XPS Investment

Investment briefing
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4 bold ideas to get illiquid DC allocations up to 20%

Overview

The discussion on the benefits available to Defined Contribution (DC) pension schemes from investing in illiquid assets is not new, neither is awareness of the barriers. However, the focus on these types of assets has never been greater.

In this paper, Mark Searle sets out his view on the primary hurdles that are not yet fully appreciated, and how these can be overcome to unlock the door to DC schemes fully capitalising on the opportunity that illiquid assets represent.

Since July 2023, the Mansion House Compact has focused attention on the objective of getting 5% of DC investment into unlisted equities by 2030.

XPS believe an allocation of 5% to private markets is beneficial but there are significant hurdles that need to be addressed to achieve this goal. However, XPS also believe that if these obstacles are overcome, then we needn't stop at a 5% allocation, and 20% allocated to illiquids is the order of magnitude required to deliver a meaningful benefit to members.

We therefore set out four bold ideas to boost investment in illiquid assets by DC schemes.

1	**Consolidate, but focus on small and medium schemes only**
2	**Change the law to reduce available liquidity for members**
3	**Address limitations of platforms and default offerings**
4	**Trustees and employers need to get on board**

Mark Searle,
Head of DC Investment

Illiquid assets — what trustees need to know

In his July 2023 Mansion House speech Jeremy Hunt set out an ambitious set of measures to boost pension savings:

> For an average earner who starts saving at 18, these measures could increase the size of their pension pot by 12% over their career – that's worth over £1,000 more a year in retirement.
>
> **The Rt Hon Jermey Hunt MP, 10 July 2023**

The £1,000 boost comes from a 12% increase in the average member's lifetime pot. However, the government's underlying analysis highlights that the investment in private markets will only contribute to a 3% uplift in the member's pot.

This represents only a quarter of the 12% increase of the combined wider mansion house reforms and is often misunderstood. The remaining 9% results from non-investment related reforms, such as saving from an earlier age.

By applying the same principles as were used within the Government analysis, an allocation of 20% to illiquid private market assets would have the potential to contribute 12% to a member's lifetime pot. We think this is a prize worth pursuing.

The thrust of government and industry investment initiatives so far have focused on:

- reducing management costs and increasing sophistication through consolidation into very large pools of assets;
- creating open-ended fund structures that accommodate moderate illiquidity;
- promoting the desirable risk and return benefits of private markets; and
- emphasising the importance of good governance and training of decision makers.

We consider that these changes, whilst helpful, do not go far enough or fast enough to deliver the potential benefit to DC savers that could be achieved with more radical thinking. We also think that these initiatives do not sufficiently address what we see as the main barrier that's holding schemes back. This is the operational difficulty that comes from holding assets that cannot easily be returned to cash.

What are illiquid assets?

By 'illiquid assets' we mean those that cannot be easily or quickly converted into cash. These are often private market assets such as private equity or private debt but also include investments such as hedge funds or property. Unlike listed equities or bonds, the underlying assets are not traded on an exchange and so a buyer needs to be found if the holder wants to sell.

There are a wide range of illiquid asset classes, and illiquidity can range from monthly dealing through to locking up assets for well over a decade.

Can you make an illiquid fund liquid?

To date a lot of solutions in DC have revolved around accessing illiquid assets via funds that are themselves liquidly traded. This creates one of two key issues:

i) the restructuring either changes the investment's risk and return characteristics, i.e. removing the illiquidity premium (for example listed property that often trades at a premium to net asset value and fluctuates in value like equities); or

ii) the asset retains some illiquid features, for instance lock ups in the event that redemptions from investors exceed buffers that exist and deferred redemptions are enforced, like has been seen in some UK property funds.

By 1 October this year, trustees will need to publish a revised Statement of Investment Principles that sets out their policy on investing in illiquid assets and most DC schemes now have to disclose their asset allocation as part of the 'Disclose and Explain' regulations.

Idea 1 Consolidate, but focus on small and medium schemes only

We agree that the large number of small DC schemes that can't access illiquids need to consolidate.

This could be by combining schemes, transferring to a master trust or consolidating investment strategies by making use of off-the-shelf products. However, we do not need £50bn mega DC funds for the benefits of illiquid asset to be harnessed. From our observations of DC and Defined Benefit (DB) schemes', assets of at least £1bn are more than sufficient to have scope to invest in a sophisticated way. That said we recognise that DC schemes typically have more uncertainty regarding their ongoing membership and so realistically a scheme needs to have assets in excess of this to have the same scope to invest in illiquids as an equivalent sized DB scheme. However we see schemes with £1bn-£5bn able to offer very significant scope to get the majority of benefit from allocating to illiquids.

Moreover, schemes need organisational stability, yet the potential for consolidation and annual comparison as part of the Value For Money assessment hangs over schemes and prevents them from investing in ways that reduce future flexibility. Illiquid assets form part of a long-term investment strategy and so schemes need to be confident that they will have the means to continue to invest in illiquid assets for the long-term. Therefore the threat of continual consolidation, for schemes that may already be at sufficient scale is counterproductive.

Solution

Consolidation of many sub £1bn schemes will be beneficial, but mega funds in the tens of billions are not necessary. We propose that scheme's beyond £1bn should consider the merit of consolidating now, but following that decision should not be continually encouraged to consolidate aside from responding to developments that arise from a material change in their circumstances.

Idea 2 Change the law to reduce available liquidity for members

It is perceived that members need voluntary access to their funds in relation to events such as taking a transfer value or retirement.

The statutory requirement is to offer a transfer within six months which in itself offers some scope to adopt some illiquidity although does represent a meaningful constraint, particularly in relation to assets with trading less frequent than quarterly.

