CASE STUDY:

FACILITATING ACCESS TO ILLIQUIDS FOR DC SCHEMES AND MASTER TRUSTS

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PHOENIX CORPORATE INVESTMENT SERVICES

Part of Phoenix Group

ILLIQUID INVESTING FOR PENSION SCHEMES

Greater investment in illiquid, or less liquid, assets – assets which cannot be easily or quickly sold or exchanged for cash – is an area of increasing focus for UK pension schemes.

Supported by regulatory guidance, there is a growing recognition within the UK Pensions industry that accessing private market assets within DC solutions could bring a number of tangible benefits for members, while also benefitting wider society via investment in areas such as sustainable infrastructure, affordable housing projects and alternative energy production.

At the same time, pension scheme trustees are coming under increasing scrutiny to ensure they are delivering value for members. Tapping into private market assets, which are typically less liquid, is one way that trustees can diversify their schemes' portfolios and potentially deliver enhanced returns via the 'illiquidity premium'.

While many Defined Benefit (DB) schemes already include allocations to less liquid asset classes such as private equity, private credit, real estate and infrastructure, this has less often been the case within the Defined Contribution (DC) market. Many DC schemes face operational challenges associated with insufficient scale and pricing, and have historically focused on keeping costs low by investing in liquid assets that can be daily priced and traded in order to meet the perceived needs of their members.

However, as DC pension schemes continue to develop and grow in size, with their assets expected to double to £1tn by 2030[1], the range of investment opportunities available to them is increasing. Barriers to investment are also being lifted, with new regulations enabling trustees to exclude specified performance-based fees from their charge cap of 0.75% per annum.

To encourage greater diversification in investment by pension schemes, the Government is now also moving forward with proposals which will require trustees to disclose and explain their policy on illiquid asset investment in their scheme's Statement of Investment Principles (SIP). The move will encourage schemes to actively consider whether an allocation to less liquid assets as part of a diversified investment portfolio could improve member outcomes in the long term.

With the demand for less liquid assets set to grow, some operational and liquidity challenges remain, however the optionality offered by investment only platforms can form a key part of the solution. Our case study explores the options available to pension trustees and their advisors through the range of solutions that investment only platforms can enable.

1 Source: Investing in Less Liquid Assets – Key Considerations, Productive Finance Working Group, November 2022

USING AN INVESTMENT ONLY PLATFORM TO DIVERSIFY YOUR SCHEME'S INVESTMENT PORTFOLIO

Investment only platforms can support pension schemes to build more sophisticated investment solutions, tailored to meet the long-term needs of their members.

While a significant number of potential investment opportunities are held within the non-listed, private market space, these assets can be difficult for DC members to access due to liquidity, minimum investment thresholds and other complexities. This is an area where the flexibility of investment only platforms can help.

By working with the right platform provider, schemes can:

- ✔ Access a wide range of investment vehicles from different fund manager groups, with opportunities to invest in less liquid assets that might not otherwise be accessible to them.
- ✔ Manage liquidity using blended fund and cashflow solutions enabled by the platform.
- ✔ Benefit from dedicated transition management support to mitigate cost and risk when restructuring funds on the platform.
- ✔ Take advantage of the platform's economies of scale to achieve cost efficiencies when accessing funds.

Investment only platforms can provide access to illiquid assets in the following ways:

Non-daily dealt funds

Unlike most funds that pension schemes invest in, where holdings can be bought or sold at short notice, investment in less liquid assets might not present the same daily dealing opportunity.

The right platform provider will be able to accommodate and manage 'illiquid' funds, which typically have non-standard dealing and pricing cycles, including trade notification requirements and liquidity constraints.

