Pensions Policy Institute

PPI

Pension scheme assets – a deep dive into alternatives

Pension scheme assets deep dive series #1

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This first deep dive, kindly sponsored by **World Gold Council** is part of the PPI's broader pension scheme asset strands study and explores how patterns in investment into alternatives have changed in the past, where investment is today, and how it might change in future, and asks what all this means for schemes and members.

Funding has been given to help fund the research and does not necessarily imply agreement with, or support for the analysis or findings from the project. The PPI does not make recommendations as to the appropriate direction of future policy, Instead, our work provides **INDEPENDENT** evidence to allow policy development to be well informed.

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Pension Scheme Assets – a deep dive into alternatives

Alternative assets, meaning assets that are generally not listed on a public stock exchange and including both liquid and illiquid assets, can be used by Defined Benefit (DB) and Defined Contribution (DC) pension schemes to diversify investments, hedge against volatility and seek enhanced returns. While accessing alternative assets is more expensive and requires greater resources through investigation and monitoring, recent years have seen an increase in both DB and DC scheme investment in alternatives.

Pension funds have widened their asset portfolios as investment markets available to them in the UK and globally, have changed and grown. From a traditional focus on equities and bonds, this has extended to property, derivatives, and, in more recent times, private equity and private credit as private markets have become significant alternative sources of finance.

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Diversification by investing in alternative assets is available to pension funds with sufficient scale

Whist the majority of pension fund assets have been invested in publicly listed shares and government or corporate bonds and deposits, there has been a range of alternative assets used over the last 50 years by pension funds and insurance companies to diversify their pension asset holdings. Diversification is a fundamental principle in asset management as a mechanism to pursue returns that are less correlated to stock markets, to spread and manage down overall risk in an investment portfolio.

Alternative investments are defined by a method of access, rather than by a specific asset type or financial characteristic. As a result, the label 'alternatives' covers a wide range of asset classes including property, private equity, private credit, hedge funds and managed financial derivatives, and commodities. This list includes a disparate mix of real and financial assets, growth, income and capital preservation assets which are typically, but not exclusively, illiquid. Different alternative investments serve quite different purposes within an overall portfolio and trends need to analysed at a lower level of granularity.

Investing in alternatives implies the achievement of sufficient scale in the fund to have the ability to:

- access these markets, either directly or via specialist pooled or segregated funds, and
- manage investments in a more diverse investment portfolio purposefully, skillfully and economically.

Funds can generally expect higher investment returns for the complexity involved on engaging directly and a premium for buying and holding assets that are less easy to sell, known as the 'illiquidity premium'. As alternatives tend to be less regulated, it also places a higher reliance on the pension fund's oversight and governance to mitigate additional risks arising in return for the additional potential returns available in these less public assets.

Exposure to alternative assets is also possible via public market investments. Investment vehicles such as Investment Trusts, Exchange Traded Funds (ETFs) and traditional listed companies can provide exposure to assets in the alternative space. These are not direct investment, but via an intermediate vehicle, with their own financial characteristics and risks. As a result, the additional returns sought from these investments may be reduced by the charges and profits earned by the intermediate vehicle. The risks and returns can also be modified by factors such as the internal financing of the vehicles[1] and the quality of the investment decisions and stewardship by the vehicle of its assets. These can diminish the attractiveness of such investments as a route to seeking enhanced risk-adjusted returns from alternative assets, but can still provide a diversification benefit without the additional costs of specialist asset management teams and oversight. As publicly traded investments, these types of investments are typically managed within equity and bond teams and their mandates. Commodities, including gold, are also widely traded on public markets and similarly are managed by public market teams as part of wider mandates.

Alternative investments have played a varying support role within pension fund portfolios for over 50 years

Around 60 years ago[2], funded DB pension schemes invested almost exclusively through UK public markets with an average scheme holding its assets roughly half in UK equities and half in UK fixed income. During the 1960s and 70s, pension funds diversified into other assets, particularly property, with allocations to alternative assets in the average pension fund reaching 22% by 1981. But the 1980s saw a major re-allocation by pension funds into equities, particularly international equities, as global equity markets boomed, and by 1991 allocations to bonds and alternatives had roughly halved in 10 years. The 1990s saw a modest growth in bonds at the expense of equities and alternatives as schemes matured. But the closure of most private sector schemes to new members and the end of the equity boom in the 2000s saw a near doubling of bond and alternative holdings at the expense of equities in the average DB scheme in 2011, in the aftermath of the Global Financial Crisis[3].

DB scheme allocation to alternatives has fluctuated over time

Source: NAPF (2013

Percentage asset allocation of the average DB pension fund (Source: NAPF, 2013)

[1] For example, the use of borrowing to enhance returns (leveraging), which also increases volatility and credit risk
[2] Data from 1962, cited by National Association of Pension Funds (NAPF) (now Pensions & Lifetime Savings Association (PLSA)) (below)
[3] NAPF (2013): Trends in defined benefit asset allocation: the changing shape of UK pension investment

Alternatives give access to diversity in investment opportunities missed by public markets

Public markets are giving access to fewer companies and opportunities. The number of public listed companies across global stock markets grew through most of the 1980s and 1990s before reaching a plateau by 2000. In the last 10 years the numbers have declined. The decline in listings is particularly pronounced in the US, at 50% from its peak in 1996, but is widespread, with 18 countries seeing declines of between 30% and 75% in the number of listed companies, including the UK with over a third (37%). In contrast, the number of active private funds globally has grown from none in 1980 to over 9,600 by the end of 2020, with assets under management (AUM) in excess of $6 trillion[4].

