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Maximising the role of unlisted assets in portfolios

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IBR Asset Allocation Strategies Forum

David Bell

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Outline

1. The opportunities provided by unlisted assets
2. Be clear on role of unlisted assets in portfolios
3. Systems and portfolio management practices
4. Liquidity / equity challenges of managing portfolios with unlisted assets
5. Implementation models
6. Governance challenges including valuation

Two groups of challenges

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The opportunities provided by unlisted assets

- Expanded opportunity set, which may provide:
  - Potentially (real or perceived) mispriced investment opportunities
  - Sector opportunities which enable thematic targeting and afford better diversification
  - Lower price volatility (≠ lower risk?)
  - Information insights

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Be clear on role of unlisted assets in portfolios

- Be clear and research-based in your reasons for using unlisted assets, and ~~scope~~ your ability to implement:
  - 1 Return enhancement
    - Be careful to account for performance measurement techniques and assumptions
  - 2 Sector opportunities and thematic targeting
    - How much peer group / YFYS tracking error will this incur
  - 3 Lower risk
    - Is risk fundamentally lower due to structural economic exposure?
    - Have you reconciled the ex-post observation of lower return volatility?
  - 4 Ability to implement
    - What scale / cost model is required to deliver targeted outcomes?
    - Is an alpha assumption incorporated into the portfolio case? Is it realistic?

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So what's required?
We always say that ~~excellence~~ governance excellence is the entry ticket to unlisted assets.

Systems which aggregate exposures

- Calculated on the basis of:
  - Look-through public and unlisted exposures
  - Accounts for exposures across the capital structure
  - Considers different lenses of risk (volatility, drawdown risk, permanent loss of capital, scenarios and stresses, etc.)
- Such systems enable a fund to:
  - Ensure that best ideas are emphasized
  - Ensure that pockets of risk are accurately identified
  - Enable a fund to meet increasing disclosure requirements / requests

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This prompts some day-to-day portfolio practice considerations

Portfolio management practices

- When portfolios contain unlisted assets day-to-day portfolio management practices arise:
  - Exposure management
    - On what basis: marked or estimated (i.e. do the Inv / Risk team run their own shadow marks?
    - This is particularly important in stressed market environments → compliance rules
  - Risk measurement
    - On what basis: marked or estimated
    - Important in risk management and compliance / fund governance

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Liquidity / equity challenges of managing portfolios with unlisted assets

We frame the risks associated with portfolios containing unlisted assets as displayed below.

First Order	Solvency • Ability to meet cashflow demands as they arise		
Second Order	1. Portfolio quality • Deterioration in portfolio quality	2. Pricing inequities • Inequities due to 'stale' or mis-pricing	3. Costs • Meeting liquidity demands • Restoring portfolio quality

often cross-subsidised

* Each of these risks are magnified by asset selection performance. A poorer asset will be harder to sell and value.

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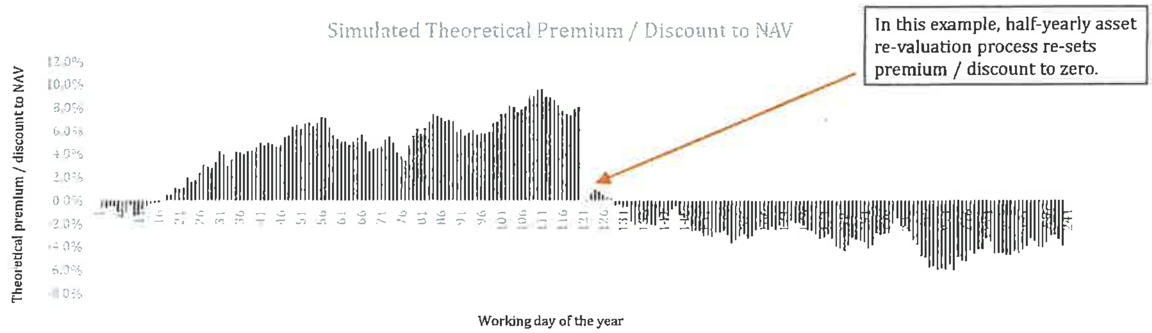
These next examples come from a project we did exploring these second order impacts. All materials including models are on our website.

Case study 1 – Explore Unit price inequities from stale pricing unlisted assets

A single simulation to illustrate the model

Chart 1: Simulated Theoretical Premium / Discount to NAV

This chart simulates the possible daily theoretical premium / discount to NAV.



