Quarterly Investment Briefing
Quarter 2 2018

First Actuarial LLP

QAS Institute and Faculty of Actuaries® Quality Assurance Scheme

Regulated in the UK by the Institute and Faculty of Actuaries in respect of a range of investment business activities.
First Actuarial LLP is a limited liability partnership registered in England & Wales. Number OC348086.
Registered address: First Actuarial LLP, Mayesbrook House, Lawnswood Business Park, Leeds, LS16 6QY.

first actuarial

Going private

In this quarter's Investment Briefing, we consider why pension schemes might want to gain access to private market investments and how they might achieve this.

Publicly traded assets such as listed equities can be bought and sold easily via an exchange (such as the London Stock Exchange). In contrast, trading private market investments is more complicated as it requires buyers and sellers to come together directly. However, the less liquid nature of private market investments can be attractive; investors should expect to be compensated for the inconvenience.

Historically, only a very large pension scheme could establish a diversified portfolio of private market investments, but new products are opening up these markets for much smaller pension schemes.

What are private market investments?

The most familiar private market is UK commercial property. Pooled funds in this market are well established and many pension schemes already have exposure to this asset class.

Other asset classes which are now readily available include:

Private Equity – owning an equity stake, usually a controlling one, in a company that is not listed on a stock exchange. Private Equity covers a range of investment styles including:

- Leveraged buyouts – taking over and restructuring a business to improve its profitability
- Venture or growth capital investments - similar to those made by the Dragons on Dragons' Den.

Private Corporate Debt – lending money directly to a company rather than purchasing their bonds in the open market. Private Corporate Debt is often also referred to as Direct Lending.

Infrastructure – investing in an infrastructure project with an expectation of receiving a future stream of income. This can take various forms including:

- Social infrastructure – owning contracts to operate schools and hospitals.
- Infrastructure debt – financing road, railways or other utility projects.
- Renewable energy – owning wind farms, solar farms or bio-mass plants.

Ground Rent – owning the freehold and collecting the ground rent from leaseholders. This ground rent is usually inflation linked and with a very long term.

Long Lease Property – owning properties which are let to high credit quality tenants (such as public sector entities) for a period of 20 years or more. Often ownership of the property reverts to the tenant at the end of the period, protecting investors from fluctuations in the property market.

Liquidity

The risk/return profiles of private market investments vary widely. At one end of the spectrum, ground rents offer low expected returns but are very low risk. In contrast, private equity can be high risk but offers the potential for very high returns.

However, one characteristic which is shared by all private market opportunities is that they are not easy to buy or sell. Furthermore, the costs associated with trading the assets tend to be material.

We consider below how private markets can be accessed but, however this is achieved, such investments should be considered to be long-term in nature.

Access routes

We provide details of the most common methods of accessing private markets below.

Listed Investment Companies[1]

The underlying product is a fund which invests in a portfolio of private market investments. However, the fund is structured as a company and listed on a stock exchange.

New investors gain access by purchasing shares from an existing investor and this is achieved via an exchange. The fund managers themselves will not be concerned about shares being bought or sold and will not need to sell down investments within the fund when disinvestments occur.

The listed nature of the shares in these funds means that such investments are liquid and inexpensive to trade but the share price can be volatile; the share price may fluctuate significantly as it will be driven by the level of demand for the shares[2].

Listed investment companies are the usual access route to private market assets for Diversified Growth Funds (DGFs) where liquidity is an important consideration. However, the sheer size of some DGFs can restrict their ability to implement a meaningful allocation.

Gaining exposure to private markets via listed investment companies will appeal to a pension scheme wishing to ensure an ability to exit the position at short notice. This could be achieved by selecting a DGF which contains a high allocation to listed investment companies or by appointing a manager to run a segregated portfolio[3] of listed investment companies.

Most pension schemes will probably be able to accept reduced liquidity on part of their portfolio. For schemes in this position, there is an increasing range of non-listed pooled funds offering access to private markets. These fall into the two broad categories discussed overleaf.

[1] These are also known as investment trusts or, for Real Estate funds, REITs
[2] On occasions, the share price may move away considerably from the level implied by the value of the investments held within the fund. This can offer an opportunity for a contrarian investor to buy the funds at a low price.
[3] This approach is commonly used by 'wealth managers' – those whose business is focused on managing the wealth of individual investors. Pension schemes can also access these managers, so even the smallest of pension schemes can access these segregated portfolios.

Growth orientated funds

Typical characteristics of such funds are:

- A double-digit annual return target.
- Diversification across higher risk/higher return assets such as:
  - Private equity,
  - Higher risk private corporate debt,
  - Property, and infrastructure projects with more embedded development risk
- Regular dealing but with the potential to restrict disinvestments in certain circumstances.
- Relatively high fees – typically around 1% per annum plus performance related charges.

Secure income orientated funds

Typical characteristics of these funds are:

- A return target of approximately 2.5% per annum above cash or gilts.
- Diversification across lower risk/income generative assets such as:
  - Lower risk private corporate debt
  - Income from operational infrastructure, ground rent and long-lease property
- Typically, these funds operate with a 5-year lock-in period. Thereafter, the funds tend to offer regular dealing but disinvestments may be restricted in certain circumstances.
- Fees for these funds are typically around 0.5% per annum.

Our view

Small and medium pension schemes have tended to operate with low exposure to private market assets. This is unsurprising given the difficulty of accessing such investments.

However, over recent years, solutions have developed offering access to a diversified portfolio of private market investments. Such investments offer the potential for long-term growth and will increase diversification within a pension scheme's investment strategy.

There are additional costs to bear in mind when considering private markets. In particular, up front trading costs and stamp duty can mean that it takes several years for expected returns to be realised. Most private market investments should, therefore, be viewed as being long-term investments.

Unless there is an expectation of imminent wind-up, most pension schemes will be long-term investors. As such, in our view, trustees should consider making an allocation to private markets.

Small print

First Actuarial disclaimer

The information contained in this briefing is, to the best of our knowledge and belief, correct at the time of writing. However, First Actuarial cannot be held liable for any errors contained herein and the recipient accepts that the information stated is provided on an "as is" basis. This briefing is for general information only. It does not and is not intended to constitute advice. Specific advice should always be sought from the appropriate professional on all individual cases.