Asset owner conversations

Date: 12 October 2023

Topic: The future of pensions – affordable solutions required

Participants:

Mark Atkinson – Alliance Trust
Tim Mitchell – Annuitas
Brnic Van Wyk – Australian Retirement Trust
Tony Broccardo – OPAM
Davide Deagostino – Brightwell
Praneel Lachman - FirstRand Bank
James Harman – HESTA
Emma Hunt – HSBC Bank Pension Trust
Michael Jabs – Kraft Heinz
Simon Ellis - LifeSight
Mark Fawcett – NEST
Scott Tully - NEST
Nacho Javier Hernandez Valiñani - PC30
Jaap Van Dam – PGGM
Andrew Lill – REST Superannuation
Andrew Thomas – REST Superannuation
Tim Hodgson – WTW
Sarah Hopkins – WTW
Ben Leach – WTW

Agenda
Sarah Hopkins – DC portfolio construction: a solution in *smart beta*
Ben Leach – DC portfolio construction: a solution in *private equity*

Introduction
Some takeaways from TAI's previous work on pensions are:

- DC that doesn't provide a retirement income for the whole of life is not fit for purpose. Therefore, DC needs to solve for longevity risk, not just accumulate a pot of assets.
- The future of pensions working group this year concluded that there is no future for defined benefit pensions and that the vast majority of pension asset accumulation globally will be via DC. This means that in the future we are going to need affordable improvements.
- One of the case studies we looked at was Australian Retirement Trust's Lifetime Income product, which attempts to make the DC offering fit for purpose. After an initial six-month cooling off period, the money is locked into the product, which offers payments for life, annually adjusted to reflect investment returns and mortality credits. There is also a money back guarantee.

Sarah Hopkins – DC portfolio construction: a solution in *smart beta*
Some of the challenges that are impacting DC portfolio construction are:

- Evolving regulation – from emphasising a focus on tracking error to the demand for daily liquidity despite members not needing to access their money for 40 years - causing challenges for creating and implementing different ideas in portfolios.
- More delegation, internalisation and consolidation in a lot of markets, which has an impact on how people think about value versus cost.

- There is greater demand for tailoring and customisation, where members' beliefs and sustainability issues are also considered.
- As a result, there is not much innovation in portfolios.

An innovative solution for smart beta would need to:
- focus on reducing cost, offering more value through economies of scale
- work for a default strategy to make sure it is applied consistently for the whole equity portfolio
- incorporate decarbonisation pathways to align with the net zero strategy
- be flexible for adjustment to new regulations without too much change
- incorporate long-term risk management

It was suggested the solution is to combine these things into an indexation approach. This would allow the right exposures for each client's portfolio, the right exclusions policy, the right long-term exposure to some specific factors, but doing that through an index so members get access to those portfolio exposures, but implemented in a low-cost way that gives value for money.

Ben Leach – DC portfolio construction: a solution in *private equity*
- The smart beta idea frees up some fee budget to enable access to more expensive asset classes which can provide better financial outcomes over the long term for retirees.
- Traditionally, private equity markets are not associated with value for money. However, there are ways in which the industry has evolved, such as through low-cost co-investments that are provided to LPs invested in a GP's main private equity fund.
- One of the innovations that has yet to come to the DC market, but has been a long-standing innovation in the DB, sovereign wealth fund, supranational and endowment markets, is the packaging of that co-investment deal flow into funds and solutions that investors can access at a much lower fee.
- The other things we have to think about in terms of providing access to private equity within a DC context is liquidity and valuations.
    - It is important to be able to provide liquidity for an open-ended DC plan, where investors are allocating more capital, moving capital around and rebalancing and clearly there are limitations around the liquidity that can be given in a private markets' context. So potentially packaging up private equity assets with some form of listed assets is one way in which private equity can be accessed by the DC space.
    - The other part is going to be some form of a valuation mechanism, where investors are allocating more capital on a monthly basis where they're participating in growth and returns that have already been potentially realised and where investors ultimately will disinvest.
    - Some form of an independent valuation that is commensurate with what the value of that portfolio is on the day would be an innovation and is necessary to enable access to DC investors more broadly into private equity.
- Also, private equity allows DC investors, who want to have more choice and feel that they are more aligned with their underlying assets and their savings, do that in a very targeted, selective way, allowing for thematic exposure.

