Embracing the opportunities

Illiquid Investments for DC schemes

Welcome to the first publication in our *Embracing the opportunities* series, where we focus on illiquid investments for DC schemes.

To begin our series, we'll first establish why DC schemes can, and should, access illiquid investments to improve outcomes for their members. We'll address some of the common myths, and cut through the noise, by identifying some specific opportunities and the potential impact they could have for members.

The Productive Finance Working Group published its report *A Roadmap for Increasing Productive Finance Investment* in September 2021, and made several recommendations. Fundamentally, the Group identified scope to significantly enhance outcomes for DC savers, but that the pensions industry needs to take action to make this happen.

Hymans Robertson welcomes the report from the Productive Finance Working Group, which in our view helps to restore the positive view on illiquid investing after the widely rebuffed attempt by The Pensions Regulator to limit exposure to 20% of pension assets. Illiquid investing is not uncommon for DC pension schemes globally.

The Australian DC market, which is more mature than the UK, invests somewhere in the region of 20% of assets, on average, in illiquid investments. The Universities' Superannuation Scheme, which includes a DC section, invests between 25-30% in illiquid investment assets. The National Employment Savings Trust (NEST) has committed to invest around 15% of default assets in illiquid investments, and Smart Pension already invest 10% in illiquid investments. Despite this, there is relatively little adoption across the DC industry more generally.

We think illiquid investing is too often placed in the 'too hard' or 'too expensive' categories, but we could be limiting the ability to improve outcomes for DC savers with this mindset.

Callum Stewart
Head of DC Investment Consulting

What is illiquid investing?

Discussions around illiquid investing for DC schemes have too often focused in general terms, i.e. referring to private markets (or 'illiquids') as one asset class as opposed to multiple asset classes. We will cut to the chase and focus on the following specific illiquid investment opportunities:

- Infrastructure
- Private Equity
- Private Debt
- Real Estate

As well as presenting potentially attractive investment opportunities, each of these also provide the opportunity for pension schemes to integrate their climate and wider sustainability goals in line with the broader portfolio. This creates the added benefit of providing opportunities to share clear stories with members about the good their money is doing, which we believe can lead to improved engagement.

We'll focus on each illiquid investments asset class individually for the remaining publications in this series. We will consider the investment opportunity in more depth, how to overcome practical challenges to access them, and consider potential roles in a glidepath for members.

So, with the opportunity to deliver higher returns, improve diversification and ultimately improve outcomes for members, why aren't DC schemes investing more heavily in illiquid investments?

Overcoming the challenges

We've set out below some of the reasons why DC schemes don't typically allocate to illiquid investment assets and cast our view on whether these are myths or reality!

Illiquid investments are too expensive

Myth or reality?

The answer is **neither.** Illiquid investments are generally more expensive than traditional listed and liquid approaches but costs and charges should not be considered alone. Individual member outcomes should be what drives allocation decisions.

Our analysis suggests that charges for the average DC scheme are between 0.3% and 0.4%, despite the current charge cap of 0.75%.

This means there is plenty of headroom to allocate to more expensive markets. The key is doing so in ways that will improve outcomes for members net of costs and charges.

DC schemes can't access illiquid investments because of daily dealing and liquidity requirements

Myth or reality?

Myth. It's possible to incorporate illiquid investments with other liquid assets in blended funds, or access via blended pooled funds.

We already have case studies for this, with NEST successfully implementing the former, and Smart successfully implementing the latter approach. There is scope for innovation here, but there is no absolute barrier for DC schemes to access illiquid investments.

Illiquid investments are too complex to implement, with onerous governance requirements

Myth or reality?

This is a **myth for some and reality for others.** Ultimately, a decision to consider including illiquid investments should be driven by your beliefs and comfort levels.
They may be more complex, but the rewards for members over the long-term could also be material.

We expect Master Trusts to be well positioned to govern illiquid investments over the long-term.

There aren't any illiquid investment funds available from our pension provider

Myth or reality?

This is a **myth**, but we can certainly do better as an industry to define what's required. The key is establishing the demand and the asset management community will respond to create an innovative and competitive environment. DC trustees and governance committees, if they believe in the opportunity to enhance outcomes for members, should demand that their pension provider makes available a suitable range of illiquid investment funds for consideration.

The key here is engagement – work with your pension provider to specify your requirements and contribute to this demand.

Illiquid investments won't deliver better outcomes over the long-term relative to cheaper and more liquid approaches

Myth or reality?

