Illiquid solutions for better DC outcomes

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Introduction

The working party was commissioned to explore the practical challenges which exist for UK Defined Contribution ('DC') pension schemes in relation to investment in illiquid assets and to explore existing and potential solutions.

The case for illiquid investment for DC schemes is strong: DC members invest for the long term and are well-placed to benefit from the characteristics of illiquid investments which offer not just the potential of an 'illiquidity premium' but the ability to diversify and access alternative asset classes with attractive attributes for DC investors.

The fundamental shift in the UK pensions landscape from Defined Benefit (DB) plans to DC plans raises challenges about the appropriateness of existing DC investment solutions which are often relatively unsophisticated. It is critical that DC members can also benefit from the investment opportunities available to DB funds including investment in illiquid assets. This also fits with the increasing focus on sustainable investment and ESG investing [1], as there are many examples of such investments where illiquidity is an integral factor e.g. social housing, wind farms.[2]

The operational framework that has built up to support UK DC pension schemes is not generally supportive of illiquid investments, being centred around the provision of daily liquidity for members. We must challenge this as daily liquidity is not strictly required for an individual member.

To date, limited demand from DC schemes and advisers alike has translated to limited pressure on providers and fund managers to develop new and improved solutions. In addition, the industry's drive towards low cost solutions inhibits solution development.

Despite today's focus on daily liquidity and cost, solutions to provide illiquid market access are already available as workarounds to the requirement for daily dealing. The technical content of this paper is focussed on describing operational models for such workarounds and proposing further development.

We believe it is critical that UK DC schemes embrace such solutions to enable good retirement outcomes for their members. Further, it is imperative that regulators and policymakers support and promote more fundamental change through an increased focus on the importance of developed investment solutions for DC and reduce the focus on absolute cost.

As part of our research into available and potential solutions for this paper we have spoken to key industry DC platform providers and fund managers to consider the potential for development and to understand their own views on the viability of various options.

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[1] ESG investing is a term often used synonymously with sustainable investment and refers to the consideration of Environmental, Social and Governance factors alongside financial ones in investment decisions

[2] Green investing is outside the scope of this paper but key reference documents include the IFoA's response to the European Commission Interim report of EU High-Level Expert Group on Sustainable Finance, September 2017 and The Law Commission's paper on Pension Fund and Social Investment, June 2017

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1. Illiquid investments

1.1 What are illiquid assets?

In very broad terms 'illiquid assets' are assets which are not easily traded. An illiquid asset does not have a convenient secondary market facilitating trades at short notice. In practical terms this means trading the asset is relatively challenging, potentially incurring relatively high transaction costs, time delays and potential discounts to price. As an example, the lack of a centralised market may result in a waiting time to find a counterparty to complete the trade; the price will then require negotiation and due diligence fees that may be high. These factors together constitute the 'illiquidity risk'.

Assets that typically fall into the 'illiquid' category are, for the purposes of this paper, any asset that is not at least daily tradeable, including:

- Direct property investment
- Investment in infrastructure projects
- Private equity and hedge funds.

Unlike listed equities and bonds, these asset classes are not traded on a stock exchange and therefore an off-exchange counterparty needs to be found when the holder of the asset wants to sell and the actual value may not be known until this point.

Some of these illiquid asset classes already appear within UK DC investment solutions; for example, property funds investing directly into property markets. These funds present challenges in relation to provision of a daily dealing structure given underlying investments are commonly valued on a monthly or quarterly basis and also may not be readily tradable at times of market stress.

To mitigate these challenges many managers supplement their direct property exposure with a highly correlated but more liquid asset, most commonly a real estate investment trust, which provides the daily liquidity to redeemers whilst still offering property market exposure. This also enables the fund to avoid incurring the higher transaction costs of selling a more illiquid property portfolio. As such, the specific characteristics of property investment are necessarily diluted, with some equity correlation.

In some situations, truly illiquid property can be accessed and these funds have specific pricing policies in place to align with a daily pricing model and controls around redemptions in circumstances of market stress e.g. funds may be 'gated' or a fair value adjustment may be applied to the price at the last valuation point. The insurer's terms and conditions would then have an explicit 'carve out' to allow for this, despite the overall promise of daily liquidity.

