**Summary**
• Illiquid assets offer clear benefits to both DB and DC funds, including long-term returns, diversification and downside protection.
• Illiquid assets can assist investors in addressing the shortfalls from the low-yield environment, as well as addressing inflation fears and helping them meet their ESG requirements.
• Drawbacks include the illiquidity itself, complexity and the governance burden, which can all be managed in various ways.

# Illiquid assets: Time to take notice

**Francesca Fabrizi looks at why investing in illiquid assets should be on pension funds' radars more than ever and what the asset class can offer schemes given today's economic environment**

Illiquid assets, such as private credit, infrastructure and real estate debt to name a few, have been getting their fair share of attention in recent years, with several initiatives not only aimed at boosting interest in such asset classes, but at finding ways to enable pension schemes to invest more, in particular in the defined contribution (DC) space.

In recent months, the government's '*Levelling Up the UK*' white paper showed its commitment to relaxing DC charge cap rules to help encourage greater levels of investment in such assets; while the government recently published its proposed next steps for encouraging pension schemes to invest in more illiquid assets, including disclosure requirements.

But why should pension schemes sit up and take notice now? What do they have to gain from investing in the illiquid assets arena?

"Illiquid assets can deliver value in a number of areas," says WTW global head of real assets manager research, Paul Jayasingha. "For schemes with a long-term horizon, they offer attractive long-term returns, benefits of diversification from public equity and bonds, as well as an important contribution to the climate transition."

For the more mature defined benefit (DB) fund, he says, illiquid assets are well positioned to deliver the characteristics that are needed – stable, inflation-linked, cash generative and societally positive assets; while the low-yield environment is another challenge that real assets can clearly solve, "as illiquid assets are able to provide an attractive and de-risked income stream at a time when bond income nears record lows".

On the DC front, Mercer investment consultant, Hannah Coleman, highlights four main benefits in using illiquid assets: To include greater return potential; diversification from other key asset classes; access to wider opportunities; and the long-term investment horizon of these funds.

In particular, she adds, the matching of time horizon between illiquid investments and most members' time in a DC arrangement is attractive, and can be challenging to achieve from more liquid asset classes.

Additionally, if DC members are looking for explicit inflation-linkage, says Aon partner, Chris Inman, many brownfield infrastructure projects and real estate assets can have this built into their contracts, supporting real long-term growth.

"The relatively high expected return potential from some private equity portfolios may also benefit members in their 'early career' stage," adds Inman. "They will typically have a higher risk tolerance and can take advantage of the opportunity to seek higher returns through illiquidity risk."

Superior downside protection is also on offer with illiquid assets, particularly relevant during times of market stress, comments Inman, while, unlike cash and fixed income, which are not providing meaningful income/yields, many illiquid assets have a natural income yield, which he explains can form a significant part of an investor's spending needs post-retirement.

**Why illiquids today?**

It is important to stress that, while illiquid assets have been attractive to pension funds for many years, today's economic environment in particular provides opportunities, argues Russell Investments head of strategic client

solutions, David Rae: "Covid has accelerated many existing trends across data traffic, the role of renewable energy sources and transportation. At the same time, it has placed political pressure on fiscal spending. These both support the private funding of infrastructure assets.

"The triumvirate of return potential, volatility reduction and inflation protection can be really powerful in today's environment where market volatility and inflation fears dominate."

Private market investments, for example, can add significant value in today's unpredictable world, comments Aon associate partner, Jeff Malluck, in that they offer better risk-adjusted returns compared to their public counterparts. He adds: "Investments in private credit are predominantly floating rate, which provides protection in a rising rate environment, which we are currently entering; and investments in infrastructure and renewables, while providing attractive long-term returns, also provide strong ESG credentials as they are assisting the world in its energy transition."

All in all, against a backdrop of rich traditional betas, illiquid assets can allow investors to extract value in several ways, says Empira Group managing director, Edward Berry: "First through providing access to inherently illiquid assets such as real estate and infrastructure, which can add inflation hedging and income to the overall portfolio. Secondly, by allowing managers to deploy capital in a manner that requires time to extract maximum value.

"Background economic factors, including more limited bank intermediation since the global financial crisis, and the continued arrival of disruptive technology across many sectors, provide additional opportunities for those deploying long-term capital."

Finally, the important role real assets can play for pension funds seeking to fulfil their ESG requirements cannot be underestimated. "For example, investments in greenfield renewable energy assets and in the production and use of green hydrogen offer pension funds the opportunity to create positive environmental impact while pursuing their financial objectives," says KGAL head of international institutional business, Christian Schulte Eistrup. "In addition, real estate investments can increasingly provide ESG impact when the funds or projects are designed with sustainability at the fore. A key for pension funds is to look at how managers are implementing the rigorous requirements of Article 9 of the EU Sustainable Finance Disclosure Regulation (SFDR)."

**The ideal allocation**

But while illiquid assets clearly offer advantages, there are many other less liquid assets vying for the attention of pension fund trustees; so how prominent a role should illiquids play in pension portfolios today? "They can have a very important role to play," says Rae and, depending on the circumstances, could represent up to 30 per cent of the portfolio. In some cases, he says, the investments in illiquid investments will be the biggest contributor of returns relative to the pension liabilities.

Their role can indeed be key in both DB and DC schemes, Rae adds: "DB pension schemes tend to have long-dated liabilities but relatively short-dated investment horizons, looking to buyout or de-risk over the next few years. Even then, however, a well-crafted illiquids portfolio with exposure to private debt and infrastructure can be highly beneficial.

"DC investors tend to have longer investment horizons and higher return requirements providing even greater scope for illiquid investments."

