OCTOBER 2021
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ROUNDTABLE

BRINGING ILLIQUIDS TO DC INVESTORS

– PUTTING ILLIQUIDS TO WORK
– VALUE AT ALL COSTS

IN ASSOCIATION WITH

Is it okay to ask, "What do I get out of ESG?"

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LET'S TALK ESG

THE LOGIC OF ILLIQUIDS

Strong returns whatever the weather make illiquids an attractive opportunity for DC

John Greenwood
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Equities have been on an incredible run since the global financial crisis, and those workplace default funds that have followed an agressive equity or equity-like asset strategy have reaped fabulous rewards. Stockmarket performance has been so strong over the last 12 years that it can be easy to forget the fundamental value of diversification.

But with equities outpeforming bonds over pretty much all 25-year periods in history, a focus on this asset class remains attractive for pension savers, particularly younger ones. Why diversify into something you don't expect to outperform over the pension saver's investment time horizon?

Fair enough - but what about diversifying into an asset class that has outperformed equities consistently, with a fraction of equities' volatility, since the mid-1970s?

That's what defined benefit schemes, sovereign wealth funds and other big institutional investors have been doing for years. Now, as DC schemes take over as the main engine of retirement provision for UK citizens, thrusting all of the investment risk onto their shoulders, don't we owe it to these savers to ensure they have access to the very best possible asset classes?

It sounds like a no-brainer, but as pension experts have known for years, there are several complexities that need to be ironed out first. There are also commercial realities to face up to. Despite the steady growth in DC assets of recent years, the sums most master trusts and single-employer trust schemes have to allocate to illiquids are still relatively modest. For the biggest players, direct investment will be the solution going forward. For the rest, making platform-based solutions work should be a priority. Pricing and valuing DC illiquids will cause some reduction in return compared to their DB equivalents - asset managers will need to make the case that this can be done efficiently. But there is still an attractive opportunity in illiquids and our industry should make a concerted effort to overcome the obstacles and bring these strong, steady returns into DC schemes.

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BRINGING ILLIQUIDS TO DC INVESTORS

PUTTING ILLIQUIDS TO WORK

Illiquid investments bring diversification and outperformance potential to investment portfolios, yet have traditionally been beyond the reach of the great majority of DC schemes and their members. Innovative thinking can overcome the technical challenge of bringing these attractive assets to DC savers. John Greenwood reports

With better-than-stock market long-term returns for a fraction of the volatility – it's not surprising that the question of introducing illiquids into defined contribution (DC) scheme is such a recurring theme. But the technical challenges of introducing illiquids into products normally the preserve of listed assets can seem like introducing a square peg into a round hole.

Delegates at a Corporate Adviser round table event last month agreed that with a collective will from stakeholders at all points in the value chain, illiquids such as private credit, real estate, private equity, venture capital and direct holdings in infrastructure could be made more accessible to DC investors. But, delegates agreed, there is still much to work out before illiquids become commonplace.

Speaking at the event, Natixis Investment Managers head of UK DC sales & strategy Nick Groom set out some of the challenges of bringing illiquids to DC.

Groom said: "There are a number of technical challenges to get managers thinking differently about how to put a solution together that would deal with the needs of the UK DC market. It is very different from the world that they've been living in. We want evergreen in DC, but illiquid investment have generally been closed ended funds, with valuation points from quarter to quarter, if you're lucky, and also coming in at a high price.

"Managers of illiquids are used to receiving a high level of fees, including performance fees. So our role is to make them understand how to access the DC market in a different way - how positive cash flows for a period of time would give access to deal flow that they probably haven't had before. In order to succeed, you need a very collaborative group of people through the chain with the will to make it happen within a DC scheme environment."

Connected Asset Management chief impact officer Rachel Neill, who was formerly at Smart Pension where she headed up sustainable investment and worked with Natixis developing the master trust's private credit solution, agreed. "We really need everybody along the investment chain on the same page when it comes to illiquids. We can have trustees with the will, but maybe a platform that isn't accommodating in terms of the requirements, or consultants that are struggling from a valuation perspective. So it really has to be everyone along the chain on the same page for it to happen."

Mirroring performance

Tess Page, Mercer partner and DC investment adviser, and chair of the Association of Consulting Actuaries' DC committee, said: "There are a small number of private markets funds that are aimed at DC, where there have been tweaks made to an existing DB focused illiquid product. We've done analysis of the differential in the performance of those funds and the full fat version. The DB fully illiquid version has over the last five years performed better than the DC one, which, while it contains a healthy dose of illiquid assets and has outperformed things like diversified growth funds, is still not as strong as the pure illiquid portfolio."

