Summary
• UK equities once dominated pension portfolios, with the remainder invested in bonds.
• Over the space of two decades, DB schemes have shifted their allocations and the proportions have fallen from close to 70 per cent in equities to just 15 per cent – and only a small slice of that is invested in UK equities.
• DC schemes remain heavy invested in equities but are still dominated by global equities, with UK stocks making up a small chunk.
• The government is keen for the pensions industry to get behind the UK economy by investing in British companies, but many argue more will need to be done at policy level.

Finding a way forward

Sandra Haurant explores how the role of UK equities has changed in pension scheme portfolios and whether they will make up a greater share of schemes' asset allocations going forward

UK stocks and shares once made up the lion's share of pension fund portfolios, but over time their dominance has dwindled to a sliver. In July 2023's Mansion House speech, the government expressed its wish to encourage pension schemes to invest in the UK economy. We take a look at the changing role of UK equities, and ask whether they will make up a greater share of allocations in the future.

The traditional role of UK equities

The relationship between domestic equities and UK pensions funds has long been a close one. As Ninety One portfolio manager, Matt Evans, says: "UK equities have *[historically]* been central to allocations as they offered exposure to domestic growth and opportunities, and supported job creation."

In fact, according to Schroders, UK equities made up close to 50 per cent of defined benefit (DB) portfolios in 1962, and they stayed around that level for decades.

As always, it's important to distinguish between DB and defined contribution (DC) pensions, as significant differences can be found. But in this case, for DC, too, the dominant area of equity investment was also UK-based when these schemes got up and running in the 1990s – and that balance has certainly shifted.

"When DC was in its infancy in the 1990s, a lot of schemes just used one manager. They'd have a multi-asset manager, a balanced approach, and that manager had freedom to allocate to equities," Mercer senior investment consultant and partner, James Brundrett, explains. "They would have a large UK domestic bias. And one of the reasons for that was because nobody was hedging any liabilities – they were just investing for growth." Even so, while it was not a primary aim, UK equities matched UK pension funds' liabilities, by their very nature.

And there were incentives, too; a tax advantage on UK equities made them attractive to pensions funds. In short, the advanced corporation tax (ACT) on dividends for British companies was waived, so it was very much in pension schemes' interest to invest in domestic companies.

But all that was set to change.

Crisis, scandal and disincentive

It's impossible to address shifts in pension fund allocations over the decades without mentioning the Robert Maxwell scandal. The discovery, following his death in 1991, that Maxwell had been plundering the company pension fund to prop up his firms shone a light on a dangerous lack of transparency in the industry. This, of course, led to a seismic shift in pensions regulation and management – the reverberations of which can still be felt today.

Brundrett explains: "Companies had to recognise pension scheme assets and liabilities on their balance sheets and impacting their profit and loss statements and so on. That caused the closing of DB schemes and that meant having to run them off. They became more mature and they had to de-risk."

This resulted in a general shift away from equities: "People started buying bonds to match the liabilities, as they had a much closer link to the liabilities."

So, what was the advice for the equity portion of a portfolio? "It was essentially that you still needed some equities, you still needed to get a good return, but you had the bonds that were matching your liabilities now. So you didn't really need them to be UK equities," Brundrett says.

Add to this a marked concentration of equities in one sector – namely, in the late 1990s and early 2000s, the swiftly inflating tech sector. "A lot of the advice was to diversify," says Brundrett. "And what great advice it was because in diversifying their equity allocations, most schemes would have gone global."

Indeed, as Evans says, some of the main reasons behind a move away from UK equities can be summed up as: "De-risking of portfolios, a shift in pension funds to really worrying about costs, and a belief that global is better."

But there was another turning point in the 1990s too. In 1997, as part of his first Budget, the then-chancellor Gordon Brown removed the ACT credit, a move that was widely considered to equate to the lifting of a key incentive for UK pension funds to invest in domestic equities.

Today's still-changing landscape

According to Mercer, the shift away from UK equities is part of a much wider move away from that asset class altogether for the DB universe. In its 2022 *UK Asset Allocation report,* Mercer said that DB pension fund portfolios in the UK contained 68 per cent equities and 31 per cent bonds in 2003. A decade later, in 2013, the balance had tipped to 39 per cent equities and 47 per cent bonds. And in 2022, equities made up 15 per cent of allocations, while bonds were up to 52 per cent, with growth fixed income and 'other' (including cash, hedge funds, real estate and private equity) forming the remainder.

In DC, though, it's a different picture. Within master trust schemes, equities continue to play a leading role. The Pension Policy Institute's *DC Future Book 2022* shows that: "On average, master trust default strategies allocate more than two thirds (70 per cent) of assets to equities 20 years before a member's retirement date." But the proportion of UK equities remains comparatively slim. "Among master trust respondents that were able to provide a more detailed breakdown of the types of equities within which they are invested, 48 per cent of overall assets under management (AUM) were allocated to global developed market equities, 19 per cent to UK equities, and 7 per cent to developing markets," the report says.

A major reason for this is the relative youth of DC schemes, explains Brundrett. "Most *[DC]* savers are in the early stage and not at retirement yet, so the majority of the money is going into equities." And again, the global exposure here is important – tipping too far into domestic stocks would mean reducing exposure to other world markets – in particular the US – which hold the growth potential that schemes require.

What does the future hold?

The Mansion House speech in July 2023 called for reforms that would encourage pensions to invest in UK high-growth companies – including unlisted firms. The aim, as Conservative MP Andrew Griffith said in parliament, is "providing returns for savers, funding for businesses, and investments for our economy".

Not everyone agrees that a shift back to higher proportions of UK equities – listed or otherwise – is desirable. "Maintaining a global investment universe will give members access to the widest possible opportunity set for their members. Any allocation to UK equities – along with any specific market – should be supported by a clear rationale and conviction that it will improve member outcomes," says BlackRock head of DC strategy for EMEA, Dominic Byrne.

But there are some who are in favour, when taking valuations of UK stocks into account. Evans is optimistic: "The future should be looking up. There has been such a reduction and move away, that levels are so low the opportunity to increase exposure is looking more compelling," he says. "Valuations are well below historic levels and the UK looks cheap relative to other global markets. Questions around liquidity and the UK economy being under pressure could be overcome by looking at the underlying companies that are in many instances competing successfully on the global market and trading at discounts to global peers."

In any case, if the plan is to encourage pensions to pour funds into the UK, many argue that plan has room for improvement. "Our government is now interested in making sure that pensions get behind the domestic economy, and in part the role they can play is providing capital for investment, so they are looking at ways to encourage pension schemes to do that," says Brundrett. "And if they are serious about that, then there are going to have to be some incentives, and the disincentives will need to be addressed. That will apply to listed markets, as well as private markets."

Written by Sandra Haurant, a freelance journalist