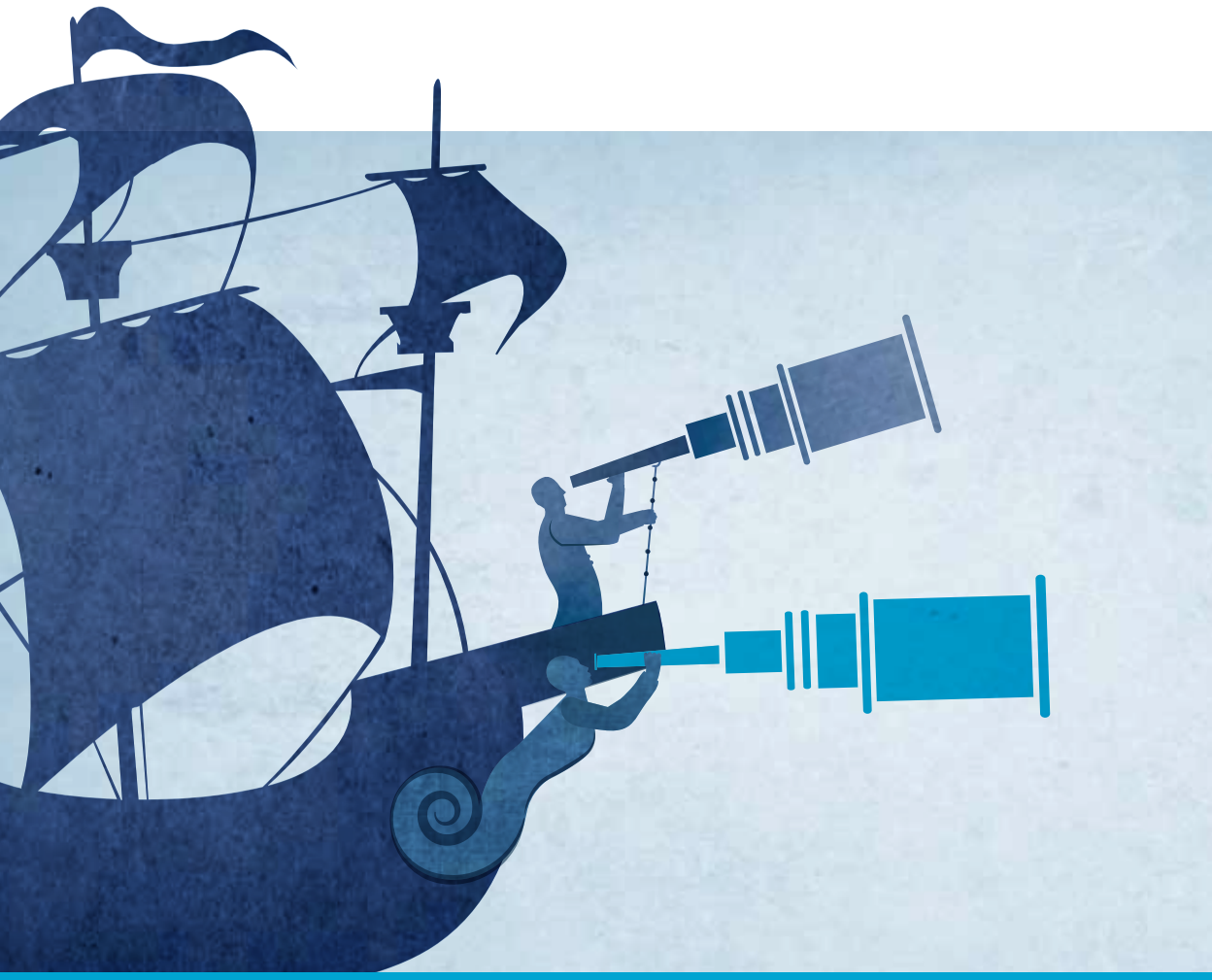
Winter 2013

Long-term investing: The route to sustained growth



EVCA-BRIEFING

LONG-TERM INVESTMENT

Some business models really do stand the test of time. Adventurous seafarers embarked on long and risky trade voyages in the 1100-1200s, financed by Italian merchant families who pooled their investments together in 'commendas'. Families spread their risk by investing in several such ventures.

