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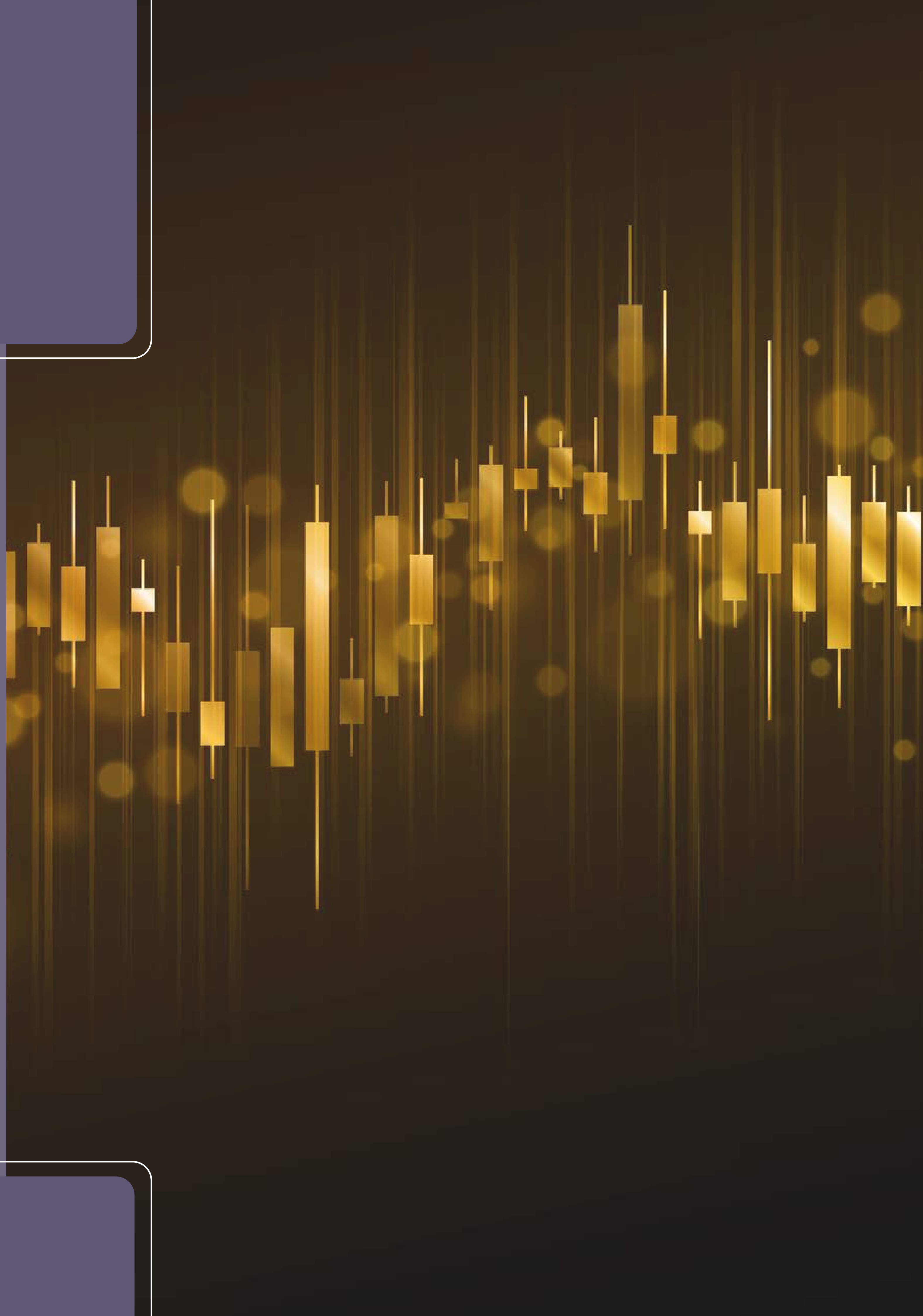
What role could alternative assets play in DC investment strategies in the future?



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What role could alternative assets play in DC investment strategies in the future?

Executive Summary

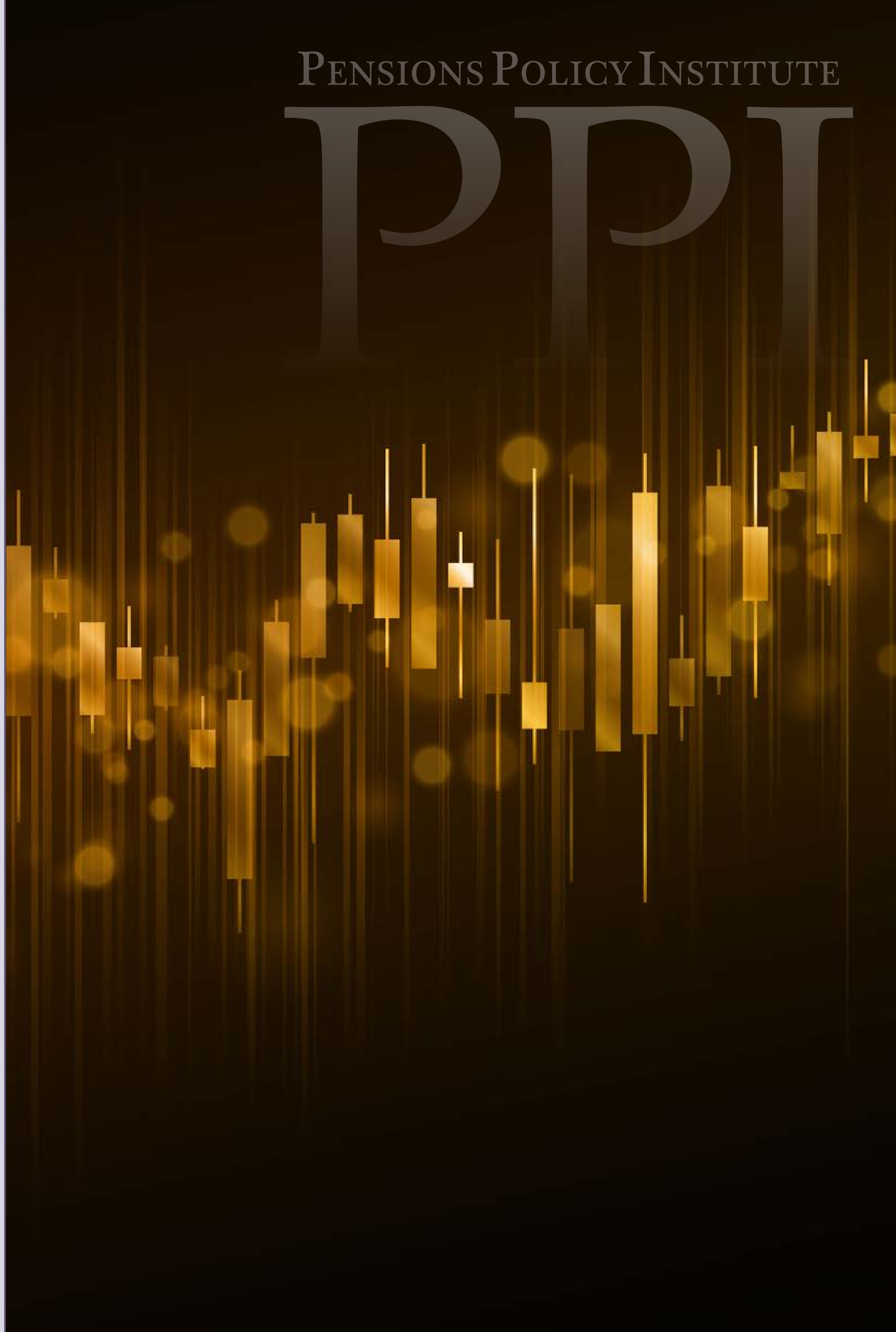
This report explores the topic of Defined Contribution (DC) scheme investment in alternative assets, particularly in light of new opportunities and the potential benefits that could be gained from the use of these types of assets during times of economic uncertainty.

