The Trouble with Illiquid Assets in Unitised Products

To invest or not to invest?

Wade Tubman

Annie Liao

Agenda

- The rise of the unitised illiquid assets
- Asset valuations
- Liquidity
- Transaction costs
- Fees and disclosures
- What does this mean for actuaries?
- Discussion

Illiquid Assets

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

How can you invest in illiquid assets?

- **Private/direct investments**
  - Investment as part of traditional portfolio (e.g. by life and investment companies)
- **Listed trusts**
  - Investors transact between themselves (i.e. fixed number of securities on issue)
  - Market determines prices
- **Unitised trusts**
  - Investor transactions add/subtract to units on issue (i.e. variable number of securities on issue)
  - Manager determines prices

Super and Illiquid Assets

- Super is driving massive growth in sector specific unitised funds investing in illiquid assets via:
  - Property securities funds (i.e. funds investing in LPTs); and
  - Direct property/infrastructure funds

And…

- Member choice is driving a need for ready liquidity

Is there a contradiction here?

Unitised Direct Property Funds

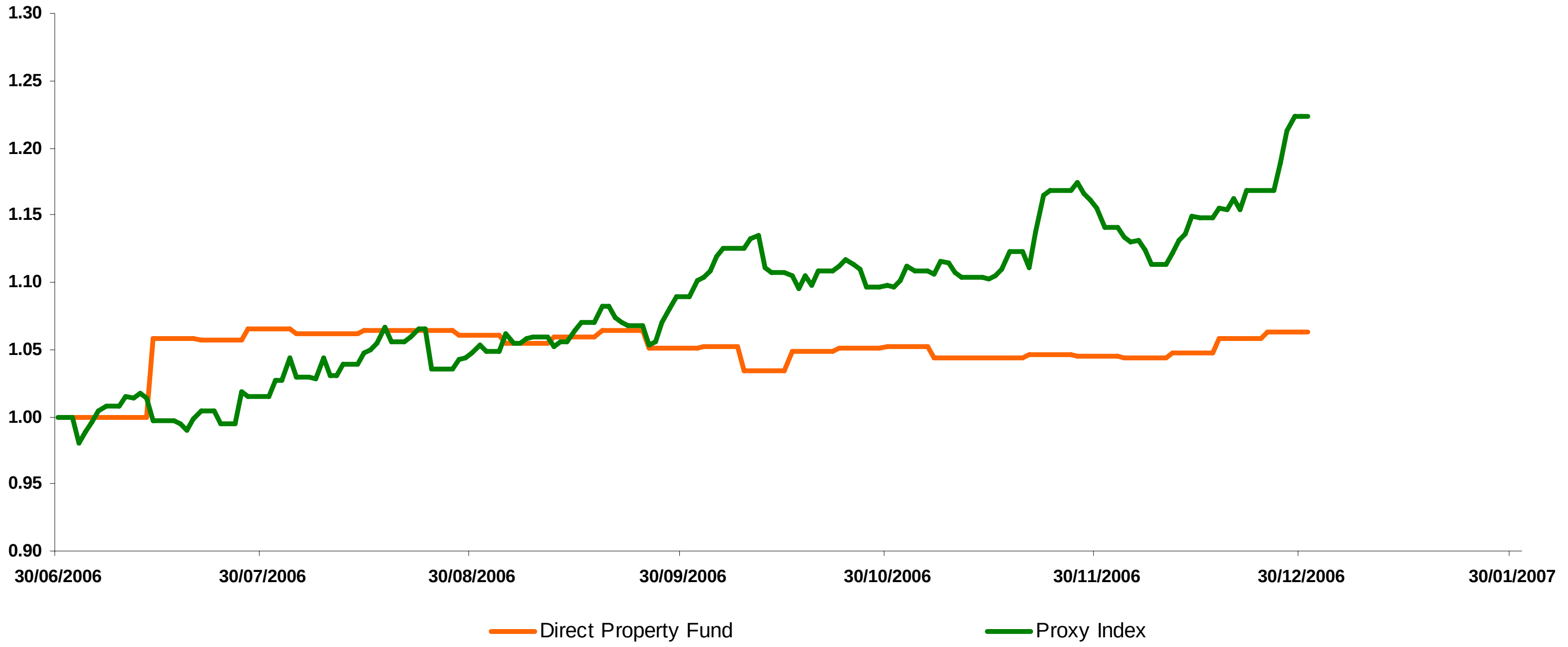
- $90billion funds under management
- 2/3 wholesale trusts, 1/3 retail
  - Direct retail investments increased from approx. $1.5billion in 1997 to approx. $30billion today
  - Some individual funds are up to $3billion in size
- Key Players: Abacus, AMP, APN, Aspen, Becton, Blackrock, Centro, CFS, Challenger,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

