PATIENT DC
GOOD THINGS COME TO THOSE WHO WAIT

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TABLE OF CONTENTS

INTRODUCTION

Savers in Defined Contribution (DC) pension schemes are missing out on illiquid investment opportunities which could boost their retirement savings by tens of thousands of pounds.

Overwhelmingly, DC pension schemes invest in daily dealt public markets that offer daily liquidity. But by doing so, they forgo a wide variety of illiquid alternative asset classes that could serve to markedly improve the risk and return profile of their members' investments. These asset classes could provide an additional return in the form of an illiquidity premium and could help narrow the range of outcomes in investment pots.

A happy retirement formula is simple: contributions + investment returns - fees.

Auto-enrolment (AE) regulations have taken care of the fees part of the equation by capping default charges at 0.75%. However the UK is plagued by very low pension contribution rates (3.4% combined employer and employee contribution in 2017[1]). That is why if DC savers are to enjoy their later life with financial security, they need all the help they can get from investment returns.

This is where long-term capital in DC, or what we like to call 'Patient DC', makes sense. If savers can't access their money for 20 years or more, why should they be forced to invest 'impatiently' in daily dealt funds? Wouldn't it make more sense to enable them to take advantage of the benefits of investing in a way that is better aligned with their long-term horizon?

This is a question we have been asking of the regulators and the industry for years. Now, finally, we can say that this issue started to gain traction, and an industry-wide discussion is underway that has the potential to change the lives of millions. We now have the Government's commitment to break down barriers to longer-term investments for DC savers, and we have several consultations on the subject in progress. However, while this topic is a very hot one, it seems to be confined to a smallish group of subject matter experts. We believe the discussion needs to spread to include all the decision makers – trustees, employers, IGC members and insurance platforms – to ensure that everyone understands that Patient DC could help fix the looming retirement crisis for Generation DC.

With this in mind, the aim of this paper is to help demystify the complexity around the subject of illiquid alternatives in DC. We hope this will serve as a starting point and a guide for decision makers to learn more and to continue to push this topic into the mainstream.

Happy retirement formula

1 https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/pensionssavingsandinvestments/bulletins/occupationalpensionschemessurvey/uk2017

1. WHAT ARE ILLIQUID ALTERNATIVE ASSETS?

Alternative assets are best defined as any asset that is not an equity, bond, or cash. Alternatives therefore cover a very broad range of asset classes, from property to fine art.

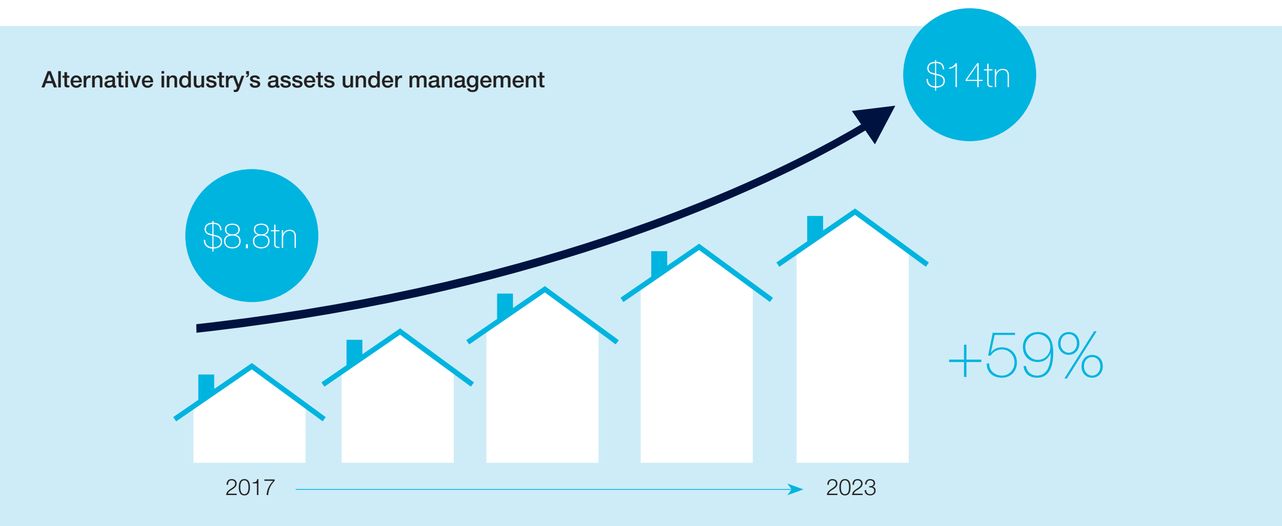
Illiquid alternatives are commonly known as private market assets as they are not tradeable on public exchanges. They include real estate, infrastructure, private equity, and private debt.

