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AUSTRALIAN SUPERANNUATION FUNDS IN ALTERNATIVES

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INTRODUCTION – FINDING THE BALANCE IN DIVERSIFICATION

Famed American stock investor Philip Arthur Fisher once said: “Investors have been so oversold on diversification that fear of having too many eggs in one basket has caused them to put far too little into companies they thoroughly know and far too much in others which they know nothing about.”

In a similar vein, one of if not the most famous investor of our times, Warren Buffet, said wide diversification is only required when investors do not understand what they are doing.

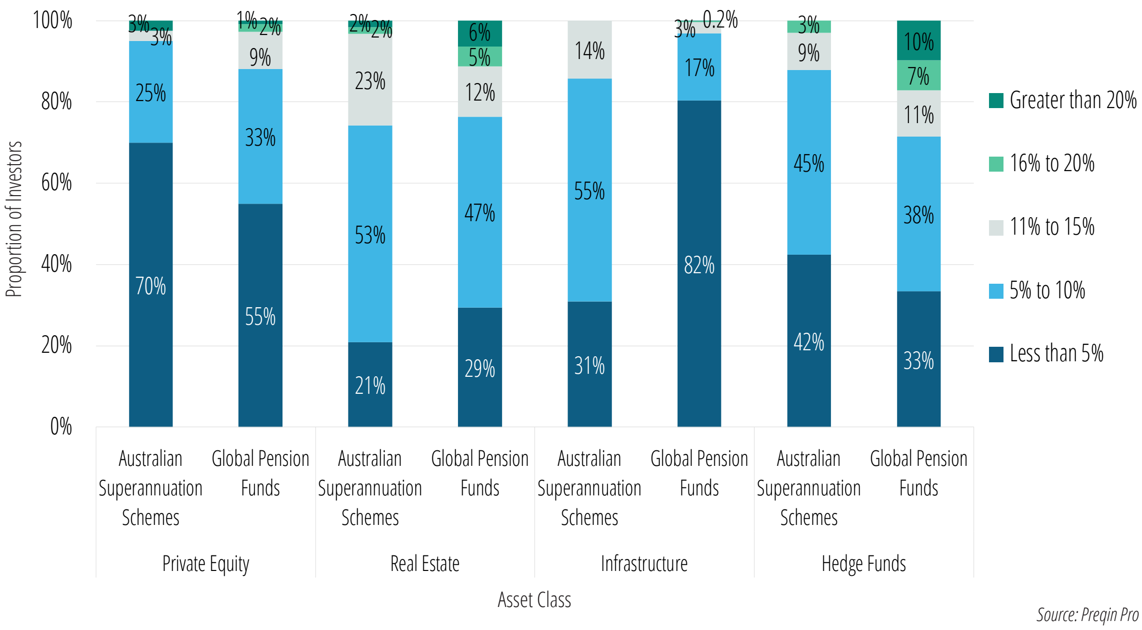
Australian superannuation schemes know what they are doing.

Since the 2008 Global Financial Crisis (GFC), Australian superannuation schemes have experienced median year-on-year growth of approximately 12% in assets under management (AUM), off the back of one of the largest bull markets in history, mainly driven by strong domestic and global equity growth. The AUD 2.7tn industry has been a global market leader in terms of allocations to some alternative asset classes, particularly infrastructure.

Superannuation funds in Australia seem to have heeded the wise advice of Fisher and Buffet, with substantially larger allocations to real assets and domestic listed equities relative to global pension funds – the strategy of less diversification has worked tremendously well for them post-GFC. But the underlying economic climate is changing: the equity cycle approaches a peak, asset prices and valuations everywhere are pricey, and interest rates are unlikely to stay low. Managing asset liability and inflation while delivering good returns to trustees will mean that superannuation funds will have to diversify more in the years ahead. And most of them have already set off down that path.

HISTORICAL PREFERENCE FOR REAL ASSETS, DOMESTIC EQUITIES

Fig. 1: Current Allocations to Alternative Assets by Asset Class: Australian Superannuation Schemes vs. Global Pension Funds (As a % of Total Assets)



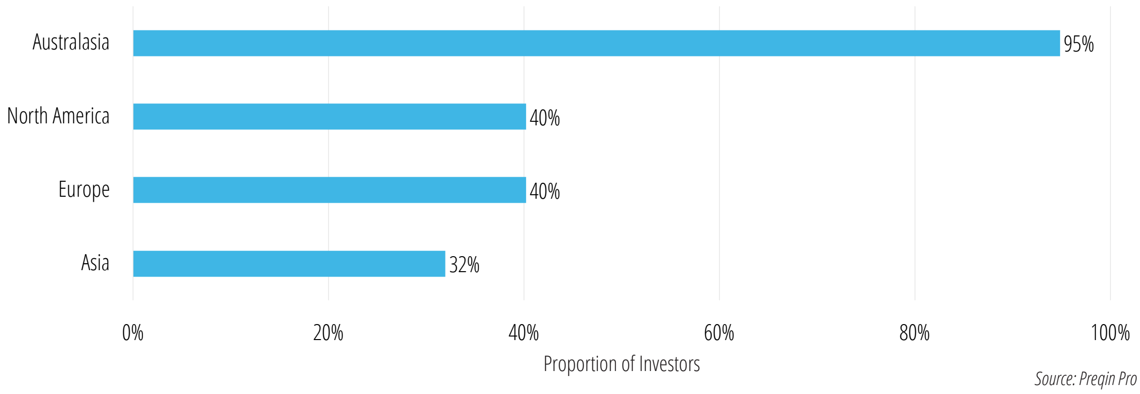
Source: Preqin Pro

According to the latest quarterly statistics released by the Association of Superannuation Funds of Australia (ASFA), superannuation schemes allocate 47% of total assets to Australian and international equities, 21% to fixed interest, 10% to cash and 3% to listed property. This leaves only 19% to be allocated across various alternative asset classes, such as private equity, hedge funds, unlisted real assets and private debt.

Australian superannuation schemes' allocations have traditionally tilted towards real assets. As Preqin data illustrates in Fig. 1, a larger proportion of superannuation schemes allocate less than 5% to private equity and hedge funds, as compared to global pension funds. Naturally, a smaller proportion of superannuation schemes allocate between 5% and 10% to these asset classes compared with global pension funds. In contrast, asset classes such as real estate and infrastructure have a different experience: a larger proportion of superannuation schemes allocate between 5% and 10%, as well as between 11% and 15%, as compared to their global counterparts.

