Defined Contribution Investment Forum

Mind the Gap

The case for a relaxation of daily dealing requirements for DC Pension funds

DCIF.co.uk

May 2013

This is the fourth paper published by the Defined Contribution Investment Forum -DCIF

The purpose, belief, activities and membership of this group are described on the next page. Our occasional papers aim to promote investment excellence in Defined Contribution pension schemes by raising a wide range of new issues and by exploring a variety of existing topics in new ways. In each paper we aim to inform and encourage debate among those with an interest in this important part of the investment landscape.

In this case we have commissioned as authors the consultancy Spence Johnson to develop the idea of what barriers exist to good portfolio construction in DC, especially the ability to access illiquid investments.

The opinions expressed in this document are those of the report authors, and do not necessarily represent the views of individual DCIF members.

About the authors of this report

Spence Johnson provides research-based services to asset management and insurance firms. Spence Johnson clients use its research-based advice to help them identify and retain clients in five key sectors within their institutional investment businesses

SPENCE JOHNSON

Purpose

The Defined Contribution Investment Forum (DCIF) consists of investment firms and other selected industry participants and aims to exchange ideas and develop initiatives to promote investment excellence in Defined Contribution (DC) pensions in the UK.

Belief

DCIF believes that members in DC pension schemes deserve the best possible investment services to help them meet their retirement objectives. DCIF is particularly concerned to promote the widest variety of investment techniques and approaches in DC schemes. The participants in DCIF believe that at present there are many DC schemes which do not give this variety to their members. Unless DC schemes are encouraged to change the way they invest, many members will fail to meet their retirement objectives. This outcome can be avoided if action is taken now.

Activities

In order to promote investment excellence in DC pension schemes, DCIF will carry out a range of initiatives such as presenting the industry with papers, arranging seminars and debates, and in other ways acting to raise DC investment standards.

Members

AXA Investment Managers – redefining / investment solutions

Barings

Invesco Perpetual

J.P.Morgan Asset Management

Schroders

Standard Life Investments

threadneedle investments

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Foreword

The Defined Contribution investment forum (DCIF) believes that members in DC pension schemes deserve the best possible investment services to help them meet their retirement objectives.

We believe that at present there are many DC schemes which do not give members adequate or indeed any access to excellent investment services. Part of this problem is the lack of effective diversification through new asset classes. The opportunity for greater diversification is a potential enhancement to current best ideas and has the potential to both improve member outcomes and also to improve the member journey.

Unless DC schemes are encouraged to change the way they invest, many members will achieve outcomes which are inferior to what they could have otherwise achieved. This result can be avoided if action is taken now.

As part of this initiative the DCIF assembled a steering group of industry figures to inform a balanced view on the daily dealing requirements placed on DC schemes. The DCIF would like to thank the contributions of this steering group for their valuable input into this project.

Andrew Dickson, Standard Life Investments
Chairman, DCIF
May 2013

DCIF Steering Group Participants

Their comments are shown in blue boxes in this document

Emma Douglas
Mercer

Kevin Legrand
Buck Consultants

Andrea Lowe
LPEQ (Listed Private Equity Association)

Douglas Jones
Legal & General

Neil Morgan
Capita Trustees

Nicole Stout
JPMorgan Asset Management

Colin Tipping
Friends Life

Stephen Budge
KPMG

Andrew Dickson
Standard Life Investments (DCIF Chair)

Simon Chinnery
JPMorgan Asset Management (DCIF Vice Chair)

Magnus Spence
Spence Johnson

This report might not represent the views of the individual members of the steering committee

Mind the gap

The case for a relaxation of daily dealing requirements for DC Pension funds

Summary

This report is our contribution to the debate on how to improve member access to illiquid investment strategies in DC pensions. The DCIF is unanimous in its desire to see DC members having full access to the widest variety of investment techniques and approaches in DC schemes. It is however split on the best way for DC members to gain access to these investment approaches. This paper is an exploration of the issues of one possible approach; the relaxation of daily dealing requirements for DC pension schemes. It does not reflect the views of all of the DCIF members.

There is a gap in investment standards between Defined Contribution and Defined Benefit pensions

DC members are currently receiving inferior investment services compared to DB members through a more restricted access to asset classes which give effective diversification.

Daily dealing limits investment options for DC schemes

Certain investment strategies, notably those which require less liquidity, are currently out of the reach of DC schemes because of requirements around daily pricing and daily trading. This disadvantages DC members through denying them the benefits of diversification and the illiquidity premium.

