

Private markets: The final piece in the DC default puzzle

The introduction of auto-enrolment in the UK in 2012 has seen significant growth in defined contribution schemes, as millions more are saving for their retirement.

This mass of new, younger savers means assets need to provide sufficient returns to fund their retirement, while Defined Contribution (DC) funds' growing scale allows them to access assets that were previously out of reach.

Private markets could potentially offer higher returns than traditional assets. Until recently, most default strategies contain mainly liquid assets such as listed equities, but this is about to change as more DC schemes are seeing opportunities to build better portfolios for their members by including private markets.

"The 'why invest in private markets' has been a conversation that's been going on for a while now, and there's certainly a lot of support for the why," says BlackRock's Head of DC Strategy EMEA, Dominic Byrne.

"We see a lot of commonality with what we're hearing from all the stakeholders in the industry, which includes schemes, consultants and platforms. I think that's the most exciting thing for me on my desk at the moment, that kind of consensus. Not every client wants to do it, but it's clear that there's a lot of common support for private market allocations," he adds.

While there are many reasons for investing in private markets, typically investors will point to the expected return premia over public markets. The long-term inflation protection that can be obtained from infrastructure assets is particularly important in this current high inflation environment. Furthermore, private markets exhibit resilience through economic cycles and play a central role within global trends – such as the transition to a green economy or the need for greater energy resilience.

Investors such as pension funds also look for assets that align with their long-term time horizon, making private markets a good match for DC schemes.

RISK: There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.

Author



Dominic Byrne

Lead Investment
Strategist for EMEA
Retirement Solutions

"The 'why invest in private markets' has been a conversation that's been going on for a while now, and there's certainly a lot of support for the why," says BlackRock's Head of DC Strategy EMEA, Dominic Byrne.

“There's a natural link between the needs of DC investors and the long-term nature of private markets. When you're talking about potentially saving for decades, this can be a very powerful boost to one's savings in the UK” says Byrne.

While this long time horizon explains why DC schemes can afford to hold illiquid assets, the discussion is now largely shifting from looking at the rationale for private market investing to implementation. It means Byrne's team can finally take a capability that has existed in the firm for more than 35 years to DC clients (Source: BlackRock, 31 December 2022).

Implementation moves centre stage

“Many DC schemes have little or no private assets as yet, so thinking about an efficient allocation is often at the top of the list. The implementation side of the illiquid investment equation ought to take into account the fact that the members are at different ages,” Byrne explains. “The time horizon of the investment needs to align with that of the member.”

The diversity of asset classes within private markets – ranging from private equity and private credit to infrastructure and property – means a private market allocation can be more return-seeking at younger ages and more focussed on providing yield and cashflow closer to retirement.

“BlackRock's large global network gives the manager an advantage when it comes to sourcing deals,” Byrne says. “It allows investors access to assets they might not otherwise be able to invest in.”

With over 1,200 dedicated alternative investment professionals working across more than 50 offices globally, BlackRock has a track record of delivering long-term returns against a variety of client objectives. Collectively, BlackRock now manages over £240bn of client assets invested in a wide range of alternatives (Source: BlackRock 31 December 2022).

“If you're going to build out your first allocation to private markets, having a broad and diversified set of capabilities is really important,” Byrne says.

He also stresses the need for being flexible about implementation, with BlackRock being able to invest alone or alongside others: “We have our own large investment capability, and then we also have a leading co-investment capability that enables us to partner with a global network.”

Private markets investment is research intensive: at BlackRock, every asset that is underwritten goes through a rigorous due diligence process. This analysis provides estimates about the risks as well as potential future returns. Against the backdrop of a potential economic recession, BlackRock will also seek to understand how a given asset might perform in a stressed scenario.

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Integrating environmental, social and governance factors is at the core of the investment process, being deeply embedded in the analysis and investment decisions taken within the underlying strategies across both private and public markets.

“Our approach to sustainability means we have discretion and flexibility over its application in the underlying building blocks with the aim of generating the best risk-adjusted returns for our clients,” he says.

The deep research and strict criteria mean the managers are highly selective about what to invest in.

“Over a 12-month period, we’ll see thousands and thousands of deals, but we’ll only invest in a very small percentage of them. This deal discipline is really key,” Byrne notes.

