sunsuper

Focus on investments: Sunsuper's alternative assets

November 2019

Executive summary

Sunsuper views the diversification benefits provided by alternative assets as very attractive.

Sunsuper's ability to maintain higher exposures to alternative asset classes, in general, and unlisted assets, in particular, is underpinned by strong, reliable net cashflows into the fund. This largely reflects the fact that our flows are overwhelmingly in the form of compulsory, default superannuation contributions from a membership that is relatively young, and hence much further away from needing to draw down on their investments to fund their retirement.

Maintaining substantial allocations to alternative assets allows us to build diversified portfolios that deliver strong long-term real returns, while being less exposed (although certainly not immune) to the short-term volatility of global share markets.

We allocate to four classes of alternative assets: property, infrastructure, private capital, and hedge funds and alternative strategies. Hedge funds and alternative strategies include allocations to carefully selected hedge funds and other alternative strategies, which include exposures to both unlisted and publicly traded assets.

> *We allocate to four classes of alternative assets: property, infrastructure, private capital, and hedge funds and alternative strategies.*

While our investments in traditional asset classes, shares and bonds, are readily classified as growth and defensive respectively, characterising alternative assets can be more challenging. Even in the case of private capital (particularly private equity), which Sunsuper characterises as a purely growth asset class, performance tends to be considerably less volatile over time than listed shares, and even during major share market downturns, private equity assets tend to experience less severe downturns.

Discovery Parks *Sunsuper direct investment since 2010*

Returns from both our property and infrastructure investments are expected to be between those of equity and fixed income while being positively correlated to inflation. From an asset allocation and risk management perspective, neither asset class fits neatly into a growth or defensive category. For the purpose of determining a growth-defensive split within our diversified portfolios, we divide both asset classes equally between growth and defensive. In practice, the returns they deliver, and their behaviour during significant and extended share market declines, are consistent with that assessment.

What alternative asset classes does Sunsuper invest in?

For many years, Sunsuper has held substantially higher weightings to alternative assets in our diversified investment options than many of our competitors. We allocate to four classes of alternative assets: property, infrastructure, private capital, and hedge funds and alternative strategies.

We invest with, or alongside, carefully chosen investment managers with acknowledged expertise in the asset class and utilise the advice of specialist consultants where appropriate. Accessing top-tier managers, particularly in private capital, and hedge funds and alternative strategies, is critical.

What's the difference between publicly traded and unlisted asset classes?

Table 1 outlines the differences between publicly traded and unlisted asset classes.

Publicly traded assets	Unlisted assets
Are either listed or quoted on the ASX (or other exchange) or actively traded between market participants (such as investment banks and institutional investors).	Are not quoted on any exchange and cannot be traded at any time.
Valued daily.	Valued less frequently. Usually quarterly, semi-annually and annually.
Subject to significant volatility driven by perceptions of the underlying security and general market sentiment.	Significantly less volatile as the assets are less likely to be influenced by market sentiment.
Highly liquid.	Low liquidity.

Table 1: *Differences between publicly traded and unlisted asset classes*

Why do we invest in alternative asset classes?

The short answer is because we can. Our ability to hold higher allocations to alternative asset classes, particularly unlisted assets, reflects our strong reliable cash inflows, from a relatively young membership making compulsory superannuation contributions. Moreover, as a large super fund with assets in excess of A$65 billion, we are able to build well-diversified portfolios in the alternative asset classes.

In general, we expect our alternative asset classes to deliver attractive long-term returns for Sunsuper members, while reducing their exposure to share market volatility. It is imperative that any decision to allocate to alternative assets be assessed against the Fund's overall liquidity requirements, and the need for member equity – the need to provide fair daily unit prices for all our investment options, so that any member buying or selling units on any given day is treated fairly.

Caruna electricity distribution network
Sunsuper direct investment since 2013

Our unlisted assets are expected to deliver long-term returns that more than compensate for the illiquid nature of the assets and the costs incurred in managing these assets. In the case of hedge funds and alternative strategies, we expect returns that are significantly in excess of cash after fees, with low volatility consistent with other defensive assets and a very low correlation to share and bond markets.

