WHY OUR INSTITUTIONS HAVE NO APPETITE FOR ALTERNATIVE ASSETS

Australian financial institutions are slow to invest in unlisted equity despite the possibility of good returns. CHRISTOPHER GOLIS contrasts the Australian approach with those of some overseas markets and develops a model showing that those looking beyond the short term will see that alternative assets can become a self-funding investment.

In overseas markets institutional investment in alternative assets (mainly unlisted equity) has become widely accepted. Overseas fund managers, who used to allocate nearly all the illiquid part of their portfolios to real estate, have shown increasing interest in alternative assets. For example, a joint study carried out by Frank Russell and Goldman Sachs of the 188 US funds with assets of more than $2 billion and 40 funds with assets of more than $500 million produced the following information:

- while in 1975 only 11 per cent of funds invested in alternative assets, that proportion had increased nearly five times (to 54 per cent) by 1992;
- total assets allocated to alternative assets tripled to $US36 billion in the six years to 1992;
- alternative assets account for 3.5 per cent of assets for those funds that invest in them, compared with 4 per cent for property.

While recently some Australian alternative asset managers such as Catalyst, Hambro-Grantham and Macquarie have been generating exceptional returns, this shift away from nearly all real estate to a 50-50 mix of real estate and alternative assets has not yet occurred in Australia.

A common explanation is that the Australian market is not yet educated. This argument does not hold water. The Singapore venture capital industry started in 1984, the same year as Australia's. However, it is now three times bigger, with more than 50 major funds (greater than $US50 million) operating. The annual investment by institutions in Singapore venture capital is running at five times that in Australia, even though the comparative performance of Australian funds is far better.

A major reason for the lack of investment by Australian institutions in the alternative asset class is the lack of a strategic approach.

OVERSEAS FUND STRUCTURES

The most important characteristic of overseas venture capital funds (VCFs) is that almost all are terminating funds. The typical VCF has a 10-year limited life. Managers of the funds also have a limited investment period, generally half of the life of the fund, or five years. The managers are expected to invest funds during the five-year investment period and then liquidate the investments during the second half of the life of the fund.

VCFs usually have a drawdown structure. Typically, an institution expects to release 10-20 per cent of the total commitment initially and to invest the rest of the commitment in roughly equal amounts over the next, say, four years. If an institution committed $5 million to a VCF, it would invest $1 million immediately and $1 million at the beginning of years 2, 3, 4 and 5.

Another key characteristic is that the VCF invests the institutional funds only once. Each investment is done on a cash-on-cash basis. The investment is made and then, say, five years later when the investment is harvested, the funds so gained are returned to the investors.

This structure and methodology are reflected in the fee structure. The typical management fee for a $50 million VCF is 2.5 per cent of funds committed for the first five years, declining thereafter by 0.25 per cent each year of the principal.
under management. Note that the fee is not a percentage of net asset value. Table 1 shows the effect in a $50 million fund where the commitment is drawn down equally over the first five years, with the investments being harvested over the next five years. It is clear that under this fee structure the manager has an incentive to terminate the fund and not prolong its life.

**THE LEWIS SPEECH**

The most common reaction to any attempts to raise a development capital fund among institutions in Australia is that the investment must have liquidity, meaning the institutions must have the ability to sell the investment quickly into a secondary market.

This may seem inconsistent, given that the institutions as a whole have allocated more than $33 billion or 11.7 per cent of total funds under management to investment in relatively illiquid real estate, but it is common in Australia. However, the issue of liquidity is rarely raised by overseas institutions. Why?

The moment of revelation for me occurred when I read a speech delivered by David Lewis, vice-chairman of Hambros Bank, London, a well known merchant bank and also a major worldwide investor and manager in alternative assets. Hambros has more than $US1 billion in direct investments and manages 29 venture funds.

One of Lewis’s more interesting comments was that the Australian funds have consistently been their best performers. The following passage caught my attention:

“The lack of liquidity is often cited by institutional as well as other investors as being a major contributor to risk. In private equity investment funds, to my mind, this is a non sequitur. If it is liquidity you want, you are by definition a short-term investor and you should not be in a private equity fund; the listed markets are for you.”

**THE MODEL**

With the above thoughts in mind, it is a simple exercise to construct a spreadsheet model. Let us assume we are the manager of an institutional super fund with, say, $500 million under management which we expect to grow to $1 billion and then stabilise. The trustees have decided to allocate 2.5 per cent to alternative assets.

As manager we decide to allocate $25 million to five VCFs over five years. Each year in April we spend one week reviewing the various proposals we have
Table 2: Model of $25 million VCF in investment

Assumptions: Institution will diversify holding among five VCFs ($5m each); Institution will invest in one new fund manager per year; each VCF manager will operate 10-year terminating funds; each VCF will draw down five annual instalments of $1 million; each VCF will earn 17% compound cash-on-cash; each VCF will return funds to investors in equal amounts of $2.2 million in years 6-10; each VCF manager will start a new fund every five years.