Daily dealing is not a regulatory requirement

To enable DC members to benefit from access to the widest universe of investment strategies the daily dealing requirements currently in place for DC schemes must be relaxed. This is not without its challenges and the DCIF encourages the sharing of best practice and the championing of the cause by industry trade bodies like the NAPF and IMA.

Gap in investment excellence

DC members don't have access to the portfolio construction methods used in DB

New asset classes have been introduced in Defined Benefit (DB) pensions

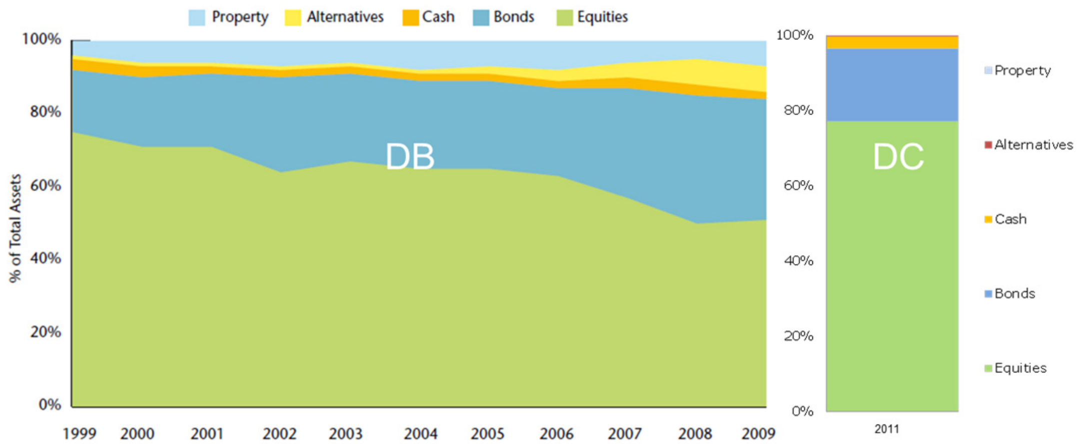
As UK DB schemes have struggled with the challenge of falling funding ratios they have reconsidered their investment approach and begun to make more use of a wider range of asset classes. This diversification can offer advantages in investment performance without needing to increase the risk budget. Some of the new asset classes being used by DB schemes are illustrated on the right.

Asset classes	
Public equity	
Short term bonds	
Real estate	NEW
Commodities	NEW
Direct private equity	NEW
Direct venture capital	NEW
Hedge Funds	NEW
Infrastructure	NEW
Long term bonds	NEW
Other real assets	NEW
Private Equity funds	NEW
Strategic Public Equity	NEW
Venture capital funds	NEW

DC schemes are less diversified than DB schemes

DC schemes have not witnessed the same move towards diversification that has been seen in DB. DC investment portfolios have a much smaller proportion of alternative investments, relying on a very high equity component for their investment returns. According to one estimate, equities represent nearly 80% of the assets in DC default funds.

DB and DC Asset Allocation
Weighted Average Asset Allocation for UK pension funds



Source: AON 2011 (DC368)

* DC analysis based on estimated asset allocation within default funds only

DC members don't currently have access to the same first rate portfolio construction methods as used in DB

At present there are many DC schemes which do not give members adequate or indeed any access to excellent investment services. Part of this problem is the lack of effective diversification through new asset classes. Unless DC schemes are encouraged to change the way they invest, many members will fail to meet their retirement objectives. This outcome can be avoided if action is taken now.

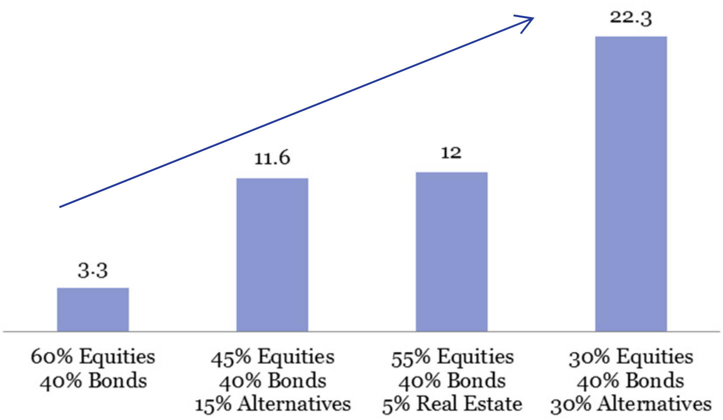
> *"What we need is a tool kit of options, including a range of illiquid assets, to work with so we can create the sort of balanced portfolios that we have in DB. It will take some time to get us this tool kit, and this is a shame for current DC scheme members who are missing out"*
> **Investment consultant**

