INVESTING IN PRIVATE MARKETS:
The barriers are coming down

Defined Contribution Investment Forum

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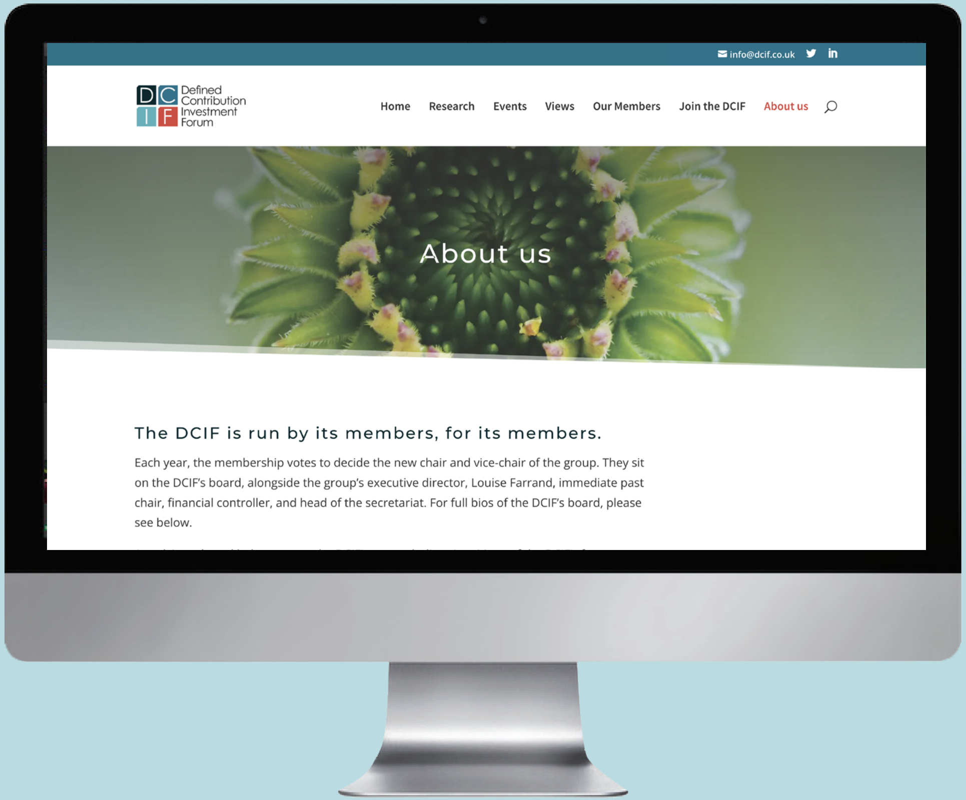


Who are we?

We're a group of asset managers who believe that a well-designed and diverse investment strategy has an important role in delivering a comfortable retirement for millions of DC savers.

A not-for-profit organisation, we commission and publish research which shines a spotlight on DC investment issues. We hope the people who determine DC pension schemes' investment strategies will use it to inform their work.

We also arrange events. From virtual roundtables to in person gatherings, they're a great way to learn more about DC investment issues and meet a like-minded community of trustees, pensions managers, investment consultants and more.

To find out more about our work and explore membership options, please visit: www.dcif.co.uk

Our members

Our members shape the DCIF's direction and steer research projects. They are:

abrdn
AXA Investment Managers
Baillie Gifford
CBRE Investment Management
Columbia Threadneedle Investments
First Sentier Investors
Janus Henderson Investors
J.P.Morgan Asset Management
J.P.Morgan
MFS Investment Management
Mobius Life
Nareit Real estate working for you.
Nordea Asset Management
Northern Trust
PGIM Private Alternatives
Phoenix Corporate Investment Services
Wellington Management

CHAIR'S INTRODUCTION

Investing in a wider range of asset classes has many benefits. Accessing private markets will give pension scheme savers exposure to a more diversified opportunity set, potentially helping to cushion them from the ups and downs of the global economy, as well as giving them a wider range of reliable sources of income.

However, members of UK defined contribution (DC) pension schemes have long been the poor relation when it comes to investing in private markets. Over the years, many reasons have been put forward for this inequity, including structural problems, a lack of demand, pricing and a lack of solutions. At the DCIF, we are keen to work with schemes and the wider industry to find constructive solutions to these problems.

The DC market is changing fast in the UK. Schemes are growing, consolidating, and becoming more sophisticated. In parallel, the solutions available to them are growing in number and versatility.

For this report, we therefore decided to take a fresh look at the demand side of this equation, to pinpoint the gap between what DC schemes want and what's already available to them.

