Superannuation fund investment in private debt

The last month has seen a flurry of newspaper coverage regarding the potential for superannuation funds to invest in private debt. That is, direct loans to businesses/projects. This discussion was started by a roundtable organised by Anthony Pratt, Gina Rinehart and Lindsay Fox. The newspaper coverage was perplexing because:

1. superannuation funds are already participating in the private debt market and have been for some time (my first direct infrastructure debt investment for my clients was in 2000); and
2. most of the coverage focused on the benefits to borrowers (that is, the billionaires) of broader participation in lending markets – rather than the benefits to superannuation funds (that is the lenders).

There are strong demographic trends supporting superannuation fund participation in private debt markets. As fund memberships age (particularly on a balance weighted basis) an increasing proportion of assets are held by older members. These members want low-risk reliable income – that is, more debt-like returns and less equity-like returns. The shift to life cycle investment options is reinforcing this trend. The net result is that there is more capital in defensive allocations than previously, and this will only grow over time. This creates a strong demand for lower risk investments.

On top of this demographic trend, low base rates mean traditional highly liquid defensive assets like government bonds or cash have negative post inflation and tax and fee returns. They certainly don't deliver the CPI + 2% after tax and fees that is the typical return target of a lower risk retirement focused investment choice.

This situation should be encouraging funds to distinguish between liquidity characteristics and defensive characteristics. Just as not all growth assets need to be fully liquid (there is room in properly structured portfolios for allocations to private equity, property and infrastructure) not all defensive assets need to be fully liquid. This creates room for allocations to sectors such as senior loans – where there are substantial liquidity premiums available to investors.

The loan market also provides a much wider range of potential borrowers/projects than the bond market. Australia's bond market is quite narrow – with a focus on highly rated borrowers (such as the big 4 Australian banks and large offshore companies). Within infrastructure, it tends only to be the very large projects/borrowers who issue bonds (i.e. the Transurban's, Sydney Airport's), while a much broader universe of borrowers principally raise debt through the loan market.

Mrs Rinehart was quoted as being keen for superannuation funds to provide "low-interest, long-term money". While every borrower wants cheap debt – the converse applies to every lender. No one wants to be the provider of cheap money, and it is naïve of borrowers if they think that is the role that superannuation funds see for themselves.

Australian superannuation funds have grown to be large players in Australian and international capital markets. They have been active investors in infrastructure for 30+ years. They don't face the same constraints as banks. However, the real opportunity for funds, is to provide finance in ways that better meets the long-term needs of projects and, in doing so, generate attractive returns aligned to member outcomes (recognising the changing demographic profile).

In this sense, projects should see the opportunity for with superannuation funds as a chance to obtain finance that better meets their needs (tenor, amortisation, flexibility), rather than to pay the same or slightly less for something they otherwise would have got from the banks (ie 3-5 year floating rate debt + swap).