Property

Sunsuper's property portfolio invests in a range of institutional-quality property assets, both within Australia and globally. Institutional-quality property investments typically include office buildings, retail centres and industrial warehouses but can also include residential, hotels, retirement villages, healthcare, education, leisure, self-storage, data centres and land.

In addition to investments in property – both directly and via institutional funds – we also invest in property-backed debt securities, in the US, the UK and Europe.

Under normal market conditions, the property portfolio will seek to provide returns between that of listed shares and fixed income that are also positively correlated to inflation.

Returns from the unlisted property portfolio are largely income – the rent levied by the property to its tenants – rather than capital gains.

We rarely take on development risk; our preference is to invest into established properties with a reliable rental income stream. One recent exception – our decision to invest alongside Mirvac and AMP in the Australian Technology Park development in South Sydney – reflects the involvement of the Commonwealth Bank as the long-term anchor tenant underpinning the development and therefore reducing the development risk.

Sunsuper's largest property exposures are outlined in table 2.

Asset	Carrying value September 2019 (A$)	Sector	Geography
Discovery Parks	>$650m	Holiday Parks	Australia & NZ
AMP Capital Shopping Centre Fund	>$400m	Retail	Australia & NZ
Goodman Australia Industrial Partnership	>$350m	Industrial	Australia & NZ
Australian Technology Park	>$300m	Office	Australia & NZ
Smart Markets Fund	>$300m	Diversified	North America
QIC Property Fund	>$300m	Retail	Australia & NZ
GPT Shopping Centre Fund	>$250m	Retail	Australia & NZ
US agency mortgages	>$250m	Residential	North America
CBRE Pan-European Core Fund	>$200m	Diversified	Europe
Australian Wholesale Property Fund	>$200m	Diversified	Australia & NZ
Berkshire Bridge Loan Investors	>$200m	Residential	North America
GPT Wholesale Office Fund	>$200m	Office	Australia & NZ
Other	>$2,500m	Various	Various
TOTAL	**~A$6,500m**		

Table 2: *Sunsuper's largest property exposures at September 2019*

Infrastructure

Infrastructure refers to the fundamental assets of a society that are required to provide essential services to its population and are accessible to or used directly or indirectly by a large number of people. As with our property investments, the aim of infrastructure investments in our investment portfolios is to provide returns between those of listed shares and fixed income while being positively correlated to inflation.

Infrastructure investments are typically characterised by several of the following key features: long duration, large initial capital outlays, monopolistic qualities, stable income, GDP or inflation-linked earnings, and returns dominated by income, once an asset has matured.

Institutional-quality infrastructure typically includes airports, roads, railways, registries, utilities, water treatment plants and sports facilities, in addition to assets operating in the renewable energy sector and through public-private partnerships with government agencies.

Sunsuper's largest infrastructure exposures are outlined in table 3.

Asset	Carrying value September 2019 (A$)	Sector	Geography
Bristol & Birmingham Airports	>$500m	Airports	UK
Brisbane Airport	>$500m	Airports	Australia
Czech Gas Networks	>$400m	Utilities	Czech Republic
EP Infrastructure	>$300m	Utilities	Slovakia
The Infrastructure Fund	>$300m	Diversified	Australia/ Europe
Caruna	>$300m	Utilities	Finland
Land Services South Australia	>$300m	Land Registries	Australia
A-Train	>$200m	Rail	Sweden
Queensland Airports Limited	>$200m	Airports	Australia
Utilities Trust of Australia	>$100m	Diversified	Australia/ Europe
Other	>$900m	Diversified	Australia/ North America
Total	**~$4,500m**		

Table 3: *Sunsuper's largest infrastructure exposures at September 2019*

Private capital

Our private capital portfolio invests in some debt but mostly unlisted equity investments across the globe. We expect to extract an illiquidity return premium relative to listed share markets. Investing via various forms of private ownership provides us with the ability to take advantage of time and control, and to access relatively inefficient markets, generally in the small and midcap companies sectors. Private capital provides access to the largest pool of companies in the world and enhances the diversification of the portfolio. For example, private companies account for over 85 per cent of US firms with 500 or more employees.

Partnering with high-quality managers in private capital is critical. The difference in performance between top and bottom quartile managers can be vast. The largest manager exposures in Sunsuper's private capital portfolio are shown in table 4.

