Alternative, and essential: The case for private market allocations in UK Defined Contribution (DC) plans

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In brief

- The evolving global landscape is posing significant challenges to the traditional 60/40 portfolio, making it increasingly difficult for DC investors to achieve the best possible outcomes for members if allocating solely to public markets.
- Alternatives offer diversified income streams, inflation protection, and enhanced returns through opportunities not available in public markets. Previously constrained by regulation and cost, trustees now benefit from a more supportive environment for accessing illiquid and alternative investments.
- DC members have historically missed out on investment opportunities available to their DB counterparts. The industry-led Productive Finance Working Group (PFWG) is working to ensure that DC schemes have access to a wide range of investment opportunities to help members reach their retirement savings goals.
- There remain a number of challenges which DC investors will face when allocating towards private markets, including increased cost, liquidity constraints and how to appropriately educate trustees and members on these new asset classes.

Alternatives are essential for a changing world

The world is evolving in ways that challenge the risk-adjusted returns investors might achieve by allocating solely to public market assets. We identify three key changes that require alternative asset solutions: Higher and more volatile inflation, the changing structure of capital markets, and the market's ambitious environmental, social, and governance (ESG) goals.

Alternatives can provide broader diversification and protection from inflation

Inflation is expected to be higher and more volatile over the next decade, posing a risk to DC pension scheme members by eroding their retirement savings. The Pensions and Lifetime Savings Association (PLSA) reports that the cost of a moderate retirement living standard has risen to £23,300 per year for a single person and £34,000 per year for a couple.[1]

Since stocks and bonds often underperform during periods of unanticipated inflation, DC investors should explore a diversified strategy that not only includes built-in inflation protection but also taps into asset classes with the potential for higher absolute returns. Real assets such as real estate, infrastructure, transport, and timber offer protection from

[1] Source: Pensions and Lifetime Savings Association (PLSA). "Retirement Living Standards." Retirement Living Standards, January 2024, https://www.retirementlivingstandards.org.uk/.

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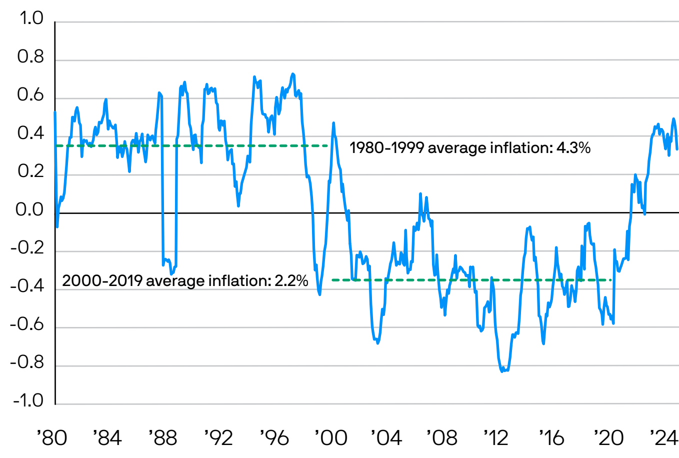
inflation, while private equity investments present opportunities for higher absolute returns and the potential to capture illiquidity premiums. By combining these attributes, private markets can play a pivotal role in helping preserve the value of retirement savings. This approach ensures that retirement portfolios are better insulated against the erosive effects of inflation, thereby enhancing the prospects for achieving long-term financial goals.

Exhibit 1: Stock-bond correlation during different inflation environments

Rolling 1-year correlation based on weekly returns; % change year on year



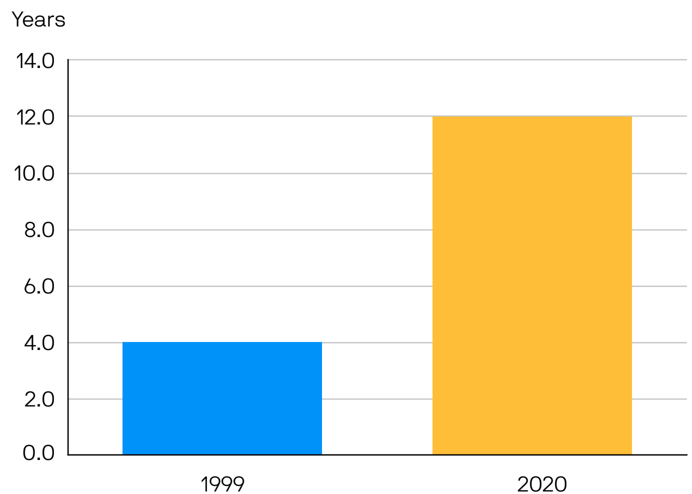
Source: BLS, LSEG Datastream, S&P Global, J.P. Morgan Asset Management. The stock-bond correlation is calculated using the S&P 500 Index and the US 10-year Treasury. Inflation is measured by the US headline CPI. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - UK*. Data as of 1 October 2024.

