THE INSIGHT SHARING

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

PENSION SCHEME INVESTMENT IN ILLIQUID ASSETS

CASE STUDIES FROM THE PENSIONS SECTOR

NOVEMBER 2023

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ABOUT THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION

The Pensions and Lifetime Savings Association (PLSA) is the voice of workplace pensions and savings. We represent pension schemes that together provide a retirement income to more than 30 million savers in the UK and invest more than £1.3 trillion in the UK and abroad. Our members also include asset managers, consultants, law firms, fintechs, and others who play an influential role in people's financial futures. We aim to help everyone achieve a better income in retirement.

INTRODUCTION

THE SUBJECT OF ILLIQUID INVESTMENTS BY THE UK PENSIONS SECTOR HAS HAD A HIGH PROFILE IN POLICY AND MEDIA DEBATE OVER THE LAST YEAR.

This debate has not always reflected the high level of such investing already underway by many schemes, nor the willingness of the pension sector to explore how illiquids can contribute to their investment goals.

This report sets out case studies from 10 public and private sector schemes – Local Government Pension Scheme (LGPS) funds, Defined Benefit (DB) schemes, Defined Contribution (DC) schemes and DC Master Trusts – with the aim to provide information for pension managers, trustees and policymakers on how pension schemes invest in this asset category and the issues to be considered when making these commitments.

CONTEXT

AS IS WIDELY RECOGNISED, INVESTMENTS TOTALLING AROUND £1 TRILLION BY PENSION FUNDS IN UK ASSETS ALREADY SUPPORT ECONOMIC GROWTH AND ARE A MAJOR SOURCE OF LONG-TERM INVESTMENT IN THE UK ECONOMY.

The scale and distribution of assets across the pensions sector is expected to alter substantially over the next decade, during which time we expect the volume of assets in DC pension schemes to double to around £1 trillion and the value of assets in the LGPS to increase to around £500 billion.[1] The value of private sector DB pension funds is expected to stay roughly the same as today's high value (£1.5 trillion).

The opportunities for schemes to invest in unlisted equity assets will largely rest with trust-based DC schemes (£38 billion), DC Master Trusts (£105 billion), LGPS funds (£425 billion), and open private sector DB schemes (£321 billion), rather than with closed DB schemes (£1.2 trillion). This potential will be all the greater if a wider definition of UK growth-related assets is used (notably, private credit as well as private equity).

The PLSA welcomes measures which improve access to invest in a broad range of assets. Pension funds will always be interested in exploring investments which have a strong likelihood of generating good returns, within their risk tolerances, and in the interests of their respective members.

That being said, it is very important that pension schemes' ability to direct their own investment strategy in the best interests of their members continues to be protected.

Pension funds always need to invest in a wide and diverse range of assets, including in illiquid assets, such as in private markets (including private equity and early-stage businesses). Although it is worth noting that the investments that best suit pension schemes will be later stage private equity investments, due to the high volatility and failure rate of early stage investments.

A key component of unlocking investment is policy certainty, and setting out a clear plan for the future of the UK economy, for example on the Green Transition or through the national infrastructure plan, which will help draw pension fund investments. Supporting and incentivising domestic investment for critical national infrastructure developments and innovative new technology, as well as encouraging a pipeline of new opportunities in this space, would also be welcome. These are areas where Government itself has a key role to play.

1 PLSA, 'Pensions and Growth - A Paper by The PLSA on Supporting Pension Investment In UK Growth', June 2023 https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2023/Pensions-and-Growth-Jun-2023.pdf.

PUBLIC SECTOR LGPS FUNDS

WEST MIDLANDS PENSION FUND

Using private assets to improve outcomes for employers and savers

AS THE SECOND LARGEST LOCAL GOVERNMENT PENSION SCHEME FUND IN ENGLAND AND WALES, AND ONE OF THE TOP 25 DEFINED BENEFIT FUNDS IN THE UK BY ASSET SIZE (£19.5 BILLION), THE WEST MIDLAND PENSION FUND (WMPF) HAS LONG STRIVED TO ENSURE THAT ITS ASSET ALLOCATION CONSIDERS THE WIDEST OPPORTUNITY SET.

In the 1990s, direct property portfolios were common for many pension funds with long-term investment horizons, but besides listed equities and bonds, few other asset classes were considered.

WMPF recognised both the opportunity but also the risk management benefits of diversification and we commenced our journey, which is now more than 25 years long, of investing in illiquid private market assets.

Private equity was the main allocation back in the mid-1990s, but over the years, as both capability within the Fund grew, and the asset management industry innovated, WMPF's portfolio of private market assets expanded to infrastructure and private debt, while incorporating special opportunities, including those emerging through innovative partnerships and networks within our region.

WMPF PRIVATE MARKETS ASSET ALLOCATION

Allocation as at 30/6/2023

ASSET	% OF PORTFOLIO	£MILLION
Private Equity incl. Venture Capital	8%	1,436
Special Opportunities	1%	223
Private Debt	3%	620
Infrastructure	5%	1,038
Property	7%	1,366
Total	**24%**	**4,683**

CASE FOR PRIVATE ASSETS WITHIN THE PORTFOLIO

When considering the Fund's approach to private markets' assets within the overall investment strategy, account is taken of the relative benefits and risks. There are a number of characteristics of private assets that, in our view, makes them attractive relative to traditional assets. These include:

- The ability to capture illiquidity risk premium
- Increasing the opportunity set to a range of businesses that are not publicly available
- The ability to add value through managers taking an active and strategic role in a company or project
- The opportunity to invest in real tangible assets, which can provide inflation protection
- Ability to invest in new technology that will often be many years from becoming available in liquid markets, previous examples include renewable energy
- Capturing better returns in asset classes such as private credit by removing intermediaries
- Capturing a growing global trend for more companies to remain private for longer or move from public to private
- Providing an opportunity to invest locally within the West Midlands, which is challenging through solely investing in liquid assets.

We are very aware that the benefits need to be carefully balanced against the specific risks of illiquid assets, which include:

- Illiquidity that can potentially be worse than originally planned
- The need for different governance and oversight arrangements, robust analysis, and decision-making around opportunities and ensuring there is strong alignment of interests with delegates to ensure that expected outcomes are delivered
- Uncertainty of cashflows for many private assets, especially private equity, both on entry and exit

- Heightened geo-political and regulatory risk, hence the importance of independent governance and decision-making
- Correlation with traditional asset classes often being much higher than expected in stressed market conditions.

Our focus has been on value added from governance and management arrangements and not on lowest cost.

STRATEGIC INVESTMENT AND RISK OBJECTIVES

In its triennial investment strategy reviews, WMPF considers a wide range of asset classes and asset mixes to achieve the long-term (15 to 20 years) return objective. To determine expected risks and returns – besides usual stochastic techniques, based on long-term capital market assumptions – we consider stress and scenario testing including liquidity events.

Over the last 25 years, our strategic allocation to illiquids has steadily increased as a percentage of WMPF's return enhancing assets. More recently, the emphasis in both liquid and illiquids has been away from growth assets to income generating assets. This is in the context of an overall lower risk portfolio and one that is more liability aware and conscious of cashflows. In the private asset portfolio, this has resulted in reduced allocations to private equity and increased allocations to private credit and infrastructure while maintaining allocations to property.

LOCAL INVESTMENT OPPORTUNITIES

We do not have a target allocation to invest in the UK or within the West Midlands region. However, we have, over time, allocated capital to local investment opportunities including direct property, infrastructure, housing and small companies, where these have offered an attractive risk and reward, alignment with our responsible investment objectives and offer a suitable scale and governance arrangements.[2]

WMPF has long recognised the potential for regional investment and innovation to address some of the environmental and social challenges in the West Midlands, while also recognising that most of these benefits will be brought through private assets. Recent examples of local investment include a West Midlands sustainable infrastructure fund, debt finance for a help-to-own scheme for local residents and a fund in partnership with the West Midland Combined Authority, providing equity to innovative businesses with high growth potential, aligned to Levelling Up missions and targeting initiatives which support climate transition and build sustainable futures.

Private assets through their inherent nature of supporting innovation, regeneration and efficiency, provide a perfect synergy such that long-term asset owners can improve their risk-adjusted returns in tandem with the goal of bringing greater economic and societal benefits than from traditional investments.

