

A Response to the DWP consultation on enabling investment in productive finance

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Introduction

This consultation comes just a few months after the modification of the charge cap and is a proposal to exempt certain classes of illiquid¹ private investments from the DC charge cap. *“Specifically, the government proposes adding to the list of charges currently out of the scope of the charge cap to include well-designed performance fees that are paid when an asset manager exceeds pre-determined performance targets.”* The title of this consultation is misleading to the extent that it is concerned solely with illiquid securities and the DC charge cap. Far more investment in productive finance and capital lies outside that limited range of instruments, and it is worth emphasising this at the start as the scope of the consultation is extremely narrow. We have in this response considered the investment merits of illiquid securities and their potential use in DC pension arrangements but have omitted, as being out of scope, several other important public policy aspects, such as consideration of the tax cost of these partnership arrangements and the economic consequences of material increases in the indebtedness of the corporate sector. We would also note that the BIS² has recently begun work on some public policy aspects of private markets, such as procyclicality and monetary policy transmission sensitivity all of which are clearly relevant to this issue.

To provide context, we commence with a brief discussion of the Ministerial Foreword to the consultation. We share the Minister’s ambition *“...to ensure optimal outcomes for the nation’s defined contribution (DC) saver”* but do not believe that the proposed changes would or should contribute to achieving that. The foreword states: *“The trustees of DC schemes are increasingly looking to private markets to deliver on this responsibility due to the benefits of diversification and greater returns.”*, which we do not believe is unconditionally true, and except for a small number of high-profile larger schemes, there is little evidence presented thus far that there is significant pent-up demand by the trustees of DC schemes for these types of investments. It seems to us that the exhortations and inducements of the Prime Minister and Chancellor in their open ‘challenge’ letter³ have been the driver of this interest. We (Keating) wrote and published an article in response to that challenge, reproduced as Appendix A. In the course of our responses to the specific consultation questions, we will challenge some of the general statements made about these asset classes that are taken as

¹ The consultation and its various supporting reports refer to an illiquidity premium when it is liquidity which has a cost. If a fund is acquiring liquid assets, it is paying on purchase the then-prevailing liquidity cost, and there can be no excess return to the fund. In general, whether a non-traded fund earns an ‘illiquidity premium’ is not a matter of its structural negotiability, but rather of the liquidity costs paid on the assets which it has acquired.

² https://www.bis.org/publ/qtrpdf/r_qt2112.pdf

³

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1008814/A_Challenge_Letter_from_the_Prime_Minister_and_Chancellor_to_institution_1.pdf

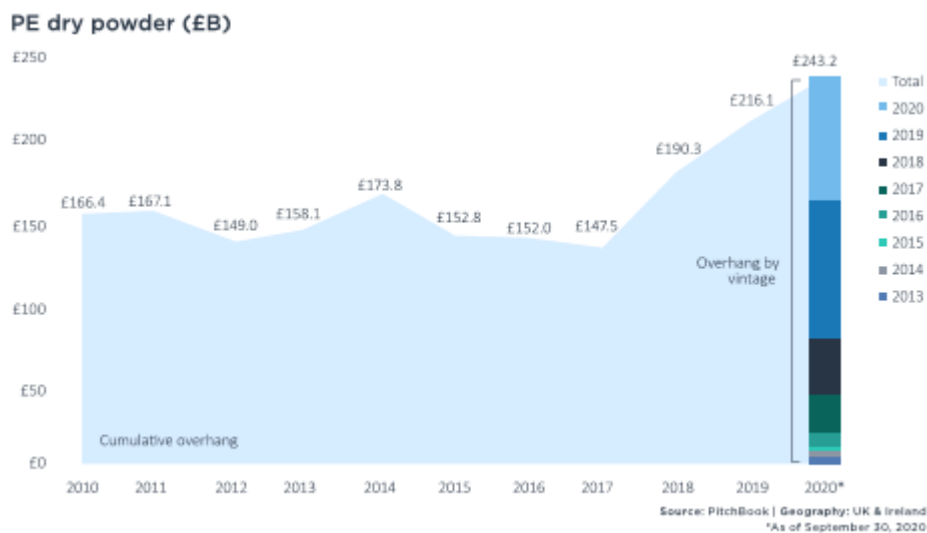
accepted wisdom e.g., the idea that these investments are truly long-term in nature, offer any materially better diversification or greater returns than conventional listed investments.

The foreword asserts: *“Investment in asset classes like green infrastructure, private equity, and venture capital, fits well with the long-term horizons of DC schemes.”* It is true that the illiquid investments, typically limited partnership interests, that investors are required to make are contractually long-term in nature, typically having a lifetime of ten or fifteen years, but this does not mean that the investments made by these partnerships are long-term – and it is that, of course, which must ultimately be reflected in the performance of these partnership funds.

According to Pitchbook⁴, the average term of investments held by private equity firms is now 4.5 years, up from 2.2 years in 2006. In 2016, the most recent year reported by Pitchbook, 31.2% of companies exiting buy-out funds had been held less than five years, down from 50.9% in 2003. With distributions to investors currently at 28.8% of net asset value annually, funds have a life, or term, to return the initial investment of just 3.47 years. Note that both traditional listed equity and corporate bonds have lives far in excess of this term. With the FTSE dividend yield at 3.2%, listed equity has a 31-year term, which share buybacks would bring down to around 27 years.

The investor in a private equity fund does not know when or for how long the funds committed will be drawn. Figure 1 shows the most recent levels of undrawn capital, the so-called “dry powder” currently sitting but undeployed in PE.

Figure 1: Undrawn Committed Capital



Note that there is uncalled but committed capital dating back as far as 2013. Moreover, this total is large by comparison with calls on committed capital as is indicated in Figure 2. This stock represents almost four years of supply based on the highest level of contributions (investments) made (~£70 billion) in recent times; at the lowest rate it has been over seven years’ supply and is equivalent to over four years of new fund raising.

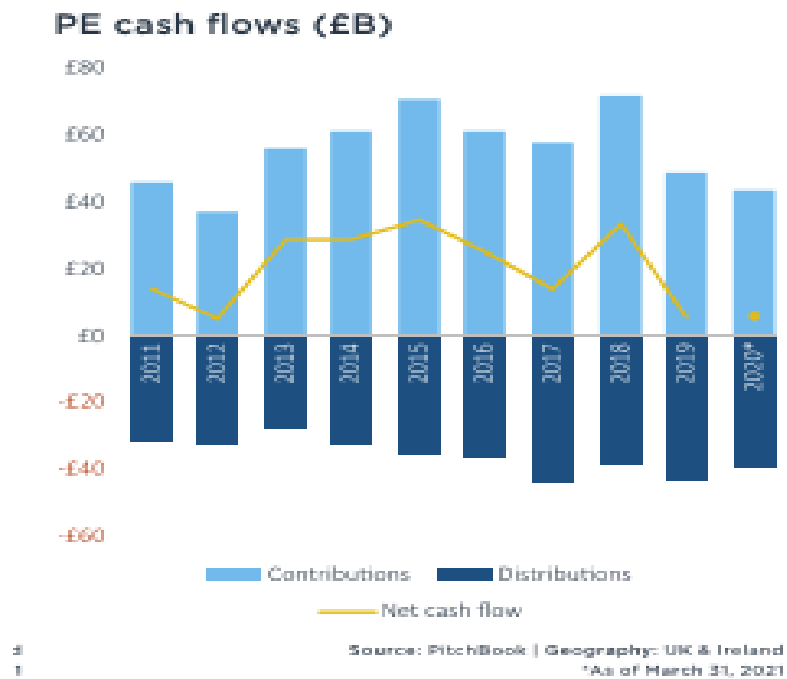
The distribution amounts arising from the realisation of investments made are also highly variable from year to year. For the US private equity market, they have varied from as little as 5% of the net asset value of funds to over 45%.

⁴ <https://pitchbook.com>

This is the source of much confusion as to achieved rates of return. The internal rate of return (IRR) is based upon the funds deployed over the period to the realisation of the investment and not on the total amounts of capital provided.

The investor knows neither when nor for how long the funds committed with be required.

Figure 2: Contributions and Distributions – UK Funds



As Table 1 shows, there is a further challenge for venture capital funds; their reported gross internal rates of return decline markedly as the holding term increases.

Table 1

Term (Years)	5	10	15	20
Reported Gross IRR (%)	18.46	15.18	11.75	8.03
Equal Weighted (%)	15.89	13.63	10.55	6.66

Source: Pitchbook. (USD returns)

As the total returns achieved by year fifteen are larger than those achieved by year twenty, it would make no sense to hold these funds beyond the fifteenth year.

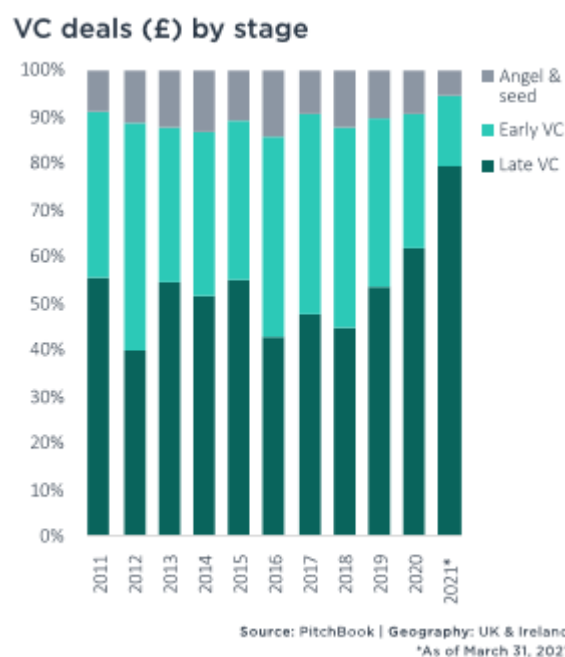
These facts with respect to investment term contradict the claim of goodness of fit to DC pension term. More importantly, they challenge the private equity industry’s claims that excess returns may arise from the long-term nature of private equity investment.

As ‘green infrastructure’ is a new investment classification there is no historic record or empirical evidence on which to base its expected behaviour. There also is no shortage of capital to invest in this area – at least where the risk/return profile is economically attractive- see the further discussion in

the House of Commons Work and Pensions Committee ‘Pensions stewardship and COP26’ Report published on 30 September 2021 at Chapter 4⁵.

UK Private equity investment flows have been around £40 billion in recent years; this is more than twice the amount raised by IPOs in the London listed markets (£17 billion). Slightly over half of the funds raised in the London market were paid to prior shareholders, with the balance (£8.3 billion) being used for new productive investment. Almost all of the flows from private equity were to prior shareholders. The correct comparator for this £8.3 billion is, perhaps, the amount raised as venture capital (£13.3 billion) – Figure 3 shows the distribution of VC funding by stage of investee company development. Note that £6.8 billion of this investment came from US venture capitalists. Few of these VC funded companies could justify the expense of obtaining a listing – the benefits of liquidity to them and their shareholders simply do not exceed the costs of providing it. Venture capital is of course new private investment and if successful will be productive, but it is important to realise that most private equity is not an investment in the firm. The investment is paid to selling shareholders, and there is no new investment in the firm. If this transaction is to increase productivity, it is the investments made by the sellers which will determine this.

Figure 3: Venture Capital Funding by Stage



The foreword continues with: “Such investments have the potential to provide better returns for members as part of a balanced portfolio and help to sustain employment, our communities and the environment.” Indeed, we might say that any socially responsible investment would help sustain employment, our communities, and the environment – these are not unique properties of private equity, venture capital, or other private markets. There are many who would challenge the idea that private equity is unconditionally good for employment or the communities in which they operate. There are all-too-many instances where the private industry’s behaviour has proved rapacious e.g., the case of Debenhams when it was first delisted, restructured, and relisted. While these investments

⁵ <https://publications.parliament.uk/pa/cm5802/cmselect/cmworpen/238/report.html>

may have the *potential* to provide better returns, we will examine later the question as to whether they have in fact achieved this.

