PRIVATE MARKETS

A POLICY BRIEFING FROM THE INVESTMENT ASSOCIATION

March 2024

ABOUT THE INVESTMENT ASSOCIATION (IA):

The Investment Association champions UK investment management, supporting British savers, investors and businesses. Our 250 members manage £8.8 trillion of assets and the investment management industry supports 126,400 jobs across the UK.

Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital.

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs.

The UK is the second largest investment management centre in the world, after the US and manages 37% of all assets managed in Europe.

INTRODUCTION

Private markets have grown rapidly in recent years, now representing over $12 trillion[1] in global AUM, as investors seek new sources of income, capital growth and diversification. These investors run the gamut from retail all the way to the largest institutional investment managers.

Private markets investment is a key source of capital for companies looking to expand and grow, and is also vital in helping the UK to meet its infrastructure needs, from housing, to utilities, to technologies crucial to Net Zero transition. In 2023 the Government has cited the importance of unlocking further private markets investment in order to help the UK meets its economic, environmental and social objectives.

However, barriers to private investment exists, including requirements for daily liquidity and pricing in many investment funds which can prevent them investing in private assets.

In this Policy Briefing, the IA's Private Markets Committee identifies not just the latest trends in private markets and the reasons for their growth, but also sets out the key opportunities and asks identified by the industry for opening up private assets investment and unlocking further capital to invest in the UK's economy and infrastructure. These asks include:

- incentivising pension scheme investment in a wide range of private assets
- improving the infrastructure investment pipeline through a stable policy framework and the development of a National Industry Strategy
- broaden access to private markets investment through innovation and evolution of the market, including:
  - the development of fund structures that remove barriers to investing in and holding private assets, such as the Long Term Asset Fund.
  - the development of a regulatory and market framework that encourages innovations such as tokenisation.

The IA and its members look forward to working with policy makers, market participants, and all key stakeholders as we build a market that meets the UK's needs.

Private markets have grown rapidly in recent years, now representing over **$12 trillion**[1] in global AUM

[1] The Investment Association, "*Investment Management Survey 2022-23*", 2023.

WHAT ARE PRIVATE MARKETS?

Private markets are investments made in assets not traded on a public exchange, stock market or other recognised or regulated market. Examples of these types of investments include:

PRIVATE EQUITY

These are investments made directly in private companies, or in public companies that become private. This can include early-stage venture capital through to mid-market investment and investment in mega-cap firms. Private equity investors may look to take either a minority or majority stake in an investee firm.

Private equity-style investments can also be made in real assets such as infrastructure or real estate. These are fixed-life closed-ended investment funds, usually highly geared and looking to generate high levels of capital growth from the development of real estate or infrastructure.

PRIVATE DEBT

Where investors lend directly (usually in the form of a bond or loan which is not then issued as a security). Often these will be privately negotiated transaction which may be to a company, secured on a real asset or a pool of financial securities.

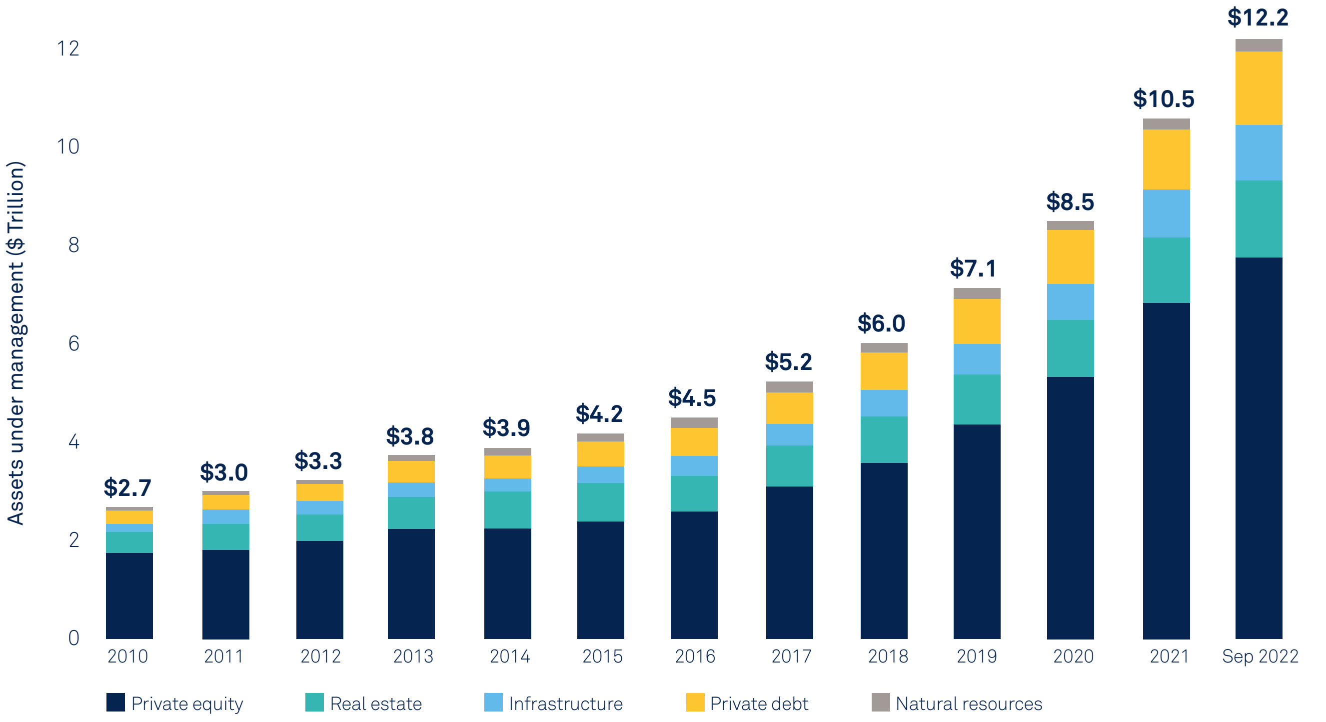
These encompass a range of investable opportunities such as in companies, infrastructure, real estate, natural resources and commodities, and other related assets. It is worth noting that what determines whether investment is private or not is whether the instrument is unlisted rather than the company being invested in – it is possible, for example, to invest in private debt in a publicly-listed company.

