Juanita González-Uribe Robyn Klingler-Vidra October 8th, 2024

Venture capital literacy could boost the potential of UK pension funds

*The UK is on the verge of a rare opportunity to transform its pension system, potentially reshaping the future for British pension savers. **Juanita Gonzalez-Uribe and Robyn Klingler-Vidra** write that the key to driving innovation-led growth lies in one critical factor: improving venture capital literacy among pension fund managers.*

Pension reform is one of the few areas where the new Labour government and the previous Conservative administration align. Both back increasing pension investments in UK private assets, particularly venture capital (VC), a move that could unlock the country's innovation-led growth.

Their reasoning makes sense. The government's other tools to boost VC, researched by Robyn Klinger-Vidra and which include direct investment and tax incentives, are already in place, with the British Business Bank as a major limited partner and numerous VC-related tax schemes available. The mechanism for financing startups and growth capital that the UK lacks, relative to other leading innovation ecosystems, are pension fund investments in venture capital. UK pension funds invest far less in VC compared to Australia, Canada, and the US.

As a result, the UK still faces a scale-up problem, with innovative firms struggling to secure funding as they grow, often seeking capital from Silicon Valley. At the behest of American investors, these scale-ups may then relocate their growing company, and its talent, to the US. Without UK pension fund support, the UK risks to continue falling behind in funding startups and scale-ups. This would leave foreign investors, not British savers, to benefit from financing the nation's innovation. And the ecosystem stands to lose future unicorns who relocate abroad.

Robust pension fund allocations to VC

The proposed shift in pension allocations toward venture capital is supported by academic research. Private asset investments can offer diversification and higher risk-adjusted returns, benefiting British pension savers. At the same time, this shift could significantly strengthen the UK's entrepreneurial finance, aligning the economy with broader innovation goals.

The study by Juanita Gonzalez-Uribe highlights this effect through a natural experiment in the US. During the 2000s, state pension funds in that country gradually increased their allocations to venture capital following the staggered adoption of "prudent-man rules" across states. Like the Employee Retirement Income Security Act (ERISA) of 1979, these rules clarified pension fund investment guidelines, classifying VC as a prudent asset class and enabling state funds to invest in it.

The results of these adoptions were striking: adopter states saw local pension funds increase their annual local VC commitments by $175 million (roughly a 50 per cent increase) on average, compared to out-of-state funds. This influx of capital sparked more investments in local entrepreneurs, helping drive entrepreneurial growth, and aligned the economy with broader innovation goals.

Applied to the UK, this suggests that the right pension reforms could unlock much-needed resources for local innovation-based growth. Currently, 16 times more global pension capital flows into UK private assets than from British pension funds themselves.

Why don't they invest (more) in VC?

UK regulations do not explicitly prohibit pension funds from investing in VC funds. Underinvestment is in large part caused by how pension funds allocate their capital.

First, allocation decisions are often made based on fee levels. VC funds tend to charge a "2 and 20" fee model; 2 per cent for management fees and 20 per cent performance fee. Other investment managers often charge less, perhaps because they have a larger pool of money to manage or because they are less active investors.

Second, VC funds tend to be small. Pension funds would need to make many small allocations, which requires both expertise to select VC managers and manpower to oversee bandoneon-style—like the multi-fold instruments popular in Latin America—portfolios with many elements. To invest in VC at scale, UK pension funds would need to invest in VC literacy to acquire capabilities in underwriting VC managers and have mechanisms for better pooling investments (such as through funds-of-funds structures).

Government efforts

Recent efforts to bolster pension fund investment in private capital have sought to mandate allocations. In July 2023, then-Chancellor Jeremy Hunt launched the "Mansion House Compact," where nine UK defined-contribution (DC) pension fund managers committed to invest at least 5 per cent of their default funds into unlisted equities by 2030. This is already manifesting in VC allocations, as Aviva Investors announced a Venture Capital and Strategic Capability fund in September 2024.