In the regional and UK investments in the private portfolio, there has been natural alignment with the Levelling Up missions. This alignment has been direct in missions such as transportation, "pride in place", digital connectivity and health, and as a second order impact on other missions, such as skills and research and development.

IMPLEMENTATION AND LGPS INVESTMENT POOLING

In terms of implementation, in the years prior to pooling, WMPF built an internal capability in private equity, allowing it to generally invest as a limited partner rather than use the fund-of-funds route.

WMPF was pleased to seed the establishment of a private markets team and a fund at its pooling partner LGPS Central, when it was established in 2018. The further breadth and depth provided by the pool in this area has enhanced what was already a successful programme.

Paul Nevin
Assistant Director (Investment Strategy)
West Midlands Pension Fund

2 Reference to Fund's ISS ISS 2023 (wmpfonline.com) https://www.wmpfonline.com/sites/default/files/2023-04/ISS%202023.pdf

SURREY COUNTY COUNCIL PENSION FUND

Diversifying investments for future generations

WITH MORE THAN 300 EMPLOYERS AND OVER 100,000 MEMBERS, AND ASSETS IN EXCESS OF £5.3 BILLION, SURREY COUNTY COUNCIL PENSION FUND HAS BEEN INVESTING IN ILLIQUID ASSETS FOR SOME YEARS NOW. BY INCREASING ITS EXPOSURE TO ILLIQUID ASSETS THAT ARE NOT PUBLICLY TRADED, THE FUND HAS BEEN ABLE TO GENERATE LONG-TERM RETURNS IN EXCESS OF INFLATION, WHILE PROVIDING SOME DIVERSIFICATION AWAY FROM LISTED EQUITIES AND BONDS.

At the moment, Surrey Pension Fund's current total target asset allocation to private markets stands at 20%, with approximately £1bn committed to these investments. A greater proportion (60%) of existing private investments is invested directly in long-standing legacy funds, while the remaining (40%) is through our partner pool Border to Coast.

SURREY PENSION FUND PRIVATE MARKETS ASSET ALLOCATION

ASSET	% OF PORTFOLIO
Private equity	5%
Private infrastructure	6%
Private Debt	6%
Climate opportunities	3%
Total	**20%**

As a long-standing investor in private markets, Surrey Pension Fund has participated in all private market fund launches by Border to Coast, and all new commitments in these asset classes are made through the pool.

The Fund's private markets allocation, as the remainder of the investments, are under constant review, but particularly after the triennial valuation. This exercise determines Surrey's Pension Fund investment strategy and the required investment returns which will be needed for the Fund to be confident of being able to pay the future benefits of members.

The current strategic return objective for the Fund is 5% per year, with private markets assets having different expected returns: 10% from private equity and climate opportunities investment, 8% for private infrastructure and 6% for private debt. The return timeline for these investments matches standard market practice, with capital paid in over the first three years and then distributions over the next five to eight years.

RIGHT BALANCE BETWEEN RISK AND REWARD

Surrey Pension Fund invests in private markets since these assets can bring diversification for the allocation, rather than focusing solely on listed equites and listed fixed income. Return and risk profiles can also be different to other asset classes at different points in the economic cycle.

Since we assume a higher risk at early-stage investments, the Fund should also expect higher returns for these investments, in excess of 10%. This is, in essence, the risk reward balance.

This is an important aspect to consider if a target allocation to, for example, Levelling Up assets, is introduced for all LGPS Funds, since risk may be mispriced as the weight of money drives down expected return. This will be a major risk to Funds. The size of these investments may also be small in relation to the Fund size, further hampering investment opportunities.

Outside of traditional risk return dynamics, Levelling Up investments may have a wider societal benefit. This should not come at the expense of traditional metrics, however, and should be measured as accurately as possible to confirm its existence.

Lloyd Whitworth
Head of Investment and Stewardship

Surrey Pension Fund

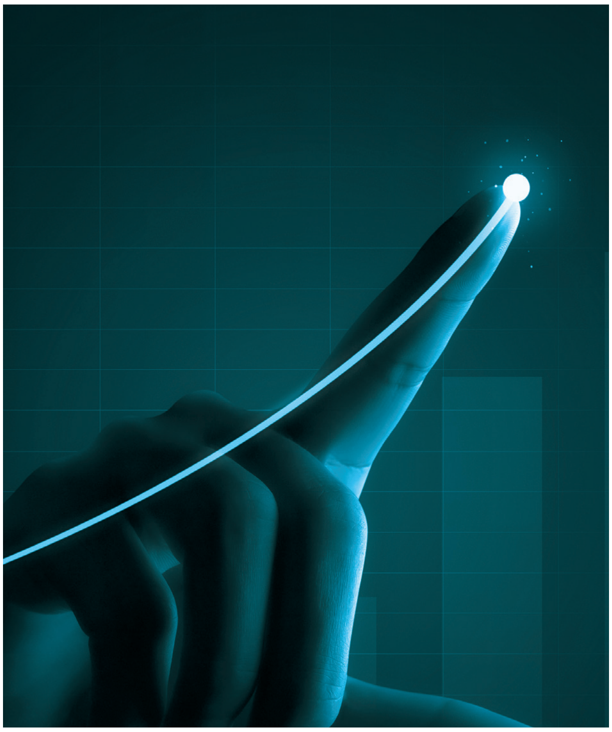
CLWYD PENSION FUND

Private markets are in our DNA

CLWYD PENSION FUND (CPF) IS ONE OF THE EIGHT LGPS FUNDS IN WALES, WITH ASSETS WORTH £2.3 BILLION AND MORE THAN 52,000 MEMBERS. THE FUND HAS BEEN INVESTING IN PRIVATE MARKETS FOR OVER 30 YEARS AND CURRENTLY HAS OVER 140 SEPARATE COMMITMENTS TO THESE ASSETS.

Illiquid and private markets are core to our investment strategy and one of the longer-term best performing asset classes. The strategy is reviewed every three years at the strategy review and the allocation to these assets, now at 29%, has steadily increased over time.

A 6% separate allocation for impact and local investments was initiated in 2020, when it was identified we were already allocating to these areas as far back as 2007. We strategically began identifying "local" opportunities in 2016. Early indications of performance since carving out this allocation are positive, with a one-year return to March 2022 of 40.3% and a one-year return to March 2023 of 22.9%.



CLWYD PENSION FUND PRIVATE MARKETS ASSET ALLOCATION

ASSET	% OF PORTFOLIO
Private equity	8%
Infrastructure	8%
Impact/Local	6%
Property	4%
Private Credit	3%
Total	**29%**

CLWYD PENSION FUND TOTAL ASSET ALLOCATION

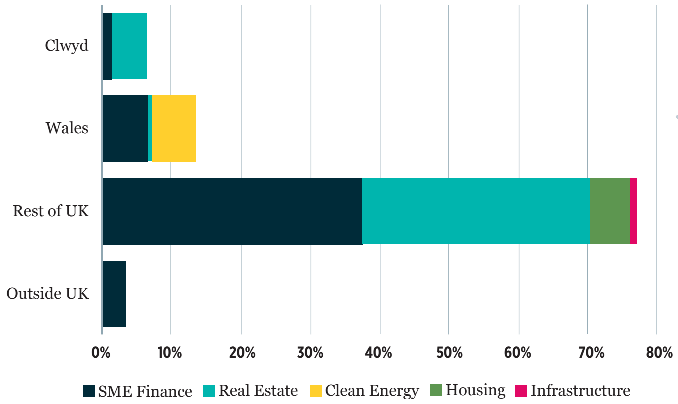
ASSET	% OF PORTFOLIO
Listed Equities	20%
Multi Asset Credit	12%
Liability Driven Investments	23%
Private Markets	29%
Hedge Fund-of-funds	5%
Tactical Allocation	11%
Total	**100%**

