UK Pension Schemes and Alternative Investments

February 2019
# Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreword</td>
<td>i</td>
</tr>
<tr>
<td>Executive Summary</td>
<td>ii</td>
</tr>
<tr>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td>Section 1: The UK Pension System</td>
<td>3</td>
</tr>
<tr>
<td>Section 2: How UK Pension Schemes Invest</td>
<td>7</td>
</tr>
<tr>
<td>Section 3: Alternative Investments</td>
<td>11</td>
</tr>
<tr>
<td>Section 4: The Potential Role of Alternative Investments in Pension Funds</td>
<td>17</td>
</tr>
<tr>
<td>Section 5: Barriers to Pension Funds Allocating to Alternative Investments</td>
<td>21</td>
</tr>
<tr>
<td>Glossary</td>
<td>25</td>
</tr>
<tr>
<td>Annex: The Case for UK Professional Fund Vehicles</td>
<td>27</td>
</tr>
</tbody>
</table>
Acknowledgements

This paper has been produced on the basis of contributions from our Parliamentary colleagues and representatives of the asset management and pensions industries who have kindly provided both oral and written evidence. We would like to thank the following individuals, firms and associations for their contribution:

Rt Hon Lord Lilley
Baroness Falkner of Margravine

AQR Capital Management
BlueBay Asset Management
Border to Coast Partnership
Capital Cranfield Trustees
Man Group

The Investment Association
Pension & Lifetime Savings Association

Particular thanks are extended to The Alternative Investment Management Association, especially Max Budra and Jane Moran, who helped to facilitate the APPG’s evidence sessions and supported with drafting the report.
Foreword

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 All-Party Parliamentary Group (APPG) on Alternative Investment Management decided to begin investigating whether and how alternative investments can contribute to UK pension schemes. This report is the first product of that research. While it is by no means definitive and very much an initial step in our investigations, it does highlight several areas in which alternative investments could be of use to UK pensions, and several actions the Government could consider to unlock that potential.

Our initial research led us to primarily focus on so-called defined contribution schemes, which are increasingly becoming the standard in the UK. We found a series of cultural, regulatory and operational pressures that are encouraging UK defined contribution schemes to shy away from investing in alternative investments.

Alternative investments may also offer an important means by which UK pension funds can protect the savings of their beneficiaries from the risks of today's world. By offering a chance to diversify away from equities and bonds, alternative investments offer the possibility of accessing different types of cash-flows, profiting from their typically long investment horizons and generating investment returns for pension beneficiaries that are less vulnerable to the volatility we see in so much of the world today.

We hope this report will not only be of interest to our colleagues in Government, but also to the wider public. The fate of the UK pension system affects us all, and we have a duty to do right not just by current pensioners, but also to future generations.
Executive Summary

The pension system of the United Kingdom is under severe strain. Demographic changes are contributing to severe funding gaps in many UK pension schemes. This situation is likely to be exacerbated by declining returns from investments in equities and bonds, which form the backbone of most pension scheme investment. As one of the contributors to this study has noted:

“Over the last 20 years, for a UK investor, global equity returns have averaged 8% and UK government bonds 6.5%. A classic 60/40 balanced portfolio would have returned over 7% per year. Over the next decade, our modelling suggests, for a UK-based investor, 3% per year is a realistic expectation. [...] But including a much wider range of assets and diversifying more aggressively provides a route for investors to do significantly better than they could if they relied on equities and low-risk bonds alone. We think an expectation of 5-6% per year is achievable for a diversified liquid portfolio, and 7-8% for those who can allocate to good private equity and debt funds.” 1, 2

As such the UK pension system is faced with some combination of the following options:

- Increase pension contributions
- Decrease pension benefits
- Review pension policies and seek alternative sources of returns to public equity and bond investments

While defined benefit (DB) pension schemes have some freedom in their investment decisions and have, accordingly, invested in alternative investments, defined contribution (DC) schemes are subject to specific regulatory, cultural, and operational pressures. DC schemes are particularly important as they are rapidly growing as a percentage of total pension assets in the UK.3 The majority of assets in UK DC schemes are held in publicly traded equities and are therefore exposed to significant risks tied to the performance of the equity markets. 4 As such this report focuses on DC pension schemes.

Our research has indicated 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. DC pension schemes represent an untapped source of long-term capital for the UK economy. Enabling such schemes to invest in alternative investments would constitute a crucial first step in unlocking that potential.

---

2 This is likely to be driven by a combination of equity prices declining from the record highs seen in recent months, the persistence of low bond yields, and slow global economic growth caused by rising protectionism, political volatility, and declining labour forces in some major economies. See Section 4. See also: Ibid.
Improving pension scheme trustees’ awareness of alternative investments, and their incentives to consider allocating to such investments

There are, however, several barriers to DC pension schemes investing in alternative assets. To begin with, the current system of incentives leads to undue inertia on the part of pension trustees, dissuading them from allocating to alternative investments. The pressures and constraints on pension trustees are understandable: they occupy positions of trust. However, those pressures and constraints seem to be dissuading pension trustees from even considering allocations to alternative investments which could be beneficial to their members. Under current regulations, 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 take action. First, by re-evaluating the requirement that any investment that is not publicly traded be specifically justified. Second, by working with industry bodies to publish guidance on how alternative investments can be integrated into pension funds; particularly the default funds of DC schemes.

Exploring ways in which DC schemes could better access investments that do not offer daily liquidity

The ability of DC pension schemes to allocate to alternative investments is also hampered by the expectation that such schemes offer daily liquidity to their beneficiaries—an expectation that does not exist for DB schemes. There are no regulatory or legal requirements for DC pension schemes to offer such liquidity: the prevalence of this norm seems to be the result of cultural and operational factors. 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.

Providing guidance on how to combine investments in order to meet the charge cap of 0.75% for DC default funds, and exploring ways of accounting for performance fees in the cap

The ‘charge cap’ on the default funds of DC pension schemes was put in place for laudable reasons: pension beneficiaries should not see their returns cut away by excessively high or unjustifiable fees. However, as currently written, the requirement that a beneficiary of the 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. This cap is particularly important given that research indicates that the overwhelming majority of DC pension scheme beneficiaries keep their savings in their scheme’s default fund.

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.
Working towards the establishment a series of UK professional investor fund vehicles that could be used by pension schemes to access alternative investment strategies and assets

Finally, 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, whether DC or DB, 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 this year, a situation that may become more difficult with the UK’s departure from the European Union. 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 within the UK’s borders.

Strengthening the UK’s pension system will not be easy, but we believe that the Government can take a series of immediate steps to begin the process.
Introduction

This report constitutes a preliminary examination of the potential role of alternative investments in the United Kingdom’s pension schemes, with a particular focus on DC pension schemes. There is considerable evidence that suggests some change may be required in the UK pension system to improve the long-term prospects of its beneficiaries. The current system was put in place at a time when lifespans were shorter and the population was younger (see Section 1). There were, in short, fewer retirees supported by a larger workforce. Today, however, the UK’s population is aging. To exacerbate matters, there are strong reasons to believe that the returns offered by equities and bonds—which form the core of UK pension investing—could decline in the coming years (see Section 4).

