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**The big contribution**

# How DC pension schemes can build a brighter future with private assets

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# The big contribution

## How DC pension schemes can build a brighter future with private assets

Private assets can make a big contribution to defined contribution (DC) pension schemes by enhancing the quality of member retirements, while helping to contribute to a more sustainable planet. They have distinctive performance attributes, improve portfolio diversification and have historically outperformed public markets over the long term. Furthermore, private assets enable DC schemes to target distinct sustainability outcomes, while seeking to generate compelling financial returns.

Radical reform is required to ensure DC pensioners stay on course to achieve the retirement lifestyle that meets their aspirations. For schemes to support members, the industry will need to raise contribution levels and ensure that savings are managed to deliver the best possible outcomes. This will require making changes to the industry's plumbing, to remove some of the barriers which currently prohibit access to a wider range of productive investments.

The breadth of opportunities in private markets offer a route for members to make a big contribution. Attractive growth companies, at the forefront of innovation, or assets which have particular defensive properties not only can improve portfolio outcomes but also pave the way for schemes to fund projects that improve societal outcomes and address global environmental challenges. This presents a compelling case for schemes to broaden their remit.

Failure to address these twin challenges could leave many pensioners struggling financially and the environment in a worse state than it is already. With the UK becoming an increasingly aged society, there are likely to be big strains on the state pension system.

**"In the long term, people have a strong incentive to save as much as they can for their retirement given there is so much uncertainty around issues such as inflation and the potential levels of state benefits many years from now."**

Natalie Winterfrost, Director, Law Debenture

Private capital has experienced remarkable growth over the last decade. EY estimated that by the end of 2022 there were US$22.6 trillion of private assets under management, compared with US$9.7 trillion in 2012.

Complexities in the listing process and support from growing capital pools aimed at private investments has resulted in many companies choosing to stay private for longer. Often an incubator of new and disruptive business models, privately owned businesses represent a growing pool of high-growth investment opportunities for DC pension schemes.

One driver of this growth, has been the opportunities on offer to solve some of the major societal challenges, such as decarbonisation, for example. It is a highly ambitious global objective that is often billed as being as significant as the industrial revolution. The economy's shift from a reliance on hydrocarbons towards renewables will require huge investments in new technologies, infrastructure, energy generation and distribution networks.

The International Energy Agency (IEA) estimates that annual investment in the energy sector will need to more than triple to US$4 trillion by 2030 to meet net-zero emissions targets by 2050. According to PwC's 2023 State of Climate Tech analysis, there has been a fivefold increase in the number of climate technology start-ups since 2010, and total global investment in low-carbon energy technology passed US$1 trillion for the first time in 2022.

Access to these opportunities is mostly confined to private markets, where smaller companies are striving to innovate and scale their ideas. As businesses mature and these ideas gain commercial viability, the depth and scope of private markets capital can help to accommodate funding requirements across all stages, from venture funding to buyout, without necessarily needing to go public. As each stage in the cycle is reached, companies tend to accrue greater value, which presents the prospect of compelling investment returns for those investors that actively contribute to unlocking growth and fostering innovation.

## Inadequate pension pots

A major societal challenge for the UK is the risk that many of today's workers will end up in poverty when they retire due to a lack of savings. This is despite the launch of auto-enrolment into work pension schemes from October 2012, which is undoubtedly a major achievement: more people than ever are now saving for their retirement. However, the Department for Work and Pensions (DWP) warned in 2023 that about 12.5 million working-age savers are not putting enough aside for their retirement.

The situation has been exacerbated for current and future retirees by inflation. The Pensions and Lifetime Savings Association said pensioners trying to maintain a basic standard of living would have needed to raise their expenditure by almost 20% in 2022. It is calling on the government to adopt: "clear national objectives for retirement income, to ensure the state pension protects everyone from poverty and, later this decade once the cost-of-living crisis has passed, to increase the scope and level of automatic-enrolment pension contributions."