Here we will simply note that the pricing formulations for these investments lead to understatement of risk and price volatility and lower correlations with market-priced assets. The true relative price volatility of venture cap funds can be estimated by the dispersion of reported returns across funds – the standard deviation and top to bottom decile values of reported fund returns for the past five years is shown in Table 2. The dispersion of private equity fund returns is twice that of the MSCI world equity index (27% versus 14%).

Table 2

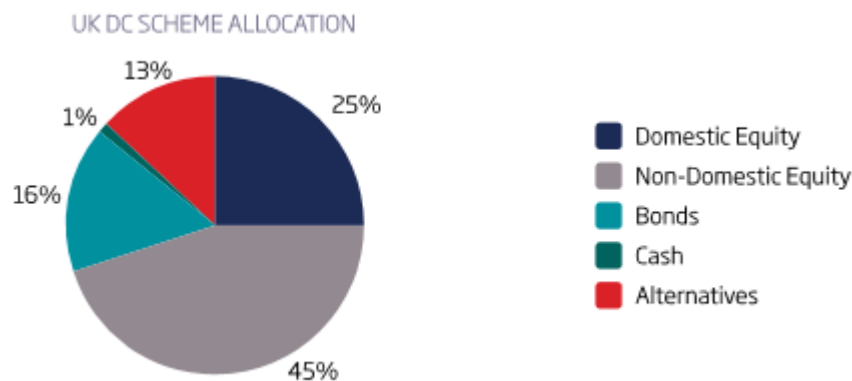
Global VC	2020	2019	2018	2017	2016
Standard Deviation %	61.99	52.98	30.65	20.57	25.86
Inter-Decile Range (%)	119	129	64	50	37

Source: Pitchbook, Author’s calculations

We offer further evidence on the reliability or otherwise of fund valuations later. With these ranges of returns possible, the selection of fund is critical. Indeed, these ranges of returns suggest that it is inappropriate to think of venture capital as a homogenous asset class. It is to be expected that investment advisors will naturally take this opportunity to levy further fees for selection advice, a cost which is borne by the scheme and ultimately employers and scheme members.

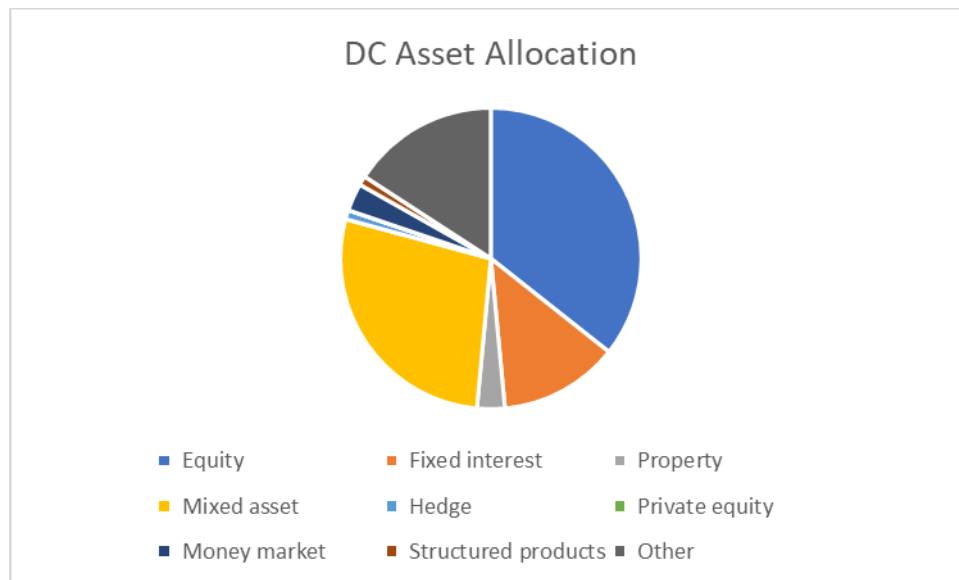
There is some disagreement as to the asset allocation of DC Funds. The Oliver Wyman/British Business Bank paper reported 74% in equity as shown in Figure 5.

Figure 5: The Oliver Wyman/British Business Bank



By contrast, the ONS reports figures as shown in Figure 6:

Figure 6: DC Asset Allocation (ONS)



The allocation to private equity is zero. The maximum allocation to equity, which would require all of the mixed-asset portfolio category to be invested in equity, is 64%.

Though DC schemes overwhelmingly hold funds rather than individual stocks or segregated portfolios, these equity exposures are the most volatile of their exposures; this reflects their considered risk appetite. If they are to maintain this risk profile while introducing say 10% of venture capital into it, they would need to sell almost 20% of listed equity and invest the cash difference in low-risk secure assets (and hope that they achieve median risk and return characteristics in the chosen VC fund(s)).

Of course, it is possible that DC schemes have some exposure to private equity or venture capital through holdings in the listed investment trusts specialising in private investment. Appendix D shows the performance of a selection of these.

It should be understood that the overall distributions of private equity portfolio returns do not have a suitable return profile from the perspective of a pension fund. Only a small fraction of venture investments has stellar performance and far more fail abjectly. These characteristics are more akin to those of a lottery – few winners and many losers. This is unlike listed market equity where a low-cost index tracker can be purchased, and so while some firms will inevitably fail, stellar performers can be picked up without the same risk profile or cost base e.g. Apple, Microsoft, Amazon, Google, and Facebook (Meta).

To illustrate this point, there are currently 186 venture capital-funded enterprises with ambitions in the field of satellite rocketry; it is estimated that, when mature, this field will consist of no more than twenty large firms. In fact, the history of technological and industrial developments suggests that this estimate may be high (think pharmaceuticals or automobiles). One might say that the rewards to the winners will be stellar while those failing will disappear into a black hole. This results in a markedly asymmetric distribution of returns; the median return lies far below the mean return; the financial effects of this may be judged by the difference between the reported results and an equally weighted

portfolio of the assets; the lower row in Table 1 above. With this risk and return profile, most investors will not achieve the mean or average return.⁶

The foreword also considers the publication of the final report of the Productive Finance Working Group to be a “...*significant step towards addressing the barriers to investment in long-term illiquid investments for government, regulators, and **industry.***” (Emphasis added). The members of the working group are shown below. In our initial response, which pre-dated the publication of this report, we cautioned against the weight of lobbying from the vested interests of the financial services lobby, but this group is heavily biased in that direction, and of course, with the position of the Prime Minister and Chancellor known, it was politically expedient to favour the inclusion of illiquid investments such as private equity. A more detailed critique of sections of this report is contained in Appendix C.

Members of the Working Group

ABRDN	London Stock Exchange Group
Association of British Insurers	Macquarie Group
Association of Investment Companies	NEST Corporation
Alternative Investment Management Ass.	Partners Group
Aviva	Pensions and Lifetime Savings Association
BlackRock	Rothsay
BNY Mellon	Simmons & Simmons LLP
British Private Equity and Venture Capital Ass.	The City UK
Fidelity International	The Investment Association
Hargreaves Lansdown	Universities Superannuation Scheme
HSBC	Willis Towers Watson
Impax Asset Management	Independent Trustees of Pension Schemes
Legal & General Group	(Ruston Smith, Paul Trickett)

The co-chairs of the working group included John Glen MP, Economic Secretary to the Treasury. It is interesting that there are no employer or employee representatives in the working group membership, nor does there seem to be any independent observers, who have been used before in other similar industry working groups e.g. The Institutional Disclosure Working Group of the FCA.

Of the 19 organisations represented on the Working Group 14 have a clear financial interest (or their members do) in the lifting of the charge cap. The optics do not look encouraging - another case of the financial services sector profiting from the hard-earned retirement savings of pension scheme members with no downside risk. Why would they not recommend lifting the charge cap?

We responded to the earlier consultation on illiquid private ‘market’ investments and performance fees. Our response was negative, and this has not changed, even though we have seen the publication since of two ‘official’ reports which promote this form of investment. In addition to the Road Map’s “Case for” narrative covered in Appendix C, we will comment on these publications in the course of our responses to the questions posed here. We have appended our earlier response and a published postscript to that, which covers the experience of the NatWest schemes (Appendix B). We urge that this should be read, before continuing to our responses and other commentary. We will, at many points in this response, refer to the specific numbered paragraphs of that earlier response.

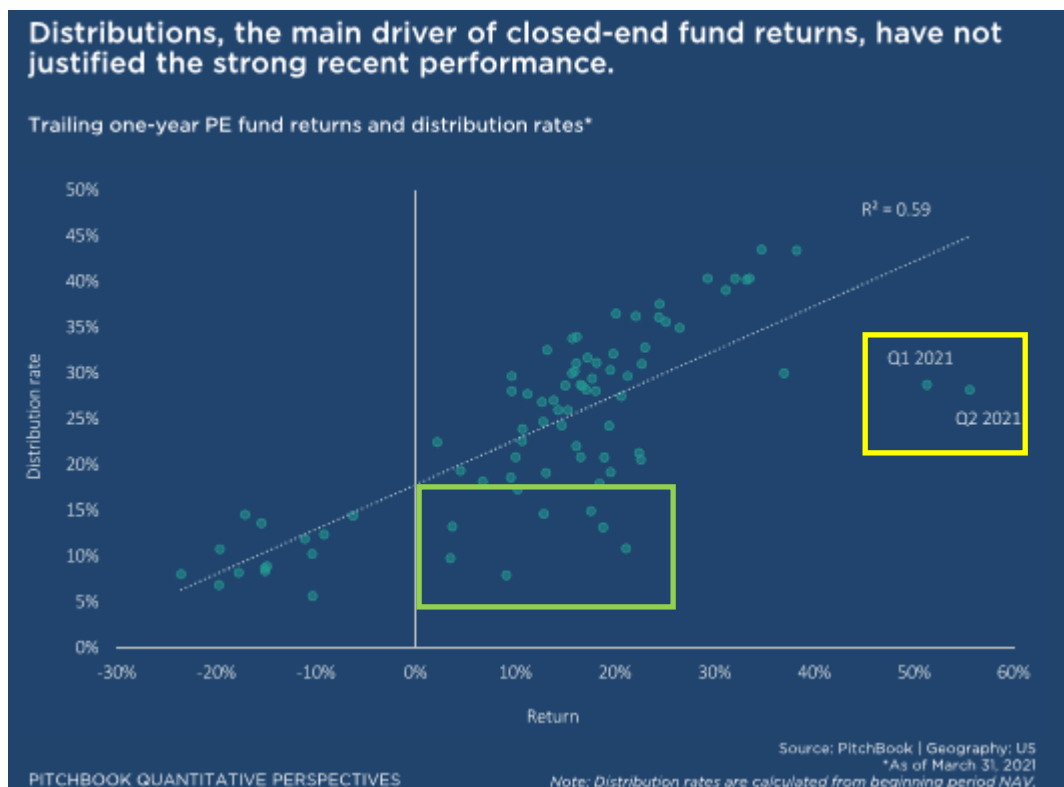
⁶ It is worth highlighting that the equally weighted nominal return of 6.6% before fees from this asset class really does not compare well with the equivalent 6.2% real return achieved by listed equity.

Before moving to consideration of the questions posed and responses to them, it is appropriate to recognise how questionable manager evaluations of performance have been in the past. It happens that this issue was raised in the context of two recent valuations by Pitchbook. See Figure 6 below.

The commentary offered by Pitchbook concerns the two most recent valuations contained in the yellow box. “The distribution rate has explained nearly 60% of the variation in one-year returns. However, this relationship broke down during the past two quarters. For example, based on the distribution rate of 28.8% in Q1 2021, the expected one-year return is 20.9% versus the reported return of 51.3%. The discrepancy between these two numbers comes from significant markups to net asset value (NAV), which represent unrealized returns. If these high valuations are not realized, it could represent a significant drag on future returns.”

