Adapting to a changing world: how the Future Fund is investing in private markets

Speech by Wendy Norris, Deputy Chief Investment Officer, Private Markets, at the Australian Investment Council Conference 2019, Melbourne Victoria

Introduction

Good afternoon and thank you for the opportunity to speak to you today.

The Future Fund was established, as Australia's sovereign wealth fund, in 2006 to strengthen the Australian Government's long-term financial position.

We invest over $200bn across six public asset funds for the benefit of future generations of Australians. The largest fund is the Future Fund itself which currently stands at over $160bn – and we've added more than $100bn in earnings over the last 13 years.

In the last financial year, the Future Fund delivered a return of 11.5%pa and the return over ten years has been 10.4% pa. Our private markets investments, in particular private equity, contributed strongly to those results.

Today I will touch on our perspectives on investing in private markets and how Future Fund is adapting to the current investment environment.

Before I talk about the market, I'd like to introduce some exciting changes in the Future Fund team and describe how we approach private markets investing.

In 2017 the government announced its intention to defer withdrawals from the Future Fund from 2020 until 2026. This means the Fund will continue to grow through accumulated earnings for years to come.

In addition, the government has allocated additional funds to us to manage; most recently the Aboriginal and Torres Strait Islander Land and Sea Future Fund and the Future Drought Fund.

Together with the Medical Research Future Fund, these perpetual portfolios exceed $20bn in their own right, materially increasing our appetite for private market investments.

Organisational Changes

These are major developments for us. They mark the beginning of a demanding new phase as we design and build our organisation to manage portfolios of substantial additional size and complexity, while sustaining the success we have achieved to date.

Last year we reviewed our organisational structure to reinforce three key functions;

- our investment process,
- our technology and
- our risk management

All designed to support efficient and flexible management of the portfolios as they continue to grow.

These changes will strengthen the core investment philosophy that has benefited us since 2006 - our guiding principal 'one team, one purpose' is at the forefront of our mind and the centre of our investment process.

Within the investment team, we created three new deputy chief investment officer roles to bring the public markets, private markets and portfolio strategy teams closer together.

I was appointed as Deputy CIO, Private Markets. Prior to this I was the Head of Infrastructure and Timberland.

David George was appointed Deputy CIO, Public Markets, and Sue Brake has recently joined us as the Deputy CIO, Portfolio Strategy.

Together with our Chief Investment Officer, Raphael Arndt, the four of us lead the bottom-up and top-down elements of our investment strategy, with a focus on a collaborative and 'joined up', approach to investing.

I was also delighted to welcome Alicia Gregory to the Future Fund as Head of Private Equity in April this year. Alicia brings outstanding experience as a leader and investor and is well positioned to further develop our successful private equity program. Sid Khotkar has also recently joined as a senior member of her team.

Future Fund's investment process

To give you a bit of insight to our process, I'll explain how the Future Fund goes about investing and how private markets fit in.

Our investment approach is based on working together for the benefit of the portfolio as a whole. This is our 'one team, one purpose' philosophy. It drives our culture and the way we invest.

When constructing our portfolios, we bring together top-down and bottom-up views – we call this being joined up.

Our top-down people look at the global economy, financial markets and political risk, and think about how this will impact the portfolio and the level of risk we can accept in pursuit of our objectives.

Our bottom-up people look across the world for great assets and investment managers, thinking about whether they are being well rewarded for the risks they are taking.

We seek to uncover the best investment opportunities across all sectors, rather than the best opportunities in each sector, and then to act with conviction on these opportunities. In this way we pursue diversification at a total portfolio level rather than creating series self-contained sector portfolios.

By blending together the big picture and local insights – the macro and the micro - we generate a rich and nuanced view of the opportunities and outlook, which enables us to create portfolios where the whole is greater than the sum of the parts.

This 'joined up' process leads us to a portfolio construction that is far from a typical 60/40 split between the public market asset classes of equities and bonds. In fact, as of 30 June 2019 the Future Fund had investments in private equity, private debt, property, infrastructure, timberland and alternatives that totalled around 45% of the portfolio.

Private Equity and Venture at Future Fund

As you can see, private markets investments play an important role in Future Fund's portfolio. At 30 June, Future Fund's private equity portfolio was over $25bn or nearly 16% of the total Fund.