Alternatives can help portfolios adapt to changing capital markets

In addition to the challenges presented by a more volatile macroeconomic environment, the structure of capital markets is also evolving. More companies are choosing to remain private for longer periods or are entering public markets at a more mature stage. As a result, investors who focus solely on public markets risk missing out on early-stage returns that were once available in the small cap equity space. For example, many exciting developments, particularly in AI and healthcare, are now occurring in private markets.

Exhibit 2: Median age of companies at IPO

Years



Source: Initial Public Offerings: Updated Statistics, Jay R. Ritter (June 2021), J.P. Morgan Asset Management. Data as of 30 September 2024.

Alternatives support broader ESG goals

Private markets can also play a pivotal role in supporting DC schemes' ESG goals. For example, investments in markets such as renewable infrastructure and forestry, enable direct capital allocation toward projects with positive environmental and social impacts. By focusing on private equity or venture capital funds that prioritise sustainable business models or innovative technologies, DC schemes can support the transition to a low-carbon economy. Additionally, private market investments often provide more granular control over governance practices, fostering alignment with broader ESG objectives. This targeted approach not only enhances portfolio diversification but also reinforces long-term sustainability, which is increasingly becoming a key consideration for scheme members.

Which alternative investments are suitable for DC clients?

Alternative investments cover a broad spectrum of assets, from real estate and timber to private equity and hedge funds, each with its own characteristics and risks. Given this diversity, schemes should first identify the portfolio challenge they're trying to address, and then allocate to the alternative asset class best suited to providing a solution. Broadly, alternatives can be characterised as either return-enhancing or return-diversifying:

Return-enhancing

These alternative investments aim to increase the overall returns of a portfolio. Examples include private equity and distressed credit, which can offer higher returns compared to traditional asset classes.

Return-diversifying

These alternative investments reduce portfolio risk by having low correlations to traditional asset classes like stocks and bonds. Examples include core real assets, such as real estate and infrastructure, core private credit, and hedge funds.

By focusing on the desired outcomes, schemes can better tailor their alternative investment strategies to meet specific portfolio challenges and objectives. This will also allow for alternatives to be appropriately included in different parts of a member journey from accumulation all the way through to decumulation.

Alternatives as sources of diversification, income, and appreciation

Alternatives category	Equity diversification	Income-driven returns	Appreciation-driven returns
Core private credit	◕	●	○
Core real assets	●	◕	◔
Low vol. Core equity	○	◕	◔
Subordinated credit	◔	◑	◑
Hedge funds	◕	◔	◕
Non-core real assets	◑	◔	◕
Distressed credit	○	◔	◕
Private equity	○	○	●

● High ◑ Medium ○ Low

Source: J.P. Morgan Asset Management. Equity diversification score is based on long-term public equity beta; income-driven returns are based on the component of total returns derived from contracted income; appreciation-driven returns are based on the component of total returns attributable to increases in valuation over time. All scores are in the context of the alternatives shown in the table.

What are the risks and challenges of private market investments?

1. Including a private markets allocation will very likely increase the cost of manufacture for a portfolio. In a cost-focused market, this may be difficult to justify, but this must be balanced with how private markets may offer better value over time – which should ultimately be defined by end-member outcomes. To deal with this, DC plans must consider how to communicate these benefits effectively and how to appropriately utilise performance fees, something common in private markets and can now be considered outside of the charge cap, as well as different investment formats such as co-investments.

2. Private markets investments are also inherently illiquid. In many ways, DC with its long-term time horizon, should not find this an issue but it does require adjustments by managers, trustees and service providers. For example, there will likely be flow through impacts on portfolio construction (how often can you rebalance?), operations, platform mechanics and governance. For example, the best investment solutions will fail if the chosen platform provider cannot accommodate, and private markets may have a different cadence of information flow, which could impact governance practices.

3. The importance of education cannot be underestimated. Public markets are a well-trodden path for trustees and members alike. Educating on the why, how and implications of alternatives is not easy. Working with managers well equipped to assist with the education and activation process can be key for speed to market and long-term success.

What does a private markets allocation look like?