As the DC market matures and there is a greater focus on the longer term needs of scheme members, there is an ongoing paradigm shift in the way in which DC schemes consider investment. Economic uncertainty and the changing shape of retirement as more DC members retire with larger pots, means that there is an increasing spotlight on investment strategies and how best to make members' money continue working for them, while decreasing volatility as they approach retirement. The traditional passive equity and bond split that has dominated DC investment is no longer viewed as the most effective way to deliver member outcomes. The other driving force steering change in investment is that of the Government's productive finance agenda, potentially opening up the space for DC schemes to invest in a wider and potentially more productive range of assets.

While allocation to alternative investments remains relatively low, this is not unexpected given the last decade has focused on the implementation of automatic enrolment and building scale. However, schemes appear increasingly focused on evolving and improving investment strategies, building quality, incorporating sustainability objectives and demonstrating value for money. There is also an increased focus on reporting and transparency (e.g. requirements based on the Task Force on Climate-related Financial Disclosures (TCFD) recommendations) which is likely to drive further change. The DC market has been shaped by a focus on charges and competition, but the Department for Work and Pensions (DWP) and regulators are increasingly shifting this focus towards value for members.

Allocation to alternative asset classes has the potential to benefit DC portfolios, with:

- potentially higher and/or less volatile returns, including the potential for an illiquidity premium in some cases;
- enhanced portfolio diversification, which could offer a risk mitigation during periods of economic uncertainty due to low correlations with traditional assets; and
- a long investment horizon that matches the long-term investment of DC members.



Some alternative assets, such as property and certain commodities, appear well understood by both schemes and members. DC schemes have been investing in these areas for some time, but allocations remain low, with less than 1% invested directly in property and 2-4% in commodities. Infrastructure investment has also been growing, with an average allocation of 3% among master trusts.[1] Some private market assets, however, including private equity, venture capital and private debt remain predominantly absent from DC investment strategies.

Some of the largest DC schemes, including some master trusts, are already engaging with alternatives in a meaningful way. Others, particularly smaller schemes, remain hesitant to engage.[2] While recognition of the potential benefits of including alternative assets in a DC investment strategy is growing, uncertainty and lack of understanding remains a headwind to alternative investment. Furthermore, there isn't a clear model for best practice and success, especially given the long horizons of DC investment, so even schemes that recognise the benefits are often unsure how to begin their journey towards greater investment in alternative asset classes. Operational and governance challenges, such as lack of scale and access hurdles, can make it particularly hard for schemes to engage.

There are a range of asset classes that fall within the alternatives category, each offering distinct benefits and opportunities, but also facing differing risks and barriers (Table Ex.1).

Asset class	Liquid or illiquid?	How are DC schemes currently engaging?	Potential benefits or opportunities	Potential risks or barriers
Property	Illiquid, but can be accessed through funds with greater liquidity	<1% invested directly, but also gain exposure through Real Estate Investment Trusts (REITs) and Diversified Growth Funds (DGFs)	Well understood by both schemes and members Strong historical returns (though more uncertainty now)	Gating challenges Sensitive to changes in interest rates
Infrastructure	Illiquid	~3% for members 20 years from retirement	Potential for strong, structured long-term returns Expected to perform well in low-growth, high inflation	Upfront costs can be substantial, while returns may take some time to materialise Risk/return highly dependent on type and stage invested in Regulatory risks in emerging markets particularly
Commodities	Can be liquid (e.g., gold) or illiquid depending on sub-asset class	2-4%	Strong portfolio diversifier as low correlation with equities and bonds (select commodities, not all) Can provide inflation protection and some sub asset classes can provide strong returns in challenging economic environment	Returns on broad-based commodities can be volatile, as well as providing lower returns than traditional asset classes in some markets
Private equity, venture capital and private debt	Illiquid (though private debt can be more liquid)	Very little engagement	Potential for significant growth through exposure to unlisted and new companies Private debt often a shorter investment horizon than many other alternatives so more liquid	High costs and governance burden Challenges around availability and selection of managers Venture capital in particular has high risk of investments failing to deliver returns

[1] PPI DC Asset Allocation Survey 2022
[2] PPI DC Asset Allocation Survey 2022 and views expressed in expert interviews carried out as part of this research

Changes in policy and regulation, industry and the economy could mean that there is significant progress in upcoming years

The Government is working to facilitate and encourage greater investment in alternative assets, in particular illiquids, with several consultations focused on this in recent years. Greater focus on ESG considerations as a result of rapid regulatory growth has also driven increased interest in the role that alternative assets could play. Meanwhile, the currently challenging economic landscape has emphasised the importance of wider diversification and may lead investors to look beyond the traditional equities/bonds split.

The introduction of new investment vehicles aims to alleviate availability challenges, especially for smaller schemes. While the largest DC schemes can access individualised offerings that allow them to be more dynamic and opportunistic in regard to alternative investment, most DC schemes are limited by scale and availability. This is expected to become less of a challenge as more options are coming to the market – in particular Long Term Asset Funds (LTAF) – which could lead to more mid-size schemes allocating more to illiquids. At present, no LTAFs have yet come to the market, but they are expected to emerge within the next year. In January 2023, the Government announced that, from April 2023, 'specified performance-based fees' would be exempt from the charge cap in order to facilitate greater engagement with illiquid assets among DC schemes.

Current economic challenges and the narrative around inflation have increased attention on alternatives and the role they could play in mitigating these risks. Significant shifts in allocation have not yet been seen, but this is understandable given the pragmatism and long-term nature of DC investment strategies. Most of the risks that have materialised so far have been relatively short term in the context of long pensions investment horizons, but have led to a reframing of risks looking to the future and reinforced the need for diversification. If economic instability is expected to be a longer-term prospect, then greater exploration of alternative assets could help DC schemes to manage these risks appropriately. It is hard to predict how quickly changes to investment strategy may materialise and exactly what they will look like. However, it is broadly agreed that there is likely to be a long-term shift which will see more DC schemes exploring liquid alternatives, such as carefully selected commodities, as well as illiquid investments, such as infrastructure.

Some barriers will need to be addressed in order to facilitate greater alternative investment

Much of the recent regulatory change relating to DC investment has focused on increasing disclosure requirements upon schemes. However, this is unlikely to be enough to encourage DC schemes to increase their allocation to alternative assets, as there are still some key challenges that will need to be addressed to enable effective investment.