The Association has long recommended that the minimum 8% of workers' salaries going into their pension schemes through auto-enrolment should be raised to 12% in the early 2030s. Echoing that advice, the Association of British Insurers (ABI) recommends that this be raised to 12% and phased in over 10 years from 2025. As a comparison, in Australia the equivalent of 11% is paid into workers' pension schemes, and this will increase to 12% in 2025.

**"As a general ambition for the UK we would support that a 12% contribution rate gives you a much better expectation of a decent outcome in retirement than 8%."**

Mark Jaffray, Head of DC Consulting,
Hymans Robertson

Another approach that would help workplace savers is to ensure that their savings are allocated to high performing sectors of the economy, including those which more typically raise capital through the private markets.

The government has been vocal about wanting to channel pension capital first into domestic infrastructure and more recently into private equity. However, its comments have raised concerns among pension trustees: could these sentiments be a prelude to political interference?

The government should avoid the temptation to mandate for pension funds to invest a certain percentage of their capital exclusively in the UK. Curtailing their investment opportunities could undermine returns, which would result in poorer outcomes for members and could see them relying more on the state for financial support in retirement.

## The role of private assets

Private assets could play an important role in diversifying DC pension schemes. There is an opportunity to drive capital into real assets (beyond real estate) that benefit from long-term structural trends; such as funding the energy transition, circular economies, sustainable agriculture, and the protection of nature. Assets in this space can have return drivers that differ to those of equity and bond markets, and this makes them an attractive way to balance risk in a wider portfolio, in our opinion.

**"Private assets offer DC pension schemes the ability to construct unique portfolios geared for very specific performance and sustainability-linked outcomes, and can therefore become a point of differentiation in the marketplace for master trusts and pension providers."**

Sam Collings, Head of DC, M&G Investments

A key characteristic of private assets is the ability to access 'pure play' exposures that can support the scheme's objectives – sustainability, for instance. Investors can find assets or strategies which specifically target areas that may be important to underlying members, for example in achieving social equality goals or through the positive impact of investments in climate solutions.

Implementing sustainable practices, investing in technologies and constructing modern infrastructure are all required for society to achieve its developmental goals. These transformative activities can pay off over the long term, which makes private markets and 'patient capital' investments well-placed to see initiatives through to realisation, without being beholden to the short-termism that is often associated with being listed on public markets.

Also, while most publicly traded companies are transitioning towards net zero, there is a risk that some may not achieve this goal. This has the potential to leave them exposed to damage arising from a shifting policy environment or other climate transition risks. In other circumstances, physical risks, such as the impact of floods or higher temperatures have the potential to impact businesses and ultimately feed through into share prices. As such some trustees believe it is safer to go straight for pure sustainability exposures – most of which are privately funded, to address these risks.

**"If you are investing in public equity, you're predominantly investing in transition assets, which should become greener over time. But you can leapfrog that by buying private assets, because you can invest directly into, for example, hydrogen technology startups, forestry, wind and solar projects and so on. And that has an immediate positive direct impact on the carbon intensity of your portfolio."**

Andrew Warwick-Thompson, Independent Chair and Accredited Professional Pension Trustee

SPOTLIGHT

## Acorn Carbon Capture and Storage and Hydrogen Project

A project by Storegga Geotechnologies Ltd aiming to capture and store $CO_2$ from industrial activities in Scotland.

### A potential game-changer for UK carbon storage

By 2030 Storegga's Project Acorn could potentially meet more than half of the 10 million tonnes a year of $CO_2$ storage targeted by the UK Government's Ten Point Plan for a green Industrial Revolution. Within its first decade of operation Project Acorn can be scaled up to potentially store more than 20 million tonnes of $CO_2$ emissions per year – around half the household emissions of a city the size of London. The captured $CO_2$ is to be piped offshore via existing pipelines to be securely stored under the seabed.

