Press Release

EMBARGOED UNTIL 00.01 Monday 25th March 2019

PPI Report: DC scheme investment in illiquid and alternative assets

"Illiquids could be a new frontier for DC pension scheme investment" says Pensions Policy Institute

The Pensions Policy Institute (PPI) is today publishing *DC scheme investment in illiquid and alternative assets* sponsored by BlackRock. The Government has recently consulted on the ways to enable Defined Contribution pension schemes to invest a higher proportion funds into illiquid and alternative assets as there are potential benefits associated with these assets. However, there are cost, operational, governance and regulatory barriers which prevent some DC schemes from exploring investment in illiquid and alternative assets. This report sets out the potential challenges and discusses how they may be overcome.

Daniela Silcock, Head of Policy Research at the PPI said "Defined Benefit schemes in the UK have, for a long time, recognised the benefits of investing in illiquid and alternative assets. Over the long-term, these assets are expected to deliver a higher overall return than publicly traded stocks and bonds and can provide other benefits to scheme members, in particular, diversification through exposure to a wider range of assets, and investment in different areas of the market which may not grow and drop in value at the same time as the public market."

"However, there are significant challenges facing DC schemes who wish to invest more in illiquid and alternative assets. Illiquid funds are not readily available on most DC platforms, and because these assets are generally priced differently than the assets which platforms usually offer to DC schemes, there will need to be innovation and development from platform managers in order to make these types of assets more widely available. DC schemes have also found that the way that illiquid and alternative assets are priced and charged can make it difficult to properly assess compliance with the 0.75% charge cap on default strategies in schemes used for automatic enrolment."

"The Government is trying to remove challenges to investment in illiquids. It has recently issued consultations clarifying that DC schemes are permitted to invest in illiquid assets and has suggested a new method of charge cap compliance. Alongside the operational and regulatory challenges, there is also an information gap facing DC scheme providers, who may be unsure of the benefits of investing in these types of assets. In order to encourage further exploration there may need to be impartial information and guidance from a trusted source, such as the Government or an industry body, explaining the potential benefits to DC schemes of investing in illiquid and alternative assets, backed up with robust data, and showing the estimated likely returns net of charges. Any communication approach should also include the main intermediaries dealing with DC scheme providers: advisers, consultants and platform managers."

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PENSIONS POLICY INSTITUTE PPI

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Notes for Editors:

1. The Pensions Policy Institute (PPI) is an educational research charity, which provides non-political, independent comment and analysis on policy on pensions and retirement income provision in the UK. Its aim is to improve the information and understanding about pensions policy and retirement income provision through research and analysis, discussion and publication. Further information on the PPI is available on our website www.pensionspolicyinstitute.org.uk.

2. This report was sponsored by BlackRock.

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3. Sponsorship has been given to help fund the research, and does not necessarily imply agreement with, or support for, the analysis or findings from the project.

Executive Summary

This report is informed by desk-research, case-studies, interviews with industry, and consultation with several Government departments.[1]

The Department for Work and Pensions (DWP), HM Treasury and the Financial Conduct Authority (FCA) have recently consulted on the best way to enable Defined Contribution (DC) schemes to invest a higher proportion of assets into less traditional asset types. Greater DC scheme investment in illiquid assets, (which lock away funds for a period of time) and alternative assets, (less traditional assets such as privately listed equity and hedge funds) could potentially yield benefits to pension scheme members. Illiquid and alternative assets:

- Widen the range of potential investments, from those only listed on the stock exchange;
- Are not generally subject to the same market forces as publicly listed equities, and therefore may not suffer losses at the same time as other asset types;
- Often provide long-term returns at or above inflation and may therefore be well suited to pension investment;
- Have the potential to deliver a higher, more secure return, net of charges, over time than liquid assets;
- Come with various costs and challenges which have traditionally made it difficult for DC schemes to invest in them.

76% of DC scheme assets are currently invested in bonds and equities, with 5% invested in cash, and the remainder in multi-asset and alternative funds.[2]

76% of DC assets are currently invested in bonds and equities. Greater DC scheme investment in illiquid and alternative assets could potentially yield benefits to pension scheme members.