The UK is thus faced with three interlocking options. First, raise pension contributions (or, in the case of the State Pension, taxes). Second, accept smaller or later pensions for retirees. Third, explore options that would improve the return prospects of pension schemes, such as giving them more flexibility to diversify their holdings and invest in alternative investments.

This report is the first step in discovering how the third option could be put into practice. The APPG on Alternative Investment Management spent several months researching the question of how alternative investments could play a part in UK pension funds. In doing so, we solicited evidence from industry participants and held hearings with representatives from the pension and alternative investment management industries.

This report is not intended to be definitive or comprehensive. Rather, its intention is to highlight areas for further investigation and to propose a series of modest steps that the Government could consider in light of its findings. This report will mainly focus on private DC pension schemes, and particularly the default funds thereof, as they are rapidly growing as a percentage of UK pension schemes and are subject to particular regulatory constraints and cultural pressures.

This report will begin by describing the modern UK pension system and examining how UK pension schemes invest their capital. It will then offer an overview of alternative investments, before analysing the ways in which they might contribute to UK pension funds. Finally, it will examine the factors preventing DC schemes from allocating to alternative assets, and what can be done by the Government to overcome those barriers.

---

5 The APPG on Alternative Investment Management was established on 10 January 2017 by Chris Evans, Member of Parliament for Islwyn. The broad objectives of the APPG are to: raise awareness of the alternative investment management sector and its valuable contribution to the UK economy; provide a forum to discuss developments in investment strategy, and the corresponding impact on UK pensions, endowments and direct lending; and support the development of an effective and proportionate UK regulatory regime governing the industry.


7 Defined benefit schemes are, of course, subject to their own particular pressures and constraints, some of which we examined in our evidence sessions. The question of how the trustees of such schemes perceive the liabilities of their funds, and the role of actuaries and investment consultants in pension investment decisions, are areas that warrant further investigation. However, they are beyond the scope of this report.
The modern pension arrangements of the UK can be traced back over 100 years, to the Old-Age Pensions Act of 1908. Under this scheme the UK Government guaranteed a means-tested pension to all residents over the age of 70 who had lived in the country for at least 20 years. This pension scheme, as with all subsequent ones, was created with the goal of ensuring that society’s elderly would be spared from destitution when they were no longer able to work.8

The Old-Age Pensions Act was subsequently supplemented by the National Insurance Act of 1946. The 20th century also saw the flourishing of private pensions in the UK, as private corporations offered their workers the chance to join pension schemes to which the corporations would also contribute.

Historically pension schemes tended to offer ‘defined benefits.’9 Under such schemes workers would pay a certain portion of their salary into a pension, in exchange for being guaranteed a defined income when they retired regardless of how much they contributed while they were working. For example, a worker might pay 5% of their annual salary into their pension and be guaranteed an annual income of £10,000 when they retire. The pension fund would invest that worker’s contributions before liquidating them when the worker retired.

In most defined benefit (DB) schemes a worker does not ‘pay’ for the entirety of their pension income. That is to say, their contributions to the pension fund are smaller than the money they take out of it when they retire. This ‘funding gap’ is closed by a combination of the pension fund’s investment returns, contributions by the sponsoring organisation, and contributions from those still in the workforce.

While this model worked for many years, it has recently been put under severe stress by demographic changes in the UK. The two most important such changes are the shrinking of the labour force and the lengthening of life expectancy. Retirees are living longer and withdrawing more from pensions. To exacerbate matters, the UK population is undergoing a shift as the ‘Baby Boomer’ generation retires.10 In 1974 the median age of the UK population was 33.9 years; in 2014 the median age exceeded 40 years for the first time in history.11 These changes have resulted in the ratio of workers-to-retirees in the UK shrinking. Today there are fewer workers supporting a much larger population of retirees, putting an even greater strain on the pension system.

---

This has contributed to a significant pension funding gap. At the end of 2015, the most recent date for which numbers are available, the Office for National Statistics estimated total pension liabilities in the UK, including public and private pensions, at £7.6 trillion, of which an estimated third was funded.

There have been several reactions to this challenge. First is the growing use of so-called ‘defined contribution’ (DC) pension schemes. In such pension schemes the size of the beneficiary's eventual pension is determined by the amount of capital she decides to contribute while she is working, as well as the returns on the pension's investments. As such, the risk of not having an adequate pension is shouldered by the beneficiary and not the sponsoring organisation. UK private pension schemes (those schemes sponsored by private corporations or organisations) are today overwhelmingly DC in nature (many of the most prominent DB schemes are based in the public sector). By 2030 it is estimated that assets in DC schemes will have increased six-fold, to £1,680 billion, overtaking DB schemes and comprising the equivalent of 15% of net UK wealth.

Table 1: Number of private pension schemes in UK, 2017

<table>
<thead>
<tr>
<th></th>
<th>DB schemes</th>
<th>DC schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of schemes</td>
<td>5,170</td>
<td>36,270</td>
</tr>
<tr>
<td>Number of open schemes</td>
<td>820</td>
<td>28,640</td>
</tr>
</tbody>
</table>

16 ‘Collective’ defined contribution (CDC) schemes have also become more popular in recent years, although they are still relatively uncommon in the UK. In such schemes a beneficiary holds a portion of the fund's aggregated investments, rather than a share of the underlying assets. As such there is no need to move an individual's capital into less risky assets as they approach retirement age, as is done in traditional DC schemes. CDCs also theoretically allow for a greater sharing of risk.
17 Ibid., 5.
18 As cited in: Law Commission, *Pension Funds*, 23
The growth of DC schemes has been supported by the policy of ‘automatic enrolment’ implemented by the UK Government in 2012. Under this framework, eligible workers are automatically enrolled in their organisation’s pension fund unless they actively opt out. This change was designed to increase pension participation in the UK and alleviate pressure on the State Pension scheme by “harness[ing] the power of inertia.” By 2013 the percentage of the workforce participating in workplace pensions doubled, to 66%.

---


22 Law Commission, *Pension Funds*, 19

23 Ibid., 21
**Section 2: How UK Pension Schemes Invest**

*Defined benefit schemes*

In order to understand how pension schemes invest we must first understand their investment goals, and how they view risk. The main purpose of DB pension fund investing is meeting the scheme's liabilities by generating adequate returns. This imperative leads such schemes to have a different understanding of 'risk' than traditional or alternative investment managers. For the former, the primary risk is not matching the returns of the wider market; for the latter it is the risk of absolute loss of capital. The primary risk for a DB pension scheme, however, is the inability to meet its predicted liabilities (the money it owes its beneficiaries when they retire).

In order to meet their liabilities, DB pension funds have traditionally invested in a blend of equities and bonds. Today, however, many public pension schemes have expanded beyond the traditional equity/bond split, and invest in alternative investments. Such schemes, which generally operate on a DB basis, have looked to absolute return strategies, private markets, and real assets such as infrastructure to take advantage of the fact that they have long investment time horizons. For many such investments they have been able to harness diversification or an ‘illiquidity premium’ (see Glossary). It should be noted, however, that participants in our inquiry highlighted several barriers DB schemes still face when allocating to alternative investments. Those challenges include the complexity of certain alternative investment strategies and the need for greater transparency from certain alternative investment managers.

