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Defined Contribution

MATCHING INVESTMENTS AND LIQUIDITY

The trend from defined benefit (DB) to defined contribution (DC) pension plans means that long-term saving has become less collective and more individualised. But today the investment vehicles offered by most DC plans still prioritise liquidity over returns.

This has prevented many savers the ability to access the illiquidity premium available from private equity and infrastructure.

Regulators, asset managers and service providers recognise this issue and are finally tackling the problem.

For decades the world's largest, most sophisticated institutional investors have allocated a portion of their wealth to private rather than publicly-listed companies. Canada's biggest pension plans have become so proficient in taking major stakes in private enterprises – from airports and railways to Chinese e-payment companies – that their style is recognised globally as 'the Canadian model'.

That model rests on the belief that the best of private equity portfolios will deliver higher returns over the long term than an index of stock market companies.

This does not mean an 'either /or' choice between owning public and private enterprises. The need for prudent diversification dictates that even the most ardent 'off-market' investor maintains exposure to a range of assets, including bonds.

For large institutions, such diversification is a given. For high-net-worth individuals (those with more than $1 million in savings), it is possible. But for other individual investors, opportunities to go the extra mile and add private enterprise to their portfolios have been few, chiefly because of unsupportive regulation, unsuitable investment vehicles and consequently high costs of access.

Nowhere is the contrast between the habits of large institutions and individuals starker than in Europe's retirement savings arena, where extant DB plans' heft and risk-sharing nature enable them to venture into harder-to-trade assets while newer DC plans prefer unitised investments and therefore steer clear of opportunities that cannot be priced daily.

According to the UK's Financial Conduct Authority (FCA), at least 85% of assets in unit-linked mutual funds come from pension plans. Of nearly £1 trillion in these unit-linked funds, less than three percent (£27 billion) reaches illiquid assets, mostly commercial property.

Ireland has approximately 160,000 DC plans but the only real estate exposure they obtain is through direct, single property type investments. The cost cap on default funds in the UK DC market is yet another huge barrier between DC savers and private markets.

The contrast between DB and DC plans can even exist under one roof where a single employer sponsors both types of arrangements.

Workplace pension plans in Australia and North America have done more to close the gap between opportunities for DB and DC investors. In this article we look at why and how their UK and other European peers may finally be able to catch up.

Defined benefit occupational pension plans still account for the lion's share of the $40.1 trillion explicitly saved for retirement globally – according to pension and investment consulting firm, Willis Towers Watson. Many DB plans are closed to new entrants and invest conservatively for their older population, while DC investments are increasing at a faster rate as they serve a growing percentage of the workforce. Whether the data is cut by number of active members or assets, then the future of pension plans is DC.

As longevity increases and DB plans shrink in numbers, these newer pensions will have to work harder to maintain DC savers' standards of living in their final years. The spotlight on DC plans grows stronger and stronger as they become the main means to financial security in retirement for the working population. One means of achieving that security is to access higher-returning assets in private markets. It is a direction both politicians and regulators now recognise. The UK's pensions minister, Guy Opperman, has talked favourably of widening the opportunity set to include social housing and green infrastructure. He also wants large schemes to report each year what they hold in illiquid assets. Government consultations on how private markets can best serve DC plan savers in the UK have been ongoing for most of 2019.[1]

The FCA, meanwhile, has realised that a slim allocation to commercial property by unit-linked funds does not reflect the economic opportunity set. The regulator is going to permit UK insurers' unitised funds to hold up to 50% of assets in any combination of real assets, including infrastructure such as sewage plants and telecom masts. Previously the limit was 10% for each asset sleeve.

The margin of higher returns from private over public markets can never be known in advance; it can't be guaranteed, but it can be modelled for informed predictions. A study from Georgetown University suggests that adding 20% in private equity to an already-diversified fund improved the median return for participants by 12.6%.[2] JLT, a UK pensions consulting firm, suggested a similar boost when the 20% in private equity was added to 80% in listed equity.[3]

"If savers can't access their money for 20 years or more, why should they be forced to invest 'impatiently' in daily-dealt funds?" asks Maria Nazarova-Doyle, head of research at JLT. "With a generation of DC savers facing inadequate income in retirement, the pension industry must collaborate with government and alternative investors to create new solutions."

[1]WTW, Global Pension Assets Study 2018
[2]The Evolution of Target Date Funds, Antonelli, June 2018
[3]Patient DC: Good Things Come to Those who Wait, JLT, Feb 2018

Brian McMahon, Managing Director, Alternatives Investment Services, EMEA at BNY Mellon, believes that pension fund fiduciaries have a duty to look after the financial interests of their members, and this must include consideration of how to provide access to higher returning private markets.