Impact on outcomes

DC members may benefit by as much as 5% in additional pension if they diversified

Core vs. Alternative Portfolios

Return per unit of Conditional Value at Risk (CVaR)



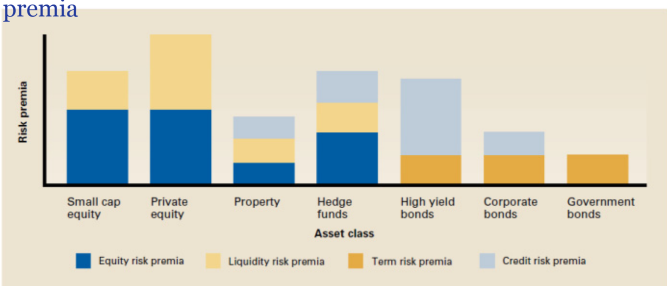
Source: DCIF5

Diversification through illiquid investments increases the return available per unit of risk

By holding asset classes that are less correlated to market returns investors can generate the same return as a portfolio of just stocks and bonds though a diversified portfolio with less risk.

Illiquidity Premia

Illustrative relationship between asset classes and risk premia



Source: Schroders, Oliver Wyman analysis

Source: DCIF18

Illiquid asset classes may also pay an illiquidity premium to investors

Less liquid asset classes should compensate investors for reduced flexibility to buy and sell assets at will through increased investment returns. The graphic to the left illustrates the existence of liquidity risk premia in a number of asset classes, including property, hedge funds and private equity.

"We target 3-5% in excess of listed markets after all fees, that is the liquidity premium as we see it."
Private Equity Fund Manager

Lessons from Australia

Australian diversified Not for Profit DC Pension Funds vs. Traditional "Retail" DC Pension funds

"Not for profit funds outperform retail funds on a risk-adjusted basis by an average of 144 basis points per annum. The regression results imply that around one-quarter of this performance difference can be attributed to the greater positive impact of illiquid investments on the net returns of not-for-profit funds compared to retail funds"

Australian Prudential Regulation Authority
Source: DCIF10

35bp of DC performance could gained from illiquid investments, producing 5% larger pension pots

Towers Watson have estimated that over a 40 year time horizon, DC members may benefit as much as 5% additional pension if they benefitted from a diversified portfolio which included illiquid assets. This is supported from evidence from Australia.

Current approaches in DC

DC access to new asset classes is mostly limited to listed vehicles which suffer some drawbacks

DC members may invest in funds which use listed vehicles to access real estate and private equity

Listed vehicles exist which offer daily trading and allow access to a broader asset class universe. These funds are used in multi-asset funds used by some DC investors. These include Diversified Growth Funds and Absolute Return funds. These listed vehicles can however suffer from a number of drawbacks which make them less desirable than the direct equivalents used by defined benefit schemes.

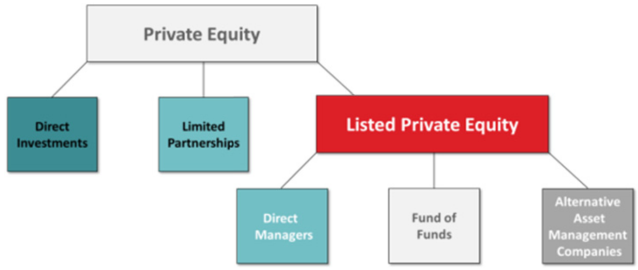
Cash buffers can be a drag on listed funds of up to 100bp

In order to offer daily liquidity, listed Real Estate vehicles must include a significant cash buffer, and this acts as a drag on performance. As is shown here, the amount of cash held can drag performance by over 100 basis points.

Listed vehicles also tend to exhibit greater volatility

In the long run Public (i.e. listed) and Private (i.e. unlisted) vehicles are driven by the same Real Estate cycle, but Private RE is much less volatile in the short term. Quoted Real Estate (REIT) will tend to be significantly more volatile than unquoted direct Real Estate funds. Optimal Real Estate returns, it is now recognised, are achieved by investing both domestically and abroad as is shown in this chart. Direct Foreign Real Estate investment is invariably illiquid.