Cost, regulatory, operational and governance challenges are preventing some schemes from exploring investment in illiquid and alternative assets.

- Higher costs: higher costs are associated with investing in liquids and alternatives.
- Operational challenges: less than daily valuations of assets, the sharing of risk and return across different cohorts of the membership, variable charges/performance fees, the lack of immediate access and limitations to the supply of appropriately structured assets on platforms can make it difficult for schemes to integrate illiquid and alternative assets into their investment strategy.

1. Including DWP, HMT, and Department for Digital, Culture, Media and Sports.
2. Law Commission (2017) p. 25, figure 4; Spence Johnson (2016) p. 60

- Governance and regulatory challenges: complexity and challenges to transparency can make it harder for schemes to do their due diligence and can interfere with schemes fulfilling their obligations to report on costs and charges. Permitted Links regulations (which describe the characteristics of assets that contract-based pension schemes are permitted to invest in) have been interpreted as not allowing investment in assets which do not allow immediate access to funds, though the Financial Conduct Authority intends to clarify the wording around these regulations to make it clear that investment in illiquid and alternative assets is allowed.

There are available avenues for overcoming challenges:

- Growth, consolidation, fund pooling and the closure of some small schemes could play a key role in overcoming some operational and cost challenges,
- Changes to, and clarification of, regulations may help facilitate DC scheme investment in illiquid and alternative assets,
- There are methods of calculating the proportion of funds which can safely be invested in illiquid and alternative assets while allowing for sufficient liquid capital to meet ongoing expenses,
- An increase in demand from schemes should ideally result in investment and development by platforms, leading to a change to the daily valuation and dealing practices of DC platforms so that assets which are valued less frequently are catered for,
- Advancements in education and a holistic communication approach involving consultants, investment managers, platforms and providers might be necessary to encourage some of the more reluctant trustees to consider less traditional investments.

Increases in scheme sizes, consolidation and fund pooling could play a key role in overcoming operational and cost challenges

Over the next few decades, individuals who have been automatically enrolled will start to accrue larger pots and total DC Assets Under Management (AUM) are expected to increase from around £280 billion in 2017 to around £1.68 trillion in 2030.[3] Larger schemes can generally charge less through efficiency savings, sharing administration costs across larger membership bases and negotiating more competitive deals with external managers. Scheme growth should help make illiquid and alternative asset investments cheaper and more accessible to DC schemes.

Very small schemes are unlikely to increase sufficiently in size to benefit from the cost reductions associated with scale. However, smaller schemes are being encouraged by the Government to consolidate through the introduction of measures which have simplified DC bulk asset transfers.[4] The Government is also consulting on whether or not to require some small DC trust schemes to publish regular assessments of whether it is in members' interests to be transferred into another scheme, such as an authorised master trust.[5] Smaller schemes may also be able to get access to some illiquid assets via multi-asset pooled funds.[6] Advancements in consolidation and fund pooling should make it easier for small schemes to join together, pool funds, or join larger schemes.

> Increases in size should make alternative investments cheaper and more accessible to DC schemes. Advancements in consolidation and fund pooling should make it easier for small schemes to pool together, join funds, or join larger schemes.

Changes to, and clarifications of, regulations may help facilitate DC scheme investment in illiquid and alternative assets

Historically, there has been an erroneous perception among some providers and trustees that DC schemes are required to invest in

3. Law Commission (2017) p. 1, para 1.2
4. The Occupational Pension Schemes (Preservation of Benefit and Charges and Governance) (Amendment) Regulations 2018, DWP
5. DWP (2019)
6. Patient Capital Review Industry Panel (2017) p. 6

daily priced assets and cannot use assets with variable fees. Clarity around regulatory requirements and promotion by Government should make it easier for DC schemes to understand the available investment options. The Government already clarified in December 2018 that DC schemes are not required by regulation to invest only in assets that are priced daily.[7]

