Pensions Policy Institute
PPI

Pension scheme assets – how they are invested and how and why they change over time

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An Independent Report by The Pensions Policy Institute

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Pension scheme assets – how they are invested and how and why they change over time

	Page
Executive Summary	1
£3 trillion of pension assets	3
Bonds are the largest asset class, closely followed by equities	3
Productive assets estimated to account for 18% of the £3 trillion	3
DB schemes are the largest investors in productive assets	4
Understanding the drivers of change helps understand the longer-term picture.	4
Members should benefit from shifts in asset allocation	4
Challenge in achieving common set of definitions and understanding	5
Government drive for investment in private equity will need to be driven by open DB and DC	5
Ensuring that changes in asset allocation meet member needs.	6
Introduction	6
Pension fund assets – a topical subject	7
Chapter One: Pension Scheme Asset Allocation, a topical but complex subject	8
How can we find out where pension assets are invested?	10
Chapter Two: How and where were UK pension scheme invested in 2023?	11
£3 trillion of UK pension assets	12
Private sector DB remains the largest slice of the pension cake.	13
Public sector DB schemes more heavily invested in equities.	13

	Page
DC schemes invest largely through pooled funds	14
Annuity business heavily invested in corporate bonds and mortgages.	14
Overall, one third of UK pension assets invested in equities.	16
Chapter Three: Trends, differences and drivers of asset allocation?	17
A structural shift in asset allocation	18
Member outcomes and profile a strong driver of asset allocation	19
Expected performance, portfolio diversification, costs, accessibility, liquidity and volatility all shape asset allocation.	21
Size, profile and scheme end-game influence asset allocation.	23
Government and regulatory policy can influence asset allocation directly and indirectly	25
ESG plays a lesser role in asset allocation.	26
Chapter Four: What do current and future trends mean for members, Government, regulators and industry?	27
Members should benefit from shifts in asset allocation	27
Challenge in achieving common set of definitions and understanding	28
Government drive for investment in private equity will need to be driven by open DB and DC	28
Ensuring that changes in asset allocation meet member needs.	29
References	31
Acknowledgements and contact details	33

EXECUTIVE SUMMARY:

This summary draws out the key findings from this first phase of research and serves as the report's conclusions.

This report is the first in a series of outputs from the PPI that will explore asset allocation and asset strands in the UK pension sector.

MAPPING THE ASSETS OF THE UK PENSIONS SECTOR IS LIKE TRYING TO NAIL 20 JELLIES TO A WALL[1] AND TRYING TO MAKE ONE SIMPLE PICTURE FROM THE MESS. UK DATA IS SLIPPERY, FRAGMENTED, INCONSISTENT AND INCOMPLETE. SO, LET'S GIVE IT A GO!

In 2021, the UK Government began a series of consultations on the use of illiquid assets in DC pension schemes, as a mechanism for generating better retirement outcomes and releasing assets to be invested in productive finance[2]. 2023 saw a parallel call for evidence on opportunities for improving access to DB funds and surpluses for investment in productive finance, either through direct investment or release of surpluses back to employers for investment in their businesses.

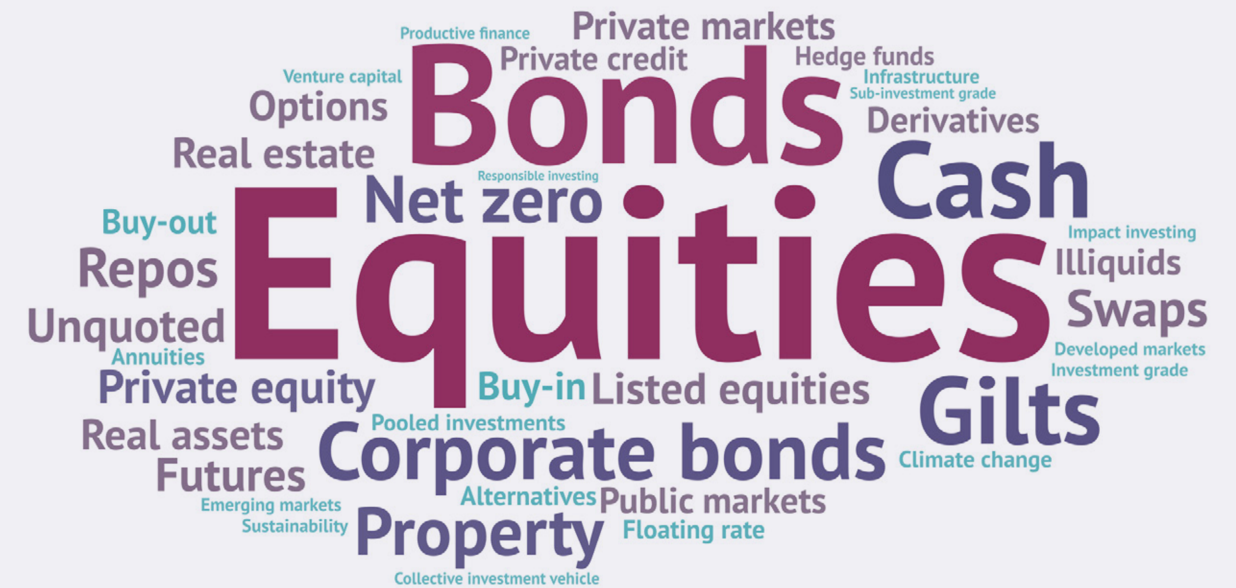
However, the picture on how pension assets are invested is patchy and inconsistent. The PPI has therefore embarked on a series of outputs and surveys designed to identify what we do and do not know about asset allocation, and to shine the spotlight on particular asset strands of interest. This report represents the first of those papers.

There appears to be no single definition of what constitutes productive finance, but, as set out in a paper published by the Bank of England*, it is essentially investment that supports economic activity. In this report we use the expression 'productive assets' to include a wider range of investments than many definitions, and include investment in listed equities, private equity (in its various guises), property and corporate bonds.

DATA ON HOW AND WHERE UK PENSION ASSETS ARE INVESTED ARE FRAGMENTED AND THE LEXICON OF PENSION ASSETS IS COMPLEX. TO MOVE FORWARD IN TRACKING HOW PENSION FUNDS ARE INVESTED, GOVERNMENT AND REGULATORS WILL NEED TO ENSURE CONSISTENT DEFINITIONS OF ASSET CLASSES THAT ARE COMPREHENSIVE AND THAT AVOID DUPLICATION.

Since this report was drafted there has been an election and a new Labour Government is now in power. Some of the policy moves discussed in this report may be modified by the current administration. The new Government may also decide to introduce new policies/regulations which change the trends discussed within.

Figure 1: A complex lexicon of terms and definitions.



Mapping asset allocation is an imprecise science. The analysis contained in the remainder of this report seeks to illustrate the map of assets broadly as it stood in mid-late 2023. However, to achieve this we have mixed and matched different data sets. **As such, the data below should be treated as approximate, with our confidence in some data greater than other.** The figure below summarises the relative levels of confidence in the data presented, with the darkest indicating relatively high confidence and the palest indicating lower levels of confidence.

Figure 2: Relative levels of confidence in asset allocation data.

How much do we know about how assets are invested?

	High level asset allocation	'Productive finance'	UK assets1
Private sector DB			
Public sector DB			
Trust based DC			
Contract based GPP			
Individual PP			
Pension annuities			

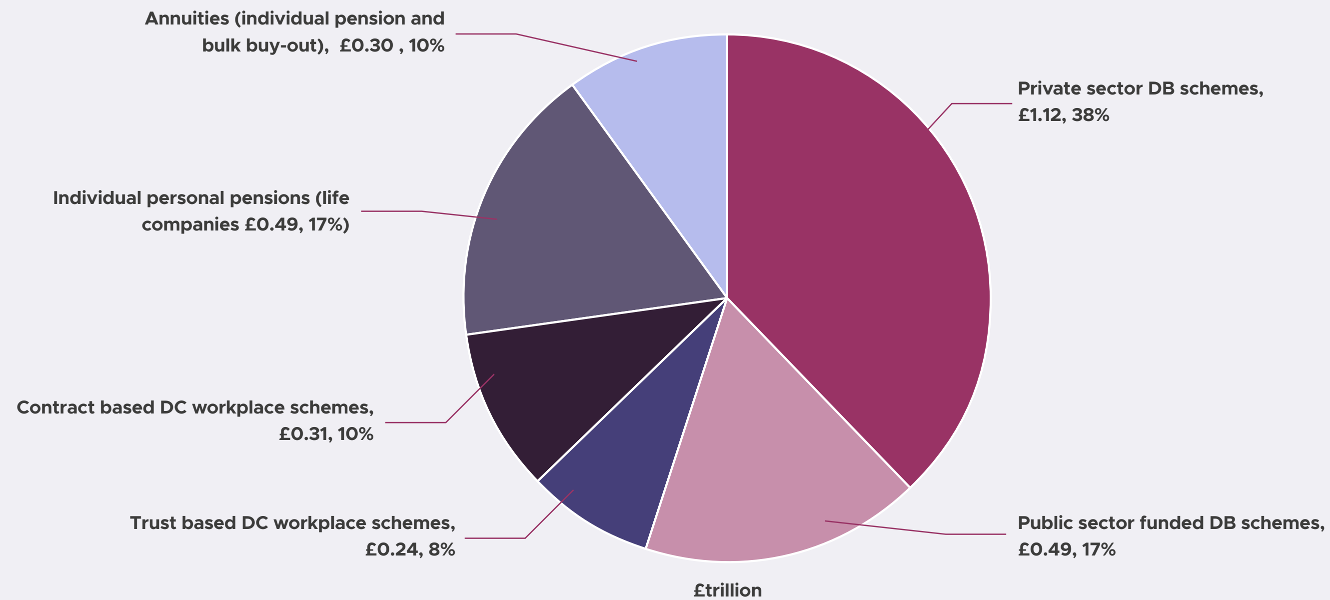
1. Productive finance includes corporate bonds, equity (both public and private) + other alternatives
2. UK assets includes assets listed or registered in UK

* Bank of England (2016) p.8
[1] "trying to give exact details for something that it is not possible to know about exactly"
[2] DWP (2021) p.7

£3 trillion of pension assets.

Combining different and incomplete data sets, the PPI estimates that the assets of the UK pension sector 'towards the end of 2023' were valued at just under £3 trillion, with Defined Benefit (DB) representing 55% and Defined Contribution (DC) having topped £1 trillion.

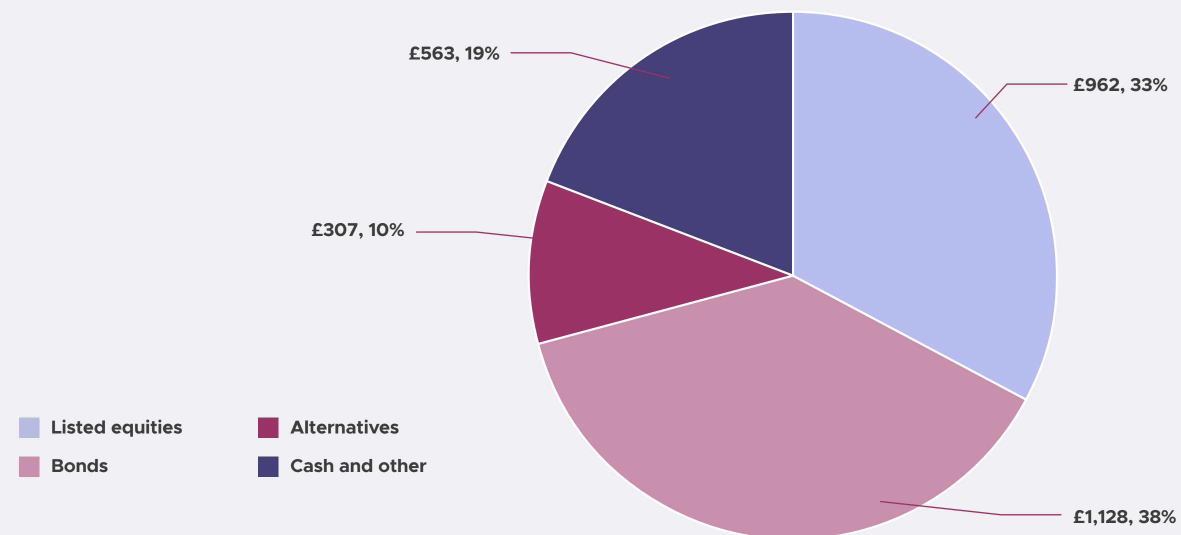
Figure 3 £3 trillion of UK pension assets (PPI estimates, FSPS, Purple book, ABI) £ trillion.



Bonds are the largest asset class, closely followed by equities.

Taken overall, bonds represent the largest share of assets at 38%, followed by equities at 33%, private equities and alternatives[3] at 10%, with cash and other (largely unclassified) investments making up the remaining 19%.

Figure 4: UK pension sector, overall asset allocation (£billion and %).

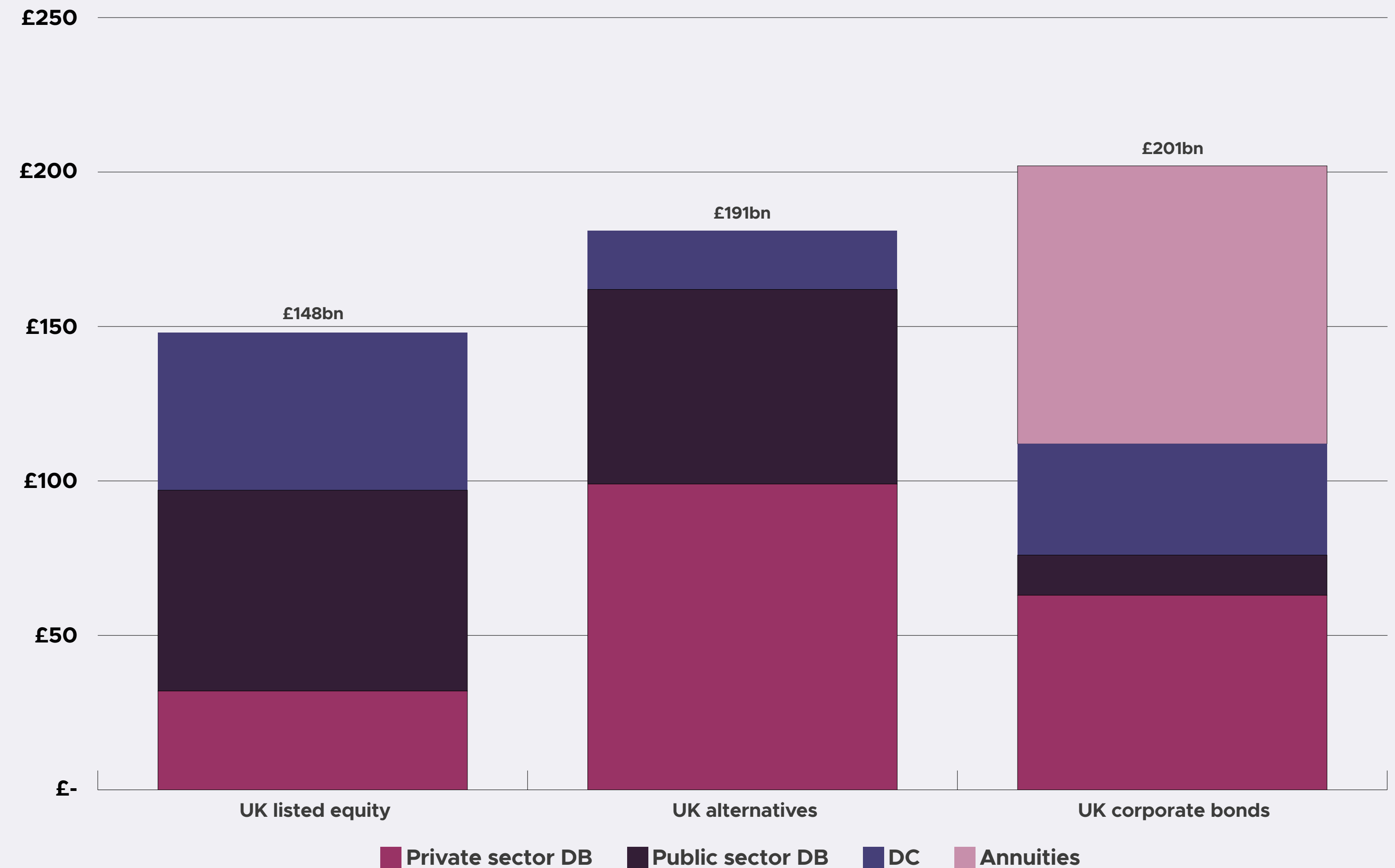


[3] Alternatives includes private equity, property, Secure Income Alternatives (SIA), infrastructure, private debt and venture capital.

Productive assets estimated to account for 18% of the £3 trillion.

Using a definition of UK productive assets that includes listed equities, corporate bonds, private equity and alternatives, the PPI estimates that 18% of UK pension assets is invested in UK productive assets. Using a much narrower definition that extends only to private equity and alternatives, the share drops to 6%.

Figure 5: Overall allocation of UK pension assets to UK listed equities, corporate bonds, and alternatives £billion.



DB schemes are the largest investors in productive assets.

When it comes to investment in these assets, significant differences exist between different types of pension scheme:

- Private sector DB pensions are the biggest investors in UK productive assets by value (£250bn).
- Public sector DB schemes are the biggest investors in UK productive assets by proportion of funds (31%).
- DC arrangements invest less by value (£101bn) and proportion (19%).
- Annuity providers are major investors in UK corporate bonds (£90bn).

