as well as volatility, continually impact SAA. A good asset rebalancing strategy deals with each effectively and efficiently.

In a low-return environment such as the current COVID-19 reality investors now face, being able to control SAA deviation leakage is more important than ever. The potential return drag from this leakage, or ineffective rebalancing processes, is proportionally more expensive when yields are low than when they are high. An efficient, systematic approach to rebalancing which minimises this drag is proportionally more valuable than ever.

In our paper *Systematic Asset Rebalancing Strategies for Better Outcomes*, we simulated the historical performance of a typical superannuation fund asset allocation while assuming a 10 per cent per annum cash inflow. We found the cash drag impact caused a material performance drag, averaging around 31bps per annum relative to the range-based rebalancing strategy. Comparing the ranged-based strategy to the end of month rebalancing strategy, we saw increased returns by 11bps per annum.

One nimble and cost-effective risk-managed rebalancing tool for SAA are derivatives. They offer the potential for immediate re-calibration of SAA strategies that have been impacted by drift.

They can also act as a counterweight or proxy exposure during rebalancing of physical assets and securities which need time for acquisition or disposal.

Derivatives are highly liquid and with low transaction costs. Moreover, their very nature means derivatives offer the potential to build out, or reduce, SAA exposures which only need to be funded by their premiums or margins. Importantly, derivatives can work harmoniously within overall portfolio rebalancing strategies, across listed and unlisted markets, as illustrated in Figure 6.

We also believe in this low return environment, it is more important than ever before to efficiently rebalance back to SAA targets as the absolute cash drag – as a percentage of portfolio returns from not rebalancing dynamically – is potentially more destructive.

Derivatives offer immediate rebalancing potential for listed and unlisted assets

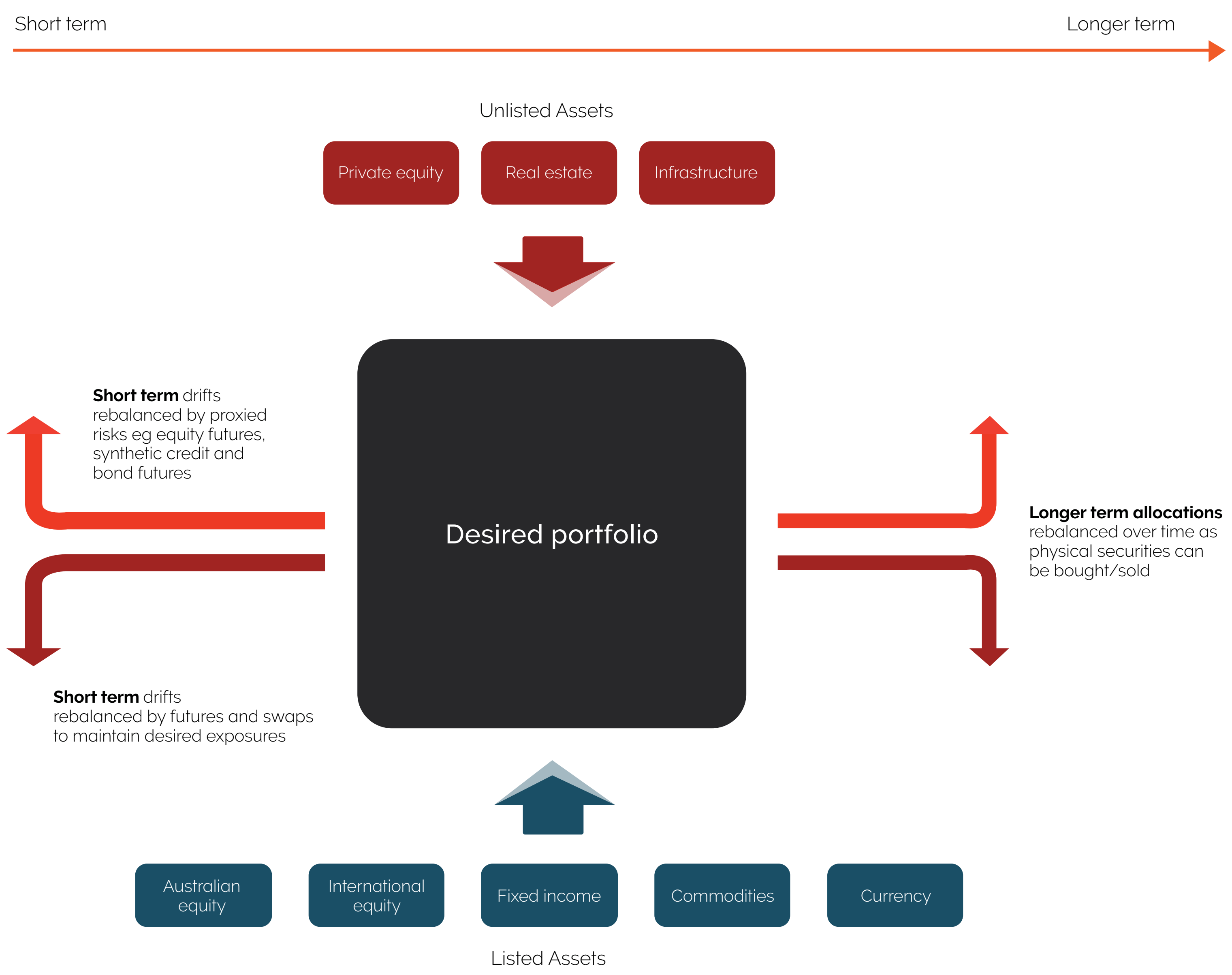


Figure 6. Derivatives integration within portfolio rebalancing strategy. Source: QIC

6 Carr, T. (September 2019). Alternatives in 2019. Preqin: SANNE's and Preqin Alternatives Lunch. Retrieved from: https://docs.preqin.com/reports/Preqin-Alternatives-in-2019-Report.pdf

Total Portfolio Approach (TPA): Greater flexibility to capture opportunities

While SAA will continue to play a major role in asset management, investors looking for even more flexibility may consider tilting towards TPA which offers a more streamlined approach to portfolio construction.

TPA involves assessing an asset for its risk and return streams and then its implications for total portfolio returns. Rather than adhering to benchmarks, fund goals are set and diversification is achieved by risk factor decisions rather than asset class choice.

Recent surveys suggest investors see greater returns from a TPA approach relative to a SAA-based approach to the tune of 50-100bps.[7]

While regulatory requirements may preclude full adoption of a TPA approach for Australian superannuation funds, we believe there is a spectrum of approaches between TPA and SAA and note many institutional fund managers are moving to capture at least some of the flexibility impacts of TPA in their portfolio management.

TPA advantages for Navigating the New World:

1. Funds can change tact and avoid pressure from the buying or selling of illiquid investments at ill-timed intervals to meet asset allocation targets.
2. TPA allows for great agility in the decision-making process as allocations are made based on risk exposures rather than rigidly defined asset-classes. As such, investors can embrace the emergence of new disruptors and "White Space" which will be highlighted in proceeding chapters.
3. There will be better quality of decision framing and decision making, as these rights reside with the teams best qualified to make those decisions.
4. The approach will allow for premia generated from active management to drive further value towards the portfolio.

7 Thinking Ahead Institute (2019) Total Portfolio Approach – A global asset owner study into current and future asset allocation practices. Retrieved September 2020 from: https://www.thinkingaheadinstitute.org/en/Library/Public/Research-and-Ideas/2019/11/TPA

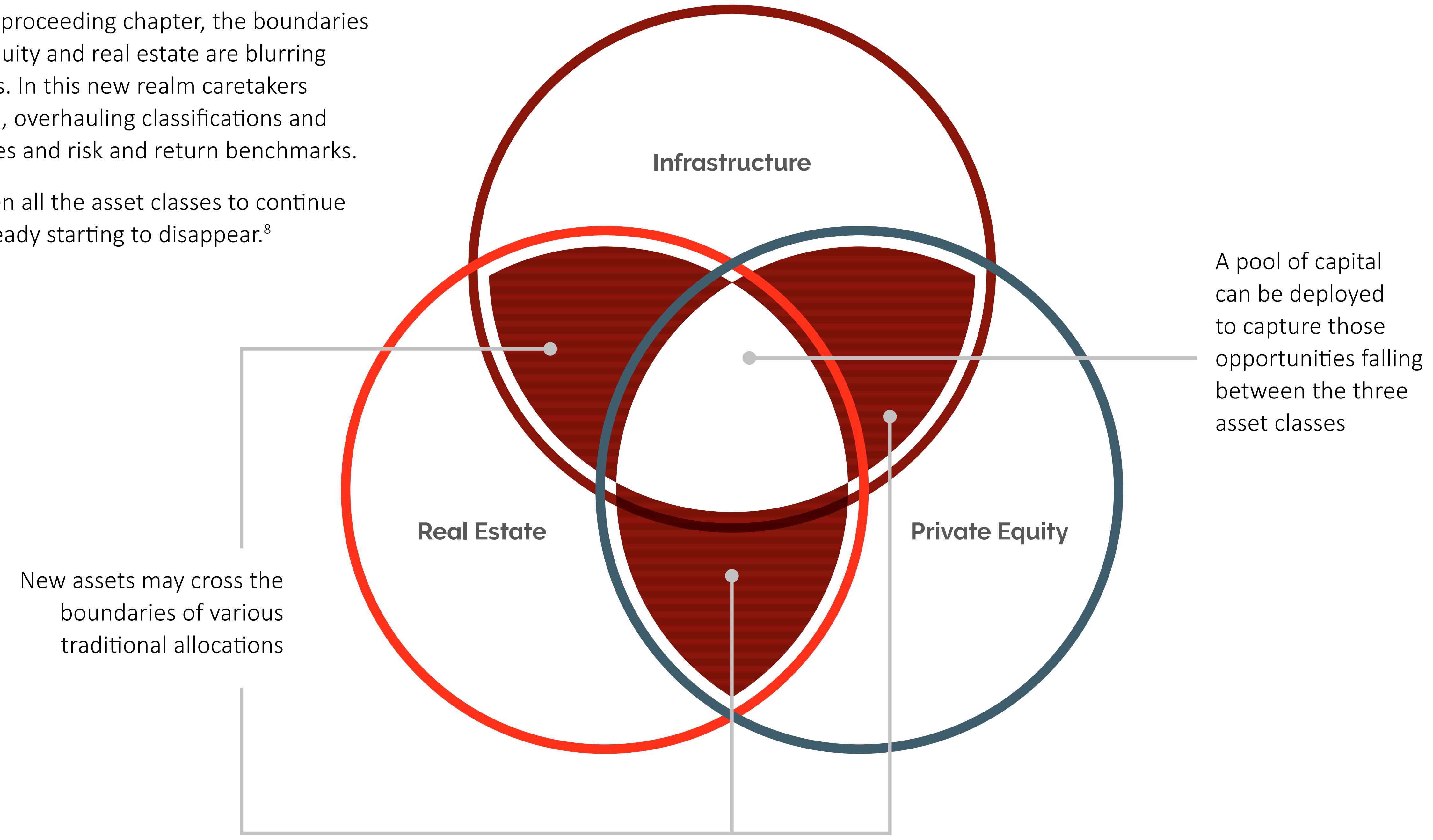
Between Asset Classes

Between Asset Classes

As the boundaries of asset classes become increasingly porous, opportunities are converging between the following realms:

As will be discussed further in the proceeding chapter, the boundaries between infrastructure, private equity and real estate are blurring and undergoing structural changes. In this new realm caretakers are out, and active stewards are in, overhauling classifications and definitions, and blurring boundaries and risk and return benchmarks.

