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ASFA Policy and Industry Practice

Classification of assets

ASFA Background Paper
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Background

Ratings agencies produce tables of investment returns of various superannuation funds segregated by the proportion of growth and defensive assets in portfolios. These surveys are used by some superannuation funds as a means of comparison to retain members as well as attract new members.

However, there is no consistency amongst the agencies or amongst superannuation funds as to which asset classes are to be classified as growth and which as defensive. This has been an issue of increasing concern over recent years particularly because the proportion of non-traditional assets classes has grown in diversified portfolios and the inconsistency of growth/ defensive classifications is most apparent within the various non-traditional asset classes.

Many superannuation funds have expressed concern regarding this lack of consistency and the "misleading" comparisons that result.

Some superannuation funds have provided their own internal solution to this classification inconsistency by selecting a subset of peer superannuation funds for returns comparison purposes rather than using the surveys' segregations.

Purpose of the Paper

The purpose of this paper is to assist in providing a basis for the comparison of diversified superannuation portfolios' returns with "like" portfolios.

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Current Situation

There is a wide disparity of views in regard to whether certain asset classes should be classified as growth or as defensive. However, there was general agreement that Australian and international listed equities and private equity are growth assets whereas fixed income (also referred to as fixed interest or debt) and cash are defensive assets.

Further, it is generally agreed that unlisted opportunistic (also referred to as value–add or development) property and listed property should be classified as growth.

The asset classes that had the most variation in classification were unlisted assets in general, and hedge funds (also referred to as absolute return funds) and unlisted infrastructure, in particular.

Unlisted property had been historically included within growth assets. However, there now appears to be a growing perception by some market participants that it is more a defensive asset than a growth asset. Fewer views were received on timber but generally they were similar to views on some unlisted infrastructure.

Differentiation Parameters

The magnitude of ***volatility of returns*** has been a dominant determinant of asset class classification.

Nevertheless, infrequent valuations may mask some inherent volatility of returns in some unlisted asset classes especially when compared to volatility of listed asset classes comprised of similar underlying assets (e.g. listed and unlisted property).

Some market participants consider that if frequent valuations of underlying unlisted assets were available then they would display similar volatility measures as their listed counterparts. Therefore they classify listed and unlisted asset classes, with similar underlying assets, in the category of the listed asset, that is, in the growth assets category.

A brief discussion on this issue is provided in the appendix to this paper.

There are factors other than volatility of returns that some market participants have identified as having a large influence on their decisions.

Equity in an asset was seen as justification for a growth classification but admittedly some of the more aggressive hedge funds were a problem as participants felt that these should be classified as growth assets yet they clearly did not have equity in an asset.

Another view was based on how ***returns*** were ***split*** – that is, whether returns resulted from capital growth or income. Again there were problems here as even equities' returns are a mixture of both.
It then became a subjective decision, as well as market strength dependent, in relation to what percentage needed to be attributable to, say, capital growth, before the asset class could be classified as a growth asset.

Further, some participants who classify assets using the volatility of returns or returns based on capital growth/income split tended to undertake additional analysis based on the characteristics of an underlying asset in the asset class to determine whether that asset should be classified as growth, defensive or a mixture of both.

For example, an infrastructure portfolio may include a mature stage project with a relatively predictable income stream and an early stage project with only projected income expectations.

In the former case, the asset may be classified as defensive or, say, 30/70 growth/defensive whereas in the latter case the asset may be classified as growth or, say, 70/30 growth/defensive.

Finally, it should be noted that, to a large extent, variations in asset class classification by volatility, equity in an asset or capital growth/income returns composition are very much influenced by the connotations that the words "growth" and "defensive" project.

The need for a practical solution

So that superannuation funds' returns may be compared with "like" portfolios, some compromises need to occur. As a first step the table below outlines how asset classes may be classified (G = growth, D = defensive) under the three different classification methods.

Asset Class	Volatility (*)	Equity in the Asset	Capital/Income Return Composition
Private Equity	G	G	G
Listed Equities	G	G	G
Listed Property	G	G	Mainly G
Unlisted Opportunistic Property	G	G	G
Unlisted Core Property	G or D depending on valuation frequencies	G	Mix of G & D
Unlisted Infrastructure	G or D depending on valuation frequencies	G	Mix of G & D A bias to D for established projects
Timber	G or D depending on valuation frequencies	G	G
Hedge Funds -less aggressive -"mid" aggressive - aggressive	 D Mix of G & D G	 D D D	(predominantly) Mix of G & D G G
Fixed Income	D	D	D
Cash	D	D	D
(*) A brief discussion on volatility measures and frequency of valuations is contained in an appendix to this paper.			

