What do DC scheme investment gatekeepers think about illiquid assets?

A Pensions Policy Institute Project
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What do DC investment gatekeepers think about illiquid assets?

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- *This work, sponsored by the DCIF, is designed to explore DC scheme decision-makers' beliefs around investing in illiquids*
- *The following slides set out the views of gatekeepers to the private markets universe (trustees, consultants, asset managers and schemes) who were interviewed for this project*

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Methodology

- *The opinions contained in this slide deck were gathered from interviews with ten "gatekeepers" of DC scheme investment decisions: four consultants, two trustees and four DC scheme providers which took place between 19th April and 7th May 2021. These people worked with contract and trust-based DC schemes from, very small single trust DC schemes with less than £100m in AUM to very large master trusts worth around £20bn.*
- *The following text represents the beliefs of the interviewees and does not necessarily reflect the views of the PPI or the DCIF.*

Contents

- *Myths*
- *Barriers*
- *Who needs to drive change and what change needs to happen?*

MYTHS

Myths

The following "myths" were generated by the PPI, the DCIF and those interviewed for the project. They are not exhaustive, but most interviewees felt that the main beliefs were covered:

1. Illiquid investment is about searching for higher returns which may not materialise
2. Daily dealing requirements of platforms hinder illiquid investment
3. Small schemes can't access illiquid assets
4. Illiquidity risk is too high in many cases for schemes to invest in illiquids
5. Regulation prevents access to illiquids
6. Higher charges associated with accessing private markets will be passed on to members
7. Private markets are riskier than public markets

"Myth" 1: Illiquid investment is about searching for higher returns which may not materialise

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- *Illiquids are not just about returns, also about risk-adjusted returns, diversification and a wider opportunity set, although investors should receive higher returns on average*
- *However, returns are uncertain, and this needs to be taken into account*
- *And all results depend on the type of illiquid assets used*

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"Myth" 1

"Some people focus on the return point and think illiquid strategies are just for younger members and just for the growth stage. But illiquids are really about diversification. It's frustrating that people question the rationale for illiquids when it's already being done in DB" – Consultant

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Illiquids are not just about returns:

- **Illiquids investment is about: the search for higher risk adjusted returns, a source of diversification, access to different asset classes (a wider opportunity set) in a growth strategy, and a way of helping schemes to be more resilient to economic shocks**
- **Trustees' fiduciary duty is to look at the net investment, but diversification and downside risk management are important to consider, especially if you can achieve similar returns while doing this**

Investors should receive higher returns on average

- **Higher returns may not materialise everywhere, but illiquid assets should offer a premium over the public market**
- **If you are going to lock assets up for a long period of time you need to be rewarded for that, and there genuinely is an illiquidity premium; otherwise why would you do it?**

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"Myth" 1

"Keep in mind member protection and the tension between the quest for yield, member interests, illiquidity premia and the need for diversification" – Trustee

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However, returns are uncertain, and this needs to be taken into account

- You can get let down, if returns fall from a promised 8% to 5% it makes you question how worth it investing in these assets was
- Investors can't go into it blindly, they have to know what they are doing, start suspicious and uncomfortable and then get comfortable

Results depend on the type of assets

- These assets should offer higher returns with lower risk depending on your choice of asset - with private debt or credit, you are lending money to an organisation and they are agreeing to pay you a relatively secure contractual return. If the business doesn't go bust it can be a nice stream of income at a higher rate than a corporate bond
- Obviously some illiquids offer higher returns but results depend on how good you are at picking the right assets
- Due diligence is vital

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"Myth" 2: Platform's daily dealing requirements hinder illiquid investment

- *Daily dealing prevents direct investment into pure illiquids, but there are semi-liquid funds available*
- *Daily dealing creates some barriers, and may be unnecessary*
- *You can structure funds to work within a daily pricing structure, though not all platforms are flexible*
- *Platforms are well suited to most schemes*
- *Those not using platforms will find illiquid investment easier*

"Myth" 2

"Platforms will struggle to host fully illiquid funds."
- Consultant

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Daily dealing prevents direct investment into pure illiquids, but there are semi liquid funds available

- There are semi liquid, multi-asset, funds available on platforms which include private debt, some private equity, some access to small amount of infrastructure
- It's easy if you want an off the shelf fund, but there are not many options – mainly partners group and funds provided by some small asset managers

Daily dealing creates some barriers, and may be unnecessary

- Daily dealing is a challenge but it shouldn't prevent investment, daily pricing is the real issue. Prices have to be shown to members and there is a need to have liquidity structures in place to meet redemption and transfer requests
- Is daily dealing really required in a DC arrangement?
- The real myth is that daily dealing is required

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"Myth" 2

"For workplace schemes not using a platform is difficult because you have to offer members the option to move their money between funds and/or out of the scheme, this constraint is really important." – DC scheme

