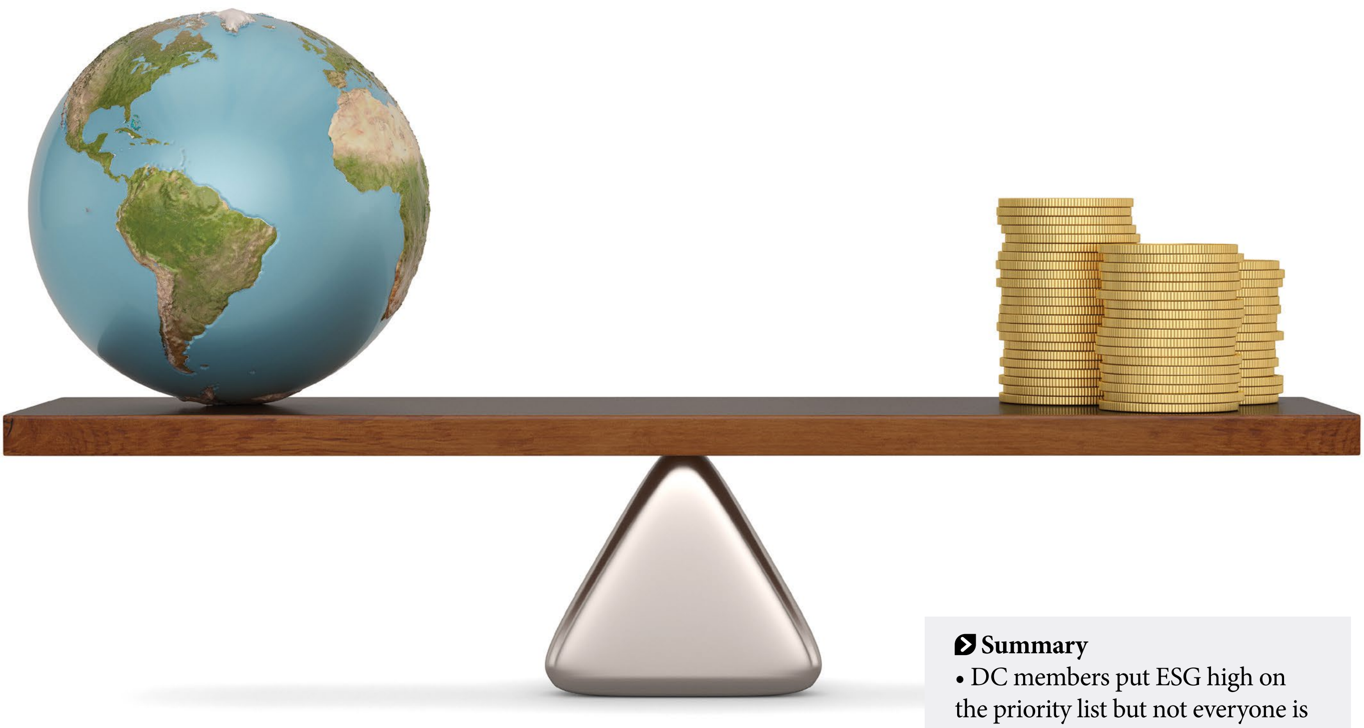


A delicate balance

Lynn Strongin Dodds looks at the balance between the desire for DC schemes to increase their sustainable investments, and the hesitancy to pay the higher fees of illiquid assets to do so

Summary

- DC members put ESG high on the priority list but not everyone is willing to pay additional fees if it is in an illiquid strategy.
- Private markets in general are seen as not only complex but expensive.
- Liquid, cheaper passive products tied to a benchmark are the most popular investments.
- The government is hoping to change attitudes with its Mansion House reforms and value for money framework.

Although a sustainable agenda is important for defined contribution (DC) schemes, not everyone is willing to pay extra if it is within an illiquid strategy. They are typically more expensive, and investors seemingly prefer the low cost, liquid passive variety favoured by default funds. The UK government would like to change their minds, but it could take time.

