Summary
- UK pension scheme holdings in UK shares have fallen significantly since the turn of the century, in favour of a more global investment approach.
- The trend towards overseas allocations is set to continue, particularly as the DB market continues to mature.
- The DC market could present an opportunity for pension scheme money to be invested in the UK as part of a post-Covid-19 recovery effort, particularly around illiquid assets, but challenges remain.

No place like home

Pension schemes have shredded their home bias to expand their horizons to global opportunities. But as the UK looks to build back better, Sophie Smith considers whether some schemes could be tempted closer to home

It's often been said that business dividends are 'paying our pensions', and many Brits may still think of the success of the domestic market as being intrinsically linked with their own pension investments.

But this connection may not be as clear as it once was. Research from the Trades Union Congress (TUC), Common Wealth, and High Pay Centre, recently revealed that the proportion of UK shares directly held by UK pension funds fell from almost one in three (32.4 per cent) in 1990 to less than one in 25 (2.4 per cent) by 2018, representing a more than 90 per cent decline.

According to the report, UK pension funds accounted for over a quarter of the total market value of UK listed shares for nearly 20 years from 1981 to 1998. By 2018, however, this had fallen to 2.4 per cent for direct ownership, and 6 per cent when including indirect ownership, while the proportion of UK shares owned by overseas investors rose from 12 per cent in 1990 to 55 per cent in 2018.

This is perhaps unsurprising, with a report from the Pensions Policy Institute (PPI), supported by the Department for International Trade, concluding that while domestic markets are the most familiar and easiest to access, the global capital markets greatly exceed any single domestic market in size, diversification and breadth of opportunity.

Legal & General Investment Management (LGIM) co-head of DC, Rita Butler-Jones, also explains that whilst DC schemes had previously shown "significant bias" towards UK investments via equities, this was primarily due to the view that UK members will take benefits in sterling, so it was better to have a larger holding in the UK to remove currency risk.

"However, as UK DC arrangements grew in size, they have looked further afield, particularly with a view to diversifying risk across different asset classes, regions and sectors, but

also looking for wider investment opportunities in order to provide better outcomes for members," she explains.

Mercer head of intellectual capital UK DB investment consulting, Wayne Fitzgibbon, also emphasises that this has been a long-term trend, not recent, with most UK schemes taking a global view of equity investing.

And similar trends have been seen in the DB market, as Mercer's *European Asset Allocation Survey 2021* reveals that holdings in UK equities have also decreased significantly amongst DB schemes since the survey was started in 1993, with 26 per cent of DB schemes expected to further decrease their domestic equity allocation in the futures.

Indeed, M&G institutional business director, John Atkin, describes UK DB activity in UK equity markets as "a drop in the ocean", emphasising that DB schemes have had to shift to the appropriate asset allocation for their current set of circumstances.

LGIM head of fiduciary management, Tim Dougall, agrees that whilst that a drive for more globally diversified equity investment has played its part, the appetite of maturing DB schemes for liability-matching bonds has been the more important factor.

"The increasing sophistication of trustee boards and the growth of outsourced investment arrangements have also led to an increase in allocations to private markets and alternative asset classes, driven by a desire for better portfolio performance with lower overall risk," he explains.

Follow the yellow brick road

Redington investment consulting team director, Mathias Rasmussen, predicts that the trend of diversifying into global investments is set to continue, stating that "many investors will have experienced the benefits of international diversification in recent years and will want to continue enjoying those, whilst the more UK-focused investors may have been given a reason to consider changing tack."

Some changes may be on the horizon, however, as Dougall notes that whilst larger DB schemes have typically led the charge overseas, it is now easier and cheaper for small schemes to access a broader range of investments.

"The Pensions Regulator is encouraging schemes to improve their investment governance arrangements and de-risk their portfolios further as they move towards their long-term funding objectives," he explains. "When it's finalised later this year, the new DB Funding Code of Practice is likely to act as a catalyst for further change."

Despite this, risks around a global approach to investing remain, with Butler-Jones arguing that it is "vital" that UK pension schemes understand where they are invested, particularly aspects such as the regulatory regime in different regions or indeed the liquidity risks.