1.2 Investment benefits – is it really worth it?

A commonly stated rationale for illiquid investment is the pursuit of an 'illiquidity premium'. This is the additional return received as reward for the additional risk of tying up capital for a period of time, as described above. There is plenty of research supporting liquidity as a rewarded risk with estimates of the illiquidity premium being somewhere in the region of 1-7% [3], predominantly driven by asset class, holding periods and the level of illiquidity risk being taken.

[3] See research by Ilmanen 2011

Some studies suggest the level of illiquidity premium an investor should expect is much less straightforward. In particular, it is difficult to quantify the premium in practice for a number of reasons including:

- The illiquidity premium cannot be entirely isolated from other risk premia,
- Illiquidity is not constant (assets are harder to sell in times of market crisis). As such, there is not a constant premium above a market rate, and the premium has to be considered in a market context.

It is outside the remit of this white paper to confirm/deny existence of premium or to try to quantify it and in our view there are other equal, if not greater, drivers for investing in illiquid asset classes, such as access to a wider investment opportunity set. Many of the illiquid assets available have positive attributes which are well suited to DC members' needs, offering:

- A stable income,
- Lower volatility than equities
- Good levels of real return, plus
- Diversification from equities.

1.3 Need for (and suitability of) illiquid investments in UK DC

The UK shift from DB plans to DC plans, accelerated by automatic-enrolment, elevates the importance of good DC investment solutions.

The benefits of illiquid investment, noted above, come as the return for the inaccessibility of capital in the short term, which is in direct contradiction with the current DC daily trading model. To date, the reliance on daily trading for DC has blinded the DC industry to the appropriateness of these investments for DC members.

The reality, however, is that the vast majority of DC investors do not require daily trading, staying invested for the long term with very limited trading activity throughout their membership. The duration of DC liabilities is longer than it is for DB, given the advanced maturity of DB schemes and the ongoing expansion of DC for the foreseeable future is a source of liquidity itself. New contributions coming into the scheme enable us to buy out the units of older members. Arguably liquidity is not a material risk in this context.

Most DC members will default into a lifestyle strategy/Target Date Fund (both providing an asset allocation glidepath which reflects a typical member's changing objectives over time) and stay there until retirement, which in some cases will be up to 50 years. These strategies/funds have many of the characteristics of a DB fund in that they are managed by professionals and invested across a range of asset classes over the long term to achieve objectives suitable for the membership overall. This long-term, managed approach, facilitates investments in illiquid assets which can be blended with other liquid asset classes so that they are kept apart from members' daily cash flows.

2. Challenges for UK DC schemes

Illiquid assets are currently held in many DC schemes via funds with highly diversified portfolios (e.g. Diversified Growth Funds). The levels of illiquid assets held in these strategies are minimal and the objectives of these funds typically require the ability to be nimble in terms of asset allocation, which affords limited ability to invest heavily in illiquid strategies.

The challenges of funds offering more focussed illiquid investments for DC members were illustrated during 2016 when, following the EU referendum result, a number of property funds experienced deferred redemptions or, alternatively, materially reduced sale prices through application of a 'fair value adjustment' of up to 10%. British property was among the sectors hardest hit by the vote in favour of Brexit and, at one point, commercial property funds worth over £18 billion were suspended.

While these actions were taken to protect non-redeeming investors against higher than usual levels of redemption activity i.e. to avoid assets needing to be sold at a discount in the context of material market uncertainty and concerns that property demand and prices would plummet, this did result in significant operational issues for DC platforms that rely heavily on automated trading procedures. Funds were gated in some cases which caused some pension providers unforeseen problems relating to the investment of member contributions.

These were largely unprecedented steps, not seen even during the time of the Global Financial Crisis, and in practice they only impacted DC members over a very short time period as most of the measures were withdrawn by September 2016.

However, this offers a good example of the some of the challenges illiquid investments can pose for automated trading procedures. We explore these issues in more detail below and also explain other challenges to ensure we identify the issues we need to address in finding a solution.

2.1 The need for daily pricing/trading

There is a general belief that DC assets are required through Permitted Links regulation to be priced and to be tradable on a daily basis. In fact, it is not the regulatory framework but the operational framework and insurers' contractual promises to members which drive the need for this.