Scale continues to be a barrier for many DC schemes

While scale has grown across the DC market, it continues to be a challenge in relation to alternative assets at the smaller end of the market, where access can be restricted by platform offerings. While larger schemes are more likely to engage than smaller schemes, even among the largest DC schemes, scale lags behind Defined Benefit (DB), where alternative investment is more developed. Large scale enables large upfront investments, as well as contracts that are structured based on annual commitments. Having strong cashflow enables larger schemes to be dynamic and opportunistic in their approach. Although even among DC schemes that currently invest in alternatives, many have low allocations, but potential benefits, while marginal, can still be meaningful to member outcomes. It is hoped that as the scale of the DC market continues to grow and consolidation continues, these challenges will become less relevant.

DC schemes may need greater support to build their knowledge and expertise

Although there is growing recognition of the potential value to be offered by alternative investments, there are questions around whether there is enough widespread knowledge and expertise in the DC market to engage effectively at the moment, especially at the smaller end of the market. With DC schemes having historically invested primarily in equities and bonds, expertise on the details and nuances of alternative assets is not as developed as in the DB market where alternative investment has been a component of investment strategy for some time. Smaller DC schemes are less likely to have appropriate expertise in this area in-house and are also less able to access external expertise due to the associated costs.

Some schemes may need to rely more heavily on knowledge and expertise of external consultants and advisors if they are to increase their engagement with alternative investments. Schemes could also benefit from stronger guidance from regulators to support their transition into the alternatives space, particularly on illiquid investments. Interviewees highlighted particular areas where greater regulatory guidance would be appreciated, especially around member fairness concerns to ease nervousness in this area, as well as a stronger steer on how to manage illiquidity. It is also felt that publication of successful case studies could help to provide a blueprint for schemes unsure how to begin. 'Disclose and Explain' proposals outlined in Chapter One could support this shift towards greater transparency.

Considerations around cost and competition are still seen to be a significant barrier

Charging structures and considerations around cost may act as a barrier, whether real or perceived, to greater investment in alternative assets. In particular, investing in illiquid assets tends to be more expensive and these investments may take some time to generate returns. Performance fees continue to be a challenge, in terms of price competitivity, inaccessibility for smaller schemes and potential for unfair sharing among members when there is a time lag on levying the fees. However, some aspects of this challenge may be resolved or at least reduced by the recent announcement that performance fees will no longer need to fall within the charge cap.

It is also important to recognise the dynamics of the DC market. One of the key challenges is the way in which DC schemes and especially master trusts are expected to compete primarily on cost, with employers generally lacking understanding or consideration of broader quality factors, particularly relating to investment. This creates a particularly challenging environment of competition, in which schemes are competing on very small margins. Alleviating these challenges to facilitate greater alternative and illiquid investment will require an industry-wide shift in the way that cost and value are evaluated and communicated with stakeholders. Value for money (VfM) for members is currently a key priority for the Government, with a consultation on a framework on metrics, standards and disclosures announced in January 2023. This aims at shifting the discourse around VfM away from just low costs and charges towards a greater focus on the quality of service provided and the value added from investments.

Introduction

In 2019, the PPI published its report, entitled 'DC scheme investment in illiquid and alternative assets', which explored the potential benefits to Defined Contribution (DC) schemes of investment into alternative assets as well as risks, barriers and challenges which may prevent some schemes from doing so. Challenges identified in that report, including a lack of scale and lack of access, are becoming less relevant as master trusts increase in size and value, though challenges remain. The discussion around investments in alternative assets has also moved on as more trustees and providers are recognising the potential value of these types of assets, and the Government is doing more to encourage this type of investment by DC schemes.

The potential value of alternative assets for DC pension schemes has recently gained more recognition, particularly their potential to help institutional investors to better manage member funds during times of high volatility. Alongside COVID-19, other events, such as Brexit and the conflict in Ukraine have demonstrated that economic uncertainty is unlikely to be a short-lived phenomenon. This is further reinforced by the currently high levels of inflation, which may well be followed by a recession or other economic difficulties.

This report explores the topic of DC scheme investment in alternative assets, particularly in light of new opportunities and the potential benefits that could be gained from the use of these types of assets during times of economic uncertainty (which may be with us for a long time). The research covers the current landscape, as well as recent developments that have contributed to it, and the way in which it may develop in future.

Chapter One – What has led to today's landscape?

Sets out recent developments that have contributed to the current landscape of investment in alternatives, including policy and regulatory changes, increased Environmental, Social and Governance (ESG) focus and current economic challenges.

Chapter Two – How are DC schemes currently engaging with alternative assets? ?

Explores the way in which alternative assets are currently being used by DC schemes, as well as alternative asset classes that are not currently being used.

Chapter Three – How might the landscape develop in the future?

Examines the potential for future developments in this area of investment, including the potential benefits for DC schemes and the barriers that may make this more difficult to achieve.

CHAPTER ONE:

WHAT HAS LED TO TODAY'S LANDSCAPE?

This chapter sets out recent developments that have contributed to the current landscape of investment in alternatives.

Between the ongoing effects of the pandemic, the war in Ukraine and additional supply constraints, in 2022 inflation reached its highest level in 40 years, and concerns about economic stability and growth remain at the forefront. As Defined Contribution (DC) forms an increasingly significant component of retirement savings for many, the current economic environment presents a considerable risk to DC pot values and, as a result, retirement outcomes. This risk could materialise if those responsible for investment strategy do not consider and respond appropriately, as the negative economic outlook presents new challenges for investment strategy.

Current economic challenges have increased focus on how alternative assets could help DC schemes to protect member outcomes as part of a more diversified portfolio. Traditionally, DC schemes have used bonds as a diversifier within their portfolio to balance against the volatility of equities, which has worked well within the economic landscape experienced over the last three decades. However, as inflation has grown and the investment landscape has shifted significantly, both equities and bonds have suffered at times, emphasising the importance of wider diversification and leading investors to look beyond this traditional mix. However, DC schemes must be pragmatic when making changes to investment strategy so any significant allocation changes will take time to materialise.

This chapter includes discussion of:

- A brief overview of the landscape and challenges identified by the 2019 report
- Progress made since the 2019 report
- Policy and regulatory changes, including increased Environmental, Social and Governance (ESG) focus

This research has been informed by expertise from interviews with a range of stakeholders across Government and industry. It also draws on data from the PPI DC Asset Allocation Survey 2022, which is undertaken annually as part of the DC Future Book series.

Previous PPI research highlighted the potential benefits of alternative investments, but recognised that some alternatives have higher entry costs, whilst others face operational and governance challenges

There are a huge range of possible investment opportunities across a range of asset classes with varied characteristics. However, DC schemes continue to invest primarily in traditional asset classes, such as equities and bonds, with low investment in alternatives across the industry.

Allocation to alternative asset classes has the potential to benefit DC portfolios, with:

- Potentially higher and/or less volatile returns, including the potential for an illiquidity premium in some cases.
- Enhanced portfolio diversification, which could offer a risk mitigation, especially important during periods of economic uncertainty, due to low correlations with traditional assets. Many alternative assets have a low correlation with public markets and therefore are not generally subject to the same market forces, and so provide a hedge against losses experienced during market downturn.
- A long investment horizon that matches the long-term investment of DC members.

