



Australian Government

The Treasury

**SUPERANNUATION FUNDS AND ALTERNATIVE ASSET INVESTMENTS
ISSUES FOR POLICY MAKERS¹**

**André Moore
Stephen Monage
Financial System Division, The Treasury**

Presentation to the 12th Melbourne Money and Finance Conference

25 May 2007

¹ The views expressed in this paper are those of the authors and not necessarily those of the Treasury.

INTRODUCTION

The theme for the 2007 Melbourne Money and Finance Conference, 'Wealth Management: Trends and Issues', is a timely one. The ever-quicken pace of growth and change in the Australian financial sector presents a range of challenges for market participants, regulators and policy makers, not least in discerning and pre-empting future developments. From a policy practitioner's point of view, successfully meeting these challenges is critical, if financial markets regulation is not only to keep up with market developments, but to contribute to a dynamic, innovative, transparent and safe financial sector.

One area of particular interest is Australia's rapidly growing pool of superannuation assets. Australians' superannuation assets have recently risen to over \$1 trillion, approximately equal to Australia's annual GDP. This rapid growth in assets has been driven by the sustained high returns achieved by Australia's superannuation funds in recent years, and by the large annual contributions flowing into superannuation, amounting to \$77 billion in 2005-06.²

These strong growth trends are underpinning the expansion in personal wealth of Australian superannuation fund members and helping to ensure that Australia is well placed to deal with the challenges of an ageing population. They are also driving the rising global prominence of Australia's funds management industry. However, this success also poses challenges for superannuation fund trustees, for fund members and for government. In particular, trustees and fund members, through the ever-widening range of investment options being offered to them, must decide how best to maintain

² Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, June 2006.

strong investment returns in a climate which may not always prove to be as favourable as it is now. They must also find a home for the so-called ‘wall of money’ flowing into superannuation in the form of new contributions each year.

One avenue through which many superannuation funds are seeking to do this is by allocating a growing share of their portfolios to so-called alternative asset classes, such as private equity, hedge funds, infrastructure, and commodities. These asset classes are attractive to fund managers because they have the capacity to generate positive returns independently of the performance of traditional asset classes, such as bonds and listed equities. In this way, alternative investments have the potential to assist in maximising a fund’s performance over the investment cycle.

Institutional interest in alternative assets is by no means confined to Australia. Indeed, major endowments in the United States have a long history of investing in such assets and have provided some of the inspiration for the investment policies of Australian superannuation funds. Closer to home, the recently established New Zealand Superannuation Fund has a long-term goal of allocating 25 per cent of its portfolio to alternative assets.³

The size and actual performance of these investments will have important consequences for superannuation fund members, and for the economy more broadly. The objective of this paper is to identify from a policy maker’s perspective some of the significant issues that are posed by superannuation fund investments in alternative assets. It is useful first to consider in more detail the factors which may lie behind funds’ decisions to invest in these assets.

³ New Zealand Superannuation Fund, *Strategic Asset Allocation Review*, March 2005.