While the commendas backed voyages to seek out spice and wine, today's private equity, venture capital, infrastructure and property funds use a similar model of long-term collective investment. Only today the medieval merchant families have been replaced by institutional investors, the swashbuckling sea captains by professional fund managers and instead of seeking out wine and spice, the modern commenda, or limited partnership, is a vehicle to help grow companies, build hospitals and develop clean power generation.

And just as investing in several commendas reduced risk, investing across a diversified group of PE funds carries a less than 1% chance of losing any part of an investment.

Investors such as pension funds and insurers need access to such long-term, illiquid asset classes to achieve the strong, stable returns required to meet their long-term liabilities. The economy, and the companies that drive it, need access to long-term patient capital. Unfortunately, too much of our current regulation requires long-term investors to price their investments as if they could be sold that day, ignoring the value creation that can occur over the long term. The unintended volatility that certain regulation can create in the value of investment portfolios is now steering investors away from long-term asset classes.

That is why we look forward to the debate on stimulating long-term investment through the European Commission's green paper. Commendas provided a structure to pool investment, reduced risk and gave skilled managers the flexibility and patience to put capital to work over the long term. Private equity funds, and their managers, are the heirs to this tradition. And just as commendas were used to drive economic development all those years ago, so too can modern long-term investment funds. They do, however, need the appropriate regulatory environment to enable them, and the companies and projects they back, to grow and prosper.

Dörte Höppner,
Secretary-General

IN SUMMARY

- Long-term ventures can deliver sustained economic growth but they need investment
- A diversified portfolio of long-term investment funds significantly reduces risk for investors
- Current accounting standards can introduce misleading volatility into the value of long-term investments
- Capital adequacy rules discourage investors from allocating capital to long-term ventures
- Long-term investments need different regulatory treatment compared to short-term, liquid assets

The long-term imperative

European leaders are seeking ways to stimulate sustained economic growth. Long-term investments need to be part of the solution

'It's an understatement that long-term investments are important for the European economy – they are vital,' says MEP Philippe Lamberts.

Lamberts is not alone in his belief that long-term investment will help put Europe's economy back on the path to growth. In 2012, the UK government published the *Kay Review of UK Equity Markets and Long-Term Decision Making*. The review contends that a culture of short-termism has eroded long-term 'stewardship' relations between companies, investors and intermediaries. It called for a cultural shift across the equity investment chain to support sustainable long-term value creation by UK companies.

> A culture of short-termism has eroded 'stewardship' relations between companies, investors and intermediaries

That culture of short-termism was built on the financial gains achieved through quick trades on the markets, removing the incentive to invest in the longer term. For the European Commission (EC), the underlying problem relates to how financial markets operate, the incentives for financial intermediaries and the lack of good instruments to allocate finance to the long term.

Long-term benefits

The economic crisis brought long-term investment back into the spotlight, however. 'Long-term investors could provide benefits by acting counter-cyclically, engaging as active shareholders, considering environmental and longer-term risks and financing long-term, productive activities that support sustainable growth,' says an OECD white paper.

Julia Prescot, Chief Strategy Officer at Meridiam Infrastructure, an infrastructure fund, agrees. 'Long-term investments enhance economic growth and provide something for the future. We're looking at assets that have to be as stable as possible,' she says.

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>
> **Philippe Lamberts,** MEP

'In public-private partnerships, for example, the contracts are robust, they state clearly the obligations, and there is a clear payment profile.'

Meridiam invests in PPPs for an average of 25 years and the stability that provides makes them appealing as a long-term investment. The same could be said for investments in PE funds,

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Julia Prescot,
Chief Strategy Officer,
Meridiam Infrastructure

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Allan Polack Chairman,
Nordea Investment
Management

by institutional investors such as pension funds and insurers, which are for the life of the fund – typically 10 years or more – and are held to maturity.

