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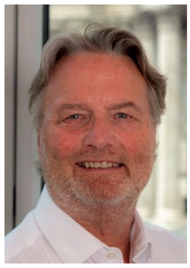
NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

LTAF Masterclass: Embracing Private Markets in DC Pensions

On the 28th of February 2024, Natixis IM and Carne Group held a masterclass on the new LTAF regime. Here are the highlights of this discussion.



Nick Groom
Head of UK DC Strategy & Sales
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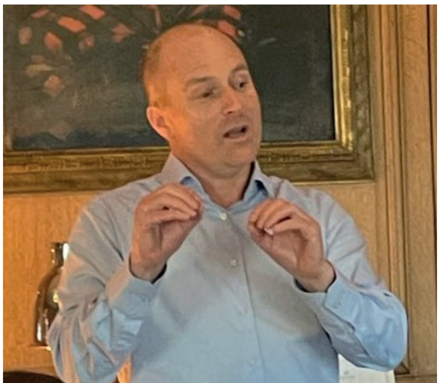
Key takeaways:

- Defined Contribution (DC) schemes are being encouraged to invest in private assets in the UK to deliver better, diversified, and stable returns for scheme members, in response to increased focus on value for money and economic improvement.
- There is growing interest in incorporating private markets into DC allocations, but significant barriers exist, such as liquidity, complexity, daily pricing, and cost.
- Long Term Asset Funds (LTAFs) are seen as one of the potential game-changers for bringing private assets into the DC market, addressing challenges such as liquidity management and regulatory compliance, although cost remains a major concern.

Will LTAFs deliver the step-change in private markets investing Government and Regulators are seeking?

Go back a few years and most Defined Contribution (DC) scheme defaults were invested in a passive equity and bond portfolio. The key drivers of this approach being simplicity and cost. But with the Government and regulators increasingly focusing on value for money, and with an eye on improving the economic fortunes of the UK, DC schemes are being strongly encouraged to think carefully about how they can invest in the UK whilst delivering better, diversified, and more stable returns for scheme members.



Hugh Cutler, Mobius Life - explaining the platform considerations

A key topic that has piqued much industry interest has been the integration of private markets or less liquid assets into DC schemes. We've worked to open up DC investing into private credit through our award winning MV Credit solution, but we know we'll need to go further to meet the challenge being posed by Government and regulators, opening up a wider range of less liquid asset classes into the DC universe.

With our friends at the Carne group – and alongside our speakers from Mobius (to give a platform perspective), the FCA (to give the regulator's viewpoint) and the Investment Association (the architects) - we wanted to understand what some of the key drivers and issues were and delve into whether new Long Term Asset Funds (LTAFs) will really enable more illiquidity in DC.

So, on the fringes of the PLSA annual investment conference in Edinburgh we ran an LTAF masterclass, bringing together across section of industry players - asset managers, consultants, administrators, platforms and regulators - to discuss the opportunities and barriers to expanding the investment horizons for DC schemes.

Ben van den Tol, Carne Group - helping us to navigate through the legislation

Embracing Private Markets in DC Pensions

The roundtable began with an acknowledgment of the growing interest in incorporating private markets into DC allocations. Look overseas, in Australia, where it is the norm for superfunds to allocate c.20% of their portfolios to private markets. The potential benefits, including diversification and improved returns, for UK DC schemes are substantial.

Attendees noted that we didn't have to go back too far where the perceived view was that there wasn't really a role for active management in DC schemes. But here we are on the cusp of automatic enrolment maturing (and AUM growing sizeably), and the regulators are certainly more neutral, indeed more positive, about the return and risk management characteristics that can potentially be offered by private markets.

Participants of our masterclass discussed the need to facilitate and enable good outcomes for those saving into a DC pension first and foremost. This is particularly important given the increasing individualisation of pensions and the shift from defined benefit (DB) to DC arrangements post the introduction of auto enrolment. Quite naturally (and rightly), what schemes are invested in is coming under increasing scrutiny. Specifically on private markets, these fit most naturally into default multi-asset funds, which realistically is the only place scale can be achieved, with allocations carefully managed by the providers or Trustees. Above all, when it comes to the overarching investment approach, the need for investments to work for people, the planet and society, whilst delivering good returns is key.