REAL ESTATE: A NATION OF PROPERTY OWNERS

Fig. 2: Regional Preferences of Australian Superannuation Schemes Investing in Real Estate



Source: Preqin Pro

"Australians simply love property" is a sentiment echoed by both superannuation schemes and their consultants alike. The dominant culture of home ownership, in part supported by risks from shorter-term rent contract durations, has greatly influenced how superannuation funds look to approach real estate going forward.

Despite the prevalent view among superannuation funds that property asset prices in real estate are currently artificially inflated, the majority are reluctant to reduce their allocation to the asset class. Many are heavily entrenched in the industry and locked into longer-term positions in property, which means investors are forced to accept the illiquidity, costs and premium that accompany the rewards.

Much of the Australian superannuation industry's real estate portfolio reflects a domestic bias, attributed to factors such as tax breaks, capital gains shelter and acting as a tax haven for investors. Assets and investment managers are easier to manage domestically, and investors do not have to fret about managing currency risk.

In line with this view, Preqin data finds that Australian superannuation funds that invest across various fund types strongly favour domestic opportunities (as recorded by 95%), while 40% look at North America and Europe, and 32% target Asia (Fig. 2).

Many investors would happily take on the risks of a higher-than-average domestic real estate allocation, given that real estate investments in the past decade have paid off handsomely.

In April 2009, the Reserve Bank of Australia (RBA) slashed its cash rate to 3%, and again in August 2016 to 1.5%. Such an environment of cheap lending has provided sizeable returns to Australian superannuation funds active in real estate and lifted core property prices in the past decade, lining the pockets of those investors that got in early. Testament to that fact, one superannuation fund said that the proportion of capital-driven growth in its real estate portfolio had doubled from 25% to 50% in the past year.

The Australian superannuation industry is definitely overweight; everyone has to go global at some point.

– Australian superannuation fund

Despite lofty outright prices, superannuation funds still view real estate as a reasonable hedge against inflation. Expected returns for the asset class range between 6% and 7% for most superannuation funds, above the current inflation of around 2%, a figure that is expected to increase in 2019 and 2020. However, real estate returns are not looking nearly as good as a decade ago, when figures hovered in the low teens, especially when there is capital rate compression in the market, as market participants have said. Weighted average cap rates for non-residential direct property sectors – including office, retail and industrial – have fallen from approximately 7.4% in March 2009 to around 5.5% in March 2018.

To negate dwindling returns from real estate, some superannuation funds are increasingly looking to shorter-duration assets to form part of their future portfolio plans. Conscious that the asset class has stronger correlations to macroeconomic and systematic risks, a small number of superannuation funds also plan to reduce their exposure to real estate, by curtailing a previously targeted approach towards real estate managers.

A small handful of Australian superannuation funds expressed concerns that their property portfolios are not geographically diversified enough, leaving them too exposed to the domestic market. Among these funds, one mentioned that “going global is a necessity; every second investment we make is with an overseas fund manager. We have seen the push for a global focus across real estate as well.”

Consultants forecast that over the next few years, superannuation funds will increasingly be diversifying away from the domestic scene and moving investments offshore.

Still, no one will be significantly reducing their allocation to the asset class lest they shoot themselves in the foot. “No one will be very proactive to sell those assets,” commented one industry fund.

WHEN THE PRICE IS RIGHT

Alternative structures like co-investments, joint ventures and separate accounts are gaining more prominence in serving as differentiated and cost-efficient vehicles through which superannuation funds can sink their teeth into real estate investments. "Co-investments will take off, especially as they reduce fees, and if you have faith in the managers who have done the work, it is hard to make the case that co-investing will not work, taking into account fees – it's all or nothing," commented one industry fund.

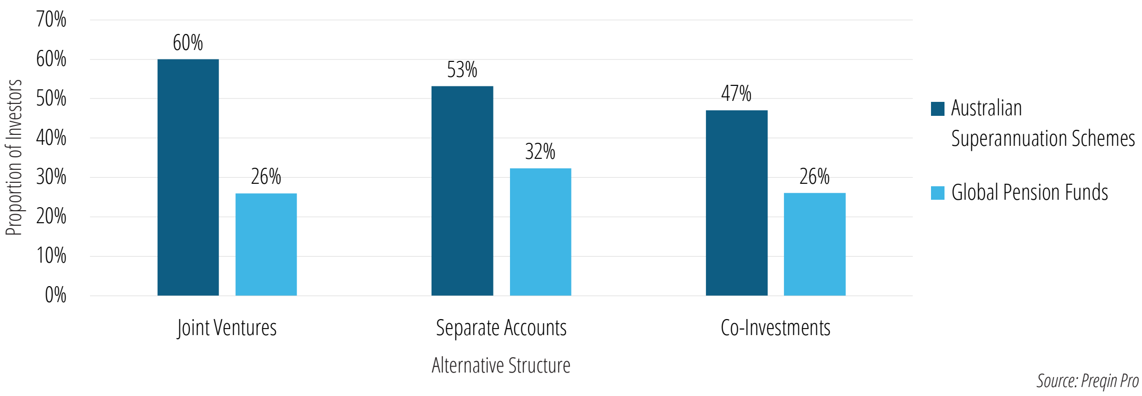
> **Fees are always a concern, but there are ways to mitigate this. Through co-investments, going direct, more joint ventures and separate accounts.**
>
> *– Australian superannuation fund*

Preqin data supports this sentiment; Fig. 3 shows that Australian superannuation funds are far more active in these alternative structures than global pension funds.

Additionally, other forms of property – such as medical, healthcare, storage, business parks and retirement villages, collectively known as alternative property – can prove to have core asset characteristics while providing another avenue for diversification within the asset class.

Despite these growth pockets, macro headwinds such as credit tightening may prove challenging for superannuation schemes looking at real estate investments. Core and core-plus strategies have traditionally been the mainstream approach for most superannuation funds; however, some investors may soon be priced out of these "safer strategies", pushing them towards riskier strategies, such as value-added, opportunistic and debt fund types.

Fig. 3: Appetite for Alternative Structures: Australian Superannuation Schemes vs. Global Pension Funds



Source: Preqin Pro

It's hard to find reasonable prices, but we try to diversify within the asset class itself where possible.

– Australian superannuation fund

The latest Preqin data is also picking up similar signals: 58% of Australian superannuation schemes prefer opportunistic strategies (Fig. 4), while 59% and 37% look to value-added and debt strategies, two fund types that have attracted significantly greater interest among superannuation funds since 2013.

We are comfortable with where we are at the moment. Core is expensive now, especially in Sydney; therefore, we could be doing more value-added and debt strategies in real estate.