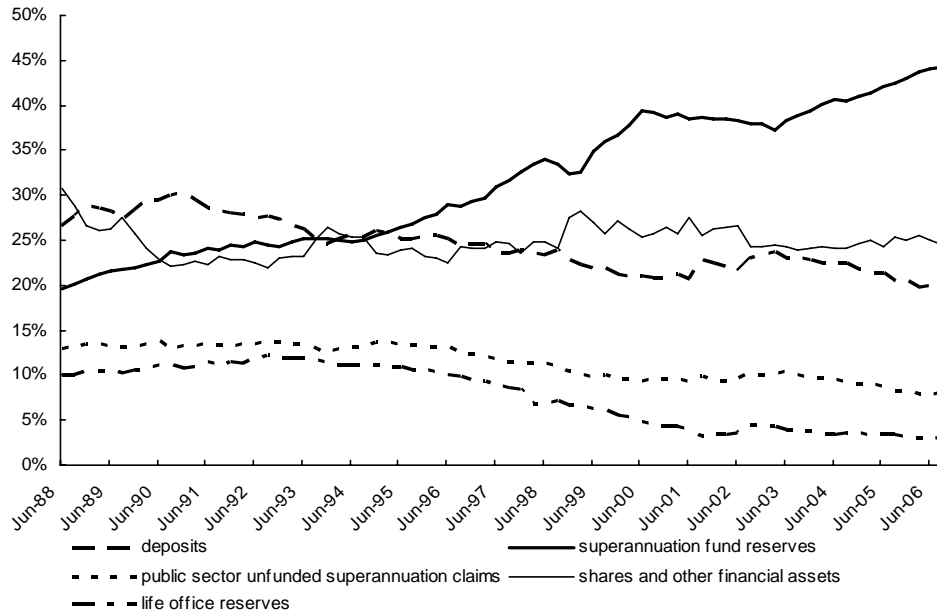
DRIVERS OF SUPERANNUATION FUND INVESTMENTS IN ALTERNATIVE ASSETS

In determining the extent and nature of superannuation fund investments in alternative assets, trustees must balance a range of often competing and interrelated considerations. Importantly, trustees need to maximise returns to enhance members' incomes in retirement while mitigating risks to their funds' financial position and performance. In seeking to achieve these objectives, trustees must also accommodate any rebalancing of the fund's assets to accommodate members' investment choices, as well as payments from the fund, either as a result of members reaching retirement age or transferring their assets to another fund.

Members' retirement incomes

As noted above, superannuation is an increasingly important form of wealth for Australians. Superannuation fund assets and unfunded superannuation claims represent over half of the financial assets held by Australian households (see **Chart 1**). As fund balances rise, Australians' awareness of, and interest in, and expectations of, their superannuation is growing. Longer life expectancies, the desirability of maintaining higher living standards in retirement, and the experience of an extended period of strong fund returns mean that members are becoming increasingly sensitised to the performance of their superannuation funds. With most Australians now able to choose their superannuation fund, this focus on performance in a competitive environment places a greater onus on trustees to manage fund assets in a way that maximises fund returns and contributes to member retention.

**Chart 1: Composition of Household Financial Assets
June 1988 to September 2006**



Source: ABS catalogue number 5232.0 and RBA data.

Superannuation fund trustees are seeking to retain existing members and attract new ones by delivering strong and consistent returns while offering an expanded range of product options. In deciding how best to allocate their funds' assets, trustees are increasingly looking to the advice of professional asset consultants and are being influenced by the investment strategies of major financial institutions, particularly internationally.

One trend that is observable both in the strategies of overseas institutions and in the advice of Australian asset consultants has been the use of alternative assets to bolster fund returns while reducing their overall volatility. High-profile endowments and foundations in the US, such as those connected with Yale and Harvard universities, have a history of innovative investing in such assets. More broadly, allocations to selected alternative asset classes by overseas institutions have grown strongly in recent years. For example, allocations to hedge funds by large foundations,

endowments and pension funds in North America are forecast to more than triple from 2.5 per cent in 2001 to 9.1 per cent of total investments in 2007. Over the same period, allocations to hedge funds amongst European institutions are forecast to more than quadruple, from 1.7 per cent to 7.2 per cent.⁴

Much of the promise of superior long-run returns from alternative investments is derived from the ability of superannuation funds, as relatively patient, long-term investors, to access the premium associated with investing in relatively illiquid investments such as private equity and infrastructure. An allocation to alternative assets is also seen as a means to reduce the overall volatility of superannuation fund returns, as the returns derived from such assets are viewed as being independent of returns derived from traditional asset classes. For example, infrastructure investments are viewed as a source of stable, long-run cash flows throughout the economic cycle, while hedge funds explicitly seek to deliver absolute returns independent of market cycles.

A series of studies by researchers at the University of New South Wales into the attitudes of, mostly larger, superannuation funds towards alternative assets illustrates that trustees of Australian superannuation funds have a particularly buoyant view of alternative investments as vehicles for enhancing returns while managing risk. In one study, the funds surveyed expected their private equity investments to outperform listed equity by over 4 per cent per annum, while helping to reduce overall portfolio risk.⁵ In the case of hedge funds, an international study of large institutional

⁴ Russell Investment Group, *The 2005-2006 Russell Survey on Alternative Investing*, 2005.

