ISSUE SEVEN CHANGE

DEALING WITH VOLATILITY AND LIQUIDITY IN AN UNCERTAIN WORLD

THINKING OUTSIDE THE SQUARE

FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

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THOUGHT PIECE

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THINKING OUTSIDE THE SQUARE

FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

GLOBALISATION

NEW INVESTMENTS & INVESTMENT STRATEGIES

GLOBAL FINANCIAL CRISIS

SOVEREIGN RISK AND DEBT

CHANGE

WE BELIEVE THAT ALL ROADS LEAD TO INCOME!

At the end of the day, regardless of gender, age, relative financial security, employment or retirement, we all seek the same thing as the product of our investment strategy: income.

Put more simply the reason we invest is so that we can have sufficient income to live and hopefully live well at the time when we choose, or someone else chooses that we no longer will receive income from employment.

Balmain Funds (Balmain Funds is the funds management division of Balmain NB Corporation Ltd (Balmain)) over the period ahead will make available a series of "thought pieces" designed to provoke new thinking on why we invest the way we do, challenge investment orthodoxy, such as "modern portfolio theory", posit and in some cases guess at future risks and opportunities. The overall aim however is to help you create a better future for you and the ones you love.

We have identified five themes that we believe will impact your ability to achieve the income you want. These are:

1. The Global Financial Crisis
2. Sovereign Risk(s)
3. Change
4. Globalisation, and
5. New Investments and investment strategies

We will over time populate these themes with "thought pieces" that are designed to inform you, challenge and provoke your investment thinking and from that hopefully assist you in making more informed investment decisions.

ABOUT BALMAIN

Using our staff of 100 located in 8 offices in Australia and New Zealand we arrange and deliver financing solutions to Australian and New Zealand commercial property developers and investors. Balmain originates between $2b and $4b p.a in transactions ranging from senior debt to mezzanine and preferred equity.

Over the years Balmain has arranged commercial loans to over 140 lenders, banks, institutions, managed investment schemes and high net worth individuals / family offices. It currently manages over $8b of ongoing loan relationships with over 100 of these organisations.

Balmain is Australia's 5th largest commercial mortgage fund manager, who on behalf of over 8000 Australian investors, we manage over $800m in commercial mortgage loans.

Balmain in its own name and via AMAL (in which Balmain has a substantial shareholding) provides special servicing skills to loan portfolio owners covering both residential and commercial loans.

DEALING WITH VOLATILITY AND LIQUIDITY IN AN UNCERTAIN WORLD

Equity market volatility spiked again in 2011, making the 'investments must be liquid' orthodoxy even more difficult to sustain.

Readers may recall the Balmain Funds August 2010 Thought Piece 'Is Volatility the price of liquidity and if so, can you afford it?'[1] where we challenged the mantra that a portfolio had to be entirely liquid. This mantra was resulting in investors being directed, by advisors and also through structural decisions by Wrap and Master trust platforms, primarily into listed ('liquid') investments.

But in an era of unprecedented volatility and extreme market events, we argued that such a strategy placed investors at risk from reduced diversification and from wildly fluctuating performances.

In this follow-up article, we show what the 'intelligent money' is doing when it comes to managing volatility and liquidity. And the simple answer is...more allocations to illiquid and 'non-traditional' markets such as real assets and private equity; and less investment in equities.

By intelligent money, we mean the three largest US university endowments (specifically the $19.4 billion Yale, $32 billion Harvard, and $19.5 billion Stanford[2]) that are regarded by some in the investment industry as the leading lights in portfolio management and in particular, the 'endowment model' of investing.[3]

And these three endowment funds have the performance to prove it. In the ten years to June, Yale returned 10.1 percent pa, while Harvard earned 9.4 percent and Stanford 9.3 percent. They beat the often used 60/40 stock/bond portfolio benchmark (used typically by US Pension Funds) which returned just 4.3 percent over the same period. Over twenty years, Yale returned 14.2 percent pa and Harvard 12.9 percent while the 60/40 stock/bond portfolio returned 8.3 percent.

Asset allocations for Yale, Harvard, and Stanford

The tables below reveal the asset allocations of these endowments.

