



British
Private Equity &
Venture Capital
Association



Private Equity's Place in Defined Contribution Schemes

BVCA Perspectives Series

Authored by the BVCA's Limited Partner Committee
and Investor Relations Advisory Group

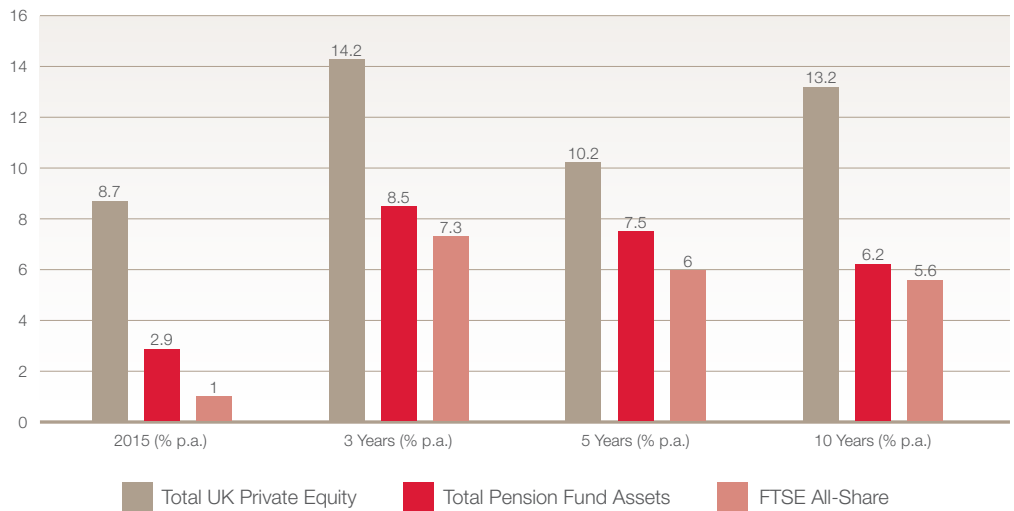


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The BVCA Perspective Series is compiled in co-ordination with General Partners (GPs) and Limited Partners (LPs) to stimulate debate within the broader GP and LP communities. In recognition of the fact that the private equity and venture capital industry is broad and funds are not homogeneous, the perspectives are not statements of any BVCA policy, nor are they intended to be prescriptive.

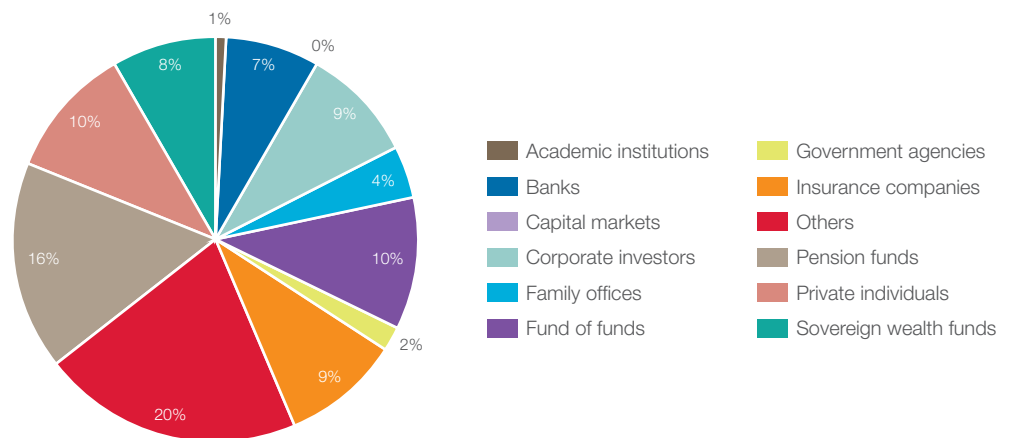
Private equity is one of the best performing asset classes for institutional investors. BVCA statistics show that over the last decade UK private equity and venture capital have generated returns of 13.2%, nearly double that of UK pension fund assets and more than double the FTSE All-Share.¹