Despite the decrease in listings, global equities' share of the total investment universe increased slightly to 49% in the period 2010-2020. More than 40% of global equities in 2020 were held in passive funds, compared with just 2% on 1995. Private funds held 4.4% of the total investment universe in 2020 (up from 2.6% in 2010). The share for global bonds was 45% (47% in 2010) and for commodities was 1.9% (1.7% in 2010)[5].

So, more money is being invested into stock markets that now have fewer companies listed and with more of this money being invested passively. In addition, those companies remaining on stock markets are older, larger and often slower growing. The concentration of public market investment in fewer firms with significant holdings on a passive mandate also suggests that these markets will become more volatile.

Seeking finance via private credit is also a growing trend. Traditionally banks made loans to businesses of all sizes but with a skew towards smaller businesses and less risky borrowers. Firms with larger borrowing needs historically accessed the corporate bond markets and issued publicly traded fixed rate debt. New regulations in the wake of the Global Financial Crisis, such as the Dodd-Franks Act and Basel III, made it more expensive for banks to hold loans on their balance sheets and the share of loans as a percentage of US bank assets has since fallen from 70% to 55%[6].

Unlike most bank loans, private credit can be tailored to meet borrower's needs. But, like bank loans, the majority of private credit takes the form of floating-rate investments that provide interest rate mitigation compared to traditional fixed-rate bonds. Private credit also offers borrowers pricing certainty and speed compared with bank lending[7]. At the start of 2024, the US private credit markets were approximately $1.5 trillion, compared with $1 trillion in 2020, and are estimated to grow to $2.8 trillion by 2028[8]. Current global private credit market size has been estimated at up to $3.1triilion[9].

These changes in the range and distribution of the investable universe suggest that exposure to alternative assets in private markets could become increasingly appealing and necessary for investors seeking diverse portfolios.

The pressures resulting from low market returns have fuelled investment in new alternatives

The Global Financial Crisis of 2007-8 and the consequent credit squeeze, resulted in a low-growth, low-interest rate economy in the UK. By this time, most UK DB pension funds were not only closed to new entrants but, increasingly, to future accrual. Many had or were adjusting their investment strategies towards bonds and money market funds to reduce risk as their member profile aged and approached or entered retirement. Some were negotiating with their sponsors and The Pensions Regulator (TPR) to secure a recovery path to fill significant funding shortfalls, while others were exploring the option to secure retirement incomes contractually for their members through arrangements with specialist insurers.

On the one hand, the Global Financial Crisis raised the value placed on the future liabilities of funds, but on the other reduced the expectation of future returns from these investments. These two effects resulted in reinforcing negative impacts on solvency and risk appetite within funds.

The scarcity of attractive returns in both the equity and bonds markets prompted larger schemes to look more closely at wide range of alternative assets to boost risk-weighted returns, in particular:

1. the use of hedge funds and other hedging approaches, to increase exposure to income assets without foregoing all the opportunities for growth assets to improve their solvency positions, and
2. the building of private markets exposure and expertise to access private equity and private credit markets, the former to boost growth strategies and the latter to find better long-term income earning assets.

The volatility of the last five years highlights potential limits and new options to use alternatives

The last five years have seen significant shocks on the UK economy that have significantly changed the investment environment for pension funds in the UK. For some DB funds, this has forced a resetting of their appetites for alternative investments, whereas for others it has extended and/or refined them.

The 2020 pandemic brought a major negative shock to the UK, putting further stress on returns and solvency margins. During this period, we also saw the UK's exit from the European Union (EU) in 2021, which introduced new frictions and uncertainties to UK businesses and equity markets. 2022 then brought the energy shock consequent to the conflict in Ukraine, resulting in UK Consumer Prices Index (CPI) annualised inflation rates peaking at 11.1% in October 2022, the highest for over 40 years[10]. UK interest rates rose rapidly from 0.1% in December 2021 to 5.25% in August 2023[11]. This monetary policy dramatically reduced the value placed on the future liabilities in DB schemes, boosting solvency ratios. The schemes that did not have full liability hedging particularly benefited as, whilst the value of their hedging assets fell, they did not fall as much as their liabilities.

Thus, DB schemes generally have now become far better funded, with around two fifths (38.7%) in surplus in 2022[12]. Many trustees can now actively explore hedging more of their liability risks or transferring the risk of paying pensions to insurers. Others may now look at capitalising on their surplus position to run off their schemes and use the surplus to enhance benefits for members and/or return value to sponsors[13].

