

PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION



THE LONG-TERM VIEW PATIENT CAPITAL AND ILLIQUID INVESTMENT

A GUIDE FOR PENSION FUNDS

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We're the Pensions and Lifetime Savings Association; we bring together the pensions industry and other parties to raise standards, share best practice, and support our members. We represent over 1,300 pension schemes with 20 million members and £1 trillion in assets, across master trusts and defined benefit, defined contribution, and local government schemes. Our members also include some 400 businesses which provide essential services and advice to UK pensions providers. Our mission is to help everyone to achieve a better income in retirement. We work to get more people and money into retirement savings, to get more value out of those savings, and to build the confidence and understanding of savers.

MINISTERIAL FOREWORD

Encouraging long-term investment in the UK economy is at the heart of this government's plan to raise the UK's productivity, boosting economic growth, delivering higher skilled jobs and lifting incomes for people across the country.

We want the UK economy to be amongst the most innovative in the world and that requires private capital, invested for the long term in the businesses and ideas that will transform the world in the years ahead.

To support public and private sector investment we have set out a modern Industrial Strategy and made major new investments in infrastructure, innovation and new technologies. At Budget 2018, the Chancellor increased the National Productivity Investment Fund to £37 billion by 2023-24, providing additional capital investment for housing, transport, digital infrastructure and R&D. Public investment is set to reach levels not consistently sustained in 40 years.

We are committed to ensuring that the UK is a central hub for enterprise, innovation and creativity. By putting more long-term funding aside to support R&D we are strengthening the UK's global position in science and innovation. We are backing entrepreneurs too, continuing to strengthen the UK as a home where some of the world's most innovative companies can start, grow and thrive. An important component in this work is the Chancellor's action plan to unlock over £20 billion of patient finance over the next 10 years. This will help to ensure that high growth innovative firms can access the vital funding they need to scale up and achieve their full potential.

Our action plan encourages the right conditions for private and institutional investors to access and invest in patient capital. The Patient Capital Review highlighted pension schemes as an important source of patient capital and this year HM Treasury led a taskforce, bringing together industry and regulatory representatives, to identify the barriers holding back investment in long-term illiquid assets. I thank the PLSA for taking part in this taskforce, offering their expertise and promoting long-term decision making among investors and pension schemes.

Our pensions investment package announced at Budget 2018 aims to help pension schemes gain access to long-term illiquid investments as part of a diversified portfolio. The new British Business Bank led feasibility study, in collaboration with industry, aims to help investors and savers access a range of long-term illiquid assets by developing a blueprint for pooling investment and investing in patient capital.

With sustained long-term investment horizons, the next generation of pension savers should have the chance to invest in a way that cultivates the type of society they want to retire into. This could mean investment in the next big innovations, like breakthroughs in cancer treatment drugs or artificial intelligence, or social impact investment in the infrastructure that underpins the economy – employment, housing, health and well-being. PLSA's guidance on patient capital and illiquid investment is a significant advance in making this a reality. By sharing individual investment journeys and experiences, it builds on the industry's investment capability and fosters an environment in which investors can make well-informed investment choices. Together, pension savers should not only have a stake in these growing innovative companies and projects that benefit the wider economy but also share in the rewards in the form of potentially strong investment returns.

We continue to foster the most innovative, pro-growth investment environment possible, so the UK continues to compete on the world stage. Increasing the range of investment opportunities for pensions investors is a key part of our plan to boost economic growth by improving firms' access to patient capital. I look forward to working with pension schemes to ensure they can achieve the best outcome for their members and for the future of our country.



Robert Jenrick MP

EXCHEQUER SECRETARY TO THE TREASURY

PLSA FOREWORD

As long-term owners of capital, pension funds are ideally placed to reap the benefits of investing in a long-term way and build a portfolio of assets which can provide stable cash flows and diversification benefits for the next 15 or even 50 years.

This is the case both for defined contribution (DC) schemes as auto-enrolment brings in a younger cohort of savers, but also for defined benefit (DB) schemes which will be paying benefits for decades to come and some of which are still open.

The Pensions and Lifetime Savings Association helps everyone achieve a better income in retirement. As part of our approach, we work with policymakers and the industry to create an environment which helps schemes access a wide range of assets which, as part of a balanced portfolio, can help them grow and protect the value of savers' capital.

We are pleased to be involved in government initiatives to remove the barriers preventing schemes from investing in illiquid assets – such as venture capital, private equity and infrastructure – with the intention of doing so for the long-term. Such investments often provide an “illiquidity premium” to investors. We’ve worked with HM Treasury’s Pensions Investment Taskforce – part of its Patient Capital programme of work – and the joint HM Treasury and Department for Culture, Media and Sport (DCMS) Implementation Taskforce on Growing a Culture of Impact Investment in the UK. Both programmes of work aimed at creating an environment which better supports schemes to access illiquid investments, where relevant and appropriate.

The long-term view: patient capital and illiquid investment will help schemes consider how and when to invest their portfolio in illiquid assets. Our members consistently tell us that they value hearing what other schemes do, so we have brought together case studies from pension schemes and asset managers to provide practical insights and tips for trustees who want to find out more. These cover a broad spectrum of possible approaches, from investing in partnership with other schemes, to infrastructure, private equity and impact investment. But what the contributors of these case studies all have in common is a commitment and willingness to commit money for a long period of time to gain benefits ranging from a positive social or environmental impact to stable cash-flows.

Some of these case studies involve a direct investment approach, often only available to larger schemes owing to the expertise and resources required. However, the market is continuing to evolve, with an increasing number of fund managers offering pooled funds with some allocation to illiquid assets, as well as models offering partnership opportunities. This guidance contains useful tips for trustees of schemes of all shapes and sizes, prompting key considerations and questions to work through with a scheme’s managers and advisers for whatever form of allocation to illiquids is chosen.

We are grateful to the Patient Capital team at HM Treasury for their support, as well to those organisations which took the time to provide case studies – each of which sheds light on a rapidly growing area of investment currently subject to significant policy and regulatory change.

We hope that you enjoy this guide and that it will be a useful addition to the trustee investment toolkit.



Caroline Escott

POLICY LEAD: INVESTMENT AND STEWARDSHIP

OVERVIEW

ILLIQUID MATTERS

In an era which has been characterised by low yields and low scheme member contributions, the PLSA and the wider pensions industry have long been campaigning for steps to be taken by government and regulators to improve schemes' access to a broad range of alternative investments which suit a pension scheme's long-term approach. This includes illiquids.

What do we mean by illiquid investment?

