

Bringing private markets to DC

Structural hurdles have prevented DC pension funds from investing in private markets, but the status quo is changing, says Joanna Asfour

Why have DC pension funds historically had no access to private markets?
Defined

contribution schemes require investment vehicles to meet specific requirements, such as daily pricing, daily dealing, and highly standardised subscription and redemption procedures. However, private markets funds are typically structured as 10-12 year limited partnership vehicles with limited or no liquidity. Most private

That said, even with daily liquidity, private markets are a long-term asset class. The underlying investments are typically made on the basis of a 4-6 year value creation business plan and holding period. We would expect private markets vehicles to be added initially to larger DC plans that are managed or advised by professional managers or advisers.

Aren't private markets fees too high for DC?

Private markets fees may be relatively higher than other traditional asset classes, but the net returns are also higher. In the UK, an added consideration is the charge cap of 75bps on DC default funds. As such, the need for an annual Total Expense Ratio cap is paramount, so plan sponsors can blend a private markets allocation with other content to comply with the charge cap guidelines. Additionally, while performance fees are the norm in private markets, the mechanism to calculate them in DC must be employed on a daily basis and must be included in the TER cap. When you look at the potential positive impact on returns and volatility offered by a relatively small exposure to private markets, we believe this offers value for money.

Why can't DC schemes just get this outperformance elsewhere?

Private markets are not commodity businesses: there is no way to replicate them. For example, private equity managers invest in a universe of private companies not available to public market investors. Private equity managers take an active, hands-on approach to creating value in their investments over long holding periods

by working alongside company management teams to make operational improvements. A successful outcome requires specialist skills on the part of practitioners. The value that is created translates to outperformance for investors.

Do you think the availability of liquid private markets vehicles will encourage a rethink of the asset allocation strategy of portable DC pension schemes?

Yes, absolutely. As the sophistication of DC scheme investment grows, we expect greater adoption of investment strategies that have been successful for the DB market. These will include private markets, which we anticipate will become an important performance driver for DC investment portfolios.

Will liquid private markets eventually become the norm, or will DC plans accept less illiquidity?

We anticipate a bit of both. In the short to medium term, we envisage more private markets managers will develop products to meet the specific requirements of the DC market. However, in the longer term, we expect the DC market to become more flexible and open to longer-term, illiquid holdings, especially for younger savers whose investment horizons are longer term and who can afford to change the risk/return profile of their portfolio.

Private equity managers take an active, hands-on approach to creating value in their investments

markets firms lack the operational capabilities and systems to meet the DC requirements, at least at the moment – they need to be developed by the industry more broadly.

Are private markets right for DC?

We believe private markets have a place in every diversified portfolio as an alternative and less volatile source of equity exposure than listed equities. Traditional DC default fund design has been focused on passive equities in the growth accumulation phase. Funds looking to diversify their sources of return have included a sizeable exposure to beta-driven diversified growth funds in addition to passive equities. A relatively small allocation to private markets – 10-20% say – could enhance returns, increase diversification and lower volatility.

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