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The Secretary

Financial System Inquiry

GPO Box 89

Sydney NSW 2001

22 August, 2014

Re: Submission to the Financial System Inquiry

Dear Sir/Madam,

Please find attached my submission for the second round of the Financial System Inquiry. While there are many issues of interest highlighted by the commission, the focus of this submission will be on the illiquid assets within Superannuation and their implications for the three day portability rule. In general I support other submissions highlighting the importance of (lower) fees in Superannuation.

Note that this submission represents my views and not necessarily those of the Department of Economics or The University of Melbourne.

Yours Sincerely,

David Marks

The Financial System Inquiry has highlighted portability requirements as a driver for high allocations to liquid assets within the Superannuation system,

“High demand for liquidity from superannuation funds may be reducing after-fee returns to members. The mandatory inter-fund portability timeframe of three days is contributing to higher allocations to liquid assets than the system requires.”

There is an assumption in this quote that illiquid assets have higher after-fee returns. In terms of the returns actually achieved by the median manager or average investors the literature suggests this assumption is likely not true on a risk-adjusted basis.

In addition other than a case of a bank-style ‘run’ liquidity (in which case a system wide ‘emergency extension’ by APRA should indeed be available as a tool), larger funds are perfectly capable of managing their own liquidity based on the profiles of their members, while smaller funds likely do not have the capacity to invest competitively in illiquid assets. For example, at time of writing HESTA offer an ‘Infrastructure Fund’ option that includes a holding in cash and is only available to holdings in the ‘accumulation mode’, presumably to ensure fund liquidity. Most balanced funds holding illiquid assets will also include cash and other short-term fixed interest instruments (and have an agreed range of values published around their strategic asset allocation). There may be a case for illiquid options which are opted into (i.e. funds outside of a default options) to include penalties or lock-ups to avoid impact costs on other members, for example some retail and industry funds already offer term deposit or rolling diversified term deposit options with notice required for withdrawal or early withdrawal penalties. A simple across-the-board relaxation of the three day rule (outside times of ‘emergency’) seems more likely to support funds with inadequate systems and processes than the best outcomes for fund members.

Andrew Ang’s excellent new book[1] includes a summary of the recent literature on investing in illiquid assets, “After taking into account biases induced by infrequent trading and selection, it is unlikely that illiquid asset classes have higher risk-adjusted returns than traditional liquid stock and bond markets. On the other hand, there are significant illiquidity premiums within asset classes. Portfolio choice models incorporating illiquidity risk recommend only modest holdings of illiquid assets. Investors should demand high risk premiums for investing in illiquid assets.”

I recommend reading the draft chapter on illiquid assets as well as chapters on hedge funds, real estate and private equity. For the sake of brevity, some key points from Ang and the papers he cites include:

- Illiquid asset returns are inflated by survivorship bias, infrequent sampling and selection bias.
- “[T]he average hedge fund and private equity fund, respectively, provide zero expected excess returns. In particular, after adjusting for risk, most investors are better off investing in the S&P 500 than in a portfolio of private equity funds.”
- “There is no “market index” for illiquid asset classes…While this large amount of idiosyncratic risk can boost returns in some cases, it can also lead to the opposite result. Returns to illiquid asset investing can be far below a reported index.”
- “You cannot separate factor risk from manager skill…*investing in illiquid markets is always a bet on management talent*”
- “[I]nvestors face agency issues and need skill to evaluate and monitor managers”. As William J. Bernstein suggests in his review of the book[2], “It belongs on the front shelves of pension and endowment managers, who should read and reread the chapters on hedge

funds, real estate, commodities, and private equity until they realize that unless their name is David Swensen, they are the patsies at ludicrously expensive poker tables."

- "Illiquidity Markedly Reduces Optimal Holdings" of illiquid assets: Ang's modelling suggests with a baseline calibration of 59% in a risky asset which is continuously traded (e.g. an allocation to shares as would be common for a diversified fund), for an average turnover between liquidity events of ten years, illiquid assets should optimally be rebalanced to a 5% weighting. Infrastructure investments have a typical turnover time far longer than ten years.
- "Investors Must Demand High Illiquidity Hurdle Rates": In a stylised model, Ang estimates a required illiquidity risk premium for an average turnover between liquidity events of ten years at 6%p.a.

There is no reason to believe that superannuation managers in Australia have comparable access to the best asset managers as influential US endowments. Rates of return to infrastructure, hedge funds and private equity in Australian superannuation funds do not appear higher than equity returns, even putting aside issues such as infrequent valuation and survivorship bias. Alpha – risk adjusted excess return – goes to the managers: as with many financial innovations the "winners" of a move towards substantial allocation to illiquid, typically less transparent assets in retail superannuation funds would inevitably be asset managers, consultants and investment banks. I do not begrudge them a profit where they add value, however the evidence is against them in this case. That said, intermediaries may have a role to play in helping governments unitise and transform illiquid assets into tradeable ones. But in general, and particularly for the 'default' options many are allocated to, only a small allocation to illiquid assets can be justified as in the best interests of fund members.

References

[1]Ang, Andrew, *Asset Management: A Systematic Approach to Factor Investing*, 2014, Oxford University Press. The quote is from a draft of chapter 13 on Illiquid Asset Investing made available for download by the author at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2200161

[2]Bernstein, William J., *Book Review: Asset Management: A Systematic Approach to Factor Investing*, CFA Book Reviews, January 2014. http://www.cfapubs.org/doi/full/10.2469/br.v9.n1.15