We expect the boundaries between all the asset classes to continue to fade and in some cases, are already starting to disappear.[8]



8 KPMG. (March 1, 2018). Trend 9: Alternative asset classes start to re-converge. Retrieved from: https://home.kpmg/xx/en/home/insights/2018/01/trend-9-alternative-asset-classes.html

The drive towards these hybrid assets – which live in the "White Space" – is not a cyclical phenomenon. It is structural; and is part of the future of the investment landscape. It will operate alongside traditional vertical asset allocations, all of which will continue to deliver value to institutional investors.

This White Space is highly customisable to create bespoke value matching individual investor needs. Within the White Space lie assets which disregard traditional definitions and customise new risk and return opportunities to generate cash flow or capital growth.

This trend is prompting asset managers to infuse and leverage greater active management skills like never before to deliver additional value components alongside quality, long-term assets, with returns generated from strong cashflows.

By harnessing these opportunities – the 'Efficient Frontier' or return for given risk on the spectrum – can be extended.

We see an exciting opportunity to offer investments in quality, long-term assets, where returns are generated from strong cashflows while also possessing a value component from active management.

The blended nature of an asset may reward the investor more: The fact it does not have a traditional home means incremental value may be harvested.

Institutional investors are no longer confined to only choosing fixed points from traditional asset class definitions to build their own Efficient Frontier. In the New World, they can embrace higher return-for-risk opportunity sets by selecting hybrid assets that traditionally fell between the gaps.

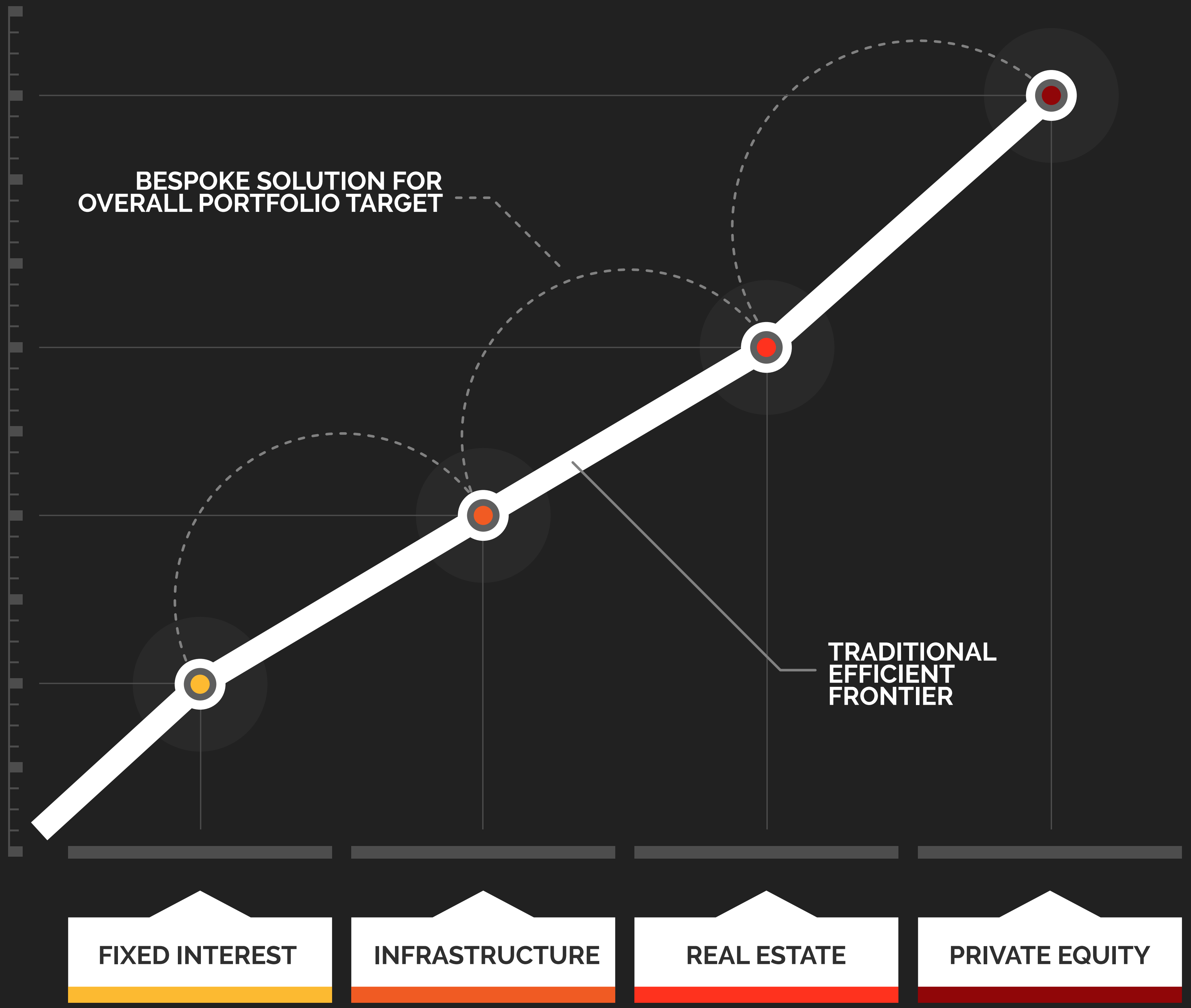


Figure 8: Harnessing bespoke hybrid opportunities in the White Space can extend the 'efficient frontier' or return for given risk on the spectrum. Source: QIC.

Case Study:
Australian agricultural opportunities

An emerging asset class delivering value for institutional investors

Is it real estate – or is it infrastructure?

This question is top of mind for Australian institutional investors when considering agricultural opportunities in the New World.

Investors assessing agricultural opportunities purely as a "land value" play, will assign a real estate asset class definition while those who see the high barrier of entry, stable income and long-term capital commitment will see an infrastructure investment. The option to "buy and build" also lends itself to be considered through the lens of private equity.

The reality however is that agriculture is an emerging asset class with a unique value proposition that can provide both strong diversification properties while also generating growth in addition to regular yield.

In 2019, Australia saw record levels of capital investment with A$4.3bn, a 30% increase from 2018.[9] However, ongoing and additional investment will only add extra value to agriculture assets and further deliver gains for investors. This capital will also help the industry increase production to A$100 billion by 2030[10] – the benchmark for ensuring Australia protects and regains market share in an external environment focused on food security due to a rising global population.

It is in its very essence, an example of "White Space".

Continued over >

9 Australian Agribusiness (2020) State of the Industry Report. Retrieved from: https://www.agribusiness.asn.au/agri-information/2020-state-of-the-industry
10 ibid

Case study: Australian agricultural opportunities – continued

Future outlooks to reach A$100 billion growth target to achieve sustainability[11]

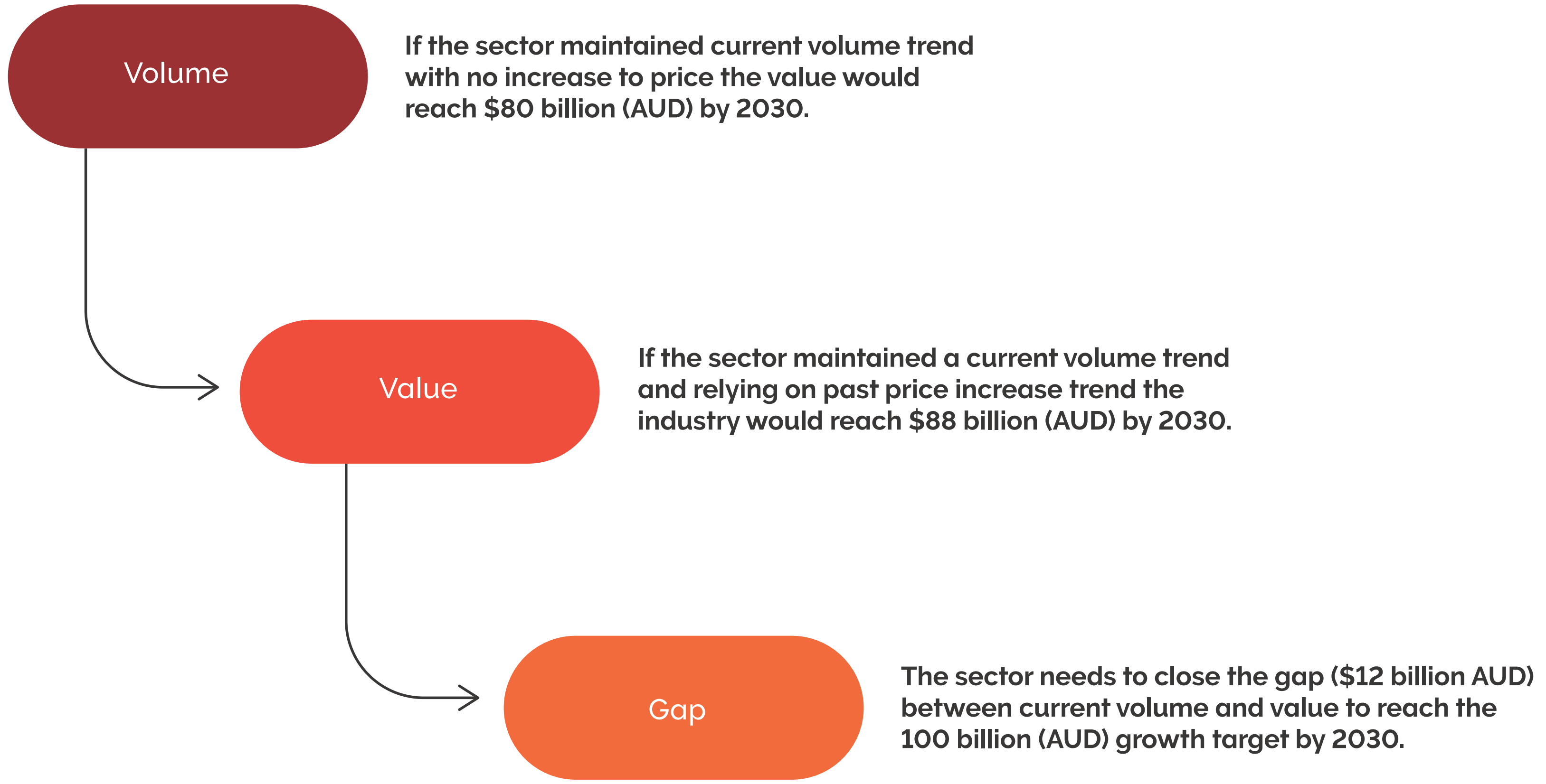


Figure 9: Australian agribusiness pathway to sustainability.

