Brookvine Pty Limited

Unlisted Assets: To Dominate Our Portfolios Notwithstanding the Risk?

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specialists in alternative investments

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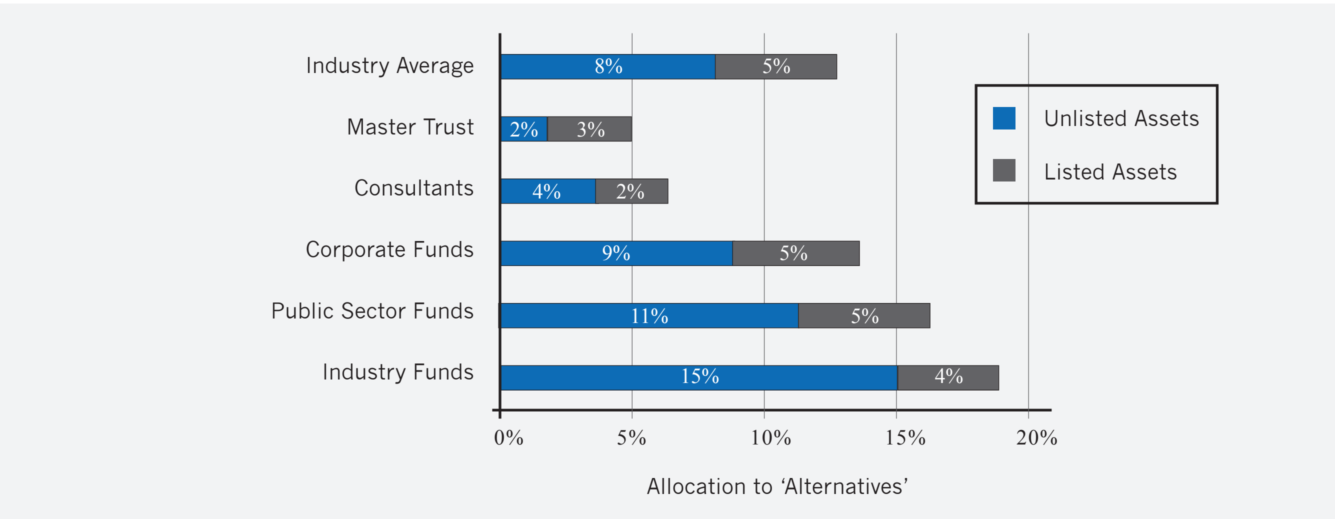
Current State*

The title hints at concern about unlisted assets, yet 15 years ago Australian institutional portfolios had 15-20% exposure to a single undiversified, concentrated sector of unlisted assets - Australian direct property. The past decade has witnessed global pension and super funds suddenly and earnestly reach for substantial exposures to the unlisted assets of private equity, VC, infrastructure, debt, property, agricultural land, hedge fund assets, and even collectibles. In Australia clients of Access Consulting have up to 45% unlisted in their Target Return Portfolios. Large Dutch public pension funds have up to 40% unlisted, and the $110b Texas Teachers fund is but the latest and most vocal to target 30-40% in unlisted assets over the next few years. As Exhibit1 shows, Australian exposure levels are more modest but increasing.

Exhibit 1 - Super Funds' Allocations to Alternatives



Source: Chant West, Multi-Manager Survey, December 2006, Vol. 4, No. 4.

A recent survey found that 85% of funds and their advisers were planning to increase their exposure to 'alternatives' over the next 18 months. Unravelling the drivers of the rush will help answer the title's question.

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*This is an expanded version of an invited talk to the Government Supperannuation Conference, Hobart, July 2008.