Private equity fulfils two functions.

The first, in the large buyout space, is to invest in high 'alpha' opportunities, where we believe we can earn a significant premium over similar - but more liquid - public market equity investments.

Secondly, in the venture space, we seek to invest in strategies that we can't readily access in public markets - innovation and small company growth.

We invest primarily in funds and in co-investments and will selectively use fund-of-funds for specific initiatives.

To achieve this, we build our team from industry professionals that have the skills to meet our managers as peers, and the expertise to openly debate the merits of a deal with them.

This helps us to understand the skill and insight our managers bring to their fund portfolios, to be responsive to investment opportunities in real time and to thoughtfully build our co-investment exposures.

Venture capital

To focus more closely on venture - venture and growth capital play an important role in our private equity program, with around $15bn invested currently. It gives us access to the innovation cycle and delivers an uncorrelated risk exposure.

We don't think about our venture capital strategy in terms of geography – innovation is not bounded by geographical borders. We have a global perspective when searching for the best ideas.

We look for opportunities in markets that can scale rapidly and have the potential to deliver the 10x outcomes that are so critical to the success of venture capital funds. That is why the US, with its large developed business and consumer markets, has been a focus for us in the first 10 years of our portfolio build out.

We are also actively engaged in the development of the Australian venture market both with investment dollars and by using our global network to develop and create opportunities for the industry.

We have been pleased to partner with the Australian Investment Council to introduce some of our US fund-of-fund managers to the Australian market – this included Greenspring Associates in 2017 and Horsley Bridge earlier this year.

Following their visit in 2017, we created a dedicated Australian venture capital mandate with our existing manager Greenspring Associates and they are actively monitoring the market to assess opportunities.

Changing market landscape – the growth in private markets

Turning now to the market landscape, the emphasis Future Fund has placed on private markets investments reflects a powerful trend in global investment flows. Over the past 20 years we have witnessed a strong and sustained shift in the market landscape, with growing private markets on one hand and shrinking public markets on the other.

Privately held investments have grown twice as fast as public markets in the last decade. Private markets now account for more than US$6tn of market value - almost 10% of global investment assets - as McKinsey says 'private markets have graduated from the fringes of the economy to the mainstream'.

We are in a market environment where loose monetary policy has led to an unprecedented supply of capital, and, at the same time advancements in technology have decreased the need for capital investment. These forces have combined to produce a sustained period of low interest rates and low inflation.

Investors have more money to invest and fewer attractive opportunities to invest in, which causes them to look for places where they can earn greater returns. The illiquidity, complexity and skill premia that are available in private markets start to look very attractive.

Consequently, when investing in equity markets, private equity is becoming an increasingly important consideration in portfolio construction.

This brings with it two challenges – the first is that it takes greater manager skill to navigate all that complexity, and investors pay away a larger portion of the excess return through fees.

The second is that as an investor, you end up with a less flexible portfolio. There is a very real risk that you may not be able to meet the liquidity demands of your beneficiaries when they make them.

This means that all investors, including the Future Fund, need to be thoughtful about how they navigate the balance of risks and rewards in private markets and how they can gain access to the best opportunities, while all the time continuing to adapt and improve their investment processes to keep up.

How are the private equity and venture industries responding to these market changes?

These market changes are also having an impact on the private equity and venture capital industries.

In the private equity market, we see fund managers that are awash with capital striving to deliver the same returns they have delivered in the past. This is despite strong market competition for deals and less use of leverage.

Everyone is working harder to try to produce their desired returns.

In the past managers could buy almost any company, add some leverage and sell it on in a few years' time at a comfortable profit. Today's market requires them to seek every opportunity to add value, at every stage through the life cycle of the investment. Operating teams are becoming more and more prevalent. Fund managers are investing in technology to improve efficiency in deal sourcing and in due diligence. Leverage is being used more intelligently.

As they seek to maximise their competitive advantage, great managers are leaving no stone unturned.

In venture capital, the sustained inflow of money means entrepreneurs have more funding options than ever before. This gives young companies much more scope to grow in private markets without having to deal with all the regulation that goes with public listing.

Staying away from the public markets also allows entrepreneurs to take a long-term view and ride out market cycles. They can keep growing at a rapid pace without focusing on short-term profitability or providing the kinds of detailed information about their strategies that they would have to in the public markets.