It is also noticeable that there are many earlier reported positive returns which the relation with distributions suggests really should be negative – the eight returns contained within the green box. Perhaps most telling is that there are no negative reported returns which the relationship would suggest should be positive.

Figure 6: Distributions and Returns



As the returns achieved must all ultimately be rooted in distributions made⁷, we should expect the regression line shown to be steeper, with a slope approaching unity, and with the R^2 statistic also approaching unity.

The Pitchbook commentary continues with: “The only period with a similar dynamic occurred immediately post-GFC. However, during this period, performance was recovering from a sharp markdown to average levels.”

⁷ Distributions are simply the sum of returns of capital and returns on that capital.

As a key ingredient of any value for money formulation, it is worth understanding the reported net returns achieved and the total fees deducted for investments by UK pension funds in private equity over the period 2018 – 2020. The sample sizes are also shown. It contains funds of all vintages owned by these funds. It does not have any adjustment for undrawn commitments.

The high levels of fees relative to those applicable to listed equivalent funds is obvious. It is perhaps surprising that infrastructure should have significant large loss experience which reduces the mean return to less than the median.

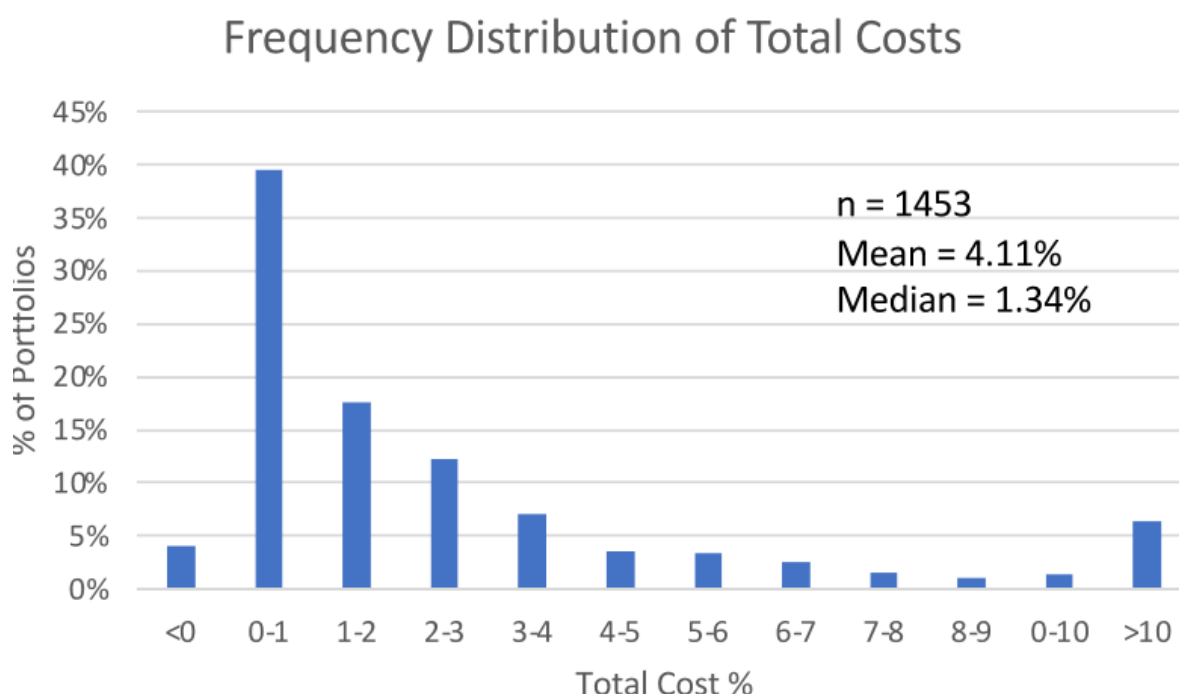
Table 3: Annual Net Returns and Fees UK DB Pension Funds 2018-2020

	No. of Portfolios	Net Returns		Fees	
		Mean	Median	Mean	Median
Infrastructure	651	6.7	7.8	1.12	1.19
Private Equity	1773	12.66	11.96	4.42	1.35
Private Debt	773	5.39	5.63	2.09	1.18

Source: ClearGlass

The distribution of fees is also informative. Figure 7 shows this for the ClearGlass dataset:

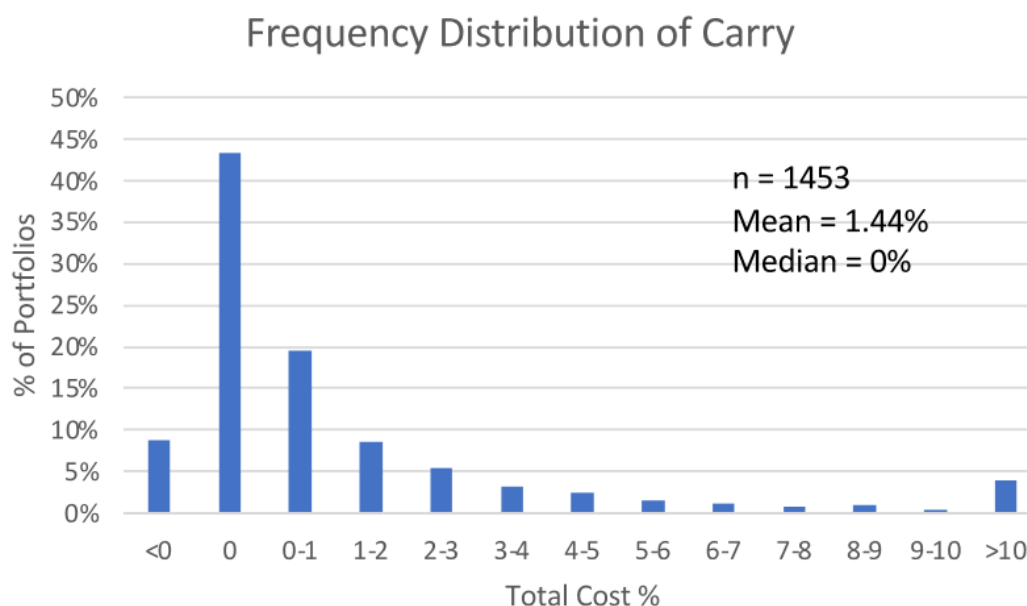
Figure 7: Distribution of Fees 2018-2020



The remarkable thing here is just how skewed the performance fees are – the mean return occurring around the 80th percentile. In addition, there are around 4% of results which are clearly corrections in excess of the ad valorem fees.

The distribution of performance fees is shown as Figure 8 from the ClearGlass dataset.

Figure 8: Performance fee distribution 2018 – 2020.



In this period, 9 percent of funds found it necessary to rebate some part of previously accrued fees (“clawback”) and 44% were unable to claim any performance fee.

The most contentious area of private market investment is of course the returns achieved by investors. The British Private Equity and Venture Capital Association (BVCA) report for realised returns: *“Across the industry as a whole since 1991, investors have received 1.43 times their original capital invested.”* This is in fact a very poor return for an investment of the ten-year term that is meant to be the typical private equity commitments, just 3.6%. Even if we consider the BVCA’s total returns figure of 1.80 times the original investment, the return is just 6.0% over ten years and that figure is inflated by any performance fees deductible on the unrealised portion. These figures really do not reconcile with the BVCA’s statement: *“Industry return since 1991, 15.1%. Overall industry since inception internal rate of return since 1991.”* In order to reconcile those two sets of figures, it would be necessary for the experienced term of investment to have been just 2.55 years for the 1.43 realised return, or 4.2 years for the 1.80 unrealised return.

Given these confusions, and difficulties establishing relevant benchmarks, it is perhaps worth considering the reported experience of a group which has been a major investor in private equity funds, US State Pension Plans. Over the past ten years this shows private equity failing on average to outperform US equity.

Table 4: Ten Year returns US State Pension Schemes

	US Stocks	Private Equity
Highest return	15.02	16.91
Median	13.17	12.65
Mean	12.9	12.75

Source: Clearwater

Questions.

The consultation poses the following five multi-part questions:

Question 1a: Would adding performance-based fees to the list of charges which are outside the scope of the charge cap increase your capacity and appetite, as a DC scheme, to invest in assets like private equity and venture capital? Are you already investing in assets like private equity and venture capital, and if so would this change increase how much you invest? If you do not currently invest in such assets would this change make it more likely for you to, and do you have an idea of to what % of AUM that might be?

Question 1b: Would adding performance-based fees from the list of charges which are outside of the scope of the charge cap incentivise private equity and venture capital managers to change their fee structures?

Question 1c: If you do not believe that the proposal outlined in this consultation is the right solution to the barrier posed by the regulatory charge cap, what might be a more effective solution?

Question 2: How can we ensure members of occupational DC pension schemes invested in default funds are sufficiently protected from high charges, whilst adding the performance-related element of performance fees to the list of charges outside the scope of the charge cap?

Question 2a: Do you have any suggestions for how we can ensure that the regulations ensure members are only required to pay fees when genuinely realised outperformance is achieved?

Question 3: Which of these conditions should the government apply to the types of performance-based fees that are excluded from the list of charges subject to the charge cap? Are there other conditions we should consider? If supported by guidance on acceptable structures would this give confidence to more schemes?

Question 4: Do you agree with our proposal to require disclosure of performance fees if they are outside the scope of the charge cap? If so, we propose this is done in a similar way to transaction costs – do you agree? Could you provide details of any new financial costs that could arise from a requirement to disclose performance fees? Please outline any one-off and ongoing costs.

Question 5a: If we add performance fees to the list of charges which are not subject to the charge cap, do you agree that we should remove the performance fee smoothing mechanism and the pro-rating easement from the Charges and Governance Regulations 2015?

Question 5b: Is there a need for transitional protection arrangements to be brought in for schemes that have decided to make use of the performance fee smoothing mechanism, and if so what do these transitional arrangements look like?

Responses

We responded negatively to the earlier consultation, arguing that the charge cap should not be relaxed. We continue to hold that position and believe that the arguments we advanced against relaxation apply with no less force to the proposed exemption of certain forms of investment from the charge cap. It is worth emphasising again that we believe the charge cap has been a highly effective piece of consumer protection regulation. This is especially true at a time when significant amounts of savers have only just started saving regularly for their pension due to the success of automatic

enrolment, but when contribution rates still remain significantly below what would be considered an adequate savings rate.

We find little or no support for the private equity industry's claims to be adding value to the companies and securities in which they invest. As these claims underpin their arguments in favour of 'performance' fees, we believe that investment structures of this form are wholly inappropriate for DC pension funds.

The problem is rather less the classic 'run-on-the-fund' such as we saw with the Woodford funds, though forms of that are possible, but rather more the effect on DC scheme member confidence. If fund valuations are over-optimistic, member contributions are likely to be over-confident and save less, at a time when many are not saving enough. If the over-optimism in valuation only comes to light in a day of reckoning at the end of the contract, it is simply too late to repair the damage.

We also worry that continuation funds may allow managers to extract unwarranted performance fees while deferring losses to later generations of fund holders, who would have no recourse for recompense.

The industry claims that performance fees align the interests of investor and fund manager, of limited and general partners. That may be, in part, true, but it comes at the cost of incentivising managers to overstate the performance and value of the fund, throughout the life of the fund. But, under how many performance fee structures does the fund manager have 'skin in the game'? Performance fees create an incentive to take more risk with other people's money. If the bet pays off, collect your performance fee. If the bet does not, the investor loses real money. The fund manager has not lost any money unless it has 'skin in the game'.

There are also potential conflicts of interest as the SEC notes: *"Private equity firms often have interests that are in conflict with the funds they manage and, by extension, the limited partners invested in the funds. Private equity firms may be managing multiple private equity funds as well as a number of portfolio companies. The funds typically pay the private equity firm for advisory services. In addition, the portfolio companies may also pay the private equity firm for services such as managing and monitoring the portfolio company. Affiliates of the private equity firm may also play a role as service providers to the funds or the portfolio companies. As fiduciaries, advisers must make full disclosure of all conflicts of interest between themselves and the funds they manage in order to get informed consent."*

While the manager's carried interest may only be removed from the fund at maturity of the fund, the overstatement of interim values will have created extra revenues from the *ad valorem* element of the fee structure. We have seen many corrections to valuation taken as losses in the current usually final reporting period, we have seen no restatements of prior valuations. Figure 8 earlier shows the distribution of performance fees or "carry".

