



## Australian Private Equity & Venture Capital Association Limited

9 September 2016

Ms Karen Chester  
Deputy Chair & Commissioner  
Productivity Commission  
Locked Bag 2, Collins Street  
East Melbourne  
VICTORIA 8003

Dear Commissioner,

### **How to Assess the Competitiveness and Efficiency of the Superannuation System**

Thank you for providing the Australian Private Equity and Venture Capital Association Limited (AVCAL) with the opportunity to comment on the Productivity Commission's (Commission) Draft Report on *How to Assess the Competitiveness and Efficiency of the Superannuation System*, released in August 2016.

The Australian Private Equity & Venture Capital Association (AVCAL) is a national association which represents the private equity (PE) and venture capital (VC) industry. AVCAL's members comprise most of the active private equity and venture capital firms in Australia, who together manage over \$28 billion on behalf of Australian and offshore superannuation and pension funds, sovereign wealth funds, family offices, and other investors. Amongst AVCAL's members are the key institutional investors in the asset class, such as Australian superannuation funds.

### **Executive Summary**

- AVCAL believes that in building a more efficient and competitive superannuation system, the focus of the system should be on maximising net of fee returns in order to grow retirement balances, which is ultimately to the benefit of current and future generations of Australians.
- Regulatory settings should not explicitly or implicitly encourage a narrow focus on low cost super products, which may distort the allocative efficiency of super fund portfolios, and is unlikely to be in the longer-term interests of super fund members.
- The PE and VC asset class has outperformed other asset classes, such as listed equities and fixed income, over the short and long term, and can boost the risk-adjusted performance of diversified portfolios of institutional investors such as superannuation funds.
- Globally, pension funds are increasingly turning to alternative asset classes such as PE in order to achieve strong investment returns amid a low yield environment.

### **Role of PE in the economy and super system**

The PE/VC business model involves fund managers providing both capital and expertise to add value to a portfolio of investee companies. These companies may be at different stages: from a business looking for capital to expand,

to distressed businesses in need of a turnaround capability, or publicly-listed companies seeking a new direction. PE and VC firms aim to deliver strong returns to investors within a typical ten-year fund timeframe, allowing adequate time to add value across a portfolio of companies.

Economic analysis conducted by Deloitte Access Economics in 2013 showed that PE-backed businesses alone contribute more than 4% per annum to Australia's national output and support, both directly and indirectly, over 500,000 jobs across almost all sectors of the economy.

Our interest in the Commission's inquiry is premised on Australian super funds being an important source of institutional funding for the PE and VC asset class. Accordingly, we have a strong interest in ensuring that the system operates as efficiently and competitively as possible. In particular, we believe that regulatory settings must not unintentionally drive super fund investment decision-making towards a narrow focus on fees, but rather encourage a focus on value for money, the best proxy for which is net-of-fee returns. In that regard, we note that the PE and VC industry has a strong record of high returns for their investors, including super funds. For example, over the ten-year period to 31 December 2015, Australian PE and VC funds outperformed the ASX 300 Index by over 5%, and the ASX Small Ordinaries Index by over 9%. It is imperative that more is done to ensure that Australian superannuants aren't missing out on returns such as these due to regulatory impediments.

## **Introduction – importance of the superannuation system to Australia**

At a time of sluggish domestic growth and global political uncertainty, now is a prime opportunity for the Commission to assess the super system and consider whether it is operating as efficiently and competitively as possible.

As you know, the superannuation system is an increasingly important part of Australia's financial and public policy landscape, with over \$2 trillion in accumulated assets designed to fund Australians in their retirement. As the 2015 Intergenerational Report has reminded us, Australia has an ageing population which over the coming decades will place increasing pressure on the health system and age pension. At the same time, Australia's working population will shrink. An efficiently operating superannuation system is therefore critical to Australia's ability to meet the social and economic challenges posed by an ageing population.

More broadly, the superannuation system is also a growing pool of capital with the potential to support economic activity across many different sectors. It is therefore vital to ensure that the superannuation system remains efficient and competitive in order to ensure that resources are allocated as efficiently as possible, with the overriding goal of generating the best possible net-of-fee returns for members. This echoes the trend seen globally as other jurisdictions, such as the UK, are also looking at ways of lifting the performance of their pension fund systems.

