Summary
• The balance between liquid and illiquid assets is scheme-specific.
• There is evidence that schemes' allocation to illiquids could increase in coming years.
• However, schemes targeting buyout in the near term will need more liquidity.

The liquidity/ illiquidity blend

Maggie Williams considers whether DB schemes are obtaining the optimal mix of liquid and illiquid assets

The role of liquidity in DB schemes' investment portfolios has come under more scrutiny in recent years, driven in part by the growing number of schemes targeting insurance buyouts.

However, for some schemes, there is still a compelling case for investment in illiquid assets, such as infrastructure and private equity, with analysts arguing that in certain circumstances DB schemes should consider more, rather than less, exposure to illiquids.

Over the long term, the trend towards buyout for DB schemes – and therefore a move away from illiquids – looks set to continue. "The strong market recovery since the pandemic, particularly the past 12 months, has seen many private sector DB schemes' funding levels improve considerably," says Hymans Robertson partner, Elaine Torry. "Achieving their long-term objective *[such as buyout]* doesn't feel quite so far away anymore. They are giving conscious consideration to whether the return from illiquids is required, and the extent of the lock-up that they can tolerate."

But despite improvements in funding positions and long-term intentions, buyout may still be a long way off for some schemes. For them, and for schemes focused on self-sufficiency, illiquid assets will remain an important part of their portfolio. "Pension schemes will run different levels of liquidity depending on their overall objectives," says Redington managing director in DB, Karen Heaven. "A pension scheme that intends to run on indefinitely on a low-dependency basis may wish to hold a significant level of illiquid assets in order to benefit from the return premia that these can offer."

River & Mercantile Group co-head of solutions, Ajeet Manjrekar, says that both a scheme's short-term requirements and its long-term aims are important factors when considering the balance between liquid and illiquid assets. "DB schemes are increasingly assessing their liquidity needs. They are becoming more mature and are paying out increasing amounts in pension benefits at a time when deficit recovery plans may be coming to an end."

With markets becoming increasingly volatile, he says trustees are re-evaluating liquidity needs related to their portfolio requirements, such as "meeting regular cashflows *[see boxout]*, increased transfer value activity and LDI collateral requirements".

A place for illiquids

Decisions to increase allocations to illiquid assets are very scheme specific, says Torry: "I wouldn't say there is evidence of a clear and consistent trend or trends regarding the level of liquidity in schemes' portfolios. There isn't an overwhelming rush for schemes to load up on the illiquidity premium, nor is there a 'dash for cash' even in light of the pandemic."

Manjrekar believes that schemes that have properly evaluated their liquidity needs and are able to tolerate illiquidity could consider more use of private market assets. "Examples include credit strategies where investors can benefit from a higher yield for locking up their capital, to longer-term assets, such as infrastructure, that provide strong matching characteristics."

BlackRock head of UK fiduciary business, Sion Cole, says he is seeing this happen in practice. "The overarching trend we're seeing is DB schemes increasing their allocations to private market asset classes. This is, however coming from a very low starting point."

Cole's experiences are borne out by data in the Pension Protection Fund's (PPF) most recent *The Purple Book*, which found the weighted average increase in allocation to private equity doubled between 2015 (9 per cent) and 2020 (18 per cent). "We believe that many institutional investors are underinvested in private markets because they overestimate liquidity risks," says Cole. He believes that, even with the increases seen in the PPF's current figures, scheme allocations are too low: "Our neutral view on a starting allocation to illiquid assets is still higher than [the allocation] many institutional investors hold today."

The PPF's figures also reflect research from Alpha Real Capital in September 2021, which points to a resurgence of interest in illiquids. Alpha Real Capital found that, of the 100 pension schemes it surveyed, 85 per cent expect to increase their allocation to illiquid assets in the next three years. Some of the key reasons for this were improved opportunities and more transparency in illiquid asset classes, but 44 per cent also said that diversification is the driving force.

Alpha Real Capita CDI director, Shajahan Alam, says: "Pension funds are increasingly looking for certainty of returns through contractual cashflows, higher yields and portfolio diversification. This means growing allocations to illiquid assets."

"If a scheme wishes to move out of liquids, the types of assets they should invest in depends on the investment horizon and objective," adds Cole. "For example, if a scheme has higher return needs, they would look for assets providing growth, such as private equity. If they favoured income over returns, they would look towards income or enhanced income assets, such as infrastructure and real estate. Similarly, many clients have an explicit ESG-focus and could consider renewable power, social housing or similar."

However, for many schemes, especially those targeting buyout, managing exposure to illiquids may be about planning a run-off of assets, or maintaining current exposure. For the first of these, Torry says trustees need to think through "the potential impact of fund extensions and run-off tails that can extend beyond the expected lock-up period. In this case the consideration is about how to enable a smooth transition from illiquid to liquid assets". She adds that for schemes looking to maintain exposure to illiquids, the focus may be on re-investing the distribution from illiquids back into other illiquid opportunities.

Liquidity and cashflow

Whatever a scheme's long-term aims, liquidity will always be a crucial part of a portfolio for cashflow reasons. The past two years have given many schemes' cashflow policies a stringent real-world test, as a result of Covid-19.

Hymans Robertson partner, Elaine Torry, recommends trustees should reassess their existing cashflow policies, to make sure that they fully understand their scheme's liquidity profile and identify where liquidity can be sourced from under normal and under stressed market conditions.

LDI strategies can be a good barometer of the liquidity position of a scheme overall, she says. "LDI managers typically carry out monitoring on a daily basis on behalf of schemes and have thresholds and early warning signals to enable plans to be made to meet liquidity demands."

"Use of leverage, particularly as part of any interest rate and inflation hedging, contributes to the need for liquidity," adds Redington managing director in DB, Karen Heaven. "Market movements can mean posting additional collateral within a short space of time." She says that prudently stress-testing a scheme's total potential liquidity needs, both in terms of responding to significant market movements that might require additional collateral, and against other scheme activity, such as meeting transfers-out and benefit payments, should be a regular activity. "Undertake monitoring frequently, and rebalance assets to free up liquidity where there is a need to do so," she recommends.

When to make change

As a scheme's circumstances evolve over time, its need for liquidity will shift too, driven by factors such as a change in cashflow requirements, or when the opportunity to buyout starts to become a reality. "Strategic objectives should guide the triggers for increasing or decreasing liquidity," says Heaven.

Cole says that categorising a portfolio's liquidity into tiers can help to monitor and manage exposure to liquid and illiquid assets. These could range from assets that are daily liquid in normal market conditions, to investments that could take up to a year to liquidate. "It's key to understand these tiers in both normal and stressed market conditions," he says. "For example, in a stressed environment, we view only a few asset classes as being typically liquid over a three-month period." He adds that in severe circumstances, even fewer assets become truly liquid and can be sold with little market impact.

Volatility is likely to characterise asset classes such as equities over the next few years, so the steady returns and long-term investment horizons of illiquid assets, coupled with better, more transparent opportunities, could drive an illiquids renaissance for some DB schemes. However, clearly understanding and monitoring ongoing liquidity needs, alongside the long-term objectives of the scheme, will still be the major determinants in trustees' investment decision-making.

Written by Maggie Williams, a freelance journalist