We think this is a **myth**. No one can claim they have a perfect crystal ball. However, based on what we know today, we have confidence in specific illiquid investments opportunities that we believe will enhance members' outcomes over the longer-term.

More generally, illiquid investments offer access to a different set of companies than those available in public markets and to an illiquidity premium which should diversify the sources of return within a portfolio.

The following table highlights our expected return, potential allocation and outcome assessment, assuming regulation and legislation is consistent with delivering the best possible outcomes for members:

Asset class	Expected net return (p.a.)	Maximum allocation comfort ranges(%)			Potential improvement to retirement outcome*
		Early years	Close to retirement	In retirement	
Infrastructure	4-8% p.a.	0-20%	0-20%	0-20%	Up to +20%
Private Equity	5-10% p.a.	0-20%	0%	0%	Up to +20%
Private Debt	3-6% p.a.	0-20%	0-20%	0-20%	Up to +10%
Real Estate	3-5% p.a.	0-10%	0-10%	0%	Similar
Overall allocation (long-term)	Subject to approach	0-40%	0-30%	0-20%	Up to +40%

**We have considered the potential impact for a representative DC saver, aged 25 and contributing at 10% of their salary. To determine potential outcomes impacts, we have assumed a relatively traditional glidepath structure comprising of 100% listed global equity in the early years, and a diversified mix of liquid assets at, and during, retirement.*

In all instances above, we believe there are opportunities to improve the certainty of achieving improved outcomes for members, with the added benefit of diversification helping to reduce risk.

So, are we saying that some DC schemes could consider overall allocations to illiquid investments of up to 40% in the earlier stages of a glidepath? For the highest conviction trustees, with the governance resources to implement, yes. In general, we believe the opportunity to enhance outcomes for members is sufficiently material to justify larger allocations and that liquidity risk and daily dealing requirements can be managed effectively.

In reality, we would expect trustees and governance committees to consider their objectives and beliefs, characteristics of each of the specific illiquid investment opportunities, their potential role at different stages of the glidepath for members (including in-retirement) and to have regard to any additional governance requirements.

This could lead to allocations of up to 40% for the most ambitious Master Trusts, and somewhere in the middle of this range for the majority. All of these arrangements should have the resources to implement. However, for smaller arrangements the most effective use of time may be to drive the demand through their pension provider.

We have a collective duty to place the emphasis on how to allocate members' future contributions in ways that can improve their long-term outcomes. We will shine a light on how to overcome the practical challenges in future publications in this series.

What is the theoretical limit to allocation sizes?

DC schemes benefit from incoming contributions which vastly outstrip transfers and retirement income. Illiquid investment assets build up over time e.g. a period of 3 to 4 years is typical, then the capital remains invested for periods of between 5 and 20 years depending on the asset class. It is preferable to use incoming cashflow to build these allocations, rather than sell more liquid assets which would result in transition costs for members.

A theoretical limit to allocation size could be determined by considering the net cashflow as a proportion of capital requirements in the 'ramp up' phase. Our analysis suggests that annual net contributions for the average DC scheme will sufficiently cover the capital requirements during the ramp up phase for allocations of up to 40%.

