An investment consultant's take on Regulation 28 and unlisted investments

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An interview with **Shainal Sukha**,
investment consultant to Consolidated Retirement Fund for Local Government ("CRF")

CRF, a large defined contribution scheme, has allocated significant capital to unlisted investments when compared to industry average allocations. Why have they done so and how can we get more pension funds making larger capital allocations within Regulation 28 limits, to private markets and the real economy?

The following are some of the factors that led to CRF's large allocation to unlisted assets:

- The preamble of Regulation 28 of the Pension Funds Act states that funds should follow a risk-based approach to their investment strategy by targeting "adequate risk adjusted" returns. It goes further to state that environmental, social and governance factors should be considered as part of a "responsible investment" approach. CRF therefore integrated ESG factors into their decision-making and adopted a holistic approach to risk management. The result was that CRF not only targeted good risk-adjusted commercial returns, but also sought to make a positive environmental and social impact with its assets, so that its members could retire in prosperous communities and sustainable environments.
- In 2015, when the industry debated the concentration of Naspers in our equity benchmarks, we noticed that our clients' capital kept going into a relatively expensive and concentrated local stock market that was becoming increasingly global in its exposure. Companies were raising money locally to invest offshore, often with poor outcomes. Our clients were not actually allocating a large portion of their capital locally and into the real economy. An abundance of capital within domestic listed equity seemed to be generating complacency and poor capital allocation decisions by local companies. On the other hand, other areas of the economy, where capital was scarce offered attractive return potential and better diversification benefits. So basic risk-management practice and taking a prospective view resulted in CRF investing into the local real economy, largely through alternative asset classes.
- With Government fiscally constrained and Corporates seeking certainty and confidence to invest, CRF felt frustrated with the lack of progress and constant "circle of blame". It therefore sought to use its influence, as a large asset owner, to take action to reduce ESG risks for its members.
- CRF seeded an unlisted credit fund in 2015, which not only targeted commercial returns, but being a blended finance fund, targeted job creation as well. The experience with this fund showed that it was possible to generate good risk-adjusted returns, while also have a positive social impact, and this event enabled further investment into unlisted assets.
- Currently, CRF has allocated more than 18% to unlisted assets, all of which have performed in line with expectations after all fees and costs. Of this, 12% has a relatively high ESG impact.

It is important for Trustees to understand the flexibility that Regulation 28 provides and the benefits and disadvantages of unlisted assets. Consider what will be appropriate for your fund. Do not be obsessed with daily liquidity if your member profile is relatively young and stable. Obtain a second opinion on complex issues and make sure that your asset consultant is being proactive and bringing suitable opportunities to the table.

In your experience, what do you see as the key benefits and risks of your clients investing in private markets?

Private markets allow one to exploit the illiquidity premium and gain exposure to other risk premia. This helps to diversify risks for asset owners and provide more consistent and stable returns, depending on the nature of the investment. It generally channels capital into the real economy and can help to reduce negative externalities or create positive externalities. However, private markets are not without risk and require greater due diligence and scrutiny. Private market funds generally have lock-up periods, charge higher fees and have higher cost structures. Concentration, liquidity and credit risks can be quite high, and most funds are closely correlated to the economic and business cycle.

In light of the current economic environment, SAVCA have proposed two amendments to Regulation 28: separating hedge funds and private equity into independent asset classes, each with their own caps and increasing the private equity cap from 10% to 15%. Do you think these proposed changes to Regulation 28 will unlock additional capital or, in your view, what will?

We support SAVCA's proposal to split out hedge funds and private equity into separate categories as well as increase the private equity limit to 15%. We do not see a need to make further changes to Regulation 28, as we have shown through a case study of CRF that Regulation 28 is not prescriptive and provides sufficient flexibility. While these changes may unlock additional capital from retirement funds, the biggest stumbling block is not Regulation 28. What is lacking is the implementation of Regulation 28 and application of its principles by asset consultants and Trustees. If the structural shortcomings in the industry (as per Rob Rusconi's 2008 paper "Whose money is it anyway?") are addressed, particularly in asset consulting, it will allow for better capital allocation into the real economy and application of Regulation 28. We should be thinking about making it easier for retirement funds to allocate to illiquid assets by offering some kind of liquidity facility or perhaps offering open-ended funds. To address high fees, the industry could play a role in coming up with better-aligned fee structures, which are often cited by asset consultants as a huge stumbling block.

In light of the current economic environment and COVID-19 crisis, what in your experience does private market investing deliver in terms of broader social benefit and impact goals in the real economy? And will larger allocations be supportive in confronting the current economic challenges being experienced in South Africa?

Climate change will amplify our social risks of high unemployment, poverty and inequality in South Africa. In my opinion, we have around ten years to urgently transition to a low carbon economy in a just manner. We also have ten years to achieve the United Nations Sustainable Development Goals. The COVID-19 pandemic has highlighted the weaknesses of our system but given us an opportunity to "build back better". The next ten years will be a massive opportunity for the private markets industry. Given the lock-up periods, private market fund managers can take long-term views and invest in solutions that address long-term risks. The private markets industry were early adopters of ESG integration and generally invest in the real economy. The mainstreaming of impact investing will be the next evolution of Responsible Investing, and the private markets industry therefore has a critical role in supporting this move.

CRF has invested in a number of blended finance solutions where government agencies provide some form of downside protection to catalyse investment from other sources. These blended finance solutions aim to provide commercial returns and social impact outcomes for investors. What has been your client's experience of these partnerships in terms of returns and impact?

CRF has invested in three blended finance funds, all of which have delivered a positive experience thus far, in terms of both risk and return. All three funds target job creation, which is an important part of CRF's Responsible Investing Policy. The funds are run by professional asset managers who also measure and report on the number of jobs that are created. The Jobs Fund has been an excellent partner in the process through their technical input and being receptive to investor concerns. Their involvement has lowered risks for both investors and asset managers and we hope that Government will create a "second" Jobs Fund or equivalent.

Concessional capital, often provided by the Government or an entity like the Jobs Fund, does serve to make it easier for retirement funds to invest in alternative asset classes. The concessional capital can either reduce downside risks by offering a first loss guarantee or it can act as a return enhancer, or both. We feel that blended finance could help mobilise the finance industry to invest more in the real economy, to crowd in long-term asset owners and to create positive environmental and social impact in our country. Blended finance funds could also help meet our National Development Plan targets and address the United Nations Sustainable Development Goals.