Local Government Pension Scheme: Opportunities for Collaboration, Cost Savings and efficiencies – BVCA response

The British Private Equity and Venture Capital Association ("BVCA") is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 500 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers.

Our members have invested £33 billion in over 4,500 UK companies over the last five years. Companies backed by UK-based private equity and venture capital firms employ over half a million people and 90% of UK investments in 2012 were directed at small and medium-sized businesses. As major investors in private companies, and some public companies, our members have an interest in streamlining the regulatory process and improving the regulators' impact on businesses, in particular small businesses.

It is of vital importance that local government employees have adequate incomes in their retirement and the Local Government Pension Scheme (LGPS) is the primary vehicle through which this can be delivered. It is understandable then that its investment approach, governance and culture be periodically reviewed to ensure scheme members get maximum value for their pension pot. The BVCA shares this goal and that is why in particular, we support the stated specific goals of this consultation process which were:

(i) Reduce fund deficits

(ii) Improve returns

Taxpayers money, the principle contributor to the LGPS, must be used wisely and this means, delivering the highest returns possible, net of fees in order to maximise retirement income for local government employees.

This Command Paper (CP) largely, and disappointingly, focuses almost exclusively on savings delivered by reducing fees, and says very little about generating maximum returns, net of fees or otherwise. Indeed the CP introduction cites the figure of £660m of savings per annum that are within the scope of this exercise. This in the context of total investment costs of £790m (2012-13). These look on face value to be significant savings. But again, it is important to focus relentlessly on returns net of fees. This is because, as the CP itself notes, investment returns and the cost of providing benefits are the most significant drivers of the overall financial position of funds. This then suggests that in making any changes to investment mandates within the LGPS, we would expect to see substantial evidence that new arrangements would be able to deliver superior returns, net of fees to the current ones, particularly where any changes are mandatory for individual funds. Otherwise we are left with risky assumptions that new arrangements will be superior.

The central plank of reform is the inception of Collective Investment Vehicles (CIVs) for the 89 funds to utilise. These, as set in the Hymans Robertson paper are to enable:

(i) Moving to passive fund management of all listed assets through a CIV (for savings of £420m pa)

(ii) Ending the use of "fund of funds" arrangements in favour of a CIV for alternatives (for savings of £240m pa).

The BVCA takes no position on the use of passive or active management with respect to accessing opportunities in listed equities, focussing instead on (ii), a new CIV for alternative investments to avoid the use of Fund of Funds.

In analysing the merits of the CIV, we should simply be assessing its ability to deliver higher returns, net of fees than current arrangements. It is on this point that we are very dubious but in order to make the case, it is important to set out the merits of what we have.

Private equity is a high performing asset class that not only delivers returns for our investors, many of them pension funds, but also has demonstrable economic benefits in the UK and across Europe. In our latest BVCA performance measurement survey, the annual IRR in 2013 for all funds was 19.2%. This compares to the Total UK Pension Fund Assets of 11%, and 20.8% for the FTSE All-Share. But private equity is also a long term asset class. If we take total returns for the last ten years, we see returns of 15.7% as against Total UK Pension Fund Assets at 7.8%, and the FTSE all share at 8.8%.

Using the early 1980s as a starting point, UK private equity funds have delivered robust returns for our investors, outperforming the market. The since-inception pooled IRR covering all of the 428 PE/VC funds in this analysis was 14.0% p.a. as of December 2012. This compares strongly with the Public Market Equivalent (PME) generated return which was 7.4%.

It is also important to note the wider economic benefits that come from encouraging pension funds to invest in private equity. This in terms of both job creation, portfolio company innovation and growth. In 2012 UK-based companies received the largest amount of investment from our members at £5.7bn, followed by European companies, which received a combined investment of £4.6bn. The amount invested overseas totalled £6.5bn. The amount invested in overseas venture capital doubled this year to £365m in comparison with 2011. For the third year in a row, over 1000 companies benefited from investment by BVCA members.

This analysis supports the notion that investing in private equity is good for returns and for the wider economy. This CP then logically asks, 'if this is the case then, why can't local LGPSs invest into private equity funds directly?' This now brings us on to the question of Fund of Funds, their value-add and indeed the ability of any CIV to replicate their strategy. There is a prevailing misconception, further demonstrated by this CP, that Fund of Funds simply pick a few high performing funds with strong reputations and spread capital across them. The thought then follows, that there is no reason why a pension fund cannot exercise these choices themselves. But this is to misunderstand and underestimate the role and value-add from investing through a Fund of Funds strategy.

The private equity returns (again, net of fees) stated above are impressive when compared to other asset classes. But by investing across the whole market, investors can access these and better returns, at reduced risk.

Indeed, if we look at the performance of BVCA member firms[1], on a net basis[2], over the past ten years, then we see that the industry has produced total returns of 15.7% on an IRR basis, as against Total UK Pension Fund Assets at 7.8%, and the FTSE all share at 8.8%.[3]

This long-term outperformance has been present since the early days of the industry. Using the early 1980s as a starting point, UK private equity funds have delivered robust returns for our investors, outperforming the market. The since-inception pooled IRR, covering the entire private equity and venture capital market since 1985 stood at 14.0% as of December 2012. This compares strongly with the FTSE All-Share, which on Public Market Equivalent (PME)[4] basis generated returns of 7.4% over the same time period.

