



Institute of Actuaries of Australia

# INSIGHTS

## The Trouble with Illiquid Assets in Liquid Products To invest or not to Invest?

Wade Tubman, Annie Liao

PricewaterhouseCoopers Actuarial

Melbourne October 8, 2008

Sydney October 17, 2008



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# Section 1

## The rise of illiquid assets



# Illiquid Assets

- Illiquid assets form a large part of “investible assets”
  - Commercial property (e.g. retail, office, industrial)
  - Infrastructure (e.g. toll roads, airports, utilities)
  - Private equity holdings
  - Mortgages
  - Non-exchange traded securities and derivatives



# How can you invest in illiquid assets?

- Private/direct investments
  - Investment as part of an investment portfolio (e.g. stat fund of the life company, super fund)
- Listed trusts
  - Investors transact between themselves (i.e. fixed number of securities on issue)
  - Market determines prices
- Unlisted trusts
  - Investor transactions add/subtract to units on issue (i.e. variable number of securities on issue)
  - Manager determines prices



## The Rise of Illiquid Assets in Liquid Products

- Super funds and investors are seeking out new investment options for diversification (and, for super funds, to differentiate offerings)
- Massive growth in super fund investments in illiquid assets via:
  - Direct property / property funds
  - Infrastructure
  - Private equity
  - Mortgages

But...

- Member choice demands a level of ready liquidity
- Changes to a Super fund's active / strategic asset allocation can demand ready liquidity from underlying managers

Is there a contradiction here?



# Industry Statistics

## Direct Property Funds

- \$90billion funds under management
- 2/3 wholesale trusts, 1/3 retail
  - Direct retail investments increased from approx. \$1.5billion in 1997 to approx. \$30billion today
  - Some individual funds are up to \$3billion in size
- Key Players: Abacus, AMP, APN, Aspen, AXA, Becton, Blackrock, Centro, CFS, Challenger, Goodman, Investa, ING, Macquarie, MFS/Octaviar

## Mortgage Funds

- \$21billion funds under management
- 1/3 wholesale trusts, 2/3 retail
- Key Players: ANZ, AXA, Challenger, CFS, ING, La Trobe, Mirvac, Perpetual, Sandhurst, Skandia



# Section 2

## Liquidity Mismatch



## Overview

- Underlying illiquid assets are not readily transactable, while an investor's units can be transacted (i.e. liquidity mismatch)
- Can be problematic if large scale redemptions of units occur
- Property market crash in early 1990s led to major liquidity mismatch problems
  - Most funds either wound down or listed



## Impact of the Credit Crisis

- This year, a number of large direct property/mortgage funds have suspended transactions due to liquidity issues:
  - Centro (\$4b in direct property funds)
  - AXA AUS (\$1b Wholesale Property Fund)
  - Challenger (\$240m Hybrid Property Fund)
  - AMP NZ (\$327m NZ Property Fund)
  - MFS / Octavia (\$770m Premium Income Fund)
  - AXA NZ (\$229m Mortgage Backed Bonds Fund)



## Accessing Liquidity in Underlying Assets

- Options for managers when faced with liquidity issues:
  - Suspend redemptions in fund (allows time to sell underlying assets)
  - Borrow to fund redemptions
    - > allows orderly wind-down
    - > however, it has the effect of gearing remaining investors into falling investments
  - Manager to provide liquidity (i.e. buyback units)
    - > could quickly overwhelm managers, causing capital issues
  - List fund (i.e. convert to LPT)
    - > takes time
    - > opening market price could be much lower



## Use of Illiquid Assets by Super Funds

- Some super funds have up to 50% invested in unlisted, illiquid assets
- However, member choice means members can transact readily
- Withdrawals could potentially erode liquid assets:
  - skewing the strategic asset allocation even more (impacting remaining investors)
  - potentially causing a liquidity issue, which could destabilise the fund
- What happens if the unlisted fund a super fund invested in suspends withdrawals due to a liquidity issue?



## Food for Thought

- Is the worst yet to come?
- Have we learnt the lessons of the early 1990's?
- What would a liquidity issue at a super fund mean for the industry?
- Is offering illiquid assets in liquid products wise?