Mark Austin

Mark Austin is chair of the DCIF

Do DC schemes want to invest in private markets, and what's driving them to do so? What asset classes are most of interest? And how do they want to access them?

21 pension schemes kindly completed a detailed survey to shed fresh light on all these questions. Their answers are revealing, suggesting some ways the industry could evolve in order for private markets access to become more widespread.

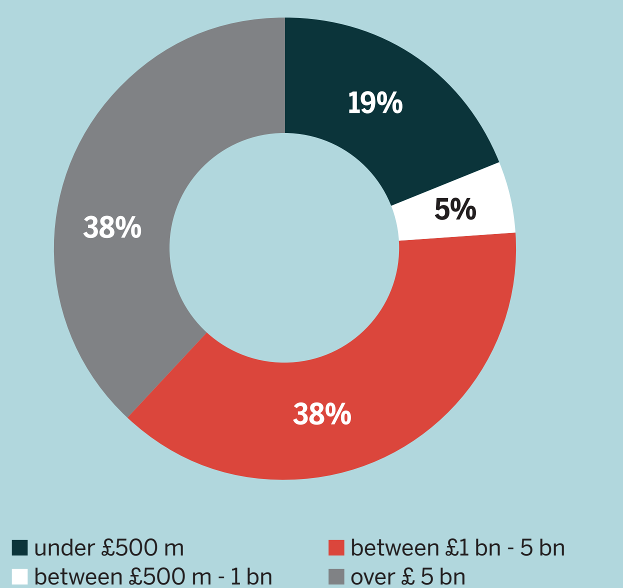
Many of them also took the time to be interviewed, shedding further light on their attitudes and approaches to private markets. We'll reveal what they told us in those interviews in a follow-up report.

Before we go into the findings, we want to say a big thank you to all the schemes who took part in this research – and to Elena Zhmurova, who conducted the research. We hope that it inspires fresh conversations about this all-important topic – and, most importantly, prompts us all to move forward.

MEASURING DEMAND: A MIXED PICTURE

Independent consultant Elena Zhmurova surveyed the largest DC asset owners about their attitudes towards investing in private markets, on behalf of the DCIF. The respondents included 11 master trusts and 10 single employer DC trusts.

What is the asset size of your DC trust?

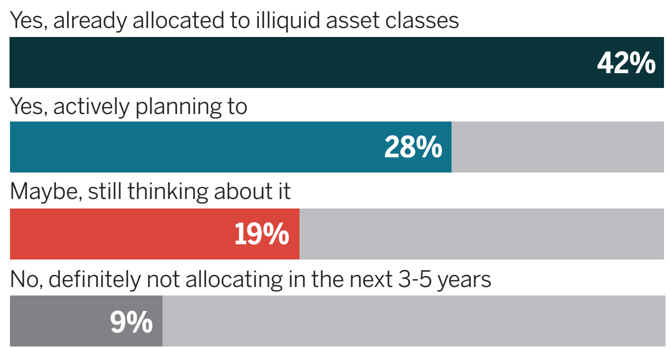


How strong is the demand for private markets among DC schemes? Many master trusts have already made an allocation to private markets, or plan to imminently. Master trusts report a great deal of innovation is happening in this space. Decision-makers at master trusts expect that the ways in which they are accessing private markets will evolve. They recognise the various ways they can access private markets at present, including through Long-Term Asset Funds (LTAFs), co-investment, and daily dealt funds with a component of private markets.

The majority of the single employer trusts that responded had overwhelmingly already invested in private markets. However, we believe that only the largest corporate DC schemes are investing in private markets at present.

We believe that we are witnessing the beginning of a broader trend where more DC schemes are becoming comfortable with allocating to private markets.

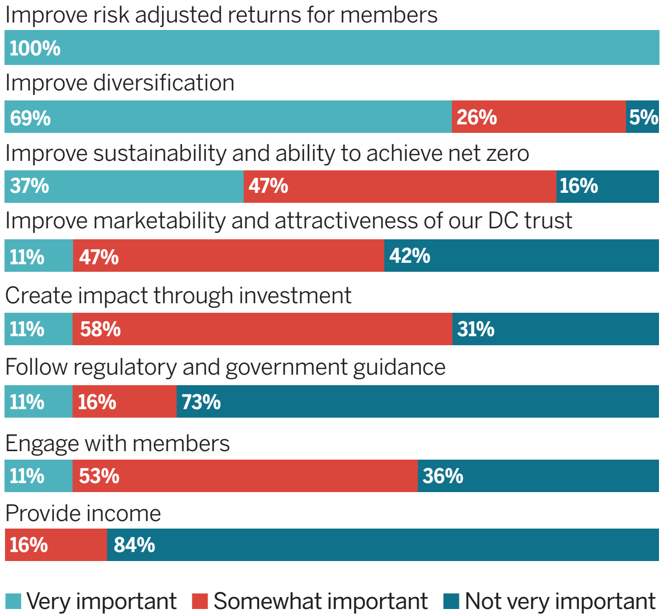
Has your DC scheme or master trust already allocated to private markets?



