

26 August 2014

David Murray – Chair, Treasury Department
Financial System Inquiry Panel
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Murray

Financial System Inquiry - Interim Report Superannuation fund liquidity and infrastructure financing

IFM Investors Pty Ltd welcomes the opportunity to respond to the Financial System Inquiry Interim Report released on 15 July 2014.

1. Purpose of this submission

IFM Investors reviewed the Interim Report with a focus on the implications for equity and debt funding of infrastructure assets by Australian superannuation funds.

This submission concentrates on the existing superannuation fund liquidity management 'regime'¹ which requires superannuation funds to maintain investment portfolios which are excessively overweight to high liquidity assets. As a consequence:

- Superannuation fund returns and members' retirement balances will be lower;
- Australian superannuation funds' medium to long-term capacity to increase their funding of Australia's public infrastructure is constrained;
- As the capacity of Australian superannuation funds to invest in Australian infrastructure is constrained, more of Australia's public infrastructure will become foreign owned; and
- Increased foreign ownership of Australian infrastructure will continue Australia's dependency on foreign capital, making Australia increasingly vulnerable to external financial shocks. A fiscally prudent Australia should not expect to be able to rely on foreign capital to fund its long-term infrastructure needs.

In addition, in response to the Interim Report's call for information from industry, we have included some commentary on impediments to the development of liquid, tradable claims on infrastructure projects.

2. Why IFM Investors is qualified to make this submission

IFM Investors is one of Australia's largest wholesale investment management firms with over \$50 billion in assets under management (30 June 2014) in both alternative and traditional asset classes. Established over twenty years ago and owned by 30 major not-for-profit industry superannuation funds, our interests are aligned with those of our investors. Our ownership structure minimises conflicts of interest and enables IFM Investors to genuinely invest with a long-term perspective to enhance the returns of investors and

¹ We use the term 'regime' throughout this submission. Liquidity management is essential to manage the stability of a predominantly defined contribution pensions system. The Australian regime is not the result of a single design, regulation or authority. Rather it is the outcome of a combination of influences that impact the level of liquid assets held by Australian superannuation funds, including APRA's regulatory oversight, portfolio management, member switching (funds and investment options), etc.

their members. IFM Investors was recently ranked as the number one manager of infrastructure assets in Australia² (by Australian-sourced funds under management) and one of the top five globally³ (by pension assets under management). We consider that we have a unique insight into the infrastructure investment market, the regulation of that market and the flow of funds into it.

3. Funding of Australian public infrastructure and the existing liquidity management regime

At section 2-72 of the Interim Report the FSI quoted and endorsed the following statement from the Productivity Commission's 14 July 2014 Public Infrastructure report:

"There is no shortage of private sector capital that could potentially be deployed to finance public infrastructure in Australia. Private capital markets will finance most projects at the 'right price'."

In IFM Investors' view, this statement reflects only the last few years' competition for infrastructure assets. During that time we experienced unprecedented demand for Australian infrastructure assets from both Australian and foreign capital.

Over the short term IFM Investors expects there will continue to be sufficient private sector capital available to fund Australia's infrastructure needs. However, from the next three years and beyond Australia's capacity to fund its infrastructure financing needs will be tested:

- Infrastructure Australia recently highlighted \$100 billion in infrastructure assets that could potentially be sold by governments in order to recycle capital to fund other critical infrastructure.⁴
- The ANZ Bank estimates that more than \$110 billion of Australian asset privatisations could take place before the end of this decade and that an additional \$50 billion worth of PPP projects will commence before 2020.⁵
- McKinsey & Company has estimated that the global infrastructure funding gap to 2030 is US\$57 trillion.⁶ As these global assets enter the market, Australian infrastructure will face greater competition to attract private sector funding from foreign and domestic investors.

In the last few years Australian infrastructure has been targeted by foreign capital. During this time Australia has been one of the few OECD nations that has been releasing quality assets to the market and has had a stable economy with no material sovereign risk concerns. However, a fiscally prudent Australia should not expect to be able to rely on foreign capital to fund its long-term infrastructure needs. Foreign interest in funding Australian infrastructure will ebb and flow over time and the volume of foreign capital seeking assets in Australia could dry up, for instance, if other countries implement their planned privatisation programmes or if financial market shocks interrupt the supply of capital (i.e. another GFC).