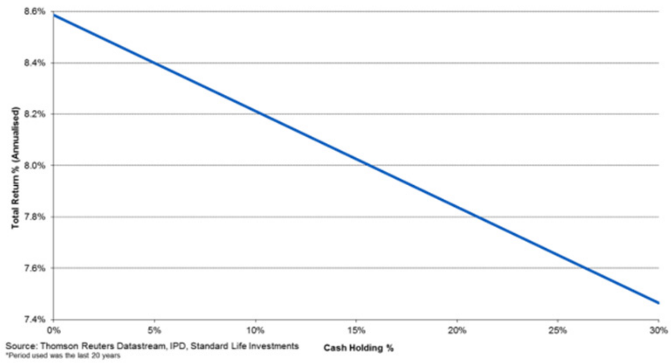
Listed Private Equity



Source: DCIF30

Impact of cash buffer

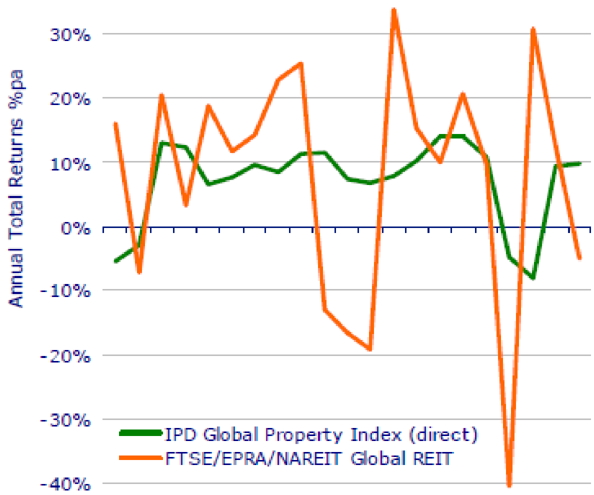
Cash impact on Real Estate Total Returns



Source: DCIF45

Volatility of listed REIT

Direct property vs. Listed Real Estate



Source: DCIF42

Regulation

There is no regulatory requirement for daily dealing but other obstacles still persist for UCITS funds

Asset classes		
Public equity		
Short term bonds		
Real estate	NEW	limits on direct investment
Commodities	NEW	limits on direct investment
Direct private equity	NEW	
Direct venture capital	NEW	
Hedge Funds	NEW	limits on direct investment
Infrastructure	NEW	
Long term bonds	NEW	
Other real assets	NEW	
Private Equity funds	NEW	
Strategic Public Equity	NEW	
Venture capital funds	NEW	

UCITS limits direct investment in:

Gold
Commodities
Property
Hedge Funds

Daily dealing is not a regulatory requirement

There is no regulatory requirement in place that dictates DC funds must have daily dealing. Daily dealing is instead a result of the evolution of the DC market and the operational systems put in place on platforms that host the bulk of DC funds.

There are still regulatory obstacles in place limiting access to illiquid investment asset classes

For funds which need to be UCITS compliant there are a number of restrictions which limits the ability of investment managers to access certain asset classes. Restrictions are in place around direct investment into gold, commodities, property and hedge funds.

> *"Long-term investments share one common feature: a low level of liquidity.....This is why access to this type of investments is normally reserved for institutional investors only...*
> *Long-term investment funds open to retail investors may be an effective enhancement to the internal market. They could create new opportunities for deepening the European asset management industry and its contribution to growth, while offering new investment opportunities for investors."*
>
> **UCITS VI Public Consultation document**
>
> Source: DCIF16

Regulators are beginning to recognise the advantages of allowing retail investors to access long term investments.

The language used in the UCITS IV public consultation document released in 2012 indicated that the regulator is investigating the benefits available from broadening the access of retail investors to longer term investments.

Steering group findings

Illiquid investments could have a place in DC in the future

The Steering group comments indicate there is a changing attitude to DC pensions.

Initially DC pensions were designed as a flexible savings vehicle where members could move money in and out of their different investment vehicles on a regular basis. This hasn't been the reality and there is now an increasing focus on improving long term default options for DC members. Steering group comments indicate that trustees could be persuaded to sacrifice some liquidity if they were repaid in better outcomes for their members.