Groom said: "Those equivalent DC solutions have to take into account liquidity for all sorts of different reasons. We had to account for having an illiquid side of our solution alongside a liquid side to take money in and deploy without cash drag. You're not getting all of the illiquidity premium like you are in the DB version.

"We're not talking about Nest here, which can deploy a huge amount of assets on a regular basis to give certainty of deal flow, without the platform implications. Most of the DC world is sitting on platforms, and needs a built in self-contained liquidity solution."

Natixis Investment Managers head of UK DC sales & strategy Nick Groom

Daily pricing

For Rene Poisson, managing director of Poisson Management, it is possible to overcome daily pricing and performance fees challenges if schemes are net-cash-flow-positive. Poisson is chair of the JPMorgan single-employer DC scheme, which has around £5.4bn of assets, a director of the Standard Life Master Trust and a director of the USS pension scheme, which has a DC section. Both the JPMorgan and USS schemes are already investing in illiquids, and Poisson says the Standard Life Master Trust has been exploring the idea.

David Porter, director, DC at Mobius Life

Poisson says: "If you've got monthly flows coming in and the pricing is wrong, then it's wrong on the way in and it would be wrong when a member leaves. If you can establish a daily price, even if trading is suspended, then if the scheme is a net cash inflow world, you can manage the ins and outs within the scheme. It was that sort of analysis that we went through when we introduced illiquids into the Morgan scheme, to satisfy ourselves, one, that we could treat our members fairly in terms of the ins and outs, and secondly, that were we to hit that horror story of a fund being closed to redemptions, we would still be in a position to deal with fund flows going in and out."

David Porter, director, DC at Mobius Life, the platform provider, suggested the industry should take baby steps in terms of pricing funds, to see what works and what doesn't. He is chair of the Pensions Administration Standards Association (PASA) master trust working group, and was formerly at AllianceBernstein, which introduced illiquid private equity in 2017, using the Mobius platform.

Porter said: "You might have a different benchmark or a different way of creating a proxy price. And then you might have a fund that values every three months or every nine months or every 12 months or 18 months. You can't have a sale price in a daily valued fund, so you do need to have some sort of accurate proxy which can be revalued on an event driven basis. And then that can trickle down into your daily proxy because the last thing you want is having a sale and then something has gone horribly wrong, possibly at the end, and how does that get covered? How do you then correct everything that you've been trying to value on a daily basis? It has to be net cash flow positive."

Porter suggested testing the water on systems for valuing illiquids would help grow knowledge on how to manage difficult scenarios.

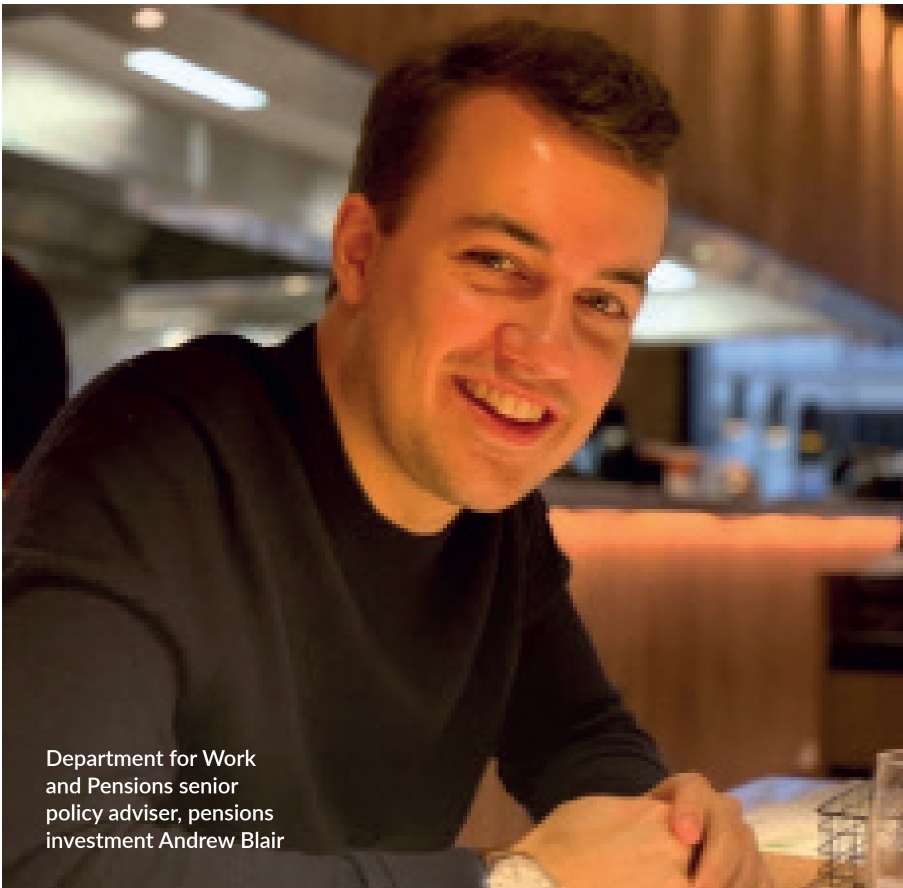
"Do we start by dipping our toes in the water to these funds that are valued every three months and get used to the mechanism over time? We can get more confident in some of the assumptions we're making, especially over how we think about performance spike fees, for example?"

