For employee benefit consultants and employers only

Defined Contribution investing

Considering the case for including private markets

AEGON

The advantages of going private

'Price is what you pay, but value is what you get.'[1]
Warren Buffett

There's no denying that the UK's currently facing a tough economic and investment climate. Both are characterised by the cost-of-living crisis, a weakening pound, rising interest rates, soaring inflation, the war in Ukraine, the climate crisis and – to top it off – increased market volatility.

This means that Defined Contribution (DC) pension schemes are under increasing pressure to deliver sustainable returns for their members.

As a result, DC master trusts in the UK are looking beyond traditional public equity and bond markets to alternative asset classes. Many are actively considering the potentially attractive investment possibilities provided through private markets – such as infrastructure, real estate, private debt and private equity.

Exposure to these private market classes could also assist DC schemes to meet their net zero commitments. This includes investment in 'climate solutions' to support the global energy transition.

We look at the core issues to determine if, and how, master trusts could access the opportunities of private markets. And, whether they can do so while mitigating risks and overcoming the barriers to investing.

Exposure to private market classes could assist DC schemes to meet their net zero commitments

The private market premium – numbers that add up

A range of studies by reputable analysts and research houses, which we refer to in the bullets below, support the argument that investment in private markets could substantially improve returns to members of DC pension schemes. The following bullet points provide a representative selection of findings. The illiquidity premiums enjoyed by private markets must be caveated by the fact that there's considerable uncertainty around private market forecasting, as well as a lack of transparency with regard to leverage and risk exposure.

- Over a 40-year time period, it has been estimated that investing in illiquid investments could add 35bps to DC performance, meaning DC members may benefit by as much as 5% additional pension.[7]
- Calculations of the illiquidity premium range from a 1%[8] to a 7% increase in return over the long-term. Over 40 years, an increase in annual return of 1% can increase the size of a pension pot by 49%.[9]
- Returns from direct infrastructure investment are cautiously forecast at 4-8% per year (net of fees). This has the potential to improve retirement outcomes for DC savers by up to 20% depending on the size of the allocation.[10]
- Forty per cent of large DC schemes and master trusts in the UK see diversification and uncorrelated returns as the top benefits of investing a proportion of a DC default fund in private markets..[11]
- Historically, global venture capital and growth equity classes have delivered average annual returns, net of fees, 7% points higher than those seen in public equity markets.[12]
- An analysis of 163 US public pensions showed a median annualised return for the 10 years up to June 2018 of 8.6% compounding for private markets, net of fees. This compared with a 6.1% return for public equities.[13]

Past performance is not a reliable guide to future performance. The value of an investment can fall as well as rise and isn't guaranteed. Scheme members could get back less than they invest.

Capturing the private market premium

Increasingly, DC pension fund managers are reassessing their approach to illiquid alternative investments. This is as attentions focus on the two primary benefits of private markets – diversification and returns that are uncorrelated to traditional listed assets.[2]

Traditionally, given the comparative ease of generating returns from public markets, private markets were considered more trouble than they were worth, from a DC scheme perspective. This was due to a combination of seemingly problematic features:

- Long-term capital lock-up
- Daunting minimum investment thresholds
- Opaque and expensive fee structures
- Absence of daily valuations
- Scenario forecasting
- Onerous due diligence and stewardship requirements
- Need for specialist professional knowledge

However, there are reasons to believe this viewpoint is giving way to a growing appreciation of private markets. As you will see in this paper, there is now evidence that these markets are now being considered as a good way to reduce the impact of market volatility, for example during the pandemic. It could also be argued that they're better aligned to the longer-term investment horizons considered by pension funds, and as an elegant solution to supporting environmental, social and governance (ESG) themes, like the transition to net zero.

By chance, this heightened interest in the possibilities of alternative private market assets coincides with increasing corporate demand for alternative sources of capital. This is given the reduction in bank lending since the Global Financial Crash of 2008.

The withdrawal of banks from the credit markets over the last 30 years has been a remarkably enduring trend. Whereas banks accounted for more than 70% of credit market activity in 1994, this had fallen to just 14% by 2020.[3]

Structural changes in the investable universe are also driving the shift in asset allocation towards private markets. Companies are staying private longer, Initial Public Offerings (IPOs) are becoming less common, and more quoted companies are delisting. Over the 20 years to 2018, for instance, the number of listed companies on US stock exchanges declined by half.[4] For passive investors in quoted companies, this has meant exposure to long-established companies that are not well-positioned to develop new climate products and solutions. This is often due to constraints by multiple and often conflicting shareholder interests.

