Meeting the call to action

DC schemes are being urged to invest in private markets, but how can they achieve this is and what are the challenges? Lynn Strongin Dodds investigates

Summary
- UK DC schemes are being encouraged to invest in private markets to help bolster and grow the economy.
- Private market investments can also be aligned with sustainable goals such as energy transition.
- LTAFs are expected to gain traction for single or multi-strategy approaches.
- Despite LTAFs and new solutions, investors need to understand these assets are illiquid, complex and more expensive.

Private assets have not been a feature of DC schemes but that is changing due to regulatory pressures, shifting investment tastes and more accommodating structures. However, there still needs to be greater understanding of how these markets operate and the challenges.

Intentions will have to be made clear this October when all trust-based DC schemes will be obliged to state their policy on illiquid assets within the statement of investment principles, including whether there are plans to increase allocations to illiquid assets. There is also a push by the government's Mansion House Compact to allocate 5 per cent of the default fund assets to unlisted equities over the next six years, according to Mercer UK wealth leader, Tessa Page, adding that the consultant along with some of the other UK's largest DC providers has made the commitment.

Page notes that former Chancellor, Jeremy Hunt, said that if all UK DC schemes pursue these opportunities and invest, there could be up to £50 billion funnelled into these markets by 2030. "However, the pace of investment to date has been a trickle rather than a flood – with both operational and strategic factors driving this," she adds.

Gauging interest

The interest is certainly there if the latest study by the Defined Contribution Investment Forum (DCIF) is anything to go by. The report found that 42 per cent already invest in illiquid asset classes. Around 28 per cent were actively planning to do so with only 9 per cent not having any intentions over the next three to five years. As for asset classes, private equity, private debt and infrastructure were the most popular.

The overall demand is reflected in McKinsey *Global Private Markets Review 2024*, which showed that private markets' assets under management totalled $13.1 trillion as of 30 June 2023, a growth of nearly 20 per cent per annum since 2018.

The main drivers cited in the DCIF report were better risk adjusted returns, greater variety and a much wider opportunity set. "Investing in private assets gives schemes diversified exposures to different asset classes at different points of the economic cycle," says Capital Cranfield professional trustee, Paul Watson. "DC schemes also do not give up financial returns by investing in these private assets, which in absolute terms might expect to provide between 8 and 10 per cent net."

Investors are also spoilt for choice in that increasingly corporates are shunning the exchange limelight. Figures from the World Economic Forum revealed that in this year alone, $120 billion has been wiped off global public equities due to delistings, the third consecutive year of decline.

"The trend started over 20 years ago with US stock exchanges now having roughly a third fewer companies than in 2000," says WTW senior director DC investments, Anne Swift. "The benefit of investing in private companies is that investors can tap into their growth story because much of this happens before they list. These investments also chime with the demand for more sustainable investments because many of these companies are based around generating a positive impact for the planet and society."

Legal & General Investment Management head of DC, Rita Butler-

Jones, agrees, noting that private market investments provide scope to really engage members with their pension funds, as they could potentially see the impacts that their funds are having on real-world issues that matter to them in their everyday lives.

"For instance, private market investments have the potential to demonstrate how pension funds can support projects in areas such as affordable housing, the development of clean energy sources, and building infrastructure such as road and bridge construction," she adds. "They could also help to harness the innovative brainpower of our universities by supporting academic programmes that are seeking to find solutions to societal conundrums, or through backing science and technology schemes."

LTAF impact

Given the complexity and cost, accessing these markets has typically been the preserve of the larger schemes and master trusts with deep pockets and resources. The DCIF study notes that the latter are interested in co-investment over the long term "because of the freedom it gives them to access different asset classes, the lower costs and flexibility".

However, it expects that Long-Term Asset Funds (LTAF) may usurp this approach, with 61 per cent of respondents preferring LTAFs with only 16 per cent of respondents looking at co-investments. First mooted about four years ago, they are designed to provide easier, simpler access for DC investors to long-term private markets. They are structured as alternative investment funds to include at least 50 per cent of long-term illiquid assets. They have been slow though to come to the market but are expected to gain traction because they provide flexibility and control over asset allocation, while outsourcing some governance aspects to the provider.

To date, one of the most common approaches being adopted is the so called 'open architecture' LTAF, where investment services are sourced from an in-house manager or external counterpart if they lack specialist expertise.

Overall, whether through a LTAF or other vehicles, DC schemes are looking at two ways to invest in private markets. The first is a multi-asset fund diversified across a broad range of assets such as private equity, private credit, real estate debt and natural capital. The aim is to diversify and enhance performance when integrated within the main default fund at a fixed percentage – at around 5 per cent across the glidepath.

The second is a single asset class or strategy within a default fund. This could be private equity fund that targets sustainable investments for energy transition aligned with the Paris climate change agreements. More sophisticated pension schemes are likely to look for best-in-class investment services for each of the asset classes to ensure the best possible management of private markets can be provided.

"Investing in private assets gives schemes diversified exposures"

Challenges to overcome

Although the advantages of private markets are widely recognised, there are still the inherent challenges that even the LTAFs do not fully address. This is because unlike other open-ended funds, there is no daily liquidity, clients are required to provide a minimum notice period of three months, and then may have to wait a month to actually receive the cash. In addition, high fees were mentioned by more than two thirds or 68 per cent as a potential barrier. In the DCIF study.

As Butler-Jones puts it, LTAFs are seen as a good step, but they do not fully solve all of the issues. She notes that management of an LTAF can require a higher cash allocation or alternatively, need decisions on which private markets funds to sell to meet redemptions. In addition, they typically offer monthly dealing, which adds operational complexity for DC platforms that are accustomed to daily liquidity requirements.

"This transition would require infrastructure and administrative changes for the platform," she says. "Regulators also suggest using LTAFs, but it doesn't solve issue of liquidity."

Page echoes these sentiments. "Launch of the LTAF regime is positive in that it has opened up options plus sets minimum requirements for illiquid asset exposure, but they are not a cure-all for accessibility headaches, she adds. "However, most have redemption notice periods, fees are high, and they will take time to build mature portfolios. There are also see non-UCITS retail schemes and funds of alternative investment fund structures being used which in some cases have proved more flexible."

Hymans Robertson head of DC investment, Alison Leslie, also notes that schemes are broadly positive but adds that for most DC schemes, accessing private markets funds will require addition of the funds onto DC investment platforms, likely via an LTAF but potentially through other means.

"Wrapping private market funds into white labelled blended funds along with liquid assets would be a viable method for DC schemes providing their platform has the ability to facilitate the liquidity needs of the scheme's membership," she says. "Larger schemes with greater scale have the ability to access private markets more directly through relationships with external managers or through in-house capabilities."

Written by Lynn Strongin Dodds, a freelance journalist