However, there are also some key challenges associated with investing in alternative assets:

- Higher costs, although these vary depending on asset class, with liquid alternatives generally associated with lower costs.
- Operational challenges, including less than daily valuations of assets, variable charges and performance fees, the sharing of risk and return across different cohorts of the membership, and lack of immediate access.
- Governance and regulatory challenges, including complexity and challenges to transparency, obligations to report on costs and charges, permitted links regulations (which can be interpreted as not allowing investment in assets which do not allow immediate access to funds), and the availability of appropriate assets.
- Scale, or lack of, as an exacerbating factor for many of the above challenges.

Discussion of alternative assets has grown in the last four years but changes have been slow to materialise in allocation

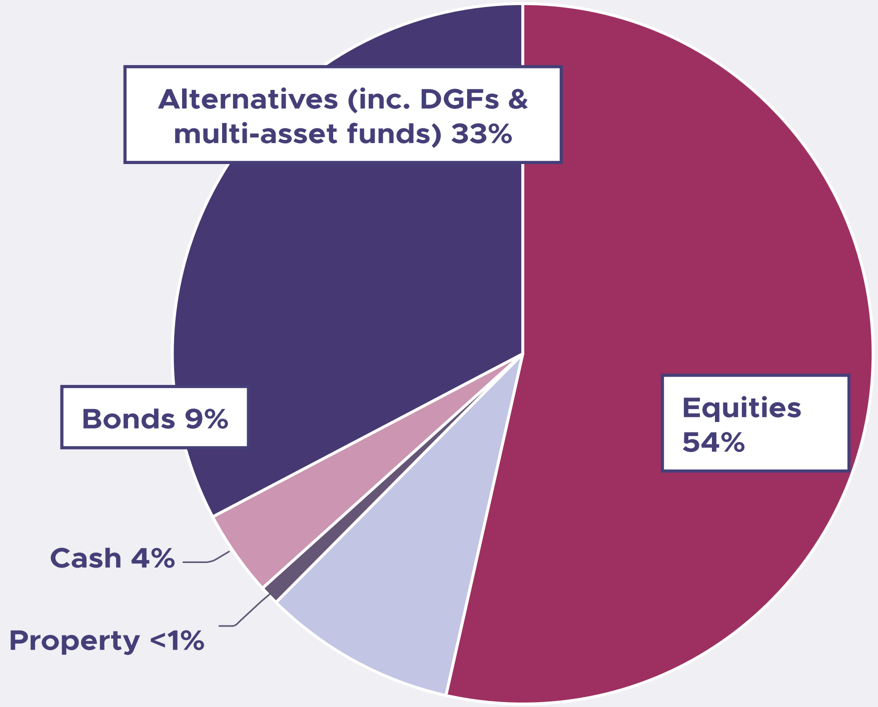
There are differing views on how much change has actually occurred in recent years, but there is broad agreement that progress has been relatively slow, particularly in terms of changes to asset allocation. The profile of alternative asset classes has grown in discussions around DC investment strategies, but attitudes towards alternatives have not changed significantly, although recognition of the benefits has grown as the variety of investment opportunities available to DC schemes has increased.[3] However, there have not been significant shifts in allocation, with investment in alternatives remaining relatively low among DC schemes and listed equities accounting for more than half of assets under management (AUM). It is challenging to gather data on specific asset allocation across the whole DC market and, as such, there are a range of estimates on average allocations to alternatives. PPI's DC Asset Allocation Survey, which included data from 31 providers covering 24.5 million members in 2022, found that DC schemes allocate around 12% to alternatives. Others estimate alternative allocation to be higher, for example Mercer's European Asset Allocation Survey found allocation to be around a third of AUM (Chart 1.1).

Chart 1.1[4]

Allocation to alternative asset classes remains relatively low among DC schemes, with listed equity accounting for more than half of AUM

Average allocation by asset class among UK DC schemes: Mercer's European Asset Allocation Insights 2021

Private equity not included as average allocation equals 0%



Some of the largest DC schemes were already engaging with alternatives when the previous research was conducted in 2019 and have continued to do so in the years since. Others, particularly smaller schemes, remain hesitant to engage with alternative asset classes in a meaningful way. While recognition of the potential benefits of including alternative assets in a DC investment strategy is growing, there is still considerable uncertainty among some schemes. Looking at illiquid assets in particular, a quarter (24%) of DC schemes surveyed in 2022 said they thought there would be no benefit to members from illiquid investment; 38% recognised the potential advantages and 37% said they were unsure of the benefits that could be delivered by allocation to illiquid assets.[5] There isn't a clear model for best practice and success, especially given the long horizons of DC investment, so even schemes that recognise the benefits are often unsure how to begin their journey.

Changes in policy and regulation, the increasing focus on ESG and the currently challenging economic outlook mean that the investment landscape has changed substantially in recent years, so we may expect to see more significant progress moving forward.

[3] Based on views expressed in expert interviews carried out as part of this research
[4] Mercer's European Asset Allocation Survey covers around £27bn UK DC AUM
[5] Aon (2022)

The Government is working to facilitate and encourage greater investment in illiquid alternatives

Since 2020, the Department for Work and Pensions (DWP) has published a series of consultations aimed at the facilitation of greater DC investment in more illiquid assets and promotion of more diversification in DC portfolios.

In March 2022, the DWP published a consultation seeking opinions on a new set of proposals and draft regulations to remove any obstacles for DC schemes to allocate to illiquid assets. This consultation:

- Proposed amendments to the Statement of Investment Principles (SIP) requirements to include disclosure of policies on illiquid investment. This would require DC schemes to outline the factors they consider when they invest in illiquid assets, as well as which members will be holding illiquid assets.
- Addressed concerns over performance fees within the charge cap.
- Proposed amendments to current restrictions on employer-related investments (ERI) for authorised master trusts with 500 or more participating employers. This recommendation was accompanied by draft regulations, which outlined how ERI restrictions could be eased in relation to the scheme funder rather than the participating employer.[6]

Additionally, the DWP proposed the introduction of a Chair's statement for DC schemes with over £100 million in AUM.[7] Within this annual statement, the scheme would disclose the percentage of assets allocated in their default in each of the main classes: cash, bonds, listed equities, private equities, property, infrastructure and private debt.[8]

More recently, a proposal to remove performance-based fees from the charge cap was put forward by the DWP in October 2022, with the consultation closing on 10 November. It also included amendments to previous Occupational Pension Scheme Regulations relating to the 'Disclose and Explain' proposals and will be introduced in October 2023.[9] As a result, relevant occupational DC schemes will be required to be more transparent on their policies guiding asset allocation.

It is hoped that greater transparency on the rationale behind investment decisions could help other schemes that are not as far along in their alternative investment journey to better understand the associated benefits, challenges and complexities. There was broad consensus among interviewees that many schemes were hesitant to take the plunge into greater alternative allocations, and primarily relating to the risk associated with being the first to do so. Increasing information about what other schemes, and particularly the largest master trusts, are doing could facilitate more of an industry-wide shift. While greater transparency through disclosure could help to provide a clearer view of the way DC schemes are engaging with alternatives, and particularly illiquids, there are concerns that the focus on reporting requirements does not go far enough to tackle the barriers that remain to greater DC investment in this area.[10]

Growing focus on ESG factors has driven increased interest in alternative assets

ESG considerations have become an increasingly important component of DC investment strategy in recent years, with rapid growth in regulation, alongside a growing recognition of the financially material risks associated. There is some recognition of the way in which alternative asset classes, may present different opportunities for incorporating ESG considerations into investment portfolios. This has begun to increase exploration of and engagement with these types of investment, although there can be challenges associated with assessing the ESG credentials of investments in private markets.[11]

Conclusions

Previous PPI research highlighted the potential benefits of alternative investments, but recognised that higher costs, operational and governance challenges, and lack of scale are barriers to greater DC investment in this area

Allocation to alternative asset classes has the potential to benefit DC portfolios with: potentially higher returns, enhanced portfolio diversification and a long investment horizon that suits the aims of members. However, higher costs, governance and regulatory challenges, and lack of sufficient scale make it more difficult for DC schemes to introduce these types of investments into their portfolio.