> "Most of the largest DC schemes have already allocated to illiquids or are on a journey to invest. At least seven or eight of our large corporate DC scheme clients are investing in illiquids in one way or another, ranging from an LTAF to a daily dealt fund."
>
> **Steve Budge, partner, LCP**

WHY DO DC SCHEMES WANT TO ACCESS PRIVATE MARKETS?

If already allocating or planning to allocate to illiquids, how important are the following objectives?



Here, we will mostly discuss trends among the master trusts we surveyed, as they showed the strongest demand for investing in private markets. They were motivated by the strong investment case they see for making an allocation to private markets. Improving risk adjusted returns and diversification were the top reasons they gave for why they wanted to invest in private markets.

Impact and ESG objectives were also important, but not the deciding factor in investing in private markets. In the industry, we've often asked ourselves whether investing in private markets would bring investment to life for members.

Master trusts have mixed views about the engagement benefits of private markets.

"We think that real assets have potentially a huge value in terms of connecting members to their pension schemes"

"Our member survey showed that member are horrified at the idea of investing in high risk companies, so we don't think that member engagement is important in terms of decision-making; however, communication with members is hugely important".

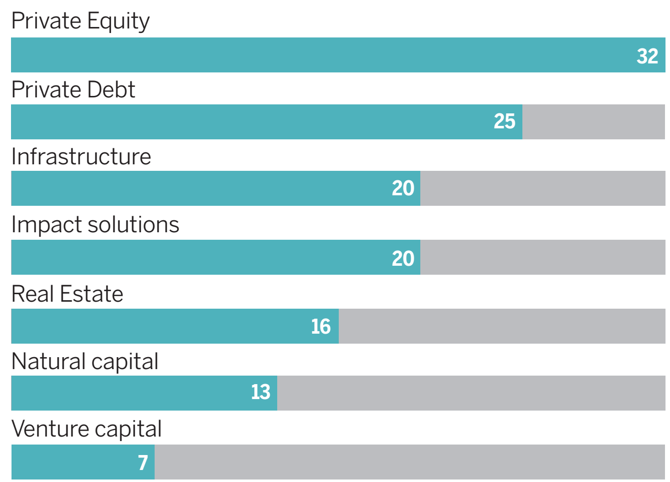
Two contrasting views from master trusts.

Master trusts were lukewarm on this, rating the engagement benefits as 'somewhat important'.

We asked schemes what asset classes they were most keen to access. They were eager to invest in the full universe of private market opportunities, from private equity and infrastructure to real estate and private debt. As most private markets investments are in the growth phase at present, it is not a surprise that most schemes were interested in private equity at this stage.

Interestingly, most master trusts were interested in accessing venture capital or private equity and had high return expectations from these investments. Some see venture capital or early growth private equity as part of a broader diversified private equity bucket. There are not many options available to DC schemes in this space at present – suggesting an opportunity for the asset management world.

What percent of your illiquid sleeve would you allocate to the following asset classes? (average percentage)



GETTING TO GRIPS WITH THE 'HOW'

> "Asset managers need to create more funds, and LTAFs are a great opportunity; the industry needs a mixture of different asset allocation and a simple way to work on a platform. We are comfortable with monthly dealing, but even quarterly dealing is fine."
>
> A corporate DC scheme

Master trusts are accessing private markets in a variety of ways. The largest master trusts are interested in co-investment over the long-term, because of the freedom it gives them to access different asset classes, the lower costs, and the flexibility.

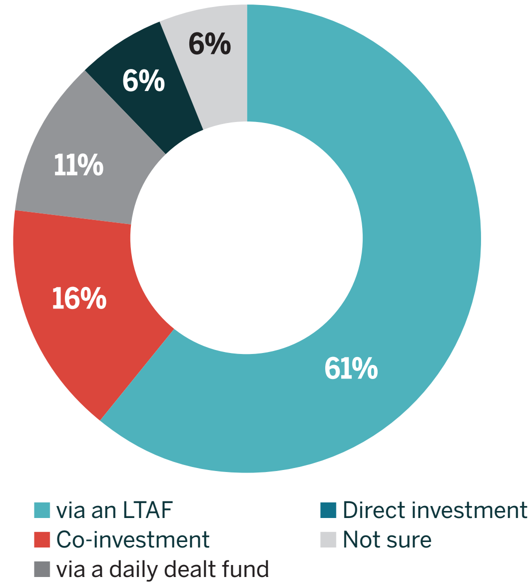
Some master trusts are already investing in LTAFs – and several are in the process of setting up bespoke LTAFs. This option gives master trusts the chance to invest in private markets flexibly and with control over asset allocation, while outsourcing some governance aspects to the provider. There are several advantages of investing in LTAFs: outsourced governance, an opportunity to build familiarity with private markets investing and access new and different sources of return.