As a defensive anchor

Agriculture can generate solid returns which are largely uncorrelated (0.15 correlation) to Australian equities.[12]

Due to this low correlation, its inclusion in a portfolio provides diversification, improves total portfolio performance and reduces volatility. The below table indicates the historical performance of a diversified portfolio both 'with' and 'without' the inclusion of a five per cent allocation to agriculture (across time horizons 1, 3, 5, 10 and 20 years to 2018).

Furthermore, a portfolio with an agriculture allocation demonstrated improved returns, volatility and the Sharpe Ratio across all measured periods.

11 ibid

12 Thompson, M. (February 2019) "A case for agriculture: Don't keep all your eggs in one basket" in Frontier Line (Issue 144). Frontier Advisors: https://frontieradvisors.com.au/wp-content/uploads/2019/02/Frontier-Line-144-A-Case-for-Agriculture.pdf. Correlation calculation on calendar year returns from 1996-2017

Contacts

Case study: Australian agricultural opportunities – continued

	Return (% p.a.)		Volatility (%)		Sharpe Ratio	
Return Period	w/o Agri	With Agri	w/o Agri	With Agri	w/o Agri	With Agri
1 year	9.2	9.0	4.9	4.7	1.52	1.53
3-year	7.9	7.9	4.5	4.4	1.32	1.36
5-year	9.2	9.2	4.5	4.4	1.54	1.59
10-year	7.2	7.5	7.8	7.5	0.5	0.55
20-year	7.9	8.1	7.6	7.4	0.44	0.49

Table 2: Portfolio performance 'with' and 'without' Agriculture to 30 June 2018[13]

Actively adding value

Returns are also able to be driven by steady long-term cash flow growth, active farm management and real-asset appreciation.

Despite the fragmented nature of the agricultural sector which is characterised by family-owned businesses, there is opportunity for consolidation with an overlaying active management commitment which can extract growth and yield from the sector.

For example, Australian large-scale 'All Broadacre Industries' delivered a 9.7 per cent total return over a 36-year period between 1980-2016, of which 5.7 percentage points were driven by income.[14]

A case study can be drawn from the Australian beef cattle farming industry which is highly fragmented and comprised of approximately 85 per cent owner-operator family businesses.[15] However, about 40 per cent of industry revenue comes from a select few premium beef producers – NAPCo, AA.Co, CPC, S.Kidman and Paraway.[16] As such, there is a high barrier to entry for premium beef supply arrangements with major retailers, feedlots and processors such as Woolworths, Coles, JBS, Teys and offshore companies.

Those leading producers with unique scale, capital and institutional capability will be able to meet large and growing customers' supply needs by providing daily volume, supply security and consistent quality and grade of product. In doing so, they will occupy a solid market position and return value to investors.

13 Ibid. Returns are gross returns. Past performance is not a reliable indicator of future performance
14 Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) database as stated in Industry Super Association (2017) 'Driving Super Fund Investment in Agriculture'
15 IBIS (2018) Beef Cattle Farming in Australia August 2018
16 ibid

Within Asset Classes

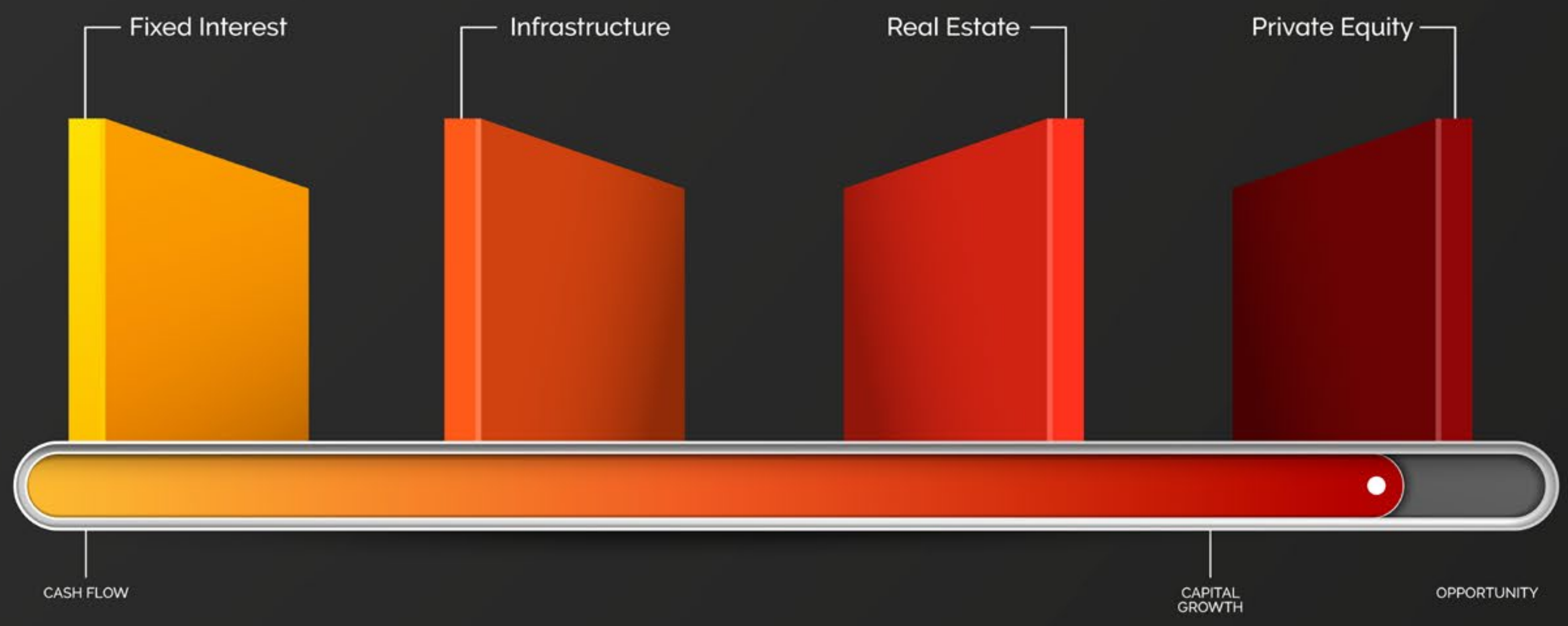
Contacts

Within Asset Classes

Despite evolving asset class definitions, we remain strong advocates of traditional alternative assets.

This ability to focus on future opportunities and traditional strengths is based on our belief that active management is vital to the sustainability of these assets – a belief that has only grown stronger through the impacts of COVID-19 pandemic on our communities, markets and economies. Being able to tilt strategies, re-prioritise strategic decisions and integrate long-term sustainable practices into our assets has enabled us to position them for future growth and sustainability.

This section will now review the evolution occurring within the alternative asset classes of infrastructure, real estate and private equity. It will also highlight the new alternative strategies for the traditional fixed income space.



Infrastructure: The rising importance of business planning

OLD WORLD

- Core sectors only
- Many natural or government regulated monopolies
- Yield orientated assets

NEW WORLD

- Core and core plus sectors
- Some regulated monopoly models under pressure due to value chain disruption from technology and decentralisation
- New infrastructure opportunities are emerging more closely aligned with these disrupting forces with attractive returns
- Sustainability focus

Infrastructure: The rising importance of business planning – continued

Ports, rail, energy and water plants, roads, bridges and airports: these are all classified as core infrastructure sectors which have traditionally provided investors with long-term stable returns and income, have high barriers to entry, provided essential services for communities and played a vital role in local and national economies and productivity levels. Their fundamental importance to the structure of nations is reflected in the record AUM outstanding of US$582 billion held in June 2019.[17]

But COVID-19 has ushered in a New World for infrastructure investors, with the pandemic acting as both the biggest disruptor, and the generator of opportunities.

We see five COVID-19 horizons requiring infrastructure asset managers to draw on active management approaches to navigate the new complexities.

1. To resolve the immediate challenges and impacts that COVID-19 represents to companies' workforces, operations, customers and the health of businesses.
2. To drive resilience by addressing near term liquidity and financing challenges during virus-related shutdowns and economic knock-on impacts. Adjusting capital structures and refinancing facilities is key and could well lead to opportunities.
3. Re-framing business plans to adjust the operations of infrastructure businesses in response to COVID-19. In the New World, there is a focus on capital expenditure both in terms of deferral of some expenditure, and acceleration of capital projects where they are of strategic value to the asset.
4. Re-imagining what the new normal will be – a state which managers are now deeply immersed. This centres on a synthesis of value chains with respect to fiscal stimulus and government-led recovery profiles.
5. The theme of this horizon is "evolve to thrive" and is where asset managers are thinking about the impacts on a business from the acceleration of megatrends during COVID-19. This focus ensures clarity about potential shifts in the regulatory and competitive environment and how businesses should evolve to thrive into the future.

17 2020 Preqin Global Infrastructure Report

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Infrastructure: The rising importance of business planning – continued

Infrastructure's role in the Fiscal Decade

Institutional investors are the main route for funding the infrastructure projects during this period as government finance – which in turn creates a natural or regulated monopoly – is under challenge as they focus on economic recovery and rebuild policies. At the best of times, governments are reluctant to foot the entire bill for new projects or the rehabilitation of existing assets. Pre-COVID-19 the Global Infrastructure Hub identified a funding gap of US$15 trillion from 2016 through to 2040.[18]

Of all the external factors emanating from COVID-19, in the long-term it is fiscal stimulus that will influence the most change in the infrastructure sector.