Yet, private market investment holds additional attractions for DC schemes. It can also potentially play a role in reducing volatility, hedging against inflation, providing reliable income and delivering high absolute and risk-adjusted returns – although of course this isn't guaranteed..[5] In addition, the scope for accessing sustainable, outcome-generating assets is significantly enhanced.

Asset allocation to real estate, private equity and infrastructure in the world's largest DC pension markets has increased from about 7% to over 26% in the last 20 years. The UK is lagging well behind.[6] However, with master trusts likely to take an increasing interest in the investment opportunities provided by private market assets may see that gap narrowing in future.

Lessons from abroad

The top performers in private markets

Interest in private market illiquid asset classes is growing among UK DC schemes. But the sums involved are paltry by comparison with the world's more developed and mature DC markets.[14]

Australia's superannuation funds, as well as US and Canadian public funds, have convincingly demonstrated the beneficial investment outcomes for members resulting from substantial allocations to private markets.

The Australian DC market is much more mature than its UK counterpart. In 2021, a total of 87% of Australian pension funds are held in DC schemes compared to just 19% of UK funds.[15] The Australians commit around 20% of their pension fund assets, on average, to illiquid private market investments.[16]

At the same time, and not coincidentally, Australia has been the world's top performing DC pension market over the last 20 years with annualised asset growth of 11.3%.[17] The critical features in this success have been government mandated pension contributions, a competitive institutional model and the dominance of DC.

A comparative study of US Defined Benefit (DB) and DC schemes over an 18-year period to 2014 found that the DB schemes outperformed their DC counterparts.[18] DB schemes enjoyed annualised returns of 8%, while DC schemes achieved an average of 6.9% over the same period.[19]

This performance difference was attributed to the fact that the DB schemes had allocations to real estate, hedge funds and private equity.[20] The DC schemes had no allocation to these asset classes.[21]

Several of North America's largest public pension funds – including British Columbia Investment Management Company (BCI), CalPERS and Maryland State – are ramping up their allocations to private markets, citing superior returns and the ability to exert control through co-investment.

Canada's BCI has substantially increased its allocation to private markets in recent years. From a 20% allocation in 2015 to around 45% in June 2022, their target is to increase to around 55% over the next three to five years.[22]

It must be noted that the major Australian and Canadian funds benefit from both their large scale and the strength of their in-house investment expertise. They're also subject to less stringent fee caps which enable them to optimise their exposure to illiquid assets.[23]

87% of Australian pension funds are held in DC schemes compared to just 19% of UK funds

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Private markets embrace a wide range of assets with varying risk profiles. Here's an overview of the principal asset classes.

Real estate

DC pension schemes already invest in REITs (real estate investment trusts) which are traded on public markets. But there are benefits in targeting private real estate investments in commercial property development (for example, office blocks and shopping centres), institutional properties and the residential rental market.

With the global real estate market valued in 2020 at over $11 trillion,[24] it's one of the largest asset classes available, with strong income generation potential and inflationary hedge characteristics. This is especially true of assets with long leases and quality tenants.

Property funds have a history of gating redemptions in difficult times, for example, the 2008 financial crisis, 2016 Brexit vote and 2020 Covid-19 pandemic. So, the illiquidity risks of direct private markets must be seen in that context.

Private credit

Providing company loans was historically the domain of commercial bankers. But as traditional banks look to reduce costs in the wake of regulations such as Basel III, capital from private credit is filling the gap.

The key attraction, apart from reduced volatility, is that private credit offers the potential of superior performance. This is through higher yields, compared with public fixed income and bond investments.[25] Private credit also tends to have shorter investment periods than private equity and is considerably cheaper owing to the much simpler underwriting process.

A floating rate on the private market is lower risk and higher return in most cases than fixed income on the public market.[26]

Private equity

This can take the form of venture capital or growth capital in privately held companies, ranging from early-stage enterprises to management buy-outs of established businesses. It's worth considering that just 0.1% of UK companies are public limited companies.[27]

The return profile of private equity tends to be higher than that of public equities. According to McKinsey, private equity fund vintages post-2008 have consistently outperformed public equity markets.[28] However, this differential has narrowed in recent years.[29] These returns must be balanced against the fact that individual venture capital and growth equity funds carry more risk than public listed equities or bonds.[30]

Fund managers take significant stakes, often a majority holding, which allows them to exercise genuine stewardship in the development of the company. It could also help to influence ESG considerations in a meaningful way.

