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Valuing unlisted assets – the intractable conundrum

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During periods of significant market volatility, valuations of unlisted assets are problematic. We saw investors dealing with the quandary of whether to devalue these assets during the GFC, so in that regard, it's far from a new complication.

But what may surprise some is that there is very little consistency in the way Australian super funds and other unlisted asset owners manage the valuation process. So, what do trustees and executives need to consider with this current market volatility, coupled with significant member switching or redemptions?

Treading the fine line of what's equitable, transparent and defensible

The bottom line is that any decision on valuations, including not doing anything, needs a governance overlay. **Exercising best practice governance is critical to ensure the position taken is transparent, equitable and defensible in front of members and regulators.**

The intractable conundrum of the super fund fiduciary is maintaining a medium- to long-term time horizon of the entire investment portfolio, while members have the ability to 'switch' on a short-term basis.

Within that Gordian knot, unlisted assets play many valuable roles; however because they remain without a daily assessment of their value, **trustees are walking a fine line in determining what's equitable, transparent and defensible.**

Those three elements are key to valuing unlisted investments at any juncture, but particularly in current market conditions. The speed at which markets have declined during this pandemic turned economic crisis is far faster than that experienced during the GFC. During periods of heightened volatility, super funds are often swamped with members looking to switch out of higher growth, equity heavy options to lower risk, cash and bond options. Past experience has also shown that plenty of members have done this 'after the horse has bolted', selling their growth assets at a relative low point by switching to a lower risk option and have therefore missing out on much of the recovery when it subsequently came.

But given this activity, as well as the government's early access to super program, funds need to **maintain sufficient liquidity** within their investment options in order to meet the requirements of their members. We will tackle the liquidity issue at another time, although it is inextricably linked with the challenges around the valuation of unlisted assets.

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Ensuring valuations are complete, accurate and represent fair market value

Other than liquidity, what other responsibilities do trustees have to their members during these challenging times? On the one hand they need to ensure they treat members equitably; in layman's terms this means ensuring that those members who remain invested in a given option are not disadvantaged by the exiting investors, while at the same time determining that the **valuations of assets represent fair value and comply with relevant accounting and regulatory standards** (e.g. AASB1056 and RG94).

Many super funds have been focused over the last few years on internalising the management of their assets, with the aim of driving costs lower. As a result, a number of large funds now own direct stakes in real estate and infrastructure assets. For these funds, there is less ambiguity around valuations — they are responsible for the valuation of the assets they hold directly, and their management team should be close enough to these assets in order to form a detailed view of the likely impact of COVID-19 on their performance. Having said that, we recognise the situation is fluid and can be challenging due to limitations of the investment and operational management capacity to take on extra work, especially during times of stress.

The question of valuations becomes more challenging where super funds have outsourced the responsibility to an investment manager, whether through a pooled trust or a segregated mandate. In these cases, the trustee has outsourced responsibility for the acquisition, ongoing management and disposal of the assets to the investment manager and who is also responsible for valuing the assets.

The primary valuation method is the use of independent valuers on a regular basis, to ensure valuations are complete, accurate and represent fair market value. But that is not the only tool or process used and of course does not relieve the trustee of the obligation to ensure that the values are consistent with the policies represented to members.

Trustees and executives remain responsible for unit prices struck

It is widely accepted that during periods of heightened volatility, and where we expect significant movement in unlisted asset valuations, that the frequency of valuations should be increased. At the moment though, things are all over the place. For the most part, real estate and infrastructure managers in Australia will be ensuring independent valuations are performed monthly to ensure valuation changes are captured in a timely manner, but valuations are also happening on a quarterly or even annual basis.

Member switches or redemptions have already begun and are taking place more frequently, but for the most part, valuation changes are yet to flow through to unit prices. Regardless of what valuation a fund or institutional investor gets from its investment manager, **trustees and executives remain ultimately responsible for the unit price they strike for members and beneficiaries.**

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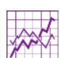
So, should Trustees review valuations more frequently?

So the question then becomes — should the super fund trustee review or mark down their portfolio of unlisted assets in order to satisfy the 'equitable treatment of members' argument, or should they wait to be informed of valuation movements from their managers (and independent valuers)? The short answer to the former question is 'Yes'.

Yes, they **should revisit the valuations more frequently**; as significant value swings are likely to occur while there are large numbers of transactions across their membership accounts.

The first question trustees need to ask themselves is whether their fund has a **valuation policy** and if so, ensuring that the actions taken are consistent with it. If there is no policy in place that supports why a trustee has taken a decision either way, then this should be clearly documented to satisfy any regulatory requirements.

The second question is that of **materiality**. Depending on the size of the unlisted portfolio, the nature of its composition and its valuation, exposure to any event will inform the fund's management and trustees of the necessity to take action.



Using a public market equivalent (PME)

If a fund is writing down the value of its assets, it's highly unlikely that the management team responsible has the same volume of information relating to the assets held by the investment manager or independent valuer. In many cases, the internal team is widely removed from the specifics relating to an asset (hence why the decision to outsource was taken in the first place). As a result, most valuation policies for funds who are in this position will stipulate the use of a public market equivalent (PME) and will assign a proxy for impairment (e.g. 50% of a PME, which is typically a listed infrastructure or real estate index or asset). The unlisted values will then be adjusted, based on discussions with the individual fund managers.

While this approach may satisfy the equitable treatment of members by, in effect, smoothing the unit price, it can still be problematic, as the valuation change is somewhat arbitrary and not based on the specifics of the underlying asset in question (although arguably it's the best that can be done with the information available). That said, it is widely accepted that unlisted valuations lag listed valuations; so if you have an equivalent listed asset then it is appropriate to assess this in the context of valuing an unlisted asset with the obvious caveat that these are not homogenous.

The importance of best practice governance

We would emphasise that any decision that is made with respect to valuations creates a precedent (this includes not doing anything), and that with any trustee or executive decision, **exercising best practice governance is critical to ensuring that the position taken is equitable, transparent and defensible** in front of members and regulators.

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