'Cultural obsession'

Department for Work and Pensions senior policy adviser, pensions investment Andrew Blair quizzed panellists on whether daily pricing was a cultural 'obsession' of DC, or a necessary element of running a scheme.

"One of the things that we and the FCA are thinking about is the monthly pricing of a Long-Term Asset Fund (LTAF) and how we get these schemes familiar with that and comfortable with that, rather than pandering down to a daily price for those funds and creating a value which is a proxy, yes, but probably no more than a finger in the air."

Porter agreed with Blair's assessment. He said: "Are we just stuck in the old ways of doing things in terms of fee structures in the illiquids world? Probably. ▶


Department for Work and Pensions senior policy adviser, pensions investment Andrew Blair

Perhaps [asset managers] need to think about things in a different way so they can just come up with a set fee. There's no silver bullet here. Everyone's talking these issues through and trying to come to a solution. The Natixis-type funds have just an AMC, which is obviously a lot easier to deploy."

Imran Razvi, senior policy adviser on pensions and institutional market issues at the Investment Association said: "Daily pricing is partly cultural, but at the same time, given that we're talking about relatively low levels of illiquid allocations, it seems unrealistic to expect to upend the entire daily dealing model when you're really allocating 5 to 10 per cent to illiquid assets.

"There doesn't appear to be any appetite from providers to say, OK, you're 90 per cent invested in liquid assets. You can get those whenever you want, but the remaining 10 per cent, there's going to be a lag based on however long it takes to liquidate those assets. So until that appetite changes, you're talking about trying to shoehorn this into the daily deal environment, and that issue exists in the retail world as well, by the way."

Poisson said: "We need to distinguish daily pricing / valuation from daily trading. A daily price that is, if you'll excuse the phrase, good enough for government work, is critical because every DC plan has its monthly payroll and investment on a different day. So if you don't have the right price on the day you do the investment, how we talking about appropriate treatment of members? Unless you mandate that people can only retire or die or transfer to a new employer's fund on a particular day of the month, you need to have a price that's good enough."

Benchmarking proxy

Porter said: "We need to get used to some sort of benchmarking proxy, something that we can get some confidence in over time. Or we could introduce a sweep method where you say, we're going to give you what we think the value is as at last month, and then we'll pay out the difference once we've done the valuation at month end. It's an administrative nightmare. You suggest that to a bunch of administration teams out there and they're just going to say 'no'."

For Groom this is an area where talking to managers about new structures can lead to simpler solutions for administrators.

Groom said: "The reality check on that is that we have daily pricing, we have daily liquidity in our in our prospectus. But actually we've worked with the platform to be flexible and go from a monthly experience. 90 percent of the assets are listed public assets and there's huge positive cash flows. So it doesn't make sense to use an illiquid fund for the liquidity."

Performance fees

Blair highlighted the complexity of apportioning performance fees fairly. He said: "The DWP has introduced a smoothing of performance fees mechanism around the charge cap and is interested in allowing schemes to pay performance fees if they believe that they are good value. I don't think we're going to get DC schemes, especially master trusts, paying anything like 2 and 20, but maybe there'll be some performance element to private equity fees."

For Blair, a deeper complexity was apportioning the cost of performance fees fairly across a scheme's evolving membership.

"It is very easy to allocate a flat fee to members as they move in and out of the fund because you just pro-rata it. But I see a real barrier to the payment of performance fees. That's going to be really difficult to administer."

Porter agreed that this would be complex.

"On value performance fee spikes, I agree - you can't do it," said Porter. "If you're going to smooth it going forward, you're

PHOTOGRAPHY: RICHARD WHITCOMBE

doing so based on the fact that I'm paying for something that someone else has enjoyed and left. On day 364 I've enjoyed the improvement in performance or I've paid a fee that's higher because there's an assumption that there's going to be a performance kicker.