Illiquid investment refers to any asset which must be bought and held for a long period of time and cannot be sold quickly without losing a significant portion of its value. Such assets include infrastructure, unlisted securities such as private debt or equity, and some kinds of social impact investment. It can also include venture capital – the provision of capital to those seeking to start up or grow an early-stage business – and the government's **Patient Capital** programme of work is targeted specifically at encouraging DC and DB pension schemes to invest in these start-ups.

In this guide, we and our contributors use the term 'patient capital' in a broad sense, to indicate an investment approach requiring a long-term investment horizons.

It is increasingly accepted that allocation of a part of a scheme's portfolio to illiquids can provide benefits. As the case studies in this guide show, some schemes undertake illiquid investment in expectation of strong risk-adjusted returns, or for long-term stable cashflows which align with their liabilities. The kinds of assets used as part of an illiquid investment approach can also help to diversify risk in a portfolio by providing returns which are uncorrelated to the returns of those assets – such as listed equities – which often make up the bulk of a scheme's investment portfolio.

What do we mean by impact investment?

Impact investment – sometimes referred to as social and/or environmental impact investment – aims to achieve tangible positive impacts on society and the environment alongside generating investment returns.

As The Pensions Regulator (TPR) notes in its guidance¹ "some less liquid investments, which may include investments referred to as patient capital, can form part of an impact investment approach".² Although the primary purpose of pension investment is to deliver an appropriate return, TPR states that "there is no barrier to investments which have a social impact as a by-product where that primary purpose is met". Trustees can "choose to actively take account of impact considerations in making an investment decision where they have good reason to think scheme members share their view and there is no risk of significant financial detriment to the fund".³

Many of the recommendations of the Advisory Group on Social Impact Investing, which aimed at reducing the barriers to social impact investment, overlapped significantly with those recommendations from the Patient Capital Review, which are intended to stimulate investment in venture capital and infrastructure.

RECENT POLICY DEVELOPMENTS

Recent years have seen UK policymakers take an increasing interest in practical steps to reduce existing barriers to pension scheme investment in illiquid asset classes or approaches such as infrastructure, venture capital and impact investment. This is in order to match infrastructure priorities with the flow of capital from institutional investors.

The government therefore commissioned and undertook in-depth assessment with industry, lawyers⁴ and regulators of the key issues which prevent DB and DC pension fund investment in illiquids. Key barriers identified⁵ in reports by the

¹ TPR's Investment guide for DC pension schemes (published October 2018). Further information can also be found in TPR's March 2018 blog on "Pension funds and illiquidity"

² Please see *Growing a culture of social impact investing in the UK* (November 2017) for further information on the breadth of the social impact investment spectrum

³ This refers to the Law Commission's "two-stage test". Please see their *Pension Funds and Social Investment* paper (June 2017)

⁴ Ibid.

⁵ Ibid. and see also HM Treasury's *Financing growth in innovative firms: consultation response* (December 2017)

Law Commission, HM Treasury and the Advisory Group to Government on Social Impact Investing include:

- ▶ A fragmented pensions market and a lack of suitable scale for many DB and DC schemes; larger schemes can tolerate more illiquidity (as it is easier to match cashflows in and out so there is no restriction on functionality for members)
- ▶ Caution amongst trustees regarding how to meet the ‘prudent person’ rule while also investing in illiquid assets
- ▶ The perception amongst DC schemes that funds in which they invest must be priced and traded daily
- ▶ DC scheme use of investment platforms run by an insurer, meaning scheme members fall within scope of the ‘permitted links rules’,⁶ where members are only allowed to invest in a small range of permitted funds
- ▶ The default fund charge cap of 0.75%.

The government has established several cross-departmental initiatives, in collaboration with UK investors and their representatives, to try to break down these barriers to illiquid investment in what are considered important parts of the economy. Key amongst these has been the government’s Patient Capital programme of work which aims to “help create an economy that is driven by innovation”. As part of the Patient Capital Review, HM Treasury set up and led a Pensions Investment Taskforce to “tackle continuing barriers holding back Defined Contribution pension savers from investing in illiquid assets.”

Another major strand of work has been on social impact investment. In 2016, the government set up an independent group (the Advisory Group to Government on Growing a Culture of Social Impact Investing in the UK) to understand how savings, pension and investment providers could help individuals more easily support social impact investment through their savings and investment choices.

Both the Social Impact Investing Advisory Group and the Patient Capital Review made a series of recommendations, many of which the government committed to consider and implement. Some of these proposals – like the need for guidance by TPR on how trustees can invest in assets with long-term investment horizons,⁷ or changes to the Financial Conduct Authority’s ‘permitted links rules’ – were made by both groups.

TIMELINE:

NOVEMBER 2016: PM announces that HM Treasury will lead a Patient Capital Review

DECEMBER 2016: Advisory Group to Government on Growing a Culture of Social Impact Investing in the UK set up

JUNE 2017: Law Commission publishes its report into Pension Funds and Social Investment

NOVEMBER 2017: Growing a Culture of Social Impact Investing report published

NOVEMBER 2017: Budget 2017, Chancellor makes series of announcements on patient capital (following consultation with industry) including the Pensions Investment Taskforce

FEBRUARY 2018: PM commissions an Implementation Taskforce to progress the recommendations in the report on Growing a Culture of Social Impact Investing in the UK

MARCH 2018: TPR publishes blog on illiquid investment (patient capital/social impact investment)

OCTOBER 2018: HM Treasury: Budget 2018 announcement of patient capital measures

OCTOBER 2018: TPR publishes guidance on social impact investment and patient capital approaches

Expected: Q4 2018 – FCA consultation on permitted links rules

Expected: 2019 – DWP consultation on the charge cap “to ensure that it does not unduly restrict the use of performance fees within default pension schemes, while maintaining member protections”

