Private market investment: Remembering ESG

Lynn Strongin Dodds explores ESG considerations for pension schemes investing in private markets

Lynn Strongin Dodds

Summary
• DC schemes offer the most promise for private assets in the longer term.
• Investors are still strongly interested in investments that align with their ESG and impact goals, with private markets increasingly able to meet those goals.
• A move away from diversified multi-asset strategies to single sleeve solutions, with specialist managers in each asset class, is anticipated in the future.

The newly elected Labour government, just like its Conservative predecessor, is hoping to motivate investors to embrace private markets to bolster the economy. The diversification benefits and risk-adjusted returns of the asset class are certainly attractive, but increasingly the environment, social and governance (ESG) alignment has also become a driving force.

As Hymans Robertson chief investment officer, David Walker, puts it: "ESG considerations will be a key focus of private market allocations. The importance of these goals is compounded given the greater impact that can be achieved through these assets, and also given their illiquid nature, meaning that the schemes will be invested in these assets for a significant period of time."

Different schemes, different needs

The level of interest from pension schemes in private markets varies depending on the type of scheme, maturity levels and liquidity constraints. Walker notes that most DB private sector funds are looking to wind down their exposure mainly due to a confluence of overall improvements in funding levels, a move towards insurance solutions and a desire for increased flexibility in their asset allocations.

Against this backdrop, DB plans tend to be focus more on cashflow generating investment, pushing allocations toward sectors such as real estate – core equity, social housing and real estate debt, as well as energy infrastructure including wind and solar, battery storage and energy efficiency solutions, according to Cardano senior investment manager, Geordie Cox.

By contrast, Walker adds that Local Government Pension Scheme (LGPS) funds have a broader view and are still in the process of building allocations across the spectrum. This is reflected in figures from the latest LGPS Advisory Board Annual Report for the year 2022/2023 which shows that alternatives such as infrastructure, private equity and debt accounted for 23 per cent of portfolios last year, a substantial hike from 8 per cent in 2013.

LGPS can afford a longer-term horizon than their DB colleagues due to strong employer covenants, but they also have government pressure bearing down on them. One of the key planks of the former Conservative government's policies was to double the existing LGPS exposure to private equity to 10 per cent, which it said could unlock £25 billion by 2030 for UK growth.

It also proposed that these schemes invest up to 5 per cent of their assets to support the government's 'levelling up' strategy. The current Labour government has now also made clear its intentions to direct pension investments into domestic projects to help offset the restricted government borrowing capacity.

Although LGPS are in the political spotlight, Mercer partner and wealth strategy leader, Tessa Page, believes DC schemes, albeit currently representing a smaller asset level than DB, offer the highest potential for investment in private markets. She points to the Mansion House Compact introduced last year by Jeremy Hunt, the then-Chancellor of the Exchequer, as one

catalyst. It encouraged these schemes to allocate at least 5 per cent of their default funds to unlisted equities by 2030. At the time, their exposure was just under 1 per cent.

Page though notes that implementation has been slow, but both standalone trusts and master trusts are looking at private markets. She adds that one key determinant for these schemes is price and that they are looking at a variety of strategies that have different sleeves including private equity and debt, and infrastructure.

Access routes

One of the most popular routes for DC schemes has been long-term asset funds (LTAFs) which made their debut three years ago. Hymans senior DC consultant, Adam Fisher, explains that the first illiquid strategies launched using these structures have mainly been multi-asset solutions that offer one fund for clients to access a wide range of private market assets such as property, infrastructure, private equity and credit. However, he adds, this is beginning to change with the launch of a number of private credit focused LTAFs and infrastructure LTAFs.

There is also a growing trend to combine LTAFs with other private market funds. For example, Legal & General launched its new private markets access fund, a fund-of-funds vehicle that invests in a LTAF as well as third-party funds, other Legal & General funds, and directly held liquid assets.

"We spoke to clients to better understand what type of solutions they would want," says Legal & General head of DC investments, governance and proposition, Jesal Mistry. "As a result, we created a diversified global fund that was straightforward, easy to access and available regardless of the size of the scheme."

He adds that daily dealing was an important attribute for his clients, which is why three quarters of the fund is invested in private illiquid strategies with one fourth into liquid securities.

Although strategies may differ, there is no doubt that ESG and impact investing will continue to be an important factor. As Cox says: "We remain in the foothills of a private market trend we expect to develop further in the coming years. We are also seeing a growing number of schemes exploring sustainability and positive impact agendas within their private portfolios. Going beyond ESG to focus on investments that can deliver positive real-world impact, alongside return that can be measured and reported on."

Real world impact

Cox adds that increasingly, across LGPS, DB and DC, schemes are leaning more and more into investments capable of delivering positive real world impact outcomes alongside return. Common themes include financing products and services that will accelerate the energy transition or social opportunity.

This is reflected in Legal & General's recently published annual DC study that found 68 per cent would prefer to invest in schemes with allocations to private markets, as affordable housing and clean energy. More specifically, they are also prioritising these outcomes with 80 per cent predicting this trend will accelerate over the next two years. In terms of opportunities, climate transition, digital transformation and AI and healthcare were top of the list for the private market themes DC schemes wanted to pursue.

"We found that the responses were much more personal to the individual, especially with the younger generation," says Mistry. "Gen Z, for example, were much more interested in affordable housing and technology because this is what is impacting them the most. Also, they are not just looking at the projects but the sustainability, for example, of how a data centre or a bridge is being built."

Mistry also notes that investing in these types of private investments can help the education process that is still underway in terms of how DC schemes operate. "We are trying to bring to life these investments because if people can see the impact, for example, of the regeneration of their town centre, they can engage with the process and also better understand," he adds.

However, as with all illiquid investments there are challenges, particularly when it comes to pricing and dealing frequency, according to IFM Investors director, clients and strategy, Phelim Bolger. "In the case of the former, cost cap charges, although altered in recent years, continue to dominate the market, with many DC providers effectively competing on fees rather than net-of-fee returns and value to members," he adds. "The second issue, that of pricing frequency, is really a legacy result of the UK's DC provision evolving from retail investment platforms."

Fisher echoes these sentiments. He notes that fees in DC are very low, particularly in the master trust market; where they are currently well below the 0.75 per cent p.a. charge cap. "Access to good quality private asset managers is therefore difficult and most schemes are limited in how much they are willing to allocate," he adds.

Looking ahead, he anticipates the move away from diversified multi-asset strategies to single sleeve solutions with specialist managers in each asset class to continue. "Over time, I would expect allocations to private markets in DC to increase from fairly small 5-10 per cent allocations to closer to 20-25 per cent. However, the DC market needs to get over the above fee constraints before this is possible," he adds.

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