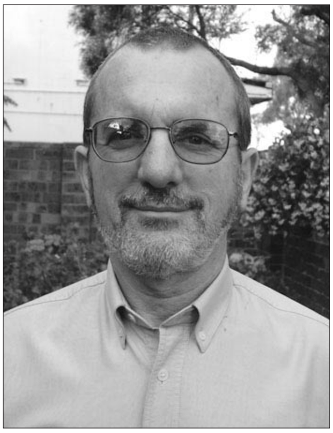
How the managers of Australia's large superannuation funds view private equity and hedge fund investing

A recent survey of major fund managers revealed that the key drivers for investing in these non-traditional assets were return enhancements and risk management through diversification. With the majority of super funds using the fund of funds method of investing, the survey also found that fund managers, on average, intended to lift their allocation to hedge funds slightly, while private equity allocations were expected to remain stable.



JOHN R EVANS F Fin is Associate Professor, Australian School of Business, University of New South Wales.
Email: john.evans@unsw.edu.au

IN FEBRUARY AND MARCH 2008, questionnaires were sent out to superannuation funds with funds under management of over \$200 million. The aim was to determine their attitudes to investing in private equity and hedge funds, both perceived as belonging to the non traditional asset sector. The surveys were a follow-up to similar surveys in 2005.

The surveys examined the funds' current allocation to these two asset groups. They also focused on whether these funds intended, in the near term, to change the allocation or the investment medium used and, if so, what were the investment objectives and issues that management saw in investing in these asset groups.

The surveys were carried out separately for private equity and hedge funds, which meant that there was some inconsistency across the samples for both the current and the previous surveys that may have affected some of the results. It was agreed that only the aggregate results would be released, and this tended to hide some of the significant differences between respondents on some issues.[1]

Survey respondents

The total funds under management for those responding to the current private equity survey was \$250 billion and \$100 billion for those responding to the current hedge fund survey.

In general, the respondents were very large superannuation funds and, as a result, the survey represents the views of the management of these funds rather than the average fund in Australia.

Of the respondents, 94% already had an allocation to private equity, and 71% to hedge funds.

Drivers for investing

Both groups of respondents indicated that they were looking for return enhancements relative to other assets, and risk management through diversification against traditional investments.

Interestingly, a significant proportion of respondents indicated that they saw both private equity and hedge funds as being in a separate category to their traditional asset classes, although private equity investors indicated they predominately used a listed equity index as the benchmark for performance monitoring. These investors also said they would most likely reduce listed equity investments to fund private equity investments in the future.

Hedge fund investors also indicated that they used a listed equity index for performance monitoring. This suggests some inconsistencies between the view that these asset groups are independent of listed asset classes and the fact that they are benchmarked against the same listed equity indicator. This would seem to disadvantage some hedge funds that have absolute return objectives, and those with positively skewed return objectives such as the long/short equity funds.

Current allocations

On average, respondents had, at the time, allocated 6% of total funds to private equity, and 2% to hedge funds, but there was a wide dispersion of allocations as shown by the following graphs.

Of the two typical methods of investing, namely, fund of funds, and single-purpose funds, the former was the most dominant method used, with 71% of respondents indicating that they used this method for private equity investments, and 60% indicating they used it for hedge fund investing.

The regional allocation is dramatically different between the two asset groups, with private equity investors splitting the bulk of their investments between Australia and the United States, but with hedge fund investors favouring a global allocation.

Future allocations

Respondents indicated that, on average, they intended to lift their allocation to hedge funds by around 1% while private equity allocations were expected to remain stable. It needs to be remembered, however, that these funds have significant cash inflows, and while the allocation as