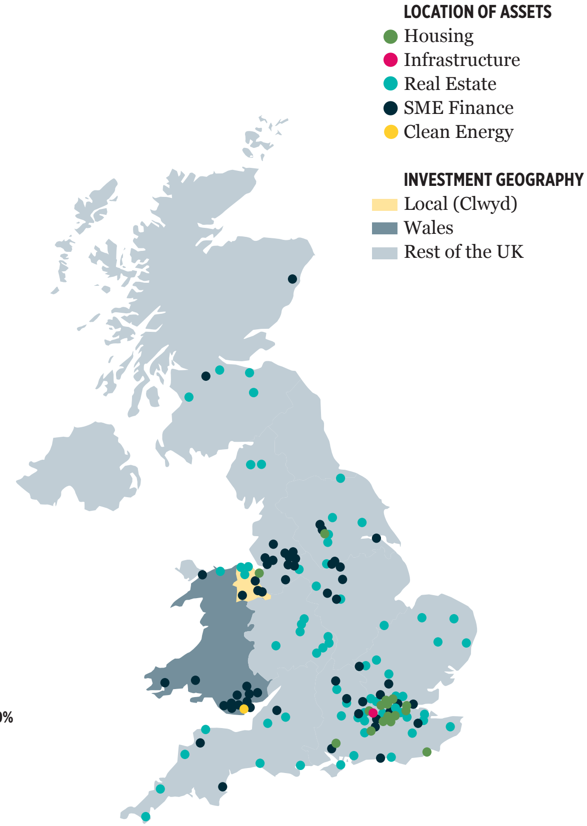
Private markets investments cover UK, regional and global mandates, all currently made through direct investments or through legacy fund-of-funds managers. From April 2023, all commitments in this area will be made through our partner pool, Wales Pension Partnership.

AS OF 31ST MARCH 2023

Where we invest (% of amount invested)

19.7% of Clwyd's Impact and Place Based portfolio has been invested in Wales





Source: Factsheet produced by The Good Economy 2023

EXAMPLES OF PRIVATE MARKETS INVESTMENTS

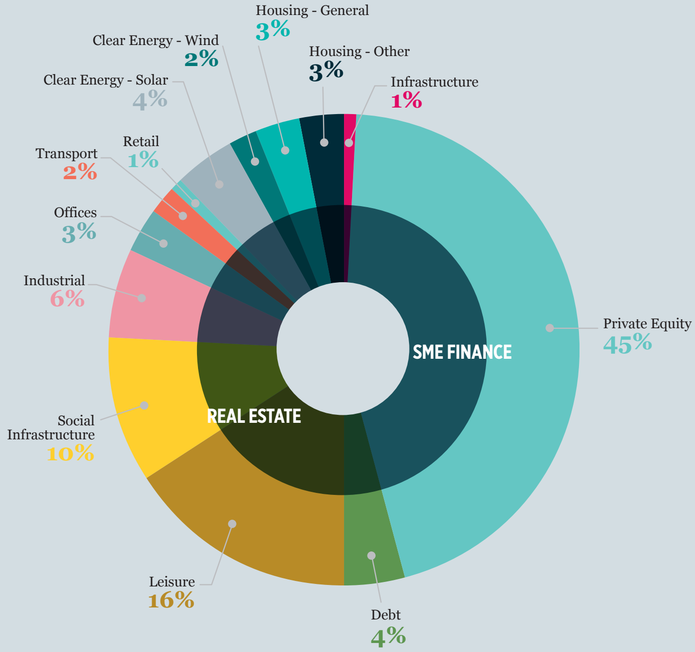
- CPF invested £10m in a £25m investment with the Development Bank of Wales alongside the Welsh Local Government Association (WLGA). We were their first limited partner and helped shape the limited partnership agreement and reporting requirements.
- We invested alongside Greater Manchester Pension Fund and South Yorkshire Pension Fund in the North West England and North East Wales Regional Fund to ensure the manager considered opportunities in North East Wales.
- In 2022, the Fund agreed a £50m separately managed account with an external manager (Capital Dynamics) to invest directly into clean energy projects in Wales. We are consulted on the projects identified and can also ask the manager to appraise projects that are brought to us. Since April 2023, £38m has been committed from the £50m, and £15m has been deployed.
- In addition, a project was identified which was too large for us as an individual Fund, so we took the opportunity to our pool. Subsequently, six of the other seven Welsh Funds invested alongside us in that project. There will be further opportunities to share in the future.

AS OF 31ST MARCH 2023

CLWYD PENSION FUND HAVE COMMITTED TO MAKING PLACE BASED INVESTMENTS. THESE ARE FUNDS THAT INVEST IN WALES OR CONTRIBUTE TO CREATING POSITIVE SOCIAL AND ENVIRONMENTAL IMPACTS NATIONALLY.

- **£197 million** committed (8.6% of Clwyd Pension Fund value)
- **£85 million** has been committed to funds investing exclusively in Wales
- **£115.4 million** has been invested in over 200 assets across in the UK
- **£22.7 million** has been invested in Wales so far.

HOW WE INVEST
(% of amount invested)



Source: Factsheet produced by The Good Economy 2023

HOW OUR INVESTMENT IS SUPPORTING WALES AND THE UK

- **86** SME businesses supported through equity or debt finance since 2013, **20** are in Wales
- Over **13,400** employed and at least **1,800 jobs** created in these businesses during the period of Clwyd's investment (11% of jobs, and 12% of jobs created in Wales)
- **12** businesses are Living Wage Foundation businesses or pay all employees the Real Living Wage

- **3,369** new homes in area where lower-cost homes are needed, 27% of homes are affordable
- **11** assisted and senior living homes for up to 490 residents

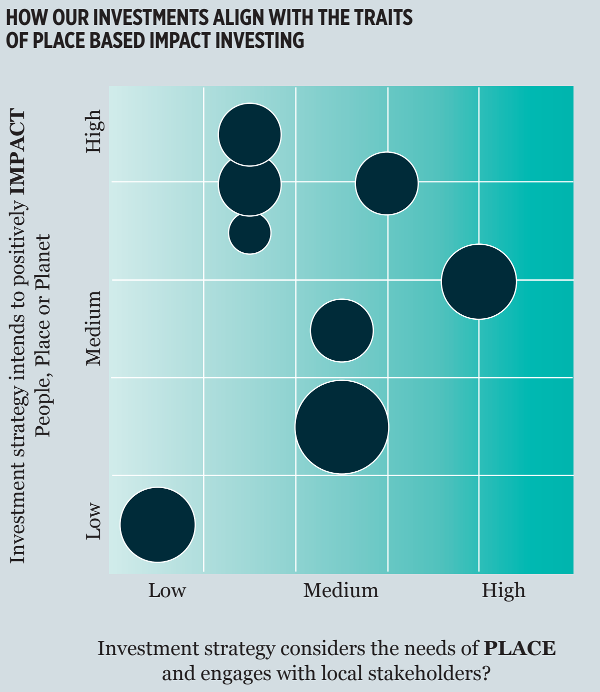
- **34** educational facilities acquired, 2,700 additional child spaces created (85% nursery spaces, 10% SEN, 5% independent school places)
- **740** permanent real living wage jobs supported in leisure based real estate, 25% in Wales
- **43** commercial real estate developments creating employment space for over 12,000 people (25% in the most deprived local authorities nationally)

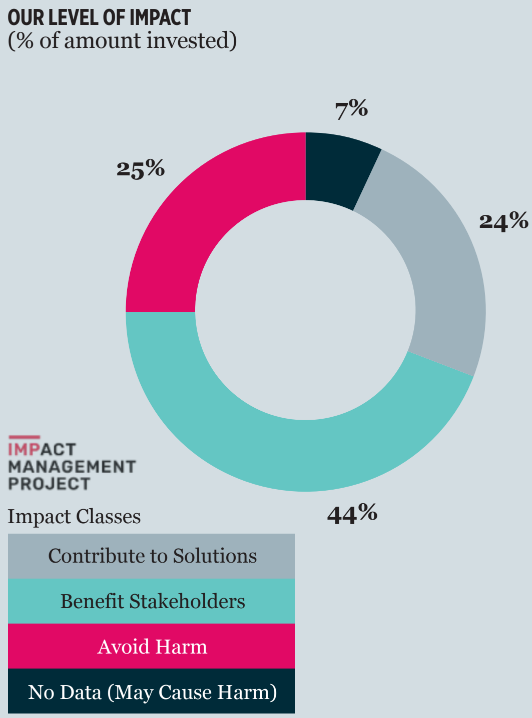
- **£50** million committed to the development of clean energy in Wales to begin being deployed in 2023.