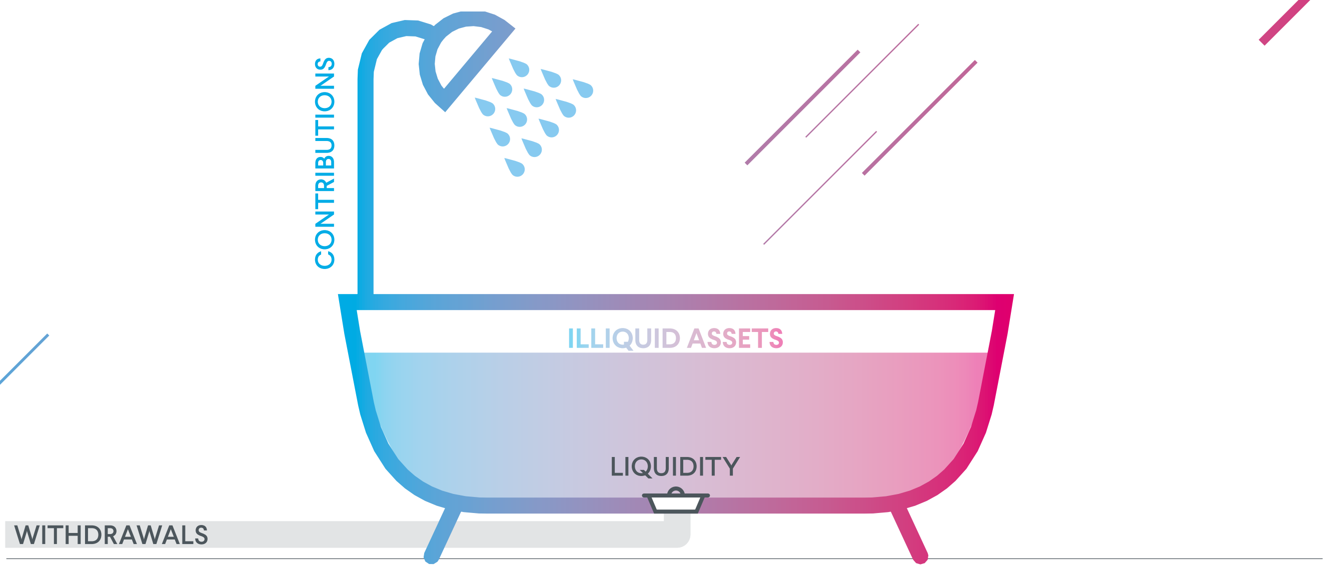
What could go wrong?

The main concern is around releasing capital to meet benefits for members e.g. transfers or other withdrawals and in the more extreme scenario, bulk transfers. These concerns are likely to be heightened during periods of market turmoil.

For more routine transactions, allocations to up to 40% in illiquid investments should not cause an issue. For example, transfers and other withdrawals for the average DC scheme represent around 5% of assets each year. If these were met solely from liquid assets, the average DC scheme could sustain up to 4x this level and still remain within a reasonable range of +/-5% relative to the target allocation to illiquid investments.

The impact is broadly similar for an asset shock e.g. if the value of liquid assets falls by around 20% the average DC scheme could still maintain the integrity of their target asset allocation. This ignores the likelihood that income and capital recycled from the underlying illiquid investment assets could be used to support outgo from the DC scheme.

As a general rule, we would advocate the use of members' contributions to fund illiquid investment assets, and the returning capital and income payments to support withdrawals from the scheme should this liquidity be required.



The main risk is for much larger transactions e.g. bulk transfers or full transfers (such as from Master Trust to Master Trust). In these instances, it may not be possible to fully liquidate a illiquid investments portfolio and this will almost certainly lead to worse outcomes for members. We think pensions policy could be helpful here.

Recommendation

We recommend that Master Trusts are required to accept incoming transfers of illiquid investment assets in order to maintain authorisation. If not part of their longer-term strategy, Master Trusts could run-off illiquid investment assets over time which will help to protect members from unwanted costs.

Another factor that could reduce the ability to improve outcomes for members is obstructive regulation. It's crucial that, as an industry and with the DWP and regulators, we work collectively to establish the most supportive environment to improve outcomes for members as well as protect their interests.

Finally, we need the asset management community to embrace the opportunity for significant growth in the DC pensions market, and reflect this in commercial terms for illiquid investment funds, particularly private equity.

We have already seen innovation in this area, but products priced in favour of profits today vs. long-term success are unlikely to pass the value for members test.

So, what are the main take-aways?

There are significant opportunities in illiquid investments which could lead to improved outcomes for members. There is also the opportunity for pension schemes to integrate their climate and wider sustainability goals in line with the broader portfolio. Here are some initial steps you can take:

Educate
The DC market is continually evolving, and there are practical solutions available for schemes to access illiquid investments. We suggest dedicating some meeting time to consider the opportunity to enhance outcomes for members, and developments in the market.

Engage
Engage with your pension provider and advisors to understand how you may be able to access illiquid investments in your scheme and understand the potential timescales around this. Engage with your members to understand whether there are real-world issues they would like addressed in their pension, where illiquid investments can help you to deliver.

Review
Review your investment beliefs to incorporate views on illiquid investing. Review your investment strategy to consider how illiquid investments can improve the retirement outcomes for your members.

Implement
Working with your pension provider and advisors, implement changes to your strategy to improve member outcomes.

Communicate
Share positive stories about the action you are taking to improve outcomes with your members.

Illiquid investments: embracing the opportunities

Look out for further publications in our illiquid investments for DC schemes series. If you have any questions on the subject in the meantime, please get in touch:

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