IFM Investors is in continuous dialogue with many of Australia's largest superannuation funds and their asset consultants. One of our topics of discussion is the superannuation funds' commitments to infrastructure investment. We are consistently advised that Australian superannuation funds will always have a desire to invest in Australian infrastructure. However, Australian funds' capacity to invest in infrastructure assets in the medium and long term will be constrained by the existing superannuation liquidity management regime. This regime forces superannuation funds to deviate from their optimal portfolio mix, to be overweight liquid assets and hold a more limited exposure to illiquid assets (such as infrastructure). Based on our discussions, superannuation funds and their asset consultants recognise and

² Rainmaker Roundup, September quarter 2013

³ FT Global Alternatives Survey, Towers Watson 2013

⁴ Australia's Public Infrastructure: Update paper – Balance sheet impacts of sell to build, Infrastructure Australia, December 2013

⁵ "The Australian Infrastructure Pipeline – Opportunities for investors" ANZ Bank Report released 13 March 2014

⁶ McKinsey & Company "Infrastructure Productivity: how to save \$1 trillion a year", January 2013 at page 6

value the excellent long-term returns and low volatility offered by infrastructure as an asset class, but are concerned that their medium to long-term capacity to invest in this asset class will be artificially constrained.

3.1 Quantifying the overweight cash holding arising from the liquidity management regime

The existing liquidity management regime strongly encourages Australian superannuation funds to be overweight in high liquidity assets. The extent of this overweight allocation is demonstrated in Towers Watson's January 2014 *Global Pensions Assets Study*, which sets out the aggregate asset allocations across the world's largest pension markets. During 2013, 75% of the Australian superannuation system's funds under management was allocated to high liquidity asset classes. The Towers Watson report also notes that the average allocation to cash as an asset class in the world's seven largest pension markets was 1%, while in Australia (the fourth largest pension market) the allocation to cash was 8% (around \$128 billion). This high allocation to cash and other liquid assets is mirrored in the portfolios of Australian superannuation funds' default options. APRA statistics⁷ show that of the \$466 billion in default funds in 2013 77% of FUM was in high liquidity assets (including 8% (\$38 billion) in cash).

This high allocation to liquid asset classes is symptomatic of the liquidity regime in which Australian superannuation funds operate. As a general rule, high liquidity assets are either low return (i.e. cash) or high volatility (i.e. shares). In contrast to this, the infrastructure asset class has lower liquidity, however, this is compensated for by relatively low volatility and relatively high returns (as detailed in section 3.3 below).

IFM Investors acknowledges that it is important for Australian superannuation funds to hold a large proportion of the portfolios in liquid assets to manage fund liquidity.

A portion of the 7% differential between Australian funds' and foreign funds' cash allocation is symptomatic of the different liquidity management needs of defined contribution and defined benefit schemes. However, Australian funds' allocating eight times the global average of their portfolios to low return cash suggests that the Australian liquidity regime is overly onerous.

3.2 Improved superannuation fund returns through investment in illiquid assets

The tables below demonstrate that:

- The long-term performance and volatility characteristics of unlisted assets (both property and infrastructure) correspond well with superannuation funds' long term liabilities; and
- The retirement balances of fund members would be materially higher if a greater part of the 75% of their superannuation funds' portfolio that is invested in cash and other liquid assets was invested in these more illiquid asset classes.

Outlined in the tables and charts below (extracted from a 2014 Frontier Advisors paper) are historical characteristics of asset classes that Australian superannuation funds typically invest in.

⁷ APRA, statistics, Annual Superannuation Bulletin June 2013 (revised 5 February 2014) Page 38.

Each asset class is represented by the index or benchmark specified in **Table 1**. The infrastructure time series is maintained by Frontier and consists of the average return of a number of unlisted open-ended infrastructure products.

