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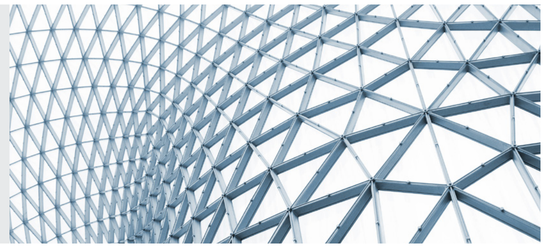

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Solving the private markets conundrum for UK DC

DC members and smaller DB schemes get long-awaited access to illiquid assets

Key Takeaways:

- Many DC schemes want to offer members access to private market assets, which have been shown to offer higher risk-adjusted returns over the long term.
- The challenge to private market assets is long lock-ups, high fees and the difficulty of finding assets that are suitable for the risk-profiles of DC members. Schemes investing in synthetic, listed assets risk missing out on the key benefits of illiquid assets.
- The solution lies in the investment, insurance and pension industries working in co-operation to incorporate listed equities into blended portfolios that allow members to access their benefits on time, and without penalties

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Many DC schemes are searching for ways to offer their members access to illiquid asset classes, but they face a number of hurdles to get there. So just how much effort is required to bring illiquids into DC, and is the due diligence, effort, time and energy worth it?

Illiquids add value, but are beset by challenges

It is clear that DC does need illiquids: they offer an illiquidity and complexity premium, impact, diversification and correlation benefits. When you consider the amount of work that goes into the sourcing, due diligence, and extra checks involved in deploying to private market deals, you realise why these investments are sought after and attractive (and why, in some cases, they can be expensive).

As it stands, it is nigh on impossible to think how DC schemes might invest directly in some private markets, particularly private equity, and not miss out on key benefits by investing in a cheaper, listed version that is a pale synthetic imitation and correlated with broader equity exposure. A further issue is that the legal structure adopted – Non-UCITS Retail Schemes (NURS) or investment trusts - may be hiding layered fees from the underlying investments.

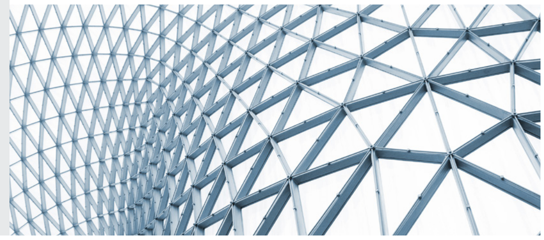
The fees issue is a huge problem. DC schemes are struggling with a fees cap that is at the opposite end of the spectrum to a private equity fund costing 2+20. A DC master trust has, in some cases, below 10bps to play with. So, as it stands, it's only really possible to consider a modest allocation, which may not be worth all the requisite time and resources.

Let's play to our strengths

We need a joined-up group of stakeholders that are happy to understand and take on the risk of an illiquid asset, that may be locked-up for a period of time, may have a deployment phase – meaning there could be a "J" curve to contend with – performance fees, monthly or quarterly valuations, and higher fees overall.

The fetish for liquidity is still at the forefront of the issue. You can't create liquidity from an illiquid asset without creating other issues, so best not to try. The answer relates to what can you do with the rest of the assets within a blended portfolio, to ensure schemes can trade happily, and daily, for people as they retire or move on.

Life company platforms still control the majority of UK-based scheme assets, and that won't change for the foreseeable future. These gatekeepers will need to be comfortable that they have mitigated the risks associated with private market assets. We have already seen a shift



in how flexible they can be, and how they can be more pragmatic about incorporating private illiquid assets into a broader portfolio of mainly listed equity and debt.

This represents an excellent start, so let's not look for daily liquidity from an illiquid asset. Let's play to our strengths and use cashflows and listed liquid assets to facilitate the daily activities and transactions in the fund.

Some asset classes are simply not viable

Having discussed a way forward and how we might be able to make this work, we must consider the asset classes themselves. They are all very different and represent different profiles and problems that must be solved include return and risk targets, correlation to other asset classes, position in the capital structure and liquidity profile.

For example, in the private credit asset space, whether the loan is senior, mezzanine or subordinated dictates the fee, risk, and liquidity profile. At the top of the structure are senior loans, and these have a secondary market that provides a degree of short-term liquidity, even though categorised as an illiquid asset.

At the extreme of the asset class spectrum, we have private equity and interesting ESG-focused natural capital strategies covering areas such as sustainable oceans, land degradation projects, re-forestation, and bio-diversity. They all tick the boxes for schemes that want to allocate to "impact" assets but, unfortunately, they are broadly inaccessible to DC schemes. They can be expensive, lock up capital for many years, are closed-ended, have a zero-liquidity profile, have a significant "J" curve and a significant risk profile, even if they do have high average net returns.

As lovely as they sound, we are some way off DC schemes being able to take a direct position in these asset classes.

Moving forward through collective effort

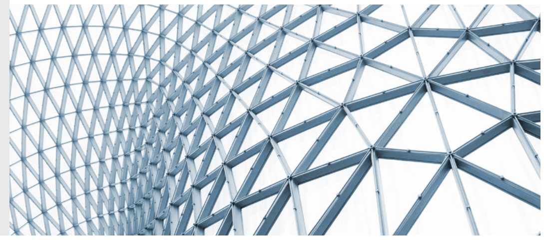
Not all schemes have the luxury of huge regular contribution flows, high AUM, and can deal with the "J" curve and liquidity in the round, but many smaller schemes do have the ambition and desire to make these asset classes available for their members.

There are currently less than a handful of solutions available to DC schemes on fund platforms, that have sufficient liquidity and daily transaction capability.

These are mainly at the credit end of the spectrum, so that the fees are manageable, but they do provide access to the precious illiquidity and diversification benefits the UK DC market desires.

So we do want to find a way for these interesting asset classes to benefit DC members. We fully appreciate the potential difficulties, and the complexity of their inclusion, and we need a collective effort, focusing more on the net risk-adjusted returns profile and what that can do for future outcomes.

Written in August 2021



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