Most DC investment solutions are delivered through an investment platform provided by a life insurer, with funds available as unit linked life policies, as opposed to direct investment in the managers' funds. There are a number of benefits to provision of funds in this way including the reduction of out of market risk associated with members changing investment strategy and the potential to create bespoke blended funds.

The relevant regulations presiding over delivery of investments to DC members in this way are the Permitted Links rules for long term insurance business, set out in the FCA handbook. These rules give a list of assets in which unit-linked life and pension funds can invest. The regulatory requirements as amended in 2007 provide that the linked assets must be capable of being realised 'in the short term' i.e. in time for the insurer to meet its policy obligations.

The adherence to the insurer's terms and conditions provides more flexibility than the previous requirement of "readily realisable" which was open to interpretation by insurers' compliance teams.

The driver for the change was the recognition by the FCA that it would be unreasonable to prevent a fund from making an "illiquid" investment if it would be to the policyholder's advantage.

Currently, the terms and conditions of most platform providers offer a commitment to provide daily liquidity, with the potential carve out of certain types of funds, including property. Therefore, if there was a delay in providing this liquidity, funds might have to be provided from the insurer's balance sheet, which comes at a cost to the insurer.

Insurers' automated trading operations have been built to facilitate this promised daily liquidity. As such the vast majority of funds added to the platform fund range must adhere to the automated 'dealing cycle' of the insurer's trading aggregation platform and valuation process.

This could be amended, should the terms and conditions change, but there would be a significant cost to this. To date, there has been little commercial incentive for providers to develop existing structures as there has been limited demand in the context of a lack of regulatory focus on supporting access to illiquid asset classes and significant focus on cost.

2.2 Cashflow

Despite our own assertion that DC members are long term investors and don't require daily trading at member level, there will of course be cash flow requirements at the scheme level which need careful management to avoid any unnecessarily costly trading. Cashflow requirements from DC schemes predominantly result from forthcoming retirements, switches and transfers out. These cash flow requirements create challenges around how we structure and govern the investments in practice to incorporate illiquid elements, as schemes would need to avoid redeeming from high transaction cost assets (i.e. illiquid assets).

2.3 Cost

Fund management costs are often higher for illiquid funds. These funds are predominantly actively managed and there may be significant set up costs including the costs of research or development of supporting operational/governance structures.

The introduction of the Charge Cap, requiring that member incurred charges within a default investment strategy must not exceed 0.75% p.a. in any charge year, means that we cannot focus purely on risk adjusted net returns, but absolute costs have to be considered. Significant regulatory pressure on absolute cost levels has exacerbated this focus such that minimising cost has generally become a greater driver of solutions design than optimising net returns/value.

With the market environment incredibly cost constrained, we will struggle to facilitate access to illiquid products DC without some degree of compromise.

2.4 Complexity

Investing in illiquids requires significant research and potentially complex operational structures, which can create a high governance burden for pension schemes. Delegation to a fiduciary manager is one way of managing this but, to date, DC investment has been slow to develop appropriate governance solutions to accommodate increased sophistication.

Complexity can create challenges in terms of member understanding. The FCA appropriately states that for contract-based schemes (e.g. Group Personal Pension Plans) the unit linked policy "must meet the expectations of the investor" and that "they must understand" the investment, which means they must understand any lack of liquidity and transaction costs that might be caused through trading illiquid assets.

Where illiquid assets are used within a default fund and the liquidity is managed at fund level, this may not create too much of a problem. However, where a member is able to self-select illiquid assets and as such may be directly impacted by deferred redemptions, for example, clear communication of the relevant risks will be highly important. There will need to be significant simplification of the issues given the level of engagement and understanding from the average DC member.

Whilst these specific requirements do not apply for trust-based professional investors, the trustees would still have a duty of care and a requirement to ensure effective communication of illiquidity issues to the DC member.

Member understanding and engagement should be significantly easier to achieve where assets are tangible (again, using our examples of social housing or wind farms) and where we can develop 'asset owner brand'.