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You can structure funds to work within the daily pricing structure, though not all platforms are flexible

- Daily proxy valuations can be constructed but the process needs to be fair between members from a trustee and platform manager point of view
- You need to be careful about how proxies are generated - monthly (or quarterly evaluations at a push) are okay, but being too illiquid rules some assets out as the proxy evaluation points lose relevance
- Some providers have refused to put partners group on platform - even when you think people have cracked it, you end up with the same problems – platforms are nervous about gating
- Some platforms are more flexible than others. Even if fund managers say they can construct a fund with daily evaluations but not daily trading some platforms still say no. At this point you either need to get a fund manager to change the fund or get a more flexible platform

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"Myth" 2

"Daily dealing is a direct result of the permitted link requirements, these platforms were built around the necessity of daily dealing from top to bottom in order to help schemes comply." DC scheme

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Platforms are well suited to most schemes

- Schemes use platforms for good reasons such as efficiency, scale economy, reductions in complexity
- If you go off platform, complications are introduced in regards to member record keeping etc

Those not using platforms will find illiquid investment easier

- If your scheme is not on the platform then it is easier to get round daily dealing issues
- Permitted links does not affect schemes which are off platform
- You can go off platform with scale in development and that allows easier access to private markets, most private market illiquid funds are unlikely to be a permitted link

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"Myth" 3: Small schemes can't access illiquid assets

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- *It's a lot harder for small schemes*
- *Governance is a key barrier*
- *Those intending to consolidate are unlikely to invest in illiquids*
- *Pooled funds could help small schemes*
- *Some small schemes could invest through a platform*

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"Myth" 3

"There is a clear consolidation agenda and this is the biggest barrier for small schemes" Trustee

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It's a lot harder for small schemes

- It's very challenging for a small scheme to invest off its own back and certainly more difficult for them to invest directly in illiquids
- Often there is a minimum initial amount of £10m or more - a scheme with AUM of £40m would not want a quarter of AUM in one investment considering that one of the great benefits of illiquids is diversification and investing this proportion would significantly dilute diversification

Governance is a key barrier

- The governance budget and cost that goes with illiquid investment is the real issue
- Once you have invested the available manager skill into equity and credit beta – the governance resources run out

Those intending to consolidate are unlikely to invest in illiquids

- Those intending to consolidate into master trust schemes will not invest in illiquids because then they won't be able to move funds quickly when the time comes

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"Myth" 3

"Most small schemes are not awash with budget and are poorly governed" DC scheme

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Pooled funds could help small schemes

- Small schemes could go through a pooled vehicle, though there are only a few of these available. There could be a lot more pooled funds available in the future which large single employer trusts may start using but schemes may also decide it's all too difficult, so there's a 50/50 chance that this could happen
- A massive pooled fund is quite attractive, especially if it includes various investments with different time horizons to allow more liquidity. However, how do you start this fund?
- The Long Term Asset Fund might help but this is also an unknown

Some small schemes could invest through a platform

- Semi liquid funds are sitting on platforms. Any DC scheme can invest in illiquid assets through a platform. There may be some differences in return and diversification potential, but not a major difference
- There are funds on platforms but we could do with more funds

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"Myth" 4: Illiquidity risk is too high in many cases to justify investment

- *Illiquidity risk should be easier for cash-flow positive schemes, especially master trusts to manage*
- *Some schemes will struggle with illiquidity risk*
- *The level of risk depends on the assets used*
- *Investing a prudent amount will help to contain the risk*
- *A liquidity cross-subsidy would reduce the risks faced by individual members*

"Myth" 4

"Illiquidity risk is just an excuse that people use, illiquidity is a fantastic opportunity for all investors, DC included. There are legitimate challenges, but this is not one of them" – Consultant

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Illiquidity risk should be easier for cash-flow positive schemes, especially master trusts to manage

- If you understand your scheme well and are cash-flow positive you should be able to make a small but significant allocation to illiquids
- Small, single employer, schemes could face a sudden exodus of members and would have to make redundancies and switch pensions, creating the potential for huge outflows - and in this situation if you are carrying a lot of illiquids that could be a huge problem. A multi-employer scheme does not face these issues

Some schemes will struggle with illiquidity risk

- If you can't get your money in or out on a daily basis that's just a hurdle too far at this stage
- How do illiquids work with life-styling or at the point of retirement? How do they work with drawdown if you have to shift everything over, sell down all illiquids, switch providers and then invest in illiquids again?