"Trustees expect that some liquidity should be in place but no specific requirements are stressed and they could be open to less liquid assets if the value was proven"

"Attitudes to DC are changing. DC is not a savings scheme, it is preparation for an income stream. We should be anticipating the long term needs of DC members, and so we should be using a DB mind-set in DC. Illiquid investments may help towards this goal."

"Property was the first of the alternative asset classes to be taken up by DB schemes, so it may be sensible to assume that this will also be the case in DC."

A focus on fees rather than value could act as a barrier to DC schemes getting access to the benefits of diversification

The Steering group accepted that it would take some time for illiquid investments to find a place in DC and that their cost could be off-putting for DC members.

"A small allocation to illiquid funds may be possible. But the challenge that exist for those who want to see more is that they must do this in a product which is made available at 20-30 basis points, because in general we are looking at a world where members pay 50 basis points all in for all administration and investment."

Steering group findings

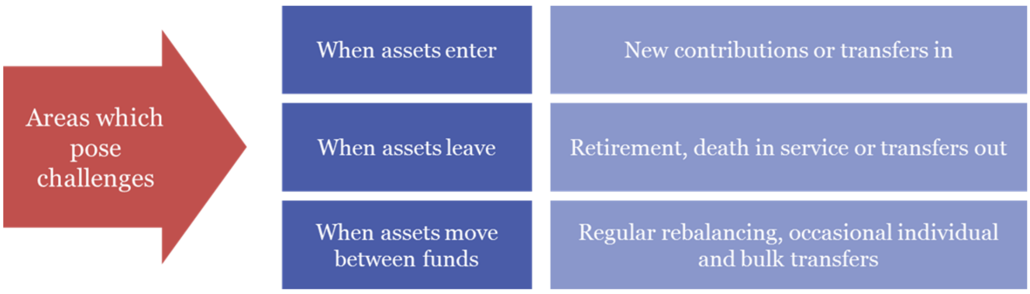
Operational challenges to changing liquidity requirements exist

"No one doubts the investment argument, but you must recognise the operational problem....it would require us to make expensive changes to our systems."

There will be operational challenges to managing DC funds without daily dealing,

The Steering group were clear that illiquid investments pose difficult challenges for platforms and that there will be costs involved in making the changes to systems.

Operational challenges
Areas of difficult for platforms



"Under solvency II we have to allocate capital against funds we carry on our platforms – more for risky illiquid funds - and this makes it difficult for us to justify using such products."

Offering illiquid investments will cause platforms to bear more liquidity risk

This will become more burdensome under Solvency II when capital requirements are more tightly contingent on risk.

"As a platform we have a responsibility for the funds we carry, and the DC saver ('policy holder') is deemed to be our responsibility. The issue is not whether illiquid assets offer a challenge to daily pricing. The issue is: will illiquid funds blow up in our faces? If a fund goes wrong, we run an execution risk, and we will be blamed."

Steering group findings

The investment case for illiquid investments needs to be better communicated

The Steering group revealed that the case for illiquid investments is not clear to all industry participants.

Although some Steering group members were convinced by the investment case for illiquid investments, others need more proof.

"The investment case for illiquid assets is not proven, and they are expensive. We need more proof. We have to choose a cost effective solution for our members, and there are cheaper and more liquid ways of getting access to these asset classes: for example accessing infrastructure via ETFs held in quoted companies that have an infrastructure story."

"No one disagrees with the need for better and stronger diversification for DC. But we need to take little steps towards this, bit by bit. First of all we should get as many ideas as possible within a default fund structure."

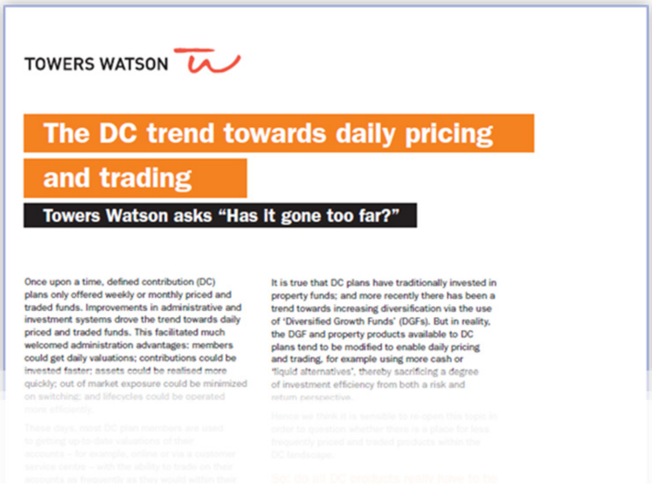
Concerns about the measurement of investment returns in the new asset classes were also revealed.