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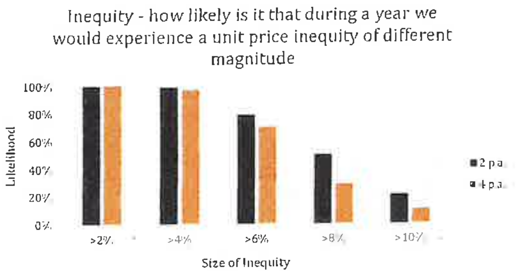
Simulate many times, can then consider a dist^n of mispricings. Communicate this to your Board.

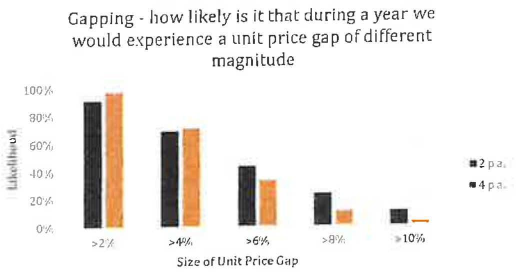
Case study 1 – Unit price inequities

The output from this case study provides a significant insight:

➔ More frequent valuations are beneficial but significant inequities and gapping may persist (the example below compares semi-annual and quarterly re-valuation processes).

- Further exploration can account for portfolio characteristics





Informs: Allocation
Pricing policy

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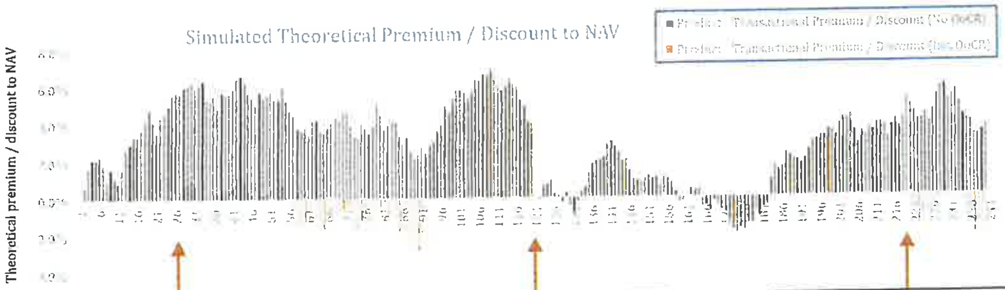
I'll move through this one quickly as, ~~it~~ while interesting, it is a little off topic.

Case study 2 – A liquid proxy

A single simulation to illustrate the model

Chart 2: Simulated Theoretical Transacted Premium / Discount to NAV

This chart simulates the possible daily theoretical premium / discount to NAV.



Out-of-cycle revaluation theoretically reduces inequality.

Half-yearly asset re-valuation re-sets premium / discount to zero.

Out-of-cycle revaluation theoretically reduces inequality.

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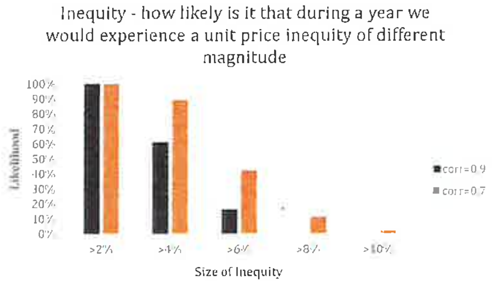
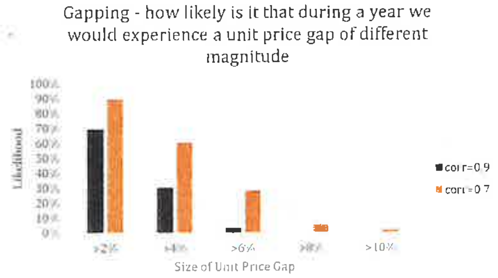
Case study 2 – A liquid proxy

The output from this case study provides a significant insight:

➔ Liquid proxies are no panacea unless there is high confidence they accurately reflect 'true' illiquid valuations.

- An alternative process where movements in liquid proxies are used to inform a valuation committee may be more appropriate.





In summary comes down to accuracy and reliability of liquid proxy.

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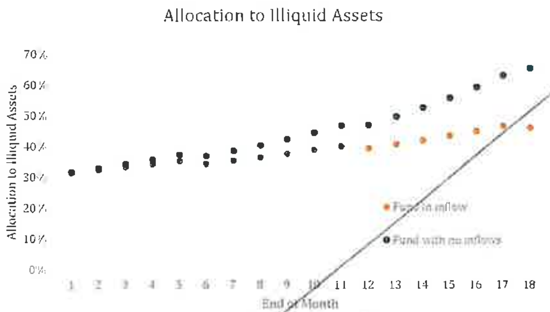
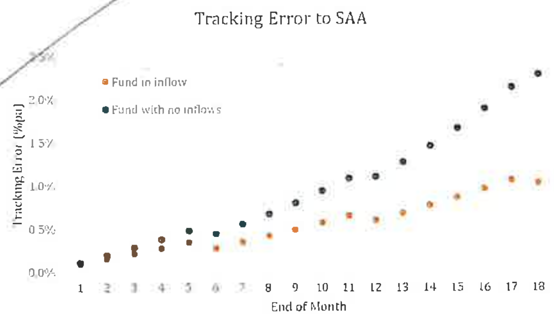
This case study is important as it considers many dimensions associated w unlisted assets.