THE GROWTH OF PRIVATE MARKETS

While publicly listed companies are widely known and understood by the general public, the vast majority of companies worldwide are privately owned. In fact, even in the sense of revenues being generated, public markets represent a small part of the available universe – more than 90% of companies with over $100 million in revenue are privately held.[2]

Private markets have experienced rapid growth in recent years, rising 22% in 2021 alone to reach over $10 trillion in global assets under management (AUM). It has been estimated that global private capital AUM could reach a total of $13 trillion by 2027.[3] There has been particularly rapid growth in the private credit space, which now represents approximately 12% of private asset AUM compared to 8% in 2006. This is as a result of private credit investment filling a gap left by a decline in leveraged loan and high-yield issuance, leaving private lenders to address financing needs no longer being addressed by banks. It is estimated that private credit will reach $2.3 trillion in global AUM by 2027.[4]

FIGURE 1: GLOBAL ASSETS UNDER MANAGEMENT IN PRIVATE MARKETS (2010-2020)



Source: Preqin

[2] Blackstone and Capital IQ
[3] PitchBook, *"What the Future Holds for Private Capital"*, 2023
[4] Preqin

POTENTIAL OF PRIVATE MARKETS

Over the past few decades, private markets have provided a source of high returns for investors, with lower volatility risk compared to public markets. Between 1988-2022 private equity produced average returns of 15.2%, compared to 7.7% in public equity. Over the same period volatility was 10% for private equity and 16.8% for public equity. Private markets have tended to offer high levels of capital growth from closed-ended private equity-style funds, and high levels of income distribution from open-ended funds.

Likewise, private credit has offered high income potential. Between 2004-2022 private credit offered an average return of 9.2% (compared to 5.3% in European High Yield and 2.2% in Global Investment Grade Bonds), and volatility of 3.6% (compared to 19.2% in European High Yield and 6.4% in Global Investment Grade Bonds.[5]

Other advantages include:

- Diversification of portfolios – private markets tend to have a low correlation with other assets, allowing for a spreading of risk and a smoothing effect on total portfolio volatility.
- Informational advantages and greater ability to intervene operationally.
- Strong governance, including more customised terms.

Private markets therefore offer the potential for good returns over a long-term time horizon.

[5] Blackstone and Morningstar

WHO INVESTS IN PRIVATE MARKETS?

Private markets are invested in by the full range of institutional investors (DB and DC corporate and government pension funds, Sovereign Wealth Funds and insurance companies) and retail investors (High Net Worth individuals and retail investors advised by Wealth Managers).

However, individual investor access to private markets is a relatively new and developing space. Individual investors are under allocated to private markets when compared to pensions and institutional investors. Where an individual investor has any private asset exposure at all, the allocation is often 3% or less of the overall portfolio.[6] The IA believes there is considerable scope and benefit to increasing individual investor access to private markets, where it is an appropriate investment for the investor.

WHY ARE PRIVATE MARKETS OF INTEREST TO INVESTMENT MANAGERS?

By choosing to invest in private markets, the investment industry directly supports the development of new infrastructure projects, social housing initiatives, and start-ups looking improve their productivity and grow their business.

Both supply and demand factors are driving this change. On the supply side, market-based finance has been more widely used since the Global Financial Crisis and there are also signs of a decline in the proportion of companies wanting to publicly list.

