The Association of Investment Companies

Investment innovation and future consolidation

Securing illiquid assets while maintaining liquidity

The Association of Investment Companies (AIC) is a trade body for the closed-ended investment company sector.

We represent 358 investment companies, managing assets of over £168 billion. The AIC's members are predominantly listed on the Main Market of the London Stock Exchange. Some have shares admitted to trading on the Specialist Fund Segment; others are quoted on AIM.

The AIC's members include investment trusts, Venture Capital Trusts (VCTs), UK REITs and non-EU companies. Our non-EU members are usually domiciled in Guernsey and Jersey and listed in London.

Investment companies are collective vehicles which pool their shareholders' capital and hold a portfolio of assets to spread risk and generate an investment return. Investment companies are 'closed-ended' funds, that is, they have a fixed number of shares. These shares are admitted to trading on a public stock market.

Unlike 'open-ended' funds, investment companies do not offer redemptions, where an individual selling their investment receives cash out of the assets of the fund. This characteristic makes investment companies well suited to provide retail and institutional investors with exposure to illiquid, patient capital assets including property, infrastructure, private equity, venture capital and unquoted debt.

Investment companies have high standards of governance. They are overseen by independent boards with legal obligations to operate the company in the best interests of shareholders. Investment companies are regulated via company law. They also report against corporate governance best practice standards.

In addition, they fall within scope of rules designed for the 'funds' sector, notably the Alternative Investment Fund Managers Directive (AIFMD) which includes rules on leverage. Investment companies must also comply with relevant accounting standards.

Those buying and holding investment company shares are also protected by the UK's robust and comprehensive range of stock market rules. These include the Premium Listing Rules (investment companies have specific requirements reflecting their role as funds) as well as the Disclosure Guidance and Transparency Rules and Prospectus Rules.

These characteristics help the sector deliver strong investment returns and act as an alternative (non-bank) source of funding for UK businesses and infrastructure projects.

Overcoming barriers to holding illiquid assets

Defined Contribution (DC) schemes typically offer daily liquidity. That is, they hold assets which can be sold, in the market, without delay. This approach allows schemes to respond to demands made by beneficiaries or to adjust their investment positions. This approach to asset allocation is also compatible with using investment platforms.

Holding shares of investment companies is easily accommodated within this approach. As discussed above, their securities are traded on public markets that offer daily liquidity. They also provide DC schemes with regulatory assurances associated with holding UK listed securities.

Investment companies with holdings of illiquid assets offer DC schemes opportunities to gain exposure to these asset classes and the benefits they provide without affecting their liquidity policy or reducing their capacity to adjust their asset allocation as the value of the underlying assets changes with market movements.

Holding these securities would give DC schemes access to the so-called 'illiquidity premium', where investors secure higher returns in exchange for locking up their capital for a longer period without options for an immediate exit. An investment company's investment policy will seek to capture these benefits, whether the underlying assets are property, infrastructure, private debt or unquoted debt. It can maintain long-term holdings and its purchase, holding and funding commitment decisions are driven by the investment case. The manager of an investment company's portfolio is not distracted by considerations arising from offering redemptions. This is achieved because trading in the shares of the investment company itself has no link with the liquidity position of the underlying portfolio.

These characteristics can make investment companies particularly attractive for smaller DC schemes, which may be less able to invest in options such as limited partnerships but could still benefit from holding a more diverse portfolio, including illiquid assets.

Investment company shares vs open-ended funds

The benefits of facilitating institutional (including pension fund) investment in illiquid assets has stimulated a reassessment of the rules applying to open-ended funds. Open-ended funds are already widely held and offer daily redemptions. Supporters of these structures consider them to be a potentially attractive option. However, there are questions about how the redemption process can be maintained when the underlying liquidity of the assets does not match the potential demand for redemption, particularly in times of market stress.

The problems arising from a liquidity mis-match between an open-ended fund's redemption policy and a portfolio comprised of illiquid holdings were brought to the fore by market developments after the financial crisis of 08/09 and the Brexit referendum. A significant proportion of open-ended funds holding property were suspended as they were unable to deal with high levels of redemption requests in the aftermath of the result and accompanying market uncertainty.