⁵ Evans, J, *Study of Australian Superannuation Fund Attitudes to Private Equity Investing*, April 2005 and Evans, J, *Study of Australian Superannuation Fund Attitudes to Hedge Fund Investing*, January 2006.

investments in alternative assets suggested that Australian pension funds expect returns of over 10 per cent in 2007, compared with return expectations of 7 to 8 per cent by European and North American institutions.⁶

Mitigating risks

As with all investments, trustees investing in alternative assets must also manage two major categories of risk, namely that the investment is inappropriate for the fund's circumstances and implementation risk.

The first of these risks might arise if the trustee assumptions about the returns from these assets prove to be overly optimistic, or if the risks inherent in alternative investments are not fully understood.

Alternative investments are not homogeneous, and the risks inherent in the different asset classes can vary considerably. However, several types of alternative assets, most notably private equity and hedge funds, may exhibit a high degree of sensitivity to changing economic conditions, due to their use of gearing. In recent years, leveraged buyouts in Australia have typically resulted in gearing ratios of approximately 250 per cent, compared with pre-buyout ratios of approximately 50 per cent and a gearing ratio for the corporate sector as a whole of 65 per cent.⁷ Equity investments by superannuation funds in such transactions will, therefore, be more vulnerable to deteriorating economic conditions than more traditional investments in listed equities.

⁶ Russell Investment Group, *The 2005-2006 Russell Survey on Alternative Investing*, 2005.

⁷ Reserve Bank of Australia, 'Private Equity in Australia', *Financial Stability Review*, March 2007.

A further characteristic of many alternative assets, such as direct investments in private equity and infrastructure, is their relative illiquidity. While this is not in itself a concern, the relationship between the liquidity of a fund's assets and the likelihood of payments from the fund, either as a result of members retiring or members moving to other funds, must be carefully managed by trustees. Less liquidity, combined with less frequent and/or transparent reporting of performance, may make it more difficult to measure accurately the volatility of returns over time. Under these circumstances, there is a greater risk of movements in asset values being underestimated.

The second major category of risk that superannuation fund trustees must manage when investing in alternative assets is implementation risk. This is the concern that even where a decision to invest in alternative assets is appropriate, it may be poorly executed. Again, while this type of risk is not unique to alternative assets, particular features of many alternative asset classes contribute to implementation risk.

Perhaps the most frequently discussed contributor to implementation risk is the risk that, in seeking to invest in alternative assets, superannuation fund trustees may pay excessively high prices for these assets. While it is difficult to assess the prevalence of this issue across the spectrum of superannuation fund investments in alternative assets, it is inevitable that in some instances, some funds will overpay for some assets. This could be as a consequence of the difficulties of measuring the performance, and hence value, of some classes of alternative assets, or because funds are entering the market late in the asset cycle. This has the effect of eroding the promised above-benchmark returns that are one of the chief attractions of alternative investments.

A related problem to overpaying for assets is investing in poorer quality assets, which may be a particular risk for trustees who are new entrants to alternative investment markets. There is some concern that the supply of high-quality alternative assets is limited, both domestically and internationally, and that there is a limited number of fund managers with the expertise and resources to manage this asset class successfully. This can result in a 'first-mover' advantage where the higher quality investment opportunities are secured by those funds with a longer history of investing in alternative assets and with more established relationships with leading fund managers. The extent of any first mover advantage could be expected to diminish over time as markets for alternative assets deepen.

However, the main factor underlying implementation risk is the risk that superannuation trustees and their investment advisers may simply not have the expertise to assess and monitor properly their investments in alternative asset classes, or the performance of their fund managers. This risk is compounded by the aforementioned relative lack of transparency of some investment structures and the difficulty in comparing performance across managers of dissimilar pools of alternative assets.

The actual significance of these risks is related to the level of exposure to specific classes of alternative assets, as well as to alternative assets in aggregate. The precise proportion of Australian superannuation fund portfolios allocated to alternative assets is a matter of some debate. There is limited comprehensive, reliable data publicly available, with estimates varying due to differences in how assets are defined and the type and size of the funds examined. Although there is little reliable published data that disaggregates trends in alternative asset investments, the Australian Prudential

Regulation Authority (APRA) publishes data on the asset allocation of funds' default investment strategies which reports alternative asset investments as a single class.