3. Solutions

We believe that DC investment funds will continue to be delivered to scheme members through existing pension provider solutions given the overall benefits that platforms provide. In light of this, we need to find a way of creating solutions which enable us to invest in illiquid assets whilst managing schemes’ cash flow needs and retaining the benefits of the insured platform structure. This liquidity can be facilitated at various levels within the insured platform structure:

3.1 Underlying Fund

- Specialist fund manager offers 'illiquid' fund through platform
- Liquidity is offered through enhancement of the daily valuation model to price illiquid assets daily
- Offer a strategy that is mainly illiquid, with liquid supplement to provide liquidity and reduce transaction cost.
- Examples of such solutions already exist and are starting to become available through DC platforms

3.2 Platform Life Policy (Managed blended Fund)

- A managed blended fund is created where liquid and illiquid assets are held within the same structure.
- Cashflows can be directed within the managed fund such that redemptions are taken from liquid portion of the blend
- Some solutions already exist but require a manager to oversee cashflow and the long term portfolio.
- Given DC is cashflow positive, the ideal solution enables re-registration of illiquid assets from retiring members to younger members.

3.3 Platform Member Trading (Pending transactions)

- Automated trading model incorporates a separation of each trade into liquid and illiquid trades.
- Pending transactions are held on the system awaiting illiquid dealing dates
- Technology portal ensures members' expectations are met in respect of dealing dates and costs, both prior and post transaction.
- Some retail platforms are already capable of this type of 'pending transaction' approach but further development is required to enable access to illiquid investments

Each of these options is explored in more detail through the remainder of this paper.

3.1 Underlying fund manager solutions offering daily pricing

This solution refers to the creation of a fund holding predominantly illiquid assets, but creating a more frequent pricing and dealing methodology to enable the fund to fit within the existing operations of the platform and as such provides daily liquidity for members.

Portfolios such as these typically benefit from a portion of the portfolio being liquid, which helps to manage transaction costs relating to cashflow and to minimise 'cash drag' from time delays caused through sourcing quality investments.

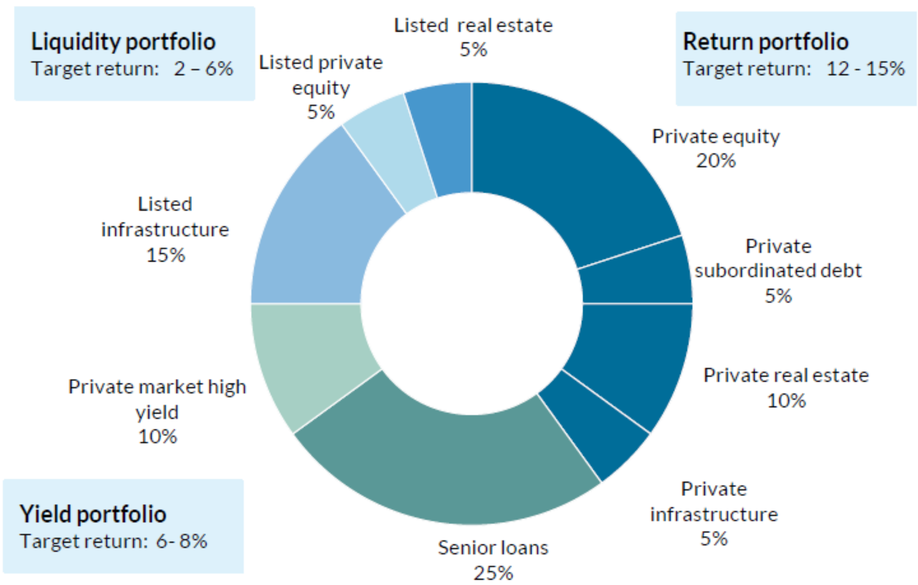
Such options are starting to appear but they are few and far between given the ongoing operational challenges this creates and because they tend to look expensive alongside other DC funds, thereby pricing out the vast majority of the DC market looking to access this type of investment, including member administration, for less than 0.75% p.a.

Creation of a daily pricing model

Valuing an illiquid asset generally takes a considerable amount of time and resource. Additionally, for illiquid assets there is no "daily" comparable price available due to the low volumes of trading and the fact that assets are distinctive, so sales in the same sector are often incomparable. Funds investing in illiquid assets are therefore often formally priced on a monthly or quarterly basis, staggering the valuation cycle of each portfolio asset.