We are living in a different world from the financial markets perspective and future return expectations from public markets are really nothing to write home about. In this low returning environment, one area for DC decision makers to turn to in their search for extra yield is alternative investments.

The 2018 Future of Alternatives Report by the private markets data provider Preqin showed the alternative industry's assets under management at the end of 2017 stood at $8.8tn. They are projected to reach $14tn by 2023, an increase of 59% over 5 years.

In fact, allocations by institutional investors to alternative asset classes have been steadily growing each year, with 84% of investors surveyed by Preqin planning to increase their allocation to alternatives in the next five years.

More investors are turning to alternative assets due to the extended period of lower returns in traditional asset classes. Many DC schemes that are currently unable to invest into more illiquid types of assets risk missing out on benefits above a more traditional equity and bonds portfolio.



2. BENEFITS OF ALTERNATIVE ASSETS

While the characteristics of each alternative asset class can vary widely (and often also vary widely within the same asset class) there are several potential benefits of an allocation to alternative assets in a traditional portfolio. These include:

A) REDUCED RISK THROUGH DIVERSIFICATION

In a traditional portfolio of stocks and bonds, the two asset classes have a relatively low correlation to each other which helps to diversify the portfolio in normal market movements. Correlation is a measure of how likely the values of two assets are to move in the same direction in the same economic conditions. In other words, if the value of equities is falling then the value of a totally uncorrelated asset is less likely to be falling compared to a well correlated asset. This is what creates a diversification benefit.

However, as we saw during the Global Financial Crisis and other market downturns, most traditional assets became highly correlated and values fell across the board as public equity and bond returns are broadly driven by economic growth, the business cycle, and fiscal policy. The introduction of alternative assets can provide further diversification to the portfolio as valuations of alternative asset classes tend to be affected by different factors to these main drivers. For example, the value of real estate is affected by macroeconomic factors (much like the stock market) but also by availability, demographic shifts in that particular area, and regional prosperity.

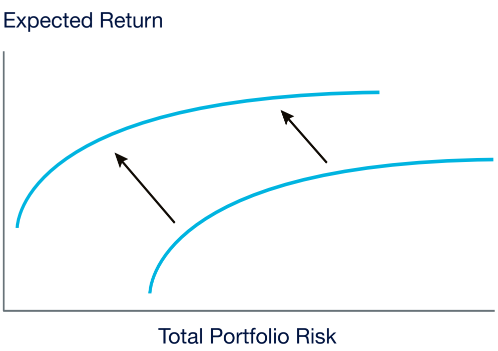
Many DC pension schemes will allocate a very high proportion (sometimes as high as 100%) to publicly-traded index-tracking equity when members are younger and further from retirement, known as the “growth phase” of the DC investment process. This exposes a member’s savings to a lot of downside risk if equity markets were to start falling.

Introducing alternative growth assets with low or negative levels of correlation increases diversification and can protect against this downside risk by dampening drawdown and even providing growth potential during volatile market conditions.

