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Mr Simon Crabb
By email: simonc@nrc.govt.nz
CC: Malcolm Nicolson, Rick Stolwerk, Bruce Howse

Dear Simon

THE CASE FOR ALTERNATIVE ASSETS

There are two main reasons to increase the proportion of alternative assets over listed assets at present.

The first is the expensive state of both equity and bond markets. With stock markets at record highs and interest rates at record lows the risk of a correction is high. A rise in interest rates or inflation, a drop in investor sentiment or a serious geopolitical event could all trigger a correction.

The second concerns the nature of the assets and how they are valued. Alternatives tend to fall into four buckets:

- Property
- Infrastructure
- Private equity
- Private debt

Northland Regional Council is already engaged in commercial property development and infrastructure through its position of influence in Northland. Listed property and infrastructure exposure is accessed through your managed fund investments.

The private businesses which make up 90% of New Zealand commercial enterprises are harder to access. More importantly they are independent businesses, generally smaller and often owner operated. Private companies tend to be valued as a multiple of actual earnings with realistic multiples for growth expectations.

The low interest rate environment and regulatory pressure from the RBNZ to increase capital adequacy is drastically reducing the banks ability to provide working capital, especially to expand or grow the business. Hence the need for private debt.

Because such businesses can afford to be patient and take the best opportunities when offered their value and viability is less transparent than those on listed markets. Their stock is illiquid but valuations tend to be more stable since there are not many shares traded. They are thus not well correlated to the listed markets which is invaluable in extreme sell offs of stocks and bonds, as we saw in Q1 2020.

Currently the Council is rightly concerned to limit the risks to its managed fund portfolios and is cashing out the profits and putting them in term deposits. That is one strategy to de-risk the portfolio.

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We recommend increasing the exposure to alternative assets, private equity in particular, as another way of reducing the risks to the LTF managed funds portfolio.

The recently amended SIPO of the LTF already caters to a 20% benchmark weighting of invested capital in private equity (up from 18% to cater for Federation). The range is to 35%.

We still consider the SIPO benchmark ranges conservative and appropriate. No change is recommended.

However with the low interest rate environment and the boost to the stock markets from investors seeking returns private equity managers are also becoming increasingly active. There have been several IPO's on both the NZX and ASX in the past year or so.

As a result the returns achieved by good private equity managers have improved and the uplifts in value of their underlying businesses are becoming realised more quickly. You should expect the frequency of both calls and distributions to increase whilst markets are running this hot.

We therefore recommend increasing the target weighting of committed capital (not the benchmark weighting) to 25%-30% which is still below the 35% upper bound to the range. In our investment report as at 31 December 2020 the actual weighting was 14.2% committed capital.

There are two upcoming NZ based private equity funds opening in February 2021, Continuity Capital No 6 and Pioneer Capital IV. Furthermore MLC Fund III is having its final close on 31 March 2021. Fund II has been very successful, and it is in AUD, providing an additional layer of currency diversification. Whilst global private equity (not Australasian) MLC, like Continuity, is very selective. They do co-investments with the best private equity managers around the globe on a business specific selective basis.

We recommend:

- NZD 2 million committed capital into CC No 6
- NZD 1 million committed capital into Pioneer Capital IV
- AUD 0.5 million committed capital into MLC Fund III

We look forward to discussing these recommendations in due course.

Warm regards

Jonathan Eriksen

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