Alternative investments: definition, importance and risks

As superannuation funds have grown in asset size and sophistication, they have expanded their portfolios to cover additional asset classes such as 'alternative investments'. The attractions of these investments are increased diversification and returns, and/or reduced risk. This article examines: what types of investments should be included under this 'alternative' umbrella; how important are they; and what are the associated risks?

MICHAEL SKULLY SF Fin is Professor,
Department of Accounting & Finance,
Faculty of Business & Economics, Monash University.
Email: Michael.Skully@BusEco.monash.edu.au

An earlier version of this paper was presented to the 12th Melbourne Money and Finance Conference, 'Wealth Management: Trends and Issues', conducted by Melbourne Centre for Financial Studies in May 2007. Original conference papers are available from www.melbournecentre.com.au/MMFC.htm

Defining alternative investment

One of the greatest problems in discussing 'alternative investments' is knowing what the term actually means. One approach would be firstly to identify the original asset to which the alternative refers. From the literature, the logical choice is listed investments. These have a ready trading market and so their value can be determined easily. If these traditional or standard investments have good liquidity, then alternative investments, as their name implies, probably do not and so we have the basis for a definition.

Alternative investments in a broad sense are those assets which do not have an immediate trading market. While this lack of liquidity represents a risk, it may also be a source of added return to long-term investors. To the extent that superannuation funds invest for the longer term, they could be well placed to assume some of this risk subject to some appropriate compensation. As Scholes (2000, p. 17) explains, 'Alternative investments require a premium return because they are illiquid'. It is not clear whether superannuation trustees or their regulators have quite grasped this concept.

So what is normally thought to constitute alternative investments? Given recent media coverage, the first choices would probably include hedge funds and private equity while others might include direct infrastructure and commodity investments.

Subject to appropriate 'sole purpose tests', other stranger alternative 'alternatives' for superannuation funds would include works of art, antiques, stamp collections and even taxi licences. However, the key investment not always considered within this context (but which should be included on the basis of the liquidity discussion above) is the direct ownership of property, as well as any major holdings in unlisted property trusts or syndicates.

Importance of alternative investments

The reason for discussing what constitutes 'alternative investment' becomes immediately apparent when examining the different approaches taken by various commentators on the subject. Taylor (2007), for example, notes that according to Investment and Financial Services Association (IFSA), Australian superannuation funds 'allocate around 11 per cent of their investment portfolio in alternative investments ($35 billion of the $318 billion being invested) and provide some 50 per cent of the private equity funds in Australia'. The article, however, is titled, 'Super funds averaging 11 per cent allocation to private equity'. So the implication is that alternative investments and private equity investments are the same rather than the latter being a sub-set of the former. Wilson (2007) explained that as these investments have 'become increasingly main stream' and no longer special case alternatives, it is important that regulators standardise how these investments are reported.

Sadly, the current position is hardly encouraging. The key prudential regulator in Australia, the Australian Prudential Regulatory Authority (APRA), does not bother to distinguish in its own reports the degree to which superannuation funds invest in those 'dreaded hedge funds' or the hopefully somewhat safer, infrastructure syndicates. If it is not listed, all assets, other than unlisted property, are simply lumped into the 'other' category. This is of particular concern in that 'other' now accounts for 12.3 per cent of large superannuation fund holdings (see Table 2). More importantly, 'other' is now the third largest of APRA's eight asset categories. Given the concern voiced over hedge fund investments and the like, it seems odd that the market is not kept better informed about the industry's overall exposure to these specific asset classes.

While neither the regulator nor the Australian Bureau of Statistics provides many insights into these new asset class holdings, the private sector has no such problems in doing so. Morningstar and others are able to identify these 'alternatives' and so present a much different picture, as shown in Table 3. The percentages here seemingly drop to a more reasonable level of 6.7 per cent.

One problem, of course, is that the APRA and Morningstar tables cover different groups of funds. APRA considers only those with assets of at least $100 million while Morningstar's coverage starts with those of more than $50 million. To the extent that larger funds are more likely to hold 'alternative' investments than smaller funds, it is difficult to make any direct observations about these investments other than that their overall importance has not increased to the extent that is widely indicated in the media. The overall level has seemingly stayed much the same in recent years.

Fortunately, Morningstar provides a further breakdown of superannuation fund investments based on their total assets. As shown in Table 4, the relative importance of alternative investment holdings across fund size change as might be expected. The smaller funds, between $50 million and 99 million, hold the smallest percentage of alternative investments with only 2.5 per cent of total assets in 2006 compared with 7.0 per cent for the largest funds. The two classes in between, $100 million to $499 million and $500 million to $999 million, increased their holdings in line with size, by 3.6 per cent and 6.3 per cent, respectively.

