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ROUNDTABLE

PERFORMANCE FEES IN DC PENSIONS

– 2 AND 20: A PRICE WORTH PAYING?
– PRIVATE MARKETS – PERFORMANCE ANXIETY?

IN ASSOCIATION WITH

TIME TO BUST THE MYTHS AROUND PRIVATE EQUITY CHARGES

Nick Groom, head of UK DC strategy and sales, Natixis Investment Managers

Whilst chatting with a number of DC stakeholders about illiquids, and around the impetus created by the Mansion House Compact and the emphasis on VC/PE asset classes into their portfolios, it struck me that the industry needs more information and education on the subject of private assets, fee structures and performance fees in particular.

There is a view amongst some commentators that they are indeed the devil, although the 2+20 model has existed for many many years, and 82 per cent of all PE funds still charge it (the rest offering lower fees due to lower quality and problems fund-raising). Are we now to expect the UK DC market to change all of that, when these quality managers can ply their trade anywhere in the world at that price? We should ask ourselves whether if it isn't broke, do we really need to fix it? Working for a global asset manager with plenty of access to these asset classes, I wanted to expel some myths about them and ensure the UK DC investing community has all the facts in front of it to make informed decisions.

At the same time we had concluded some work with Corporate Adviser using their CAPA Index data (the average quarterly asset allocation of 23 master trusts and GPP's) projecting forward the returns using a conservative 10 per cent allocation, to prove the case for illiquids, and using independent asset class returns as historic data is not well developed unfortunately.

Our roundtable was well supported, not a seat to be found, which suggests a hunger for information around this topic. We had trustees, platforms, consultants regulators, and other actors keen to learn more.

The Mansion House Compact has focused our minds on the way an investment in VC/PE can both help net returns for members, but also the UK economy. In doing so it has zoomed in on the fees that these asset classes charge and demand, but given where we are on VFM and consolidation activity both driving the price to unprecedented low levels, getting them into play is not without its challenges.

The origins of performance fees are from the 18th century and more than likely the East India Company sending ships overseas where the captains were often granted a share of the profits from a successful voyage, known as the "carriage," to incentivise them to make sound decisions and ensure the safety of the voyage. Creating true alignment of interest in its pure sense, not necessarily that different from where we are now.

At the roundtable, Eric Deram from Flexstone, a private equity fund of funds founder/portfolio manager came along to talk us through the origins, the application, and the reasons why this approach is commonplace. This was an opportunity for UK DC to learn more, to fully challenge and perhaps to accept that if you want quality, and there is a broad dispersion of returns from first to fourth quartile, and if you want the best, you may need to pay for it to access those compelling net returns.

With the benefit of having been at the Mansion House Pensions Summit the day after our roundtable, and before writing this, it was clear that we have government and regulatory ambition. There is conflict still amongst stakeholders; trustees are too risk averse, consultants not willing to move away from price being the main driver, and an unfounded perception of operational risk and complexity being a barrier to entry, although our roundtable looks to dispel another myth right here.

So change needs to happen, the risk of not doing this must be a key risk consideration for all, and notably in the Chairs' statement. We must move the thinking to net returns, as Damien Webb from Aware Super explained, they have enjoyed 23 per cent annualised returns over the last 5 years for their 6 per cent PE allocation, so decision makers may need to perhaps just "suck it up", and enjoy the compelling fruits of these illiquid asset classes.

2 AND 20: A CHARGE STRUCTURE FOR THE GREATER GOOD?

Trustees and IGC members will need to take a crash course in utilitarianism to decide whether they should accept private equity charging structures

John Greenwood
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With two of the most eminent figures of the world of pension trustees, both from the same firm Capital Cranfield, holding opposing views on the topic, the suitability of 2 and 20 charging structures for DC investments is clearly a highly contentious issue.

Andrew Warwick-Thompson, former regulator and chair of the Scottish Widows master trust, thinks allowing performance fees is a mistake, arguing that schemes have been successful at battering down charges anyway, and raising his concerns at the potential for intergenerational unfairness in terms of who gets charged and who reaps rewards.

Andrew Cheseldine, chair of the Smart Pension master trust on the other hand, speaking at the round table covered in this supplement, thinks the opportunity to access the 80 per cent of the world's companies not listed, by number not market cap, means a pragmatic approach is worth taking.