APRA's data suggests that 11 per cent of the assets held in funds' default investment strategies at 30 June 2006 were allocated to alternative assets.⁸

In the case of investments in some specific asset classes, the University of New South Wales studies cited previously suggest an average current exposure to private equity and hedge funds of approximately 3 per cent each for Australia's larger superannuation funds. Allocations to hedge funds were expected to rise to 4 per cent in coming years while almost all funds surveyed had yet to achieve their target allocations to private equity, which averaged over 4 per cent.⁹ Infrastructure investments appear to represent a somewhat higher proportion of superannuation funds' investment portfolios, with one study of industry superannuation funds estimating an average fund exposure to infrastructure of 5 per cent.¹⁰

These figures represent averages, and there are some prominent funds with significantly higher allocations to alternative assets, in particular infrastructure.

Chart 2 describes the results of a private sector survey of the asset allocations of 45 industry superannuation funds and indicates that several of these funds have alternative asset allocations in excess of 15 per cent, with one fund having an allocation of 45 per cent.¹¹ There are also some funds that provide their members

⁸ Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, June 2006.

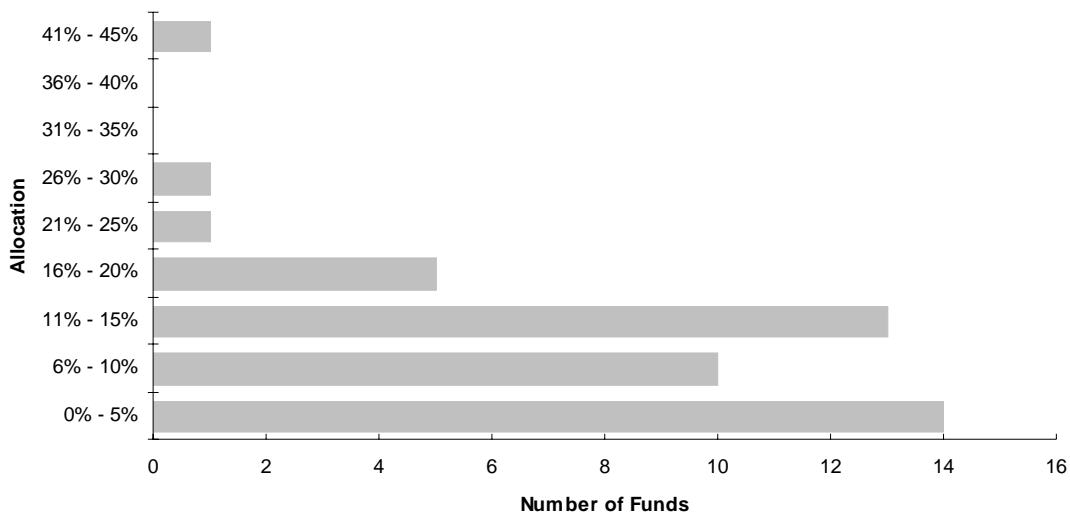
⁹ Evans, J, *Study of Australian Superannuation Fund Attitudes to Private Equity Investing*, April 2005 and Evans, J, *Study of Australian Superannuation Fund Attitudes to Hedge Fund Investing*, January 2006.

¹⁰ Access Economics, *Asset Allocation and Investment Performance of Industry Superannuation Funds*, February 2005.

¹¹ Data provided by SuperRatings and published in *Superfunds*, March 2007.

with the option of investing 100 per cent of their superannuation in a portfolio of alternative assets. This development is of particular interest, as one of the most common justifications for investing in alternative assets is the perceived low correlation of their returns with those of traditional asset classes. This benefit is, of course, only realised when fund members adopt exposures across both types of assets.

Chart 2: Industry Fund Allocations to Alternative Assets at 30 June 2006



Source: SuperRatings data

Despite these exceptions the evidence suggests that, overall, Australian superannuation funds' allocations to alternative assets are not especially aggressive either in absolute terms or by international standards. By one estimate, large North American institutions are investing over 9 per cent of their portfolios in hedge funds and almost 8 per cent in private equity.¹²

Funds' aggregate exposures to alternative assets are, of course, only part of the risk equation. As noted above, the risks that superannuation funds face from investing in

¹² Russell Investment Group, *The 2005-2006 Russell Survey on Alternative Investing*, 2005.

assets such as private equity, hedge funds or infrastructure projects are driven not just by the level of funds' investments in such assets but by trustees' ability to assess, price and manage the risks flowing from these investments.

