UK DC: A fetish for liquidity
The case for real assets

By **Nick Groom**, Head of UK DC Strategy and Sales,
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Our survey of over 60 UK DC pension schemes explores the relationship between liquidity needs and cash flows. We have seen significant demand for the benefits that illiquid assets can bring, and many major institutions have already benefitted. We found that DC schemes have both the liquidity and desire to invest, so is it now time for DC to follow suit and find a way for our pension scheme members to benefit from this precious resource?

> "Of the maxims of orthodox finance, none, surely, is more anti-social than the fetish of liquidity."
> John Maynard Keynes, economist

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Executive summary

A recent survey[1] of over 60 Defined Contribution (DC) plans in the UK found that many DC schemes have both the liquidity reserves and a positive intention to invest in illiquid assets.

Key findings from the survey:

- Master trusts are much more likely to invest in illiquid assets in the future, compared to Group Personal Pensions (GPPs) and trusts. On a scale of 1 to 10, where 1 is very unlikely and 10 is absolutely certain, master trusts gave their likelihood to invest in illiquid assets as 7.4 compared to 4.2 for GPPs and 4.6 for trusts.
- Asked what would be an appropriate allocation to illiquid assets, master trusts said 24.4% on average, compared to 25.6% for GPPs. However, trust-based DC schemes gave 14.8% as an appropriate allocation.
- The desire of DC plans, particularly master trusts, to use illiquid assets is supported by their liquidity position. According to the survey findings, master trusts are in receipt of annual cash flows equivalent to 30.2% of their total assets, compared to 12.6% for GPPs and 11.2% for trusts. And the proportion of members they expect to transfer out or retire in the next 12 months is 4.4% of total active members for master trusts (4.2% for GPPs and 5.5% for trusts).
- Asked to estimate their current and future liquidity requirements, the average percentage of current assets that need to be liquid was estimated at 3.8% now, 7% in five years from now and 14% in ten years' time reflecting mainly the maturity of some of the single trust scheme responses in the survey. Given the positive cash flows and the fact that most of the funds are liquid, the relatively low liquidity required in the next five years shows that DC schemes have the scope to handle illiquid assets.
- Average combined employer and employee contribution rates of 16.2% for trusts, 13.2% for GPPs and 13% for master trusts. This ranking is not surprising, given the fact trust-based DC plans were often set up by employers actively involved in occupational pensions, whereas master trust members are more likely to be receiving contributions at the minimum mandatory rate under the auto-enrolment regime (currently 8% combined contributions).

1. Natixis Investment Managers, survey of UK DC Pension Schemes on liquidity requirements. Research was conducted from 01/07/19 -31/07/19. This survey was of 65 UK based DC pensions schemes, representing Trusts (27), GPPs (21), Master Trusts (17).

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Foreword

The renowned economist John Maynard Keynes was a trenchant critic of outmoded economic thinking. Indeed his best-known work, The General Theory of Employment, Interest, and Money[2], which still influences macroeconomics and government policies to this day, was produced as an antidote to the blinkered economic policies that exacerbated the Great Depression of the 1930s.

One particular object of Keynes's scorn, which is relevant to today's DC pensions, was **the obsession, as he saw it, of investment institutions in holding "liquid" securities.** As he put it: **"Of the maxims of orthodox finance, none, surely, is more anti-social than the fetish of liquidity."** In his view, this leads investors to concern themselves with solely immediate changes in news, or the mass psychology that drives short-term market sentiment. Keynes went on: "there is no such thing as liquidity of investment for the community as a whole". In other words, liquidity for all depends on the interaction of individual buyers and sellers and this cannot be guaranteed if, say, most of the buyers in a market step back from trading, as can happen in a market crisis.

What does this mean for DC pensions? At one level, we should remember the words of Keynes and consider whether it makes sense for a DC pension fund to be liquid at all times. After the experience of the Global Financial Crisis in 2008, we know that most pension funds and assets are in the same boat regarding liquidity in the event of a global crisis. **Liquidity in a wide range of assets can evaporate overnight when institutions lose their trust in each other.** And it is also the case that DC funds that try to stay 100% liquid at all times will forgo investment in illiquid assets that can enhance returns and broad diversification.

Many major institutional investors have benefited from an allocation to illiquid assets, especially in recent years. However, it's not quite as easy as that in DC funds in the UK, for a myriad of historic reasons. However, it becomes more manageable when you get to the point where a scheme has considerable scale, enough to directly manage investments of this nature internally and where they can utilise cash flows to net off the transfers and retirements in-the-round. In any event, a likely allocation to illiquid assets in a DC fund is probably only going to be in the region of 5% to 25% of the overall portfolio, leaving the great majority of the fund in assets which are fully liquid.

"There is no such thing as liquidity of investment for the community as a whole."

John Maynard Keynes, economist

We have seen significant demand for the benefits that illiquid assets can bring, but **the majority of the current DC market does not quite have the luxury of scale or the skills yet to buy real assets directly.** Most DC schemes sitting on life company platforms are waiting for a solution to emerge from asset managers who have been slow to deliver such a solution at the right price. This solution will need to be an open-ended fund structure, with daily valuations and pricing, enough liquidity to manage short-term needs, and able to work for all DC schemes on all unitised platforms and their variations.

In our survey of UK DC pension schemes[3], Natixis Investment Managers explore the perceived barriers to master trusts, single trusts and Group Personal Pension (GPPs) investing some (not all) of their portfolios in illiquid real assets. **The survey discovers their propensity to invest in illiquids, how much they think they might invest, their likely liquidity needs, when they need the liquidity, and how much liquidity they need.**

We also look at what's stopping them from investing in this asset class, the challenges and misconceptions, and we put the case forward for how these can be overcome, urging buyers to look beyond the issues we have faced historically and to find an appropriate way forward for the benefit of the members they serve.