FIGURE 1: **Private equity and hedge fund allocations**

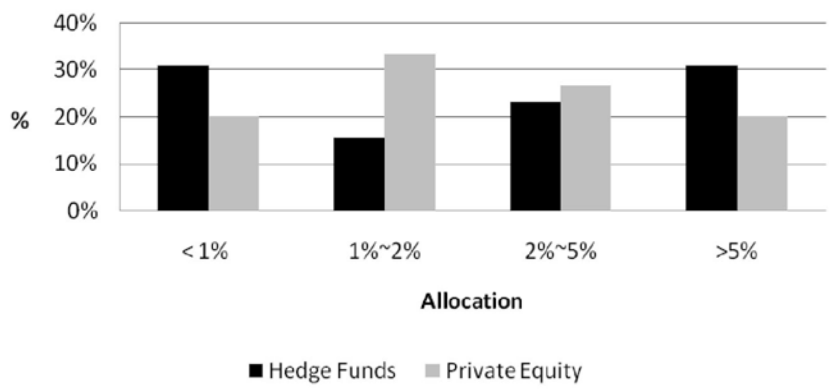
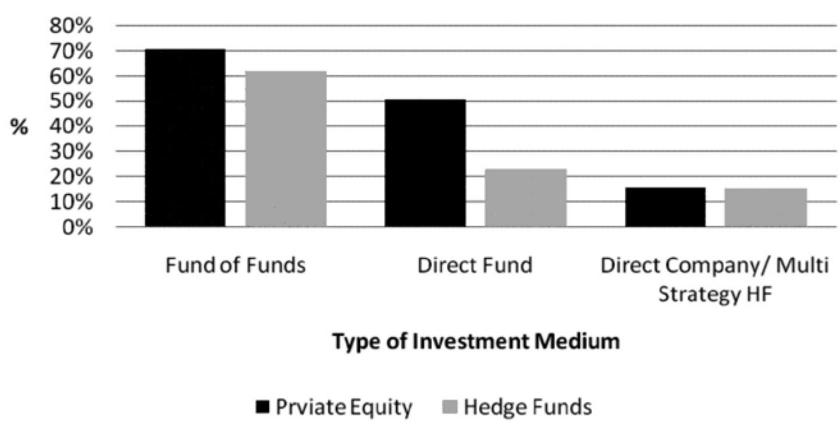


FIGURE 2: **Investment mediums**



a percentage may remain reasonably stable, the actual dollars invested will rise considerably.

Although the overall allocation to the two asset groups were not expected to change significantly, the regional allocation for private equity investments can change with a significant drop in the allocation to Australia and the United States, and a corresponding increase in the allocation to global strategies and Asian investments. Hedge fund investors didn't expect to change their regional allocation very much, and were likely to retain a global perspective.

Manager selection issues

Respondents to both surveys indicated that they saw the expertise of the manager as being the most significant issue when deciding who to hire.

And, most respondents saw problems with returns as the key issue that needed to be carefully monitored. This was closely followed by transparency, which was seen as the most significant obstacle to investing additional assets to these asset groups.

Interestingly, the J-curve effect in private equity was not seen as an issue. The J-curve effect in private equity investing relates to the fact that it is common in the first few years for the target investment to consume cash and show little return (or negative return) as they restructure or make capital investments. Later, hopefully, the investment pays off and the investors receive positive returns.

Changes from 2005 to 2008

The responses by super fund managers in relation to hedge funds were not much different from those in 2005, but there were some significant changes in relation to private equity investments. The management of the funds indicated that, whereas in 2005, fund of funds was expected to decline as an investment medium, this was significantly reversed by 2008, and this situation was not going to change much. The reasons for this are not clear but it could indicate that trustees/management did not have the confidence to make single fund choices that they thought they would in 2005. Possibly, this reflects the difficulty of assessing private equity managers and the huge number that exist, and also that the market has decided that despite the 'double fees' issue, the costs are a reasonable payoff for the expertise of the fund of funds manager.

Note

1 I would like to acknowledge the support of Adveq from Zurich and AIMA (www.aima-australia.org) in Sydney in sponsoring the surveys in both 2005 and 2008.

FIGURE 3: **Regional allocations**

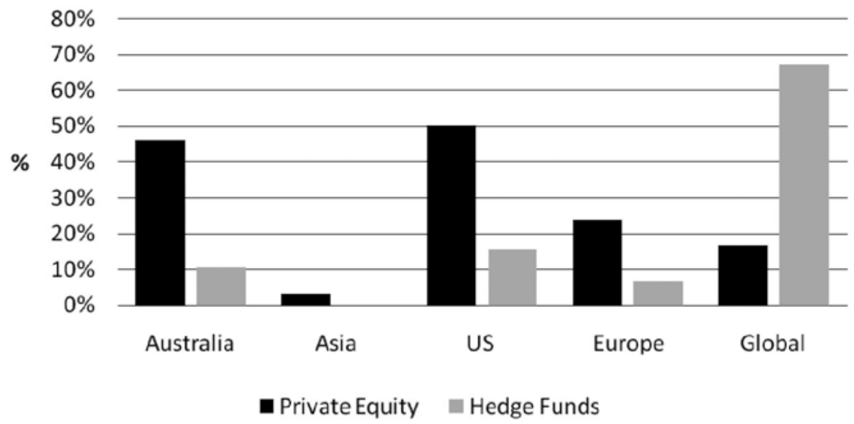


FIGURE 4: **Proposed regional allocation**