As expected, the greatest variation occurs in the classification of alternative assets as well as for unlisted core property.

Proposed Solution

Any proposed solution needs to:

- take into account current views and methodologies as much as possible;
- allow the data to be gathered and analysed in a relatively uncomplicated manner;
- minimise subjectivity which may lead to inconsistent classifications; and
- be relevant to current and prospective near term investment structures of superannuation funds.

Taking the above into account the following is proposed:

Asset Class	Growth (G)	Defensive (D)
Private Equity	G	-
Listed Equities	G	-
Listed Infrastructure	G	-
Listed Property	G	-
Unlisted Opportunistic Property	G	-
Unlisted Core Property	50%G	50%D
Unlisted Infrastructure	50%G	50%D
Timber	50%G	50%D
Hedge Funds and "other" (**) - standard deviation < 5%pa - 5%pa = or< standard deviation < 9%pa - standard deviation = or > 9%pa	 - 50%G G	 D 50%D -
Fixed Income	-	D
Cash	-	D
(**) Includes currency and commodities		

The main compromises have been made in those asset classes for which valuations occur relatively infrequently and/or where valuations, if sought on a more frequent basis, may be subject to some challenge.

For asset classes proposed to be a mix of growth and defensive we have suggested a 50/50 growth/defensive split. Some participants have indicated that they would prefer to indicate their own split, especially for direct property and infrastructure, based on the characteristics on the underlying assets.

We consider that this may again lead to inconsistency of classifications due to subjective overlays, and, for most portfolios, result in only very little effective changes in a portfolio's growth/defensive assets mixes.

For example, we assume that a portfolio has a total 20% exposure to unlisted property and infrastructure. Under the proposed classification this would result in 10% being allocated to each of growth and defensive asset classes. A super fund may consider that its unlisted property and infrastructure assets should be, at the extreme, classified closer to 70/30 or 30/70 growth/defensive. This would have the effect of changing the entire portfolio's growth/defensive mix by +/- 4% compared to that under the 50/50 growth/defensive scenario. (Note: under current classifications, portfolios' exposures to growth/ defensive in this example may vary by +/- 20% in the extreme cases where some super funds classify both unlisted property and infrastructure as growth whereas others classify both as defensive.)

Related Issues

THE BALANCED PORTFOLIO VS THE GROWTH PORTFOLIO

Some market participants have expressed that they would like more uniformity amongst superannuation funds, ratings agencies and investment consultants as to what range of growth assets comprises a balanced fund and what range comprises a growth fund. They felt that using the labels "balanced option" by some funds and "growth option" by others for portfolios having very similar underlying investment structures result in confusion when members are comparing superannuation fund returns.

Some confusion may arise due to inconsistent labelling but it may not be practical to introduce an industry standard on the issue. In fact if superannuation funds were to change the names of their investment options this would also likely result in some concern amongst their membership and it even may be a trigger for some to seek alternative superannuation providers.

In any case, members should be encouraged to make informed fund and investment option decisions through a matching of portfolios' investment objectives and the risk & return expectations to that of the member rather than an undue reliance on labels.

Nevertheless, we do not rule out that this may be an issue to be addressed at a later time once uniformity of asset class classifications is achieved.

SHOULD THE WORDS "GROWTH" AND " DEFENSIVE" BE RETAINED?

There are now a number of superannuation funds that have ceased to use the words growth and defensive in their Product Disclosure Statements (PDSs). Rather, the funds just name the asset classes that comprise the diversified asset class options.

This is one solution to the problem of how to classify assets into two categories for which there are, at best, only rather vague definitions and, some assets have a number of characteristics attributable to both categories. Further, there also is some categorisation to growth and defensive based on the subjective interpretation of these words.

However, in order to allow for the comparison of peers' investment returns it is necessary to split portfolios into groups so that portfolios in each group have similar expected risk levels and investment objectives. In this way the portfolios returns may be compared and reflect the success, or otherwise, of making limited asset allocation moves and/or manager selection decisions.

To date, the grouping of the portfolios has been based on an allowable range to growth assets and a corresponding allowable range to defensive assets with some disagreement as to which asset classes should be allocated to growth and which to defensive.

Although some superannuation funds no longer provide members with portfolios' "growth" and "defensive" assets split, it continues to be necessary to classify asset classes into two "buckets": these may then be used as a basis to split superannuation portfolios into suitable peer groups.

Again, once uniformity of asset class classification is achieved then market participants may decide to replace "growth" and "defensive" with terms that are less likely to be open to subjective interpretation.

CONSISTENCY WITH COMMUNICATION TO MEMBERS

Communication material to members should reflect any changes that are made to the methodology adopted to split portfolios into peer groups.