Key Considerations for Unitised Illiquid Assets

- Asset values / Illiquidity
- Potential for inequity
- Consumer issues

We will now explore the implications of some of these

Asset Valuations and Pricing Risks



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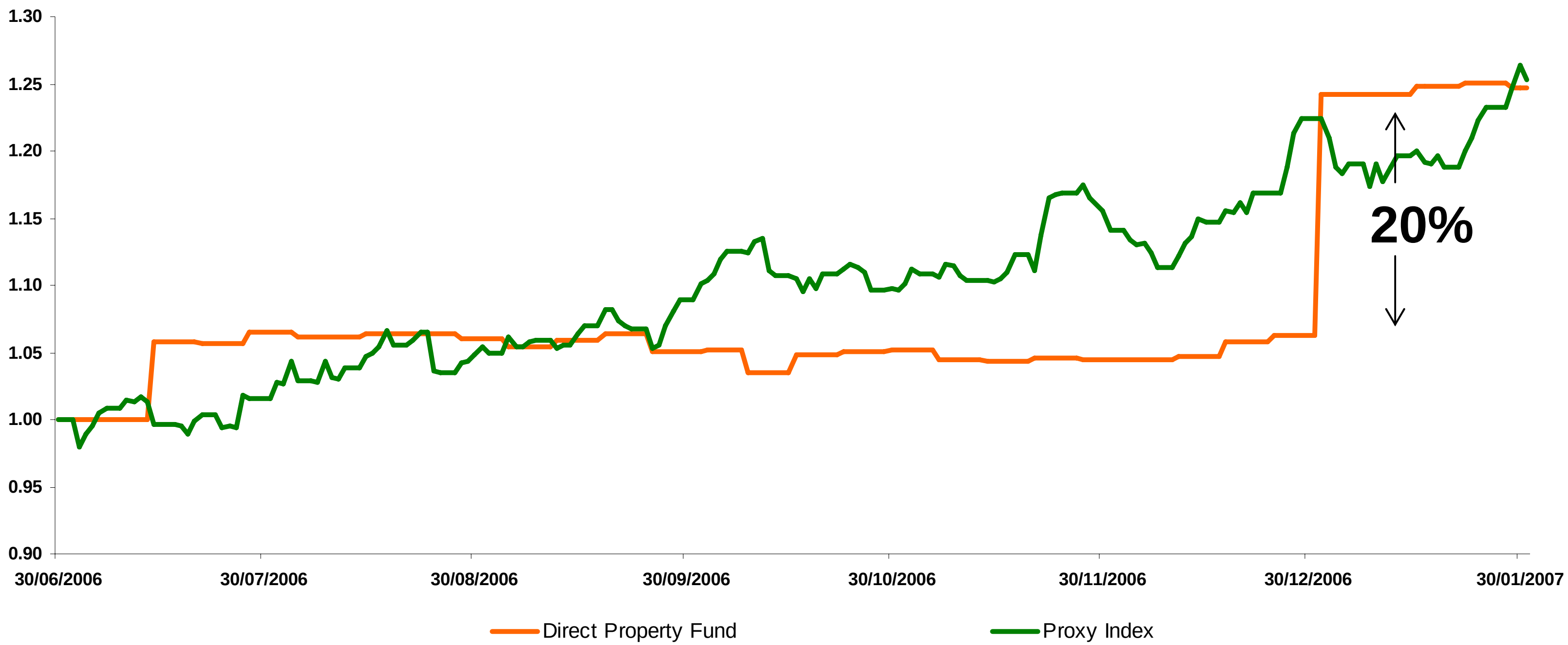
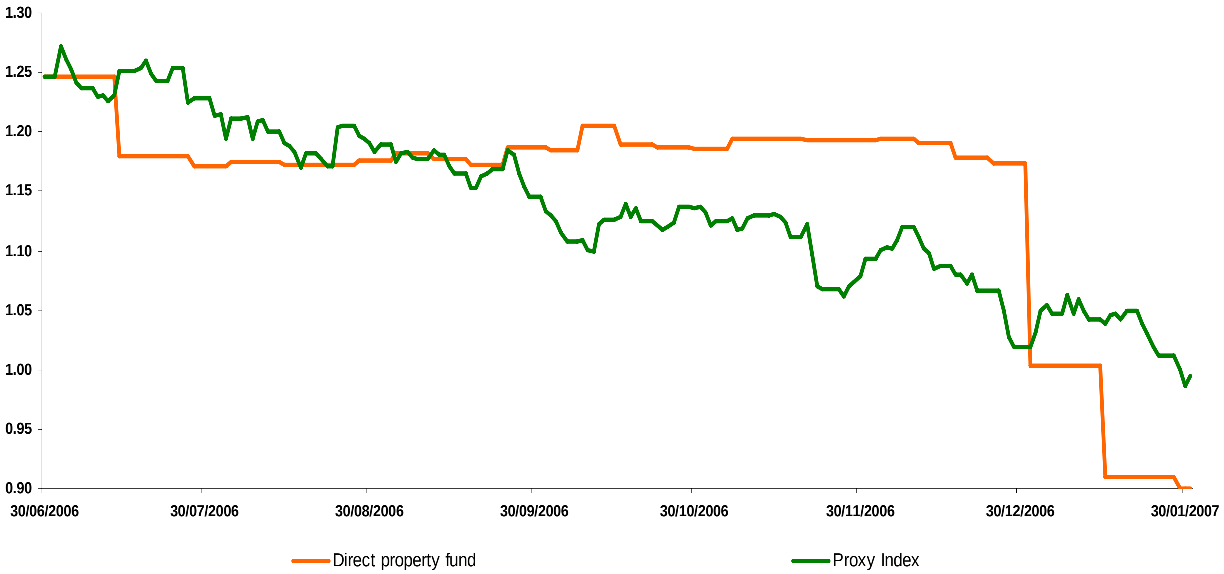