But, says Prescot, the appeal of long-term investments is being hindered by regulatory blocks. 'Some of the regulatory approaches to investment, which place demands on institutions to match their liabilities, have been geared towards the short term.'

Frameworks such as Basel III and Solvency II have created a headache for investors, as Allan Polack, Chairman of Nordea Investment Management and Chair of the Centre for European Policy Studies' long-term investment task force, explains. 'The requirements, in Solvency II, for matching assets and liabilities and risk-weighting assets are punishing long-term investors.'

EC green paper

The EC plans to publish a green paper on how to stimulate long-term investments in the European economy. 'The purpose of our green paper is to initiate a debate about how to address the challenges [to long-term investment],' says Audrey Augier, spokesperson for Michel Barnier, the EC's Internal Market Commissioner. 'Further consideration is needed on how to incentivise the behaviour and develop the savings and investment products conducive to long-term financing.'

The outcome of the EC's consultation remains to be seen

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Audrey Augier, spokesperson, European Commission

but many ideas about how to stimulate long-term investment are already on the table. The OECD proposes removing regulatory barriers and addressing unintended short-term biases in funding regulations. It also recommends a more supportive policy framework, which would include longer-term policy planning and tax incentives.

Lamberts hopes politicians will have the courage to make changes in favour of long-term investments, despite the challenges. 'When you favour long-term returns, you're favouring people who are not today's voters. It's the same for industrialists: when you're confronted with the short-term pressures of shareholders to see immediate returns, it's difficult to think longer term.'

However, in light of Europe's desperate need for economic growth, the imperative to build a long-term investment culture may be too great to ignore.

Unintended consequences

Transparency, clarity and stability are the watchwords of current financial regulations but are these rules having a detrimental impact on Europe's ability to invest for the long term?

When the International Accounting Standards Board (IASB) introduced fair value (or mark-to-market) accounting, it never meant to create volatility in the value of long-term assets. And when capital adequacy regulations were passed, they were never meant to prevent investors from allocating capital to long-term investments. Yet both regulatory developments have led to exactly that.

'The IASB mark-to-market philosophy is particularly damaging to long-term investments, attributing instant market values to assets the value of which is by essence based on several years; and the Solvency II Directive, in Europe, will discourage insurance companies and pension funds from holding infrastructural assets, not allowing for a proper matching of long-term liabilities and assets on their balance sheets,' Franco Bassanini, former Italian Minister and President of Astrid, a think tank specialising in long-term investment, wrote in a paper for the OECD.

At a 2012 seminar hosted by Finance Watch, a Brussels-based NGO, Sharon Bowles, MEP and Chair of the Economic and Monetary Affairs Committee of the European Parliament, said: 'Despite having the best of intentions, policymakers have gone astray. Too frequent reporting, even in the interest of transparency, encourages short-term horizons in the thinking of executives.'

The legal solvency frameworks do not support institutional investors, who should be able to take a longer view and have longer investment horizons but are in effect unable to do so

Matti Leppälä,
Secretary-General/CEO,
Pensions Europe

Not so stable

Solvency regulations – notably Basel III capital requirements for banks and the Solvency II regime for insurance companies – is one area policymakers are being urged to revisit. Introduced to bring stability to the financial system in the wake of investment bank Lehman Brothers' collapse

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and the subsequent folding of other big-name financial institutions, the rules mean institutional investors are restricted in the amount of equity capital they can supply to long-term asset classes such as infrastructure or private equity funds.

'The investment approach within the institutional investor community has changed dramatically over the last few years,' says Matti Leppälä, Secretary-General/CEO of Pensions Europe, formerly the European Federation for Retirement Provision. 'In most marketplaces today, the average holding periods are drastically down and on average, for institutional investors, they are down to under one year. The legal solvency frameworks do not support institutional investors, who should be able to take a longer view and have longer investment horizons but are in effect unable to do so. Everyone, including institutional investors, is being pushed towards procyclical investments, where the end result is not the best possible.'