Table 1: Representative Benchmarks

Asset Class	Benchmark
Australian equities	S&P ASX 300
Australian fixed interest	UBSA Composite All Maturities
Global equities	MSCI World ex-Australia
Global fixed interest	Barclays Global Aggregate ex-Australia
Listed Property	S&P/ASX 200 Property
Listed Infrastructure	UBS Global Infra & Utilities Infrastructure Index (Hedged)
Unlisted property	Mercer Direct Property Index
Unlisted infrastructure	Frontier Infrastructure Benchmark

Table 2 outlines the performance of these asset classes to December 2013. Infrastructure is the strongest performer over the long term and also demonstrates a relatively consistent return throughout the entire period.

Table 2: Period Returns to 31 December 2013 (% p.a.)

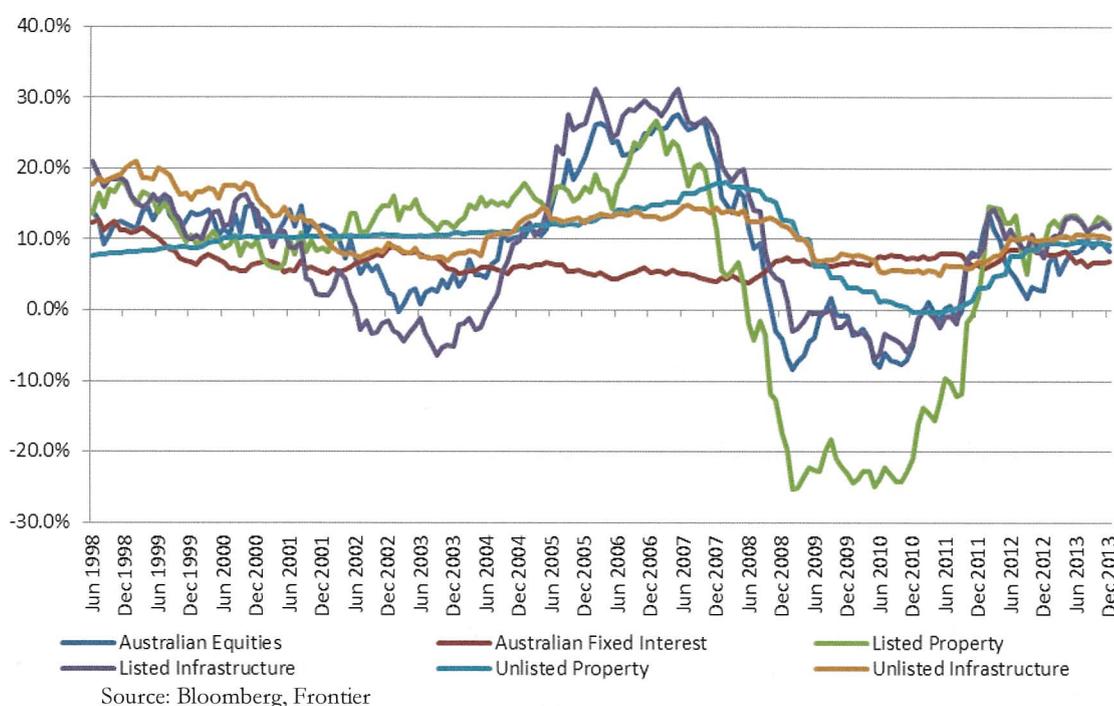
	1 year	3 years	5 years	10 years	15 years	18 years ¹
Australian equities	19.7	8.5	12.3	9.5	9.0	9.5
Australian fixed interest	2.0	7.0	5.7	6.2	6.0	6.9
Global equities	32.3	15.5	17.2	8.6	5.5	7.9
Global fixed interest	2.3	7.4	7.9	7.5	7.4	7.9
Listed Property	7.1	12.0	8.6	2.4	4.6	6.7
Listed Infrastructure	19.6	11.7	10.6	11.7	8.3	9.8
Unlisted Property	9.5	9.3	5.4	9.1	9.6	9.3
Unlisted Infrastructure	11.0	10.2	8.1	10.4	10.5	12.0

Source: Bloomberg, Frontier

Limited by length of the unlisted infrastructure time series.