Evidence for the investment case might therefore need to be supported by more third party research. The DCIF hopes that the list of sources at the end of this report will aid any other researchers looking to build more evidence of the benefits of diversification into new asset classes.

"We don't really believe the measurements that are used by alternative asset managers. HFR is not a proxy for hedge fund performance for example, it is not accurate."

The future

Influential consultants are beginning to support discussion of change



TOWERS WATSON

The DC trend towards daily pricing and trading

Towers Watson asks "Has it gone too far?"

Once upon a time, defined contribution (DC) plans only offered weekly or monthly priced and traded funds. Improvements in administrative and investment systems drove the trend towards daily priced and traded funds. This facilitated much welcomed administration advantages: members could get daily valuations; contributions could be invested faster; assets could be realised more quickly; out of market exposure could be minimized on switching; and lifecycles could be operated more efficiently.

It is true that DC plans have traditionally invested in property funds; and more recently there has been a trend towards increasing diversification via the use of 'Diversified Growth Funds' (DGFs). But in reality, the DGF and property products available to DC plans tend to be modified to enable daily pricing and trading, for example using more cash or 'liquid alternatives', thereby sacrificing a degree of investment efficiency from both a risk and return perspective.

Source: DCIF48

Despite the challenges to change, millions of savers moving into DC would benefit from any changes.

Towers Watson has recently released a paper on the trend towards daily pricing and trading in DC.

> "Not having daily trading can cause some administrative issues…this would need to be thought about carefully when constructing solutions which incorporate investment products that cannot be daily traded…none of which we believe is insurmountable"
>
> **Towers Watson report**

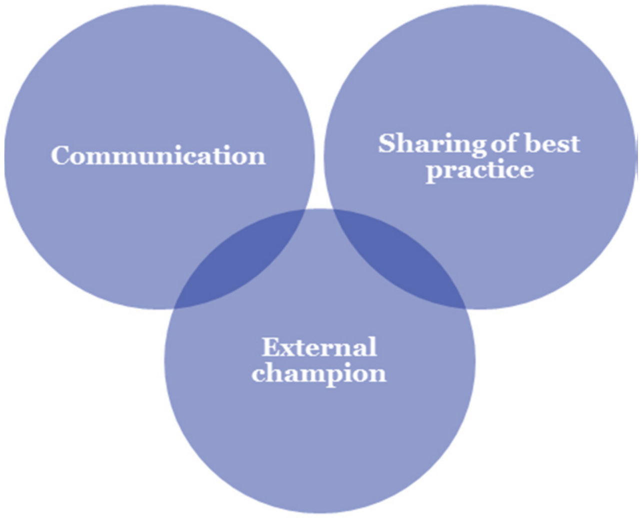
NEST have already committed to accessing Real Estate and are investigating Infrastructure

Mark Fawcett, Chief Investment Officer of NEST, revealed at the 2013 NAPF Investment conference that NEST have committed to allocating to direct real estate and that they're currently investigating the best possible way to access infrastructure.

Conclusion

The DCIF propose three steps that need to be taken to advance this discussion

The opportunity for greater diversification is a potential enhancement to current best ideas and has the potential to both improve member outcomes and member journeys. The DCIF proposes three steps that need to be taken to advance this discussion:



1. Communication of the value of illiquid investments

There is appetite for change amongst consultants, and trustees will be open to new arrangements with lower liquidity if the value to their members can be demonstrated. The reactions of the steering group show that there remains work to be done communicating this value to key influencers, especially in regard to performance net of fees. Communicating the value of illiquid investments to trustees is therefore critical.

2. Sharing of Best Practice

There are obstacles to relaxing the daily trading requirements. If they are to be overcome then best practice needs to be shared. Details of successful examples incorporating less liquidity onto DC platforms must therefore be circulated amongst the industry.

3. Change must be championed by trade bodies and the regulator

Trade bodies for schemes (NAPF) and asset managers alike (IMA) must work with the FSA to overcome the challenges facing platforms when it comes facilitating access to illiquid investment strategies.

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