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60-second summary

Are Long-Term Asset Funds Applicable to LGPS?

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A new solution for illiquid investments

Because of the long investment time horizons involved, and a lack of a need for liquidity, the LGPS has invested for decades in illiquid assets like property, infrastructure, and private equity and debt. When combined with a traditional portfolio of equities and bonds, these asset classes provide strong diversification benefits and better risk-adjusted returns.

However, defined contribution (DC) pension schemes haven't been able to invest in illiquids – with the exception of some types of property funds – because DC investments need much more regular pricing and liquidity than traditional illiquid-asset funds offer. Given the growing number of DC pension savers, the UK government has been looking for ways to allow them to gain exposure to the benefits of illiquid assets in their pension pots.

This has prompted the Financial Conduct Authority to authorise Long-Term Asset Funds (LTAF), with the first launched by Schroders in March 2023. These LTAFs are designed to provide access to illiquid assets via a fund that offers more regular pricing and liquidity points. They'll open up illiquid assets to DC savers, and they're also likely to be used in wealth management. But will LTAFs be as suitable for the LGPS?

How the LGPS currently invests in illiquid assets

Most LGPS funds get their illiquid asset exposure by investing in limited partnerships run by a professional investment manager. The manager raises a fund to invest in a market opportunity, and investors, such as pension funds, commit money to that fund. The manager then looks for attractive opportunities, asking the investors for some of their commitment to make the investments after they've been identified.

This system is well designed for the way the illiquid investment market works, whereby opportunities must be sought out by managers, rather than being listed on public investment markets and, therefore, always available to purchase. However, this method also has its downsides, including the relatively long time it takes to have money invested or returned – not forgetting that the returned money needs to be reinvested to maintain exposure. Meanwhile, the longer timescales for providing valuation and performance information create challenges for monitoring and accounting.

The LGPS also invests in property through pooled funds, such as unit trusts. These combine capital from a wide range of investors into larger funds that can invest in a diversified portfolio of properties. Each investor then gains a pro rata share of the portfolio of properties.

This approach has the important benefit of getting your money invested quickly into a diversified portfolio of properties. It also offers regular dealing, usually monthly, albeit with a notice period required – often 3–6 months

– before dealing can start. However, while these funds offer regular dealing and liquidity, they're only met on a best-efforts basis. Many pooled property funds have long queues to get out, dealing at large discounts to NAV in order to leave, meaning capital may be trapped for long periods.

A good fit for LGPS?

So, could the LTAF's benefits of more regular pricing and liquidity be of use to the LGPS? This would largely depend on funds' own positions. But we don't see a particularly strong reason for the LGPS to make use of this fund structure right now.

The LGPS doesn't generally need the same levels of liquidity as the DC market. Accessing illiquid assets through an LTAF structure could be helpful for funds that do require liquidity, either for cashflow or rebalancing purposes. But there are many solutions to these problems already available. Also, the liquidity that can be offered by LTAFs will still be driven to a large extent by the liquidity of the underlying assets. Just like other fund structures, LTAFs can't magically create buyers for illiquid assets, which means we may encounter similar liquidity issues to those seen in property unit trusts. The LTAF manager will need to put sensible trading rules in place to prevent forced sales of assets and rushes for the exit.

There may also be challenges presented by an LGPS fund using an LTAF, such as being a very large investor in a pool of much smaller investors, making it difficult to access meaningful liquidity.

Whether the more regular pricing is a key benefit to the LGPS is also questionable. While it would be helpful for the purposes of accounting and rebalancing, from an investment perspective, fast monthly or quarterly pricing isn't required. These are long-term holdings in which capital is locked up, meaning regular pricing has little practical use. Similarly, if LTAFs can price the assets, presumably the managers of the limited partnerships can too, if pressured.

Funds have also developed solutions to the challenges of investing through limited partnerships. Many have processes and models for dealing with the cashflows involved, and some have built up a roster of preferred managers to whom they can regularly allocate as new funds are raised, in order to maintain their exposure. The pools have also been proactive in providing solutions in this area.

Conclusion

The LTAF is a new fund structure, and much is still unknown about how these will affect markets and investors. However, looking back at the reasons it was designed, these don't necessarily match up with the requirements of the LGPS – which could make the LTAF a square peg for a round hole. But that doesn't mean funds shouldn't keep an open mind about how things may develop in future.

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