"The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future"

John Maynard Keynes, economist

The "fetish of liquidity" in the institutions Keynes refers to, might well be a generally safe place to be, but in such a low yielding environment and with our members invested mostly for the very long term, more than likely up to and through retirement, safe may not be helpful. On the other hand, as Keynes said when criticising the fetish of liquidity and having an excessively short-term approach: **"The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future".** If DC funds can include an allocation to illiquid assets in their portfolios, they should be better equipped to do this.

2. John Maynard Keynes, 1936, The General Theory of Employment, Interest and Money

3. Natixis Investment Managers, survey of UK DC Pension Schemes on liquidity requirements. Research was conducted from 01/07/19 -31/07/19. This survey was of 65 UK based DC pensions schemes, representing Trusts (27), GPPs (21), Master Trusts (17).

Positive cash flows

Our survey findings shows that in most cases schemes had positive cash flows that exceeded their need for short, medium and longer term liquidity. This is before we consider the fact that most of the funds they are invested in are fully liquid and daily traded, so a prudent allocation to real assets is possible.

The rise of DC pensions

Globally, Defined Contribution (DC) pensions are becoming the dominant form of pension provision and the UK is very much part of this trend. **By the start of 2019, DC pension funds accounted for over 50% of total pension assets across the seven largest pension markets**, according to the *Global Pension Assets Study 2019* from Willis Towers Watson (WTW[4]). In the report, it has been found that while DC assets have grown at 8.9% annually in the last decade, Defined Benefit (DB) assets have grown at just over half this rate, at 4.6% annually in the same period.

While the UK is the third largest pensions market after the US and Japan, with $2.8 trillion in assets (£2.2 trillion) according to WTW's 2019 report, most of this is in DB assets (other sources, the Pensions and Lifetime Savings Association and The Pension Regulator (TPR) give the UK's DB pension assets as approximately £2 trillion, DC making up the rest).

But with many DB funds reaching maturity, the future will be very different. **Since pension auto-enrolment was introduced to the UK in 2012, membership of DC funds has grown rapidly**, while there has been a large-scale shift away from DB, a consequence of its high cost in an era of low interest rates and an ageing population. The membership of DC plans, which has been estimated at over 10 million active members in around 50,000 plans, now greatly outweighs an estimated 1.1 million active DB members in around 6,000 DB schemes.

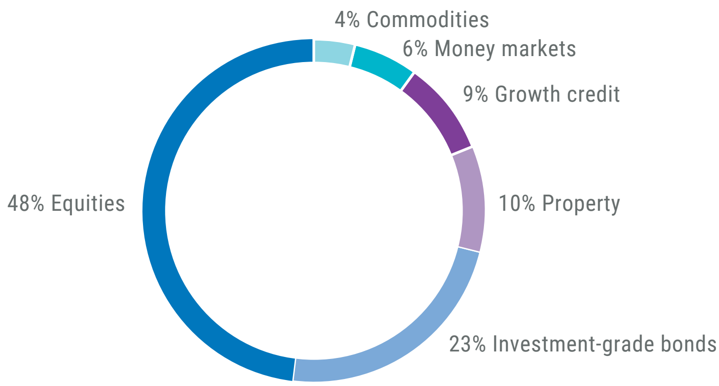
Because DC pensions are seeing rapid growth and DB pensions are in decline, **by 2025 DC assets are expected to exceed DB assets in the UK.** The means by which DC assets are invested will become more economically significant, as pension assets have traditionally been a source of long-term capital for the UK economy.

How DC funds are invested

At present, many DC funds are dominated by default fund strategies which are heavily weighted to listed equities and fixed income assets, with some use of cash and other asset classes. Few DC members feel equipped to make active investment choices, so **default funds aim to provide a good investment solution for DC members**, usually by investing in growth assets when they are younger, with a gradual move towards lower risk assets as they grow older.

The National Employment Savings Trust (Nest) is one of the UK's largest multi-employer pension plans, as it was created as the auto-enrolment vehicle of the last resort for millions of lower paid workers and/or those at smaller firms. **In the past, many such employees did not have access to a workplace pension fund, as commercial pension providers did not find it profitable to serve this market segment.** In its research report, *How the UK Saves 2019*[5], Nest said its asset allocation was equities 48%, investment-grade bonds 23%, property 10%, growth credit 9%, commodities 4% and money markets 6%. Given that Nest is seen as a leading DC fund in terms of its investment approach, it is reasonable to assume that most DC funds will have even higher allocations to listed market bonds and equities. A major reason for this is that most DC funds are administered via investment platforms which use daily pricing, so will only invest in assets that have a high degree of liquidity and therefore can be priced on a daily basis.

FIGURE 1: Nest asset allocation



NEST, 2019, How the UK Saves.

4. Thinking Ahead Institute, Willis Towers Watson, 2019, Global Pension Assets Study 2018

5. NEST, 2019, How the UK Saves - 4. Preqin, 2018, Australian Superannuation Funds in Alternatives - 5. Bédard-Pagé, G., Demers, A., Tremblay, M., Tuer, E., 2016, Large Canadian Public Pension Funds: A Financial System Perspective

Many of the world's biggest and most successful institutional investors have benefited from allocations to illiquid assets.

The investment rationale for illiquid assets

There are a number of reasons why investors with sufficient scale and time horizon allocate to illiquid assets, such as real estate, infrastructure, or private market assets such as private equity and private debt. These assets can provide diversification from listed equity and bond markets and after the global financial crisis of 2008-09, many institutional investors decided they had to find a counterbalance to the volatility of listed markets.

Illiquid assets can also provide attractive risk-adjusted returns in their own right. Data from CEM Benchmarking comparing returns for US DB and DC schemes found that between 1997 and 2014, US DB plans enjoyed annualised returns of 8%, outperforming US DC schemes, which made annualised returns of 6.9% over this period. A major reason for this was that US DB schemes had allocations to real estate, hedge funds and private equity, which gave annualised returns over the 18 year period of 9.5%, 7.6% and 11.1% respectively. In contrast, US DC schemes had no allocation to these illiquid asset classes, restricting their overall performance.

