XPS Investment

Investing in Private Markets

A once in a decade buying opportunity?

April 2023

Contents

Overview

The dynamics for private market investment for both Defined Benefit (DB) and Defined Contribution (DC) schemes have shifted considerably in the last 12 months as a result of several independent market and regulatory factors.

Recent public market price falls, caused by concerns about the banking sector, have further exacerbated valuation pressure at a time where many organisations will be coming to the end of their financial year and be required to audit asset values.

In this paper Steven Hickey explores the potential impact on the UK pensions market, including the opportunities and pitfalls this has thrown up.

Key issues for DB and DC trustees:

1	**2022 witnessed 3 separate factors that have generally driven down demand from DB pension schemes for private market assets. Underlying valuations of private asset have also been challenged by the market backdrop.**
2	**Lower valuations have created buying opportunities for investors that can tolerate illiquidity.**
3	**Indiscriminate buying of private market investments will miss the opportunities and could involve overpaying. Our view is that private markets as a whole are not necessarily cheap.**
4	**There are also challenges that need to be overcome in order for DC investors to access private markets. Currently only a very small proportion of the DC market have the means to access private market investments and change is not coming fast enough.**

What are private markets?

Private markets relate to assets that you cannot buy on an exchange or public market. As a result it is more difficult to buy and sell the assets which means holding periods are typically much longer and this reduces the number of investors who are able or willing to invest.

Examples of private markets include private equity, property, infrastructure and direct lending. These markets are all very different and the complexity and illiquidity involved leads to an expectation for higher returns for a given level of investment risk.

Improved funding and increased liquidity requirements for defined benefit pension schemes has created an opportunity for those investors who can tolerate illiquidity to buy discounted private markets assets. But, private market are not cheap across the board.

Steven Hickey, Head of Credit Research

The private market dynamic — fundamentally lower defined benefit investor demand

UK Defined Benefit pension schemes have historically taken advantage of the benefits private assets can offer, including return enhancement, diversification, inflation protection, resilience and access to a significantly larger opportunity set.

There are three key reasons as to why the landscape for private market investment has changed for UK DB pension schemes coming into 2023:

1

Funding level improvement from falling liabilities

DB pension schemes are, in aggregate, now 102% funded on a low dependency basis, which is a funding improvement of 17% from the beginning of 2022*. This striking improvement has meant that schemes are now significantly closer to their end-game targets than they were the year before and, as such, don't require as high an expected return as previously.

As a consequence, schemes are also now considerably smaller in size and have, in many cases, shrunk around their illiquid allocations. Rising gilt yields in 2022 reduced the value of liability matching asset investments which required rebalancing, this combined with the poor performance of liquid growth assets served to significantly reduce liquid asset values. These falls, however, were not reflected in many private market investment valuations as of the end of December 2022, due to their lagged valuations, different valuation methodology and market dynamics. Many schemes that hold illiquid assets became overweight relative to their strategic targets for these allocations as a result; an occurrence known as the 'denominator effect'.

2

Increased regulatory requirements

New scheme funding regulations and pension legislation, expected to be coming into force later this year, will enforce stricter requirements on how much risk and return DB pension schemes can take as their scheme progresses towards significant maturity where the membership are increasingly pensioners. This will lead to greater de-risking of schemes. Whilst the regulation does put an emphasis on a greater use of assets that generate a cashflow, which certain private assets do, the wider direction of travel is ultimately expected to reduce the demand for higher returning assets with long-term lock-ins such as private equity.

3

Increased liquidity requirements

Changes made by the LDI managers and new guidance from the Pensions Regulator post the gilts crisis have placed increased liquidity demands on DB pension schemes. This has shifted the dial in terms of the ability and the opportunity cost for DB pension schemes to hold illiquid assets and is expected to reduce demand overall.

Some DB pension schemes also now find themselves in the fortunate position where they can transact a full buy-in and afford to accept the discounts required to sell their private assets on the secondary market. These schemes will want to maintain high levels of liquidity within their strategy to give them greatest flexibility to complete a transaction.

Each factor has had an impact individually, but they have also combined in different ways to exacerbate the headwinds against the use of private markets by DB pension schemes. For example, improved funding levels are expected to lead to more schemes wanting to utilise higher levels of LDI, meaning schemes will require more liquidity all else being equal. We've witnessed indiscriminate selling down of illiquid asset holdings in late 2022, and we expect a steady flow of private assets to continue to be sold over the short-to-medium term as schemes reposition their portfolios in response to these dynamics.