On the demand side, the drivers have been fairly clear. Pension schemes and other institutional customers are looking for more diversified sources of return and income, reflected in greater interest in alternative strategies and asset classes.

In addition, private markets offer an opportunity to access companies throughout their lifecycle of development and growth, which is being sustained longer in the private ownership space. Private markets also offer different forms of exposure at different stages, i.e. equity, as well as the opportunity for direct lending and lending to the private equity ecosystem.

[6] Bain and Company, '*Global Private Equity Report 2023*'

WHY ARE PRIVATE MARKETS BENEFICIAL TO GOVERNMENT, THE ECONOMY AND WIDER SOCIETY?

As mentioned, private investment can help provide vital capital for companies, including start-ups looking to grow their business. As bank finance has declined along with the number of publicly-listed companies, there has been a growth in unlisted companies seeking investment capital.

Likewise private investment can play a key role in helping the Government to meets its Levelling Up and Net Zero objectives, supporting infrastructure and social projects and generating new jobs, while at the same time reducing the amount of public spending necessary.

Particularly in terms of financing the UK's infrastructure and housing pipeline, private finance is expected to provide a significant proportion of the total capital necessary. According to the National Infrastructure Commission, around half of infrastructure investment is financed and delivered through the private sector, with much of this being delivered through private markets funding.

In terms of ensuring environmental objectives – including decarbonisation – are met, private markets are expected to be equally important. Private markets capital – particular in the form of venture capital – will be required to help fund the technologies and innovations needed to tackle climate change and accelerate development, as well as to build, operate and maintain key renewable and decarbonisation projects. The Government's Net Zero Strategy estimates that an additional £50-60bn per year in capital investment will be needed in order to achieve Net Zero, with most of this coming from private capital.[7]

WHAT ARE THE BARRIERS TO INVESTING IN PRIVATE ASSETS?

Investing in private assets often requires quite specialised knowledge and experience. They also bring different operational and management challenges to public investments.

In addition, because they are not publicly listed, private instruments tend not to trade as often and as such are quite illiquid. This means that it can be more difficult to exit or price an investment.

As a result, many types of funds which have requirements to allow daily liquidity and pricing are restricted from investing in these types of assets.

[7] HM Government, '*Net Zero Strategy*'

KEY ASKS AND OPPORTUNITIES:

PENSION CAPITAL

The Chancellor's Mansion House Speech in Summer of 2023 (and subsequent budgetary announcements) focused heavily on unlocking pension capital so that it could flow into UK companies, including private assets.

The IA considers that, while there remains a place for investment by Defined Benefit (DB) schemes to invest in private assets as the look to meet their liabilities, the focus of pension scheme investment should shift from DB schemes to Defined Contribution (DC) schemes. This is due to regulatory constraints, scheme maturity, current interest rates, and DB funding issues, which limit the ability of corporate DB schemes to provide risk capital.

Furthermore, with UK DC schemes already heavily invested in listed, liquid equities, the opportunity is to encourage more DC schemes to expose their members to the growing activities in private markets which could potentially diversify their investment portfolios and yield higher returns.

Therefore, the IA welcomes the Mansion House reforms' focus on getting DC schemes to voluntarily increase allocations to unlisted equities. However, focus should also expand to broader private asset classes including private credit and infrastructure to diversify and enhance returns to DC members and also to assist in the improvement of the UK's infrastructure and the shift towards renewable energy.

While we recognise the aspiration for greater UK investment through the Mansion House reforms, we share the common view that investment should not be mandated. As long as there are attractive UK opportunities, DC capital will find its way to them as long as certain conditions are met.

Investment consultant advice has a significant impact on the investment management profession, particularly in the private assets space and therefore there should be regulatory oversight over the investment advice given to pension schemes.

Additionally, the application of trustees' fiduciary duty, applies to investment in private asset classes. Observations around the operation of the DC market highlight the combined impact of a predominantly daily-dealing delivery infrastructure and the relentless focus on cost as the ultimate measure of value. These factors are significant blockers to a shift towards an investment decision-making culture that can better support private market productive finance through vehicles like the Long-Term Asset Fund.

Addressing these factors will facilitate in delivering the goals of the Mansion House reforms and will ultimately encourage and increase pension capital investment into private markets.

INFRASTRUCTURE

As noted above, private markets are expected to play a vital role in helping the UK meet its infrastructure needs, not least through funding of new housing and of infrastructure projects necessary for the UK to meet its Net Zero targets.

However, while there is considerable interest amongst asset managers in investing in UK infrastructure, the number of investible projects currently does not match demand. The National Infrastructure Commission has itself commented that the pace of planning and delivery is currently too slow, and that a "change in gear in infrastructure policy" is necessary for the UK to remain competitive.