Source: Factsheet produced by The Good Economy 2023

ESG CONSIDERATIONS AT FRONT OF MIND

All CPF's private market investments are managed by external managers, but professional advice is sought on all those managers by our consultants, who conduct full due diligence and provide the Fund with both investment ratings and environmental, social and governance (ESG) ratings. As a Fund, we are concentrating on impact, local and sustainable investments within our private market programme and will only consider managers who are rated ESG 1 or 2.





Source: Factsheet produced by The Good Economy 2023

Investing in illiquid private markets is part of the Fund's DNA. These commitments need to be well managed and we know the risks associated with these assets. CPF has been able, so far, to achieve good returns from a well-diversified programme of investments.

We believe that selective local investments with a credible manager can provide us with both an impact, social and fiduciary return.

Philip Latham
Head of Clwyd Pension Fund

MERSEYSIDE PENSION FUND

Search for income in illiquids pays off

WITH MORE THAN 144,000 MEMBERS AND £11 BILLION IN ASSETS, MERSEYSIDE PENSION FUND (MPF) IS ONE OF THE MORE MATURE LGPS FUNDS WITH A GROWING REQUIREMENT FOR INCOME. DUE TO THIS, WE HAVE BEEN DIVERSIFYING AWAY FROM OUR PUBLIC MARKET HOLDINGS INTO ALTERNATIVE ASSETS FOR THE PAST 10 YEARS. WE BELIEVE THAT LONG-TERM ASSETS, SUCH AS REGULATED INFRASTRUCTURE AND DIRECT PROPERTY HOLDINGS, WILL PROVIDE US WITH A DEGREE OF INFLATION-LINKAGE AND A GROWING SOURCE OF INCOME.

As we have increased allocations to private market assets, we have also broadened the range of sectors and assets in which we invest. For example, as well as direct property holdings, our property allocation now also involves direct property loans which includes lending to investment opportunities in the Merseyside area.

Currently, the Fund invests in a wide range of illiquid assets within its private markets allocation, through our partner pool Northern LGPS, including the GLIL infrastructure platform and Northern Private Equity Pool (NPEP).

MERSEYSIDE PENSION FUND PRIVATE MARKETS ASSET ALLOCATION

Allocation as at 31/3/2023

ASSET	% OF PORTFOLIO	£MILLION
Private Equity	9.6%	996
Private Credit	5.1%	528
Infrastructure	8.6%	890
Real Estate	11%	1,144
Total	**34.3%**	**3,558**

PIONEER IN ILLIQUIDS

MPF has been a pioneer and a strong advocate of investing in private markets, due to benefits such as diversification, attractive long-term returns, and the low correlation of these assets with publicly traded assets. Thanks to the MPF's very long investment horizon, the Fund can tolerate illiquidity and the elevated uncertainty ingrained in private markets.

However, these investments bring a variety of risks, such as:

- Governance – the resources required to source, manage and monitor the investments
- Scale – these are sometimes smaller-scale projects/businesses which, combined with the use of local contractors, bring greater risk of cost overruns or project/business failure
- Cost – governance, scale and complexity increases costs
- Reputational – local businesses/projects heighten the risk of failure or in respect of conflicts of interest.

GRAVITY LOAN

IN 2020, MERSEYSIDE PENSION FUND PROVIDED FINANCING TO FACILITATE THE REMEDIATION AND DEVELOPMENT OF A MORE THAN 600-ACRE SITE IN SOMERSET, WHICH HAS RECENTLY BEEN SELECTED BY TATA GROUP FOR THE LOCATION OF ITS £4 BILLION ELECTRIC CAR BATTERY GIGAFACTORY.

In July 2020, at the height of the Covid-19 pandemic, MPF committed to a senior land and infrastructure loan in Somerset. The loan was secured against an existing strategic site in Southwest England known as "Gravity" and provided funding to refinance existing debt, finish the buildout of infrastructure, remediation, and fund enhanced planning.

The project's objective was to create the UK's first "Smart Campus" that would be technology and low-carbon focused. The investment contributed to creating 616 acres for Storage & Distribution, Energy Generation, Manufacturing, R&D, and leisure. The initiative targeted occupiers in various sectors, including electric car manufacturing, e-commerce, food distribution, and life sciences.

In 2017, the site had gained Enterprise Zone status, valid until 2042. Businesses basing themselves on the site benefit from lower taxes, access to superfast broadband, and streamlined planning permission to facilitate local infrastructure.

In 2022, the Gravity Local Development Order (LDO) was adopted by Sedgemoor District Council (now Somerset Council). The LDO is a streamlined form of planning consent, contributing to the UK proposition to attract investors and new business to Somerset, as it provides certainty to inform decision-making. The site had outlined planning consent for up to 1.1 million square metres of industrial space and 750 homes under the LDO.

Gravity is collaborating with Bridgwater & Taunton College to create a leading network of education and skills initiatives. Together, they developed a "Skills Charter" intended to outline principles and objectives from which individual Employment and Skills Plans for each occupier/site will be developed to deliver benefits to the local community, Gravity, and its occupiers. The objectives are to meet occupier demand for talent and provide strategic linkages into local schools, such as Bridgewater and Taunton College, to foster young people's ambition and provide the new workforce with support and training.

The Gravity site can also offer bespoke renewable and low-carbon on-site energy solutions. In addition, it has licences to abstract up to 1.1M m^3/year from the adjacent Huntspill River. In 2019, Gravity was shortlisted by the Advanced Propulsion Centre commissioned by the UK government to identify locations for Gigafactory sites. It resulted in its international promotion by The Department for International Trade. Gravity also had strategic ties with the Faraday Institute to attract battery producers to the UK, leading to discussions with global battery producers about potential factory requirements.

The efforts of promoting the site proved to be fruitful. In July, Tata Group announced that it had chosen Gravity for the location of its £4 billion electric car battery gigafactory. It will be one of the largest-ever investments in the UK automotive sector and is said to create up to 4,000 highly skilled jobs on-site. With an initial output of 40GWh, it will be one of the largest factories in Europe, providing almost half of the battery production that the Faraday Institution estimates the UK will need by 2030 to support its transition to zero emissions vehicles.

The gigafactory will secure UK-produced batteries for another Tata Sons investment, Jaguar Land Rover (JLR), as well as other manufacturers in the UK and Europe. It will supply JLR's future battery-electric models, including the Range Rover Defender, Discovery, and Jaguar brands. Production at the new gigafactory is due to start in 2026.

LOCAL INVESTMENTS

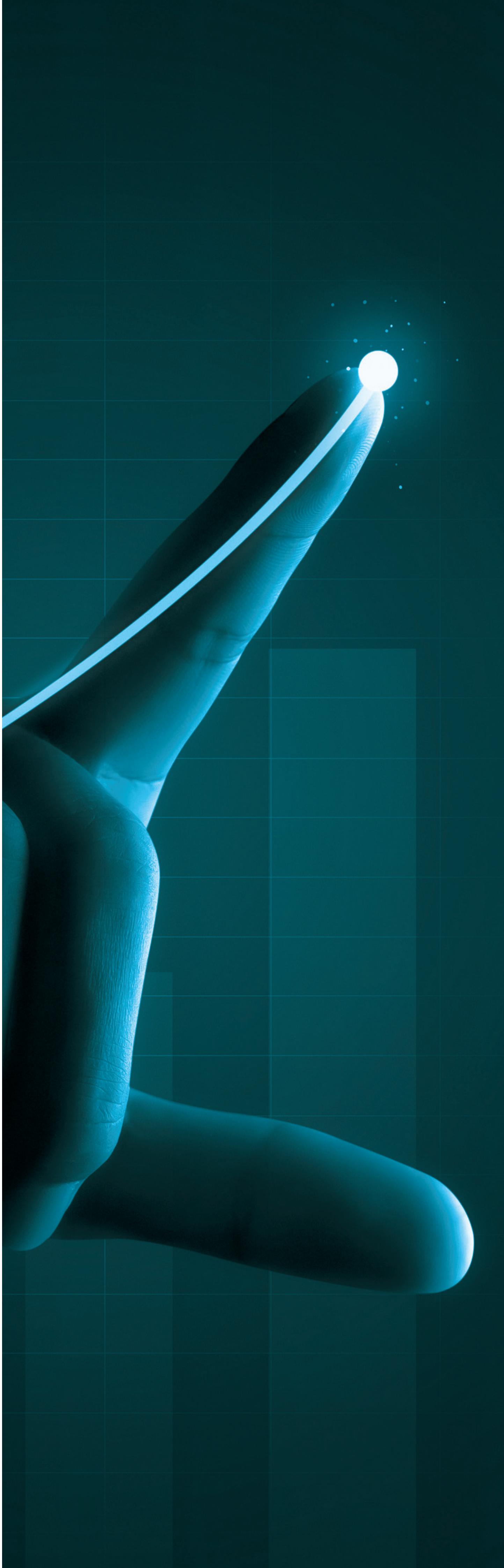
There are several examples of commitments in the Fund's local region, such as direct property loans, which we have been investing in since 2018. From a standing start, we now have around £400m committed of which £100m is in projects in the Merseyside area. The value of commitments varies as loans are drawn down and repaid, but the Fund has an ongoing loan programme committing to new opportunities as the previous loans mature. The average life of a loan is around 36 months and we generally target a term of between 18 months and 5 years.