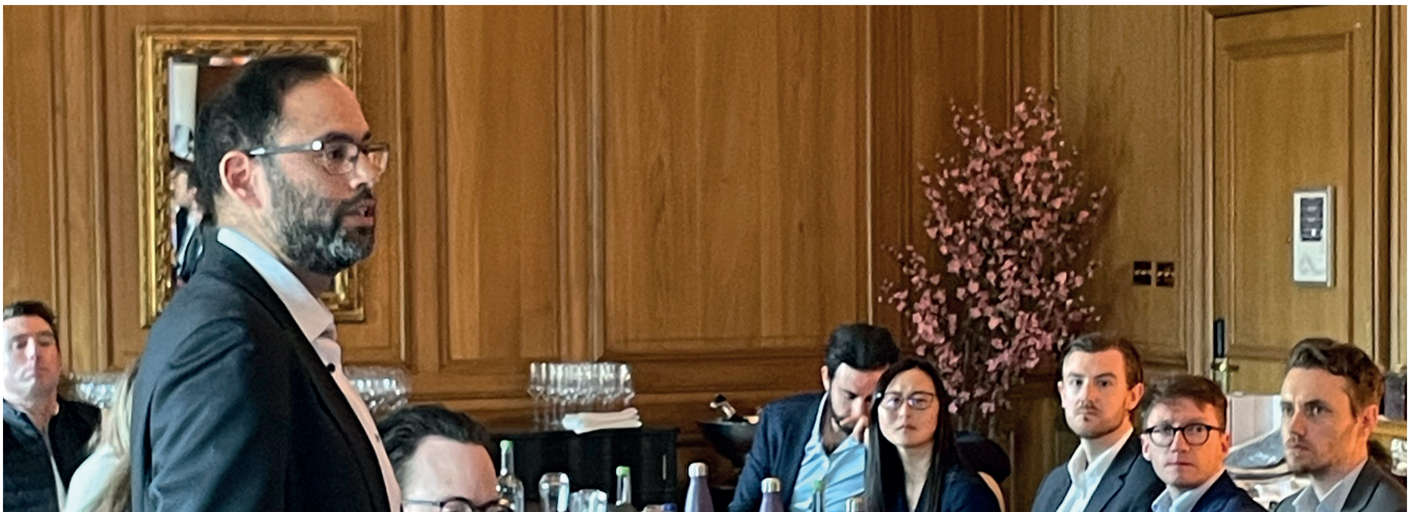
So why hasn't investment in less liquid assets taken off?

There was much discussion around the reasons why there were, sometimes, significant barriers to investing in private markets. There are well-documented problems around liquidity, complexity around managing such assets (including sourcing and managing underlying investments and due diligence), daily pricing, permitted links, the open or closed nature of funds, gating, accessibility through the investment platforms schemes use, and, of course, cost.

An important point that can quite often get lost in the conversation is that even if a scheme or fund can hold illiquid assets at a total level, individual members will be buying and selling units in the default fund every month (or indeed every day!). This means that frequent and fair pricing of the private assets is necessary even if dealing is not. And, as we know, past performance is no guarantee of future performance and that applies to illiquids as much as any other investment.

Key barriers to investing in illiquids

- Efforts have been taken to reform the permitted links regime to enable DC investment in illiquids following the recommendations of the Productive Finance Working Group. However, some industry practitioners continue to view them as complex and restrictive.
- Operational challenges exist as Illiquid assets can be more complex to manage and may require additional expertise, as valuations and liquidity pose challenges for trustees and administrators coming from a daily trading regime.
- Funds need to be evergreen, and have historically been closed ended vintage based, this represents a challenge for managers to build new structures and processes.
- Private markets need to fit into an extremely low competitive fee regime, and performance fees represent additional potential challenges, although now can be treated outside of the fee cap.



Imran Razvi, The IA – a view from one of the architects of the LTAF

Euan Ryan, The FCA - giving us the view from the regulator

The Long Term Asset Fund

The LTAF has been highlighted as a potential game-changer for bringing private assets into the DC market, as well as the wealth and retail sectors too. While there are other ways to access private markets in DC structures, LTAFs can offer a one stop shop for private market, illiquid investment that is optimised for the UK DC market environment, slotting nicely into the UK DC investment framework. LTAFs will allow investors to access a much wider range of illiquid assets, including investments such as: Private equity, private credit, venture capital, infrastructure, real estate, and forestry.

Before we look at some of the key advantages and features of an LTAF, we should remined ourselves that it is just a structure/wrapper that will only ever be as good as the underlying investments. This means everything within it needs to work in its own right, for example, from having the right structure, liquidity points, being evergreen in nature, and meeting an appropriate price point.