A particular shock for DB schemes was in September 2022 when chancellor Kwarteng's "mini budget" caused a 1.2% spike in gilt yields in just three days. This created a liquidity crisis for those DB schemes who had significantly leveraged trades in implementing a Liability-Driven Investment (LDI) strategy[14], hedging against bond yield moves, and required additional collateral for the resulting margin calls on these trades. The consequent distressed sales of their most liquid assets, which were overwhelmingly gilts, created the potential for a systemic crisis that required Bank of England intervention[15]. Whilst defaults were avoided, this resulted in a deleveraging of LDI portfolios from an estimated three times to two times in this short period[16] and a resultant unintended shift in exposure from income to growth assets in their portfolios, including alternatives. It also caused a reassessment of the levels of liquidity required in DB schemes, especially those that have implemented leverage liability matching strategies, and a consequent reduction in appetite for illiquid investments.

There are also emerging opportunities to deploy alternative investments in workplace DC schemes. These schemes are set to grow fast, with the majority of new member contributions directed to DC schemes with accelerating accruals within them in the wake of automatic enrolment. These opportunities are supported by the consolidation of workplace DC schemes to achieve economic scale, encouraged in part by Government and regulatory policy. There is also a very high concentration of investment by members within these schemes into the default fund arrangements.

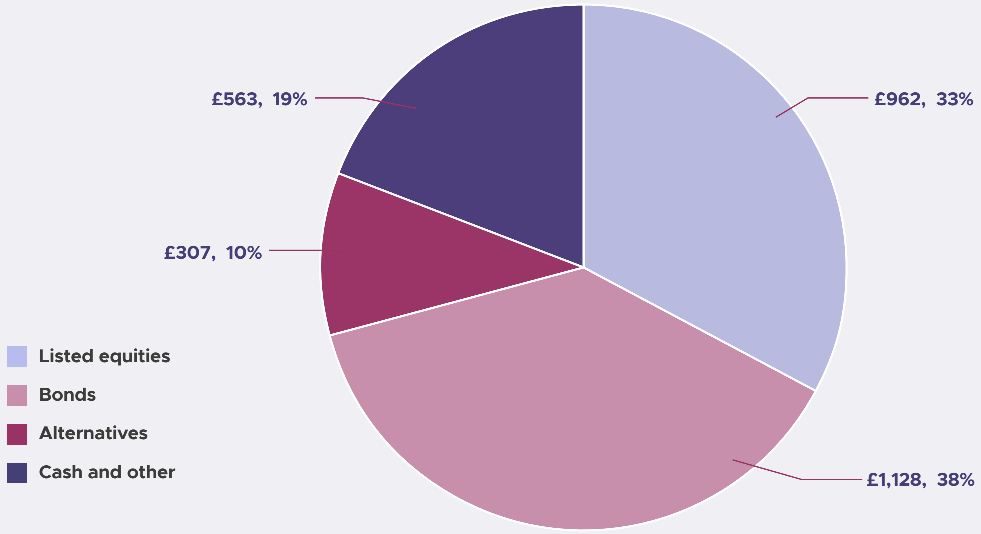
The scale of workplace DC is set to transform over the rest of the decade. The DC trust market is set to triple in size from £143billion in 2023 to an estimated £420 billion by 2030[17], with the NEST DC scheme expected to be around £100 billion of that total. PPI analysis estimates that the total workplace DC market will be around double that at £800 billion in 2030 and £1.2 trillion in 2043[18].

[4] Buenneke, B and Wilson, C (2021): The shrinking public market: A continuing trend (Pantheon))
[5] Ibid
[6] Buchak, G et al (2024): The secular decline of bank balance sheet lending (NBER)
[7] Morgan Stanley (2024): Understanding Private Credit
[8] Buenneke, B and Wilson, C (2021): The shrinking public market: A continuing trend (Pantheon)
[9] Wigglesworth, R (2024): Private credit is even larger than you think (Financial Times, 71/4/24)
[10] Office for National Statistics (ONS) (2024): https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/june2024
[11] Bank of England (2024) https://www.bankofengland.co.uk/monetary-policy/the-interest-rate-bank-rate
[12] TPR (2023): Scheme funding analysis 2023 https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/scheme-funding-analysis-2023
[13] Mercers (2024) https://www.mercer.com/en-gb/insights/pensions/defined-benefit-schemes/shifting-considerations-db-pension-schemes-2024/
[14] LDI can be used to manage a pension fund's exposure to interest rate and inflation risks better to secure its ability to meet its future liabilities to members
[15] Financial Times (FT) 29 September 2022 LDI: the better mousetrap that almost broke the UK
[16] FT 24 October 2022: The LDI crisis is spurring a seismic shift in the gilt market
[17] Department for Work & Pensions (DWP) (2023): Analysing the pensions landscape and consolidation in the DC trust-based pensions market
[18] PPI (2023): The DC future book 2023

Overall, around 10% of UK pension scheme assets are now invested in alternatives across DB and DC

PPI analysis of how the £3 trillion of UK pension scheme assets are invested shows that, despite these trends, just 10% (£307 billion) are invested in alternatives, reflecting the low allocation of just 3% to alternatives within current DC schemes[19].