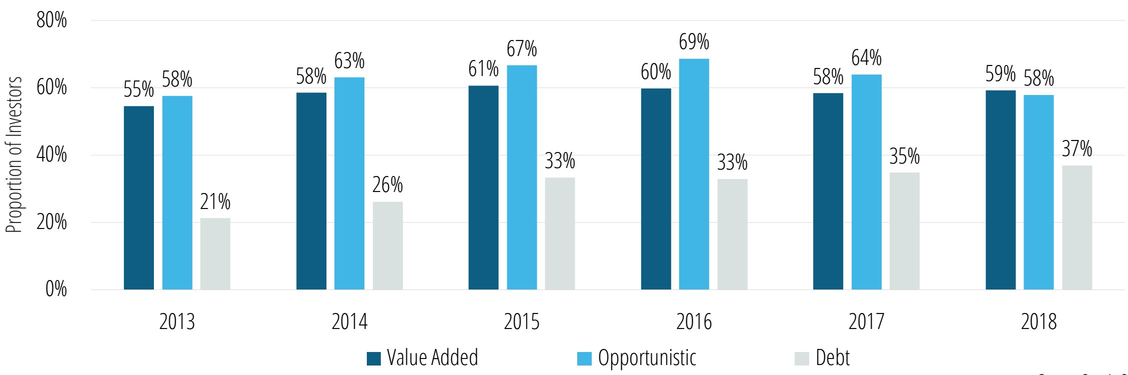
– Australian superannuation fund

WAIT AND SEE

The consensus among most superannuation funds is to maintain a cautious outlook on real estate going forwards. While returns in property may not prove as strong in a rising interest rate environment, in a climate where all assets look overpriced, several superannuation funds conclude that the returns on real estate still look relatively attractive on a yield basis. The investments in the sector henceforth are easier to justify, given that the asset class has a history of stronger returns, and so funds are thus willing to sit on their current allocation.

"It is an asset class that has a proven track record of having a strong income return component," said one superannuation fund.

Fig. 4: Australian Superannuation Schemes Active in Real Estate by Strategy, 2013 - 2018



Source: Preqin Pro

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FIND FUTURE WINNERS
View all funds open to investment globally. Drill down to details using filters and customizable searches to find the best opportunities for your firm.

BENCHMARK PORTFOLIOS.
Benchmark funds and your current investments against the largest dataset of fund returns available to achieve a new understanding of your investment performance.

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Equip yourself before meetings and due diligence efforts with access to comprehensive fund manager profiles, track records, holdings, deal activity, lead partners and more.

TAKE THE NEXT STEP.
Access detailed information on privately held companies and assets, and identify potential direct acquisition opportunities.

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Understand the past, present and future of the industry. Interactive visual analytics harness data to make sense of your place in the market, your peers and potential.

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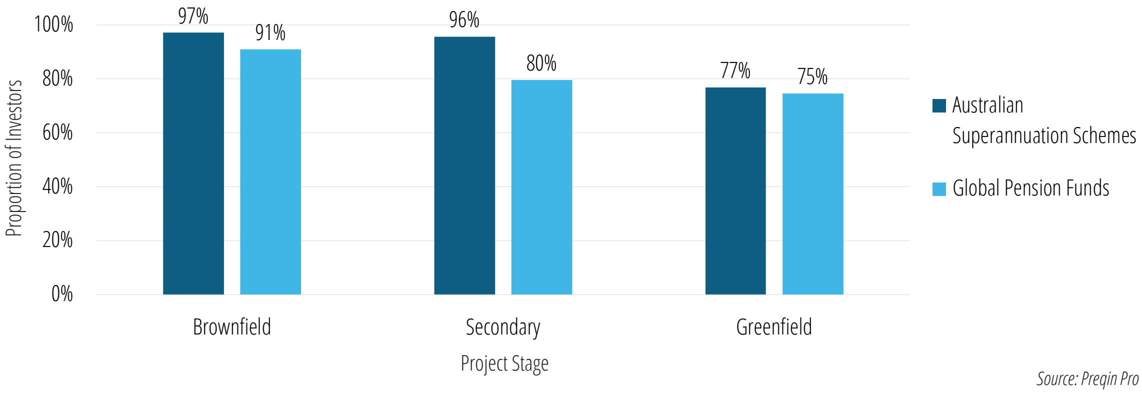
- **Private Equity**
- **Venture Capital**
- **Real Estate**
- **Hedge Funds**
- **Infrastructure**
- **Private Debt**
- **Natural Resources**

Firms	Funds	Open Funds
34,600+	**63,000+**	**22,600+**
Investors Monitored	Funds with Performance	Deals & Exits
17,300+	**29,500+**	**358,800+**

INFRASTRUCTURE: THE MAGIC ASSET

Fig. 5: Project Stage Preferences of Investors in Infrastructure: Australian Superannuation Schemes vs. Global Pension Funds



Source: Preqin Pro

Everyone wants to get their hands on infrastructure. But not everyone can. Good assets are few and far between and where available, snapped up like hot cakes. Compared to other asset classes like private equity, venture capital or hedge funds, infrastructure assets provide lower risks and stable, attractive returns. For larger superannuation funds, the added benefits associated with ease of access and management of infrastructure assets make it the magic asset to which everyone wants to increase their allocation.

Infrastructure development has been a core focus of the Australian Government, and has played a critical role in shaping public policy as well. Australia's robust economy and transparent business environment creates an ideal climate for many firms to finance, construct and manage major infrastructure assets. Australian superannuation schemes in particular have led the world on infrastructure investments, and have had great success in the asset class over the past 20 years.

Australian superannuation schemes look to infrastructure as a source of stable returns, given that the asset class is defensive and income-generating in nature for most superannuation funds' investment portfolios. Core infrastructure assets are predominantly favoured among the industry, and Preqin data supports that view. Fig. 5 shows that Australian superannuation schemes have a greater preference for brownfield (97%) and secondary (96%) investments than their global pension fund counterparts.

> **There are only so many highways and bridges lying around.**
>
> *– Australian superannuation fund*

The case for infrastructure can also be made when superannuation funds elect to seek out co-investment opportunities and separate account mandates as avenues for fee reduction. Therefore, in the event that Australian interest rates rise, returns can ideally be sustained at current levels.

It's changing for sure. You can't directly invest in infrastructure, but together with a manager, or teaming up with other Supers, going direct, it is more possible.

– Australian superannuation fund

An industry fund commented on the changing infrastructure investment landscape, whereby investments are more accessible when a fund teams up with a manager or other superannuation schemes, or by going direct if possible. Consultants note that the average number of co-investment mandates has been rising in the industry.

Fund size determination is one of the key considerations for Australian superannuation funds regarding infrastructure. Among the superannuation schemes Preqin interviewed, a good proportion cited that a substantial amount of "buy-in" capital is required to invest in infrastructure to see any material returns on their overall portfolio. "Infrastructure is attractive for Supers due to their large fund size, hence, better opportunities for higher returns," said one. "Additionally, it also has a fee structure which is suitable for most superannuation fund structures in Australia."