Chart 1 shows the rolling three year performance of various asset classes (global bonds and equities have been excluded for clarity but show very similar characteristics to the Australian equivalents). Fixed interest has provided the most consistent performance, with rolling three year returns staying between around 4% and 8% p.a. Listed equities and listed property were very volatile over the charted period with three year annualised performance for listed property varying from around -25% to +27% p.a. Both unlisted property and infrastructure fall between these two extremes, arguably closer to bonds than equities.

Chart 1: Rolling Three Year Performance



In **Table 3** Frontier set out the annualised volatility of each asset class. The fixed interest sectors exhibit the lowest volatility, followed closely by unlisted property and then unlisted infrastructure. In IFM Investors' view, the low volatility of infrastructure is attributable to the nature of the underlying assets invested in, with core assets generally being chosen for characteristics of low risk and high income.

Table 3: Annualised Volatility to 31 December 2013

	1 year	3 years	5 years	10 years	15 years	18 years
Australian equities	11.9	11.8	13.4	13.7	12.9	12.9
Australian fixed interest	2.3	2.8	2.9	2.7	2.9	3.3
Global equities	8.5	11.8	14.5	14.5	15.1	15.2
Global fixed interest	3.1	2.6	2.5	2.7	2.8	2.8
Listed property	12.1	11.5	16.4	18.3	15.7	15.2
Listed infrastructure	11.5	8.8	10.9	11.3	12.1	11.7
Unlisted property	1.2	1.2	3.8	4.4	3.7	3.5
Unlisted infrastructure	4.6	3.8	4.0	4.6	5.6	5.8

Source: Bloomberg, Frontier

Table 4 examines the correlations between the various asset classes over the last five years. This provides a guide to the diversification benefit that could have been gained from investing in a range of different asset classes. The unlisted asset classes have low or negative correlations with listed equities and bonds, which suggests there are significant diversification benefits to including unlisted assets in a portfolio that consists largely of listed equities and bonds.

Table 4: Five Year Correlations to 31 December 2013

	Aust. Equities	Aust. bonds	Global equities	Global bonds	Listed prop	Listed infra	Unlisted prop	Unlisted infra
Australian equities	1.00							
Australian bonds	-0.40	1.00						
Global equities	0.81	-0.47	1.00					
Global bonds	0.07	0.50	-0.08	1.00				
Listed property	0.64	0.06	0.51	0.24	1.00			
Listed infrastructure	0.65	-0.14	0.76	0.11	0.66	1.00		
Unlisted property	-0.24	0.08	-0.03	-0.15	-0.20	-0.03	1.00	
Unlisted infrastructure	-0.18	0.05	-0.08	-0.29	-0.06	0.14	0.40	1.00

Source: Bloomberg, Frontier

As a conclusion to these observations, Frontier Advisors summarised that infrastructure is an asset class with strong historical performance, reasonably low volatility and low or negative correlations with bonds and equities. IFM Investors considers that these characteristics correspond well with the long-term liabilities of superannuation funds and provides a materially better return than cash. Therefore, a greater exposure to infrastructure assets would improve Australian retirement outcomes.

3.3 Why Australian superannuation funds are ‘overweight’ high liquidity assets

As noted above, 75% of Australian superannuation funds’ assets are allocated to high liquidity assets. It is not possible to quantify the exact dollar size of this overweight allocation to high liquidity assets, however, based on the returns provided by Frontier (Table 2 above), \$1 billion invested eighteen years ago in Australian Infrastructure would now be worth \$7.67 billion, whereas the same \$1 billion invested in Australian Fixed Interest would now be worth \$3.32 billion and invested in Australian Equities would be worth \$5.12 billion. In other words, a dollar invested in Australian Infrastructure 18 years ago is worth 2.31 times more than a dollar invested in Australian Fixed Interest and 1.50 times more than a dollar invested in Australian Equities. These metrics demonstrates the potential detriment to Australian retirement balances if the existing liquidity management regime constrains Australian superannuation funds’ capacity to invest in Australian infrastructure assets over the medium and long term.