Ensuring that trustees maintain robust risk management practices is an important objective of Australia's framework for prudential regulation of superannuation funds. The *Superannuation Industry (Supervision) Act 1993* provides a well-established legislative framework that requires a fund's trustees to formulate an investment strategy having regard to all the fund's circumstances, including risk and likely return, diversification and liquidity.

More recently, in July 2004, the Government introduced a universal system of superannuation trustee licensing, designed to support a more risk-based and proactive prudential regulation regime. Under this system all superannuation fund trustees must have an adequate risk management framework covering both their own operations and the operation of the entities they manage, supported by adequate financial, human and technical resources. Collectively, these requirements help to ensure that trustees are well-placed to assess the risks, including investment risks, faced by the fund, have in place processes for addressing those risks and are able to access the necessary expertise and resources to address any problems.

The introduction of superannuation trustee licensing has coincided with a major consolidation in the number of trustees over the last five years. At 30 June 2006, which marked the end of the transition period to the new licensing framework, 307 trustees had obtained a licence from APRA. This compares with around 1,300 trustees operating funds with more than four members in 2004 and around 2,500 trustees operating funds with more than four members in 2002. In addition, the

five years to 30 June 2006 saw the number of funds with more than four members fall by 77 per cent from 3,730 to 870.¹³ This consolidation could be expected to promote better economies of scale which, alongside better practices being driven by the new licensing regime, should ensure that superannuation funds are better placed to take advantage of the opportunities presented by alternative investment markets.

Member choice

This paper has so far focused on the role of superannuation fund trustees. However, the rapid growth of member investment choice and a broadening of the scope for members to choose their fund mean that superannuation fund members also have the potential to influence directly a fund's overall allocation to alternative assets.

Since 1 July 2005, most Australian employees have been able to choose the superannuation fund into which their mandated employer contributions are to be paid. This reform built on the introduction of portability of superannuation benefits the previous year, which allowed members to move their existing superannuation benefits to a fund of their choice. Collectively, these reforms are designed to provide employees with greater control over their superannuation savings and stimulate competition between superannuation funds.

In addition to being able to choose their own superannuation fund, most Australian fund members are being offered a wide range of investment options, including options that involve varying allocations to alternative asset classes. As at 30 June 2006 49 per cent of the total assets held by superannuation funds with more than four

¹³ Jones, Ross, *Living in a Post Licensing World*, Australian Prudential Regulation Authority, November 2006.

members were held in the default investment strategy for the fund, compared with 60 per cent the previous year.¹⁴ This suggests that a larger number of fund members are taking an active interest in where their superannuation savings are invested.

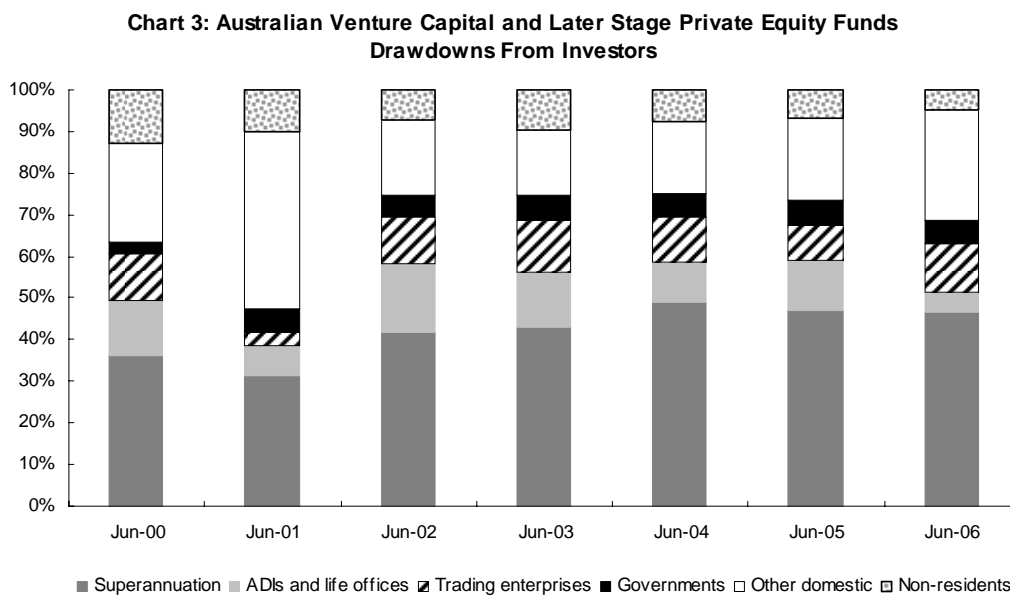
The ability of fund members to choose their fund, and also to choose between investment options within the fund, potentially influences trustee attitudes towards investing in alternative assets in a number of ways. Firstly, heightened media coverage of particular alternative asset classes, such as the current interest in private equity or in investment products aimed at taking advantage of the current commodity boom, may prompt some fund members to seek out products which provide increased exposure to such assets.