In response to this pandemic, we have seen some of the biggest stimulus since World War II – it is well around US$9 trillion and could be more.[19]

It has been a factor supporting liquidity, offsetting a decrease in consumer consumption and also underpins business investment.

There are two other black swan events in history that provide some relevance:

- **The Great Depression:** The US response saw 800 airports built, 78,000 bridges constructed and more 125,000 buildings were developed.
- **Post-World War II and the Marshall Plan:** From 1948, the U.S. provided about five per cent of its GDP to the restoration of Europe, which is the equivalent of US$120 billion today.

18 Claerhout, A., Hammoud, T., Birgl M., Haddon J. (7 November, 2018). Infrastructure's Future Looks a Lot Like Private Equity: The Future of Infrastructure Investing. Retrieved from: https://www.bcg.com/en-au/publications/2018/infrastructure-future-looks-like-private-equity.aspx
19 QIC, Fiscal Stimulus: Implications for institutional investors (July 2020). https://www.qic.com.au/knowledge-centre/fiscal-stimulus-20200826

Infrastructure: The rising importance of business planning – continued

Shovel ready – or Shovel worthy

The implication from these stimulus programs in response to the COVID-19 crisis is to affect an increase in infrastructure spending and the delivery of shovel ready, but perhaps more importantly, *shovel worthy* projects. Within this unprecedented environment, where infrastructure is slated to help global economies recover from the impacts of this health crisis, there is an opportunity for investors to focus on sustainability.

To prioritise the investment into more sustainable assets – those *shovel worthy* projects – investors' portfolios can further withstand future shocks and build greater resilience against prevailing megatrend tailwinds which include decarbonisation, digitalisation and democratisation. Factors driving *shovel worthy* projects in the New World include:

- Green-related initiatives driving net zero emission targets
- Increased government PPP pipelines
- Asset recycling by governments as they seek to pay down debt increased by COVID-19
- Advancing climate resilience projects
- Digitalisation, in particular the roll out of 5G
- Logistics and automation
- Building health care system resilience post COVID-19.

Case Study: Decentralisation

We have identified a number of key megatrends impacting the infrastructure in the New World and underpinning real asset opportunities moving forward:

- Decentralisation and localisation
- Digital convergence
- Populism and customer centricity
- Sustainability
- Aging demographics.

Decentralisation is particularly relevant to the energy sector. The value chain associated with energy will fundamentally evolve over the next ten years thanks to renewables, battery storage and micro-grids. The battery storage phenomenon is going to be exciting to watch. In the past five years the costs associated with battery storage have dropped by 66 per cent and it is anticipated that by the time we reach 2050 we will have an investment opportunity of greater than US$500 billion dollars in energy storage.[20] With respect to renewables, we currently have about 8.4 per cent of the world's electricity being sourced from renewables and by 2050 we anticipate this to be around 50 per cent.[21] These are significant investment opportunities for the New World.

20 Allianz Partners (June 2019) "The World in 2040 – the future of healthcare, mobility, travel and the home". Accessed from: https://www.allianz-partners.com/content/dam/onemarketing/awp/azpartnerscom/reports/futorology/Allianz-Partners-Megatrends-of-the-21st-Century-ENG.pdf
21 ibid

Infrastructure: The rising importance of business planning – continued

Active management key to delivering new infrastructure opportunities for the New World

The nature of the delivery of essential services is also evolving due to technology and the rising power of the consumer. This is in turn leading to increased risks for some traditional monopolistic utilities, which are in some instances being replaced by decentralised customer-driven solutions or subject to significant regulatory scrutiny as the consumer voice becomes louder. It is leading to the emergence of new infrastructure opportunities.

Moreover, in the Lower for Longer environment, the search for yield has also changed the relative value proposition of yield-orientated versus growth-orientated infrastructure assets, with the latter growing in significance. This divergence in relative value is particularly notable for a number of regulated assets which have been subjected to return compression to very low levels, whilst simultaneously becoming exposed to increasing levels of regulatory risk and or technological disruption [See case study: Regulatory risk in the transmission and distribution (T&D) sector].

As such, the capability to develop strong business plans and drive outperformance through active asset management has become increasingly valuable. This is due to the heightened importance placed on differentiated business plans within competitive processes. There is also further potential for attractive relative value in certain growth-orientated sub-sectors, as well as scope for the implementation of new processes and technology, both of which require deep sector expertise to execute successfully.

For all infrastructure investments today, those deep domain sector specialists –who can identify risks and opportunities for each asset while also developing and implementing business plans which cater for an ever-evolving landscape – are the ones who will deliver alpha for institutional investors.

While there is still a role for core GDP assets in building out diversified portfolios, in particular core essential nodal assets such as ports and airports, we recognise the need to construct portfolios across geography, sector and lifecycle. Portfolio construction will need to be active and thoughtful to correlations emerging between sectors and in value chains – such as electric vehicles and the electricity grid – to deliver resilient, stable and predictable core infrastructure returns.

Overall, regardless of the asset risk, it is important to fully understand and price the risk/return and develop business plans which can extract maximum value and diversification in a clear and robust framework of portfolio construction in infrastructure.

Infrastructure: The rising importance of business planning – continued

Case Study: Regulatory risk in the transmission and distribution (T&D) sector

Regulatory and policy risks are particularly evident in the T&D segment of the market. In Germany, there has been a significant build-out of utility-scale renewable projects in the northern part of the country due to generous subsidy programs. However, there is a lack of regulatory and public support to build the required transmission to transport the energy to the load centres in the south. Similarly, in the U.S., while there was a major build-out of transmission lines in the 1960s, transmission has been difficult to build due to increased regulatory requirements. The charts below show this trend in Australia, where capital expenditure for transmission network expansion has declined (Figure 10) alongside the return on transmission assets allowed by the regulator (Figure 11). This is despite sustained construction of centralised renewable energy generation in Australia, which is creating challenges with respect to grid connection and transmission congestion for these projects.

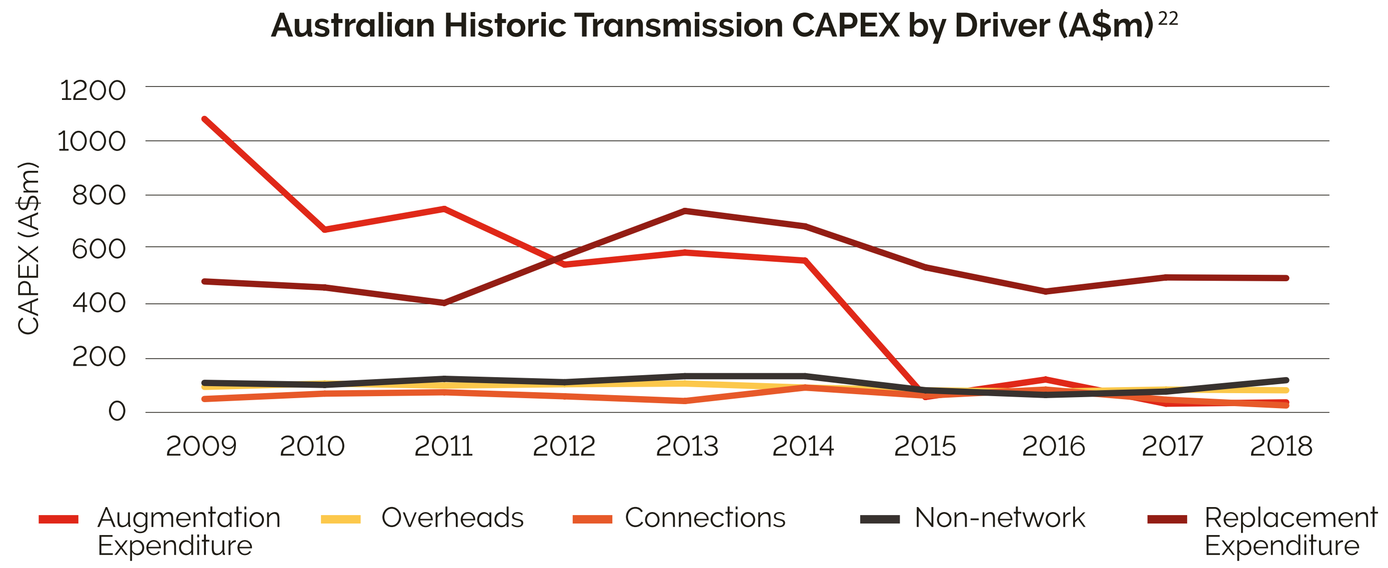


Figure 10: Decline of capital expenditure for transmission network expansion.

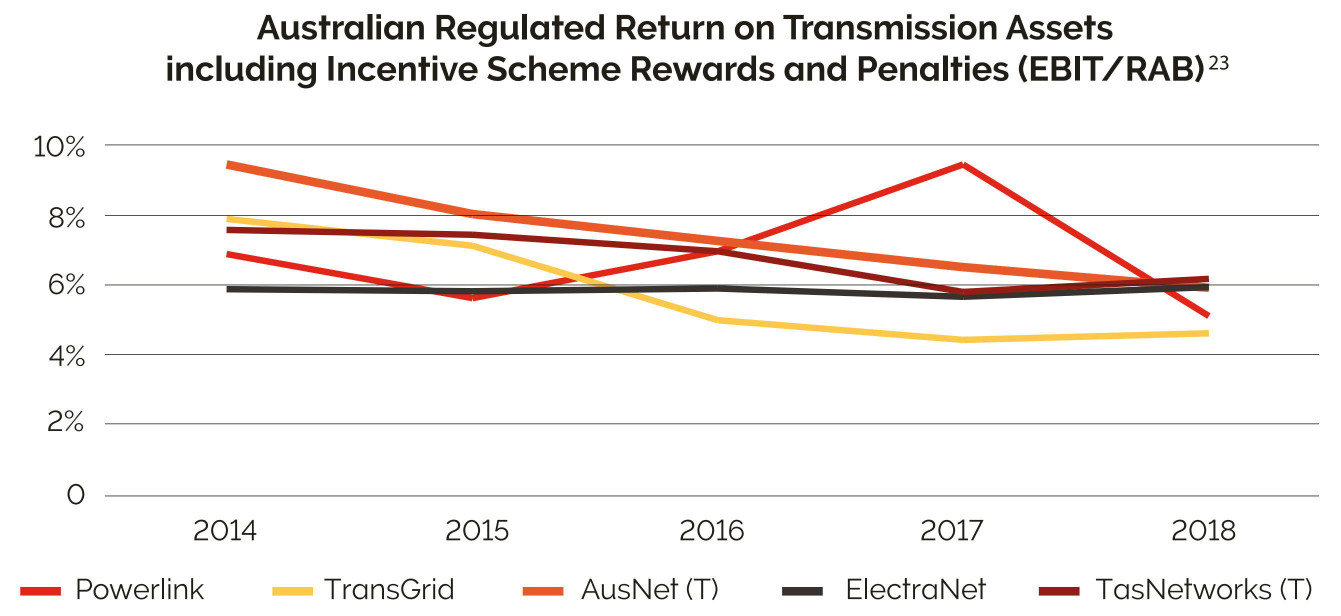


Figure 11: Return on transmission assets.