Before having a view either way on the matter, it is worth taking a moment to clear up some of the misconceptions that may exist around how private equity performance fees work.

Hedge fund managers can walk away with very tidy profits when their funds experience short-term surges in value. For them, high watermark performance fees mean they can walk away with bonuses following paper profits, only for the investor to lose out in the following year when the fund's value falls. At which point it may be closed, merged or the manager sucks up the lack of a performance fee and lives to fight another day.

When it comes to private equity, performance fees are only paid on real returns. So under a typical carried interest waterfall structure the investor's initial capital is returned to them, followed by their initial returns, up to say 8 per cent. This usually covers off the first seven or eight years of the investment - before the manager gets a payout. If it takes 8 years before the investor receives returns up to the hurdle rate, they will have received a refund of all their initial investment plus a 64 per cent return. The next 16 per cent would go to the manager under the catch-up as they recoup their eight years of 2 per cent, and only after that does the 20 per cent return kick in. So on an investment making a 100 per cent return, there will only be a 20 per cent fee after 84 per cent of returns have been paid out. This feels considerably less generous than a high watermark hedge fund approach.

Ultimately, trustees may ask themselves what is the problem with a generous manager fee share that only kicks in after a return that is higher than what's expected of pretty much every other asset class the fund is investing in.

The intergenerational issue still remains - so trustees must weigh up the extent to which investors will out if they leave before returns are delivered versus the improved upside for the greatest number of members.

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PERFORMANCE FEES IN DC PENSIONS

2 AND 20: A PRICE WORTH PAYING?

Is it worth it for DC funds to pay 2 and 20 charges for access to the best private equity managers? Or is it more a question of communication? **John Greenwood** hears the arguments

The controversial issue of whether defined contribution pension schemes should embrace the 2 and 20 performance fee structures common in the world of private equity was a key area of debate at an industry round table last month.

Government proposals that allow performance fees on private equity holdings within defined contribution pensions have been met with criticism in some quarters. But several delegates at the event were generally supportive of the concept of performance fees, with Capital Cranfield professional trustee Andrew Cheseldine arguing that a hurdle rate of 8 per cent meant 2 and 20 private equity investments would normally beat most other asset classes in the default before any performance fee was actually paid.

Charge controversy

The event was hosted by Natixis Investment Managers, which presented potential performance outcomes for portfolios with differing levels of private equity holdings for typical asset allocation approaches based on figures from Corporate Adviser's CAPA-data analysis of over 23 master trust and group personal pension (GPP) default funds.

Cheseldine's comments contrasted those of his Capital Cranfield colleague Andrew Warwick-Thompson, who was also former executive director for regulation at The Pensions Regulator, who has in recent weeks been critical of the Department for Work and Pensions for allowing performance fees to be excluded from the charge cap, citing intergenerational unfairness.

Nest, the giant public service provider established by the UK government, has resisted two and 20 charges in its pitch for private equity, that will see it placing around £1.5bn with Schroders Capital by 2025, as it targets a 5 per cent allocation.

Eric Deram, managing partner of Flexstone Partners, a private investment

Darren Philp, Shula PR and Policy managing director

Nick Groom, Natixis head of UK DC strategy and sales, and (top right) Eric Deram, managing partner of Flexstone Partners

firm owned by Natixis, said that a 2 per cent management fee plus a 20 per cent carried interest over a hurdle rate of 8 per cent was the industry standard, and would have to be paid if DC schemes were serious about getting access to decent PE managers.

Hard bargain

So how do proponents of performance fees for private equity respond to the challenge from some corners of the UK DC sector that providers can drive a hard bargain because they will have a steady and growing flow of assets? With guaranteed scale, isn't the boot on the provider's foot?

Deram pointed out that the Hostplus Superannuation Fund, which surpassed AUS$100bn of assets earlier this year, has a 20 per cent allocation to private equity specifically, with 40 per cent in illiquids, and it pays fees on a two and 20 basis.

Deram said: "The very successful VC funds that you may have heard of, they have zero hurdle and 30 per cent carried interest, and they are 50 times over-allocated every time they raise a fund. So they will never change their terms. But they deliver performance that is mind blowing. They have triple digit IRR, but the only people who get to invest in them are the likes of the Yale, Harvard and Princeton endowments."