Discussion of alternative assets has grown in recent years, but changes have been slow to materialise in allocation

Attitudes towards alternatives have not changed significantly, although recognition of the benefits has grown, as has the variety of investment opportunities available to DC schemes. Allocation to alternatives remains low among DC schemes, with listed equities continuing to account for more than half of DC AUM.

Regulatory and economic changes could encourage greater investment in alternative assets

The Government is working to facilitate and encourage greater investment in illiquid and alternative assets, with several consultations focused on this in recent years. Greater focus on ESG considerations as a result of rapid regulatory growth has also driven increased interest in the role that alternative and illiquid assets could play. Meanwhile, the currently challenging economic landscape has emphasised the importance of wider diversification and may lead investors to look beyond the traditional equities/bonds split.

[6] DWP (2022a); DWP (2022b)
[7] Sackers (2022)
[8] DWP (2022a)
[9] DWP (2022c)
[10] LCP (2022) Response to DWP consultation 'Facilitating investment in illiquid assets by DC pensions schemes'
[11] OECD (2020)

CHAPTER TWO:

HOW ARE DC SCHEMES CURRENTLY ENGAGING WITH ALTERNATIVE ASSETS

This chapter explores the way in which alternative assets are currently being used by Defined Contribution (DC) schemes, as well as alternative asset classes that are not currently being used. The chapter sets out the benefits and challenges of the main alternative asset classes, as well as current DC scheme engagement with these types of assets.

The asset classes explored in this chapter are:

- Property
- Infrastructure
- Commodities, with specific focus on oil and gas, gold, and forestry
- Private equity
- Venture capital
- Private credit

Each asset class will be considered in terms of:

- The extent to which it is currently being used in DC investment;
- The potential benefits;
- The barriers and risks; and
- The interaction with Environmental, Social and Governance (ESG) considerations.

Property

Property: Also known as real estate. Mainly involves commercial property development (for example, offices, warehouses, distribution centres and shops) and residential rental properties.

Property is one of the better understood alternative asset classes, both by schemes and members. Because of this, it is an area many DC schemes have been engaging for some time. Although allocations to property are more common among DC schemes than some other alternatives, they remain very low relative to allocations to equities and bonds, with an average allocation of less than 1% directly invested in property.[12]

Schemes can invest directly in property, but many choose to invest indirectly through pooled vehicles. Real Estate Investment Trusts (REITs) are the most popular instrument used by DC schemes, with around 24% allocating to REITs and an average allocation of around 8% of assets among those who do invest.[13] Many schemes gain exposure to real assets such as property through diversified growth funds (DGFs). However, listed funds such as REITs have a weaker connection to the real pricing of the underlying asset, with a stronger correlation to stock markets, and are therefore a less effective diversifier, compared to direct investment.

Property has provided strong returns in recent years, although there is more of a headwind now with greater economic uncertainty. Property has often outperformed other asset classes during previous episodes of inflation, as leases and revenue streams are generally linked to inflation, whether directly or indirectly.[14] Depending on the type of property invested in, property can often pass inflationary increases through into rental contracts and property prices, providing investors with returns that are correlated with inflation. There has been a strong correlation between inflation and rent increases over the last 50 years.[15] In addition to rent cost increases, property values generally increase to reflect the increased price of commodities such as land, raw materials and labour costs, making property a potentially effective way to introduce some additional inflation protection into investment strategies.

However, increasing inflation is not the only uncertainty in the current economic landscape which could impact property investment. With concerns about possible stagnation or declines in economic growth, the potential for recession would also have an impact on the returns real estate could deliver to investors. Property values are also sensitive to changes in interest rates, so investment returns can be impacted when the Bank of England utilises this economic lever.

Enthusiasm for investment in property has varied in recent years in light of uncertainty, for example, based on uncertain demand for offices and retail. Gating challenges, or difficulties divesting from certain allocations, experienced during the pandemic have also made some investors more wary. Some funds with greater numbers of direct holdings in property, may temporarily close during periods of uncertainty in the market. DC schemes experienced some investment challenges during the pandemic due to property investments that were ‘gated’. This experience emphasises the importance of scenario planning based on how large the allocation could potentially become if the market shifts.

Within allocation to real estate, there is a bias towards UK property as rents are often linked to inflation, which helps schemes to deliver positive returns in times of high and rising inflation. Social housing is a popular investment among institutional investors in the US but not as much in the UK, especially not in the DC market. Direct investment in this area is viewed as a potential reputational risk, as well as generally not providing as high a return as other forms of real estate. However, there can be strong performance on ESG factors.

Infrastructure

Infrastructure: Structures and organisations which are essential to the efficient operation of society and the economy, including transportation structures such as roads and tunnels, utility and energy provision, and communication structures such as telephone fibre networks.

Infrastructure is recognised as an investment that can provide strong, structured long-term returns, as well as

the potential for strong ESG credentials, although assessing this in private markets can be more challenging.[16] Increasing allocation to infrastructure has been partly motivated by the pursuit of inflation protection, although not directly in response to currently high levels of inflation, but rather as part of longer-term strategies towards greater risk mitigation. The long investment horizons of infrastructure also make it a good fit for DC aims. While recognition of these potential benefits has grown, allocation among DC schemes remains low, with master trusts allocating an average of 3% to infrastructure for members in the default fund who are 20 years from retirement.[17]

Infrastructure is expected to perform well in low-growth, high-inflation environments, although this is highly dependent on the stage of the project invested in. As with many other asset classes, it is vital that scheme decision makers understand the specific nature of the infrastructure within which they are invested, and the contractual terms of their investment, most importantly, in this instance, as to whether inflation is explicitly covered in their contract. The inflation protection that can be provided through allocation to infrastructure takes many forms and varies across company and sector.[18] More generally, opportunities offered by investment in infrastructure depend on the type and stage invested in (Table 2.1).

[12] PPI DC Asset Allocation Survey 2022
[13] Mercer (2021a)
[14] BlackRock (2021)
[15] Schroders (2021)
[16] OECD (2020)
[17] SPPI (2022) The DC Future Book
[18] Tsenova, Staab & Boing (2022) Hymans Robertson (2022)

Table 2.1: There are a range of different risk and return profiles across infrastructure investment[19]

Segment	Example	Typical Return %pa
Core	Operational solar farm in Western Europe backed by long-term power purchase agreement (PPA) with large industrial end user	4-6%, mostly income
Core-Plus	Australian airport where revenues vary with passenger numbers	7-10%, mostly income
Value-Add	Underutilised toll road that requires significant capital expenditure	10-15%, capital gain and income
Opportunistic	Offshore wind farm in emerging country in early stages of development	15%+, mostly capital gain

DC schemes are unlikely to invest in 'Value-Add' and 'Opportunistic' infrastructure as the 'J-curve' nature of returns, with low or negative returns during development and positive returns delivered at a later stage, creates different return expectations for members, depending upon the time of entry and exit to the underlying fund.