While it is important to note that not all alternative assets exhibit lower levels of volatility than traditional asset classes, many of them do experience less volatility than the stock market and, when combined with a traditional portfolio of stocks and bonds, can lower the overall portfolio risk.

The lower volatility and overall diversification of risk factors achieved when adding alternatives to a portfolio shifts the overall risk and return profile as illustrated below.

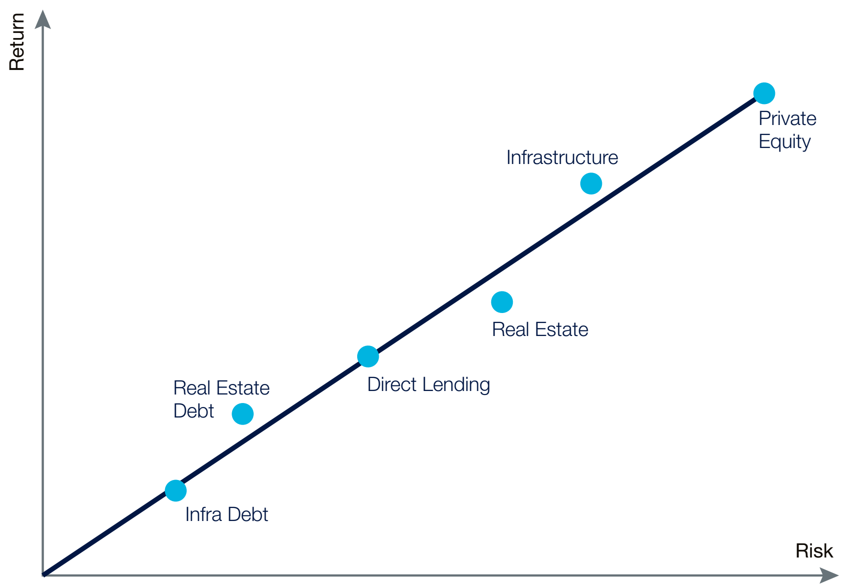
This is exactly the kind of shift you want to see – returns are increased and risk is reduced. This kind of shift could have a profound impact on the savings of DC members, helping to drive better retirement outcomes for those who will rely on DC in later life.



Source: CAIA Association

B) ENHANCED RETURNS

Across alternative asets, there are different levels of risk and return as illustrated below.



Source: JLT, illustrative purposes only

In private markets, there are possibilities to enhance returns over and above the public markets. For example, the **capability of sourcing new deals** in private markets can be a crucial factor in driving higher returns, as many transactions are relationship-driven. A manager with the opportunity to negotiate deals bilaterally rather than participating in a bidding process for an asset is generally expected to end up with higher fund returns. The manager's skill and ability to optimise an investment and create accretive value can also add meaningful returns when the fund eventually exits the position.

Because of the lack of transparency in the private markets compared to the public markets, there are opportunities to exploit market inefficiencies where having an information edge can prove to be important for returns.

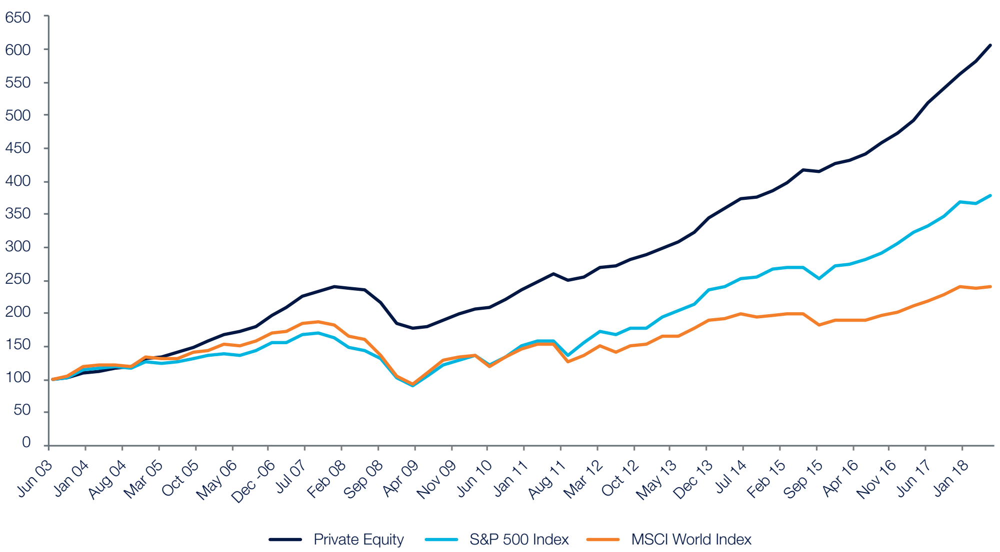
This is a crucial point in private market investments:

