Murtaza Merchant

DC investment in private credit

MV Credit managing partner, and co-head of business development, Murtaza Merchant, speaks to *Pensions Age* about the opportunities for private credit investment within DC schemes

Private markets were traditionally seen as an inaccessible area for DC scheme portfolios. Why was that the case; what were the barriers preventing this?

The reason private markets have been difficult for DC schemes to access is primarily because of the nature of the structuring of private market funds. Private market funds are typically structured as closed-end funds because they are illiquid investments. Really to benefit from the investment strategy of private markets, investors need to be in the strategy for the long term. The closed-end nature of these funds hasn't helped DC schemes, which need to be invested in open-ended set ups, to be able to access these.

The second challenge is that these private market funds invest over a period of time. It's not possible to take capital from an investor and put the money to work immediately in private markets. I need time to build a diversified portfolio, and each time I find an investment I will draw capital from the investor. This doesn't work for DC schemes because they need the ability to deploy capital immediately and consistently.

Then the final two points are really valuation and pricing. It's getting better now, but there was always the idea that if you need daily liquidity, you need daily pricing and private assets don't change daily in price. There is management fee and then there tends to be a performance fee as well, which is very alien, or it used to be very alien to the DC community. So, it was difficult for DC schemes to then reconcile all of these factors and think about private market investments.

Is this situation starting to change now; are the challenges you mentioned being overcome?

It's definitely changing and we have been lucky enough to be at the forefront of this change, as we launched one of our hybrid products more than three years ago now.

We created a product that combines illiquid investments, which is private markets, with an allocation to liquid investments. We are credit-focused, so we have a liquid strategy in there. By doing that we addressed two of the challenges; we addressed the challenge of liquidity because we have a liquid allocation within our investment strategy, but we also solved the problem of immediate deployment.

So by having a liquid strategy, if we get incoming cashflow from an investor we can immediately deploy that into the liquid strategy and then reallocate to the illiquid strategy.

We understand that performance fee is very sensitive for the DC community, so we came up with a structure that had a flat fee and no performance fee for the investors

The last, but most important point, is we made sure that we were marketing it to the right DC community. This is meant to be a long-term investment, and therefore we positioned our fund very much towards the default funds strategy, where you eliminate the ability for investors to trade in the fund.

Why would you suggest that those managing DC schemes look at investing in private markets – what benefits can it provide for DC schemes?

The biggest point is diversification.

If you look at private credit, it's one of the fastest growing asset classes globally. After the global financial crisis, there has been a shift away from traditional bank lending, with capital flowing into private markets.

Typically, private credit has yield enhancement, as the fact that you are illiquid means that you are compensated for being illiquid, which provides a higher yield and higher return over the long-term to investors.

Private credit, direct lending where we operate, is at least in our case, a 100 per cent floating rate. We are not exposed to interest rate movements, which is very, very important from a duration perspective for DC schemes because we will capture the underlying interest rate movements automatically.

There is less volatility by including private credit in your portfolio by nature, because private credit investments are not 100 per cent marked to market and they do not move in a volatile fashion.

The final point I'll make is ESG. Given DC investors are so focused on ESG, sustainability and impact, in the private markets you really have the option to drive that forward with the underlying companies.

Looking at MV Credit's hybrid fund solutions – please could you tell me about its structure and how it is created to meet the needs of DC pension fund investors? And how does this approach compare to other funds in the market?

We solved the challenges facing DC schemes investing in private credit by having the hybrid liquid and illiquid strategy. But structuring was the key to making sure that we had the right outcome for the investors.

What that involves is a very significant amount of operational efficiencies. We need to make sure that we were well-positioned in cash management, in operations, in making sure that we worked well with our liquidity providers on the fund, to ensure that if there was ever a need for liquidity we could provide that. So operationally and logistically, it requires a lot of work to make sure that all the things that are sensitive to the DC community are addressed.

You have to make sure that there is a lot of cooperation between the managers managing your portfolio to be able to deliver what is required for the investor. Again, I'd stress that this is very much geared towards a long-term horizon investor, so we make sure that in our conversation with the investors we keep that front and centre.

We were first movers three and a half years ago, so there are not many strategies that we can compare to. Of course there are a lot of private credit managers out there, but there are not many private credit managers who have actually been able to structure a product that is tailored for the DC community.

MV Credit's hybrid fund is now over three years old. How do you ensure it continues to meet the evolving needs of pension schemes amidst changing market conditions?

Trustees of DC schemes are getting more and more comfortable with the idea of illiquid assets in the portfolio. I think as the familiarity and as the comfort factor increases, the market has started to evolve. For example, in our hybrid strategy we have a 60 per cent allocation to illiquids and a 40 per cent allocation to liquids, but we have the flexibility to vary that, depending on what the underlying DC scheme's objectives are.

That flexibility is very important. In fact, we are on the verge of launching with another investor, a strategy which is 100 per cent illiquid. The reason this works is because DC investors are now getting comfortable with the idea that frankly this so-called need of liquidity isn't really a need for liquidity, because most of these large DC schemes have a very small allocation to illiquids, and the rest of their portfolio is in liquid assets anyway. The cash management can be done at a global level at their end, and they really don't need liquidity to be coming from an illiquid bucket.

So, we are really happy that we moved early and are now evolving and providing solutions to other DC investors as well.

UK DC schemes are being increasingly encouraged by the government to invest in private markets to help bolster and grow the economy – how do you see DC levels of investment in private markets changing in the near future?

I think the government has done a good job here in making sure that there is the ability for DC schemes to participate in private markets. The new LTAF structures are one example of that. I personally think that this is a question of comfort and familiarity, as trustees and decision-makers see this really works for the long-term. As more products come online, as new managers come online with similar products, I think that familiarity will help the decision-makers to make decisions.

The hardest thing to do is to be the first mover, both for the manager and the DC trustees, but as the concept of investing in private markets is adopted more widely, it makes the process a little bit easier. I think the consultant community will also then be able to analyse the track records for some of these managers and so, be much more comfortable in proposing strategies to the DC community.

It is a joint effort between decision-makers, consultants and managers, but the more this happens, the more familiarity increases and it becomes easier for everyone.