As impressive as these returns are, however, they reflect a pooled, capital-weighted view of the industry. If an investor were able to invest in the same proportion in each of the funds that comprise the total performance, then this pooled, capital-weighted return is what they would receive.

In reality of course, this is simply not a viable proposition. Instead, investors will construct a portfolio of private equity and venture capital based on investments into individual funds, not into the market as a whole. As such, the median and quartile breakdown of the performance of funds is the appropriate measure to consider.

Here we see a slightly more nuanced view of performance. The median performance of all funds in the BVCA data set up to the end of 2012, the most recent date for which detailed breakdowns are available is 8.2%, with the top quartile returning 17.6% and the bottom quartile returning -1.8%. This performance differs quite markedly depending on the stage of investment being looked at, with a full table below:

	Venture capital	**Small buy-out**	**Mid-market buy-out**	**Large buy-out**
Top quartile	4.7	20.5	22.9	22.5
Median	-4.5	3.5	10.6	12.6
Bottom quartile	-11	-5.3	1.4	6.3

[1] Taken from the BVCA Performance Measurement Survey, a survey which directly collects data from the BVCA's membership and has a response rate of over 95% of the eligible industry. http://www.bvca.co.uk/Portals/0/library/documents/Performance%20Measurement%20Survey/PMS%20Summary%204pp%20Jun14-web.pdf

[2] That is, excluding the impact of fees and other performance costs, and therefore representative of the actual returns received by investors.

[3] Note that IRRs and time-weighted returns are calculated different not directly comparable – ten year returns have been used to give the most direct comparison.

[4] The Public Market Equivalent is a method creates a hypothetical market investment vehicle which buys the market when private equity draws money from its investors and sells it when money is distributed back to investors. It is used to provide a like-for-like comparison between private equity and the public markets. http://www.bvca.co.uk/Portals/0/library/documents/PME_analysis_Nov-13.pdf

This disparity in performance between different funds means that for an investor, choosing the right funds to invest in is key.

This is where funds of funds come in. By actively managing a significant portfolio of private equity fund investments, these vehicles are able to mitigate a significant proportion of the downside risks associated with investor fund selection. According to data from Preqin, and again on a net basis, the quartile performance for the UK's fund of funds market breaks down as follows:

	All private equity	Fund of funds
Top quartile	17.6	12.5
Median	8.2	8
Bottom quartile	-1.8	5

What we see, then, is that the median net performance of both funds of funds and the entire private equity market are close to identical, there are differences in the quartile performance. At the top quartile level, the overall private equity market outperforms the fund of funds. However, more importantly, the bottom quartile performance of funds of funds is significantly stronger than that of the market as a whole – even down to making the difference between producing positive returns for investors and returning less than they had invested in the fund.

It is a mistake, however, to assume that it is possible to recreate the success of funds of funds, at a lower fee level, through a collective investment vehicle. The fund of funds industry has become increasingly concentrated over recent years [STAT], and the relationships with fund managers that allow them to invest in the best funds have been built up over time. It remains the case that when a firm is successful in producing strong returns for investors in one of its funds, then its ability to raise subsequent funds increases markedly.

Because of this, any newly created Collective Investment Vehicle would have to spend years building up a new portfolio of investments – with the risk that many of the investments made in its initial years would be in funds with lower quartile performance than those currently invested in by funds of funds.

In addition, any Collective Investment Vehicle would have to spend a significant amount of time and resources building a team of investment professionals, backed with the necessary analytical capacity and support infrastructure if it is to have any chance of delivering strong and sustained returns to its members.

By deploying global reach with dedicated research and extensive data analysis, Fund of Funds can tap the best of private equity, across different geographies and investment strategies, using the best and most experienced investment professionals. It seems unlikely that a CIV could attract and retain the personnel needed, nor the infrastructure and network required to support it.

Q1 Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments?

Please explain and evidence your view.

There are series of far reaching assumptions in the consultation response, many of which stem from a failure to focus on returns, net of fees. By reducing upfront investment costs, any CIV is being asked to delivered market beating returns, worth billions for pension fund returns, over the short, medium and long term. There has been no nuanced analysis of the advantages of a Fund of Funds strategy as set out above, only the assumption that returns could be replicated at lower cost, by a yet to be convened CIV. The top quartile fund of fund returns for private equity in 2012 were 12.5% but more significantly, the bottom quartile was 5%. This is against 17.6% for top quartile direct private equity investment, but significantly. -1.8% for bottom quartile. By entrusting a private equity investment strategy to the unknown quantity that is a CIV, unfortunately the risk is increased and the returns are potentially lower. There are also specific reasons why a CIV is unlikely to replicate an existing, high performing fund of funds provider. These are principally around recruitment and network. The strength of fund of funds providers is a cohort of seasoned investment professionals with a global network of relationships with private equity fund managers. This allows them to carefully construct a portfolio of opportunities that will allow pension funds to access those whole-market returns, net of fees, at reduced risk. It is not clear at all that a CIV would be able to attract the right people to duplicate that approach, leading to potentially lower returns, net of (all be it reduced) fees.

Q2. Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?

Yes, given that we reject the approach of using a CIV to access alternative investments.

Q3. How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

n/a

Q4. What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

n/a

Q5. In light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and employers?

n/a

BVCA