MLC Investments

May 2010

Unlisted investments – valuation lag moves from a bonus to a handicap

Paul Ireland
General Manager, MLC Implemented Consulting

'...when considering unlisted assets it is important to be clear that the benefits outweigh the disadvantages.'

Unlisted investments have become 'flavour of the month' among super funds and other institutional investors in recent years.

This trend has been reinforced by the strong industry fund returns, which we have heard so much of in recent media campaigns, largely on the back of their unlisted exposures. Some commentators have even gone so far as to suggest that to be competitive, super funds need a minimum allocation to unlisted investments.

So do unlisted investments provide the silver bullet for investors?

Valuation lag turns into a drag

A major issue with unlisted investments is that there tends to be a lag or delay in their valuations adjusting to changes in listed markets and the real economy.

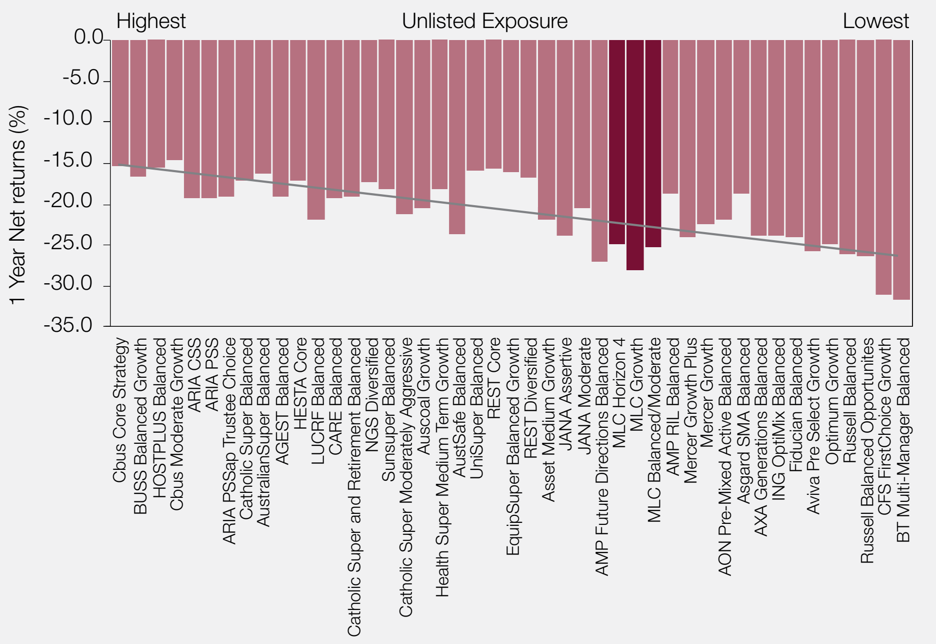
The appraisal-based valuation methodology used for unlisted investments tends to be backward looking, with a key input being previous transaction values. In contrast, listed market valuations capture what investors are actually prepared to pay for the future long-term cashflows of these assets.

Listed valuations capture investor views on the current market and what the future is likely to bring. This has been easiest to see over the past two years where there are both listed and unlisted versions of the same or similar underlying assets, such as in property and infrastructure.

It is now clear that valuation lag on unlisted investments has been the main driver of super fund performance differences over the past two years. The unlisted valuation lag effect can be seen in the following two charts.

Unlisted investments – valuation lag moves from a bonus to a handicap

Chart A: Net one-year returns to February 2009 for funds ranked by their level of unlisted assets from the highest on the left to the lowest on the right



Source: ChantWest

'It is now clear that valuation lag on unlisted investments has been the main driver of super fund performance differences over the past two years.'

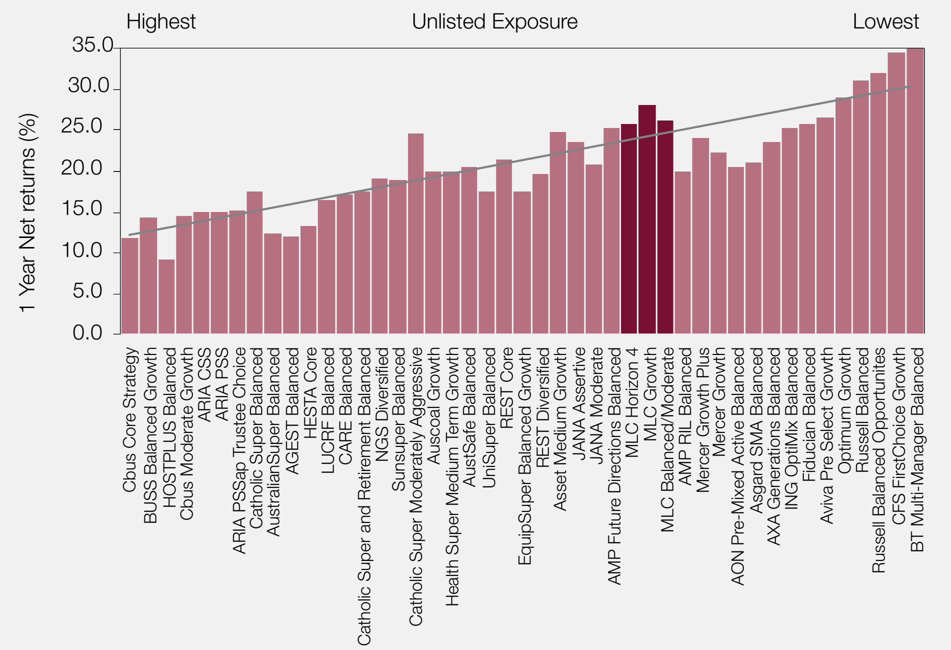
Chart A shows the one-year returns to around the low point of the GFC in February 2009 of funds from the ChantWest Multi-Manager Growth Survey, for which details of the asset allocations are available.[1] These funds have been ranked from the highest unlisted exposure on the left to the lowest on the right. We have added a trend line to highlight the impact of the exposure to unlisted assets.