Overall, a more balanced portfolio



UK pension sector, overall asset allocation (£billion and %), 2023

The current appetite for alternatives depends on the circumstances and strategy of the scheme

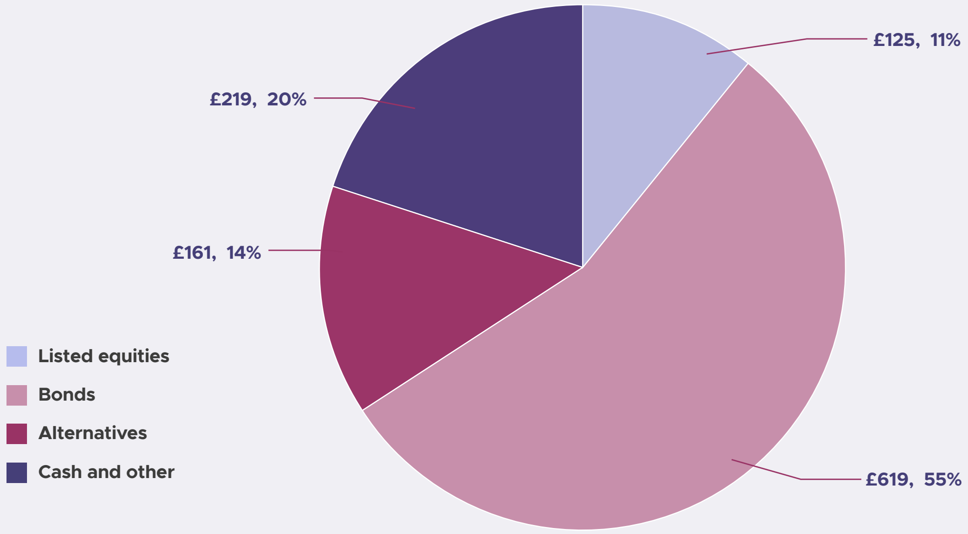
Looking at schemes now, we can segment these into three broad groups:

- Closed (largely private sector) DB schemes, including those now managed by specialist insurers,
- Open (largely public sector) DB schemes, and
- DC schemes.

Most closed schemes now have limited opportunities to invest in alternatives

Private sector DB schemes, of which only 4% remain open to new members[20], represent the largest part of the UK pension sector by assets. Of the £1.1 trillion of assets held by them, PPI estimates[21] that, in 2023, almost two thirds were invested in bonds and bond-like assets to match schemes' liabilities and cashflow requirements. Only 14% was invested in property, private equity and other alternatives.

Bonds still dominate private sector DB schemes (£bn)



High level asset allocation of private sector DB schemes (PPI estimate based on data from Financial Survey of Pension Schemes (FSPS) Q3 2023) £billion

Full buyout is the most common long-term aim amongst larger DB schemes, with 38% targeting this as their long-term objective in 2023, compared with only 11% in 2015. All these schemes were aiming to complete a transaction within the next three years. Nearly half (46%) of all larger DB schemes had already implemented or were currently investigating an investment strategy to target buyout. A further 15% were considering it as a potential future strategy and more than three quarters (76%) of large schemes were monitoring their buyout funding level on a quarterly basis[22].

The investment priority for schemes targeting buyout is to make their asset portfolio attractive to transfer to an insurer. This would typically be cash and a segregated portfolio of public bonds which are Matching Adjustment (MA) eligible[23]. This largely precludes investment in alternatives and any assets not fitting the transfer criteria will be divested to implement a buyout-friendly portfolio. Generally, there is little overlap between pension scheme illiquid assets and the illiquid assets that insurers want[24].

As demand is now high and buyout capacity is limited, both in terms of available capital in specialist insurers and administrative capacity to take on new schemes, there is considerable pressure on schemes to optimise their portfolios in this way to maximise their attractiveness as a transaction prospect.

For those schemes not targeting buyout, opportunities remain to invest in alternatives, mainly to generate long-term income through private credit, property and infrastructure investments. Opportunities for growth assets will be limited but will still be present if the aim is to extract additional value for members and sponsors.

Insurers taking on closed DB assets may look beyond public bonds to alternatives to match long-term income requirements

Once through the transfer process, large specialist insurers are able to take a more diversified approach to investment as they assume DB pension liabilities from closed schemes. They are more likely to have the scale and expertise to use alternatives to match the duration of the income streams required by the profile of scheme members. For example, in June 2022, Pension Investment Corporation (PIC) reported that 18% of assets were held in debt securities linked to private investments and a further 8% in participation in other investment schemes[25]. Rothesay Life reported that 36% of their assets were held in alternative illiquid assets in 2023[26 27].

So, we might reasonably expect the buyout process to increase the use of alternative assets for closed DB pensions as specialist insurers are able to access alternatives and have the appetite to do so. Our research interviews also support this view.