22 Australian Energy Regulator. (5 September, 2018). Transmission Performance Data 2006-2017. Retrieved from: https://www.aer.gov.au/networks-pipelines/network-performance/transmission-performance-data-2006-2017

23 ibid

Real Estate:
Refocusing on the consumer

OLD WORLD

— Sector predominantly retail and office

NEW WORLD

— Retail transformation adopting town-centre strategies

— More institutional appetite for residential assets in a variety of forms: sale and rental

— The rise of alternative real estate assets

— The demand for logistics assets enabling warehouse / distribution

Real Estate: Refocusing on the consumer – continued

Unlisted real estate's current story reads as follows:

A strong fundraising period with a six-year run of raising at least US$100 billion; an all-time AUM high of US$909 billion in 2018; capital concentration; and positive cash flows generated for investors with US$212 billion distributed in 2017.[24]

There have been two central 'characters' in real estate portfolios – office and retail. Even before the advent of COVID-19, which has dictated a new socially-distanced reality for interacting in public spaces, the following drivers were affecting structural changes in real estate: shifts in human behaviour and consumption patterns, changing business models, demographic trends, falling interest rates, and technology.

These structural changes have seen a reshuffling of previously supporting characters – the 'others' – to be of greater prominence for investors. The 'others' are primarily categorised as 'alternative real estate' with sub-categories including student accommodation, residential, build-to-rent, industrial buildings, logistics centres, health-care facilities and data centres.

The MSCI Global Annual Property Index found: [25]

— In 2001, office accounted for 46 per cent of the capital value and retail amounted to 31 per cent.

— These two sectors made up over three-quarters of the total index.

— By the end of 2018, they accounted for less than two-thirds, with office falling below 40 per cent and retail eroding to 24 per cent.

— Meanwhile, residential rose to 17 per cent from 11 per cent, industrial increased to 13 per cent from 9 per cent and 'other' has increased from four per cent to six per cent.

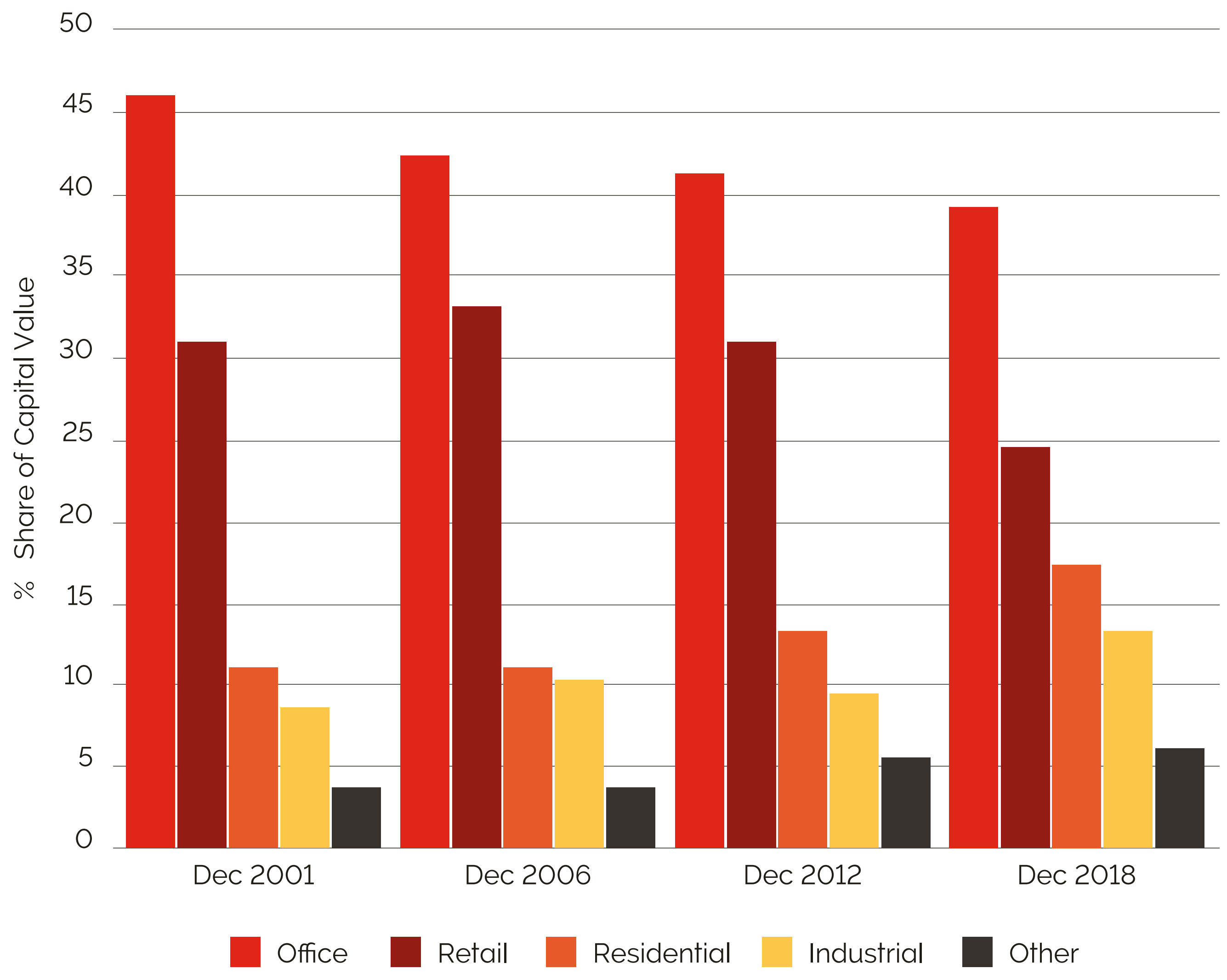


Figure 12: Sector Weights in the MSCI Global Annual Property Index for Listed Assets[26]

24 Carr, T. (September 2019). Alternatives in 2019. Preqin: SANNE's and Preqin Alternatives Lunch. Retrieved from: https://docs.preqin.com/reports/Preqin-Alternatives-in-2019-Report.pdf

25 ibid

26 Reid, B. (August 14, 2019). The changing face of real estate portfolios. Retrieved from: https://www.msci.com/www/blog-posts/the-changing-face-of-real/01565613401

Real Estate: Refocusing on the consumer – continued

The common theme binding the growth of the alternative real estate sector is the focus on the consumer.

Logistics
E-commerce is fuelling interest in logistics assets.

Industrial
Industrial facilities in Australia are getting a new focus as technological developments offer new areas of growth to meet consumer demand. Long leases, secured by high-quality covenants offer institutional investors both stable cashflows and if well-located, potential capital upside.

Residential
The recent rise in investor interest in build-to-rent residential is also tracking the preference of Millennials for rental opportunities with a recent survey finding only 49 per cent of millennials and 52 per cent of Gen Z's aspire to buy their own home.[27] Build-to-rent promises stable, less cyclical cashflows which will meet ageing superfund members' needs for long term stable cashflows.

Healthcare
The growing trend for patients to be treated as customers was highlighted in research into the healthcare sector – *Health and Wellness: Diagnosing Opportunities for Institutional Investors.* This paper examined growing investor interest in community-based care and hospital facilities.

Within this New World, the categorisation of core assets has shifted alongside the space requirements needed for changing "live, work and play" dynamics, the emergence of the experience economy and the new socially-distanced reality forced upon communities by COVID-19.

As such, asset managers need to embrace a greater spectrum of specialisation to secure returns for clients, encompassing a broader range of risk.

The core assets in real estate are also undergoing a transformation, with the retail sector the most visible.

27 The Deloitte Global Millennial Survey 2019. Access from https://www2.deloitte.com/content/dam/Deloitte/global/Documents/About-Deloitte/deloitte-2019-millennial-survey.pdf

Contacts

Real Estate: Refocusing on the consumer – continued

Case study: Watergardens – An exercise in true localisation

For generations, retail has played an integral role in stitching together the fabric of Australia's communities. Yet in recent years structural changes impacting the retail industry has prompted a re-evaluation of established models. The outbreak of COVID-19 has only strengthened QIC's view of the need to adapt and accelerate a strategy aimed at building resilient and thriving destinations for the communities in which we serve.

As an active asset manager and developer, our priorities are clear:

1. To harness these structural changes to continue our retail evolution, embracing our responsibility to use these accelerated changes to the advantage of our places, communities and clients.
2. To leverage the strength of our core assets and the strategic nature of their locations to fully realise the real estate uses within their landholdings and produce sustained performance.

By reinterpreting the role our retail assets play in their communities – and by continuing to evolve them into retail-led, mixed-use destinations, or town centres – we are actively responding to the changing Australian retail landscape which is adapting to the new realities shaped by COVID-19, macro-economic and technological forces.

Watergardens: A town centre strategy come to life

Positioned in western Melbourne, one of Victoria's strongest growth corridors, Watergardens serves the needs of an ambitious and rapidly growing corridor. Watergardens opened its doors in 1997 as QIC GRE's first ever greenfield development. Occupying the central portion of a developable 52-hectare site – a third of the size of the Melbourne CBD – Watergardens was ideally positioned to evolve into a major civic and commercial hub for the outer western suburbs over the coming decades.

Over the last 20-plus years, Watergardens has undergone continual expansion, evolution and enhancement which has been closely aligned with the changing needs of a quickly expanding population and a constant refocus on the customer.