"Then day 365 five comes along. I've left, I've taken all that, but I've paid nothing or I've not suffered any loss because actually it hasn't performed as well as expected because the final numbers have come in. I don't agree that that can be done on any platform or any administration tool because it's an input that doesn't exist. It's not treating customers fairly."

Poisson agreed. "The performance fee is an issue in the context of fair treatment of members. Unless you can be satisfied that you're applying the performance fee on a daily basis, then you're not fairly allocating cost between members, and that will be true in the default to some extent, just as much as it is in a self-select world," he said.

Groom said this was an area that needs new thinking from asset managers, to reflect the potential long-term value of them of dealing with the emerging DC market. "So we're saying 'factor in some performance fee on top of your annual management charge' and they're saying, 'okay, we'll do that for known cash flows in the future'."

Permitted links

Razvi raised concern over impact of the permitted links rules in the life-wrapped world.

He said: "If you look at trust-based DC investing outside life wrappers and contract-based, the life wrapper is a complete pain from an illiquid allocation perspective.

"You can think of it as the FCA trying to put on retail protections to an institutional investment process, and it doesn't really work. I'm talking particularly here about the, at the moment, 35 per cent cap that exists on illiquid assets in the unit linked fund.

"The FCA are partially addressing it through the Long-Term Asset Fund (LTAF) work – they will designate the LTAF as a permitted link in its own right, which will really help. But the LTAF is currently restricted in the FCA's proposals to the default, so it's just not going to work for those schemes that want a self-select option if you're going through the life world.

"So it seems utterly bizarre that you've got this situation in DC, where to the member, it all looks the same, but if you're going through the life world, you're much more constrained. If you sit outside the life world, you've got a lot more flexibility to bring in a wider scope of asset classes. Levelling the playing field towards the non-life way of doing things would be enormously helpful."

Porter said: "If you're a trust based scheme or a master trust at the moment, you're not going to be put 35 per cent allocation into it. So really, the regulation at the moment from the permitted source is more than adequate for super solo, as they're calling, large single DC schemes nowadays, and also for the larger master trusts that do have that significant 10 per cent allocation of their overall holdings to invest. So at the moment, regulation isn't stopping allocation to illiquids.

"On the wider point of being able to bring more DB-esque levers and more esoteric investment asset classes to the fore, then yes, levelling that playing ground for the life platform would be very helpful."

The UK DC sector is still relatively immature – but as schemes consolidate and continue their exponential growth, demand for investment in illiquids is only going to increase. Those schemes that have the will to iron out the technical difficulties and make illiquids work can expect better returns, which should, in the long term, mean greater market share. ■

ILLIQUIDS IN WORKPLACE PENSION SCHEMES

'Illiquids' are often grouped together as a single asset type, but the term is used to cover a broad range of assets with varying risk attributes.

Real estate

This is an asset class that has seen managers gating redemptions in difficult times. However, some DC plans have used open-ended real estate funds, as they had previously offered lower volatility than real estate investment trusts, with a relatively stable return.

Private credit

Strategies using private credit are typically employed to generate higher levels of income within a portfolio but can have a vast spectrum of risk profiles. Direct lending funds can be thought of as like bank lending to private companies and typically have yield as a priority, but these differ from special situations or distressed funds that aim for equity-like returns and can dabble in higher risk credit scenarios.

Private equity and venture capital

Here investments are made in privately held companies, ranging from companies in their infancy to established businesses that have been taken private through a management buyout. Research from the Defined Contribution Alternatives Association argues that the return profile of private equity tends to be higher than equities, but investors must be willing to accept a degree of opacity compared to listed investments.

Direct holdings in infrastructure

Current rules around DC products make this difficult for pension schemes, but regulators are moving to make it easier, and some providers are taking steps towards facilitating direct investment, in the way that local government pension scheme pools have done.

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BRINGING ILLIQUIDS TO DC INVESTORS

VALUE AT ALL COSTS

A change of mindset amongst employers, consultants, asset managers and regulators is needed if DC pension savers are to reap the benefits of illiquid assets. **John Greenwood** reports

Most pension experts agree that in an ideal world, exposure to illiquid investments would be good for defined contribution (DC) schemes, boosting returns over the long term, while adding diversification and reducing risk.

With DC illiquid investment currently in its infancy, delegates at a round table event held by Corporate Adviser last month explored the obstacles to greater uptake and the ways industry stakeholders could work together to improve access to this valuable range of asset classes.

The investment case for illiquids is strong. A recent paper from the Bank of England/DWP/FCA-sponsored Productive Finance Working Group pointed to empirical estimates by Oliver Wyman and the British Business Bank that suggested a 22 year-old new entrant to a default DC scheme with a 5 per cent allocation to VC/ growth equity could achieve a 7 to 12 per cent increase in total retirement savings. They also showed that between 1970 and 2016, global VC/growth equity assets have outperformed global public markets by 7 per cent a year. That paper also referred to Pensions Policy Institute work suggesting the illiquidity premium has varied between a 1 per cent and a 7 per cent increase in returns over the long term.

