There's no place like home, except for pension fund investments

As UK pension funds continue to shift away from domestic investments, the government must identify the causes and implement changes to address this trend

Summary
• Expected performance and diversification needs are causing pension funds to reduce investment in the UK economy.
• Compared to countries like Australia, the US and Canada, UK funds are outliers for not investing back into their domestic economy.
• Consolidation and regulatory reform could encourage investment in the UK economy, but the government must ensure these measures do not conflict with trustees' fiduciary duties or harm members' retirement outcomes.

The idea of boosting pension funds' investment in the UK economy has dominated the new government's agenda recently, with reforms and reviews aimed specifically at directing funds into domestic markets to increase pension pots and stimulate economic growth.

Pension funds' investment in the domestic market has been on the decline for the past few decades. The Pension Policy Institute's (PPI) *Pension scheme assets – how they are invested and how and why they change over time* report found that, in DC schemes, £51 billion is invested in listed UK equities and £21 billion is invested in UK property.

Pensions Minister, Emma Reynolds, says there is "no really good reason" why funds should not be investing in the UK economy – but schemes do have their justifications, which may also shed light on how to reverse the trend.

fund assets, the UK stands out as an anomaly for reducing investment in its domestic markets over the past few decades.

BVCA chief executive, Michael Moore, demonstrates that the UK is an outlier when compared to countries like Australia, the US and Canada, citing that over the past five years, overseas pension funds have invested 16 times more than UK pension funds in British venture capital and private equity.

In particular, Swedish pension funds alone have invested more in British private businesses than UK equivalents, he says.

While Wilkinson notes that comparing the investment behaviour of UK pension funds with their international counterparts is challenging due to differences in pension landscapes and domestic markets, she agrees that the data suggests evidence of greater investment in funds' domestic assets in some instances.

"For example, Australian funds invest a higher proportion of their assets in domestic business than UK schemes, in particular in alternative markets," she says.

She adds that Australian funds are taking this approach to investment because they are tax incentivised to invest in their domestic market, whereas the trend in the UK has been in the opposite direction.

"The UK DC market is in many ways following in the footsteps of Australia, where the market is more mature, so could potentially see investment following a similar trajectory, with the right market conditions in place," she says.

Moore says that investing in domestic markets is leading to better retirement outcomes for members in these countries, particularly in comparison to UK members. I think you can add something here about how it's good even for non-members.

"These countries' pension funds typically invest a significantly larger

Why has investment in the UK economy declined over recent decades?

Asset allocation is influenced by factors such as expected performance, portfolio diversification, costs, accessibility, liquidity and volatility. Therefore, many funds choose not to invest in the UK economy because it doesn't meet their criteria.

PPI senior policy researcher, Lauren Wilkinson, says performance is the main factor why most master trusts have reduced their exposure to UK equities in recent years.

"Those who have invested more heavily in UK public equities than a global index have found that to be a drag on their performance, something that then makes them uncompetitive in responding to tenders," she says.

Wilkinson highlights that master trusts may also question whether they are really satisfying their fiduciary duty by investing in long-term underperforming assets.

Arc Pensions Law partner, Beth Brown, agrees that trustees' duties often steer them away from investing in the UK economy, adding that their responsibility to ensure diversification plays a key role.

Trustees of trust-based pension schemes have an obligation to ensure their scheme's assets are diversified so that "excessive reliance on any particular asset, issuer or group of undertaking" is avoided, Brown notes.

She says this is arguably a contributing factor that leads trustees to allocate to a mixture of riskier and less risky investments in the UK and globally.

"It is in members' interest not to put all assets in one basket because concentration in any one aspect of the market, particularly a risky part of the market, does not allow for a safety net if things go wrong," Brown says.

Wilkinson adds that equities play a major role in DC default funds, with high use of passive, usually global, equity index funds, which is in part driven by the need to keep investment costs low and within the price cap.

"It's also driven by the strong long-term performance of global equities, much of which can be attributed to the so-called 'Magnificent Seven' *[seven famous and high-performing US tech stocks]* shares that have led to growth in the US equity market," she says.

She explains that with passive investment, as the US and other territories outperforms the UK, UK holdings shrink to mirror the global market capitalisation.

UK is an outlier compared to other countries

Unlike other countries with large pension

portion of their assets into private capital, resulting in more diversified portfolios and higher returns for savers," he says.

For example, Australian pension savers enjoy a more diversified portfolio as well as better returns compared to their UK counterparts, according to Moore.

Wilkinson adds that this not only has a positive on retirement outcomes for Australians, but it also helps stimulate investment in the domestic economy.

"This difference highlights the need for reform in the UK pensions industry," Moore says.

Change is needed to boost investment

To address the continued declined investment in the UK economy, the Chancellor, Rachel Reeves, has launched a 'landmark review' aimed at boosting investment.

This effort seeks to unlock £2 trillion in pension schemes in order to boost the UK economy, particularly DC pension schemes and the Local Government Pension Scheme (LGPS), to help kickstart economic growth in the UK.

However, significant changes are needed to make the government's goal of increasing pension fund investment achievable.

Moore recommends a revision of the regulatory framework to improve cooperation between DC pensions and private capital firms, including a review of regulation relating to life-insurance platforms to facilitate DC investment in private capital.

The government should take inspiration from overseas as "learning from successful international models, such as France's Tibi scheme, would offer valuable lessons for the UK on how to address these challenges", he says.

He also strongly advocates for the consolidation of UK pension schemes into fewer, larger entities as he says this would significantly enhance their ability to invest in private capital.

Brown agrees that consolidation could help. For example, allowing the separate pension funds that participate in the LGPS in England and Wales to pool their £360 billion worth of assets would allow them to invest in a wider range of UK assets using economies of scale, she says.

Brown adds that a suitable offering of investment that will boost the UK economy will need to be developed and marketed to trustees of trust-based pension schemes.

The Chancellor has already said that the government will focus on the financial service sector's role in delivering more investment and financing growth, including getting the industry and regulators to work in partnership to deliver growth, she notes.

"This could lead to some exciting new investment products being developed. The intention is to continue to fix the foundations of the economy, rebuild Britain and make every part of the country better off," she says.

Government should consider risks when implementing change

Brown cautioned that the government needs to be very careful when making changes to reach its goal of boosting investment because each individual, especially in DC pension schemes, relies on the investment performance of their pension pots to boost their savings for retirement.

"It is an admirable goal to want the UK economy to do well for the benefit of all, but pension funds are private property. They represent the retirement savings or deferred pay of individuals. The government must be well aware of the political risk of interfering with members' money," she says.

Wilkinson agrees that the government needs to be careful, especially as the policy initiatives currently underway could lead to some unintended consequences.

"For example, there is the risk that disclosing asset allocation could lead to less innovation in asset allocation as schemes tend towards the mean and disclosure could lead to a reduction in UK investment if it becomes more evident that schemes that are overweight in the UK are underperforming," she says.

"Any attempt to force providers to invest more heavily in certain asset classes is a direct challenge to trustees' fiduciary duty and can be expected to be met with considerable backlash. The government could also find itself in conflict with regulators, both of whom put member outcomes at the forefront of their strategies and policy," she adds.

Written by Niamh Smith, a freelance journalist