In addition, the overstatement of profitability increases the apparent value of the stock of the management group, making it more attractive than warranted in stock-based acquisitions. The private equity industry has, in recent years, been acquiring traditional fund managers in 'paper-based' transactions at a remarkable pace.

Before moving to the specific questions in the consultation, it is worth noting that these questions are limiting the scope of response to those who are managers or trustees of pension funds, or similar. This, therefore, excludes a wider set of expertise and evidence that may be relevant to understanding the complexities and relative costs and benefits to the proposal. The questions below have therefore

been answered based on the experience of one of the authors running a Family Office and DB pension funds.

Question 1a: Would adding performance-based fees to the list of charges which are outside the scope of the charge cap increase your capacity and appetite, as a DC scheme, to invest in assets like private equity and venture capital?

Clearly, removal of these classes of charges and fees from the scope of the cap would enhance the capacity of our DC schemes to make and hold these investments, but it would not enhance our appetite. Some such as VC with their lottery-like pay-off profile will remain wholly inappropriate for any form of pension scheme. Similar doubts exist with respect to early-stage investment in infrastructure; cost escalations and construction time over-runs, particularly in larger projects, are commonplace. In these cases, equity is wiped out and debt written down severely. The story of Eurotunnel is worth remembering: <https://www.connexionfrance.com/Archive/Channel-Tunnel-is-20-years-old-today> Indeed, exemption from the charge cap would reduce our appetite for them in our DB funds and Family Office portfolio.

As is evident from the trade press ‘news’ stories, papers and webinars, the mere prospect of this removal has seen a plethora of new entrants to these markets, with traditional fund managers, in particular, looking to expand their range of activities into these markets. It is clear that the asset management industry sees private investment by DC schemes as a major opportunity; one they are actively encouraging. Quite how these new entrants propose to justify their use of performance fees is not yet clear.

The private equity industry has, by some accounts, more than one trillion US dollars of ‘dry powder’, funds available for investment.⁸ Competition is already extremely high; the terms on which transactions are being finalised make them extremely expensive for investors. It is notable that foreign competition has displaced UK investors in much domestic infrastructure investment⁹. Adding further funding from UK DC schemes can only exacerbate that. It seems that international competition for UK infrastructure assets is causing many UK investors to look overseas.

Are you already investing in assets like private equity and venture capital, and if so would this change increase how much you invest?

We have long invested in illiquid instruments for our DB funds and Family Office. In addition to commercial and residential property, we have also participated in fixed income private placements and have opportunistically bought private debt in the secondary markets. We have never paid a performance fee on any of these investments.

We do not invest in debt funds and if we were to do so, we would certainly not offer performance fees to the managers. Unless the fund is buying exclusively in the secondary markets, any excess returns can only come from the company receiving the investment. Charging companies in this manner would be detrimental to its productivity and possibly to employment and the community. If the purchases are secondary market purchases, they have no impact on the company’s finances or productivity. Table C2 later compares private debt performance with a range of fixed income comparators – there appears to be little advantage gained relative to these liquid traditional methods

⁸ <https://www.internationalinvestment.net/news/4035384/private-equity-firms-deploy-dry-powder-economic-recovery>. The BIS quarterly review reports “dry powder” globally as being \$3.18 trillion citing Pitchbook data.

⁹ see the further discussion in the House of Commons Work and Pensions Committee ‘Pensions stewardship and COP26’ Report published on 30 September 2021 at Chapter 4 referred to earlier.

at the gross level and at the net after fees level, some underperformance. With costs and fees at four to ten times those of traditional fund management, these clearly represent an extremely poor value for money.

We have never bought VC for the DB funds. We have been active in VC for the Family Office since 1982 and have made a total of 217 distinct direct investments over that time. 29 of these proved total write-offs. Just 11 of those investments returned more than 100% and these accounted for all the outperformance relative to listed equity. Initially, we had a policy of participating in second and subsequent round financings of investee companies but abandoned that policy as the valuations those financings grew to levels we believed far too high. We have sold all these investments, in many cases, and particularly the lack-lustre ones, to the management of the company. We completed the sale of our last direct investment three years ago.

In recent years, we have investigated the markets for 'follow-on' financing but on the few occasions when we made offers, we were outbid by sovereign wealth funds. For both the pension fund and Family Office fund, we have bought private equity and hedge funds since the early 1980s but no longer own any. The motivation for ceasing was disappointment with the performance achieved.

If you do not currently invest in such assets would this change make it more likely for you to, and do you have an idea of to what % of AUM that might be?

We do not currently have any of these assets, and this proposed change would reinforce our decision not to buy. Furthermore, it would add to our currently active consideration of sale of the UK listed equities we currently own.

Question 1b: Would adding performance-based fees from the list of charges which are outside of the scope of the charge cap incentivise private equity and venture capital managers to change their fee structures?

No. It is most likely to have the opposite effect, encouraging private equity and venture capital managers to resist pressures to lower fees.

Question 1c: If you do not believe that the proposal outlined in this consultation is the right solution to the barrier posed by the regulatory charge cap, what might be a more effective solution?

The charge cap serves its purpose – protecting pension savers. It has contributed to the lowering of costs of DC schemes. Performance fees operate at multiples of the fees currently charged for traditional asset portfolios and there is no substantial or sustained evidence that this is warranted.

Diverting pension savings from traditional assets such as equity has already damaged the standing of the London Stock Exchange, exempting these asset classes will add to that damage. There is already a structure which would serve DC investors well – the listed investment trust. These could hold as their assets one or more of these funds, with those funds charging performance fees. The listed equity would have the advantage that it would have a quoted price at which investors might sell if they so wished and moreover the price itself would carry information with respect to the market's view of the performance of the investment trust's investments, and the quality of the manager's valuations. Some do already exist – see Appendix B and also here: https://citywire.co.uk/funds_insider/investment-trusts/best-investment-trusts-by-sector.aspx?citywireclassid=24. If the DC investor's retirement account is invested in an index tracking fund that includes the FTSE All-Share Index, the DC investor will already have some exposure via these investment trusts to private equity and venture capital.

The question which should be asked is why the managers of these illiquid funds resist listing as investment trusts – one cannot help but wonder if they wish to avoid the scrutiny.

Question 2: How can we ensure members of occupational DC pension schemes invested in default funds are sufficiently protected from high charges, whilst adding the performance related element of performance fees to the list of charges outside the scope of the charge cap?

The short answer is that it cannot be done. Using hurdle rates is simply recognition that performance fees are inappropriate for the range of returns below that rate. It is rather less that high charges are to be avoided, but rather more inappropriate performance fees.

Question 2a: Do you have any suggestions for how we can ensure that the regulations ensure members are only required to pay fees when genuinely realised outperformance is achieved?

It would be extremely difficult to base *ad valorem* fees solely on realised values – in traditional fund management they are based on unrealised market prices for the portfolio held, and the implicit understanding is that this could have been realised. The problem with private illiquid values is that these may prove spurious.

This is not a problem for carried interest if all carried interest is held, perhaps in an escrow account, until the final liquidation and wind-up of the fund; the final valuation might then show a large loss correcting earlier over-estimates (and many do show such losses).

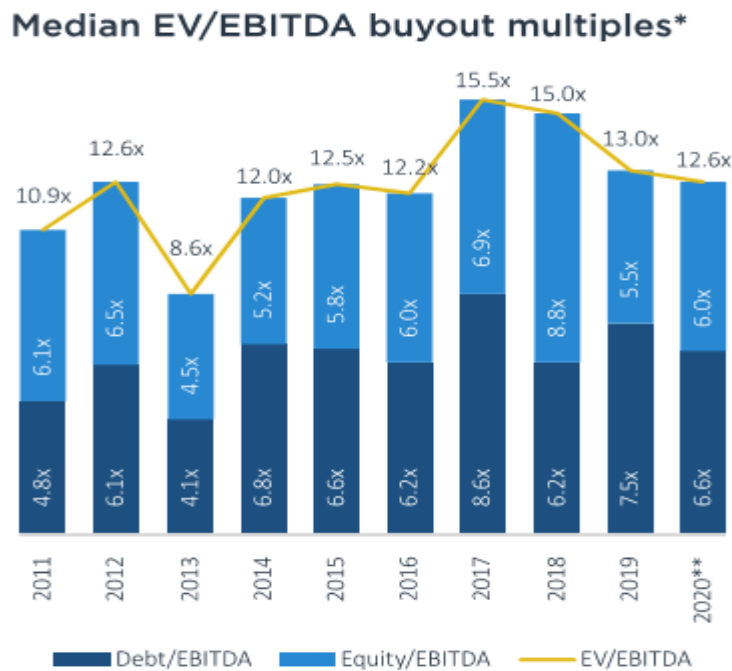
Using an external pricing source or basing fees on audited values would raise questions as to the frequency (and therefore cost) of these valuations. For *ad valorem* fees, it should be possible to allow the drawing of these fees provisionally based on the manager's valuation, and for the auditor's value then to override requiring the immediate repayment of anything in excess of that due under the auditor's valuation.

Distributions made prior to the maturity of the commitment are also potentially problematic and can affect the estimate of the return earned over the life of the fund. Distributions are usually part repayment of funds invested and part return on an investment, but it is not always simple to establish this distinction. Distributions may take the form of cash or stock and are not always final – they may be in part or wholly recallable.

Furthermore, there are some issues with leverage. It is well documented that private equity held companies have about twice the indebtedness of listed companies, and though that may raise questions as to the true value-added of a manager, it is leverage within the fund which is the issue – so-called subscription lines. Where these function as originally intended (short-term bridge finance) they are not problematic, but at longer maturities this is gearing and usually occupies a senior position in the creditor hierarchy.

The internal leverage of private equity is best measured by the net debt to EBITDA ratio; this is shown in Figure 9.

Figure 9: Net debt to EBITDA ratio



Source: PitchBook | Geography: UK & Ireland
 *As of December 31, 2020
 **In 2020, EV/EBITDA counts were less than 30.

Net debt to EBITDA ratios in excess of 3 are usually considered problematic, with the exception of highly regulated industries such as utilities. To offer some comparisons, firstly as interest rates have declined companies have increased their levels of borrowing – over the past twenty years, the net debt/EBITDA ratio of the S&P 500 has increased from 1.5 to 2.3. Table 5 below shows the ratios for a selection of London market indices. It is only real estate and regulated utilities, with their stable income flows which have comparable debt ratios to those of private equity.

Table 5: Net Debt / EBITDA ratios 2021

FTSE All-Share Index	0.48
FTSE All-Share Real Estate Investment Trust	6.17
FTSE All-Share Gas, Water and Utilities	6.47
FTSE All-Share Consumer Discretionary	3.19
FTSE All-Share Pharmaceuticals	2.31
FTSE All-Share Retailers Index	1.55
FTSE All-Share Industrial Engineering	1.19
FTSE All-Share Technology Hardware and Equipment	2.38
FTSE All-Share Basic Materials	0.55
FTSE All-Share Telecommunications	3.01
FTSE All-Share Utilities Index	5.08

Source: London Stock Exchange

Incidentally these levels of internal and external leverage render untenable the private equity industry's claim that private equity is less risky or less volatile than listed equity. These leveraged companies are more precarious than their listed counterparts – and with that employment and their role in the community is also more precarious. The need for an investee company to support the debt service of fund borrowings adds to its precarity.

