Spotlight on Pensions

PRESENTS

Le Grand View

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The illiquid assets conundrum

Defined contribution is currently the main basis for active private pension provision and is likely to remain so for the foreseeable future.

Boosted by automatic enrolment, the aggregate funds held in DC pensions are already large and will continue growing at a significant rate. This is so even without the overdue and sorely-needed increases to the contributions and qualifying conditions necessary to achieve pot sizes that will give a fighting chance for individual members to achieve an adequate retirement income.

Savings need to be invested effectively. Apart from the basic principle that members will naturally want a good return on their investments, the issue is given added importance by the small size of individual members' pots available for investment. Those charged with arranging investment are obliged to ensure that no sensible options are overlooked.

Getting the "best" return for each member

We all know that investment is a complex subject. The key risk versus return conundrum can challenge even the most expert professional. The challenges become overwhelming for lay individual members, who are expected under the DC system to make their own decisions on this (and other) complex technical subjects. This inherent weakness in the DC system continually prompts head-scratching as to how to help members cope.

The default investment fund system allows members to contract-out their investment decision-making to the trustees or managers of a pooled fund. Although it cannot provide individual member-specific focus, it does provide a pragmatic solution that can be expected to deliver generally acceptable risk-balanced outcomes. Given the detrimental impact on individual members' funds of this compromise option, it is even more important that returns from the default fund are as strong as possible.

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The risk/return balance

The quest for higher returns moves the risk/return balance further towards the "risk" end of the scale. However, trustees and managers of pension schemes have been facing increasing criticism in recent years that their understandable desire not to expose member funds to "excessive" risk results in their avoiding some investment types that could enhance returns. The "lost" return in itself constitutes an increase in the risk of poor outcomes for members.

Much of the focus of this criticism has been around "illiquid" investments. Critics point out that schemes rarely use these in their default funds in particular, and that by avoiding them as an investment class they are unnecessarily cutting members off from an important source of returns. It is suggested that in many cases trustees recognise the increased risk that illiquid investments can carry and are unable or unwilling to find the time and effort required properly to assess these higher risks: It feels safer to stick with investment classes with which they are more familiar.

Government interest

This criticism of trustees is shared by the Government. However, although recognising the necessity for strong investment returns on modest member savings, it is also attracted by the potential for investment of large amounts of pension monies to support the "build back better" agenda. Many of the investment needs under this heading would involve illiquid investments.

Previous Governments have looked enviously at the funds under the control of the pensions sector with suggestions to encourage investment to support particular favoured projects. However, such suggestions have generally come to nought, having been overridden by the duties of trustees to put members' interests first. Recent legal cases have softened the strictest legal interpretations of that duty formerly applied by trustees, but the core principle (rightly) remains intact.

New proposals

A recent consultation exercise conducted by the DSS seeks to generate support for new measures to pressure trustees to incorporate illiquid investments into their portfolios. Whether the motive behind this is to support a political agenda or (as the consultation document maintains) to improve members' investment returns, there is certainly a valid case for schemes to consider and, where appropriate, embrace illiquids. However, that must be a decision for each scheme following due consideration of the membership's circumstances, and not something dictated by generic external doctrine.

The consultation document, "Facilitating investment in illiquid assets" contains a number of proposals to drive schemes towards becoming significant investors in illiquids. There are proposals to remove what are seen as current potential blockages to investment, such as the inclusion of performance-based fees – which are often higher for illiquid funds - within the charge cap on default funds.

Whilst the consultation document's proposals would not directly require trustees to embrace illiquids, they do ramp up pressure to actively consider them and to demonstrate that consideration has occurred. Key proposals would impose new disclosure obligations on schemes, ostensibly to encourage members to influence trustees, and where possible to encourage members to select funds that contain illiquids. If one accepts the premise that trustees should be pressed, then a strong disclosure regime may be a useful tool.