Reports show the different sides. For example, a Legal & General Investment Management DC study, which canvassed 4,000 UK DC members late last year, found that despite nine in 10 schemes feeling financially squeezed, environment, social and governance (ESG) investing was still a high priority. In fact, 65 per cent reported that inflation had made them think harder about the need to invest in climate solutions and sustainable food production, in order to increase the UK's long-term economic resilience.

In addition, three quarters would be willing to pay higher fees for increased exposure to ESG private market assets, such as renewable energy infrastructure and affordable housing. The caveat is the funds have to deliver the performance goods, although these views are more popular with baby boomers where only 7 per cent said they were willing to dig deep into their pocket irrespective of returns. The figure rose to 22 per cent for their Gen Z cohort.

By contrast, WTW's latest *DC Pensions and Savings* report revealed that only a quarter of UK schemes were interested in enhancing their investment in ESG strategies if it meant shelling out additional fees. The remainder were reluctant or, simply, did not know if it was the right thing to do. A similar percentage expressed the same views on private markets across the board. Only 26 per cent were willing to trade-off higher charges for increased access to illiquid assets. The survey polled 122 of the FTSE 350 companies and 140 other leading UK employers.

A race to the bottom

Their hesitancy is perhaps not surprising. As Natixis Investment Management lead on the UK DC business, Nick Groom, points out, all funds generally need to have an ESG story, so in private markets this means energy transition, renewables,

social and place-based housing, and then natural capital for biodiversity. "Some of these are hugely capital-intensive projects, or difficult to reach, they may well be great stories for the members, but they come with complexity and risk," he adds. "They also have liquidity profiles that do not suit the daily nature of DC, and it is for this reason that due diligence is far more important, and where a portfolio manager makes his money."

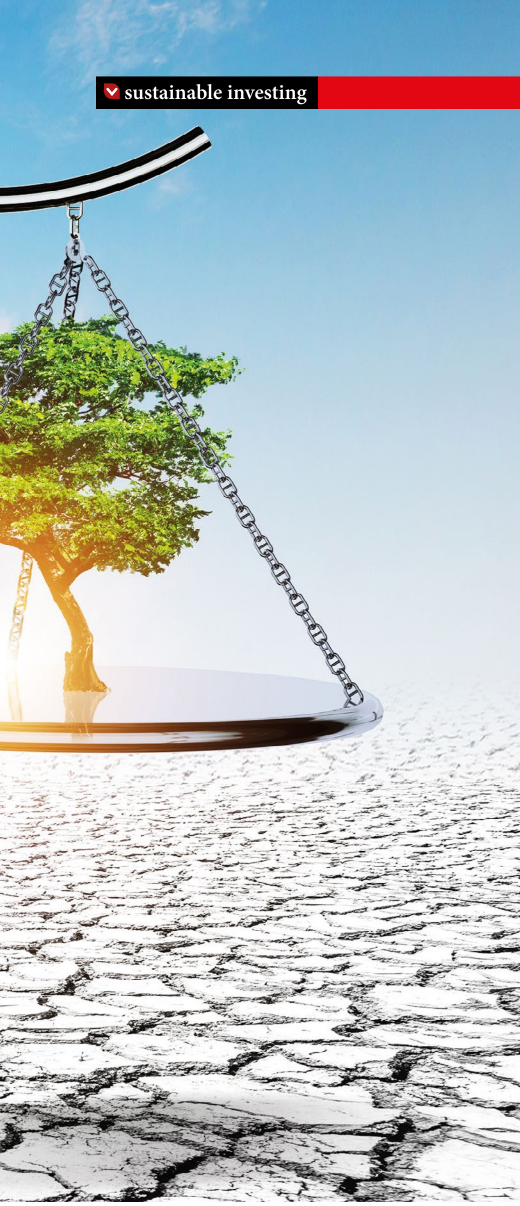
Investors have also been spoilt by the downward trajectory of costs over the past 10 years. WTW shows the average charges for DC pension schemes slid by 20 per cent, from 41 basis points (bps) in 2014 to 33 bps today. "We are seeing many of our clients implement ESG strategies, including many into their default funds," says WTW senior director, DC investments, Anne Swift. "Fees are generally not an issue because they are benchmarked to an index and the management is straight forward."