While there are individual differences in fund returns due to asset allocation and manager selection, the trend is clear – the higher the level of unlisted assets, the better the return was likely to be. This can be contrasted to Chart B which shows the same funds in the same order but for the one-year to February 2010.

1 Asset allocation data is for December 2009

Unlisted investments – valuation lag moves from a bonus to a handicap

Chart B: Net one-year returns to February 2010 for funds ranked by their level of unlisted assets from the highest on the left to the lowest on the right



Source: ChantWest

It's clear that the level of unlisted exposure has been the dominant factor driving performance over this two-year period.

The reason for this is that during the fall in markets in the first half of the GFC, valuations of unlisted assets did not fully reflect changes that were occurring in the real economy. In the following year these changes have gradually fed through into the valuations of unlisted investments at the same time that listed markets were recovering strongly. And once again, the valuation lag means that unlisted assets have been slow to register this recovery.

Weighing up the costs and benefits of illiquidity

Higher returns?

In Australia's choice of fund regime, where super members are offered full liquidity by their funds, illiquid unlisted investments should offer unambiguous benefits over listed markets to be included in portfolios. These benefits need to be either in the form of higher returns, greater diversification or both.

The promise of higher returns of unlisted investments is often referred to as the 'illiquidity premium'. What is meant by this is that investors should require higher returns for investing in an unlisted asset than they would for investing in an equivalent listed asset. The illiquidity premium is to compensate them for the costs and delays that they face when buying and selling the unlisted asset, as well as the costs of valuing the asset on an ongoing basis.

This illiquidity premium is not an automatic benefit of unlisted investments. There is increasing evidence that the rush into unlisted assets that has occurred over recent years has not always benefited investors. For example, over the past two years we have seen dramatic write-downs in the value of some infrastructure investments (eg. Babcock and Brown, Macquarie and Allco assets), with some – such as the Cross City and Lane Cove Tunnels in Sydney – being forced into receivership.

Unlisted investments – valuation lag moves from a bonus to a handicap

As more and more funds have decided that unlisted assets are a panacea for good returns, prices have been bid up and the promised illiquidity premium has been squeezed. In some cases it has even become negative, with investors having all the hassles and costs of illiquidity without the compensation of higher returns.

Lower risk?

The other important reason for investing in unlisted assets is to access potential investments that are not well represented – or not represented at all – on listed markets, thereby improving the risk/return characteristics of the portfolio. Major examples in the past have included property, infrastructure, timberland and, of course, private equity.

However, the large scale privatisations and the listing of many property trusts over the past two decades have meant that these sectors are now well represented on listed markets. For example, infrastructure now represents around 4.5% of the MSCI World Index and property 6% of the ASX300 Index, limiting the need to access unlisted versions of these investments.

Diversification through unlisted exposures can be either real in the sense of investing in assets which fundamentally are not correlated with equity cycles (eg. returns on catastrophe bonds), or perceived resulting from the smoothed return stream that the less frequent, appraisal based valuations produce. A potential trap is to confuse the two.

The smoothed returns delivered by valuation lag unfortunately come with some costs attached. Two of these key costs are:

- Inequitable unit pricing. This problem is often overlooked or underplayed, but it represents a severe challenge to fiduciaries to ensure that members leaving or joining the fund, or switching options, do so based on fair unit prices. This inequity can be aggravated if members can actively switch out of options with large unlisted exposures to those with only listed exposures during bear markets, or do the reverse during bull markets.
- A less well-known cost of valuation lag is that portfolios will be most overweight unlisted exposures when these assets are most overvalued (eg. early in 2009). As these assets can't be rebalanced, the investor has no choice but to wait for the inevitable fall in these over-priced, overweight assets. And, of course, the reverse applies in bull markets ie. the investor will be most underweight when the assets are most undervalued.

Conclusion

Unlisted investments are a significant part of the potential investment universe and, therefore, need to be considered. However when considering unlisted assets, it's important to be clear that the benefits outweigh the disadvantages. Investors should be sure that they are buying unlisted investments at a significantly lower price than their listed equivalents, if the listed equivalents are readily available as they are for property and infrastructure.

If diversification is the key driver for an unlisted exposure, investors need to be clear as to whether the diversification is real or perceived. If the underlying assets are not available on listed markets and the expected returns are uncorrelated with other portfolio investments, an unlisted allocation can play an important role. If the diversification benefit is simply due to valuation lag, investors must be sure that the benefits of greater smoothing of returns outweigh the costs of valuations that don't fully reflect what is actually happening in markets and the real economy.

There is clearly no one right level of unlisted assets for all our portfolios. The right approach is to tailor the unlisted allocation to the needs and constraints of each portfolio. This involves not just getting the liquid/illiquid balance right, but also taking into account issues such as the investment horizon and fee tolerance.

MLC Investments

If you have comments or questions please contact us on 133 652 or email mlc_investments@mlc.com.au

For additional news and information please visit our website at mlc.com.au

75619M0510