Storegga aims to capitalise on a market expected to be worth €10 billion by 2030 and offers the potential to provide stable income streams for investors. It will achieve this by removing and safely storing $CO_2$ gases that are causing damaging climate change. It will also create employment opportunities in Northeast Scotland.

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Given the long-term nature of these investments and the now large private infrastructure investment industry, there are a huge number of opportunities in private markets. The private infrastructure universe offers DC pension schemes far more choice and access to differentiated return characteristics. From a public markets perspective, infrastructure is often seen as mature pure income play. Income-focused infrastructure does exist in private markets, but the megatrends of climate and the energy transition, digitalisation and demographics are creating opportunities in growth-oriented projects. These can include supplying energy-efficiency solutions to companies, rolling out 5G networks and providing electric bus fleets.

This evolution of the asset class creates opportunities with very different return drivers and the opportunity to build diversified portfolios that have low correlations to public markets. And infrastructure's importance, and hence pricing power, lends itself well to contracted and inflation-protected cash flows, which is particularly important for DC savings that need to be protected from inflation over time.

Private transactions, given their bilateral nature, frequently provide the flexibility to negotiate and structure tailored investments. This allows for risk mitigation strategies, such as employing political insurance for emerging markets exposures or establishing seniority in the capital structure through preferred return instruments.

More opportunity and a diverse and expanding pool of investors creates a compelling environment for implementing strategies that seek to generate attractive returns while often allowing for the secondary trading of the assets. This aligns well with the investment requirements of DC plans at different stages of a member's retirement journey.

**"You have the opportunity to structure deals to incorporate protection, or you can ensure that specific conditions are met before buying an asset. It means you can more closely align the investments you make with your risk tolerance."**

Anish Majmudar, Head of Real Assets, M&G Investments

## Private ownership can mean more influence

Another important aspect of private ownership is that it offers the ability to partner with investors that can exercise more influence over board decisions than is typically possible with listed companies. DC pension schemes can use that influence to steer boards towards more ESG-friendly approaches.

Investment horizons tend to be long, which gives investment managers the opportunity to steer companies towards long-term objectives – often, by aligning goals through remuneration and governance policies.

**"In many respects, with investments in private companies we have more access to data. You're working directly with the company, and we normally take a board seat. We don't struggle accessing information and you don't have issues with insider information that exist with publicly listed companies."**

Naomi Clark, Head of Investment Product Management, USS

## Today, there are fewer listed companies

Despite the variety of opportunities offered by private markets, pension schemes have traditionally leaned heavily on public markets for their investments. But the changing nature of equity markets in particular means that DC pension schemes may need to widen their scope if they want the opportunity for greater access to diversification and outperformance.

For several decades, there have been steadily fewer companies listed on stock exchanges as a result of mergers and acquisitions and newer companies spending longer in private ownership or shunning IPOs altogether.

Even in the US, which is widely considered to be the home of publicly traded companies, the number of listed firms peaked at more than 8,000 in 1996, but by 2019 that number had shrunk by nearly 50%, according to the American Council for Capital Formation (ACCF). The UK has also experienced this trend. In 2022, there were fewer than 1,200 listed companies on the main market of the London Stock Exchange, compared with 4,400 in the early 1960s. EY, meanwhile, estimates that 75% of companies globally that generate at least US$1 billion in revenue annually are privately owned.

This means that many of the businesses of the future are simply not available in public markets, and most of these growth businesses sit in private markets. By the time they consider listing, there is a good chance that many will have their best growth years are behind them.

**"Private capital, ranging from venture capital through to private equity, offers businesses the necessary resources to drive transformational growth. As a result, being able to access this universe offers investors a rich opportunity to gain exposure and help grow the businesses of the future. Many of these will be well-placed to help solve some of the big climate and other global challenges."**

John Euers, Co-head of Private Equity, M&G Investments

SPOTLIGHT

## Environmental Infrastructure Partners (EIP)

EIP designs, builds and owns/operates critical efficiency infrastructure on behalf of municipalities, universities, schools and hospitals in the US.