YALE

Source: The Yale Endowment 28 September 2011

Asset class	% allocation 2011
Private Equity	34
Real Estate	20
Absolute Return	17
Natural Resources	9
Foreign Equity	9
Domestic (US) Equity	7
Bonds and Cash	4
	100

[1] *Available from http://www.balmain.com.au/Balmain/PublicationsDetail.aspx?Id=3*

[2] *The fourth largest US university endowment is Princeton ($17.1 billion, 9.8% pa return over 10 years. Asset allocation data is not publicly available). MIT is another major endowment –see appendix one for their asset allocation model.*

[3] *See The Endowment Model of Investing: Return, Risk, and Diversification. Wiley Books*

HARVARD

Source: Harvard Management Company, September 2011

Asset class	% allocation 2011
Absolute Return	16
Commodities	14
Private Equity	12
Domestic (US) Equity	12
Foreign Equity	12
Emerging Market Equity	12
Real Estate	9
Inflation Indexed Bonds	4
Fixed Income (Domestic Bonds)	4
Fixed Income (Foreign Bonds)	3
High Yield Bond	2
Cash	0
	100

STANFORD

Source: Stanford Management Company, June 30 2010. *2011 data not publicly available.

Asset class	% allocation 2010*
Public Equity	37
Absolute Return	18
Real Estate	16
Private Equity	12
Fixed Income	10
Natural Resources	7
	100

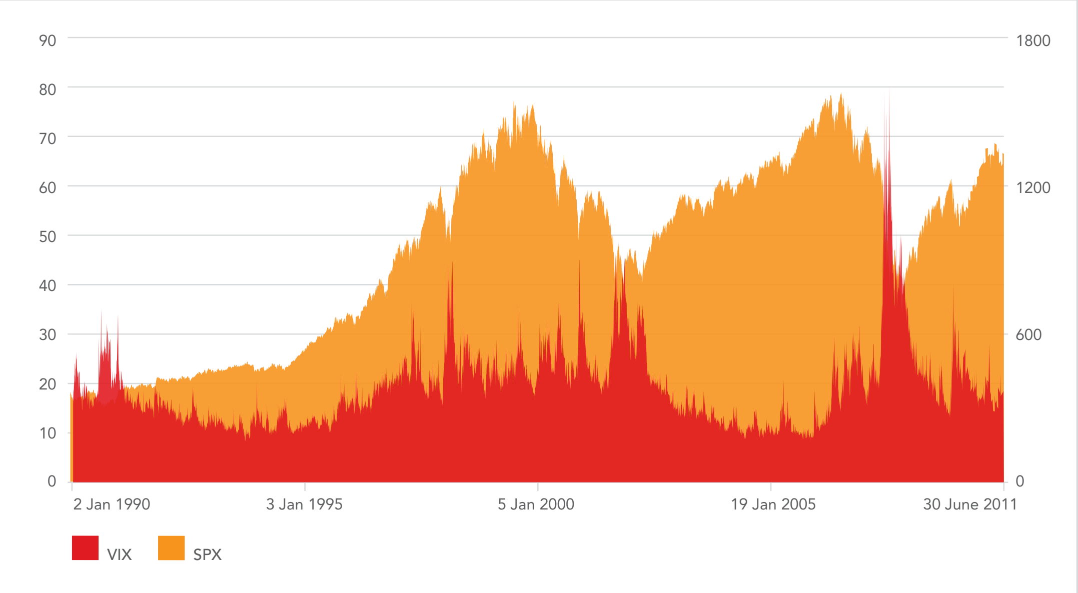
Note that Yale has nearly 80 percent of its assets in 'alternatives' such as private equity, real assets and absolute return products[4], and just under 17 percent in US and global equities.

[4] *Private equity –typically includes venture capital and buy-outs, real assets typically includes timberland and direct natural resources investments, absolute return typically includes hedge funds and investment funds that are not swayed by benchmarks.*

These allocations are in sharp contrast to Australian investors who, partly as a consequence of the liquidity mantra, have significant equities exposures. For example, SMSFs have on average 44% in shares (directly and via managed equity funds[5]) while the top 10 not-for-profit super funds have 54% in equities. (See table below)

FIGURE 2: VIX® AND S&P 500 INDEXES

Sources: Bloomberg and CBOE



AVERAGE ALLOCATION OF THE TOP 10 NOT-FOR-PROFIT SUPER FUNDS IN AUST

Source: Brookvine and Superfund Annual Reports 2010 & 2011

Asset class	% allocation
Australian shares	31
International shares	23
Fixed Interest	15
Property	9
Infrastructure	8
Cash	6
Absolute Return	4
Private Equity	4
	100

With stock market volatility repeatedly spiking (see chart below), Australian investors are well and truly exposed to the gyrations of equities.