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"Myth" 4

"DC schemes have far too much liquidity. Within a week any DC scheme could liquidate their entire portfolio to cash."
Consultant

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The level of risk depends on the assets used

- There is a mixed bag between illiquid investment managers, some known, some unknown. If you go with unknowns you are taking a serious risk and you have to manage that reputational risk as well as the return risk (scheme funder and member risks are aligned in this)
- It depends on the vehicle that you are using and the nature of the underlying asset class, property can work well in life-styling, for example

Investing a prudent amount will help to contain the risk

- the risk is going to only be too high if you are over concentrated in illiquids and if your investment strategy doesn't suit your scheme, but at 5%-15% you should be fine

A liquidity cross-subsidy would reduce individual risks

- People with larger pots can subsidise admin for smaller pots but we are uncomfortable with a liquidity cross subsidy. These should not be an issue for cash-positive schemes. You can add in design features, such as selling out all illiquids by age 50 etc

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"Myth" 5: Regulation prevents access to illiquids

- *Some believe that regulation is a barrier*
- *Others believe that regulation provides no barrier*
- *However, cost pressure from market competition has created difficulties*
- *The market should be pressured to change the cost structure of assets*

"Myth" 5

"If your scheme is priced at 0.5% and you make a 10% allocation to illiquids, this could bring the total member cost up above 0.75%, therefore absolute affordability is a challenge." DC scheme

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Some believe that regulation is a barrier

- Performance fees worry some people - the charge cap methodology and testing over different periods is very complex. Trustees are unlikely to make an investment that means they could breach the cap and get in trouble with the Regulator
- The Value For Money regulations and the push for consolidation are barriers - they focus on costs and demonstrate to members that costs are everything - you either pay more and have access to a wider opportunity set including infrastructure or you drag costs lower
- Performance fees - the idea that you can accidentally make members too much money and then have to compensate them is ridiculous - maybe just cap performance fees and bring them out of the charge cap, though this is still sub-optimal
- The charge cap will impact more on small schemes because they are likely to have less purchasing power and higher admin costs, it will take up more of the 0.75% to invest in illiquids

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"Myth" 5

"Regulation is a red herring." Consultant

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Others believe that regulation provides no barrier

- Performance fees are not a barrier, they are an aspect that schemes need to consider and work their way through which may involve more governance but can still be done
- As long as you don't have a strategy full of illiquids then regulation is not a barrier
- The charge cap is something you have to consider but it is not a barrier - it is not stopping investment innovation
- It's not the regulation itself that's the issue - look at NEST, they are also affected by these regulations. NEST has shown that if you have the head space and the structure it can be done, though NEST also has the advantage of scale
- Regulation is not a hindrance in itself. The charge cap is a limit, but it is really the competitiveness in the landscape that provides more of a hindrance. Schemes should be able to innovate within the constraints of the current regulations

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"Myth" 5

"The proposals in the consultation will help but we are in danger of pandering to an existing charging structure that doesn't really work." - Trustee

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However, cost pressure from market competition has created difficulties

- To be competitive, schemes have to offer a flat rate charge between .2% and .5%; if these go up to .6% plus a variable rate on top, schemes cannot remain commercially viable, especially if this increase is only for 10% of the investment portfolio
- The attitude towards cost in the DC sector arises from post automatic enrolment competition rather than the charge cap
- The DWP consultation around consolidation is going to be mostly about comparing prices. DWP's focus is on low cost and this is driving the direction of travel

The market should be pressured to change the cost structure of assets

- The message should be that if private markets want investments from this rapidly increasing part of the market, then they need to adjust. There is no reason for performance fees. The government consultation should have been aimed at private markets; you need a market that is synergistic with the investors

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"Myth" 6: Higher charges associated with private markets will be passed on to members

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- *Most schemes pass extra costs on to members, but these costs should be justified*
- *By shifting budget allocation, you can avoid increasing member charges*

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"Myth" 6

"In a DC space members pay fees so this is true by design, but they will benefit from higher and more stable returns arising from greater diversification. " - Trustee

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Most schemes pass extra costs on to members, but these costs should be justified

- Illiquids are more expensive and there must be a premium for this. For trustees the key point here is the value it delivers and the net benefit for members, if something is more expensive it has to be proven to deliver that net benefit
- Naturally the cost will be passed on to members, but this needs to be calculated in risk and reward. If the investment strategy improves outcomes, then it's worthwhile

By shifting budget allocation, you can avoid increasing member charges

- Allocation to private markets can go up without total member charges rising, though it may mean spending more of the fee budget, and/or shifting more allocation of the cash-flow to investment than previously
- As schemes grow, administration costs can be reduced and the savings can be spent on investment, as you increase in scale you can squeeze down the cost base in other areas without harming the quality

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"Myth" 7: private markets are riskier than public markets

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- *It depends on the type of assets being used*
- *If schemes don't use private markets, they will miss out on opportunities*

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"Myth" 7

"The assets in and of themselves are not riskier, there are many that are less risky than bonds, let alone equities." – DC scheme

