Summary
• Pensions in other countries – such as the US, Australia and Canada – are enthusiastic about venture capital.
• The UK has been less keen to get involved.
• The Mansion House Compact, signed by 11 industry giants, signals a commitment to invest in UK unlisted assets, including venture capital.
• Some argue that setting the focus of venture capital allocations to the UK is restrictive and potentially counterproductive, and that a global outlook is required.
• Until pensions are willing to pay the necessary fees for venture funds, they may find themselves excluded from the best performing managers.

Venturing on new investments

Is the time right for UK pension funds to consider venture capital investment?

In February, Aviva Investors launched a new Venture and Growth Capital fund, with a £150 million commitment from Aviva, and the aim to open pathways to investment opportunities in "cutting-edge tech sectors". Conceived with a UK-bias, the fund also explicitly aims to match the intentions of the 2023 Mansion House Compact, in which signatories stated a shared aim to increase investment in UK PLC's emerging industries, and in particular unlisted companies.

Billed as a win-win for pensions savers and for the UK economy, and backed by both the former and current governments, the Mansion House Compact has 11 signatories (Aviva is a founding signatory), committed to achieving a minimum 5 per cent allocation to unlisted equities through defined contribution (DC) pension funds, and other sources of long-term savings. The big idea is to unlock more than £50 billion of capital by 2030.

Aviva group CEO, Amanda Blanc, commenting on the launch of the fund, said: "Aviva is investing more and more in the UK, to support growth and back Britain's flourishing early-stage companies. This new fund will provide vital finance to some of the UK's most promising, high-growth businesses, aiming to deliver great returns for our customers." Aviva's objective, the firm says, is to give investors better access to "early-stage companies", at the same time providing them with the benefit of diversification and the potential for returns offered by private markets.

What venture capital wants

As the British Private Equity and Venture Capital Association (BVCA) head of policy (legal and regulatory), Tom Taylor, puts it: "The prime aim with venture capital funds is to find innovative startup companies that have really good ideas. They want to really supercharge the growth of those innovative ideas." Aviva's new fund, then, gets to the essence of venture funding – providing capital for new ideas, helping them reach their potential, reaping the rewards further down the line.

Essentially, it could be said that all good ideas are fair game for venture capital firms, which go about driving investment into innovation by gathering funds from institutional investors around the world. "The ideas *[funded]* might be coming out of university spinouts, they could be in biotech, life sciences, software as a solution, or any other kinds of technological solutions to society's problems. These are the things that venture capital firms are looking for." In short, though, these are companies that have "very, very, powerful growth potential", says Taylor, and something that has the "potential to grow really very quickly".

The pension perspective

Of course, boosting the companies of tomorrow is laudable and driving growth through innovation is to be applauded, but to put it frankly, what's in it for pension savers? Cardano senior investment manager, Geordie Cox, says: "The greatest potential lies within the diversification benefits that venture capital provides. Venture capital has a relatively low return correlation to public equity markets. Venture capital investments do however live at the higher end of the risk spectrum and, as such, will not be suitable for all pension investors."

Still, according to VenCap chief investment officer, David Clark, there are some very strong arguments in favour of a greater investment in venture capital for pensions. "When you look at the long-term performance *[venture capital]* has the capacity to significantly improve overall returns for a scheme, which ultimately means better outcomes for members," says Clark. And UK pensions have been able to observe venture successes in other geographical regions, Clark says. "They can see they are potentially missing out. Canada and Australia, for example, have been accessing private markets for 15-20 years now, and we can see the results."

Indeed, Taylor says: "There's a heavy bias towards non-UK capital generally in UK private capital firms. About 85 per cent of the capital that our members invest comes from overseas, and it varies year-on-year, but about probably about 30 per cent of that is pension funds.

"The vast majority of that is pension funds that are non-UK pension funds, particularly North American pension funds, Australian pension funds, and so on. Only about 3 per cent of the capital that is invested on behalf of investors by our members comes from UK pensions, and that's probably almost entirely local government pension schemes (LGPS) and some of the more open corporate DB schemes, as opposed to DC schemes' capital. Very little, if any, DC capital is invested in these kinds of products."

Taylor says the reasons for much of this are historical. "Around the 1980s, when the UK's private capital fund industry and the venture capital industry were much younger, it really become a popular institutional asset class in the UK, and the UK's corporate DB pension schemes were big investors in this asset class," he says. That continued until the general shift towards DC provision, and the different investment needs that came with that – leaning towards open ended funds with greater liquidity and lower fees.

Nonetheless, some schemes are better suited to venture capital than others. "DB schemes that are well-funded and amenable to being patient with the capital deployed in their growth portfolios as part of a run-on strategy are best placed to take advantage of the higher potential returns that come alongside the segment's higher risk characteristics," says Cox. "Venture capital can pack a punch even with a small allocation."

But in the DC world, Cox adds: "Much will depend upon the path of consolidation that is rising through the sector; as larger pools of capital are formed, greater potential could accrue from larger critical mass in portfolios that have a longer investment time horizon than DB schemes. DC schemes are therefore more inherently suited to taking on the illiquidity that characterises investments in the venture capital market."

A global view

According to the BVCA, the UK has the second-largest private capital industry in the world, and there is 16 times more capital invested by non-UK pension schemes than by UK schemes. "What that means is that all these strong returns, but also the diversification, the good that this does economically for investors, is going to Texan teachers and the Canadian civil servants and Australian firefighters; those are whose retirement portfolios are getting the benefit of these strong returns, and we've always thought it's a shame," says Taylor.

However, some argue that it would be a mistake for UK pensions to focus solely on UK growth. "When we look at the government's Mansion House incentives, we are fully behind their aims – growth and returns for pensions – but it does feel like killing two birds with one stone is not necessarily the best approach, and could have the opposite effect in both cases," says Clark. "There is no reason why, as a UK investor in venture capital, you should be particularly overweight in the UK. If you want to increase returns through venture capital, you need to have a global perspective."

Indeed, argues Clark, the only way to access the real returns on offer from venture capital is to aim for the areas that will deliver. And, Clark says, the target area is vanishingly small. "When you invest in venture capital, you have to do it right," says Clark. "The reality is that the majority of investments lose money. Over 60 per cent of venture-capital backed companies will not return the capital."

But, says Clark: "The flipside if that the bulk of returns are generated by the top 1 per cent of companies." Those that win, win big, but the winners are highly concentrated, although, crucially, not in geographical terms; they could be anywhere in the world. That's why, Clark says: "I am a bit nervous when I see some of the recent announcements about pension funds investing in UK-focused funds. I'm not sure they will generate the returns the pension funds need, long term."

Getting what you pay for

Still, done right, many experts argue that venture capital could give UK pension funds (and the economy) a much-needed boost. Co-writing for the London School of Economics' LSE Business Review in October 2024, LSE associate professor, Juanita González-Uribe, and King's Business School associate dean for global engagement, Robyn Klingler-Vidra, said: "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." But the authors highlight another potential block for pensions eyeing venture capital funds: High fees.

Typically, venture capital funds might charge 2 per cent management fees and 20 per cent carried interest (performance-related) feed. Clark says: "The very best venture capital funds have fees, and you can't reduce those; you need to find a model where you can pay the market fees, because the returns will justify those."

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