HYMANS ROBERTSON

Embracing the opportunities

Can DC schemes reap what they loan?

Welcome to the fourth publication in our *Embracing the opportunities* series, focusing on the potential role of private debt in DC default design.

The use of illiquid assets in DC pension schemes has been gradually taking off in recent years and is expected to accelerate following the recent introduction of Long-Term Asset Funds (LTAFs). Following previous publications focusing on illiquid assets generally, infrastructure and private equity, we consider how private debt could be used to enhance outcomes for DC savers.

What is private debt?

Private debt refers to any debt instrument that's not publicly traded. It can include a wide variety of sub-asset classes, including "performing" (income generating) strategies such as direct corporate lending and real asset debt, to more opportunistic strategies such as special situations financing and distressed debt. Investors typically invest through a closed-ended fund structure where capital is locked up for the fund term (typically around 8 years). Like other illiquid asset classes, private debt typically benefits from an illiquidity premium and is likely to be issued at a higher yield (and therefore additional return) compared to public markets to compensate for reduced liquidity.

The private debt opportunity is growing. Total assets under management in private debt has now passed $1 trillion (versus an estimated $370bn 10 years ago).

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Private debt is a heterogenous asset class with a wide variety of types of issuers, each with varying risk and return characteristics, as summarised in the table below. As well as varying by issuer, debt can vary in other ways:

- **Seniority**: investors can lend across the capital structure, either in senior loans or junior loans (or unitranche which is a blend of the two). Senior loans have a lower risk-return profile compared to junior loans as they rank above junior loans in the order of repayment in the event of the issuer defaulting. Return expectations vary depending on the risk profile of the loan.
- **Credit risk**: the credit rating of the debt issuer can vary widely, with higher rated investment-grade loans offering lower risk and return, while lower rated "speculative-grade" loans are issued at a higher yield to compensate for their higher risk. It's worth noting that direct corporate lending (which most investors target) is largely speculative grade.
- **Duration**: a debt instrument can have a term of anywhere between a few months to 30+ years. Longer term loans may be better suited to the growth phase of DC glidepaths, while shorter term loans could play a role in the de-risking phase and decumulation given alignment with time horizon.

The table below summarises the different types of private debt issuers, including the typical targeted returns based on a sample of 102 private debt managers.

Type of PD Investment	Definition	Targeted Return* (%pa)
Direct corporate lending	Non-bank lenders providing medium term private financing to US and European (typically) sub-investment grade corporates.	6 – 8%
Real estate debt	Loans backed by commercial real estate, such as factories, shopping malls and offices.	2 – 10%
Infrastructure debt	Loans backed by infrastructure assets, typically segmented between economic infrastructure and social infrastructure. There is potential to use this asset class to align with environmental and social goals, for example, through investment in education or green energy infrastructure.	2 – 7%
Asset backed lending	Loans backed by a specific asset pledged by the borrower, such as equipment or inventory.	8 – 12%
Special situations financing	A special situations investor will purchase debt in a company that is undergoing some sort of event-driven situation, such as a merger, reorganisation or liquidation, in the belief that the value of the debt will appreciate in value.	13 – 17%
Distressed debt	Debt issued by a firm that is experiencing financial difficulty. The debt is priced at a significant discount and the investor purchases the debt in the hope the firm will recover. This is therefore a high risk, high return approach.	15 – 20%

*figures are indicative and based on the targeted returns of 102 private debt managers. These returns are not guaranteed.

Why invest in private debt?

Illiquidity premium

Private debt is usually issued at a higher yield than an equivalent exchange-traded bond to compensate investors for the additional risk of investing in an illiquid security. This premium should offer potential for more attractive returns compared to publicly traded debt.

Stable income stream

In private debt, such as direct corporate lending, investors can potentially experience lower variability of returns than comparable public credits due to the corporate due diligence and tailoring of loan terms that typically takes place. Allocations to private debt can provide a regular, stable income stream to pension schemes, which continues to be of significant importance in a market that endures varying levels of volatility, as well as high rates of inflation. This is of importance to DC savers closer to retirement with shorter time horizons, as a stable income stream helps to manage downside risk and provide stable cashflows.

Potential Impact

Private debt could be used as a way of aligning environmental and social goals by lending to companies or projects that are having a positive impact on the world. A good example would be an infrastructure debt investment in renewable energy infrastructure. This impact will of course be dependent on the specific strategy used.