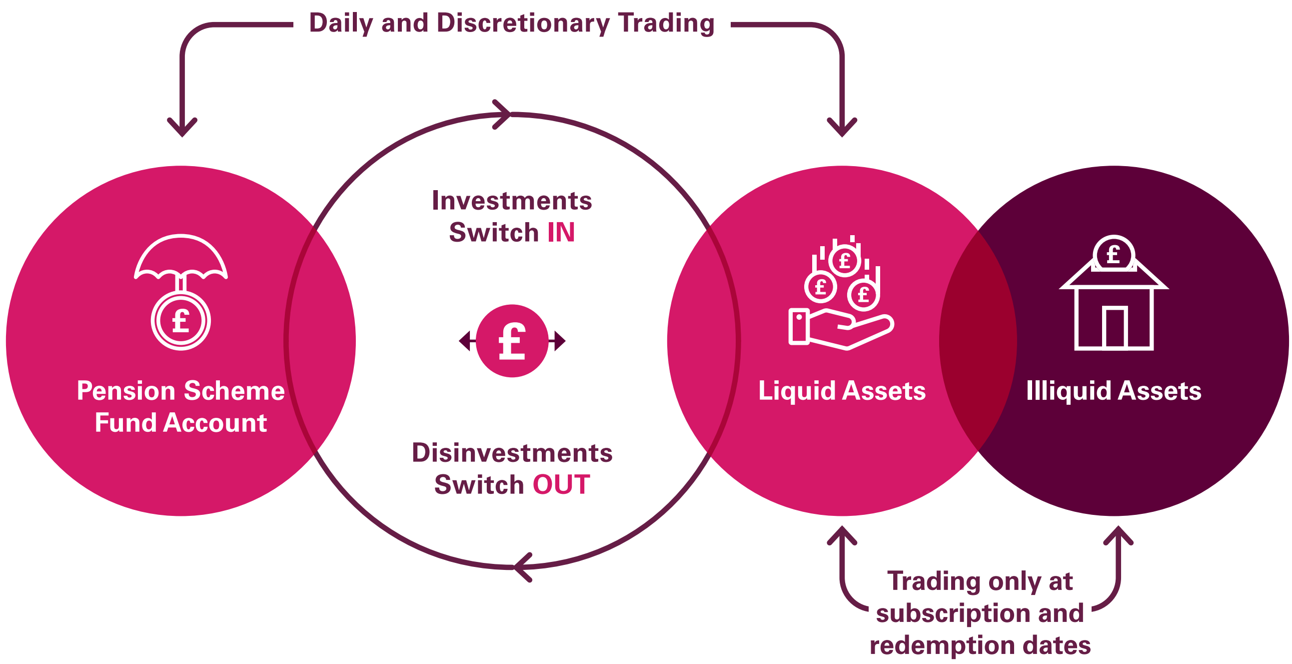
The platform provider will implement a robust process to manage these non-standard fund dealing requirements, and will provide a daily price reflecting the latest prices received from the underlying fund managers for the third-party administrator.

USING AN INVESTMENT ONLY PLATFORM TO DIVERSIFY YOUR SCHEME'S INVESTMENT PORTFOLIO **continued...**

Blended fund solutions

Investment only platforms can also provide trustees with a blended fund structure that includes both liquid and illiquid components, and allows efficient cash flow between the different components of the blend.

For example, daily cash flow can be invested or disinvested from traditional collective fund vehicles or Exchange Traded Funds (ETFs), with monthly or quarterly rebalancing occurring with the illiquid assets at the appropriate trading points.



EXAMPLE: LAUNCHING PRIVATE EQUITY FOR A MASTER TRUST CLIENT

In 2022 Phoenix Corporate Investment Services implemented a new investment solution for a leading Master Trust client, giving members access to the potential growth opportunities afforded by private equity. Recognising the potential returns from investing in privately held businesses, the client was keen to explore a solution through its default strategy utilising target date funds (TDFs) that would overcome the challenge of investing in an illiquid asset class.

Working with the client and fund manager, we were able to develop and implement an approach that met the investment objective while still providing daily liquidity to members.

Background and challenges

At Phoenix CIS we have successfully operated target date funds on our platform since 2013, investing in a broad range of mainstream asset classes such as equities and bonds.

In order to gain access to private equity, the client and fund manager decided on a range of globally listed investment trusts, which in turn invest in unquoted companies.

We therefore developed a solution to support these client needs on our investment platform; the solution would enable the fund manager to maintain control over the asset allocation and any trades made into the private equity investment trusts, thereby offering trading efficiencies.

And with the client being a significant Master Trust, where member trades are received on a daily basis, we recognised that the management of cash flow and ensuring sufficient liquidity were key requirements of the solution.

