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Laura Trott, MBE, MP
Minister for Pensions
Department for Work and Pensions

By e-mail: smallpots.policyteam@dwp.gov.uk

5 September 2023

Dear Minister

**Re: Consultation on ending the proliferation of deferred small pension pots**

The BVCA is the industry body and public policy advocate for the private equity and venture capital (private capital) industry in the UK. With a membership of around 650 firms, we represent the vast majority of all UK-based private capital firms, as well as their professional advisers and a large base of UK and global investors. We are happy for the content of this submission to be quoted in any future response the Government may issue.

We have responded below to the questions in the call for evidence on which our members have specific views.

**Q6: As a whole, do you agree with the framework set out above for a default consolidator approach? Are there any areas that you think have not been considered, that need to form part of this framework?**

*Why the BVCA agrees with the overall direction of Government policy in this area*

We welcome the Government's agenda of improving opportunities for UK pension scheme investment in productive finance, including private capital funds, and improving UK pension savers' retirement outcomes. The direction of Government policy here is supported by robust BVCA returns data which clearly demonstrate that the UK's private capital fund industry has a four-decade track record of delivering market-beating returns and diversification benefits for global institutional investors (as evidenced further below). Investment activity data provided by BVCA members also clearly demonstrate that UK pension schemes comprise only a very small part of the UK private capital fund industry's pension investor base, which is dominated by overseas pension schemes (alongside a range of other types of institutional investor).

We therefore applaud the DWP's objectives of encouraging consolidation amongst UK's pension schemes, where necessary, and facilitating their access to long-term, high-performing illiquid assets. The Mansion House proposals are an opportunity for the Government to improve retirement prospects for millions of UK pension savers by starting to level the playing field between UK schemes and other institutional investors. Non-UK pension schemes, for example, can already improve the outcomes they achieve for their beneficiaries by building balanced, resilient portfolios with a broad range of assets, including illiquid strategies. Currently members of overseas pension schemes are benefitting from investment in UK growth companies via UK private capital funds, which offer different risk-return profiles and collectively have consistently outperformed public equities, in far greater numbers than members of UK pension schemes.

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*Impact of private capital investment on the UK's real economy*

In addition, the UK private capital fund industry is a critical partner for Government in driving economic growth and ensuring that the UK's high-growth businesses of tomorrow can access the capital they need to start up and scale up in the UK. In 2022, £27.5bn was invested by private capital funds into UK businesses in sectors across the UK economy, ranging from consumer products to emerging technology. There are over 12,000 UK companies backed by private capital, which currently employ over 2.2 million people in the UK. Over 55% of the businesses backed are outside London and 90% of the businesses receiving investment are small and medium-sized businesses. The UK pensions industry urgently needs improved access to these innovative, unlisted UK companies that private capital funds identify and then support to realise their growth potential. The private capital fund industry's investment of capital and expertise in that collective potential is a powerful driver or broader economic growth across the UK.

*Advantages of the Government's multiple default consolidator model from a private capital perspective*

For various reasons explored in the Productive Finance Working Group Roadmap and elsewhere, UK DC schemes face a number of unique challenges in investing in the market-standard limited partnership fund structures used by their international peers and the broader institutional investor market for investing in the growth of unlisted UK and global companies. One of these challenges concerns liquidity management, given the potential mismatch between: (a) the closed-ended nature of almost all private capital funds (which means investors cannot redeem their interests during the 10-12 year life of the fund) which is driven by the five-plus year typical holding period of portfolio companies; and (b) DC schemes' daily dealing architecture, the need to give schemes members' freedom to access their investments relatively quickly and certain regulatory complications. The PFWG has proposed approaches to liquidity management that address this mismatch, and vehicles like the LTAF have been designed to ensure the same. We think it is important, from a private capital fund perspective, that this work on overcoming DC schemes' existing challenges in relation to liquidity management are supported by a consolidator model that does not make liquidity management even more challenging. For that reason, we agree with the Government's selection of a multiple default consolidator model over the pot follows member approach.

*Why scale through consolidation is important for increasing allocations to private capital funds*

We also welcome that Government's approach will have the emergence of a considerably more consolidated Master Trust market as a central objective. As the Government is aware, the UK's pensions sector is fragmented. Generally, it is easier for larger investors to deploy the resources required to run effective private capital investment programs and diversify across managers, geographies and vintages, which is an important ingredient of successful strategies. So we would expect the consolidation of UK pension schemes into fewer, larger schemes to facilitate an increase in the aggregate deployment of pension capital into UK private capital funds.

The World Bank's 2018 report on the Canadian pension system concluded that scale allows pension funds to access a broader range of assets, improve member outcomes and reduce costs. The World Bank also suggested that scale is important to make it economical for pension funds to invest in the level of in-house expertise required to select private capital fund managers, manage partner relationships and generally run a private markets program effectively. Where investors have sufficient scale to bring this work in-house, according again to the World Bank, their returns (net of additional costs) are likely to improve, relative to exclusive reliance on external advisers and consultants. Scale also allows investor portfolios to achieve an appropriate level of geographic, sector and asset class diversification, which also tends to result

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in stronger returns and diversification benefits. The World Bank's conclusions were supported somewhat by DWP's own analysis, in its 2018 white paper on Protecting Defined Benefit Pension Schemes, which concluded that consolidation would reduce UK pension schemes' running costs, improve their investment strategies (including by allowing a greater focus on illiquid investments), and bolster their governance, leading to improved outcomes for members.