Direct holdings in infrastructure

The current rules on DC pension schemes make infrastructure investment difficult. But government and the regulators are currently taking steps to open up this asset class.[31] Infrastructure can broadly be summarised as immovable assets and projects which are essential for the efficient functioning and operation of society and the economy. For example, telephone networks, roads, tunnels, bridges, railways, hospitals and water supplies.

Clean energy assets, including wind, solar, hydrogen, carbon capture and community power, are a major component of infrastructure investment.

The attractions of DC investment in infrastructure are the generation of steady, mainly fixed returns with good inflation protection return characteristics. Operational infrastructure has a lower risk profile than equities or property, providing some diversification – though potential total return is less than these asset classes.

The Illiquidity issue

Naturally, trustees and fund managers have concerns regarding the higher fees and illiquidity associated with private market investments that are valued on an appraisal basis, rather than a market transaction basis.

However, illiquidity must be seen in the context of holding assets for the long-term. If many pension scheme members don't plan to access their pots for 20 or 30 years, it may seem unreasonable to compel them to invest exclusively in daily-traded funds.

There's also a compelling argument that daily pricing fails to adequately take climate risk into consideration. This is because short-term pricing mechanisms don't always align to long-term investment horizons. For this reason, private equity portfolios may align better with long-term investor interests.

Certainly, DC schemes require some liquidity for transfers, fund switches and income withdrawals – but not so much that they require almost all of their assets to be invested in daily-priced, unitised funds. Doing so means losing out on the potential illiquidity premium.

Daily proxy valuations can be constructed in such a way that the process is fair from a trustee, platform manager, and member point of view. The distinction must be drawn between daily evaluations – which are possible – and daily trading, which is not.[32]

In response to demand, funds with illiquid assets are devising acceptable forms of daily pricing. The already familiar quarterly 'fair value' valuation is being adjusted, using new qualitative and quantitative information, for the daily valuation requirements of the DC market.[33]

Robust frameworks for the daily valuation of alternative assets in DC plans have also been developed by organisations such as the Defined Contribution Alternatives Association (DCALTA).[34]

Analysis indicates that a relatively low percentage of current pension assets needs to be liquid now and in future. Master trusts tend to have the highest immediate liquidity requirement, at 5%, rising to 14% after 10 years. Their annual cash flows are around 30%, leaving very comfortable headroom for an optimised allocation to illiquid assets.[35] Initially, such an allocation may comprise around 10-15% of the funds in question.

The holding period for private market investments is typically several years (four to seven years on average) compared to that of public market investments which are traded daily.[36] Although, a majority of UK pension funds are happy with holding periods of 10 years or longer for private assets like infrastructure or real estate.[37] In considering these holding periods it should be acknowledged that many schemes may have held the same companies listed in the FTSE100 index for up to 30 years.

It's also worth bearing in mind that liquidity is not a given in public markets. It can vanish quickly if trust among institutions is compromised, as happened in the 2008 Global Financial Crisis. A similar liquidity crisis situation arose in the wake of the then Chancellor Kwasi Kwarteng's special fiscal event in September 2022, known as the mini-Budget. DB schemes were obliged to sell liquid assets, especially gilts (publicly listed UK government bonds) into a falling market in order to make margin calls.

30% annual cash flows for Master Trusts, leaving headroom for illiquid assets

The fee conundrum

Traditional thinking on charges is being increasingly challenged in the trade-off between value and price. It's true that the fees for private market investments are higher than those for listed and liquid strategies. However, the flipside is the superior net-of-fees returns that an allocation to private markets can potentially deliver. Plus, there are the uncorrelated characteristics that this can bring to the investment strategy. This is strongly reflected in the attitudes of scheme members. More than half (51%) of customers consider maximising long-term value to be the most important factor in their pension strategy, compared with 12% who prioritised minimising short-term costs.[38]

Much of the continued focus on price among UK DC schemes is market-driven and cultural. Since the advent of automatic enrolment in 2012, there's been increasing scheme consolidation through master trusts which have competed vigorously on price, seeking to provide the lowest possible costs in race-to-the-bottom tender processes.