### Boosting efficiency of public buildings

The company seeks to deliver reliable, sustainable infrastructure for communities across America. EIP's projects include installing and managing water meters, EV charging hubs and water treatment on long-term contracts to improve energy efficiency and help preserve water.

EIP has over US$200 million of projects approved. They are long-term and without usage risk, providing a diversified portfolio of uncorrelated cash flows that reduce energy and water use. The business is expected to deliver an attractive return by taking on development work and creating a scaled platform of assets.

The information provided should not be considered a recommendation to purchase or sell any particular security.

### Value for money

Some DC pension schemes – particularly the ones that are pursuing very competitive pricing strategies – are conscious of the higher fees typically associated with private assets. This is in the context of the 0.75% fee cap set by the UK Government. Management fees for private assets can be up to 2%.

For example, in private equity the fee model has traditionally been a 2–20 approach: a 2% management fee plus a 20% performance bonus based on realised profits.

However, private assets are unlikely to comprise more than 25% of an overall DC portfolio. The recent non-binding Mansion House compact between the government and some pension providers aims for a 5% exposure to non-listed equities, and these do not have to be UK specific.

Since many passive strategies in DC pension schemes charge far below this threshold, and occasionally in single-digit basis points, this could allow for potentially higher management fees for private assets. Some DC schemes aim to have up to 15% of their portfolios invested in private assets, leaving scope to absorb higher fees. Also, the government has relaxed the rules around including performance fees in the 0.75% fee cap.

In practice, many pension providers operating in a competitive environment seek to charge well below the fee cap. The pressure to do so comes partly as sponsors tend to heavily weight costs in their selection criteria when choosing a provider or master trust. The average DC scheme all-in fee is estimated to be about 0.5%, according to data compiled by DWP, but many charge even lower than that.

**"Fee competition has been a particular feature of the market over the last 10 years and has been the case since auto enrolment kicked in. There is a need to shift the dialogue and create a legitimate comparison where the focus is not just fees but overall value and returns in particular."**

Mark Jaffray, Head of DC Consulting, Hymans Robertson

Some DC schemes charge very low fees by investing heavily in low-cost passive funds, which provide broad exposure to public equity and fixed-income markets. However, index construction can be biased towards certain parts of the market, such as in 2023 when the 'Magnificent Seven' achieved an average return of over 70% – far outstripping the remaining 493 stocks in the S&P 500. This can result in unintended challenges, such as concentration risk. Importantly, schemes might overlook the advantages of an active investment management strategy, potentially missing out on other levers of value creation attainable through a diversified portfolio.

Long term, a focus on low fees risks delivering poorer outcomes for DC pension members and may also miss the value-for-money argument.

**"In terms of allocating to private markets, we need to take into consideration member outcomes and net risk adjusted returns rather than just focusing on fees."**

Stephen Budge, Partner, Head of DC Investment Strategy, LCP

## The origins of private assets' outperformance

Long-term outperformance of private assets over their publicly traded counterparts is attributed to the 'illiquidity' premium, navigating and managing intricate investment structures and the value created through active and engaged ownership.

Unlike investing in publicly traded securities, investing in private assets usually requires locking up capital for extended periods of time, and investors are compensated with higher returns in exchange for committing 'patient' capital. This patient approach often means that investors can take steps to drive value over the long term. In private equity, investors typically take a hands-on approach, reshaping companies, redefining strategic direction and employing financial and operational levers to set companies up for future growth.

The complexity premium revolves around the skills-intensive nature of sourcing, analysing and managing private assets. These deals require structuring and engaging with the management of these assets to achieve better outcomes.

It is for these reasons that fees for managing private assets tend to be higher than for portfolios of publicly traded securities. From a historical perspective, the higher costs associated with managing private assets are more than compensated for by their tendency to outperform over the long term.

According to Cambridge Associates, US private equity produced a 13.8% annual return (net of fees, expenses, and carried interest), in the 25 years to the second half of 2022. By contrast, the S&P 500 managed 8.3% and the Nasdaq composite achieved 10.4% over that timeframe.