*Defined contribution schemes*

The main objective of DC scheme investing is the maximisation of a beneficiary's pension outcome over the course of their working life. In such schemes the beneficiaries are presented with a range of funds to which they can allocate, each with a different expected return and risk profile. In practice, however, research suggests that the vast majority of DC beneficiaries—potentially as high as 98%—keep their capital in their scheme's ‘default’ fund. Given that such funds are subject to special regulation, and that they hold the capital of a majority of DC beneficiaries, we will focus our discussion of DC schemes on them.

Default funds are designed by a scheme's trustees, advisors, and platform providers to provide the best possible blend of risk and return for their beneficiaries. Beneficiaries are automatically enrolled in a scheme's default fund unless—or until—they request otherwise. As the beneficiary comes closer to retirement, default funds will typically automatically transfer capital from riskier assets to less risky ones. For instance, capital is taken out of equities and put into cash and bonds. The question of when this shift in investments, a process sometimes referred to as 'de-risking,' should occur in the lifespan of a beneficiary is debated.

The UK’s DC schemes are subject to distinct regulatory and operational constraints. To begin with, most DC funds are governed by the Financial Conduct Authority’s (FCA) permitted links rules, which permit the funds to hold no more than 20% of their capital in Qualified Investor Schemes. Second, DC funds typically offer daily liquidity. That is to say, DC funds generally hold assets that they can trade out of on any given trading day.

---


For a more detailed explanation of the permitted links rules see:

This means that such funds generally do not invest in ‘illiquid’ assets that require long-term capital commitment. It is important to note that there are no regulatory obligations for DC schemes to offer daily liquidity; the daily liquidity norm seems to be the product of cultural and operational forces (including an expectation on the part of regulators that pension schemes carry transactions out promptly).

Further, DC default funds are also subject to strict charge caps, enshrined by FCA rules. Since 2015, the administrative charges borne by a beneficiary by the default fund of a DC scheme have been capped at 0.75% of the value of that beneficiary's assets in the fund (this cap does not apply to a DC scheme's non-default funds). For instance, if a beneficiary had £10,000 saved in the default fund of a DC scheme, the maximum annual charge that could be made in respect of the beneficiary would be £75. Research has indicated that, even apart from this cap, many DC schemes prefer to invest in the lowest cost investments possible, often within a fee range of 0.04% to 0.20%.

Under the Occupational Pension Schemes (Investment Regulation) 2005 4(5), the assets of an occupational pension scheme must “consist predominantly of investments admitted to trading on regulated markets.” In its code of practice for trustees of DC pensions the Pensions Regulator further stipulates that “where investment options which are not admitted to trading on regulated markets are offered, we expect trustee boards to identify those as such in the [statement of investment principles] and explain why it was appropriate to include them in that form.” In effect, DC pension trustees must ensure that the majority of their scheme's assets are held in publicly traded assets, and must justify any exceptions.

Because of these regulatory and operational factors, DC schemes tend to have less flexibility than DB schemes when choosing assets in which to invest. DB schemes around the world already allocate to alternative investments, whereas DC schemes still largely hold traditional assets. As shown in Figure 4, a significant majority of DC assets are held in equities, typically through passive index funds (see Glossary). Less than 5% of UK DC pension capital is held in assets other than equities, bonds, or cash—a small number compared to other jurisdictions. A recent report by the UK Law Commission on the investments of DC pension schemes summarises the situation:

“The system works through inertia. Most people do not make an active choice to be in a scheme. They do not decide how much to save, and they do not choose how their savings should be invested. The great majority of savers, over 90%, are in the default fund. So far, the emphasis has been to funnel money into investments quickly and cheaply. Most money is invested in listed equities, generally using passive funds. For older workers, money is then transferred to lower risk bonds.”

The problem, however, is that there is strong reason to believe that returns on equities and bonds could be lower than average in the coming years (see Section 4). As such, pension funds that are only invested in equities and bonds could see their investment returns shrink, thus increasing their funding gaps. There are

---

29 Ibid., 13.
35 Ibid., 25
37 Ibid., 27
three possible responses to such a situation: accept smaller pensions, raise mandatory minimum pension contributions, or ensure pension funds have the flexibility to invest in alternative investments. In the following sections of this report we will examine how alternative investments work, and what they may be able to offer UK pension schemes.

Figure 4: DC scheme investment by asset class

Source: Pension Funds and Social Investment, *the Law Commission*[^38]

Section 3: Alternative Investments

During the course of our evidence sessions it became clear that the UK is home to one of the most robust investment management hubs in the world. Research suggests that the UK is the second largest global hub for alternative investment management. This paper will look at four types of alternative investment: private equity, private credit, absolute return, or hedge fund, strategies, and real assets.

In private equity, alternative investment managers purchase entire companies, or significant minority stakes in them. Managers implement managerial, organisational, strategic, and financial improvements, and then hope to sell the companies or stakes for a profit. Private equity managers will hold companies for years—generally four to seven—as they work to improve them. Whilst some of the fundamental economic drivers are the same as for public markets, the returns of private equity managers are distinct from the returns of the wider equity markets. This is largely due to private equity managers avoiding the ‘principal/agent’ problem in which the interests of the owners of a company and the interests of its managers do not necessarily align. Since private equity managers own companies outright, and can choose the management teams of those companies, they are generally able to implement substantive reforms with relative ease.

Private credit, meanwhile, is also known as non-bank lending. In this strategy, alternative investment managers lend capital directly to companies, real estate and infrastructure projects. Private credit managers create unique returns by lending to companies that cannot, or choose not to, secure lending from traditional sources such as banks or public bond markets. As such their investors can derive new sources of return by providing financing to underserved segments of the economy. Traditionally private credit has focussed on lending to mid-sized enterprises, which tend to be too small to list on the equity markets or access the public bond markets (larger companies are also increasingly availing themselves of private credit). By lending to such companies, private credit managers can provide financing to the real economy while generating attractive returns for their investors.

Absolute return managers, also known as hedge fund managers, invest in both traditional and alternative investments. However, unlike traditional investment managers, these alternative investment managers do not seek to match a benchmark of market performance. The pursuit of absolute returns means that such alternative investment managers attempt to deliver positive returns to their investors and avoid losses no matter whether the overall markets are rising or falling. In order to deliver such returns alternative investment managers use strategies such as leverage, short selling, and derivatives.

In real asset strategies, alternative investment managers invest in physical assets: generally residential and commercial real estate, infrastructure, and commodities. As with private equity, such investments tend to be long-term in nature, as they take time to generate profit, and the physical assets themselves tend to be illiquid (real estate, for instance, generally takes time to liquidate). As with private credit, real asset investing generally provides its investors with access to non-traditional sources of revenue—as the value of the underlying assets are not directly tied to the wider equity and bond markets—while simultaneously providing capital to an important facet of the economy.

42 As one of the participants in our evidence sessions noted, real estate traditionally formed a substantial portion of pension funds’ holdings, before falling out of favour in the latter half of the 20th century.
43 An exception to this general rule may be commercial real estate, the returns on which are often tied to the health of corporate bond and equity markets.
Despite their differences, alternative investment managers are distinguished by several key traits:

- They typically invest in non-traditional assets or revenue streams, or in traditional assets using non-traditional techniques such as leverage and short selling;
- They do not generally benchmark their performance to an equity or bond market index;
- They use different tools and techniques than traditional managers to manage downside performance risk;
- They usually function as limited-liability partnerships or corporations, with liquidity restrictions for their investors;
- They tend to charge higher fees than passive index investments due to the need to employ specialist resources to execute complex and sophisticated investment strategies.