However, in the Real World where trustees are already faced with a heavy and rapidly-increasing workload, any new legal obligations must constitute an effective use of scarce resources relative to the likely gain in benefit for members. If trustees are so tied up in satisfying bureaucratic requirements that other important member issues become compromised due to lack of time to deal with them effectively, then the wrong balance has been struck. So, do the flagship "disclose and explain" proposals in the consultation document strike the right balance?

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Disclosure proposal #1: amendments to the statement of investment principles

The consultation document acknowledges that there is already the opportunity for schemes to disclose their policies on illiquid investment in their Statement of Investment Principles (SIP), especially if they already disclose their liquidity risk management policies. Despite this it proposes to require new disclosure of a specific illiquid assets policy statement in the SIP.

The proposal starts by striking a balanced note. It says "We do not want trustees to have to spend significant resources or time forming their 'house view' of the issues that keep illiquid asset allocation low within DC pensions. Similarly, it is not our intention for trustees to have an esoteric discussion amongst themselves, and with members, about the relative merits of, for example, closed-ended and open-ended fund structures or liquidity management governance."

So far so good. However, it then goes on to list the matters which it wants to see in the statement, which it envisages as being one to three paragraphs long:

- what illiquid assets are
- whether trustees choose to invest in illiquid assets
- which members will be holding illiquid assets (does the scheme lifestyle members in and out of illiquid assets and at roughly what age?)
- a description of these allocations, including whether the investment is direct or indirect and under which asset classes the investments fall
- why trustees decided to make an allocation to illiquid assets (this should include their assessment of the benefits to members of such an allocation)
- If trustees do not decide to make an allocation to illiquid assets, why
- what factors they consider when deciding whether to invest in these assets
- any current barriers to investment in illiquid assets
- any future plans for investment in illiquid assets.

Producing a statement of this length and detail would not be a minor undertaking. The work required to ensure that the full breadth of the potential illiquid investments class is identified and considered in order to distil into a statement is considerable. A major challenge here will be to produce an appropriate definition for illiquids for this purpose, and to then identify which assets fall within it. It is also unlikely that all this will be capable of distillation into the envisaged number of paragraphs.

Disclosure proposal #2: asset allocation disclosure

This proposal would require DC schemes with over £100million assets under management, and which are required to produce a chair's statement, to disclose the percentage of assets allocated in the default to each of the following seven main asset classes in their annual chair's statement: cash; bonds; listed equities; private equity (including venture capital and growth equity); property; infrastructure; and private debt.

"Just" wasted effort – or worse?

The potential overall benefit from these proposals when balanced against the work involved is questionable. Members are unlikely to read and understand this disclosure and so it will not drive greater member influence of trustees. Furthermore, placing so great an emphasis upon illiquids risks conferring upon them a disproportionate level of importance. Consequently, members and others who do read the disclosures may be led into making decisions based upon misleading impressions.

Proper focus

Trustees' precious time and limited scheme resources (in a DC scheme, usually provided from members' own retirement savings) need to be carefully targeted. It is difficult to see that the work required to satisfy the proposed "disclose and explain" requirements both initially and on an ongoing basis will produce a significant enough benefit for members to justify the effort.

There is no doubt that further work is needed to improve member outcomes under DC pension schemes. That further work certainly includes making improvements to net returns from investments. However, imposing new obligations to formally consider and assess a specific but difficult to define investment sector then to spend time in distilling that into a document which in practice is likely to be read and considered only rarely, if at all, seems to be the wrong focus.

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Trustees have a duty to look after their members' interests under the scheme. They are given considerable discretion over how to discharge that duty and are accountable over how they exercise that discretion. The title of the consultation refers to "facilitating" investment in illiquid assets. The disclose and explain procedures however seem more about putting pressure on trustees to invest in illiquids (however defined). We should be careful about the extent to which we allow legislation to erode trustee discretion by imposing prescriptive obligations, particularly where the benefits of those obligations are unclear.

Pendragon