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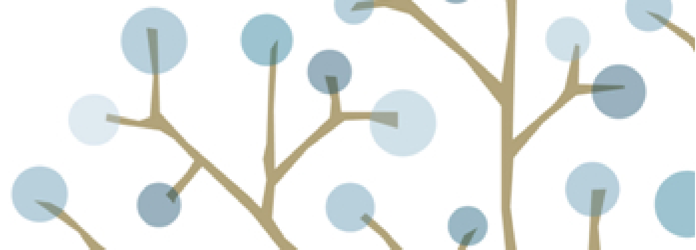

ASFA Investment Interchange.

Melbourne/Sydney, 25/26 March 2015

David Neal, Managing Director Future Fund. *Check against delivery*

Prospective asset returns are being eroded. What do you need to consider?

Why are prospective asset returns being eroded?

Slide 2

A large part of the story is the persistent, long term downtrend in global interest rates. For more than three decades, every cyclical peak and every cyclical trough in rates were lower than the ones before. This has made it even cheaper to service debts, producing stronger demand growth, and bringing that demand forward from the future.

When this came to an abrupt end in 2008, central banks sought to defend economic growth through QE, pushing long term yields down and sending asset prices across the board up. Some figures I saw earlier this week suggested that there is now $2 trillion of debt trading on negative yields. In trying to escape these extraordinarily low yields, investors are being pushed out along the risk curve. Equities, real estate, infrastructure and credit have all been beneficiaries. Despite clear risks around the globe, risk premia across the board are now on the tight side. Prospective returns are being eroded.

Slide 3

If we reflect for a second on the key defining characteristics of a long term investor, these two would be most apparent I think. If a fund is investing for the long term, so it doesn't have an immediate need for the assets, it can afford to ride out the natural market volatility associated with riskier assets in the search for higher returns.

But we need to think critically about this rather than blindly accept it. If the reward for higher risk is not there, it doesn't make sense to accept that risk. Put another way, if the market reprices at some point to restore the reward to a more appropriate level, the investor will make permanent, potentially material, capital losses.

The second characteristic is the ability to hold an illiquid asset because the fund can accept the risk of not being able to sell. Again this demands some critical analysis in the current environment. Whilst there **should** be a return for illiquidity, that does not mean there always is a return premia in practice. As has been widely reported, prices of so-called "safe" or "core" assets in real estate and infrastructure are rich indeed. In the last few months we've seen shopping centres trading at cap rates well below 4%, and infrastructure assets at sky-high multiples.

So the question must be: is constructing the traditional strategy with a high allocation to risk assets, including material exposure to illiquid investments, going to well serve your members' needs from here?

My suggestion is that funds need to consider adding another couple of characteristics to the armoury.

Slide 4

The first is to think not just about where to take risk, but when to take it. One advantage of being a long term investor is that the task is to generate the return over the long term, which means that the portfolio does not have to be constructed to achieve that target return all the time. If the reward for risk is low, it is perfectly reasonable to take lower risk (and accept an even lower return) for a while, waiting for the time when the reward for risk is once again higher. This introduces the concept of inter-temporal risk management – allocating your risk taking through time.

To be clear, trying to predict changes in short term risk-adjusted returns is certainly extremely hard, potentially impossible. As the time horizon extends though, the prospective risk adjusted returns become a little more observable, and managing the total risk exposure becomes viable.

On the face of it, the second additional point on my slide doesn't seem to add anything. Surely all superannuation funds here are already free to invest in any sector, any strategy, any geography, any time? Well I'm sure that's true, except in practice. In practice the way funds organise themselves places considerable constraints on the allocation process and these lead to less efficient portfolios.

The traditional linear process starts by defining a long term SAA which is relatively fixed, defining the allocation to broad class buckets. Changes in the market environment are unlikely to change those allocations materially.