We welcome Government and regulator engagement on how best to improve the investment pipeline. The IA considers that the following steps would be greatly beneficial in encouraging the flow of capital into UK infrastructure:

- The development of a National Industrial Strategy, to complement the ongoing work of the National Infrastructure Commission.

- Ensuring a stable policy framework. Infrastructure projects are long-term investments, and investors need to be confident that policy expectations set at the outset will remain in place over the long-term.

- Speeding up planning and delivery. The process of applying for and receiving planning approval for infrastructure projects can take years, with the uncertainty significantly impacting the willingness of investors to provide capital. This issue is compounded by wider delivery delays (for example, it can take five to six years to get a grid connection if you are investing in a UK solar plant). Efforts to shorten these time horizons will be beneficial.

- Amendments to Solvency II. Solvency II is the prudential regime for insurance groups and firms, and among other things places restrictions on the kinds of investments that insurance capital can go into, mainly into investment-grade and long-duration debt. While recognising the need to strike a balance between risk and return, amendments to Solvency II that incentivise infrastructure investment would have a positive impact on capital flow into infrastructure projects.

INNOVATION AND EVOLUTION

Private assets can be difficult for some investors, particularly smaller investors but also some institutional ones, to invest in, as they are illiquid, cannot be traded on exchanges, and often require a significant up-front investment. Over the years the market has evolved in a number of ways as it looks to open up access by a wide range of investors to private assets.

In recent years, there has been significant product innovation in the private markets space with the launch of semi-liquid funds, also known as perpetual or evergreen funds, across the breath of alternative asset classes. These funds are the middle ground between long-time horizons and capital lock ups of traditional drawdown funds, and daily liquidity expectations from the public market-oriented world of mutual and liquid funds structures. The funds are designed for individuals with features such as small investment minimums, professional and retail investor eligibility, and no multi-year locks ups. They also differ in important ways from liquid fund structures, for instance in the possibility of redemption limits or 'caps', which are designed to protect performance for all investors by avoiding forced selling of assets.

Semi-liquid funds have opened access to private markets to a wider range of individual investors across the US and EMEA. The introduction of the ELTIF for Europe and LTAF for UK is the next iteration of product developments seeking to offer individual investors access to historically illiquid asset classes.

We welcome additional efforts to innovate in private markets, and note the Government's recent announcement of the new Private Intermittent Securities and Capital Exchange Systems, which will look to remove barriers to investors keen to invest in illiquid assets and companies looking to scale up, by improving the interface between private and public markets.

LONG-TERM ASSET FUND

The IA originally proposed, and has supported, the development of the Long-Term Asset Fund (LTAF), a new fund structure allowing wider access to assets such as infrastructure and private companies which are not regularly traded.

This is an open-ended fund: that is, a fund which can issue an unlimited number of shares. New shares are created when investments are made into the fund, and cancelled when investments are withdrawn. As such, the price of each unit in the fund moves in line with the value of the underlying assets rather than due to demand for the units in the fund.

Importantly, rules are set for buying and selling units in the LTAF meaning that they are aligned to the liquidity of the underlying asset classes which the units are invested in. In particular, LTAFs can be sold at set intervals, depending on the particular investment strategy being pursued, alongside the appropriate notice periods. This is to ensure the fund manager has time to make enough cash available to meet the redemption requests, and if needed, has enough time to sell some of the assets for a reasonable price.

Strong governance rules apply to the LTAF. Strict rules on asset segregation, due diligence on investment and independence of valuation apply. The Board of the Authorised Fund Manager, which must include 2 independent directors, is required to assess at least annually the due diligence undertaken, valuation process, liquidity management and conflicts of interest management, in addition to an assessment of value, to ensure the LTAF is being managed in the interests of its investors.

The IA believes the LTAF will provide the benefits of greater diversification for pension savers and investors, while helping to provide much needed additional investment for the UK economy. The LTAF has been designed to be particularly helpful for defined contribution (DC) pension schemes. The IA considers that the LTAF can be used by individual investors as a building block in their overall portfolio, providing such investment is appropriate having regard to the investor's portfolio size, composition, investment horizon and risk appetite. The LTAF is likely to be appropriate only for investors receiving professional advice or who are knowledgeable and experienced investors.

TOKENISATION

Tokenisation is the process of converting real-world assets into digital 'tokens' that can be bought, sold or traded on exchange. This can be done with private assets, including assets such as infrastructure and real estate.

Tokenisation therefore provides investors with a digital right of ownership over an asset using blockchain technology. As a result, the cost to the investor for having a share in the ownership of an asset reduces significantly, with tokenisation also granting increased liquidity. This makes the process of investing in private assets easier for smaller investors, thereby democratising private markets so that more people can benefit from them.

The IA encourages regulators and market participants to work together to build a regulatory and market structural framework that encourages innovation in the private markets space, including tokenisation, while ensuring key protections remain in place for retail investors.

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