**Risk management**

Alternative investment managers employ active risk management. Active risk management means taking steps to try to reduce the risk that investments lose value, rather than accepting them losing value as part of a wider movement of the markets. This is an important distinction between alternative investment managers and passive investments. Since the latter try to match the performance of the overall market they tend to be exposed to market risk. Alternative investment managers, in contrast, engage in active risk management. How such managers manage risk, however, varies with the assets in which they are invested.

Private equity managers are generally concerned with risks that reside within the companies they purchase. Private equity managers work to ensure that their portfolio companies have strong management teams and operational infrastructures in place. They also work to ensure that their portfolio companies have levels of financing that optimise the performance of the companies’ assets (and thus ultimately the returns delivered to investors). Given that such companies are privately held they are generally insulated from short-term volatility in equity markets. However, private equity investments are still exposed to equity markets when the investments end and the companies are sold on the market.

Private credit managers are primarily concerned with the risk of their borrowers defaulting on their loans. Private credit managers generally take several steps to manage this risk. They conduct deep due diligence on each individual loan they originate. The loan contracts are bespoke, with ‘covenants’—restrictions on borrower behaviour written into lending contracts—tailored to the individual needs of a borrower. Such covenants allow for monitoring and intervention before there is an actual payment default situation. Further, private credit managers tend to secure their loans with collateral, allowing them to recoup some of their losses should a borrower default by possession of this collateral. Private credit managers are also generally highly selective when it comes to choosing industries which tend to be less cyclical and somewhat more resistant to economic cycles. Finally, private credit managers tend to charge higher interest rates on their loans than traditional lenders, in order to offset the risk of a borrower defaulting.

Many hedge fund managers use short selling to manage risk. Short selling is an investment technique in which an alternative investment manager borrows equities, immediately sells them, and then waits for them to fall in price before buying them back, taking the difference as profit. By using short selling, alternative

---

44 The prevalence of passive index funds in DC pension funds means that many such funds have little to no management of market risk. Passive index funds have grown in popularity in recent years in part due to quantitative easing leading to an increase in equity prices.
46 Ibid., 18-20.

12
investment managers may be able to generate returns for their investors even when equity prices decline, theoretically allowing them to protect their investors’ capital against downturns.\(^{49}\) Properly carried out, the use of short selling may also reduce the volatility of a fund’s returns, as short selling acts to ‘hedge’ the fund.

Risk management in real assets tends to centre largely around the investment process itself. Real asset managers tend to focus on discerning such factors as potential regulatory changes, along with cycles, for example, in the real estate market, before making investment decisions. Once they have invested in an asset they monitor its environment, while also keeping abreast of such possible risks to their investment as poor building upkeep.

Alternative investment managers in general can also use leverage: borrowing capital to increase the amount of assets in which a manager can invest (note that short selling is a form of leverage). Alternative investment managers can use leverage to decrease risk in their portfolios, or increase their exposure to low-risk assets. For instance, rather than invest in a small amount of risky assets that deliver high returns, alternative investment managers can use leverage to invest in a larger amount of lower risk assets, theoretically gaining the same returns with less risk.\(^{50}\) Note that such techniques are not used by traditional managers, as they present the issue of ‘funding liquidity risk’ (see Glossary).\(^{51}\)

**Diversification**

Our evidence sessions suggested that the primary benefit delivered by alternative investment managers is diversified returns. By investing in a wide range of assets and employing different strategies, alternative investment managers can offer their investors the possibility of returns that have not historically been directly related to the performance of equities or bonds, and thus may provide protection against market fluctuations. This phenomenon is known as ‘low correlation.’ For instance, even though an alternative investment manager is invested in equities, if they are using short selling their returns will not be perfectly ‘correlated’ to the wider equity market, which may protect their investors in the event that equity prices decline (this is known as ‘downside protection’). It should be noted, however, that strategies designed to provide downside protection often offer lower returns. A ‘hedged’ position in an equity market, for instance, will by definition not capture all of that market’s positive returns. It should also be emphasised that ‘low correlation’ is distinct from ‘negative correlation.’ Even if an investment has historically exhibited low correlation to the wider markets, this does not mean that it will generate positive returns in a downturn.\(^{52}\)

Our evidence sessions also made plain that, contrary to public perception, alternative investment managers are not inherently ‘riskier’ than traditional assets. As explained in the previous section, alternative investment managers are distinguished by their active approach to managing risk. Figure 5

---


52 It should also be noted that ‘low correlation’ is not the same as no correlation. The same forces that affect equities and bonds can also affect alternative investments, but due to their low correlation alternative investment will generally be affected to a smaller degree.
shows the investment drawdowns—peak to bottom value of an investment at a given time—of hedge fund managers over the previous ten years compared to other assets.

Source: HFRI, S&P500, MSCI, Barclays, Case Shiller

Liquidity

Liquidity is a key consideration in any investment decision. In the case of alternative investment managers, liquidity is the ease with which an investor can withdraw their capital from a manager’s fund. Unlike traditional investment managers, alternative investment managers traditionally have not offered their investors daily liquidity. While liquidity arrangements vary across alternative investment managers, certain arrangements are common across the industry.

To begin with, many alternative investment managers employ ‘lock-up periods,’ during which investors can-...
not redeem their capital. Further, alternative investment managers commonly require their investors to give advance notice of their decision to liquidate (or ‘redeem’) their investments. These ‘redemption notice’ periods commonly last between one and two months.\(^57\) Finally, many alternative investment managers employ liquidity ‘gates,’ which restrict the amount of capital that can be redeemed from a fund, or by a single investor, at any given time.

Further, some alternative investment managers employ so-called ‘closed-end funds.’ These funds are particularly common in the private equity and private credit industries.\(^58\) Such funds are open to investments for a period of time (the ‘fundraising’ period) before closing and locking investor capital in. Generally, investors cannot redeem their investments until the fund has run its course and liquidated its investments.\(^59\) In the case of a private equity fund, for instance, returns are disbursed when portfolio companies are sold.

**Fee arrangements**

Alternative investment managers typically charge a ‘management fee,’ calculated as a percentage of the total capital invested with the manager, and a ‘performance fee’ (known as ‘carried interest’ in private equity) calculated as a percentage of the returns that a manager delivers over a certain threshold (known as a ‘hurdle’). Research indicates that the average fee for alternative investment managers is roughly 1.0 to 1.5% for the management fee and 15% to 17% for the performance fee.\(^60\) Fees do, however, vary based on the strategy employed by the alternative investment manager, and they have declined in some alternative investment strategies over the past years.\(^61\)

Some commentators have argued that the relatively high fees charged by alternative investment managers are unreasonable.\(^62\) We investigated such claims with both alternative investment managers and pension fund investors at our evidence sessions. The general conclusion was that investors should carefully investigate the returns they gather from alternative investment managers and be careful to ensure they receive good value for the fees they agree to pay. In many cases the extra fees may be justified by superior performance or investing infrastructure, or the larger headcount needed to execute a strategy. In other words, though fees may be higher an investor could potentially receive higher returns net-of-fees with alternative investments than with cheaper alternatives.

