Chislehurst Business Centre
1 Bromley Lane
Chislehurst, BR7 6LH

01689 856691
Email: uksa@uksa.org.uk
Web: www.uksa.org.uk

ShareSoc
UK Individual Shareholders Society
Suite 34, 5 Liberty Square, Kings Hill,
West Malling, ME19 4AU
Phone: 0333-200-1595
Email: info@sharesoc.org
Web: www.sharesoc.org

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Department for Work & Pensions

Caxton House, Tothill St, London SW1H 9NA

Email pensions.investment@dwp.gov.uk

Dear Sirs,

Enabling investment in productive finance

The UK Shareholders' Association (UKSA) and ShareSoc represent the voice of private investors in the UK. We are not-for-profit companies that represent and support shareholders who invest in the stock market. In this respect we also defend the interests of savers in defined contribution pension schemes. Between us we have over 22,000 members.

We would like briefly to register our deep concern about the suggestions in this consultation paper.

Firstly, fee structures in general are notoriously complex and usually disguised, nearly always confusing consumers to the extent that they are unable to assess whether the scheme offers value for money. Indeed, the suspicion often arises that the complexity of fee structures is designed to mislead consumers. Performance fees are even more complex.

Secondly, annual performance fees offer a free option to the manager. Even a strategy driven by dartboard will have some volatility which drives the performance positive or negative. If negative, the manager suffers no direct losses, if positive, the manager takes a fee, so the fee structure has option-like characteristics. We note with serious concern the suggestion that 'clawback', which would mitigate the optionality, could be banned.

Even if there is a hurdle, this will merely provide an incentive for the manager to leverage the exposure, leaving pensioners with even greater risk.

The proposed system seems weighted towards incentivising managers to take on greater risk - at no meaningful risk to the manager but at significant risk to investors.

Thirdly, there is no strong evidence that management of any kind can provide superior performance in the long run, as argued in a series of articles by Jonathan Ford in the *Financial Times*.[1] Furthermore, the recent demise of the Woodford Equity and Income Fund, which has left many private individuals who were saving for their futures seriously out of pocket, is a salutary reminder of both the myth of the star fund manager and the dangers of putting investors' savings into illiquid assets. This is particularly true when the investors (i.e. the members of a DC pension fund) may have little understanding of the assets in which their money is being invested and no idea of the risks.

This whole idea from the DWP sounds to us like something that has been put forward by members of the fund management industry and advisors to pension fund trustees to allow them to improve their own profitability.

We are seriously concerned that the DWP has failed to think these proposals through. The Ministerial Foreword says, for example, "In the last few months, the government, *alongside industry* and regulators, has made significant steps towards addressing the barriers to investment in long-term illiquid investments in the UK. We would prefer the DWP and the regulator to speak also to those who are likely to question the wider consequences for pension savers, such as UKSA and ShareSoc, and not just to those who have a vested interest in the approval of such fee structures

Our response to your questions is below. Please note that we have only replied to questions 3 and 4.

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[1] See e.g. "Private equity returns are not all they seem", *Financial Times*, September 15 2019, arguing that 'Public Market Equivalent' figures are not so flattering for private equity. "A large study conducted in 2015 by three academics looked at nearly 800 US buyout funds between 1984 and 2014. They found that before 2006, these funds delivered an excess return of about 3 per cent per annum, net of fees, relative to the S&P 500 index. In subsequent years though, returns have been about the same as on the stock markets. A study of 300 European funds produced similar results."https://www.ft.com/content/2812c2c6-d634-11e9-a0bd-ab8ec6435630 . See also https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3250315 which finds that funds with performance fees underperform those without.

Question 3: Which of these conditions should the Government apply to the types of performance-based fees that are excluded from the list of charges subject to the charge cap? Are there other conditions we should consider? If supported by guidance on acceptable structures would this give confidence to more schemes?

We think your questions are over simplistic and not based on a proper, detailed understanding of the way incentives and performance fees work.

Private Equity partners' 'carry' which acts as a type of performance fee, typically vests over many years (6 to 8 is not uncommon), and managers are encouraged to leave their carry in the fund. Collectively these factors create a long term focus in both culture and rewards which has a very clear alignment with investors.

In contrast, annual performance fees offer asymmetric rewards and have been avoided by the Private Equity industry. Asymmetric rewards are a potential disaster waiting to happen.

We regard the numbers the consultation document chooses to play with in paragraphs 42 – 47 as essentially meaningless and contributing nothing to the consideration of the issue. It is very easy to put together a set of numbers and assumptions to make any case one wishes, by selective choices of assumption.