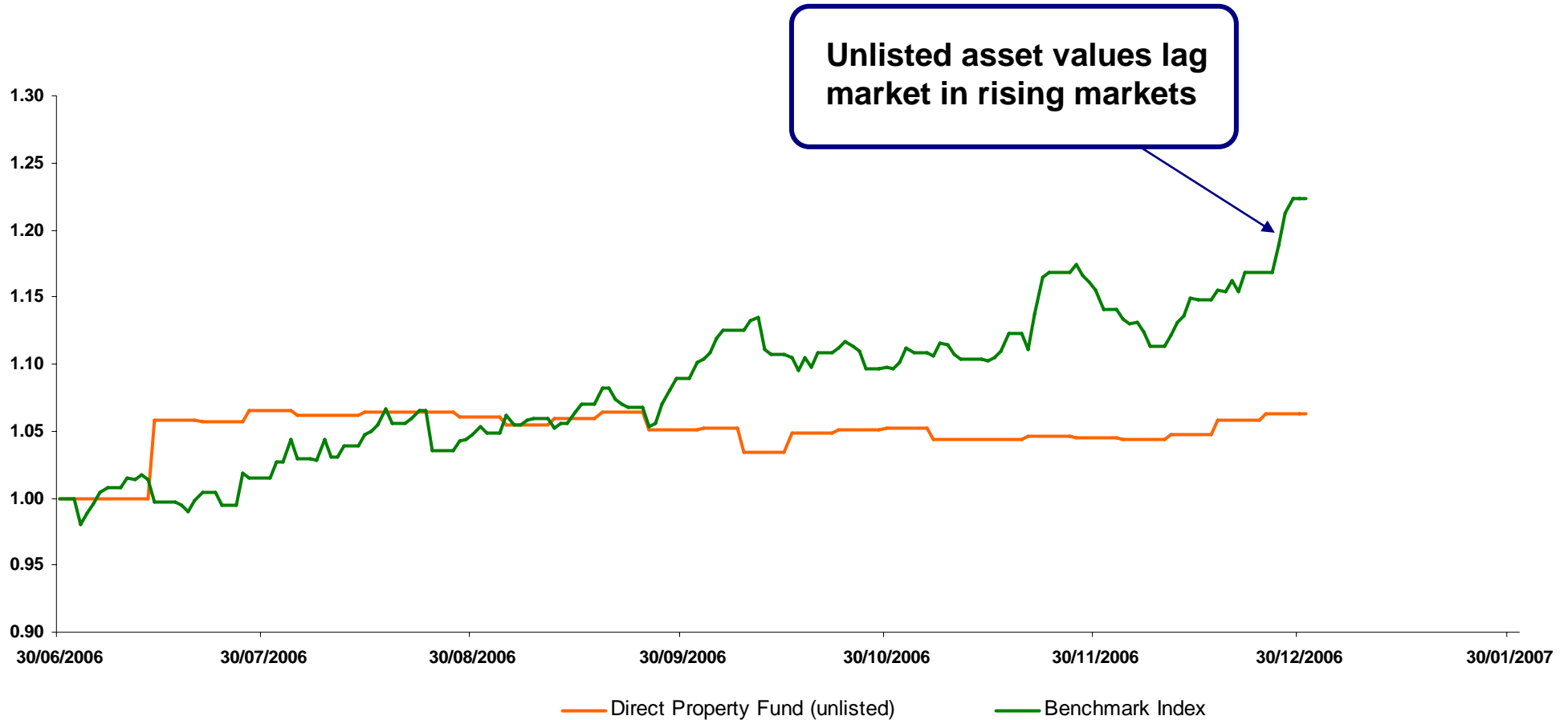


# Section 3

## Asset Valuations



# Asset Valuations and Pricing Risks



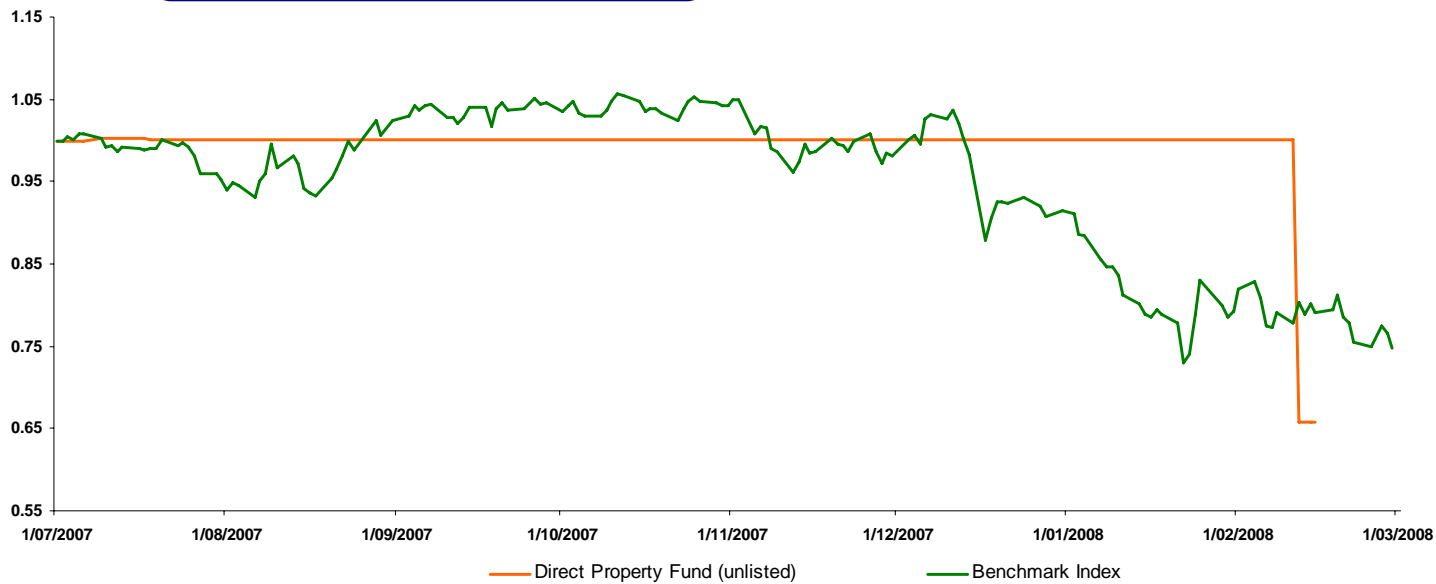
# Asset Valuations and Pricing Risks



## Section 3 - Asset Valuations

# Out-of-date valuations can accelerate the liquidity problem

**Issues can be more serious in a falling market**



Sharp falls in property market

Unit prices lag behind realistic asset values

Overvaluation encourages rapid withdrawals

Soon becomes unsustainable as assets undergo fire sale

Remaining investors bear all the losses



# Performance Reporting

- For the last 12 months
  - Listed property funds: -38%
  - Unlisted property funds : 2%
- While there can be many reasons for differences (e.g. levels of gearing, asset mixes etc), is such a gap reasonable?
- The top performing super funds rated by SelectingSuper invest a large proportion in unlisted, illiquid assets
  - while this allocation may deliver outperformance, is some of this performance differential related to timing of asset valuations?



## Regulator and Industry Guidance

- **ASIC/APRA Unit Pricing Guide to Good Practice (2005)**

- *“In principle, unit prices should only be struck with the same frequency that asset values are determined.”*
- *“Where an asset is valued infrequently, daily or weekly prices cannot be struck between valuations unless there is a reasonable basis for estimating the unit price.”*

- **David Rush – “Unit Pricing Guide to Good Practice: A year on” (2007)**

- *“We have particular concern about the use of frequent (e.g. daily or even weekly) unit pricing which can be incompatible with significant investments in unlisted and not frequently valued assets.”*

- **Recent APRA Actions** (AFR, 21 July 2008)

- APRA has recently stepped up monitoring of super funds & required year-end valuation of unlisted assets be justified.

