An appetite for priva

Pension funds are seeing private equity as an investment option but are proceeding with caution. **TONY CHARLWOOD** reports

Austerity could now run through to 2020, according to recent predictions by the prime minister. There are many factors contributing to the current situation and which affect the ten-year gilt yield, a measure crucial to the valuation of local authority pension funds.

The seemingly insoluble crisis in the eurozone; the credibility of the chancellor's austerity programme; quantitative easing; lower or negative growth; event risk; high institutional demand for gilts (indeed a 100-year gilt is mooted) – these are all contributing to a worrying scenario for local authority pension schemes in England and Wales approaching the triennial valuation date of 31 March 2013, with Scotland following in 2014.

It is likely that the results of the revaluation will show valuation levels around 60%. No doubt this will unleash a media storm of criticism about 'gold plated' public sector pensions when the implications of planned deficit recovery strategies are made public.

There will undoubtedly be much comment about strategies that involve increases in employer contributions when local authorities are stretched to provide basic services such as education (a million extra school places needed by 2020), social services and emptying the bins.

These anticipated valuation levels will put pressure on managers of local authority pension schemes to invest in higher yielding assets, while heeding risk.

Against this challenging backdrop LGC, with sponsor SL Capital Partners, carried out a reader poll over the summer to gauge the temper of local authority fund managers, with a particular focus on their attitude to – and appetite for – investment in private equity.

Higher yields

Private equity, of course, ranks as one of those higher yielding asset classes. It as an investment vehicle used primarily by institutions to gain equity ownership in companies, frequently using debt to finance the purchase with the usual result that the company so acquired is taken 'private' and delisted. Such funds are not readily available to retail clients.

Investment in private equity, therefore, is for experienced institutional investors who can commit their investment for considerable periods (often more than seven years) to allow for the turnaround of a poorly managed company to enable it to be sold at a profit.

> "Investment in private equity is for experienced institutional investors who can commit for considerable periods

Private equity can give diversification into areas when an investor has limited assets to invest; it can give access to funds managed by top performing managers not otherwise accessible, access to specialist investment strategies or exposure to difficult to reach markets.

Returns from private equity, however, are difficult to monitor. Private equity managers are not required to state performance on a regular basis. Because of the often illiquid nature of their investments it is not possible to value the assets except at the time of disposal.

The reader questionnaire was drafted by LGC, in conjunction with SL Capital Partners, to get a better understanding of what local authority pension schemes are looking for when investing in private equity funds.

Among the first findings was that two-thirds of respondents, when asked to rank asset classes in order of preference, still viewed equities as the choice to deliver the returns needed.

However, what was particularly interesting was that while coming in third to equities and fixed income, as would be expected, private equity as an asset class was identified as being more attractive than real estate and bonds by two-thirds of the survey's respondents.

Interestingly, the remaining third was very negative about equities, putting between 40% and 50% in fixed interest and bonds and around 21% in private equity. A total of 70% had some investment in private equity. But most also conceded they invested between 3% to 5% in private equity, and no fund committed more than 10%.

Nevertheless, those investing in private equity said they were looking for good returns over the next five

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years, with 62% looking for between 10% and 20%.

Peter McKellar, co-ordinating partner at SL Capital Partners, argues: "The attractiveness of an asset class depends on an investor's appetite for risk and return, while taking account of its need for liquidity. Private equity is often matched alongside real estate as an asset class given their comparable risk, return and liquidity profiles, although there are significant differences in their respective investment strategies.

"For investors looking for an element of alpha return from their portfolio of investments, private equity offers outperformance against most asset classes over the longer term – we are encouraged that local authority pension funds agree that private equity is an important part of their portfolio allocation."

When asked how their funds had performed, nearly half – 46% – said they enjoyed

> "For investors looking for an alpha return, private equity offers outperformance against most asset classes

good or outperformance over the longer term of their private equity investment and only 3% reported underperformance. When asked to review recent performance of their private equity fund during the recent period of financial crisis, 9% were very satisfied, with a further 74% giving this an average or above average rating, and 17% considering themselves dissatisfied.