Natixis Investment Managers head of UK DC sales & strategy Nick Groom

Obsession with cost

For Department for Work and Pensions senior policy adviser, pensions investment Andrew Blair, changing the industry's focus on cost to one of value is key.

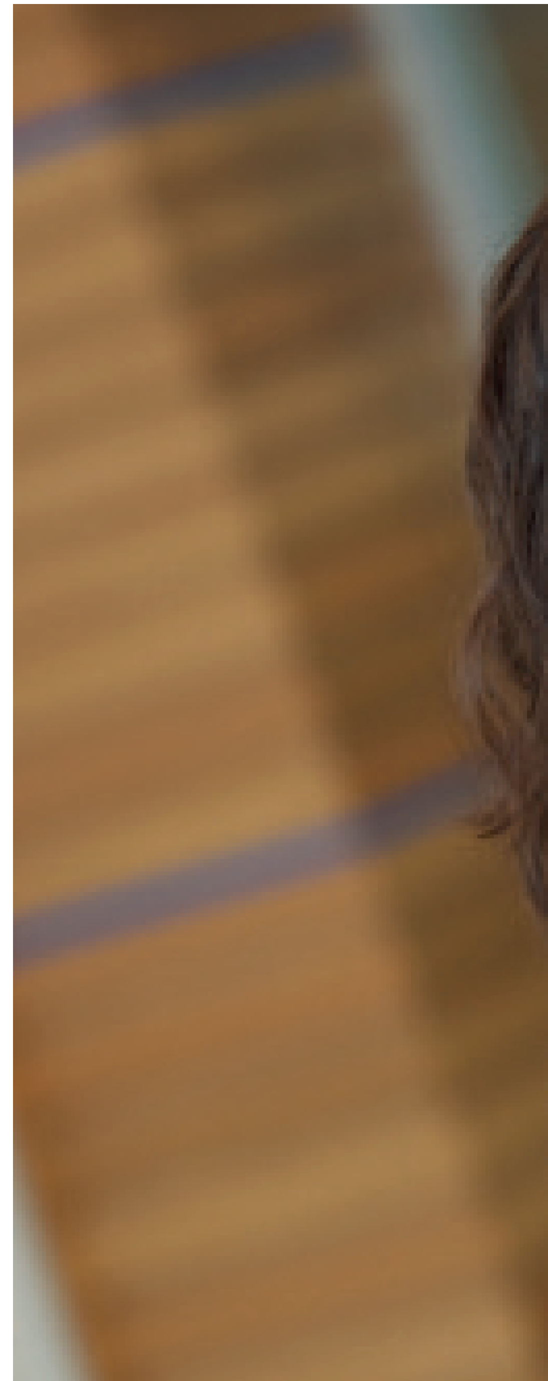
"At DWP we are seeking to address market failures. Since automatic enrolment kicked in in 2012 we've had the emergence of master trusts which have competed very aggressively on price. Costs have a role to play in overall value for member outcomes. But we are now seeing that cost element define the way in which schemes are chosen by single employer trusts that wish to consolidate," he said.

"A key aspect of our work going forward is to shift the focus of DC schemes away from a narrow focus on cost towards an overall focus on value," he said, adding that the £2bn to £3bn scheme size access point for illiquids was a key factor in the DWP's consolidation drive.

But he rejected the suggestion that the government is pushing this consolidation agenda to boost its own infrastructure spending plans.

"Illiquids tend to give you more active way of investing and some impacts that you might not get in traditional assets, and that happens to have trickle down effects to some government objectives - levelling up, building back better and the transition to net zero, but our position is about removal of barriers rather than forcing schemes in any particular direction in terms of investment," he said, adding that the charge cap was not a big factor given how few scheme charge anywhere near it.

Rene Poisson, managing director of Poisson Management argued that trustees would be unlikely to want to focus on UK illiquid assets in any event.



"If I want private equity, probably the leading managers in that area are on the west coast of the US. If I want infrastructure, there are clearly best-in-class managers and they're not necessarily located in the UK. And so if I'm looking to provide best value for my investment buck to the member, it probably is not going to be entirely correlated to the broader objectives of the UK government," he said.

