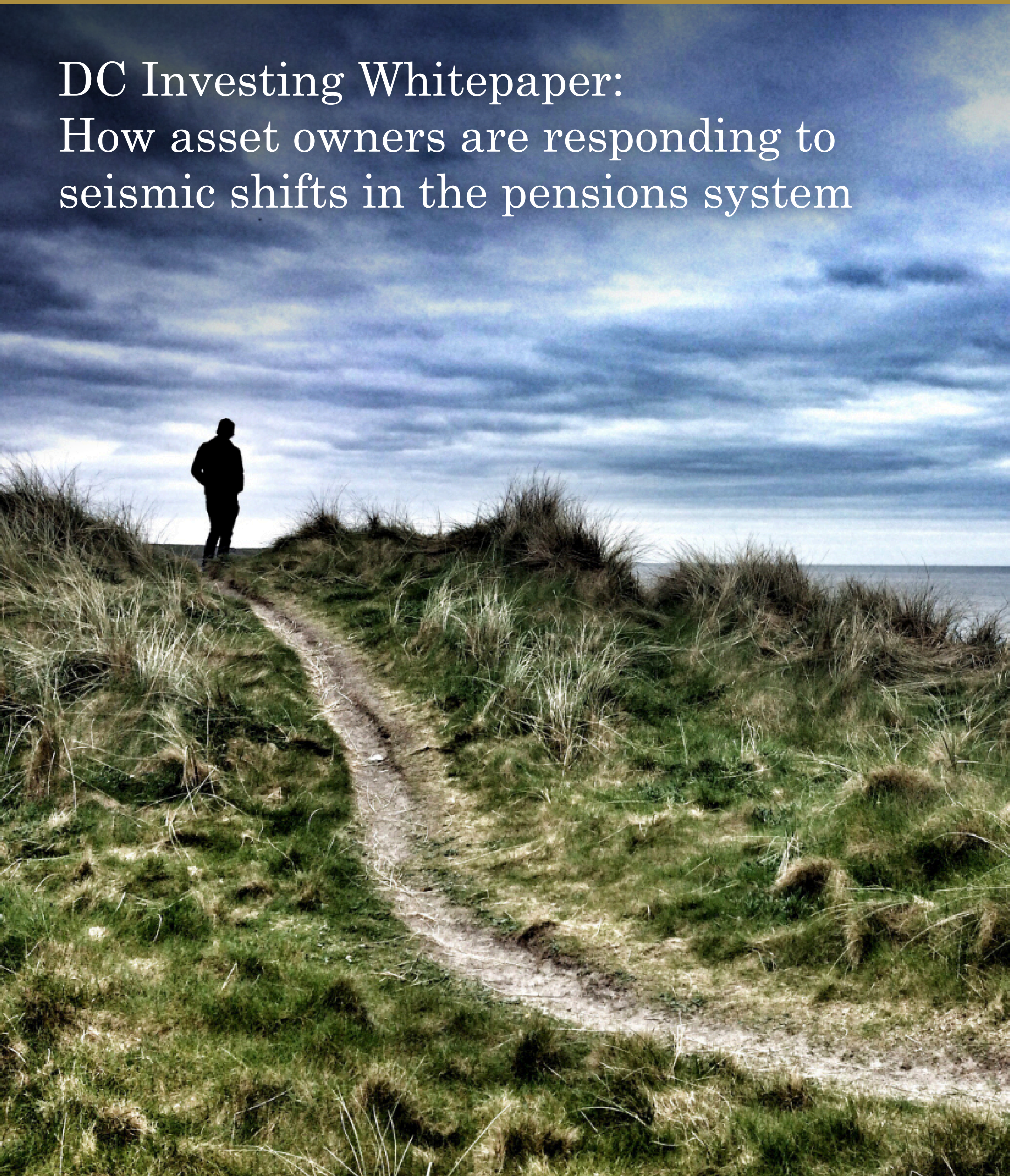
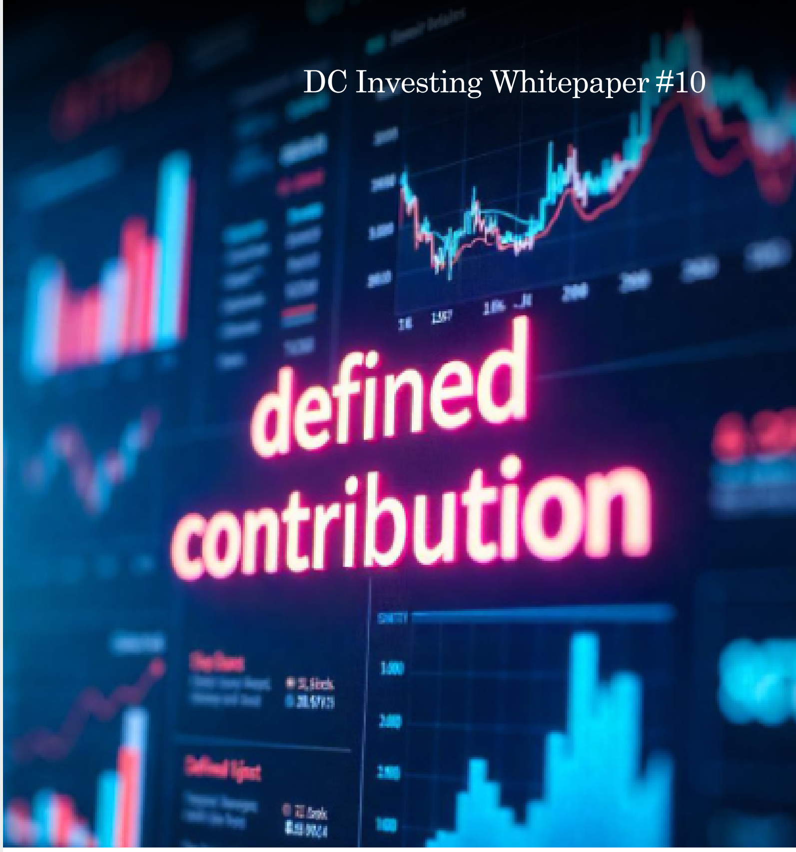
cio investment club