** Source: XPS's DB:UK tracker shown on a Gilts +0.5% basis as at 30 March 2023)*

Market pricing

Interpreting the pricing of private market assets is not straightforward and it's important to differentiate between the real world pricing that these assets are bought and sold for in the market, versus the reported net asset value of the underlying fund holdings. This is important as these often move differently as a consequence of being privately owned. We'll cover these in relation to the two main categories of private investment, primary and secondary markets.

Primary markets

Investing in the primary market involves becoming a new investor into a fund that is open to new commitments.

These are typically structured as a limited partnership (LP) interest in the wider fund alongside the general partner (GP) who operates the fund.

The GP will subsequently deploy the fund's committed capital, including the LP investment, directly into deals they source and originate. Where some investments have already been made, any new LP investor dilutes the holdings of the current investor base who are compensated for this by receiving a cash payment including an interest payment, typically at a premium of between 2.5% to 4% above the cash interest rate.

Current primary market pricing

The underlying valuation of primary market funds, known as the Net Asset Value (NAV) reflects the accounting value. As they are private assets and not traded, this price needs to be estimated employing an appropriate accounting approach depending on the type of asset.

These accounting approaches tend not to reflect market dynamics in demand and supply but instead look at the inherent value of the investment, where that is observable. As such they tend to be more stable over time as they do not fluctuate with market swings. However where a meaningful loss in value is expected due to increased risk of the investment or losses, an impairment can be applied to the fund value.

Due to delays in reporting we are just starting to see asset valuations as at the end of December. Depending on the valuation approach taken by funds they may have seen some mark down in NAV over 2022 reflecting rising borrowing costs and greater discounting of future profits. However given the valuation approach employed, many investments will not have seen this feeding through fully to valuations.

There has been a lot of discussion around whether any mark-downs will be applied to the underlying private asset NAV's. Different managers have shared a variety of perspectives and there hasn't been a uniform view on this.

However our observation would be that if you made a similar investment in the primary market today, you are likely to be able to do so at a cheaper price than buying into an existing primary fund at current valuations depending on the specific asset in question. This may lead you to the conclusion that buying into a primary investment late in its investment period is less attractive compared to investing in an early stage fund which doesn't have the 'baggage'. This may be the case but another factor to bear in mind is how long a newer fund will take to get your money invested, compared to an immediate investment with the more established fund.

Given these competing factors we consider the opportunities within the primary market to be dependent on specifics but are not on the whole 'cheap'.

We have seen illiquid funds trading at discounts of 20% below their net asset value following the fire sale of assets by pension schemes. This has created an opportunity.

Secondary markets

Investing in secondary markets involves buying or selling a primary fund investment that already exists.

Secondaries are typically traded at a price that is different to the NAV of the underlying fund assets which provides scope for favourable opportunities to be identified. Secondary markets for the various private market assets differ in their size. For example, the secondary market for private equity is a lot larger than the secondary market for private debt, infrastructure and real estate.

There are two broad types of secondary sale, LP-led and GP-led transactions.

- **LP-led transactions** involve an LP investor selling their ownership in a fund to another investor.

  This change in ownership does not affect the investments that the underlying fund will make, nor does it typically affect the capital calls or distributions of the fund.

  Existing investors in a fund may decide that they do not wish to see their investment in a primary fund through to the end of its fund life – which can typically range between 5 years and 15 years. As a result a secondary market exists for these investors to sell their stakes to other investors.

  Buying a secondary investment offers buyers immediate exposure to a portfolio of underlying assets. Sellers can be motivated by a number of drivers such as the need for liquidity or specific considerations around the make-up of their wider portfolio, these reasons will often not relate to direct concerns about the fundamental of the underlying assets.

  LP-led transactions are often completed at discounted prices to the NAV. The size of the discount offered is dependent on many different factors, but generally the greater the need for the seller to sell, the larger the discount.

- **GP-led transactions** are often more complicated where the general partner decides to restructure the overall fund and offers existing investors a price for their share of the fund or an opportunity to participate in the new fund.

  The terms and pricing of these restructurings varying widely as they aren't being driven, in the main, by a desire for investors to get their capital back early.

Current secondary market pricing

Following last year's gilts crisis, private asset secondary markets saw an influx of LP interests being sold by UK DB pension schemes looking to frantically raise liquidity. This flood of LP-led transactions meant that holdings of high-quality assets were available to buy in the secondary markets at very attractive prices; the size of the discounts to NAV seen were typically of the order of 5-20%.

This panic has now subsided but given the general trend in terms of reduced desire for UK DB pension schemes to hold illiquid assets, we expect this selling pressure to continue and hence expect this secondary market opportunity to persist over the short-to-medium term. This is where we see the greatest opportunity for those schemes who can take advantage of it.