Manager	Sector
HarbourVest	Buyout/Co-investments
StepStone	Buyout/Co-investments
Vista	Buyout
Barwon	Listed
Golden Gate	Buyout
Anchorage Capital	Special Sits / Distressed
Waud Capital	Buyout
Unigestion	Buyout/Co-investments
Neuberger Berman	Buyout/Co-investments
Other managers	Various

Table 4: *Largest manager exposures in Sunsuper's private capital portfolio*

Partnering with high-quality managers in private capital is critical.

Sunsuper's private capital portfolio is primarily invested with 20 to 30 carefully chosen managers across the key sub-sectors of the asset class: buyout, venture capital, distressed debt and special situations. The portfolio either directly or indirectly invests in well over 1,000 companies. While we do invest in managers' funds, we also seek to co-invest alongside our preferred managers. This allows us to lower costs and gain greater transparency and control over our private capital investments. The top 10 company exposures in Sunsuper's private capital portfolio are shown in table 5.

Top 10 company exposures	Sector
PSI Services	Business Services
TIBCO	Software
Preston Hollow	Financials
H-Line Shipping	Transportation
LeasePlan	Financials
MBI	Transportation
IntelliHUB	Utilities
Staples	Business Services
Oakley Capital	Listed
Press Ganey	Healthcare

Table 5: *Top 10 company exposures in Sunsuper's private capital portfolio*

Hedge funds and alternative strategies

The hedge funds and alternative strategies asset class consists of absolute return strategies, which invest in both listed and unlisted securities or their derivatives in order to produce a return well above cash.

The purpose of having hedge funds and alternative strategies in Sunsuper's diversified options is to produce consistent and stable absolute returns that help diversify our listed shares and debt exposure. In other words, the portfolio is designed to have low volatility and a very low correlation to the performance of global capital markets.

Hedge funds and alternative strategies is a cross-asset, non-conventional portfolio that focuses on private and alternative credit. It employs an opportunistic and bottom-up approach, taking advantage of market dislocations where our capital can earn outsized returns.

In recent years, we have focused on bank replacement credit in asset-backed sectors such as real estate and energy. We have also been active in non-traditional insurance strategies, and invest in event-driven opportunities such as liquidations and trade claims, as well as both equity and credit arbitrage.

This portfolio is designed to be defensive, with a strong asset-backed, income-generating focus.

Sunsuper's hedge funds and alternative strategies portfolio is primarily invested with 20 carefully chosen managers across the key sub-sectors of the asset class: credit, event-driven and macro. While we do invest in managers' funds, we also seek to co-invest alongside our preferred managers. This allows us to lower costs and gain greater transparency and control over our investments.

The top manager exposures in Sunsuper's hedge funds and alternative strategies portfolio are shown in table 6.

Manager	Sector
Two Sigma	Macro
Blackrock	Credit & Event Driven/ Co-Investments
Manikay	Event Driven/ Co-Investments
Nephila	Credit/Insurance
EIG	Credit/Co-Investments
One William Street	Credit/Co-Investments
Taconic	Credit & Event Driven/ Co-Investments
Oceanwood	Event Driven/ Co-Investments
Janchor	Equity Long-Short
PAG	Credit/Co-Investments

Table 6: *Top manager exposures in Sunsuper's hedge funds and alternative strategies portfolio*

Growth vs defensive

The level of growth assets is a key differentiator between investment strategies and it is a regularly used metric when determining the appropriate investment strategy for an investor.

Growth assets are typically characterised by higher long-term expected returns but with higher volatility or variability in returns in the short term. Growth assets typically display pro-cyclical behaviour with strong performance when economic conditions are improving.

In contrast, defensive assets are characterised by lower long-term returns but with lower volatility, delivering a more stable return pattern. Defensive assets are not generally linked with the economic cycle and they can, in certain situations, produce their strongest performance when growth assets are suffering.

Our investments in traditional asset classes, shares and bonds, are readily classified as growth and defensive respectively. Characterising unlisted assets, however, can be more challenging. Even in the case of private equity, which Sunsuper characterises as a purely growth asset class, performance tends to be considerably less volatile over time than listed shares, and even during major share market downturns, private equity assets tend to experience less severe downturns.