Others see it as a step along the road towards co-investment. A couple of master trusts are considering investing in an LTAF outside their usual platform, where that platform cannot accommodate a semi-liquid element.

Several platforms are working to bring more monthly dealt funds on board, which could be a more acceptable option to corporate DC schemes, as opposed to LTAFs, which are traded quarterly. Currently DC schemes can invest in daily dealt funds; some are only planning to invest in private markets with monthly or quarterly liquidity, subject to their availability on platforms.

For single employer DC schemes, daily dealt funds proved the most attractive option, as they reduce operational complexity and the need for liquidity management.

Absent any constraints, how would you prefer to access illiquids?



HURDLES STILL EXIST – BUT PROGRESS IS BEING MADE

This wouldn't be a private markets report without addressing some of the barriers that exist. Some schemes say that high prices and the lack of products, such as the relatively small number of LTAFs and multi-asset solutions on the market, are the most significant barriers to access. Schemes had mixed views on whether they were prepared to pay performance fees. While some of our respondents were concerned about intergenerational fairness, some would consider performance fees at the right level because it provides alignment of interests. We believe the dialogue should continue between schemes and managers to find an acceptable structure of performance fees as part of DC propositions.

We'd like to challenge the pricing point. Private markets tend to be a more expensive area of the investment universe to access, because of the additional research and active management needed to identify the right opportunities, engage with underlying companies and monitor performance. However, the returns and additional diversification benefits should justify the higher price. A shift in mentality is needed so that the industry considers investment costs in the context of net returns, rather than simply in isolation. The Value for Money Framework is a step in the right direction in this regard.

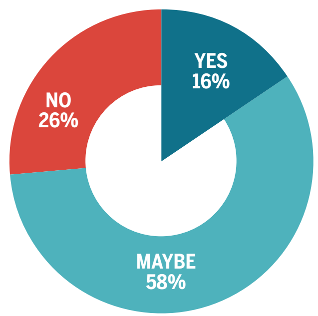
There's good news: as DC gathers scale, the barriers to investing in private markets are being steadily eroded. A couple of the master trusts which have already started investing in private markets, or are imminently set to make an allocation, see the barriers as negligible or non-existent.

We will expand on how they've broken down those barriers in the second part of this report, as well as in the conclusions section below.

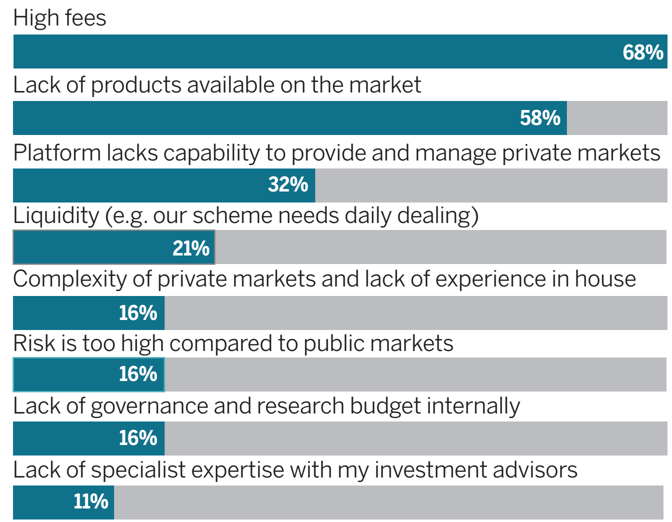
Platforms have often been blamed for failing to accommodate less liquid fund structures. However, this survey shows that the vast majority of schemes said their investment platforms were able to accommodate fund structures with at least monthly liquidity. Quarterly liquidity, however, remains a challenge for a lot of platforms and the responses reflect forward-looking expectations, rather than today's reality.