In 2016, with the approval of its Pensions Committee, MPF launched the Catalyst Fund. Its aim is to help deliver economic growth projects across Merseyside by providing debt and equity investments, while producing a commercial return for the Pension Fund. Catalyst's strategy sought to align with the Liverpool City Region Growth Prospectus, principally for sustainable economic growth through regeneration and employment growth.

The majority of our investments in the Merseyside area are property loans fulfilling MPF's requirement for income, commercial returns and delivering regeneration benefits in Merseyside.

Peter Wallach
Director of Pensions

Merseyside Pension Fund



PRIVATE SECTOR DB SCHEMES

BT PENSION SCHEME (BRIGHTWELL)

A holistic approach to growth assets

AT THE BT PENSION SCHEME (BTPS), ONE OF THE LARGEST DB SCHEMES IN THE UK PRIVATE SECTOR, PRIVATE MARKETS INVESTMENTS ARE NOT CONSIDERED TO BE A STAND-ALONE ASSET CLASS, BUT INSTEAD PART OF THE SCHEME'S OVERALL 'ONE PORTFOLIO APPROACH'.

With some £40bn in assets and around 270,000 members, BTPS investments are managed by Brightwell, where we consider the risk, return, liquidity and other characteristics of private markets investments, in the context of the scheme's overall portfolio construction. This means we target specific outcomes at total portfolio level, rather than separately managing and optimising public and private markets.

In fact, we view and consider the relative attractiveness of private assets based on the characteristics and role strategies play – for example, a private long income real estate may have a role more aligned with investment grade credit (i.e. providing long duration cash-flows) than it would with a value-add real estate strategy. The other key driver of considering private exposure as part of the overall portfolio is to appropriately manage illiquidity risk – this is more critical than ever given some schemes' recent experience during the gilt crisis.

BTPS, which closed to new members in 2001 and to future accrual in June 2018, currently invests in private equity, focused on global growth and small-mid market buyout, core infrastructure and real estate debt, which are UK focused with a minor exposure to Europe, global real estate equity and global private credit.

BT PENSION SCHEME TOTAL ASSET ALLOCATION

Allocation as at 30/6/2022

ASSET	% OF PORTFOLIO
Equities	15.8%
Property	9.4%
Other Growth Assets	16%
Investment Grade Credit	27.5%
Secure Income	8%
Government Bonds and Cash	23.3%
Total	**100%**

PORTFOLIO TRANSITION AND REGULAR REVIEWS

We transitioned from a more traditional strategic asset allocation framework to a one portfolio approach in early 2021, as we believed it allowed us more flexibility and tailoring to the scheme's needs.

Our overall allocation to private markets has not changed significantly since then, but has evolved more from growth orientated to more secured and cash-flow matching, as the scheme is de-risking and building its cash-flow aware portfolio.

The overall investment strategy is reviewed at least on a quarterly basis, where we compare portfolio outcomes with portfolio expectations and the ongoing appropriateness of investment strategy is discussed. Third-party managers' mandates are monitored and evaluated on an ongoing basis and systematically assessed via quarterly update meetings, reporting, ad-hoc engagement, and communication.

MAKING THE BEST USE OF EXTERNAL MANAGERS

All our non-gilt investments are managed through external investment managers. Our manager research and selection approach is applied across the whole portfolio (private and public) and the process consists of three well-defined steps which are mandate design, short listing and final selection and implementation.

We look for mandates that align to specific outcomes, and design them to optimally capture the desired asset class, risk factor or cash-flow characteristics, and select managers that generate alpha net of fees and costs. We favour fewer, longer-term partnerships, low manager turnover (which helps reduce cost) and customisation of our investment mandate.

The due diligence process compromises four key areas:

- Qualitative research – We undertake multiple meetings with managers to understand their philosophy, process, people and critically – the manager's edge, desire, and team
- Quantitative research – This informs our understanding of performance, profile of returns, underlying portfolio composition and fit within the scheme and other key quantitative metrics. Fee analysis, including benchmarking and alpha share is analysed. The latter allows us to consider value-for-money consistently across different strategies and asset classes
- Operational due diligence – We evaluate the business and operational control environment at fund managers
- Legal diligence and contracting – We negotiate investment management agreements or fund documentation with managers, ensuring all necessary legal protections are in place to limit client risk.

FOCUSING ON OUTCOMES

We believe that complexity and illiquidity from private markets can enhance investment outcomes for the scheme and offer diversification away from listed markets. But we focus on the outcome and characteristics of the mandate/strategy and not the asset class outperformance.

For example, infrastructure and real assets often have inflation indexations embedded in their cash flows. Private credit can offer a high degree of protection when backed by senior claims on company cash flows or assets, helping to give the lender more security.

We also believe that in private markets, the managers can influence the outcome through their activity. This could be also true in public assets, for example in engagement or activist strategies, but this is often more the case in private markets such as private equity or real estate.

On the downside, the main risk is illiquidity and the ability to exit. We aim to mitigate that risk through our implementation approach. We have evolved to favour investments via fund of one structures, having a critical emphasis on having strong alignment with general partners/managers, and avoiding hard-wired target allocations. This ensures:

- Better control, liquidity, and position level look-through for risk management and monitoring
- Better protections – e.g. key man, leverage limits, lower fees and fund cost caps – with fund costs being often hidden and excessive
- Greater flexibility – to evolve the strategy and exposures over time
- Improved alignment – through targeting managers focused on returns rather than asset gathering
- Greater opportunism.

Wyn Francis
Chief Investment Officer

Brightwell

OPEN DB SCHEME (ANONYMOUS)

Bringing a green spotlight to illiquids

INVESTING IN ILLIQUIDS HAS BEEN PART OF OUR SCHEME STRATEGY SINCE THE NOUGHTIES AND ATTENTION TO ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ISSUES HAS BEEN AN INTEGRAL PART OF THIS APPROACH IN RECENT YEARS.

The pension fund, one of the few remaining open DB schemes in the UK, invests in illiquid assets within our equity, real assets and credit allocations.

We have been invested in illiquid assets from as early as 2007, and we increased the allocation over the years to private market assets to help deliver higher expected returns from the investment strategy, driven by the illiquidity and complexity premia. Given the open nature of the scheme, we have a long time horizon over which to harvest strong returns.

At an aggregate level, our illiquid investments are invested globally, being made up of a mix of global, European and UK specific mandates. Our illiquid mandates include:

- Private equity (directs, primaries and secondaries, across buy out and venture capital)
- Infrastructure equity (core plus and renewables)
- Real estate (long-lease property)
- Senior direct lending, asset-based financing, mezzanine debt, special situations financing, infrastructure and real estate debt and structured credit.

ESG CONSIDERATIONS ARE FRONT OF MIND

Our scheme typically recommits to new vintages of existing strategies in which we invest and have on occasion identified attractive opportunities to invest into new strategies. Each time a commitment is made, our in-house team carries out investment due diligence and provides a recommendation to the investment committee.

The investment committee has also been more active in meeting with our private markets managers to ensure ESG factors are being considered throughout the investment process. Managers have improved their ability to demonstrate their ESG credentials, but we note there still remains a gulf between European and US managers.