The Alternative Credit Council (ACC), an advocacy group representing private credit managers, argues that the value of fund liquidity has been misunderstood. The ACC claims individual investors in DC plans are often told daily liquidity of their fund investments is something desirable in and of itself. But that not only makes accessing long-term illiquid investments more difficult – it also exposes them to the risk that they do not use liquidity sensibly.

Jiri Krol, Global Head of the ACC and a former European Commission executive responsible for drafting and negotiating financial services regulation, notes that academic studies show many individual investors do not behave in their best financial interests during periods of market stress (in contrast to many institutional players who recognize the opportunities available from spikes and crashes). Krol says that regulators should thus frame the need for liquidity in this context of behavioural finance and not persist with the assumption that individual investors will always use ready access to buy or sell rationally.

Whatever regulators decide, there are still considerable obstacles to overcome. Share prices for companies on the world's advanced stock exchanges are refreshed every 15 minutes, making daily valuations of even a lengthy portfolio relatively simple.

Unlisted companies, on the other hand, are valued infrequently, often only on a quarterly or an annual basis, and not simultaneously by computer but by judgement of portfolio managers and independent experts, based upon a series of assumptions about the companies and the markets in which they trade. Buying or selling these assets usually takes longer. For the patient capitalist, this makes private equity not more, but less, risky because it is free from the noise of the market and media speculation that affects listed companies.

For DC pension provision, however, the norm, if not a legal requirement, is to provide daily valuations, as Nazarova-Doyle notes. There is thus a conflict to be resolved between regulatory protection of individual savers and appropriate conduits for their savings to reach a fuller spectrum of investment opportunities.

"The challenge has been to fit the various asset types found in private markets into daily valuations," says Rob Barr, a partner at Pantheon, a private markets specialist that launched its first private equity vehicle for individual savers back in 1997.

"You can't have daily dealings if you take four years to invest," says Roberto Cagnati, Managing Director at Partners Group, a leading private markets investment manager, which has been offering private markets programmes with liquidity features since 2001 and, in 2016, launched the UK's first private markets fund structured specifically for the DC market.

Closing the gap between days and decades

Traditionally, private markets firms have had years to invest because they have used closed-end vehicles. Their large clients, not just DB pension plans but wealthy family offices and sovereign funds, have been content to commit capital which, as Cagnati notes, typically takes years to be deployed in the purchase of businesses.

Given the typical duration of a private markets fund, the holdings in these investee companies might last three to five years, sometimes longer, during which time the private equity firms aim to increase the value of the company through a series of so-called 'value creation' initiatives, ahead of a resale.

Infrastructure funds can have a much longer tenure, sometimes spanning more than 20 years. It begins with a commitment stage, followed by a construction period for brownfield assets, the investments finally become operational and regular cash flow occurs. An example includes energy distributors in the case of a windfarm fund, which might push the length of the fund into decades.

In all cases, there are significant challenges that allow less sophisticated investors to join in these types of ventures. These closed ended funds are, in fact, prohibited from marketing to retail investors. They typically have minimum investment levels that are substantially higher than most investors' total savings. For those structures that do allow retail investors to access the funds, problems of tradability and valuations come to the forefront. In order for DC plans to be able to buy or sell their exposure to said windfarm, there has to be sufficient liquidity. That liquidity depends on a share or unit price with which other buyers can be comfortable. Their comfort will derive from reasonable valuations of the wind farm and all other investee companies.

To these essential problems we could well add education. For all the regulatory and product innovation in private markets investing, the goal is not to replicate the trading conditions of a stock exchange, which is a far easier and more transparent arena for ordinary investors to understand than private markets.

What is changing, however, is the will from both private markets specialists and DC pension plans to educate themselves about each other's needs and find common ground.

"It is extra effort but real assets and private markets managers have to engage with the majority of the pensions industry," says Barr.

As their first act in this engagement, a handful of private markets specialists have launched open-ended or 'evergreen' investment vehicles for the DC market. These vehicles have daily valuations and dealings as retail and small collective investors would expect.

1 THE DIRECT INVESTMENT APPROACH

The private markets DC funds currently in the market - not all of them available to investors in the UK - have all taken different approaches. When Partners Group launched its DC fund for the UK market, the Partners Group Generations Fund, it chose to structure it as a Non-UCITS Retail Scheme. The Partners Group Generations Fund provides investors with access to private equity, private debt, private infrastructure and private real estate, while at the same time providing daily liquidity and pricing and fulfilling the regulatory requirements of platform providers for highly standardized purchase and redemption procedures.

2 THE FUND OF FUNDS APPROACH

The strategy used by Pantheon in its DC fund, meanwhile, is to invest in a combination of secondaries, co-investments and primary investments thus leveraging their different investment characteristics for the benefit of investors and gaining exposure to a variety of real assets.