Opportunities for pension schemes

Defined benefit

Ultimately, a scheme's position against its journey plan and its ability to accept illiquidity without compromising its overall portfolio, will be the biggest consideration as to whether a private market allocation is suitable. It will also inform what private asset, specifically, is best suited, if any.

Features of scheme that may be positioned to take advantage of illiquid opportunities:

1. Schemes with a long timeframe to reaching significant maturity and pursuing a medium to high return target

These schemes will be well placed to utilise both low and higher returning illiquids such as private equity, infrastructure, real estate and opportunistic and distressed debt.

2. Schemes in the middle to late part of their journey that don't plan to buyout but invest in a low risk portfolio to run-off

These schemes may have the ability to utilise private market investments that sit at the lower end of the private market return spectrum, for example senior secured private credit, infrastructure debt, commercial real estate debt and securitised investments.

3. Schemes in the middle to late phase of their journey who plan to buyout

New private market allocations are not typically suitable for schemes close to buyout due to the requirement to retain flexibility to transact. Having illiquid asset classes has scope to materially undermine any transaction.

For schemes with the ability to invest in illiquid assets and a desire to earn meaningful level of expected return there is a fantastic opportunity in discounted secondary investments accessing a range of private market asset classes.

Defined contribution

In contrast to the DB market, the UK DC market has been largely restricted to date in terms of its ability to utilise private market assets, even though it's widely agreed that their use would improve the investment toolkit and ultimately the outcomes for DC scheme members.

The investment case for DC investment into private assets, particularly for younger members with over 10 years to retirement, is very strong and backed by a similar rationale to that of DB schemes. High returning assets such as private equity could particularly have a key role in the accumulation phase.

There's also scope for the use of private assets for members close to, or in, retirement. These investments would be more limited to the higher quality end of the credit spectrum, such as infrastructure debt and commercial real estate debt. However, we would expect to observe fewer discounts on these assets in the current environment.

There are a number of operational hurdles that need to be overcome in order for DC schemes to capitalise on this opportunity:

Platforms

Many DC schemes invest through a platform which offers a range of funds to implement their desired exposure. These platforms, however, are built from a promise of daily dealing / pricing and this governs the funds that are available on them. Private market funds, which do not offer the liquidity required, are largely excluded as a result. This can already be overcome by combining illiquid and liquid funds to create units which are daily dealt and offer exposure to private assets. However, ideally platform flexibility needs to develop to accommodate less liquid strategies as members themselves do not require daily liquidity for their pension savings which they can't access until they are 55.

Lifestyling flexibility

We generally see reluctance from trustees to commit to assets that cannot be quickly realised in large quantities. This stems from the potential delay when investing monthly contributions, and the day-to-day difficulties managing lifestyle arrangements that include less liquid investments. In larger schemes, the liquidity needs of a modest allocation could be effectively managed by crossing trades between members. Where this is the case it's important that expectations are carefully managed for unexpected transfers such as large transfer requests or bulk transfers.

Fund structures

A new type of fund structure – Long Term Asset Funds ('LTAF') – was introduced to improve DC access to private market assets. LTAF's are open-ended funds which are liquid, but at least 50% of their holdings must be in private assets and they must publish regular valuations. The first structure of this type was very recently approved and we are aware of further funds coming down the line.

Charge cap

The charge cap of 0.75% on default arrangements provides some constraints on investment options. However, helpfully new rules which exclude 'specified performance fees' from the charge cap will partially ease the situation. That said, the typical high cost of fees of private market funds place limitations on the size of a default strategy's allocation to private markets, even where this cost is justified by the additional value to the member from the return enhancement of their investment.

Reduced flexibility to consolidate to a mastertrust

Where consolidation is expected to be a possibility this should be taken into account. However, illiquid assets need not prohibit a transfer to a Master Trust but it adds complexity to the exercise.

Although the DC market is facing these practical challenges, they are widely acknowledged and a lot of work continues to be done by various parties, including regulators, asset managers, platforms and consultants to resolve them and improve accessibility for DC schemes. The benefits of having illiquid investments in the toolkit are significant and we expect these hurdles to be overcome.

New regulations are due to come in later this year where certain DC schemes will be required to 'disclose and explain' their policies on illiquid investments in their Statement of Investment Principles. This provides scope to prompt the conversation within trustee groups.