This has created a situation where master trusts are effectively self-capping well below the regulatory charge cap, for fear of leaving themselves at a competitive disadvantage.

Trustees, government and regulators are increasingly accepting that value-for-money is more than just price and is perhaps better achieved by improving returns for members. This is rather than slashing costs to the point at which they arguably potentially undermine overall performance, by preventing allocations to longer-term, higher returns.

Analysis from 2021 suggests the charges for average DC schemes are between 0.3-0.4% – well below the 0.75% fee cap imposed by legislation.[39]

If funds are investing in very low-cost index-tracking funds with annual charges of between 5bps to 15bps, then this allows for meaningful allocations to more expensive illiquid assets.

The largest master trusts can offer AMCs as low as 0.2% by using predominantly passive investing strategies in a default fund.[40] Industry experience indicates that a 15% allocation to private assets in a DC default portfolio would result in a 15bps increase in fees. This is well within the parameters set by the charge cap.

Given the long-term outperformance of private markets, net of all fees, versus listed markets, members would potentially receive improved outcomes (a bigger pension pot at retirement) from an allocation to private markets.[41] Remember of course that past performance is not a reliable indicator of future performance.

Supporters of this strategy have been given a boost with the government's September mini-Budget. It confirmed that 'well-designed' performance fees will now be excluded from the current 0.75% annual fee cap for DC schemes.

Regulation revisited

DC pension schemes are required by regulation to provide members with sufficient liquidity to meet their needs in terms of fulfilling obligations such as drawdown or transfer. Daily dealing has become the established norm in DC schemes because allocations have been focused on highly liquid asset classes. But contrary to widespread supposition, this is not a regulatory requirement.

In its guidance for DC pension scheme trustees, The Pensions Regulator states that liquidity management should be balanced against investment objectives. Indeed, it explicitly states that:

'You should seek to balance the liquidity of assets against the investment objectives. Holding too high a proportion of liquid assets may impact the level of investment return, and limit opportunity for diversifying your portfolio of assets.'[42]

Draft regulations published by the UK government this year aim to reduce the burdens on trustees and further open private markets. It proposes to do this by removing certain employer-related restrictions that currently apply to large, authorised master trusts, making compliance much easier. This will maintain reasonable protection for members while cutting the cost of investment in private equity and debt.[43]

Market models and accessing the assets

Some major fund managers are already planning next generation DC growth portfolios that comprise an allocation to illiquid private market alternatives. Whereas a traditional portfolio might comprise the classic 60:40 balance of equities and fixed income, with a little cash – the new-style long-term asset portfolios see private assets accounting for up to a fifth of the total allocation.

Undeniably, private market investment is more complex than buying shares on public markets. This is given the need to identify the opportunity, conduct due diligence, ensure the appropriate legal structure and monitor performance.

However, one of the main difficulties in the past, namely the lack of a DC-friendly pooled vehicle for holding illiquid private market assets, is being addressed.

Various methods of accessing private markets asset classes are now available. This includes diversified growth funds (DGFs) and bespoke blended funds created by major fund management partners.

Evidence indicates that smaller schemes like to access private assets via diversified growth funds (DGFs) or other multi-asset funds.[44] Larger schemes prefer specialised pooled funds and segregated mandates.[45]

The FCA has introduced a new type of authorised fund vehicle, the LTAF (Long Term Asset Fund), specifically to overcome these barriers. The LTAF is designed to make it easier and safer for retail investors and DC schemes to invest in long-term illiquid assets and private market alternative investments. Despite this innovation, there are still relatively limited opportunities to access multi-asset solutions that invest in alternatives and provide daily liquidity to pension funds. This protects DC schemes in the event of the exit of a large client.

Looking beyond ESG

Improving impact investing and the road to net zero

Freeing up DC schemes to invest in private assets grants many benefits in terms of ESG integration. It allows DC master trusts to more effectively support the transition to net zero, given the much greater potential to invest in renewable energy, green infrastructure and nature-based solutions.

From an investment perspective, compared to secondary market investing, direct investment in private markets confers two benefits. It increases the targeted intentionality of the investment – in terms of its desired social or environmental impact – and the ability to measure those outcomes. It permits DC schemes, and their members, to act as engaged owners and apply influence.