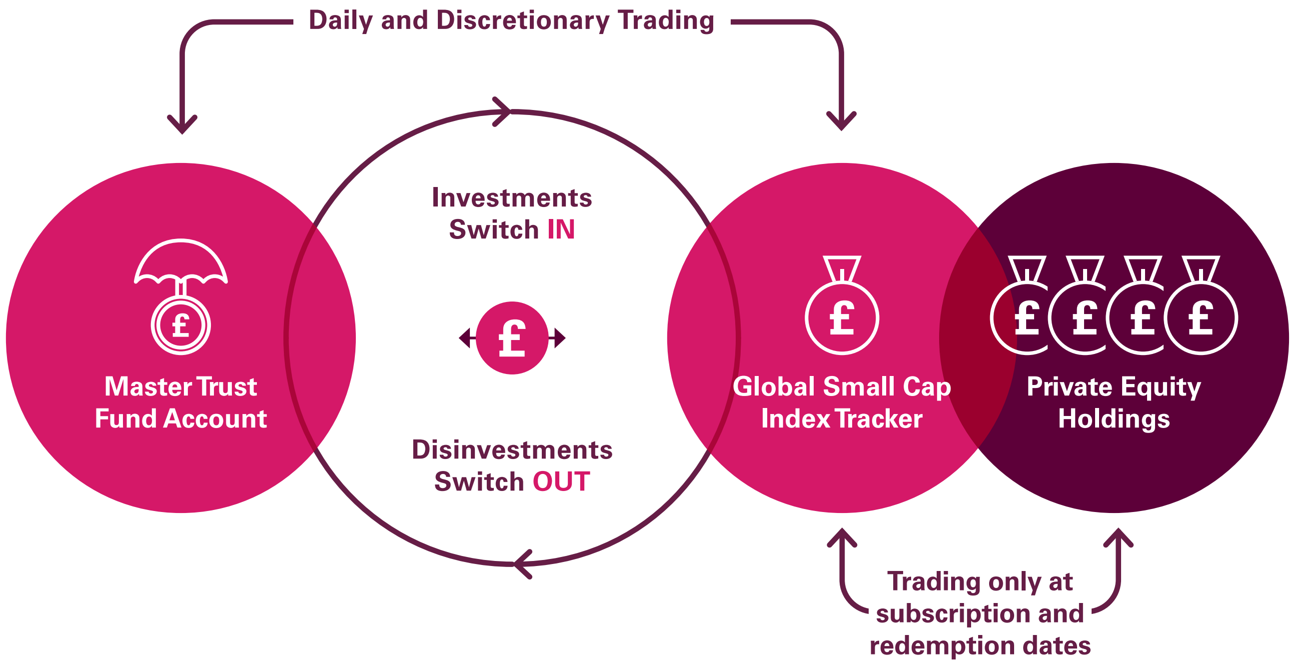
EXAMPLE: LAUNCHING PRIVATE EQUITY FOR A MASTER TRUST CLIENT **continued...**

Our solution

To facilitate daily trades for members, we blended the private equity holdings with a Global Small Cap Index Tracker Fund. Any investments, disinvestments and switches are placed in the Global Small Cap fund initially. This allows for trades into and out of the investment trusts to be made on an ad hoc basis and at the fund manager's discretion.

By trading less frequently, transaction costs are reduced and the fund manager is not a forced seller of the investment trusts when members disinvest or switch out of a TDF.

Our investment platform derives a daily price for both the Global Small Cap fund and the private equity holdings of the target date fund solution, which in turn is used to establish the overall unit price of each TDF.



Project implementation

During the implementation phase, we completed a number of steps. These included:

- ✔ Ensuring accurate price feeds for the private equity investment trusts and determining valuation points for pricing purposes.
- ✔ Ensuring consistency of pricing and currency exchange rates for globally listed assets.
- ✔ Setting up a new account with the custodian.
- ✔ Updating the investment management agreement and service level agreement with the fund manager to reflect the different investment vehicles being traded and associated processes.