Recognising that the monthly/quarterly pricing cycle does not suit a DC investor's daily dealing model, the UK DC market has recently seen investment managers attempting to bridge the gap between the latest formal monthly/quarterly pricing points by issuing a formal price for their fund on a daily basis. To do this, the fund manager will look to derive a daily price using their best estimate of a reasonable price for the fund on any one day. Fund managers can also take into account a wide variety of readily available quantitative and qualitative factors.

One manager pioneering an approach to pricing illiquid assets on a daily basis is Partners Group. The newly launched "Generation Fund" is a DC friendly (daily priced) fund that offers DC members the opportunity to invest in a wide range of asset classes with the target allocation below, offering broadly a 75% allocation to truly illiquid assets:



Source: Partners Group

How is it done?
Ordinarily Partners Group price their illiquid assets on a monthly basis. To do this they will take a full 'fair value' valuation each quarter based upon their stringent valuation guidelines – this forms the quarterly price. Then, on a monthly basis the most recent quarterly 'fair value' valuation is adjusted based on new material information that is available using both quantitative and qualitative data. This adjustment will include factors such as:

- New fair values provided by underlying fund managers
- New transaction information (Mergers & Acquisitions, Initial Public Offerings)
- New information on adverse events (e.g. bankruptcy)
- New information from fund and direct investment monitoring activities
- New public information on the portfolio

In order to go one step further and value daily for the DC market, a similar form of adjustment is made, but due to practicalities of a daily valuation process, this is based on more quantitative factors such as:

- Interest accruals on private debt instruments
- Intra-month fund revaluations
- Valuations of listed companies held by the fund
- 3rd party pricing available of debt instruments
- Foreign exchange impact on underlying positions
- Investment related cash flows
- Extraordinary events identified through the daily monitoring of direct investments which are deemed to have a significant impact on their valuation.

Whilst not possible to capture all factors impacting price, Partners Group expect their daily valuation adjustments to capture significant valuation changes. The combination of the daily valuation process and the staggering of monthly valuation cycles creates a strong smoothing effect in the valuation process to avoid any pricing corrections. It is worth noting that this daily value estimate is essentially a further enhancement of their monthly fair value process which has been utilised by the firm for many years.

What are the fees?
Given the cost constraints on the DC market, this type of fund, offering active management of private markets with the additional operational overlay relating to daily pricing, will struggle to achieve demand without compromising the investment approach in some way.

Illiquid funds commonly charge performance fees and these would typically be paid quarterly. This does not work in a DC environment as fees are not split equitably across members. Partners Group circumvent this by utilising their daily price to generate a performance fee on a daily basis, using a daily watermark.

What are the pros and cons?
The process appears well thought out and Partners Group can point to the fact they have been successfully running a similar strategy for 2 years now in Australia. Clearly, there will always be

discrepancies between an estimated daily valuation of an asset and a full, audited, valuation but this solution appears to offer a heavily illiquid private markets portfolio alongside true daily liquidity.

On this basis, this product does appear to offer a real, implementable way for DC clients to access illiquid assets and the diversification benefits that they bring with them.

This solution will also present challenges for various managers across the illiquid spectrum, most notably where the manager is unable to find comparable liquid assets to their portfolio to help create the daily pricing model.

The key drawback to this solution is the level of fee which applies.

Summary

This solution places the majority of the operational development on the asset manager, where there is typically the most amount of revenue earnt, thereby offering a strong incentive for the asset management market.

This solution fits within the existing DC operational model, but itself carries significant operational cost to ensure that the fund is priced effectively. Unfortunately, most managers offering access to private markets have been priced at a level that is prohibitive for meaningful allocation for the vast majority of DC arrangements.

3.2 Managed blended fund solution

This blended fund concept exists within many schemes already, with many schemes creating bespoke 'white labelled' funds to achieve a specific investment objective for their members and some schemes going further and delegating the asset allocation either within one fund or even across the whole glidepath (e.g. through Target Date Funds). However, if DC schemes are to benefit from illiquid assets within the blend there will be a need for a fund manager to ensure cashflow is available to DC members where necessary, and that the portfolio does not become over exposed to illiquid markets due to member cashflow requirements.