Many of the world's biggest and most successful institutional investors have benefited from allocations to illiquid assets. For example, the Australian superannuation funds and Canadian public funds have done this. A recent report from alternatives consultancy Preqin[6] found that Australian superannuation funds have a higher propensity to allocate to real assets, such as real estate and infrastructure, compared to global pension funds. And a 2016 report by the Bank of Canada on Canada's big eight public pension funds found they held 29% of assets in less liquid alternative assets[7]. In both cases, investing in illiquid assets has arguably improved investment performance without increasing costs excessively. However, the leading Australian and Canadian funds do have the advantages of scale and internal investment expertise, and a less penal fee cap to enable them to benefit from using illiquid assets.

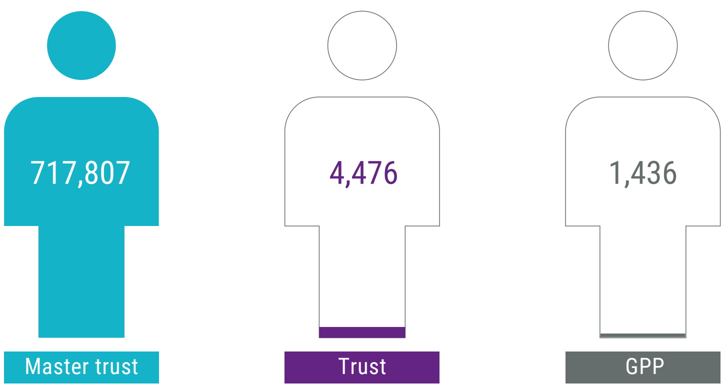
In this low yield environment, we are seeing demand from the largest DC schemes in the UK looking to make use of illiquid assets to capture returns. Indeed, this is already happening at Nest, who announced in September 2019 that it plans to invest 5% of its assets in private credit funds and has since introduced Infrastructure, Corporate and Commercial Real Estate (CRE) debt to the platform.

DC funds in the UK: Survey findings

In our survey[1] of 65 UK DC schemes, we found that master trusts now dominate in terms of average member size, which is consistent with their increasing dominance in the DC market and the consolidation seen among master trusts. Master trusts have 717,807 members on average, compared to an average membership of 4,476 members for trusts and 1,436 members for GPPs (see figure 2).

In our survey, Master trusts have 717,807 members on average, compared to an average membership of 4,476 members for trusts and 1,436 members for GPPs.

FIGURE 2: DC market membership



Natixis Survey as of December 31, 2019.

6 Preqin, 2018, Australian Superannuation Funds in Alternatives

7 Bédard-Pagé, G., Demers, A., Tremblay, M., Tuer, E., 2016, Large Canadian Public Pension Funds: A Financial System Perspective

The presence of a large Master Trust in the sample skews the average membership figure for master trusts, but even after excluding this, the average membership for master trusts is 262,670, which still towers above the average membership for the other two DC fund types. **This shows the success of master trusts in acting as the main vehicles for pension auto-enrolment.** It should also be stated that there are some very large trust-based DC pensions, particularly those set up for large employers in the UK, so the average size figures above are purely representative of the DC schemes that took part in this survey.

According to the Pensions and Lifetime Savings Association (PLSA), master trusts had 9.8 million members in January 2018 and are now **the pension vehicle for 70% of DC trust-based scheme members**[8]. From October 2018, master trusts have had to obtain authorisation from the Pensions Regulator to operate in the UK and as at early November 2019, 37 master trusts have been authorised. Now Pensions, The People's Pension and Smart Pension are among the other large master trusts alongside Nest, while several asset managers and consultants offer their own.

Group personal pensions (GPPs) and stand-alone trust-based DC plans have lower average memberships. Trust-based DC schemes are normally set up by more paternalistic employers who want to use a trust-based structure to set up a DC arrangement, often as a replacement or alternative to their own trust-based DB plan. **Trust-based DC schemes are likely to be older plans, with a more mature age profile,** as GPPs and master trusts have generally superseded trusts as the main vehicles used for DC pensions.

Compared to trusts, GPPs are contract-based and are generally seen as a less burdensome way for employers to offer staff access to a workplace pension, with a financial adviser or benefits consultant setting up the GPP, which is administered by a life insurance company. Because of this, they were often used at smaller employers, before the arrival of auto-enrolment and master trusts.

Contribution rates for DC schemes

Due to the paternalistic nature of trust-based schemes it is predictable that they have the highest average combined employer and employee contribution rates at 16.2%, compared to 13.2% for GPPs and 13% for master trusts. This is not surprising, as master trusts are widely used for auto-enrolment purposes, so will often take contribution at the mandatory contribution rate, while GPPs were marketed as a lower cost workplace pension option for employers and used for minimum contributions too.

Of the three types of scheme, a GPP recorded the highest combined contribution at 30%, with a trust at 25%, then a master trust at 20.4%. This indicates that generous combined contribution rates can be found at all three types, despite average rates being lower at GPPs and master trusts than at trusts.

Default and self-selection options for DC members

As the majority of DC members remain in their fund's default fund, the default fund strategy is instrumental in how DC assets are invested. In the survey, we found that the average number of default funds is between one and two, with almost two-thirds (65.7%) of DC schemes only offering a single default fund option. Master trusts offer slightly more default funds on average (2.1 default funds), compared to GPPs (1.5 default funds on average) and trust (1.8 default funds on average). The highest number of default funds, nine, is a master trust, compared to a maximum of seven for a GPP and just three for a trust-based DC scheme. More than one default fund can be offered by DC schemes to cater for differing risk appetites among members and for those with strong views on ethical and environmental issues (one size does not necessarily fit all members' needs).