Whitepaper #10 December 2024

DC Investing Whitepaper: How asset owners are responding to seismic shifts in the pensions system





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sean.thompson@cioinvestmentclub.com
www.cioinvestmentclub.com
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Introduction

The Defined Contribution landscape is undergoing a period of upheaval, and trustees, providers, and consultants are navigating a changing landscape.

According to the PLSA, the scale and distribution of assets across the pensions sector is expected to alter substantially over the next decade, during which the volume of assets in DC pension schemes is expected to double to around £1trn.

The government is pushing for pensions to diversify into illiquid asset classes such as private equity, with former Conservative chancellor Jeremy Hunt announcing the Mansion House Compact in 2023. Signatories are expected to allocate at least 5% of their default funds to unlisted equities by 2030.

Changes to regulation by the FCA have also enabled the launch of Long Term Asset Funds, open-ended vehicles designed to invest efficiently in long-term or illiquid assets, with firms such as Schroders, L&G and Willis Towers Watson launching LTAFs.

Meanwhile Labour chancellor Rachel Reeves launched the first phase of the Pensions Investment Review in July, seeking to boost investment in UK businesses – particularly in private markets, increase pension pots and tackle waste in the pensions system.

A call to evidence ran in September and an interim report was published in November (after the cio investment club roundtable on DC investing had taken place). As part of the Pension Investment Review the government has proposed measures to deliver a major consolidation of the DC market and the Local Government Pension Scheme in England and Wales (LGPS).

Navigating the road to consolidation

At a cio investment club roundtable attendees were asked how consolidation in the DC space might play out and the potential ramifications.

Tony Broccardo, former CIO of the Barclays UK retirement fund, was supportive of the rationale behind the government's plans, agreeing that substantial inflows into DC schemes lends them a competitive advantage in the marketplace in terms of seeking investment, particularly in the illiquid space, but warned the road to consolidation may prove bumpy.

"The advantages to scale are big and fairly dependable, but how you get there is another matter," he said. "What gets consolidated? If liquid assets are consolidated, but illiquid assets are not, that can create inefficiencies. And how like-minded are the entities that are part of the consolidation in terms of their governance structures and how they delegate. The local authorities' experience over the last ten years is probably a learning point for DC."

Dean Wetton, managing director at Dean Wetton Advisory, said in his experience the journey to consolidation is "quite uncomfortable".

"There's elbowing and jostling with schemes collapsing and moving into others. We've advised around nine master trusts on being wound up into other master trusts. Several years ago, a senior member of the PLSA suggested only six superfunds licenses should be issued and there was an outcry at the time. But how many master trusts are we looking at now? Probably six.