The operational structure

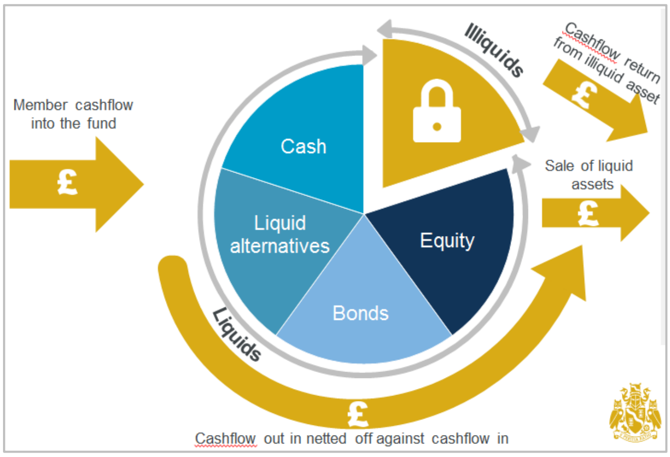
The operational structure we outline in this section is designed to provide careful management of cashflows by a fund manager around a diversified portfolio. The critical difference between this structure and the development of the fund manager pricing model just described, is that within the latter, liquidity is offered through daily pricing of an illiquid asset, whereas the Blended Fund offers liquidity only from the more readily realisable elements of a DC member's pension fund.

The most attractive version of this operational model to enabling illiquid investment is within a provider Default strategy. In this scenario, an Investment Manager is able to choose, for a consolidated solution (i.e. at scale), how much of the illiquid asset is held within each stage in the members' journey (potentially within a Target Dated Fund structure). Then, through reliance on the DC cashflow, they can create a secondary market whereby the illiquid assets of older retiring members are bought by the younger members.

How is the structure achieved?

In order to provide liquidity from the more readily realisable elements of the portfolio, this structure requires a fund manager monitoring the portfolio of the blended fund on a daily basis.

Fund management is not commonly a core service for most pension providers and so this is generally outsourced to a third party with the relevant regulatory permissions and skills.



It requires an Investment Management Agreement to be struck between the provider and the fund manager. It can either be considered for a single portfolio, or can be applied to the entire member journey within a lifestyle, where all funds are managed by the same managers, or within a Target Dated Fund structure.

As the fund manager is managing the blended fund, they are required to ensure that each portfolio continues to be well balanced and in line with their respective objectives, while ensuring that enough liquid portfolio is available to meet the cashflow requirements of a DC membership, even in extreme scenarios where a scheme or schemes are transitioning out of the strategy.

The investment solution provider can choose to offer illiquid assets within a single fund, or can choose to construct the asset allocation glidepath in such a way that enables the fund manager to pass the illiquid asset holdings of older members back to younger contributing members in return for cash, ideally without even needing to trade with the market and re-registering the asset between various portfolios targeting different parts of the member journey, within a Target Date Fund structure.

Typically a pension provider will require significant incentive to consider this type of model meaning that this structure will only be considered, given the risks and development costs involved, if significant assets are likely to be invested. However, due to commercial and regulatory (charge cap) pressures, most pension providers are currently too cost focussed to feel able to allocate to specialist illiquid asset managers in a meaningful way.

What are the pros and cons?

This model can be easily integrated into most DC platforms – Target Date Fund structures already exist and further development of the underlying allocation to allocate to illiquid strategies and implement the supporting cash flow management is within the capabilities of some consultancies and providers with strong investment teams and manager research resources. However, in most cases because member administration is included within the 0.75% charge cap, the investment budget for illiquid investments is prohibitive at present, although as the market consolidates we might expect this to change.

Target Date Funds have the added benefit of offering a simple packaged solution to the member, hiding the complexity that lies beneath.

Because liquidity is not required of the illiquid portfolio, this solution allows 'best of breed' access to the illiquid funds available to DB, without a requirement from fund managers to 'water down' their portfolio down with liquid versions to meet DC dealing requirements.