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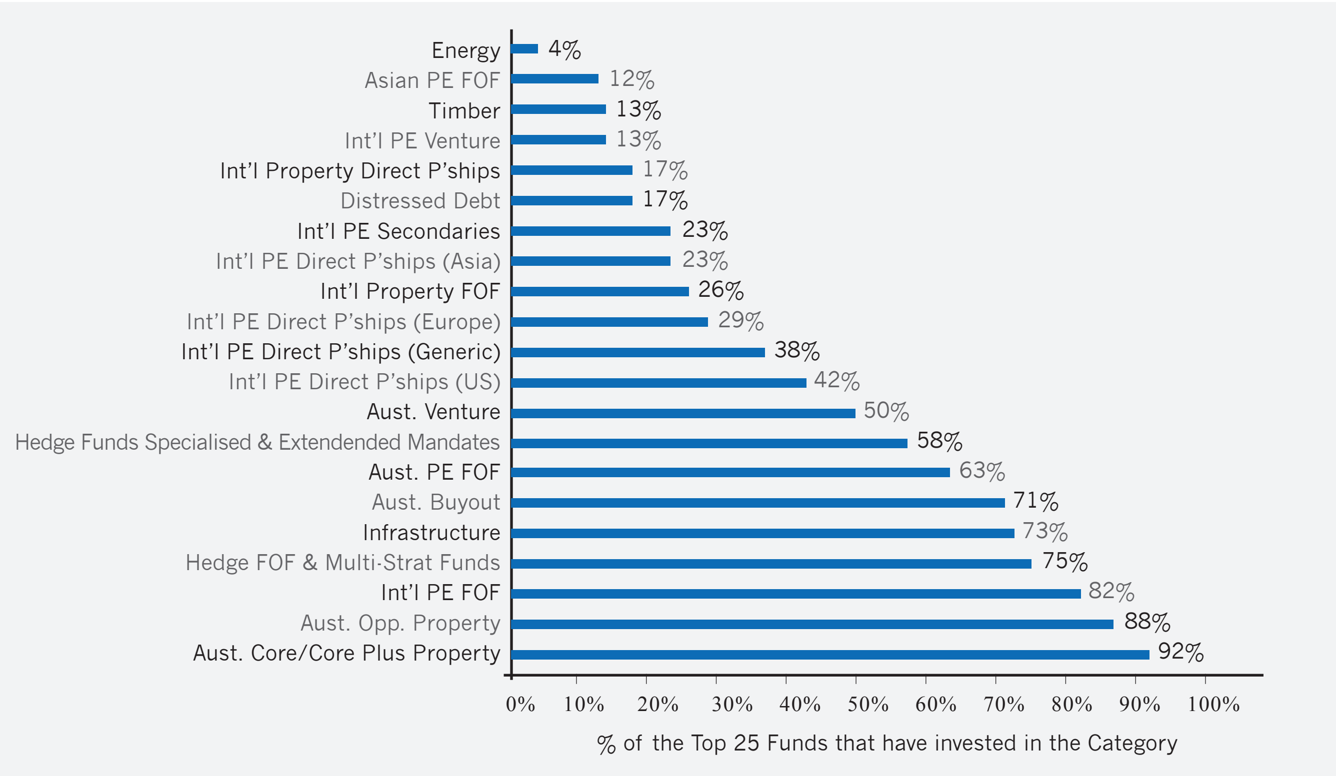
There's More to Unlisted Than Being Unlisted

But first a warning. Merely categorising assets as unlisted is potentially dangerous as it misses their broad heterogeneity of purposes and outcomes, their wide variation in return drivers, risk, expectations, and the differing roles they can play in portfolios. For instance, on the grounds of opportunism some funds eschew the common desire to diversify private equity across size, geography, type, and vintage. Some see Private Equity as a substitute for listed equities even to the extent of trying to balance overall industry exposures. That unlisted assets can be more varied than listed assets is apparent in Exhibit 2.

Exhibit 2 - Top 25 Super Fund Allocations



Source: Brookvine

The simple state of being unlisted does of course induce extra risks: illiquidity, unfamiliarity, greater duration, greater idiosyncratic behaviour (including greater dependence on individual firms and individuals within them), paucity of data resulting in lower levels of understanding and predictability of drivers and outcomes, greater immediacy risks of being too early, greater operational risk demanding deep due diligence and attention to deal terms, and less transparency at both the portfolio and firm level, resulting in an asymmetry of information that encourages 'rent-seeking' by managers.

Why the Rush to Unlisted?

Two problems drove the initial rush to alternatives. First was a growing awareness that however diversified funds thought they were their dominant risk remained an exposure to the listed Equity Risk Premium (ERP). The breaking of the Tech bubble in 2000 saw many DB funds suffer as a result (some UK funds had 90% exposure to equities) and unlisted alternatives were held out as diversifying away from ERP, while providing a less volatile alternative, and a better match to the long duration of liabilities. Second was dissatisfaction with the performance of active managers of listed securities. In a crowded competitive environment searching for genuine alpha in listed markets has decreasing appeal, especially for large funds vulnerable to diseconomies of scale. This might be culminating in a secular trend to passive funds such as ETFs and fundamental indices, leaving the search for outperformance to other sectors. Again unlisted alternatives were seen as a saviour, providing the promise of net risk-adjusted returns in excess of passive listed markets.