Rasmussen identifies currency risk as the main consideration, clarifying however, that it is "usually straightforward to hedge".

"You can get GBP-hedged share classes for some overseas funds and otherwise a lot of pension schemes have LDI managers that can put on currency hedges using the same collateral pool to minimise cash drag," he explains. "It can sometimes be beneficial to not fully hedge currency risk, however – for more volatile assets like equities, depending on the currency and the time period you look at, you can find that having some unhedged currency exposure provides diversification and reduces overall risk."

Echoing this, Atkin points out that whilst there is an implicit hedging most want when investing overseas, some may specifically want a currency volatility, whilst others may take the approach that the risk will balance in the end and "all things will equalise".

And whilst most investors would hedge out the currency risk, Atkin states that "actually the cost of a currency hedge when put against the return expectations of a growth portfolio is de minimis, so they're not that worried about the cost of hedging".

In addition to this, Butler-Jones notes that many UK based companies are global in nature and therefore already take currency risk within their business, which means that even by investing solely in the UK, investors are not completely immune from it.

Getting homesick in a crisis

Despite the longer-term trend away from home bias, the pandemic has placed renewed focus on the need for domestic investment, with the government recently challenging pension schemes to help trigger an investment 'big bang' by investing in UK infrastructure projects.

According to Fitzgibbon, most schemes have looked at this issue since the government announcement, particularly infrastructure.

"Anecdotal evidence suggests a significant percentage of schemes will increase exposures, but predominantly from a global perspective," he says, clarifying however, that, because certain opportunities, such as social infrastructure and affordable housing are more plentiful in the UK, UK weightings within an global allocation could rise.

Butler-Jones agrees that the push from the UK government on using pension scheme money to invest in long-term projects together with the general market discussions around illiquid assets will drive a push, with the initial focus being on UK infrastructure projects.

"However," she clarifies, "there is much work to be done to make this accessible for UK DC schemes in particular, not least the issue of low cost versus value for money, which are not the same thing."

Indeed, the PPI's report suggests that while it is likely that the trend towards global investments will continue to grow, particularly amongst DC schemes, challenges around practical implementation and/or cost still remain.

"Familiarity and understanding are key factors for overcoming these

challenges, along with increased scale and resources," it says. "Finding the right partners to work with is an important part of the global investing process. Choosing a reputable global custodian will help ensure the safety of global investments and effective operations."

Amid the pandemic, many consumers have also placed a renewed focus on the importance of social and climate issues, with many looking to support local businesses amid the challenges of Covid. And this may be feeding through into their attitudes on investment, with industry research suggesting that savers are increasingly aware of the impact of their pension investments.

"Our research into engaging with members has definitely shown that if individuals can connect better with their investments then they are more likely to engage with them," Butler-Jones says. "It seems logical that if members can connect their investments to making a positive difference in their local communities, then they will be more engaged."

Dougall also points out that whilst equity holdings provide DB schemes with a "fantastic opportunity to influence companies' behaviour at a global level", private market portfolios are typically more concentrated due to the illiquid nature of the underlying investments, which restricts geographic diversification.

"As a result," he explains, "many schemes will have a preference for investing locally in these markets, seeking to generate strong returns whilst also helping to develop regional and national infrastructure, improve housing stock, and regenerate local economies".

However, Butler-Jones notes that there are groups of members who want their money to work as hard for them as possible following the pandemic, which may not always be possible in the UK.

Adding to this, Atkin argues that the vast majority of pension schemes will simply view matters through the lens of what risk taking the most efficient way to get the outcomes might meet. "They will not be drawn into emotional arguments about funding the UK or anything like that," he says, emphasising "that's not their job".

However, he acknowledges that whilst the DB market may not be ready to wade back into the riskier waters to increase their investment in UK equities, the government could look to the growing DC market to find ways of funding its plans to 'build back better' – although it will need to tackle issues on daily dealing and liquidity requirements.

Indeed, the government has already set its sights on funds from the Local Government Pension Scheme (LGPS), announcing plans to work with the LGPPS to set a target for at least 5 per cent of assets to be allocated to local projects. Whether this is a challenge or a trend towards compulsion is yet to be seen.

Written by Sophie Smith