May 2024

Illiquid Assets – DC Providers

Data is as at April 2024

The UK DC Master Trust default market and plans for inclusion of illiquid assets.

Following the launch of the Mansion House Compact in 2023, there has been increased murmurings from DC providers regarding their plans to incorporate illiquid assets into their default investment strategies. However, the degree of transparency in these plans vary, with few clearly setting out their plans beyond stating "it's in the pipeline".

In order to shed some light on this we have spoken to 12 major commercial Master Trusts on their plans for incorporating illiquid assets into their defaults. This sets out the latest position as at the end of April 2024. These MT's are listed on the back page. With subsequent news of elections over the coming months, any change in public policy may also impact providers plans.

Very simply, we define illiquid assets as those which cannot be bought or sold easily, i.e. non-listed assets including Private Equity, Private Debt, Property, Infrastructure, Natural Capital among other asset classes.

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How many defaults?

When considering the evolution of your default, please select the position from below which is closest to your considerations:

All providers are planning to include illiquid assets in some form within their default solutions.

Most providers are going down the two default route, with a "premium" and a "low cost" default. This reflects the fact that cost is still a dominant factor in provider selection.

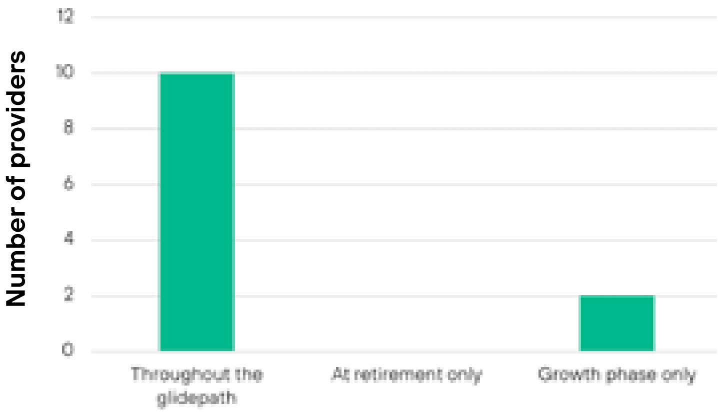
A smaller proportion are sticking to maintaining one default, with illiquid assets. This is arguably the bolder approach.

- 1 default solution, with no illiquid assets
- 1 default solution, with illiquid assets
- 2 default solutions; 1 lower cost, 1 higher cost (only higher cost holding illiquid assets)
- 2 default solutions; 1 lower cost, 1 higher cost (both holding illiquids)
- Other

Note: Other refers to three default offerings

Where in the glidepath?

In which stages of the default glidepath do you anticipate allocating to illiquid assets?



10 of the providers are considering allocations throughout the whole glidepath, with only 2 currently focussing solely on the growth phase (in the short term at least).

Most providers are keeping the same asset allocation within the illiquid portfolio throughout and just reducing the size of the allocation as a member approaches retirement.

More innovative providers are adjusting the underlying illiquid asset allocation dependent on the point on the glidepath.

Note: Those considering growth only at this stage may expand throughout glidepath over the long term.

What allocation size?

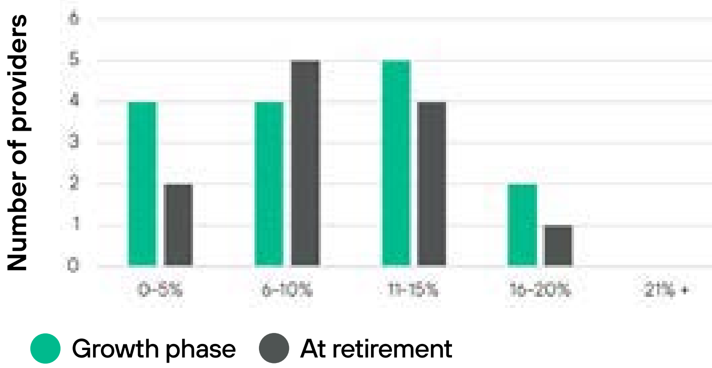
Planned % allocations within the overall default structure vary significantly, with some considering only modest allocations (0-5%) and some up to 20% in the growth phase.

The allocation size is heavily influenced by whether a provider is targeting one or two defaults.

Those adopting a two default "premium" and "low cost" approach are expected to be more aggressive around the illiquid allocation in their "premium" default.

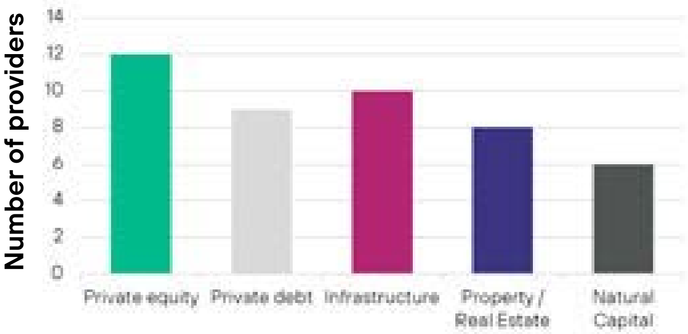
Note: May sum to more than 12 to account for multiple defaults.