While we cannot accurately state the dollar value of the overweight allocation to high liquidity assets we can analyse the drivers behind it. The 75% allocation to high liquidity assets is made up of two components:

- The ‘natural’ allocation to high liquidity assets (which makes up the majority of the 75% allocation), reflects the superannuation funds’ preferred portfolio construction and also reflects those

superannuation fund members who have chosen a high liquidity investment option. This component of the 75% allocation to high liquidity assets is effectively the superannuation fund's preferred long-term portfolio construction, and we do not characterise this natural allocation to high liquidity assets as a constraint on superannuation funds' capacity to fund infrastructure investment.

- The remainder of the 75% high liquidity allocation is 'overweight' as it is contrary to the superannuation fund's preferred long-term portfolio construction and should be allocated to other asset classes. Superannuation funds maintain this 'overweight' allocation to:
 - Satisfy liquidity stress test requirements imposed under the *Superannuation Industry (Supervision) Act (1993)*, *Prudential Standard SPS 530* and *Practice Guide SPG 530* the implementation of which are monitored by APRA;
 - Permit member switching between superannuation funds;
 - Facilitate member choice between investment options within the same superannuation fund;
 - Fund the rebalancing of superannuation portfolios during periods of volatility in investment markets; and
 - Fund lump sum payouts and other draw downs by members.

Superannuation funds' 'overweight' allocation to high liquidity assets will vary on a fund by fund basis. It is set in response to historical and anticipated funding needs and the liquidity stress tests applicable under APRA's administration of the prudential standards.

The liquidity stress testing includes global financial crisis type 'shock' scenarios. As a consequence, superannuation funds hold a significantly greater proportion of liquid assets than is required for 'normal' market conditions. This more onerous liquidity stress testing was introduced during the GFC after several superannuation funds experienced heightened levels of liquidity risk (largely brought about by member switching and asset price fluctuations). The stress testing regime seems to be the only regulatory tool through which fund liquidity is assured. A more holistic approach to ensuring superannuation fund liquidity across the economic cycle could ameliorate many of the undesirable consequences of the existing regime.

3.4 The implications for retirement balances and government funding of pensions

As detailed in section 3.2, historically, infrastructure investment has performed very well against all other asset classes and consequently it is widely recommended by most Australian asset consultants as a component of a well balanced portfolio. However, due to the existing liquidity regime the volume of money which superannuation funds can allocate to infrastructure is artificially and excessively constrained.

These constraints are in place despite APRA's recognition that infrastructure contributes materially to fund out-performance. APRA's Working Paper published in November 2011 found that for the period September 2004 to June 2010 " ... *not-for-profit funds outperform retail funds on a risk-adjusted basis by an average of 144 basis points per annum. The regression results imply that around one-quarter (35 bps) of this performance difference can be attributed to the greater positive impact of illiquid investments on the net returns of not-for-profit funds compared to retail funds.*"⁸

Australian superannuation funds have been significant investors in Australian public infrastructure over the last 20 years. Superannuation funds' attraction to infrastructure investment reflects the alignment between the long-term stable returns and capital growth of infrastructure assets and the long-term liabilities of superannuation funds. This alignment has provided an excellent source of investment funds for Australian infrastructure and also contributed to the growth and stability of Australian superannuation members' retirement balances.

⁸ Page 24, APRA Working Paper "Risk and return of illiquid investments: A trade-off for superannuation funds offering transferable accounts" November 2011

The existing liquidity regime will constrain the medium to long term capacity of funds to invest in illiquid assets (including infrastructure) and this will impair the long-term performance of those funds (based on historical returns), which would otherwise have greater illiquid assets exposure in their portfolios. The reduction in superannuation funds' risk adjusted returns ultimately reduces retirement balances, which translates into an increase in the Commonwealth's obligation to fund the aged pension, thereby adding to the taxation burden of future generations of Australians.