Tess Page, Mercer partner and DC investment adviser, and chair of the Association of Consulting Actuaries' DC committee

"Writing to your members, saying your charges are increasing is it really hard behavioural thing to do and there needs to be evidence that that will bring value for members. Yes, if there is evidence that these things do deliver better outcomes for members, then the cost impact should not be an issue"

Overseas expertise

Natixis Investment Managers head of UK DC sales & strategy Nick Groom said: "There is a lot of capability we're looking for in the UK, which is domiciled somewhere in continental Europe, especially for the energy transition, for example. They're better at that in France than we are at the moment - that's a fact.

"We have to go overseas to find some of this capability and these guys overseas can ply their trade in markets where they don't have to consider lower fees for what they do. As a global fund manager at Natixis we do ask why should we put capacity in the UK when we can go to Asia and charge double the price? And that's one of the one of the conundrums that we face in managing the sort of asset classes that we all want coming into the UK, that are going to create an impact and give a big ESG tick is difficult at a price point that works.

"We have a polarised marketplace, with master trusts not playing anywhere near the charge cap. We have investment budgets of 10 to 15 basis points. Are we going to have a passive core and an active outlying bubble effect where in the end the price of illiquid assets are so high that you probably can't get more than 10 percent into a portfolio, so why bother. Do schemes actually think it's worth it, going through the more quite complex route of actually finding a way to get illiquids into a DC scheme?"

Mindset problem

Imran Razvi, senior policy adviser on pensions and institutional market issues at the Investment Association said: "I think the charge is not really the barrier that everyone thinks it is. There are specific issues around performance fees, but my expectation would be that managers will adjust to the needs of the market.

"But it's really hard to change that mindset over a relatively short period of time where, frankly, the message from regulators since auto-enrolment began has been that actually cost really does matter. The asset management market study had a very strong implicit preference for index funds exhibited by the regulator."

Razvi also said historically DWP submissions to the Work and Pensions Committee had suggested it was difficult to find active managers who will outperform on average, with the result of pushing DC funds heavily down the index route.

"I think it's quite difficult to just suddenly change that mindset overnight," said Razvi.

Poisson, who is chair of the JPMorgan single-employer DC scheme, argued the ▶

Connected Asset Management chief impact officer Rachel Neill

cap does remain restrictive. He said: "Even within a scheme like the Morgan scheme, where all of the underlying admin and other costs are paid for by the employer so that the only thing charge covers is investment, there is still a significant limit on what you can incorporate and remain within charge cap. I'm happy to use 60 basis points if that provides value for my members, but it still restricts to a very significant extent the quantum of assets I can get in.

"So on value, you really have to ask the question are illiquids the best way to add value for that level of investment cost? Or are there perhaps other areas of active investment which can provide a better bang for that investment buck?"

Separated by bps

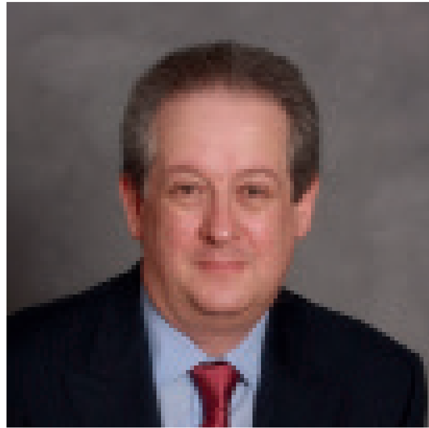
Poisson agreed attitudes to charges needed to change. "I've sat on board of a master trust for a very long time now, watching the RFPs come in from prospective clients. And when you see that the difference between being invited to tender and not being invited to tender is 2 basis points of investment cost, it really brings the issue of illiquids and their cost into perspective, because it's actually not the master trust or the investment manager at that point, you need to be persuading. It's actually the purchasers of those services. If you see a world in which master trusts can give 10 basis points of investment to the default solution then it really begs the question 'how do you bring in illiquids?"

Mercer partner and UK wealth leader Tessa Page pointed out the real-life challenge of actually raising charges. She said: "If own trust schemes are going to make any change to their default arrangement, they need to write out to members. Writing to your members, saying

"So on value, you really have to ask the question are illiquids the best way to add value for that level of investment cost? Or are there perhaps other areas of active investment which can provide a better bang for that investment buck?"

Imran Razvi, senior policy adviser on pensions and institutional market issues at the Investment Association

your charges are increasing is a really hard behavioural thing to do and there needs to be evidence that that will bring value for members. Yes, if there is evidence that these things do deliver better outcomes for members, then the cost impact should not be an issue. But, in reality it's really hard. I had a case recently where the scheme was not trying to implement illiquids - just a slightly better index tracker within their default. And it involved an increase in costs for the members. It was really hard for the trustees to make that decision and they



Rene Poisson, managing director of Poisson Management

were nowhere near the charge cap."