Secondly, trustees' perceptions of the potential for members to undertake significant shifts between investment options, transfer their savings to other superannuation funds or draw down on their assets as they retire may lead trustees to adopt a more cautious approach to investing in relatively illiquid assets. Some commentators consider that this could temper superannuation funds' investments in alternative assets that are least liquid, such as infrastructure or, at the very least, lead to a greater emphasis on risk assessment and management and, potentially, a preference for managed or listed exposures to alternative assets over direct investment.

¹⁴ Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, June 2005 and June 2006.

BROADER IMPACTS OF INVESTMENTS IN ALTERNATIVE ASSETS

The importance of superannuation fund investments, including in alternative assets, is not limited to their contribution to improving the retirement incomes of Australians and meeting the challenges of an ageing population. Australia's \$1 trillion pool of superannuation savings should also be recognised for its role in driving growth in other sectors of the economy. For example, **Chart 3** shows that, in recent years, almost half the funding for Australian venture capital and later stage private equity funds has been sourced from superannuation funds. Domestic superannuation funds also accounted for approximately one-fifth of assets allocated to Australian hedge funds and funds of hedge funds as at 30 June 2006, in this way underpinning growth in the domestic hedge funds industry.¹⁵

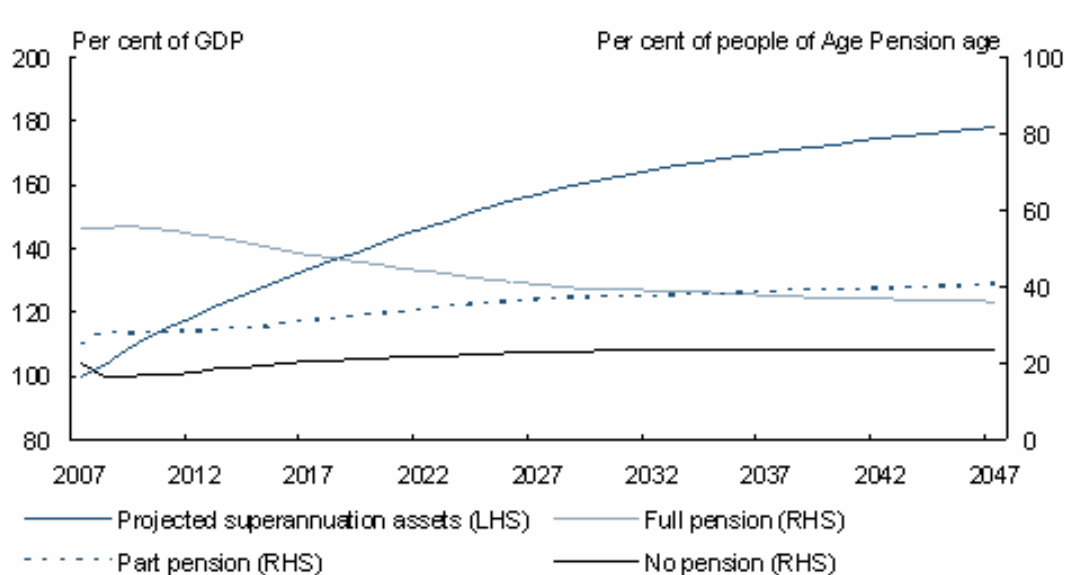


Source: ABS catalogue number 5678.0

¹⁵ LCA Group, cited in Axiss Australia, *The Hedge Funds Industry in Australia*, 2006-07.