"That might have been a better process to get to where we are at, rather than the regulatory approach, which is to make it more and more uncomfortable for providers and trustees to exist, so that eventually they give up."

Kara Robinson, senior DC solutions investment consultant at Aon, said while there are advantages to consolidation an element of customisation will be important.

"There are different needs within the population, and six schemes can't cater to them all - unless there are bespoke offerings within the schemes, which is what we're seeing."

A point of debate among the participants was how the smaller pool of schemes would compete, and whether consultants would be attracted to higher returns or lower costs.

Punil Chaubal, insurance investment advisory leader at Willis Towers Watson, posited that consolidation would initially lead to fee compression, with increased concentration to a few large asset management firms with multi-asset capabilities, but under that scenario fees were likely to gradually creep up.

There are different needs within the population, and six schemes can't cater to them all

Are illiquid assets all they're cracked up to be?

Moving the conversation towards investing in illiquid assets, the attendees were asked how they envisioned the Mansion House compact panning out. The most recent update from the ABI, which is tasked with tracking industry progress, revealed that as of February, signatories held £793m of unlisted equity assets in their DC default funds, equivalent to 0.36% of the total value of their DC default funds.

Felix Currell, senior investment consultant at XPS, expressed concern that many of the smaller schemes would pay lip service to the ideas behind the compact without either regulation or incentives encouraging them to invest in such assets, while Kara confirmed Aon is a signatory but acknowledged the challenges.

"It's an aspirational target. Progress has been made over the year but the scalability and the ability to do it isn't there quite yet," she said.

Gareth Doyle, principal DC investment consultant at Barnett Waddingham, contended that firms were reluctant to be the first mover while the government is possibly overegging the advantages of illiquid assets.

"Nobody wants to be ahead of the pack in case things go wrong. And I wonder if there's too much optimism in terms of what illiquids can do for DC. It's difficult to get hold of the past performance of the full universe of different illiquid asset classes. The lack of transparency is going to be a problem."

> *"Default rates are artificially lower in private credit than in public markets because you can kick the can further down the road"*

Elena Zhmurova, founder and independent consultant, Altconsult, raised concerns about the absence of a secondary exchange, meaning there is no fair pricing mechanisms for illiquid assets.

Punil warned that while there hasn't yet been a seismic crash in the private space, the significant

growth in the private markets over the past decade may lead to an increased risk of a potential crash.

“Default rates are artificially lower in private credit than in public markets because you can kick the can further down the road, particularly if you're in bilateral deals. That downside risk is not well understood.”

Punil also questioned the wisdom in smaller schemes allocating to private markets given the steps taken towards the market converging.

“How will that convergence take place if schemes have illiquid, private credit asset allocations? The weighting towards privates in the DB space has increased substantially in the wake of the Liz Truss crisis and they're a difficult asset class to get out of in order to transact. Plus would Nest want a small scheme’s allocation to private credit in their portfolio?”

He continued: “Some insurance companies are trying to broker deals where they include some private asset allocations as part of buy in/out, but that creates a capital strain on the insurance balance sheet, because insurance companies have specific requirements to meet beneficial balance treatment.”

Dean countered that many DC schemes can't take on large allocations to illiquid assets because they’re unable to administer them or price them.

“It’s easier administratively for DB schemes because they have a single pot. DC schemes typically use insurance platforms to price assets, where you've got permitted links requirements slowing that down; it means those investments can't get through that filter.”

Elena summarised that while there is an appetite among DC schemes trusts to invest in illiquids, there is a gap in the supporting infrastructure, which includes a secondary exchange, pricing, transparency, research and monitoring.

The question of whether smaller schemes should invest in illiquid assets was picked up by Tony, who asked if illiquid investments presented good value and whether smaller schemes would have the necessary oversight inhouse.

“If you add 10% illiquids to a 60/40 portfolio, it should add some cumulative value over time. However, are these smaller schemes willing and able to put the governance in place to oversee this? If the answer is no, then even putting their toe in the water could prove dangerous.”

“*It’s easier administratively for DB schemes because they have a single pot. DC schemes typically use insurance platforms to price assets*”

LTAFs could offer an interim solution

Dean asserted that LTAFs could be an interim solution, which Kara agreed with, caveating they need to be "well structured", while Felix concurred that "LTAFs are where we'll see the most pick up".