The risk of delays and policy or regulatory changes, in emerging markets in particular, is a concern for investors, especially in the context of current economic uncertainty. Recent global developments, in particular the conflict in Ukraine and its far-reaching impact, have put focus on how much understanding investors have of emerging markets. This may lead to further hesitance among trustees when making investment decisions and communicating them to members.

Commodities

Commodities: Land-based goods such as oil, gas, cotton, wheat and cattle but also includes precious metals such as gold and platinum.

Investment in certain commodities can offer strong potential for portfolio diversification, as they have historically had low correlation with stock market movements. Commodity prices generally rise with inflation, which makes them an attractive proposition within the current high-inflation environment. Commodities have historically performed well during periods of high and rising inflation because they have a structural link to the inputs to inflation, which is to say that when commodity prices increase, so does inflation. There has been extreme pressure on commodity supply and prices over the last year, contributing significantly to the current levels of high inflation. However, as with other asset classes, the exact level of inflation protection offered by this type of investment will depend on the particular asset invested in and the way in which it is accessed. Unlike many other alternative asset classes, commodities can be liquid, again depending on the particular asset and the way in which it is accessed. This may make them an attractive option to DC schemes looking to diversify their portfolio without sacrificing liquidity.

DC schemes currently allocate around 4% to commodities for members 20 years from retirement, declining to around 2% at retirement.[20]

As well as pressures from traditional inflation, DC schemes also need to consider concerns around 'greenflation' in relation to commodities. DC investors are increasingly focused on ESG considerations, driven by rapid regulatory change and a growing awareness of the financially material risks associated with ignoring these factors. Although recognition of the relevance of ESG factors has grown, developing knowledge and understanding of how to effectively integrate these factors into investment strategy is a more challenging undertaking. This is exacerbated by the complex relationship between the carbon footprint associated with producers of fossil fuels, metals and minerals, and the way in which many of these materials are required to support the development of renewable technologies, especially during the transition period.

With more investors looking to invest in ways that support the transition to a low-carbon economy, supply shortages of raw materials needed for the transition to greener technology are making it more expensive and harder to achieve. Prices of raw materials have already seen large increases as economies have reopened following pandemic-related lockdowns, and there are concerns around whether the current production levels and existing reserves of these materials will be sufficient to support the transition to greener technology.

At the same time that demand for these materials is increasing, supply is stagnating, as investors focus on integrating ESG factors into their strategy. This has led to limited investment in fossil fuels and metals, further increasing the cost of these materials. While 'greenflation' is unlikely to cause DC investment strategies to backtrack on ESG progress, rising costs and limited supply of the raw materials needed for the creation of renewable technologies are likely to further complicate decisions about how best to allocate investment in order to meet targets and mitigate risks.

The transition to more sustainable energy sources is expected to drastically increase demand for:

- lithium, nickel, cobalt, manganese and graphite (for batteries);
- rarer earth elements (for wind turbines and electric motors);
- copper, silicon and silver (for solar panels); and
- copper and aluminium (for the underlying energy grid).[21]

Commodities are not a homogenous group. Sub-asset classes within the broader category of commodities have distinct characteristics that mean they can provide different benefits and opportunities, but may also face different risks and barriers. Three examples of specific assets within the broader category of commodities are highlighted below.

Oil and gas

Prices of assets used for energy production, such as oil and gas, have risen dramatically in recent years and have been a strong driver of inflation increases. However, many DC schemes have fully or partially divested from these types of investments due to ESG concerns and the aim to transition to a low carbon economy. This can create a tension between securing investment returns for members while also accounting for ESG risks. However, it is important that investment strategies consider the potential risk and return profiles of these types of assets over the longer term.

Although negative screening or divestment continues to be an approach to the incorporation of ESG factors into investment strategies, many investors are beginning to explore higher engagement strategies. Some of the companies in sectors that are traditionally high carbon are also making substantial investment in working towards a low-carbon future, and in many cases produce the raw materials needed to support the transition to greener technologies. So, by divesting from these companies, investors may be withdrawing capital from companies who are leading low-carbon innovation. This makes decisions about divestment even more complex.

The majority of pension scheme investment in oil and gas is through holdings in listed energy companies rather than direct investment in the commodities themselves.

[19] Hymans Robertson (2022)
[20] PPI (2022) The DC Future Book 2022
[21] Mercer (2021b)

Gold

While gold is often grouped in with other commodities, its unique characteristics mean that it can play a different role within a diversified DC portfolio. With many assets becoming increasingly correlated as market uncertainty rises, gold is different in that its negative correlation to equities and other risk assets increases as these assets sell off. This means that gold may be an effective component of risk mitigation strategies, particularly in low-growth, high inflation environments (Chart 2.1).

Chart 2.1

Gold has been more negatively correlated with equities in extreme market selloffs than commodities, UK Gilts and Property

Based on weekly returns of the FTSE Developed Total Return Index, LBMA Gold Price, ICE BofA UK Gilt Index, Bloomberg Commodity Index Total Return and FTSE EPRA NAREIT Developed Total Return Index using data between 31 Dec 1993 and 31 Dec 2022

While investors have long considered gold a beneficial asset during periods of economic uncertainty, historically, gold has generated long-term positive returns in both good and bad economic times, outperforming many other major classes over the past 20 years. The diverse sources of demand give gold a particular resilience and the potential to deliver solid returns in various market conditions. Gold is, on the one hand, often used as an investment to protect and enhance wealth over the long term, but on the other hand it is also a consumer good, via jewellery and technology demand. As such, the long-term performance of gold is supported by income growth, making gold an efficient hedge.

Within the context of current economic uncertainty and high inflation, diversification and risk mitigation are particularly high priorities in DC portfolios. While higher inflation typically weakens the appeal of Government bonds as a diversifier, gold may be an effective addition as it can provide protection against high inflation. More broadly, diversifying the sources of risk mitigation within portfolios beyond traditional high-quality government bonds could result in better risk-adjusted returns and improve member outcomes.[22] The liquid nature of gold may also be beneficial during times of market stress, where many other alternatives are subject to liquidity constraints.[23]

Forestry

An investment in forestry can include land suitable for growing trees, the trees themselves, or both. Carefully selected forestry investments can provide strong long-term returns and the potential for positive ESG impact. Investment in timberland for growing 'mass timber' can help to slow deforestation by increasing supply, particularly as demand grows due to population growth, economic development and increasing urbanisation, as well as increased exploration of biofuels which could also increase the demand for timber. Sustainably managed forests can provide a range of environmental benefits, in addition to good risk-adjusted returns, as well as social and economic benefits.[24] Some DC schemes in the UK, including Nest and Cushon, are now beginning to explore introducing forestry investments into their strategy.[25]

Private equity, venture capital and private credit

Private equity: Shares in companies that are not publicly listed, i.e., not traded on the stock market.

Venture capital: Investment in new, unlisted, start-up companies.