GILT CRISIS IMPACTS ILLIQUIDS ALLOCATION

Prior to the gilt crisis in September/October 2022, our scheme had been making increasingly larger commitments to private market strategies, with the goal to ensure that over time the scheme's asset allocation would reach the strategic target.

However, since the rapid increase in yields caused by the mini-budget in 2022, which resulted in a need to sell liquid growth assets to maintain liability driven investments (LDI) protection, the scheme has become significantly overweight in illiquid assets versus the strategic target.

Going forward, private market assets will form a smaller part of the investment strategy, in part due to lower excess returns over gilts being needed due to the cost of meeting pension liabilities having fallen – but also since a higher allocation to listed assets will be necessary, in order to meet higher collateral requirements as a result of the mini-budget.

We are also focussing our attention on strategies that are managed in an ever-green structure, reducing the need to make new commitments on a regular basis.

PRIVATE SECTOR DC SCHEMES

UNIVERSITIES SUPERANNUATION SCHEME (USS)

Making DB illiquid assets work for DC

THE UNIVERSITIES SUPERANNUATION SCHEME (USS) ALLOCATES AROUND 20% OF ITS DC DEFAULT OPTION ASSETS TO ILLIQUIDS, WHICH IS MADE POSSIBLE BY A SHARED £28 BILLION PRIVATE MARKETS PORTFOLIO SERVING BOTH DB AND DC MEMBERS.

This unique approach was planned several years ago by USS and implemented in 2020. We have an in-house team of about 70 people that acquire and manage these assets, and have been doing so for 17 years, but initially only for DB.

We wanted to expand investments in illiquids to our DC part – the Investment Builder with £2.2bn in assets and 168,000 members – but we were conscious we would need to build our own portfolio if we wanted to allocate to our own managed assets.

We believe we can achieve better risk adjusted returns for members via our use of private markets assets, such as outperformance and greater diversification.

DC ILLIQUIDS INVESTMENTS LAUNCHED IN TURBULENT TIMES

The first step was to create a project to unitise and price those assets. A swing price committee was set up and we also consulted the fair value committee, which was already in place for the DB part of the scheme.

The project was launched in the peak of Covid-19, and the economic and market repercussions tested our valuation framework. This worked as it was supposed to, with the added benefit that private asset values generally display lower levels of volatility than public assets.

There are specific challenges with illiquid asset allocations in DC, notably around providing liquidity and asset valuations. In our case the relative scales of the DB and DC portfolios allow DB to provide liquidity to the DC part. With respect to valuation, we have re-designed our approach with monthly revisions to pricing on many assets and increasing the previous frequency of full valuations for material assets. This coupled with managing diversification and allocation size allows us to manage the valuation challenge.

In 2021, we saw good performance of our illiquid assets as the economy rebounded. In 2022, the outperformance of our Growth Fund against 16 UK DC master trust default growth fund returns was driven, primarily, by the strategy's allocation to private market assets. Our members in the USS Default Lifestyle Option are invested in assets such as infrastructure, private equity, private debt, sustainable growth equity and special situations.

USS GROWTH FUND ASSET ALLOCATION (ONE OF THE FUNDS WITHIN THE DEFAULT OPTION)

ASSET	% OF PORTFOLIO
Growth	**71%**
Commodities	0%
Infrastructure	11%
Private Growth	0%
Public Equities	56%
Real Estate	4%
UK Government Bonds	**2%**
UK Government Bonds	2%
Credit	**27%**
Private Credit	5%
Public Credit	21%
Cash & Other	1%
Total	**100%**

LIFECYCLE DETERMINES ASSET TYPE

With an allocation to private markets which fluctuates between 20% and 25% in the DC part, all participants in the default option (90% of all DC scheme members) have access to some type of illiquids.

However, we allocate to differing types of illiquid assets at each stage of the lifecycle – at the initial phase, more capital is allocated to private equity; as people get closer to retirement, we shift more to private credit and debt. There are very good opportunities for inflation linked cashflows in these assets, which are very beneficial for members who are coming up to retirement.

We are in the process of integrating this offering in the USS Ethical Lifestyle Option, with a similar allocation we have in the USS Default Lifestyle Option, which we believe is the optimal percentage of growth assets.

Naomi Clark,
Head of Investment Product Management

USS Investment Management

LEGAL & GENERAL INVESTMENT MANAGEMENT (LGIM)

For professional investors only. Capital at risk.

Private market investments to expand in 2024

LGIM MADE A FIRST FORAY INTO ILLIQUIDS IN DC THROUGH AN INVESTMENT IN PRIVATE CREDIT. AFTER A SUCCESSFUL ENDEAVOUR, THE GOAL IS TO INCORPORATE A DIVERSE RANGE OF PRIVATE MARKETS ASSETS DURING 2024.

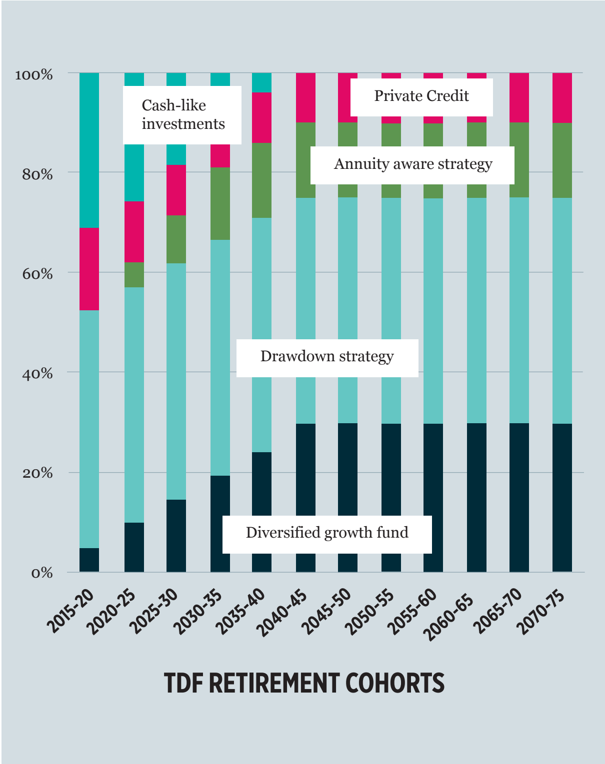
With assets under management of £12.5 billion at the end of August 2023, the LGIM Target Date Funds (TDFs), which are the core default for the L&G Mastertrust and our group personal pension arrangements, currently allocate 10-15% to private markets.

Initially, the private credit fund – which now has an AUM of around £170 million[3] – was only introduced into nearer dated cohorts. The TDFs are split into 5-year cohorts, with the flexibility of having differing glidepaths for each cohort designed in line with the expected requirements for members within them.

After a successful launch, the fund was then introduced into all TDF glidepaths. It is used in all cohorts in the lead up to, and post-retirement, to provide members with additional returns above cash with a lower risk profile than conventional bonds.

However, the use of private credit within the glidepath is focused closer to retirement, as these funds are focused on delivering returns above cash but in a risk-controlled manner. We are currently working on integrating an allocation to a multi-strategy private markets fund as part of the earlier stages, focused more on high levels of growth.

AT RETIREMENT TDF COHORT ASSET ALLOCATIONS



The TDFs also have an allocation of around 2% to direct property via the Retirement Income Multi Asset Fund. The allocation to property is accessed as part of a diversified portfolio included at retirement specifically designed for members ‘drawing down’.

MANAGING RISKS

The TDFs invest in private credit via the Short Term Alternative Finance Fund (STAFF) across all cohorts. This is a diversified portfolio of sub 1-year private credit assets delivering an attractive premium over liquid credit of similar ratings, giving members direct access to private markets. The fund is expected to return cash +1.25%.[4]

3. As at 31 August 2023.

4. As per the L&G Short Term Alternative Finance Fund (STAFF) official target.

At LGIM, we consider there are many benefits to investing in illiquid assets, the most prominent being accessing the illiquidity premiums and diversification benefits via an expanded opportunity set.

On the other hand, we face risks such as having increased governance and operational burden of managing liquidity risk. This is managed in the case of STAFF by having limits, while also having alongside other cash-like liquid investments. In the case of direct property, this can lead to gating/suspension of funds, as we have seen in the past.