[5] *Source Brookvine/Multiport SMSF Investment Patterns Survey Sept 2011*

These gyrations are a global phenomenon given;

- the growing international nature of capital flows,
- the rising 'short-termism' mindset of investors and fund managers,
- the 'career risk' influenced tendency for some fund managers in large institutions to 'move with the herd' so that the performance of the funds they manage is not too far away from the industry average,
- the growing ease of dealing (and in huge volumes where billion scan be moved with the touch of a button) due to lower costs and electronic trading
- and the growth of 'High Frequency Trading' that results in higher trading volumes as a percentage of market capitalisation, leading to higher risks of fund flows distorting valuations.

Another driver of the heavy allocations by Australian retail and SMSF into shares is a function of structural biases within the financial planning industry. These include the leading role that investment platforms play in selecting the product range (biased towards funds and listed markets) compounded by the high penetration of platform usage among financial planners which them means that non-platform products are never considered.

Australia's Future Fund

Australia's largest investor, the $73.1 billion[6] Future Fund, has also created a well diversified portfolio... with just 31.6% global and domestic in equities,) which compares quite starkly to the average 54% of the top 10 not-for-profit Super Funds in Australia). The Future Fund is only five years old and being a new player, has been able to deploy leading edge investment strategies (see table below).

Category & Asset class	December 30, 2011 % (ex Telstra)
Alternative assets	19.8
Debt securities	17.8
Global equities	20.8
Australian equities	10.8
Property	6.0
Infrastructure and timberland	5.7
Private equity	5.3
Cash	13.8

Source: Future Fund

[6] *31 December 2011*

Illiquid and 'Non-traditional' investments dominate

What is particularly interesting about the three endowments funds and the Future Fund is the percentage of investments that are typically regarded as 'illiquid'. More than 57 percent in the case of Yale which is in sharp contrast to the 'investments must be liquid' mantra currently espoused by many in the Australian financial advisory and platform industry!

The three endowments also have the majority of their assets in non-traditional assets - 80 percent in the case of Yale.

Institution	% of assets in illiquid markets such as PE, property, infrastructure etc*	% of assets in non-traditional assets (ie not listed equity, fixed interest or cash)
Yale	57.8[7]	80
Harvard	27.0	57
Stanford	35.0	63
Future Fund	16.9*	38.5
Average top 10 Super Fund	21.0	21

* If 'alternative assets' are regarded as 'illiquid', this percentage would rise to 38.5%

Even though endowments such as Yale have far longer time horizons than a typical SMSF (but not that far from superfunds), nevertheless, their asset allocation policy is insightful. Gleaned from their annual reports, they are summarised below;

- Yale reviews asset allocation targets only once per year. This limits the possibility of ill-considered moves made in response to the 'transient gloom or euphoria' surrounding market movements.
- A long-term investment horizon is well suited to exploiting illiquid, less efficient markets such as venture capital & private equity; natural resources such as oil, gas and timber and real estate.
- While allocations to US equities may be low, these endowments are still 'biased towards equity.' Yale notes that 'The need to...preserve purchasing power of assets dictates investing for high returns, causing the Endowment to be biased toward equity....Hence, more than 95 percent of the Endowment is targeted toward investment in assets expected to produce equity-like returns.'

[7] *Source: Yale Endowment Fund, 30 June 2010*

APRA study finds superfunds with more illiquid investments make better returns

A recent report by the Australian Prudential Regulation Authority (APRA)[8] has also supported our views that the mantra for liquidity has perhaps swung too far.

APRA found that not-for-profit superannuation funds with a higher allocation to illiquid investments, such as directly held property, infrastructure and alternative investments, have higher risk-adjusted returns.

The APRA study was based on 146 super funds with total assets each of at least $200 million between September 2004 and June 2010.