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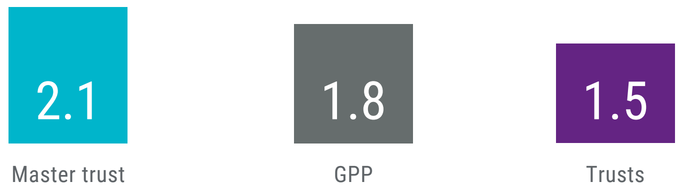
8. Pensions and Lifetime Savings Association, 2018, Master Trusts: A Made Simple Guide

FIGURE 3: Default funds on average



Natixis Survey as of December 31, 2019.

For DC members who actively decide where their contributions are invested, DC funds can offer a range of self-select funds. **In the survey, GPPs were found to offer the most self-select investment options by far, with an average of 385 self-select options and a maximum of 1,000.** By contrast, master trusts had an average of 16 self-select options and a maximum of 60, while trusts had an average of 11.5 self-select options and a maximum of 30.

"The [investment] options for GPPs are not only too numerous, but also over-represent 'retail' equity funds. More focus should be on delivering institutional type quality. This includes illiquid options, such as property."

GPP respondent, London

The much higher number of self-select options for GPPs is not surprising, as GPPs can have access to the full range of unitised funds offered by the GPP provider, usually a life office or a fund manager. **However, offering DC members too many options is seen as counter-productive, as it can lead to difficulties for members in deciding which funds are most suited to their needs.** There is evidence from behavioural finance that increasing the investment options offered to members actually makes it harder for them to make decisions, or the 'paralysis of analysis' effect. To this point, one respondent said: "The [investment] options for GPPs are not only too numerous, but also over-represent 'retail' equity funds. More focus should be on delivering institutional type quality. This includes illiquid options, such as property". Suggesting there is appetite for fewer options that capture long term investors needs.

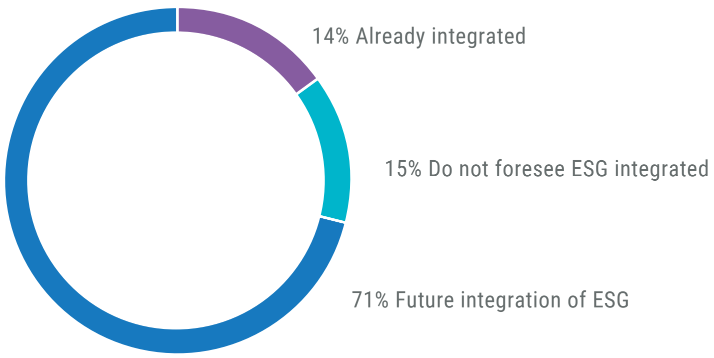
ESG options for DC members

In the survey we also enquired about the ESG options available to DC scheme members, given the opportunity that exists to invest in real assets, for example, renewable energy.

The survey found that almost **60% of DC schemes overall offer an environmental, social and governance (ESG) choice under self-select options for members.** This rose to 88% of master trusts and 76% of GPPs, but only 33% of trust-based DC schemes. Given the very wide fund choice offered by GPPs and the fact that master trusts are seeking to win as much DC business as possible, it is not surprising to see a high number of ESG self-select options for them. However, only a third of trusts offering an ESG option is very low, showing that these funds are falling behind the growing interest in ESG among many DC members, especially younger workers.

However, the survey indicates that **trust-based schemes do foresee their default fund(s) becoming more ESG integrated in the future, with 74% of trusts anticipating this, along with 71% of GPPs and 65% of master trusts.** Further still nearly 30% of master trusts said that their default funds were already ESG integrated, compared to less than 10% for both GPPs and trusts.

FIGURE 4: Overall average of default funds becoming more ESG integrated



Source: Natixis Investment Managers, as of December 31, 2019.

Cash flows represent **12.6% of plan assets in GPPs on average**, and **11.2% at trusts on average**. However in Master trusts cash flows represent 30.2% of the assets.

DC schemes and their liquidity requirements

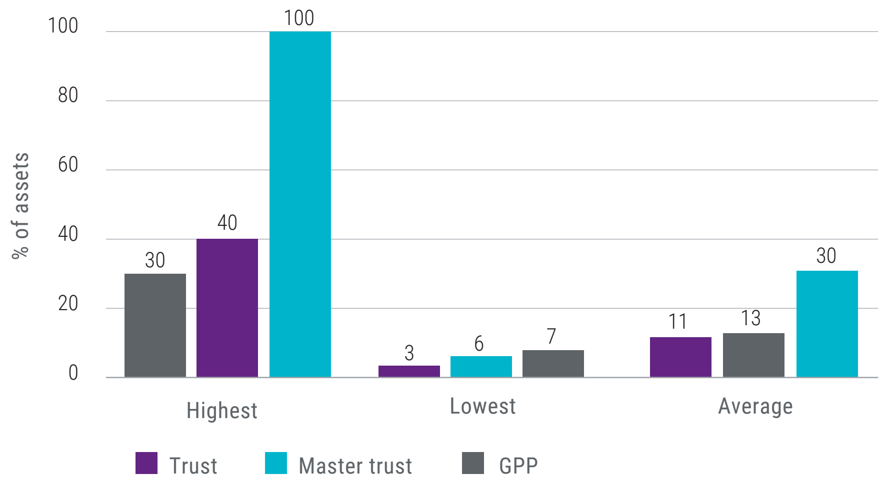
A paradox of DC pension fund investing is that while most, if not all assets, are invested in daily priced, unitised funds, which are highly liquid, this degree of liquidity is not needed at an overall, fund level notwithstanding platform needs. Some liquidity is, of course, necessary to provide cash for transfer and benefit withdrawals, **but holding most, if not all assets in a liquid vehicle means that opportunities to benefit from the illiquidity premium are missed, when these can be dealt with in-the-round.**

In the survey, DC plan respondents were asked how to express their scheme's total annual new cash flows as a proportion of the scheme's total assets (e.g. if a scheme has total assets of £10m and new cash flows of £1m, its cash flows are 10% of total assets).