Case study 3 – Portfolio quality





Note: these charts have been created by manually combining the output from the two cases.

Key finding: Funds with lower inflows will experience larger deviations from their targeted allocation to liquid/illiquid investments.

Key finding: As portfolio allocations deviate from their target allocations, risk (as measured by tracking error) increases.

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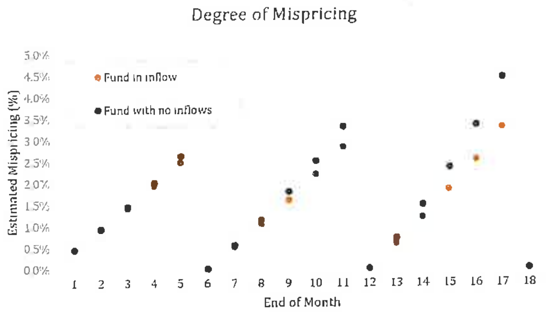
We work through a GFC style scenario where ~~the~~ unlisted assets are held. We consider market movements, currency settlements, member switching etc.

We consider a fund in inflow and a fund in outflow

Case study 3 – Portfolio quality



Note: these charts have been created by manually combining the output from the two cases.

Key finding: Funds with lower inflows will experience larger mispricings.

Key finding: Funds with lower inflows will bear higher costs of selling down illiquid assets to restore SAA.

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Implementation models

- Range of implementation models including:

Internal team | Separate subsidiary

Fund of funds | Manager selection → Co-invest → Direct transactions

Role of external consultants

Sourced externally | Sourced internally

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Needs to wrap back into your underlying portfolio case for unlisteds.

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Governance challenges

- There are many governance challenges. We call out three:

1. Valuation processes
   - APRA's requirements have been updated a number of times. It remains a balance between principles-based and prescriptive requirements (SPG 530)
2. Your Future, Your Super considerations
   - Disperse treatment of unlisted asset classes – private debt ➔ unlisted property / infrastructure ➔ private equity
   - Clash between best portfolio and managing performance test tracking error
   - J-curve effects pose a specific challenge, especially for private equity
3. Peer group risk difficult to manage
   - Funds are often peer group risk aware but funds have different liquidity profiles

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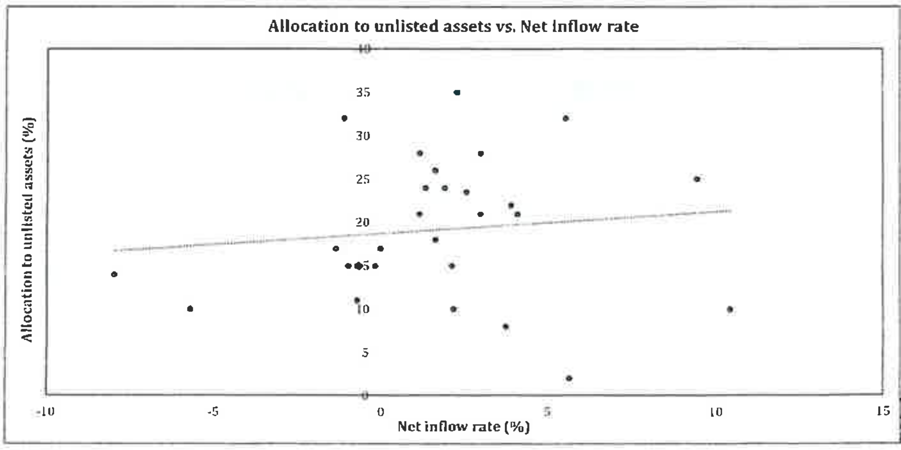
I finish on this slide.
— very topical at the moment

Governance challenges

- Knowledge and skills-based challenges
  - Can be managed through board skills matrix and separate committees
- External pressures



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~~If~~ Funds have unique demographics and inflow profiles;
Yet they like to manage peer group risk.
~~If~~ they ~~don't~~ focus too much on peer group then risk of ~~for~~ bigger problems

Welcome your questions and feedback

David Bell
Executive Director
The Conexus Institute
E: david.bell@theconexusinstitute.org.au

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