Cash waterfall

Deram outlined the carried interest waterfall mechanism that operates in private equity to manage distributions between general partners (GPs), who are the managers of the fund and limited partners (LPs), the investors.

Once the investment is made there are typically no payouts in the first two years. Stage one of the waterfall sees the LPs' initial capital returned to them before any profit share is paid. Stage two sees the LPs receive their 'preferred return' or 'hurdle rate' up to the threshold agreed. ▶

Stage three in some arrangements is the catch-up provision, which kicks in once and only if the hurdle rate has been met. This allows GPs to take profits so their overall return matches that of the LPs, under the agreed ratio. For example, on a two and 20 arrangement, they will receive a quarter of what the LPs have received under stage two.

The final stage is when the profit-sharing mechanism takes effect and 20 per cent carried interest is paid to the GP.

Deram said under typical European waterfall structures, one needs to reimburse 100 per cent of the capital on the entire fund basis, whereas the US waterfall model is deal by deal, with an escrow account to make sure that the GP doesn't get too much performance fee if later investments underperform compared to earlier investments in the fund.

Private matter

Cheseldine said: "There is a wide range of assets here. Smart has productive finance bond elements which don't pay anything like these fees. But this is different because we are looking at equities and performance.

"My only concern is for outperformance for the member in the long term. I'm relatively relaxed about paying higher fees as long as it's within the charge cap, within the regulations, which are now broader.

"But I want to make sure that it works. And I also need to make sure that there's cross-generational fairness. I don't want to have someone who gets the benefit from this and then doesn't pay any of the fees. But I think the way that Eric's described the waterfall and certainly with escrow accounts, that would work."

Lawrence said: "It is insane to exclude 80 per cent of the market effectively. The 20 per cent that is left is probably not going to be the top 20 per cent.

Deram pointed out that for eight years out of the most recent 20-year period for which figures are available the median internal rate of return did not exceed the 8 per cent trigger for which carried interest is paid.

"This gives you a sense of the impact of the hurdle rate," he said. "Alignment of interest is the famous principal versus agent problem. I would say it is equivalent to stock options for managers in a publicly traded company.

He also highlighted the fact that the hurdle rate was introduced at 8 per cent when that was the risk-free rate.

Hedge contrast

Deram also stressed the difference between hedge fund and liquid funds with performance fees, which paid managers on high water marks in a good year for the fund, even though they may never regain that high valuation again. While hedge funds paid performance fees on paper profits, often over short time periods, private equity 2 and 20 structures only paid out on actual profits, and typically saw no carried interest payouts until after seven or eight years.

Sophia Singleton, XPS partner and head of DC

Deram said funds are typically 10 years in length although in practice go on to 12 years. "For the first few years that you invest you have negative cashflows, and then as you start resetting your portfolio you generate distribution. Remember the 20 per cent carried interest is very rarely paid to investors before year eight or nine."

He cited figures from research carried out by data firm Prequin which found that 68 per cent of private capital fund investors believe their interests are aligned with those of the 'general partners' managing the investments.

For Cheseldine, who sits on the boards of the Smart and Lewis master trusts as well as Aon's GPP investment committee, perception is as much a challenge as the actual charges.

Cheseldine said: "The biggest challenge here is perceived fairness bias, because to a user, a trustee or a member, saying you're taking 20 per cent of the outperformance sounds enormous. But if you recast that with a hurdle of 8 per cent, it is less of an issue because realistically I don't think many members expect more than 8 per cent in today's environment."

Asked whether, as a trustee, he would be comfortable with such a charge structure, Cheseldine said: "As an individual I might be comfortable. But I would need to figure out how we would get that across."

Communication challenge

James Lawrence, of Smart Pension, said his organisation had figured out a better way to phrase the charges.

"The discrepancy between the best and worst funds is huge, and you need to be in those very best funds. They are oversubscribed consistently. So why would they negotiate?" said Deram.