As the Australian superannuation industry experiences more consolidation, fund sizes will increase, making infrastructure investments more viable for smaller funds that could not previously access the asset class, which can ultimately benefit their members' retirement portfolio in the long term. One superannuation fund Preqin spoke to said that "we think there are good-quality assets, and we allocate a reasonable sum into infrastructure via a consortium."

Patience is the name of the game when it comes to investing in infrastructure, as it is an asset class that needs to be invested in through market cycles. "Liquidity is not so much an issue, because we take a long-term view with core infrastructure," said the superannuation scheme. However, one key concern expressed by other superannuation funds interviewed by Preqin was that the number of infrastructure assets is limited, and therefore the opportunities to gain access to premium portfolios are scarce.

Secondary markets offer an alternative solution to circumvent this, by allowing superannuation funds to purchase fund stakes that are already between mid-to-late cycle phases. However, gaining access to those secondary markets is not cheap either. Superannuation funds are not sure it is worthwhile. Asset managers require return hurdles, particularly on infrastructure, to be higher to justify their investment in the asset class. On a similar note, one industry fund observed that skilled infrastructure managers are few and far between, but as it tends to be a simpler asset to manage, investors are more likely to establish separate mandates with their fund managers or bring that capability in house and invest directly in the asset class.

Although Australian superannuation schemes have been investing in infrastructure for the past two decades, industry funds and consultants alike still consider infrastructure a relatively new asset class for the superannuation industry, and most investors still see room for growth. "Australian Supers are way more progressed than [those in the] US and EU; no one is looking to reduce their infrastructure allocation. We are less optimistic on real estate than infrastructure," commented an asset consultant.

But while superannuation funds maintain a bullish outlook on the asset class, like real estate, views have also become increasingly cautious as historical returns were largely based on a low interest rate environment and easy access to cheap borrowing. Some industry funds are seeing their infrastructure returns gradually decreasing. One asset consultant advised that investing in infrastructure or illiquid assets requires taking a long-term view; it is hard to navigate short-term changes: "You need to take into account inflation, interest and growth rates. From that perspective, infrastructure is mostly a defensive asset and it's a benign outlook on that."

ILLIQUIDITY, TAX BENEFITS DISTORT ALLOCATIONS TO DOMESTIC EQUITIES

The majority of Australian superannuation schemes allocate anywhere between 45% and 70% of their portfolios to listed equites, far higher than global pension funds' average allocation of 20-40%. What is more unusual is that a large proportion of that is weighted towards domestic equities, to such an extent that some superannuation funds are calling it unhealthy and, given the narrow scope of the Australian market, largely unsound.

The argument for equities as a dominant component of superannuation funds' portfolios boils down primarily to two factors: liquidity concerns and tax benefits.

LIQUIDITY CONCERNS TRUMP IN DC MARKET

More than 90% of superannuation schemes are in a defined contribution (DC) structure, which means that, unlike a defined benefit (DB) structure in UK pension funds for example, the monies are less sticky, and superannuation funds need to be wary of ageing member bases and drawdowns far more than others. That feeds a reluctance to go into illiquid assets while putting a premium on liquid assets, and that can act as an access block to diversification, experts say.

"The DC structure is a very important driver for the Australian market," says Geoff Warren, Associate Professor at the Research School of Finance, Actuarial Studies and Statistics, Australian National University. "DC funds have to worry about their funds being taken away while on DB the money is sticky, so therefore you have more capability to take on illiquidity if you want it, but in DC you worry about people taking the money out. Australia is 95% DC market, and that creates a certain wariness."

Experts add that the structural issues impact different types of funds differently. While retail funds are more beholden to liquidity constraints, industry funds are managed as a pool which gives them more scope to hold illiquid assets. As such, equities invariably become more dominant in investor portfolios.

"Property is a much larger asset class, but much of it is tied up and so you cannot get access to it. Infrastructure similarly is tied up, or at least not available in the quantities being sought. So in comparison, equities is an easy asset class to access – it becomes very hard to get your equity exposure down to 20-30%," said Warren.

DEBATABLE BENEFITS OF FRANKING CREDITS

Franking credits, otherwise known also as imputation credits, were first introduced by the Hawk/Keating Government in Australia in 1987. These franking credits essentially allow Australian companies to prevent double taxation of company profits by passing them onto shareholders. These benefits can be used to reduce income tax paid on dividends

> **"Australia needs to be more global today (on equities). There are structural risks in terms of dividend limits, market knowledge and market security; there is a much bigger savings pool today and Australia is at risk of saturating its own market with its savings. Invariably we will have to go global and the more sophisticated Super funds will see that.**
>
> *– Australian superannuation fund*

The trend here has been to make investors happy by paying out high dividends which has discouraged fresh ideas. You wouldn't put Australia at the top of innovation or growth industries and this tax policy has been partly responsible as it has discouraged entrepreneurship. We also need more competition here and are vulnerable to disruption because Australia contains oligopolies across many industries (i.e. banking, supermarkets, airlines) with high pay-out ratios meaning that earnings are not re-invested so that companies have gone ex-growth.

– Bev Durston, Founder and Managing Director, Edgehaven

or be received as a tax refund. And while they are not unique to Australia, they have made material difference in superannuation funds' portfolio allocations to domestic listed equities.

Local academic experts say franking credits invariably lead to a preference for Australian equities and, in some extreme cases, an over-allocation to the asset class.

"They [superannuation funds] get back from the government on average 1.5% every year, and it's essentially a one-way bet on Australian equities," said an industry fund. "To an extent it distorts true performance; you can say equities have less of a reason to come down if Super monies are in them and won't pull out – Australian company valuations are all higher because of superannuations' investments. But whether it is enough to stop it from going into a downturn is to be seen."

A combination of 5-5.5% dividend yield on Australian equities plus a 1.5% franking credit makes it appear foolhardy for investors to pass up. Critics say that risk-adjusted returns – post-tax and post-fees – on domestic equities are not as attractive today as franking credits, broadly, if not at the very least partially, have been priced in the market.

"Australia needs to be more global today (on equities)," said an industry fund. "There are structural risks in terms of dividend limits, market knowledge and market security; there is a much bigger savings pool today and Australia is at risk of saturating its own market with its savings. Invariably we will have to go global and the more sophisticated Super funds will see that."

Franking credits have other unintended consequences, too. Originally devised to prevent double taxation and encourage entrepreneurship in new businesses in the country, the tax policy could have biased the industry away from asset classes like venture capital, other industry participants said.