Most investors will be familiar with the idea of an umbrella fund or fund of funds. But there are unique operational challenges when dealing with real assets. A fund of funds dealing in listed securities may introduce an additional layer of management but it still profits from that very frequent pricing of securities and the accompanying ease of trading on exchange. In contrast, a daily-dealing fund accessing private markets has to find a way to aggregate all those disparate valuations of the underlying investments.

McMahon says that this is a critical element of the fund construct. Investors subscribe or redeem based on these valuations, and each manager must have processes in place to provide reliable values, updating for market events and other pertinent information. Barr gives some indication of how Pantheon manages it: “Between quarter ends the General Partner [fund manager] is valuing assets in the context of the broader market environment. Then, we true up with small actual valuation adjustments as they come in after every quarter-end.”

So the quarter-end value for each underlying holding gets integrated into an aggregate price for the target (invested) fund, whose price in turn contributes to the daily share or unit price of the evergreen fund. These underlying target funds provide valuations at different times and may follow substantially different investment strategies. Thus the valuation policies have to allow for updates and for adjustment based upon market events and reporting that is made available.

The result is still not perfect, according to Kristoffer Andersen, a collateral and derivatives specialist in transaction management at Nykredit Wealth Management in Denmark. “The setting of a daily Net Asset Value is hard based on limited data and the lag in reality is not just three but four and a half months,” he says.

Andersen’s unit provides management and administration of investment and pension funds. Other challenges he sees are brought by the tendency of private-enterprise valuers to underestimate what they inspect. “They prefer any surprises to be on the upside,” says Andersen, which may be sensible and at the same time be at odds with fair value. Then there is the added challenge of foreign exchange. Andersen says it is tricky to reconcile the choice of conversion rate with both the valuation date of months ago and the need for a unit price today.

Its underlying portfolio includes a significant allocation to direct investments in return-seeking private markets asset classes, complemented by an allocation to a yield-seeking credit portfolio. Liquidity is facilitated via an allocation to diversified listed private markets. The fund is designed to be included as a performance driver within a professionally-managed DC plan, for example as part of a corporate pension plans’ default fund in the growth accumulation phase.

3 TRADABILITY

If valuations remain as much an art as a science, what about buying and selling the underlying private markets assets? Tradability, or liquidity, is, for obvious reasons, not as great as for listed companies, whose shares are easily traded.

In the case of the fund of funds approach, prospective buyers have to find a current shareholder willing to sell or wait for the next fund launch. This is true of many alternative investment vehicles.

The bigger picture is that private markets are going to increase their importance as a source of funding as such enterprises represent an increasing share of the real economy (in contrast to listed companies whose number in the US halved between 1996 and 2016). The needs of DC pension savers for higher returns and diversification dictates the need for access to the full breadth of economic activity, including private enterprise and other real assets.

4 LIQUIDITY GATES

Given the limited tradability of their underlying private assets, open-ended private markets vehicles such as Partners Group's Generations Fund have set amounts of shares that can be redeemed per day, month and year.

Withdrawals in Partners Group Generations Fund cannot exceed 10% of the Net Asset Value of all outstanding shares on that day; 25% over a 30-day period; and 40% over the last year. Cagnati explains that these redemption limits are an all-weather feature, not emergency barriers erected should too many clients head for the exit on the same day. The beauty of this feature is that clients can learn in advance how much of their total commitment is available for withdrawal during any given period – the redemption limits are in the fund's prospectus. Cagnati emphasises that the manager, pension plan and any financial advisers communicate the purpose of the gates, so that individuals recognise why limitations exist.

McMahon adds that liquidity modelling of the kind necessary when linking pooled vehicles to real assets is much improved after some sore lessons during the global financial crisis of 2008-9.

"Fifteen years ago there would be an approximation of liquidity and a new spreadsheet for every client. Nowadays everything is automated and tested in advance. Platforms offering DC provision do the due diligence on administrators like BNY Mellon. The "What if?" discussions take place before the final contract is signed."

All-weather gates are one means of regulating cash flows between clients and assets. This maintains stability along the chain so that the manager does not have to sell assets at cheap prices just to meet excess redemptions.

Another way to achieve liquidity while recognising that real assets are not readily-tradeable is to invest a sufficient minority of total assets into liquid instruments such as broad-market ETFs. This is the case with many real estate funds in the US, where easily traded ETFs are used to add diversification of returns but more importantly, daily liquidity instead of buying or selling office blocks at short notice. When the UK voted to leave the European Union in 2016, real estate funds based in London - without the liquid ETF element - experienced considerable withdrawals and many erected emergency gates to halt outflows.[4]

Barr suggests that putting initial commitments into a liquid tracker of public equities gives DC savers some immediate return while they wait for capital to be deployed in unlisted markets. This avoids consternation from individuals that they are not receiving some benefit from their contributions being put to work immediately.