What is your estimate of the proportion of the strategy you will allocate to illiquids?



What asset classes?

Which asset classes do you anticipate holding within the illiquids sleeve?



Nearly all providers are looking to build a diversified portfolio of illiquid assets as opposed to focusing on one area.

Private equity is the most popular choice for DC providers. However, allocation sizes in this asset class are likely to be small given fees.

In terms of size of allocations, we expect to see the largest allocations in real assets, in particular property and infrastructure.

Sustainable themes are also likely to have an increased focus with a number of providers considering stand-alone allocations to natural capital.

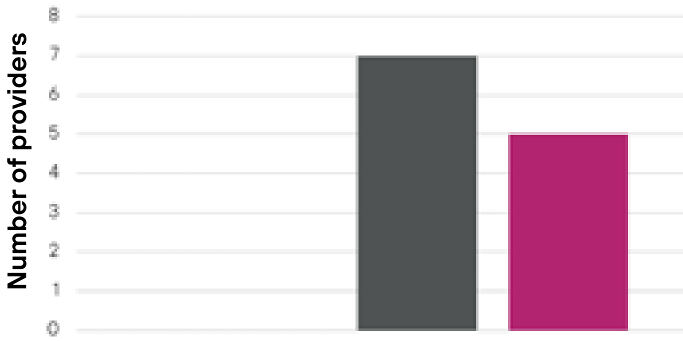
Internal or external management?

One concern in the market was that providers would over-estimate their own capabilities in managing a portfolio of illiquid assets in order to manage cost.

It is therefore pleasing to see that all providers are either using solely external managers or a mixture of internal and external.

From what we have seen the fund management community is incredibly keen to be part of the DC Master Trust universe and is offering incredibly attractive fees.

Do you anticipate using internal or external managers for this mandate?



Is LTAF the only option?

Which vehicle for illiquids do you view as most likely to implement the allocation?

In reading the pension press, you'd be forgiven for thinking that LTAFs were the only show in town to implement a DC illiquid allocation.

Providers however are looking at a range of different approaches not just LTAFs, with many providers considering blending co-investment or direct investment with the LTAF structure.

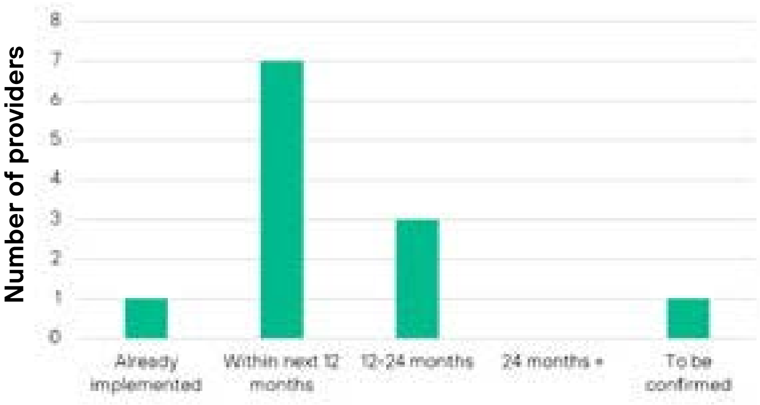
Over time as illiquid experience increases, we expect segregated custodial structures to challenge LTAFs.

- LTAF
- Co-investment
- Direct investment
- Blend of above
- Other

Note: LTAF - Long Term Asset Fund

How quickly will this come to market?

What are your current timescales for implementation?



Most providers are aiming to implement illiquid assets in strategies within the next 12 months. However a few are still to confirm timescales or looking at the following 12 months.

The market could view this in one of two ways - early adoption sets you apart and members benefit from illiquid holdings earlier, verses those that wait and may have more time for considered implementation and design.

Whichever route providers take, the next 12 months will be a significant turning point for DC default design.

Isio views on illiquid allocations

Asset Allocation

Adopting an illiquid allocation within a default if done appropriately should improve risk-adjusted returns net of fees and lead to better member outcomes.

Some providers are adopting a "premium" and "low cost" approach to overcome fee constraints given commercial pressures the MT market faces. We would much rather see fee barriers broken down and allocations to illiquid assets prioritised with best in-class investment managers.

We would like to see meaningful illiquid allocations (at least 15%) and providers to plan for the future (i.e. different allocations across the glidepath) in how they structure their illiquid allocation.

Portfolio Construction

Our preference is for a diversified portfolio of illiquid assets, and we hope providers are bold in how they incorporate Sustainable themes within this.

We believe an illiquid asset allocation should have a range of managers, it is incredibly difficult for one manager to be good across the whole range of illiquid assets.

LTAFs provide an easy way to access illiquid assets, but other options should not be ruled out. We expect to see other options grow over time as the market evolves. Our next paper in this series will consider the vehicles and asset mix used in more detail.

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Notes: Data includes responses from the following Master Trusts:

- Aegon,
- Aviva,
- Aon,
- Cushon,
- Fidelity,
- Legal and General,
- LifeSight,
- Mercer,
- Scottish Widows,
- SEI,
- Smart,
- Standard Life.

We note that providers plans are evolving at rapid pace, data contained within represents data collected as at April 2024.