The impact of the Australian combination of meaningful dividends, high pay-out ratios and imputation credits may be short-sighted as it prevents companies from ploughing their earnings back into innovation, said Bev Durston, Founder and Managing Director of Alternatives advisory firm Edgehaven.

"The trend here has been to make investors happy by paying out high dividends which has discouraged fresh ideas. You wouldn't put Australia at the top of innovation or growth industries and this tax policy has been partly responsible as it has discouraged entrepreneurship," said Durston. "We also need more competition here and are vulnerable to disruption because Australia contains oligopolies across many industries (i.e. banking, supermarkets, airlines) with high pay-out ratios meaning that earnings are not re-invested so that companies have gone ex-growth."

THE ICE ON VENTURE CAPITAL THAWS

Unlike the West and parts of Asia, venture capital (VC) has had a rather cold reception in Australia.

In the past decade, VC has largely been plagued with a poor reputation – lack of success stories, lack of information to make structured decisions comparative to other asset classes, smaller opportunities, and an ecosystem that was not mature enough to support a good level of deal flow, superannuation funds said.

Even offshore, gaining access to more mature VC markets like the US is challenging, and while there are pockets of opportunities in parts of Asia, namely China, manager skill has been found lacking, and selection, rather hit-and-miss. Due diligence on VC investments is also highly intensive.

"Most Supers see more downside to VC than upside; it's not accomplishing the yields and returns that moves the dial in terms of overall returns. Chasing the right talent for it is also difficult," said a superannuation fund.

With the exception of one superannuation fund, industry participants say that there are but a handful of funds that would invest in risk-heavy VC due to limited awareness and a lack of confidence in the sector.

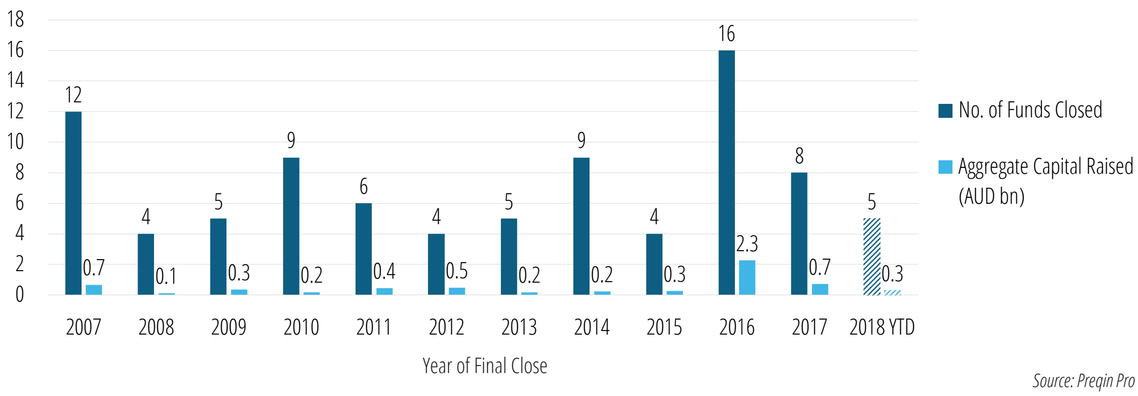
"Going into VC requires a unique mindset," said an industry fund. "It is a very high-risk asset class and you have to be prepared to lose on 7-8 out of 10 bets in the hope that 2-3 of them pay off, and it is oftentimes hard to convince a board that it would be worthwhile."

Consultants say the two largest challenges in VC remain capacity and access.

"If you plan to go into private equity, you need to either have the ability to identify good managers, for which you rely on a consultant or internally, but you also need some in-house capability and a specific skillset," said Geoff Warren. "Still, you might not get access to really good managers, and to be a player in that game you need internal capability and relationships – and not everyone will have that." But there are signs that that is changing.

According to Preqin data (Fig. 6), in 2016, the Australian VC sector hit a historical high in terms of the number of funds closed at 16, while the

Fig. 6: Annual Australia-Based Venture Capital Fundraising, 2007 - 2018 YTD (As at August 2018)



Source: Preqin Pro

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– Australian superannuation fund

aggregate capital raised in that single year of AUD 2.3bn outpaced the cumulative capital raised in the three years prior. And while fundraising in 2017-2018 YTD paled in comparison to 2016, aggregate annual capital raised in 2017 was the second highest total since 2007.

According to Preqin data (Fig. 8), an increasing proportion of Australian superannuation funds recorded a preference for venture capital strategies over the course of 2014 and 2016; however, appetite for such strategies has since plateaued. Indicative of this trend, most funds acknowledge that the scene has changed from a decade ago, but are less certain that the conditions for VC are now, finally, ripe.

Proponents of VC argue that the sector is gaining critical mass and holds a larger role in the overall economy in terms of driving innovation and embracing technological changes – they believe that there is genuine value creation in VC.

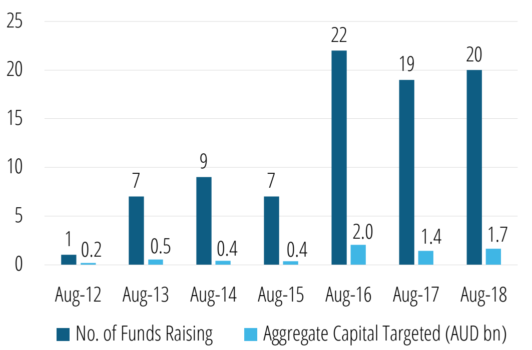
HostPlus, VC's strongest proponent, called for the industry to shift from a "mine boom" to the "mind boom". The Chief Investment Officer told local press at the AIST Super Investment Conference that Australia has to move from a "labour-driven to a cognitive-driven economy."

HostPlus is the largest investor in VC in the country, and has invested $900mn in VC assets, saying there is more to come. Its investments seek to build a VC ecosystem by providing capital to local start-ups that would otherwise uproot and seek capital offshore. HostPlus is working with a number of private equity (PE) and early-stage investment firms, including M.H. Carnegie, Brandon Capital, Siguler Guff, Blackbird Ventures and Carthona Capital.

"PE and VC markets in Australia will go the way of real assets over time; it is just a matter of when," said a superannuation fund.

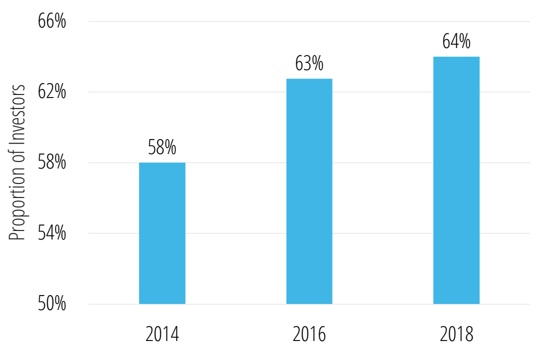
Notwithstanding, VC still has some way to go in winning the hearts and minds of the Australian superannuation industry. Many are still averse and there are doubts over how quickly that change would come. "The power of inertia is one of the strongest forces in Australian Supers," said Troy Rieck, Executive Officer of Investments at EquipSuper.