UK private equity performance versus principal comparators



It is an asset class which continues to produce robust and consistent returns, even during times of recession or economic downturn. As a consequence, pension funds have been among the largest sources of capital for private equity and venture capital funds. In 2015, 16% of all capital raised by UK funds came from pension funds, both domestic and international, totalling over £1.9 billion.²

UK private equity funds raised by source, 2015



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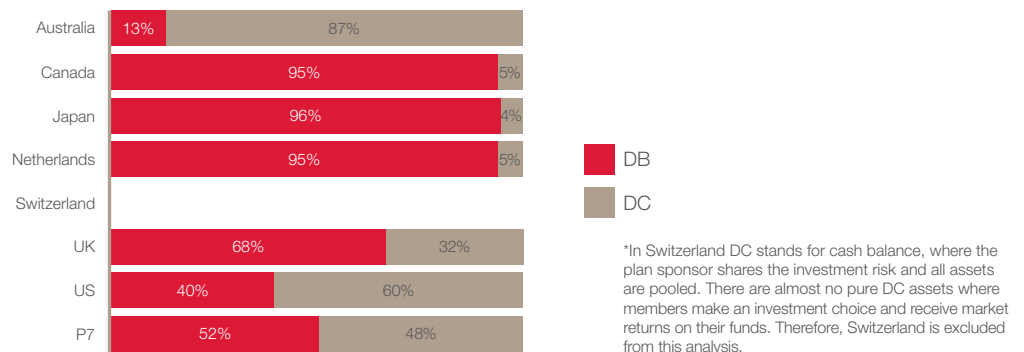
¹ BVCA Private Equity and Venture Capital Performance Measurement Survey 2015
² BVCA Private Equity and Venture Capital Report on Investment Activity 2015

The shift from Defined Benefit (DB) plans to Defined Contribution (DC) plans that is currently underway in the pension sector will have a significant impact on both private equity fund managers and, potentially, pension fund holders. This movement raises fundamental questions about the nature of returns within the pensions industry. As a generation emerges to whom DB schemes are unavailable, it is important that the investment opportunities that are available to DB funds are not closed to those who can invest only into DC schemes. Private equity has consistently been one of the best performing asset classes for those that choose to invest in it, delivering outperformance against both public benchmarks and overall pension fund assets, and it is important that as many people as possible are able to access it as they seek to build a foundation to support themselves during retirement.

Is this a concern for the GP community?

Over the last 10 years in the P7 markets, Defined Contribution (DC) assets have grown at just over 7% per annum and DB assets have grown at just over 3% per annum. Countries where retirement savings assets were dominated by DC in 2015 were Australia (86.6%) and the US (59.7%).³

DB/DC split 2015*



In dollar terms, these are non-trivial sums of money. US retirement assets totalled US\$24.7 trillion as of 31 December 2014 and they accounted for 36% of all household financial assets in the US.

This shift may not be a concern for GPs over this or the next fundraising cycle but it raises some obvious questions around what happens for the next generation and whether the private equity industry should take notice.

Those in the DB camp would be wise not to rest on their laurels as companies freeze or terminate their DB plans and replace them with DC options. Nor should we conclude that the buoyant public markets performance of recent years is going to save the day via retirement plan investments in equity mutual funds. Fundraising in the private equity industry is going through a period of change. New sources of capital are opening up, and new forms of investment are coming to the fore. The industry is responding to these changes, but one of the core questions that this new landscape will open up is whether pension funds are able to continue to invest at the same levels as before – and the access of DC schemes to private equity is the crucial component of this.

³ Willis Tower Watson Global Pension Assets Study 2016

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Given that many sponsors have enjoyed strong returns from their private equity portfolios in relation to their DB arrangements, and given obvious concerns about the ability of the broader listed markets to make much of a difference to individual savings pots, there is popular support conceptually for the inclusion of private equity in the DC plans. However, there are a number of challenges to overcome.

Can private equity play a role in DC?

Strong cultural differences have emerged between DC plans and DB plans which stem from more choice and control being placed in the hands of the individual saver. Clearly the DC environment differs considerably from traditional DB. However, there are some structural changes which are taking place in DC which support a more traditional approach to investment in 'illiquids'.