A key advantage of LTAFs is that it is an authorised vehicle. This gives schemes, especially smaller ones, comfort and reassurance whilst potentially reducing the due diligence efforts of investing in illiquids individually. The authorisation regime for LTAFs is robust and sets a high bar.

Furthermore, liquidity can be managed either inside or outside the LTAF so schemes can tailor their requirements depending on need (there was a view that managing liquidity in an LTAF was a costly way of doing so, so might not be appropriate for all schemes if it wasn't necessary).

An LTAF is also an open-ended vehicle that can issue an unlimited number of shares, although redemptions will be subject transactions at set intervals, including appropriate notice period depending on the illiquidity of the investment.

The other key advantage is that it is a permitted links compliant vehicle in its own right… cue lots of nodding from roundtable participants about the challenges presented by the permitted links rules for DC pensions.

One participant even went so far as to note that for schemes of a certain scale, the real (only?) advantage of the LTAF is navigating the permitted links rules, which was well worth doing in itself as that was the root cause of many problems.

Discussion turned to whether this raises a bigger and more fundamental question about the purpose and efficacy of the permitted links rules and whether they needed looking at? It was suggested by some that if they are there for the protection of members/ investors then bypassing them may have unintended consequences, so may call for further protections. It's worth remembering that the LTAF is an authorised fund with a number of additional protections in place. However, others went as far as to say, if the permitted links rules are no longer doing their job then could there be an argument for removing them and then institutional investors can have full control in how they invest? One for a further discussion!

LTAFs aren't the only game in town

While LTAFs are one way of opening up private market opportunities for DC pension schemes, participants discussed other mechanisms for accessing these types of investments outside of the LTAF structure.

The discussion focussed on LP structures and custody arrangements (rather than an investment only platform).

Unit-linked funds can also invest in other private assets as long as they meet the permitted links rules on a look-through basis. It was noted that some platforms can also blend the prices of assets that sit outside of unit-linked funds to create defaults including a wide range of assets if Trustees want to include assets that do not meet the permitted links rules.

The conversation also touched on the challenges of liquidity management in private markets investing and the potential for alternative structures like segregated mandates to offer more flexibility.

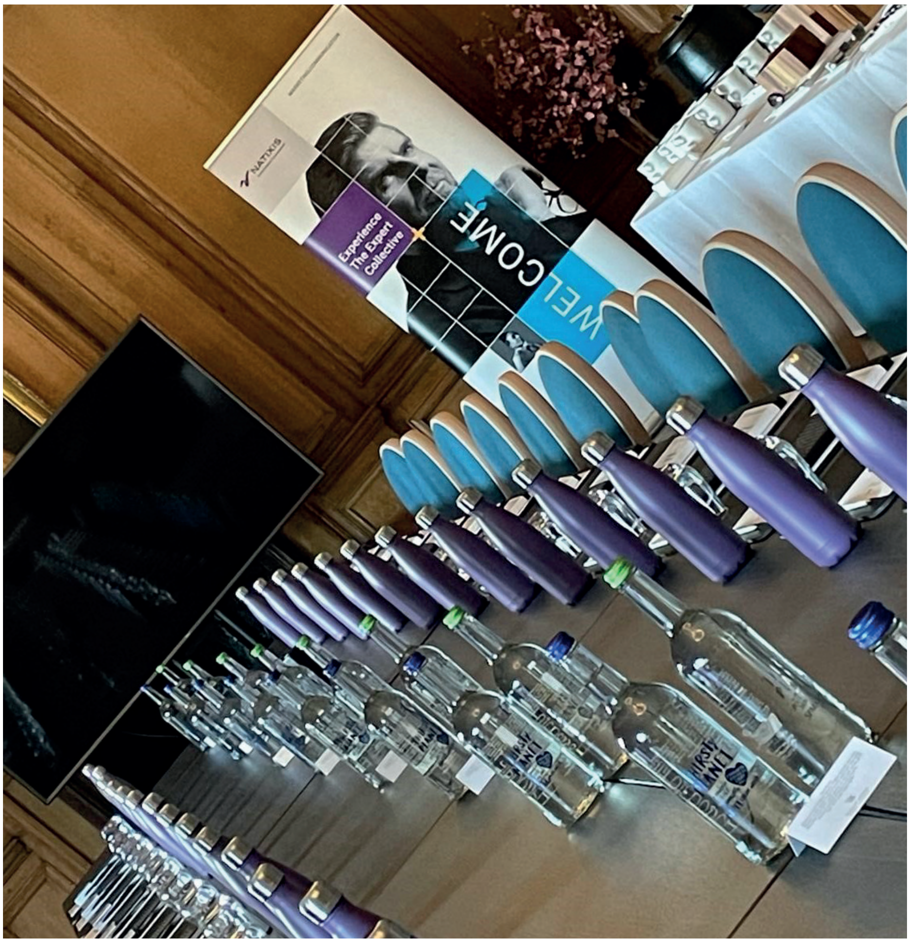
Discussants highlighted that some of the alternative solutions do not necessarily solve the challenges of having fair and frequent prices, appropriate liquidity and, of course, the fee constraints that DC schemes face. It was suggested that, ultimately, trustees might like the protections that life funds and LTAFs provide them and their members.