With Australia currently attempting to transition to an innovation-focused, rather than natural resource-based, economy, it is vital that the super system – a pool of capital larger than Australia's GDP – operates in a way which does not discourage investment into asset classes such as PE and VC which are focused on high growth companies and sectors.

This submission addresses several specific issues discussed in the draft report, in particular how the superannuation system should serve to maximise net returns on member balances over the long term, which in AVCAL's view, should be the key objective in order to ensure adequate and sustainable retirement outcomes. It also explores broader issues of the super system and the role that PE and VC play within it. The submission is structured as follows:

### **Issues relating to specific questions in the draft report**

1.1 Asset benchmarking

1.2 Opportunities for funds to invest in upstream capital markets

1.3 How funds compete on costs

## **Wider issues - the allocative efficiency of the superannuation system**

2.1 Why PE fees are higher than other asset classes

2.2 The value-add of PE: super returns and diversification

2.3 How the focus on fees has affected super fund allocation to Australian PE

2.4 International comparisons of PE allocations by pension funds

2.5 Other structural issues (e.g. portability)

We note that the draft report, as the first part of the Commission's inquiry, is focused on developing criteria to assess the competitiveness and efficiency of the super system. We understand that the Commission will review the system against the developed criteria after July 2017. Nonetheless, it is important that the criteria that are adopted have been developed with an eye to this later structural review and with due recognition of current distortions in the regulatory system.

### **1.1 Asset benchmarking**

The draft report explores the issue of benchmarking in order to assess net returns (pp. 115-116), both at the system-wide level and for different asset classes that super funds invest in. The Commission favours the approach of using listed indices as a benchmark for each asset class, including unlisted asset classes. While this approach may be easier to implement, it does present some challenges, especially for a unique asset class like PE.

Firstly, the use of a listed index as a benchmark for an unlisted asset class may be inappropriate due to the nature of unlisted assets and how managers of unlisted assets operate. A listed index may, for example, not be able to replicate the investment structure that is employed by a super fund to get exposure to PE, wherein the investment is made up of one or more of the following: investment into a PE fund, an investment through a fund-of-fund, a direct investment or co-investment (alongside a PE fund) into an unlisted business.

The leading industry benchmark for the domestic PE and VC industry is the Australia Private Equity & Venture Capital Index (Index), published by Cambridge Associates and AVCAL. The Index measures the performance of the PE and VC funds at a pooled level, whereby all capital inflows and outflows from funds participating in the index are combined to determine the aggregate level of investment returns, net of fees, being generated by those funds to their investors (e.g. super funds). For many years this has been an accepted benchmark for measuring how this asset class is performing. Further, the index's data set is comprehensive, representing the returns of the vast majority of PE and VC fund managers to investors. Accordingly, AVCAL recommends that this be one benchmark used for the purposes of measuring the efficiency of asset-class net returns.

AVCAL would be happy to discuss further with the Commission any questions it may have regarding the make-up of the Index and the nature of the underlying data.

An alternative approach suggested and implemented by at least one institutional investor member of AVCAL is benchmarking performance against the ASX Small Ordinaries Index (which tracks listed companies at a comparable size to that of PE-backed companies), which is public and investable, but including an illiquidity premium (often set at around 3%). For reference, over the ten-year period to 31 December 2015, Australian PE and VC funds outperformed the ASX Small Ordinaries Index by over 9%.

The task of asset benchmarking in this context is a difficult one. AVCAL recommends that the Commission assess all available measures for unique asset classes like PE and VC in order to establish measures that do not distort the relative outperformance or underperformance of super funds across their portfolios.

### **1.2 Opportunities for funds to invest in upstream markets**

The Commission's draft report poses the question (p. 127) as to whether there are any institutional or market impediments to investment in upstream capital markets – for example, can fund size act as an impediment to super funds investing in certain asset classes.