Those asset class buckets are then handed down to sector specialists to be managed. Often these are outsourced specialist investment managers, although increasingly funds are building those sector capabilities in-house. Either way, these specialists are likely given a benchmark and a dollar allocation, and off they go. Their bonus, if not their career, is on the line so they are naturally loathe to depart too far from the benchmark or to take too big a risk in their sector.

The property team for example will want to spread the portfolio across retail, office and industrial and will be unwilling to have a single asset dominate. Similarly, equity managers will manage their tracking error. I suspect Paul Woolley will discuss this issue in more detail shortly, so suffice to say that these are material constraints that impact the efficient and effective allocation of capital.

So I would encourage all funds to think deeply about their processes. Do they have this ability to identify great strategic opportunities, and if so, do they have the ability to right-size them in the context of the total portfolio.

Let me give you an example from our fund. Following the GFC, banks have been materially capital constrained, and so many mid-sized companies have found it hard to get financing, even strong and profitable ones. With the help of our managers and other relationships, we were able to identify the opportunity and build a specific private lending strategy. This didn't appear in any benchmark, but it forms a large proportion of our debt allocation (we have $4bn in the strategy).

Another constraint is the MER budget. I can buy a core property and pay 40bps to have it managed, or I can buy an off-core asset, perhaps it needs repositioning and re-leasing, and pay 100bps to have it managed (because it's more labour intensive). But if I can buy that asset at a material discount to intrinsic value and sell it in three years' time, when the remediation work is complete, to those funds willing to overpay for core, this additional 60bps fee can turn a very healthy profit indeed. MER budgets constrain the investment universe, and as such are categorically bad for members.

To be clear, higher fees are themselves not a good thing. Fees across the asset management industry are too high. But removing the ability to make better investments is not helpful. For our part, we have found that the more generic, cheaper strategies are where the bulk of capital has been flowing, leading to high prices and lower returns. We have in a number of areas been favouring more labour intensive, and therefore higher fee, strategies where we think the net returns are more attractive.

Slide 5

So to sum up, I think the low return world we see before us should prompt funds to think about their investment process, and how that process is governed. It is the investment process that turns the universe of opportunities into a portfolio, and right now that process needs to be as efficient and effective as it can possible be.

In my view, the types of process evolution I am advocating here require substantial internal resources. These resources need to have the skills and experience to understand the environment and to be able to integrate the top-down and bottom-up information. Note this is largely a strategic exercise, but operating in a much more granular and joined-up way than current practice. This is not an argument for building internal sector implementation which is more about cost reduction. That is fine but won't on its own deliver a step change in efficient portfolio construction.

Thank you for listening and I'd be happy to take your questions.

ENDS

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ASFA INVESTMENT INTERCHANGE

Prospective asset returns are being eroded

What do you need to consider?

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Australia's Sovereign Wealth Fund

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Low prospective asset returns

Global "risk free" interest rate

GDP-weighted policy rate

14%
12%
10%
8%
6%
4%
2%
0%

1955 1958 1961 1964 1967 1970 1973 1976 1979 1982 1985 1988 1991 1994 1997 2000 2003 2006 2009 2012

Composite of US, Eurozone, Japan and UK

Characteristics of a long term investor

- The ability to take on greater levels of market risk
- The ability to accept the riskof not being able to sell

Are these going to be enough?

Characteristics of a long term investor

- The ability to take on greater levels of market risk
- The ability to accept the risk of not being able to sell

Should we add these?

- The ability to exploit changes in long term prospective risk/return characteristics
- The ability to invest in any sector, any strategy, any geography, any time

So what is a long term fund to do about low prospective returns?

1. Consider when to take risk, not just where to take risk
2. Pursue more granular strategic portfolio construction
3. Remove artificial constraints
   - peer group risk
   - MER "race to the bottom"
4. Integrate the top-down and bottom-up

Bottom line: experienced, capable, internal resources focused on strategic portfolio construction and integration

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Rethinking strategies for investment and retirement income