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The impact of smoothed unlisted returns ... and the father-in-law effect



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It's often the little things in life that make the difference. Over a relaxing family dinner last night, we experienced a scene that I'm sure many of you will be familiar with.

Our five-year old boy suddenly developed a strong attachment to his two-year old sister's blue cup. Drawing upon whatever zen-like calm I could muster, I suggested that it was not a good idea to grab/steal items full of water. The tired and emotional little fellow responded to this penetrating insight by knocking his own (offensively un-blue) water laden cup onto the floor.

So far, so familiar. The beautiful thing was that when he and I had finished towelling the floor dry, we got back up to the table to find that his sister had spontaneously placed her blue cup on his table mat.¹ What could have been a painful end to the day, flowed serenely to lights out.

Just as every small act makes a difference in life, so the same principle applies to investing. It is often the 'below the radar' considerations that can make a big difference over time. The one I'd like to focus on in this article is the trade off between the psychological benefits of 'smoothed' returns (caused by lagged valuations) and some hidden financial costs. The benefits are well known, the costs less so.

Background

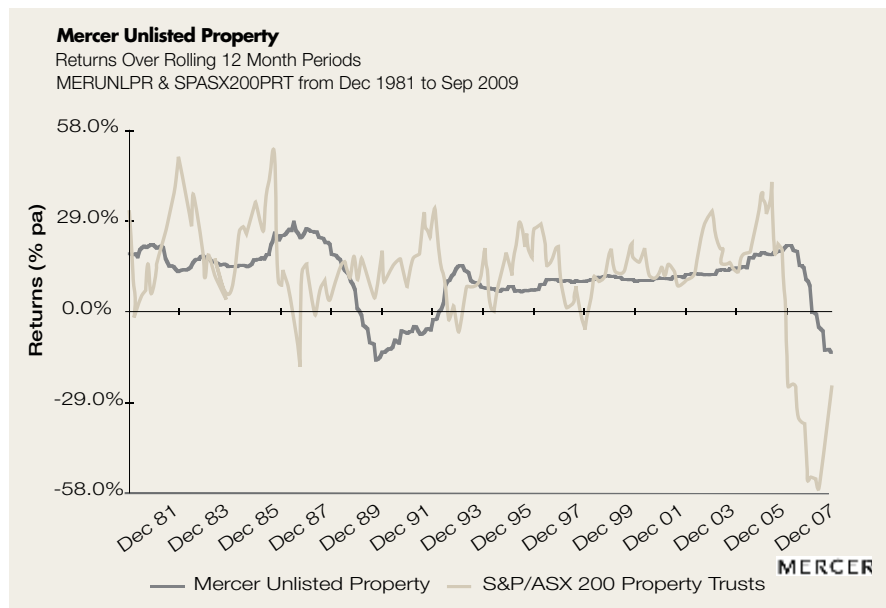
Superannuation funds with high allocations to unlisted assets (particularly property and infrastructure) considerably outperformed during the recent bear market. Some have argued that this is because unlisted assets are 'lower risk' than their listed equivalents. Others have argued that it is the underlying asset that defines the true risk, not whether it happens to be housed within a listed or an unlisted vehicle.

These arguments were summed up by a listed property manager who barked—"if unlisted property is really lower risk – why don't we just delist the entire sharemarket and then we can all get equity returns for bond-like risk!"

Nobody can argue whether unlisted assets generate smoother performance—they clearly do—but it is important to know if this is only because their valuations are lagged. This matters for a number of reasons, some of which we explore later.

¹ To be fair, she could have been rationally thinking anything for a quiet life! But given two year olds don't have much of a neo-cortex, I'll choose to put it down to a kind heart.

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The evidence increasingly supports those who have argued that the key driver of the current performance difference is valuation lag.² We are seeing this in the continuing write-downs of unlisted infrastructure and unlisted property ...

Psychological benefits

Regardless of the debate around valuation lag, the reality is that smoother returns still flow through to investors. This has real value to a number of stakeholders.

A large allocation to unlisted assets pretty much guarantees outperformance in an equity bear market. While the benefit is almost certainly transient (due to the lagged pricing, which eventually has to catch up), it still translates into better published returns at a time in the cycle when both fiduciaries and members are most focused on performance. While the smoothing may be artificial, it still helps members and fiduciaries react more calmly to emotionally capricious markets.