It could be argued that this indicates private equity will show significant

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COMMENT

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Performance long-term

Private equity as an asset class continues to have a profile much larger than its position in the overall asset management mix (private equity: $2 trillion v global asset management: $76 trillion) would imply. In the US, Mitt Romney's time at private equity firm Bain Capital has sparked fierce debate about the industry's stewardship of investments; in Europe, private equity has been the foil for politicians who are looking to increase scrutiny, regulation and control over certain elements of the financial services sector.

So, when considering an investment in private equity today, you need to look through this 'noise' and consider the real opportunity and real risks.

The positives are proven – strong returns over the long term. Recent work by a number of leading academics, including the Oxford University Private Equity Institute, has provided unbiased evidence that private equity in North America and Europe has outperformed listed equities by 300-500 basis points a year since the 1980s. To deliver this performance, further research has shown that investors must select the right private equity fund managers to back, given the high dispersion of returns between them. Investors should also continue to invest over the long term to capture performance when the cycle is beneficial.

Liquidity remains a concern for pension funds. Private equity develops capital for three to five years prior to exit and, since the financial crisis, exits have slowed. As a result, allocations to private equity have capped out for many pension funds. Given subdued M&A markets, it is unlikely that this will ease in 2013. However, investors that can continue to invest today in private equity should see strong leveraged returns compared to other equity markets as we enter a recovery cycle in Europe and North America. Increasing regulation will affect all organisations in the private equity industry. This hurdle, especially in Europe, means pension funds will need to work closely with internal or external advisors to navigate the new requirements.

Given all of this, the message that should be communicated to clients is clear – private equity is a strategy that can deliver a strong return. Clients need to be clear on their strategy, how they access the top managers and should be prepared to invest for the long term across vintage years in attractive markets. In this way private equity, even if it represents a small component of a client's pension fund, can make a positive contribution.

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outperformance as the resolution to the financial crisis is found, giving, in particular, 'turnaround equity' a chance to be returned to the market at a premium.

More than half of the respondents looked to advisers or trustees to set their allocation to private equity. In many of the larger funds officers are, subject to due diligence, authorised to invest in private equity within certain limits.

One limiting factor to investing in private equity is the cap on investment in limited partnerships, currently prescribed by regulation to 15% of the total pension fund. Many funds are already substantially invested in limited partnerships of various types (including private equity) so the ability to invest further in private equity is constrained.

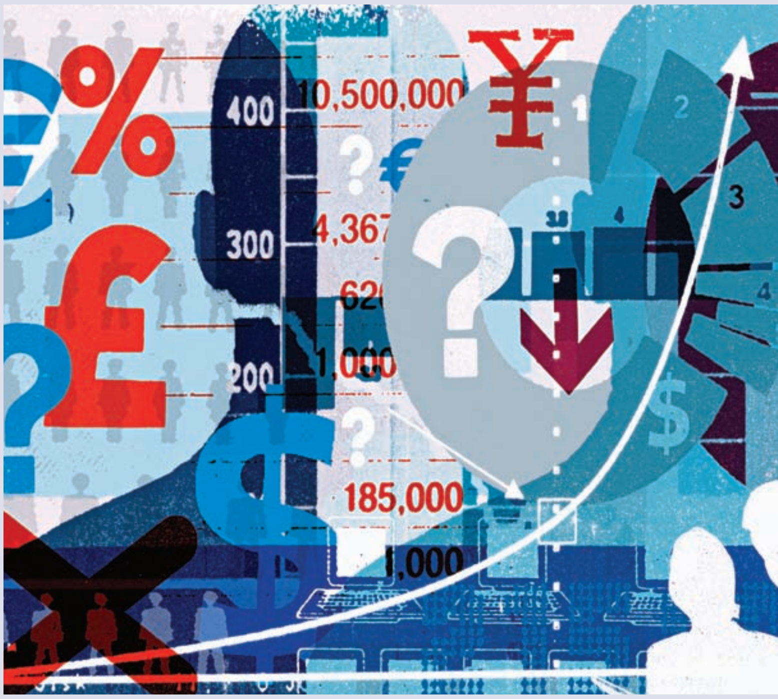
Funds saw a variety of ways to manage their investment in private equity, mostly through careful monitoring of cash flow and further commitment to their existing private equity managers bringing 'new product' to them, through the secondary market or through co-investments (which are outside the scope of the regulation).