These ways in which scale helps improve returns are confirmed by feedback from BVCA investor members that have themselves successfully executed private capital investment programs. These investors have told the BVCA that scale affords them greater resources which improve their access to investment opportunities, market knowledge and ability to negotiate favourable fund terms. These investors also report that scale increases investors' commercial ability to negotiate rights to be offered co-investment opportunities by a fund's manager. These rights give a fund's investors the chance to make further investments alongside the fund in existing portfolio companies and gain further, lower cost exposure to portfolio companies that are demonstrating strong performance post-acquisition. Scale also helps to support the investor's internal resources for effectively analysing the commercial potential of any such opportunities and allowing the investor to make an informed decision on whether to co-invest.

*Institutions investing in UK private capital funds have consistently received market-beating returns*

A key reason often cited to explain why non-UK pension schemes have invested significant amounts into UK private capital funds is the industry's track record of delivering market-beating returns. The BVCA has been collecting UK private capital fund returns data from members and publishing aggregated UK industry-wide performance reports using a data set stretching back to the 1980s. These offer the most comprehensive and robust record available of UK private capital fund returns. Below we have set out how this dataset demonstrates that private capital funds have collectively and consistently delivered market-beating returns.

The BVCA's upcoming[1] Public Market Equivalent (PME) report applies two rigorous methodologies to present a comparison of the relative performance of private capital funds managed by BVCA members against the public equity market, as represented by the FTSE All-Share Total Return index and by the MSCI Europe Total Return index. The key conclusions from the upcoming report to be published next week include the following:

1. Collectively, private capital funds managed by BVCA members have outperformed the stock market as represented by the FTSE All-Share and the MSCI Europe, the most comparable indices for the range of small, medium and large investments held by UK private capital funds, in each year since 2001.

2. Since 2001, investors would have earned 34% more from investing in funds managed by our members than if they made equivalent investments in the FTSE All-Share Total Return Index.

3. Since 2001, investors would have earned 41% more from investing in funds managed by our members than if they made equivalent investments in the MSCI Europe Gross Total Return Index.

[1] We will be happy to provide this once it is published. Last year's edition based on the previous year's data is available here.

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The BVCA's 2022 annual Performance Measurement Survey then uses a large dataset of member fund level cash flows and valuations from 1980 to 2022 to provide significant, up-to-date detail on the returns achieved for investors in private capital funds. The findings clearly indicate that:

1. Private capital funds managed by our members have collectively continued to outperform the FTSE All Share for investors over three, five and ten year time horizons.

2. Since 2001, investors into private equity and venture capital funds have collectively earned a pooled return of 14.3% per annum. These annual returns are equivalent to investors nearly doubling their money, getting a 1.81x pooled return on capital invested, including the value of unrealised investments as at 31 December 2022.

3. Large private equity funds performed the best out of all fund subcategories, delivering a pooled return of 15.6% per annum since 2001.

4. Private capital funds perform particularly well for investors in the medium and long term, with returns being reasonably resilient throughout the economic cycle (hinting at the diversification benefits of this asset class).

The economic case for Government policy to support investment by UK pension schemes into private capital funds, in terms of overall returns and diversification, was also highlighted by the Productive Finance Working Group, whose 2021 report cited "a wide range of literature [that] illustrates how less liquid assets can outperform their more liquid, often listed, counterparts." The PFWG report cited the conclusions of earlier research conducted by various academics and data providers, and supports the BVCA's own analysis of member data which suggest that the UK's private capital fund industry as a whole has consistently delivered higher returns to investors than the FTSE All Share Total Return index, from 2001 onwards.

To complement BVCA and PFWG data, there is also US research that shows how allocations to private assets can improve investment performance:

1. Data from US endowments and foundations provided to Cambridge Associates LLC showed that portfolios with more than 15% allocated to private investments have outperformed their peers consistently, and for decades. Cambridge attributed the outperformance to venture capital, private equity, and distressed securities far outperforming public asset classes, earning annualized returns of 12.5%, 11.9%, and 10.8% respectively over the 10 years covered by the report.

2. Analysis by Willis Towers Watson looked at the asset allocations of a subset of large plan sponsors for 2010 and 2011, comparing DB and DC plan performance to simulated investment returns. Using an asset-weighted measure of returns, DB plans outperformed DC plans by an annual average of 76 basis points from 1995 to 2011.

*UK pension schemes are underinvested in private capital funds, relative to international peers*

We believe that UK pension schemes are underinvested in private capital funds, compared to international comparators.

The benefits of investing in UK private capital funds are already acknowledged by pension schemes around the world. The successes of, for example, Canadian and US schemes investing in alternative asset classes is well known. Yet, despite the UK having second largest pensions market in the world, UK pension schemes invest much less in private capital funds than their global peers. Data from the BVCA's latest Report on Investment Activity shows that although 30% of all capital raised by UK PE/VC funds in 2022 came from pension schemes, often based in North America, only around 4% came from UK pension schemes.

Independent commercial data from Preqin confirm that allocations to private capital funds by non-UK pension funds are typically much higher, with the Canadian pension schemes most active in private capital investment typically allocating on average 21% of their capital to private equity and the top US schemes averaging 14%, whilst even the UK private DB schemes most active in private capital on average allocate only about 5%.

We feel the evidence is very clear that UK pension savers have been missing out on the market-beating returns and diversification benefits that private capital funds have historically offered.

Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of the above in more detail (please contact Tom Taylor (ttaylor@bvca.co.uk) and Nicholas Chipperfield (nchipperfield@bvca.co.uk).

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