He continued: "Talking to the platforms about permitted links and maximum holdings, they're generally comfortable with 20% in illiquid assets, and at that point, we're starting to talk about the additional expected returns becoming material. Obviously, you need governance structures in place. But within the LTAFs space, several platforms are comfortable with these material illiquid holdings."

However, Gareth was less sanguine on the future of illiquid assets using LTAFs.

"I suspect LTAFs won't be around in five years' time as they're not the most efficient vehicle for accessing illiquids."

According to figures from the Pensions Policy Institute, published in September, £560bn is held in workplace pensions, of which "a very significant but unquantified amount" is held in the schemes' main default funds. With that in mind and given default funds should be suitable for the average employee, we asked those around the table where LTAFs fit within default funds.

Gareth responded that it was difficult to quantity how much illiquids exposure the average employee should have.

> *I've seen a few examples of 50/50 liquid/illiquid assets but at higher levels of illiquidity*

"If you look overseas you might find between 0-40% in illiquids," he said. "However, countries are all unique in terms of regulatory requirements, how people access their pension savings, member behaviour, attitudes to risk, taking personal responsibility from a young age versus dependency on state benefits, public buy-in to investing in own infrastructure. As such, I don't think it's as easy as saying x% is the proportion we should expect to see."

In Punil's experience, clients tend to prefer semi-liquid strategies with quarterly dealing or fungibility, which he said isn't possible with fully illiquid underlying allocations.

"I've seen a few examples of 50/50 liquid/illiquid assets but at higher levels of illiquidity I'd be concerned because there's a big disconnect between the dealing terms and the liquidity profile."

Horses for courses

As of June 2024, 12 LTAFs had been authorised by the FCA, but will this momentum continue? And how sustainable is the new fund structure?

“There will likely be a range of LTAFs launched within single providers,” predicted Gareth. “This could either be single asset class sleeves, or one LTAF for the growth phase, an LTAF for the consolidation phase, and an LTAF for in-retirement Over time, providers may then take a step back and consider combining or splitting up these LTAFs, at which point I suspect they may abandon LTAFs in favour of more efficient vehicles.”

“At the turn of the year it seemed every individual manager was talking about LTAFs, but that seems to have died away a little now,” added Kara.

Getting to what is arguably the nub of the question, Dean said the viability of LTAFs would largely lie in whether they have a seed client.

“The LTAFs that launch will be those with a seed client, and they’ll be tailored to that client,” he said. “It’s possible one or two other clients may follow, but I suspect we’ll see one LTAF per asset manager and client, because they’ll be bespoke, approved funds, and then they’ll become obsolete in five or ten years.”

He continued: “If consolidation leads to a group of six or so providers, those could start to look more like Nest [the workplace pension scheme set up by the government].

“Nest doesn't require an investment insurance platform; it's able to price the assets itself because it's big enough. When the six providers are big enough to do that, there's no point in an LTAF. You can go straight into a limited partner structure, because you've got the infrastructure yourself to price those illiquid assets. LTAFs are an interim solution.”

Running with that idea, Punil suggested: “At that point you can almost build your own investment platform; you can internally provide the liquidity to individual members by swapping units out.”

An area of concern for Elena was whether manager research is equipped to deal with LTAFs.

Kara countered LTAFs are unlikely to invest in niche areas of the private markets and the mix of assets they hold could prove advantageous: “The way we can see LTAFs succeeding is through a more diversified portfolio.”

Elena argued that LTAFs are in the same category as multi-asset vehicles, claiming “you have to be an expert not only within a particular asset class but also on liquidity and operational matters”.

Punil divulged that WTW has a team of over 100 researchers dedicated to individual sectors and across asset classes, prompting Elena to query whether ten researchers would work on a single vehicle and the affordability of that.

“It depends on the scale and on what the underlying vehicles allocated to,” Punil responded. “You'll often find they’re allocated to asset classes we have some degree of familiarity with. Manager research is not fit for purpose in all circumstances, but we respond to client demand. If clients are demanding an allocation to a certain niche, we’ll either hire in that expertise or develop it internally, but we will try to cater to that demand.”

Participants

Dean Wetton

Managing Director, Dean Wetton Advisory

Dean Wetton, BComm (Hons), MBA, CFA, Managing Director, founded Dean Wetton Advisory in 2009, recognising the need for a fresh approach to providing investment advice to clients: an approach that delivered straightforward, clear advice in a cost-effective way.