A similar trend is evident in private debt markets, according to Prequin and Bloomberg. From 2009 to 2021 private debt markets delivered annualised returns of 9.0%, compared with 5.2% for European high-yield corporate bonds. This trend continued into 2022, where private debt returns were mostly in positive territory, in contrast to the steep declines seen in public fixed income and equity marketse.

**"Most private credit is non-investment grade because the companies are much smaller. But you are getting an uplift. You're probably getting anywhere between 100 and 150 basis points of uplift, depending on the opportunity, the sector and so on."**

Jo Waldron, Co-Head Diversified Private Debt, M&G Investments

It is notable that part of the success of Australian superannuation funds has been their commitment to investing in private assets to boost their returns.

Also, the increasing size of UK DC pension schemes thanks to consolidation and regular investment inflows places them in a stronger position to negotiate more advantageous fee structures for private assets.

**"Some schemes are having success driving down fees to below 100 basis points for fund managers involved in social housing, private equity and natural equity."**

Julius Pursaill, Strategic Advisor, Cushon

Their bargaining power is likely to increase as DC pension schemes become increasingly important players in capital markets. Assets held by workplace pension schemes are projected to hit £1 trillion in 2030 – rising from about £500 billion in 2023.

### There is a consolidation opportunity

So far, almost all DC and occupational pension schemes are underweighted towards private assets. But most of the larger schemes are now actively considering private assets in order to benefit from greater diversification, more exposure to sustainable investments and the potential for outperformance. Regulatory guidance is also shifting to encourage schemes to consider a broader range of assets. From October 2024, all trust-based DC schemes will be required to state their policy on illiquid assets within the statement of investment principles, including whether there are plans to increase allocations to illiquid assets.

Master trusts are expected to consolidate rapidly – from , representing 20.7 million UK members, to just 10 or 12 larger trusts in the coming years. There were as many as 90 in 2019. These trusts are also expected to absorb many of the smaller occupational pension schemes.

Large master trusts have far more scale, capital and personnel resources to participate meaningfully in private markets. This will enable these schemes to allocate resources to what are typically more management-intensive investments.

Their scale is also likely to transform the way they own and manage their assets. Most DC pension schemes hold their assets on life insurance platforms that are designed to house funds rather than direct asset holdings. The pace at which life platforms have modernised operational and administrative processes to accommodate non-daily traded assets has been a limiting factor for DC investment in private assets.

Among the larger DC and occupational schemes, there is an emerging trend of dispensing with this arrangement and building their own custody platforms – allowing them to directly own private and public assets. This makes it much easier for them to interact with company management of privately and publicly traded companies.

**"The benefits of having our own platform include same day trading and it's a lot cheaper. It's more flexible in terms of being able to build the asset allocation we want, and it is easier to change them."**

Naomi Clark, Head of Investment Product Management, USS

Though some asset managers are trying to make private assets more accessible to a broad range of individuals, they are still largely the preserve of institutional investors and high-net-worth individuals. They are out of the reach of most DC pension scheme savers.  Through leveraging scale and developing new investment solutions, DC pension schemes are democratising these assets for people who would otherwise have very little opportunity to benefit from them.

## Long-Term Assets Funds: A bridging solution

However, smaller pension schemes might struggle to invest in private assets because of a lack of resources or because other items are higher on the agenda, such as consolidation.

**"At the moment because of the complexities of getting into private assets, the main interest for DC schemes has been in more multi-asset solutions, so we're talking about areas like private credit, infrastructure and private equity."**

Stephen Budge, Partner, Head of DC Investment Strategy, LCP

One solution to make holding private assets easier for schemes could be Long-Term Assets Fund (LTAF) structures authorised by the FCA. Still relatively new, these open-ended funds are designed to invest in illiquid assets and were introduced by the UK Government to direct investment into private assets and support the transition to a low-carbon economy.