The Morningstar figures also offer a further insight in terms of the relationship between the actual type of superannuation fund and the alternative asset holdings. As shown in Table 5, there is a considerable difference. Industry funds hold more than twice the level of alternative investments held by either the corporate or public sector superannuation funds. Within this industry fund category, the position is probably even more skewed with some industry funds holding few such investments but others hold a considerably larger percentage. Moore (2007,

TABLE 1. ALTERNATIVE INVESTMENTS SUB-GROUPS

Private equity (venture capital)
Hedge funds (unlisted)
Infrastructure (direct)
Commodities
Property (direct and unlisted syndicates)
Art and antiques
Other unlisted assets

TABLE 2. ASSET ALLOCATIONS OF SUPERANNUATION FUNDS

	2004	2005	2006
Australian shares	31.0	31.1	32.0
International shares	22.8	23.0	24.5
Listed property	3.2	3.1	3.1
Unlisted property	4.6	4.7	5.5
Australian fixed interest	12.1	10.8	9.6
International fixed interest	5.7	5.9	5.3
Cash	7.9	9.4	7.6
Other	12.7	12.0	12.3
Total	**100.0**	**100.0**	**100.0**

Source: APRA 2007, *Insight*, Issue 2, p. 57.
Note: Covers funds holding assets of at least $100 million.

The justification for better disclosure is, as indicated earlier, that alternative investments have some risk characteristics that are additional to and different from traditional listed investments. Liquidity risk is seemingly the easiest to identify and most common of these risks. These investments are also unique.

p. 11) confirms this, citing SuperRatings data for the year ending 30 June 2006 with one industry fund allocating 41 to 45 per cent of its assets to alternative investments, another with 26 to 30 per cent, one more with 21 to 25 per cent, and five with 16 to 20 per cent. The others held much more modest positions.

The point of these comments is to signal to the regulators and others that if alternative investments are matters of concern, then these holdings need to be both carefully defined and disclosed to existing and potential investors.

Alternative investment risk characteristics

The justification for better disclosure is, as indicated earlier, that alternative investments have some risk characteristics that are additional to and different from traditional listed investments. Liquidity risk is seemingly the easiest to identify and most common of these risks. These investments are also unique; one BHP share is the same as another, but a direct equity stake in, for example, Sydney airport is not the same as one in Rome. So while we might understand the former well, this same expertise might prove quite misleading when applied in a different context. So each alternative investment brings with it a different set of risks as listed in Table 6.

If one considers airports, toll roads, hedge funds or private equity investments, another common characteristic is that their fee structures are unlikely to be the same. Furthermore, even if well disclosed, their complexity may make it more difficult for potential investors to make useful comparisons. So they may prove much more costly in terms of annual and special charges than might have otherwise been expected. A lack of transparency brings with it the risks of being overcharged.

Similarly, whereas shareholdings in listed companies bring with them voting power, the investors' ability to impact on the management of alternative investments is not so clear. Sometimes investors can appoint directors, but they need to be major stakeholders. Alternatively, they may be able to appoint members of an advisory committee. Only where all investors join together can they be effective, but this may only result in the underlying investment being liquidated. So this lack of effective direct involvement in the management raises other risks not normally present with listed investments.

This problem of clarity with the investment itself and its management suggests that potential investors need considerable expertise both in conducting their due diligence before any investments and in monitoring the operations afterwards. While this expertise can be purchased or outsourced through independent third parties, the position differs from a normal listed share investment. Funds can develop this expertise in-house but these additional expenses cannot be easily recovered without a sufficiently large exposure.

TABLE 3. ASSET ALLOCATION OF SUPERANNUATION FUNDS

	2005	2006
Australian equities	32.5	31.5
Australian fixed interest	7.9	6.1
Global equities	26.0	24.1
Global fixed interest	5.4	4.7
Diversified fixed interest	5.6	7.8
Property	9.0	9.4
Cash	7.0	6.4
Alternative	6.2	6.7
Other	0.2	3.1
Total	**100.0**	**100.0**

Source: Morningstar 2007, *InvestorSupermarket Market Wrap*, March.

Note: Figures as percentage of total assets for the year ending 30 June for funds with assets in excess of $50 million.

TABLE 4. ALTERNATIVE ASSET HOLDINGS AND SUPERANNUATION FUND SIZE

	2005	2006
Greater than $1 billion	6.6	7.0
Between $500 to $999 million	4.4	6.3
Between $100 to $499 million	2.8	3.6
Between $50 to $99 million	2.0	2.5
Total	**6.2**	**6.7**

Source: Morningstar 2007, *InvestorSupermarket Market Wrap*, March.

Note: Figures as percentage of total assets for the year ending 30 June.