Fund manager A B C D E Super fund
Year Fund 1 Fund 2 Fund 1 Fund 2 Fund 1 Fund 2 Fund 1 Fund 2 Fund 1 Fund 2 Funds flow Cum
1 -1 -1 -1 -1 -1 -1 -1 -1 -1 -1
2 -1 -1 -1 -1 -1 -1 -1 -1 -1 -1
3 -1 -1 -1 -1 -1 -1 -1 -1 -1 -1
4 -1 -1 -1 -1 -1 -1 -1 -1 -1 -1
5 -1 -1 -1 -1 -1 -1 -1 -1 -1 -1
6 2.2 -1 -1 -1 -1 -1 -1 -1 -1 -1
7 2.2 -1 2.2 -1 -1 -1 -1 -1 -1 -1
8 2.2 -1 2.2 -1 2.2 -1 -1 -1 -1 -1
9 2.2 -1 2.2 -1 2.2 -1 2.2 -1 2.2 -1
10 2.2 -1 2.2 -1 2.2 -1 2.2 -1 2.2 -1
11 -1 2.2 2.2 -1 2.2 -1 2.2 -1 2.2 -1
12 -1 2.2 2.2 -1 2.2 -1 2.2 -1 2.2 -1
13 -1 2.2 2.2 -1 2.2 -1 2.2 -1 2.2 -1
14 -1 2.2 2.2 -1 2.2 -1 2.2 -1 2.2 -1
15 -1 2.2 2.2 -1 2.2 -1 2.2 -1 2.2 -1
16 2.2 -1 2.2 -1 2.2 -1 2.2 -1 2.2 -1
17 2.2 -1 2.2 -1 2.2 -1 2.2 -1 2.2 -1

The results of the model in terms of cumulative cashflow are shown in Figure 1. The returns and the shape of the cashflow curve appear significantly better than most infrastructure investments.

CONSISTENCY WITH RULES OF INVESTMENT STRATEGY

A good test of any investment strategy is to see whether it embodies some of the widely recognised rules in successful investment decision-making.

Diversification
This strategy certainly follows the rule of diversification. After five years the institution will have a portfolio diversified by both managers and time.

Dollar-cost averaging
The strategy also follows the rule of dollar-cost averaging, widely regarded as a tenet of successful professional investing.

received from VCF managers, hold a beauty parade and choose one new manager. In September and March we will spend one day compiling a summary of the VCF reports for our trustees.

Each year we will pick one new fund manager and make a commitment of $5 million. Each VCF performs identically. For years 1 to 5, the VCF draws down $1 million a year and for years 6 to 10 the VCF returns 17 per cent compound or $2.2 million per year. In year 5 of the first fund, the manager starts fund-raising for a second fund which is successful and starts in year 6. The process is repeated for each of the five fund managers, as is shown in Table 2.
The strategy is independent of the investment cycle and says to the institution to keep making an allocation every year. The institution may certainly drop one manager in favour of another but every year it makes an investment in unlisted equity.

While there have been other explanations, the lack of a proactive approach to development capital investment does much to explain why the Australian development capital industry has not grown, compared with those of other countries. The strategy adopted by nearly all Australian institutions has been either reactive or "toe-in-the-water".

In the reactive response, approaches by prospective VCFs seeking, say, $5 million are examined on a case-by-case basis and then rejected as being either time-inefficient or too small.

In the toe-in-the-water approach, the first step has been to appoint an asset consultant. Much time is then spent on which criteria to use to choose a manager and then which VCF manager to appoint. The institution makes one or two commitments and then waits. Such an approach is tactical and not strategic. It is almost certainly doomed to failure.

In telling a retail investor with $100,000 to invest in equities to buy $5,000 each of BHP and News Ltd, wait for five years and then, on the basis of the experience of these two stocks, decide what to do next. I know of only one Australian institution that has adopted the proactive strategy. The following is an example of its operation.

- Estimate the size of the institutional fund in five years (say, $1.5 billion).
- Decide on the percentage allocation to alternative assets (say, 2.5 per cent or $37.5 million).
- Divide this allocation into five equal amounts ($7.5 million, say $8 million).
- If the annual amount is more than $5 million, divide it into roughly equal parcels (two parcels of $4 million).
- Decide on the week of the year in which you will choose the VCF manager and hold a beauty parade.
- Assuming three days to choose the VCF manager or managers for that year and two days for monitoring, the total time consumed will be about one week a year or 2 per cent of the available time.

REFERENCES
Hardy, Donald (director, Frank Russell Company), 1993, "Investing in Private Equity: Strategies for Building Value", address to ASFA Conference, October.