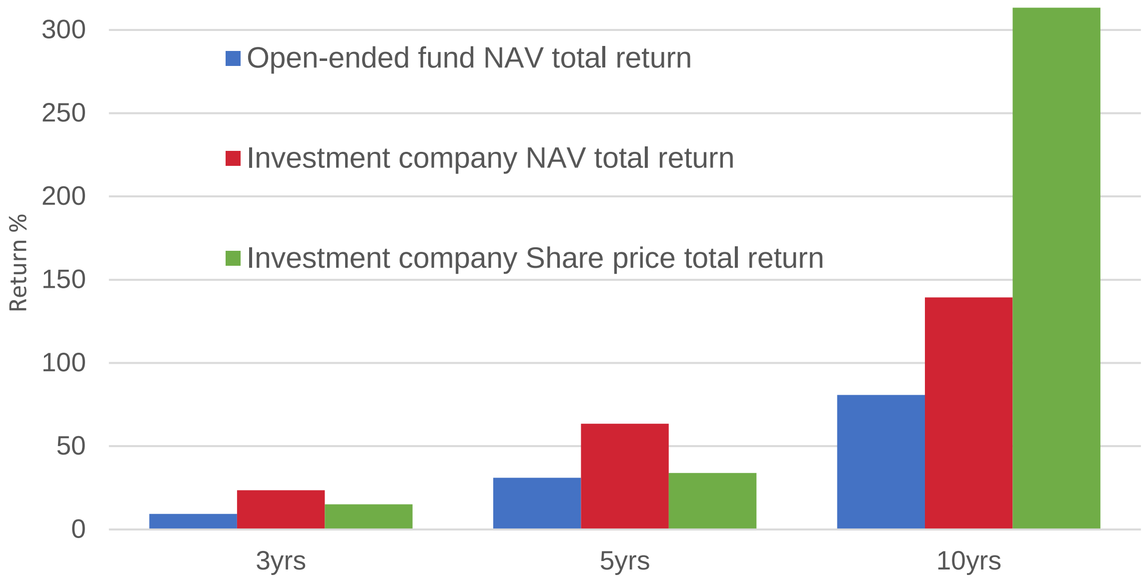
The issues this raised for investors, whose expectations of liquidity were not met, caused the Financial Conduct Authority (FCA) to consider what changes might be made to the rules to make open-ended funds more appropriate for holding illiquid assets.

The FCA is considering introducing a new regime for Funds Investing in Inherently Illiquid Assets (FIIAs). This would require open-ended funds within scope to have systems which may result in more frequent suspensions (when there is material uncertainty about underlying asset valuations) and enhanced risk warnings. Whether these regulatory reforms will achieve their regulatory intention is unclear.

What is not in doubt is that offering redemptions (whether daily or less frequently) creates a need for liquidity, typically via cash holdings. In the open-ended UK property direct sector (the most significant open-ended sector offering access to illiquid underlying assets), cash holdings currently average some 20% of assets under management. This reduces the overall exposure of these funds to the illiquid asset class. This is likely to have a significant impact on long-term performance.

The UK property direct sector offers a useful illustration between the returns which can be achieved via an open-ended fund in comparison with investment companies.

Fig1: Investment company vs open-ended (UK property direct)



Facilitating investment in illiquid assets by pension schemes should prioritise the potential to secure superior returns for beneficiaries. Investment companies provide an important option which should be among those considered.

Consultation questions

Q1. We would welcome comments on the following proposals around reporting pension schemes' approach to investing in illiquid assets. We would also welcome any other proposals which use reporting to prompt consideration of illiquid assets.

(a) Scope: 'Relevant schemes' (broadly, schemes offering money purchase benefits other than from AVCs alone) with 5,000 or 20,000 or more members (or alternatively £250m or £1bn assets to provide for money purchase benefits) would be in scope of the proposed requirement. Would an asset-based or a membership-based threshold be more proportionate and effective?

Requiring trustees to publish a statement on illiquid assets in their investment strategies is intended to act as a prompt to consider opportunities for further investment innovation.

Transparency can be a useful mechanism to shift behaviour, where appropriate, and tends to be a proportionate intervention.

To make this disclosure effective, trustees should be encouraged to explain their policy on exposure to illiquid assets in context. It should be related to the liquidity needs of the scheme itself as well as the potential to secure diversification, superior investment returns etc.

Even smaller schemes, which may be constrained from making direct investments in illiquid assets or non-tradable funds (such as limited partnerships), should make a statement on illiquid assets. They should also be encouraged to consider if other options, such as investing in investment companies, could allow them to capture benefits of the illiquidity premium, additional diversification etc. in a way which is suitable for the scheme and its beneficiaries.

The AIC does not agree with the conclusion that "*a wide range of illiquid assets will not be available to smaller DC occupational schemes*" (Investment Innovation and Future Consolidation. Ch 3. Para 6. Page 21). These assets can be secured using investment companies. It is unclear why only individuals whose income in retirement depends on larger schemes should gain the benefit of encouraging pension funds trustees to consider securing exposure to illiquid assets.