**Fund vehicles**

Alternative investment managers use specific fund vehicles to implement their strategies. Alternative investment managers require several characteristics in their fund vehicles. First, the regulatory regime under which the fund vehicles are established must permit strategies such as short selling, and the use of leverage and derivatives. Given the complexity of such strategies, the fund vehicles that offer them are generally barred from accepting investments from retail investors.

Second, alternative investment managers commonly use ‘tax neutral’ fund vehicles.\(^63\) In such arrangements

---


59 Positions in some closed-ended funds can be traded out of on secondary markets.


61 Ibid.


63 The Alternative Investment Management Association, “Transparent, Sophisticated, Tax Neutral,” accessed November 22, 2017. [https://www.aima.org/uploads/assets/uploaded/7e4e349c-ab04-41b0-8d5409ad3bd80e6b.pdf](https://www.aima.org/uploads/assets/uploaded/7e4e349c-ab04-41b0-8d5409ad3bd80e6b.pdf)
the fund vehicle itself is not taxed on its investment returns; investors are simply taxed on their returns by
the relevant jurisdictions. This prevents double taxation, in which investment returns are taxed at both the
fund and the individual level, significantly lowering realised investor returns. Currently most of these funds
are based in such jurisdictions as the Cayman Islands, Luxembourg, the Republic of Ireland, the US State of
Delaware, and the Channel Islands, for historical reasons.64

Transparency

Alternative investment managers have been criticised over a lack of transparency. This is partially driven by
many such managers using highly complex strategies to generate returns; it is also a function of their desire
to keep their investment strategies confidential. This confidentiality can lead to a manager’s investors not
being aware of the exact investments into which the manager has allocated their capital. For instance, an
investor who has not conducted proper due diligence could find themselves in the position of having their
capital invested in volatile derivatives. This is, however, less of a concern today, as regulatory developments
and investor demand have led to increased transparency.

Section 4: The Potential Role of Alternative Investments in Pension Funds

Our research has led us to believe that there is a role for alternative investments to play in UK pension schemes. We believe that the inclusion of alternative investments will allow pension funds the opportunity of greater potential returns, access to the illiquidity premium, and greater potential diversification. The inclusion of alternative investments can provide pension funds with more flexibility to protect and grow the capital of their beneficiaries.

Outperformance

Historically, alternative investment managers have often promised investors ‘outperformance’: the chance to generate returns superior to those of the wider market (this outperformance is also known as ‘alpha’). Research indicates that some alternative investment managers have indeed been able to deliver superior returns to those of the wider public markets.65 This is not a guaranteed proposition—while some alternative investment managers have delivered superior returns in the past decade, others have struggled to do so—but the available data suggests that some alternative investments, properly chosen, can be a source of superior returns.

Given that the goal of DC pension schemes is the maximisation of a beneficiary’s pension outcome, it seems logical that such schemes should allocate to investments that offer the chance of superior returns. Pension schemes would, of course, need to conduct thorough due diligence before allocating to any investment that promised outperformance, to ensure that any such outperformance would persist (and was not merely the product of luck on the part of an alternative investment manager). However, if persistent outperformance could be delivered to investors, allocating to such investments could have a tangible, positive effect on beneficiaries’ pensions.

Illiquidity premium

One way that alternative investments can deliver superior returns is through the so-called illiquidity premium, in which investors reap an excess return for keeping their capital invested in an asset over a long period of time. Pension schemes generally have long investment timeframes; as such they are well placed to take advantage of this phenomenon. By not taking advantage of the illiquidity premium pension schemes are foregoing potential returns for their beneficiaries.

Research has shown that the illiquidity premium does indeed exist, and that illiquid investments can, in some cases, offer superior returns than more liquid assets such as equities.66 Illiquid assets and strategies generally fall under the purview of alternative investment managers (real assets, private credit and private equity are all examples of this).

Many DB pension schemes around the world have already realised the utility of illiquid assets. Numerous Canadian pension plans, for instance, now invest in infrastructure. Ontario Teachers’ Pension Plan (OTPP),

for instance, moved from a portfolio consisting solely of provincial debentures to a diversified portfolio that includes significant allocations to illiquid assets; the scheme now has its own real estate arm.\textsuperscript{67} In 2018 OTPP announced that it was in surplus.\textsuperscript{68}

Increased allocations to illiquid assets by pension funds would not just potentially benefit their beneficiaries: it could also theoretically increase the amount of long-term 'patient capital' invested in the broader UK economy. Many infrastructure projects, for instance, require years—or even decades—of steady investment, which can be difficult to source from conventional investors. By allocating to illiquid assets through the alternative investment managers that fund them, UK pensions could play a significant role in helping to grow the UK economy as a whole.\textsuperscript{69} If UK DC pension schemes were to invest the same amount of capital to private equity, real estate, and other alternatives as DB schemes around the world they could potentially contribute billions of pounds in additional patient capital to the UK economy over the coming years.\textsuperscript{70}

\textit{Diversification}

The equity investing environment has generally been relatively benign over the past decade. In the wake of the 2008 global financial crisis, central banks around the world began a programme of quantitative easing, leading to key interest rates falling to record lows.\textsuperscript{71} This, combined with strong economic growth in countries such as the United States of America, has arguably led to the record highs in equity market valuations seen in the past year.\textsuperscript{72}

However, there are reasons to believe that the current financial cycle may be coming to an end. Interest rates are rising, as quantitative easing gives way to quantitative tightening. Ongoing trade tensions between the United States of America and the People's Republic of China, meanwhile, may lead to significant economic harm around the world.\textsuperscript{73} Closer to home, the UK's decision to leave the European Union in 2019 has led to market uncertainty.\textsuperscript{74}

At the time of writing, the UK's FTSE 100 equity index has lost all the value it gained in the 21\textsuperscript{st} century, falling to the level the index has reached in 1999.\textsuperscript{75} Given these disruptive developments it is essential for the UK's pension funds to be as risk-resistant as possible, especially given that passive index funds offer no protection from these developments.

\textsuperscript{69} The need for patient capital was recognised in UK Government policy by the creation of the British Patient Capital Programme in June of 2018. For more information see: British Business Bank, “£2.5 Billion British Patient Capital Programme Launched to Enable Long-Term Investment in Innovative Companies Across the UK,” accessed November 21, 2018. https://www.british-business-bank.co.uk/2-5bn-british-patient-capital-programme-launched-enable-long-term-investment-innovative-companies-across-uk/
\textsuperscript{70} See 2015 numbers of DB benefit scheme allocations and total estimated DC liability schemes in the UK. For estimated DB scheme investment allocations see: Hentov et al., \textit{How do Public Pension Funds Invest?}, 5.
\textsuperscript{71} For total assets under management of UK DC schemes see: Office for National Statistics, \textit{Pensions in the National Accounts}, 2.
\textsuperscript{73} Robert Azevêdo. “DG Azevêdo: "We Must Preserve What We Have, Even as We Work to Improve It."” Speech. October 17, 2018. https://www.wto.org/english/news_e/spra_e/spra243_e.htm
Diversification is an obvious way of accomplishing this. Diversification is famously the ‘only free lunch’ in investment, as it can allow for the lowering of risks without additional costs. At present much of the diversification in pension funds, especially in DC schemes, comes from bonds. However, research has shown that bonds and equities can in some cases move in the same direction.\textsuperscript{76} Further, analysts have predicted that the returns of both asset classes may decline in the coming years, or exhibit greater correlation.\textsuperscript{77} Finally, research has shown that bonds contribute relatively little diversification to a portfolio composed mainly of equities, unless exposure to those bonds is increased through the use of leverage.\textsuperscript{78}

Alternative investments can play a role in helping to diversify pension fund holdings. Such investments, as explained in Section 3, can offer low correlation to the wider equity and bond markets. Long/short equity hedge funds, for instance, can theoretically limit the losses suffered by their investors during a downturn of equity prices through the use of short selling (when such techniques are successfully implemented). Infrastructure funds can offer investors access to investments with timespans that outlast equity and bond cycles. Many private credit managers, meanwhile, offer their investors exposure to a different part of the corporate world, while providing essential funding to a crucial pillar of the national economy.