Chancellor Rachel Reeves has also made pension reform a key part of her economic strategy. The chancellor advocates for consolidation, mirroring the Canadian model, so that the UK deploys capital through large investment managers. This could partly address the issue of pension fund capabilities inhibiting their VC allocations; a consolidated pension fund manager could be better positioned to hire and retain talent adept at underwriting VC manager quality.

The problem of forced allocations

Some government rhetoric suggests that VC allocations might be imposed if pension funds do not adopt them voluntarily. While the government's frustration is understandable, forcing pension funds into rigid structures is unlikely to produce good results. The government's role may be better served by clarifying investment rules, as shown by the US experience with the Prudent Man Rules. Current uncertainty about pooling mechanisms, for example, may be stalling action. In a recent interview, Mike Weston, chief executive of Local Government Pension Schemes Central, said "pooling could move significantly further and faster if the government provided stronger guidance and clarity".

Investors move towards private markets for returns, not because of mandates. If pension funds have the right capabilities and governance, they will invest where returns are strongest. John Graham, CEO of the Canada Pension Plan (CPP) Investment Board, one of the world's largest pension funds, recently emphasised his opposition to "any constraint on portfolio construction" or being forced into specific asset classes. In an interview, he pointed out that CPP's success has come from "governance, scale, and a return-focused mandate that gives us the freedom to invest wherever we see the best chance of returns."

VC training for pension funds

While strong-arming large pension funds into five per cent allocations (and consolidating dozens of small pension funds into a mega manager) address some of the root causes of UK pension funds' anaemic investment in VC, it doesn't solve the problem of pension managers' lacking VC literacy.

Unlocking pension funds for the UK venture capital market requires significantly boosting the VC capabilities of pension fund managers. This market is notoriously complex, with returns that are highly skewed and persistent. It's not just about investing in VC: it's about investing in the right funds and engaging as high-quality limited partners. Unlike mutual funds, there's strong evidence of "alpha", but top-performing funds are often oversubscribed, which can make access a challenge. Also, pension fund managers' ability to invest in new and emerging VCs who have small, verticalspecific funds would be key. Emerging VC managers can deliver strong risk-adjusted returns, according to Preqin data.

Whether UK pension funds can secure access to elite funds at competitive terms depends on their ability to build internal capabilities or attract seasoned investors—both costly endeavours. Many link the UK's broader productivity issues to a lack of managerial capabilities, yet the conversation around pension fund management VC skills has been lacking. Enhancing technology and early-stage investment literacy is essential to developing pension fund managers who can effectively navigate the risks and complexities of the VC industry.

Indeed, the US experience with public pension funds offers cautionary lessons. A study by Yael Hochberg and Josh Rauh found that US state pension funds' private capital in-state investments underperformed by two to four percentage points compared to both their out-of-state private capital investments and those by external investors. "Local" does not always mean better. In wider academic literature, evidence suggests that geographic constraints are a pitfall to be avoided.

Next steps are key

The UK's pension reform process is accelerating. Last month the government's Pensions Investment Review Call for Evidence closed, and the Pensions and Private Capital Expert Panel released its interim report. The UK has a once-in-a-generation opportunity to overhaul its pension system. Exciting times lie ahead for British pension savers—and possibly for UK innovation as well.

If this wave sees UK pension funds achieving strong risk-adjusted returns in their VC allocations, it will trigger a virtuous cycle in which more money will flow in. This is what has been happening since the late 1970s in the US, with pension funds and university endowments reaping substantial returns from VC investments.

But requiring pension fund managers to identify quality VC managers and to act as high-quality limited partners when they are not yet ready to do that will most likely result in poor returns. Low risk-adjusted returns or investments in mismanaged funds would poison the well, not invigorate it.

Now is the time to invest in training around VC literacy, not to force investments for pension fund managers that may or may not be ready. Training is needed on understanding the unique features of venture capital, including how to conduct due diligence (well), how high-quality venture capitalists work with their portfolio companies, how returns are calculated (such as total value to paid-in capital and public market equivalent), possible liquidity backstops requirements so defined-contribution funds can invest, and more. That way, pension fund managers will be better adept at assessing the potential of VC managers, especially among emerging and small managers who can deliver returns and focus on cutting-edge innovation.

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