Headlines on pension asset allocation are driven largely by the shift away from equities to bonds among closed DB schemes. In fact, the UK is undergoing a structural shift which is reshaping asset allocation in different directions.

Significant differences exist between closed and open DB schemes, with a narrower and largely liability or cashflow driven approach featuring in closed schemes, but a much more comprehensive, complex and more growth-driven approach in open DB schemes.

DC scheme asset allocation, by contrast, has been shaped in part by the limits on charges, the relatively small scale of many schemes and the dominance of pooled funds rather than direct investments.

Understanding the drivers of change helps understand the longer-term picture.

Although the high-level picture suggests a move away from equities and a move away from UK investments, it is evident that the shift is far more complex than these two high-level changes suggest. To understand the direction of travel in asset allocation, it is necessary to understand the drivers of change and the way in which they are affecting different parts of the UK pension sector.

Figure 6: Asset allocation influenced by multiple drivers of change.

1. **Member outcomes and profile.** The starting point for asset allocation in both DB and DC schemes is member outcomes. However, the profile of the membership and the maturity of the scheme will play a big part. A more mature membership with an emphasis on retiring or retired members demands a different allocation to one dominated by active younger savers.
2. **Performance, cost and accessibility of assets.** The second major step in determining asset allocation is to model the expected returns and volatility of different asset classes. The cost, accessibility and liquidity of different asset classes will play a part in shaping the strategy.
3. **Size and profile of schemes.** Larger, particularly open, schemes have greater opportunity to move away from pooled funds and develop a more diverse investment portfolio. Closed DB schemes have different drivers of asset allocation to open schemes.
4. **Government and regulatory policy** has an influence on both DB and DC arrangements whether through an emphasis on funding levels, consolidation or on value for money.
5. **Environmental, Social and Governance (ESG).** Increasingly decisions on how to invest pension assets are being influenced by the need to protect the world's environment and an increasing focus on ESG issues, responsible investing, and sustainability.

Members should benefit from shifts in asset allocation.

For members, the trends should provide more secure and better retirement incomes:

- Members of closed DB schemes should see their retirement incomes secured through better funding and, in many cases, buy out through an annuity with a life assurance company (with the associated protection from the Financial Services Compensation Scheme (FSCS)). Those schemes that choose to run on or which join a consolidator may be able to secure improved benefits for their members but may not provide the same degree of certainty or security.
- Members of open DB schemes should continue to benefit from diversity in asset allocation.
- Members of DC schemes with a default fund should see better designed defaults, more diverse portfolios, better risk management, and better returns as asset allocation becomes more sophisticated. However, charges may rise with the higher costs associated with some asset classes. This may be offset by the economies of scale and negotiating power of fewer, larger schemes.
- Members of DC schemes outside of the default and individual DC clients will continue to rely on their own resources or those of a financial adviser to select the best mix of assets.

IN ADDITION TO SEEING THEIR PENSIONS YIELD BETTER AND MORE SECURE RETIREMENT INCOMES, MEMBERS OF SCHEMES SHOULD ALSO BENEFIT FROM THE SOCIETAL IMPROVEMENTS THAT SUCCESSFUL INVESTMENT IN UK BUSINESS SHOULD YIELD, INCLUDING: MORE SECURE JOBS, ECONOMIC GROWTH, WAGE GROWTH, AND BETTER PUBLIC SERVICES.

Challenge in achieving common set of definitions and understanding.

Measuring and reporting asset allocation, as this report shows, is fraught with difficulties:

- Definitions differ across the different organisations collecting data and between scheme types.
- Asset class definitions currently overlap, for example infrastructure can also be included in equity or debt asset classes.
- Some asset classes can mean different things to different people and will need to be carefully defined.
- Seeing through pooled funds to the underlying assets is not straightforward, particularly in mixed asset funds.

IF THE GOVERNMENT WANTS TO ACHIEVE A SINGLE VIEW OF ASSET ALLOCATION ACROSS THE PENSION SECTOR, IT WILL NEED TO WORK CLOSELY ACROSS SEVERAL ORGANISATIONS: REGULATORS, TRADE BODIES, RESEARCH BODIES, DATA COLLECTORS, MEDIA AND, MOST IMPORTANTLY, THE INDUSTRY TO ACHIEVE COMMON DEFINITIONS AND UNDERSTANDINGS.

Government drive for investment in private equity will need to be driven by open DB and DC.

The Government's ambitions for more investment in private equity look likely to be realised in the medium term, but it is less clear how much of this will feed into UK business. Continuing the trend towards greater diversity in assets relies very much on the current transitions being allowed to work their way through, in particular, the consolidation in the DC sector and the continued use of default funds.

The growth in private market assets will largely be driven by the very small number of open DB schemes in the public and private sectors and DC funds. However, the policy initiatives currently underway could lead to some unintended consequences:

- The potential for a herding effect with providers all putting more money into private equity at the same time, which could have a detrimental effect on asset prices and returns.
- A risk that disclosing asset allocation could lead to less innovation in asset allocation as schemes tend towards the mean.
- Disclosure could lead to a reduction in UK investment if it becomes more evident that schemes that are overweight in the UK are underperforming.
- Any attempt to force providers to invest more heavily in certain asset classes is a direct challenge to trustees' fiduciary duty and can be expected to be met with considerable backlash. The Government could also find itself in conflict with regulators, both of whom put member outcomes at the forefront of their strategies and policy.
- Changes such as the lifetime provider and the small pots initiative could disrupt the current trend towards consolidation and, with funds moving more between providers, could lead to providers needing to emphasise liquidity.

THERE IS POTENTIAL FOR THE GOVERNMENT'S AMBITIONS TO BE ACHIEVED AND, TO SOME EXTENT, THIS IS ALREADY HAPPENING. HOWEVER, CHANGE WILL NOT COME OVERNIGHT AND PATIENCE IS REQUIRED AS THE TRANSITIONING TAKES FULL EFFECT.

Ensuring that changes in asset allocation meet member needs.

Schemes and providers face a number of challenges arising from the shift in asset allocation and recent policy initiatives:

- For closed DB schemes and their employers, decisions on the endgame need to be reviewed in the light of Government policy. At the time of writing this report, it was not clear that whether the Government proposals would change the direction of travel. For those schemes heading for buyout, getting the assets into shape to make that transition smooth and as low cost as possible will be a key driver of asset allocation.
- For open DB schemes, including the Local Government Pension Scheme (LGPS), diversification of assets will continue to be important but with some continuing pressure or encouragement from Government to direct funds towards productive finance in the UK.
- In DC, the potential shift away from insured pooled funds to more segregated funds, as trust-based schemes grow and consolidate further, will lead to a number of issues for trustees and contract-based providers:
    - Investment governance will become more complex and will require greater spread of expertise on trustee boards and Independent Governance Committees (IGCs) and access to different advisers and managers.
    - Member-borne costs could rise as new assets are accessed, hopefully offset by scale efficiencies and the ability to negotiate down fees.

For all schemes, ensuring that member needs remain at the forefront of any decisions will be essential.

CONSOLIDATION IN DC WILL SUPPORT AND DRIVE GREATER DIVERSIFICATION OF ASSET CLASSES. WITH THIS MAY COME SOME ADDITIONAL COSTS FOR MEMBERS AND INCREASED DEMANDS ON GOVERNANCE BODIES TO ENSURE THAT NEW ASSET CLASSES ARE UNDERSTOOD. CONTINUING TO PUT MEMBER OUTCOMES AT THE FOREFRONT OF DECISIONS WILL BE ESSENTIAL.

Introduction

This report has been informed by analysis of available data sets, desk research, interviews with industry and consultation with regulators and Government departments[4].

Pension fund assets – a topical subject

In 2021, the UK Government began a series of consultations on the use of illiquid assets in Defined Contribution (DC) pension schemes, as a mechanism for generating better retirement outcomes and releasing assets to be invested in productive finance. 2023 saw a parallel call for evidence on opportunities for improving access to Defined Benefit (DB) funds and surpluses for investment in productive finance[5], either through direct investment or release of surpluses back to employers for investment in their businesses.

A report by the Resolution Foundation in 2023[6], highlighted the limited engagement of UK pension schemes with UK businesses. It estimated that just 2% of DB and DC scheme assets are allocated to directly held UK equities. In other countries, Australia and Denmark are often quoted, asset allocation strategies have been shown to have a material and positive impact on that country's productivity and economy[7].

There appears to be no single definition of what constitutes productive finance but, as set out in a paper published by the Bank of England*, it is essentially investment that supports economic activity. In this report we use the expression to include a much wider range of investments than many definitions, and include investment in listed equities, private equity (in its various guises), property and corporate bonds.

The Government has consulted on several initiatives designed to address this issue and the subject arose again in the Chancellor's 2023 Mansion House speech[8]. As part of the Mansion House speech, the Chancellor announced a compact with nine (now eleven) of the largest providers in the DC pension sector. They have made a commitment to investing 5% of their default fund assets to unlisted equities by 2030. It was calculated that this could unlock £50 billion of investment in high-growth companies (although the commitment does not lock in providers to invest in the UK).

The Chancellor returned to the debate in the Spring 2024 budget and, as indicated in the excerpt below, confirmed a decision to require schemes and providers to disclose the level of their UK investment.

EXCERPT FROM SPRING BUDGET 2024

"ACROSS THE PENSIONS INDUSTRY AS A WHOLE, THE BEST DATA SUGGESTS INVESTMENT INTO UK EQUITIES HAS FALLEN TO AROUND 6%. TO IMPROVE DATA ON CURRENT HOLDINGS, THE GOVERNMENT INTENDS TO BRING FORWARD REQUIREMENTS FOR DEFINED CONTRIBUTION PENSION FUNDS TO PUBLICLY DISCLOSE THE BREAKDOWN OF THEIR ASSET ALLOCATIONS, INCLUDING UK EQUITIES, WORKING CLOSELY WITH THE FINANCIAL CONDUCT AUTHORITY (FCA) WHO SHARE RESPONSIBILITY FOR SETTING REQUIREMENTS FOR THE MARKET. THE FCA WILL CONSULT IN THE SPRING. THE GOVERNMENT WILL INTRODUCE EQUIVALENT REQUIREMENTS FOR LOCAL GOVERNMENT PENSION SCHEME FUNDS IN ENGLAND & WALES AS EARLY AS APRIL 2024. THE GOVERNMENT WILL REVIEW WHAT FURTHER ACTION SHOULD BE TAKEN IF THIS DATA DOES NOT DEMONSTRATE THAT UK EQUITY ALLOCATIONS ARE INCREASING."[9]

However, the picture of how pension assets are invested is patchy and inconsistent. The PPI has therefore embarked on a series of outputs and surveys designed to identify what we do and do not know about asset allocation, and to shine the spotlight on particular asset strands of interest. This report represents the first of those papers.

Chapter One – Pension scheme asset allocation, a topical but complex subject

This chapter explores the context for this piece of research, in particular the policy landscape that encourages scheme consolidation and investment in productive assets that support the UK economy. It also describes the complexity of mapping UK pension assets by asset class and the various sources of data used in Chapter Two of this report.

Chapter Two – How and where were UK pension schemes invested in 2023?

In this chapter we set out the size of the UK pension sector in terms of assets under management (AUM) and, within each part of the sector, describe how assets are allocated and estimate the percentage held in UK assets.

Chapter Three – Trends, differences and drivers of asset allocation?

This chapter examines trends in asset allocation, exploring the differences between different scheme types. It then describes what is driving decisions on asset allocation and the way in which these drivers interact to create the pattern and trends that we see today.

Chapter Four – What do current and future trends mean for members, Government, regulators and industry?

This chapter considers what current and future trends and policy positions could mean for the different stakeholders, and what impact policy could have on future asset allocation.

* Bank of England (2016) p.8
[4] Including FCA, HMT, DWP, TPR, PRA
[5] DWP (2021), p.7
[6] Resolution Foundation (2023) p.50
[7] World Economic Forum (2022)
[8] Gov.uk (2023)
[9] HM Treasury (March 2024) p.57

CHAPTER ONE:

PENSION SCHEME ASSET ALLOCATION, A TOPICAL BUT COMPLEX SUBJECT

This chapter examines the context for this PPI project, the availability and consistency of data on pension scheme asset allocation, and the different asset class definitions that currently exist.

How can we find out where pension assets are invested?

Multiple, partial and inconsistent data sets

We know both 'quite a lot' and 'not enough' about the assets that back current and future retirement incomes. Quite a lot because there are several sources of data that map pension fund assets and the way in which they are invested. Not enough because there are gaps in our knowledge and a multiplicity of data sets that classify assets in slightly different ways. The timing of different reports can also create difficulty mapping assets consistently. Moreover, asset values change all the time, meaning any analysis is always out of date.

One reason for the lack of data or consistency lies in the multi-layered system for pension provision in the UK (over and above the State Pension provision). A very significant proportion of private sector pensions are provided through trust-based, occupational pension schemes, pure Defined Benefit (DB), DB hybrid (including DB and Defined Contribution (DC) assets), and pure DC. These are regulated by the Pensions Regulator (TPR) with data collected by them and by the Office for National Statistics (ONS).

However, many employers and individuals provide for pensions through contract-based arrangements with life companies or other providers who are regulated by the Prudential Regulation Authority (PRA) and/or the Financial Conduct Authority (FCA). Their data is less comprehensively mapped, with data collected by several different bodies, including the Association of British Insurers (ABI), and not always disaggregated to see pension assets separate from other insurance company assets.

Annuities provided by insurers (both bulk and individual) are also a major part of the pension landscape, but the assets backing these products are rarely included in the pensions map.

In the public sector, many pension schemes are unfunded, i.e. pensions are paid for from general tax revenues. However, the Local Government Pension Scheme (LGPS) and a small number of other public sector schemes are funded and their assets are included in this report.

Further confusion can arise because:

- the assets of many trust-based pensions are invested in insured funds which can easily lead to the risk of double counting;
- buy-in bulk annuities of DB schemes are assets of the DB scheme, but backed by assets that sit in the life company;
- the assets in some hybrid DB/DC schemes are aggregated in ONS data sets with not all of the DC assets included in DC analysis.

Moreover, the landscape of pension schemes is ever moving. DB schemes are wound up and the assets transferred to annuity providers, the Pension Protection Fund (PPF) or a DB consolidator. DC arrangements can move from being contract to trust based, and significant consolidation has taken place which may reshape the asset mix.

In this report we have sought to disentangle the different groupings of assets as best we can.

Current sources of data from Government, regulators and less formal sources

What we do know needs to be drawn from several sources that themselves are not always complete or consistent. The most comprehensive datasets relating to asset allocation are:

- **ONS:** The ONS publishes quarterly findings from the Financial Survey of Pension Schemes (FSPS)[10], a survey of large occupational pension schemes (drawn from TPR's database) with a response rate of around 80%. The survey maps assets and non-pension liabilities (i.e. borrowing) broken down by asset class and geographic split. The Q3 2023 survey is weighted to represent £2.1 trillion of pension fund assets, separated by private sector DC and DB, and public sector DB, and is by far the most comprehensive and detailed analysis available at present. The data provides considerable granularity and allows some analysis of investments relating to UK and overseas assets. Missing from this analysis is the contract-based DC sector (which accounts for approximately £300bn of assets), individual pensions and most annuity business. The latest published data used for this report relates to assets held in September 2023.
- **TPR:** TPR publishes an annual landscape report and a survey of private and public sector funded DB schemes as well as a more detailed analysis of the funding of tranches of DB schemes (tranches are determined by the schemes valuation dates)[11]. TPR also publishes reports on DC trust-based schemes using data from scheme returns[12]. However, these publications provide only a high-level analysis of asset classes, and the data are not the most up to date.
- **PPF:** The PPF, in conjunction with TPR, collates and publishes The Purple Book annually[13]. It contains data on asset allocation in those DB schemes that qualify for the PPF (5,063 schemes in 2023 with combined assets of £1.4 trillion). The data provides a breakdown of total assets by asset class since 2006 and breaks down equities by broad region (UK and overseas, with the latter broken down in 2023 into developed and emerging markets). Asset mix is also provided by scheme size, funding ratio and scheme maturity. The data used in this report relates to March 2023.
- **Bank of England / PRA:** The PRA collates and publishes high-level data on asset allocation in life companies[14], which includes both assets relating to contract-based workplace and individual pensions, as well as some assets managed for trust-based schemes. While some analysis by very high-level business line is possible, it is not possible to isolate data relating to the contract-based pension sector. The data does provide a breakdown of the assets backing annuity business but does not separate out the different classes of annuity. Furthermore, the data may not represent all contract-based pension assets, as some providers are not insurers (typically wealth managers) and are not regulated by the PRA.
- **ABI:** The ABI collects data from its members relating to asset allocation by some classes of business, but does not publish this data. The data are often incomplete as some life companies do not provide data to the ABI and some contract-based pensions are not insurance backed.
- **ONS:** The Wealth and Assets survey[15] collects data on total pension wealth held by individuals and grosses this up for the population. While it does not provide a breakdown by asset class, it does attach a more comprehensive value to pensions both in accumulation and in payment. In the latest published data (2018-2020 survey), a total value of £6.45 trillion was attributed to pension wealth in England and Wales, £3.66 trillion of which related to active and deferred pensions and £2.79 trillion to the value of pensions in payment (based on the discounted current value of future payments). The difference between this and our figure of £3 trillion is accounted for largely by unfunded pensions in the public sector and the State Pension. Since these have no explicit assets backing them, we exclude them from this analysis.
- **It is also possible to understand patterns of investment and trends** for the largest individual pension schemes in the UK through published data, including the LGPS, and some of the largest DB schemes such as USS and Railpen. The PPF also publishes details of its asset allocation[16].
- **Through DC Chairs' Statements and Independent Governance Committee (IGC) returns,** the master trust and Group Personal Pension (GPP) sectors have started to report details of their asset allocation. It is expected that this will develop further as the new Value for Money (VfM)[17] rules are consulted on and implemented in the next few years. For trust-based schemes, the Department for Work & Pensions (DWP) has published statutory guidance[18] that defines categories of assets that schemes need to disclose. The data available through these documents is not available in a consolidated form.
- **DG Publishing** collates and produces reports on the asset allocation of LGPS funds, but the data is not publicly available and has not been accessed for this report.

