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Alternative Investment Management

UK Pension Schemes and Alternative Investments

When people retire they should be able to enjoy the rewards of their labour and draw on pensions to keep them comfortable in their golden years.

Today, the UK pension system is under severe strain, as the population ages and fewer workers support more retirees. Furthermore, there are reasons to believe that pension funds may soon be faced with lower returns from the traditional assets in which they invest.

There is, therefore, a very real worry in the future that the UK will be left with the choice of smaller pensions, later pensions or higher pension contributions. There is a way to at least partially mitigate this challenge: encouraging pension schemes to move towards alternative assets and strategies to better diversify their investments and improve returns.

The report on which this summary is based examines the potential benefits of alternative investments to pension schemes, with a focus on defined contribution (DC) schemes. The report also examines the cultural, regulatory and operational pressures that are encouraging UK DC schemes to shy away from investing in alternative investments, and recommends potential actions the Government could take to alleviate those pressures.

The potential benefits offered by alternative investments, as well as the steps the Government could take to unlock those benefits, are outlined in this summary document.

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The potential of alternative investments

There are two main areas in which alternative investments could potentially benefit pension schemes: diversification and access to the illiquidity premium. Currently DC pension schemes largely rely on investments in bonds to diversify their portfolios. However, there are reasons to doubt the diversification such assets will provide in the future. By integrating alternative investments which provide returns that are uncorrelated with equity and bond markets into their funds, UK pension schemes should be able to lower the risks to their beneficiaries' capital.

Further, by investing in alternative investments DC pension schemes may be able to take advantage of their long-term investment horizons and gather an 'illiquidity premium'—excess returns gained by investing capital for the long-term. Making it easier for DC pension schemes to access the illiquidity premium would have the added benefit of providing potentially billions of pounds worth of long-term investments to the wider UK economy.

Helping trustees consider alternative investments

The current system of incentives leads to undue inertia on the part of pension trustees, dissuading them from allocating to alternative investments. Under current regulation, pension trustees are obligated to specifically justify any allocation made to an investment that is not traded on public markets. There is strong reason to believe that this requirement has a chilling effect on the willingness of trustees to allocate to such investments. Further, many pension trustees seem to perceive alternative investments as 'riskier' than traditional investments, even though this perception is not supported by historical data.

As such, we recommend that the Government re-evaluate the requirement that any investment that is not publicly traded be specifically justified. We also recommend that the Government work with industry bodies to publish guidance on how alternative investments can be integrated into pension funds; particularly the default funds of DC schemes.

Moving away from daily liquidity

The ability of DC pension schemes to allocate to alternative investments is hampered by the expectation that such schemes offer daily liquidity to their beneficiaries. There are no regulatory or legal requirements for DC pension schemes to offer such liquidity. Nonetheless, the result is that DC pension schemes struggle to allocate to alternative investments, many of which are illiquid in nature.

As such the beneficiaries of DC pension schemes are deprived of any illiquidity premium their investments might otherwise be able to collect. The daily liquidity norm may also be depriving the wider UK economy of potentially billions of pounds worth of long-term capital investments.

We recommend that the Government investigate ways of encouraging DC pension schemes to access investments that are less liquid and move away from the daily liquidity norm. We second the call made by others for the Government to publish guidance for DC trustees on how to integrate illiquid assets into their funds.

Ensuring value for money

As currently written, the requirement that beneficiaries of a default fund of a DC pension scheme may incur an annual charge of no more than 0.75% of their savings with that fund is impairing the ability of such funds to access alternative investments. Many investments may charge fees greater than 0.75% but deliver higher quality net returns for those fees. Further, most alternative investment managers charge a 'performance fee' as a percentage of the returns they deliver to their investors—such performance fees have no theoretical cap.

We do not call for a revision of the charge cap. However, we recommend that the Government issue further guidance on how investments with complex fee structures could be integrated into the default funds of DC schemes. We also recommend that the Government explore ways of accounting for performance fees within the fee cap.

Creating UK professional investor fund vehicles

There is reason to believe that the absence of a UK professional investment fund vehicle is also hampering the ability of all UK pension schemes to invest in alternative investments. Alternative investment managers require specific fund vehicles in order to implement their strategies; for many types of alternative strategies, no such fund vehicle is currently available in the UK. As such UK alternative investment managers are compelled to domicile their funds abroad. The result is that UK pension schemes wishing to invest in alternative investments may have no choice other than to invest in an offshore fund.