Private credit: Direct investor lending to companies (also known as private debt) or syndicated loans (a pooled loan made to company by several investors at the same time).

Private equity, venture capital and private credit allocations provide exposure to smaller, new companies (although private equity can also involve more well-established companies), including those in health and technology, with the potential for significant growth. These asset classes are easily understood by members so may feel like a good fit for DC, and there is some recognition among investors of the benefits through potentially higher returns. However, these types of investment are largely absent from DC investment strategies.

Private equity, venture capital and private credit are generally viewed as expensive and risky, particularly in the context of the current charge cap and the low cost of passive equity in the public market. The broadly held view among many DC schemes is that these types of investment may not be worth the risk or additional governance burden. Because private equity and venture capital often relate to smaller, new companies, investment deal sizes tend to be relatively small, but still require the same level of due diligence as larger scale deals. This means that managers often charge more, relative to investment size, in order to make a feasible profit. The availability of private market funds is a challenge for smaller schemes, while a limited choice of private equity managers available for DC schemes can also present challenges. For venture capital, there are similar concerns as those around private equity; it is viewed as expensive and risky but to an even greater degree, which means it is even less prevalent in DC portfolios.

In order for private equity and venture capital to become a viable component of DC investment strategies, there would need to be an improvement in the quality and availability of industry-level data and greater education of DC trustees on the value and nature of these types of investments.[26] Larger DC schemes could use their scale to encourage better provision of pooled investment vehicles in this area by generating appetite and negotiating better fees on DC-centric structures.[27]

[22] World Gold Council (2022)
[23] https://www.gold.org/goldhub/data/gold-trading-volumes
[24] Binkley, Stewart & Power [World Bank] (2020)
[25] https://www.pensionsage.com/pa/Nest-and-Cushon-look-to-explore-forestry-investment-opportunities.php
[26] Oliver Wyman & British Business Bank (2019)
[27] Oliver Wyman & British Business Bank (2019)

Conclusion

There are a range of asset classes that fall within the alternatives category, each offering distinct benefits and opportunities, but also facing differing risks and barriers. Allocation to alternatives remains low across all asset classes, even those where the potential benefits are well understood.

Real assets such as property and commodities are well understood by both schemes and members. DC schemes have been investing in these areas for some time but allocations remain low, with less than 1% invested directly in real estate and 2-4% invested in commodities. Infrastructure investment has also been growing with an average allocation of 3% among master trusts. Private market assets including private equity, venture capital and private credit remain predominantly absent from DC investment strategies.

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CHAPTER THREE:

HOW MIGHT THE LANDSCAPE DEVELOP IN THE FUTURE?

This chapter examines the potential for future developments in this area of investment, including the potential benefits for Defined Contribution (DC) schemes and the barriers that may make this more difficult to achieve.

With recognition of the potential benefits of alternative investment growing, it may be that allocations will grow further in upcoming years, especially with the introduction of more accessible platforms and new investment vehicles, and considering the role that these types of assets could play in mitigating risks within an uncertain economic landscape. However, there are still some barriers that need to be addressed in order to facilitate greater investment in this area, including:

- operational challenges associated with insufficient scale;
- knowledge and expertise; and
- charging structures and competition

While scale has grown across the DC market, it continues to be a challenge in relation to illiquid alternatives

Increasing scale, particularly among master trusts, and consolidation of smaller schemes, is helping to alleviate some of the challenges associated with alternative investments. However, scale continues to present operational challenges for DC schemes looking to invest in more alternative assets, particularly at the smaller end of the market.

In 2022, the aggregate value of workplace DC assets was around £545 billion.[28] While this has grown substantially in recent years, up from around £324 billion in 2015[29], the aggregate scale of the DC market remains much lower than the scale of Defined Benefit (DB). In 2022, the aggregate value of assets held by private sector DB schemes was £1.67 trillion.[30] While larger DC schemes are more likely to engage than smaller schemes, even among the largest DC schemes, scale lags behind DB, where alternative investment is more developed.

However, scale is growing rapidly among the largest master trusts due to high numbers of active members and consistent contributions over time. For example, Nest's total assets under management (AUM) reached £24.6 billion by September 2022.[31] Large scale enables larger upfront investments, as well as the ability to diversify across a greater range of sectors and investment horizons, and contracts that are structured based on annual commitments. Having strong cashflow enables larger schemes to be dynamic and opportunistic in their approach. Although even among DC schemes that currently invest in alternatives, many have low allocations, but potential benefits, while marginal, can still be meaningful to member outcomes.

It is expected that as the scale of the DC market continues to grow, these challenges will become less relevant. Assuming that current trends continue, the aggregate value of workplace DC assets could grow to around £1.03 trillion over the next twenty years.[32] In the shorter term, if larger schemes that already have substantial scale are able to find ways to work through cashflow and operational challenges (e.g. liquidity, governance and structuring of contracts), then scale should become a less significant issue, with smaller schemes able to effectively implement learnings from larger schemes leading the way.

DC schemes may need greater support to build their knowledge and expertise relating to alternative investment

Although there is growing recognition of the potential value to be offered by alternative and illiquid investments, there are questions around whether there is enough knowledge and expertise in the DC market to engage effectively, particularly at the smaller end of the market. With DC schemes having historically invested primarily in equities and bonds, expertise on the details and nuances of alternative assets is not as developed as in the DB market where alternative investment has been a component of investment strategy for some time. Smaller DC schemes are less likely to have appropriate in-house expertise in this area and are also less able to access external expertise due to the associated costs. Some schemes, however, may already have appropriate expertise and understand the benefits but still be unable to or choose not to allocate more to alternatives due to other barriers, such as higher costs or for some smaller schemes the prospect of imminent consolidation.

Some schemes may need to rely more heavily on knowledge and expertise of external consultants and advisors if they are to increase their engagement with alternative investments. Schemes could also benefit from stronger guidance from regulators to support their transition into the alternatives space, particularly on illiquid investments. Interviewees highlighted that greater regulatory guidance would be appreciated around member fairness concerns to ease nervousness in this area, as well as a stronger steer on how to manage illiquidity. It is also felt that publication of successful case studies could help to provide a blueprint for schemes unsure how to begin. 'Disclose and Explain' proposals outlined in Chapter One could support this shift towards greater transparency.

The Productive Finance Working Group (PFWG) has produced a series of guides for trustees, employers and other key DC scheme decision makers covering key issues around investment in illiquid assets. These guides cover a range of areas relating to illiquid investment, including:

- Value for Money (VfM)
- Performance fees
- Liquidity management
- Fund structures for less liquid assets
- Legal guide to the Long-Term Asset Fund (LTAF)
- Due diligence[33]

Considerations around cost and competition are still seen to be a significant barrier to greater investment in alternatives

Charging structures and considerations around cost may act as a barrier, whether real or perceived, to greater investment in alternatives and particularly illiquids. Investing in illiquid assets tends to be more expensive and these investments may take some time to generate returns. Performance fees continue to be a challenge, in terms of price competitivity, inaccessibility for smaller schemes, and potential for unfair sharing among members when there is a time lag on levying the fees. In January 2023,[34] the Government announced that from April 2023 'specified performance-based fees' would be exempt from the charge cap in order to facilitate greater engagement with illiquid assets among DC schemes.