The societal benefits from allowing DC schemes to invest in private markets could be substantial. According to the TUC, in 2018 the UK ranked 34th, in a ranking of the 36 OECD countries, in terms of private and public investment as a percentage of GDP.[46] At an average of just 19% of GDP over 40 years, total fixed investment in the UK is also the lowest among the G7.[47]

> Given that UK workplace DC assets are expected to grow to £1 trillion by 2030,[48] allowing more long-term investment in infrastructure could be game-changing. As economist John Maynard Keynes pointed out in his 1936 book The General Theory of Employment, Interest, and Money, 'Of the maxims of orthodox finance, none, surely, is more anti-social than the fetish of liquidity.'

The introduction of new guidelines means DC scheme trustees will need to consider how to report private market and illiquid assets in terms of ESG and sustainability metrics. These guidelines include the Taskforce on Climate-related Financial Disclosures (TCFD) reporting, to be followed shortly by new sustainability disclosure requirements (SDRs) and TNFD (for nature and bio-diversity impact reporting). Private market investments in areas such as windfarms, energy transition and social housing may tick many boxes in terms of carbon reduction and societal impact.

The opportunities for stewardship are also significantly greater in private markets given the greater requirement for due diligence and ongoing active engagement. This is achievable in private credit as well as private equity.

These strategies aim to increase the potential for greater investment returns by focusing on greener companies that are expected to perform better in the long-term. It will see investment in environmental projects – such as the planting of new sustainable forests, the financing of new wind and solar farms, energy efficient buildings, smart cities and the circular economy.

£1trn is the amount that UK workplace DC assets are expected to grow by 2030

The master trust advantage

With DC scheme consolidation continuing at pace, master trusts will emerge as one of the dominant forms of pension provision by 2025. This greater scale permits greater sophistication in investment strategies and more strength in depth of expertise and governance oversight.

For example, master trusts have the critical mass to create tailored strategies for private market assets on all-in total expenses basis that may be beyond the scope of smaller schemes. That capability generally makes them very competitive and allows them to keep member charges down.

This scale and enhanced competence give master trusts a significant advantage in managing issues of cost, illiquidity and complexity in private market investment. This allows them to exploit the potential illiquidity premium and the uncorrelated return characteristics for the benefit of DC members. Illiquidity risk should be easier for cash-flow positive schemes, especially master trusts, to manage.[49]

According to recent industry research, one in five master trusts already has some modest allocation to private markets in its default funds.[50] An additional 20% are considering investing up to 10% of their default assets.[51]

Master trusts also have a stronger appetite for all private assets, including private debt and infrastructure, than other DC and hybrid schemes. Seventy per cent are interested in private equity compared with just half of other DC schemes.[52]

Conclusion: key takeaways

1. The challenges of illiquidity and higher fees are not impossible to overcome. They don't prevent DC pension schemes from accessing the potential superior returns, diversification and volatility reduction achievable with portfolio exposure to private markets.
2. Greater allocations to the core asset classes of infrastructure, real estate, private equity and private debt can potentially drive improved member outcomes over the long-term. They can also increase the flow of capital into the real economy in the form of macro-level projects, social housing and low carbon infrastructure.
3. There is reason to believe that accessing private markets will unleash the investment potential of DC pension schemes. This will allow them to deliver the returns already enjoyed by defined benefit pension schemes, insurance funds and sovereign wealth funds as well as those more advanced DC markets like Australia.
4. The DC pensions sector is in the process of challenging the belief that the lowest possible AMC is the primary consideration in value for money.
5. Since pensions are specifically long-term savings plans that members won't access for up to 40 years, it's desirable to prioritise investment asset classes with the potential to deliver superior and more stable long-term returns, net of fees.[53]

'More than 95% of members of DC occupational schemes are invested in the default arrangement and are likely to remain invested there for many years. This offers compelling opportunities to invest in long term, illiquid assets.'
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Contact: Andy Dickson
Master Trust Strategic Development Director
Aegon Workplace Investing
andy.dickson@aegon.co.uk
07919 948876

Andy is Aegon Master Trust's Strategic Development Director. He is a regular contributor to the pension trade press and a presenter at leading pension and investment conferences in the UK and overseas. Andy is the former Chairman of the DC Investment Forum and a current member of the Advisory Committee. Prior to joining Aegon UK, he was Head of Market Strategy at Atlas Master Trust and Investment Director at Aberdeen Standard Investments.

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