RETHINKING THE INVESTMENT ECOSYSTEM

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Since the introduction of mandatory employer superannuation contributions in 1992, the Australian investment ecosystem has been propelled by a virtuous cycle with superannuation investment in publicly listed equities growing consistently. This has fed the growth of the Australian economy whilst delivering strong investment returns. But success has come at the cost of depth and diversification with a market dominated by the financials and materials sectors. As the sheer size of superannuation investments on the ASX grows, we argue that the market may be reaching saturation. This is evidenced by the increasing proportion of superannuation's increasing ownership of the ASX even as the ASX declines as a proportion of superannuation investments. The elephant in the room is Private Equity. We offer a framework that integrates long term growth Private Equity into the current virtuous cycle to drive economic growth and add necessary depth and diversity to the market.

Australia has enjoyed a period of prolonged growth

Over the last twenty-five years we have witnessed extraordinary growth of Australia's superannuation system. Since the introduction of the Superannuation Guarantee in 1992, superannuation capital has steadily grown. Superannuation funds now manage $2.5 trillion (total system) of assets which is expected to grow to over $9.5 trillion by 2035.

Moreover, as superannuation funds grew, so too did the market capitalisation of equities on the Australian Stock Exchange (ASX). Importantly, the growth has been sharply focused in the financials and materials sectors underpinned by a small number of banking and mining stocks respectively.

For superannuation, investing in the Australian economy may be hitting a saturation point. The challenge for Australia's superannuation asset allocators is that it is getting harder to allocate capital within the Australian economy. While the virtuous cycle has generated consistent if not world-beating periods of strong returns, it has come at a cost of the development of the depth and diversification of the market.

The superannuation saturation

As the Reserve Bank of Australia (RBA) identified in a recent speech the "ASX is bank-heavy and the financial sector more broadly makes up about a third of the exchange by market capitalisation".

Moreover, according to the RBA "concentration has been a feature of the Australian stock exchange throughout its existence. In fact, it has been largely the same set of companies that have comprised most of the universe of Australian stocks over its history."

The RBA's analysis reveals that the average listed Australian company when weighted by market capitalisation is about 100 years old. These are mostly the predecessors of the banks and mining companies, which have their origins in colonial banks and 19th century mining booms, respectively.

By contrast, other global markets such as the New York Stock Exchange (NYSE) possess top 10 companies less than 20 years old. This is because very few large public Australian companies have been founded in the past 50 years - and many of the large listings, such as the Commonwealth Bank of Australia and Telstra, have been privatisations. In this respect, Australian markets are something of an outlier globally.

The virtuous cycle is breaking

As the amount of superannuation capital increases, in order to ensure that a superannuation fund is adequately diversified, asset allocators need to find new investment opportunities.

Over the last five years this has been happening. Australian prudential and regulatory Authority (APRA) statistics demonstrate that superannuation funds with over four members have collectively been increasing their allocation to international listed equity markets.

From 2013 to 2018 superannuation funds' ownership of the ASX grew from 18% to 20%, even whilst the portion of investment allocated to listed Australian equity declined from 25% of total investments to 23%. In the same period, proportion of superannuation investments allocated to international equity increased from 17% to 25% of total investments.

Asset Class	September 2013	September 2018
Australian Equity ($million)	269,338	396,641
International Equity ($million)	184,032	429,474
Australian equity / total portfolio	25%	23%
International equity / total portfolio	17%	25%
Superannuation investments / ASX market capitalisation	18%	20%
Total investments ($million)	1,098,193	1,737,938*

*Source: APRA Statistics, Quarterly Superannuation Performance, ASX Historical Market Statistics

TABLE 1: Australian superannuation fund asset allocation (funds with more than 4 members)

The virtuous cycle, where growth of superannuation assets supported the growth of the ASX is at the point of being broken. But is this a problem?

We argue that if the ASX does not continue to evolve, not only will new businesses struggle to access capital, superannuation funds will increasingly seek depth and diversification in international markets. In order for the ASX to finally outgrow its colonial roots we need a new framework.

A new investment ecosystem framework

There's no doubt that the virtuous cycle has delivered continuous micro and macroeconomic benefits represented by a record-breaking recession-free period of more than 25 years.

But the global economy is experiencing a number of headwinds exemplified by increasing geopolitical and trade uncertainties and the peak of the China boom. All of which have a potential to impact the Australian economy. To mitigate risk and ensure our economic future, Australian investors require more than returns. They require increasing market depth and diversification.

As such we propose a new investment ecosystem framework – depicted below - that better integrates PE to the virtuous cycle of superannuation and publicly listed assets.