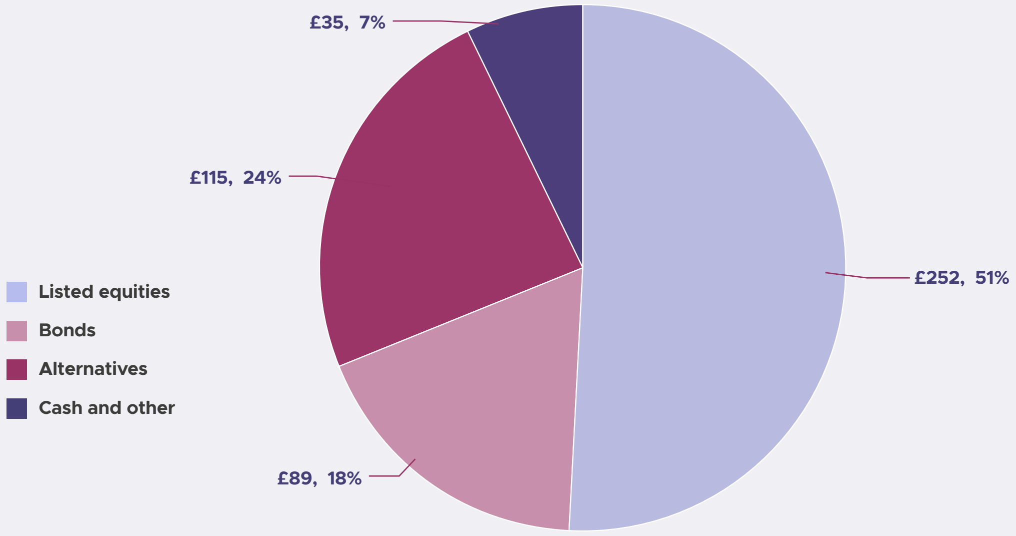
[19] PPI (2024 unpublished): Pension Scheme Assets
[20] TPR (2024); Occupational pensions landscape in the UK 2023 https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/occupational-defined-benefit-landscape-in-the-uk-2023
[21] PPI (2024 to be published) Pension Scheme Assets
[22] Pensions Age (26 July 2024) Growing number of DB schemes targeting buyout
[23] The MA in Solvency II regulations allow insurers to reduce the capital requirements associated with portfolios by increasing the discount rate for annuity business when backed with eligible assets and hence to allocate capital more effectively
[24] Phoenix group (2024): Managing illiquid assets during a bulk purchase annuity transaction accessed at https://library.standardlife.com/DB-Solutions-report-managing-illiquid-assets-bpa.pdf
[25] PIC Capital (2023) Pension Investment Corporation: A significant investor in real assets.
[26] Rothesay Limited (2024) Annual reports and accounts 2023
[27] PIC held 14% and Rothesay Life 26% of the buyout market in 2023 (Pensions Age https://www.pensionsage.com/pa/New-entrants-bolster-pension-risk-transfer-market-volumes-in-2023.php)

Open DB Schemes remain significant investors in alternatives

Funded public sector scheme asset allocation reflects the open nature of these schemes. In public sector schemes, more than third (37%) of members are active and a further third (34%) are deferred, with only 29% pensioners[28]. The continuing flow of contributions and younger age profile of open schemes places an emphasis on allocation to growth assets in their portfolios.

PPI analysis of the £0.5 trillion spread in 2023 across 86 Local Government Pensions Schemes (LGPS) and a small number of other funded public sector schemes reveals that half (51%) are held in equities, but with a further quarter (24%) held in property, private equity and other alternatives. Two thirds of LGPS assets (67%) are held in pooled funds (predominantly those managed by the eight LGPS asset pools)[29].

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



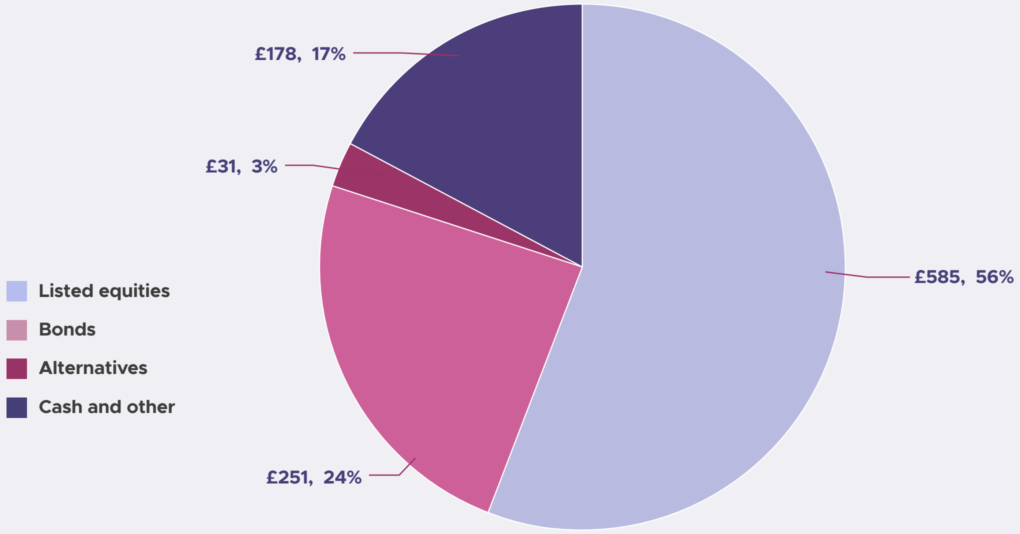
High level asset allocation of public sector DB schemes (PPI estimate based on data from FSPS Q3 2023) £billion

