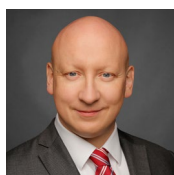


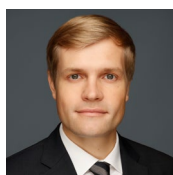


Re-thinking the management of committed capital

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Private assets¹ investing is an increasing feature of institutional investor portfolios. It is no longer the preserve of 'multi-generational' investors such as endowments, foundations and sovereign wealth funds. The reasons for the increased allocation are varied, but the primary motivation is the prospects of enhanced total return. More democratic access as smaller investors began to gain access via multi-fund providers has resulted in wider investor interest and an increase in demand. Corporate and Local Government pension funds are participating in this trend with vigour.

Investors, and especially UK pension funds, have made much progress over the last couple of decades on the governance of all aspects of managing their asset pool; does anyone remember the Myners Principles set out back in 2001²? This includes steps taken to ensure the sound management of portfolio switches within or between listed asset classes – for example equities to equities or equities to fixed income. The increased scrutiny in this area has resulted in more efficient management of asset and manager transitions to ensure that transaction and market impact costs are minimised and risks, particularly out of market risk, are properly managed.

This paper asks if the allocations to private assets are enjoying the same level of sound governance and whether there is adequate attention being paid to the many frictional costs and risks of switching from generally listed legacy assets to the ultimate destination in private markets. Given that the capital commitments to private assets are contractual but are likely to be drawn down and invested over a period of years, we posit that this issue is of increasing relevance. Further we understand that the increased demand³ for private market assets is resulting in delays to the expected commitment timetables; this amplifies the challenge of the management of the 'dry powder' of committed but yet to be deployed capital.

To be clear this paper is not about the merits of private markets investing. Private assets have a role to play for many long-term investors, the focus is more on the governance of the movement of capital from legacy asset to destination asset.

1. For the purpose of this paper, private assets refer to private equity, private debt and infrastructure. Property (or real estate) has been a long-standing allocation of many investor portfolios.
2. Institutional Investment in the United Kingdom: A Review https://webarchive.nationalarchives.gov.uk/ukgwa/20010603090552/http://www.hm-treasury.gov.uk:80/pdf/2001/myners_report.pdf
3. In early 2021, estimated dry powder commitments reached USD3 trillion; roughly 30% of the total value in closed-ended private equity, private debt and other forms of private market assets combined. This is based on a report 'Dry Powder meets low interest rates – time for private markets boom or bust' Mercer 2021.

So, what are the issues that require attention?

In our view, the governance and operating challenges are:

- In liquid markets a manager switch or asset class change by a pension fund takes place at the effective date decided by the Trustee/Board, with the performance measurement clock starting from the effective date. This approach is not possible in private markets as it takes a number of years to fully deploy the committed capital. So where should the 'money waiting' be invested⁴ whilst waiting deployment? Should it remain invested in the legacy asset, be invested in cash or something else, such as a viable proxy for the destination asset?
- What are appropriate expectations for the return and the tolerance to risk of the 'money waiting'? This is a very important consideration. The modelling that will have resulted in the increased allocation to private markets will have assumed an 'immediate' switch from the legacy to the destination private markets asset. The longer it takes to deploy the capital the further away the outcomes will be from the modelling results that drove the allocation decision. Ideally the money waiting should be generating a good return. But the commitment is an absolute amount and the notice period can be a matter of a week, so what are appropriate volatility and liquidity budgets?
- The success of a private markets programme is currently judged largely on the money-weighted returns delivered by private assets managers in the form of Internal Rate of Return or 'IRR'. However, this calculation focuses only on the returns generated on capital once it has been deployed - it does not take into account the return on the capital whilst waiting to be invested. This leaves the return generated and risks incurred by this 'money waiting' to be accounted for elsewhere within the investor's portfolio as an unintended consequence.

"This raises a fundamental governance question – should the returns, risks and real opportunity costs of the 'money waiting' be included in measuring the success of the fund, or indeed the overall program?" Some have suggested alternative measures of success such as modified IRRs or Return on Committed Capital. The key governance question is 'what is the correct measure of success for the private assets program?' We believe that the outcomes of the complete investment journey across both money waiting and money invested should be considered alongside those of money actually invested in private assets.

- Once the program is mature, distributions from the programme are likely to occur at the same time as commitments to new programmes take place. Are cash flow management processes adequate to capture the additional complexity of managing this process? Should the cash-flow process include cash-flows across the entirety of a fund such as net contributions, dividends and coupons? Indeed, if natural cash-flows are to fund some of the allocation should this be factored into the SAA decisions, with a lower percentage switch from the legacy asset as a result?

These challenges are not new. Investors with a long history of private markets investing will have found ways to tackle these issues. A number of different approaches are adopted. Some are 'ad-hoc' and pragmatic, some more structured. These include remaining invested in the legacy asset whilst waiting for the capital calls, while for those with liability or solvency considerations 'over-hedging' may be of appeal as the capital is thus providing some portfolio utility in that it reduces overall risk relative to liabilities. Still others will invest in some 'mid-risk' asset such as a multi-asset portfolio.

What is becoming obvious is that there is no 'best practice'; research has indicated that this is especially true of LGPS funds. This is not surprising nor a criticism; some are just starting their journey and are focused on the 'front office' issues such as identifying and allocating to private assets funds.

We believe that this issue is ripe for discussion and that a clearly set out and pre-planned approach to managing committed capital is appropriate. This is an increasing relevance as private assets now play a greater in portfolios and the resulting cash flows become more complex as a result. Such an approach will strengthen the governance, reduce operational risks and costs and optimise cash flow management.

Our paper 'A new approach to managing capital waiting deployment to private assets'⁵ examines this issue in more detail and suggests a way forward.

4. It may be that some of the commitments is sourced from positive cash-flow but other than in very specific circumstances an asset allocation switch will be the majority of the source of capital.

5. MJ Hudson have also written on this issue: 'Safe Storage of Dry Powder – A Committed Capital Solution' [https://mjhudson.com/mjh_post_type/white-paper].

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