On this basis, cash flows represent 12.6% of plan assets at GPPs on average, and 11.2% at trusts on average. The figure for master trusts is much higher, 30.2% of assets on average. This higher figure is due to the fact that master trusts are a newer development in the DC market, and are seeing rising membership due to auto-enrolment, consolidation and their growing dominance in the DC market.

In any case, generally UK DC plans are seeing healthy positive cash flows, which should increase their ability to invest part of their overall portfolio in illiquid assets.

FIGURE 5: Annual cash flows by scheme



Source: Natixis Investment Managers, as of December 31, 2019.

Transfers and retirements out in the next 12 months

As well as cash flows in, DC plans were also asked to give the number of members retiring or transferring out in the next 12 months, as a percentage of their total active members.

On average, the results varied from 4.2% of actives for GPPs, to 4.4% for master trusts and 5.5% for trusts. While some DC schemes will see a relatively high percentage of leavers, depending on their circumstances, these results show that for DC schemes as a whole, the proportion of those leaving or retiring is relatively low to the active membership, which is positive for overall cash flows. Combined with healthy cash flows into DC funds, this shows that there is scope for investment in illiquid assets.

Transfers out in 12 months

	Average	Highest	Lowest
GPP	4.2%	10%	0%
Master Trust	4.4%	15%	1%
Trust	5.5%	20%	0.5%

Source: Natixis Investment Managers, as of December 31, 2019.

This is likely to be particularly so for large DC master trusts, which are seeing their membership on the rise due to auto-enrolment. In its How the UK Saves 2019 report, Nest said the overwhelming majority of its members are in their working years and the accumulation phase of retirement saving. Its statistics show the bulk of member disbursements are from age 55, when members can take their benefits as they reach retirement age. Nest said 68% of all disbursements it has seen since inception are related to retirement, with 28% for transfers to a qualified scheme and 4% for death benefits.

Based on a rising membership which is largely of working age, **large master trusts are in a position where cash contributions coming in will significantly outweigh cash needed** for member disbursements for many years to come.

On average, DC schemes have a liquidity requirement of 3.8% of current assets now, **rising to 7% in five years and 14% in ten years**.

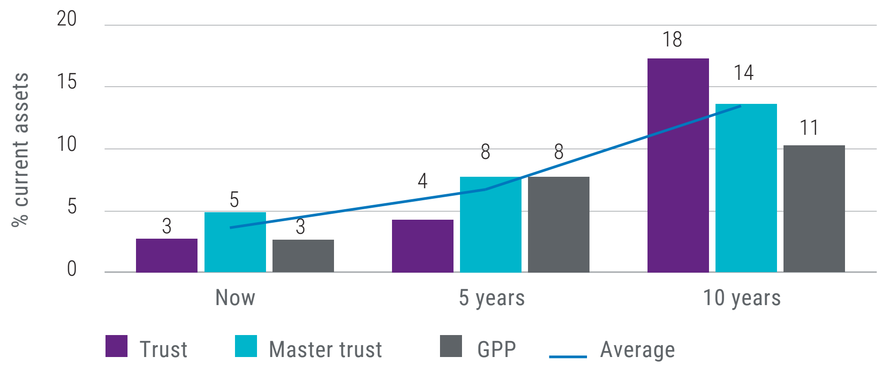
Liquidity requirements now and in the future

The DC schemes surveyed were also asked, in addition to cash flows needed to pay for retirements and transfers out, what percentage of their current pension assets they need to be liquid now, and in 5 years' time and then in 10 years' time. The answers to this question give an additional perspective on the liquidity needs of DC schemes, supporting the information on their cash flows and transfers out and retirements.

Here, we found clear trends for all three types of DC pension, with the average percentage of current pension assets needed to be liquid rising over time. On average, the DC schemes have a liquidity requirement of 3.8% of current assets now, rising to 7% in five years and 14% in ten years.

Master trusts have the highest liquidity requirement now, 5%, but have a liquidity requirement of 8% after five years and 14% after 10 years. The liquidity requirement at trusts rises quite sharply, from 2.8% now, 4.4% in five years, to 17.9% in 10 years, suggesting the age profile of their membership is older, meaning liquidity will be needed as the members retire and withdraw their assets.

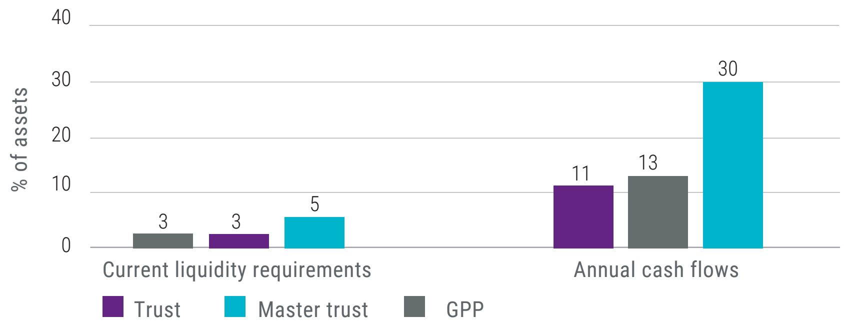
FIGURE 6: The average percentage of current pension assets needed to be liquid



Source: Natixis Investment Managers, as of December 31, 2019.

The graph below shows the amount of liquidity required now against the current positive cash-flows. Schemes have on average greater annual cash-flows than their liquidity needs, and with suggestions that an optimal allocation to illiquids is in the region of 25%, that leaves 75% of the portfolio liquid excluding the balance of positive cash-flow over liquidity needs.

FIGURE 7: Liquidity needs now vs. current cash flows

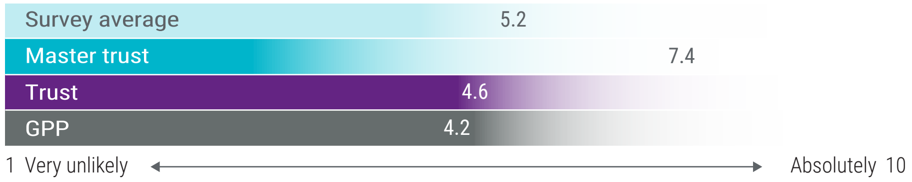


Source: Natixis Investment Managers, as of December 31, 2019.