The degree to which trustees are able to integrate alternative asset investments successfully into their broader investment portfolios, and meet or exceed performance benchmarks, will have long-term consequences for household wealth accumulation, the levels of consumer demand and government income support for the household sector. As a result, policy makers could be expected to monitor closely how these trends evolve over the coming years and the extent to which actual outcomes match expectations.

Chart 4: Superannuation Assets and Age Pension coverage projections



Source: Intergenerational Report 2007

The 2007 *Intergenerational Report* (IGR) illustrates the significance of these issues (**Chart 4**). Over the next forty years, the value of total superannuation assets is projected to approach 180 per cent of GDP, compared with approximately 100 per cent today. While the proportion of the population of age pension age is projected to double over this period, the increased value of individuals' superannuation and other private assets and income is projected substantially to offset the impact of this trend on government spending. This is reflected in the fact that the

proportion of pensioners receiving a full Age Pension will decline significantly over the next forty years.

The impact of alternative asset investments on whether these outcomes are realised will ultimately depend on long-term trends in superannuation fund exposures to these assets and their performance. If investment theory is borne out in practice, alternative asset investments could contribute to a further improvement in the outcomes projected by the IGR. However, should these investments be poorly managed or not realise their promise, there is a significant potential downside, particularly given the extent of leverage associated with alternative assets such as private equity and the difficulty of exiting poorly performing, relatively illiquid assets such as infrastructure.

As noted above, there is substantial anecdotal evidence that Australian superannuation funds are increasing significantly their investments in alternative assets in recent years, from a low initial base. While it is difficult to predict whether these trends will be sustained, the willingness of some funds in Australia and overseas to allocate over twenty per cent of their portfolios to alternative assets suggests that there will be significant exposures to these assets over the long term.¹⁶

CONCLUSION: ISSUES FOR POLICY MAKERS

The importance of superannuation investment decisions, not only with regard to alternative assets but more broadly, for the allocation of capital in the economy, growth in household wealth and meeting the demands of an ageing population, raises several key issues for superannuation policy makers.

¹⁶ An alternative hypothesis is that the ageing of the population may lead funds progressively to allocate a higher proportion of their portfolios to defensive asset classes over the long term, limiting exposures to growth-oriented alternative asset classes.

Firstly, policy makers need continually to enhance and confirm their understanding of market developments and how the regulatory and non-regulatory incentives faced by trustees influence their investment decisions. This includes gaining a better understanding of how trustees' professional advisers and general market trends influence decisions about where superannuation assets are invested.

Secondly, policy makers must be able to monitor accurately the outcomes of trustees' decision-making, in terms of trends in asset allocations and resultant financial performance. Recent collaborative work by APRA and the Treasury in developing and implementing the 2006 Superannuation Research Questionnaires, which surveyed around 200 APRA-regulated superannuation trustees, will make a useful contribution to these efforts.

A major consideration for policy makers going forward will be the level of aggregate risk in the superannuation system. This is extremely difficult to measure directly with any accuracy. Consequently, a good deal of the focus will necessarily be on intermediating factors, such as the ability of trustees and advisers to assess and manage risk properly, particularly investment and implementation risk. Recent reforms to the prudential framework are designed to promote enhanced risk management practices and the emphasis in the coming years should be on ensuring that this framework remains flexible and responsive to emerging developments in the superannuation industry.

Finally, in designing their funds' asset allocations and investment options, the manner in which investment decisions are executed, and the ways in which subsequent risks are assessed, priced and managed, superannuation fund trustees influence more than just the fortunes of their individual funds. The broader economic, fiscal and systemic

consequences of superannuation fund performance will be an increasingly important factor in superannuation policy making as the size of the superannuation pool continues to grow.