Actions for trustees

a) DB schemes with a current allocation to private markets

- Consider the scope to expand your current allocation to illiquids in the context of the wider strategy and the scheme's objectives, including current allocation vs strategic target, return profile and investment timeframe.
- Understand the scope for your current private markets manager(s) to invest into secondary assets.
- Consider what specific opportunities exist and how they complement your current program.
- Consult with the sponsoring employer on any changes to the investment strategy and the changes needed to your Statement of Investment Principles.

b) DB schemes considering new allocations to private markets

- Consider the suitability of an allocation to private markets in the wider context of the scheme and its financial position.
- Consider the risk and return features of private market asset classes that are most suitable to meet your requirements.
- Select an appropriate manager and fund.
- Consult with the sponsoring employer on any changes to the investment strategy and the changes needed to your Statement of Investment Principles.

c) DC schemes considering new allocations to private markets

- Seek training on the new requirements concerning illiquid assets disclosure to understand the new requirements.
- Explore the types of illiquid assets available to help formulate your policy.
- Consider the scope to enhance your lifestyle strategy with an illiquid or partially illiquid element.
- Consult with the sponsoring employer on any changes to the investment strategy and the changes needed to your Statement of Investment Principles.

How can we help?

If you'd like to find out more about opportunities in private markets, or if you are considering selling holdings and would like support in deciding how to approach it, please get in touch with Steven Hickey or your usual XPS contact.

Steven Hickey
Head of Credit Research
t 020 3994 4930
e steven.hickey@xpsgroup.com

Simeon Willis
Chief Investment Officer
t 020 3967 3895
e simeon.willis@xpsgroup.com

About us

XPS Pensions Group is a leading pensions consulting and administration business fully focussed on UK pension schemes. XPS combines expertise, insight and technology to address the needs of over 1,500 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over one million members and provide advisory services to schemes and corporate sponsors in respect of schemes of all sizes, including 51 with assets over £1bn.

XPS Investment provides clear and independent investment advice that can be quickly and effectively implemented. We advise pension schemes and their corporate sponsors and have over £113bn of assets under advice.

Award winning

Pensions advisory

Professional Pensions UK Pensions Awards 2022 (25 Anniversary) – WINNER – Actuarial/Pensions Consultancy of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2021 – WINNER – Actuarial/Pensions Consultancy of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2019 – WINNER – Actuarial/Pensions Consultancy of the Year

Administration

Professional Pensions UK Pensions Awards 2022 (25 Anniversary) – WINNER – Third-Party Administrator of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2020 – WINNER – Third-Party Administrator of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2019 – WINNER – Third Party Administrator of the Year

Investment consulting

Professional Pensions UK Pensions Awards 2022 (25 Anniversary) – WINNER – Investment Consultancy of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2021 – WINNER – Investment Consultancy of the Year – XPS Pensions Group

Technology

Professional Pensions UK Pensions Awards 2022 (25 Anniversary) – HIGHLY COMMENDED – Technology Innovation of the Year – XPS Pensions Group

Pensions expert Pension and Investment Provider Awards 2020 – Winner – Technology Services of the Year – XPS Pensions Group

Culture and Sustainability

Business Culture Awards 2020 – Gold Overall Winner

UK Employee Experience Awards 20 – Gold Award Winner – Employee Engagement

UK Employee Experience Awards 20 – Silver Award Winner – Employee-centric Company

UK Stewardship Code

Important information: Please note the information and opinions expressed herein do not take into account the circumstances of individual pension funds and accordingly may not be representative of the circumstances affecting your fund. This note, and the work undertaken to produce it, is compliant with TAS 100, set by the Financial Reporting Council. No other TASs apply. The note has been written on the basis that decisions will not be based on its contents. Appropriate advice should be obtained before any decisions are made. The information expressed is provided in good faith and has been prepared using sources considered to be reasonable and appropriate. While information from third parties is believed to be reliable, no representations, guarantees or warranties are made as to the accuracy of information presented, and no responsibility or liability can be accepted for any error, omission or inaccuracy in respect of this. This document may also include our views and expectations, which cannot be taken as fact. The value of investments and the income from them can go down as well as up as a result of market and currency fluctuations and investors may not get back the amount invested. Past performance is not necessarily a guide to future returns. The views set out in this document are intentionally broad market views and are not intended to constitute investment advice as they do not take into account any client's particular circumstances.

Please note that all material produced by XPS Investments is directed at, and intended solely for the consideration of, professional clients within the meaning of the Financial Services and Markets Act 2000 (FSMA). Retail or other clients must not place any reliance upon the contents.

This document should not be distributed to any third parties and is not intended to, and must not be, relied upon by them. Unauthorised copying of this document is prohibited.