- **IFSA Unit Pricing Focus Group – Draft Position Paper: Asset Valuation and Unit Pricing for Infrequently Valued Assets**

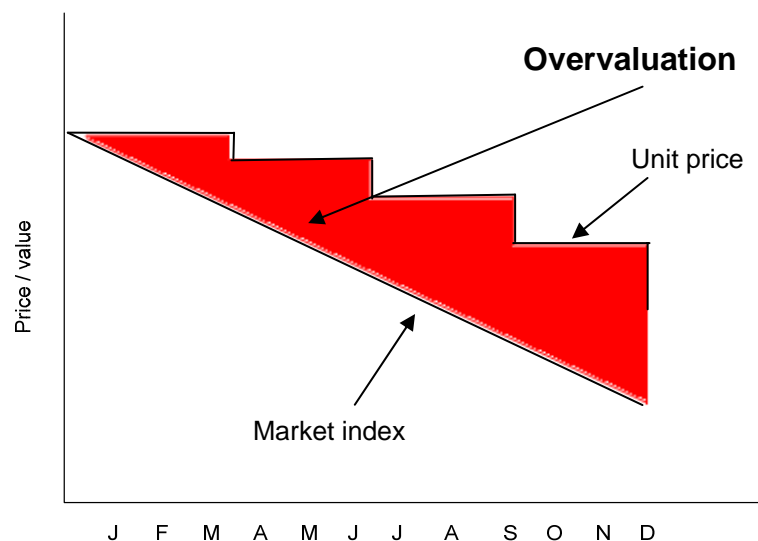
- *“To maintain investor equity, Scheme operators need to monitor the movement of Scheme assets values within a portfolio between periods, and must revalue any Scheme assets where there is a significant difference between the value of the portfolio used for Scheme pricing and the current market value of the portfolio. This can be achieved through updated valuations or estimates.”*



# Approaches

## Industry - Rolling Valuations

- Revalue some assets every quarter to smooth unit prices



- In a rapidly falling market, still leaves 3/4 of assets overvalued (out-of-date)
- This only goes part way, and has not prevented investor losses

## Proposed Alternative

- Monitor market indicators for movements in asset values:
  - Like sales
  - Market index
  - Portfolio revaluations
  - Occupancy / rental yields
  - Interest rates
- Establish tolerance level for market value movements of the portfolio
- Suspend of transactions when this tolerance is breached; and
- Seek independent valuation of the assets that are mis-valued or make a reasonable estimation of realistic asset values



# Section 4

## Consumer Issues



# Transaction Costs and Fees

- **Transaction costs**

- Transacting in property / infrastructure is expensive
- Two common market practices
  - > Capitalise purchase costs upfront and amortise over time – inequitable in an open fund
  - > Buy/sell spreads – need to reflect economic reality (equitable spreads need to be 5%-10%)
- Investor equity vs marketability

- **Fees**

- Fee structure tends to be more complicated than traditional unitised products

**Fee Disclosure table**

Transaction based fees	Establishment fee	Up to 4% to advisers
	Contribution fee	Nil
	Withdrawal fee	Nil
	Termination fee	Nil
	Performance fee	20% of outperformance

+

**What can be in the fine print?**

Asset acquisition / disposal fee	2%
Liquidity facility fee	10bps
Fund establishment fee	\$1m
Capital works management fee	3%
Fund termination fee	2%

Management fee	MER disclosed as	0.7% of GAV
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MER calculated as	1.4% of account balance (assuming 100% gearing)
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# Section 5

## Conclusion & Discussion



## What does this mean for actuaries?

- **Investment / Superannuation Actuaries**

- What to consider when investing?
- What do you do if the fund you invest in suspends?
- Are wholesale manager valuations transparent / what is the valuation basis?
- How do you ensure realistic reporting of member performance/returns?

- **Product Actuaries**

- By having these products on your platform/menu, what issues would you be exposing your investors to?
- The playing field is not level, especially in relation to disclosure

- **IAA / Consumer Protection**

- IAA encouraging actuarial involvement in investor protection issues
- For mums and dads, is Centro/MFS as damaging to the managed funds industry as Fincorp/ Bridgecorp/ACR were to the finance industry?
- Market stability



## Discussion

- Have we learnt the lessons of the early 1990's?
- We have already seen property funds with liquidity issues in Australia, are mortgage funds also at the risk (as in NZ)?
- What would a liquidity issue at a super fund mean for the industry?
- Why does superannuation (meant for long term savings) need to be readily mobile? Should the super framework allow for product designs that require some degree of investor commitment? Do we need to daily price?

## Contacts

Wade Tubman

[wade.tubman@au.pwc.com](mailto:wade.tubman@au.pwc.com)

PricewaterhouseCoopers Actuarial

Annie Liao

[annie.liao@au.pwc.com](mailto:annie.liao@au.pwc.com)