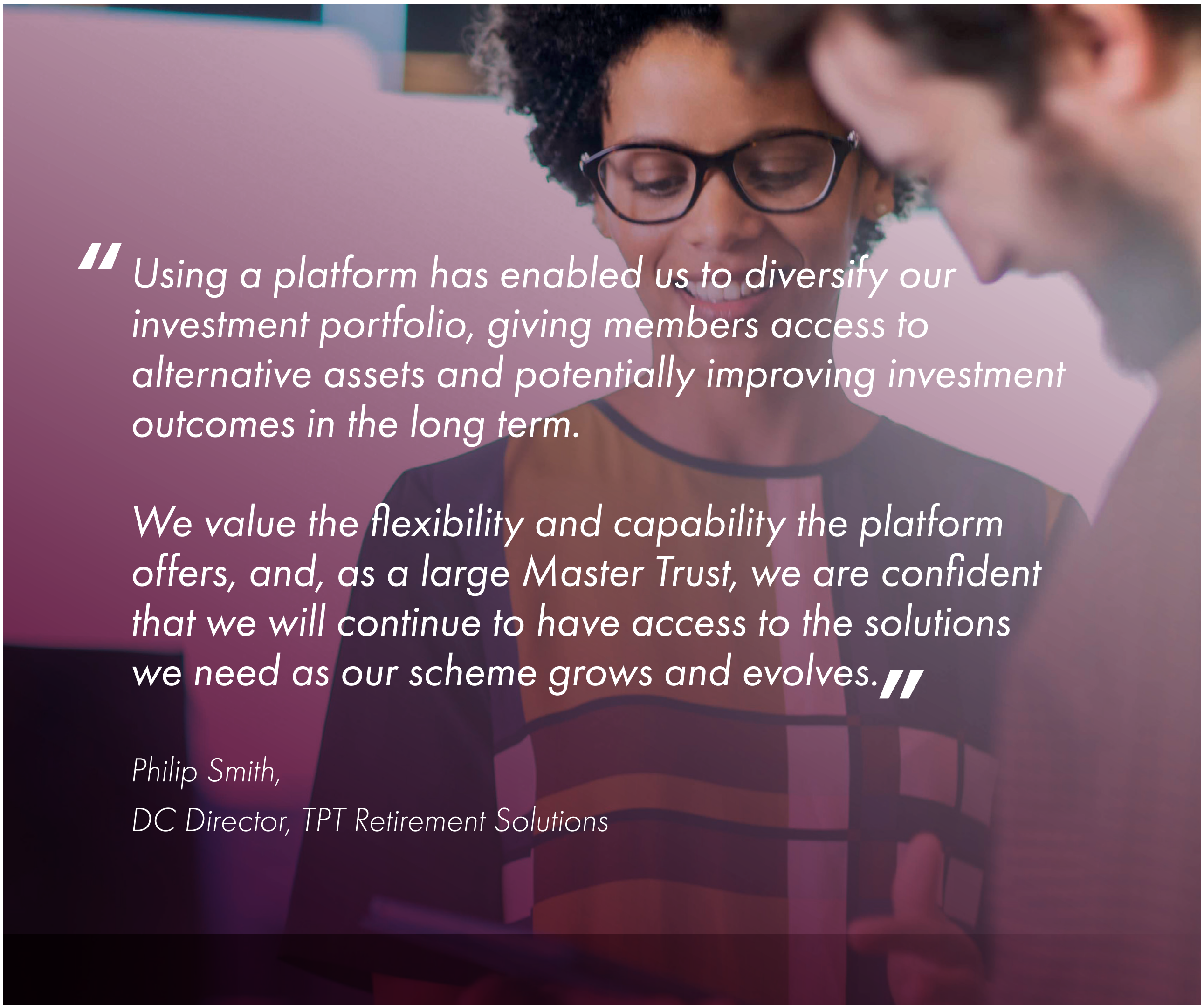
Once operational set up was complete, we ran all the necessary testing cycles before receiving client investments into the fund.

Results

These changes were made seamlessly for members, with no requirement for a blackout period. The target date funds continue to operate as normal, but members now have access to an illiquid asset class offering potential investment growth opportunities by investing in privately held businesses.

The same investment model and investment vehicles have since been adopted to provide members with a range of sustainable investment options as well.

Although this particular example focuses on TDFs, the same blended fund solution can be applied to other investment structures as well, creating opportunities for DC pension schemes across the UK to include an allocation to less liquid assets within their investment portfolios, even if they're structured in a different way.



FUTURE FOCUS: WIDENING ACCESS TO ILLIQUIDS THROUGH LTAFS

Recognising the challenges that pension schemes face when looking to invest in less liquid assets, and in response to increasing Government support for private market investment, the UK's Financial Conduct Authority (FCA) has authorized a new type of fund which will invest mainly in long-term, illiquid assets.

The Long-Term Asset Fund, or LTAF, will offer new investment opportunities and choice to institutional investors, including pension schemes, while providing appropriate structural safeguards.

How will LTAFs work?

The LTAF will be an 'open ended' fund, meaning it can grow to accommodate new investor demand by issuing shares as needed. Shares can also be sold, enabling investors to withdraw their money, according to agreed rules.