In March 2024, one of the largest open DB funds, the Universities Superannuation Scheme (USS) held a third (34%) of its £75 billion of DB assets in alternative assets, including private equity, infrastructure, property, private fixed income, renewable and natural capital. Levering their scale in DB, their DC default scheme also invested 20% of its £3 billion assets in alternatives[30]. This provides insight into the potential appetite for alternative assets not just within DB, but also DC pensions in the future where schemes are able operate at the scale and investment freedom of current open large DB schemes.

Currently only 3% of DC funds are invested in alternatives

In marked contrast to the USS scheme, overall DC is dominated by traditional assets with only 3% estimated to be invested in alternative assets[31].

DC assets dominated by equities (£bn)



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

Assets within DC are still dominated by contract rather than trust arrangements

- Of the estimated £1 trillion assets in DC pensions, only just over a half are within workplace DC arrangements. The remainder are in individual (contract-based) pension arrangement with investment determined by the individual member (with or without advice)
- Of the £560 billion in workplace DC pensions, approximately
  - £310 billion is held in Group Personal Pension (GPP) or Stakeholder contracts, with asset allocation determined by the employer (with input from their adviser)
- Only around £250 billion (just one quarter) is held in trust-based workplace DC, with
  - o £170 billion in master trusts and
  - o £80 billion in single-employer trust-based schemes.

This is significant, as most contract-based arrangements are almost entirely invested in pooled funds. In addition, of the £250 billion held in trust-based schemes, 89% of funds are invested through pooled investment arrangements (typically life funds and, typically, passive index funds) with only 11% holding assets (around £28 billion) invested directly through segregated funds.

The overwhelming majority of trust-based DC schemes are currently immature and under scale for direct investment, being invested in pooled funds arrangements. Estimates suggest that assets of around £25 billion to £50 billion are the scale point for a scheme to enter direct investment in a wider range of alternative assets[32]. In some ways, it seems this pattern in current DC investment echoes the investment position of DB in the 1960s.

[28] TPR (2023) Annual landscape report on UK defined benefit and hybrid schemes 2021
[29] PPI (2024 to be published)
[30] USS (2024): Report and Accounts for the year ended 31 March 2024
[31] PPI (2024 to be published)
[32] DWP (2023): Analysing the pensions landscape and consolidation in the DC trust-based pensions market

Technical and practical issues also need to be addressed in widening access to illiquid alternatives.

Technical issues of daily valuation required by the unitised investment structure of DC arrangements are a potential stumbling block to accessing illiquid alternatives. The requirement for the daily valuation of funds under DC brings an overlay of additional investment accounting processes and governance to ensure fair process can be established, as pricing errors risk exposure to the consequent liquidity and mismatching risks. Ultimately, these issues are all manageable, as is evidenced by the long history of unitised property funds, but this is more readily achieved within large and diversified funds.

A further potential issue arises from interaction with fees and the DC charge cap. It has been argued that the charge cap can limit the investment options for DC funds, particularly for high-risk investments such as infrastructure and renewables. Whilst these options give potential for higher returns, it is argued that they cannot be delivered and keep charges under the 0.75% cap[33]. The Government consultation on excluding performance fees from the DC charge cap in 2021 received a mixed response and concerns were expressed that such a change would have a limited impact on investment, but might impact value for money and member confidence[34]. Nevertheless, from April 2023, trustees have had the option to exclude performance-based fees from the charges falling with the charge cap, although they must disclose these charges separately and robustly assess their value for money[35].

NEST had £30 billion of AUM in 2023, with 15% invested in illiquid alternatives (property, private credit, unlisted infrastructure and private equity)[36]. This has been implemented through external fund managers whilst taking the stance of not entering into any performance-based fees. Again, this tends to suggest that the issue of fees is manageable and is more readily addressed as funds grow and achieve scale.

A number of factors influence continued and further investment in alternatives

A more stable political environment for UK investment is anticipated

The past five-year period has seen a period of increasing political uncertainty and volatility. The election of a new Labour government, with a majority of over 150 MPs, has given grounds for optimism for stable government with a renewed focus on policy and sound economic management. Whilst the current fiscal position means that there is very limited room for direct government stimulus, the UK can be seen as one of the more stable governments in the G7 countries and so better able to attract private sector capital both from the UK and overseas.

Labour's polices and initial statements have emphasised the intention to foster a growth economy with a particular focus on easing the barriers in the planning process to new housing and infrastructure development, and creating catalytic investment for public/private partnerships for UK infrastructure investment through the creation of the £7.3 billion national wealth fund. The five preliminary sectors to be focused on by the fund, identified as green steel, green hydrogen, industrial decarbonisation, gigafactories and ports, have been welcomed as a logical place to start[37]. In addition, whilst further capital budget cuts have been announced, a number of key Government infrastructure projects have retained funding, such as HS2 and the Lower Thames Crossing.