It may be that trustees of smaller funds will need advice to take a position on this issue. However, it is likely to be desirable for them to seek advice in any event (that is, even if they chose not to purchase illiquid assets directly).

The AIC **recommends** that all DC schemes be required to make a statement on illiquid assets.

However, to ensure proportionality, while protecting the integrity of the scheme, the AIC **recommends** that a more detailed disclosure should be made when the strategy adopted involves purchasing this exposure directly, or via a fund or partnership which itself does not allow for daily liquidity and/or which may require additional commitments to be made.

(b) Reporting their policy: Schemes in scope would be required to explain their policy in relation to illiquid investments in their Statement of Investment Principles.

The AIC supports this proposal.

The AIC **recommends** that where a scheme chooses to secure access to illiquid assets utilising funds which do not offer frequent liquidity, such as direct investments or limited partnerships, the policy should explain the implications of this for manging the scheme. Where exposure is gained via liquid funds, such as investment companies, the requirements may be tailored to reflect the compatibility of these holdings with the general investment approach of the scheme.

(c) Reporting their actions: Schemes in scope would be required to report annually on their main default arrangements' approximate percentage holdings in illiquid assets, and with a breakdown in holdings of the trustees' choosing.

The AIC supports this proposal.

Q2. Do you think Government should encourage or nudge smaller occupational DC pension schemes to consolidate? If this should only happen at some point in the future what factors should be taken into account in determining that point?

The AIC has no comments on this matter.

Q3. We would welcome views on the following proposals around pension schemes reporting their position on the potential benefits of future consolidation, or any other associated proposals.

(a) Scope: 'Relevant schemes' with fewer than 1,000 members (or alternatively less than £10m in assets to provide for money purchase benefits) would be in scope of the proposed requirement.

The AIC has no comments on this matter.

(b) What should be reported: Schemes in scope could be required to explain their assessment of whether it would be in members' interests to be transferred into another scheme with significantly more scale. Should charges, investment, governance and administration all be compared? Is a reference scheme, or other guidance needed for comparison?

The AIC has no comments on this matter.

(c) Reporting vehicle: The requirement could be added to the value for members assessment which forms part of the Chair's Statement and published annually.

The AIC has no comments on this matter.

(d) Updating frequency: The explanation of whether it is in members' interests to consolidate should be updated at least every 3 years, and after any significant change in size or demographic profile.

The AIC has no comments on this matter.

Q5. What do you think about the use of indicators such as trustee knowledge and understanding, open or closed status or member demographics to identify and encourage schemes to consider consolidation? What indicators do you recommend and how could they best be communicated and verified?

The AIC has no comments on this matter.

Q6. To what extent are performance fees used or required for funds which offer illiquid investment such as venture capital, infrastructure, property, private debt and private equity? Are market practices changing?

There is no requirement to establish performance fee arrangements between the contracted asset manager and the investment company offering access to illiquid assets. The level and structure of fees is determined via a negotiation between the board of the investment company and any external manager employed. The picture for investment companies holding illiquid assets is mixed.

Fig 2: Investment companies (illiquid asset classes) performance fee frequency

AIC sectors	No with performance fee arrangements	No. in sector	% with performance fees
Private Equity	14	21	67%
Property Direct - Asia Pacific	1	1	100%
Property Direct - Europe	3	6	50%
Property Direct - UK	2	13	15%
Property Specialist	2	16	13%
Infrastructure	1	6	17%
Infrastructure - Renewable Energy	1	10	10%
VCT AIM Quoted	3	8	38%
VCT Generalist	38	39	97%
VCT Generalist Pre-Qualifying	3	3	100%
VCT: Environmental	5	5	100%
VCT: Healthcare & Biotechnology	1	1	100%
VCT: Healthcare & Biotechnology Pre-Qualifying	0	0	0%
VCT: Media, Leisure & Events	1	1	100%
VCT: Technology	4	4	100%

Investment companies in a variety of sectors offering exposure to illiquid assets do not have performance fee arrangements. Perhaps reflecting this, there is a wide variation in the *ad valorem* management fee charged by investment companies investing in asset classes such as private equity.

Market practices have been changing in recent years with the result that the overall number of performance fee arrangements in the investment company sector have reduced.

There have also been new charging structures introduced. One example of this was the launch of an investment company investing in illiquid assets with no *ad valorem* management fee, a small administration charge and a performance fee. Also, there have been fulcrum fee arrangements introduced, involving a baseline fee which is reduced or increased depending on whether the investment company underperforms or outperforms the benchmark.

Critically, whatever fee structure is adopted, the boards of investment companies are required to consider whether these arrangements are in the best interests of shareholders. Different arrangements can each satisfy this requirement, but the underlying obligation placed on the board remains the same.