The leverage also reduces the amount of tax paid, where the interest is tax-deductible from UK profits and is paid free of UK withholding tax to an offshore company based in a low tax jurisdiction, and so amounts to a taxpayer subsidy under which gains are privatised and the losses are borne directly or indirectly by the taxpayer¹⁰ when the overleveraged company fails.¹¹

We are sorry to say that we have never seen a wholly satisfactory and universally applicable method of calculating the returns of a private illiquid fund. Even if we confine ourselves to the ex-post evaluation when all cash flows are known, the different timings of distributions can make comparison of different funds impossible.

All of these problems go away for the investor if the investment takes the form of an investment trust, though of course they remain for the investment trust itself.

¹⁰ Source: <https://www.ft.com/content/426c1465-9561-4300-8d3e-2430e4124c93>

¹¹ We note that HMRC has recently limited the deductibility of interest to 30% of an investee company's EBITDA in any given year.

Question 3: Which of these conditions should the government apply to the types of performance-based fees that are excluded from the list of charges subject to the charge cap? Are there other conditions we should consider? If supported by guidance on acceptable structures would this give confidence to more schemes?

We do not support the idea of excluding any performance fee based investments from the charge cap. If there are to be exemptions, then it should be incumbent on the fund manager to also report the return experienced by the investor based on their notional committed funds, while performance fees are based on drawn and invested funds. It would be necessary to specify the cost of committed undrawn funds to investors to do this.

At a more basic level, the valuation of the fund should be audited at least annually. The cost of audit should be borne by the fund manager or general partner.

These actions would tend to increase investor confidence.

Question 4: Do you agree with our proposal to require disclosure of performance fees if they are outside the scope of the charge cap?

If performance fees are outside of the cap, they should certainly be disclosed. Any *ad valorem* fees should remain within the cap, as appears to be proposed.

We have been unable to reproduce the figures quoted in the consultation for fees within and outwith the cap – for example, in the 2 + 20 instance, our calculations for the all-within-cap variation show fees at 85.3 basis points on the initial investment and 78.4 basis points on the net residual one year value.

We would also make the point that with the return assumptions made, and no rebalancing possible in reality, the portfolio will over time skew to higher allocation to VC. After one year the portfolio is 10.6% VC.

If so, we propose this is done in a similar way to transaction costs – do you agree?

Yes

Could you provide details of any new financial costs that could arise from a requirement to disclose performance fees? Please outline any one-off and ongoing costs.

The performance fee is already calculated by the fund manager. Its disclosure would have no additional costs.

Question 5a: If we add performance fees to the list of charges which are not subject to the charge cap, do you agree that we should remove the performance fee smoothing mechanism and the pro-rating easement from the Charges and Governance Regulations 2015?

Yes.

Question 5b: Is there a need for transitional protection arrangements to be brought in for schemes that have decided to make use of the performance fee smoothing mechanism, and if so what do these transitional arrangements look like?

We believe that very few schemes, if any, have availed themselves of the smoothing mechanism. If they have investments with fees being treated in that way, there is no need for any transitional – existing investments being accounted for under that simply ceased to be counted in that manner once the exemption is introduced.

As several of our reviewers suggested that we should include this, Box 1 below contains the form of fee structure we believe necessary to protect DC pension investors.

Box 1 Fee structure if Performance Fee is exempt from the Charge Cap.

If the performance fees for VC and PE are excluded from the charge cap and these asset classes become easier for DC pension funds to use, we believe that a number of further protections for those investors are needed.

The change we propose is from a fee structure which is ad valorem plus performance, to one which is the higher of ad valorem or performance fee.

The ad valorem fee should be levied on the value of deployed funds, and this should fall within the overall 0.75% charge cap. We find the sometimes-seen application of an ad valorem fee to committed funds completely unacceptable. Ad valorem fees calculated in this manner may be withdrawn from the fund.

The performance fee element should be performance in excess of a hurdle rate, which we would suggest should be 8% per annum for equity related funds. Performance fees should be expressed and levied on the rate of return achieved on the committed funds, not those deployed in investments. The performance fee charged should be the aggregate limit payable; in other words, the performance fee chargeable should be net of the ad valorem fee.

How this would work in practice

The following worked examples illustrate these points: suppose we have a £100 million fund which has 25% invested which returns 30%. The fund has an ad valorem fee of 2% of assets under management and the performance element is 20% of returns above 8%.

The ad valorem fee would be 2% of the deployed value of the fund which in this case would be 2% of £32.5m [$£25m * 1.30 = £32.5m$]. This is £0.65 which when deducted from the value of the fund leaves £31.85.

The calculation of the performance fee is based upon the value of the committed and deployed amounts [$£75m + £31.85m = £106.85m$] but as this is below the hurdle rate of 8% on committed funds no performance fee is payable.

If we increase the return performance of the deployed assets from 30% to 40%, the ad valorem fee rises to £0.70.

The value of the committed and deployed funds is now [$£75m + £34.3m = £109.3m$] and the 20% fee on the performance in excess of 8% is [$£109.3m - £108m = £1.3$] * 0.2 = £0.26m.

But as this fee is less than the ad valorem fee, no performance fee is payable.

Finally, we will consider the case when 75% of the fund has been deployed and these investments have a current value of £105.

Here the ad valorem fee will be £2.1m and the committed and deployed value after deduction of that fee is £127.9m.

This is £19.90 in excess of the 8% hurdle rate, which implies a performance fee of £3.98m which, after deduction of the ad valorem fee, is £1.88m and this is the amount payable to the manager.

The investor receives a net £123.92 and the Fund Manager a total of £3.98.

Appendices

A: Challenging – Questions, questions, and a very short answer.

The Prime Minister, Boris Johnson, and Chancellor, Rishi Sunak recently issued a challenge to UK institutional investors, calling for us *“To seize this moment, we need an **Investment Big Bang**, to unlock the hundreds of billions of pounds sitting in UK institutional investors and use it to drive the UK’s recovery.”*

They seem to have noticed that the ONS estimated UK private pensions wealth, in March 2018, at £6.1 trillion of a wealth total of £14.63 trillion, greater even than property. However, what they don’t seem to have noticed is that it is already invested. So, the first question: who is going to buy the assets these institutional investors would need to sell?

As is to be expected, there is the not-so-veiled threat in the challenge letter: *“The Government is doing everything possible – short of mandating more investment in these areas as some have advocated - ...”* If nothing else, these politicians understand the electoral consequences of that putative action.

The explicit challenge is: *“Whether you are a trustee or manager of a DC or DB pension fund, running an insurance company or advising investors on their investment strategy, we are challenging you this summer to begin to invest more in long-term UK assets, **giving pension savers access to better returns (emphasis added)** and enabling them to see their funds support an innovative, healthier, greener future for their country.”* Of course, seeing an innovative, healthier, greener future is irrelevant to the discharge of my fiduciary duties. So, the second question: if these investments are going to yield such attractive outcomes, surely, we should finance them with gilts and reap the rewards as a nation? A subsidiary and trivial question: when will you publish the analysis supporting this ‘better returns’ assertion?

The Pensions Regulator has relaxed its 20% quota for illiquid investments to accommodate this agenda. It is notable, though, that they have not scrapped their proposed DB funding code with its objective of low dependency on the corporate sponsor, run-off and wind-up.

They seem not to have noticed one of the principal effects of quantitative easing had been to lower the price of liquidity to record lows levels – one consequence of which has been that the investment banks now maintain far lower inventories of debt securities than previously. Buying long-dated debt securities at today’s inflated prices will prove extremely costly should normal times return, to those fool enough to do it.

There are other worrying statements, such as: *“We are reviewing the prudential regulatory regime for the insurance sector (Solvency II), ...”* Playing fast and loose with insurance security is not a good idea. It is bad enough that increased issuance of long-dated illiquid securities will permit even more ‘matching adjustment’ magical accounting and capitalisation.

*“Our Ministers and officials will be in touch during the coming weeks ... to invite **those institutional investors who are willing to make specific commitments to invest more (emphasis added)** in Britain’s long-term growth to join us at an Investment Summit in Downing Street in October.”*

My response to these challenges is to decline. I will continue to exercise my fiduciary duty seeking the best investments for my scheme membership wherever they may arise. And of course, I will not and cannot in the exercise of those obligations buy “green gilts” at a premium to conventionals.

B: A Response to the DWP Consultation on Illiquid Investments and Performance Fees

Dr Con Keating

Chair, EFFAS Bond Commission

April 2021

- 1) It would not be surprising if the DWP were swamped by responses to this consultation from the 'alternative investments' industry and their lobbyists. I hope that you will recognise these as vested interests. I am writing this as Chair of the Bond Commission of the European Federation of Financial Analysts Societies. My response is grounded in my more than fifty years of experience managing investment portfolios institutionally.
- 2) There is nothing intrinsically objectionable to the purchase of illiquid securities by 'pension' funds. Strictly speaking DC funds are merely tax-advantaged savings accumulation arrangements. The draft of the new Code of Practice outlines the current position on investment decision-making:
- 3) "Governing bodies of trust-based pension schemes with 100 members or more must invest in a way that ensures security, quality, reasonable liquidity and profitability for the scheme as a whole. ... The law also requires these governing bodies to invest scheme assets predominantly in regulated markets. Unless there are exceptional circumstances, governing bodies should ensure no more than a fifth of scheme investments are held in assets not traded on regulated markets." However, it appears that many large DB schemes have allocations materially above this 20% limit; for example, in their 2018 valuation, USS report that 23.7% of the assets of their implemented portfolio are invested in "Private Markets".
- 4) There are though some further significant concerns. The first of these is that such assets may prove extremely difficult to realise in response to demands from the holders of fund units. We have seen this occur recurrently with respect to conventional property funds in times of market and economic stress. Denying immediate access ("gating") to the value of a unit-holder's claim may serve to reduce 'fire-sale' losses of value, but that is far from guaranteed. The classic recent exemplar is the liquidation of the Woodford funds.
- 5) There is in general a problem with the valuation of illiquid instruments. They are marked to model, not marked to market; the result of this is that their valuations will appear far less volatile than their market traded counterparts. In the case of property, it is common to see wide variation between the performance of a property company's net asset value, a modelled value, and its market price. The net asset value (model) of Land Securities fell by 9% in the six months to March 2020 while the share price (market) declined by 35%[\[1\]](#). As volatility is the most widely used measure of risk, this allows the unscrupulous to present, and the uninformed to consider illiquid investments as being less 'risky' than their traded counterparts.
- 6) Portfolios of illiquid investments may often be 'hollowed out' by these methods of valuation. With private equity, the successful investments within a fund may be realised by sale at values which are at or above their modelled values, while the 'lemons' continue to lie within the fund and tend to increase in number with the passage of time. These 'lemons' may, ultimately, only

be realised at a small fraction of their modelled value. In the meantime, the private equity manager has reported and collected fees on a strong performance.

- 7) The valuation problem is much less acute for bonds and debt securities, provided there is clear and timely disclosure of financial condition by the issuer. The debt financings for infrastructure projects should fall into this class of illiquid investments.
- 8) There is no natural linkage between illiquid investments and performance fees. In fifty years of investment in (commercial, industrial and residential) property, I have never even been asked to pay a performance fee to a manager. Similarly, I have never encountered performance fees for illiquid untraded debt securities. They are certainly not necessary features of infrastructure project financing.
- 9) If there is a case for performance based managerial fees, these should be a matter of contract between the entity and those managers, not related to the performance of investments in those entities.
- 10) This brings me to a current concern. As a result of quantitative easing, the price of liquidity is currently at or close to an all-time low. One result of this has been that the investment banks have cut their inventories of traded debt securities by well over 90%, as the creation of this credit has not been sufficiently well-compensated for them^[2]. The chase for yield by pension funds and insurance companies has spread widely across the different classes of investments, driving prices up and future returns down. Given that it is likely that we will eventually return to market conditions where liquidity is appropriately priced, the idea that pension funds should be buying illiquid instruments now is clearly misguided.
- 11) Performance fees are largely confined to 'alternative' investments. Hedge funds are typically no more than investment strategies operating in liquid securities markets. The lock-up periods associated with these have no relation with the liquidity of their investments, which are overwhelmingly traded securities. By accepting these lock-ups, the investor should be expecting to receive more than when investing in a UCITs-type mutual fund. There was evidence early in the development of hedge funds that there were excess returns to investors, though when corrected for the leverage involved these returns were little different from unlevered market allocations. As strategies operating on market securities, we should not expect an excess return from hedge funds.
- 12) The most popular early form of private equity, the leveraged buy-out fund, also showed strong excess returns. However, it was subsequently shown that the majority of this outperformance came about from the disenfranchisement of the prior debtholders. As this led to stronger bond and debt covenants in corporate financings, this source of performance has been eliminated. This brings us to private equity. There is a considerable body of academic and practitioner research^[3] which shows that there are no material gains from private equity above those of listed equity markets. Indeed, there is evidence of substantial failure, as may be gauged by the table below, which shows the experience of a major US DB fund (L.A. County) with many billions of PE investments. The benchmark is the Russell 3000 index.