Cheseldine said: "The biggest number for me is that hurdle rate of 8 per cent. Because for the other asset classes that you're investing in, how confident are you that any of them are going to get close to that? If you think 8 per cent is a good, relatively high return, why would you be particularly worried about paying extra charges for going above 8 per cent?" ■

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PERFORMANCE FEES IN DC PENSIONS

PRIVATE MARKETS – PERFORMANCE ANXIETY?

Will private market investments deliver the performance boost that their advocates, including the UK government, say they will? Emma Simon hears both sides of the argument

There is clear political and regulatory momentum to encourage DC schemes to broaden their investment remit and commit more money into private markets.

A recent roundtable, held by Natixis Investment Management in partnership with Corporate Adviser, industry professionals from across the DC landscape, including trustees, consultants, providers, regulators and those working for platforms, discussed the potential benefits of these illiquid investments, as well as current barriers to wider adoption.

One key issue was the potential performance boost illiquids can offer DC defaults as part of a diversified investment strategy.

Natixis IM Solutions director Jochem Tielkemeijer said there are a number of reasons DC schemes might want to consider allocations to private markets. These include diversification, lower volatility, inflation hedging and ESG objectives — as well as enhanced returns.

However, given the higher cost of investing much of the drive to include illiquids is likely to be framed around the performance question — and whether higher asset allocations to private markets can deliver better member outcomes.

Tielkemeijer said that while there seemed to be consensus across the investment industry that private markets offer an "illiquidity premium", there remains debate as to the size and significance of this enhanced return.

Given the lack of clear public data on performance for private assets, which are, by their very nature private, views will "depend on who you are speaking to within the industry" as well as the duration and timing of these investments and the particular asset class, be it venture capital, private equity or private debt, he said.

But Tielkemeijer attempted to quantify what this range of enhanced returns might mean within a DC context, by using data from the Corporate Adviser Pension Average (CAPA) data set, which shows average asset allocations and returns for the default funds of all the major DC master trusts and GPPs operating in the workplace pensions market.

Natixis IM's future scenario modelling takes into account both macro factors and long-term return assumptions for the major asset classes. These inputs, collated from a range of sources, suggest future returns from private debt, infrastructure, direct real estate and private equity are all likely to outperform expected returns on global equity — and outperform significantly in the case of private equity.

Given these projections, Tielkemeijer modelled how a 10 per cent allocation to illiquids could impact future DC returns on typical default constructions. On the default portfolio for investors in the growth phase (30 years from SPA) this allocation boosts the median annualised return from 5.2 per cent, per annum to 6.16 per cent pa— a difference of 0.96 percentage points.

Tielkemeijer said that while this may look like a modest increase, it has a marked effect on total returns over a 30 year period, with the average total return increasing by 218.5 per cent. Even on the worst-performing default funds (in the bottom 10 per cent performance-wise) a default with a private market allocation should see total returns increase by 47.4 per cent (compared to an allocation without private markets) while the top performing funds should see a 452.2 per cent uplift.

This translates into approximately 20 per cent increase in capital at retirement according to Natixis's figures graph — or a 42 per cent increase in pension capital with a 20 per cent private markets allocation (see graph below). It also significantly increases the probability that members will be able to outpace inflation.

Natixis IM also modelled returns for defaults five years from retirement. The average boost to annualised returns was broadly similar, although as this was over a shorter timeframe the effect to total returns was more modest.

Private asset allocations were different for different age cohorts. During the growth phase Natixis modelled a larger (6 per cent) weighting to private equity, with smaller allocations to private debt, infrastructure and direct real estate, while the allocation five years to SPA included 5 per cent in private debt and 3 per cent in private equity and just 1 per cent invested in real estate and infrastructure.

While those attending the debate did not disagree that illiquids could boost returns, there was scepticism around some of the assumptions made, particularly the expected returns for private equity which forecast 18 per cent a year going forward, compared to 7.4 per cent for global equity, 7.9 per cent for emerging market equity and 5.6 per cent for global corporate bonds.

Andy Cheseldine a professional trustee with Capital Cranfield said this is unlikely to include the 'cash drag', typical on most private market investments, with returns typically not paid out until the sixth or seventh year. This 'J-curve' effectively dampens returns he said, and could make the premium above global equity less impressive", although Natixis head of UK DC strategy and sales Nick Groom said the

Ben Van den Tol, director business development at AMX

cash drag impact could be minimised by the fund structure.

