Superannuation funds **Why the Aussie supers need to re-evaluate risk**

Australian superannuation funds should not be too worried by either the volatility or risk of private credit, according to a new study from Melbourne-based fund manager Epsilon Direct Lending and consultant Atchison, ***writes Andy Thomson.***

The super funds are required to outperform a fixed income benchmark set by the regulator, the Australian Prudential Regulation Authority. This benchmark – the Bloomberg AusBond Composite 0+ index – comprises government and public corporate bonds but excludes private debt, which makes up more than 36 percent of the $3.6 trillion total Australian debt market.

The funds are very wary of falling below the benchmark, as doing so on a repeat basis can result in them being prevented from taking on new members. They have therefore been worried about tracking error (essentially volatility) and credit risk when it comes to adding private credit to their portfolios.

But is this justified? That's what Epsilon and Atchison set out to examine through their report *Private Credit Allocations in a 'Your Future, Your Super' World*. "The risk of deviating too far from the benchmark can be meaningful for super funds," says Joe Millward, a founding partner of Epsilon. "But what is that risk? The super fund research teams have competing priorities so we decided to try and answer the question through an asset consultant [Atchison]. No one had done a deep dive into this area before."

Marginal error

What the study found is that, assuming 10 percent of a fixed income allocation goes into private credit, the tracking error was marginal – 0.6 percent measured over an eight-year rolling period – while returns could be increased by up to 1.0 percent per year.

"People think it's a risky asset class but actually you don't take much of a hit on the risk relative to many other fixed income products which are mark to market," says Millward. "Loans in Australia tend to be held at par unless they're truly impaired. You get a lot of repricing in other markets which have secondary or public pricing but there's not really a secondary market in Australia. The only major volatility is if there's a macroeconomic event causing broad impairments, but with conservative corporate balance sheets and a AAA country rating, Australia is well placed to weather any storm."

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Australian bond and debt market 2020

Bond market and debt	$trn	%
Government bonds	0.9	25.0
Public corporate bonds	1.4	38.9
Total bonds	2.3	63.9
Private bonds and loans	1.3	36.1
Total Australian debt	3.6	100.0

Source: Australian Bureau of Statistics, Bank for International Settlements, Q3 2020

Millward believes the study shows super funds can improve their return profile without being in danger of falling foul of the benchmark. In light of this, he argues that they have a responsibility to open the markets to better financing options. "The super funds have a strong interest in the economy performing well. But if they're not allocating to private credit then there's no competition to the banks and you don't have a competitive credit market."

In terms of Australian institutional investment in general into private credit, Millward says it's a mixed picture. The Future Fund, Australia's sovereign wealth fund – which had nearly $144 billion in assets under management last year – has been a regulator allocator to private credit and alternative assets in general but is not constrained in its activities either by regulators or fee budgets.

Millward adds that some of the larger super funds have also been supportive of the asset class, mainly overseas but also to some extent in their home market. "Those really missing out are the small to medium-sized super funds which are not pitched to very much by the offshore credit funds."

Millward says Epsilon's main source of capital is private wealth. "We've had a few super funds engage. The asset consultants have received the pitch well and acknowledged our arguments but some are still on their journey to understanding the intricacies of the local market and how it stacks up against the mature offshore offerings." ■