Fig. 7: Australia-Based Venture Capital Funds in Market over Time, 2012 - 2018 (As at August 2018)



Source: Preqin Pro

Fig. 8: Australian Superannuation Schemes Active in Venture Capital, 2014 - 2018 (As at August 2018)



Source: Preqin Pro

HEDGE FUNDS: LIQUID VEHICLES LEAD THE CHARGE

Liquid alternatives, typically encompassing alternative risk premia (ARP), are gaining momentum worldwide, but perhaps more so in fee-conscious Australia. Preqin data shows that the average management fee for ARP UCITS at 0.99% and ARP hedge funds at 1.23% is substantially lower than the average 1.54% charged by conventional hedge funds (Fig. 9). Additionally, the median redemption frequency for both liquid alternative structures is much lower than the monthly redemption frequency typical of traditional hedge funds. And principally in Australia, voracious investor demand for more liquidity has fuelled acute offerings: 25% of Australia-based hedge funds offer daily liquidity compared with only 3% of the global hedge fund industry.

This is unsurprising given that hedge funds do not enjoy the best reputation in Australia. The promises of a more resilient asset class, in diversifying away from equity risk and providing stable returns in the event of a market downturn, went unfulfilled in the GFC and left bad memories, many of which are still fresh in the minds of several superannuation funds.

"There is a pervasive view in the sector now that fees are too high and their promises are not realistic; we do not have an allocation to hedge funds," said an industry fund.

Nor do they charge the lowest fees. Most hedge funds use a 2/20 compensation structure, charging a flat 2% of total asset value as a management fee and an additional 20% of any profits earned. Hedge fund managers have come under increasing pressure from regulators seeking to tax carried interest more.

Such a fee structure will become a thing of the past, some superannuation schemes say, evolving to a more realistic 1/10 structure. But, fees aside, other industry funds suggest that perhaps it is time to move on in light of renewed enthusiasm for the asset class. Some superannuation funds view hedge funds as a truly differentiated asset class that provides good diversification benefits, especially away from equity risk. Even some of the more conservative superannuation funds have a decently sized allocation to hedge funds, typically split 50% CTA, 35% global macro and 15% volatility strategies.

"We take a long-term view on the market and we see a strong correlation between liquid alternatives and the broad equity market, listed and unlisted," said an industry fund. Similarly, consultants recommend liquid alternatives to their clients to provide downside protection from private equity products, for the broad range of differentiated strategies and for diversification from other private market fund structures.

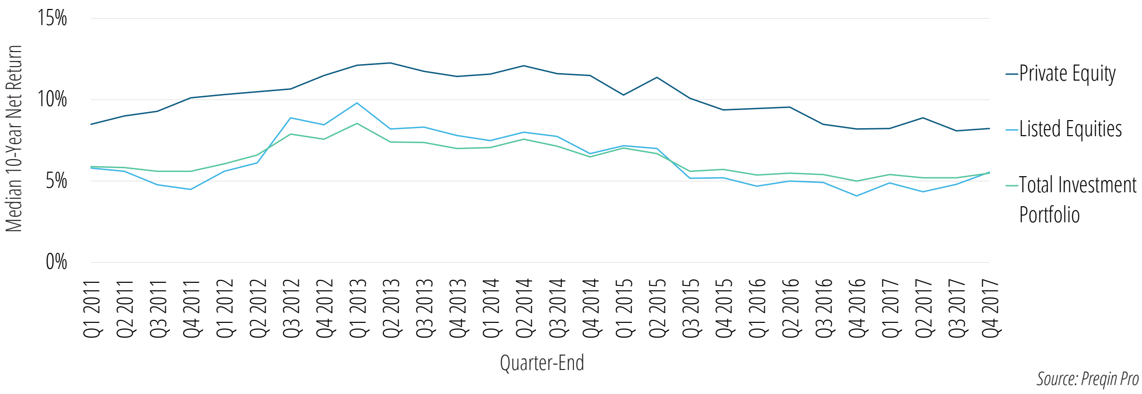
Fig. 9: Terms & Conditions for Alternative Risk Premia vs. All Hedge Funds

Terms & Conditions	Alternative Risk Premia UCITS	Alternative Risk Premia Hedge Funds	All Hedge Funds
Mean Minimum Investment ($)	430,138	1,803,509	2,754,731
Mean Management Fee (%)	0.99	1.23	1.54
Mean Performance Fee (%)	17.12	17.12	19.14
Median Redemption Frequency (Days)	1	30	90
Median Redemption Notice (Days)	1	23	45

Source: Preqin Pro

PRIVATE EQUITY: ONCE BITTEN, TWICE SHY

Fig. 10: Rolling 10-Year Median Public Pension Fund Net Returns: Private Equity vs. Listed Equities and Total Investment Portfolio, 2011 - 2017



Source: Preqin Pro

The Australian superannuation industry's AUM was just short of AUD 1tn in 2008. Ten years on after the GFC, this figure has more than doubled to AUD 2.7tn based on ASFA's latest September 2018 superannuation statistics. The sheer size of the superannuation industry makes them market-movers in any asset class in which they invest.

According to Preqin data, Australian superannuation funds make up 40% of institutional investors in Australia, followed loosely by asset managers (16%), wealth managers (14%), banks/investment banks (9%) and family offices (7%). Superannuation funds are not new to private equity, but since 2008 the asset class has held a very poor reputation alongside hedge funds, having not always delivered what it promised in terms of returns.

Many superannuation funds are visibly still perturbed by what they experienced during the GFC. Illiquidity, sub-par returns, high fees and valuations have not helped. One consultant reported: "PE has had a 10-year bull run, and they tend to get more valuation problems in PE than in real assets. We would be very cautious for anyone going into PE now. Being an intensive asset class, it is paramount to get the strategy right; therefore, if PE investments do not fall within top-quartile performance, you pretty much get the same return as listed equities."

The 2018 Preqin Alternative Assets Performance Monitor analyzed data on 100 global pension funds, which juxtaposed median net returns of their private equity and listed equities portfolios over 10 years and found that private equity on a whole had outperformed listed equities (Fig. 10).