In the case of many super funds (other than self-managed super funds (SMSFs)), their sheer size and scale can make investment into asset classes like PE and VC very difficult. This is particularly the case for funds which have tens of billions of dollars under management which means that the minimum investment that they make – in order to be cost effective – will be in the tens of millions of dollars. Such investment sizes are difficult for Australian PE funds (let alone VC funds) to absorb, particularly given the fact that these funds are typically structured to have a number of different investors and will have a cap on the fund size that is sought to be raised. Further, from a super fund's perspective, investing in PE or VC requires in-house professionals with expertise in the (relatively specialised) asset class which may become difficult to justify given the small size of allocations (of those super funds that do invest in PE, allocations are typically only around three to four per cent).

Additional issues that pose difficulties for super funds which may be considering investing in the asset class include the need for sufficient liquidity to meet 'portability' requirements (see section 2.5 below).

Currently there is limited SMSF investment in the PE and VC asset class. Reasons for this include: the asset class being marketed at institutional rather than retail investors; fund managers' preferences to have a sophisticated investor base obviating the need for resource-intensive investor management; and the need for SMSFs to be of sufficient scale so as to be able to commit sums of capital comparable to other much larger institutional investors. That said, we are aware of one fund-of-fund whose business model involves aggregating money from various SMSFs for investment into PE funds. As noted in the Commission's draft report (p. 257) however, SMSFs do have a tendency towards holding greater allocations to assets such as cash and domestic equities rather than unlisted investments.

Finally, it is worth noting that retail investors seeking to gain exposure to PE or VC may invest in a small number of ASX-listed entities which engage in PE or VC investment. That said, the very nature of the asset class is that funds operate as closed-end, typically ten year funds, meaning that investment is inherently suited to (illiquid) unlisted rather than (highly liquid) listed channels.

### **1.3 How funds compete on costs**

While funds compete on a number of fronts – including returns and services to members – it is competition on costs that appears to be particularly encouraged by current regulatory settings. Indeed, it is inherently easiest for funds to compete on cost given most costs can be quite accurately budgeted for in advance, as opposed to returns which are dependent on many variables, and service to members, which is inherently subjective.

The issue of minimising fees and costs in the superannuation system has been a much-publicised topic in recent years, including in the recent Financial System Inquiry. While we support funds trying to minimise fees and costs wherever possible, they should also be aware of any negative impact that such minimisation could have on their net returns – put at its most extreme, a super fund could seek to minimise its costs by holding purely cash and fixed income products which would be an overly conservative investment strategy that is unlikely to be in the interests of members.

In AVCAL's view, particularly in respect of investment management fees, the focus of super funds must be on value for money – that is, can the investment manager or asset class deliver higher net of fee returns than other, cheaper asset classes. In recent years, there have been a number of regulatory reforms which have had the effect of encouraging superannuation funds to compete primarily on cost, including Stronger Super reforms and the introduction of low cost "My Super" default products, and the issuance by ASIC of Regulatory Guide 97 (November 2015) focused on detailed disclosure of super fund and managed investment scheme (MIS) fees and costs some of which will be of little interest to members.

In our view, based on feedback from super funds that invest in the PE/VC asset class, these reforms have made it more difficult for funds to invest in higher cost, alternative asset classes, such as PE and VC. This is despite the fact that such asset classes have consistently produced stronger investment returns than others (see below). Accordingly, it is little surprise that the majority of the products in the \$474bn My Super market have no allocation to PE/VC – denying members stronger returns, and, at an economy-wide level, denying companies the capital they need to succeed and grow.

These issues are elaborated further upon in section 2.3 below.

## 2.1 Why PE/VC fees are higher than other asset classes

The performance of PE/VC funds and the highly ‘active’ management involved in the asset class needs to be taken into account when looking at the level of fees paid to PE fund managers.