Malluck agrees that illiquids can and should play a prominent role in DB pension portfolios, and that the exact size of any allocation needs to be balanced with the scheme's overall objective. "For example, a scheme with a longer-term time horizon can allow illiquids to play a prominent role in their portfolio, but for schemes with a buyout objective of less than five years, illiquids should form a very small portion, if any."

Jayasingha concurs that allocation sizes will vary for each scheme depending on their needs but, he argues, many pension funds aren't embracing illiquidity to the extent they could, given their liability profile.

In DC schemes, how prevalent a role illiquids should play is also not clear cut: "As with all DC investments," says Inman, "illiquid assets have to be viewed in the context of improving member outcomes. Their role and prevalence will depend on many factors, including what the DC scheme's investment objectives are, their level of expertise, membership profile, etc. If we look to more mature DC markets around the world, we generally see average allocations in the c.20-30 per cent range, but this average hides a wide variation that depends on the above mentioned factors."

All in all, says WTW head of DC, Paul Herbert, as DC schemes potentially have longer-time horizons, in theory illiquid assets should be playing a key role today; however, he explains, a combination of their origins that were focused on liquid assets, the subsequent development of an operational structure reliant upon liquidity, and the longevity uncertainty for some schemes in a consolidating market has led to illiquid assets playing a limited role.

**Drawbacks of illiquids**

While there are clear benefits to both DB and DC schemes of exploring what illiquid assets have to offer, no asset class is perfect, explains Cartwright senior investment consultant, Tom Hawthorn. "If cash is needed then other assets have to be sold, potentially at inopportune times and at discounted prices. Also, de-risking can concentrate a scheme's growth assets in illiquids that cannot be sold immediately. The remedy is not to overinvest in illiquid assets given a scheme's particular circumstances."

Malluck adds that, while there are drawbacks, these can and are being managed. "The drawbacks of investing in illiquids are mainly complexity, the illiquidity and governance burden. However, we would consider these to be more operational and can easily be overcome through trustee training, ensuring the illiquid investment timescales align with the scheme's time horizon and implementing via solutions which can ease any governance burden. These are all areas where we work with trustees, in particular helping them develop a solution to meet their requirements and ease the overall governance burden."

Additionally, argues Rae, illiquidity influences both the investment and deployment of capital as much as the realisation of assets to generate returns. Investors therefore need to be thoughtful about the illiquid asset classes and opportunity set and think about the dynamic deployment of capital over time. "This is particularly pertinent for DB schemes thinking about exploiting illiquidity over their remaining de-risking horizon," he says.

Secondary opportunities can be particularly valuable in accelerating commitments, he continues. "The higher level of fees and costs have often been seen as an impediment, but a focus on value for money and net of fee returns, not just headline fees, can mitigate this."

A key point here, stresses Berry, is that investors should only be prepared to lock up their assets if there is a good reason to do so. In other words, the lock-up/liquidity profile should match both the underlying assets and the approach of the manager, and the returns compensate for this illiquidity. "Examples where a manager's approach requires time are widespread, for example the fact it takes time to redevelop a large property or restructure a company's business. However, giving this time may generate excess returns without having to increase the leverage or reduce the credit quality of your investment and consequently improve the anticipated risk-reward of the aggregate portfolio."

Golding Capital Partners founder, Jeremy Golding, emphasises that illiquid investments simply require excellent risk management and strategies to stabilise cashflows over the investment period. "The infamous j-curve in private equity, for instance, can be managed quite effectively by tapping into the secondary market and diversifying not only across geography but also investment cycles. Each investor needs a bespoke cashflow profile tailored to their needs. The higher the illiquid allocation, the more crucial that becomes."

For pension schemes without in-house expertise in these alternative private market investments, he adds, it makes sense to partner up with specialised asset managers with long track records. "Illiquid strategies usually rely on deep market networks to gain access to prime opportunities in the first place. Fund-of-funds solutions can be an effective diversifying tool when starting out with illiquid asset classes. Later on, co-investments often make sense, too."

For DC schemes, one of the obvious drawbacks is the illiquidity of these types of assets, says Herbert, however, when these assets are integrated within a wider portfolio of assets in combination with effective liquidity managements processes, then schemes can extract the illiquidity premium associated with these assets without feeling these drawbacks.

Of course, in relation to DC, trustees may be nervous about being the 'first movers' in this area, says Inman. "This is a particular issue for DC schemes as members are directly impacted by investment performance and will hold trustees responsible for their decisions. Other DC schemes looking to consolidate in the near term may find the potential liquidity profile (or lack thereof) off-putting."

Coleman notes that it is also currently challenging for DC schemes to invest in illiquids in a cost effective way. "There are limitations to illiquid asset classes due to the lack of provision on many of the key platforms used by DC schemes, which means that schemes, particularly those smaller in assets under management, are unable to access these opportunities."

It can be challenging for many illiquid managers to gain access to these platforms due to the liquidity requirements imposed, she continues, "therefore, the industry needs to consider how liquid we actually need our asset classes to be for DC savers years from retirement".

The level of fees are a further barrier to investment, says Coleman, especially for more commercial master trust schemes that are facing challenges with continuing pressure on charges. "For those fund managers who would like to charge performance-based fees, there is a challenge to the fairness and transparency of these arrangements. In a recent consultation response, Mercer asked the regulator to consider making a performance fee calculation recommendation to help with this challenge."

Looking ahead, concludes Golding, the trend towards illiquid real assets in pension portfolios is no doubt likely to continue. "Investors have built up considerable expertise in asset classes such as private equity, infrastructure and private debt. Many pensions are much more familiar and comfortable with illiquids and appreciate the stabilising role in their portfolios. Private market alternatives have done much to anchor pension portfolios during recent spikes in volatility. Most pensions have not yet maxed out their regulatory limits for illiquids yet, so we expect further allocations going forward."

**Written by Francesca Fabrizi**