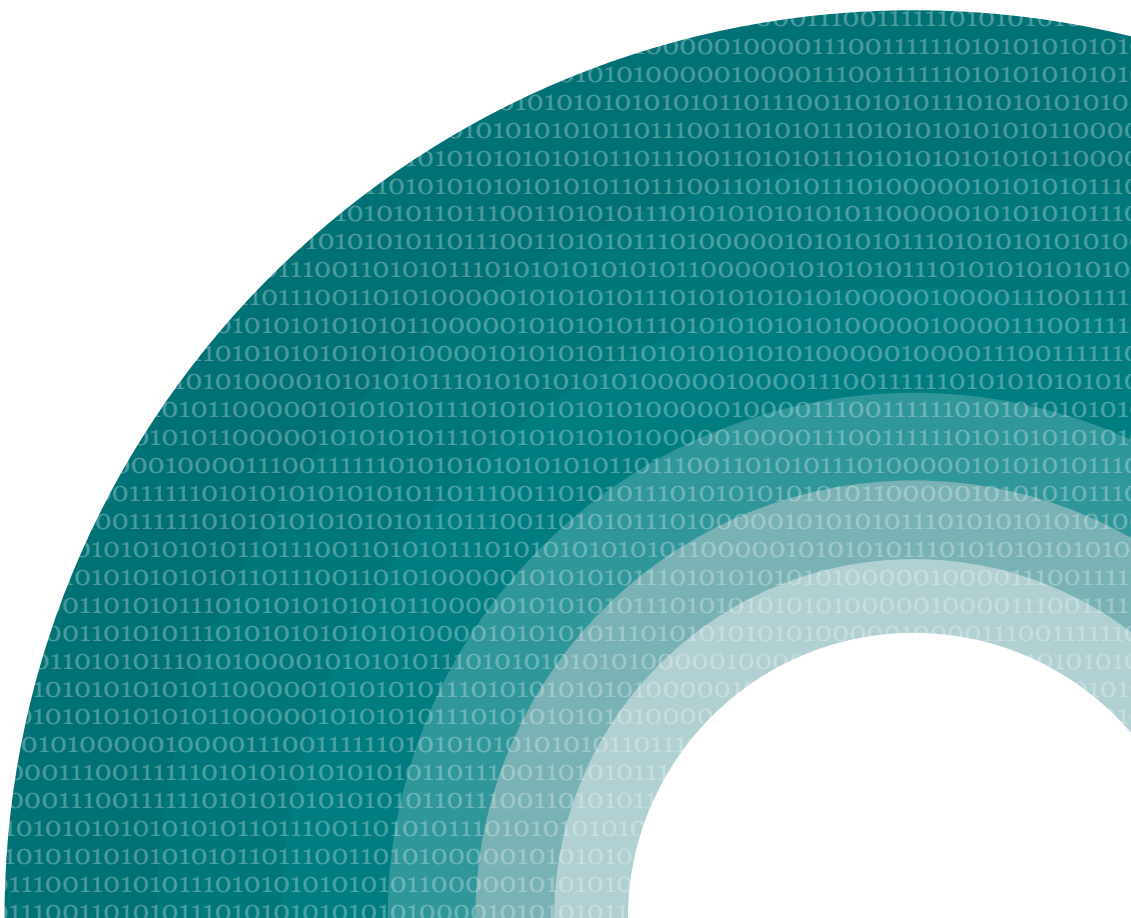
⁶ The ‘permitted links rules’ are outlined further in the FCA’s Handbook under COB 21.

⁷ For further details, please see TPR’s investment guidance for DB and DC schemes.

THE TIMES, THEY ARE A-CHANGIN'

At the time of writing, the government and regulators are considering making some key regulatory changes to support DB and DC schemes in their consideration of investing in illiquid assets. TPR has issued high-level guidance to help trustees assess how social impact investment might fit in with their scheme's investment principles and delivery approaches. At the same time, TPR produced guidance on illiquid investment and patient capital, stating that trustees "may consider such an allocation for diversification, positive risk-adjusted-returns and higher-yielding long duration inflation-linked income streams."

The following case studies, tips and checklists should be read by trustees alongside TPR's guidance for DB and DC schemes. Trustees should also work closely with their advisers to consider how any illiquid investments might affect the security, quality and returns of the overall portfolio and their scheme's objectives.



CASE STUDY

1



STRATHCLYDE PENSION FUND

With over 230,000 members and £20 billion of investments Strathclyde Pension Fund is one of the two biggest Local Government Pension Scheme funds, one of the top 20 UK pension funds and one of the top 50 European pension funds.

Regrets, we've had a few, but then again...

Having a long-term perspective is one of six key principles in our Statement of Investment Principles (along with Diversification, Efficiency, Competitive Advantage, Pragmatism and Stewardship). Investing in patient capital helps us live up to those principles.

◆◆ ONE OF OUR REGRETS IS THAT WE DIDN'T EMBRACE ILLIQUID INVESTMENT MORE AT AN EARLIER STAGE ◆◆

That said, we did start a private equity programme in 1990. And private equity does require patience. It takes time to invest your money – you can't just buy a ready-made portfolio. And once invested, the money is effectively 'locked up' for 10 to 15 years or even longer. But it does come back to you. The programme we started in 1990 is still running. Our regret is that we didn't build it up more quickly. We waited instead to see how those initial investments got on. They did very well – an annual return of over 25%. So we did eventually increase our allocation to 7.5% of total assets – we're a big fund, so that's over £1.5 billion. Over the years we have invested £2.7 billion in private equity, had £2.5 billion returned to us, and our current investments have a value of £1.9 billion. Total return has been more than 13% per annum. Worth being patient for.

SOME LESSER-KNOWN BENEFITS OF PRIVATE EQUITY

As well as the returns, which were the main attraction for us, there are other things we like about private equity in comparison to quoted equity:

- ▶ **Managers take significant stakes in companies** – usually a majority holding. This allows them real influence or control of how a company is managed and developed.
- ▶ **Private equity can bring about real change** – by bringing technologies to the market, creating new businesses and allowing existing businesses to make a step change in their growth. Many of today's biggest companies started out in private equity ownership.
- ▶ **Good managers do take environmental, social and governance (ESG) considerations seriously** – and they can do something about them. That matters a lot to us.

HOWEVER...

- ▶ **Private equity does have a whole new jargon** – of drawdowns, distributions and Internal Rates of Return.
- ▶ **It requires some management** – the money can't all be invested at once and doesn't all come back at once.
- ▶ **It is expensive** – but the returns above are after all fees and expenses.

We don't think you need to be a fund our size to invest in private equity. But you do need a good manager or consultant.

MOVING INTO PRIVATE DEBT AND INFRASTRUCTURE

We've recently started a private debt programme which complements our private equity programme, meaning we're providing both debt and equity capital to private companies. The debt programme requires less patience – the lock-up period is shorter, more like five to seven years. The returns are less, but still much better than bond investments are currently earning.

We also started to invest in infrastructure around five years ago. Some of that requires real patience – a fund length of as much as 25 years with very little real opportunity to exit in the interim. That took a bit of getting our heads around. What if we changed our minds? What if we needed the money for something else? What if something better came along?

INFRASTRUCTURE INVESTMENT IS A GOOD FIT FOR A PENSION FUND

Typically with infrastructure the money is invested as individual assets are acquired or completed. (You can also invest in infrastructure at the construction stage, and we do. But that has a very different risk profile and most of our investment is in post-construction operational assets.)

Once operational, the assets (think schools, hospitals, prisons) are typically let to a government or local government entity on a very long-term lease. Payments are fixed, usually with inflation uplifts.