Another industry fund said that with private equity, returns are not necessarily as important as an easy exit: the question often lies in whether the underlying assets can be sold on the market easily. The huge premiums might not be sustainable over the longer term and a 3-5% premium over the listed market needs to be on a continual basis. Another fund agreed that there is genuine value creation and diversification in private equity, but also questioned the ultimate beneficiary of economic returns.

The sharing of returns is not equal to the sharing of risks and responsibilities. PE is expensive, and more weighted towards fund managers than investors.

– Australian superannuation fund

"The sharing of returns is not equal to the sharing of risks and responsibilities. PE is expensive, and more weighted towards fund managers than investors," said an industry fund.

THE JUSTIFICATION IS THE RETURN

Fees are another thorn in their side; one asset manager Preqin spoke to mentioned that fees in private equity are 1.5-2x greater than in real estate and infrastructure, even without performance fees. However, the justification is the return, as another superannuation fund rightly remarked. The 2/20 model may be dated among superannuation funds, but is it not fair if the manager is able to obtain a 15% return? Co-investments offer a reasonable rate of fees, but also require the superannuation fund to have scale and in-house capability to manage the underlying portfolio companies. In that respect, small to mid-sized funds simply do not have the capacity and resources to conduct the due diligence required for private equity fund investments, much less co-investments.

APPROPRIATE DIVERSIFICATION

On a more optimistic note, some superannuation funds do believe that private equity provides good returns and diversification. The trick is to understand the effect vintage years can have on a superannuation fund's portfolio and also to find a manager with a solid track record. To tackle the former, secondary markets offer superannuation funds one way to mitigate the J-curve effect.

One industry fund told Preqin that there has been an overall decline in the performance of listed companies. Comparatively, private equity firms are seen as a way to gain access to mid-market companies, and also to the fastest-growing parts of the economy. In a consolidated industry, the buy-and-hold approach works well, especially when it is most fragmented. A few superannuation funds Preqin interviewed revealed that some of their private equity exposure takes the form of legacy investments which are approximately 10 years old. Therefore, as the funds are in harvesting mode, they may make new private equity fund investments opportunistically going forward.

Nor is private equity merely the reserve of the daring. Another superannuation fund, whose previous portfolio and member base were intrinsically and characteristically conservative, implemented plans to carve out a new private equity program. After conducting a thorough review, the investment team saw that across time, private equity vehicles yield higher returns and have lower volatility, which would serve as a good hedge against a substantial weightage towards listed equities. The program was further streamlined so that it would correlate investments through the different age bands of its members, as opposed to building it around the needs of its average member, giving it flexibility around liquidity.

MID-TO-LARGE SUPERS MOVE AWAY FROM CONSULTANTS

Until recently, some would say consultants held the keys to investing in alternative assets in Australia. The "Big Four" – Willis Towers Watson, Frontier Advisers, JANA and Mercer – were known as the gatekeepers to the industry that had the Midas touch. Superannuation funds relied on consultants to provide independent, objective and shrewd recommendations on the alternatives sector, but now say that this is changing quickly.

"Super funds are growing in knowledge and sophistication," said one fund. "The reliance on consultants will gradually decrease. Consultants work with so many managers and funds, but nothing is really unique, nothing is bespoke."

Most superannuation funds acknowledge there is an over-reliance on consultants in Australia, compared with global pension funds. But while mid- to large-sized superannuation funds focus on building out their own internal teams, with some hiring from within the consultant industry, smaller funds are likely to maintain the status quo. Such funds find they get better fee deals with consultants as their investments are pooled with others' and, as building in-house teams is not as feasible for most of them, can enjoy the relative freedom of having their investments outsourced.

"With consultants, if you are not happy with their performance, you can give them the boot and go elsewhere," said a superannuation fund. "If they are in house, it goes beyond a rational decision – there are far more considerations."

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– Australian superannuation fund

Others seek a happy medium by using a hybrid approach, that is combining internal leadership with external expertise. One mid-sized superannuation fund said that while consultants have strengths in areas like fund manager research, many of them remain quite orthodox in their methods and are slow to innovate. By driving their own strategies, they seek to utilize consultants and niche specialists for their strengths in a synergistic way.

Nevertheless, local experts are saying that that in itself is driving diversification.

"Driven by the underlying assumption that you got the right person to manage your investments, employing different strategies etc., generally in-house management will facilitate more diversification," said Geoff Warren. "[Selection is] capability driven but is often personality related; it allows them to add internal capability and investment teams in Supers are getting larger as a trend, and that will continue to develop."

FEES A PERENNIAL PAIN, UNDER INCREASING PRESSURE

Nobody likes paying fees, and that is especially true in Australia. What was once a collective and persistent moan about fund manager fees has now evolved into a broad-based resistance. Australian superannuation funds and, to an extent, the government are forcing investors to play hardball.

Fees are the main driving force behind increased demand for co-investments and direct investments, industry funds say, even into the secondary market and liquid alternatives. Although there are double-layered fees for secondaries, investors still get an income stream which offsets and negates costs.

RG97 is not a real representation of costs and it distorts perceptions on investing. Super funds should focus on the net benefit to member; the rest causes unnecessary unrest and distorts the cost of investing.

– Australian superannuation fund

"There is so much capital available now, performance fees have to change – at 1.5% it is not worth the money," said one superannuation fund. "All strategies are worthwhile but at that price, no. The theory of 'keeping the lights on' is relative and only applicable for perhaps the first fund, but otherwise it is not necessary and entirely a rip-off."

One would struggle to find an Australian superannuation scheme happy to accept a 2/20 fee structure, and to a degree even the 1/10 fees are being challenged.

Some Australian superannuation funds are shying away from investing with fund managers and think it will invariably force them to re-evaluate their fees. The new fee disclosure regulation for pension funds in Australia, otherwise known as the RG97, has also changed the operating environment significantly. It is likely to accelerate the move to passive investment strategies as pension funds will seek to reduce fees. The focus on transparency and visibility on all costs will mean that fund manager fees come under increasing scrutiny as well, industry funds said.

The RG97 regulation places much emphasis on disclosures, which can lead to additional operational due diligence, transaction costs and reporting costs, a lot of which is not well defined, and there is an ongoing debate as to what should be included. One Australian superannuation fund commented that arbitrary costs are being reflected on their reporting statements, which, to the ill-informed, may treat it as realized costs, painting an inaccurate picture of the actual costs that the superannuation funds have taken on.

As such RG97 can make diversification into alternatives harder, some superannuation funds say, because fee structures have come under so much pressure that even if some of them make sense, managing public perceptions and expectations is twice as difficult as it used to be.

"If you are under pressure for costs to come down, then you cannot invest in asset classes like private equity or hedge funds, however much you want to," said one superannuation fund. "The net result is there is now ridiculous competition and it's all focused on fees and not returns. I have no issue with performance fees because they are meant to incentivize performance."