The fund management team oversee the asset allocation and liquidity of the TDFs. Private markets are accessed as part of a diversified portfolio, and therefore liquidity is managed across the portfolio. As we manage the TDFs and underlying components ourselves, we are in the unique position to be able to use the full scale of LGIM to be able to aggregate cashflows minimising the risk of gating and continuing to support DC members in particular.

After a successful first endeavour into private credit, we are actively looking at incorporating other private market investments into our DC investment strategies and expect to be able to incorporate a diverse range of private markets during 2024 – this will include asset classes such as private real estate, unlisted infrastructure, private equity and private debt.

Hemisha Malkan
Solutions Strategy Manager

Jesal Mistry
Interim Head of DC Investments

LGIM

Key Risk Warnings

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DC SCHEME (ANONYMOUS)

First foray into private markets

AFTER MANY YEARS OF INVESTING IN PROPERTY, WE ARE NOW TAKING OUR FIRST STEPS INTO THE WIDER ILLIQUIDS ASSETS MARKET, WITH AN INVESTMENT OF 5% OF ASSETS IN A MULTI-ASSET PRIVATE MARKETS FUND.

As part of the plan's 2021 strategy review, the investment committee agreed to explore the use of more illiquid assets. The new fund, which offers an exposure to a diversified portfolio of private market assets, will sit within the growth phase of the default strategy, and will have an allocation of approximately 5% of assets once appointed.

The plan, which has a large number of members and assets surpassing £3 billion, is provided by a Master Trust on a shared governance basis, and also has a 4% allocation to direct UK property within the growth phase.

When initially considering how illiquid assets could be incorporated into the default strategy, the committee carefully considered the benefits of and challenges with investing in illiquid assets.

Perceived benefits:

- Attractive long-term returns
- Diversification with low correlation with equities
- Relatively low volatility compared to equities
- Exposure to real assets; inflation hedge
- Significant development in more niche real assets. Many of these funds aim to have positive climate or social impacts
- Becoming a more mainstream DC investment option and development of these funds is actively encouraged by the Government.

On the other hand, the perceived risks are:

- By their nature, illiquid assets are more difficult to trade
- Investors need to undertake high levels of due diligence. To mitigate this risk, on the committee's behalf, its advisors issued a request for information before presenting funds to the committee. Members of the committee in turn met with the managers as part of its own due diligence process and the Master Trust has also conducted its own due diligence on the fund
- Relatively expensive compared to global equities. However, the committee has successfully negotiated competitive fees for the fund through fee negotiations
- Gating or pricing problems have caused concerns on some platforms. However, the committee has reduced this risk by limiting the allocation to 5%
- Limited choice, albeit growing, while custom solutions are available.

MANAGER SELECTION

The plan's investment strategy was designed by the investment committee, with the help of its advisors, and the committee regularly engage with the Master Trust trustees as those ultimately responsible for the strategy.

Each of the managers appointed within the strategy were selected following a thorough review exercise, considering the merits and value each manager would bring to the strategy.

The Master Trust trustees have recently reviewed the strategy and its evolution, providing feedback to the Committee and areas to consider in the next review of the strategy.

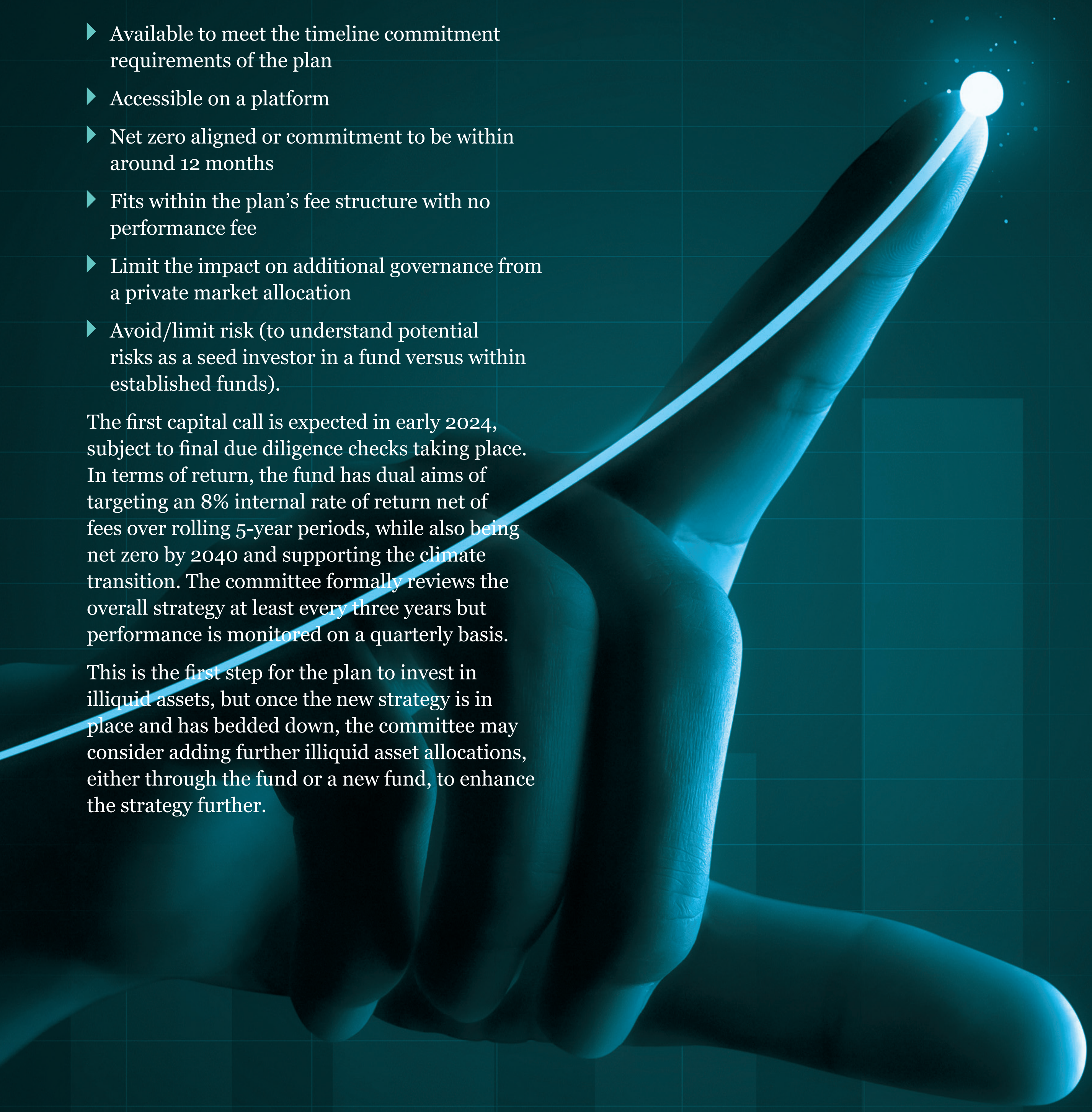
To ensure the new fund would fit into the overall investment strategy, the committee established a set of principles when selecting an illiquid manager, which included:

- The need for the proposed allocation to support the plan's net risk adjusted returns improvement objective
- Multi-asset private market product covering equity and debt across asset classes

- Available to meet the timeline commitment requirements of the plan
- Accessible on a platform
- Net zero aligned or commitment to be within around 12 months
- Fits within the plan's fee structure with no performance fee
- Limit the impact on additional governance from a private market allocation
- Avoid/limit risk (to understand potential risks as a seed investor in a fund versus within established funds).

The first capital call is expected in early 2024, subject to final due diligence checks taking place. In terms of return, the fund has dual aims of targeting an 8% internal rate of return net of fees over rolling 5-year periods, while also being net zero by 2040 and supporting the climate transition. The committee formally reviews the overall strategy at least every three years but performance is monitored on a quarterly basis.

This is the first step for the plan to invest in illiquid assets, but once the new strategy is in place and has bedded down, the committee may consider adding further illiquid asset allocations, either through the fund or a new fund, to enhance the strategy further.