Page agreed that messaging from the Government or regulator that cost is not the be-all-and-end-all would help move the dial on this issue.

Razvi said: "There's a fundamental issue in DC that we all need to grapple with, which is how do you get a focus on member outcomes in a world where those outcomes are fundamentally uncertain.

Regulatory burden

Poisson also argued that any master trust or own trust scheme has a limited budget for governance and investment. "So you have a slightly contradictory situation in which there's a desire to accentuate investment in, to use the blanket term, illiquids. But actually, the incremental burdens that may counterbalance the overall value proposition in terms of what the trustees can spend their time governing and adding value on. There's a need for some more joined up thinking across the totality of the issue rather than investment over here, ESG over there and regulatory reporting somewhere else.

"When as a trustee board, we think about whether to go into a new asset class or whatever, we are going to have to now think about 'and what are the knock on effects of that decision in terms of the overall running of the plan going forward?' In the old days, it was it was relatively simple. It's a new fund, it's a new manager. We want to meet them twice a year. We want this sort of reporting. Suddenly, we've got a significant incremental set of issues to try and work our way through."

TCFD reporting

Connected Asset Management chief impact officer Rachel Neill highlighted the challenge of Taskforce on Climate-related Financial Disclosures (TCFD) reporting with illiquids. "There will come a point where trustees will have to have to look at how that asset classes reports under TCFD and along ESG and sustainability lines. Sometimes it will be easier depending on the actual asset class, and sometimes it will be a little bit harder."

But she added that illiquid investments offered real opportunities for impact, developing the 'S' in ESG, and also for engaging members.

"If you think more broadly around stories and messaging that you can have around energy transition and investing in wind farms, that ticks the TCFD box. But you can also engage members around stories about what their savings are actually doing. Where it might become a little bit more complicated is if in the area of say social housing, where, yes, you're looking for that carbon reporting under the TCFD, but you also can look at how many families are housed. You're looking at different metrics but there's lots of different frameworks out and not much standardisation."

Page added: "We need to also recognise the difference between metrics and data versus actual ESG integration because in many respects for some of these asset classes, the ESG is better, but it's just that we haven't got a number on a spreadsheet that says it's better. So I think that more holistic assessment is really important."

Stewardship opportunity

Groom pointed out that illiquids had great potential for delivering real ESG influence. "We always thought stewardship would be much easier achieved by being a stockholder than perhaps a credit manager in a loan environment. What you get with illiquids is you get a far greater degree of due diligence over the deals that they're actually putting together, so they must work that much harder. That's why we get a higher price in these particular markets - they work much harder around due diligence. With the solution we have within the Smart structure the credit offering has introduced a ratchet system for loans to be ratcheted up or down based on their KPIs from an ESG score perspective. That's really neat. You can do that in an illiquid environment because you've got that relationship with fewer clients. The learning for me there was that it was interesting to see stewardship being as possible from a credit perspective as it was from an equity perspective." ▶

Product availability

But delegates agreed that the more players entering the market, the better.

Page said we are 'reasonably fortunate' in that there is a small handful of good quality investment products available in this space for UK DC schemes. "But it's nowhere near the level that would be there for any other asset class. Look at all the ESG funds suddenly come out of nowhere, and yet we've got one or two viable illiquid asset funds. There is a need for more product development.

"There is a significant governance and bandwidth problem at the medium and smaller end of the DC market. It might be that they just need to consolidate because they're unable to provide good value for their members. But there are some very good old trusts that do try and do the right things, but at the moment they've got a lot on their agendas. And so actually getting to this [illiquids] doesn't always feel like a priority area."

Razvi agreed, but said commercial realities could impede a mass of product innovation any time soon. "Firms are very interested in the DC market, but there is a recognition that it's going to take time and allocations are likely to be small. And that's challenging from a commercial perspective and is also one of the reasons why when as a manager you think about developing new products, not just looking at the DC market, and so the fact that UK regulators have been so resistant to looking at broader retail distribution of the LTAF is a problem from a commercial perspective. It comes back to bite DC because it reduces the overall commercial viability of producing the product in the first place."

Page agreed, saying: "I've lost count of the number of fund managers who have been very keen to talk to us about new potential products. And then we have the conversation and we talk to them about the cost issues and the platform issues, and you can gradually their interest, the light in their eyes, just days away and then we never hear from them again."

The end DC investor will be hoping this light is reilluminated as the potential of the defined contribution market is more broadly understood. With DC savers bearing the investment risk themselves, they need the best asset classes possible. ■

THE LONG-TERM ASSET FUND

The Long-Term Asset Fund (LTAF) is a new fund structure allowing wider access to assets such as infrastructure and private companies which are not regularly traded.