There are several recent consultations which involve clarification of or changes to the regulations that DC scheme investments are subject to. These changes and clarifications may facilitate more exploration of alternative investment options by providers and innovation by DC platforms:

- In December 2018, the FCA published a consultation on Permitted Links, which aims to clarify and change regulatory requirements.[8]
- In December 2018, the FCA published a discussion paper to explore how to remove barriers to investment in patient capital assets through authorised funds.[9]
- In February 2019, the DWP published a consultation on the consideration of illiquid assets, the development of scale, and changes to the way schemes assess compliance with the charge cap.[10]

There are methods of calculating the proportion of funds which can safely be invested in illiquid and alternative assets while allowing for sufficient liquid capital to meet ongoing expenses

While DC schemes depend on a liquid capital buffer to fund ongoing costs and transfers out, they are unlikely to require access to the total AUM. There are methods for calculating the proportion of funds a scheme can safely invest in an illiquid asset. For example, the optimal allocation of a fund to illiquid assets which cannot be accessed for four years is estimated, using one method, to be around 13%.[11]

An increase in demand from schemes could result in innovation and development by platforms

Alternative funds are not widely available because of:

- Platform constraints, particularly around the regularity of asset valuations, and,
- Subdued demand due to the administrative complexity associated with investment in illiquid and alternative assets.

Changes in the marketplace, such as scheme growth and changes to regulations which make investment in illiquid and alternative assets easier, could increase accessibility and encourage innovation by asset managers.

> Changes in the marketplace such as increased scale and changes to regulations which make investment in illiquid and alternative assets easier, could increase provider demand, and encourage development and innovation by asset managers.

Asset managers may need more guidance on reporting on charges and transaction costs

The difficulty of determining ongoing charges and transaction costs in relation to some illiquid assets might make it hard for platform managers and providers to comply with disclosure regulations in relation to these assets. In order for schemes to find it easier to comply with disclosure regulations, asset managers may need more of a prescriptive framework for reporting charges that appear more opaque, or vary over time. The Cost Transparency Initiative[12] is planning to produce

7. FCA (2018)
8. FCA (2018a)
9. FCA (2018b)
10. DWP (2019)
11. Robeco (2015) p. 7, table 2
12. Includes: Association of Consulting Actuaries, Pensions & Lifetime Savings Association, LGPS Central Limited, JP Morgan AM, LGPS Advisory Board, Insight Investment, Investment Association, British Private Equity & Venture Capital Association, Financial Services Consumer Panel, RBS Pension Fund

some templates for asset managers to use when reporting charging on some assets, which should make reporting easier.

Advancements in education and a holistic communication approach involving consultants, investment managers and platform managers will be necessary to encourage trustees and providers to consider alternative investments

DC pension scheme provider ambivalence regarding the benefits is a major barrier to alternative investment. DC scheme providers are unlikely to change their investment strategies unless they feel comfortable that change is in the best interest of members. Therefore, in order to encourage trustees and providers, a better investment case needs to be made.

Some trustees and providers are uncertain as to whether the estimated benefits associated with investment in illiquid and alternative assets outweigh the potential risks; particularly risks associated with illiquidity and whether the higher costs are proportionate for DC scheme investments, particularly in light of the charge cap. Though trustees in DB schemes may be comfortable with the case for DB investment in illiquids, they might benefit from well set out impartial information and guidance from a trusted source, such as the Government or an industry body, explaining the potential benefits to DC schemes of investing in illiquid and alternative assets, backed up with robust data, and showing the estimated likely returns net of charges.

DC scheme providers might benefit from well set out impartial information and guidance from a trusted source, such as the Government or an industry body, explaining the potential benefits to their schemes of investing in illiquid and alternative assets, backed up with robust data, and showing the estimated likely returns net of charges.

DC schemes receive most of their information from intermediaries who could be incorporated into education campaigns that aim to help providers and trustees to understand their options and the potential benefits of investing in illiquid and alternative assets. Therefore education may need to be undertaken directly with consultants, advisers and platform managers before being undertaken with providers.