[10] ONS (2024)
[11] TPR (2024a)
[12] TPR (2024b)
[13] Pension Protection Fund (2023) p.21
[14] Bank of England / PRA (2024)
[15] ONS (2020)
[16] PPF (2024)
[17] DWP (2023a)
[18] DWP (2023b)

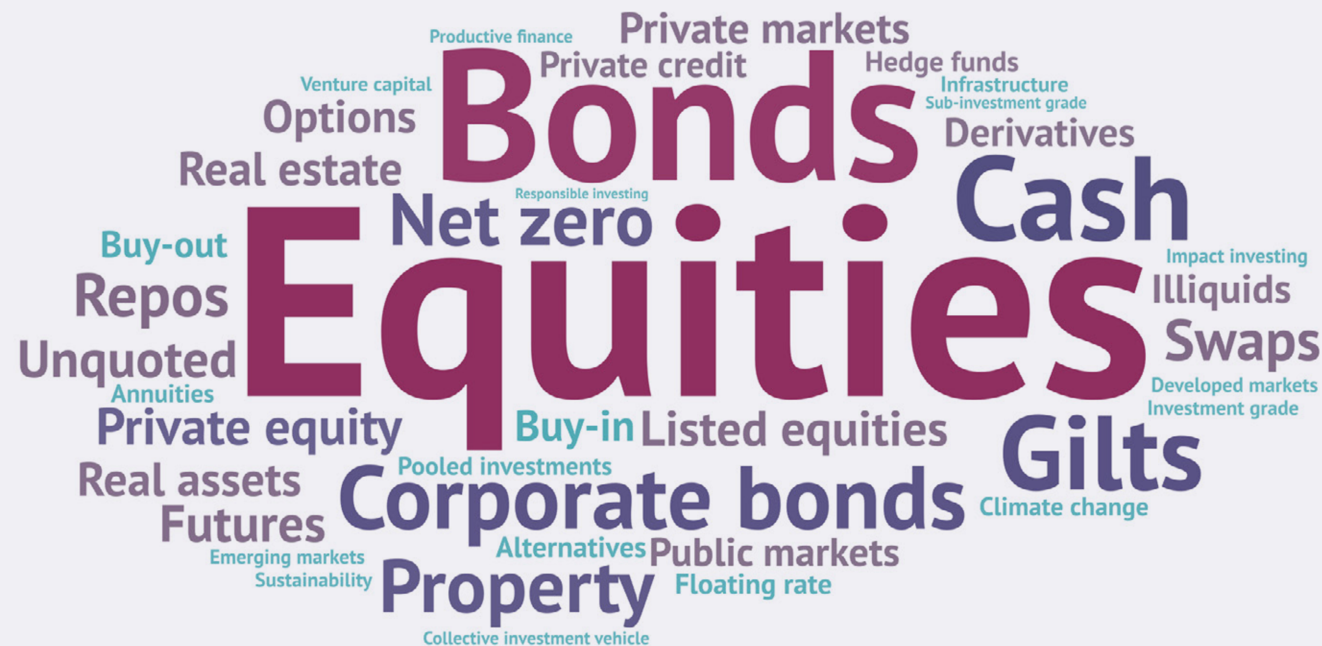
- **Corporate Adviser** collects and publishes data annually on the default funds operated by master trusts and GPPs[19], but does not separate each from the other, making it hard to compare with other data sets.
- **Various consultancy firms publish data on global,** European and UK pension scheme assets.
- **The PPI collects data on DC assets for its DC Future Book[20],** an annual publication but the data is incomplete and not weighted.

WHAT BECOMES QUICKLY EVIDENT ON REVIEWING DIFFERENT DATA SETS IS THAT THERE IS LITTLE CONSISTENCY IN THE CATEGORISATION OF ASSET CLASSES ACROSS DIFFERENT SURVEYS AND SCHEME REPORTING. TO PRODUCE A CLEAR AND COMPLETE PICTURE OF UK PENSION ASSETS, IT WILL BE IMPORTANT FOR DIFFERENT PARTIES (GOVERNMENT, REGULATORS, TRADE BODIES, PENSION SCHEMES AND ASSET MANAGERS AND OTHERS) TO AGREE ON A STANDARD SET OF CATEGORIES AND DEFINITIONS.

A word on asset classes and groupings

Figure 7: A complex lexicon of terms and definitions

A complex lexicon



If there is one lesson we have learned through this exercise, it is that the lexicon of investments and asset classes is complex, interwoven and sometimes misunderstood. Examples of the complexity include:

- Even the seemingly simple issue of public equities is fraught with difficulty. Public, quoted or listed are used interchangeably even by industry experts but can in fact mean different things. For example, the London Stock Exchange defines shares listed on the Main Market as listed (but not quoted) and shares listed on AIM as quoted, but unlisted. The Companies Act 2006 definition of 'quoted company' in s. 385 refers to companies listed on 'regulated markets' including the Main Market, but not AIM. The Government's own classification adds further complexity to the debate[21]. Furthermore, whichever of these is used, none describes the domicile of the company which may be anywhere in the world.
- Alternatives and illiquids have very similar and overlapping definitions depending upon the source used, and are sometimes used interchangeably in discussions, with real assets forming a sub-set of both of these.
- As noted above, there are various definitions of what constitutes productive assets or finance, ranging from a narrow definition that includes only private equity to a more expansive definition that incorporates public equities and corporate bonds, as well as other alternatives.
- Private debt and private credit are used interchangeably but some definitions describe the latter as a sub-set of the former.
- Infrastructure investment can be either equity or debt and may be made through a fund, co-investment or some other mechanism, meaning that a desire to separate out infrastructure as an asset class means disaggregating it from other asset classes to avoid duplication.
- The same can be said for property investment, which may be through direct ownership of a property, through shares in a property company, through REITS, or other fund types.
- Investment through derivatives and repurchase agreements (Repos) adds yet another layer of complexity to splitting up the assets of a pension scheme, particularly DB pensions but also some DC schemes.
- In most cases, disaggregation of pooled funds is necessary if the desire is to look through to the underlying assets.
- Sustainable, responsible and impact investing are all expressions with similar but not completely the same meanings.
- Defining a UK versus overseas asset is also fraught with difficulty, particularly when moving away from 'listed' or 'quoted' UK equities and UK Government bonds. The ONS defines overseas assets, as used in some of the analysis below to isolate UK assets, as "A direct investment is considered to be overseas if it is held or issued overseas. In this context, 'issued' refers to the location of the original issuer, not the location of the intermediary organisation through which you purchased the asset. It does not depend on where an asset is listed, nor is it always indicated by the currency in which the asset is traded."

THE PPI HAS NOT SUCCEEDED IN REACHING A CLEAR VIEW ON ASSET CLASS DEFINITIONS, BUT IT HAS, THROUGH THIS PROJECT, BEEN ABLE TO IDENTIFY SEVERAL AREAS OF COMPLEXITY THAT REQUIRE FURTHER CO-ORDINATION BY DWP, HMT, TPR AND FCA AS DISCLOSURE REGIMES FOR VFM ARE DEVELOPED.

In the next section of this report, we have relied upon the definitions used by the organisations collecting the data and have not sought to make any adjustments.

[19] Corporate Adviser (2024)
[20] Wilkinson, L. et al (PPI) (2023)
[21] HMRC (2024)

CHAPTER TWO:

HOW AND WHERE WERE UK PENSION SCHEME INVESTED IN 2023?

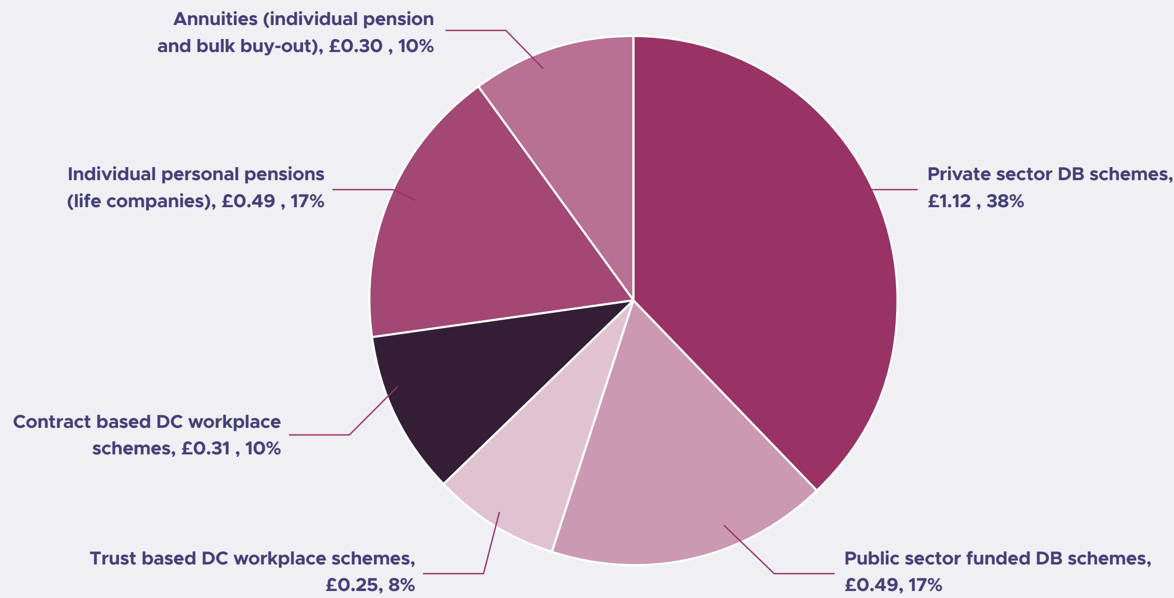
This chapter describes how UK pension assets were invested in 2023 and how asset allocation differs between scheme and product types. The chapter concludes with a summary of the UK assets held by UK pensions.

£3 trillion of UK pension assets.

The PPI estimates the total size of UK pension assets in late 2023 at approximately £2.96 trillion. This estimate is derived from a number of sources with the breakdown shown in the chart below.

Figure 8: £3 trillion of UK pension assets (PPI estimates, FSPS, Purple book, ABI) £ trillion.

£3 trillion of UK pension assets



Alternative ways of looking at the data are shown in the table below.

Split by workplace and individual	**£bn**	**% of total**
Workplace schemes (Defined Benefit (DB) and Defined Contribution (DC)) and bulk buy-out annuities	£2,378	80%
Retail products (individual pensions and individual pension annuities)	£578	20%
Split by pension type		
DB (including bulk buy-out)	£ 1,821	62%
DC (workplace and individual)	£1,044	35%
Other (individual pension annuities)	£ 91	3%

- By far the largest part is made up of the assets of private sector DB and hybrid schemes with £1.12 trillion (private sector DB schemes as of September 2023 in the Financial Survey of Pension Schemes (FSPS)[22]. This figure includes buy-in annuities purchased by schemes and is a net figure with borrowing and liability-driven investment (LDI) positions taken into account.
- Just under £0.5 trillion relates to public sector funded DB schemes[23], of which the Local Government Pension Scheme (LGPS) is by far the largest with £0.37 trillion under management[24]. Similarly, this is a net figure.
- The final piece of the DB funded sector is the Pension Protection Fund (PPF), which manages £33bn (and is excluded from the chart above)[25].
- DC workplace schemes, contract and trust based combined, account for just over £0.5 trillion -contract based being estimated as being the larger at £0.3 trillion. Master trusts represent approximately 74% of the DC trust sector assets[26] with £0.17 billion in assets.
- Individual personal pensions including Self-Invested Personal Pensions (SIPPs) administered by the major wealth managers add approximately £0.49 trillion.
- Individual pension and bulk-buy-out annuity business represent the final slice at around £0.3 trillion (a PPI estimate that may understate the size of this sector).

In calculating the size of the contract-based part of DC workplace schemes, we began with some 2022 data from the Association of British Insurers (ABI), increased this by 10% to account for growth in 2023 (other ABI data suggests that this may have been closer to 15%) and supplemented the data with estimates for companies missing from the ABI data from various published reports, including Corporate Adviser's report* and companies' report and accounts.

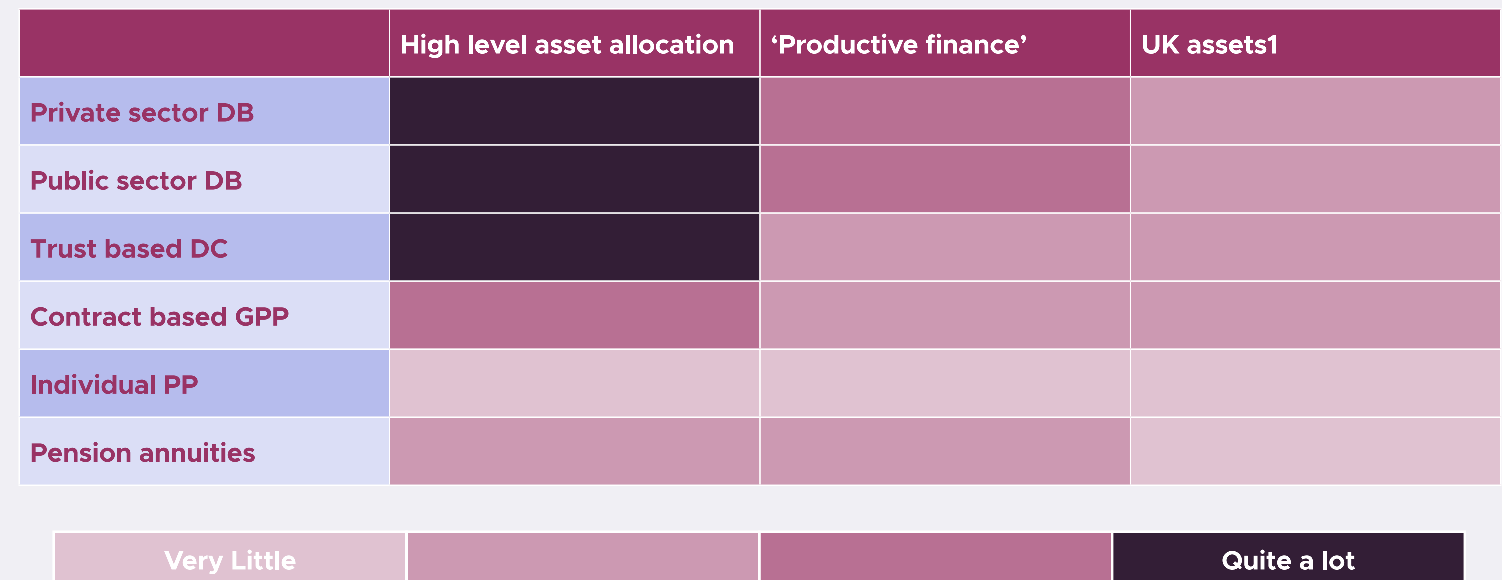
The figures for individual pensions and annuity business were calculated in a similar way.

Excluded from all of the data sets used are Executive Pension Plans (EPP) and Small Self-Administered Schemes (SSAS), both of which are trust-based arrangements but are typically small in terms of assets but large in terms of numbers of schemes. It is also likely that some additional voluntary contribution (AVC) arrangements have been excluded from the totals.

Mapping asset allocation is an imprecise science. The analysis contained in the remainder of this chapter seeks to illustrate the map of assets broadly as it stood in late 2023. However, to achieve this we have mixed and matched different data sets. **As such, the data below should be treated as approximate with our confidence in some data greater than other.** The figure below summarises the relative levels of confidence in the data presented, with the darkest indicating relatively high confidence and the palest indicating lower levels of confidence.

Figure 9: Relative levels of confidence in asset allocation data

How much do we know about how assets are invested?



1. Productive finance includes corporate bonds, equity (both public and private) + other alternatives
2. UK assets includes assets listed or registered in UK

[22] ONS (2024)
[23] ONS (2024)
[24] LGPS SAB (2023a)
[25] PPF (2024a)
* Corporate Adviser (2024)
[26] DWP (2023c)

Private sector DB remains the largest slice of the pension cake.

Because private sector DB represents the largest part of the UK pension sector, what happens here tends to dominate the news on asset allocation. In fact, it is a shrinking part of the sector and in the not-too-distant future, the story on asset allocation will come to be dominated by DC assets. However, for the time being, various media reports tend to focus on the lack of equity investment in private sector DB schemes.