That said, only half of the respondents – 53% – saw the present as a good time to increase existing allocations to private equity investments, and only a quarter of those said they were going to increase their allocation in the near future.

Varied preferences

There was no general consensus on the best type of private equity investment. Respondents were asked to rank the subsectors within the private equity universe in order of attractiveness and there was no strong winner.

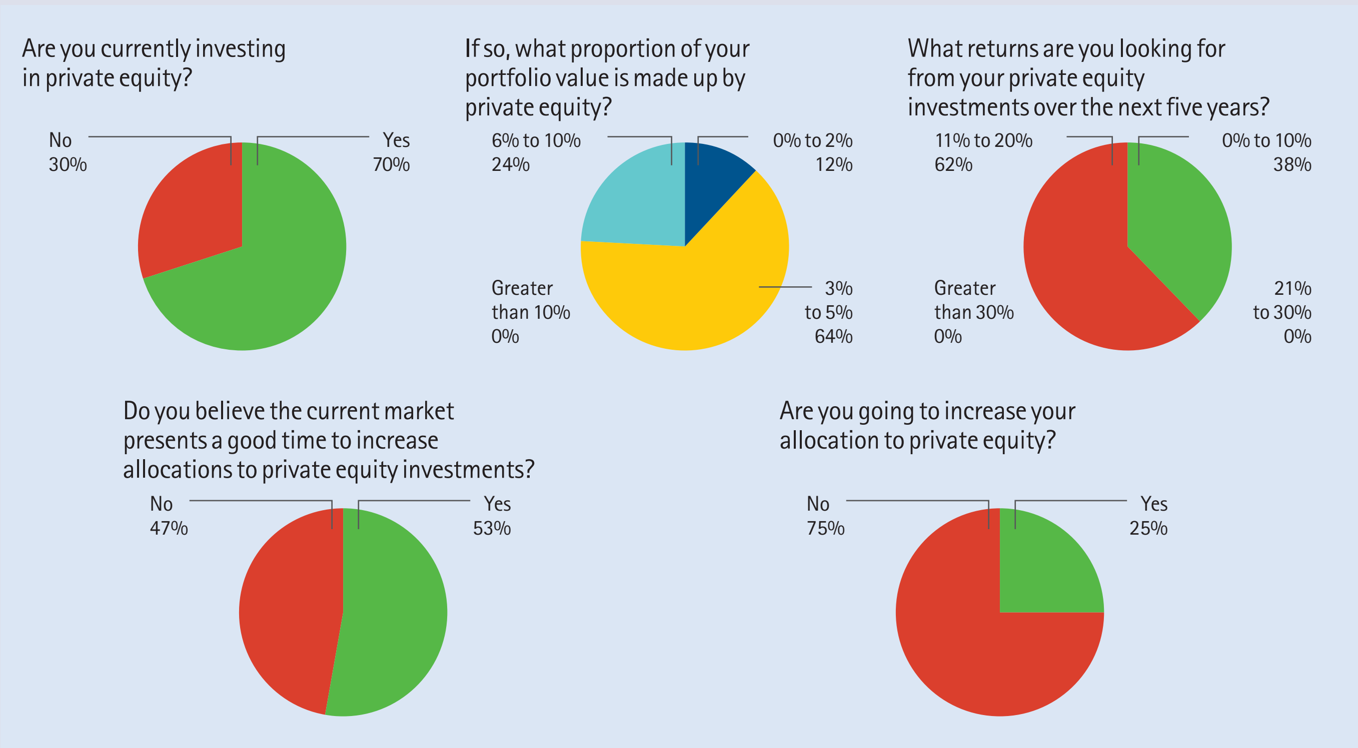
Turnaround equity was, on balance, the most popular area, with distressed debt and secondaries following closely. Energy was also popular but real estate was an outlier. North America, Europe and



emerging market equity (in particular BRIC) had their allocations but were generally insignificant compared with positions held in other types of private equity investments.

Placing money into private equity fund-of-funds as a method of investment also had its fans – with some 60% rating this as effective or very effective but 40% either coming back with either a middle ground or outright critical response.