Diversification

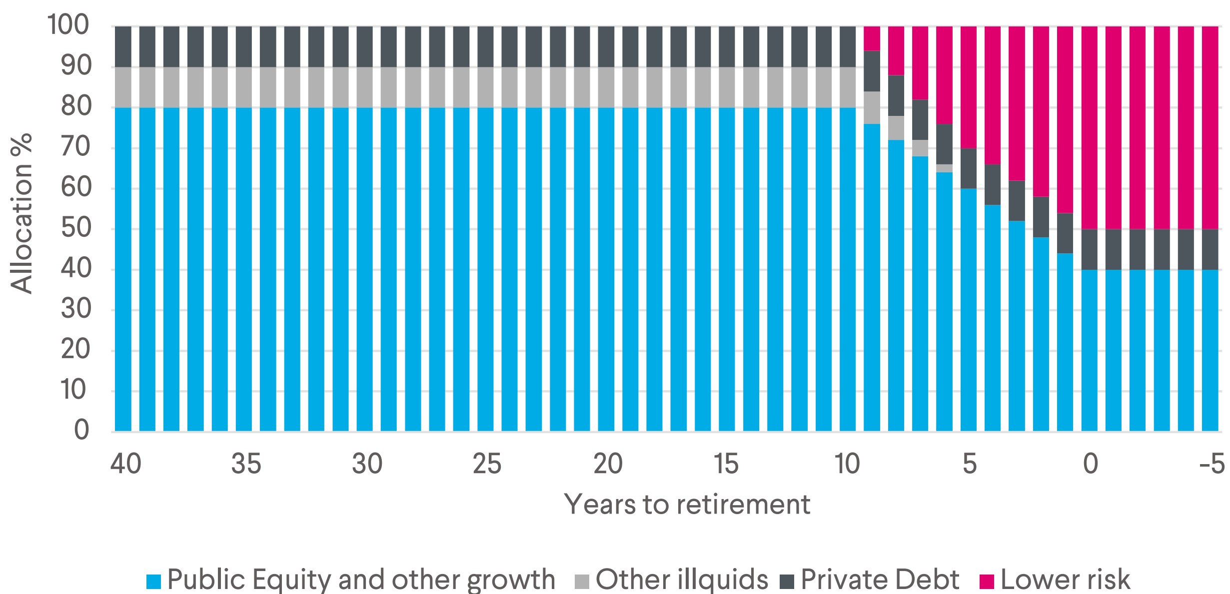
Private debt has a relatively low correlation with traditional publicly traded equity and bond investments, therefore offering potential diversification at all stages of a DC glidepath.

We foresee there is potential for up to £200bn of DC assets to be committed to private debt investments by the end of this decade, reflecting growth in the size of the DC market to well over £1tn. This will require a shift in emphasis on cost to overall value, which we're driving with a longer-term member outcome focus in mind.

What is the potential role in DC strategies?

Our initial "Embracing the opportunities" piece proposed that an allocation to illiquid assets of up to 20% throughout the glidepath could be reasonable for the largest DC schemes (over £1bn). While we believe a more growth-oriented approach in the earlier stages of members' savings journeys can maximise the potential to improve their retirement outcomes, we think private debt is sufficiently attractive from a growth and diversification perspective to justify a meaningful allocation. We expect most DC schemes will take a balanced risk approach to illiquid assets across the glidepath, with an allocation of up to 10% private debt and 10% allocated to assets such as infrastructure and private equity.

Given private debt's nature of providing regular, steady income streams, we believe there's a place for private debt across all stages of DC glidepaths. Riskier forms of private debt (such as speculative-grade debt, junior tranche debt, distressed debt and special situations) could be used during the growth phase to provide diversification away from listed equities, while safer types of debt (such as short-term, investment-grade private debt) could play a role in the growth, de-risking and decumulation phases, providing suitable liquidity provisions are put in place. An example glidepath is shown below:



Source: Hymans Robertson

As a reminder, we continue to advocate the 10:10:10 rule of thumb; that a 10% allocation to illiquid assets, at an additional cost of around 10 basis points, could improve outcomes for younger members by up to 10%. This is based on a balanced approach to illiquid assets across the asset classes mentioned above.

How can private debt be implemented in DC schemes?

We believe blended or target date funds are now an essential feature for future proofing your DC scheme's investment strategy. This means you can make changes to the underlying asset allocation without creating onerous consultation and reporting requirements each time a change is made. It also means liquidity management and rebalancing can be structured efficiently. This will be increasingly important as the ability for DC schemes to access more sophisticated asset classes and fund structures improves.

Managing liquidity

As with other illiquid assets, managing liquidity is a key consideration for private debt investments. Private debt funds tend to be closed-ended and therefore, after an investor commits their capital to the fund, there will be a period of time (usually around 3-4 years) for the manager to originate and execute deals. This period is known as the "investment" period. Following the investment period, proceeds are distributed to investors as loans repay. However, more liquid evergreen vehicles are becoming available for private debt investments due to the relatively stable cashflows that this asset class provides.