Discussion
- Could you clarify the suggestion that private equity could be accessed without paying for it.
    - Yes, the access to co-investments in private equity at no fee no carry is typically through them being a partner or an investor in that fund or across that fund platform. Private equity solutions providers would have exposure to lots of funds, through which they will see more co-investment deal flow. Within some of our discretionary portfolios we have been doing co-investments for the clients that wanted us to do it as a part of a broader solution. This innovation is just isolating that part of the solution and providing access to a broader set of clients' pool that ordinarily wouldn't necessarily be able to get access to it. There's still a cost to the end saver, but it is materially reduced in comparison to a primary funding solution.
- The thing with regards to private equities is that there's a very long road to go when we're talking about ESG and sustainability. There is not enough information available which makes

it hard to access one's impact. So, for us to achieve our net zero commitment by 2050 private companies will need to commit much more than they are doing right now. The challenge is for us as an industry to collectively do a better job on pushing private equity managers in this respect.

- In terms of the access to private assets, it seems that bargaining power comes with scale. However, most DC schemes would not want to leap into private assets, but rather tiptoe into it, which means small scale and very little liquidity. Are there any thoughts therefore on working together in some form of syndication approach as a possible way forward?
    - Yes, the ability to move into scale is an advantage in private assets. WTW has a discretionary business where clients borrow our scale to syndicate essentially by accessing a platform where they get the benefits of scale and lower pricing.
    - Syndication sounds interesting and we can probably expect more collaboration and syndication to emerge in the future.
- It is challenging to see how, at least in the UK, private markets can neatly fit into a DC framework given all the constraints on scale and cost. And also, how longevity fit into it (unless you buy an annuity, which might be expensive). So, it looks like we are trying to fit into something that is almost impossible to fit into and therefore, should we consider a shift to a new framework instead, an evolution where we can really have this income for life solution?
- The Dutch pension reform is an example of trying to improve DC in a cost-effective way. The new system can be labelled as collective DC, and sometimes referred to as 'defined ambition'. The new system will be catering for the life cycles of cohorts of members, which is an improvement from the old system, where there was one solution for the whole population and lots of complex mechanisms with a bit of wealth transfer between generations in certain circumstances. Doing this collectively means that we can smooth costs etc. However, the system will still have an enormous amount of complexity and the average investment mix will not change a lot. Therefore, it's hard to see the outcomes of the system being significantly better.
- With regards to smart beta, our experience was very positive until the liquidity crisis, at which point the gains were gone. It is important to be careful with your expectations of these strategies, how you govern them and to whom you outsource, etc.
    - In the past, many of these structures were wrapped up with multi factor investing and factor rotation, etc. And that could be the key error. We are trying to get in less factors, but some other criteria that we want to manage more effectively, such as sustainability. Also, instead of outsourcing to multiple managers, where you don't know if you are getting double exposures or non-exposures, having our own smart beta formula / index, where the mapped in sustainability characteristics are the ones we want to have.
- There is an increasing sense that we are at a point of discontinuity – after decades of positive demographics, we are entering a period of adverse demographics, as well as going through some form of transition driven by climate change. We have to either transition the economy markedly, or we will continue to emit and transition the climate markedly. This would appear to be a headwind for long-term asset returns (hurting the affordability of pensions) and sovereign balance sheets. Are we as an investment industry ready for how different the future is going to be to the past? We know that we're heading into a DC problem where the investment risk is on the saver, and should that change our mentality? We know how to do risk management in the old paradigm, but in a complex adaptive system risk management becomes a very different gig. Therefore, we need to grapple with systemic risk management.
    - That is correct, we can optimise our portfolio in order to find the point of balance between risk and return, but the worry is what is not expected. This is where a lot of our work is right now.
    - Sometimes we set ourselves impossible tasks. There's a limit to our knowledge about the future. We build what we believe the best portfolio is and try to anticipate the risks that are visible.
    - There's something in the zeitgeist at the moment, which might challenge our conventional way of doing things. Trying to work forwards might be a bit more about

visualising the future and then working backwards, which would turn the neoclassical sort of scenario analysis and assessment on its head.
  - Let's try and manage what we can control as well as we possibly can. It is certainly fascinating to think about some of the big term threats, but in the end, we can't control these things.

About the Thinking Ahead Institute
The Thinking Ahead Institute is a global not-for-profit member organisation whose aim is to influence change in the investment world for the benefit of savers. The Institute's members comprise asset owners, investment managers and other groups that are motivated to influence the industry for the good of savers worldwide. It has over 55 members with combined responsibility for over US$16 trillion and is an outgrowth of WTW Investments' Thinking Ahead Group.