Bonds still dominate private sector DB assets

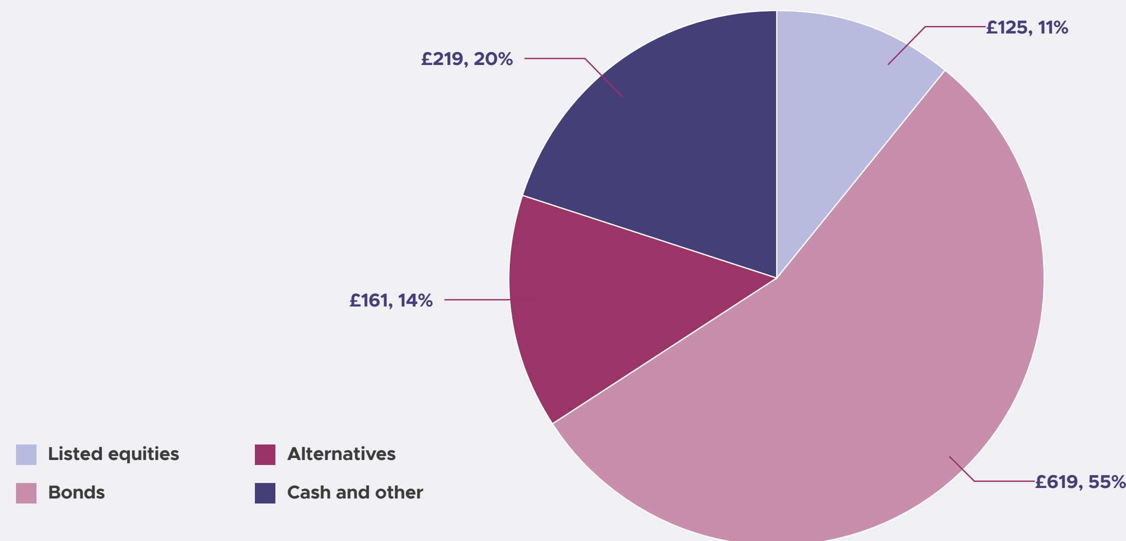
The most comprehensive breakdowns of occupational pension scheme assets are provided by the FSPS and PPF. In this part of the analysis, we rely on data from FSPS but have cross-referred to the Purple Book for some of the narrative.

> FSPS reports that these schemes invest 33% of their assets in pooled funds with the remainder invested directly and through buy-in annuities. In the analysis below, we have used the classification of pooled funds provided through FSPS to 'look through' the pooled funds as best we can to combine the directly held assets with pooled fund assets. By way of example, equity funds are allocated to equities, fixed interest to bonds, and mixed-asset funds as 60% equities and 40% bonds.

The break-down of the £1.1 trillion of private sector DB assets is first allocated between listed equities, bonds, alternatives (including private equity)[27], and cash and other investments. In this analysis, buy-in annuities (which are backed significantly by bonds) are included under 'cash and other'. The dominance of bonds and annuities reflects the need for closed schemes in particular to follow an asset allocation strategy that matches their liabilities (LDI) and cashflow (cashflow driven investment (CDI)). Open schemes, as shown in Chapter Three of this report, tend to follow a very different strategy due to their different level of maturity and cashflow which allow them to invest in a wider range of growth assets.

Figure 10: High level asset allocation of private sector DB schemes. (PPI estimate based on data from FSPS Q3 2023) £billion.[28]

Bonds, still dominate private sector DB schemes (£bn)



Using FSPS data, the PPI estimates that almost two-thirds of the assets are invested in bonds and bond-like instruments, worth £619 billion. Of this:

- 43% is invested in index-linked Gilts;
- 23% in conventional Gilts;
- 21% in corporate bonds; and
- 13% in other Government bonds or short-term debt instruments.

A comparison with PPF data suggests that the proportion invested in bonds may have fallen significantly in recent years, as PPF analysis suggests 69% of funds were invested in bonds. However, the FSPS data is believed to be more up-to-date.

£161bn (14%) of assets are invested in property (£44bn), private equity and other alternatives (£117bn). Other assets include cash (£85bn), buy-in annuities (£120bn), other unidentified assets (£170bn), and a negative position on repos and derivatives (-£156bn).

> **Productive assets: Private sector DB**
>
> **Using FSPS data on geographic distribution[29], we estimate that:**
>
> - **£62bn is invested in UK corporate bonds**
> - **£32bn is invested in listed UK equities**
> - **£44bn is invested in UK property and**
> - **£55bn invested in UK private equity and alternatives**
> - **Totalling £193bn and representing 7% of £3 trillion UK pension assets**
>
> **In addition, approximately £410bn is invested in UK Government bonds, representing a further 14% of UK pension sector assets invested in the UK.**

Looking through buy-in annuities held by private sector DB schemes.

Buy-in annuities are a significant and growing part of the private sector DB portfolio, especially for mature and well-funded schemes.

In the same way that this analysis 'looks through' the pooled assets of DB schemes to the underlying assets, the PPI has attempted to 'look through' the underlying assets backing annuity business. Data on this is incomplete (with annuity business not broken down by buy-in and buy-out annuities) but PPI analysis[30] suggests an approximate mix of assets across all annuities along the following lines:

- 25% Government bonds
- 30% corporate bonds (including investment in property, infrastructure and commercial mortgages)
- 40% residential mortgages and loans
- 5% other assets

Like DB schemes, the asset mix backing annuities is driven largely by the need to match liabilities and cashflow needs.

> **Putting a value on UK assets is difficult but, using analysis provided by some annuity providers interviewed for this project, the PPI estimates that up to £29 bn could be invested in UK corporate bonds.**
>
> **This represents 1% of UK pension assets.**

[27] Alternatives includes private equity, property, Secure Income Alternatives (SIA), infrastructure, private debt and venture capital.
[28] Listed equities is used as short-hand in this and the following charts derived from ONS statistics. In fact, this includes equities on AIM which are technically unlisted. It does not include private equity which is included under alternatives.
[29] FSPS geographic data relates only to direct investments and those held by private sector and public sector DB and a small slice of occupational DC schemes assets. However, in the absence of any better data, we have applied the split to the entirety of holdings including the inferred pooled assets.
[30] PPI has used a combination of ABI data and published asset allocation data from individual providers. The data does not apply only to buy-in annuities.

Public sector DB schemes more heavily invested in equities.

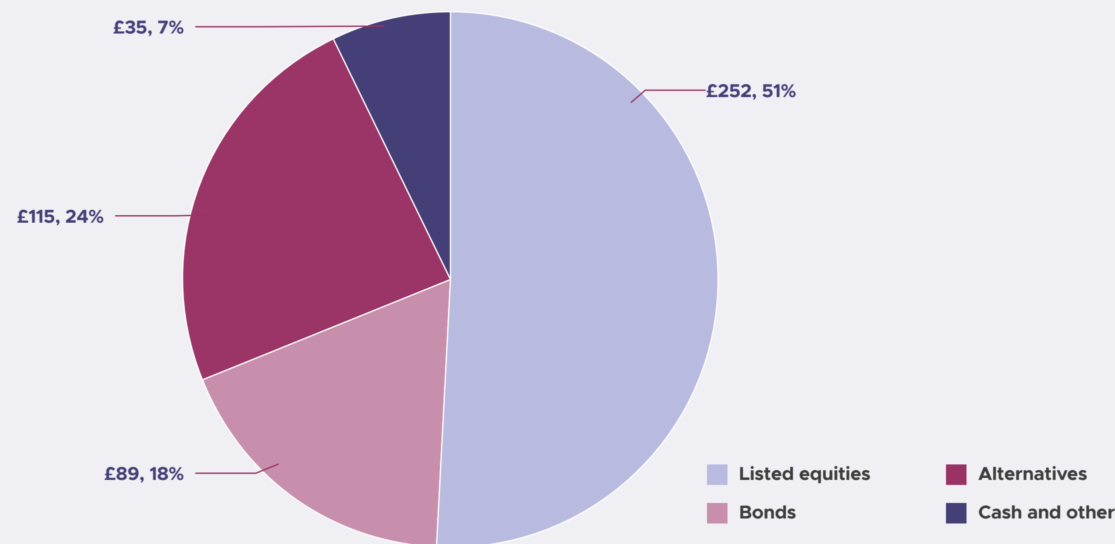
Unlike private sector DB schemes where most schemes are closed to further accruals, the profile of assets in the public sector reflects the open nature of the schemes.

The best publicly available data detailing the asset allocation of public sector DB schemes is the ONS survey of pension schemes FSPS. The £491bn of net assets is spread across 86 LGPS funds and a small number of other funded public sector schemes.

This survey reports that in Autumn 2023, 58% of public sector DB assets (£291 billion) were held in pooled funds (predominantly those managed by the eight LGPS asset pools) with 42% invested directly (the proportion of LGPS funds in pools was 67% in 2022[31]). The data looks through the pools to provide an overall high-level view of the split of assets. This reveals that, unlike schemes in the private sector (which are largely closed to new members and future accrual), public sector DB schemes hold around 51% of their assets in equities with just 18% held in bonds. Almost one quarter of the assets are held in property, private equity and other alternatives.

Figure 11: High level asset allocation of public sector DB schemes, (PPI estimate based on data from FSPS Q3 2023) £billion

Unlike private sector, equities dominate in public sector DB (£bn)



Productive assets: Public sector DB

Using FSPS data on geographic distribution[32], we estimate that:

- **£14bn is invested in UK corporate bonds**
- **£65bn is invested in listed UK equities**
- **£36bn is invested in UK property and**
- **£36bn invested in UK private equity and alternatives**
- **Totalling £150bn and representing 5% of UK pension assets (£3 trillion)**

In addition, approximately £42bn is invested in UK Government bonds representing a further 1% of UK pension sector assets invested in the UK.

DC schemes invest largely through pooled funds.

Mapping DC asset allocation much more difficult

Mapping the asset allocation of DC funds is considerably more difficult than DB. No single source of data exists:

- The Pensions Regulator (TPR) collects partial data for trust-based schemes but does not publish the data.
- The ONS through FSPS collects survey data from trust-based schemes but not contract-based schemes.
- The ABI holds aggregate data contract-based arrangements for most insurers and kindly made data available to PPI for this report.
- Prudential Regulation Authority (PRA) holds data for insurers but again the data does not separate out contract-based pensions.
- Corporate Adviser collects and publishes data from most master trust and Group Personal Pension (GPP) providers in relation to their default funds but does not separate contract-based and trust-based data.
- Some wealth managers such as Hargreaves Lansdown, AJ Bell, Pension Bee and others report total assets held by their SIPP clients.
- Various consultancies publish data on DC pensions, sometimes based only on the trust-based sector.

In seeking to provide equivalent data we have relied mainly upon a combination of FSPS, ABI, individual company reports and Corporate Adviser data. The data reported below is undoubtedly incomplete as we have not gathered all of the data for the wealth management sector.

One of the complications in mapping DC asset allocation is that whereas in excess of 90% of members of workplace DC schemes invest in the default fund arrangement, some members of workplace schemes and all individual personal pension and SIPP members (often with higher-than-average pot sizes) adopt a self-select approach to investing. Asset allocation among the latter group is harder to gather data for and can change significantly over a short space of time.

Around £1 trillion in assets sit in DC pensions

We estimate that the assets of DC pensions amounted to approximately £1 trillion in late 2023, with DC workplace pensions accounting for just over half of that amount. Of the £560 billion in workplace pensions, approximately:

- £170 billion is held in master trusts;
- £80 billion relates to other trust-based DC schemes (single employer); and
- £310 billion is held in GPPs or stakeholder pensions.

Of the assets held in workplace pensions, a very significant but unquantified amount is held in the schemes' main default funds. Asset allocation for default funds is determined by the strategy set or agreed by the trustee board (trust-based) or the provider (contract-based). Asset allocation for the remainder is determined either by the individual employer (with input from their adviser) or by the individual member (with or without advice).

The asset allocation of DC trust-based schemes is mapped by ONS in their FSPS survey and various organisations publish information on the asset allocation of workplace pension default funds. In the analysis below we have applied the split provided by ONS to all DC pensions.

[31] LGPS SAB (2023b)
[32] FSPS geographic data relates only to direct investments and those held by private sector and public sector DB and a small slice of occupational DC schemes assets. However, in the absence of any better data, we have applied the split to the entirety of holdings including the inferred pooled assets.

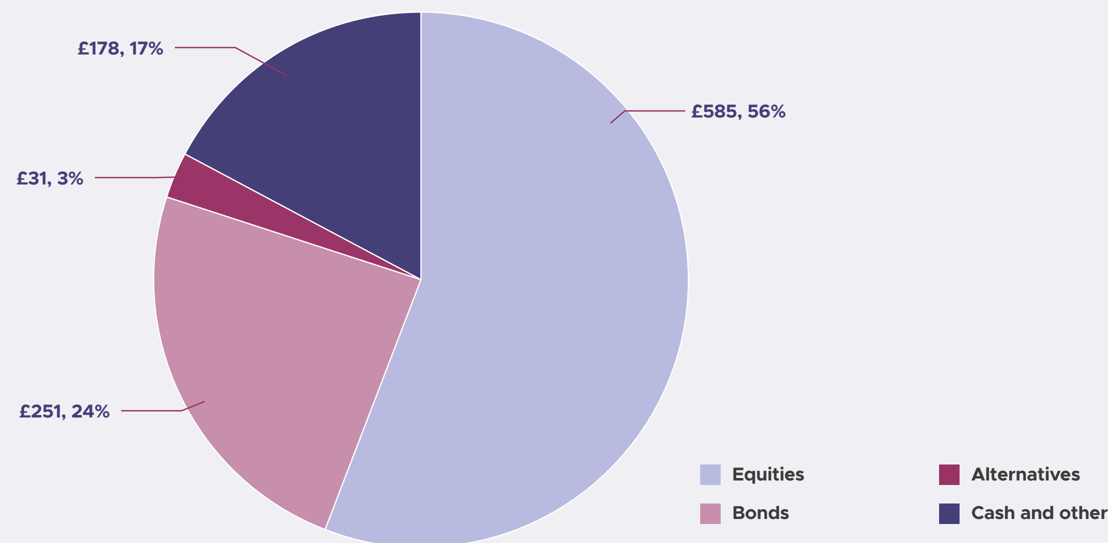
Pooled funds dominate DC pensions

Of the £250 billion held in trust-based DC schemes, 89% is held in pooled investment funds (typically life funds and, typically, passive index funds) with the remainder holding assets directly through segregated funds. The percentage held in pooled investment funds varies by size of scheme with some master trusts, some single-employer trusts and most contract-based arrangements being almost entirely invested in pooled funds. The chart below assumes all DC pensions, including individual pensions, are invested along the same lines as trust-based schemes (several life companies operate both master trusts and contract-based arrangements and some will offer the same default arrangement in both types of schemes).

Using FSPS data, the PPI estimates that just over half of the assets of DC assets are invested in listed equities (£585 bn).

Figure 12: Split of workplace DC assets (PPI estimate based on data from FSPS) £billion

DC assets dominated by equities (£bn)



Productive assets: DC

Using FSPS data on geographic distribution[33], we estimate that:

- **£36bn is invested in UK corporate bonds**
- **£51bn is invested in listed UK equities (PPI assumption, adjusted from FSPS data to reflect dominance of passive global funds)**
- **£21bn is invested in UK property and**
- **£10bn invested in UK private equity and alternatives**
- **Totalling £106bn and representing 4% of UK pension assets (£3 trillion)**

In addition, approximately £118bn is invested in UK Government bonds representing a further 4% of UK pension sector assets invested in the UK.

Annuity business heavily invested in corporate bonds and mortgages.

At approximately £300bn, the remaining pension annuity business is another significant part of the UK pension sector. As noted above, the data on asset allocation of annuity business is incomplete but suggests the following breakdown:

- 25% Government bonds
- 30% corporate bonds (including investment in property, infrastructure and commercial mortgages)
- 40% residential mortgages and loans
- 5% other assets

Although we do not have comprehensive data to quantify the amount, we are aware that some annuity books are being backed by investment in infrastructure and some other alternatives.

A split between UK and overseas is difficult, but the PPI estimates that up to £90bn could be invested in UK corporate bonds.

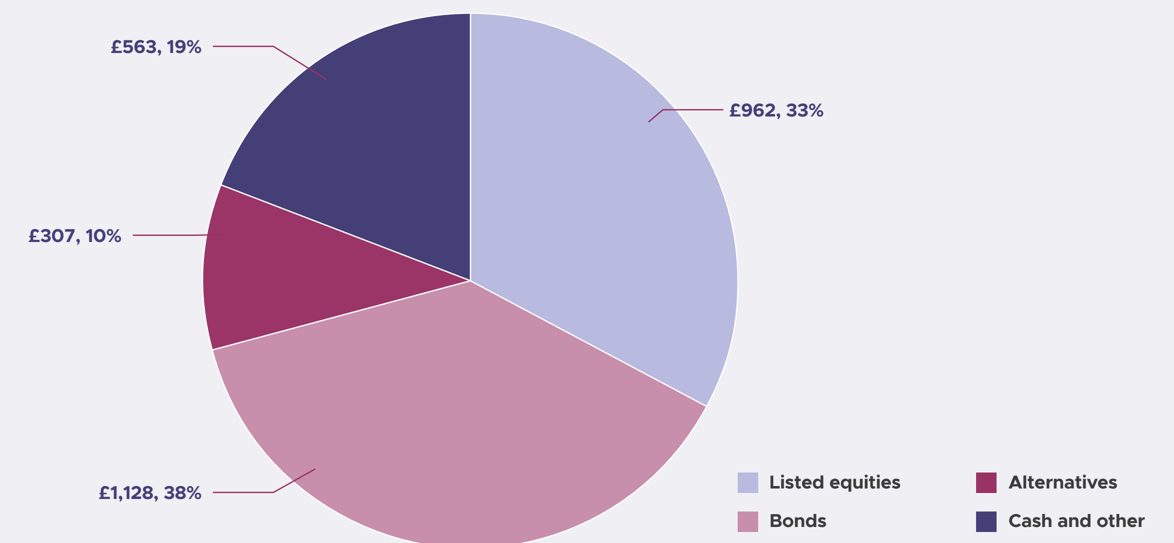
This represents a further 3% of UK pension assets.