3.5 Foreign ownership of Australian infrastructure assets

Privatisation of existing infrastructure by governments can facilitate 'recycling of capital', where the sale proceeds are then utilised by government to invest in valuable new infrastructure. This can then bring into play a 'virtuous circle', in which the privatised infrastructure asset is acquired by an investor whose values are well aligned with the community's interests and is 'owned' by members of that community, such as an Australian superannuation fund.

A notable example of this virtuous circle occurred last year when the New South Wales Government awarded the long-term lease of Port Botany and Port Kembla to a consortium led by IFM Investors. The Government directed a substantial proportion of the proceeds of the privatisation to much needed new infrastructure in NSW, primarily roads. What was a taxpayer-owned asset is now over 80% owned by around 5 million Australian superannuation members.

The virtuous circle of 'social privatisation' breaks down when there is no participation by Australian investors.

The comment in the Interim Report that there is no shortage of private capital to fund Australia's public infrastructure needs ... at the right price ... is true in the short term, but unless the existing liquidity regime is improved this funding will increasingly come from foreign investors (to the detriment of Australian retirement balances). Unlisted infrastructure assets are generally tightly held. As such, once they are sold into foreign hands there will be limited opportunities for those assets to be acquired by Australians again and the profits will be sent offshore instead of contributing to the greater wealth of Australia.

Furthermore, community support for privatisation grows if an element of ownership remains with an Australian superannuation funds.

3.6 Potential solutions to the existing superannuation liquidity management regime

A systemic solution needs to be developed for superannuation fund liquidity management to reduce the constraint on funding illiquid investments, including infrastructure, and the drag on member returns which results from the existing high allocation to cash and other high liquidity assets.

There is no single solution to the problem. However, the following in combination could contribute to a reduction in the volume of funds tied up in liquidity management and IFM Investors recommends them to the FSI for further investigation:

- Consideration of the stringency of the existing liquidity stress testing regime;
- A government-backed liquidity scheme, which allows funds to access liquidity if markets, and therefore funds, become disorderly. In this way markets do not become pro-cyclical by forcing superannuation funds to sell assets into them. Two components of this could be:

- A liquidity pool into which funds could 'deposit/sell' illiquid assets with fairly priced repurchase agreements; and
- A facility for superannuation funds analogous to the lender of last resort arrangements, which are available in the banking sector and which are designed to inhibit a run on a bank;
- Superannuation funds offer their members a premium to their normal returns if they agree not to switch funds or investment options for a set period of time; and
- Encouragement for superannuation funds' to pass on to members the costs associated with members switching funds or investment options rather than being absorbed by the fund and defrayed across all members (currently few funds pass on member switching costs).

4 Impediments to the development of liquid, tradable claims on infrastructure projects

In its Interim Report the FSI requested further information in relation to impediments to the development of liquid, tradeable claims on infrastructure projects.

Like any other business, infrastructure assets can be invested in through the listed and unlisted markets, and a listed infrastructure business can be as liquid as any other listed entity. Despite this, many infrastructure assets are held in unlisted infrastructure funds and the interests in those funds are characterised as illiquid in accordance with APRA's definition of liquidity.

In our view, the infrastructure asset class displays characteristics which make it better suited to relatively illiquid unlisted funds. These assets attract long-term investors seeking stable performance with reliable returns and low volatility. Among other things, these investors are seeking a premium return in consideration for the lower liquidity of the asset class, and this premium return is a core part of their investment strategy. Creating liquidity at the asset level, where it is not wanted, would be trying to solve one problem at the cost of creating another. The reliability of those returns makes infrastructure investment attractive in periods of financial uncertainty such as during the GFC.

5 Conclusion

IFM Investors considers the Australian superannuation system to be amongst the best of the global pension systems and that generally the system does not need to be materially reworked. However, improvements should be made to the liquidity management regime to both improve investor returns and facilitate greater investment in infrastructure assets.

We look forward to seeing the FSI's final report and would be happy to participate in discussions or respond to any queries that you have in the interim.

Yours sincerely



Brett Himbury
Chief Executive
IFM Investors Pty Ltd

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