DC funds' plans to invest in illiquid assets

Asked what the likelihood is that they will invest in illiquid or liquid alternatives in the future, on a scale where 1 is very unlikely and 10 is absolutely, master trusts showed the greatest inclination to invest, with a score of 7.4, compared to 4.2 for GPPs and around 4.6 for trusts.

FIGURE 8: Likehood of investing in illiquid assets

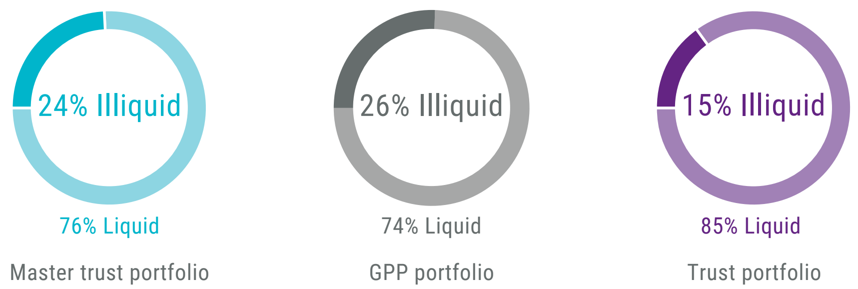


Source: Natixis Investment Managers, as of December 31, 2019.

> "Illiquids and alternatives are necessary in a long-term portfolio"
>
> GPP respondent, London

DC schemes were also asked what they thought was an appropriate percentage to invest in illiquid funds, if they think that illiquid funds will be important in a default fund in the future. For GPPs this was 25.6% and for master trusts, it was 24.4%. For trusts, the appropriate allocation was significantly lower, at 14.8%. Given the liquidity requirements of the three types of DC schemes, these allocations appear reasonable, especially if illiquid assets are held through a default fund, which is managed at a fund level and is designed to operate over the life of a typical DC scheme member.

FIGURE 9: Allocation to illiquid assets



Source: Natixis Investment Managers, as of December 31, 2019.

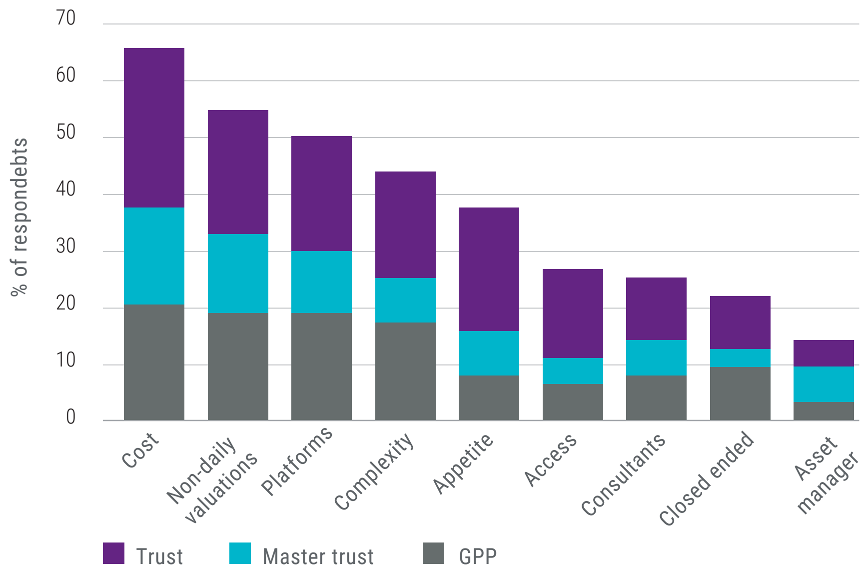
What are the barriers to DC investment in illiquid assets?

We have seen that DC funds believe that investing up to 25% of a default fund in illiquid assets could be appropriate for them leaving 75% of the fund fully liquid. Given these DC plans also believe that less than 20% of their assets need to be liquid in ten years' time, this approach appears reasonable.

But there are barriers to investing in liquid and illiquid alternatives in the eyes of DC plan respondents. **Cost is seen as a barrier as is the lack of daily valuations for these assets and the use of platforms which require daily prices.** Complexity and investor appetite for these assets were also cited as barriers, along with consultants, close-ended fund structures and asset managers.

However, if we examine these potential barriers, we can see that they are not insurmountable and they ought not to hold back DC funds from using illiquid assets where there is a strong investment case and sufficient liquidity available at an overall fund level.

FIGURE 10: Barriers to investing in alternatives



Source: Natixis Investment Managers, as of December 31, 2019.

Is cost really an issue for illiquid assets?

> "Illiquid investments will be needed for future DC returns and member expectations. Price with the charge cap is an issue which needs to be resolved as does the fixation with daily pricing"
>
> Master trust respondent, London

Approximately 60% of the respondents raised cost as an issue for illiquid assets in DC schemes. While charges for illiquid assets are higher than index-tracking funds, the fact that Nest has already invested in private markets shows that large DC funds can invest in illiquid assets within the charge cap, albeit at the credit end of the spectrum. Buying power is critical here, as large schemes reach scale, and understanding future cash flows when negotiating internally for competitive fee levels is key to attracting DC assets. Many DC funds invest heavily in very low cost index-tracking funds, which can have annual charges of 10 to 15 basis points (0.1% to 0.15%) and can be as low as five basis points (0.05%). We also hear stories of passive funds at 0% where the manager can use stock lending to meet their needs (not withstanding platform fees). This leaves room for a higher fee for smaller allocations to more expensive assets. For instance, if a DC fund had an investment fee budget of 15 basis points (0.15%) and invested 80% of its assets in index-tracking funds with fees of 7.5 basis points (0.075%), then for the remaining 20% of its assets, it could afford fees of up to 45 basis points (0.45%) to have aggregate total fees of 0.15%. At this level, some illiquid assets, such as private credit, could be within reach, although more expensive illiquid alternative assets, such as private equity funds, might be out of reach.