This is not expected to have an impact on funds that do not provide a growth and defensive assets split. However, where funds provide such a split and, if the terms "growth" and "defensive" continue to be used, then members' communication material should be consistent with the adopted growth and defensive classifications used to split portfolios into peer groups.

An alternative would be to cease to split assets into growth and defensive in members' communication material.

Conclusions

- In order to allow for the comparison of peers' investment returns, portfolios should be split into groups so that portfolios in each group have similar expected risk levels and investment objectives.

- In formulating suitable classifications of assets into growth and defensive, current views and methodologies need to be taken into account. Further, any solution should be relevant to current and near term prospective investment structures of superannuation funds.

The following classification of assets is proposed:

Asset Class	Growth (G)	Defensive (D)
Private Equity	G	-
Listed Equities	G	-
Listed Infrastructure	G	-
Listed Property	G	-
Unlisted Opportunistic Property	G	-
Unlisted Core Property	50%G	50%D
Unlisted Infrastructure	50%G	50%D
Timber	50%G	50%D
Hedge Funds and "other" (**) - standard deviation < 5%pa - 5%pa = or< standard deviation < 9%pa - standard deviation = or > 9%pa	 - 50%G G	 D 50%D -
Fixed Income	-	D
Cash	-	D
(**) Includes currency and commodities		

- Where funds provide such a split and, if the terms "growth" and "defensive" are used, then members' communication material should be consistent with the adopted growth and defensive classifications used to split portfolios into peer groups. An alternative would be to cease to split assets into growth and defensive in members' communication material.

- At a later date market participants may decide to replace "growth" and "defensive" with terms that are less likely to be open to subjective interpretation in the classification of asset classes into the two categories.

APPENDIX
Volatility and frequency of valuations

DISCUSSION OF ISSUES FOR CONSIDERATION

Some market participants have expressed that they would like more uniformity amongst superannuation funds, ratings If daily valuations were available on assets such as unlisted property, infrastructure, timber and hedge funds, it is possible that this would tip those asset classes closer to the growth rather than defensive classification.

However, it should not be forgotten that valuations of listed assets are based on more than the net tangible asset value and (variable) perceptions of likely changes to the value based on assumptions of prospective market conditions and the entity's management ability.

A major additional factor is market sentiment. It is well documented that when sentiment is overly positive then stocks become overvalued and when sentiment is overly negative then undervaluation occurs. This adds to volatility of returns of listed assets as volatility measures are based on daily valuations that include sentiment effects.

For example, some unlisted property values may be decreasing in the current market environment at a greater rate than is reflected by their periodic valuations. However it is unlikely that the values would reflect the daily volatility of the listed property market where share prices may be down one day and up the next day. Also, the strength of the listed property market over the 2 years to, say, 30 September 2007 was not reflected in the physical market so there may be no reason for the physical market to now decrease to the same extent as the decrease in the listed property market. This all means lower volatility of returns for unlisted property compared to that of listed property.

Another factor to take into account is the undeniable dampening volatility effect of including unlisted assets, compared to listed securities with similar underlying assets, in a diversified portfolio. This needs to be recognised in the classification of assets.

Further, superannuation needs to be viewed over the longer term. So would it not make more sense to base classifications on volatilities of all asset classes on, say, monthly, quarterly or even semi–annual returns? This would allow a like-to-like comparison of volatilities between listed assets and many alternative assets.

However, one difficulty that may arise by using less frequent valuations to assess volatilities may be that there are too few measurements to allow significance, in the statistical sense. That is, the volatility so obtained for a particular asset class may show little consistency over various periods of measurement. An alternative would be to use projected volatilities as provided by investment managers for their particular products.

This is not an ideal solution as many products' actual returns fail to produce expected results. That said, until history produces the returns we need to calculate volatilities, the managers' estimates, or perhaps conservative modifications to them, may be good estimates of volatilities.

A factor to consider is that, if an investor is in strong disagreement with an investment manager regarding a product's risk/return classification then it may be wise for that investor not to invest in that manager's product.

CONCLUSIONS

- Listed securities, which have similar underlying assets to their unlisted counterparts, are expected to experience greater volatility of returns than the unlisted assets even when frequency of valuations for the latter is increased.
- The inclusion of listed securities in a diversified portfolio is expected to result in the portfolio's higher volatility of returns compared to that when unlisted assets, which consist of similar underlying assets to those in the listed securities, are included in the portfolio.
- As superannuation should be viewed over the long term it may be appropriate to compare the volatilities of various asset classes based on quarterly or semi–annual returns rather than more frequent measures. These comparisons could then assist in the classification of assets.