Under normal market conditions, the property portfolio will seek to provide returns between those of listed shares and fixed income that are also positively correlated to inflation. Returns from the unlisted property portfolio are largely income – the rent levied by the property to its tenants – rather than capital gains. As with our property investments, the aim of infrastructure investments in our investment portfolios is to provide returns between those of shares and fixed income while being positively correlated to inflation. Returns, however, tend to be tilted more towards capital gains than income. From an asset allocation and risk management perspective, neither asset class fits neatly into a growth or defensive category. Both asset classes capture returns generated by a growing economy, and yet a significant proportion of the returns over time are likely to come from relatively stable income streams. For the purpose of determining a growth-defensive split within our diversified portfolios, we divide both asset classes equally between growth and defensive. In practice, the returns they deliver, and their behaviour

Arlanda Express *Sunsuper direct investment since 2014*

during significant and extended share market declines, are entirely consistent with that assessment. Moreover, both portfolios are deliberately structured to be significantly more defensive than either listed real estate investment trusts (REITs) or listed infrastructure vehicles.

We categorise our hedge funds and alternative strategies portfolio as defensive. There are several reasons for this. The portfolio is funded from, and held instead of, cash. As a consequence, the objective of the portfolio is to deliver a significant return premium above cash, net of fees. While the portfolio will exhibit some growth characteristics from time to time, it is designed, consistent with our other defensive asset classes, to have low volatility and a very low correlation to the performance of global capital markets.

Just how valid is our approach to categorising asset classes as either growth or defensive? We would expect private capital returns to be more systematically related to share market performance than either unlisted property or infrastructure. In turn, we expect our hedge funds and alternative strategies portfolio to be even less systematically related to share market returns. We use the concept of portfolio Beta to test how systematically related each of our alternative asset classes are to the performance of share markets. In order to prevent artificially understating the extent of the relationship, we allow for the valuation lag between the performance of share markets and the valuation of our alternative assets.

Table 7 summarises the percentage growth exposure we assign to each asset class to the actual growth exposure as determined by the relationship between Sunsuper's alternative asset class returns with those of listed share markets.

	Growth %	Estimated valuation lag (months)*	Estimated Beta**
Property	50	9	0.33
Infrastructure	50	9	0.34
Private capital	100	6	0.49
Hedge funds and alternative strategies	0	3	0.25

Table 7: *Percentage growth exposure of Sunsuper's alternative asset classes*

* Estimated valuation lag from regression analysis of rolling 1-year returns.

** Estimated Beta after allowing for valuation lag. Beta measures the responsiveness of asset class returns to those of share markets, e.g. a Beta of 0.49 implies that a 1% gain in share markets would be associated with a 0.49% gain in for the asset class in question. Calculations based on Sunsuper unlisted asset returns and the returns of an equally weighted index of Australian (S&P/ASX300) and developed market (MSCI World hedged into A$) equities.

Birmingham Airport *Sunsuper direct investment since 2017*

How do alternative asset classes fare during major market downturns?

Another way of assessing the validity of our growth versus defensive categorisation is by examining the behaviour of alternative asset classes during periods of share market weakness.

During periods of sharply weaker share prices, such as the December quarter of 2018, Sunsuper's diversified investment options tend to perform very favourably against our peers, as unlisted asset valuations do not respond to short-term changes in market sentiment. In the event of a longer-lasting share market downturn, unlisted asset valuations are inevitably impacted. Just how much of a decline in value our unlisted assets experience depends on both the depth and duration of the share market downturn and the impact on the broader economy. If weaker share markets are followed by a recession, then virtually all growth assets – listed or unlisted – or assets with even moderate growth characteristics are likely to fall in value. However, unlisted assets, particularly property and infrastructure assets, are more defensive and have historically not declined as much in value as listed shares in such an environment: a result which has typically led to Sunsuper outperforming our peers, particularly our retail competitors, during market downturns.

The Global Financial Crisis was perhaps the most powerful "stress test" of this approach. Chart 1 shows the peak-to-trough performance of the key publicly traded growth asset classes against Sunsuper's alternative asset portfolios.