"RG97 is not a real representation of costs and it distorts perceptions on investing," said another fund. "Super funds should focus on the net benefit to member; the rest causes unnecessary unrest and distorts the cost of investing."

MORE DIVERSIFICATION, MORE OF THE SAME THING?

Australian superannuation schemes agree there is a trend to diversify more into alternative assets in the industry. It is a necessary move against a backdrop of stable-to-higher interest rates, higher risks on equities, lofty valuations and asset prices. But critics also warn against over-diversification and that unique structural characteristics of the superannuation industry might negate the overall effects of diversification.

Some benefits of diversification are illusionary, local experts say, particularly from the perspective of smoothed returns, and question if the underlying economic exposures of different assets are as disparate as they seem.

ILLUSIONARY BENEFITS OF DIVERSIFICATION

Geoff Warren explains that often when funds deal with alternatives they do not see the full spectrum of variation because they do not get revalued often enough, and particularly if measurements are only conducted using short-term data, it can look as if alternatives are really low risk, when it is largely because valuations have not caught up with change.

“Diversification benefits can appear to be much less if calculated using monthly or quarterly data; it also puts unlisted and listed markets out of sync,” explains Warren. “So if property falls, listed property markets fall first and more aggressively, then they rebound. Unlisted property falls later and not by as much, and possibly as the listed market was then rebounding. This gives the impression you are diversified, but you end up in roughly the same place over time.”

Another common view held by some industry experts is that however varied they might appear, every asset is just a combination of macro-exposure like economic growth, inflation or illiquidity.

So if you look at it through that lens, just buying a whole different suit of asset classes does not diversify away the underlying exposure – you are getting similar exposure factors in differing combinations. If you think that you are diversified just because of differing asset labels on the assets, you may be overstating the benefits.

– Geoff Warren, Associate Professor (Research School of Finance, Actuarial Studies and Statistics), Australian National University

“So if you look at it through that lens, just buying a whole different suit of asset classes does not diversify away from the underlying exposure – you are getting similar exposure factors in differing combinations. If you think that you are diversified just because of differing asset labels on the assets, you may be overstating the benefits,” Warren adds.

To superannuation schemes and other investors alike, diversification has to be meaningful, targeted and strategic.

“Yes, more diversification is a good thing for managing equity risk, bond market risk and interest rates, but it is also about asset liability management,” said an industry fund. “You cannot diversify for its own sake, it has also to be an asset liability mix, like how real estate is a good protection against inflation.”

And from an end-user perspective, local experts regard diversity only as a good thing if it leads to genuine competition between providers.

If your alternatives program is not big enough to make a difference to portfolio risks and returns, to hurt if it doesn't work, then you might as well not be in it at all. Diversifying assets should make a material difference to your returns profile, especially when traditional assets and strategies have such low expected returns.

– Troy Rieck, Executive Officer of Investments, EquipSuper

"Otherwise I would call it complexity, and regard it as a negative influence," said Nicholas Morris, Adjunct Professor of La Trobe Law School.

DIVERSIFY NOT JUST TO MANAGE RISK BUT RETURNS

Enthusiasts believe true diversification does not pertain solely to risk management, it also has to drive returns.

"If your alternatives program is not big enough to make a difference to portfolio risks and returns, to hurt if it doesn't work, then you might as well not be in it at all," said Troy Rieck, Executive Officer of Investments at EquipSuper. "Diversifying assets should make a material difference to your returns profile, especially when traditional assets and strategies have such low expected returns."

Non-conventional diversifiers often include assets with low correlation to traditional markets, like re-insurance, increasing cash holdings that give more optionality, acquiring more growth assets and active management. Some superannuation funds have tried to diversify within each asset class with a mix of geographies, industries, managers and strategies. But to start, most superannuation schemes should begin by moving at least 10% of their equities allocations to alternatives.

GO GLOBAL, PLEASE

Local academic experts say that although the Australian superannuation industry can look diverse on the surface, in practice funds are grouped into smaller entities. Morris explains that the providers of various services within the sector – custodians, insurance, master trusts, advisors etc. – are drawn from a limited pool in Australia. Many of the providers with different names in fact share common ownership or are part of larger financial services groups.

In the Journal of Financial Regulation, a paper by Scott Donald and associates titled "Too Connected to Fail: The Regulation of Systemic Risk within Australia's Superannuation System", Donald warns of "the interconnections that bind and constitute the (superannuation) system create and transmit risks with the system, creating the potential for the impact of local failures to amplify through propagation... and undermine the system's resilience to exogenous shock."

There is a growing awareness among consultants, advisors and superannuation funds that they need to adopt a more global investment mindset and portfolio, and to be prepared for worse times ahead. Australia is looking increasingly vulnerable because it has not experienced a recession in nearly 27 years, nor did it experience the GFC in the same way as other countries. Market participants need only to look at how their currency has declined this year to appreciate just how susceptible Australia is to global macroeconomic forces, which underscores how its largely domestic investment portfolio is failing to manage risks linked to those broader exposures.

The Australian dollar suffered a huge decline against the greenback in 2018, losing over 11% from 0.81 against the US dollar in January to 0.72 as at 2 October 2018. Losses in large part were attributed to Australia's exposure to China and the impact of ongoing trade tensions between the US and China.

"Australians also have a heavy home-country bias – too much of our allocation is invested in Australia. Our economy is directly and indirectly dependent on China, not just in terms of minerals exports, but

From an investing perspective, Australia has filled up on alternative beta which may not prove liquid when needed. Even if Australia manages to avoid a recession it is more vulnerable than overseas pension funds who are more diversified and can be nimble to re-allocate as opportunities present themselves. It is a far better way to face an uncertain future with a mix of diversifying alternatives and having private market dry powder ready to invest when an opportunity presents itself.

– Bev Durston, Founder and Managing Director, Edgehaven

also tourism, education and residential real estate. If China catches a cold, Australia might just get pneumonia," said Rieck.

Several superannuation funds, consultants and advisors echo similar concerns that Australia is still significantly overweight in equities, local property and local infrastructure. Combined with a fully invested position, their ability to capture good investing opportunities by having to sell hard assets that may prove to be illiquid, especially in a downturn, is severely hampered.

"From an investing perspective, Australia has filled up on alternative beta which may not prove liquid when needed. Even if Australia manages to avoid a recession it is more vulnerable than overseas pension funds who are more diversified and can be nimble to re-allocate as opportunities present themselves," said Bev Durston, founder of alternatives advisory firm Edgehaven. "It is a far better way to face an uncertain future with a mix of diversifying alternatives and having private market dry powder ready to invest when an opportunity presents itself."

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