SOME OF THE BENEFITS OF INFRASTRUCTURE

- ▶ **It generates a steady, largely fixed return with good inflation protection** – we can use that to pay pensions. We won't change our minds about doing that, and that's what all our investments are ultimately for. And we have other sources of funds if something better comes along.
- ▶ **Operational infrastructure has a lower risk profile than equities or property, providing some diversification** – though total return is less than these asset classes and often no residual value is assumed.
- ▶ **Investing in social assets has merit** – our infrastructure investments to date – around £500 million – have almost all been in the UK. Around half of that is in schools and hospitals. As a UK public sector pension fund we think there is some merit in investing in these kinds of assets.
- ▶ **Investing in renewable energy assets contributes to our responsible investment and climate change strategies** – the other half of our infrastructure investment is in renewable energy assets – onshore wind, offshore wind, small hydro, community power, anaerobic digestion. There's definitely merit in that. We estimate that our renewables investments are saving around 87,000 tonnes of carbon a year, and generating enough power for 61,000 homes.

HOWEVER...

- ▶ **Like private equity, infrastructure has its own jargon.**
- ▶ **Infrastructure is a different investment structure** – unlike a typical quoted equity or bond portfolio where the money is invested all at once and returned when you ask for it, with infrastructure your capital is committed for the long term.

OUR FUTURE IN INFRASTRUCTURE AND PATIENT CAPITAL

Infrastructure is still quite a small part of our overall strategy, but we will continue to expand and develop this programme. We have just agreed a £500 million investment in a global fund to complement our UK investments.

Strathclyde Pension Fund has invested in, built, or is building the following UK projects:

- | | |
|--|--|
| ▶ 92 schools | ▶ 14 hospitals |
| ▶ 2,000 social housing units | ▶ 9,000 government and defence personnel housing units |
| ▶ 5,000 units of student accommodation | ▶ 3 social care centres |

Overall, our illiquid assets – infrastructure, private equity and private debt – make up less than 20% of our total investments. But that will continue to grow. And we are quite patient with our other investments – we have held some individual properties in our UK portfolio for more than 20 years; and we prefer equity portfolio managers who take a long view.

CASE STUDY

2



Partners Group

REALIZING POTENTIAL IN PRIVATE MARKETS

PARTNERS GROUP

Partners Group is one of the largest private markets investment managers in the world. We serve over 850 institutional investors who seek superior investment performance through private markets for their more than 100 million beneficiaries. We have USD 78 billion in assets under management and more than 1,000 professionals across 19 offices worldwide. Since inception, we have invested USD 100 billion in private equity, private real estate, private debt and private infrastructure on behalf of our clients.

THE ROLE OF PRIVATE MARKETS IN A PATIENT CAPITAL APPROACH

Typically, private markets funds are long-term in duration (six to 14 years with potential to extend) and closed-ended (i.e. generally no, or limited, liquidity), meaning they are inherently aligned with the principle of patient capital. This is equally true of the ‘illiquidity premium’ – the notion that additional return is expected to compensate for an investment not being easily or quickly sold for fair market value.

◆◆ OVER THE LONG TERM, PRIVATE MARKETS HAVE DELIVERED HIGHER NET PERFORMANCE TO INVESTORS THAN PUBLIC MARKETS ◆◆

This is partly due to structural advantages, as there is often a greater emphasis on longer-term thinking for private markets, with a focus on operational value creation, exit timing and finance efficiencies. This is in opposition to a shorter-term approach in public markets, the focus on the latest quarterly earnings projections being one such example.

WHAT SHOULD DC SCHEMES CONSIDER WHEN THINKING ABOUT PRIVATE MARKETS?

DC schemes are well placed to access an illiquidity premium due to the long-term nature of their investment horizons. Private markets can also offer attractive diversification benefits for DC schemes, especially those exposed entirely to public markets.

From our experience, there are three main factors that DC schemes could consider when looking to integrate private markets into their portfolio: **liquidity**, **cost** and **complexity**.

LIQUIDITY

The regulatory and operational framework of investment platforms that DC schemes are administered through has created an expectation amongst many schemes of daily trading. This is in spite of daily trading being neither essential nor the best option for members to extract value from their investments.

This expectation can present a barrier to schemes’ investment in private markets, as privately-held assets do not have a readily available exchange to trade in and out of positions on a daily basis.

COST

The annual charge cap of 0.75% for DC workplace default funds means there is a tangible limitation when considering the costs of investing in private markets – even if the potential returns mean such investments represent good value for money.

Private markets funds are more costly to operate because:

- ▶ The model is usually less scalable (i.e. in order to source and manage more deals, you often need more investment professionals).
- ▶ There are significant costs involved in the structuring of investment vehicles and in creating value in the assets held within these vehicles.

COMPLEXITY

The fundamental nature of holding a private asset involves several distinct factors from public markets:

- ▶ **Control:** Unlike public equity, where shareholdings can be increased or decreased based on portfolio strategy and executed daily through a broker, holding a private asset means having control over the day-to-day operation of, say, a healthcare company or infrastructure project.
- ▶ **Complexity of ownership structures:** The ownership of private assets often uses several vehicles located in different jurisdictions around the globe. As a result, there are legal and monitoring costs which you do not typically get in public markets investing.

INVESTING IN PRIVATE MARKETS ON A DC PLATFORM

To date, much patient capital or private market investment has required a direct investment approach, which often necessitates an in-house team to undertake extensive groundwork and due diligence. However, the market is evolving so that smaller DC schemes that would like to increase their exposure to private markets are better able to do so. One approach has been to create a private market fund that is suitable for investment platforms.

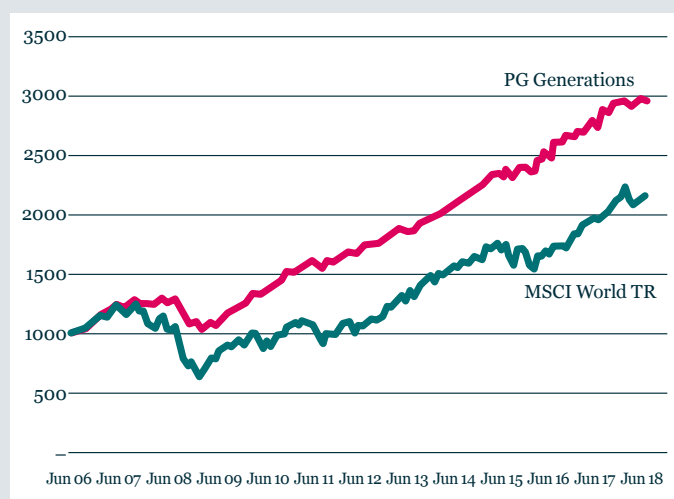
LIQUIDITY CONSIDERATIONS

It is not, of course, essential for DC schemes or master trusts to use a platform to invest. However, for those schemes that use platforms, it is possible to create a fund with a 'permitted link': an important element of this is that the manager of such a fund must show that the entire portfolio can be liquidated within six months once a redemption request is accepted. This enables a fund to provide the daily valuations expected by DC schemes while still offering illiquid private markets exposure.