Overall, one third of UK pension assets invested in equities.

Combining the data above reveals an approximate picture of how the £3 trillion of UK pension assets are invested, with approximately one third invested in listed equities and just 10% in alternatives. Overall, bonds play an important role in delivering liability and cashflow matching, whether in DB or DC pensions or annuities.

Figure 13: UK pension sector, overall asset allocation (£billion and %)

Overall, a more balanced portfolio



[33] FSPS geographic data relates only to direct investments and those held by private sector and public sector DB and a small slice of occupational DC schemes assets. However, in the absence of any better data, we have applied the split to the entirety of holdings including the inferred pooled assets.

An estimated 18% of £3 trillion UK pension assets invested in UK business.

It has recently been stated in several policy papers and media articles that less than 10% of UK pension assets are invested in UK productive assets[34]. A narrow definition of productive assets limited to private equity and other alternatives would support this view with PPI analysis suggesting that 6% of the £3 trillion of UK pension assets is invested in this way.

A broader definition that includes UK listed equities, as used by the PPF[35], would put the proportion at 12%. In total, the PPI estimates that £541bn of UK pension assets (18%) is invested in UK business. In estimating the amount of assets invested in UK business, the PPI has included investments in:

- UK listed equities: £148bn, 5% of UK pension assets;
- UK private equity and other alternatives: £191bn, 6% of UK pension assets.
- UK corporate bonds: £201bn, 7% of UK pension assets.

Figure 14: Overall allocation of UK pension assets to UK listed equities, corporate bonds and alternatives £billion.

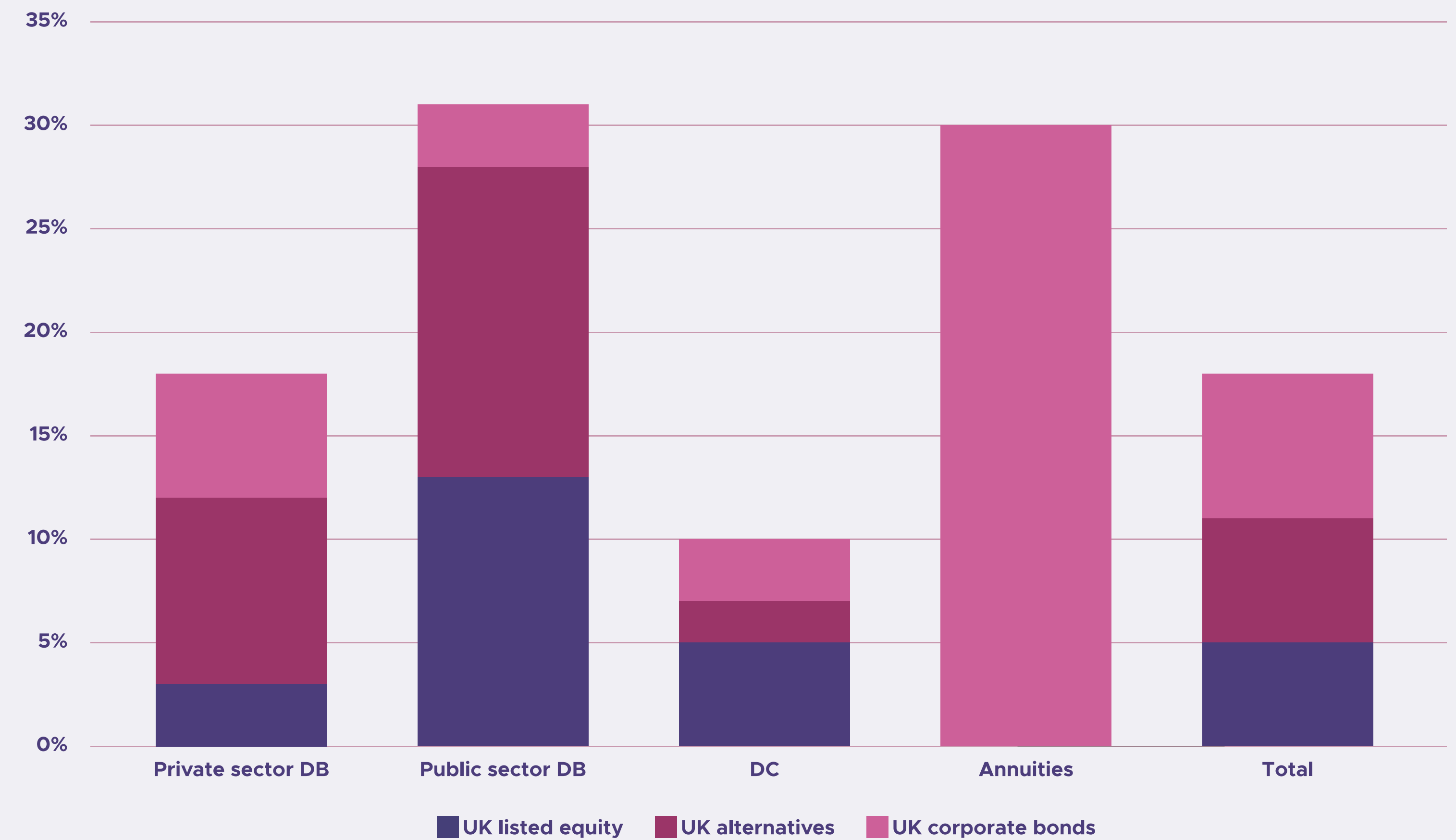
£541 bn of UK assets held by UK pensions (by asset type)

The figures above and opposite reveal that:

- The biggest investors in UK corporate bonds are private sector DB schemes and annuity providers.
- Public sector DB schemes are the biggest investors in UK equities and the biggest investors in UK productive assets overall.
- Private and public sector DB schemes are the largest investors in alternatives by value but public sector schemes invest a higher proportion of their assets.
- DC (workplace and individual included here) is a relatively small investor in the UK with listed equities being the largest category.

Figure 15: UK investments held by UK pensions by asset class £bn 2023 (PPI estimates, excludes UK Government bonds) £billion

DB the largest UK investor by £bn (private sector) and % (public sector)



[34] We define productive finance here as investments in UK public and private equities, corporate bonds issued by UK companies and UK property (other UK assets may be held but data detailing holdings is not available). We do not include Gilts in the definition.
[35] PPF (2024b)

CHAPTER THREE:

TRENDS, DIFFERENCES AND DRIVERS OF ASSET ALLOCATION?

This chapter explores the changes in asset allocation that have taken place in recent years, the differences between scheme types and the drivers behind the changes. It also draws comparisons with the Australian pension sector.

A structural shift in asset allocation.

It is uncontentious to state that there has been a marked shift in asset allocation across UK pensions in recent years. Most notable and most often discussed has been the shift away from equities and towards bonds and, within those categories:

- a shift in equities away from a UK preference to worldwide holdings; and
- a shift away from Government to corporate bonds.

> ***"The big moves are out of public equities and into private credit and corporate bonds".***
> PPI interview

Private sector Defined Benefit (DB) asset allocation make the headlines

The shift in asset allocation can be seen most clearly within private sector DB pensions, still the largest, albeit shrinking, part of the UK pension sector; net assets[36] fell from £1.8 trillion in 2021 to £1.1 trillion in Q3 2023.

The closed nature of most of private sector DB schemes drives the asset allocation towards liability management and away from growth assets.

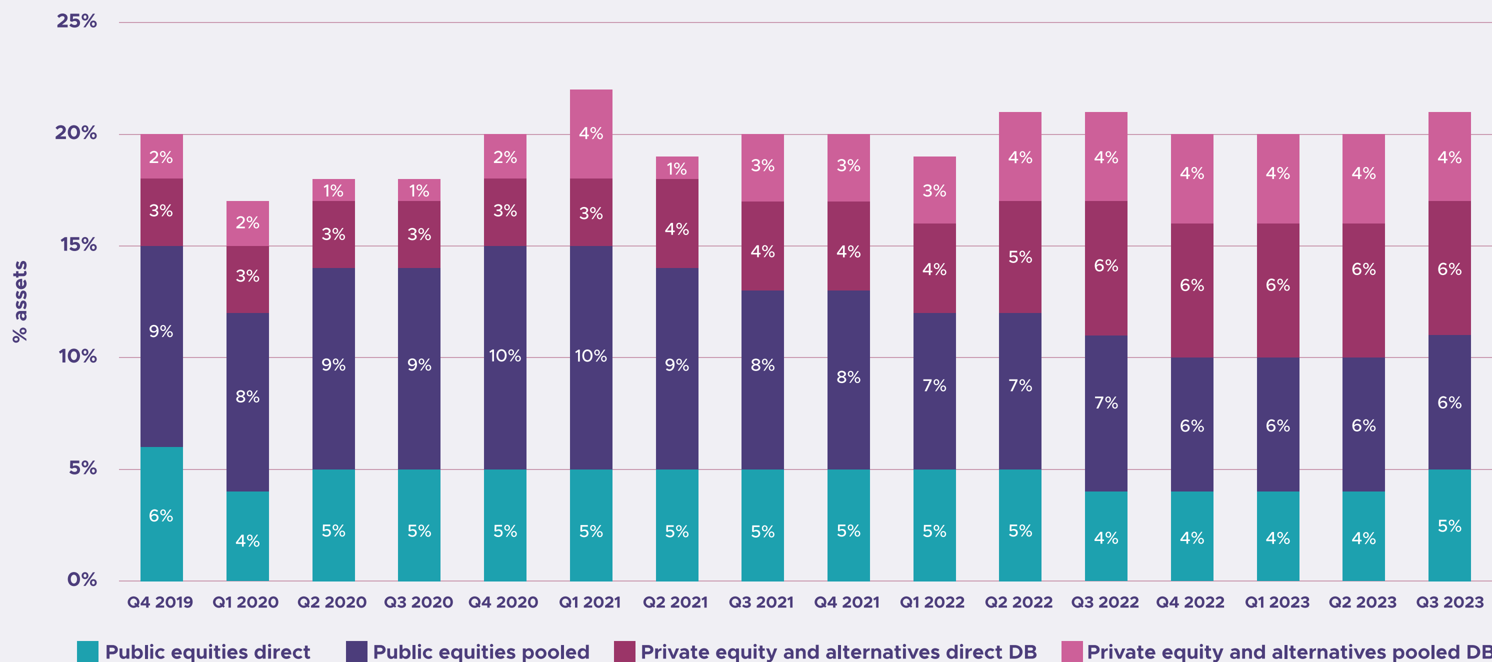
Data from the Purple Book[37] suggests that equity investment in private sector DB schemes fell from 41% in 2011 to 18% in 2023, but that the mix of equity investments changed significantly over that time:

- UK public equities made up 38% of all equity investments in 2011 but fell to under 8% by 2023.
- Overseas public equities remained broadly steady at around 60%.
- Private market equities rose from under 5% in 2011 to almost one third of equity investments in 2023.

Office for National Statistics (ONS) data shows a slightly more granular picture since Q4 2019, with equity investment overall remaining steady but with both direct and pooled investments in private equity, and alternatives taking a larger share and public equities in decline.

Figure 16: Changes in equity asset allocation private sector DB schemes 2019-2023 (ONS:FSPS % of net assets)

Equity investment private sector DB schemes steady since 2019

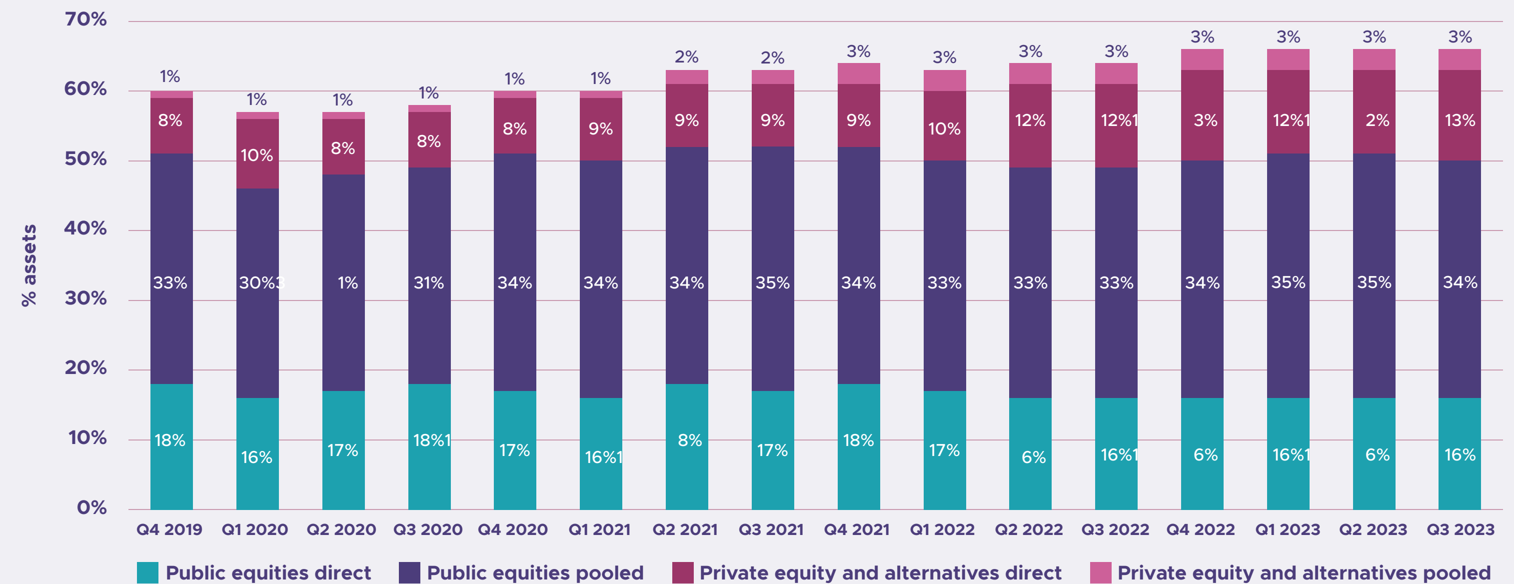


Equity exposure of public sector DB schemes holding up

By contrast, equity holdings by public sector DB schemes have held up over both the longer and shorter term. Indeed, the overall percentage of assets invested in equities and alternatives rose from 59% to 66% between Q4 2019 and Q3 2023. All of the increase is accounted for by a growth in investment in private equity and alternatives, both pooled and direct.

Figure 17: Changes in equity asset allocation public sector DB schemes 2019-2023 (ONS:FSPS % of net assets)

Equity investment public sector DB schemes has risen since 2019



Defined Contribution (DC) equity investment growth in absolute terms but percentage stays steady

DC workplace schemes have grown in size since the start of automatic enrolment in 2012. The PPI estimates the size of the combined trust-based and contract-based workplace schemes at £560bn in 2023. It is difficult to estimate the growth of the total sector since 2012, but TPR estimates of £20bn for the trust-based in 2012 implies that the trust-based is now nearly 12 times larger than in 2012. It is unlikely that the contract-based sector has grown quite as much due in part to many new employers to pensions choosing master trusts over GPPs. However, ABI data does suggest that there has been continued growth in GPP assets over recent years, driven in part by new members joining existing arrangements and by investment growth. If we apply half the level of growth experienced by the trust-based, it suggests that in total the sector has grown by around £500bn in 12 years.

No detailed data exists on asset allocation in 2012. ONS data for trust-based schemes shows a steady pattern of between 30% and 40% of assets being invested in public equities with a slight shift away from pooled to direct investments since 2019. If applied to the whole of the workplace sector, this would suggest that equity investments held by DC schemes have grown to around £195bn, perhaps from as low as £22bn at the start of automatic enrolment.

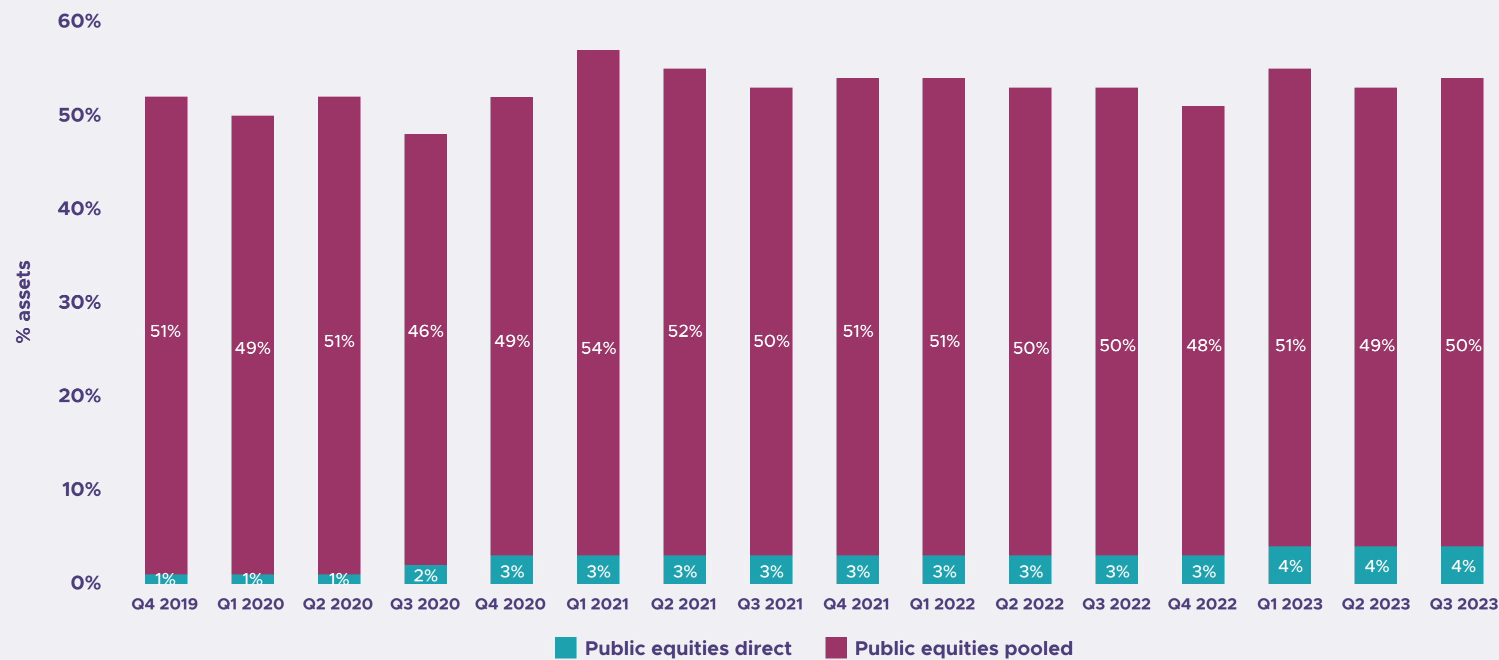
These data almost certainly understate the allocation to equities since they do not take account of equity investments in multi-asset funds, which account for 35% of DC assets.