As more money has flowed into DC, sponsors have adopted default investment options for their participants in order to help them manage the risks associated with long-term investment. The defaults have many of the characteristics of a DB fund in that they are managed by professionals and invested across a range of asset classes over the long-term, with specific targets in mind. In the US these default options can be very large and highly customized to meet the specific needs of the sponsor's workforce. This bespoke approach facilitates investments in private equity and real estate sleeves which can be mingled with other liquid asset classes so that they are sheltered from the individual participants' contributions and withdrawals.

Challenges facing private equity in DC

Having identified a long-term mechanism, a number of other key structural factors inherent in private equity need to be addressed in order to meet the requirements of defined contribution plans and the expectations of plan participants. These are:

Putting money to work quickly

When investors make commitments to private equity it can take months for managers to secure the first investment and five years or more for the original capital commitment to be fully drawn. This draw on investors' capital while the investment program is getting underway creates a j-curve, which will not be tolerated by DC participants or sponsors, even if it is part of a broader asset mix.

To mitigate the early negative returns from new investment programs and create a more mature investment portfolio, professional investors can seed a scheme with secondary private equity investments. Secondaries are common for many established and new private equity investors as they generally can bring an earlier stream of distributions and returns than primary investments.

Other options can be considered to ensure that DC pension fund investors are able to see their capital working from day one.

Once the j-curve has been mitigated it is possible to consider more traditional approaches to portfolio construction over the long-term, although it is still important to consider portfolio construction for an evergreen vehicle and also how to deal with the possibility of dilution when new investors come into the vehicle from time to time.

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Providing accurate daily valuations

Unlike public equities, which have readily available share prices set by the market, GPs typically provide valuation updates on their funds and companies to their investors on a quarterly basis or even every six months. In order to bridge the gap between these infrequent reporting dates and create a daily valuation for these private investments, it is important to have a thorough understanding of the fair market valuation techniques used by the managers for their portfolio companies. It is then possible to estimate the portfolio company value changes by considering specific changes in company values, the daily market value changes of similar listed companies and how the portfolio company earnings are impacted by the broader economy.

Managing liquidity in an illiquid asset class

Private equity is illiquid. Investors have been rewarded with higher returns than in listed equities for committing capital over long time periods.

Providing liquidity around a private equity portfolio for defined contribution investors can be managed through exposure to liquid instruments such as ETFs that can effectively replicate private equity market exposure. Investing a portion of capital commitments in something like an S&P500 ETF means liquidity can be managed effectively to ensure that employees with DC pension funds can still enjoy flexibility and control over their retirement funds, whilst investing in private equity.

Creating transparent and auditable operational processes

Opening up private equity investing to defined contribution plans requires systems and processes that are transparent and auditable to the very highest standards.

Fees

Whilst it is important to note that private equity typically has higher fees associated with it than public equity, this is mitigated by the net return potential of private equity.

In the US DC market there are stringent requirements for disclosing the total fees incurred in relation to the investments that make up the default funds. This is alongside a keen desire by advisers and sponsors to keep fees as low as possible for the participants. However, there are plenty of sponsors who have experience of private equity in their DB arrangements and they understand how the fees work and the benefits of the net returns that are achievable.

In the UK there is a regulatory 'charge cap' on the fees and administrative expenses (0.75%) that can be borne by investors in default funds that are set up by employers to meet their automatic enrolment duties. This has driven many of the default funds towards passive investment to keep the charges well within the cap. In this kind of environment, the appetite for private equity will be limited and if members are to benefit from the extra returns that private equity can bring, more has to be done to educate investors and the regulators.

Risks

Managers of DC pension schemes should be aware of the risks of investing in private equity, and consider that DB schemes may have benefited from strong private equity returns as a result of their highly prudent approach to investment selection.

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Conclusion

Investments such as private equity have the potential to provide high returns and improve the level of replacement income for retirees. This is especially important in the current low-return environment. Fitting the asset class into the system presents challenges. However, by addressing key issues, most notably liquidity and daily valuations, many GPs will be able to provide an option for savers to invest into the asset class.

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