'Balanced fund'	6 months to 30/9/2009	% unlisted
MLC	20.9%	~6%
Australian Super	9.1%	~30%
MTAA	-2.3%	~60%

Source: ChantWest survey, fund websites

... and the turnaround in performance of providers with varying allocations to unlisted assets.

Both of these stakeholders tend to value outperformance more in bear markets than bull markets. Fiduciaries and members are much more likely to shift providers when returns are bad in absolute and relative terms. This provides an incentive for commercial providers (managers and consultants) to skew their portfolios to outperform in downmarkets. There are a number of ways to achieve this:

- Just take lower risk than peers (easy, but at the cost of likely long-term underperformance).
- Reduce exposure to equities before markets fall (possible, but hard to time).
- Choose managers who outperform in downmarkets (possible, but difficult to do).

There are obvious problems with a), while b) and c) are difficult to execute consistently. On the other hand, loading up on unlisted assets pretty much guarantees outperformance in a bear market.

So given these benefits, if you can find unlisted assets that will deliver the same returns as listed, why not have a big allocation to unlisted? The answer is that doing this may make sense, but it depends on a range of factors, including the tolerance for illiquidity, the price and quality of the assets relative to listed equivalents, fees and whether the diversification benefits go beyond just a reliance on lagged pricing. Importantly, it also needs to consider whether these benefits offset the almost certain financial cost that flows from 'smoothed' returns.

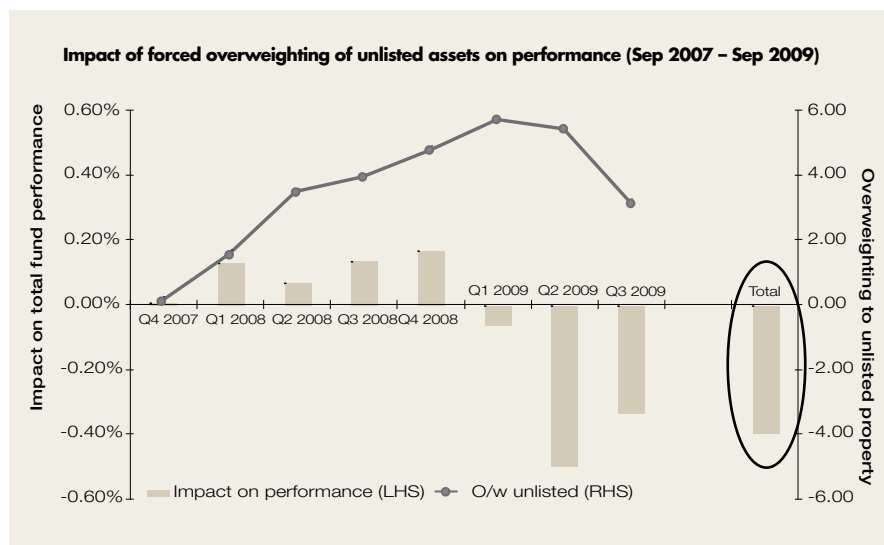
² David Klug wrote the July 2009 edition of My Consultant 'Unlisted in Wonderland', where he analysed the causes of the huge performance gap between listed and unlisted property. His conclusion was that it was almost completely due to valuation lag.

Financial costs

This is a very important issue that is rarely discussed in the industry. Namely, due to the lagged pricing, funds can become forcibly over-allocated to overvalued unlisted assets after falls in listed markets. This can create a drag on long-term performance.

This can easily be illustrated by considering the example of a superannuation fund with a 20% strategic allocation to unlisted property. During the eighteen months to March 2009, unlisted property defied gravity and outperformed listed markets by about 25% pa. This caused investors' exposure to unlisted property to rise materially. This is shown in the chart to the right.³

The chart shows that as listed markets fell, the unlisted exposure increased. The illiquid nature of these assets would have meant this super fund would have found it nearly impossible to rebalance to keep its strategic allocation.⁴ This overweighting would have added to the cushioning of performance on the downside. This is shown by the bars in the chart. These represent the impact on the total fund performance of being overweight in unlisted property (relative to being at the target strategic allocations) each quarter. Being overweight when unlisted property outperforms has a positive impact—as we see up to the end of 2008—and vice versa in 2009.



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³ We've assumed an investor started with a 20% allocation to unlisted property, 50% to listed equities and 30% Australian bonds (and used actual index data to calculate the impact on performance). The allocation to unlisted assets then drifts according to returns, reflecting its illiquid nature. Bonds are kept fixed at 30% with listed equities the balancing item.