Another facet of these investments observed in 2007 is the capacity constraints within its sub-asset classes. For example, the first movers into direct infrastructure investments have probably done quite well (Sydney's airport train and cross tunnel excluded). New investors, however, may find the same relative, potential returns and package features unavailable. Indeed, the recent shortage of new infrastructure investments have forced Australian superannuation funds overseas into North American toll roads and European airports. Similar cases can be argued for private equity investments, hedge funds and others in the alternative category.

The investment decision on an alternative asset obviously requires an appropriate risk-adjusted price evaluation. This is not just a one-time exercise. Superannuation funds need to report on their performance regularly to their members. To ensure objectivity, these assets must be valued regularly by qualified third parties, independent of the fund concerned. So their fees, typically annual, are an added expense. Annual valuations, though, mean that a fund should only adjust its carrying value of these assets once a year. As investment performance competition increases, the more frequent valuations required will result in additional costs.

Regulatory issues

There are also regulatory issues to be considered. APRA and Australian Securities and Investments Commission (ASIC) have already expressed some concerns over some types of alternative investments and new regulations concerning these holdings could hardly be unexpected. Funds with significant holdings of these investments may need to reduce them accordingly.

One obvious concern is that the regulators could remember their rule that superannuation funds should not borrow, but then note that hedge funds and, to a lesser extent, private equity use high gearing to enhance their returns. Where a superannuation fund is a direct participant in a hedge fund or private equity syndicate, the difference between the superannuation fund borrowing and the syndicate is not so far removed. So, new regulatory guidance on overall indirect borrowing exposures could easily be anticipated. The same is true in the taxation area where again superannuation funds are forced to adopt interesting legal structures to conform to overseas practice while avoiding direct conflicts with Australian law.

In addition to these direct risks, there are several other matters to be considered. Whereas superannuation funds have had the advantage of effectively longer term liabilities, fund members can now more easily move their money, if not their employers' future contributions, to a competing fund. Poor performance, lack of product features, or poor ratings might cause them to switch funds and, if in sufficient numbers, force the liquidation of some alternative investments. As these holdings are illiquid, further write-downs might result from a forced sale, resulting in even poorer performance, even more departures and the start of a downward cycle.

Conclusion

While superannuation funds' interest in alternative investments is seemingly obvious, the impact of regulation needs to be considered. As investment portfolios have grown in size and complexity, superannuation fund trustees have been forced, in response to the *Superannuation Industry (Supervision) Act 1993* and APRA regulations, to protect themselves by obtaining external third-party advice on such matters. As Moore (2007) comments, 'trustees are increasingly looking to the advice of professional asset consultants'. These experts advise their funds to diversify so as to reduce risk and their trustees would seemingly be viewed as irresponsible if

TABLE 5. ALTERNATIVE ASSET HOLDINGS BY SUPERANNUATION FUND TYPE

	2005	2006
Corporate super funds	3.5	4.9
Public sector super funds	4.4	4.4
Industry super funds	9.5	9.9
Total	**6.2**	**6.7**

Source: Morningstar 2007, *InvestorSupermarket Market Wrap*, March.

Note: Figures as percentage of total assets for the year ending 30 June.

TABLE 6. RISKS AND ALTERNATIVE ASSETS

Liquidity risks
Unique products
Complex fee structures
Poor governance structures & transparency
Lack of experience staff (select/monitor)
Capacity constraints in asset classes
Valuation problems (costs, validity, frequency & impact)
Regulatory and legal risks
Taxation risk (particularly offshore)

Source: Adapted from Cheever 2006.

they did not implement such advice. It is therefore ironic that those responsible for enforcing the regulations, who effectively forced the superannuation funds move into alternative investments, should now express concerns over this very change. This suggests that regulators, too, must become much more informed over the risks that their regulated institutions are undertaking and, perhaps more importantly, the unintended impact of any subsequent regulatory changes.

References

Australian Prudential Regulatory Authority 2007, *Insight*, no. 2.

Cheever, Daniel 2006, 'Alterative Investments: Administering new horizons', paper presented to the Investment & Financial Services Association P Group meeting, Sydney, 24 August.

Moore, A. 2007, 'Superannuation funds and alternative asset investments: issues for policy makers', paper presented to the 12th Melbourne Money and Finance Conference, Melbourne, 25 May.

Morningstar 2007, *InvestorSupermarket Market Wrap*, March.

Scholes, M. 2000, 'The near crash of 1998: Crisis and risk management', *American Economic Review*, vol. 90, no. 2, pp. 17-21.

Taylor, M. 2007, 'Super funds averaging 11 per cent allocation to private equity', *Superview*, 8 May.

Wilson, N. 2007, 'Alternatives become ever more main stream', *AIMA Journal*, Spring.