“Illiquid private markets offer the best net returns over the long-term and DC is prevented from accessing these returns due to the fee structure”

GPP respondent, London

DC funds used for auto-enrolment have a charge cap of 0.75% and a recent Department for Work and Pensions consultation paper stated that average annual charges for DC funds subject to the charge cap are between 0.38% and 0.54%, indeed, many of the master trusts set up for auto enrolment use the full fee cap of 0.75%. However, their investment budget may be as low as 0.15%. Given the figures above, this means there's potentially some headroom for higher fees for illiquid assets. Overall, there is pressure on investment management fees across the pensions industry, driven by a shift to index-tracking, as well as competitive pressures and greater fee transparency. These factors may also help DC funds to invest in illiquid assets within a charge cap or existing fee structures.

It should also be remembered that large DC master trusts are reaching the point where they can be price makers rather than price takers when dealing with asset managers (NEST are a prime example of this).

Can we calculate daily prices for illiquid assets?

Another concern flagged by around half of the respondents is the fact that investment platforms use funds with daily pricing and illiquid assets use non-daily pricing. **However, it is possible to calculate a net asset value for daily pricing for an illiquid asset fund using valuations at, say, monthly intervals.** The methodology for this is established and has been accepted by investment platforms provided it is consistent and transparent, so mark to market valuations do not have to be performed on a daily basis.

It should also be borne in mind that DC schemes do not face the liquidity requirements of purely retail funds, where in theory, all the investors in a fund could want to withdraw their investments at once. Within a DC pension fund, liquidity can be managed at a higher level, as in a default fund. This allows DC funds to balance their liquidity requirements over time with obtaining the illiquidity premium in private market assets.

“What’s the problem? Just because a very small minority of people want to know how much they have in their pension at any time of the day, we fail in our fiduciary duty to provide the best outcomes for our members!”

Master Trust respondent, London

As DC funds, particularly master trusts, become bigger, investment platforms are likely to face greater pressure to cater for funds that do not use daily pricing. It is likely that large master trusts will either develop their own capabilities for trading, in order to access a wide range of investments, or work with platform providers that can offer the full range of potential investments to them.

Are illiquid assets too complex for DC funds?

Complexity was also seen as a barrier to the use of illiquid assets in DC investing, by 20% of respondents. One respondent stated “Members cannot understand them, not only do they have high costs and reduce the ability of members to access their funds quickly, the intricacies within each asset class are difficult for the average member to comprehend”. However, the term ‘illiquid assets’ covers a wide range of underlying assets, from private markets to real assets such as real estate and infrastructure. On the latter, most DC investors can relate to the benefits of investing in real estate and infrastructure assets, as they are tangible and easily understood. Private credit consists of loans made to corporate borrowers and this is similar in nature to corporate bonds. Private equity follows similar investment principles to public equity investing, such as looking for value and growth in an investment. The underlying investments used for illiquid assets are not necessarily more complex than those used in public markets. Indeed, real assets have a far greater linkage to the member who can understand property, infrastructure and loans. Members of a UK DC scheme might find it easier to appreciate the case for investing in UK infrastructure assets than for a listed biotech or software company.

One of the attractions of illiquid assets is the fact that it can be possible to enhance returns through the illiquidity premium. This is the additional return given when investors are willing to give up liquidity and be tied up in an investment for longer. **The concept of exchanging the short-term benefit, liquidity, in exchange for a long-term gain and a higher return, is intuitively understandable.** Most people can relate to the idea of ‘delayed gratification’, or holding off from a smaller, immediate win in pursuit of a larger, long-term gain, through everyday concepts such as dieting and taking exercise, or saving for treats or holidays.

So for all of these reasons, complexity should not be an impossible barrier for DC funds looking at investing in illiquid assets.

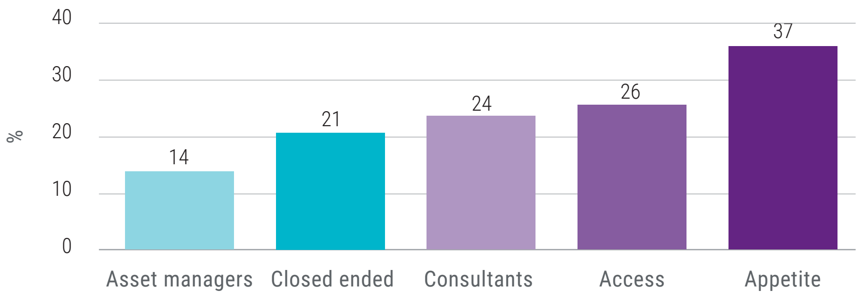
"Our DC members are missing out as a result of outdated thinking and legacy technology, we must get this right, otherwise they could potentially hold us to account that we didn't try hard enough to improve their outcomes."

GPP respondent, London

What of the other barriers to illiquid assets in DC funds?

Asked about other barriers to getting liquid and illiquid alternatives in DC pension schemes, respondents cited investor appetite (37%), access (26%), consultants (24%), closed-end funds (21%) and asset managers (14%).

FIGURE 11: Barriers to getting liquid and illiquid alternatives in DC pension schemes



Natixis Survey as of 31/07/2019.

On investor appetite, as around 90% or more of auto-enrolled members of DC funds do not make active investment choices, the main use of illiquid funds would be as part of an overall default fund strategy. Here, illiquid assets such as private credit, real estate and infrastructure can provide diversification and improve the risk-reward profile of a strategy. In addition, illiquidity can be managed at an overall fund level, given that, as we have seen, DC funds have relatively low liquidity requirements in the next few years and see an appropriate allocation to illiquids of up to 25%, so there is scope to use illiquid assets within a default fund strategy.