[4]Review of property funds and liquidity risks, FCA, June 2017

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Managing Director, Alternative Investment Services, Europe, BNY Mellon

As with liquidity gates, the ETF component is variable: providers can model how much flexibility they need to manage inflows and outflows. Adding exposure to listed securities does, of course, change the strength of the real asset exposure. We are no longer talking about a pure private markets strategy.

For Barr this is no problem because in the UK pension arena, he sees private markets as a significant but minority element within DC plans' default fund – this is a fund constructed to manage participants' contributions if they make no active choice about where to invest their money. DC default funds currently hold more than 90% of assets (such results are not restricted to the UK but universal – see for example Sweden's PPM system) and so it makes commercial sense to position any offering within the default. The two studies quoted earlier, from Georgetown University and JLT, both factor in private markets exposure as a minority allocation alongside more tradeable securities.

In such a multi-asset default fund, there is thus less pressure to buy and sell the private markets exposure. Crucially, it also avoids breaking the UK's charge cap on DC default funds of 75 basis points, which currently stifles much innovation in product design. The issue is not confined to the UK. Munro O'Dwyer, a partner in PwC's pensions practice in Ireland says that cost has become the overwhelming criterion in Irish DC pension provision, to the detriment of other aspects of investment management. "In private, advisers recognise there is more that could be done to make the investment journey less volatile. But in public, cost is the standard by which scheme management gets measured, which limits the solution-set that can be brought to savers," he said.

Pantheon nevertheless has ideas about how exposures to real assets and private markets can be adjusted to better suit DC customers.

“You need a platform that can incorporate primaries, secondaries and co-investments; as well as knowledge of an investment cycle and cash distributions and reinvestment rates,” says Barr. “These are all the elements that go into building a private equity portfolio.”

Secondaries add liquidity to private markets by giving current investors a means of buying or selling existing commitments. Co-investments are another alternative to accessing specific private markets deals without disturbing the existing investor base.

Both secondaries and co-investments enable quicker deployment of cash, which matters for the DC world, where savers are less likely to tolerate their savings sitting as cash commitments for months without adding visible value.

“You want short-term increases in value to give momentum behind first seeding investments and to get returns moving,” Barr says. “As you build fund size, you need to manage cash inflows. You don’t want to dilute returns for either the existing investors or the new investors.”

Though Partners Group takes a very different approach to building a well-rounded portfolio in its PG Generations fund, Cagnati is quite clear that only those private markets managers with breadth of expertise but also size can do this. “Only those with economies of scale can win,” he says.

Heft is required not just to access opportunities, but also to report on them. Andersen notes that many small private markets teams broke away from managing public securities to free themselves from excessive reporting and accounting. That may improve their alpha generation, but fund selectors such as Nykredit still need to know what they are doing. “Each manager has its own way of reporting,” says Andersen. To improve this situation, Nykredit is working with data provider SimCorp on standardisation of reporting information on private market assets. The proposed templates are expected to give clients better transparency on the underlying holdings.

Finally, costs are often considered a dissuasive factor in accessing private markets, and there are numerous layers of fees when buying into evergreen funds that take a fund of funds approach to providing private markets exposure. Barr recognises that the appeal of these assets only works if pension funds are hiring superior managers. Andersen adds that those who generate the alpha will charge higher fees accordingly. “And why would you be interested in any but the best funds?”

McMahon notes that “the retailisation of private markets is a topic that has been discussed for many years. Bridging the practicalities of the investment universe and the requirements imposed by the regulatory and investor needs is the key challenge to be addressed. Automation in the fund services industry helps, but these funds typically require greater focus than traditional funds or standard private markets funds. The cost caps imposed in certain regions mean operations have to be efficient and the managers and service providers must be aligned. This is too important a topic to ignore, and as an industry we must make sure that we are ready to support it.”

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Rob Barr

Partner, Pantheon

Conclusion

After the Second World War, unitisation began to democratise investing in publicly-listed companies. More than seventy years later, access to private enterprise via financial markets has finally caught up. McMahon remarks that any worker with Euro 250 to save a month could never have gotten close to buying real assets in investment products ten years ago. Now via their DC pension plan, that same saver will be able to buy into private markets investments with exactly the same sum. Private markets are no longer the preserve of the world's elite investors.

A positive correlation is that as DC savings consolidate in the UK and auto-enrolment feeds into a smaller bunch of Master Trusts, these vehicles may begin their own private markets programmes. So in future both the great and the small of DC will have access to a wider range of assets.

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