Dean has wide experience of advising clients on a range of investment issues, having previously been Head of the Manager Evaluation Function at P-Solve Asset Solutions and a senior member of Hewitt's Manager Research Team.

Dean Wetton Advisory

Punil Chaubal

Insurance Investment Advisory Leader, WTW

Punil is the Insurance Investment Advisory Leader at WTW. He leads a team of over 20 dedicated insurance investment professionals advising on over $500bn of assets globally. His team are committed to supporting insurers consider their investment strategy, strategic asset allocation and portfolio implementation.

Punil has over 13 years of experience and joined WTW in 2022, working with insurance companies globally. Prior to joining WTW, Punil supported numerous UK and European insurers with management of investments, capital and sustainability risks.

He earned a BSc in Mathematical Science from City University and an MSc in Actuarial Science from Heriot Watt University.

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Felix Currell

Senior Investment Consultant, XPS Group

Felix is a Senior Investment Consultant for XPS Group, advising a range of DB and DC pension schemes over the last 12 years.

With the industry moving towards DC pension provision, Felix is helping his clients explore an ever-changing market, currently with increased interest in illiquid assets and consolidation options.

Kara Robinson

Senior DC Solutions Investment Consultant, Aon

Kara Robinson is a senior DC solutions investment consultant at Aon. Kara has worked in investments for c12 years, until recently leading on DB investment advice for schemes, ranging in size from £15M to £3Bn+ on all areas of investment strategy and implementation.

Within the DC solutions practice at Aon, Kara, working closely with the CIO, is heavily involved in investment delivery for clients across Aon's offerings.

Kara is also actively involved in I&D at Aon, including being Aon's representative on the cross industry Diversity Project Steering Committee.

Gareth Doyle

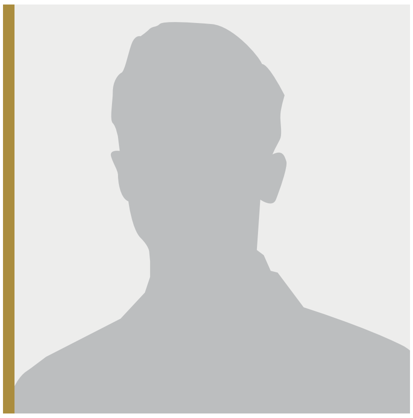
Principal Consultant, Barnett Waddingham

Gareth is a Principal consultant at Barnett Waddingham, where he leads on all aspects of investment advice for a range of large DC pension schemes, master trusts, investment platforms and asset managers.

Gareth joined Barnett Waddingham in 2024, having previously worked at two Master Trust providers.

Outside of work, Gareth can typically be found taxiing his daughters, walking his dog, or racing against other (indoor) cyclists on Zwift.

BARNETT WADDINGHAM
beyond the expected



Tony Broccardo

Independent

Tony has over 35 years of experience leading investment teams and organisations in Chief Investment Officer and Chief Executive roles at Invesco and F&C.

In his most recent role Tony designed and set up Oak Pension Asset Management Limited to manage the assets of the £35b Barclays Bank Pension Fund which he took from a significant deficit position in 2009 to a significant surplus position today.

Tony has Chaired Global Asset Allocation Committees continually for over 25 years, and in the last 14 years has been at the forefront of building one of the largest positions in global venture capital of any UK based asset owner and which has delivered top decile investment performance.

Elena Zhourova

Founder & Independent Consultant, Alt Consulting

lena has over 20 years of experience in asset management, defined contribution pensions, investment strategy and asset class research.

She is an independent consultant specialising in private markets in DC.

Previously, she worked at Hymans Roberston as a DC research lead, Invesco, and McKinsey. Elena holds an MBA from Columbia Business School and she is a CFA charterholder.

In attendance

Beth Brearley (Moderator)

Freelance Writer

Beth Brearley is a freelance writer specialising in asset management, institutional investing and private equity.

A former editor of several prominent B2B titles, Beth has spent almost two decades covering the financial services sector.

Sean Thompson

Founder & Director, cio investment club

Sean has nearly 40 years of experience working in London's financial services sector and the insurance market. After 10 years as Managing Director of CAMRADATA, Sean launched the cio investment club on 1st January 2024.

The cio investment club's mission is to become the voice of chief investment officers and investment professionals at institutional firms. To help achieve this the club hosts events throughout the year that educate and inform, whilst providing thought-provoking content to its members.

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