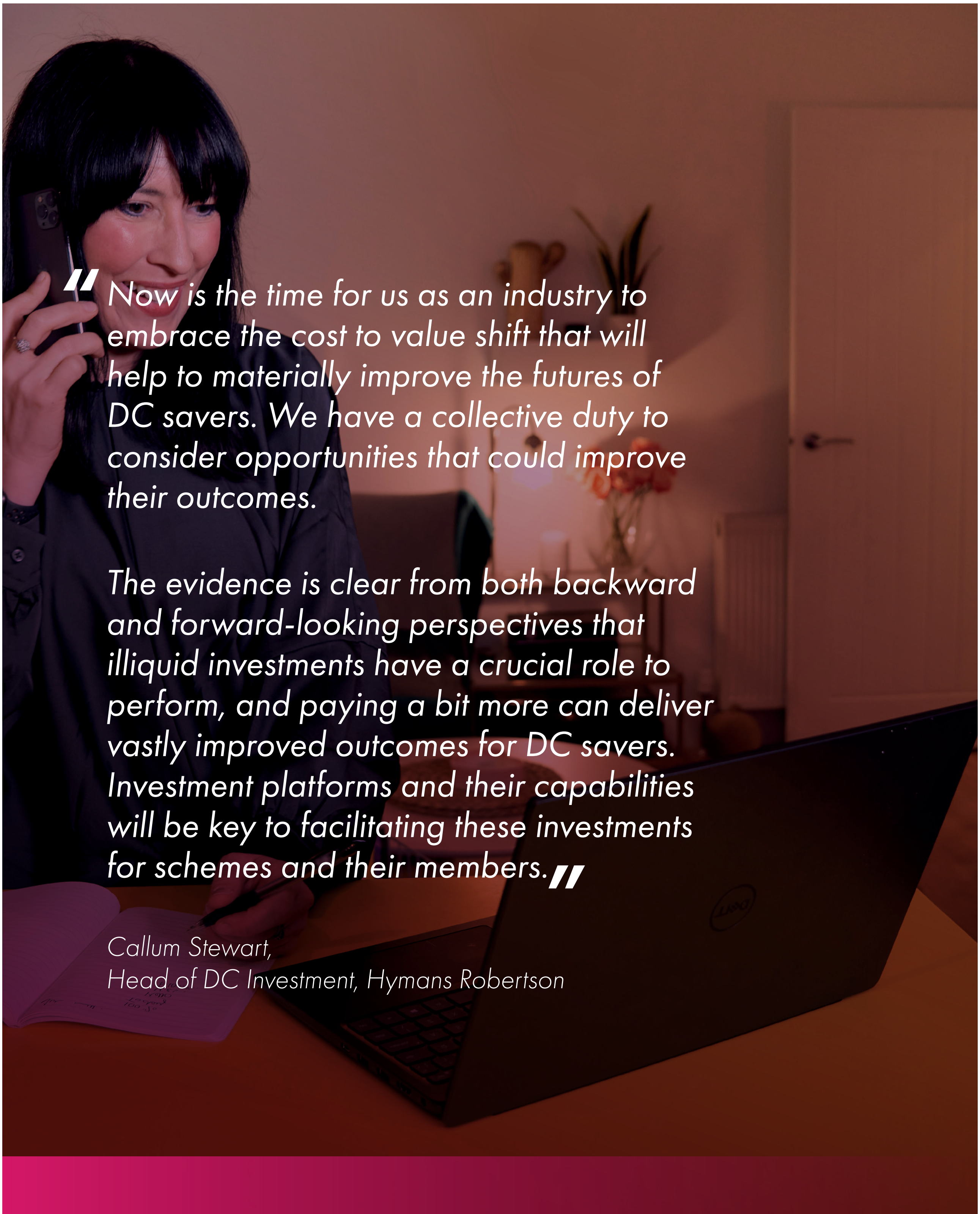
The fund's liquidity will be carefully managed, and investors will be able to buy into the fund at longer intervals than traditional daily dealt funds. A portion of an LTAF's assets may be in listed assets, which can be sold more quickly to increase its liquidity, and the mix and nature of the assets will determine how often investors can buy or sell the fund after any initial lock in periods as the fund's assets are accumulated.

Access to LTAFs for pension schemes

LTAFs from Schroders and Aviva have already received regulatory approval from the UK's FCA, with others in the pipeline awaiting authorization. Once launched, they promise to widen access to illiquid investment opportunities and provide a potential illiquidity premium for UK pension scheme members.

At Phoenix CIS we are already working with fund managers to ensure these can be made available on our platform once they are authorized, offering trustees and their advisors greater choice when implementing an investment strategy.

The flexibility of an investment only platform also means that LTAFs can be included as part of a bespoke blended fund solution, tailored to meet the long-term needs of each scheme and deliver the best possible outcomes for members.



"Now is the time for us as an industry to embrace the cost to value shift that will help to materially improve the futures of DC savers. We have a collective duty to consider opportunities that could improve their outcomes.

The evidence is clear from both backward and forward-looking perspectives that illiquid investments have a crucial role to perform, and paying a bit more can deliver vastly improved outcomes for DC savers. Investment platforms and their capabilities will be key to facilitating these investments for schemes and their members."

Callum Stewart,
Head of DC Investment, Hymans Robertson

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