Q7. To what extent is the charge cap compliance mechanism a barrier to accessing funds which charge a performance fee? Does this act as a barrier to accessing certain asset classes?

Investment companies which invest in specialist areas, such as illiquid assets, tend to have higher costs than those investing in listed equities.

Investment companies investing in the private equity and venture capital sectors, for example, may have additional costs related to identifying potential opportunities, undertaking legal due diligence, negotiating and completing transactions. There may also be additional costs arising after an investment is made. For example, providing input to management to better execute and develop the business plan, including taking the company onto the next stage of its commercial development (such as preparation for an IPO). These research and investment expenses are very different from investing in traded securities, where the transaction and management costs are, broadly speaking, 'hands off' or less involved. The process and expenses of engagement with a company where quoted shares are held in the portfolio is - notwithstanding developing expectations regarding shareholder voting and other issues - likely to be relatively limited.

Property is another area with a very different cost profile to investing in traded securities. Refurbishing properties, facilities management, including taking steps to ensure high levels of occupancy, can create expenses. However, the objective will be to maintain the value and yield of the assets. These costs are in addition to the legal costs, stamp duty and various other fees involved in buying and selling properties. Investment companies investing in infrastructure may also have additional costs depending on the nature of the underlying assets.

Some of these funds may also have performance fees (see above). They may also have borrowed for investment purposes (gearing). The level of gearing used by investment companies is typically modest. However, over the longer-term, even where gearing is used cautiously, it has the potential to contribute to significant outperformance. It may also increase reported costs.

The charge cap applied to DC schemes used for automatic enrolment is currently 0.75%. This does exclude certain charges, notably transaction costs and costs associated with holding ‘real’ assets. However, the expenses involved in actively managing a portfolio of illiquid assets may nonetheless be somewhat higher than for investment in quoted securities, especially if the exposure to quoted holdings is based on a ‘passive’ strategy. The process of assessing compliance with the charge cap is complicated and likely to be more so where investments exposure to illiquid assets is sought.

The starting point for the cap is also potentially problematic. It is intended to protect beneficiaries from “*excessive charges*” (Investment Innovation and Future Consolidation. Ch 4. Para 2. Page 28). This policy stance may be too inflexible in that as it considers investment in quoted instruments alongside illiquid assets.

It is unclear that the specific policy proposals set out in relation to the current cap will enable a meaningful increase in investments in illiquid assets. If so, investors saving for their retirement via automatic enrolled schemes will continue to be denied access to assets which may provide additional diversification and superior investment returns. Facilitating even a small proportion of exposure to illiquid assets this could be particularly important for beneficiaries with relatively small levels of pension savings. They may benefit disproportionately from the potential for superior long-term performance and additional diversification offered by illiquid assets.

The AIC **recommends** that the structure of charge cap should be reviewed. One option which should be considered is to apply the 0.75% cap only to holdings where the underlying investments are quoted securities.

The AIC **recommends** that the overall structure of the cap be modified to allow for a certain proportion of the scheme’s assets, say up to 25%, to be held under different arrangements where they offer underlying exposure to illiquid assets/patient capital.

The AIC **recommends** that these alternative arrangements could involve, for example, no charge cap – where a statement is instead made that these specific arrangements have been assessed as being consistent with achieving the objectives of the scheme. Alternatively, a higher charge cap could be set.

This more flexible approach would facilitate greater investment in illiquid assets by pension schemes, and offer the potential for higher investment returns, while still protecting the interests of beneficiaries.

Q8. Do you agree that we should permit the additional method of charges assessment? Do you envisage any problems with complying with this method of assessment, or any reasons why it might disadvantage members?

It is unclear that the additional method of charges assessment will enable higher levels of investment in illiquid assets.

Q9. We propose that:

(a) We should publish guidance – which might carry statutory weight – on appropriate performance fee structures.

(b) We should in particular specify in statutory guidance that performance fees should be calculated and accrued each time the value of the fund is calculated.

(c) Performance-related fees should only be permitted alongside a funds under management charge, and not alongside contribution charges or flat fees. We would welcome respondents' views on all these points.

The AIC has no comment.

Q10. Do you believe that the updated non-exhaustive list of costs and charges provides increased clarity about the scope of the charge cap? Are there any areas where further clarity might be required?

The AIC has no comment.

Q10. We would welcome views and any estimated costing for the impacts of these proposals.

(a) Stating a policy on illiquid holdings

(b) Reporting on illiquid holdings.

(c) Considering and reporting on whether it might be in members' interests to consolidate

(d) The additional method of assessment with the charge cap.

The AIC has no comment.

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