

Intellectual Framework

The stated aim of this consultation exercise is to address the Government's concern that "there may be factors encouraging institutional investors to follow industry-standard investment patterns which focus overwhelmingly on quoted equities and gilts and avoid investing in SMEs and other smaller companies".

It is surely necessary to address this task by looking at two fundamental aspects:

1. How do institutional investors arrive at their asset allocation decisions, i.e. what factors determine their choice of which asset classes to hold and in what proportions?
2. What are the factors inherent in SMEs and other smaller companies which would influence institutions' decisions to invest in this asset class?

Item 1 above is addressed in the draft consultation document that I have seen, but item 2 is not really examined at all. I believe this is a fundamental omission and would suggest that several factors can explain some of the reluctance of institutional investors to include these assets in their portfolios. Of course, to a certain extent, examination of item 1 will allude to some of the factors involved in item 2, but it seems to me that, from an intellectual point of view, the Review should focus explicitly on item 2. This analysis would lead more readily to policy recommendations than merely looking at the issue from one side only.

There are many factors specific to SME and venture capital investment. Some of these characteristics are common to investment in such companies worldwide, but some are particularly problematic for the UK and a comparative examination of these elements internationally (particularly US versus UK) would be of interest. I list below the more important issues which should be considered:

- i. Lack of marketability/liquidity
- ii. Difficulty of obtaining reliable valuation for companies which are not quoted
- iii. Costs of dealing or fund management are generally higher for this asset class
- iv. Perceived higher risk associated with such investments
- v. Low relative returns from smaller UK companies (smaller companies generally underperformed in the late 1990's)
- vi. Requirement for longer term time horizon before payback - i.e. a buy and hold strategy, rather than trading
- vii. Less sympathy with 'enterprise culture' in the UK than in US or Europe
- viii. Smaller companies and start-ups are not well organised to attract investors, who might want to invest on a pooled basis to spread risk
- ix. There is little government assistance for these companies as an asset class to promote themselves to institutional investors and consultants
- x. Lack of income from early stage businesses would prevent many funds investing (mezzanine finance would not involve this problem).

In summary, I believe it is necessary to consult on both sides of this issue – i.e. why institutions have tended to invest so heavily in quoted equities and gilts and follow relatively similar investment patterns and why SME's may not be attractive to these investors.

Important Factors to be Addressed

Apart from this 'intellectual framework' issue, there are several other factors which I believe to be important for the consultative document, but which are not really dealt with in the draft that I saw. Some of these we discussed at our meeting but I thought it might be of use if I list the major ones here for you:

1. Turnover of institutional portfolios

Do fund managers and institutions – in practice – tend to adopt a buy and hold strategy or be rather more trading oriented? An examination of turnover figures for institutional equity portfolios, for example, would be of assistance here. Trading orientation would mitigate against smaller company investment.

2. Fee structure of fund managers

The draft document looks at the incentive effects of the fees charged by consultants, but does not actually mention the fees of fund managers themselves. This issue is relevant in many ways. Firstly, do trustees and consultants take much account of fund management fees charged? Secondly, there may be hidden fees which lead to a reluctance to invest in smaller companies. The latter would particularly refer to commission charges on every trade carried out for an institutional fund, which could lead to higher turnover of holdings than would otherwise be the case. This should also be specifically focussed on when considering fund management fees. Thirdly, what is the extent of performance related fees in the UK institutional fund management business? Such fees may encourage investment in other asset classes, but only if returns are attractive and the time horizon issues are accounted for.

3. Use of the 'competitive' benchmark

What proportion of funds set a performance benchmark based on the industry median? Is such a benchmark actually logical? The use of a competitive benchmark has two fundamental problems which it would be useful to take views on. Firstly, in practice, it leads to managers trying to 'guess' where the competition actually is (because the figures for each quarter are only released with a time lag and – by then – other funds may have altered their distributions). They then vary their asset distributions relative to this 'estimate'. Secondly, the use of such a benchmark is rather circuitous in that it means the client is saying 'we want you to do better than most of the other managers', but funds would surely have chosen a manager who they expect will be one of the better ones!

4. Time horizon of investment

What is the typical time horizon of investment decisions taken by institutions? Measuring performance on a quarterly or even annual basis can deter institutions from investing in assets like venture capital, where the payback time horizon is often longer than one year and may be hard to actually pre-determine. To what extent do trustees/consultants/fund management companies encourage short-term performance measurement? What proportion of funds take a truly long-term (5 or 10 years) horizon? If investors, in practice, are generally assessing performance over shorter periods (and this may differ between different players in the market), this would make investment in more marketable equities and gilts relatively more attractive.

5. Performance measurement for unquoted or unmarketable investments

What are the performance issues which arise if institutional investors invest in assets for which there is no agreed value? A venture capital investment may not generate returns until sale or flotation, which can take some time. In what proportion of funds would such a situation prevent the use of this asset class?

6. How much influence do trustees actually have on asset allocation decisions?

How common is it for trustees NOT to follow consultants' advice? It would be interesting to gauge how the trustees actually decide asset allocation in practice. Intuitively, one would suspect that a committee structure would ultimately lead to the following of 'expert' advice – from consultants/actuaries - particularly where trustees are inexperienced in investment matters or have relatively little time to devote to this task.

7. Asset allocation decisions of life companies

It is necessary to ask specifically who makes the asset allocation decisions of life companies and on what basis are these decisions normally made?

8. Small cap or venture capital investment by personal pension schemes

The document should seek to identify what proportion of personal pension schemes offer the ability to invest in these asset classes.

9. Active versus passive management

The draft document does not explicitly deal with the issues relating to the choice of active versus passive management. For example, if a fund has a large passive core equity position, the ability to invest in 'higher risk' assets, such as small companies, may be enhanced. What are the trends and what does the industry generally think of this issue?

10. Increased use of specialised managers

To what extent is the industry moving away from the traditional balanced mandate and how much has the use of specialised managers increased? Trends from the US suggest that UK funds will move increasingly in this direction and this should have a beneficial effect on investment in smaller companies. What are these figures and what can be done to speed up the process?

These are just some of the important points which need to be addressed in the Review.