A fund-of-fund investment, if managed properly, should of course give a good spread of underlying investments,



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This survey was sponsored by SL Capital Partners. Questions were drafted jointly by LGC and SL Capital Partners. The report was independently written and edited.

which should mitigate risk and loss if one of the funds should fail. However, the counter argument is that fund-of-funds investors can end up paying twice, one fee to the underlying fund and one to the fund-of-fund manager. On balance, therefore, respondents thought fund-of-funds was an effective or reasonably effective way of accessing private equity and ignored the double fee 'downside'.

SL Capital Partners' McKellar agrees going the fund-of-funds route is something local authorities should approach with their eyes open.

"It is important to note that the fund-of-funds route of investing in private equity is not appropriate for all local authority pension funds. However, for those who are looking for a general exposure to the asset class due to the smaller size of their potential allocation, an experienced fund-of-funds manager can offer a high level of access, performance and the overall management of the programme.

"In addition, larger plans can use fund-of-funds for specific strategies or geographies that are hard to cover with limited resources. In such cases, fund-of-fund managers can be the 'eyes and ears' for pension funds.

"We are encouraged by the continued acceptance that fund-of-funds are seen as a valid partner with local authority pension funds. It is critical that fund-of-funds continue to deliver value for the fees incurred, and that managers continue to develop their investment strategies, portfolio monitoring and reporting to be state of the art."

The survey also asked about more esoteric issues such as governance and socially responsible investing – where interest among local authority pension funds has waned since the early part of the century, especially as returns did not match up to expectation.

Asked about whether SRI or ESG ideals impinge on investment decisions in private equity, it was clear they generally are not a high priority with around half – 46% – considering this not to be important, a fifth going the other way and a third sat plumb in the middle.

Balanced views

Similarly most local authority pension scheme managers did not believe private equity investment managers placed SRI or ESG factors high in the criteria when considering making an investment. Around a third felt negatively on this issue, half were on the fence and around a fifth took the view that, yes, this was something taken seriously.

The number of fund managers a pension scheme employs and the number of funds in which it invests has clear governance implications for officers' managing investment for their authorities.

> "Larger plans can use fund-of-funds for specific strategies or geographies that are hard to cover with limited resources

Custody, monitoring and accounting are all matters that have to be taken into consideration and the manpower implications of keeping on top of all these issues.

Respondents were therefore asked how much work investments in private equity funds created, how expensive it was and how burdensome on an in-house investment team it was to manage and monitor the investment.

There was little consensus on how onerous it was to monitor private equity funds; however, 7% did say they thought it very burdensome.

Similarly there was little consensus on fee levels, with more than 55% of the sample ambivalent and the balance spread on either side of the mean. Restrictions on private equity investments were not seen as very burdensome, with almost 90% arguing this was not an issue.

Similarly management of cash flows relating to private equity was not generally seen as burdensome, nor was reporting to trustees.

Liquidity, too, was not thought to be an issue, although this might change with the implementation of the 'new' local authority scheme in 2014.

Finally, respondents were asked how they rated their investment experience when using consultants to advise on sectors to invest in with private equity. The majority, 74%, reported their experience as either average or poor.

However, when asked about performance, 33% said those recommended either outperformed or were good, with 50% saying performance was average and 17% poor.

Overall, what should local authority pension fund managers be taking away from all this? On balance the case for investing in private equity does appear to rest on the economics of recovery.

Actual returns experienced by 68% of the sample rated average or above, so investment in private equity would seem to meet expectations, although it remains to be seen whether the expectation of a return between 11% and 20% over five years from the present will be met.

From the sample in this survey there does not appear to be an overwhelming desire to invest in the sector, although more than 50% do believe now is a good time to invest.

Opportunity

Perhaps more positively, the diversity of response appears to back the view that individual schemes are constantly considering ways of improving investment performance.

Clearly, too, overall investment returns for the local government pension scheme are critical and the need to improve paramount.

The need to diversify into higher yielding asset classes is proven but if the implementation of the 'new' scheme pushes funds up the maturity curve in 2014 the question is will they be able to do so or will they have to move towards investment in liability matching assets?

● **Tony Charlwood is an independent financial services adviser**

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