LTAFs are open-ended funds investing mostly in illiquid assets, and have minimum 90-day redemption periods along with terms that more accurately reflect the nature of the underlying assets they hold.

LTAFs are available to professional and sophisticated investors including DC pension schemes, with the expectation that they will soon be available to a wider investor base once incorporated into the ISA regime. They can also be held on life insurance platforms within the permitted links regime.

More asset managers are now starting to launch LTAFs. In the interim, they could be a viable solution for many DC pension schemes. But once the consolidation of master trusts reaches its peak, some trusts and schemes will be of a scale that could allow them to switch to custodian platforms – and they might not need LTAFs.

**"I think LTAFs will be a step on the way to the big DC schemes, particularly the master trusts, moving away from pooled fund structures into segregated mandates with the assets held by custodians and appointing fund managers directly to run those segregated mandates."**

Andrew Warwick-Thompson, Independent Chair and Accredited Professional Pension Trustee

## Private assets can improve member engagement

Private assets can support DC pension scheme trustees in another way. Engagement is increasingly recognised by the pensions industry as an important way to keep members committed to saving for their retirements. However, research has consistently shown that many members have little awareness of the value of their pension savings or how they are invested.

According to the Financial Conduct Authority (FCA), one-third of members of workplace pension schemes do not know the approximate value of their pensions, and 53% have not reviewed how much their pension is worth in the past 12 months. Only 29% recall receiving a statement in the past 12 months; a further 14% received one but did not read it.

And there is a lack of understanding about pensions. Research commissioned by Royal London found that one in four 18–24-year-olds with a workplace pension think their contributions end up in a bank account. The research also revealed that 22% of people did not know what happened to their pension contributions – 15% of men and 30% of women.

Digital is one way to improve engagement. A survey by Smart Pension, for instance, found that 80% of members would engage with their pension more via a digital app if it was quick and easy to use and helped them understand their pension.

But there's far more that can be done. Engagement could be stimulated by demonstrating to members that their pensions are not just low-cost and tax-efficient savings vehicles, but are also a way to improve the environment that members will go on to live in. A 2020 survey by the Defined Contribution Investment Forum (DCIF) found that only 8% of DC pension savers expressed no interest in climate-friendly funds. Eight in 10 would like their pensions to be invested in a way that does 'some good' as well as provide financial returns. And 7 in 10 people indicated that they were interested in responsible investing for their pensions.

The DCIF said that high-profile climate activists and TV nature programmes, such as Blue Planet, had raised member awareness of social and environmental issues.

One of the benefits of private assets is that they are tangible: they might be a wind farm, a hospital or a decarbonisation project. The physical nature of these assets makes them more relatable than say securities in a large listed multinational company to DC pension scheme members and can be 'pure play' sustainable investments.

**"Making members feel proud of their pension scheme is a step change in the way that DC providers can interact with their members. There is good evidence that impact investments can improve members' engagement levels and improved engagement levels lead to better member outcomes and, in turn, higher contribution rates."**

Julius Pursaill, Strategic Advisor, Cushon

Communication is critical for improving awareness about where pension funds are invested. Research by NEST found that many members are investing for the first time and may have little understanding of the topic. It identified five principles for communicating responsible investing to members: making investments relevant to them, which can include storytelling. The other four principles revolve around keeping the language simple; supporting claims with proof; demonstrating that responsible investing benefits members personally; and showing that they are getting a good investment product.

**"One of the superpowers of private assets is that they often deliver great stories. These can be your secret weapon for member engagement."**

Jo Waldron, Co-Head Diversified Private Debt, M&G Investments

## Contributing where it matters most

Carefully structured portfolios containing private assets could make a 'big contribution' to investment returns, sustainability, diversification and member engagement. They can position DC schemes to capitalise on the new industrial revolution that is focused on decarbonising the economy, which will create new opportunities and businesses. They will play an important role in enriching the lives of the UK's DC members in retirement and in supporting the enormous investment needed to create a better world.

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