- in public markets managers are left to estimate the prospects of a particular stock or bond based on limited information in the public domain;
- in private markets confidential information is provided to potential investors (subject to non-disclosure agreements) so they can make a fully informed decision regarding the prospects of target companies.

> *"I want people to tell me what's really going on, so I can figure out whether what they're saying makes sense or doesn't make sense. You can do that in the private equity business, […] because you're allowed to get all that inside information, if you're trying to buy a company".*
>
> **Stephen Schwarzman**, the founder of Blackstone, the largest private equity firm in the world.

When looking at alternative assets, we can see that illiquid asset classes consistently outperform their listed counterparts. Private equity, in particular, has consistently outperformed public equity. Using Preqin's database shows that private equity has generated a return premium over public markets.

15 YEAR PERFORMANCE OF PRIVATE EQUITY VS PUBLIC EQUITY (REBASED TO 100)



Source: Preqin (Private Capital Quarterly Index), Bloomberg

Looking at the years ahead, we expect this trend to continue. In fact, estimates from the JLT Market Forecast Group as at Q4 2018 show 6.2% net returns p.a. for listed developed equities and 8.9% for private equity funds of funds over the next 20 years (GBP returns).

In addition to information and sourcing advantages, two other notable drivers of additional returns for private markets are the illiquidity premium and complexity premium.

Illiquidity premium - the term 'liquidity' is used to describe the ability to sell an asset quickly without impacting its price. Investments can range from completely liquid (i.e. the asset could be sold today at the prevailing market price) to completely illiquid (i.e. it would take a significant period of time to find a buyer at a heavily discounted price).

Alternative assets are generally considered illiquid and investors expect a premium as recompense for this lack of liquidity. This premium over a more liquid investment is known as the illiquidity premium and, while the size of the premium can fluctuate over time due to market conditions, it has been shown to be persistent across a market cycle, particularly in private credit and private equity.

Complexity premium - many alternative asset classes are complex and require specialised expertise and enhanced levels of due diligence before investment, therefore most transactions trade with a complexity premium as well. A complexity premium is difficult to quantify but, as a general rule, more complex assets such as collateralised loan obligations or real estate mortgages will have a complexity premium for investors over ordinary, public-market bonds.

The extra returns that illiquid investments could add compared to a traditional default fund are not to be disregarded. We have to take advantage of the long investment horizon of DC and harness the available premia to ensure we don't leave money on the table.

C) INFLATION SENSITIVITY

Certain alternative asset classes are popular amongst investors whose liabilities or objectives are exposed to inflation. This is particularly important for DC investors as they need to protect the purchasing power of their savings, and this should be one of the main goals of any DC default strategy.

Alternatives such as commodities, infrastructure and real estate are collectively referred to as real assets, because their returns are in some way related to inflation. This can be because the cashflows they generate tend to vary with changes in inflation, or it can be because their prices respond well to some of the factors that drive or are associated with inflation shocks.