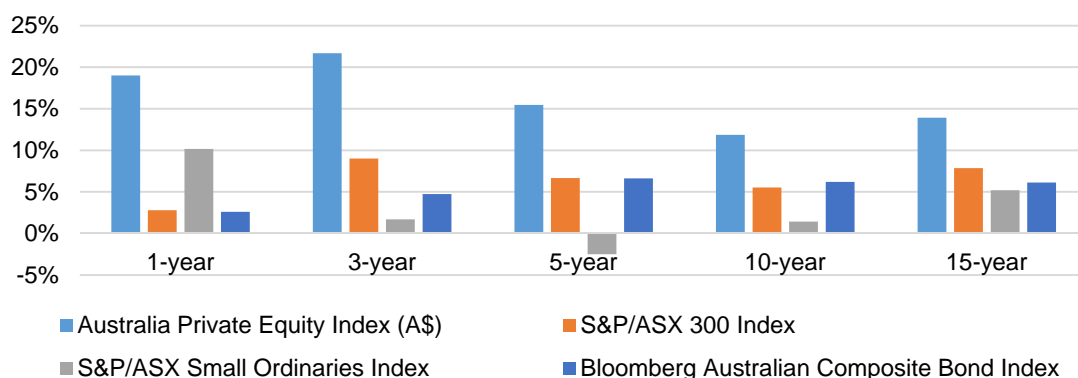
One key distinction between PE/VC and other asset classes is that PE/VC requires highly active management by the fund manager of the fund’s portfolio of companies. This is in contrast to the less active management, or in some cases ‘index-hugging’ (fund manager performance that is little different to the returns of a benchmark index), that is often seen within listed equities and other asset classes.

The returns generated by PE/VC funds are highly dependent upon the work and influence that the fund manager has on the fund’s portfolio companies. Performance is intrinsically linked to the fund manager’s skill and ability to drive value from the investments, and is a function of an intensive deal-sourcing model, and a more time-consuming and costly approach to making and exiting investments.

PE and VC is able to add value to portfolio companies through a combination of strategic advice, operational improvements, access to networks and new markets, and high quality management teams. PE/VC fund managers also deliver ongoing assistance to the management teams of their portfolio companies through participation on Boards, guidance on strategy, and, in the case of PE, through ‘bolt on’ acquisitions of complementary assets or businesses. These activities are not found in listed equity strategies, even those considered to be ‘active’ strategies.

The end result of this active management of portfolio companies is the outperformance that is generated by Australian PE funds. They have historically performed better than other asset classes, such as listed equities and fixed income, and can provide significant value-add to super fund returns and diversification, as discussed below in section 2.2. Figure 1 demonstrates that outperformance. It should be noted that the Australian Private Equity Index is calculated net-of-fees, expenses and carried interest.

**Figure 1: Australian PE returns vs other asset classes**  
As of 31 December 2015



Source: Cambridge Associates

While there may not always be a strong correlation between investment fees and returns for some other asset classes, this is not the case for PE/VC whereby fund managers are reliant on strong returns in order to generate performance fees (known as ‘carried interest’) once a hurdle rate of return is exceeded (eight per cent is typical). Accordingly, under this business model there is a strong alignment of investor and fund manager interests.

We note that domestic PE/VC fee structures have a high degree of similarity to those used by overseas PE/VC fund managers. In short, market practice is typically a two per cent of committed capital management fee, followed by a twenty per cent of profit contingent on achieving a hurdle rate of return. It is important to note that under this fee model, management fees are often repaid to investors in circumstances where the hurdle rate of return has been met, and that management fees will often ‘step down’ over the life of a closed-end fund. Further, the complexity of the fee model poses particular difficulties for fee disclosure which is premised on ‘point in time’ rather

than life of fund disclosure (which is more accurate and meaningful for PE and VC given they are multi-year, closed end funds). If the Commission is interested in further information on this point, we would be happy to elaborate.

## **2.2 The value-add of PE to super returns and diversification**

Several recent studies into the portfolio allocation decisions of institutional investors have demonstrated that a meaningful allocation to PE and VC can boost the returns generated by a well-diversified super fund.

Rice Warner modelling shows that an allocation to PE and VC can enhance (within a diversified portfolio) the risk-adjusted long term retirement outcomes of superannuation members.<sup>1</sup> A study on asset allocations by Cambridge Associates<sup>2</sup> found that institutional investors with an asset allocation of greater than 15% to private investments such as PE and VC performed better than other institutional investors with smaller allocations.