The belief that unlisted assets solved both problems was re-enforced by the 90's decade of very positive US experience with private equity and Australian experience with the hybrid asset class of unlisted infrastructure. But both sets of exceptional returns depended to some extent on non-repeatable broad mis-pricing. The US, European and Australian past performance (see Exhibit 3) as evidence in support seems compelling when combined with the well-known consistency of persistence of top quartile managers. One study found that for Private Equity funds a 100bp boost to performance resulted in a 77bp boost to the next fund. To some this smacks of almost a free lunch, a dangerous perception given the difficulty of accessing top performers in sufficient size to make a difference, and to the sleight of hand effect of leverage.

Exhibit 3 - Performance Enhancement

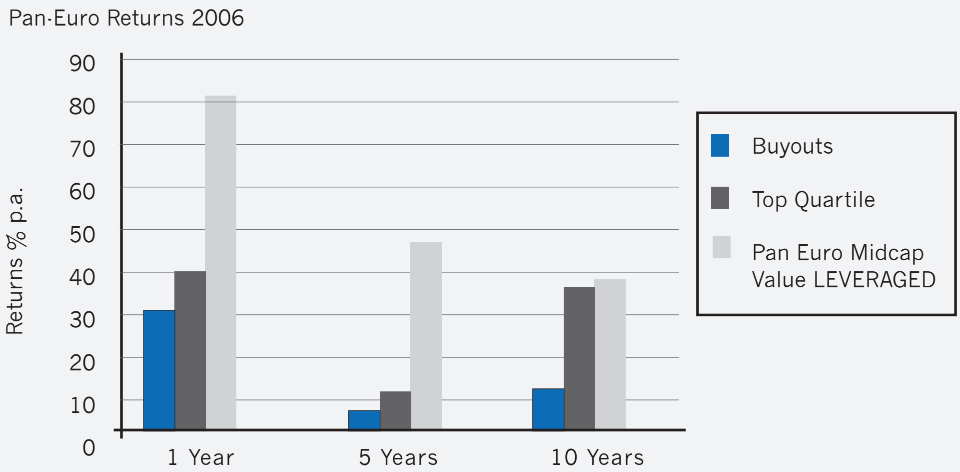
SuperRatings Fund Category	Range of 5-Year Return	Avg Weight to Alternative Assets
Top 10 Funds	8.8% - 10.8%	15.8%
Bottom 10 Funds	5.5% - 7.0%	8.0%

Source: SuperRatings 2006, Babcock & Brown

Why the Rush to Unlisted?

Exhibit 4 shows how even top quartile buyout managers can be beaten by the listed market leveraged to the same degree, a comparison that masks the extra and serious risk of being stopped-out by a margin call to which a leveraged listed investor is exposed.

Exhibit 4 - Value-Adding or Just Leverage

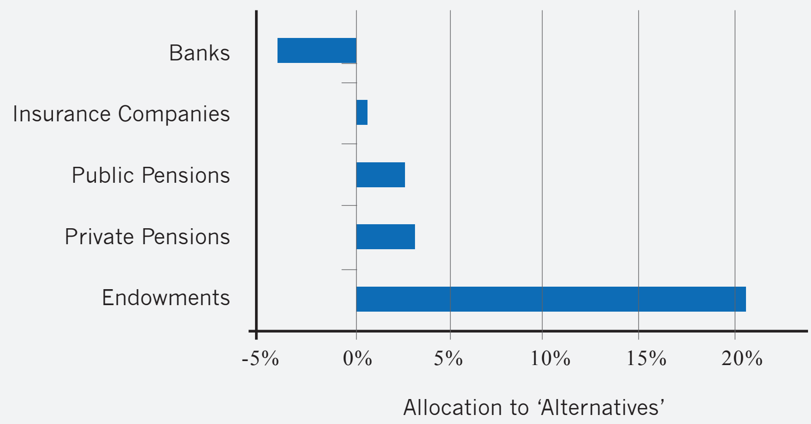


Source: Citigroup Investment Research, 2006

That's one version of history. But 'history' is plural. Another history surrounds Yale and other US Endowments and a number of innovative US Public Sector pension funds that were early into large exposures to VC, MBOs, Timber and Real Estate. David Swensen's remarkable 25 year investment performance at the Yale Investment Office, with up to 70% exposure to alternatives that helped rank Yale consistently in the top percentile of Endowments, has created a surreptitious "We all want to be like Dave" movement. But almost none can. His non-replicable advantages include a unique investment talent, experienced professional staff, Alumni support and networks into deals, extensive Wall St savvy and contacts, and the Yale and Swensen brands that ensure he gets early, substantial and well-priced access to quality deals and to liquidity if needed. Yale's uniqueness is born out in the IRR spread across different institutions as in Exhibit 5.

