

Where are your hurdle rates leading you?

First a confession. I used to be a hurdle rate user. I have designed, implemented and used hurdle rate systems. I used to be a believer.

While hurdle rates can provide a useful tool in ranking and assessing disparate investment opportunities, they are not a panacea, and all too often they reinforce an industry trend of focusing on returns first and risk a distant second.

What are hurdle rates?

Hurdle rates, or minimum return requirements, are commonly used within investment governance frameworks and are most ubiquitous in the consideration of unlisted assets. The typical approach is that a fund will set return hurdles (either absolute numbers or premiums above government bonds or CPI) for different types of investments. Individual investment opportunities are only considered if their forecast returns exceed the hurdle.

The underlying principle of hurdle rate investing is that you should only make an investment that provides an expected return that compensates for the risks involved.

Some funds set these on a sector or sub-sector basis (ie the return hurdle for Australian core infrastructure is x%, for core-plus it is y%, for overseas infrastructure it is z%), while others will build individual hurdle rate estimates based on the characteristics of individual investments.

A key benefit of hurdle rates is that they can assist in the delegation of responsibilities to specialist teams. Rather than each new opportunity needing to be compared with every other opportunity in deciding whether an investment should proceed, an opportunity can be compared to the hurdle rate. This allows compartmentalisation and delegation of decision making. For example, a Trustee can delegate responsibility for executing new infrastructure investments within allocation and hurdle rate limits to an infrastructure team.

Hurdle rates are intended to avoid “box filling” mentalities. That is, given a particular strategic asset allocation to a sector, rather than investing irrespective of valuations, new investments are only meant to proceed if expected returns exceed the hurdle rate. While the creation of asset class “boxes” and the need to fill them once they are created is the bane of our industry – as detailed below – I am not really sure that hurdle rates actually stop box filling. They just alter what you fill your box with!

What are the issues?

While the objectives of hurdle rate approaches are laudable – the devil in the detail of these systems is how they are implemented.

For example:

- Hurdle rates typically only apply to unlisted investments – not the liquid asset classes such as cash, fixed income or equities. When was the last time you heard a fund was no longer holding cash/bonds because they didn't meet its hurdle rates?
- Application to existing assets is often inconsistent with the application to new assets. For example, how many times will a fund not undertake new investments in a sector when the same logic would imply they should sell their existing holdings?
- Return forecasts are subjective/not comparable. Who is responsible for developing the return forecast (the deal proponent or others)? Are the forecasts developed on the basis of internally consistent macroeconomic inputs such as forecast inflation rates, interest rates, exchange rates?
- How objective/reliable are the return forecasts for selecting between opportunities? Increasingly infrastructure investments involve material non-traditional return sources such as unregulated revenue, benefits from large scale cost reductions/reorganisations, etc. I would question how reliably these can be forecast, particularly for the purposes of comparing between competing opportunities.



- Does the hurdle rate drive a selection bias? For example, at the moment many funds are moving from investing in core infrastructure to investing in “infrastructure like” investments because core assets no longer meet their hurdle. While core assets are undoubtedly expensive, I would question whether “core plus” or “infrastructure-like” are actually cheap on a risk adjusted basis. The last time I saw a shift up the risk spectrum in infrastructure was in 2006-2007 and we know how that ended.
- How frequently do you update hurdle rates to account for changes in the interest rate environment, inflation outlook or the pricing/valuation of listed asset classes? Do you base these building blocks on your own forecasts, historical averages or market implied estimates?
- How do you control for risk characteristics. Strategic allocations are decided on the basis of a combination of return and risk expectations for each asset class. Hurdle rates can result in significant drift in the risk profile of asset classes. For example, there is a big difference in risk characteristics between a core infrastructure portfolio and a portfolio of “infrastructure like” private equity. How does the decision framework manage this risk and prevent “risk drift” either at an individual asset class or whole of fund level?

My final criticism of hurdle rates is that they create a culture of focusing on returns first and foremost (i.e. the greed part of the investment equation), to the detriment of quality analysis of the risk profile of investments/portfolios (i.e. fear). For example, does a hurdle rate approach just encourage proponents to gear assets up to meet hurdle rates? An important question you should ask yourself is when did I last adjust a hurdle rate down because an asset was less risky than average?

Investors would be better served by trying to rank opportunities on the basis of risk adjusted returns within a pragmatic framework of diversification by sector/risk profile. This would lead to a more balanced assessment of risk and return. We know in this environment it is difficult returns are continually being squeezed, competition for trophy/quality assets is hot, and member return targets are ever harder to achieve. But given the point we are in the investment cycle, risk should be at the forefront

