ESG and illiquid assets – coming together within DC?

Summary
- The UK government is encouraging DC schemes to increase their exposure to illiquid asset classes.
- These investments are a natural fit with ESG, especially in sectors such as renewables, healthcare, social housing and infrastructure that tackles climate change.
- Younger DC members are willing to pay higher costs for these assets although the trustees are less keen.
- It is early days and schemes are just beginning to look at incorporating ESG criteria into illiquid assets but there needs to be a greater understanding of the opportunities and risks as well as better available data.

Lynn Strongin Dodds explores how the government's recent efforts to increase illiquid asset investment within DC schemes fit in with ESG priorities rising up investors' agendas

Illiquid assets are often not featured in UK DC schemes, but the government wants them to play a bigger role. There has been a slew of initiatives that dovetail nicely with sustainable investments. However, it will take time before robust environmental, social and governance (ESG) frameworks will be developed for the DC market.

Increasing illiquids in DC initiatives

The first step is to encourage DC schemes across the board to embrace the recent Mansion House reforms that were recently announced. The Mansion House Compact in particular is seen as an important move, although few expect it to significantly move the needle. This is because the aim is to get DC schemes to invest just up to 5 per cent of their default funds into unlisted equities by 2030. However, it boasts an impressive roster of signatories including Aviva, Scottish Widows, L&G, Aegon, Phoenix, Nest, Smart Pension, M&G & Mercer, and others are likely to follow.

The compact follows on from the launch two years ago of the Long-Term Asset Fund (LTAF), an open-ended authorised structure with a much wider remit. Private equity is on the list but so is venture capital, real estate, private debt and infrastructure. Unlike most existing retail vehicles, they do not offer daily dealing, but fund managers have to align their redemption terms with the liquidity of their underlying assets.

Schroders head of UK defined contribution, Tim Horne, points out that in the past, the perceived need for daily liquidity and the requirement to meet permitted links rules had been major obstacles for DC funds looking at private assets. He said that these issues were typically overcome by allocating to a diversified growth fund, which blended illiquid assets with more traditional liquid assets, such as equities and bonds.

Incorporating ESG

The LTAFs reduce these risks and enable DC schemes to look at investments that sit within the ESG sphere. "Whilst LTAFs are not required to allocate to sustainable investments, the very nature of investing for the longer term means there is a natural fit with the likes of renewable energy infrastructure, natural capital, waste prevention, sustainable forestry and regenerative agriculture," says Horne. "This supports DC funds in being able to clearly showcase the ESG benefits of their investment."

One of the most popular ESG investments in DB world is infrastructure, which covers water, energy, roads, airports, railways, ports, satellites and communications systems, as well as hospitals and social housing. They not only provide stable income in volatile times but also act as a hedge against inflation and are seen as a good use of capital.

To date, most of the projects have been tied to a climate change theme.

This can be seen in the Investment Association's 2021-2022 survey, which was published in September. It noted that renewable energy projects comprised a significant proportion of investment in UK infrastructure projects, which mainly consist of offshore and onshore wind farms.

A bumpy road ahead

While no one refutes the advantages of private markets and ESG investments, market participants expect the road ahead will be bumpy, and take time to get all the participants on board, especially with higher inflation and interest rates. As a result, the Productive Finance Working Group (PFWG) is urging schemes to evaluate illiquid investments in terms of value rather than cost and lengthen their traditional one-to-three-year investment time horizon.

This will not be easy. As Legal & General Investment Management (LGIM) head of DC investments, Jesal Mistry, points out, there is currently a conundrum between the views of DC fiduciaries and members. "What we have seen is that younger members are very interested in investments, such as renewables, social housing and hospitals, which have a positive impact on society," he says. "However, for the fiduciary there is some element of shifting their focus away from short-term, low-cost investments to those that can create value for money."

The dichotomy is reflected in two recently published studies. In LGIM's survey, ESG considerations are a priority for DC savers despite the rising cost of living. Around 65 per cent of its survey respondents said that higher inflation focused their minds even more on companies that could bolster the UK's long term economic resilience while a "clear majority" would be willing to pay higher fees to invest in private market assets such as renewable energy infrastructure and affordable housing.

By contrast, WTW's latest defined contribution pensions and savings report revealed the majority of those managing pension schemes were reluctant to accept higher fees in return for a greater emphasis on ESG investments or access to diversified asset classes. One of the main reasons is that they did not want to relinquish the savings achieved over the past decade. The report noted that the average charges for DC pension schemes in the UK dropped by 20 per cent, from 41 basis points (bps) in 2014, to 33 bps today.

"In the current interest rate environment, it can be more difficult to convince fiduciaries of the benefits of investing in private markets and the rewards that can be achieved with taking a longer view," says Mistry. "However, it was only five years ago that we were having to convince our clients that taking account of ESG matters within their funds was really important. Now there is almost no new investment strategy that does not have an ESG tilt. Therefore, whilst it might take some time, investment in private markets should not be entirely dismissed."

Education is key, according to WTW head of alternative solutions, Katie Sims. "I think illiquid assets lend themselves quite well to incorporating ESG but there is a question as to whether there is a return premium," she says. "For example, there are certain sectors such as solar and wind in the renewable space where there is a lot of capital and demand. The returns will not be as great as in other investments that are not as well established."

Improving understanding

In general, Sims believes there needs to be a better understanding of the opportunities and risks in mitigating the impact of climate change or fulfilling social policy. She also highlights the need for better data to better assess companies with an ESG lens. "There also needs to be an idea of what illiquid assets DC schemes want along the journey," she adds. "For example, they may invest in higher risk assets early on and then have a multi asset portfolio as the individual nears retirement."

Abrdn head of private market solutions, Nalaka De Silva, also believes the right governance frameworks need to be in place such as strong management teams, cashflows and positioning of the company. "When you build a portfolio, it is important to think carefully about the features that will make a sector successful," he adds. "For example, people need social infrastructure such as transportation and utilities, but you need to assess whether it operates responsibility and what are the risks."

Mercer UK, Europe and IMETA head of sustainable investment, Brian Henderson, echoes these sentiments. "Younger members want to invest in companies that can develop solutions for the future, and they are more willing to take a risk," he says. "However, as with all companies, you have to understand what makes it tick, what are the policies, processes and individuals in place that will enable them to deliver those future sustainable solutions."

Against this backdrop it is no surprise that master trusts are and will continue to lead the way incorporating ESG considerations within a default investment strategy. They benefit from size, scale and economies of scale to develop robust structures to evaluate ESG criteria in illiquid assets. "There is a lot of talk about consolidation among master trusts with government consultations to facilitate this," says Janus Henderson director, Dave Whitehair. "Once they reach a certain size, they will be able to have the resources to build out the governance needed to assess illiquid assets at meaningful levels, including ESG considerations."

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