Hymans Robertson partner and head of DC trustee consulting, Rona Train, agrees, adding that over recent years, there's been a 'race to the bottom' for many DC schemes on fees. Most default strategies have a large proportion of their assets invested in passive investment strategies, which means that most strategies come well below the current charge cap of 0.75 per cent.

"In our view, low fees do not necessarily equate to good member outcomes," she says. "We, as a firm, are playing a key role in shifting the emphasis from cost to value within DC schemes. At the end of the day, what we're looking to achieve are the best long-term outcomes for DC members."

Mansion House reforms

This is exactly the aim of the government's Mansion House reforms introduced last July. It is hoping to unlock up to £50 billion in high growth companies by encouraging DC schemes to cast their nets wider to include unlisted equities, private markets and illiquid assets. To date, nine of the UK's largest pension providers with about £400 billion in combined assets, have pledged to invest at least 5 per cent of default funds into unlisted assets, such as private equity, or early-stage companies by 2030. This compares to the industry's current average of 0.5 per cent.



The government is also hoping its value for money framework will also provide an impetus. Launched in 2021, occupational DC schemes with assets worth less than £100 million have been required to complete a detailed VFM assessment and report their conclusions to The Pensions Regulator (TPR), including whether they propose to consolidate or make improvements if they do not provide good value for members.

Last year, a new and stricter version was put on the table, which could see schemes be closed if they fail meet these objectives or in turn make any improvements. At the moment, it is going through the consultation process and the industry is waiting for the latest update from the Financial Conduct Authority, TPR and the Department for Work and Pensions, according to Mercer head of sustainable investment for UK and Europe, Brian Henderson.

"Until the guidance is made clear, there is a concern that the long-term nature of illiquid assets, including those that are sustainable, may fall foul of well-intentioned short-term performance league tables," he says. "One approach is to look at performance net of fees and hope DC schemes get rewarded for taking on the higher costs of investing in illiquid assets."

"There needs to be more education about the importance of investing in private assets overall and how they can improve outcomes as well as provide sustainable solutions"

Increasing momentum

However, Legal & General head of DC, Jesal Mistry, believes there is momentum across the regulatory gameplan. "Over the past year, a number of new policies have been introduced including reforms to drive value for money in DC pensions, the removal of performance fees from the charge cap for occupational DC schemes and facilitating greater consolidation to create larger pots of capital," he adds. "All of these changes are designed to deliver a DC pensions market with the scale and long-term incentives to prioritise value over cost."

Mistry notes though that legislation is only one part of the equation. It also requires a change in mindset. "It's critical that the industry moves away from the current culture of 'low cost at all costs' and towards considering overall value for money," he adds. "This is all about finding the right balance to deliver the best possible outcomes for members. The DC market has tended to focus almost exclusively on reducing costs. Keeping fees in check is important, but there's a risk that driving down fees at all costs stifles investment innovation and limits the opportunities that DC members can gain access to."

Franklin Templeton head of UK retirement, Lee Hollingworth, echoes these sentiments. He believes there are two factors that will influence a change in behaviour. One is where schemes reach a scale where they can explore alternative asset classes to improve their member outcomes. The second is regulators pressing for governance processes to move from a cost to a value focus, through their new value for money framework that will place a greater emphasis on the net investment returns being achieved.

"Behavioural change will typically take time to embed itself within the value chain," he adds. "Change will happen incrementally, with schemes first making small allocations to private markets, increasing these allocations in response to industry demand and in time schemes will compete based on net investment returns rather than price."

Swift also believes that there needs to be more education about the importance of investing in private assets overall and how they can improve outcomes as well as provide sustainable solutions. WTW is also working with clients to help them better understand the government's value for money framework and the focus on outcomes and not just the cost.

Although the debates and discussions will continue, all agree that smaller trust schemes will eventually congregate to become master trusts and be equipped to tackle the issues of investing in illiquid markets from an ESG perspective. They are already researching opportunities in private markets with a sustainability focus, including carbon trading.

Written by Lynn Strongin Dodds, a freelance journalist