The FCA also approved major changes to the listing rules for London-listed companies in July designed to address the outflow of investment from UK markets, attract listing for high-growth start-ups and retain the listing of larger groups in London. Further changes to prospectus rules are expected with a review to be launched in summer 2024[38].

The new Government's pension review promises to boost growth and investment in alternatives

The newly announced pension review looks to build on the work of the previous Government in the Edinburgh and Mansion House reforms, designed to increase investments in UK assets by domestic pension funds. The review focuses on further actions to drive investment into areas such as science, technology and infrastructure on the expectation of higher returns from productive assets. Specific emphasis is being placed on 'unlocking' the investment potential of the LGPS. The review also intends to prioritise gilt market stability, liquidity and diversity[39].

DC schemes will grow, with large trust schemes achieving scale in the next five years

The scale of workplace DC is set to transform over the rest of the decade. The DC trust market is set to triple in size from £143 billion in 2023 to an estimated £420 billion by 2030[40], with the NEST DC scheme expected to be around £100 billion of that total. PPI analysis estimates that the total workplace DC market will be around double that at £800 billion in 2030 and around triple the size at £1.2 trillion in 2043[41]. Over half of trust-based DC assets are expected to be in schemes of over £50 billion and two-thirds holding more than £30 billion by 2030[42]. Consolidation of providers is also widely predicted, with some experts predicting as few as 10-12 master trust providers in the next five to 10 years[43].

This would give scope for DC to become a more significant investor in alternatives as DC trusts compete to scale up quickly and develop further their value for money propositions.

Large DC schemes will need time to build in-house skills to invest directly in private markets

Whilst scale appears to be the key constraint on the growth of investment in alternative assets within DC, standalone DC schemes (as opposed to those managed alongside large DB schemes or in organisations with wider investment capabilities, such as insurers, banks and asset managers) expect to develop their alternative investment teams as the funds available for these mandates scale up. Whilst this does not preclude investments in alternatives, for example via delegated mandates, there is still an expectation that the best outcomes for members will be delivered through direct investment in-house, as in DB.

Experience from organisations developing these capabilities suggests that the appetite to invest in alternatives may outstrip the capability to invest direct, for the short to medium term.

FCA regulatory changes provide new ways for DC schemes to invest in illiquid alternatives

In 2021, the FCA introduced a new category of authorised fund, the Long-Term Asset Fund (LTAF), aimed at DC pension schemes. LTAFs are designed for investing in long-term private illiquid assets such as venture capital, private equity, private debt, real estate and infrastructure. LTAFs manage the liquidity challenges through a number of strategies, including liquidity buffers and notice periods[44].

These allow members to invest directly in private assets rather than in liquid proxies as part of their DC scheme. Fund managers, such as Schroders, Blackrock and LGIM, have now launched LTAFs as a route to include alternatives in default funds for DC funds without in-house teams. Whilst the use of LTAFs will increase the charges for default funds, as a smaller part of a wider asset allocation to traditional investments, interviews suggest that the consequence increase in the overall default fund charge is not a fundamental barrier to consideration by trustees.

[33] Sardana, S (2022): What changes to the pension charge cap mean for you (Money Week 27/9/2002)
[34] FT advisor 30/11/21: Govt to remove performance fees from DC charge cap.
[35] TPR (2023): Focus on value from DC pension investment set to increase after regulation changes
[36] Greenwood, J (2023): Nest hits £30bn with 45pc of private assets in the UK (Corporate Adviser 25/5/23)
[37] Cheung, C (2024): A closer look at the government's £7.3bn national wealth fund (FT adviser, 29/7/24)
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Solvency regulation is moving cautiously to support wider role for alternatives for insurers

Reforms to the Solvency II MA regulations were implemented on 30 June 2024 and are relevant to insurers in the bulk annuity market assuming DB liabilities. The reforms widen eligibilities for MA from assets with fixed cashflows that cannot be changed to include assets with 'highly predictable' cashflows[45], subject to safeguards[46] and a 10% cap on total MA benefit. This is expected to favour certain secure alternative investments, in particular infrastructure[47].

Whilst relatively modest changes, they give a positive indication of the Government's wider productive finance agenda.

Focus on Value for Money (VFM) is also perceived to favour more alternative investment

The introduction of the VFM framework by TPR is designed to shift the focus from cost to value in assessing the proposition offered by pension schemes. Trustees, providers and advisors should consider a wide range of investment opportunities to deliver value[48].

This places alternative investments in a stronger position as an option to diversify and enhance investment performance. Our interviews suggest that there may be a segmentation between funds that take this view and others that remain focused on minimising charges first. This second group are expected to wait for performance data in alternative DC funds to emerge to make a stronger case, given that the VFM framework has also emphasised back-tested performance for investments via five-year net return disclosures.