\textsuperscript{77} Aberdeen Standard Investments, Long-term Investment Outlook, 11-16.

Table 2: Predicted returns of diversified portfolio including alternative investments

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

Section 5: Barriers to Pension Funds Allocating to Alternative Investments

Our preliminary investigation has led us to believe that pension schemes may benefit from allocating to alternative investments. The question therefore arises why this is not already more common, especially in DC schemes. There are no direct legal or regulatory prohibitions to DC pension schemes investing in alternatives. Our evidence sessions and research have led us to conclude that there are, however, indirect regulatory barriers, as well as cultural and operational barriers that hamper the ability of DC schemes in particular to invest in alternative investments. However, we believe that these challenges can be overcome. In this section we will examine each main challenge and recommend remedies to incorporating alternative investments in DC schemes—particularly the default funds thereof.

We suggest that the Government and the relevant stakeholders consider the following:

- Improve pension scheme trustees’ awareness of alternative investments, and their incentives to consider allocating to such investments;
- Explore ways in which DC schemes could better access investments that do not offer daily liquidity;
- Provide guidance on how to combine investments in order to meet the charge cap of 0.75% for DC default funds, and explore ways of accounting for performance fees in the cap;
- Work towards the establishment of a series of UK professional investor fund vehicles that could be used by pension schemes to access alternative investment strategies and assets.

Trustee Incentives

Trustees are a crucial part of any pension scheme. They are entrusted with the formation of a pension scheme’s statement of principles which, among other things, delineates the kind of investments a scheme may make. Pension trustees can, in certain circumstances, be found legally liable for the underperformance of a pension scheme (i.e. its failure to meet its liabilities).

This is entirely understandable: trustees occupy an important position of trust and should be held to account. However, evidence suggests that the current environment for pension scheme trustees has led to excessive conservatism in investment decisions. Our evidence sessions made clear that the pressure on trustees often leads them to make the safest and cheapest possible investment, even if it will not generate an optimal return for beneficiaries. In other words, the current environment may be encouraging pension trustees to focus on cost at the expense of value.

We believe that this situation is largely a function of the incentive structures surrounding pension trustees—for instance, the requirement that pension trustees explicitly justify any investment in assets that are not publicly traded (discussed in Section 2). This is leading to an aversion to alternative investments. Alternative investments are often perceived as too complex and ‘risky’ by pension fund trustees, even though in many cases historical data indicates that they offer greater protection from market downturns than traditional asset classes (see Section 3). Further, the addition of alternative assets to a pension portfolio reduces the risk of the entire portfolio by adding diversification.

---

80 In comments provided on this paper, the Pensions and Lifetime Savings Association (PLSA) agreed that alternative investments have a role to play in pension scheme investing. They noted that allocations to alternative investments can improve a fund’s diversification.

81 Law Commission, Pension Funds, 82.

82 Note that we do not examine the question of permitted links, discussed in Section 2, in this section. While this issue deserves closer attention, we feel that it does not constitute the greatest obstacle to the integration of alternative investments into DC pension schemes. For an examination of this issue see: The Investment Association, Putting Investment at the Heart of DC Pensions, 12-14. https://www.theinvestmentassociation.org/assets/files/consultations/2018/20180621puttinginvestmentattheheartofdcpensions.pdf

Given that this situation is particularly acute in the creation of DC scheme default funds, we recommend that the Government take action. First, we believe that the requirement for trustee boards of DC schemes to formally justify any investment that is not traded on public markets may have a chilling effect on trustees’ willingness to allocate to alternative investments. As such we recommend that the Government re-evaluate this requirement.

Second, we recommend that the Government publish guidance on how alternative investments can be integrated into DC pension funds. The existence of such official guidance would, we believe, help shift the incentives of pension trustees by giving them a better understanding on how to diversify their funds. We encourage the Government to investigate the possibility of working with such external bodies as the Pensions and Lifetime Savings Association (PLSA), the British Venture Capital Association (BVCA), and the Alternative Investment Management Association (AIMA) to also provide educational programmes and materials to better highlight the key benefits and challenges of using alternative investment strategies in pension portfolios.

Daily trading in defined contribution schemes

As described in Section 2, DC schemes generally offer daily liquidity. There are no regulatory reasons for this, only operational and cultural ones. The prevalence of daily liquidity seems to be a result of two factors. First, a cultural expectation that DC schemes will rapidly process any transaction requested by a beneficiary—for instance, moving their capital from one of the fund’s schemes to another. However, as written, regulations only require DC schemes to process transactions within six months. Second, it may also be a by-product of the structure of the investment platforms used by many DC schemes. Such platforms are also typically used to service retail investors, and thus were built to handle assets providing daily liquidity. This daily trading deprives the beneficiaries of DC schemes of the ability to harvest any potential illiquidity premia, as they cannot invest in illiquid assets such as funds which use quarterly redemptions or closed-ended funds.

Testimony provided in our evidence sessions suggested that there is a risk the current situation could lead to liquidity mismatches, and thus significant market disruptions, in the future. That is to say, providers may be tempted to offer liquid funds that contain underlying assets that are not liquid in order to sell to DC pension schemes. In the event of a market disruption, pension schemes that invest in such funds may try to liquidate their positions only to discover that their capital is locked into illiquid assets. This scenario is not hypothetical: in the aftermath of the Brexit referendum, daily dealing UK real estate funds—liquid funds with illiquid underlying assets—had to suspend redemptions.

A move away from daily liquidity could also make more ‘patient capital’ available to the UK economy, as discussed in Section 4. Overhauling the daily trading of DC pension funds would allow them to invest in such crucial assets for the UK’s future economic growth as infrastructure, hospitals, and schools. As such, a revision of daily trading on the part of DC pension funds would offer tangible benefits not just to pension beneficiaries, but also to the wider UK economy.

---

85 The PLSA indicated their support for this goal in comments they provided on this paper. The PLSA already publishes guidance on such matters. For instance, see: Pensions and Lifetime Savings Association, “The Long View: Patient Capital and Illiquid Investment,” (London: December 2018). https://www.plsa.co.uk/Policy-and-Research-Document-library-Patient-capital-and-illiquid-investment
88 Law Commission, Pension Funds, 88.
89 Crucially, DB schemes do not have this constraint. As such, DB scheme beneficiaries are able to access sources of return that DC scheme beneficiaries cannot, effectively creating two tiers of pension schemes.
We therefore recommend that the Government investigate ways by which DC schemes could better access more illiquid investments. There is reason to believe that demand from DC schemes for daily liquidity will be met by their platform providers. A recent Law Commission report investigating this issue has already recommended that the Pensions Regulator provide pension trustees with guidance on the integration of illiquid assets into their funds; we would strongly second this proposal.