> "Previously, lack of platform capability, a lack of available products and liquidity were barriers preventing our DC trust from investing in private markets, but these have all been overcome."
>
> A corporate DC scheme

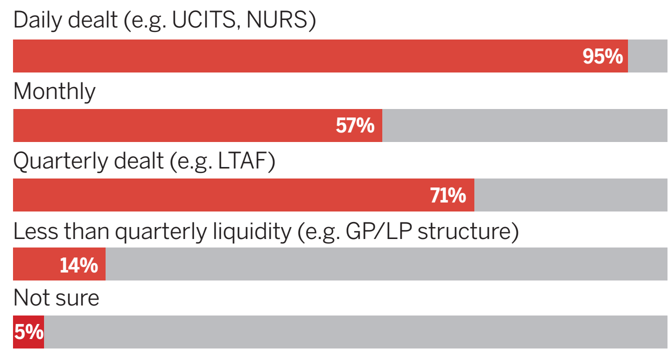
Would you be willing to pay performance fees for a private markets solution if it delivered more value for money?



What are the most significant barriers to investing in private markets for your DC trust?



What type of fund structure can your investment platform accommodate? Select all that apply



WHO IS MAKING THE DECISIONS?

Deciding how and where to invest within the vast universe of private market opportunities takes time, knowledge and oversight – as does the ongoing monitoring of that allocation. For that reason, all eyes should be on the people who are gatekeepers for DC schemes' private market investments.

Generally speaking, governance within master trusts and corporate DC schemes is under-resourced and should evolve significantly. Most master trusts have plans in this area; they expect to grow their in-house investment teams and gradually build their own expertise. This means they will have more dedicated resources in the future to make informed investment decisions.

Large master trusts tend to already have in-house resource, with consultant and trustees expected to provide challenge, oversight and other input.

By contrast, in the corporate DC scheme world, responsibility for private markets allocations tends to sit directly with trustees and investment sub-committees. These teams are more often stretched and rely on investment consultants' expertise and research, rather than being able to conduct their own. Lack of resources is a constraint.

As a result, DC schemes prefer multi-asset solutions with an element of illiquids, which partly puts the burden of managing asset allocation and underlying investments on asset managers.

> "Unlike master trusts, which are professionally managed, well-resourced entities; most schemes are under resourced; trustees don't hold full time positions and can only spend little time on investment considerations. We have to heavily rely on our investment consultant".
>
> A corporate DC scheme

CONCLUSIONS: WHAT HAVE WE LEARNT?

1

The barriers to access are coming down… for master trusts

Surprisingly few barriers to investing in private markets cannot be overcome, as master trusts are demonstrating. Three or four years ago, the barriers to investing in private markets seemed insurmountable, but today, the picture looks very different.

Liquidity has turned out not to be an issue for the majority of DC master trusts. A lack of availability on platforms is changing: platforms are accommodating a wide variety of structures and working towards accommodating monthly – or even quarterly – liquidity. Some trusts, as we have mentioned above, are finding innovative ways of investing in LTAFs that are being managed outside their platform. As master trusts grow, they are appointing more investment specialists; a lack of knowledge has scarcely come up in this survey as a barrier.

While fees are cited as a barrier, more innovative solutions are allowing significant reductions in fees in this area. We'd argue that schemes should move away from a focus on cost and shift towards value. Master trusts see higher fees as a significant commercial challenge, however, they are starting to recognise that a slight increase in the overall solution price is worth the value it creates for members in the long run.

The vast majority of master trusts are already investing in private markets or are planning to make an allocation imminently. They are using a variety of fund structures and implementation options, demonstrating that there's no 'right' way to access private markets.

2

Single DC trusts want simplicity

Single DC trusts would like to invest in private markets but are deterred by perceived complexity: lack of scale, high cost, liquidity constraints and lack of internal resources remain a challenge. They would like to see more simple solutions, more akin to a one-stop-shop like a diversified growth fund.

Only large DC schemes responded to our survey; we anticipate that interest and awareness would be lower among most small to medium sized DC schemes.

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Where do we go from here?

While DC decision-makers overwhelmingly want to invest in private markets, their access routes vary a great deal.

This lack of consensus creates challenges for platforms: what funds do they bring on board? Similarly, investment managers will only build funds where they see clear appetite. This could explain the small number of LTAF launches we have seen so far. Creating a plethora of bespoke solutions is not practical – although perhaps there is some middle ground to be found here.

This research highlights that the industry must work closely to find routes forward. At the DCIF, we are keen to play a role in bridging the gap between schemes, platforms and investment managers, creating forums for discussion and consensus on the future direction of travel.

Many of these issues may be resolved with time and growing scale. As master trusts reach scale and consolidate, co-investment will become possible for more of them, making private markets access a reality for the many DC savers who would benefit, not just the few.

Acknowledgements:
Huge thanks to all the pension schemes which took the time to fill out the survey or speak to us for this report. We immensely appreciate your time and valuable insights.

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