Analysis completed by Frontier Advisors, an investment consultant to a number of Australia's largest superannuation funds, found that funds with higher alternative asset allocations posted marginally improved crediting rates (a measure of investment returns credited directly to superannuation fund members' accounts, hence taking investment management fees into account) over the 2016 financial year to June 2016. However, that result was reversed – higher alternative allocations actually dragged down crediting rates – when infrastructure and PE were stripped out of the alternatives allocation.<sup>3</sup> That is, PE and infrastructure contributed disproportionately more to members' crediting rates than other asset classes, thereby underlining value for money.

Accordingly, when assessing the allocative efficiency of the super system, including its regulatory settings, it is important to ensure that asset classes – like PE and VC – are not unfairly prejudiced by a regulatory bias towards low cost super products and investment management fees. This would not be in the interests of individual Australians, nor a federal government facing structural fiscal constraints.

## **2.3 How the focus on fees has affected super fund allocation to Australian PE**

If the objective of superannuation is to provide retirement income to substitute or supplement the Age Pension, it is imperative that superannuation regulations do not present disincentives towards achieving that outcome. In particular, it is crucial that the system is not structured in such a way as to distort its allocative efficiency.

In the context of the superannuation industry, an unintended consequence of policy and regulatory changes in recent years is an increased (and problematic) focus on highly liquid, low-cost investment products in default super funds. Since the introduction of MySuper and increased focus on low-cost superannuation portfolios, there has been a shift by many superannuation funds to cheaper liquid asset classes, such as listed equities and fixed interest, to reduce their headline fees. While there is no legislated 'cap', the market has pushed funds towards offering very low cost MySuper products. However, whether this is the right direction towards achieving higher levels of retirement savings and easing reliance on the age pension is questionable.

The Financial System Inquiry Final Report noted that, "In some cases, higher costs and fees may be in the interests of members. For example, alternative asset classes, such as infrastructure and other unlisted investments, tend to be more expensive to manage, but they may also diversify risks and offer higher after-fee returns for members. Submissions support this point." This is borne out by our discussion of fees and returns in sections 2.1 and 2.2 above.

The draft Commission report also referenced studies that point to Australian super funds having a higher exposure to alternative asset classes than other jurisdictions. This is indeed true for asset classes such as property and infrastructure. However, if this is broken down into the different components of the alternatives classification, then it can be seen that Australia's super funds on average have a smaller exposure to PE than pension funds in other countries.

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<sup>1</sup> Rice Warner, *Implications of MySuper asset allocations for retirement outcomes*, May 2015

<sup>2</sup> Cambridge Associates, *The 15% Frontier*, July 2016

<sup>3</sup> Frontier Advisors, *Funds need to dig deeper into alternatives to get results*, June 2016

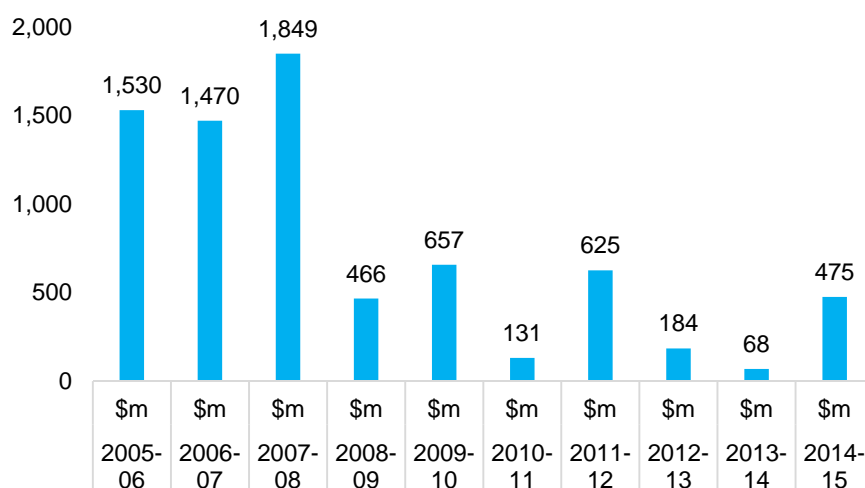
Indeed, over recent years, driven partly by the focus on fees and increasing scale encouraging larger minimum investments, Australian super funds have been allocating less and less capital to Australian PE and VC funds (see Table 1 and Figure 2 below). Meanwhile, super funds' high allocation to Australian equities, in part due to the benefits associated with franking credits, has remained steady at just over 40%. Hence, the super system has a high risk exposure to the Australian economy through local listed equity markets. This makes further exposure to the Australian economy via unlisted equities (e.g. PE funds) less attractive.