	Realised	Benchmark
One Year	13.71	21.47
Three years	12.64	14.89
Five Years	11.81	15.86
Ten Years	12.44	14.42

This experience marries well with the observation here in the UK that the total costs, that is ad valorem and performance fees, associated with private equity are typically in the range of 3% – 5% p.a.

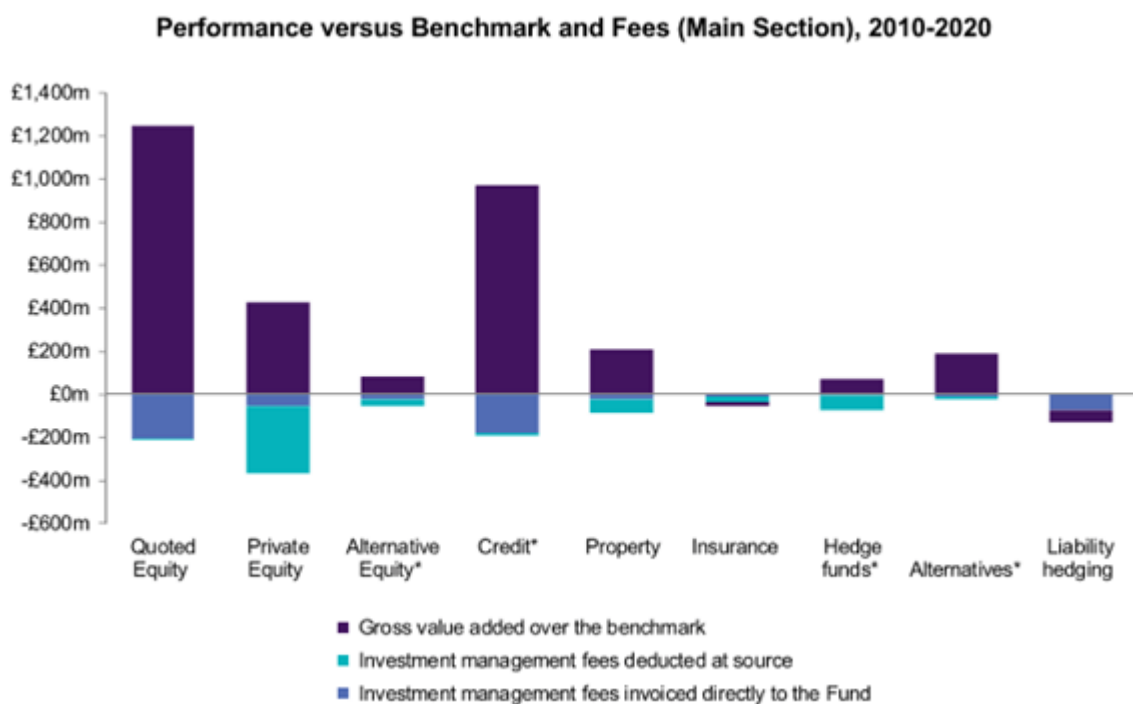
- 13) There are sound theoretical reasons to expect the returns to leveraged buy-out funds and private equity, more generally, to be lower than those of listed equity. These funds are typically buying liquid securities, and in doing so, paying the liquidity cost of the market at that point in time and in addition, they are paying a ‘control’ premium. If their exit is by way of a public sale, they may expect to receive the liquidity premium at that time, though they will have borne the costs of a public offering to achieve that.
- 14) It happens that the current outlook for private equity is not stellar. Funds have unprecedentedly high amounts of uninvested cash and also access to extremely high levels of leverage, resulting in extremely high prices for the companies they might wish to buy.
- 15) It should be said that the presentation of the returns of private equity funds is all too often an exercise in the dark arts. The figures published are almost always those which present the fund in the best possible light and allow the manager to extract maximal fees.
- 16) I would also point out that all of these ‘asset classes’ can all already be bought on the London Stock Exchange where they are listed and traded as closed end investment trusts; for example: Pantheon International plc (private equity); 3i Infrastructure plc (infrastructure); BH Macro Limited (hedge funds) and Tritax Big Box REIT plc (property). The investments made by these closed end investment trusts can pay whatever performance fees they feel appropriate. In addition, of course, these investment trusts do not suffer the liquidity problems of ‘gating’ and the like, as the pension fund owns and can trade shares in the investment trust in the market. Indeed, an investment trust could consist entirely of illiquid investments, with no effect on its share price. The proposal to modify the charge cap is not only unadvisable, but also unnecessary for the promotion of investment in the desired classes and forms.

Conclusions

- 17) In moderation, illiquid instruments could serve to increase the returns achieved by ‘pension’ funds. However, this should be limited in extent, unless it is proposed also to restrict the ability of scheme members to switch funds (and cash).
- 18) There is no reason at all to associate illiquid investments with performance fees. Indeed, performance fees applied to the capital of a firm, and the returns on the instrumental claims on that, are misplaced. Such fees should be applied to and contained within the performance of the firm.
- 19) The so-called alignment of interests of manager and investor through the use of performance fees is more Potemkin village than reality; there is a clear principal/agent conflict.
- 20) The charge cap has led to lower costs for pensions savers, though there are still some evasions which need to be addressed. It has been a success. The proposal to accommodate performance fees by smoothing over many years would be a mistake; it would misrepresent the true position of the fund and raise costs while the gains seem likely to prove illusory.
- 21) As all of these alternative asset ‘classes’ may be accommodated within closed end investment trusts, modification of the charge cap is unnecessary.

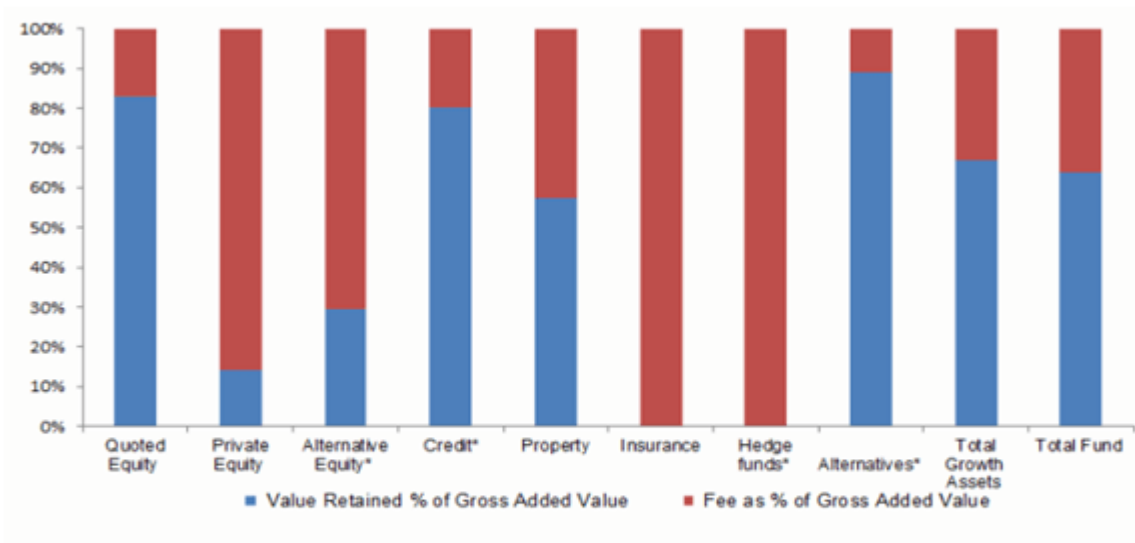
Postscript

- 22) Since writing and submitting this response, my attention was drawn to the following analysis of the costs and charges of NatWest schemes. Firstly, we are shown the benchmarked income and fee expense of different classes of assets held by the scheme over the period 2010 – 2020.



- 23) There are not many conclusions which can be drawn from this analysis alone, though it is interesting that liability hedging is costly, as should be expected, though rarely recognised. The NatWest analysis continues with a breakdown of the proportions of gross value added retained by the scheme and paid to the fund managers involved.
- 24) This is a most basic measurement of value for money. It is striking that hedge funds and insurance had fees and charges which were as high as or higher than the investment returns earned. Private equity is also striking with some 85% of the gross value added being paid away to its managers. The sectors offering the best value for money are quoted equity and credit, the traditional asset classes of DB schemes.
- 25) The final figures show that the NatWest scheme has been rather well managed in the sense that over this time they have reduced management costs markedly. The reductions have saved the scheme 1.45% of its value to date and hold the prospect of saving almost 16% of its value over the coming forty years.

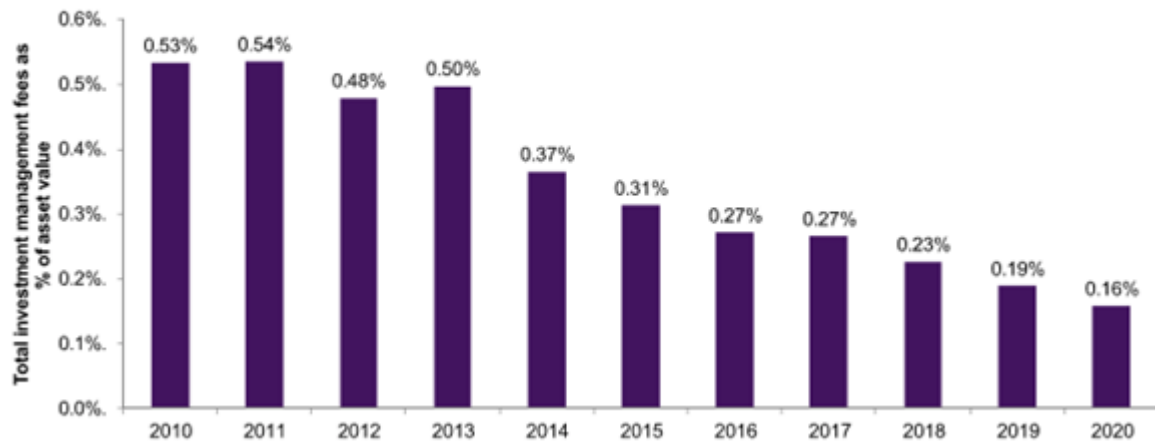
Value Retained and Fees as a percentage of Gross Value Added (Main Section), 2010-2020



* Benchmark against value added over GBP Cash + 3%. In 2015, Alternatives were split into Alternative Equity and Credit while Hedge Funds were removed.

The fees shown in the chart above include both fees deducted at source and fees invoiced to the Fund. The fees detailed in note 12 of the accounts exclude fees deducted at source (including performance fees and carried interest).

Fees as a Percentage of Assets (Main Section), 2010-2020



[1] The reported NAV was £11.82 at end March 2020, while the share price was £5.57, a 53% discount. I am indebted to the Secret Pension Fund Manager for this illustration.

[2] There are further relevant measures of the price of liquidity, such as the on-the-run/off-the run spread of US Treasuries. There are also measures of the quantity of liquidity, such as the volumes of new debt security issuance and secondary market turnover, most of which is now brokered rather than principal account traded.

[3] See, for example the work of Peter Morris and Ludovic Phalippou of the Said Business School Oxford. There are also commercial performance analysts who have similar findings – see Chris Sier, Clearglass and Henry Tapper, Agewage.