In March 2020, QIC GRE delivered *The Marketplace at Watergardens*, a 5000m^2 precinct inspired by the famed produce markets in Melbourne and one that expanded the centre's fresh food offering into a vibrant indoor-outdoor space introducing a range of new-to-area dining and food retail offers. The development also marks the first phase of Watergardens' proposed multi-stage evolution into a cultural, relevant town centre. In 2021, QIC GRE will next undertake an aesthetic upgrade of the centre's entertainment offering, and a new 86-room Quest serviced apartment hotel is also targeted to open on the site, depending on demand.

Contacts

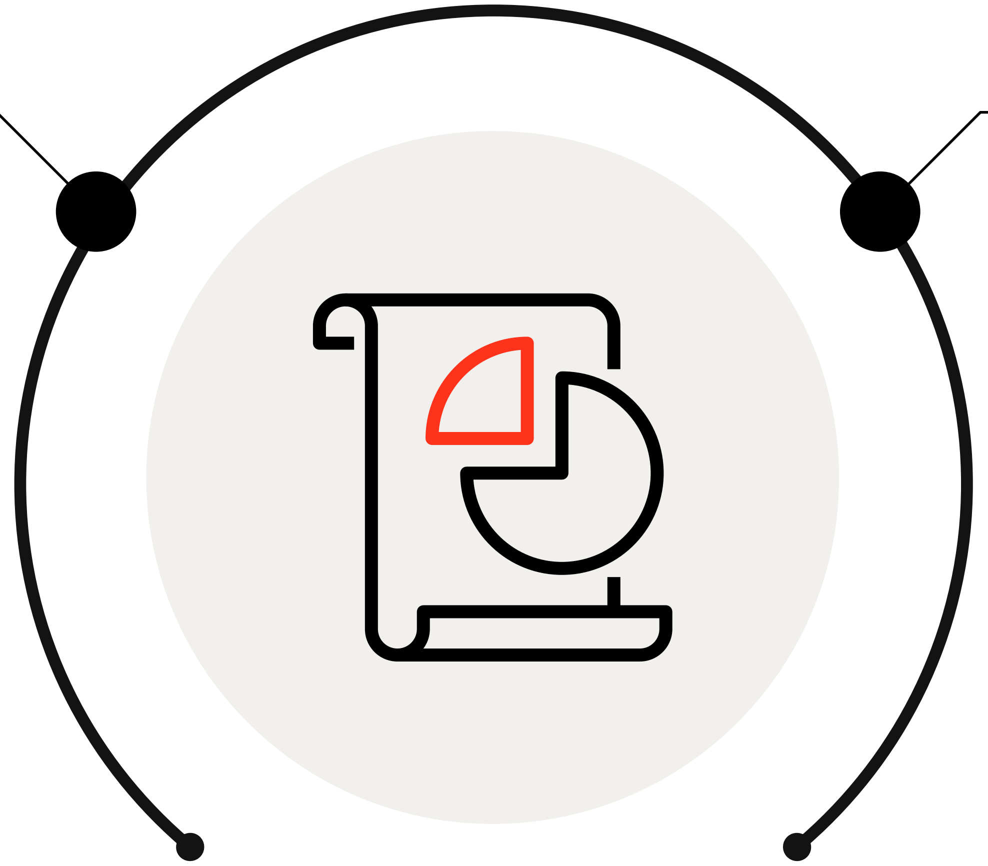
Real Estate: Refocusing on the consumer – continued

The masterplan for Watergardens provides significant development opportunities to be delivered within the Town Centre strategy, whilst also presenting the opportunity to potentially seed new GRE-managed investment products in new sectors.

Private Equity: A leader in constant motion

OLD WORLD

- High financial leverage
- Cost cutting and optimising balance sheets
- Simple deal structures – mainly direct fund investing
- Limited liquidity for institutional investors
- Exit by way of IPO or trade sale



NEW WORLD

- Buy and Build; high impact operational improvements and strategic M&A
- Co-investments are becoming a core part of portfolios
- Deep secondary market enhancing asset class liquidity
- Additional exit options e.g. late stage investors looking for long-term investments with lower return thresholds

Private Equity: A leader in constant motion – continued

The rise of the alternative asset industry is grounded in the success of private equity, with AUM for the asset class reaching a record high of US$4.5tn in December 2019.[28]

Private equity's strength can also be seen in the returns it generates when compared to other asset class benchmarks.

Yet the asset class is not stationary; it is continuing to evolve to meet changing external demands. Superior private equity investment performance driven by a focus on investing in sustainable company growth through integrated strategic and operational improvements make this asset class well placed to also harness the digital transformation of global economies.

Private Equity: Creating more solutions in the New World

For Investors:
The tool kit to access private equity exposures has grown. Tailoring exposures to funds, direct investments and co-investments allows investors to construct more tailored portfolios, J- curve mitigation and strong fee outcomes.

For companies:
Access to capital over longer time horizons beyond the five-to-seven years currently offered in private equity will enable some businesses to execute a "second stage" of growth under the control of one private equity firm, rather than being sold to a new owner.

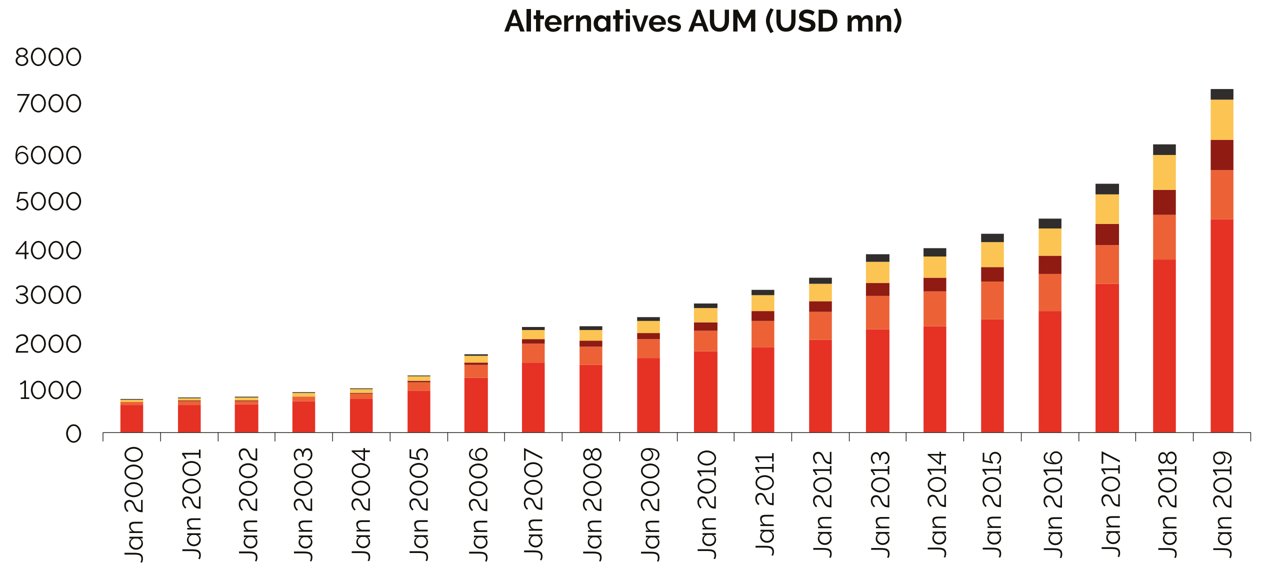


Figure 13: Private Equity AUM has reached record highs of US$4.5tn as of December 2019[29]

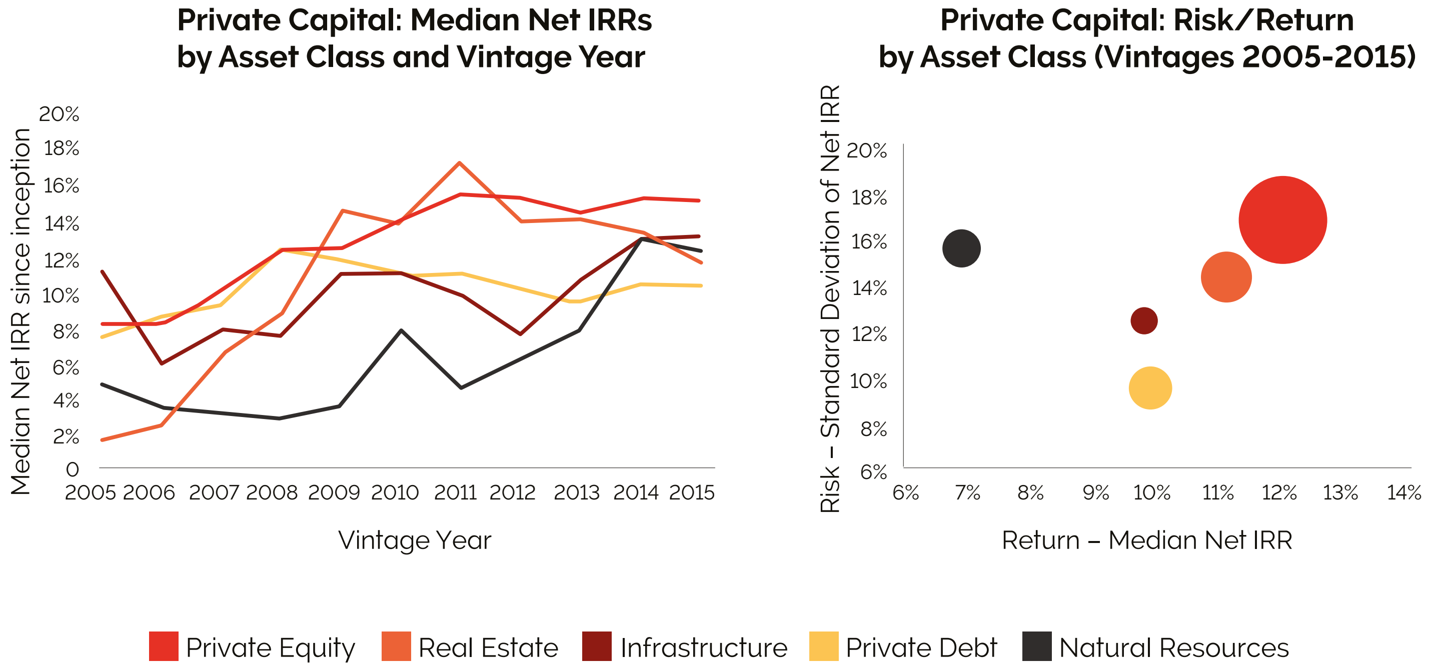


Figure 14: Private equity delivers higher IRR and risk returns when compared with other asset classes[30]
Past performance is not a reliable indicator of future performance.

