

# Thinking Ahead Institute



## Innovation conversation

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**Topic:** The future of pensions – affordable solutions required

### **Participants:**

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### **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.

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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

- Keeping costs down may well come from consolidation of schemes at scale. The distinction between private and public equity is arguable, as is the idea that capital deployment is somehow different in public than it is in private. Private equity is probably necessarily more expensive.
  - Including private equity increases the economic opportunity set. There are 50% less listed companies on stock exchanges today than there were 20 years ago. The estimated size of private capital companies is around two times that of public stock markets. Private markets in DC portfolios is likely to help members to achieve better financial outcomes.
- Consolidation is one of the big forces moving through the industry. This might be a great thing, an opportunity for greater efficiency.
- Interested in hearing more about the kind of solutions used in the high-net-worth space and whether they might be applicable to DC.
  - There are several innovations in products to enable access for individual investors within their portfolios. Increasing prevalence of the secondary market in private markets means one can buy more mature private equity, private credit, asset portfolios, that have a shorter time horizon and some income generation properties. Secondary market evolution is enabling tools for asset managers to be able to create products that are more liquid and therefore can accept smaller minimum investment sizes and make it more relevant to the individual wealth client.

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- The key challenge in the wealth market is around valuation. Third party valuation companies are popping up everywhere – from some of the larger ones that build bottom up DCF models for each individual company / asset, to some other AI providers who provide independent valuations by referencing a number of public market proxies. All of them are flawed to a degree and have issues, but there's a lot more innovation happening in the market to address valuation.
- In the UK and the US, as examples, there is a limitation in the way that DC structures are administered causing a bias towards simplicity and simple products. Of course there is the fee component to consider, but in general there is little tolerance for complexity within the DC context and thus, looking for some simple innovations that people can understand feels more doable. At the moment, there's a range of forces that pull things towards simplicity and it will be interesting to see when we will reach the breaking point on that and realise that it's just not good enough.
- As a result of this, there's a very real danger that DC systematically underperforms all other investor types in the market. That is something I think we need to be very cognizant of, because arguably this will drive people to other savings mechanisms.
- 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 we will 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? And how are we going to journey with these DC members through the transitions? We need to step back and holistically provide them the best vehicle to navigate these changes.
- This is primarily about the deployment of capital within companies, whether they're private or public. The vast majority of new capital deployment happens under the auspices of the management of listed companies, so there's a huge engagement problem. It is our responsibility as investors to guide that capital deployment.

## About the Thinking Ahead Institute

The [Thinking Ahead Institute](#) is a global not-for-profit member organisation whose aim is to mobilise capital for a sustainable future. 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 around 60 members with combined responsibility for over US\$16 trillion and is an outgrowth of WTW's Investments' Thinking Ahead Group.