We know that some larger schemes such as NEST are now investing in private market assets, but data and details are limited. Several of those interviewed for this report were either already investing or were looking for opportunities for investment in private equities, private debt or infrastructure projects. A recent report by ISIO[38] points to coming changes to DC default funds, with the majority expected to incorporate a range of illiquids into either their existing or new default arrangements, potentially offering a different price for funds that incorporate illiquids.

[36] ONS definition. The market value of pension schemes includes all assets, the net value of derivative contracts that schemes have invested in, and liabilities other than pension benefits owed to members.
[37] Pension Protection Fund (PPF) (2023)
[38] ISIO (2024)

Figure 18: DC schemes – percentage of assets invested in public equities

Public equity investment by DC schemes shows slight shift from pooled to direct



Understanding the drivers of change helps understand the longer-term picture.

Although the high-level picture suggests a move away from equities and a move away from UK investments, it is evident that the shift is far more complex than these two high-level changes suggest. To understand the direction of travel in asset allocation, it is necessary to understand the drivers of change and the way in which they are affecting different parts of the UK pension sector.

We consider some of the more detailed trends and drivers below.

Figure 19: Asset allocation influenced by multiple drivers of change

Decisions on asset allocation are driven by a range of, often interconnected, forces both internal and external to the scheme:

1. **Member outcomes and profile.** The starting point for asset allocation in both DB and DC schemes is member outcomes. However, the profile of the membership and the maturity of the scheme will play a big part. A more mature membership with an emphasis on retiring or retired members demands a different allocation to one dominated by active younger savers.
2. **Performance, cost and accessibility of assets.** The second major step in determining asset allocation is to model the expected returns and volatility of different asset classes. The cost, accessibility and liquidity of different asset classes will play a part in shaping the strategy.
3. **Size and profile of schemes.** Larger, particularly open, schemes have greater opportunity to move away from pooled funds and develop a more diverse investment portfolio. Closed DB schemes have different drivers of asset allocation to open schemes.
4. **Government and regulatory policy** has an influence on both DB and DC arrangements whether through an emphasis on funding levels, consolidation or on value for money.
5. **Environmental, Social & Governance (ESG).** Increasingly, decisions on how to invest pension assets are being influenced by the need to protect the world's environment and an increasing focus on ESG issues, responsible investing, and sustainability.

Member outcomes and profile a strong driver of asset allocation.

The starting point for asset allocation in both DB and DC schemes is member outcomes, i.e. securing the best possible retirement income. The way in which this is achieved differs between DB and DC schemes, in part due to the different regulatory environment and in part due to the differing maturity of schemes.

Member outcomes at and in retirement primary driver in default DC allocations

For all DC default arrangements, the starting point for determining asset allocation is member outcomes at and in retirement.

Automatic enrolment has delivered a significantly younger membership profile than mature DB schemes. However, as more and more DC schemes see members continuing to invest into their retirement years, the emphasis becomes more about sustainability of drawdown in retirement and risk management than about pure growth.

> ***"We do see quite a lot of people taking cash and we have got more and more people in drawdown, but not many people taking an annuity."***
> PPI interview

Typical default arrangements are structured around a glide path that takes a member through a growth phase towards a pre-retirement phase where derisking takes place. Before, and in the early days of, automatic enrolment this meant getting members ready for purchasing an annuity, which involved investing in assets that reflect the assets backing annuities to ensure that purchasing parity was maintained as markets moved. With the pension freedoms introduced by the Government and implemented in 2015, the emphasis shifted for some schemes more towards cash as an outcome at retirement, while many have now moved to target a sustainable retirement income through drawdown. The Pensions & Lifetime Savings Association's (PLSA) retirement living standards have established benchmarks for target outcomes for members[39] and are used by several schemes and providers.

> ***"So, it's very much an outcome-based approach to optimisation … it's all linked to the PLSA retirement living standards."***
> PPI interview

[39] PLSA (2024)

Interviews in this sector revealed a number of trends in asset allocation:

- Members accumulating larger pot sizes can result in fewer seeking to cash in their whole pot, which has brought about changes to the glide path in the default fund.
- The availability of in-scheme drawdown solutions is, for some schemes, slowly shifting the maturity of the membership.

"Our asset allocation is shaped by the needs of the members. We traditionally assumed that they would take cash [at or before retirement] and derisked accordingly but now we are moving towards a 60-80-year timeframe for investing [as members stay into retirement] which requires a different approach to derisking."
PPI interview

LCP's analysis of master trusts[40] reveals very different approaches to asset allocation among the default funds of the leading commercial master trusts:

- Strategies in the growth phase ranged from 100% equity at one extreme to a more diversified approach of 50% equity and 50% split between property, bonds, infrastructure, cash, and other growth assets at the other. Different strategies delivered returns of between 7.9% (diversified portfolio) and 17.3% (high equity exposure) in 2023.
- Strategies in the at-retirement phase ranged from almost 50:50 equities and bonds to schemes with a mix of cash, equity, bonds, infrastructure, and other growth assets.
- In recent years, members moving into retirement (or taking their tax-free cash) are offered access to four investment pathways; each of which has a different asset allocation designed to align members' drawdown investment with their retirement objectives.

Corporate Adviser's analysis[41] of the master trust and GPP sectors suggests that, across the average portfolio, equities dominate the growth phase for master trusts and GPPs. Schemes vary in their exposure to private markets, infrastructure commodities and property.

Cashflow and liquidity become king in mature DB schemes

The profile of the membership and the 'promises' made to members are also key drivers in shaping asset allocation in DB schemes, although this can also be influenced by the desire on the part of employers to wind up the scheme.

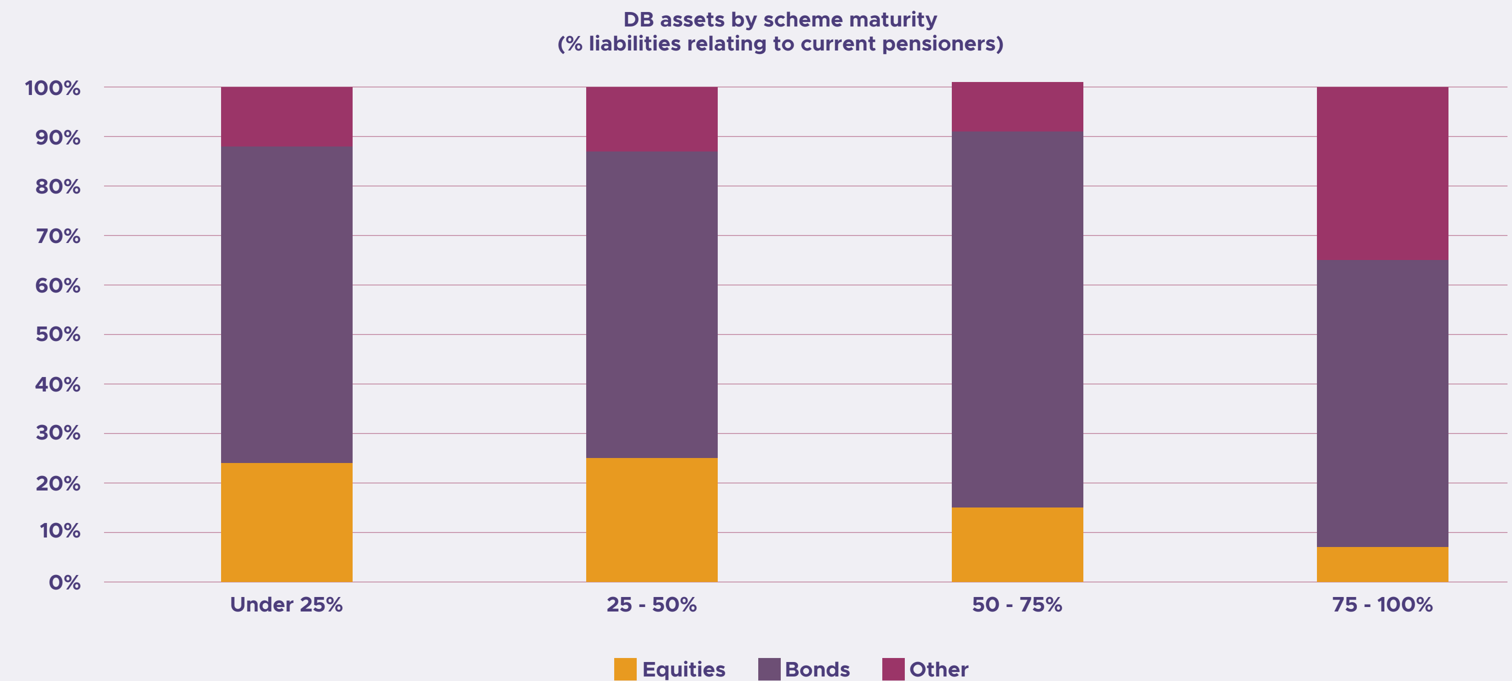
Among young DB schemes (those with a lower proportion of current pensioners) equities feature more strongly than in mature schemes (more than 20% in the youngest schemes). Young schemes tend by definition to be schemes that have remained open to new members.

DB schemes, particularly those closed to new members and future accruals, can find their membership profile maturing quickly. This places very different pressures on the finances of the scheme and, as the proportion of pensioners increases, makes cashflow to pay pensions the most important driver. Buy-in annuities (included in 'other' assets in the chart below) represent 33% of assets among the most mature schemes, reflecting the need for closer matching of cashflows.

However, cashflow management need not mean limiting assets to listed corporate bonds. Among some of those interviewed, several commented on a wider range of assets being used to support cashflow, including private debt and infrastructure.

"When pension schemes mature, they need to focus on cashflow and deliver income generation strategies. This can mean using private debt, infrastructure, real estate"
PPI interview

Figure 20: Asset allocation of private sector schemes by scheme maturity as measured by the percentage of liabilities that relate to current pensioners. Source: PPF Purple Book



Expected performance, portfolio diversification, costs, accessibility, liquidity and volatility all shape asset allocation.

How markets are expected to perform shapes decisions about asset allocation, as does portfolio diversification. It is usually the secondary factor in determining asset allocation after the assessment of membership needs, expectations and outcomes.

Other market factors that can determine how pension schemes invest include liquidity, cost, accessibility, risk and volatility. Short-term market shocks, such as that experienced in the UK in the Autumn of 2022, when both equity and bond markets fell, can also play a part in reshaping portfolios over the short and medium term.

'Magnificent seven' drive geography of public equity investment

As noted above, equities play a major role in DC default funds. A common theme described by those interviewed for this project is the use of passive, usually global, equity index funds. In part this is driven by the need to keep investment costs low (and within the price cap), in order to be competitive in responding to tenders.

It is also driven by the strong long-term performance of global equities, much of which can be attributed to the so-called 'magnificent seven' shares[42] that have led growth in the US equity market. With passive investment, as the US (and other territories) outperforms the UK, so UK holdings shrink to mirror the global market capitalisation. The MSCI World Index has delivered an average annual gross return of 12.63% over five years to 29 March 2024[43]. Just 3.79% of the index is invested in UK equities, with over 70% invested in the US. Over the same period, the FTSE All-share index has delivered an average annual gross return of 5%[44]. Several of those interviewed for this project pointed to structural problems with the UK economy being behind the poor performance of many UK public equities. Corporate Adviser data point to a drop in UK equities from 11.8% in 2022 to 8.8% in 2023.

[40] LCP (2024)
[41] Corporate Adviser (2024)
[42] Bank of America strategist Michael Hartnett coined the term "Magnificent 7" stocks for the most dominant tech companies. The group is made up of mega-cap stocks Apple (AAPL), Alphabet (GOOGL), Microsoft (MSFT), Amazon.com (AMZN), Meta Platforms (META), Tesla (TSLA) and Nvidia (NVDA). What to Expect from the Magnificent Seven Stocks in 2024 | Nasdaq
[43] MSCI (2024)
[44] FTSE Russell Factsheet (2024)

Most master trusts are reported to have reduced their exposure to UK equities in recent years. Those who have invested more heavily in UK public equities than a global index have found that to be a drag on their performance, something which then makes them uncompetitive in responding to tenders. They may also question whether they are really satisfying their fiduciary duty by investing in long-term underperforming assets.

> ***"We are overweight in UK equities (compared to a global equity index) which is hurting our performance and putting us middle of the pack."***
> PPI interview

Corporate bonds favoured over Government bonds

Following the global financial crisis in 2007/08 when interest rates plunged to extremely low levels, yields on Government bonds fell to their lowest for many years, making them considerably less attractive for all types of pension scheme than some other asset classes. As interest rates started to rise in early 2022, so yields began to improve, and the market value of bonds started to fall. The collapse in the value of bonds following the Autumn 2022 UK budget triggered a forced sell-off of bonds, as DB schemes sought to meet margin calls on LDI contracts, thus prompting a downward spiral in bond values necessitating the Bank of England to intervene in the market. DB pension schemes are reported to have experienced a fall in asset values of £425bn in 2022[45].

Bonds still play a central role in investment strategies, particularly in DB pensions but there has been a marked shift away from Government towards corporate bonds, driven by a number of factors. Higher yields on corporate bonds, allied to the goal of buy-out for many private sector schemes, has encouraged the shift, as has the ability of some schemes to use corporate bonds rather than Gilts as collateral to back LDI contracts[46].

Private markets and alternatives finding favour but some barriers remain

Even before the Mansion House compact, many DC schemes had begun to expand their exposure to private markets through private equity, venture capital, private credit, real estate and infrastructure investments, as had some of the largest open DB schemes. For trustees, this was driven by the need for diversification in the portfolio and a recognition that illiquid assets can yield higher returns (the so-called illiquidity premium). A lack of positive correlation between public and private market performance and lower levels of volatility are also attractive features.

Historically, private markets have delivered good returns for investors. In 2019, a report published by the PPI[47] reported that estimates of the illiquidity premia for private markets ranged from 1% to 7% over what could have been earned from another comparable liquid assets over the long term. However, some commentators, including the Bank of England[48], have expressed concerns about the sustainability of returns.

> ***"… the size of the private credit market has grown three to four-fold since 2015, while the leveraged lending, high-yield bond, and private credit markets account for around a quarter of all market-based debt globally. Beyond private markets, in the UK we have seen an increase in net lending from non-banks of around £425bn over the last 15 years. Much of the growth has taken place while interest rates have been low. Consequently, vulnerabilities could be exposed by the adjustment to higher interest rates and the changing macro-financial environment. For example, private finance valuations have been under pressure, and financing and exit routes have become more difficult."***[49]

The Financial Times (FT)[50] has reported concerns about the sustainability of private equity returns due to the maturity of the sector and higher borrowing costs. Some of those interviewed for this project also expressed concern about potential herding behaviour that could lead to schemes all looking to invest in similar assets at the same time, risking inflated asset values.

Other alternatives, both liquid and illiquid, such as commodities can also feature as diversifiers in DC portfolios. The extent to which these features at present is difficult to quantify using available data sources. Investment in certain commodities can offer strong potential for portfolio diversification, as they have historically had low correlation with stock market movements. Commodity prices generally rise with inflation, which makes them an attractive proposition within the current high-inflation environment. Unlike many other alternative asset classes, commodities can be liquid, again depending on the particular asset and the way in which it is accessed. This may make them an attractive option to DC schemes looking to diversify their portfolio without sacrificing liquidity[51].

Diversification not straightforward

The decision to diversify has not been straightforward for all schemes and a number of barriers or complexities have been described in interviews conducted for this project. The illiquid nature of these types of investment is not a barrier for most DC schemes as long as they remain cashflow positive, with younger savers adding more funds than older savers are typically withdrawing. However, there are limitations and schemes use scenarios to explore the risks involved and determine the proportion of the portfolio that can safely be invested in illiquids.

The typical J-curve of returns in private equity (where returns are negative in early years but higher later) can make it an unsuitable asset for members of pension schemes approaching and in retirement. It can also make it difficult to be fair to younger members who transfer out of the scheme early. For this reason alone, schemes or providers limit their early exposure to private equity or build exposure over time to mitigate against the J-curve effect.

> ***"You can't make a big allocation [to private equity] on day one."***
> PPI interview

Other private assets do not follow the same pattern of returns and are therefore suitable across the members' savings and drawdown journeys.