The long-term capital commitment should not be an immediate concern for DC schemes given savers' very long time-horizons. As discussed in our previous piece on private equity investing, incorporating illiquid assets into a blended fund and fulfilling cashflows using liquid assets is a workable method for managing liquidity, providing the platform provider has the capabilities required.

In practice, we would anticipate illiquid assets being left untouched within an asset mix, with cashflows facilitated through other liquid components held in the portfolio. We cover liquidity management in more detail in our first publication.

Examples of private debt in DC Schemes

To the right are some examples of how DC schemes have successfully incorporated private debt investments and other illiquid assets into default strategies. We expect the range of funds offering access to private debt and other illiquid assets to expand substantially over the long-term, in part thanks to the introduction of Long-Term Asset Funds (LTAFs).

Smart Pension Master Trust

Smart has a 10% allocation in the growth phase of their default strategy to the MV Dual Credit Fund, which blends private and public debt within a pooled structure.

NEST

Nest has maintained an allocation to private debt for a number of years via Amundi (real estate debt), BlackRock (infrastructure debt) and BNP (diversified private credit), with an allocation of around 5% during the growth phase.

Legal & General (L&G)

The L&G Mastertrust default includes an allocation to the L&G Short-Term Alternative Financing Fund (STAFF), which invests in short-term private debt instruments and produces a cash-like risk/return profile.

Source: provider SIPs

Fees and the charge cap

The UK government recently ran a consultation on removing performance fees from the 0.75% charge cap calculations for DC schemes. From 6 April 2023, DC schemes will have the option to invest in arrangements with certain performance-based fee structures which may be excluded from the charge cap calculations. We're supportive of this legislative change and hope that access to private debt and other illiquid assets will improve as a result, as managers of these assets do often charge performance fees alongside a relatively high annual management charge.

We would typically expect a private debt fund Total Expense Ratio to be in the region of 2.0% pa due to the high level of active management required to run a fund of this nature. This includes a management fee (usually 1.0% or below) plus a performance fee. Assuming a typical DC scheme fee of around 0.30%, there's headroom within the 0.75% charge cap to support a meaningful investment in private debt.

Risks of private debt investing

As with all forms investing, there are certain risks associated with private debt investing. Most notably:

- Investing in less liquid assets introduces the risk that a member is unable to access their savings at short notice. However, as discussed in our initial "Embracing the Opportunities" publication, we believe suitable liquidity provisions can be put in place for large DC schemes to significantly reduce this risk.
- As with other forms of fixed income, private debt investments have a degree of sensitivity to interest rates. Therefore a significant rise in interest rates could negatively impact the value of private debt investments.
- As with other forms of fixed income, the primary risk is credit risk, which is the risk of loss due to a borrower failing to service its debt. To mitigate risk from default, lenders will carry out detailed due diligence to assess a company's credit worthiness, including a company's cash flow profile and assess its ability to pay interest and capital back.
- As noted above, private debt managers generally charge higher investment fees compared to managers of publicly traded securities due to the high level of active sourcing, due diligence and management required.
- Once money is committed to a private debt fund, a period of time is required for the capital to be actually invested in private debt securities while the manager seeks and executes deals. This may drag on returns if capital is temporarily held out of the market during this period.

So, what are the main take-aways?

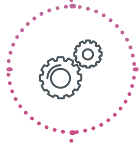
As demonstrated in this publication, there are significant opportunities in private debt investments which could lead to improved outcomes for members.

There's also the opportunity for pension schemes to integrate their climate and wider sustainability goals in line with the broader portfolio. Here are some initial steps you can take:

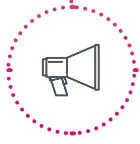
Educate
When receiving training on illiquid investing more generally, seek specific guidance on private debt investment. This should cover risk and return characteristics as well as social and environmental impacts.

Engage
Engage with your pension provider and advisors to understand how you may be able to access private debt investment opportunities. Platform capabilities will be key – is your platform provider up to scratch? This is a key engagement area to drive support for DC schemes well into the future.

Review
As part of your next review of your investment strategy, explore how private debt and other illiquid assets can be used to improve outcomes for your members. As part of your next provider review, attribute a weighting to platform capability, given lack of functionality could stifle your ability to deliver good outcomes for your members over the long-term.



Implement
If you identify opportunities to improve outcomes, you should take action to capture these for the benefit of your members. Work with your provider and advisors to develop plans to introduce allocations to private debt and illiquid assets over a reasonable time period.



Communicate
Share positive stories about the action you are taking to improve outcomes with your members. Private debt investments have potential to create engaging stories about how your members' money is being used to build a more sustainable future.

Illiquid investments: embracing the opportunities

For more information on illiquid investments for DC schemes, check out our Illiquid Investments Hub. If you have any questions on the subject in the meantime, please get in touch:

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