⁴ If the fund has huge cash inflows, this can help steer the actual allocation towards the strategic target, but when markets fall strongly, even this won't be enough.

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The problem is that the exposure to unlisted property would have peaked at what looks like the point of maximum valuation lag ie March 2009. This would have heightened the financial cost to the fund as the valuation lag between unlisted and listed closed. As a consequence, the total impact on the fund over this two year period—taking into account the benefit before the turn in March 2009 and the subsequent pain—would have been -0.4%. This number, would increase if unlisted assets are still overvalued relative to listed, as some argue. Importantly, this drag is an inevitable consequence of the inherent bias to be most overweight at the point when the unlisted asset is most overvalued.

Note that this impact is separate to the issue of when returns flow through ie this is not a transient lag effect—it is a permanent loss of capital caused by being forcibly overweight an overvalued unlisted asset. The ebb and flow of markets means this type of drag is likely to happen many times over the forty-year horizon of the average member.

The key point is that this performance drag is an inevitable consequence of having an allocation to unlisted assets with lagged valuations. The higher the allocation, the bigger the effect. It is worth noting that this drag can also apply during a bull market. In this situation the bias is to be underweight unlisted property when it is relatively cheap compared to listed markets.

None of this means that investors should avoid unlisted assets. What it does mean is that unlisted assets (if they have lagged pricing) need to provide a performance premium over the long-term to overcome

this headwind. Either that or the fund must be willing to incur this performance drag to obtain the benefit of smoothed returns.

The father-in-law effect

The other major cost of 'smoothed' performance is the risk of being gamed. Super funds provide full liquidity to members even though parts of the portfolio are often invested in unlisted and illiquid assets. This is reasonable given super is a long-term investment and membership is sticky. However, informed members can know with almost 100% certainty that the unlisted assets will fall and can switch their assets accordingly. They win—but at the expense of the remaining members who lose.

In March this year, my father-in-law, who is quite close to retirement, showed me how he'd moved his asset allocation completely out of listed markets, which had fallen, into various unlisted assets that hadn't. While my general rule is to avoid offering financial advice to family members at all costs, I handed him the 'crystal ball' provided by valuation lag. By choosing to undo his switch he has saved himself about one hundred thousand dollars and made sure his retirement was not unnecessarily delayed by a couple of years. This reiterated to me that the risks and costs of lagged pricing are very real to members,⁵ not just theoretical. (On a separate note, this also helped cement my father-in-law's position as a leading contrarian indicator of when markets have bottomed.)

⁵ And son-in-laws who may be called upon to subsidise their father-in-law's retirement.

While superannuation is a long-term investment and only a small minority of members are likely to take advantage of the opportunity, it is still a risk that fiduciaries need to factor in.

Conclusions

The bottom line is that there are always trade offs with any investment decision—the key is to know what they are. We think meaningful allocations to selective unlisted assets can make sense, but it is important to be aware of all the issues. There are advantages to smoothed performance, but there are real financial costs. Ironically enough, the way to mitigate these costs is by writing down unlisted exposures quickly and aggressively in line with listed equivalents. This means you lose the benefits of smoothing but avoid going overweight in overvalued assets at exactly the wrong time.

The issues regarding lagged pricing reinforce the need to make sure that any unlisted assets have a high likelihood of delivering a return premium or genuine diversification benefits (beyond a different pricing method). Factoring in these 'below the radar' issues, in investing as in life, can make all the difference.



Faro Mok Investment Analyst

Faro joined MLC Investment Management's Implementation team in 2006. His role focuses on the monitoring of asset allocation within MLC's funds. This includes managing regular fund cashflows and rebalancing between assets when required.

Prior to this, Faro worked in the wider nab group, where he first joined as a graduate within Institutional Banking (now nabCapital). This programme led him to a dealing role in global markets, where he traded interest rate derivatives for the bank and its wholesale clients.

Faro graduated with a double degree in Actuarial Studies and Applied Finance in 2005. He has also attained membership to the Institute of Actuaries of Australia as a Fellow in 2007.

Outside MLC

In my free time I enjoy listening to music, especially classical music, which helps me relax after work. I hope to be able to play a musical instrument one day. I'm also trying to learn basic photography skills so I'll be able to take better pictures on my next holiday.

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