Unfair fair value?

New accounting rules have also created challenges for long-term investors, who were traditionally encouraged to value their investments conservatively. Historical cost accounting was based on past transactions. Simpler, more stable and easier to perform but rather than reflecting current market value, it simply summarised past transactions.

Mark-to-market was introduced in the US under Generally Accepted Accounting Principles (GAAP) in the 1990s and has become the standard around the world. Mark-to-market accounting requires firms to revalue their assets to current market prices, such as a stock's price at the close of business. However, asset values can become inaccurate if market prices change unpredictably.

Mark-to-market induces a lot of false volatility into pricing and this forces people to make decisions that they doubt, for example, in their benchmarking and tracking, says Michael Mainelli, Chairman of consultancy Z/Yen and founder of Long Finance – an initiative to 'improve society's use and understanding of finance over the long term'. 'You are often managing pension funds very much on an artificial annual basis at best. So I do think that you are constantly putting your pension fund manager on alert; that you are expecting him or her to perform all the time at the ultimate level, rather than focusing on the long-term performance that matches the liabilities,' Mainelli adds.

All long-term asset classes are experiencing the unintended consequences of fair value accounting, including private equity funds. 'There is no doubt that the drive to transparency,

The drive to transparency has created an environment where you have the capacity for a much greater degree of volatility in the valuation of private equity portfolios and that in itself is intuitively just not right

Tim Green, Managing Partner, GMT Communications Partners

which has to be a good thing, has created an environment where you have the capacity for a much greater degree of volatility in the valuation of private equity portfolios and that in itself is intuitively just not right,' says Tim Green, Managing Partner of technology, media and telecoms private equity fund GMT Communications Partners. 'These can be long-term illiquid investments and to see the valuations drop by 30% just because the public markets are reacting to the economic environment is a problem in as much as it doesn't necessarily reflect the true underlying value of the portfolio.'

The issue is that mark-to-market requires firms to place a value on an asset as if it were to be sold in the open market that day, when that is rarely the intention, particularly for long-term, hold-to-maturity assets such as investments by pension funds and insurers in PE, real estate or infrastructure.

A different approach

Should mark-to-market accounting be changed? The consensus among standard setters is that it is the best system tried so far and the arguments about the alternatives were extensively debated in the 1980s. But it does seem that a special case should be made for long-term investments that are vital to economic and social development.

Long Finance recommends moving to a system of 'confidence accounting'. The idea is that, like all scientific measurements, accounts are not 100% accurate and thus results should be presented within a range of likely values with a statistical probability. This would allow investors some leeway in presenting their numbers and could reduce volatility.

'We didn't write confidence accounting to fix mark-to-market,' says Mainelli. 'But it would allow people to say I had a valuation last year which I put down as being in this range, and a year later it's still in that range. People wouldn't have to react to every annual change in value, particularly if revaluation was within the stated range.'

Confidence accounting might not necessarily be the right solution, but it does help to kick-start a desperately needed debate about how to redress the regulatory balance in favour of more stable and more secure long-term investments. And there is a growing consensus on the need for redress. As Bowles told delegates at the Finance Watch seminar: 'There needs to be a return to long-term behaviour and investment.'

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Michael Mainelli, Chairman of consultancy Z/Yen and founder of Long Finance

FAIR VALUE ACCOUNTING: The pros and cons

PROS

- Reflects current fair value
- Fair value accounting may not be satisfactory, but the alternatives are worse
- Creates trust among investors

CONS

- Innaccurate if market prices change unpredictably
- Inability to both accurately and collectively value
- How to mark assets to market highly complex and controversial
- Makes markets even less liquid
- Procyclical effects that inflate bubbles on the way up and add to panic on the way down

Private equity: in good company

Some wrongly see investment in private equity funds as a high-risk activity: its characteristics and performance place it firmly in the stable, long-term category

The seeds of private equity's reputation as a risky asset class were sown in the 1960s when private equity firms started investing in untested Silicon Valley start-ups, Hans Lovrek, Managing Director of private equity consultancy Commenda, observes. That reputation was compounded by private equity's support for the internet boom and the losses it suffered when the dotcom bubble burst. Lovrek and many others in the industry contend that this public perception is different from the reality. Private equity shares many characteristics with long-term asset classes such as infrastructure and property.