The main challenge, aside from cost, is the overlay of the research and functionality to support illiquid investment with appropriate cash flow management. Whilst some providers are set up for this, many others are not. The fund manager's trading systems must be well understood to ensure efficient implementation of ideas is achieved and that re-registration between younger and older members can be effected.

A further drawback is that, because the illiquid portfolio is not required to be daily priced, members trading on this blended fund are using a fund price that is partially 'stale'. If the illiquid portfolio is stale-priced on the platform systems, financially aware members may be able to benefit from this stale-pricing, to exit the portfolio before a material loss is reflected in the illiquid fund unit price and by extension the blended fund unit price. This stale pricing also has the potential to disadvantage members and so needs careful communication and monitoring.

An additional concern is that there is a risk that the manager may need the ability to 'gate' the blended fund if there were concerns that redemptions could be sufficient to imbalance the portfolio. This would generally require a review of the insurer's Terms & Conditions to support this given it is common that gating is only allowed in the event that an underlying fund manager gates a fund. This would also be highly challenging for any provider default strategy to communicate to all the employers and members. In the context of the cash flow positive scenario of UK DC default strategies, this risk is clearly reduced.

Summary

This solution enables an optimal allocation, not being limited by the need to keep additional cash or liquid assets alongside for cash flow purposes. Many industry default funds are offered through a Target Date Fund format though most do not include material illiquid fund investment given constraints on cost. As the market consolidates we can expect administration costs to reduce in proportionate terms and to create capacity for further development.

The managed blended option offers a way for members within the default strategy to benefit from illiquid investment. However, within this structure it is still not possible for members to control their access to illiquid investments through self-selecting. It is for this reason we have considered pending transactions as a way for members to self-select illiquid assets, while not requiring illiquid asset managers to change their existing operational model.

3.3 Pending Transactions

We have explored two solutions to providing liquidity to members in illiquid markets; however, each of these solutions come with drawbacks as noted.

One solution to achieving a best of breed investment approach, as the blended managed fund solution does, but whilst also retaining the automation of a platform (thereby avoiding the requirement for cash management overlay outside of the daily dealing cycle) would be to change the operational structure of DC platforms, and amend attaching terms and conditions to support this.

An overview of the solution

The 'pending transactions' approach outlined here is aimed at maintaining daily liquidity for liquid funds, whilst enabling trades on illiquid assets to occur at the next available dealing point.

This requires more fundamental development of life insurance trading systems and changes to insurer terms and conditions than the two other solutions set out previously. In fact it requires development to a similar level as some retail platforms' trading operations, while keeping some of the structural, governance and operational benefits of the institutional life platform.

The DC industry's requirement for daily dealing access to funds is borne out of the expectation that a large membership is on average going to have at least one member trading each day. However, in reality, the trading requirements of an individual are significantly less.

Illiquid funds do not typically fit into the platform trading operations, which are highly automated with virtually no manual intervention, because they might have any number of dealing or settlement restrictions. In the current DC platform model, if a transaction comes through the system for an illiquid fund on a non-dealing date, the trade would fail and any buy and sell trades relating to this transaction would be cancelled entirely.

If platform systems and online technology is able to develop to the point where each member account is segregated and we can separate out liquid and illiquid elements, we can treat the elements differently, processing liquid trades as normal on a daily basis whilst storing transactions on illiquid assets on the administrative systems waiting for a dealing date. Each time a trade is placed, the liquid element of the trade is placed in line with current institutional service levels, pre-funding the switch to the recipient liquid fund. However, the illiquid trade is separated out from the liquid trade and sits as a pending transaction, waiting for the next available dealing date.

How would it work in practice?

Trades involving illiquid assets would need to be considered separately, with the existing online functionality developed to provide additional transparency to members around transactions yet-to-be-executed to ensure that member expectations were met.

Where illiquid assets form part of the lifestyle, there would be a liquidity requirement from the Pension Provider for the level of illiquid assets to be reduced on approach to the expected retirement age when we will start to see liquidity demands from the membership.

The lifestyling administrative functionality could generate trades in a similar fashion to the current systems; however the illiquid portion of any automatically generated trades would then need to sit as pending until the illiquid asset(s) dealing date(s). In this fashion we believe it would be possible to include illiquid assets within a default lifestyle.