Here the consultation document is seeking to show that elaborate high charging structures for such illiquid investments can be justified without breaching the overall 0.75% charges cap on the total pension fund. It achieves that by the simple sleight of hand of making the assumption that 90% of the total pension fund is invested in non-PE assets with a charge of "only" 0.4%, which obviously creates the headroom for high charges on the 10% of the fund invested in PE without breaching the overall 0.75% cap.

We regard this section of the consultation document as verging on being misleading, since the numbers and assumptions have clearly been chosen to make the case that the proponents for change want to make.

Paragraph 43 of the consultation gives an example of what it says is a 2+20 "a "2:20" fee structure in which investors are charged a fixed annual management fee of 2% of assets under management (AUM) alongside a 20% performance fee on returns delivered above an 8% hurdle rate;". **We note that this 20% annual performance fee on returns delivered above an 8% hurdle rate is not the case.**

This type of structure is frequent in the hedge fund industry, **but not in the private equity industry**. The Private Equity industry will raise a fund and the 20% performance fee is paid over a hurdle of say 8%p.a. which will cumulate. As few investments are sold in the early years of the fund, very little performance fee will accumulate in the early years. However, a successful fund will generate good

performance fees as the years go by and this will tend to be rear ended over the life of the fund.

The hedge fund industry tends to have managers who have large portions of their wealth invested in their own hedge fund and this creates an alignment with their investors.

The hedge fund industry and private equity managers have 'skin in the game' - something to which the consultation makes no reference and which we regard as a crucial concept in both incentivisation and alignment. It also helps (but does not totally stop) asymmetric rewards.

We are not holding up private equity (or hedge funds) as a paradigm of unalloyed virtue. The outcomes for some stakeholders (such as the customers in UK water companies owned by private equity) are proving to be very questionable. That however, is not the subject of this consultation; the key issue is that private equity and hedge funds demonstrate how the reward system for the partners and mangers can be closely and effectively aligned with the interests of the investors.

The consultation paper fails to address a number of problems in the asset management industry that are relevant to this consultation on fee regulation of productive finance. Many of these issues were clearly explained in the 2016 FCA Interim Report on the asset management industry, but to date the FCA has only made limited progress in addressing them.

- Most active managers underperform passive funds; and the proportion that underperform increases over the period over for which performance is measured.

- One reason for the difference is the higher fees for active versus passive managers.

- Survivor bias makes precise measurement difficult and may result in the data for active fund performance to be higher than it really is. The industry tends to close or merge underperforming funds into higher performing funds, so the data on (some) underperformers gets omitted over time.

- The industry can only market (sell) to consumers funds that have a good track record and a good story to tell. This increases the pressure on underperformers to take higher risks, so as to gain the accolade of outperformer.

- The asset management has a history of extracting excessive fees from consumers. Any proposals they make should be viewed with extreme scepticism and carefully modelled to ensure that dysfunctional behaviour is not rewarded.

- Asset managers tend to have large numbers of funds as this increases the chances that they will have some that are stars and can be marketed successfully to consumers. However this approach increases the overall costs to consumers, whilst providing no clear benefit.

One other point about the Private Equity Carry Remuneration Model is that as the carry build up in value, managers are awarded units in the carry pool. This forms a retention incentive and so managers are less likely to leave or flip between firms. It builds loyalty to the firm and its culture. It also ensures that managers continually question the underpinning business model and investment decision process to ensure it continues to be effective. In short, managers are more likely to behave like owners rather than hired hands - here today, gone tomorrow.

Question 4: Do you agree with our proposal to require disclosure of performance fees if they are outside the scope of the charge cap? If so, we propose this is done in a similar way to transaction costs – do you agree? Could you provide details of any new financial costs that could arise from a requirement to disclose performance fees? Please outline any one-off and ongoing costs.

Transaction costs are paid for by consumers. They should be disclosed clearly. They should not be outside the scope of the charge cap.

We would be happy to meet with you and explain our views of these issues. Cliff Weight who has co-authored this response is an expert in remuneration: formerly he was a remuneration consultant before he retired and wrote the Directors' Remuneration Handbook. Dean Buckner retired in 2018 from the Bank of England.

Yours sincerely,

Dean Buckner, Policy Director, UK Shareholders' Association

Email: dean.buckner@uksa.org.uk

Cliff Weight, Director, UK Individual Shareholders Society

Mobile: 07712 793114; Email: cliff.weight@sharesoc.org