The cost of investing in some illiquid investments and the impact that it can have on overall fund costs has been of concern to trustees, particularly in default DC arrangements where charges are capped at 0.75bp. In its analysis of private market investments[52], TPR notes that investment costs for most types of private market assets are high when compared to public equities or bonds, often allied to low levels of liquidity and very high levels of risk.

Anecdotal evidence (and comments from those interviewed) suggests that advisors to employers on scheme selection often use member-borne charges as a discriminator between DC providers. Responses from those interviewed suggested that only a slightly higher charge can mean losing business. The cost of investing in private markets or illiquids can be significantly higher than public markets, for a number of reasons:

- Higher charges, sometimes including performance fees, are levied by the manager of the assets. Interviews conducted for this report suggested that the traditional '2+20' fee structure for private equity is a thing of the past, although negotiated charges may still include performance fees. NEST has been vocal in stating its position on performance fees and claims to have been successful (along with other large schemes) in negotiating down fees for private market investments.
- Investing in illiquids requires additional research resources, specialist managers and increased (or different) standards of governance. Several of those interviewed stressed the importance of the trustee board having a sound grasp of the different opportunities and risks associated with illiquid or alternative investments.

> ***"I don't think you should underestimate the need to have high-quality governance to be able to invest in illiquids"***
> ***PPI interview***

[45] FT (2024)
[46] FT (2024)
[47] Silcock D, (PPI) (2019)
[48] Bank of England (2024)
[49] FCA (2024)
[50] FT (2024c)
[51] Wilkinson, L et al (PPI) (2023a)
[52] TPR (2024c)

Some of those interviewed for this project pointed to a shortage of suitable assets in some alternative asset classes. Infrastructure projects remain popular, but some of those interviewed felt that there is a lack of UK projects that help schemes meet their net zero ambitions with the lack of clarity from the Government hampering developments. Others point to the UK being an important source of new technology spin-offs from universities and opportunities for overseas investment in solar and other decarbonisation.

Structural issues may limit diversity in asset allocation

One other barrier to wider investment mentioned by several of those interviewed is the use of pooled funds which may not or cannot provide access to a full range of assets. Many platforms have been developed that rely on daily pricing, something which does not work well with assets that are less frequently valued. Although mentioned frequently, some of those interviewed noted that the industry was working on ways of addressing this and that new funds investing in illiquids, some of the Long-Term Asset Funds (LTAFs), were in the process of being developed / launched.

> ***"The use of life company platforms and pooled funds can limit access to illiquids"***
> ***PPI interview***

Size, profile and scheme end-game influence asset allocation.

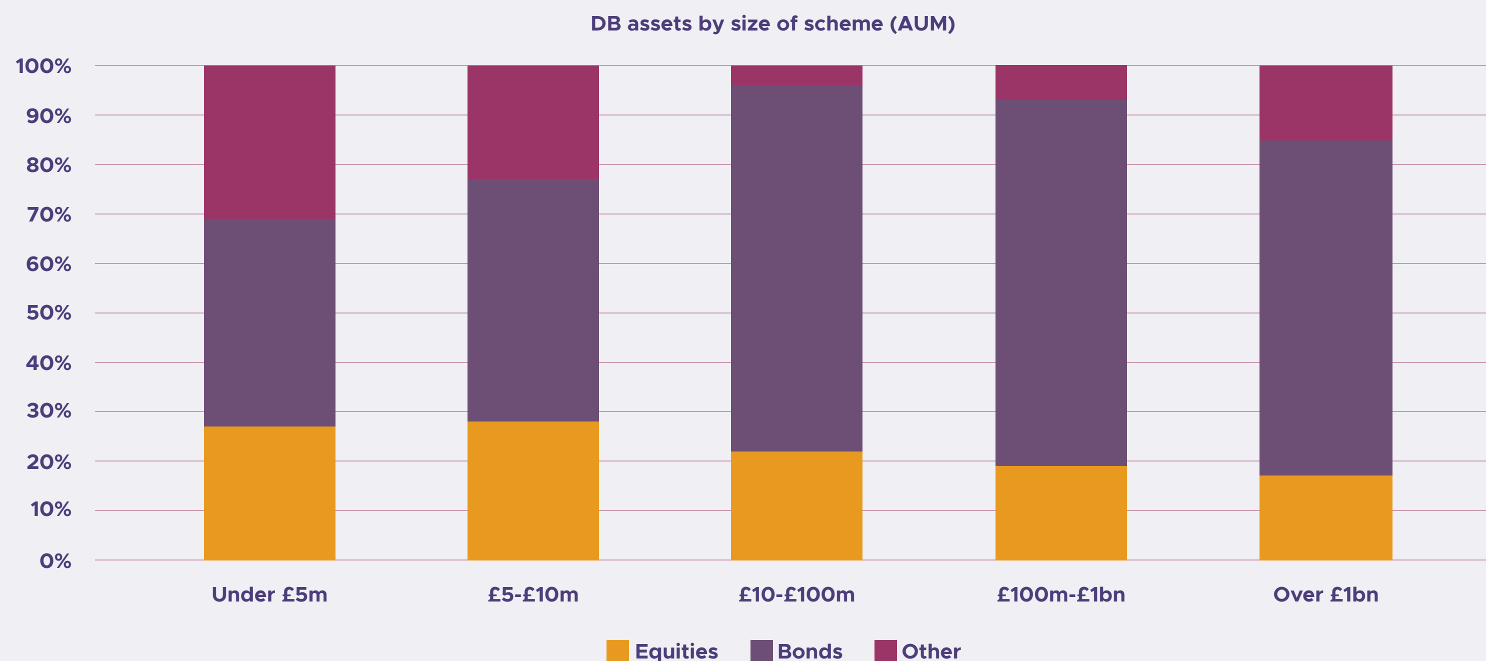
DB asset mix varies considerably by scheme size and funding status

Size of scheme has an effect on asset allocation in the private sector DB sector:

- Smaller schemes are more dependent upon equities, annuities and diversified growth funds (DGFs). Within equities, they are almost entirely invested in quoted equities and more heavily invested in UK quoted equities than larger schemes. In turn they are less heavily invested in bonds but, within this, are more biased towards fixed interest Government bonds.
- Larger schemes are more heavily invested in bonds and property. The bond portfolio is more heavily skewed towards index-linked bonds while the equity portfolio more heavily invested in private equity, with very little UK quoted equity.

Figure 21: DB assets by size of scheme (% AUM)

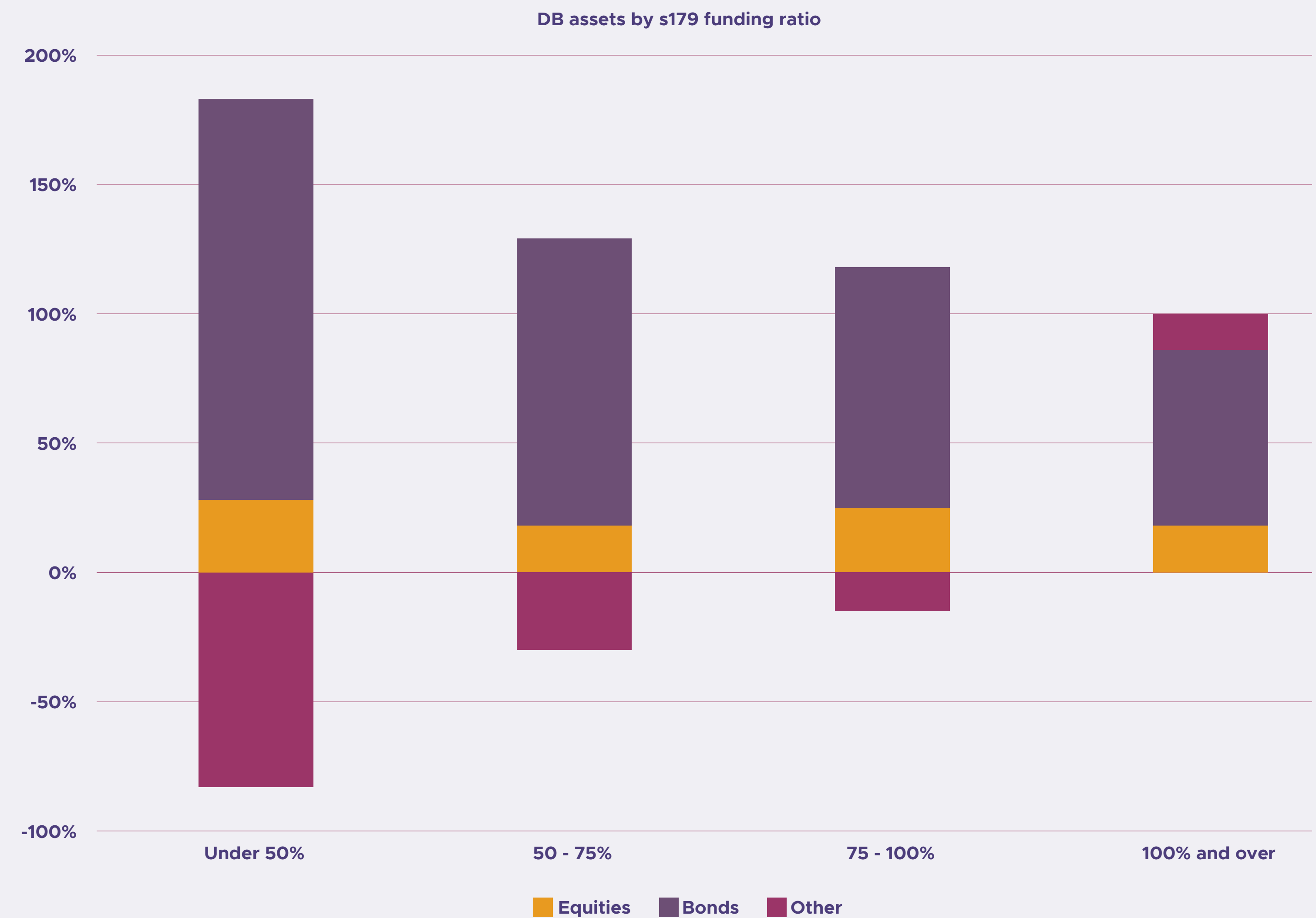
Bonds dominate portfolio in larger schemes while equity allocation shrinks



The funding ratio of schemes reveals a pattern of increased leverage among those funds with lower funding ratios (i.e. proportionately larger deficits), with high negative levels offset by levels of bond ownership exceeding 100% of total assets. Buy-in annuities feature most strongly in schemes in surplus.

Figure 22: Asset allocation of private sector DB schemes by s179 funding[53] position

Equity allocation varies less by s179 funding position



Since these data were published, more schemes are believed to be in surplus, some on a buy-out basis. The view of those interviewed for this project was that, for many schemes and employers, buy out is likely to continue to be the desired end game with the result that the profile of assets is unlikely to change radically in spite of the current Government consultation on options for DB schemes[54]. We discuss this in more detail later in this chapter.

> ***"If you weren't impacted too badly by the fall in asset values because you didn't have gearing in your LDI portfolio, actually you move to a situation where it was like kind of end of life where you don't need growth assets. Schemes that are already at 120% [funding] don't want growth assets as they want to stay at 120%"***
> PPI interview

[53] "A section 179 valuation applies the PPF compensation levels to the valuation and will show whether the scheme would need to call on the PPF if the employer was to enter insolvency" TPR understanding-db-_scheme-funding (1).pdf
[54] DWP (2024)

Exceptions to the rule in DB

Looking at the overall sector disguises some very different approaches to asset allocation that exist in large open schemes. The Universities Superannuation Scheme (USS), as the largest private sector scheme with £75.5bn assets under management (AUM)[55], can adopt a very different approach to investing than a smaller and closed DB scheme. Similarly, the Local Government Pension Scheme (LGPS) with combined assets of £359bn[56] at the March 2023 has a very different approach to investment.

USS[57]

USS invests 57% of its DB assets in growth assets, including public and private equities, infrastructure, real estate and commodities. The remainder is invested in liability matching investments, public and private assets, and leverage. USS invests 46% of its assets in the UK.

LGPS

LGPS has both direct investments made by each of the 90 funds that make up LGPS, as well as investments in eight investment pools set up to provide a more efficient way of managing the assets. ONS data for public sector schemes[58], of which LGPS represents almost three-quarters, suggests that approximately 50% is invested in public equities with a further 16% invested in private equity and alternatives. Bonds make up just 18% of the portfolio.

Shift to DC is helping to slowly offset the DB trend

The trend away from equities has been offset to some extent by the growth in DC assets and consolidation within the sector. Further shifts are expected as schemes grow and slowly mature. Unlike private sector DB schemes, DC arrangements have grown in size since the advent of automatic enrolment in 2012.

Figure 23: Growth in workplace DC assets 2019-2023 £bn

Source: PPI estimate based on ABI, individual company data and ONS data

There has been considerable consolidation within the sector with the number of master trusts reducing and many employers moving from single-employer trusts to master trusts. Since 2012, the number of non-micro trusts had fallen by two-thirds from 3,660 to 1,220 in 2022[59].

The average size of trust-based schemes has risen from £6m to £117m over the same period. The average size of a master trust stood at £2.9bn at the end of 2022 and £8.8bn at the end of 2023, with the five largest reporting assets of £113bn[60]. Further consolidation is expected to have taken place in 2023.

As DC arrangements grow in size, so their approach to investment becomes more sophisticated. The very largest, NEST, with £36bn of AUM at the end of 2023[61], has moved away from 100% pooled funds to a position where a significant proportion of their assets are managed on a segregated basis, giving them scope to invest in a broader range of asset classes. As more master trusts reach critical mass (one interview put this at £10bn), asset classes may broaden out still further with more adopting a segregated approach.

> ***"UK master trusts, except NEST, tend to not be large enough to be institutional investors with a segregated mandate investing in private markets."***
> PPI interview

[55] USS (2024)
[56] DLHC (2023)
[57] USS (2024)
[58] ONS (2024), FSPS
[59] TPR (2023)
[60] Go Pensions (2024)
[61] NEST (2024)

NEST

NEST has the largest and perhaps the most diverse portfolio[62] of the master trusts, with assets including both public and private markets, liquid and illiquid assets:

- Private equity
- Infrastructure equity - renewables
- Infrastructure equity
- Short-duration investment grade bonds
- Low-risk sterling liquidity
- Global investment grade bonds
- Sterling corporate bonds
- Global high-yield bonds
- Emerging market debt
- Private credit
- Hybrid property (UK direct & REITs)
- Climate aware global developed equities - GBP hedged
- Commodities
- Global listed property
- Climate aware global emerging market equities

Government and regulatory policy can influence asset allocation directly and indirectly.

Several recent policy initiatives have and will continue to have a direct or indirect effect on asset allocation across workplace pensions, both DB and DC.

Reforms seek to increase investment in private markets

In July 2023, the Chancellor of the Exchequer announced a range of reforms designed to 'boost pensions and increase investment in British businesses'[63]. The speech anticipated that £75bn of additional investment could be released to support the UK economy through changes being made to public sector pensions and commitments from the largest 11 DC pension providers to invest 5% of their default fund assets in unlisted equities by 2030 (known as the Mansion House Compact).

The Mansion House Compact was followed by an announcement in the Spring budget 2024 confirming that, in addition to the requirement for occupational DC schemes to disclose the breakdown of their assets[64], the FCA would be consulting on equivalent disclosure requirements for contract-based workplace schemes including a disclosure of holdings in UK assets. The FCA consultation is expected to be launched in late Spring 2024.

EXCERPT FROM SPRING BUDGET 2024

"ACROSS THE PENSIONS INDUSTRY AS A WHOLE, THE BEST DATA SUGGESTS INVESTMENT INTO UK EQUITIES HAS FALLEN TO AROUND 6%. TO IMPROVE DATA ON CURRENT HOLDINGS, THE GOVERNMENT INTENDS TO BRING FORWARD REQUIREMENTS FOR DEFINED CONTRIBUTION PENSION FUNDS TO PUBLICLY DISCLOSE THE BREAKDOWN OF THEIR ASSET ALLOCATIONS, INCLUDING UK EQUITIES, WORKING CLOSELY WITH THE FINANCIAL CONDUCT AUTHORITY (FCA) WHO SHARE RESPONSIBILITY FOR SETTING REQUIREMENTS FOR THE MARKET. THE FCA WILL CONSULT IN THE SPRING. THE GOVERNMENT WILL INTRODUCE EQUIVALENT REQUIREMENTS FOR LOCAL GOVERNMENT PENSION SCHEME FUNDS IN ENGLAND & WALES AS EARLY AS APRIL 2024. THE GOVERNMENT WILL REVIEW WHAT FURTHER ACTION SHOULD BE TAKEN IF THIS DATA DOES NOT DEMONSTRATE THAT UK EQUITY ALLOCATIONS ARE INCREASING." [65]

While at present none of the policy proposals seek to mandate exactly where and how the assets of pension schemes are invested, the budget excerpt above appears to consider further moves should growth not be forthcoming.

Some of the organisations interviewed are party to the Mansion House Compact or supported the overall direction of travel. Some were somewhat sceptical about the precise commitment that was being made and expressed strong views on any Government move to mandate where funds are invested. Several felt that additional incentives that make UK investment more attractive for scheme members, such as tax changes, might be needed to encourage greater investment in the UK.

"Well, we need incentives to do that or we need to unpick some of the costs of [investing in UK private equity]"
PPI interview

The announcement stemmed in part from concerns raised by a number of research organisations, such as The Thinking Ahead Institute[66], New Financial[67] and the Resolution Foundation[68], that UK pension funds are investing little in equities and productive assets compared to other countries. The shift away from investment in the UK by pension funds has made UK business more reliant on overseas investment and limits the scope for UK business to raise funds.