The World Economic Forum defines long-term investing as 'investing with the expectation of holding an asset for an indefinite period of time by an investor with the capability to do so'. In other words, it is investing over a period of years – a minimum of five years, but usually ten years or longer – by institutional investors such as insurance companies, pension funds, sovereign wealth funds and foundations.

Compared to short-term investments, designed to gain a significant return over a short period, long-term investments show a slow-but-steady increase with a significant yield at the end of the term, allowing for a much greater degree of stability and a much lower risk – an attractive proposition for certain types of investors.

> Private equity shares many characteristics with long-term asset classes such as infrastructure and property

Fund structures in private equity have been specifically designed for long-term investing. Funds cannot be traded like liquid assets, nor can investors withdraw during the life of the fund.

A study by Ernst & Young, *Private Equity Creates Value in Europe*, points to profit in private equity-backed companies coming from the purchase and sales of company assets, operational improvements and organic growth. On this basis, private equity-backed companies are more resilient and profitable than others, the study says.

Long-term investments can play a stabilising role in financial markets while still funding long-term corporate growth and developing infrastructure. This longer-term commitment pays off for investors. Over the past decade, private equity has significantly outperformed public equity. In the UK, for example, private equity delivered a return of 13.4% IRR on a yearly basis, compared with just 3.7% from the FTSE All-Share Index.

Furthermore, the asset class carries almost zero default risk. Investors' average net invested capital – the capital at risk – is measured by the paid-in amount less distributed capital. This amount is, invariably, much lower on average than the investor's overall legal commitment to the fund. The EVCA study, *Calibration of Risk and Correlation in Private Equity*, shows that in a normal market environment the maximum proportion of capital at risk during the life of the fund is only around 60% of the commitment made by the investor.

The evidence of private equity's performance should go some way to rectifying its reputation as a risky asset class.

BY THE NUMBERS

10 years

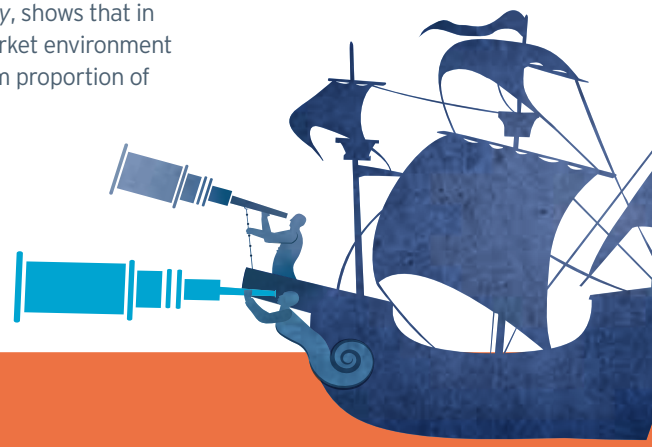
The typical life of a private equity fund

5 years

The average time a private equity fund is invested in a company

<1%

The probability of investors in a diversified portfolio of private equity funds making a loss



Limited partnerships: from historical roots to long-term investing

The majority of institutional investors access private equity via 10-year, closed-end limited partnerships. The fund manager acts as the general partner and the investors are the limited partners. The limited partners make a legally binding commitment at the start of the life of the fund to invest a certain amount of money in the fund. They enter into a fund commitment in the full expectation of remaining committed to the fund for the entire duration of the fund's life.

This limited partnership structure is said to have medieval roots, where Italian merchant families were financing trade voyages through 'commendas'. Spices, garments, wine, weaponry and much more were traded between the ports of Venice, Constantinople and Alexandria. While the potential rewards were great, the voyages were risky ventures subject to storms and crusaders.