Why the Rush to Unlisted?

Exhibit 5 - US Private Equity IRRs, 1999-2001



Source: Lerner et al (2005), "Smart Institutions, Foolish Choices?" NBER.

Funds should examine the reasons behind these relativities to assess whether they stem from institutional and governance barriers. Folklore about Public Sector funds includes cumbersome and slow decision-making, and interfering Boards and Governments. Unlisted investments can invite dual sources of interference from poorly governed funds, Government and non-government alike. On one hand is the "A-friend-of-mine-has-a-wonderful-opportunity ...." pressure. On the other is Board pressure from increased headline risk, and the greater chance of being alone in the headline. Everyone held NewsCorp; not everyone held Sydney Tunnel Bonds. Headline risk leads Boards to object to their buyout managers firing staff of newly acquired unlisted companies while ignoring the many listed companies in their portfolio that regularly "downsize".

Listed vs Unlisted

The question in the title, and the qualifier "alternative", hint at listed assets being the acceptable norm. But on what grounds? Certainly not in terms of relative opportunities as the pool of unlisted global assets swamps that of listed assets. 'Norms' are often driven by the ubiquitous Status Quo Bias. In one experiment subjects are told to imagine a rich uncle leaving them a substantial portfolio. One group's portfolio consists of cash and short-duration notes; the other's consists of a balanced mix of equities, private companies, and bonds. Each group is asked to re-structure the portfolio to better meet their needs, expectations, and risk tolerances. Each changes their given portfolio only at the margins. They can't both be right. Swensen is a rare exception of one who overcame the bias and totally changed Yale's portfolio and indirectly everyone else's through insight, courage and a very supportive Board whose confidence and trust he had to earn.

To hedge the Status Quo Bias turn the question around, "*Listed assets: To dominate our portfolios notwithstanding the risks?*", and all is different. Push further against the bias and ask, *"Are there circumstances under which you would consider a portfolio of* **exclusively** *unlisted assets?"* 'Yes' is a possibility. Imagine a family trust, for instance Gates', designed to provide income in perpetuity to members of an extremely tight family. The fund is un-regulated, has no competition, and no liquidity needs as members are never expected to withdraw. Under these circumstances, assuming unlisted markets have the same breadth as listed markets, it might be optimal to hold no listed securities. Some trusts are structured this way, and it's how all family wealth was structured until the relatively recent creation of listed markets. Do superannuation funds have features that make them look a little like family trusts? NZ Super with a guarantee of no withdrawals for 20 years does. A more subtle question is: If your fund had a substantial exposure to a listed company, to what extent would your view of the company change if it was being privatised?*

So why are listed assets the norm and how real are their advantages? As well as the greater depth and diversity of listed markets especially in the US, the tight demands of listing do provide protection and comfort to investors through an enforced modicum of operational honesty and effectiveness. Eliminating the dregs, even imperfectly, is an under-recognised source of improved performance. Yet the demands of listing notwithstanding, some studies reveal how privately owned businesses have significantly better corporate governance because the small number of shareholders with their larger stakes have greater incentives and power to actually act like owners.

* In answering assume no impure motives such as avoiding compliance, creating a class of shares with special voting rights, or reaping short-term stag profits by flipping the company back as an IPO. In the latter case where institutions are the dominant investors in the listed company, and again in the unlisted company, and yet again in the 'new' listed company, it's unclear whether they, the LPs, profit from the round trip. GPs do.

Liquidity and Valuations

The dominant perceived advantage of listed assets is the comfort derived from liquidity, the ability to realise assets in cash at the 'right' price and in a short time-frame. But liquidity is a vexed notion. Not only is there no agreed definition, but the underlying supply/demand mechanisms are ill understood almost to the point of mystery. There are two serious technical weaknesses and a substantive behavioural weakness in the demand for liquidity.

