Going private

Jack Gray explores whether there has been an uptick in demand from DC schemes for private market investment and what barriers exist that are preventing increased allocations

Summary

- Some industry figures have observed heightened interest in private market assets for pension scheme portfolios, including DC default funds.
- However, barriers remain that are making investment in these assets more difficult.
- The government's push to increase DC illiquid investment has raised awareness, but not necessarily resulted in increased demand.
- Despite this, there is confidence in the industry that private market investment has a long-term role to play in DC pensions.

Defined contribution (DC) pension scheme investment in private markets has been thrust into the spotlight amid the government's push to encourage greater allocation to illiquid assets and changes in regulation that will see trustees reporting on their illiquid policies in their Statements of Investment Principles.

While DC schemes have always been able to invest in private markets, the sector is evolving, and some industry figures have observed an uptick in demand for illiquids. However, the government's initiative is not appearing to have as pronounced an impact as it may have hoped, and others within the industry do not believe demand has increased, despite the increased awareness.

Interest rather than demand

"There has certainly been a heightened interest in private market investments," comments Standard Life head of investment solutions, Gareth Trainor. However, he concedes, this has mainly been to understand the asset class, and its potential benefits and challenges, regarding DC investment.

"We are not seeing significant demand for investment into these assets at the moment, at least not for inclusion with an off-the-shelf DC default," he adds.

WTW senior director, investments and LifeSight lead investment adviser, Marc Bautista, notes that while he has not observed huge demand from DC members yet, it is something clients are interested in, as many "recognise the benefits" illiquids can bring to a portfolio.

However, others are seeing different trends. Quantum Advisory senior investment analyst, Joe Condy, states that an increase in demand has not been seen amongst its clients, but there has been some interest through the selection of private market allocations by individual members, although not through default strategies.

"We are aware that demand has increased across the industry as a whole," notes Condy.

Meanwhile, Zedra client director, Richard Butcher, states he has not seen a marked increase in private market investments from DC investors: "DC schemes have always been able to invest in private markets and they have done so where it is consistent with their strategy and objectives.

"The exception to this is some of the very large trusts and master trusts who, perhaps, have been reminded of some of the benefits."

Supply push

There are several potential reasons for why some industry experts have witnessed increased interest. The government's recent push for greater illiquid investment by DC schemes is one, alongside new regulations that will force trustees to consider their illiquid investments and the creation of the Long-Term Asset Fund. Trainor notes that this means increased interest comes from the perspective of 'supply push' rather than 'demand pull'.

"Interest from industry stakeholders is typically driven by stakeholders across the industry keen to know more about the asset classes and the potential opportunities and challenges," he says.

"Or where stakeholders have a DB background and recognise the benefits of illiquids and are keen to see them used in DC. There is minimal support or demand from advisers, employee benefit consultants, employers, trustees etc to include illiquids into DC defaults beyond the 'in principle' support."

Outside of the 'supply push' there are other factors that may make private market investments attractive for DC schemes.

"In an era where returns from traditional asset classes such as listed equities and fixed income are likely to be more modest going forward, allocating to private markets may be necessary in order to achieve decent returns," explains Smart Pension chief investment officer, Paul Bucksey.

Furthermore, Bautista states that the illiquidity premium is "perfect" for long-term investors to exploit, both from a return and diversification perspective.

"The case for DC schemes investing in private markets is becoming clear: Potential for higher long-term performance, diversification from traditional asset classes and inflation protection," says Condy.

"There are also strong opportunities to incorporate environmental, social and governance considerations into private market investments, which are becoming increasing popular with members."

Overcoming barriers

While there are potential benefits in private market investment, there are also barriers that need addressing to help investors access the asset class more easily.

"Private market investment has some merits but also some drawbacks, not least its illiquid nature and the opaque costs," says Butcher.

Condy adds that interest is being deterred by the practical implications, reduced liquidity, costs and barriers to entry of implementing these strategies.

Bautista agrees, stating: "Implementation is still restricted because pure illiquids cannot easily be accommodated through traditional platform arrangements. Work is ongoing, but there are still challenges to be overcome, which is easier said than done, but we believe it's possible."

Bucksey believes that employers and DC consultants need to focus less on charges in absolute terms, and more on the overall value and the quality of the investment proposition.

"Implementation is still restricted because pure illiquids cannot easily be accommodated through traditional platform arrangements"

Understanding the risks

Alongside these barriers, as with any asset class, the risks need to be carefully considered. Liquidity risk is the most obvious, as Trainor explains: "This plays out if the fund overall is shrinking significantly and would impact a customer who may not be able to access their investments when required, and in extremis may prevent a scheme from transferring from one provider to another.

"If due to terms and conditions or other reasons a large scheme leaves a DC default/provider, then the provider maybe left with more illiquids than it requires.

"Performance may be impacted if the assets don't perform as expected, or are performing less well than traditional assets. Given the inability to sell the assets this may lead to longer-term performance challenges, and questions around value for money, especially if poor performance drives towards a 'crowded exit' scenario."

Butcher also points to other risks, including costs opacity, inability to price accurately, and greater volatility and failure risk, while Bucksey highlights higher costs offsetting returns, and manager and sector risk.

However, Condy notes that while the potential risks "seem plentiful", he believes they are manageable if approached correctly.

"Private market investments should also be considered to be high risk," he adds. "We would therefore expect them to make up a part of a well-diversified investment portfolio and be used in conjunction with a range of other asset classes and funds."

Moving forwards

While appetite for private market investment appears mixed, most agree that it will play a role in DC scheme investment going forwards.

"I think private markets/illiquids have to be part of default strategies in order to achieve meaningful scale and have a positive impact on a majority of DC members," comments Bautista.

"We are working on solutions to incorporate more illiquids and true illiquids in our defaults to get the full benefits of the illiquidity premium.

"Initially, I would like to see allocations building up to around 5 per cent true illiquids within a default strategy. That will mean that we've overcome the liquidity challenges and operational barriers, managed to get an illiquid vehicle on a platform solution, and found a way to do it at a reasonable cost and at a good value.

"Once that's done, we can start thinking about what the next stage is. Whether at some stage in the future we can get up to 10-20 per cent, I don't know yet, but let's get to the first target first and then take it from there."

Written by Jack Gray