DC SCHEME (ANONYMOUS)

Tapping illiquids through a bespoke LTAF

WITH THE BELIEF THAT INCLUDING AN ALLOCATION TO ILLIQUID ASSETS WILL IMPROVE RISK-ADJUSTED RETURN FOR MEMBERS, OUR DC PLAN IS IN THE PROCESS OF LAUNCHING A BESPOKE MULTI-PRIVATE MARKETS LONG-TERM ASSET FUND (LTAF) WITH AN INVESTMENT MANAGER.

The LTAF, which is expected to launch in the fourth quarter of 2023 and incorporated into the lifestyle strategies in the second quarter of 2024, will include an array of illiquid asset classes, such as real estate, infrastructure, private equity, private credit, commodities, farmland and forestry, and natural resources. The private equity allocation includes venture capital, co-investments and pre-IPO investments.

The investment will be made via a fund-of-fund approach where the investment manager can propose a new asset class, and if there is a compelling investment case, it can also be included in the fund.

The LTAF will invest in all developed regions globally. The proposed portfolio is expected to have an approximate 25% allocation to the UK in the first year, and once the fund reaches steady state, is expected to invest around 30% of its assets in the UK.

INTEGRATION WITH LIFESTYLE CYCLES

The LTAF will be blended with passive equities (15% allocation to LTAF) and predominately be utilised in the early growth phase of the lifestyle cycle, but members will continue to hold an allocation to the fund up until 10 years from their target retirement age.

Currently, the diversified growth fund that is utilised within the main lifestyle strategies also has the discretion to invest in illiquid assets, since the trustee believe the plan will offer members improved net risk-adjusted investment returns. All members within 20 years of their target retirement age in the main lifestyle strategies are invested in this fund.

As of 30 June 2023, the diversified growth fund that is utilised within the main lifestyle strategies had exposure to illiquid assets that included microfinance, insurance-linked securities, direct property and infrastructure debt, which together constituted around 8.4% of its allocation.

The trustee formally reviews the investment arrangements every three years with an additional annual review of the lifestyle strategies against their objectives.

THE MANAGER SELECTION PROCESS

The investment in a bespoke multi-asset private markets LTAF is being made via an external manager. The plan's trustee decided on a single manager for the entire portfolio – as opposed to different managers for each asset class – as it wanted to delegate setting the asset allocation to the investment manager, make it easier to implement the strategy, while offering wider scope to the manager to meet the trustee's criteria of outperforming equities and improving risk-adjusted returns.

Since the investment is being made via a bespoke 'fund of one', the trustee followed a comprehensive process to select the manager. Seven managers were sent a request for information asking them to outline their best ideas for a multi-private markets portfolio. Six managers responded and a final three were shortlisted.

The final three were then sent a request for proposal and then invited in to present to the internal team and consultants on their proposal. The trustee also established a set of environmental, social and governance (ESG) principles which the shortlisted managers agreed to.

The shortlist was narrowed down to two for a final round of presentations, then an overview of both proposals and a recommendation was presented to the trustee. The shortlisted managers were asked to design a portfolio that is expected to outperform listed global equities by 0.5% per year.

A benefit of the fund-of-fund approach we are adopting is that it allows the plan to access a greater range of managers, including those that would not have the scale to allow DC investments on their own, and to invest in best-in-class managers in each asset classes.

This approach taken by the selected investment manager also leads to the opportunity to invest in smaller earlier stage investments, which offer greater asset-level diversification and potentially higher return from earlier stage investments.

ADDRESSING RISKS

The trustee is aware there are a number of risks for investing in illiquid assets, focusing on fund gating risk, pricing risk, risks around needing to place significant redemptions and ramp up risk.

To minimise fund gating risks, the trustee has sized the bespoke multi-private markets LTAF at around 15% for members furthest from retirement, and re-designed the main lifecycles to exclude members within 10 years of target retirement age – with the objective of minimising the risk of the fund gating and members not being able to retire.

To reduce pricing risk, the investment manager will update the price of the fund whenever an underlying asset provides new prices – for the liquid component of the fund this will be done on a daily basis, which minimises the portion of the portfolio that will be stale priced.

To reduce ramp up risk, the allocation will be built up gradually over between six and nine months, while the manager is also using co-investments and bespoke ‘fund of one’ to avoid the issues of the j-curve effect.

The trustee asked all shortlisted managers to design the fund as a ‘fund of one’ structure, which will enable more control over building up and selling down assets to reduce ramp up and redemption risks.

Helen Shackelford
Partner
Lane Clark & Peacock

PRIVATE SECTOR DC MASTER TRUSTS

SMART PENSION

Private credit fund kicks off illiquids journey

WITH THE GOAL TO PROVIDE A STRONG DIVERSIFIER TO THE REST OF OUR PORTFOLIO, WE CREATED ONE OF THE FIRST PRIVATE CREDIT INVESTMENTS WITHIN A DC SCHEME, AND WE ARE NOW LOOKING AT WIDENING OUR PRIVATE MARKETS INVESTMENTS WHICH WILL PROVIDE STRONGER RISK ADJUSTED RETURNS FOR OUR MEMBERS.

With 1.5 million members and £4 billion in assets under management, Smart Pension Master Trust made its first investment into illiquids in 2021.

Our investment into private credit provides a strong diversifier to the rest of our portfolio, which is in listed equities and fixed income. As we are a DC scheme, we are very much at the start of our private markets journey, and this is our first investment into private markets.

At 6% of the total assets, it does not overpower the rest of the portfolio, but helps the risk adjusted return of our portfolio, particularly during market downturns (versus other asset classes).

This investment is accessed through the MV Dual Credit fund within our default growth fund, Smart Sustainable Growth. The MV Dual Credit fund is a 10% allocation within this fund, formed of 6% into private credit and 4% into multi-asset credit, the latter of which provides liquidity for the MV Dual Credit fund, and means it is daily dealing.

The private credit portion invests in pan-European senior leveraged loans, with some subordinated debt, and has £180m invested as of 30 August 2023.

The fund was built from scratch as a blended strategy with Natixis Investment Managers, and is one of the first private credit investments in a DC scheme. We have strategic partnerships with a number of investment managers, including Natixis, who are the parent company of MV Credit, who manage the private credit allocation, and Loomis Sayles, who manage the multi-asset credit allocation.

The investment has grown over time as a function of the growth of our master trust. The timeline for expected returns is approximately five years. We review the strategy every quarter, with a formal in-depth review on an annual basis, where the manager presents.

MORE INVESTMENTS IN THE FUTURE

Smart Pension is looking at widening our private markets investments beyond private credit, to areas such as venture capital, infrastructure (equity) and natural capital, such as forestry.

The perceived benefits are stronger risk adjusted returns from our growth fund, with both improved returns and reduced risk, strong member engagement on particular areas of illiquids (in particular the more impactful end of the spectrum), and an enhanced investment proposition to the market.

In terms of risk, the main one is liquidity risk; while we are a long-term investor, there may be events whereby we need to liquidate our portfolios, for example if we are bought by another company. While we see this as a remote risk, it is still a risk nonetheless.

In addition, from a DC perspective, we are investigating how to most effectively treat members fairly, particularly with illiquids investments, where performance fees are paid over long-time horizons. There are of course the other key risks when investing in these areas, such as the counterparty risk from VC investments.

James Lawrence
Head of Investment Proposition
Smart Pension Master Trust

NEXT STEPS

THE PLSA HAS BEEN WORKING CLOSELY WITH ITS MEMBERS ON HOW PENSION SCHEME INVESTMENTS CAN ENCOURAGE UK GROWTH.

After an initial report published in June - Pensions And Growth: A Paper by the PLSA on Supporting Pension Investment in UK Growth, we consulted with a wide range of pension providers, policymakers, think tanks and other stakeholders over the summer, publishing an update to the PLSA Policy Position on Pensions & Growth at the PLSA Annual Conference 2023 in October.

The new paper makes specific policy recommendations to Government in six key areas, such as a pipeline of assets, DB regulation, taxation, consolidation, the market for DC under automatic enrolment and raising pension contributions.

Following this case studies publication, which we hope will inform pension managers, trustees and policymakers, the PLSA will continue to engage with stakeholders and Government on this matter. We plan to continue to discuss this topic at our flagship events in 2024, and contribute to the wider debate of illiquid investments.

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