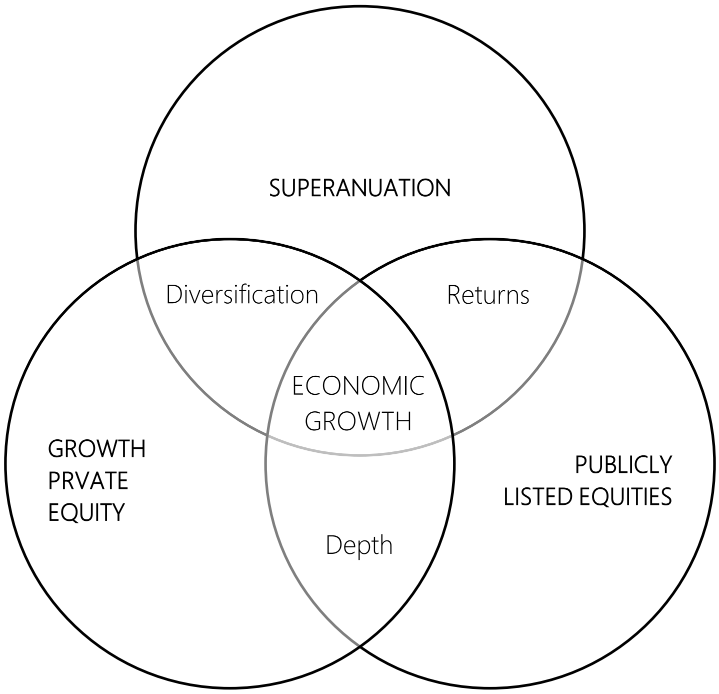

FIGURE 1: A framework to realign the Australian investor ecosystem.

The framework, depicted in a Venn diagram, brings to the fore the current relationships between superannuation and the ASX and the track record of returns. In addition to that, the Venn diagram conceptualises the role and the significance that PE can play for added depth and diversification. We believe that this innovative framework can be used to derive an extended virtuous relationship and ultimately lead to a longer-term sustainable economic growth.

Long term growth Private Equity brings known challenges

Australia's PE industry is comparatively small: average PE allocations are 40% higher for US pension funds than Australian superannuation funds.

The Australian Productivity Commission's (PC) recent inquiry into superannuation revealed that whilst returns for PE are exceeding benchmarks, returns in other jurisdictions are exceeding Australian returns. Of interest is that the PC identified that the investment management costs for Australian superannuation funds are relatively comparable to international pension funds for PE.

Why hasn't Australia's PE industry grown? We believe that the business frameworks of many PE firms create three significant impediments that need to be recognised:

Volatile Returns

The traditional exit strategy for PE firms is a trade sale. Where a firm has successfully identified and commercialised new innovations this may result in a company being sold overseas. The challenge for super funds who are long term investors is that having supported the growth of a company it is not necessarily in their interests to sell. The preference would instead be redemption, to maintain the investment over the long term.

Illiquidity of Investments

Australia's choice of fund regulatory regime means that superannuation fund asset allocators must manage the liquidity of their portfolios to ensure that they are able to meet requests for redemption at short notice.

The so-called "illiquidity budget" represents the portion of a fund's investments that are allocated to illiquid investments that cannot be quickly sold. Illiquid investments include unlisted infrastructure, PE and venture capital. Because PE investments are illiquid, they have competed with other unlisted asset classes such as infrastructure for a relatively small portion of the total superannuation investment universe.

Private Equity Fees

Whilst the PC inquiry into superannuation revealed that PE fees in Australia are comparable with other jurisdictions, this level of fees may regardless act as a deterrent to investment.

Developing an Australian PE industry that is aligned to the needs of long term investors such as superannuation funds needs to recognise these three impediments and develop a framework that is uniquely designed for the way Australia's superannuation system is structured.

Integrating long term growth Private Equity and ASX investments

The answer to developing a pipeline of new ASX listed companies that can provide new opportunities for superannuation fund asset allocators may lie in investing in long term growth Private Equity that aligns with the ASX. Our argument is that if, a new framework of investment is developed, this approach can be applied to both ASX listed companies and Australian PE investments. Whilst there are different types of PE strategies, our focus is on what we term long term growth PE, where firms are focused on two principles; Aligned and Future Focused:

Aligned

Exit strategies for long term growth PE would focus on building companies that will be listed on the ASX. This would allow a superannuation fund to remain an investor for the long term. From a cost perspective once a pipeline of investable opportunities is developed a superannuation fund can maintain investment in a newly listed company with or without a PE manager. This addresses the cost structure of investing in PE, with successful investments ultimately absorbed into a fund's Australian equity portfolio.

Future Focused

Long term growth PE investments should focus on building companies that address long term needs. Australian superannuation funds understand long term risks such as climate change that have the potential to impact returns. An activated approach to PE investment is based around a fundamental understand of how a changing environment and changing society will create new opportunities.

Australia's public listed markets are heavily weighted to mining and financial stocks. From a diversification perspective, superannuation funds do not need more of these companies. A key reason for increasing investments in offshore listed markets is to increase exposure to sectors that are underrepresented on Australia's publicly listed markets. Australia is however well placed to meet future gaps in markets. The core strengths of a strong economy, university research clusters and deep pools of human capital provide a foundation for investment.