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It depends on the type of assets being used

- Some private market assets don't have credit ratings
- Private assets vary widely - Infrastructure is very different to a post construction bond
- A lot of private market assets are safe things e.g., debt, which is lower risk than public market debt. A floating rate on the private market is lower risk and higher return in most cases than fixed income on the public market. While venture capital is risky, there is some very safe private credit e.g., syndicated loans, etc

If schemes don't use private markets, they will miss out on opportunities

- Going forward, DC schemes will need to look more to private markets as options in the public market become more scarce; this will drive the price of public market assets up
- Start-ups are coming to markets later in their life cycle – there is a risk of missing out of early gains from these
- There is an education piece here and a reputation risk point, if you go into private market illiquids and it goes wrong, people may say you behaved in a risky way

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Are there other myths preventing DC scheme investment in illiquids?

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"You don't need illiquids, the diversification and illiquidity premium are not worth it, and equities are all you need."

"Illiquids are only relevant to people early in their life cycle, 25-50 year olds who are building a pot."

"No DC schemes invest in illiquids."

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BARRIERS

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What are the genuine barriers?

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Trustee reluctance

- Trustees are obliged to understand what they are invested in, but illiquids are opaque, some more than others, which doesn't fit comfortably with trustees' duties and responsibilities
- Among single-employer trustees there is fear of the unknown. DC master trusts are experiencing increasing volume and use accredited professional trustees, which means that there is more awareness among these types of schemes. Single employer DC has lay trustees but master trusts almost all have professional trustees
- There is a considerable psychological barrier of not wanting to increase fees from the current position. If you want to do illiquids properly you need to build up a meaningful allocation or it's pointless, that's 10% to 20%
- Trustees get worried about members trading in and out on a daily price, because members move funds and retire.
- Property funds gating last year interfered with people's retirement plans and changed the views of some trustees

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What are the genuine barriers?

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Governance

- If you are going in to illiquids there is quite a lot of governance risk - the regulations are not written to accommodate these type of governance needs
- These are more complex asset classes, and more difficult to monitor. A lot of trustees are juggling DB and DC, so if these assets are already in the DB strategy this is easier and the governance spend will be limited
- There is so much else going on, ESG etc. Schemes need to carve out a huge amount of governance time to invest directly (or sometimes indirectly) in illiquids. Schemes have too much to do and there is a trustee head space capacity challenge. As you don't have the regulator saying you have to invest in illiquids, these inevitably drop down the priority list

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What are the genuine barriers?

Lack of supply for platform users

- There are very few private market managers who are able to structure illiquid funds for DC. DC needs open ended vehicles which operate at scale and deal with people coming in and out

Pressure to keep costs low

- The biggest barrier is the cultural structure that the market is set up in, schemes want to invest in the cheapest daily dealing that they can find and now there is a whole infrastructure set up around that

Private market charging structures

- Schemes are trying to fit into a structure that is unnecessary, a heritage structure where private markets feel they have a right to charge performance fees. We need to demand that private markets change their charging structures to accommodate future DC schemes and come up with a more palatable way of charging.

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CHANGE

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Who needs to drive change and what change needs to happen?

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Asset managers

- A big help for a lot of schemes would be if the fund administration part of the value chain invested in product development
- The asset management community needs to realise that DC is different and needs specific knowledge and products designed for it and suitable fee structures
- Asset mangers need to move away from performance fee structures or cap performance fees to remove some of those barriers

Consultants

- There needs to be education about the benefits and risks of these assets provided by consultants, TPR, PLSA and others. Education reduces governance costs. The key is about trustees understanding these assets and the value that they can provide

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Who needs to drive change and what change needs to happen?

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Platform providers

- For larger schemes, platform providers will be important, these providers need to work on getting round structural issues
- Find a solution to daily pricing – they could use monthly pricing and put that in every day as the price – or come up with some other pragmatic option

Government

- Improve consistency in transparency and terminology
- Push for private market providers to structure charges that fit to DC schemes rather than the other way around
- The big barrier is the problem of increasing fees, this needs ultimately to come from government and regulators - not ripping up the charge cap but starting to get the view out there that it is okay to increase fees for members a little bit

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Conclusions

- There are diverse views regarding the ease and accessibility of illiquids for DC schemes
- Most schemes can invest into semi-illiquid funds through a platform, but these are costly, not all platforms host them and small schemes may not be able to afford these
- Daily dealing is not necessary and may hinder innovation
- Performance fees are not necessary and should be discouraged
- Governance resource is a key challenge for schemes looking to invest in illiquids
- Competition to be low cost discourages some schemes from pursuing illiquid investment
- Change and innovation needs to come from a combination of Government, consultants, fund managers and platforms

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