Given these figures are net of charges Chesledine suggested a 18 per cent projection for private equity as an "heroic assumption". But Tielkemeijer countered that even if the returns were several percentage points lower than this, there would still be an overall performance boost.

There were comments that while private markets have delivered strong returns in recent decades. this has been in relatively benign economic conditions where low interest rates have seen increase funds ploughed into this sector.

Shula PR and Policy managing director Darren Philp said he would like to know what kind of economic scenarios might see a reverse of these figures, where global equity outperforms private equity?

He also asked another provocative question. "If this outperformance looks so impressive, why are we proposing just a 10 per cent allocation to private markets?" Although he did not necessarily recommend allocations of 40 per cent plus – given liquidity issues and the overall size of the market – he said making bold performance claims for illiquids could trigger such questions.

Tielkemeijer said that data on the performance of private markets is, by definition more limited, when compared with the raft of information available from publicly listed markets. "This is self reported data, so you have self-selection and also survivorship bias. Assumptions are just that, assumptions and need to be taken with a grain of salt," he said.

But he said these figures are based on information from leading private market data providers, just as Cambridge Associates, practitioners such as Yale Endowment and a range of academic papers.

The roundtable discussion highlighted one important aspect of performance – the considerable difference in private equity returns between the top and bottom of the market.

Flexstone managing partner Eric Deram said DC schemes need to gain exposure to these higher performing private market investments.

"In private equity the average is not interesting; you need to be first or second quartile to deliver good results." He pointed out that in a survey of private equity vintages over the past 20 years, around half did not achieve sufficient performance to trigger their performance-related fee. He also questioned whether those pension providers who had achieved investments in private equity without embracing 2 and 20 charges would get access to the best investments. He said even big investors struggled to get access to the very best private asset funds, as they were competing with huge high prestige investors such as the Yale, Harvard and Princeton endowments.

This question of selecting the right investments raised an interesting discussion point for trustees and consultants. In recent years default investment strategies have favoured passive strategies, which trend in line with the market averages rather than trying to pick winners. Would this approach have to change to incorporate private market ▶

The impact of capturing the illiquidity premium

Portfolio 30 years from State Pension Age

	Distribution Total Return				Ann. Return (5Y)	Distribution Volatility		Distribution Sharpe	
	10% perc.	Average	Median	90% perc.	Median	Average	Median	Average	Median
Initial Portfolio	1.4%	34.5%	33.6%	68.2%	5.97%	9.6%	9.2%	0.77%	0.63
Alternative Portfolio	6.1%	39.3%	38.5%	72.9%	6.73%	9.5%	9.1%	0.88%	0.73%
Difference with Private Markets	4.7%	4.8%	4.8%	4.7%	0.76%	-0.2%	-0.2%	0.11%	0.09

Portfolio 5 years from State Pension Age

	Distribution Total Return				Ann. Return (30Y)	Distribution Volatility		Distribution Sharpe	
	10% perc.	Average	Median	90% perc.	Median	Average	Median	Average	Median
Initial Portfolio	39.8%	623.3%	357.0%	1410.1%	5.20%	15.1%	15.0%	0.36%	0.35
Alternative Portfolio	87.2%	841.8%	500.6%	1862.2%	6.16%	15.1%	14.9%	0.43%	0.41%
Difference with Private Markets	47.4%	218.5%	143.7%	452.2%	0.96%	-0.1%	-0.1%	0.07%	0.07

allocations? And do those working across the DC sector have the necessarily skillsets to do this?

The Investment Association senior policy adviser Imran Razvi said he did not think that this was significantly different to the decisions made around active management. Those attending the debate added that schemes were likely to use fund managers that specialise in this area.

But XPS partner and head of DC Sophia Singleton said one of the reasons private markets weren't a key part of most DC portfolios was that management charges were expensive — and the DC world remains price driven. She added there was also a reluctance to change investments within defaults as this also incurs additional costs.

Philp agreed with this analysis: "There are certain types of investment that are much easier for people to get their heads around. Often this is a capacity issue as well as a price issue. We know that time can be an issue when it comes to trustee meetings. So the more exotic you go in terms of asset class, the more effort and work you need to put in and this has been a key barrier preventing the wider take up of private market investments in DC."