The LTAF will allow investors to access:

- Private equity
- Private credit
- Venture capital
- Infrastructure, including transport
- Real estate
- Forestry
- Collective Investment Vehicles that invest in private asset classes, including limited partnerships

The LTAF will also be able to hold cash, listed shares and bonds, including money market instruments to provide options for managing portfolio liquidity while awaiting opportunities to invest in less liquid asset classes.

The LTAF can be an ICVC (investment company with variable capital), AUT (an authorised unit trust scheme) or ACS (an authorised contractual scheme). Maximum borrowing is 30 per cent of the fund's net assets. Assets must be valued at least monthly.

OPINION

SOLVING THE PRIVATE MARKETS CONUNDRUM FOR UK DC

» **Nick Groom** Head of UK DC Strategy & Sales, Institutional Business, Natixis Investment Managers

Many DC schemes are searching for ways to offer their members access to illiquid asset classes, but they face a number of hurdles to get there. So just how much effort is required to bring illiquids into DC, and is the due diligence, effort, time and energy worth it?

Illquids add value, but are beset by challenges

It is clear that DC does need illiquids: they offer an illiquidity and complexity premium, impact, diversification and correlation benefits. When you consider the amount of work that goes into the sourcing, due diligence, and extra checks involved in deploying to private market deals, you realise why these investments are sought after and attractive (and why, in some cases, they can be expensive).

As it stands, DC schemes find it impossible to invest directly in private markets, particularly private equity. Exposure to private markets can only be obtained by investing in cheaper, listed versions that are often correlated with broader equity exposure and may be hiding layered fees.

The fees issue is a huge problem to direct investment. DC schemes are struggling with a fees cap while private equity fees stand at 2+20. A DC master trust has, in some cases, below 10bps to play with. So, as it stands, it would only be possible to consider a modest allocation, which may not be worth the requisite time and resources.

Let's play to our strengths

What is needed is a joined-up group of stakeholders that are happy to take on the risk of an illiquid asset, that may be locked-up for a period of time, have a "J" curve, higher fees and more complex reporting constraints.

Life company platforms control the majority of UK-based scheme assets, and that won't change for the foreseeable future. These gatekeepers will need to be comfortable that they have mitigated the risks associated with private market assets. We have already seen a shift in how flexible they can be, and how they can be more pragmatic about incorporating private illiquid assets into a broader portfolio.

This represents an excellent start, so let's not look for daily liquidity from an illiquid asset. Let's play to our strengths and use cashflows and listed liquid assets to facilitate illiquid transactions in DC funds.

> What is needed is a joined-up group of stakeholders that are happy to take on the risk of an illiquid asset, that may be locked-up for a period of time

Some asset classes are simply not viable

To transition DC schemes from totally liquid to blended portfolios containing illiquid assets, we must have sound understanding of illiquid asset classes. They are all very different and represent different profiles and problems that must be solved, including return and risk targets, correlation to other asset classes, position in the capital structure and liquidity profile.

For example, in the private credit space, whether the loan is senior, mezzanine or subordinated dictates the fee, risk, and liquidity profile. At the top of the structure are senior loans, and these can be traded in a secondary market that provides a degree of short-term liquidity, even though they are categorised as an illiquid asset.

At the other of the asset class, we have private equity and innovative ESG-focused natural capital strategies covering areas such as sustainable oceans, land degradation projects, re-forestation and bio-diversity. Unfortunately, we are some way off DC schemes being able to take a direct position in these "impact" asset classes. As lovely as they sound, they can be expensive, lock up capital for many years, are closed-ended, have a zero-liquidity profile, and have a significant "J" curve, even if they do enjoy high average net returns.

Moving forward through collective effort

Not all schemes have the luxury of sizeable and regular contributions, and high AUM, to be able to generate liquidity. Nevertheless, many smaller schemes have the ambition to make illiquid asset classes available to their members and provide access to the precious illiquidity and diversification benefits the UK DC market desires.

So we do want to find a way for these interesting asset classes to benefit DC members. We believe getting over the difficulties requires a collective effort – a combined effort – based on the understanding that better risk-adjusted returns can be achieved by DC schemes if the will is there. ■

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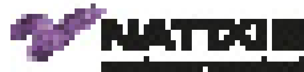

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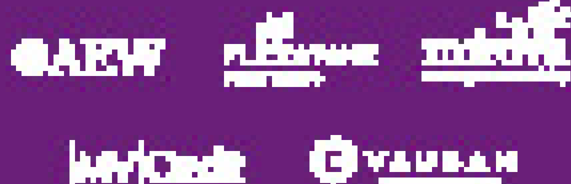

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