Clarifying the charge cap for defined contribution default funds

As explained in Section 2, under current regulations a beneficiary of a DC default fund may only be required to bear a charge of up to 0.75% of that beneficiary’s savings with the fund (a scheme’s non-default funds are not subject to this cap). This rule was implemented for good reason: high investment fees can cut into a beneficiary’s returns. However, our evidence gathering has indicated that this charge cap is hampering the ability of DC schemes to invest in alternative investments.

This is because, put simply, some investment strategies cost more than 0.75% to deliver, although they may offer greater value for that cost (i.e. higher net returns). As outlined in Section 2, many alternative investment managers charge management fees of over 1.0% of assets. Universities Superannuation Scheme (USS) Investment Management, for instance, reported in evidence submitted to the 2017 Law Commission report on pension funds and social investment that when it attempted to find infrastructure funds to which its DC scheme could allocate, they “found none available that were within the cost bounds of [their] funds and suspect that it would be difficult to find this at the charge cap of 0.75%.”

While pension schemes must always ensure they are getting the best possible deal for their beneficiaries, we must acknowledge that certain investment strategies are simply more expensive to run than others. Many alternative investment strategies require more employees, with greater levels of knowledge, as well as more robust risk management, in order to be successful. Such strategies can also be subject to higher regulatory compliance costs.

Further, the fee cap does not account for the fee structure of the alternative investment sector. As discussed in Section 3, alternative investment managers generally charge a performance fee as a percentage of the returns they deliver to their investors; this fee constitutes an important part of an alternative investment manager’s remuneration. Since this fee is tied to performance, there is no theoretical cap on it. As such, should an alternative investment manager generate significant returns for a default pension scheme, they may exceed the 0.75% cap. As such, as currently written the charge cap may inadvertently hinder the ability of DC default funds to access outperformance.

We believe that the Government could take several steps to ameliorate the current situation. First, we call on the Government to issue guidance on how DC default schemes can combine higher-cost alternative investments with lower-cost passive investments in order to meet the charge cap. Second, we suggest that the Government explore ways by which to account for performance fees in the charge cap for DC default funds. The Government may also wish to give thought to how DC schemes could reach the scale at which alternative strategies could be offered to them at a cost that meets the cap requirements.

---

91 In comments on this paper, the PLSA agreed that the daily liquidity norm represents a barrier, and indicated support for efforts on the part of the Government’s Patient Capital initiative to overcome it.

92 Investment Association, Putting Investment at the Heart of DC Pensions, 14.

93 Law Commission, Pension Funds, 89.

94 This may be particularly true in the case of smaller pension funds, which may have less bargaining power than larger funds when they allocate to a manager.

95 Ibid, 105.
A UK professional investment fund vehicle

Alternative investment managers rely on specific fund vehicles which give them the flexibility they need to manage their strategies (see Section 3). At present few such fund vehicles exist in the UK, and those that do generally need supplementing. This has forced UK alternative investment managers to domicile their funds offshore, in such jurisdictions as the Republic of Ireland, Luxembourg, and the Cayman Islands (fully 53% of global hedge fund assets are domiciled in the Cayman Islands). As such, any UK pension scheme wishing to invest in alternatives may need to invest in funds that are not domiciled within the UK. It was reported in our evidence gathering that this situation is limiting the adoption of alternative assets by pension funds in the UK.

As such, we call on the Government to examine the feasibility of creating a UK professional investment fund vehicle. This fund vehicle would be fully compliant with the Base Erosion and Profit Shifting project of the Organisation for Economic Cooperation and Development and the G20. The existence of a UK professional investment fund vehicle would allow UK alternative managers to keep ownership of their assets within the UK, and thus more attractive to UK pension funds as investors.

Further, there is reason to believe that a UK professional investment fund vehicle may have a positive impact on the wider UK economy. The existence of such a fund vehicle could bring significant numbers of high-quality jobs, including auditors, fund accountants, and lawyers. Such a fund vehicle could also attract capital from around the world, as investors move their capital to the UK to benefit from the UK's strong legal and regulatory regimes. Further, such a vehicle could serve as a trial for a UK ‘liquid alternative’ fund vehicle, which would provide more frequent liquidity to its investors than traditional alternative investment vehicles and provide retail investors with access to alternative investments.

The UK’s departure from the European Union presents an opportunity to overhaul the UK’s regulatory structure, and to ensure a regulatory regime that creates well-paid jobs, protects the UK's status as a global hub of investment management, and ensures that UK pension funds can easily access sophisticated investments.

**Glossary**

**Alternative investment**
Broadly speaking, an alternative investment is an investment that is not a bond or an equity. Examples include commodities, derivatives and real estate.

**Alternative investment fund**
This is the fund that holds investors’ capital, which is then invested and managed by the alternative investment manager. Note that the fund and the manager are two distinct entities, and are often based in different regions of the world.

**Derivative**
A derivative is a financial security, the value of which is derived from its relation to an underlying asset. Derivatives take the form of contracts between counterparties. For example, in a ‘future’ derivative, one party may sign a contract pledging to buy a security from another party at a given price at a given time in the future.

**Fiduciary duty**
Fiduciary duty is the fundamental principle of all investment management, and all alternative investment managers abide by it. The Chartered Financial Analyst Institute defines fiduciary duty as the principle that investment managers “must act for the benefit of their clients and place their clients’ interests before their employer’s or their own interests.”

**Funding liquidity risk**
The risk that an investment manager may not be able to obtain the necessary funding for their strategies, or that funding may be pulled. For instance, an investment manager using leverage would be open to the funding liquidity risk of their leverage provider pulling their capital.

**Illiquidity premium**
The illiquidity premium is a phenomenon in which less liquid assets can offer higher returns for investors. Investors are ‘compensated’ for the opportunity costs of committing their capital for a longer-than-usual period of time, and for the risk that they may not be able to quickly liquidate their investments.

**Index fund**
An index fund is a type of investment fund that seeks to match the performance of a given index. For instance, an index fund may try to match the overall performance of the FTSE 100, or the S&P 500. Index funds are passive: they seek to match the performance of an index, not beat it.

**Pension fund**
For the purposes of this paper, the term ‘pension fund’ refers to a fund, run either by a private corporation or by a government agency, that collects pension contributions from its beneficiaries and invests that capital on their behalf. Pension funds can either be based on a ‘defined benefit,’ in which beneficiaries are guaranteed a certain level of pay when they retire, or ‘defined contribution,’ in which beneficiaries receive retirement pay in line with what they contributed to the fund while they were still gainfully employed.

**Pension funding gap**
The amount by which a pension fund’s liabilities (i.e., the funds it must disburse to its beneficiaries) exceed its assets. For instance, if a pension fund had liabilities of £1 billion, but assets of only £600 million, the pension funding gap would be £400 million.