COST (AND VALUE FOR MONEY) CONSIDERATIONS

Private markets investing involves higher costs than public markets. However, to conduct a like-for-like comparison that demonstrates value for money, performance must be assessed net of fees. An analysis of 163 US public pensions showed a median annualised return for the past 10 years of 8.6% compounding for private markets, net of fees. This compared with a 6.1% return for public equities.⁸

Partners Group has observed a similar result in respect of both our investments as a firm and our private markets fund ('Generations', which blends a liquid public allocation with private markets exposure to allow its use on DC platforms) specifically.



| | 30 JUN 06 – 30 JUN 18 | PG GENERATIONS FUND | MSCI WORLD EQUITY |
|-------------------------------|-----------------------|---------------------|-------------------|
| Return statistics | | | |
| Annualised return | | 9.4% | 6.6% |
| Total return | | 195.0% | 114.6% |
| % positive months | | 76.4% | 64.6% |
| Average positive month return | | 1.4% | 2.8% |
| Average negative month return | | (1.4%) | (3.4%) |
| Maximum draw down | | (21.2%) | (49.2%) |
| Skewness | | (1.0) | (0.9) |
| Kurtosis | | 2.9 | 2.3 |
| Time value of \$100 | | 295.0 | 214.6 |
| Risk statistics | | | |
| Volatility | | 5.6% | 13.5% |
| Equity correlation | | 0.65 | 1.00 |
| Equity beta | | 0.27 | 1.00 |

For illustrative purposes only. Past performance is not indicative of future results. *Private markets: PG Generations actual track record has been used from since the fund's inception on 29 April 2016; before then, back-tested monthly returns based on all private markets investments made by The Partners Fund, measured by value creation (in local currency) according to the modified Dietz method. Listed private markets: LPE and Listed infrastructure track records +1.15% p.a.; for listed real estate the FTSE/NAREIT Global Index has been used. Portfolio and benchmark returns have been adjusted for a 100% hedge of return streams by adding the monthly GBP/USD interest rate differential for better comparison. Public benchmark return figures (Bloomberg: NDDLWI Index and SBWGU Index) sourced from Bloomberg. Note that to estimate the returns for PG Generations prior to its launch in April 2016, the investments made by The Partners Fund are re-weighted to align to the PG Generations strategic allocation, gross of fees. To arrive at the net returns, PG Generations fee schedule was applied: a management fee of 1.25% p.a. and a performance fee of 10% of profits subject to a High Watermark.

⁸ Financial Times, 23 July 2018, Private equity returns are still best, even after fees

The Australian market also provides a noteworthy case study on the incorporation of private markets into DC schemes. The Australian market, while notoriously cost-conscious, does not opt for the cheapest options at the expense of net performance.

An article in *Professional Pensions*⁹ compared the UK and Australian markets and noted that the average fees for Australian super DC schemes is 112 bps and the largest scheme's average fee is 84 bps, resulting in much more flexibility for schemes to make the "right" investments. It states that "the multifarious asset mixes of Australian DC plans make the 50% diversified growth fund, 50% global equity fund composition of UK plans look like something out of the Stone Age". This article was written four years ago but there has been little evolution in the asset mix of UK DC schemes since.¹⁰

Further, on average, Australian DC superfunds have outperformed UK DC schemes. Australian super schemes have a 19% allocation to alternatives (including illiquids) compared to <1% for the UK DC market¹¹. A more specific example is QSuper, an Australian superfund over AUD 100 billion in size, which has allocated 7.0% to private equity in addition to 7.4% in other illiquid alternatives and 19.1% to real estate and infrastructure. This significant allocation to private markets assets has contributed to QSuper's Balanced Options' returns exceeding the industry average for Australian Balanced Options returns over the last seven years.¹²

COMPLEXITY CONSIDERATIONS

Investing in private markets is a complex business, for the reasons we highlight above. However, smaller DC schemes should not assume that their scale means they are unable to do so. As investment in illiquids becomes increasingly popular, schemes must make sure they choose a fund with a manager that they trust not only in terms of their private markets expertise but also their approach to liquidity management.

Questions to ask your private markets funds manager

- ▶ Are investors getting 'true' exposure to private markets, and not simply a fund comprising solely listed stocks as a proxy exposure (e.g. listed infrastructure)?
- ▶ What capabilities do managers have with publishing daily prices to be suitable for platforms?
- ▶ How do managers prepare for the scenario of significant redemptions (e.g. through gating)?
- ▶ Do the managers have significant deal flow to construct a portfolio of private markets assets diversified by asset class, instrument and vintage year?



⁹ *Professional Pensions*, 30 October 2014, Eight things the UK can learn from Australian superannuation

¹⁰ See, for instance, Camradata's DC default fund survey (Q1 2018) which shows a significant allocation to equity and fixed income instruments.

¹¹ Willis Towers Watson survey 2018

¹² QSuper annual report 2018, allocations as of 30 June 2018

CASE STUDY

3



UNIVERSITIES SUPERANNUATION SCHEME (USS)

The Universities Superannuation Scheme is a pension scheme in the United Kingdom with over £60 billion in assets under management. Its members include academic and academic-related staff in over 350 UK higher education institutions.

At USS, our approach to investing in infrastructure assets is patient and considered – from our initial approach to investing to a time horizon looking decades into the future.

Our duty to meet the funding requirements of our members' pensions long into the future demands the strict criteria upon which we base our investment decisions. We look to invest in companies in stable industries, on a clear upward trajectory and with strong management teams.

As a strong advocate in the area of responsible investment, we also take the proactive stewardship of our assets seriously.

THE IMPORTANCE OF DUE DILIGENCE

For schemes looking to take a 'patient capital' approach, we think it is vital to undertake significant due diligence. Before investing for the long-term, we:

- ▶ **Closely track companies and sectors** in which we are thinking of investing, staying close to management teams.
- ▶ **Analyse the macro- and micro-economic themes** in our target sectors. This enables us to avoid being influenced by prevailing sentiment and instead supports a detailed picture of a business and its potential future.
- ▶ **Look closely into the management team** and their individual backgrounds, health and safety record, reputation and whether the conduct of the business aligns with our values. Our responsible investment team plays a key role in this process.
- ▶ **Speak to existing shareholders and, where appropriate, industry regulators.** We look at whether shareholders share a similar ethos to us. We want to test the company's relationship with regulators and understand its long-term objectives for its customers and for its industry. At all stages, we build a clearer picture of the business, its values and future in order to help avoid pitfalls down the line.
- ▶ **Consider whether we need to bring in specialists.** Sometimes you need a specialist to cover the required groundwork – even big schemes like USS will bring in external advisers to complement in-house knowledge and skills.