**Table 1: Superannuation funds held in Australian equities vs Australian PE and VC (FY06-15)**

| Financial Year | Total super fund assets under management (AUDm) | Total super funds held in Australian equities (AUDm) | % held in Australian equities | Total super funds committed to Australian PE and VC (AUDm) | % committed to Australian PE and VC |
|----------------|---|--|-------------------------------|--|-------------------------------------|
| 2005-06        | 860,123   | 359,033  | 42%                           | 6,337  | 0.74%                               |
| 2006-07        | 1,129,631                                       | 485,159  | 43%                           | 8,520  | 0.75%                               |
| 2007-08        | 1,098,944                                       | 461,511  | 42%                           | 9,700  | 0.88%                               |
| 2008-09        | 1,025,495                                       | 411,297  | 40%                           | 9,861  | 0.96%                               |
| 2009-10        | 1,149,818                                       | 476,634  | 41%                           | 10,429   | 0.91%                               |
| 2010-11        | 1,285,996                                       | 555,062  | 43%                           | 9,352  | 0.73%                               |
| 2011-12        | 1,332,145                                       | 532,607  | 40%                           | 9,452  | 0.71%                               |
| 2012-13        | 1,536,712                                       | 624,277  | 41%                           | 9,502  | 0.62%                               |
| 2013-14        | 1,749,045                                       | 723,380  | 41%                           | 8,492  | 0.49%                               |
| 2014-15        | 1,947,401                                       | 799,383  | 41%                           | 8,392  | 0.43%                               |

Source: ABS 5655.0, 5678.0

**Figure 2: New superannuation fund commitments to Australian PE & VC funds (A\$m)**



Source: ABS 5678.0

## 2.4 International comparisons of PE allocations by pension funds

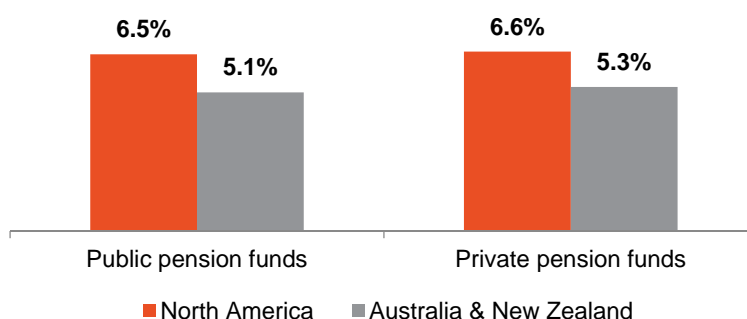
In assessing the efficiency of Australia's superannuation system, it is important to compare features of our system with pension fund systems in other countries.

The long experience of US pension funds in the PE asset class provides a strong body of evidence on the consistency of long-term PE returns over multiple economic cycles. Of the US public pension funds that do invest in PE and VC, disclosures under the Freedom of Information Act show that their 10-year returns from this asset class have averaged 14% per annum compared to just 8% for the S&P500 Index. Australian PE funds provide similarly competitive returns vis-à-vis the listed markets (as outlined in sections 2.1 and 2.2); however, due to the declining participation of superannuation funds in these funds, these gains are increasingly being realised by foreign investors (such as overseas pension funds and sovereign wealth funds) rather than Australian retirees. Indeed, in FY2015, around seventy per cent of all new PE commitments came from overseas investors. While we do not yet have available FY2016 data, we expect the trend to continue.

Globally, the trend among institutional investors has been an increase in allocations to alternative assets such as PE and VC, infrastructure, real estate and hedge funds.<sup>4</sup> Reflecting the experience of Australia's own super funds, these alternative asset classes have contributed strongly to the performance of pension funds across the developed world. Indeed, according to the OECD, many overseas funds have developed PE allocations for the first time in recent years, reflecting a recognition of the growth-generating potential of the asset class. Shifts in demographics, sluggish growth, and other challenges mean that pension funds will need to look at altering their asset allocations in order to meet future obligations. For example, Japan's Government Pension Investment Fund, considered the largest public pension fund in the world, announced in October 2014 a major change in investment policy, including alternative assets (including PE) in its new asset mix for the first time.