A typical growth phase DC scheme features a portfolio, shown below, that is primarily equity-oriented, with smaller allocations to fixed income and UK real estate. An allocation to private markets will depend on the scheme's target outcomes, as previously discussed regarding the role of different alternative asset classes. One of the key considerations for DC schemes currently is to meet the requirements set out by the UK Mansion House Commitments, which, among other things, mandate at least a 5% allocation to unlisted equities.[2]

To achieve this, a DC plan may aim to allocate 10% or more to private markets, with half of that investment directed towards private equity. The remainder of the private markets portfolio can offer broader diversification across assets such as infrastructure, timberland, hedge funds and private credit. These assets contribute to diversification, resiliency, inflation mitigation and sustainable exposures within the portfolio.

Typical DC Asset Allocation	%
Global Equity	81%
UK Large Cap	7%
UK Gilts	2%
UK Inflation-Linked Bonds	1%
UK IG Corporate Bonds	6%
UK Core Real Estate	3%
Cash	1%

Illustrative Private Markets Allocation	%
Private Equity	50%
Infrastructure Equity	15%
Global Timber	10%
Diversified Hedge Funds	5%
UK Core Real Estate	5%
Direct Lending	10%
Global Special Situations	5%

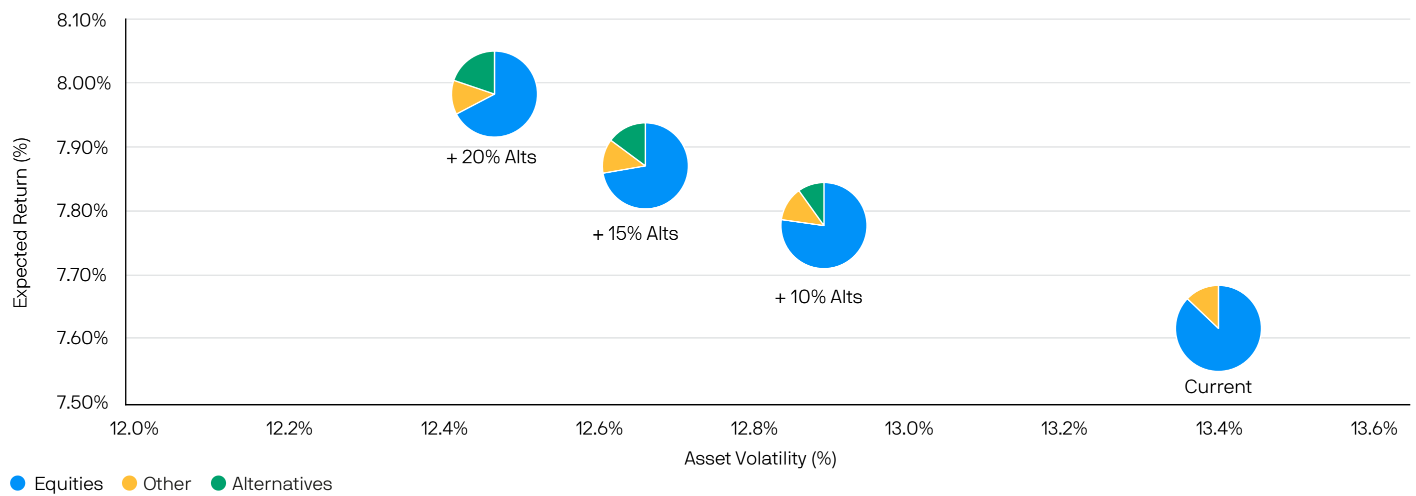
[2] *The definition of unlisted equities can be broad, including not just private companies but also equity position in infrastructure, real estate and other assets. For the purposes of this analysis we have only considered private equity as contributing towards this Mansion House commitment.

What are the outcomes?

Based on our 2025 Long-Term Capital Market Assumptions, an allocation to private markets can increase expected returns and reduce volatility as shown below. As master trusts already have equity dominated allocations, the benefits to target return may be more modest than some may expect. Nevertheless, at a 10%, 15% and 20% allocation, the private markets portfolio highlighted above can increase expected return by +0.18%, +0.27% and +0.36% respectively when funded from equities. At the same time, expected volatility would be expected to decrease by 3%-7%.

Importantly, this analysis is based on median manager returns. In the private markets space, manager dispersion can be extreme and therefore manager selection is key to both managing risk and to achieving target outcomes. For example, historically, the difference in return between median and top-quartile managers in mid-market PE (USD 1bn-USD 5bn) has been around 10%[3]. If a DC plan is able to capture this, at a 5% allocation, this could lead to an additional 50 basis points of expected return above those predicted.

Exhibit 3: Impact of Private Markets Allocation on Expected Returns



Source: J.P. Morgan Asset Management. Long Term Capital Market Assumptions. As of October 2024.

[3] Source: Burgiss Private iQ, J.P. Morgan Asset Management; data as of December 31, 2022. * Includes buyout and expansion capital funds. Represents vintages from 2006 to 2022.

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