Assets whose returns respond to inflation are considered desirable, particularly by long-term institutional investors as they reduce the uncertainty of future returns being eroded by inflation. In contrast, many studies have shown that publically traded stocks alone do not provide a good hedge against inflation. This is because the positive relationship between inflation and company earnings is overwhelmed by equity markets responding badly to unexpected changes in inflation.

These benefits and additional returns do, however, come at a higher cost than public market investments. While even after fees the returns are usually still superior, DC schemes are restricted by the charge cap at 0.75%. Therefore, the default portfolio needs to be constructed carefully to ensure that the allocation to illiquids is still meaningful enough to drive enhanced returns at the overall portfolio level while making sure that the cap is not breached.

3. ACCESS TO ILLIQUID ALTERNATIVES

The vast majority of investors will invest through a pooled fund managed by a specialised alternative investment manager. There are broadly two types of funds; open-ended and closed-ended.

Open-ended funds are the type DC investors are more familiar with – they can subscribe to a fund at anytime and (usually) redeem their units at will.

Closed-ended funds are the most common type of fund in alternatives, and investor capital is locked up for the life of the fund (generally 6-10 years depending on the asset class). Closed-ended funds may be more appropriate where the underlying assets cannot be quickly sold (i.e. they are less liquid).

It is the question of access that is being mulled over in greater detail by the industry. The FCA is consulting on relaxing their rules around permitted links to allow more illiquid assets to be offered to retail investors (particularly keeping in mind the needs of DC pension investors) via insurance platforms. They are also discussing a potential new type of fund to provide an easier access point to Patient Capital for DC and are looking into their regulations around illiquid investments more generally too.

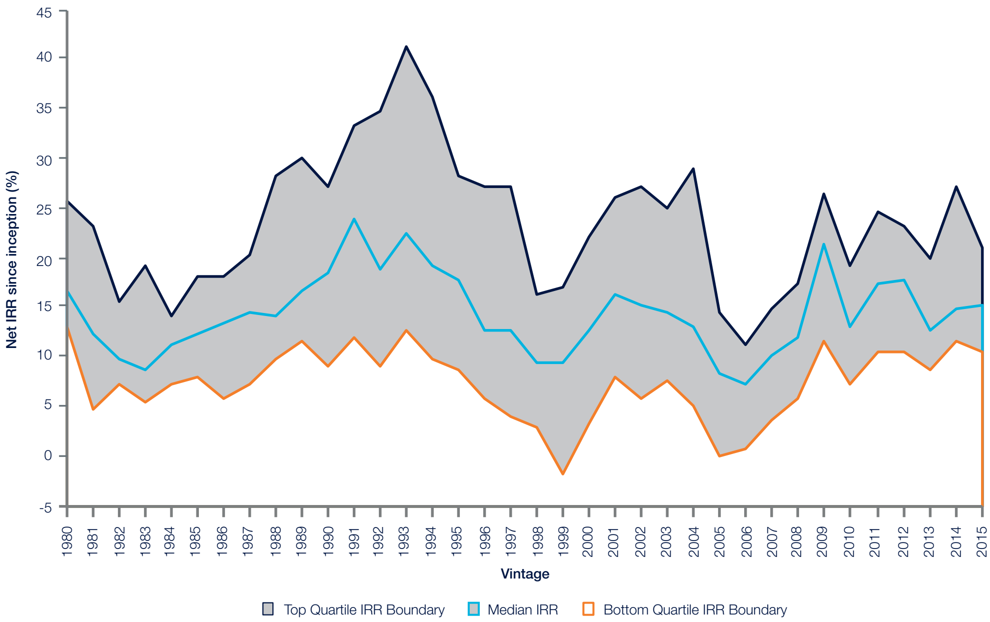
With so much investment flowing into DC and so many people dependent on its success, we wholeheartedly support these efforts.

4. SELECTING YOUR ILLIQUID ALTERNATIVES MANAGERS

It is important to note that there is large dispersion of manager performance in alternatives, much more so than among managers for public securities.