Maximum drawdown* during GFC

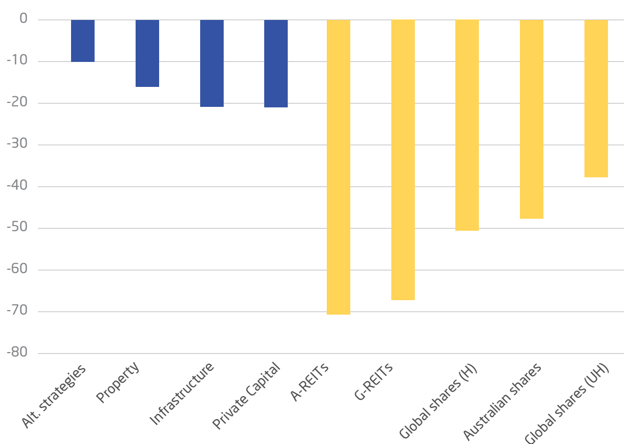

Chart 1: *Peak to trough performance of key publicly traded growth asset classes against Sunsuper's alternative asset portfolios*

*Sources: Sunsuper, Refinitiv. Data for alternative asset classes: Sunsuper portfolio performance. Data for public markets: Australian REITs - S&P/ASX300 A-REIT Accumulation Index; Global REITs - FTSE/EPRA NAREIT Index hedged into A$; Australian shares - S&P/ASX300 Accumulation Index; International shares - MSCI World Indices. *Dates for drawdown calculations vary between asset classes.*

As with the previous table, the results are adjusted for the lag between share market declines and the timing of alternative asset valuations. While alternative assets were far from immune to the crisis, they nevertheless demonstrated significant defensive characteristics.

> *While alternative assets were far from immune to the crisis, they demonstrated significant defensive characteristics.*

Conclusion: the proof in the pudding

Charts 2 and 3 compare the total returns from Sunsuper's alternative asset classes against an index of Australian and international shares since November 2004. By holding a substantial allocation to alternative assets, we aim to deliver strong long-term returns – in particular, by capturing the illiquidity premium attached to unlisted assets – while reducing the short-term volatility our members face by investing in share markets. Sunsuper's three unlisted asset classes have delivered on those objectives. Our hedge funds and alternative strategies portfolio has delivered solid net returns above cash, while acting as an important diversifier during difficult share market conditions.

Sunsuper's unlisted assets performance

Cumulative return (November 2004 equals 100)

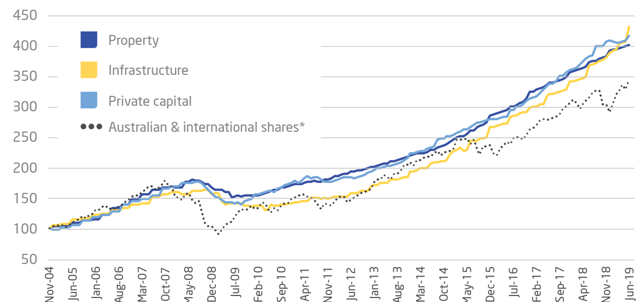

Chart 2: *Sunsuper's unlisted assets performance*

*Sources: Refinitiv, Sunsuper. *Total return index comprising 50% MSCI hedged in A$ and 50% S&P/ASX300 Accumulation Index.* **Past performance is not a reliable indication of future performance.**

Sunsuper's long-run alternative strategies performance

Cumulative return (November 2004 equals 100)

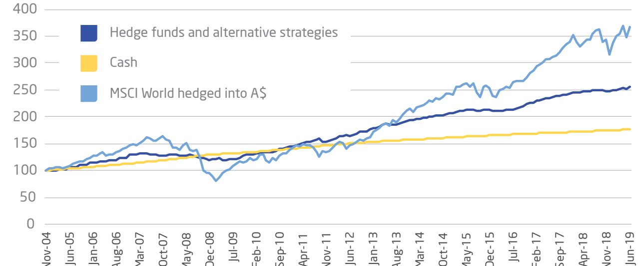

Chart 3: *Sunsuper's long-run hedge funds and alternative strategies performance*

Sources: Refinitiv, Sunsuper. **Past performance is not a reliable indication of future performance.**

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