Not surprisingly, venture companies are staying private for longer, stretching the definitions of venture and growth. As companies no longer look to public markets to fund their expansion stages, growth funds, 'select funds' or 'greatest hits' private funds are supplanting the role of IPOs. Those companies that do go public, or are acquired by a public company, are much older and more mature than they were in the late 1990's.

Venture fund managers are responding to the competitive environment by pulling every lever they can. Where private equity firms have developed operating teams, venture capital firms place more emphasis on the human element. By building networks of business growth experts and 'CEO whisperers' they cultivate their entrepreneurs and guide management teams to lead larger and more mature companies.

Impact on private markets investments

However, from the investor's perspective, the return dispersion between best and worst performing venture funds is large, and average market performance has been, well, average.

According to Bridgewater, when you look at the average market returns from venture funds over the last 20 years, there has been little return for illiquidity or the higher risk of early stage companies. Total venture capital returns post fees have underperformed both private equity and small cap stocks in all but the five years post the global financial crisis.

In the more recent past, a lot of the supercharged returns that used to be seen in the public markets for newly listed companies have disappeared, with recent IPOs tending to perform in line with overall listed equity market performance. This is consistent with companies IPOing at a more mature stage of their life cycle. Returns from younger companies have shifted from public to private markets.

How is Future Fund adapting to these market changes?

As I mentioned earlier, for the Future Fund, venture remains the key way to access the innovation cycle and disruptive technology, and it will continue to hold a prominent place in our portfolio as a result.

To ensure that we end up earning an acceptable return for the risk, we are keeping a laser-like focus on partnering with top quartile managers that are responding proactively to the changing macro environment.

It puts the onus on us to make active hold or sell decisions about the individual stocks we end up owning when mangers do exit their now more mature investments in to the public markets.

It also requires us to actively adjust our investment pacing decisions to reflect the longer expected hold periods across private equity and venture.

What are we currently prioritising

We, like the fund managers we invest with, have more capital to manage and are working harder to maintain returns in a low interest rate environment.

We are investing in our organisation - enhancing our technology capability which is giving us more insight into our portfolio exposures. We are also uplifting our leadership skills as we push ourselves to collaborate more effectively and make better investment decisions.

We are working the portfolio harder to ensure that every exposure we hold is delivering the right outcome.

We are also focussed on getting the right balance of flexibility and return in our portfolio overall. To this end we have exited about A$5bn of private markets investments in the last couple of years. When assets become mature and the expected look-forward return has decreased, we look to sell them and re-deploy the capital within the portfolio.

The increasing maturity of secondary markets is helping us to optimise the portfolio we hold today, and we are focused on ensuring we are in the best possible position to maximise returns without taking excessive risk, in the future.

What is Future Fund looking for in investment managers?

We know capital is abundant right now, but we continue to look for partnerships that will stay with us through the long term.

Capital availability is like a pendulum and whilst it is very favourable towards managers right now, we know this will swing back at some stage and those who treat us well when capital is abundant will find us to be a great partner through leaner times.

We are always seeking strong and consistent investment processes which value diversity of perspective and that limit downside risk without cutting off the opportunity for the outperformers that significantly influence overall fund performance.

We also value robust fund manager business structures with considered sharing of economics and thoughtful team development and succession planning.

Partnership and an open two-way dialogue are becoming even more important to us. Asset owners face higher scrutiny and as we seek to be a responsible investor through the investments we make, we place more emphasis on understanding the way our managers engage with their investee companies about social and environmental impacts.

Conclusion

Let me conclude by thanking you once again for the opportunity to be here.

The Future Fund is in an exciting period of change and renewal as we embark on our next period of growth.

Private markets have graduated to the main stream of portfolio construction as investors around the world seek diversifying opportunities that offer attractive risk / return trade-offs beyond traditional public markets.

We collectively face an investment environment where capital supply is in abundance and the look-forward return environment is challenging, forcing – or creating the opportunity for – investors like us to respond by working harder to build more efficient processes and work their portfolios harder, while managers work harder to re-invest in their own value creation strategies.

The investment environment is changing, and we are adapting to it.

We look forward to continuing to partner with the private equity and venture industries as we work towards generating strong returns for the benefit of future generations of Australians.