Manager selection is the primary determinant of returns across most alternative asset classes, so it is very important to choose your manager well. However, the good news here is that the returns on private investments tend to be "sticky" – once you've chosen a good manager, performance can be persistent. This goes back to the point we made earlier around manager capability to source good deals ahead of their competition due to their networks and relationships and their skill in optimising investments to add value. These qualities tend to transfer with the manager from one fund to the next and help support superior returns.

ALL PRIVATE CAPITAL FUNDS' MEDIAN IRR BY VINTAGE YEAR



Source: Preqin (Private Capital Market Benchmarks), Bloomberg

The graph above shows the rate of return from funds investing in private capital (across asset classes) by their year of vintage (inception). It illustrates a wide range between the upper and lower quartiles, particularly during periods of high economic growth. The median rate of return, however, remains strong throughout and typically doesn't fall much below 10%.

The returns during periods of economic downturn such as around the dot-com bubble bursting in early 2000s or the 2007-2008 financial crisis are also markedly better than traditional assets classes such as listed equities, which fell sharply in value during those periods.

5. ILLIQUIDITY AND RESPONSIBLE INVESTING

Environmental, Social and Governance (ESG) factors are becoming increasingly prominent in the pensions industry and it is important to consider these factors when selecting investment managers and funds.

The Government is driving the sustainability agenda for UK pension fund investment and is now mandating schemes to incorporate a section on the trustees' consideration of ESG factors in their scheme's Statement of Investment Principles, including drafting stewardship policies.

However, for most private market asset classes and their investment managers, ESG is already embedded in the investment process as part of the enhanced due diligence completed at origination as the assets cannot be sold easily. Infrastructure, for example, is an area where consideration of environmental factors has historically been embedded into the origination and due diligence process as the potential for regulatory fines must be assessed and underwritten.

DC schemes can therefore be confident that by investing in private markets they are meeting their requirements to consider ESG factors, while often going even beyond that and providing a positive impact on the future world that DC savers will retire into.

6. IMPACT OF ILLIQUID ALTERNATIVES ON DC SAVERS

Crucially, it is important to understand the impact that illiquid strategies could have on the values of DC savings in later years of accumulation.

An allocation to private markets can reduce the variability of returns and enhance the future value, compared to an allocation to stocks and bonds alone.

We call on the help of Max, our example of a young DC saver at the start of his working life, to try and measure the potential benefit that could be had.

MEET MAX

Max is 22 years old and has just been auto-enrolled into his employer's pension scheme. He earns a UK average salary of £29,588 which increases in line with inflation and his total contributions are set at 8% (minimum AE level from April 2019). He has no starting savings.

Below are the results that he could expect by the age of 57 using estimates of net long-term market returns provided by JLT's Market Forecast Group for Listed Equities (LE), Private Equity (PE) and Infrastructure Equity (IE), for illustrative purposes.

Investment strategies	Pot at age 57
LE	£373,180
80% LE / 10% PE / 10% IE	£403,074
80% LE / 20% PE	£416,478

Our results show that Max could increase his pot at the age of 57 by around 12% if an allocation is made to illiquid private equity compared to listed equities alone, after all fees and using median manager returns.

A more diversified portfolio would be expected to still provide 8% over and above what traditional daily dealt equities can offer Max.

As stated earlier, the dispersion of returns among private markets managers is rather high, so better due diligence during the manager selection process could result in even bigger potential upside.

If there is one point you take away from this whole paper, it should be this: **on average, member pots could be boosted by c. 10% through the addition of some illiquid assets to the default strategy early on.**

From a member's perspective, the results will depend on many factors, but generally speaking the earlier in the savings stage illiquids are added and the higher the contributions that members pay in, the better the results will be from these investments, compounded over many years.

7. OUR VIEW ON PATIENT CAPITAL

In 2017, HM Treasury carried out Patient Capital Review to help identify additional sources of funding for innovative UK start up companies. They define the term as capital provided to support the UK's innovative start up companies with high growth potential – or, in other words, domestic venture capital.

