

unlisted assets – heading for a fall?

The decision to invest in unlisted or listed assets had a significant impact on fund performance in 2008. Funds invested in unlisted assets produced higher returns than those that held mainly listed investments – an average 6% higher for the year, as estimated by Superannuation research and consultancy firm Chant West.¹

Many investors have questioned whether this trend is likely to continue. And if it is, should they now be investing in funds that have a greater exposure to unlisted securities? The following *insight* provides some context around the performance of listed and unlisted securities, and explains why ipac believes that now is not the time for investors to be holding a large exposure to unlisted assets.

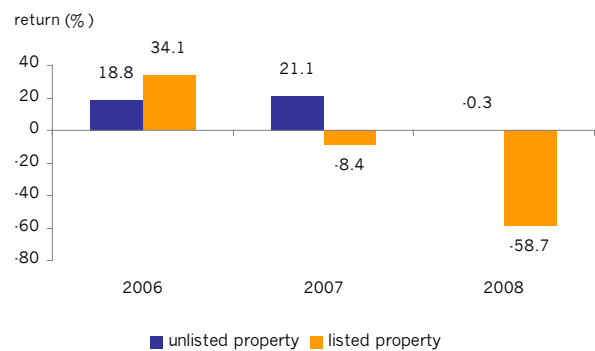
¹ source: Chant West. Performance is net of investment fees and tax. It does not include administration fees or adviser commissions.

asset allocation was the main driver of fund performance in 2008

In recent years many industry funds have increased their exposure to unlisted assets such as unlisted property, infrastructure and private equity. Chant West estimates that around 28% of industry funds' assets are invested in unlisted markets. The largest allocation is in unlisted property (9%), followed by hedge funds, infrastructure and private equity. Non-industry funds invest only 10% in the unlisted segment of the market.² Non-industry funds invest the bulk of the portfolio in more traditional and liquid assets like shares, bonds and listed property. This difference in asset allocation is the main factor contributing to the differential in returns between industry and non-industry funds.

Over 2008 there was a considerable gap in performance between unlisted and listed markets. If we look at Australian property (within unlisted markets property is the asset class that industry funds have the largest exposure to), the chart opposite shows how the two market segments have performed. In 2008, the listed property market suffered significant falls, down 58.7%, while unlisted property fell just 0.3%. That is an extraordinary 58% gap in performance. This extraordinary difference in returns is the main reason why the performance of industry funds was stronger than that of non-industry funds in 2008.

returns of unlisted and listed property (2006-2008)



source: Mercer MPA Wholesale Database. S&P/ASX 300 A-REITs Index and Mercer Unlisted Property Index. Data as of 31 December 2008.

² source: Chant West as of December 2008.

unlisted assets are valued less frequently than listed assets

So why the big gap in performance between listed and unlisted markets? How can the returns be so different, especially when the underlying assets are the same?

Again, taking property as an example, it is important to note that some listed property securities have had unique structural issues such as financial engineering and equity-like risk taking. However, the divergence between the listed and unlisted markets' performance appears to be out of line with what is reasonable.

One major factor contributing to the difference in performance between the two market segments is the timing of asset valuations. Listed property, like shares, is valued daily. The price, therefore, always reflects the sentiment of market participants and their view of the future.

Unlisted property is valued less often, in some cases as infrequently as once a year. Therefore, when property values go up or down, this is not recognised in the returns of unlisted assets until the next valuation. This can result in returns appearing less volatile. It can also result in inequity between investors.

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When markets are falling, investors who exit the market early receive an artificially high price at the expense of those left behind (a situation we could be seeing now). The opposite occurs in rising markets. When valuations are occasional, rather than frequent, all investors face the risk that someone else will benefit at their expense.

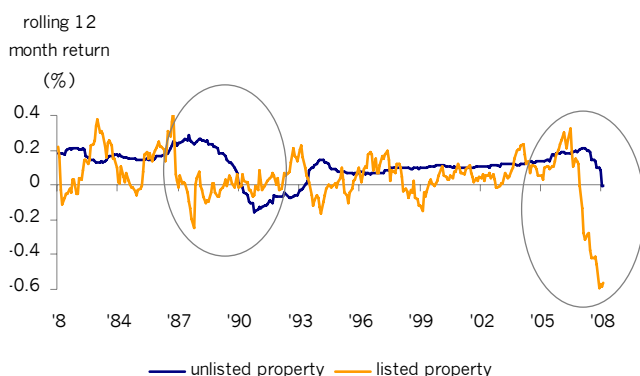
unlisted valuations typically follow the listed market – with a time lag

Another factor worth considering when investing in assets that are valued less frequently is the performance ‘time lag’.

As the chart below shows, valuations in private markets typically lag the price performance of listed markets. Listed markets price in what’s expected in the future – not what’s happening now.