Another challenge for DC is that the repricing of illiquid assets is slow. While there have been questions around the possibility of members arbitraging the differences in price changes, this is largely mitigated by expected lower volatility than in liquid, public markets and as long as the weighting isn't too large. Where there is a time lag in member transfers this could wipe out any potential arbitrage benefit.

[28] PPI (2022) The DC Future Book 2022
[29] PPI (2022) The DC Future Book 2022
[30] PPF (2022)
[31] Nest quarterly investment report: at end September 2022
[32] PPI (2022) The DC Future Book 2022
[33] Productive Finance Working Group (2022)
[34] DWP (2023)

It is also important to recognise the dynamics of the DC market. One of the key challenges is the way in which DC schemes and especially master trusts are expected to compete primarily on cost, with employers generally lacking understanding or consideration of broader quality factors, particularly relating to investment. This creates a particularly challenging environment of competition, in which schemes are competing on very small margins. Alleviating these challenges to facilitate greater alternative and illiquid investment will require an industry-wide shift in the way that cost and value are evaluated and communicated with stakeholders. VfM for members is currently a key priority for the Government, with a consultation on a framework on metrics, standards and disclosures announced in January 2023.[34] This aims at shifting the discourse around VfM away from just low costs and charges towards a greater focus on the quality of service provided and the value added from investments.

The introduction of new investment vehicles aims to alleviate availability challenges, especially for smaller DC schemes

Improving direct access through investment platforms and offering new investment vehicles could enhance DC schemes' ability to introduce alternatives into their portfolios. Large DC schemes and master trusts can access individualised offerings that allow them to be more dynamic and opportunistic in regard to alternative and illiquid investment, whereas most DC schemes are limited by scale and availability. If platform providers are not incorporating significant alternative holdings, this type of investment is less accessible for small and medium DC schemes.

This is expected to become less of a challenge as more options come to the market. In particular, LTAFs are a new category of open-ended authorised funds designed to invest efficiently in long-term illiquid assets. These funds are being introduced to facilitate greater investment in illiquids among investors with long investment horizons, such as DC schemes, and could be especially beneficial for small and medium-sized DC schemes that are unable to negotiate DC-focused contracts in their own right. At present, no LTAFs have yet come to the market, but they are expected to emerge within the next year. There is also expected to be an increase in hybrid and custody-led platform offerings as growth and consolidation continues in the DC market.

The currently challenging economic outlook could lead to longer term re-evaluations of DC investment strategies

Current economic challenges and the narrative around inflation have increased attention on alternatives and the role they could play in mitigating these risks. Significant shifts in allocation have not yet been seen, but this is understandable given the pragmatism and long-term nature of DC investment strategies. Most of the risks that have materialised so far have been relatively short term in the context of long pensions investment horizons, but have led to a reframing of risks looking to the future and reinforced the need for diversification. If economic instability is expected to be a longer-term prospect, then greater exploration of alternative assets could help DC schemes to manage these risks appropriately.

[34] DWP (2023)

Conclusions

- While scale has grown across the DC market, it continues to be a challenge in relation to alternative investment.
- DC schemes may need greater support to build their knowledge and expertise relating to alternative investment.
- Considerations around cost and competition are still seen to be a significant barrier to greater investment in alternatives.
- The introduction of new investment vehicles aims to alleviate availability challenges, especially for smaller DC schemes.
- The currently challenging economic outlook could lead to longer term re-evaluations of DC investment strategies.

Glossary

Active member: Pension scheme member who is currently contributing (or having contributions made on their behalf) into their scheme.

Alternative asset classes: Assets that are not part of conventional investment types such as equities, bonds and cash. Alternative asset classes include private equity, hedge funds, property, commodities and infrastructure.

Automatic enrolment (AE): A policy requiring employers to enrol eligible employees into a qualifying workplace pension scheme. Employees have the right to opt out of the scheme. Employers (and usually employees) must pay at least a minimum level of contributions into the scheme if the employee does not opt out.

Bonds: Loans made to an issuer (often the government or a company) which undertakes to repay the loan at an agreed later date with interest. Bonds typically consist of pre-defined levels of interest payments (known as coupon payments) on the capital amount and a final payment of the capital at a pre-determined time.

Charge cap: The Occupational Pension Schemes (Charges and Governance) Regulations 2015 introduced a cap on member charges in default strategies used for automatic enrolment of 0.75% of funds under management. The cap applies to all scheme and investment administration charges. Transaction costs (third-party costs generated when investments are sold and bought on the market) are excluded from the charge cap. Some performance fees are excluded or calculated in a different way.

Default strategy: The investment strategy in which members will automatically have their contributions invested if they do not make an active choice of a different strategy.

Defined Benefit (DB) Pension Scheme: A trust-based pension scheme which provides members with an income for life based on a specified accrual rate (i.e. a proportion of either final or career average salary for each year of service) irrespective of investment returns on contributions.

Defined Contribution (DC) Pension Scheme: A trust-based or contract-based pension scheme that provides benefits based on the contributions invested, the returns received on that investment (minus any charges incurred) and the way the savings are accessed at and during retirement.

Department for Work and Pensions (DWP): The DWP is the government department responsible for welfare and social security, including pensions, working age benefits, and disability services.

Diversification: Investing in a broad range of asset classes with the aim of reducing overall investment risk if there is a downturn in a particular type of asset.

Environmental Social and Governance (ESG): ESG factors affect long-term investment returns. Pension schemes are required to consider the role that these factors may play when designing their investment strategies.

Equity: Shares in a company which are bought and sold. Owning shares makes shareholders part owners of the company in question and usually entitles them to a share of the profits.

Gilts: Bonds issued by the UK Government, which have a fixed rate of interest. If they are index-linked, the value of the gilts increases each year with inflation, alongside the value of interest paid. Gilts are often used as investment for pension schemes because they are highly secure and provide a good match for cashflows for pension payments.

Inflation: A measure of the change in the general level of prices of goods and services.

Inflation risk: The risk that one's income may lose value relative to the price of goods and services.

Intergenerational fairness: The fair distribution of risk and cost across different generations, ensuring that no generation benefits unfairly at the expense of another.

Master trust: A Defined Contribution pension scheme, governed by a board of trustees, offering the same terms to multiple employers and their employees. Master trusts are regulated by The Pensions Regulator.

Member: A general term for an individual who has built up entitlement in a pension scheme.

Passive fund management: The management of assets, e.g. equities, gilts, that generally attempt to replicate the performance of a given index, e.g. FTSE100, FTSE350, with some selection of assets made in response to market changes.

TCFD (Taskforce on Climate-related Financial Disclosures): is the taskforce who created a framework to help public companies and other organizations more effectively disclose climate-related risks and opportunities through their existing reporting processes. The government requires pension scheme trustees to fully consider and disclose their climate-related financial risks and opportunities in line with recommendations by TCFD.

Transaction Costs: Third-party costs generated when investments are sold and bought on the market.

Volatility: Volatility describes the range of gains and losses that a particular fund is likely to experience. A fund which has potential to experience high losses and gains has a high volatility and a fund with potential for low losses and gains has low volatility. In many cases volatility and returns are viewed as a trade-off, with funds incorporating higher levels of volatility in order to achieve higher returns. However, a high level of volatility exposes funds to the risk of high losses.

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