◆◆ WE SEE OURSELVES AS SUPPORTERS AND INFLUENCERS AND ALWAYS AIM TO WORK WITH MANAGEMENT TEAMS TO REALISE THEIR COMPANIES' POTENTIAL ◆◆

When we invest in companies that meet our criteria, we do not seek to run them. We see ourselves as supporters and influencers and always aim to work with management teams to realise their companies' potential. This is a key difference between being an active investor and being an activist shareholder.

CASE STUDY: INVESTING IN REDEXIS GAS

In 2010 we invested in Redexis Gas, a regulated Spanish gas transmission and distribution business. It was newly separated from its former parent company and there was some uncertainty over its ability to grow and perform as a standalone entity.

Our due diligence revealed a management team with a clear strategy to deliver improved performance and grow the regulated network. Since making our investment and as responsible stewards of our assets, we have worked in close collaboration with the management team and other shareholders to make many positive changes.

Since our investment, the company has more than doubled its EBITDA (Earnings before Interest, Tax, Depreciation and Amortisation) and its number of gas connections under management. We have been highly supportive of the company's growth plans and over the same period we have provided additional capital to the company on four occasions in order to support its expansion.

CONCLUSION

If we have learned anything from our many years working with patient capital it is that time and effort in understanding and engaging with business strategy is rarely wasted. Yes, it may take resources to get to a place where you are comfortable enough to move ahead. But investing resources in understanding risks and rewards now and avoiding nasty surprises in the future means we invest in assets that can help us fund our members' pensions for many years to come.

DUE DILIGENCE CHECKLIST FOR TRUSTEES

Whether you are considering a direct investment or outsourcing to your manager, these are some of the key considerations in undertaking a thorough due diligence process.

Sector insight and long-term view of the future including:

- ☒ Regulatory/legislative analysis
- ☒ Competitor analysis
- ☒ Previous deals in the sector and their valuations and performance

Specific company review including:

- ☒ Market share and position. Future market disruption risk
- ☒ Group structure
- ☒ Financials, capital structure, profits and dividends
- ☒ Shareholder register
- ☒ Business activities, e.g. regulated/non-regulated
- ☒ Health and safety operating record
- ☒ Compensation/litigation payments
- ☒ Pension schemes and other major liabilities
- ☒ Technical due diligence of assets
- ☒ Tax structure
- ☒ Business performance and business plan
- ☒ Previous audits

Risks:

- ☒ Business and sector-wide risks, e.g. regulatory change
- ☒ Environmental due diligence and associated risk
- ☒ Political risk from change of government

Enhanced due diligence including analysis of:

- ☒ Governance
- ☒ Regulatory risk
- ☒ Workforce management practices
- ☒ Environmental impact and climate change

Board analysis including:

- ☒ Background checks on board members from a wide variety of available sources
- ☒ Meetings with key management team members
- ☒ Feedback from shareholders and other sources

CASE STUDY

4



HERMES

Hermes Investment Management is an investment management firm providing public and private markets investment strategies and engagement services to institutional and wholesale investors, operating worldwide.

Hermes is majority owned by Federated Investors, Inc (Federated), a leading US investment manager with \$437 billion assets under management. BTPS retains a minority stake, alongside members of Hermes' management. Hermes has 15 specialist teams totaling 132 investment professionals, located in London, New York, Singapore and Denmark, serving clients across the globe. At 30 September 2018, it managed £36 billion of assets and engaged on £359 billion in assets.

IMPACT INVESTMENT AND PATIENT CAPITAL

Impact investing encourages a forward-looking view of where the world is heading, with investors essentially buying tomorrow's leading companies today. It is truly long-term investing, and this long-term value creation is perfectly aligned with the time horizons of pension funds, which can often afford to be 'patient' in their investment approach.

IMPACT VS. CONVENTIONAL INVESTING: THE THREE PILLARS

Analytical thinking, along with a proactive approach to understanding and measuring the positive and negative impacts that all businesses have on society and the environment, is fundamental to long-term investment success.

The concept of ESG investing is now well understood. However, impact investing goes a step further by investing in companies, organisations and funds with the express purpose of creating a positive social or environmental impact. More broadly, the three concepts (or 'pillars') which trustees can use to distinguish impact investing from conventional investing are:

- 1. INTENTIONALITY:** the intention of an investor to make a positive social or environmental impact.
- 2. ADDITIONALITY:** fulfilling a good cause beyond the provision of private capital. This is often seen as too idealistic for mainstream investors, but is arguably the purpose of capital markets, helping to reinforce the connection between capital and its commercial and societal purpose.
- 3. MEASUREMENT:** being accountable and transparent in reporting not just on the financial but also the social and environmental performance of investments.

These ideas can bring significant benefits compared to the way traditional investors approach investing. This approach also reflects the complex, interrelated nature of the world in which we operate as investors and our responsibility for sustaining that system for future generations.

THE CASE FOR IMPACT INVESTING

- ▶ Investors have to live in the societies shaped by their investments, therefore environmentally and socially positive investing is inherently in their interests. This is particularly important to ordinary pension savers, most of whom will not have the very high levels of wealth necessary to insulate themselves from the problems of wider society.
- ▶ In the long term, businesses can only thrive if the wider economy/society does as well, so investors should consider prioritising investments that enable a more resilient economy, environment and society and which offer the potential to access superior long-term returns.

◆◆ THERE IS A STRONG ARGUMENT THAT IMPACT INVESTMENT DELIVERS THE BEST HOLISTIC OUTCOMES FOR BENEFICIARIES AND IS THE MOST SUSTAINABLE APPROACH TO LONG-TERM INVESTING ◆◆

However, impact investing is not just about ‘doing good’, it is about doing a good job. First and foremost, you have to be a good investor. You still have to think about valuations and the quality of business – until the market develops, a problem in the near term is that everyone wants to invest in a sustainable way and there are not enough credible options that meet the criteria.

WHAT SHOULD YOUR MANAGERS BE LOOKING FOR IN INVESTEE COMPANIES?