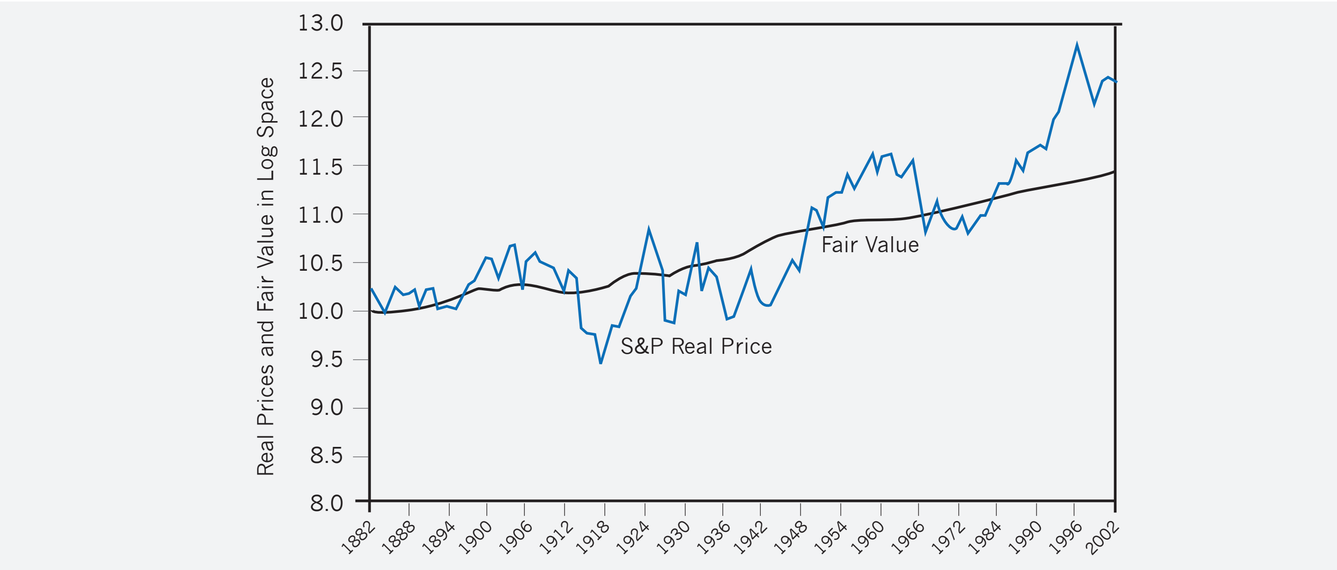
First and foremost on the technical side is that measures of liquidity of listed markets fail to account for the most common case where everyone heads for the exits simultaneously, as we saw recently with even short duration bank loans. Like low correlations liquidity ain't there precisely when needed. PIMCO's Paul McCulley highlighted this and the mystery of liquidity in August last year: *"Where did all the liquidity go? 6 months ago everybody was talking about boundless global liquidity supporting risky assets, driving risk premiums to virtually nothing, and now everybody is talking about a global liquidity crunch, driving risk premiums half the distance to the moon. Tell me Mac, where did the liquidity go?"* Marking-to-market of public assets is not the total public good it's held out to be. It can drive markets into dangerous downward spirals as each lower valuation triggers more selling and hence lower valuations, a process known as 'marking-to-misery', to be compared to the IASB approach of 'marking-to-model' and the common 'marking-to-myth' of unlisted assets. Yet to an extent unlisted assets act as financial stabilisers, a valuable public good that should be recognised.

The second technical weakness is the assumption that the market price is "right", an assumption that echo's the increasingly discredited Efficient Market Hypothesis. Over even moderately long periods the Market Value of assets can stray far from Fair Value due to investors' short-term sentiment-driven trading.* The low volatility (and correlations) of unlisted assets, a consequence of infrequent and appraisal-based valuation methods and 'stale pricing', is seen as artificial compared to the supposed 'naturalness' and 'correctness' of mark-to-market. Yet, as revealed by Exhibit 6, the volatility of the fair value of even listed assets is remarkably low compared to that of the market value.

*Moreover the market price can even vary with the size of the trade and the broker/dealer executing the trade.

Liquidity and Valuations

Exhibit 6 - Market Value is Volatile... Fair Value Ain't



Source: GMO, S&P, Prof Shiller, As of 12/05

Could it be that many private assets are priced more 'accurately' than public assets because the price discovery process is more rational and less driven by the sentiment of listed markets? That seems to be so with the recent behaviour of Australian property. 18 months ago Listed Property Trusts traded at a 70% premium to NTA. Now they trade at a 30% discount. Listed Infrastructure too is down 40% for the year, yet the soundness of the underlying businesses has surely not fallen 40%. Tell me Mac, are LPT and listed infrastructure valuations more accurate and more reliable than those of unlisted property and infrastructure? Is their volatility more 'natural'?