The ASX is already transforming

The ASX is a developing market for early stage growth companies, providing an attractive alternative to traditional means of funding for technology companies across all the various industry sub-sectors, with particularly strong peer groups in financial technologies (Fintech), Online Marketplaces and Software-as-a-Service (SaaS).

There are now over 230 listed technology companies – nearly doubling between since 2013. In fact, ASX ranked ahead of National Association of Securities Dealers Automated Quotation (NASDAQ) by number of tech IPOs in 2015 and again in 2016. The ASX is also proving attractive for international tech firms – more than 502 foreign technology companies are now ASX-listed. These are positive developments that will, no doubt, support further evolution of the market.

Long Term Growth Private Equity stimulates economic growth in new industries

PE investment is a key driver of growth, job creation and innovation.

In 2015/16, Australian firms under PE ownership achieved average revenue growth of 20% and expanded the size of their workforces by 24% on average. By comparison, over the same period, economy-wide company gross operating profits fell by 2.6% and employment in the wider economy grew by 0.3%.

Further, more than 85% of PE portfolio companies introduced some type of innovation in that year, significantly more than businesses in general, demonstrating PE's role in spurring innovation.

By unlocking new investment from superannuation funds into Long Term Growth PE that is aligned with the ASX there is the potential that PE can play a significant role in driving economic growth whilst delivering super funds with risk adjusted investment returns.

Stimulate new industries

The Fourth Industrial Revolution (4IR), anecdotally referred to as the Data Revolution, has emerged since the Global Financial Crisis of 2008 as a proliferation of our ability to capture, store and manage data and harness real-time information for insight, prediction, planning and decision support. Profound technological change, the commoditisation of data and intensifying competition in an increasingly borderless commercial environment are often-agreed characteristics of the 4IR that define a new paradigm.

Both federal and state governments already have strategies, incentives and are reformulating policy and regulation to support the growth of a number of new industries. As an example, the Victorian Government's Future Industries Strategy has identified there are significant opportunities in areas including:

- Medical Technologies and Pharmaceuticals
- New Energy Technologies
- Food and Fibre
- Transport Technologies
- Defence Technologies
- Construction Technologies
- Professional Services

While the ASX has been catching up to global markets in the rate of listed technology companies, the new industries are but a minuscule representation.

Create new skills and jobs

The 4IR is shaping new technology-driven futures underpinned by today's emerging automation technologies, including data analytics, deep learning, artificial intelligence and cognitive computing. Automation technologies are already becoming essential parts of everyday life and will increasingly transform our workplace.

A wide range of new technology-intensive and high-skilled occupations are expected to be in demand in the future, along with new growth broadly across sectors such as education, healthcare, sustainable energy and more, calling for a new approach to education, skills development, human capital and ultimately leadership in the digital age.

The 4IR isn't a force we can stop and Australia's economy has a lot to gain with an estimated $2.2 trillion of economic growth over the next 15 years that will be deployed to successfully move affected workers into new employment, accelerating the rate of our automation in public and private sectors.

Economic growth, driven by a new investment ecosystem, will ensure the opportunities don't escape our grasp. Together ASX and PE can play a central role in determining the future prosperity for Australia in our economy.

Questions for further consideration

APRA's data on superannuation asset allocation over the last five years demonstrates that super funds may be close to reaching saturation point investing in the ASX.

This paper proposes a new model for superannuation funds to invest in long term growth Private Equity as a mechanism to align superannuation to the long-term growth of the Australian economy. We would note a number of questions that should be discussed by investors and policy makers alike.

1. What is the implication on the Australian dollar if Australia's superannuation system were to increasingly invest offshore?
2. Is there a sovereign risk to investors if the trend to offshore superannuation investment continues?
3. What is the system wide significance of superannuation fund liquidity budgets?
4. What role can the Federal Government play to facilitate superannuation fund investment in long term growth PE?
5. What mechanisms can be established that provide a platform for the superannuation industry, government and stakeholders to discuss, debate and develop new models of investment?
6. Is there a role for ASX to develop a private listed market that provides a mechanism for long term growth PE companies to have a bridge between private and publicly listed markets?

We believe there is a compelling need to apply and translate the investment ecosystem framework to practical outcomes. This may be delivered through a multidisciplinary approach across research, government and private sector organisations to provide knowledge, activities and collaboration to enhance culture, infrastructure, leadership, and support that facilitates creative discovery on issues crucial to science government, industry and society.

Strategy[61] brings together a complex network of disparate organisations that can contribute logistical support, postdoctoral or senior fellowships, complex data management, informatics and computing capability or expertise, and most of all, opportunity for group discussion and reflection, lowering the "activation energy" necessary to promote creativity and the cross-fertilisation of ideas.

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About Strategy[61]

Strategy[61] is an integrated professional services firm providing strategy and risk management, digital transformation and investment advisory. We are specialists in cyber physical systems and technologies as well as platforms and business frameworks that underpin the fourth industrial revolution - fusing the physical, digital and biological worlds, and impacting the sustainability of all disciplines, economies and industries. Our unique approach includes strategic innovation advice for institutional investors.

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