C: A Roadmap for Increasing Productive Finance Investment

We consider here the case for investment in less liquid assets and the current DC pension scheme landscape as set out in “A Roadmap for Increasing Productive Finance Investment”. We note first that the sole element considered is the use of illiquid investments within DC pension funds. The paragraph numbers are those of the Roadmap Report – blue typeface indicates a verbatim quotation from that report.

1. Investment in long-term, less liquid assets, managed appropriately, can help savers secure higher net returns.

We agree with this statement. However, we would note that the Roadmap Report does not address the most elementary questions surrounding liquidity: what is the price of liquidity, how might we measure that and how does it vary with security instrument structure? The failure to address these questions undermines most of the conclusions of the report. The report consistently and incorrectly refers to an “illiquidity premium” when it is in fact liquidity which has a cost.

2.1. THERE IS A STRONG CASE FOR INVESTMENT IN LESS LIQUID ASSETS AS PART OF A DIVERSIFIED PORTFOLIO..

If we are to consider investment as part of a diversified portfolio properly, we need to consider prices, returns, and their volatility, and the correlation among assets on common terms. None of the analysis presented does this adequately. Nor does it present any evidence to the contrary, and there is much out there that would challenge the underlying case being made.

2. Pension scheme members receive regular illustrations setting out their projected investment returns under the assumption of high, medium and low returns. The gaps between these are typically material and can make the difference between a comfortable retirement for members and one that is less so. Investment in less liquid assets, such as infrastructure, private equity (PE) and venture capital (VC), as part of a diversified portfolio – and with the appropriate advice and due diligence - could support pension schemes’ ability to improve retirement outcomes for their members.

This has no evidential value beyond being a statement of the fact that higher returns should produce higher portfolio values at later dates. This of course is true of any form of investment, not simply those being promoted by this working group. Note that the utilisation of the proposed asset classes will require “*appropriate advice and due diligence*” but there is no mention of the costs of this, which is another source of income for the financial services industry.

3. While no investment return can be guaranteed and past performance may not be a good guide for the future, a wide range of literature illustrates how less liquid assets can outperform their more liquid, often listed, counterparts.

There is also a wide range of rigorous academic studies which challenge the existence of excess returns from the asset classes being promoted.

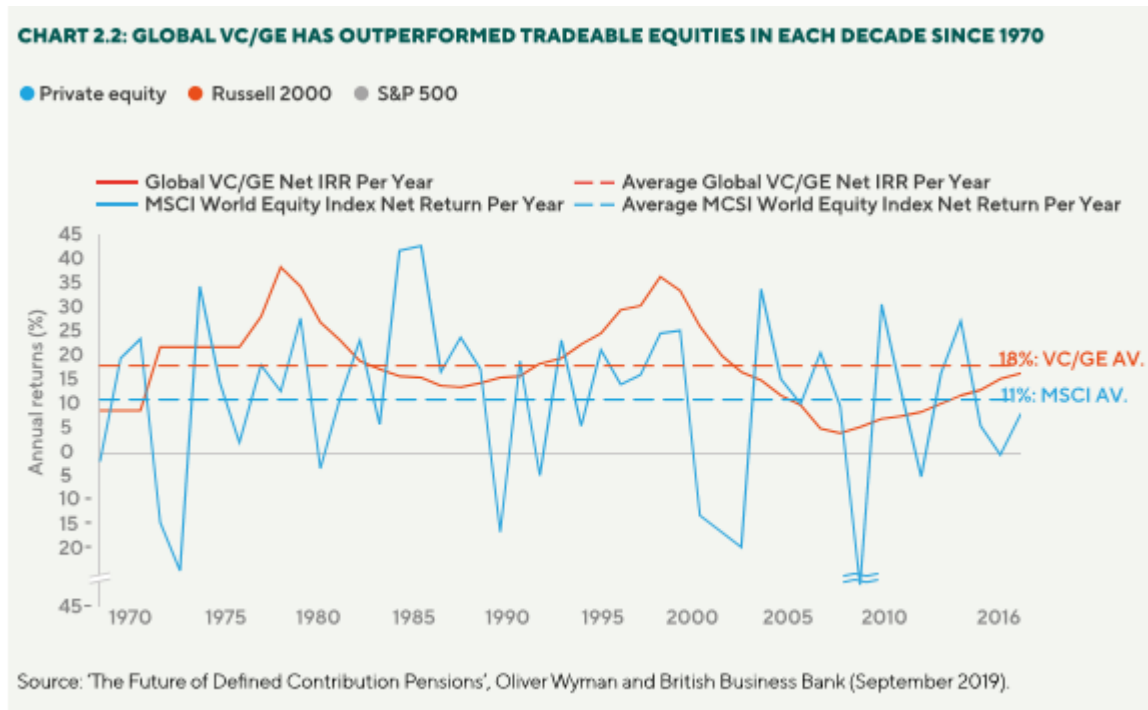
For example, empirical estimates by Oliver Wyman and the British Business Bank suggest that a 22 year-old new entrant to a default DC scheme with a 5% allocation to VC/ growth equity (GE) could achieve a 7%-12% increase in total retirement savings.

This is simply repetition of the earlier problem (see point 2).

This ‘illiquidity premium’ is partly a compensation for more restricted exit opportunities from such investments. And while there is no consensus on the existence and size of this premium, analysis from

the Pensions Policy Institute suggests that it has varied between a 1%-7% increase in returns over the long term.

The cited PPI paper quotes other’s estimates of the return differential but it does no analysis of its own. The 7% estimate appears to be rooted in the British Business Bank / Oliver Wyman publication “The Future of Defined Contribution Pensions, Enabling Access to Venture capital and Growth Equity” The report uses the chart reproduced below to illustrate the situation.



Prior to 1980, VC and Growth Equity were really specialised craft industries which would not warrant the description ‘asset class’, and if there was any international dimension to it, it was carefully hidden. That raises concerns as to the appropriateness of the MSCI world equity index as a benchmark. In addition, prior to 1980, UK international investments were subject to the dollar premium of exchange control regulations.

According to this chart, VC/GE has never experienced an annual loss in the period since 1970, but the earlier Pitchbook chart of private equity returns shows 12 negative annual returns, and 8 which probably should be, in the much shorter period since 2002. The annual losses reported by Pitchbook are not trivially small, they lie in the range -10% to -25%. In the period since 1970, gilts have experienced losses in eleven years, which have ranged up to -10%.

The chart is of course comparing apples with pears: self-reported IRRs versus market-valued equity returns. It is also comparing average rather than median returns. If we had bought the MSCI in 1970 and held this portfolio reinvesting income, we would have achieved the 11% return cited but the VC/GE average shown does not possess this property. To achieve the 18% return shown the portfolio would have had to be rebalanced in each year, with perfect foresight, to the average portfolio of that future year. If there is even a small difference between the annual mean and median returns of the sample of funds, over this time, the chance of any investor achieving 18% is vanishingly small. Moreover, the volatility of this mean figure is irrelevant in the context of portfolio construction.

The further point to note is that these analyses are attempting to compare net returns available to investors and liquidity. There is no mention of the committed but undrawn funds which lower the investment returns achievable by investors. The PPI study refers to a Robeco paper which makes the point: *“It is however not always clear what the required extra return or diversification benefits for the illiquidity should be. Additionally, there are numerous reasons for illiquidity each with their own challenges.”*

There is one indicator of the cost of illiquidity to private equity investors in the sense of the foregone return on assets sold to secondary traders when compared with the return achieved by funds. Table C1 shows the median IRRs reported for global private equity and secondaries for the vintage years 2016 - 2020. The suggested liquidity cost proxy would be the difference in returns realised. The concept is simple – that the secondary purchaser is acquiring the same assets as the fund continues to hold. It is immediately obvious that the cost of liquidity, in the sense of the experienced cost of realising an investment is highly variable and may be very large indeed.

Table C1: Median Reported IRRs

	2020	2019	2018	2017	2016
Global PE %	12.37	15.20	17.73	20.00	19.10
Secondaries %	91.23	37.78	41.54	15.50	21.80

Source: Pitchbook

This is reinforced by the inter-decile ranges of reported IRRs for secondaries; these vary over this period from a low of 22% to almost 200%. One possible interpretation of this is that there is some predatory pricing in the secondary market, such as it is. At the least, it suggests that global private equity is far more volatile in reality than it is in the valuations raised by the managers of these funds.

4. This section begins by repeating claims such as those considered and criticised earlier.

... [There is also some evidence on the potential increased returns from investments in private debt and infrastructure.](#)

The evidence referred to is in fact some Aviva marketing documents. Table C2 shows the mean and median reported IRRs of 787 private debt portfolios held by UK DB pension funds over the period 2018 – 2020. These are returns reported for funds of all vintages held.

The gilt comparator is the FTSE all gilts total return index; the global bond index is the Bank of America/Merrill Lynch global bonds total return reported in sterling terms; the High Yield is the Barclays Capital Very Liquid High Yield index in sterling terms.

Table C 2: Private Debt and some fixed income comparators

Net Returns	Bonds	Mean	Median
	Gilts	5.50	7.1
	Global	5.27	6.5
	High Yield	7.53	7.0
	Private Debt	5.39	5.63
Gross			
	Fees	2.08	1.18
	Private debt	7.36	6.74

Source: ClearGlass.

It is far from obvious here that there is any advantage to private debt though there is clear evidence of the profitability of private debt to its managers. These figures are based upon drawn funds. In terms of value for money, all of the traditional debt asset classes are superior.

5. These potential additional returns could make a material difference to the size of DC scheme members' pension pots at retirement.

Indeed, but this statement is true of all asset classes.

6. Allocating to less liquid assets also offers the benefits of diversification, which can help manage portfolio risk, reduce volatility and enhance returns. For example, adding less liquid assets to a hypothetical portfolio comprised of 60% stocks and 40% bonds would have increased returns and reduced volatility materially between 2004 and 2018 (Table 2.1). These benefits, in part, reflect less liquid assets tend to have a low correlation with other assets.

Allocating to any assets with heterogenous return characteristics will bring reductions in portfolio volatility, but it will only be the addition of an asset class with a higher expected return which will enhance returns. We do not know the correlations used by FS Investment Solutions in generating the table referred to, but another footnote suggests that the Oliver Wyman / British Business Bank study suggests a correlation of around 10% between global VC/GE returns and MSCI World Index returns over 1970-2016, and a correlation of around 40% between global VC returns and US equities over 1990-2018. These are highly questionable values; they are inconsistent with the cross-sectional volatility of private equity funds, and with the volatility of secondary buy-out returns shown earlier.

They are also inconsistent with the fact that private equity owned companies are on average about twice as leveraged as listed companies. This will have the effect of increasing the volatility of the value of their equity. In addition, many funds also utilise leverage in the fund, which will further multiply the volatility of holdings.

There is a further issue. The IRRs reported by private equity and other funds are on deployed, drawn, and invested capital, but the investor has committed to a larger sum and needs to hold reserves to meet further drawdown calls. This will lower the returns experienced by the investor – if 50% is undrawn and held as cash, the IRR experienced by the investor will be half that reported by the fund manager.

7. Investment in less liquid assets can also have broader benefits, including facilitating the financing of long-term projects, such as the transition to a net zero carbon economy.

These benefits are not unique to less liquid assets, they extend to listed equity and debt.

Many less liquid investment strategies involve direct relationships with the underlying business or project, which can offer investors greater influence over environmental, social and governance (ESG) or sustainability issues by reducing agency problems.

This is again a very broad statement with no obvious evidence to support such a statement. If there is any reduction of agency problems, it is very small. Direct relationships as described are usually the exclusive province of the fund manager, not investors in a fund. Very few pension fund managers have the scale to be able to serve as the fund manager. The exception would be direct co-investments manager alongside the private equity fund manager. Furthermore, if an investor were to approach the management of an investee company, that management would know that the investor really does not have a simple market sale exit available to them. Such lobbying would likely be less effective than as a direct shareholder with the vote/exit option available.