28 Data from Preqin Pro datapull. Retrieved from: https://pro.preqin.com/analysis/dryPowderAUMBreakdown
29 ibid
30 Borda, J. (May 2019). Private Capital and Hedge Fund Outlook: Where are we Now? What does the Future Hold? Retrieved from: https://www.preqin.com/DownloadInterim.aspx?d=https%3a%2f%2fdocs.preqin.com%2fpresentations%2fConnex-Investor-Sector-Meeting-May-19-JBO.pptx

Private Equity: A leader in constant motion – continued

1 Co-investments: A new "norm" for modern private equity portfolios

In our recent article – *Are we near the turning point? Implications for private equity investing* – we noted the pick-up in co-investment activity. Investors can benefit from the alignment between the asset and the manager's expertise and an active two-way relationship between the investor and manager. We believe the knowledge transfer between the three parties can be mutually beneficial, and in some instances, help investors integrate other company strategies from learnings gleaned.

There is a word of caution however: While co-investments have their place in private equity allocations, investors should be aware of a drive-for-fee minimisation that may not result in net-return maximisation.

2 Secondaries: Accessing a rising, sophisticated market

The private equity secondary market is now a deep and active channel through which institutional investors buy and sell their private equity exposures. Over the last two decade, the secondaries market transitioned from a nascent cottage industry to a sophisticated, large market with US$77bn raised in private equity fund and direct secondaries in 2019.[31] This provides institutional investors with greater flexibility and liquidity than ever before. Secondary funds, followed by funds of funds and then pension accounts, were the most active buyers. General Partners (GPs) and pension funds were the most active sellers, making up 24.5% and 22.7% of the volume, respectively.[32]

The secondary market is now a strong force, prolonging the time companies remain in private equity hands and is proving to be a dominant force over longer-dated vehicles seeking capital.

31 Setter Capital Volume Report FY 2019
32 Setter Capital Volume Report FY 2019

The advantage of secondaries markets is they build exposures, manage cost, balance portfolio and achieve liquidity across cycles, including the current market dislocations being experienced due to COVID-19. They are also offering companies the ability to be held by private equity for longer than the typical five to seven years – which leads into our final key theme.....

3 The rise of longer investment horizons

While historically private equity tended to offer three to seven-year time frames, over the last several years we have seen a growth in longer-dated funds that hold companies for longer periods and continue to facilitate their growth through different maturity stages. However, more recently the desire from companies to have longer dated financing has benefited more from the rise of the secondary market than necessarily needing to be locked into ten to fifteen-year vehicles.

So now we are seeing companies mature from an early stage of growth to their next phase and potentially stay with the same GP but move into a different vehicle with a slightly lower risk profile. The active management and patience that private equity offers still has value to bestow on the company – but at a different phase of its growth. The rise of the secondary market has significantly influenced and facilitated this trend of "continuation" or "follow-on" vehicles.

As private equity continues to cast a longer shadow over investment horizons, a perception is arising of the melding between this asset classes, and others, especially infrastructure. This is particularly the case in sectors such as technology infrastructure, like data centres, and healthcare assets; where long-term supply dynamics support long-term capital for businesses which have achieved a relevant scale and sophistication. However, investors should note that the returns targeted in the longer-dated funds are lower than the current private equity strategies and structures.

Private Equity: A leader in constant motion – continued

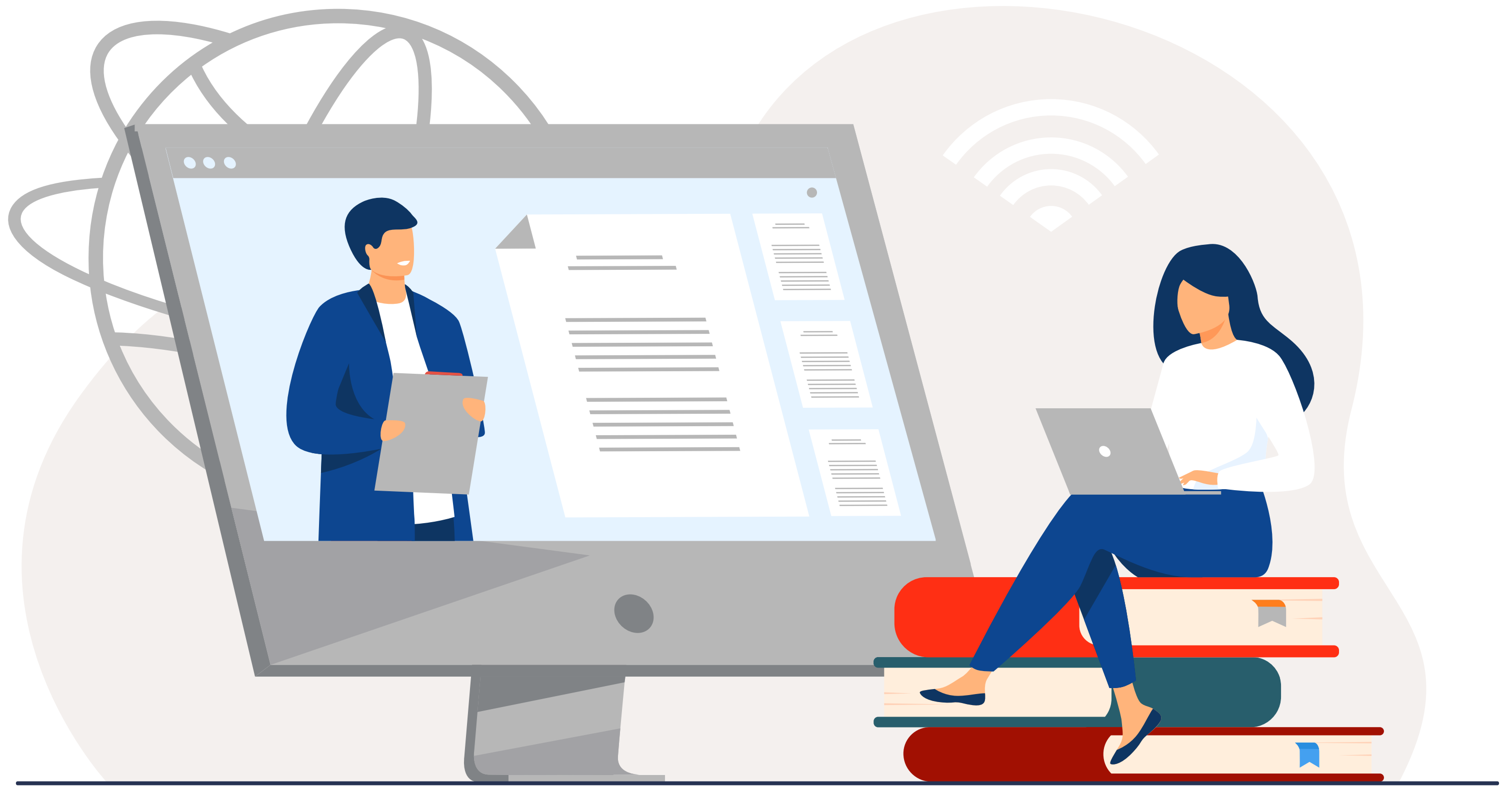
Case study: Digital platforms revolutionising how we live, work and play

euNetworks is a leading European provider of bandwidth infrastructure services, including metro and long-haul fibre assets, and data centre facilities. In 2014, QIC co-invested into eunetworks. Since that time, the co-investment partnership has enabled eunetworks to significantly expand to 51 cities across 15 European countries, and evolve into an in-demand piece of digital infrastructure.

The demand for this capability has been on show during COVID-19, when extensive lockdowns saw telecommunication companies register a surge in traffic. This spike, also prompted Telecom Italia Chief Executive Officer Luigi Gubitosi to note: “We reported an increase of more than 70% of internet traffic over our landline network, with a big contribution from online gaming such as Fortnite.”[33]

Fortnite and other digital platforms which rely on bandwidth infrastructure services, are reaping the benefits of a ‘lock-down’ economy, spurring new on-line business models. For instance, when music festival Coachella cancelled its 2020 event, Fortnite stepped in to provide a digital, live performance experience for headliner, rapper Travis Scott. The performer drew the biggest live audience in the game’s history in April 2020, with 12.3 million viewers tuning in for his 15-minute set.[34] Following the event’s success, additional ‘tour dates’ have been set.

Epic Games is an American video game and software developer which developed Unreal Engine, a commercially available game engine which powers video games such as Fortnite. Epic Games and euNetworks are both companies that have benefited from the patience, active management and considered investment that private equity GPs and LPs have to offer.

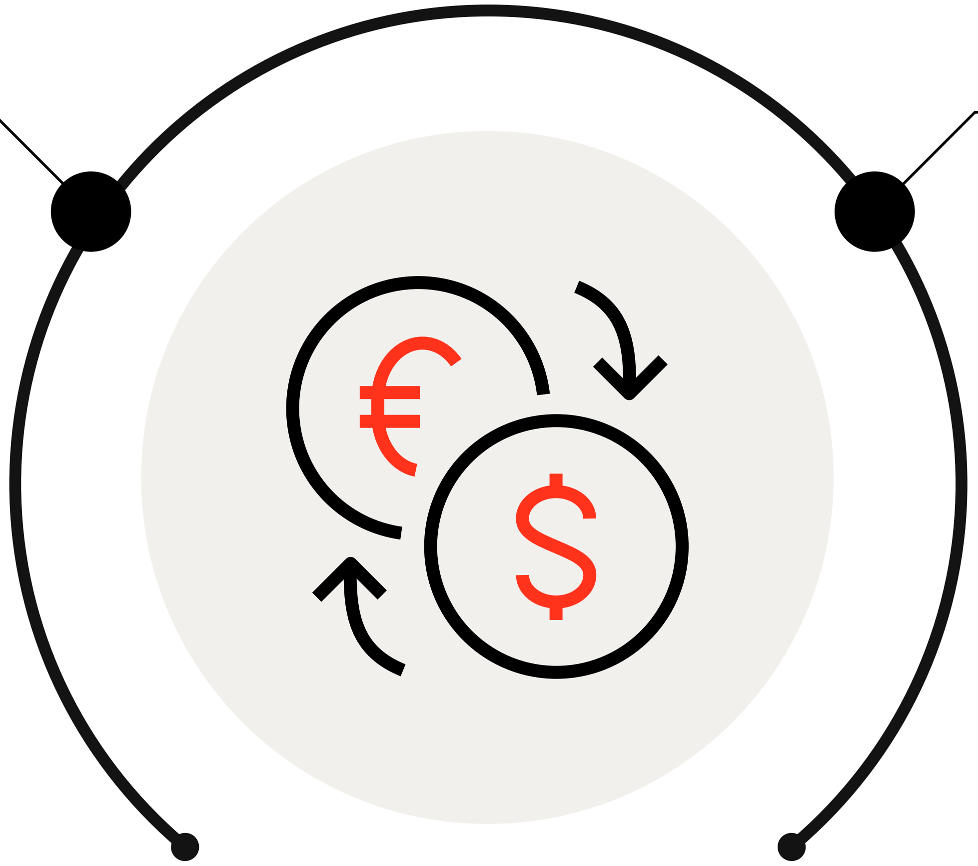


33 https://www.cnet.com/news/coronavirus-has-a-lot-of-people-playing-fortnite-and-watching-twitch/
34 https://variety.com/2020/digital/news/travis-scott-fortnite-record-viewers-live-1234589033/