Leading to inequity / arbitrage

Liquidity Mismatch



Sharp falls in property market

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Unit prices lag behind realistic asset values

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Overvaluation encourages rapid withdrawals

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Soon becomes unsustainable as assets undergo fire sale

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Remaining investors left with significant excess losses

Leading to inequity / liquidity issues / market instability

Case Studies

- **Property market crash in early 1990s**
  - Property market crash leading to major liquidity mismatch problems
  - Corporations law amended to require trustee/RE to consider, whether withdrawals would "have a material adverse effect on the value of the remaining units in the trust".
- **Property boom 2005 – 07**
  - Sharp increases in property market leaves some funds undervalued
  - Investors arbitrage leading to inequity
- **Credit crisis – 2007 / 2008**
  - Credit / liquidity crunch leading to unsustainable gearing levels
  - Investors run on unitised funds stopped (by suspending redemptions)

Is giving investors transaction liquidity on illiquid assets wise?

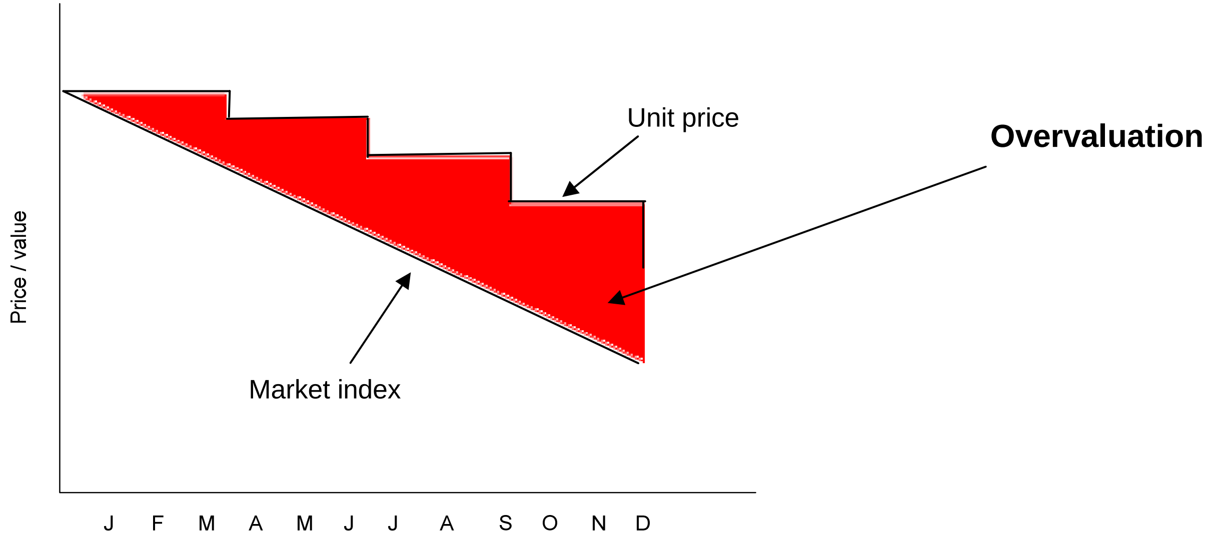
Regulator’s View

- **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.”*

Industry Response – Rolling Valuations

- Revalue some assets every quarter to smooth unit prices



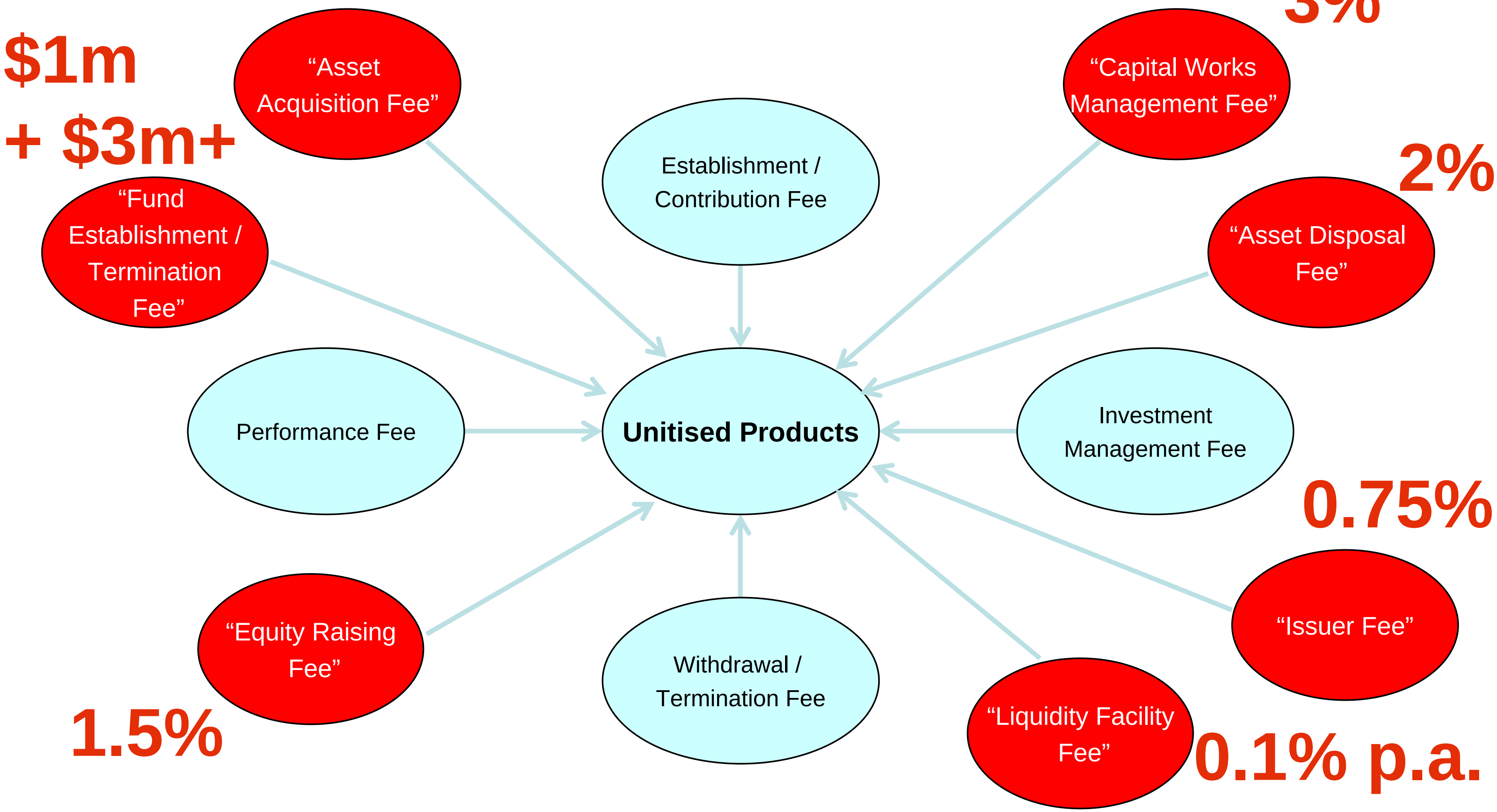
- In a rapidly falling market, still leaves 3/4 of assets overvalued
- This only goes part way, and has not prevented investor losses