Environmental, Social and Governance (ESG), and Net Zero requirements also favour alternative investments

Large investors are increasingly being driven by ESG requirements and the need to demonstrate the ESG and Net Zero credentials of their investment activities and choices. This is evidenced in the reports and accounts of pension funds and insurers, and was a repeated theme in our conversations with investment professionals in private markets. Alternative investments in social housing and infrastructure are prominently featured in these reports to illustrate the positive links between alternative investments and ESG objectives to stakeholders, including scheme members.

Climate change risk is frequently discussed in corporate risk assessments and investments that both mitigate climate change risk and take advantage of the growth opportunities in related infrastructure and technologies. This is typically through private credit and private equity vehicles, and is cited as evidence of risk mitigation and Net Zero commitments.

Some concerns are being expressed about potential systemic risks outside public markets

Whilst many of the indicators are positive for continued and expanded investment in alternatives, there are also concerns reported amongst observers and regulators as to the potential for unexpected and/or unpriced systemic risks arising in less regulated and transparent private markets.

In 2021, credit agency Moody's highlighted opacity, eroding standards and difficulty in trading private debt, as well as warning of risks of leverage that were rising beyond the spotlight of public investors and regulators. These risks may be difficult to quantify, even as they come to have broader consequences[49].

In its latest stability report in June 2024, the Bank of England warned that the private equity sector was facing challenges in the higher interest rate environment and that risks in the sector could spill over into the rest of the market.

"Vulnerabilities from high leverage, opacity around valuations, variable risk management practices and strong interconnections with riskier credit markets mean the sector had the potential to generate losses for banks and institutional investors," the report concluded[50].

Implications for stakeholders

For trustees, insurers and advisors, access to a wider universe of investments through alternatives appears an important and growing fundamental trend for pension investment.

The changes in both the DB and DC pensions markets are promising to release new sources of funds for long-term investment over the short to medium term. Whilst much of these funds will still be invested in traditional public markets, alternative investments have the potential to grow in scale and to deliver improved outcomes for members.

DB can expect a growth in the use of alternatives, especially to generate long-term secure incomes for members

For open DB schemes, alternatives are already an established part of the asset allocation, and there still may be some expectation that this will increase, for example in LGPS funds. The Government's forthcoming pensions review will examine this specific question more closely.

For closed DB schemes, there now appears to be a period of transition accelerated by the marked recovery of solvency positions in the last couple of years. On the one hand, the majority of trustees targeting buyout will seek to divest their schemes of any remaining alternatives assets in preparation for a buyout transaction with a specialist insurer. However, once the liabilities are assumed by these insurers, it is expected that a significant minority of the assets acquired will be invested in alternatives, particular private credit and infrastructure, to match their long-term annuity-like liabilities. The speed of this transition will therefore be heavily influenced by the capacity of the bulk buyout market to take on these new schemes and assets.

On the other hand, there are other trustees who are re-examining their run-off strategies and may choose to use their improved solvency positions to manage run-off themselves to extract additional value for members and potentially shareholders. If they adopt this strategy, we could expect them to increase their investment in alternatives, both to match the need to pay retirement incomes and, to a lesser extent, provide some growth opportunity.

For members, the majority can expect more security from the guaranteeing of their pension incomes through the buy-out process. For others, alternative investments provide the prospect of schemes having stronger asset positions to both protect and even enhance member benefits.

[45] To be eligible, assets would need to be (1) contractually bound in timing and amount (2) be bonds or have bond-like cashflow characteristic (3) be capable of receiving either an external or internal credit rating
[46] The include additional risk management, modelling, governance and disclosure requirements
[47] KPMG (2024): Solvency II – Matching Adjustment reform accessed at https://kpmg.com/xx/en/home/insights/2023/10/solvency-2-matching-adjustment-reform.html
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DC is also set for expansion of alternative investment, but from a low base

The rapid growth of DC funds and expected consolidation of schemes presents the opportunity for significant expansion of the use of alternatives from its very low current allocation. The speed and extent of expansion is likely to be determined by:

- the ability of DC master trusts to develop the skills to manage and oversee a wider range of investments,
- the success of asset managers to offer pooled alternative investment funds at charge levels that trustees (and their advisors) consider will offer VFM within TPR's framework, and
- the speed of consolidation with the master trust sector.

It is worth noting that these forces only bear directly on the 25% of DC assets currently in trust-based arrangements. For the 75% still in contract-based arrangements, little change can be expected unless the trust-based sector has significant success in securing the inward transfer of existing contract-based arrangements.

For those DC members in master trusts, the achievement of scale promises growing access to alternative investments reflecting the quality and diversification of investment solutions enjoyed by members of large open DB schemes.

Summary

The use of alternative assets in pension funds is a topical subject and there is evidence of significant change both in asset markets and pension scheme asset allocation to play out over the medium term. The launch of PPI's asset strands programme provides an opportunity to track these changes more closely and see the extent to which schemes and members are able to benefit from the potential differential returns promised from exposure to alternatives. Next year, it is intended that the PPI's asset strands project will be updated and expanded with a more detailed survey.

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