In some cases, schemes will have the resources to engage directly with companies on issues including impact. Many others will be relying upon their managers and advisers to do so. However, it is important that schemes take the time to ensure they understand some of the factors their managers should be considering when constructing a portfolio of companies which demonstrate a commitment to long-term sustainable returns that bring real societal benefits.

Questions for assessing the investee company

- ▶ Does the company have a clear mission and is this enforced through its supply chains?
- ▶ Does the company embody strong cultural values, embracing diversity, employee development and environmental awareness?
- ▶ Is the company providing impact through innovative products, broadening access, and/or through the way it operates?
- ▶ How core and systematic is the delivery of impact to the company’s business model today or in the future?
- ▶ Is the company’s activity helping to adapt to, mitigate or transform a UN Sustainable Development Goal (or other framework) challenge?
- ▶ Are there actual or potential negative consequences to the company achieving impact?
- ▶ Is the company working towards improving its practices and collaborating with others?

ENGAGEMENT FOR IMPACT

Measuring and reporting on impacts achieved is essential to help foster strong relationships between companies and investors. Active engagement with investee companies is therefore vital and also results in better alignment between all stakeholders in a business. Schemes should ensure they have a good understanding of their manager’s engagement policy when investing for impact.

Impact engagement requires time, resources and focus. It is primarily driven by face-to-face executive- and board-level interactions with a company and an ability to shape the engagement strategy to suit the circumstances, local regulatory framework and the specific issues affecting the investee company. It can also include intelligent voting across the portfolio of companies.

Through engagements with companies, the aim is to create a positive feedback loop that strengthens and sustains the changes they are creating. The primary focus of schemes and their managers should be to generate long-term value, not seek media headlines.

CASE STUDY: SEEKING POSITIVE IMPACT AT A DIAMOND MINING COMPANY

This diamond mining company has the scope to fundamentally transform lives and communities – changes that will further improve its business. The company’s mines are the primary economic contributors to the isolated rural communities in which it functions, and it operates in a particularly water-scarce region.

The engagement plan focuses on the following targets:

- ▶ Provision of decent jobs and the mine’s contribution to local economic growth, which relate to Sustainable Development Goals (SDGs) of ‘No poverty’ and ‘Decent work and economic growth’.
- ▶ Efforts to support the SDG of ‘Good health and well-being’ through reducing accidents and fatalities, and supporting greater treatment of prevalent communicable diseases among the workforce, their families and within the wider community.
- ▶ A long-term water-use plan that serves the local community equitably, which is aligned with the SDG of ‘Clean water and sanitation’.

Although this is still at an early stage, the company’s on-the-ground impacts will be measured by assessing enhanced company disclosures, external data sources and our in-house analytical tools.

Questions to ask your asset manager

- ▶ Is the rationale for pursuing impact investing clearly expressed and understood by stakeholders, and does it take into account the needs and wishes of beneficiaries?
- ▶ Does the manager have a defined impact investment strategy?
- ▶ How is the impact of investments and the effectiveness of the impact investing approach measured?
- ▶ How does the manager and/or the funds they are invested in engage with companies regarding their impact? Can they provide any meaningful, detailed examples of when they have engaged and how it achieved a positive impact?
- ▶ How does the manager communicate impact investing activity to beneficiaries?



CASE STUDY

5



PENSIONS INFRASTRUCTURE PLATFORM (PiP)

PiP was created by pension schemes, for pension schemes, and are a UK-focused investment manager with expertise and experience across a range of infrastructure debt and equity investments.

Founded in 2012 to allow pension schemes of all sizes to gain exposure to the well-recognised benefits of investing in core infrastructure, and to participate in the opportunities arising from the UK's drive to improve the nation's infrastructure. The distinctive nature of infrastructure investment means that the expertise and experience that PiP provides is vital in achieving these aims.

INFRASTRUCTURE INVESTMENT IN PARTNERSHIP

The Pensions Infrastructure Platform (PiP) was established in 2012 to improve UK pension schemes' access to UK infrastructure investment opportunities. Five fundamental founding principles were supported by a core group of committed founding investor pension schemes:

1. Long-term buy and hold investment strategy. Twenty-five-year life investments.
2. Low base management fees, with no additional performance-related elements or management carried interest.
3. Alignment of interest between PiP and its investors – acting as their 'in-house infrastructure investment team'.
4. Mandated only to cover full operating costs, not to make profits.
5. Open to all sizes of pension schemes – low minimum investment size.

We believe this model aligns well with a 'patient capital' approach, ensuring better governance, better alignment and better value for UK pension scheme investors in infrastructure.

CASE STUDY: RED FUNNEL FERRIES

When considering potential investments, PiP looks for assets that will be able to provide long-term, inflation-related cash flows for underlying pension scheme investors, helping them secure the ongoing payment of their member benefits.

The PiP investment team have an established origination network which gives them sight of the majority of UK infrastructure transactions. One of these was the sale of a portfolio of infrastructure assets from an investment fund approaching the end of its life. Assets were being realised by the fund's manager in order to return proceeds to its investors.

PiP identified Red Funnel Ferries as the most attractive asset within the portfolio because of:

1. A well defined market linking the Isle of Wight with UK mainland with two major competitive operators and high barriers to entry.
2. Commonality of ownership interests: both ferry companies owned by infrastructure investment funds.
3. Strong underlying base business: island residents and businesses who cross the Solent on a year-round basis.
4. Relatively predictable seasonal tourist business.
5. Low probability of construction of an alternative fixed link, bridge or tunnel.

PiP began an internal due diligence process on the company and the Isle of Wight ferry market. A thorough due diligence is particularly important for schemes investing in any asset which they intend to hold for the long term.

In parallel, the West Midlands Pension Fund (WMPF), an existing PiP investor with an appetite for co-investment opportunities and which was also an investor in the liquidating fund was keen to remain invested in Red Funnel. WMPF appreciated the long-term stability of the business and preferred to continue as an owner, rather than receive a lump sum cash payment on disposal which they would then have had to reinvest into a different asset.

HOW TO MANAGE A CONSORTIUM AND PARTNERSHIP APPROACH

Asset allocation and concentration limits meant that WMPF was unable to fund the entire acquisition cost. PiP therefore worked in partnership and on behalf of WMPF and used its network of investor contacts to form a consortium bidding group.

◆◆ CONSORTIUM MANAGEMENT IS A DELICATE PROCESS, TAKING GREAT SKILL, DIPLOMACY, PERSEVERANCE AND PATIENCE ◆◆

In our experience, the key elements of any successful consortium include:

- ▶ An understanding of the philosophies and motivations of potential partners
- ▶ A common attitude to risk and governance
- ▶ Compatible decision-making processes
- ▶ Good personal chemistry.