Such journeys required skills, a daring and nimble 'crew' and could not be micro-managed. In this asymmetric partnership, the 'sleeping partners' were not liable for debt and stayed at home while the 'travelling partners' controlled the venture searching for profitable business.

At the height of Venetian trading power, sleeping partners made small investments in a large number of commendas to spread the risk, thus resembling today's diversified portfolios of private equity funds held by funds-of-funds or other institutional investors.

Hans Lovrek, Managing Director of private equity fund-of-funds manager Commenda, named after the Venetian model, believes the characteristics core to the commenda are also core to modern private equity and ensure a state-of-the-art corporate governance system while shielding long-term investors from risks such as an insecure political environment, fluctuating market prices and exchange rates.

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The investor perspective

Institutional investors see private equity as an important part of their long-term investment programme. We asked them why

Mike Powell, Head of Alternative Investments, Universities Superannuation Scheme

'Private equity is a natural fit for a pension fund because it is a long-term asset class. We need assets that generate long-term returns above inflation so that we can meet our liabilities.

'We expect private equity to be able to generate returns that are at least 3% above public market equities.

'The asset class that matches our liabilities most perfectly is index-linked bonds. However, the current level of return offered is too low to generate the returns that the pension scheme needs. An asset class such as infrastructure provides long-term inflation-linked returns but with a potential return well above that of index-linked bonds.'

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Allan Polack, Chairman, Nordea Investment Management

'Private equity is a valuable asset class for two reasons: first, it's different from the listed equity world, which has volatility embedded in it. Private equity depends on macro factors such as economic growth, not a daily re-evaluation of a share price.

'Second, private equity is exposed to pockets of the corporate sector that are very difficult to get hold of through listed companies – such as start-ups or turnarounds. This is where private equity is different from listed companies, because your investment has a direct impact on the business.
So there is no doubt that private equity will continue to attract interest from long-term investors – but worries remain around regulations such as Basel III and Solvency II.'

2013: A year of debate

In line with the European Commission's green paper on long-term investing, calls are growing for a more supportive environment for long-term investors. This year will see a number of high-profile discussions take place within European policy circles

Q1 2013:
The EVCA hosts its Responsible Investment Summit

The EVCA's Responsible Investment Summit will explore the development of frameworks to support long-term investment projects that benefit society at large, providing necessary capital to fulfil new projects alongside flexibility, vision and sound governance.

Q2 2013:
EIOPA conducts impact assessment on long-term guarantees under Solvency II

The European Insurance and Occupational Pensions Authority's study will examine how valuations of certain long-term hold-to-maturity asset classes will be affected by not using a market consistent approach to valuations. The initial scope of the impact assessment will cover bonds but it is hoped this will eventually be broadened to cover other long-term asset classes.

H2 2013:
CEPS' task force on long-term investing reports

The Centre for European Policy Studies (CEPS) has launched a new task force on long-term investing and the single market for long-term savings. The task force, chaired by Nordea Investment Management's Allan Polack, is focusing on economic growth and the provision of adequate retirement incomes. The final report will be launched in the second half of 2013.

Q4 2013:
The OECD presents findings of its long-term investment project

A project by the OECD – Institutional Investors and Long-Term Investment – aims to tackle 'regulatory obstacles' and market failures preventing long-term investment. Through building on existing OECD databases, the project will monitor and research long-term investment issues – such as governance, regulation, infrastructure, green investment and emerging markets – in order to share its learnings with members.

The EVCA is the voice of European private equity.

Our membership covers the full range of private equity activity, from early-stage venture capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions. We represent 700 member firms and 400 associate members.

The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

We explain private equity to the public and help shape public policy, so that our members can conduct their business effectively.

The EVCA is responsible for the industry's professional standards, demanding accountability, good governance and transparency from our members and spreading best practice through our training courses.

We have the facts when it comes to European private equity, thanks to our trusted and authoritative research and analysis.

The EVCA has 25 dedicated staff working in Brussels to make sure that our industry is heard.

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