Less liquid investment strategies often target newer industries or innovative business models, which are likely to play an important role in the growth of the economy more generally.

These of course are also the riskiest of companies; fifty percent of UK companies fail within their first five years of operation. There are also very serious issues of valuation surrounding these enterprises, which can tax even the most professional investors, as the travails of Softbank demonstrate. It is not that these businesses should not be invested in, it is a question of who should invest and at what point. Amazon notably listed on public markets very early in its existence and so there are other paths for funding for innovative and new businesses.

8. Although there are benefits to investing in less liquid assets, they also present different risks to more liquid ones and may not be suitable for some investors. For example, by their nature, such assets typically involve liquidity risk, whereby investors may have to wait significant lengths of time to realise their investments.

There is a recurrent confusion evident in the many papers covering illiquid investments. There is illiquidity of the instrument recognising ownership of a fund and that is quite distinct from illiquidity of investments made by that fund. It is perfectly possible, for example, to have a listed and traded investment trust which owns a portfolio of entirely illiquid investments such as private equity funds and participations. Private equity and venture capital funds typically hold investments which are far shorter in term than the investment capital committed to them. The fact that an investor is 'locked up' for some period does not mean that the investments are held for that term.

A large infrastructure project such as a windfarm, for example, is likely to require investors to tie up cash for many years. Conversely, the shares of many companies listed on an exchange can usually be traded frequently throughout the day.

There is again confusion. It is true that the funds invested in a windfarm may take many years to be repaid from the proceeds of operation, but it is also true that the funds invested in and by a company may take many years to be repaid by the proceeds of operations. It is the instrument recognising the claim on the company or windfarm which is the object of concern. The shares of a listed company have incurred the costs of initial listing and the maintenance of that listing to enhance the ease of their negotiability. By listing on an organised market, the shareholder has reduced the search costs of identifying a buyer when they may be looking to sell. In addition, sale in an organised market eliminates potential issues with the performance and execution of sales and exchange. This also holds true of listed debt instruments. If the windfarm is structured as a company, it can enjoy the same benefits.

One of the principal ancillary advantages of market listing is the availability of the market price for valuation. In theory at least the market price should be superior, in the sense of being more accurate on average, to other methods of valuation.

All of the proposed investment classes, private equity, venture capital, infrastructure and private debt can be accommodated as assets within a listed limited company i.e., an investment trust. This would allow the managers of those assets to continue with their existing performance-based fee structures and offer a market price valuation of those assets to pension fund investors. As noted, in Appendix B, several such closed end investment trusts already exist. The reluctance of private equity managers to use the investment trust structure may be interpreted as a reluctance to have their valuation assessments closely scrutinised.

9. Several factors could help reduce liquidity risk. An appropriate fund structure design could help align the liquidity of the fund with that of its assets.

It is not necessary to align the liquidity of a fund with its assets and often not even desirable. Companies may make long-term illiquid investments in, for example, property, plant, and equipment but have shares which recognise the investor's claims on those assets as liquid traded securities. By contrast, hedge funds may have portfolios of assets which are themselves liquid traded securities but choose to restrict access to those securities to facilitate the investment strategies involving those assets.

In addition, it should be recognised that even with alignment of the duration of assets and liabilities, order imbalances may arise. Liquidity is not simply a matter of speed of sale or purchase execution; it is also a question of price.

Such risks are also likely to be less material where allocations to less liquid assets are made as part of a diversified portfolio, such as within a DC scheme default arrangement, where liquidity may be sourced from other parts of the portfolio.

It is true that the liquidity of the elements of a diversified portfolio will tend to differ in ease of use, which may mitigate the likelihood of distressed sales of less liquid assets, but the sale of some of these does require the diversified portfolio's owner to be prepared to tolerate the lesser diversified, riskier residual or resultant portfolio. Liquidity is not being sourced elsewhere in the portfolio, it is being sourced elsewhere in the markets.

Finally, as retirement investment vehicles, DC pension schemes have long investment horizons. Scheme members are unable to access their pensions until age 55, so those joining a pension scheme after leaving school or university have an investment horizon of at least 30 years. Some scheme members may also choose not to access their pension until they are significantly older, further increasing the investment horizon.

It is true that DC pension scheme may have long investment horizons but that does not imply that any or all of its investments should be contractually long-term. Such a philosophy would deny the value of the option to alter asset allocations in the event on new information coming to light.

The optimal duration of investments within this horizon is a question of the expected term premium available. It should also be noted that some 'asset classes' such as venture capital are poorly suited to long-term horizons. Pitchbook reports the IRR of venture capital declining from 18.5% at a five year horizon to just 8.0% at twenty years.

These sections above comprise the Roadmap report's "*...case for investment in less liquid assets*".

The report continues with a description of the current extent of use within DC schemes. It does though offer one bizarre opinion (14 below):

14. The differing approaches to investment in less liquid assets means that many DC pension savers with similar investment needs may see potentially different outcomes for their retirement income simply because of the scheme they happen to be in, which would not be a desirable outcome.

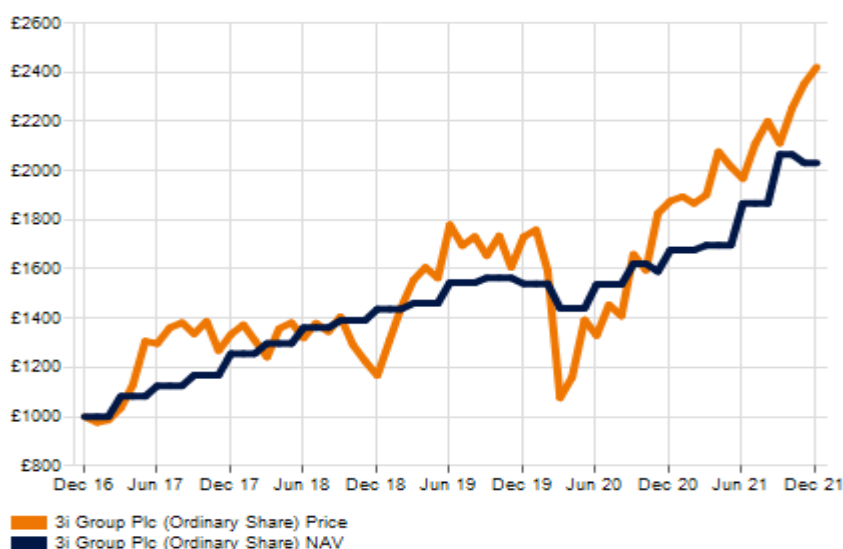
This is incorrect. Whether or not schemes invest in less liquid assets, it is likely that the outcomes of the chosen investment strategy will produce different outcomes. If anything, the inclusion of less liquid assets is likely to increase the range of those outcomes.

The Roadmap Report and more importantly the DWP consultation consider this “case for investment” to be overwhelming and final. However, it is a serious concern that some of the contentious aspects of private equity such as subscription lines (leverage within the fund) or continuation funds (which can defer the day of reckoning for overstated returns indefinitely) pass without any comment. Indeed, the DWP refer to the purpose of this working group in the following terms: “The key focus of the group was to develop practical solutions that remove current barriers to investment in long-term, illiquid assets by DC schemes.”

It is notable that government has referred to this report as being “industry-led” rather than as an independent evaluation of its agenda. The final report looks like uncontroversial evidence that what is being proposed is inherently correct and can only lead to good outcomes. However, the reality is much more complex and nuanced, and the risks of this are borne by members. While there are aspects of the ambition that most will agree with around funding the transition, better member outcomes, and so on, the fundamental issue is the method for doing so being proposed and it is far from clear that a compelling case has been made.

D: Private Equity Funds Structured as Listed Investment Trusts

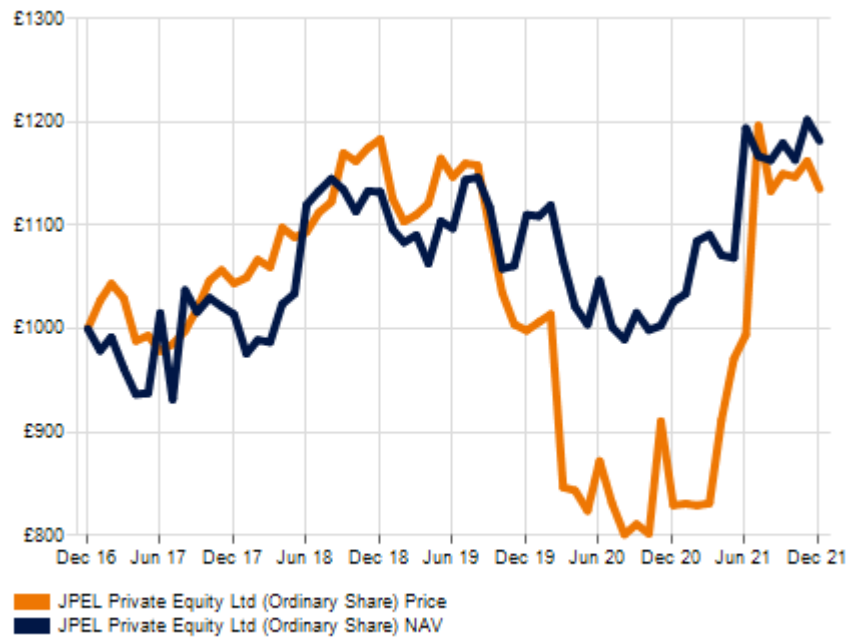
There are 19 London listed investment trusts investing in private equity. There is considerable heterogeneity among them in terms of their investment mandates and even geographic diversity. The best of these over the past five years command, on average, premiums relative to their estimated net asset value.



Source: Citywire

The volatility of the share price is three times the volatility of the estimated net asset value at 24%

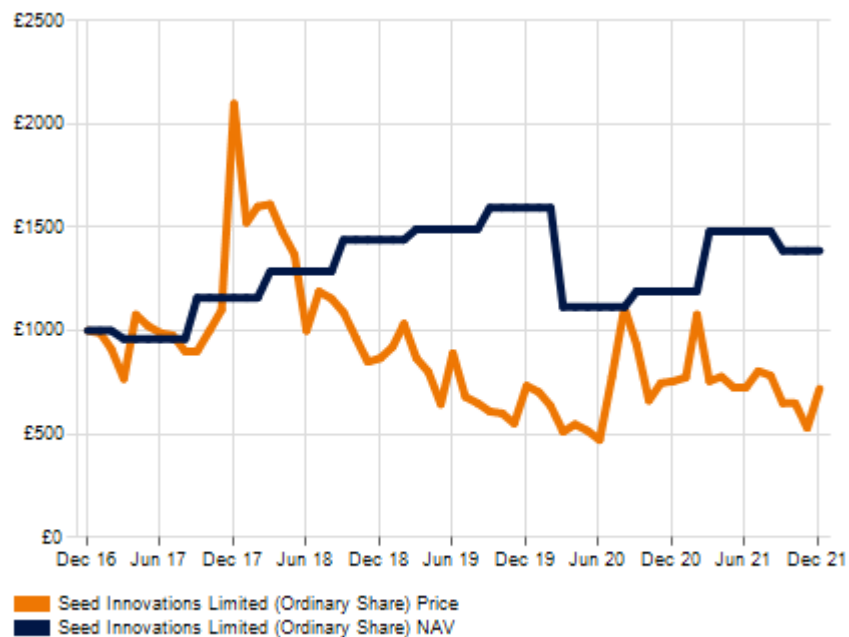
The worst performing, but not distressed of these has returned just 2.5% pa over the past five years. It has also traded at large discounts to its estimated net asset value.



Source: Citywire

The share price has been 2.4 times as volatile as its estimated NAV at 22%

There is even a venture capital fund.



The return on this fund has been -6.4 % pa over the past five years. The share price is also staggeringly volatile at 62% but that is 3.2 times the volatility of its NAV. The estimated NAV has increased at 6.7% pa.