After numerous discussions two other like minded investors agreed to work with PiP and the consortium was able to submit a winning offer to the vendor.

THE DUE DILIGENCE PROCESS

As an operating business, with its own employees, management team and executive board, an assessment of the human capital of the business was a key element of PiP and WMPF's acquisition due diligence. Did the incumbent management team have the capabilities we sought, or would new hires have to be injected on day one? And a retention strategy had to be developed to ensure key individuals were identified and motivated to stay for the long term.

In July 2018 the consortium was informed its bid had been successful and within a month it would become the new owner of Red Funnel. The business is an essential transport link from the island to the mainland and it was vital that there was no interruption of service during the process of ownership change. A detailed 'First 100 days' transition plan was developed and implemented alongside the incumbent management team to ensure the ships kept sailing.

During the first 100 days, important actions were taken to secure the long-term future of the business:

- ▶ Proactive engagement with all the business' stakeholders – especially those on the island
- ▶ Implementation of a new governance structure including the appointment of independent non-executive directors from the island
- ▶ Agreement of a new long-term business plan, including two new ferry additions to the fleet which would be manufactured in shipyards on the island and on Merseyside
- ▶ Agreement of a succession plan for the Chief Executive

- ▶ Thorough review of all elements of health and safety, to ensure the security of the hundreds of members of the public the business comes into contact with every single day
- ▶ PiP continues to manage the Red Funnel asset day-to-day on behalf of WMPF.

Schemes considering investing in an infrastructure asset such as Red Funnel should realise that this is not a passive investment. There are significant up-front costs to acquire the asset, and then an ongoing commitment to work alongside the management team to ensure delivery of performance levels which will preserve and enhance the value of the business. But in return pension schemes can secure long-term ownership of attractive, cash-generating businesses which support both the retirement incomes of scheme members and the local communities in which they operate.



GLOSSARY

| | |
|--------------------------------------|---|
| EBITDA | Earnings before Interest, Tax, Depreciation and Amortisation. This is one way of evaluating a company's performance. |
| Engagement | A process that allows investors to interact with companies in which they invest on issues that they care about. This can enable the achievement of long-term positive outcomes. |
| Illiquid investment | A security or other kind of asset which cannot be easily sold without a significant loss in value. |
| Impact investment | Investing in companies, organisations and funds with the intention of achieving both a tangible positive impact and financial returns. This can also be called social or environmental impact investment. |
| Patient capital | A long-term approach to capital, can include investment in early-stage companies but also more illiquid investments. |
| Sustainable Development Goals | The United Nations Sustainable Development Goals are a universal call to action to end poverty and protect the planet. They can provide a useful lens through which to view impact investing. |

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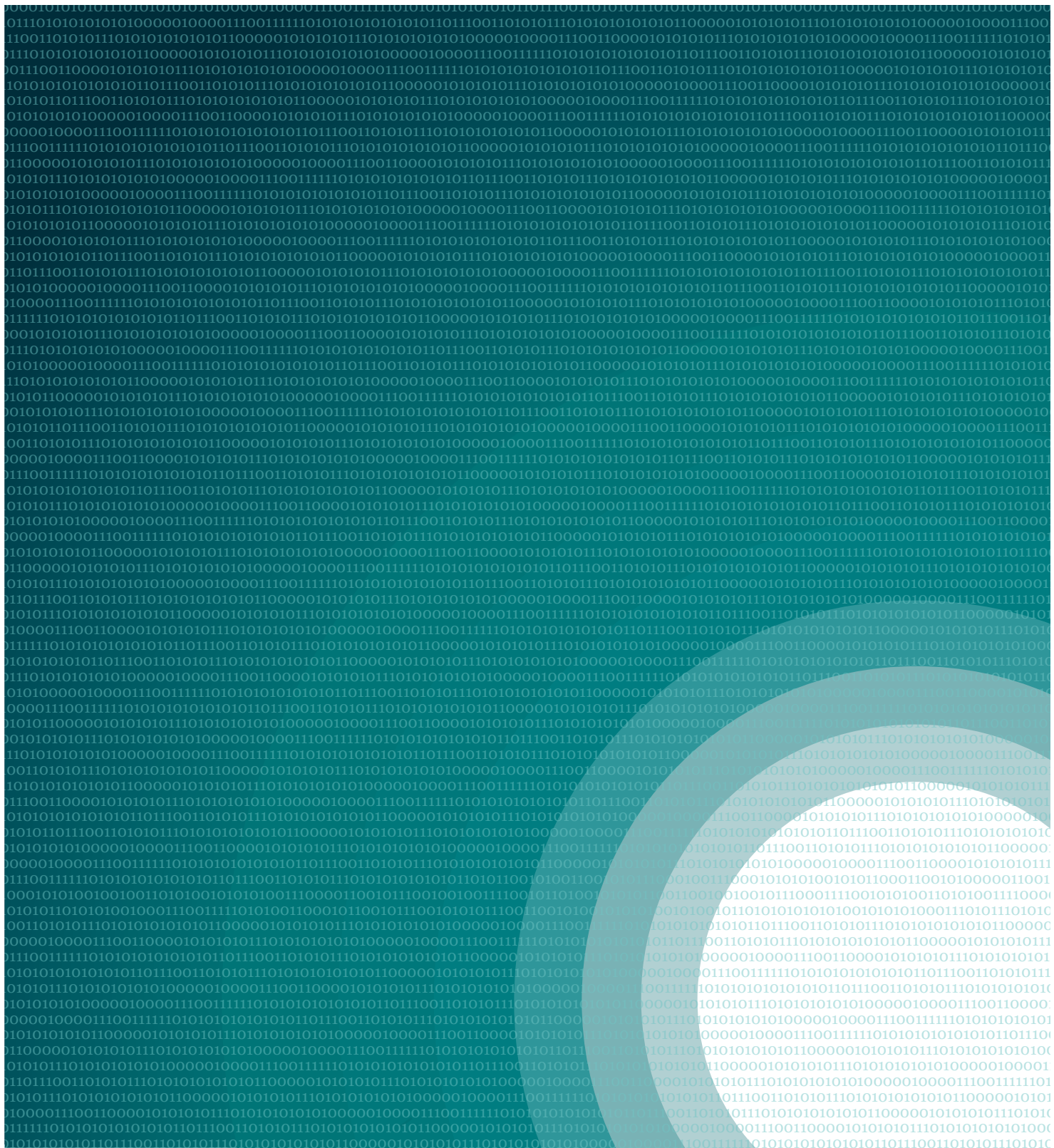
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NOTES

WANT TO KNOW MORE?

Look out for *Patient Capital Made Simple*, sponsored by Partners Group, in March 2019.





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