However, no matter how schemes look to access private markets, many of the challenges remain. And importantly the cost factor doesn't get any easier.

While attendees agreed that scale was important there was also recognition that certain types of private markets investments are massively oversubscribed, which means what you

High level of advantages of an LTAF

- Categorisation of the LTAF as a permitted link in its own right enables schemes via platforms to operate within a regulatory framework and allow them to invest in a wider range of assets, including illiquid alternative investments.
- Underlying funds can invest in the LTAF and gain all the benefits of passporting through Permitted Links Rules.
- Controls on liquidity dates accommodate the less liquid nature of the underlying assets by providing less frequent dealing points and therefore the chance of liquidity mismatch.
- Creates easier access and regulatory support for a wider range of investment opportunities including private equity, private debt, infrastructure, natural capital & real estate, which can offer attractive long-term returns & diversification benefits, as well as reduced price volatility.
- Government and FCA support to remove barriers where necessary and move the dial on allocations to private assets to benefit savers and also assist in growing the UK economy.



are buying into is quality of opportunity which will always come at a price.

Put another way, if funds that are charging two and twenty are oversubscribed, the further you stray away from this price point the more you potentially compromise on quality and hence performance, which could lead to a failure to even achieve the hurdle rate. As the saying goes, sometimes you need to be careful what you wish for!

Price is still seen as a problem

While an LTAF structure cuts through some of the operational and regulatory challenges, it doesn't solve one of the major problems of getting such asset classes into DC pensions, the perennial issue of price.

While it is fair to say views were mixed, the prevailing sense from the discussion was that DC schemes are still too focussed on price as a key driver of decision-making.

The history of cost-based pricing comes from the introduction of stakeholder and then automatic enrolment, with price caps introduced to make sure the DC landscape was suitable for everyone. As soon as the price cap was introduced there has been a race to the bottom on AMC, with many employers using cost as the key decision point when selecting a pension provider. This then filtered through the value and investment chain.

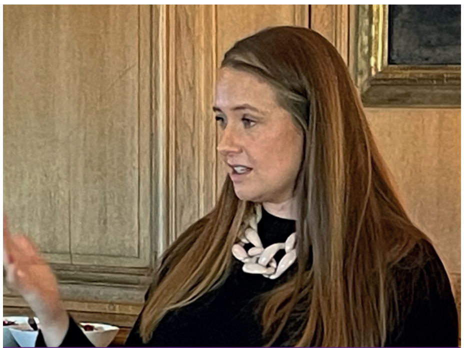
So, we are now in the realms of cultural and attitudinal change to break the idea that lowest cost is best - a key point of the VFM framework… It remains to be seen whether this new framework and increasing interest from, no less than, the Chancellor of the Exchequer will lead to a change in approach.

Looking Ahead

We finished the masterclass discussing potential trends and challenges, focussing on the future of the UK pension industry's regulatory landscape and the importance of bespoke asset allocation for DC schemes. A handful of new LTAFs have, so far, been authorised, and it was noted that there was a healthy pipeline of new LTAFs in the system. However, it's one thing getting an LTAF authorised, its another thing getting a scheme to invest in it!

The integration of private markets into DC allocations represents a significant shift in investment strategies and culture, offering the promise of diversified sources of return, but also presenting new challenges in terms of regulation, liquidity management, and infrastructure. As DC comes of age, so we begin on the next challenge of maturity, the bigger the assets, the bigger the potential risks and rewards.

A really interesting roundtable, debating one of the hot topics in UK pensions. The insights from the industry experts we had at the roundtable highlighted the opportunities and challenges of incorporating private markets in DC schemes, along with the potential for LTAFs to really make a difference, certainly through improving accessibility to more esoteric asset classes.



Francesca McSloy,
Natixis IM - on the case for private assets

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