Where members are looking to self-select their investments involving illiquid investments, the same online functionality would need to provide members with clear pre-trade communication around the next dealing date available on each illiquid asset and any potential transaction costs that may be incurred through the transaction.

This information is available from fund managers but would be required to be fed into a technology portal to ensure that member expectations are met and that they are clearly communicated with about where their monies can sit until the dealing date.

What are the pros and cons?
The greatest benefit to this model is that it provides investment control and transparency on trading, opening up a wide range of illiquid assets without the requirement for cash flow management, thereby offering more direct access to illiquids than the blended fund solution.

This does then mean that the benefits of cash flow management which fall within the blended managed fund solution are not achieved.

This model would receive less of a compliance challenge from a Treating Customers Fairly (TCF) perspective relative to the blended fund solution, where liquidity of the fund would vary over time driven by cashflow.

Trades involving illiquid assets would result in significant out of market risk, while the illiquid trade was pending; although we believe there are a couple of ways this risk can be mitigated. This could be by leaving the assets invested in the liquid investment until the illiquid asset is available to trade, or through matching each illiquid investment with a correlated liquid asset, where the money can be parked until investment in the illiquid fund is available. We believe the latter approach has merit but will incur two layers of transactional cost and there will inevitably be illiquid funds with limited compatibility with any listed investments.

Unfortunately, the Investment Only life insurer platforms utilised by unbundled trust-based schemes would not be able to operate this model, given that it would require member-by-member transparency of investments, which sits with the third party administrator. So this solution would only be available to bundled trust based solutions or GPPs, with the first movers likely to be those with strong retail platforms.

There would be scheme level issues for transitions caused by pending transactions. There would have to be a blackout on illiquid transactions in advance of any transition, to ensure any pending transactions were processed prior to the transition. However, the ability to cancel pending transactions would be a prudent service to offer members in this circumstance. This would encourage insurers to put in place a limit on dealing frequency, requiring illiquid assets to be tradable at least on a quarterly basis.

There would need to be clear communication of each expected trade date, split between liquid and illiquid trades, and the implications and costs of investing into illiquids would need to be disclosed and communicated up front. Ensuring the average DC member understands this will be a challenge.

Lock-up periods on illiquid funds would still need to be waived. Likewise, redemption notices, often present on illiquid funds, would either need to be waived or monitored and fed into the dealing technology, to ensure any trade placed within the notice period is deferred to the next dealing date.

Summary

This solution requires the most development although some providers are already moving in this direction with separation of trades to enable both institutional and retail investment from one platform. The potential benefits of the solution centre on the transparency and avoidance of the requirement for cash flow management. The solution would support the offer of illiquids to self-select investors.

4. Next steps: Joining forces will help make a change

Following the implementation of auto enrolment, the continued risk transfer from DB to DC schemes and an ever growing proportion of UK pension fund assets invested in DC schemes, it is now more important than ever, that DC pension investing focuses on achieving optimised (net of fee) outcomes.

As part of this, the arguments for DC schemes and members to hold investments in illiquid assets are compelling and, despite what may initially appear to be unsupportive operational structures and regulation, with support from all key stakeholders it is possible to achieve illiquid investment today.

This will help bring the toolkit available to DC investors closer in line with that accessed by DB and other institutional investor classes, ultimately offering the opportunity for better member outcomes.

To see real change we believe:

- **Consolidation and stability** must occur within the UK market to achieve the necessary scale and longevity for illiquid solutions. To provider wider access to illiquid assets, scheme managers/employers must be confident the current investment arrangements will continue in their current form.

- **Regulators and governments** should focus attention and guidance towards net of fee outcomes and value for money over above absolute cost.

- **Advisers** should bring best ideas to clients, helping to drive industry demand where appropriate, not automatically accepting the status quo. Without demand these solutions will never be fully developed.

- **Scheme managers and employers** must think long term about the future of their DC arrangements and the employer's desire to retain or outsource investment responsibility. Increasing investment sophistication requires increased levels of governance.

- **Fund Managers** should work with consultants and seed clients to provide illiquid solutions that fit the desired implementation mechanisms. Without relevant product, it is ultimately impossible to implement strategy.