Since then, more initiatives have been announced and a task force set up to take these initiatives further. This culminated in a package of measures announced in Autumn Budget 2018 to help bring down the barriers to DC pension schemes accessing Patient Capital investments.

Let's look closely at what this really means. Venture capital is an investment strategy within private equity, and is one of the riskiest sub-strategies. Investment is typically made at an early stage of a company's development, when a company may not yet be profitable and there are still significant hurdles for it to overcome. An allocation to venture capital may have a place in a well-diversified alternatives portfolio but, given its risk profile, is generally not suitable as the sole allocation to alternatives in a default.

The failure rate of UK start ups is high; according to the Enterprise Research Centre, almost half of all start ups do not survive until their third year. Of the ones that do, an extremely small amount (1.9% nationally) generate at least £1m of revenues after 3 years.

There is also additional risk posed by investing into UK venture capital in the current environment. At the time of writing, the UK ranks second only to the U.S. in the world in the Venture Capital and Private Equity Country Attractiveness Index 2018 (a measure which assesses the investment activity, quality of the investment environment, and the ease of making transactions within each country). With Brexit on the horizon, the authors of the report expect the UK to fall to at least sixth in the rankings with the potential to slip lower should there be a hard Brexit.

To sum up, while Patient Capital as specifically defined by the Government has a role to play in a DC default, we strongly advocate for Patient DC instead, defined by us as approaching default design with a longer-term view and creating a well diversified illiquid allocation within the default fund.

8. SO WHAT'S CURRENTLY AVAILABLE IN THE ILLIQUID ALTERNATIVES FIELD?

Due to the current barriers (both actual and perceived) for DC schemes to invest in more illiquid funds members are missing out on investment opportunities. However, there are funds available which offer exposure (albeit diluted) to illiquid asset classes in a liquid fund structure.

This is achieved by combining alternative assets which are listed on the public markets and cash with an allocation to more illiquid investments. Such an approach allows schemes to have their cake and eat it to a certain extent. They need to be mindful that having a liquid allocation to be able to maintain daily liquidity is likely to reduce the return from the private markets part of the fund.

Partners Group launched such a diversified liquid alternatives fund in April 2016 and has enjoyed a first mover advantage in this space. However, other fund managers are in the later to final stages of launching similar products which will target the DC market specifically, so we will have a good variety of offerings shortly. These funds are very advantageous, particularly to smaller schemes which may not have enough capital to build their own diversified alternatives portfolio.

For larger schemes, however, and particularly master trusts, these "one size fits all" solutions may not be optimal. In an ideal world, larger schemes would need to choose their own allocation of alternative asset classes according to their needs – diversification, extra growth etc. Notably, NEST is the first master trust that is about to add an illiquid allocation to private credit to their default portfolio, and they are also looking to add an allocation to private equity.

As more fund offerings in alternatives become available to DC schemes, and as the DWP's push progresses on the structural and regulatory side, we would hope to see more investment approaches evolve.

CONCLUSION

While incremental changes are a big driver of overall progress, a real sweeping change is required if we are to create happy retirements for Generation DC.

Introducing illiquid assets as part of a default arrangement could be that change. While on their own these investments may not be appropriate for members to select themselves, they are perfectly placed as an allocation within the default. And as 96% of DC trust scheme members in the UK are in a default strategy, by improving the quality of defaults we can make the biggest impact.

Now that the regulators are relaxing the rules and new products are being developed, Patient DC has finally moved into the realms of possibility.

Good things come to those who wait, but not to those who wait too long to implement changes for the better. We need to act now to turn DC schemes into Patient DC schemes so that members can reap the benefits for years to come.

That is why we urge those who are responsible for default design decisions to consider the evidence provided in this paper and make the necessary changes to your schemes. It's time to do more, so that millions don't sleepwalk into retirement ruin.

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