The chart compares historical returns of listed and unlisted property assets, highlighting the lag that occurs between them. It compares the current situation to the period between 1988 and 1992, and shows that during this period, listed property fell sharply, significantly underperforming unlisted property (similar to the situation today). However, as the listed market began to recover, unlisted property entered a slump. A risk for unlisted property investors now is that history repeats.

12 month returns of listed and unlisted property



source: Mercer MPA Wholesale Database. S&P/ASX 300 A-REITs Index and Mercer Unlisted Property Index. Rolling 12 month returns. Data as of 31 January 2009.

benefits of investing in listed assets

In addition to considerations about timing of returns, there are a number of distinct advantages to investing in listed assets, including:

greater liquidity - like shares, listed assets are traded on a stock exchange. When investment opportunities arise, changes to holdings can be implemented quickly and efficiently.

greater transparency - listed assets provide investors with transparent valuations based on daily transactions.

broader diversification - investors are able to invest in a greater variety of properties. In the case of property, this can include investing in different regions, different lease lengths and different tenant types.

While exposure to the unlisted property sector may sometimes be appropriate, it is important to understand the nature of these investments. Unlisted property trusts can pose significant risks to investors, such as lower liquidity, less transparency and greater transaction costs that have to be carefully managed. This is why many non-industry funds focus mainly on listed assets.

ipac’s diversified portfolios invest primarily in listed assets with only small unlisted holdings in asset classes like private equity. The portfolios focus on listed assets to ensure high levels of liquidity for all ipac’s clients. While this counted against the portfolios in 2008, in previous years it has been of benefit. Given recent market distortions, there is reason to believe it will be of benefit again in the future.

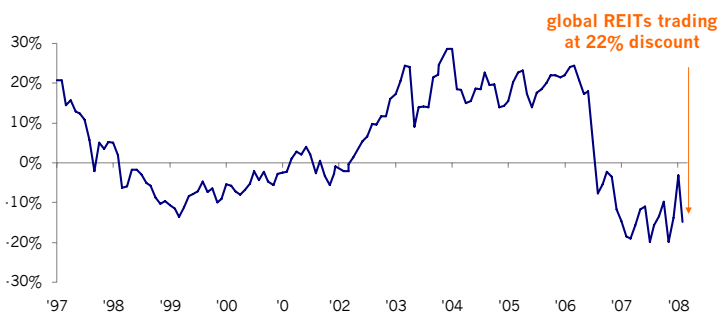
where to from here?

In the short-term, listed asset prices are likely to remain volatile and could fall further. However, a combination of solid fundamentals with lower valuations gives listed markets a reasonably good outlook over the medium- to long-term.

One of ipac’s managers has calculated that as at 16 March 2009, global real estate investment trusts were trading at a 22% discount to estimates of their net asset values. This compares to a long-term average of a 0% to 5% premium. This means there is scope, over time, for significant outperformance of listed property trusts relative to the net asset value of unlisted markets.

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net asset values of global listed property



source: LaSalle Investment Management (Securities) EPRA. Global REITs are comprised of REITs in US, Canada, Netherlands, France, Australia, Japan and the UK (from Jan 2007) and re-weighted monthly by EPRA/NAREIT Index USD market cap. Data as of 16 March 2009.

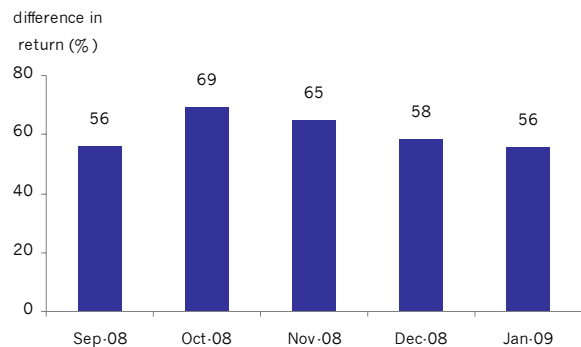
Going forward, Chant West believes unlisted property could have to be devalued by 16% from today's starting point. It also believes that private equity investments will fall in value by about 20% over the next six months, and that infrastructure valuations will need to fall by between 15 and 20%.³

Within the Australian property market evidence is now emerging of small downward revaluations in unlisted securities. Latest available data showed the Mercer Unlisted Property Index recording a three month fall of 3.98% at the end of January 2009.

Looking out over the next few years, the most likely scenario is that prices of listed property trusts will rise while unlisted valuations will decline. As this begins to occur, we expect to see the performance gap narrow considerably. Indeed, this may have already started to happen. The chart below shows that the gap in returns between listed and unlisted property has been falling steadily since October 2008, albeit marginally.

Although it is still too early to say whether this trend will continue in the near-term, we do believe that now is unlikely to be a good time to maintain a large exposure to unlisted assets.

difference in 12 month returns between listed and unlisted property



source: Mercer MPA Wholesale Database. S&P/ASX 300 A-REITs Index and Mercer Unlisted Property Index. Rolling 12 month returns. Data as of 31 January 2009.

³ source: Chant West.

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