Greater use of illiquid assets could go hand-in-hand with greater **emphasis on ESG integration** in DC funds.

Access to illiquid assets for many DC funds will depend on existing illiquid funds becoming available on investment platforms. This will be possible with more flexible and pragmatic pricing methodologies. **There has been rising investor interest in private markets and real assets in recent years, as investors have looked for alternatives to very low core fixed income yields and diversified sources of growth.** As a result, asset managers have developed and launched more funds using illiquid assets, which should lead to the availability of these funds on investment platforms, once the pricing and valuation issues are resolved.

Another issue is that closed-end funds are often used for illiquid assets. Here, there are solutions for multiple closed-end funds to run in parallel or consecutively, to create similar structures to open-ended funds. Evergreen funds are another option, investing continuously or in the underlying closed-end vintages, remaining open to investment as opposed to traditional closed-end funds.

> "[Recent examples have]... showed us how not to do it, but that affected retail investors, quite different, and shouldn't stop well governed and managed DC schemes like ours from allocating to private markets."

Trust respondent, South East

Other factors to consider

When an investment fund for retail investors offers daily liquidity, there can be a 'rush for the exit' if investors are worried about performance, or getting trapped if they are too late to redeem their investment. The usual triggers for this are extended periods of poor returns, exacerbated by bad publicity, leading to rising withdrawals of assets under management.

But these triggers are less likely to affect DC funds, as pension fund assets are 'stickier' than funds held by relatively flighty retail investors. Most **DC fund members will only look at their DC fund valuation annually, or not at all; DC fund performance does not have the same visibility as a high-profile mutual fund, which is sold solely on performance and manager reputation.** Most DC members are in a default fund, which is highly likely to be diversified, thus reducing the chance of a sudden dip in performance. **Additionally, the very nature of Master Trusts for example have a high level of diversification at the client level, another mechanism which safeguards existing investors.**

By investing only a relatively small proportion of overall assets in illiquid funds, as part of a diversified investment approach, DC schemes can ensure they always retain sufficient liquidity for their day to day needs.

The other important factor to note is that we do not advocate such funds being offered as a self-selected option.

And a counterpoint to recent news stories on the topic of retail fund liquidity is the fact the **UK government is keen to see DC funds providing 'patient capital', or being used to invest in asset classes which are long-term in nature and benefit the wider UK economy,** such as private debt, private equity, infrastructure and real estate. In the 2018 Budget, the then chancellor, Philip Hammond, said that DC funds had a vital role to play in long-term financing for UK growth and innovation. And a consultation paper[9] from the Department of Work & Pensions in February 2019, stated: "While some members can and do switch between funds and schemes, more than 95% of members of DC occupational schemes are invested in the default arrangement and are likely to remain invested there for many years. This offers compelling opportunities to invest in long term, illiquid assets". This paper looks at issues such as scale, consolidation, the use of investment platforms and fees and how they affect DC investment in illiquid assets.

The interest of government in how DC funds are invested, and the involvement of the regulator, is likely to lead to a regime where DC funds are permitted to use illiquid assets, provided any liquidity issues for the members are properly dealt with. As we have seen, many DC funds, particularly large master trusts are likely to be able to hold an allocation of illiquid assets while still meeting their overall liquidity needs. **So within a few years, we can expect to see a regulatory regime where DC funds are encouraged to use illiquid assets, provided certain conditions are met.**

On investment platforms, the paper said proposed Financial Conduct Authority (FCA) rule changes are expected to enable more investment products to blend liquid and illiquid assets in future. In addition, as larger DC plans increase in size, it pointed out that they might move off platforms altogether.

Another aspect of DC investment and illiquid assets is that **by investing directly in assets such as real estate or renewable infrastructure, investors have more opportunity to exert an influence on ESG issues and act as an engaged owner.** So greater use of illiquid assets could go hand-in-hand with greater emphasis on ESG integration in DC funds.

9 Department of Work & Pensions, 2019, Investment Innovation and Future Consolidation: A Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution schemes.

Conclusion

As DC funds grow in size in the UK, their investment strategies will evolve from investing mainly in listed equities and bonds, to using a wider choice of assets, including liquid and illiquid alternatives. In this, large UK DC plans will be following a path developed by large institutional investors around the world.

The findings of this survey support this view. At present, many DC schemes in the UK, particularly master trusts, are seeing strong cash inflows, as their membership rises. And **there is evidence of a strong belief among master trusts in particular that illiquid assets have a role to play in their investment portfolios.** Overall, as UK DC plans develop in size, and provided that their governance skills and internal resources are sufficient, we can expect to see more use made of illiquid assets. The fact that Nest has already invested in private credit and will next invest in infrastructure equity is both a clear indicator of the direction of travel and a case-study of how and why this will happen.

At the same time, there are a number of issues for DC plans and those advising them to consider. **The recent travails shows how illiquidity can damage investors if it is not properly handled.** But against this, the UK government and the regulatory authorities are taking a close interest in the use of illiquid assets by DC funds, as DC pensions will become a significant source of investment capital in the future. As well as having the potential to improve the risk-return profile of an investment portfolio, illiquid assets can also be part of a portfolio with high standards on environmental, social and governance issues, which is now a vital consideration for many when investing for the long term.

Looking at large pension funds elsewhere in the world, such as the Australian superannuation funds, the investment journey for the UK's largest DC funds seem clear. **As they grow in size, they will diversify and make use of a wider range of asset, including alternative and illiquid assets.** Private credit, real estate and infrastructure, among other assets, can boost the return potential and diversify risk for long-term investors. DC funds in the UK with sufficient scale and expertise will no doubt want to explore opportunities in illiquid alternative assets. The keys to this will be understanding how illiquidity can be managed within a DC framework and for asset managers, investment platforms, regulators, consultants and DC pension funds to work together to overcome any challenges and issues that they face.

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