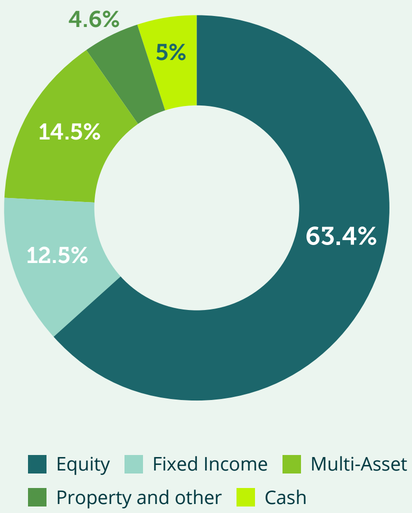
In order to remedy this situation, we recommend that the Government begin working towards the establishment of a series of UK professional investor fund vehicles. Such fund vehicles could be used by UK pension schemes to access alternative investments, and they would help ensure that the regulation and governance of UK capital stays inside the UK's borders.

Predicted returns of diversified portfolio including alternative investments

	Traditional Balanced		Modern Balanced		Diversified Growth			
	Weight (% of fund)	Expected return (%)	Weight (% of fund)	Expected return (%)	Weight (% of fund)	Expected return (%)	Volatility (%)	Sharpe Ratio
Global Equities	60	3.2	50	3.2			16.3	0.09
Global Equities Low Volatility					30	3.2	14.0	0.11
Global Developed Market Govt Bonds	25	1.9	15	1.9			3.5	0.06
Global Investment Grade Bonds	15	2.9	15	2.9			4.7	0.25
Global High Yield Bonds			10	4.0	10	4.0	11.3	0.21
Emerging Market Debt (Local)					15	6.1	8.4	0.52
Senior Secured Loans					10	4.7	8.3	0.36
Asset-Backed Securities - Mezzanine					5	6.4	7.0	0.67
Insurance Linked Securities					5	4.6	5.4	0.54
Global Commercial Property			10	4.5	5	4.5	9.6	0.29
Infrastructure Social					10	6.1	8.4	0.52
Hedge Funds					5	3.9	4.0	0.55
Other Diversifiers					5	5.9	10.4	0.40
Portfolio Total Return (%)		2.8		3.2		4.6		
Portfolio Volatility (%)		10.5		10.0		7.1		
Portfolio Sharpe Ratio		0.11		0.15		0.41		

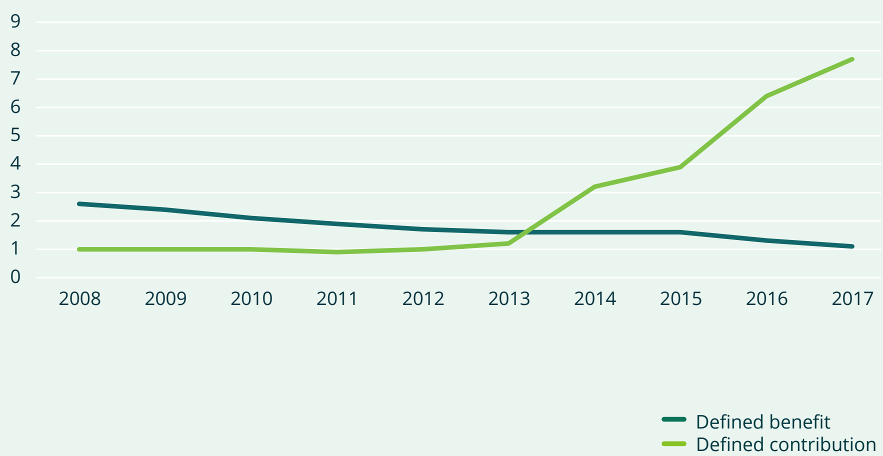
Source: Long-Term Investment Outlook 2018, *Aberdeen Standard Investments*

DC scheme investment by asset class



Source: Pension Funds and Social Investment, *the Law Commission*

Active membership of private sector occupational pension scheme by benefit structure, UK, 2008-2017 (millions of members)



Source: *Office of National Statistics*