Transaction Costs - Issues

- **Transacting in buildings and airports etc is expensive**
- **Two common market practices:**
  - Capitalise purchase costs upfront and amortise over time
    - Results in lower performance
    - OK for close ended funds
    - Causes inequity between different generations of investors if used in an open fund
  - Buy/sell spreads
    - Common practice in mainstream asset classes (equities etc)
    - However, equitable spreads would need to be over 5%, making marketing very difficult

Both methods have pros and cons, but investor equity may be secondary to marketability

Unitised Product Fees



Fee Disclosure

- **Fee disclosure table from a direct property PDS**
- **What else is in the fine print?**

Transaction fees	Establish-ment fee	Up to 4% to advisers
	Contribution fee	Nil
	Withdrawal fee	Nil
	Termination fee	Nil

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Asset Acquisition fee	2%
Asset disposal fee	2%
Fund establishment fee	$1m
Capital works management fee	3%
Performance fee	20% of out-performance
Termination fee	2%

Management fee	MER disclosed as	0.7% of GAV

→

MER calculated as	1.4% of account balance

To Invest or Not To Invest

- **Valuation Actuaries**
  - Can you trust manager valuations?
  - How do you value suspended securities?
- **Investment Actuaries**
  - What to watch out for when investing
- **Product Actuaries**
  - The playing field is not level, especially in relation to disclosure
  - By having these products on your platform/menu, what issues would you be exposing your investors to?
- **IAA / Consumer Protection**
  - IAA encouraging actuarial involvement in investor protection issues
  - For mums and dads, is Centro/MFS as damaging to super funds as Fincorp/ Bridgecorp/ACR were to the finance industry?
  - Market stability

Discussion

- For the last 12 months: (source - Morningstar Performance)
  - LPT funds: -26% (and lowest performing sector)
  - Direct property fund index: 9.2% (and highest performing sector)

  Why are they so different when they invest in the same assets?
- Have we learnt the lessons of the early 1990's?
- Why do we have fee disclosure templates if they are being abused?
- In a recent crisis, the manager was also a major unitholder. Are there conflicts of interest here?
- 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?
- Options / solutions / way forward?