Fixed Income: An alternative take for a traditional class

OLD WORLD

- Issuer-determined benchmarks
- Clear Emerging Market (EM) v Developed Market (DM) divide
- Broad symmetry in yield moves higher and lower



NEW WORLD

- Tailored benchmarks offer more downside protection
- The rise of China bond market straddling the EM and DM divide
- Asymmetry in yield moves as we near the zero lower-bound
- Income is the new defence

Contacts

Fixed Income: An alternative take for a traditional class – continued

When the U.S. yield curve inverted in 2019 for the first time this cycle, it once again spurred debate as to the arrival of the long-predicted recession.

Then COVID-19 turned that uncertainty into a reality for economies across the globe. In this era of uncertainty, defensiveness reigns supreme while investors move from aggregated products to embracing more clearly understood allocations at the asset class level.

Traditional fixed income usually acts as ballast within this environment. It is a diverse asset class which provides investors with opportunities across the full market cycle and is capable of supplying the 'building blocks' necessary for creating bespoke return and defensive characteristics for individual portfolios. Typically, core fixed income products include treasury bonds and bills, municipal bonds, corporate bonds and certificates of deposit.

But the traditional anchor of a defensive portfolio – the government bond – is under question as headlines dominated by global low interest-rates in a post-COVID environment are leading investors to question their effectiveness as a shield against an equity market downturn. Adding complexity and further doubt to government bonds' selling points are the negative yields being experienced across the world's largest bond markets, including the U.S. Over 20 per cent of bonds now trade with negative yields which is more than three times the amount that existed just over a year ago.[35]

These fixed income benchmarks also highlight the evolution occurring in this asset class [See below case study: Jettisoning the negative yield from traditional benchmarks] as well as the rise of a new form of defence.

Income is the new defence

In our recent paper – *Income is the New Defence* – we signalled a strengthened focus on income will be a crucial element for investment strategies aimed at delivering strong, risk-adjusted returns.

As stated above, fixed income's traditional defensive role has been jettisoned. Yet, the compounding power of interest income has led income to become increasingly important for enhancing defensiveness strategies.

The choice to boost income is more nuanced than simply a choice to increase investment maturity or to move blindly up the risk spectrum. The ideal solution should not be complex, employ excessive leverage, be illiquid or expensive. An income solution will need to focus on the production of income objectives with a greater degree of predictability which means giving up some of the upside, to avoid downside risks.

"One year ago, an investor with A$1 million allocated to a cash fund would receive an income of A$10,000 per year. Today, that A$1 million allocation would only return A$1,000 per year."

35 Barclays (27 July, 2020) based on Bloomberg Global Aggregate Index

Fixed Income: An alternative take for a traditional class – continued

An investor checklist for Income

Investors who are seeking to improve their income prospects in the coming years need to focus on their income predictability, positive returns, with low volatility and low drawdowns.

- Have skilled, detailed and robust credit analysis to "pick the winners"
- Have short-term maturity to protect from sharply higher moves in yields
- Focus on a diversified portfolio of high-quality bonds producing interest income in a predictable and repeatable approach
- Identification of robust scenario analysis hedges to dampen volatility
- Strong focus on a nimble approach to remain liquid and flexible

Case Study:

Jettisoning the negative yield from traditional benchmarks

A typical issuer-weighted global government bond index gives countries that issue the most debt, larger weightings.

This means that investors may be unwittingly allocating significant proportions of their capital to investments with not only a poor expected return, but also may be left feeling underwhelmed by the defensive performance during the next downturn. If a particular country has a monetary policy setting near the lower bound, the ability for its bonds to significantly rally and provide protection to a portfolio during an equity market downturn is questionable.

Noting this, we believe it is time to question the appropriateness of traditional passive fixed income investing with issuer-determined benchmarks.

Continued over >

Following these benchmarks closely means tilting towards countries with large amounts of outstanding debt and thus potentially giving up more defensive positions that can protect portfolios in an equity downturn or offer more attractive carry in stable times.

The Barclays Global Aggregate Bond benchmark highlights the predominance of the U.S. and Japan, reflecting their place as two of the largest issuers of sovereign bonds. Japanese bonds comprise about 40% of the Bloomberg negative yield bonds in the index. Further, with the official interest rate held at-0.10 per cent since January 2016, the ability for bonds to rally in equity market downturns is stunted. Even in the U.S during the COVID-19 market panic of March 2020, longer dated bonds' ability to serve as a liquidity instrument over-ruled their traditional defensiveness benefits. Investors looked to sell Treasuries to finance redemptions and margin calls during the peak stress period. Bonds later rallied but their volatility is diminishing from where it was in previous crises as central banks have essentially anchored the front end of the curve for a lot longer, and the bank end is dampened by Quantitative Easing (QE) buying.

It would be bold to claim that this lower volatility is a permanent feature of the bond market and we are cognisant that consensus views can be the most painful – but for now, achieving defensiveness from bonds is challenged.

What this tells investors is that the weighting of this benchmark gives no consideration to characteristics investors are looking for– an important flaw of benchmarks in the fixed income universe. In the past when yields were high, this 'oversight' mattered less. But in the New World where bond yields are approaching historic lows, there are greater limits to bond price appreciation. This has also reduced the ability of 'traditional' bond allocation to play the role of shock absorber in a multi-sector portfolio.

By unpacking the global sovereign bond universe and identifying the key characteristics that individual investors value most, investors can be more confident their bond portfolio will not only perform as expected, but that it will also deliver a better return over the medium term. For example, some investors may value the defensive qualities of bonds above all else; some will seek to maximise yields, while others still may have a strong focus on ESG considerations. Different sovereigns can rank very differently on all measures.

Unshackling investors from traditional index rules can ensure a stronger outcome.

Alternatively, removing the drag from negative yielding assets can be done in other ways. Derivative overlays and smart currency management can change the composition of the physical investments and can be a timely and cost-effective solution to simply achieve investment goals. For example, the actual return on negative yielding Japanese Government Bonds can be attractive for AUD-based investors if the FX basis is attractive.

Moving away from traditional indices has been especially evident in the recent moves in the China Bond Market – the world's second largest – where regulators have advanced their commitment to open their country's financial system and eased access for foreign investors.

These policies, combined with the sheer size of the Chinese capital market, is to too big to ignore and has resulted in Bloomberg Barclays including Chinese Bonds in its Global Indices. The inclusion of China Bonds in the mainstream fixed interest benchmarks offers significant opportunities for all stakeholders, investors and governments alike.

Conclusion: Setting Sail for the New World

Conclusion: Setting Sail for the New World

The New World is one filled with a wide array of new risk and return parameters for institutional investors.

This paper has identified opportunities across the following horizons:

Space	Opportunity	Example
Across	In this low-return environment besieged by COVID-19, whole of portfolio management tools have heightened in importance and include: 1. Both direct and indirect options to protect for equity downside risk while also potentially to allow for more asymmetric upside risk. 2. Strategic management of currency risk. 3. Systematic Strategic Asset Allocation (SAA) rebalancing. Even the traditional approach to asset allocation, SAA, is coming under microscope as a growing number of investors move further towards TPA to extract value in the New World.	Foreign currency exposure is an indirect hedge which can provide defensiveness while one nimble and cost-effective risk-managed rebalancing tool for SAA are derivatives.
Between	White Space opportunities may either take the form of a new asset which crosses the boundaries of traditional allocations; or take the form of a pool of capital that can be deployed to capture those opportunities which fall between the cracks of traditional definitions. With the right navigator beside them, institutional investors can then set sail for the New World and capture the opportunities on offer.	Agricultural sector The Australian agricultural sector is an emerging asset class with high potential.
Within	1. **Infrastructure** – Investors can harness the rise of growth-orientated infrastructure assets which are achieving greater value and outperformance through active management and business planning.	Core-plus infrastructure assets will play a new, key role in delivering essential services in a COVID-19 economy and delivering value to investors.
	2. **Real Estate** – Assets within this class are embracing a greater spectrum of specialisation to secure returns. By adopting active management and technological advantages, the real estate sector is transforming itself from being regarded as place makers to becoming access providers and in doing so, continue to generate strong returns for investors.	Retail portfolios adapting to town-centre and master-planning approaches will have additional resilience, especially in a socially-distanced COVID-19 world.
	3. **Private Equity** – Active managers who are able to create high-impact operational improvements and strategic M&As will continue to generate returns.	Investors can also benefit from the rise of co-investments and secondaries.
	4. **Fixed Income** – New benchmarks and new markets ensure this traditional asset class keeps afloat with the structural changes to the economy, which have occurred more rapidly in the aftermath of COVID-19, while also providing greater protection and opportunity for investors.	Tailoring fixed income allocation to focus on defensive income will offer portfolios greater predictability.

Contacts

Before setting sail for the New World in search of these opportunities, we believe institutional investors should also prepare by considering the following:

1. The key to capturing the above opportunities lays with choosing a partner who has extensive expertise in active management and is able to set a bespoke course along an investor’s risk spectrum. With the right navigator beside them, institutional investors can capture the opportunities on offer.
2. Understand the need for agility in adjusting investment strategies to account for a New World in which COVID-19 and other headwinds, have steered portfolios off their traditional 60/40 course.
3. Have an open mind to asset classifications and judge opportunities on “their merit” to secure the untapped potential that the White Space is presenting.
4. With the unfolding economic and financial storm, find a partner who has a broad scope of capabilities and is able to scan for untapped growth opportunities while also combining various instruments and assets to provide defensiveness.

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