Many around the table agreed that when it came to performance there was often a 'herd' mentality within the DC sector. Deram pointed out that this isn't just an aspect of the UK DC sector - it is a trend he's observed globally with pensions.

Ben Van den Tol, director business development at AMX, which offers LTAFs in the UK said useful lessons can be learned from Australia, where he previously worked.

There schemes compete on net returns, he said, marketing themselves direct to members, not just employers. This puts far greater focus on investment performance, rather than price alone.

The focus on price in the UK means schemes have been reluctant to embrace private markets, which add costs and may only drive performance after several years. In Australia he said it was the schemes that invested heavily in private market 15 years ago that are now delivering the strongest returns, and have subsequently attracted new business as a result. This has driven similar investment strategies among competitors he said. Australian Super giant Hostplus, for example, has nearly 50 per cent of its default allocated to non-listed assets.

Recently Australian regulators have move to take action against under-performing funds. While Van den Tol said this has been effective in removing "deadwood and dross" he warned this may only be an effective strategy over the short-term.

A focus on action against underperforming schemes could result in more of a herd mentality in the long-run, he said, with schemes reluctant to pursue investment strategies that risk short-term underperformance, even if there may be more of an longer-term upside.

While there was considerable focus on the performance impact of illiquids and private market investments, the modelling and analysis undertaken by Natixis showed that this wasn't the only significant benefit offered to default portfolios.

While private market investments, particularly private equity can be a more volatile asset class than equities or bonds, its inclusion within the multi-asset portfolio can reduce the distribution volatility of the whole portfolio according to Natixis analysis.

Tielkemeijer pointed out that the volatility of default portfolios, both during the growth phase and five years to SPA, are lower with these assets. This is in part due to increased diversification and relatively low correlation on returns from these different asset classes.

Deram said that all various data points relating to performance suggests that it could prove beneficial for DC portfolios, despite the higher management and investment costs.

Despite the increase in private market investments in recent years he said that there is still substantial opportunity in this asset class. Rather than focus on the minutia of this data he said it was important for scheme managers and investment specialist to look at the bigger picture.

"If you ask me why you should invest in private markets, my main answer is because the world is essentially private.

"Around 80 per cent of the world's companies are privately owned, this includes some of the very biggest companies to start up enterprises that will be the engines for creating future wealth.

"You now have more private companies than public companies so it is much easier to diversify your portfolios. I went to my first private equity conference in the 1990s and one of the issues debated was whether there was too much money in private equity. That was close to 30 years ago and the industry is 50 times bigger today. My message is there is still substantial opportunity in these diverse markets." ■

Assumptions & Inputs

Expected Returns[1] from NIM Solutions' Strategy Team per Q1 2023

		5 year		30 year	
		ER	Vol	ER	Vol
LIQUID ASSETS	Cash	3.3%	1.9%	2.8%	2.7%
	Gilts	4.9%	7.0%	4.0%	7.6%
	Index Linked Gilts	5.1%	9.4%	4.6%	10.2%
	Glbl Corp Bonds	5.6%	6.5%	5.4%	7.2%
	UK Eq	8.3%	13.6%	8.2%	15.0%
	Global Eq	7.5%	15.0%	7.4%	16.8%
	EM Eq	7.9%	18.6%	7.8%	21.1%
	UK Property	4.7%	11.6%	4.3%	13.3%
PRIVATE MARKETS	Private Debt	8.2%	7.4%	11.0%	7.2%
	Infra	9.7%	7.4%	12.3%	7.9%
	Direct Real Estate	7.6%	8.3%	10.1%	8.6%
	Private Equity[2]	18.0%	19.3%	18.0%	20.4%

[1] Expected returns for liquid asset classes are from NIM Solutions' Strategy Team per Q 1 2023 The expected returns for private markets represent annualised net IRRs over the past 10 years and based on net capital flows to LPs Infra is based on an average of 32 funds, real estate 154 and private debt 59 Annualised volatility are computed within Moody's Economic Scenario Generator.
[2] The expected return for private equity is based on a private equity feasibility study from "The Future of Defined Contribution Pension" 2019 Oliver Wyman, The British Business Bank.

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