ASFA Global Investment Forum: Infrastructure and Long Term Investment

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Long Term Investing

The Future Fund typifies most of the characteristics ascribed to a "Long Term Investor". We do not have members, we do not have to report short term returns, and we do not have to worry about switching or outflows. We often think about what this means and, in fact, have commissioned some research with the **Centre for International Finance and Regulation** looking at what Long Term Investing really means.

We aim to construct a diversified portfolio which will be robust over time. We balance the desire for strong capital returns with building a portfolio which is resilient to periods of poor market returns. You will therefore typically see us maintain a lower weight to equities than common in this country. This means that we may underperform our domestic peers during strong markets but we should have less volatility in our return path overall. To implement this approach we need to be able to switch the portfolio around.

For us – being a Long Term Investor means having the ability to look over the horizon and think about the issues which could impact asset values in the future. It does <u>not</u> however mean that we necessarily buy and hold investments for very long periods. After all, the long run is just made up of a series of short runs. If your asset is over valued in the current market why not sell it and buy it back later if valuations fall? In my view too many investors fail to think this way and therefore forgo return opportunities. I think this type of thinking is particularly pervasive in asset classes with long duration assets such as infrastructure.

For the Future Fund, being a true Long Term Investor means focussing on a few key aspects of our investments:

- First, **understanding value**. To do this we need enough information to form a view about our investments. This requires our managers to provide transparency.
- Second, **the ability to make and implement portfolio decisions**. What is the point of being a Long Term Investor if all of our investments are locked up in illiquid structures and we cannot effect changes in our portfolio which arise from our long term views?

- Finally, **manager alignment**. There is no point being a Long Term Investor if you use managers with short term incentives to implement your portfolio.

It is this last aspect that I wanted to focus on today. In particular I want to provide an example of two areas where we have been applying this approach to ensure that our managers are truly working for us over the long term.

Hedge Fund Example

A you may know, the Future Fund is a strong believer in the benefit of Alternatives to insulate the portfolio from the volatility of equity markets. In particular we have around 13% of the portfolio, or A$13 billion exposed to various hedge fund strategies. Now since hedge funds are not renowned for their transparency or alignment to their clients, the question for us has been how do we get comfortable that we are investing with aligned managers?

One area we have concentrated on is improving our analysis of hedge fund returns to determine where those returns are coming from. We assess historic performance against a number of betas. These include the obvious candidates of equity and debt returns but also other betas such as commodity indices, volatility, momentum and carry. We have found situations where managers are really only providing an expensive beta return which we can access much more cheaply either directly or through synthetic options.

Secondly we then calculate the "true alpha" delivered by the manager after adjusting for the "beta" return and assess the proportion of that skill that is retained by the manager through the fee structure. We are looking for managers who can consistently apply their skill to deliver true uncorrelated returns and who share a significant portion of that return with their clients.

Finally, we watch closely for variation in this behaviour over time. It is common for managers who have had "skill" to lose their edge as they get larger. This is either because they find it harder to implement their views with very large pools of capital, or else because the pure profit that's made off the base fees deters the manager from taking true risk and jeopardising that safe profit by striving for outperformance.

Application to Infrastructure

Now, you may well ask, what has that hedge fund example got to do with infrastructure which is the topic of this conference? Well there is plenty of work going on in the industry to help develop an unlisted infrastructure benchmark. We support this. The sector will struggle to reach its potential until it can be much more transparent about performance. But what about if you, as investors, could determine how much of your infrastructure portfolio return was due to changes in bond yields, inflation expectations or GDP growth? What if you could assess whether your managers were adding any value over and above those, and other factors which you could buy much more cheaply and in a more liquid form? And what if you could talk to your manager about the proportion of their "skill" they were proposing to keep via their fee structure?

Infrastructure Example

We have been applying this thinking to other areas of Infrastructure as well. As you might know, a couple of years ago we acquired some large interests in Perth and Melbourne Airports from the Australian Infrastructure Fund. We had previously been shown the opportunity by several managers to acquire these assets but, to our dismay, they all proposed illiquid holding structures which effectively locked in the manager forever.

Given the attractiveness of the assets to our fund, we decided to acquire the assets directly. As a result, we ended up with significant minority interests in both airports but with no locked in arrangements about how we would manage those interests.

Having been involved in managing airport investments around the world for many years, it is my strong view that Australian airports could all be managed better than they are now. Who wouldn't agree that airport retail offerings couldn't be improved, car parking products be more sophisticated or the land bank be developed more effectively? The Future Fund has access to some of the best retail shopping centre and development property managers in the world and we applied these learnings to our thinking about the true, long term, value of these assets.

We designed a new way of engaging with the infrastructure manager community. We ran a tender process seeking one or more managers to come in and show us how they could really drive value in our assets. This meant that we asked to see a team of people who had true expertise – not just in infrastructure investing, but in retail, car parking, capital investment programmes and land development. It meant that these people had to be available to work on our account.

Many managers had this expertise in house, but it was sitting in a parallel real estate silo. We set out to break down these silos. There is nothing like a competitive tender process to do that.

We agreed to pay for the services provided on a fixed fee basis and demanded transparency as to the cost of providing that service including the manager's profit margin. We then decided to maintain alignment and focus by entering into flexible mandates which can be terminated at any time. Of course we recognised the implementation costs and developed an appropriate mechanism to protect our managers from incurring losses if we chose to terminate the mandate early – for example if the assets had been bid up to a value so high that it justified selling them. A true long term investor needs to preserve that flexibility.

As I said earlier, we believe in alignment so we set a performance fee. But that fee is not based on the investment performance. After all, we decided to buy the assets and set the entry price. We may decide to sell the asset at any time for our own portfolio reasons – which may not optimise returns on that asset on a stand alone basis. It would not be fair to incentivise a manager on factors outside their control.

Nor would it be right for us to pay a manager for returns generated by beta factors such as a further decline in bond yields – most likely if the economy is soft, in which case the assets could actually be underperforming operationally. Nor would we want to pay bonuses if the economy was booming but the asset in question was losing market share.

So we agreed a framework where we set fixed performance fees based on a series of KPIs designed to focus on the issues for the asset in question, and the value add from the manager. For example we look at:

- Retail spend rates per passenger
- Revenue from the property bank over time
- EBITDA margins
- Delivery of capital programmes under budget and on time.

I am pleased to say that we now have managers appointed to each of the airports operating under this type of arrangement and, although it is early days, the signs are promising.

Conclusion

So in conclusion, the Future Fund is thinking hard about how we maximise returns as a result of being a long term investor. This means understanding the true value of our assets and having a view. It means ensuring we have access to all of the information we need in order to form that assessment. And it means aligning our managers to that way of thinking and ensuring that they stay on that track. Managers who embrace that performance accountability have nothing to fear from our approach.