Although the table below demonstrates comparative allocations to PE across North America compared to Australia & New Zealand, it is worth noting that the majority of the Australian allocation is directed towards foreign fund managers. APRA data shows that as of June 2016, Australian super fund entities with more than four members allocated a total of 5% of investments to unlisted equity (which would include investments in PE and VC, as well as direct investments in unlisted companies). But less than half a percent of superannuation assets are committed to Australian PE and VC funds, as per Table 1. Given fee structures are similar across domestic and foreign fund managers, we understand that the key driver of this trend is scale – that is, for increasingly large Australian super funds it is more efficient to gain exposure to private equity via investments overseas (i.e. they can make larger investments that are more readily absorbed by larger foreign PE funds). As noted, domestic super funds already have significant exposure to the Australian economy via listed equities.

**Figure 3: Annual average PE allocation (% of assets) of pension plans, by region**



Note: Includes pension funds with zero allocation to PE.

Source: The Extent and Evolution of Pension Funds' Private Equity Allocations, Collier Institute of Private Equity, 2014

<sup>4</sup> OECD, *Annual Survey of Large Pension Funds and Public Pension Reserve Funds*, 2015



Finally, it is worth noting that Australia's own sovereign wealth fund, the Future Fund, has an allocation of around 10% to PE and VC, at approximately \$12.8b. Its publicly released fund performance data shows that this allocation, despite being amongst its higher-cost investment strategies, has delivered consistently strong returns which have outperformed that of Australia's super funds. Accordingly, the Future Fund stands as an example of a fund receiving superior returns as a result of a well-considered, long term PE investment program.

## **2.5 Other structural impediments to allocative efficiency – portability**

As outlined above, there are a number of structural impediments to super funds allocating capital into PE and VC, including: the increasing scale of funds necessitating larger minimum investments; and the regulatory focus on fees encouraging lower cost investment strategies. A final area of regulation that has had the effect of deterring investment into PE and VC are the super fund portability requirements.

Following Super Stream reforms, an RSE licensee must complete a standard rollover as soon as practicable but not later than three business days after receiving the request containing all mandated information. A consequence of this requirement is that super funds have to carefully manage liquidity within their fund so as to ensure that they are able to meet the portability requirements. Accordingly, unlisted and illiquid assets, such as PE and VC, can consume a significant portion of their liquidity buffer, encouraging higher allocations to liquid assets such as cash or listed equities.

While we respect the need for super fund members to be able to choose which fund they would like to be a member of, and to have that desire quickly actioned, we submit that a preferable timeframe would be thirty days. This would better allow super funds to manage their balance of liquid and illiquid assets, would likely lead to higher allocations to higher yielding alternative asset classes like PE and VC, all the while ensuring that members' wishes are met within a reasonable timeframe. The net result would be better allocative efficiency and, based on historical performance, better returns for Australian retirees.

### **Next steps**

As the Australian economy faces a period of sluggish expected growth and global economic and political uncertainty, it is imperative that our \$2 trillion superannuation system is structured as efficiently and competitively as possible. Changed market dynamics over recent years, including a regulatory focus on fees, and the rapid growth of the superannuation system, have unfortunately made investments into higher yielding asset classes like PE and VC less viable, to the detriment of both super fund members and a broader economy in need of transition.

We hope that the Commission's three-part inquiry offers an opportunity to assess the system against the core, overarching policy objective of the superannuation system: to provide income in retirement to substitute or supplement the Age Pension. It is our firm view, like that of the Commission, that this can be best achieved through a focus on net of fee returns over the long term.

We would like to thank you for the opportunity to provide a submission to the Commission in respect of its inquiry. Please do not hesitate to contact me or Christian Gergis, Head of Policy & Research, if you would like to discuss any aspect of this submission further. We look forward to continuing our engagement with you throughout the inquiry.

Yours sincerely



Yasser El-Ansary  
Chief Executive