It also followed several years of reviews and consultations on the subject by the Bank of England[69], HM Treasury[70] and the Department for Work & Pensions (DWP), including the 2019 consultation on illiquid investment and consolidation for occupational DC funds[71]. The recent report produced for the City of London[72] also examines the opportunities for wider investment for DC schemes.

2024 potentially heralds a change of Government in the UK. The Labour party's positions on encouraging investment in the UK are similar to those of the current Government and are committed to reviewing the barriers to pension schemes investing in UK assets. It also plans to establish a British 'Tibi' scheme: an opt-in scheme for DC funds to invest a proportion of their assets into UK growth assets.

"This will mean working with industry and consumer groups to ensure savers are getting the best possible returns, and to identify and tackle the barriers to pension schemes investing more into UK productive assets, including cultural and regulation-induced risk aversion." [73]

[62] NEST (2024)
[63] GOV.UK (2023)
[64] DWP (2023b)
[65] HM Treasury (2024)
[66] Thinking Ahead Institute (2024)
[67] New Financial (2024))
[68] Resolution Foundation (2023)
[69] Bank of England (2021)
[70] HMT (2017)
[71] DWP (2019)
[72] City of London (2023)
[73] Labour Party (2024)

DC growth and consolidation – will it create a sector more like Australia?

Looking to the future, DC will shortly become a larger part of the UK pension sector than DB (particularly if we include individual plans as well as workplace schemes). Historically the DC sector has been much more fragmented than DB, as there are still 26,990 occupational DC schemes of which 21,580 (80%) are small schemes (fewer than 12 members)[74].

Policy and regulatory change has played a part in reducing the number of small schemes:

- The Government has called for further shrinkage in the number of DC schemes. It has set out to achieve this through a number of initiatives, including:
  - the introduction of a more detailed value for member assessment for schemes below £100 million designed to quicken the pace of consolidation[75]; and
  - proposals for reforming the value for money framework used by other schemes[76]

"If the current trend for falling numbers of DC schemes by between eight to 10% each year continues, we would expect there to be around 1,000 (non-micro) DC schemes operating in five years' time. Government believes that this is too many schemes and wants to accelerate the pace of scheme consolidation over this period so that there are significantly fewer schemes." [77]

- Since 2018, master trusts have required to be authorised by TPR[78]. This process led to a reduction in the number of master trusts with just 34 now operating and further consolidation expected.
- Regulations permitting the establishment of DB superfunds designed to encourage further consolidation among private sector DB schemes[79].

As the size of the average scheme grows, so the degree of sophistication in asset allocation and investment management can be expected to continue to develop.

The Government regularly draws comparisons between the UK DC pension sector and the Australian Super sector. Consolidation, addressing the issue of small pots and organic growth of DC in the UK will certainly bring some similarities. However, there are other important differences between the markets that we draw out below.

How does the UK differ from Australia?

The Australian DC market regularly features in the top above the UK in the Mercer CFA Global pension index[80]. The key similarities and differences between the Australian and UK markets include:

- The Australian DC funds, known colloquially as Supers, are more mature than the UK with compulsory contributions introduced in the 1980s and the 'superannuation guarantee' introduced 20 years before the UK's automatic enrolment began. Levels of minimum contributions are higher in Australia (11%, rising to 12% in 2025) than in the UK, where employees may opt out and contributions are set at 8% of banded earnings.
- Employees select their provider in Australia. Where an employee does not choose, the employer is required to search for an existing or 'stapled' employee account and direct contributions to that account. Only if the employee does not choose and does not have a stapled account do contributions flow to the employer's default 'MySuper' fund (a low-cost fund)[81]. In the UK, employers typically select one provider and all members' contributions flow into that scheme, leading to many employees having multiple small pots. The concept of a lifetime pot could be developed in the UK in a way which would mirror the 'stapling' of accounts in Australia.
- A small number of industry-wide funds dominate the Australian 'Super' market with a greater concentration of schemes than the UK. The largest MySuper fund in Australia, AustralianSuper, has assets of Aus$315bn[82] (£166bn) compared to NEST, the largest UK master trust, at £41bn[83]. The number of MySuper funds has been falling in recent years and numbered 64 in 2023[84] (more than the number of master trusts in the UK). Like the UK, the Australian pension sector is becoming more concentrated but remains fragmented with 150 schemes and almost 620,000 small and self-managed superannuation funds. In many ways, the UK and Australia are on the same journey.
- A key element of Australian reforms has been the implementation of net returns benchmarking as a performance test. This performance test is performed by the Australian Prudential Regulatory Authority (APRA) using quarterly returns data on investment performance and fees[85]. If a scheme fails the performance test in two consecutive years, the provider will be prohibited from accepting new members into that product. In 2023, almost 100 funds were reported to have failed the test[86]. One of the consequences of the test has been a narrowing of investment performance with funds with a reversion to median as funds seek to avoid failing the test[87].
- Australian funds invest a higher proportion of their assets in domestic business than UK schemes, in particular in alternative markets. This has been shown to have a positive but not transformative effect on retirement outcomes[88], but also serves to boost investment in the domestic economy. Australian funds are tax incentivised to invest in their domestic market, whereas the trend in the UK has been in the opposite direction[89].
- Australian funds are not subject to the same charge cap restrictions as the UK, with average default charges in Australia significantly higher than the UK at around 1% (of fund) per annum[90].

Taken overall, there are many similarities between Australia and the UK and it seems that the trajectory is, often by design, moving in the same direction.

[74] TPR (2023)
[75] DWP (2021a))
[76] DWP (2023a)
[77] DWP (2022a)
[78] DWP (2018)
[79] (DWP (2023e)
[80] Mercer CFA (2023)
[81] Australian Taxation Office (2024)
[82] Australian Super (2024)
[83] Nest (2024)
[85] Hurman, N. et al (PPI) (2021)
[86] APRA (2023)
[87] Corporate Adviser (2024a)
[88] Hurman, N. et al (PPI) (2021)
[89] Pensions Age (2024)
[90] Corporate Adviser (2024a)

DB funding codes, proposals for DB and LGPS options also driving consolidation

The current (2014) funding code[91] (soon to be succeeded by a new code, currently in consultation) introduced a funding objective for schemes "to have sufficient and appropriate assets to cover their technical provisions (accrued liabilities)", along with a requirement for integrated risk management.

This shift resulted in a concentration of low-risk assets in a desire to stabilise funding, reduce calls on employers for additional funding and, for many schemes, to secure buy out of all or part of the liabilities to an insurance company. At the time of writing, this trend seems to be continuing with reports of schemes continuing to sell growth assets in favour of credit assets[92 93].

The Government has launched a consultation on a range of options for DB schemes[94], designed again to encourage investment in UK businesses. Of particular relevance to this paper are proposals to "support schemes to invest for surplus in productive asset allocations by making it easier to share scheme surplus with employers and scheme members". At the time of writing this report, the sector appears to have mixed views on the proposal, as reported in the earlier Government response to the call for evidence[95]. In particular, it was not clear that the proposals would generate the wished-for increase in investment in UK assets.

The Government has also consulted on a number of changes to the way in which LGPS invests its assets. Of most relevance to this report are two proposals[96]:

- An ambition for LGPS funds to invest 5% of their assets in levelling up projects[97] in the local areas in the UK. The proposal met with broad support from LGPS funds but with some concerns about clarity of definitions.
- An ambition for LGPS funds to invest 10% of their funds in private equity. This proposal met with a more negative response, in large part due to a perceived conflict with the funds' fiduciary duty but also due to the higher risks and costs and lower liquidity. The Government has responded by stressing that it would not be mandating this level of investment and is planning to keep the ambition in place.

Permitted links and long-term asset fund (LTAF) expand options for investment

Until recently, FCA regulations acted as a limitation on the amount and the types of assets that retail life company funds could invest in. Since most GPPs use life company platforms, invest in pooled life company funds, and are technically individual contracts sold to retail customers, this had acted as a barrier to some types of investment. In 2020 the FCA changed these rules to extend the range and value of assets that could be included in unit-linked funds made available to retail customers[98].

One of the regulatory changes that is intended to extend the investment options open to UK pensions was the development of a new category of fund, the LTAF, by the FCA in 2021[99]. LTAFs were developed specifically to provide access to funds that invest in long-term illiquid assets, including venture capital, private equity, private debt, real estate and infrastructure. To date, only a few LTAFs have been launched, but our interviews for this project suggested that more are awaiting approval and that at least one has overcome the barrier mentioned above regarding daily pricing.

Initially, access to LTAF was limited to DB pension schemes, DC default arrangements and professional investors. In June 2023, however, the FCA widened access to LTAFs[100] to include retail investors (for example DIY investors in a contract-based workplace pension or individual pensions), subject to protections suited to the higher risk nature of the investment.

ESG plays a lesser role in asset allocation.

All schemes have adapted their portfolios in response to a growing emphasis on ESG factors. Schemes have a net zero target for their portfolio, often with a goal for 2050, with intermediate targets.

ESG factors have become more deeply embedded in default strategies in recent years. However, they are more likely to affect decisions with asset classes than asset allocation. Some notable exceptions were mentioned in the interviews for this project:

- Investment in emerging markets. Schemes express some concerns that although there is a trend towards emerging market assets becoming more closely aligned with ESG, emerging markets do not have the same standards in governance and monitoring as developed markets.
- Investment in commodities. Some funds have a review alert that sounds when commodity investment reaches a certain percentage. Given that not all commodities satisfy ESG, the alert ensures that there is no conflict between ESG goals and asset allocation.
- A nascent interest in asset classes (or within asset classes) that satisfy bio-diversity targets. One example mentioned in interviews was a growing interest in forestry.

"All of our portfolios are aligned to net zero policy. We have flags on asset allocation. For example. if commodities increased it could flag possible concern for ESG which makes us stop and think and check before investing. Emerging market debt can also be an issue due to higher risks, including less influence, more natural resources and greater risks from climate change."
PPI interview

[91] TPR (2024d)
[92] Pensions Age (2024a)
[93] FT (2024ds
[94] DWP (2024)
[95] DWP (2023f)
[96] DHLC (2023a)
[97] DLHC (2022)
[98] FCA (2020)
[99] FCA (2021)
[100] FCA (2023a)

CHAPTER FOUR:

WHAT DO CURRENT AND FUTURE TRENDS MEAN FOR MEMBERS, GOVERNMENT, REGULATORS AND INDUSTRY?

This chapter considers what current and future trends and policy positions could mean for the different stakeholders, and what impact policy could have on future asset allocation.

The analysis undertaken for this project shows clearly that the UK pension sector is in a period of transition, with members and assets moving from Defined Benefit (DB) to Defined Contribution (DC) across private sector schemes and within DC. This includes:

» members and assets having moved from individual pensions to workplace arrangements, to large workplace pension schemes, and

» from pooled and insured to segregated funds (for a small number of schemes at present).

It is this transition and the changing needs of pension savers that have driven many of the shifts in asset allocation rather than an inherent aversion to any one type of asset. The transition is far from complete. In the coming years, further changes can be anticipated:

- Barring any significant new incentive for employers to run-on their DB schemes, the winding up of more private sector DB schemes as more liabilities are transferred to insurers. This will inevitably lead to a reduction in illiquid assets among those schemes seeking buy out, making it unlikely that, barring a small number of open schemes, the private sector DB market will see any significant increase in such assets. The few large open schemes will continue to invest in a wide range of assets.
- Continuing pressure for LGPS funds to direct more money to pooled investment vehicles, invest to support levelling up in the UK, and to increase investment in private equity.
- Further consolidation in the DC market as the Government's policy initiatives continue to affect smaller schemes. As schemes grow, so they can be expected to spread their funds over a wider range of assets and to invest more of their funds directly. If, as reported by Corporate Adviser (see quote below), the assets of the largest schemes do double within the next six years, and barring any major disruption in the shape of the market, it is reasonable to expect a considerable increase in illiquid / private market assets both in absolute and percentage terms.

DC providers are confident that their assets under management will continue to grow. In anonymised answers to Corporate Adviser Intelligence, several predict their assets will double by 2030, with some predicting they will grow by a factor of three, four or even five times. This suggests further acquisition activity will take place in the coming years[101].

Members should benefit from shifts in asset allocation.

For members, the trends should provide more secure and better retirement incomes:

- Members of closed DB schemes should see their retirement incomes secured through better funding and, in many cases, buy out through an annuity with a life assurance company (with the associated protection from the Financial Services Compensation Scheme (FSCS)). Those schemes that choose to run on or which join a consolidator may be able to secure improved benefits for their members but may not provide the same degree of certainty or security.
- Members of open DB schemes should continue to benefit from diversity in asset allocation.
- Members of DC schemes with a default fund should see better designed defaults, more diverse portfolios, better risk management and better returns as asset allocation becomes more sophisticated. However, charges may rise with the higher costs associated with some asset classes. This may be offset by the economies of scale and negotiating power of fewer, larger schemes.
- Members of DC schemes outside of the default and individual DC clients will continue to rely on their own resources or those of a financial adviser to select the best mix of assets.

IN ADDITION TO SEEING THEIR PENSIONS YIELD BETTER AND MORE SECURE RETIREMENT INCOMES, MEMBERS OF SCHEMES COULD ALSO BENEFIT FROM THE SOCIETAL IMPROVEMENTS THAT SUCCESSFUL INVESTMENT IN UK BUSINESS SHOULD YIELD – MORE SECURE JOBS, ECONOMIC GROWTH, WAGE GROWTH AND BETTER PUBLIC SERVICES.

Challenge in achieving common set of definitions and understanding.

Measuring and reporting asset allocation, as this report shows, is fraught with difficulties:

- Definitions differ across the different organisations collecting data and between scheme types.
- Asset class definitions currently overlap, for example infrastructure can also be included in equity or debt asset classes.
- Some asset classes can mean different things to different people and will need to be carefully defined.
- Seeing through pooled funds to the underlying assets is not straightforward, particularly in mixed asset funds.

IF THE GOVERNMENT WANTS TO ACHIEVE A SINGLE VIEW OF ASSET ALLOCATION ACROSS THE PENSION SECTOR, IT WILL NEED TO WORK CLOSELY ACROSS SEVERAL ORGANISATIONS: REGULATORS, TRADE BODIES, RESEARCH BODIES, DATA COLLECTORS, MEDIA AND, MOST IMPORTANTLY, THE INDUSTRY TO ACHIEVE COMMON DEFINITIONS AND UNDERSTANDINGS.

[101] "Corporate Adviser (2024)

Prev Next

Government drive for investment in private equity will need to be driven by open DB and DC.

The Government's ambitions for more investment in private equity look likely to be realised in the medium term, but it is less clear how much of this will feed into UK business. Continuing the trend towards greater diversity in assets relies very much on the current transitions being allowed to work their way through, in particular, the consolidation in the DC sector and the continued use of default funds.

The growth in private market assets will largely be driven by the very small number of open DB schemes in the public and private sectors and DC funds. However, the policy initiatives currently underway could lead to some unintended consequences:

- The potential for a herding effect with providers all putting more money into private equity at the same time, which could have a detrimental effect on asset prices and returns.
- A risk that disclosing asset allocation could lead to less innovation in asset allocation as schemes tend towards the mean.
- Disclosure could lead to a reduction in UK investment if it becomes more evident that schemes that are overweight in the UK are underperforming.
- Any attempt to force providers to invest more heavily in certain asset classes is a direct challenge to trustees' fiduciary duty and can be expected to be met with considerable backlash. The Government could also find itself in conflict with regulators, both of whom put member outcomes at the forefront of their strategies and policy.
- Changes such as the lifetime provider and the small pots initiative could disrupt the current trend towards consolidation and, with funds moving more between providers, could lead to providers needing to emphasise liquidity.

THERE IS POTENTIAL FOR THE GOVERNMENT'S AMBITIONS TO BE ACHIEVED AND, TO SOME EXTENT, THIS IS ALREADY HAPPENING. HOWEVER, CHANGE WILL NOT COME OVERNIGHT AND PATIENCE IS REQUIRED AS THE TRANSITIONING TAKES FULL EFFECT.

Ensuring that changes in asset allocation meet member needs.

Schemes and providers face a number of challenges arising from the shift in asset allocation and recent policy initiatives:

- For closed DB schemes and their employers, decisions on the endgame need to be reviewed in the light of Government policy. At the time of writing this report, it was not clear whether the Government proposals would change the direction of travel. For those schemes heading for buy out, getting the portfolio into shape to make that transition smooth and as low cost as possible will be a key driver of asset allocation.
- For open DB schemes including LGPS, diversification of assets will continue to be important but with some continuing pressure or encouragement from Government to direct funds towards productive finance in the UK.
- In DC, the potential shift away from insured pooled funds to more segregated funds as trust-based schemes grow and consolidate further will lead to a number of issues for trustees and contract-based providers, including:
    - Investment governance will become more complex and will require greater spread of expertise on trustee boards and IGCs and access to different advisers and managers.
    - Member-borne costs could rise as new assets are accessed, hopefully offset by scale efficiencies and the ability to negotiate down fees.

For all schemes, ensuring that member needs remain at the forefront of any decisions will be essential.

CONSOLIDATION IN DC WILL SUPPORT AND DRIVE GREATER DIVERSIFICATION OF ASSET CLASSES. WITH THIS MAY COME SOME ADDITIONAL COSTS FOR MEMBERS AND INCREASED DEMANDS ON GOVERNANCE BODIES TO ENSURE THAT NEW ASSET CLASSES ARE UNDERSTOOD. CONTINUING TO PUT MEMBER OUTCOMES AT THE FOREFRONT OF DECISIONS WILL BE ESSENTIAL.

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