In general, members of DC schemes start saving in their early 20s and can't withdraw their benefits until at least age 55 at present. Many will not touch their savings until they are well into their 60s and this could be even later for members who start saving today. Of course, members may decide to move savings between arrangements before retirement but the principle is that their savings horizon is decades long and potentially half a century before retirement.

Despite this, most DC providers currently offer daily liquidity and so offer considerably more flexibility to members than the vast majority can reasonably benefit from or need.

There is some scope to invest a small portion of assets in illiquids relying on the collective pooling of member assets and cashflows to accomodate outflows. However, the scope for this to capitalise on the true potential of illiquids is unlikely to be great enough to materially benefit members.

In order to capitalise on this opportunity, the answer is to impose some illiquidity upon members. This could be done on a fully voluntary basis, but given the minority of assets that are invested in self select funds, this is not going to have a meaningful impact on the average DC member. The bulk of DC funds in the market are invested via default arrangements. Therefore, default arrangements are what needs to change to benefit the majority of members.

Solution

To fully embrace illiquidity requires a relaxation of some legislative requirements. Statutory requirements could be revised so that a portion, say 20%, of a member's default investment pot can legitimately be locked up by their provider for a period of time, say one year, to smooth potential cash outflows.

Members could opt out if they wish, perhaps to a simpler default arrangement more in keeping with today's investment strategies. Even so, experience of automatic enrolment shows that opt outs are unlikely so this approach could prove very effective. Subject to appropriate protections for members, the only major downside to members from this conceptual approach is that they wouldn't have complete freedom to move their savings pot to another solution at any time.

Idea 3 Address limitations of platforms and default offerings

There are legitimate and material commercial constraints preventing DC providers from introducing illiquid assets into their existing arrangements, given they are more expensive than listed assets.

It is not plausible for their clients to be 'flipped' across to a more sophisticated, more expensive strategy without a decision being made by each trustee/employer who has invested via that arrangement.

Platforms also need to adapt to offer the administrative sophistication to cater for the requirements of illiquid investments in order to offer access to DC schemes.

Consequently, the industry's focus on the constraints imposed by the charge cap and how this constrains default arrangements is misplaced. The cap is not the issue. We observe there has been a race to the bottom in terms of costs in the Master Trust market, so the cap has not placed any constraint on the available offerings.

It is already possible to comply with the 0.75% p.a. charge cap whilst allocating to higher cost illiquids (say 80% in listed equities at 0.1% p.a. charges and 20% in illiquids at 2% p.a. charges) whilst leaving some headroom for administration costs.

When evaluating the advantages and disadvantages of different Master Trusts, decisions have often been based on the few basis points cost difference rather than genuine differentiation by value and services. This means the potential for value is arguably lost with more expensive but higher returning strategies (net of fees) losing out to other providers. A typical all-in charge for default arrangements is commonly in the region of 0.30% all in, which is well below the 0.75% cap.

New regulations have further helped with this constraint; since 6 April 2023 trustees are able to exclude specified performance fees from the charges that fall within the charge cap. Whilst these charges are on the back of higher performance, and so likely to be in the members' best interests, trustees must focus on the terms of the performance fee and the timing to ensure it is fair and the investment provides value to members.

The charge cap is not a problem that needs solving. We would argue that at 0.75% combined with the performance fee exception is appropriate and serves a useful function to avoid some scheme's overpaying.

Solution

DC providers, administrators and platforms need to take the bold step of offering an alternative, more sophisticated, more illiquid, more expensive offering(s) and successfully convince their clients to move to their scheme default arrangements to these. Systems also need to be developed to accommodate lock ups or delayed liquidity in conjunction with a relaxation of statutory requirements on transfers mentioned earlier.

Idea 4 Trustees and employers need to get on board

Trustees and employers should choose a provider that offers best value for money, not simply lowest cost.

This involves good governance and knowledge. Currently available offerings are typically confined to the lowest common denominator of cheap listed defaults. That is largely driven by the criteria that these offerings have been assessed against when they have been selected.

As set out earlier, there is a requirement for providers to rise to the challenge of increasing sophistication of products. But in order for this to happen trustees and employers need to demonstrate a desire to utilise the more sophisticated approaches as and when they become available – subject to them meeting the overall requirements.

Solution

If more sophisticated strategies are to take off, trustees and employers need to promptly adopt these offerings where they are offered by their existing provider. Without this take-up the commercial case for further development will fail to meet the required threshold.

In order to do this, trustees and employers need sufficient knowledge to make the right decision for their membership, but this isn't really a barrier. In our experience, trustees and employers are generally knowledgeable and receive independent advice to address gaps in their knowledge. For those that are inadequately resourced, regulation should enforce a requirement for schemes to resource appropriately to evidence the suitability of their chosen approach.

Conclusion

In combination, these four ideas represent the changes that need to happen to meaningfully move the dial on DC investment in illiquid assets.

We think that illiquid assets can offer the opportunity of significant advantages for UK DC schemes, but the illiquidity itself poses challenges and risks that need to be carefully managed. In particular this needs a change in mindset from the entire industry and regulators that an element of higher costs and delayed redemptions is likely to form a core part of the solution.

That said, the decision to invest in illiquid assets depends on trustees' objectives, constraints and preferences, as well as the availability and attractiveness of the investment opportunities. The use of illiquids in DC investment should be driven by the best interests of the underlying members, and it is ultimately for illiquid assets to prove their merit to be included in DC portfolios.

How can we help?

If you'd like to find out more about illiquid assets and the role they might play within your scheme's investment strategy, please get in touch with Simeon Willis, Mark Searle or your usual XPS contact.

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