Technology enables us to have a clear view of the overall DC default portfolio

The underlying economic risk of an asset needs to be well understood, as the less frequent valuation of illiquid assets compared with public ones means their returns look smoother. Risks also need to be seen in the context of wider capital markets.

“Our first consideration is, ‘What is the economic risk of an investment?’ What that means is we’re looking at things like the commonality of risks relative to the public markets, the specific risks that we’re getting from infrastructure or property, and that allows us to understand the portfolio from an economic risk perspective,” Byrne says.

Through the combination of our industry-leading technology platforms, BlackRock is able to manage portfolios more effectively, with a greater understanding of risk and return.

“We do recognize that private markets are different but through our investment in technology we are able to bring consistency to private markets through unparalleled access to data, which provides more transparency into our investors’ portfolios,” says Byrne.

Using these combined tools “allows us to think about the economic risk of the portfolio and then understand what the specific risks are to those private assets – and importantly, how they correlate or how they react to other parts of the portfolio”, he explains.

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Long-Term Asset Fund (LTAF) will open up new opportunities

A big boost to private market investment of DC schemes will come from the UK's new LTAF. The LTAF was introduced by the Financial Conduct Authority in 2021. LTAFs are open-ended vehicles which must hold at least 50% unlisted or other long-term assets, while any remainder can be used to balance the liquidity needs of the fund.

BlackRock has played an important role in contributing to the public dialogue on LTAF. A Productive Finance Working Group was set up in late 2020 by the Treasury, Bank of England and the FCA and recommended among others to widen access to less liquid assets. The LTAF could, therefore, be the key that unlocks private market investment opportunities for DC scheme members.

Byrne welcomes the introduction of the LTAF: "It's very clear for DC schemes that the structuring component is going to be vital and the reason for that is that we have regular contributions, this means we have a requirement to rebalance portfolios."

The fact that LTAFs must be open-ended means they can continue to grow overtime. They will also have a specific subscription and redemption policy.

"This gives people the confidence that the LTAF could grow alongside the default, as well as having visibility around what that subscription and redemption policy is," says Byrne.

In the growth phase, illiquid assets could improve risk-adjusted returns compared to public markets. A special advantage of the LTAF is that it has the flexibility to provide a DC scheme member with exposure to a wide range of long-term alternative asset classes, which means managers can unlock the opportunities in a wide range of private markets rather than just peripheral exposures or more traditional single asset class investments such as property which is probably one of the few less liquid investments DC schemes have accessed historically. This delivers greater diversification for members and well-managed private markets portfolios could lead to better risk adjusted returns over time.

Vitality, investment platforms – which form a core part of the DC ecosystem – have the ability to access LTAFs, as they are a so-called 'permitted link' under FCA rules.

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Moving from the 'why' to the 'how'

DC trustees today are having to navigate a much less benign environment than that which prevailed since the start of auto-enrolment. Higher inflation, higher interest rates and heightened market volatility are forcing them to reconsider their investment approach.

“Such an environment will impact public markets” says Byrne. “Private assets are not immune to higher macro and market volatility or higher rates, but they are long term commitments and the environment can potentially create opportunities for private markets, which have historically performed well following periods of crisis and economic dislocations.”

DC schemes that do not incorporate alternatives could miss out on opportunities that institutional investors globally are benefitting from – and so could their members.

DC is moving from the 'why?' to the 'how?', says Byrne. A key part of building a private market portfolio is the flexibility to meet pension schemes' requirements, he adds, both in building up an allocation and maintaining it over time. For this, a manager has to have strength and depth in their private market capabilities.

In structuring the portfolio, consideration will need to be given to how it would sit in a scheme's default option, ability to provide regular access, and generally able to work operationally.

“Helping a generation of savers plan for a secure retirement is one of the most pressing challenges and responsibilities we face in the UK. Building portfolios that will deliver on these outcomes requires investors to think differently about how they construct portfolios. We believe that incorporating private assets into DC default strategies can improve potential outcomes for savers through a diversified, well managed pool of private assets. This is a really exciting moment to be working with our clients and industry stakeholders to meet this societal need head on,” he adds.

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