Other key findings include;

- (Academic) studies generally conclude that holdings of illiquid assets benefit pension funds by improving diversification and thereby increasing return per unit of risk incurred.
- APRA suggests that those super funds with greater illiquid assets "captured a return premium for investing in (illiquid) assets".
- In broad terms, a superannuation fund under current switching legislation may be subject to 'run' risks similar to those that have long existed in banking. *(that is, the expansion of investment choice within a super fund, together with legislation permitting investors to switch their retirement savings between fund providers, has increased the likelihood of member balances moving between options within a fund and from one fund to another. This creates a potential liquidity shortfall for superannuation funds, when they experience periods of unexpectedly high redemption volume. Thus 'member choice' is forcing super funds to be more liquid, therefore reducing risk-adjusted returns.)*

Liquidity management and Access to Investment Products

When considering higher allocations to illiquid non-traditional investments, there should also be a corresponding awareness of liquidity management....that is, the need for an investor to have adequate cash flow to fund outgoings (or redemptions in the case of a pension fund –see 'run risks' in the APRA section above.)

For SMSFs, there is little 'run' risk, although SMSFs in the pension phase need careful cash-flow management, with perhaps greater consideration given to reliable yield-driven or dividend-driven non-traditional investments.

This brings us to the topic of accessing non-traditional investment products. Endowments are endowed (pardon the pun) with the resources to access the best alternative investment opportunities. They have analysts scouring for the globe for investments, and a strong alumni that offers contacts, insights and ideas not freely available to most investors (including Australian super funds). And in particular, they are not 'held captive' by planners and/or platforms that offer a limited menu of products.

For SMSFs, accessing a truly independent range of alternatives will remain a challenge, particularly as the 'Big Four' Australian banks dominate much of the financial planning, platform and product (funds) industry. (see Our article 'The big banks have large fingers in your financial wallet,' February 2011[9].) This 'quadropoly' of banks have an economic interest in keeping the independent providers out, and controlling the information flow (via their hefty and powerful PR/lobbying teams) to channel investor interest into their own networks.

[8] *APRA Research 7 November 2011*

[9] *Available from here http://www.balmain.com.au/Balmain/PublicationsDetail.aspx?Id=98 APRA Research 7 November 2011*

Conclusion and Action

The 'intelligent money' has significant allocations to illiquid investments and 'non-traditional'...nearly 60 percent and 80 percent respectively[10] in the case of the Yale Endowment. The rationale is to capture an illiquidity return premium and reduce risk by improving diversification within an investment portfolio.

In an era of volatility and increased risk of 'extreme market events,' illiquid investments have a role to play to stabilise returns, particularly if an investment portfolio is designed for the long term. Even for investors close to retirement, illiquid assets have a place in a portfolio, particularly if there is a yield, dividend or rent to provide cash flow.

Illiquid investments can become a problem when a forced or urgent sale is required to fund unexpected cash outflows. The global financial crisis of 2008/2009 highlighted this risk but the irony is that many investors were forced to sell illiquid assets when their 'liquid' investments also turned out to be illiquid during the extreme market volatility. Damage was added when correlations between many 'diversified' liquid investments converged to one, resulting in no real diversification benefits.

By including illiquid investments in a portfolio, the range of assets classes and opportunities are opened. At Balmain, we believe investment ideas are at their most dangerous phase when they become mantras and investment orthodoxy, as it often means the whole world is doing the same thing. We hope this article provides food for thought to challenge the 'liquidity' mantra, and for investors to consider new investment options that provide equity-like returns with lower volatility.

Appendix 1 MIT Investment Company Asset Allocations

(over 70 percent of the investments in private equity, real estate, real assets, and marketable alternatives)

MIT INVESTMENT COMPANY ASSET ALLOCATIONS

Source:MIT Investment Mgt Company website http://www.mitimco.org/whatwedo/investment_management

Asset class	Current % allocation
Marketable Alternatives**	28
Private Equity	25
International Private Equity	14
Domestic (US) Equity	7
Real Estate	12
Real Assets***	8
Fixed Income	6
	100

*Hedge funds **Timber, commodities, oil & gas

[10] *Source: Yale Endowment Fund, 30 June 2010*

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