Concern about inter-generational equity, related to these technical weaknesses, is less apparent but just as real for listed assets. If I withdraw from a fund when markets are deeply undervalued relative to fair value, for instance in 1982 when the equity market was trading at a P/E of 8, and the trustees knew or should have known how unreasonably deep and transitory the discount was, haven't I been treated inequitably? Isn't the

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* Aside from market-based and appraisal-based valuations a third equally problematic option is 'valuation-by-committee-of-experts' as used by Ratings Agencies.

Liquidity and Valuations

trustees' justification that they accepted "conservative" valuations, as is often said with unlisted assets, problematic? Similarly if I withdraw at a peak (eg, in 2000) aren't remaining members treated unfairly? Valuation and equity are problematic in both arenas. The fact is there is *no correct* method of valuing assets; all demand trade-offs.

The behavioural weakness underlying the demand for liquidity is that people and organisations over-pay for it to avoid the often irrational fear of being locked-up. One downside of this weakness is an induced transactional state of mind resulting in short-term decision-making and increased costs. Keynes recognised that 70 years ago: *"To make the purchase of an investment* **permanent** *might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only."* Unlisted assets at least point in the direction of permanence.

Excessive demand for liquidity is priced into unlisted assets as an illiquidity premium, which even exists and persists in illquid listed securities such as micro-caps. Illiquidity fear explains why a miniscule 3% of US equity mutual funds are closed end, and why investors seem to include a preference for 'realisation' in their utility function. Are trustees overly concerned about the need for liquidity? Do they overpay for it? Will members rush out en masse when they receive negative returns for the first time? Possibly, but extremely unlikely, although runs have occurred in all other types of financial institutions. Superfunds like banks, borrow short and lend long, so risk management must at least advert to mis-match risk. The history of financial institutions is replete with the consequences of failure to do so. But there are tools for hedging liquidity risk including investing in secondaries, not re-investing, collaborative pooling to avoid market panic as favoured by APRA, the Australian regulator, and possibly some sort of swap of illiquid assets between for instance a cashflow negative closed DB fund and a cashflow positive open DC fund. Australian fiduciaries are required to pay benefits without delay and transfers within 30 days although APRA can allow extensions for illiquid portfolios. Trustees are only required to advert to liquidity as part of risk management and to have *"a plan for orderly, prioritised, sell-down of assets to meet liquidity requirements"*, to avoid the necessity of a fire sale.

Conclusion

On balance I'm arguing for pushing beyond the limits of comfort for larger allocations to unlisted assets, but only for funds with access to the investment and management skills needed to develop and maintain strong dealflow networks, to ensure the deal is well structured and aligned, to hedge the massive informational asymmetry that can result in inappropriate rent-seeking, to monitor necessarily imbalanced lumpy portfolios, to avoid the tendency to fill pre-set allocation buckets, to not necessarily insist on complete diversification, but most of all to not overpay. These skills are quite different to those needed in listed assets and require different patterns of thought, behaviour and organisational structure. Without that funds can end up in a sub-optimal state where 20% of the portfolio occupies 80% of staff and board time and energy.

The on-going squeeze for talent argues for more mergers, collaboration, and pooling of assets to get the best out of larger allocations. Increasingly, unlike listed investing, unlisted investing is a scale business of global extent that may require offshore offices to develop networks and generate dealflow. Very large funds have long recognised this. The C200b Dutch APG has its own PE firm and offices in four countries; Ontario Teachers is the lead manager executing the largest ever buyout (of Bell Canada at C$52b)*; the £30b USS in the UK is buying 10% of a management buyout firm; SWFs from China, Singapore, Dubai and Qatar are purchasing large chunks of equity in distressed financial services organisations partly to get scale.

Australian funds, some larger than the Yale Endowment, have extra challenges. For instance, where do diseconomies of scale set in? Do we have sufficient talent? Are almost all opportunities and funds overseas? Is governance appropriate? Did the fund start too late in the cycle to 'win' from unlisted? What will success with an alternative program look like and how will it be recognised?

With those caveats my answer to the question in the title is 'yes'.

*By December 2008 the deal had collapsed

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