**Senior secured debt**
This is the first level of debt a company must repay should it default or enter bankruptcy. Secured debt is backed by collateral that could be seized by debtors in lieu of a payment, thus providing them with more security.
The Case for UK Professional Fund Vehicles

The UK needs to modernise its capital market infrastructure to enable domestic and international professional and sophisticated investor capital and assets to be managed, domiciled and administered in the UK within new internationally competitive professional fund vehicles.

The current UK funds regime functions well for UK retail and, to a limited extent, private equity funds. However, the UK corporate non-tax transparent regime is overly complex and unattractive for non-UK resident investors and for strategies intended solely for sophisticated and professional investors - such as those run by alternative investment fund managers. These require a significant degree of flexibility in terms of the range of fund units, investable assets, markets, liquidity and leverage, as well as tax neutrality and tax efficiency, which the current range of UK vehicles does not easily offer. It is not that managers and investors do not want to place assets in funds domiciled in the UK, rather they come up against challenging obstacles to doing so.

Significantly for the UK fund management sector, the absence of viable corporate and non-corporate vehicles to be used by alternative investment fund managers (AIFMs) has allowed other jurisdictions to move ahead of the UK and to establish themselves as high-quality modern fund domiciliation and administration centres for UK and non-UK based managers - thereby enjoying significant economic benefits from the jobs associated with the servicing of those funds such as the establishment of a sophisticated servicing and professional and systems based infrastructure, including administrators, custodians, directors, lawyers and accountants.

It is logical that the UK should seek to break down the obstacles which prevent managers from holding and administering assets in funds domiciled in the UK to obtain a greater share of these economic benefits. This paper provides predictions for the jobs and tax benefits available to the UK as a result of an update to its professional fund vehicles regime.

Such a funds regime will require both regulation and tax (including value added tax) to be addressed in order to create a fund vehicle which is:

- familiar to UK and international professional investors and managers and flexible enough to accommodate their requirements
- appropriate for use across the spectrum of alternative investment and other private funds
- suitably regulated, including an efficient regulatory process which minimises the costs and time to form the fund
- available in corporate and limited partnership form
- available as open or closed-ended vehicles
- able to act as a feeder or master fund
- tax exempt, but capable of achieving tax neutrality by electing into treaty eligibility or favourable UK tax regimes (e.g., income streaming)
- able to hold interests in a subsidiary or special purpose vehicle which may access double tax treaties or securitisation vehicle and similar tax regimes, and
- subject to appropriate VAT treatment.

The Defensive Necessity

Almost all alternative asset classes managed by UK established investment managers, including assets committed by UK based investors, are held within funds domiciled outside of the UK in major funds jurisdictions. These jurisdictions include Bermuda, the BVI, the Channel Islands and the US, but the key jurisdictions are the Cayman Islands and Member States of the EU other than the UK.99

97 But note that international retail investors typically have their assets in UCITSs domiciled in Luxembourg and Ireland
98 Including hedge fund and private credit managers
99 Cayman is the fund domicile of 53% of the $3.2tn global hedge fund AUM; Ireland and Luxembourg are the fund domicile to 6% and 4% global AUM respectively. Other key offshore fund domiciles include Jersey, Guernsey, Isle of Man and the US (Delaware). The US is fund domicile of 29% of global AUM, although this is mostly US domestic capital. (Figures courtesy of “Final Report - IOSCO Fourth Hedge Funds Survey” https://www.iosco.org/library/pubdocs/pdf/IOSCOPD587.pdf)
The key risk is that UK managers may become unable to manage EU vehicles or market non-EU vehicles from the UK. The risk of managers located in the UK no longer being able to manage and/or market funds or have them administered in an economically and operationally efficient way is already causing globally mobile fund management groups to reconsider their physical presence in the UK for their EU and international management businesses. As a worst-case scenario, this could render UK investment management a purely domestic industry managing assets only for UK investors as international investors take their business to other jurisdictions, losing a valuable net export market.

A commercially viable option for professional fund managers to domicile funds in the UK would serve to mitigate many of these risks and place the UK on a level playing field with the EU and other jurisdictions globally which have modernised their legal and operational infrastructures and are now looking to build their domestic industries and exploit the further advantages offered to them as a result of Brexit.

The Positive UK Growth Opportunity

It is likely that the UK professional fund management industry will lose some job functions and EU focused business as a result of Brexit. However, there is a significant growing global investor market, an additional proportion of which UK based managers could acquire if given the best tools to do so. An economically and operationally attractive UK funds regime would put UK professional fund managers in an optimal position to secure a greater proportion of global capital allocated to alternative asset classes, including the current $3.2tn global hedge fund and $650bn private credit markets and their future growth. An appropriately regulated UK funds regime could also help to preserve and promote EU business for UK managers, marketed either through private placement regimes or, if activated, the AIFMD third-country passport.

Notwithstanding the impact on managers, the introduction of competitive UK professional fund vehicles would itself generate material economic benefits for the UK economy by creating additional professional jobs not just in the South East of England, but across the whole of the UK including Wales, Scotland and Northern Ireland.

Network effect of the UK as a global capital markets centre – the UK financial services sector has a largely unrivalled network effect from the concentration of principals, service providers and clients all in close geographic proximity. This functions within the City of London, as well as the broader regions of the UK, where over two thirds of UK financial services jobs are located, and is only likely to improve as high-speed rail links and other such infrastructure projects are developed across the UK.

The critical mass of global managers in the UK means that a UK fund vehicle already has a key target demographic. All things being equal, in particular, international tax treaties and other rules create a significant incentive to domicile assets in the same jurisdiction in which they are managed – for example, BEPS rules in practice tend to encourage assets to be domiciled where the substance of management takes place. In some instances, when relying on double taxation treaties, it is helpful for the fund (and any subsidiaries) to be in the same jurisdiction as a substantial proportion of its investors.

The presence of managers will also create operational synergies for institutional investors themselves undertaking on-site due diligence visits. Rather than additional international travel, they need only to visit one country. Due diligence of a manager and fund is a particularly expensive enterprise, thus the ability to minimise costs would be a material draw.

A concentration of key service providers in the UK would also be extremely useful for the uptake of the new UK regime. The UK already has a significant custodian and depositary business, as well as a deep pool of legal and accountancy expertise upon which to build. There are current fund administration centres in various locations in the UK for retail funds, as well as various other relevant infrastructures and human resources.
such as fund directors. These can be built upon to cover professional fund vehicles. The UK is also home to many capital introduction teams to facilitate investments.

What new UK professional jobs would be created and where?

The UK professional fund management sector currently employs over 56,000 people.

The domiciliation of funds in the UK will require additional headcount within the existing UK fund industry. In particular, increased and new roles will include:

- auditors
- custodians and depositaries
- IT and other systems providers, including cybersecurity specialists
- fund accountants
- fund administrators
- fund directors
- fund marketers and distributors
- lawyers
- subscription and transfer agents
- valuation agents

Overall anticipated job increases would be in excess of 10,000 direct roles, plus related indirect functions. It is important to stress that current UK fund servicing jobs are located across the UK. It is highly likely, therefore, that any new roles will build upon existing expertise centres outside of London and the South East.

The success of a UK professional funds regime could also draw additional managers to establish in the UK, thus leading to additional direct employment in the UK from new investment management roles. Even if the number of investment management jobs increases by a small proportion, this could result in thousands of new highly paid roles.