*▶ **Liquid real assets in DC pension plans:** We discuss how a strategic exposure to liquid real assets can be a useful component in a DC default investment strategy, providing not only further diversification but also long-term protection in different inflation environments **p70***

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Real assets focus:

The opportunities for DC schemes

Liquid real assets in DC pension plans

We discuss how a strategic exposure to liquid real assets can be a useful component in a DC default investment strategy, providing not only further diversification but also long-term protection in different inflation environments

Real assets are an asset class that covers investment in physical assets such as real estate, commodities, natural resources, precious metals, and infrastructure.

For DC investment strategies, there have been a number of barriers to investing in real assets. Many require large capital investment to be tied up for a long time, which conflicts with platforms requiring daily pricing and dealing. The cost for attaining these exposures along with close-ended fund structures can also be prohibitive. This complexity has dulled investor appetite.

However, liquid real assets are at the more accessible end of the real asset spectrum. The 'liquid' component of liquid real assets indicates that the investment can easily be bought and sold on an exchange through daily liquid mutual funds, index funds, and exchange-traded funds.

Four main categories of liquid real assets:

Inflation-linked bonds is the most integrated liquid real assets asset class so far in the DC investment design, allowing investors to mitigate inflation risks when purchased for the long term. However, in this article we would like to focus on four additional main liquid real assets categories, as shown below, that could be considered as well:

1. **Real Estate (REITs):** A Real Estate Investment Trust, or REIT, is a fund that owns, operates, or finances income-generating real estate. Investors have the opportunity to earn dividends from real estate, without having to buy, manage, or finance the properties themselves.

2. **Commodities:** The commodity universe includes grains, livestock, oil and natural gas, and precious and industrial metals. Commodity futures within a mutual fund or ETF are used to provide exposure to those assets without the costs of owning physical commodities.

3. **Infrastructure:** This universe includes utilities, transportation, and telecommunication infrastructure. Infrastructure can be accessed through both equity (e.g. shares of listed infrastructure companies) and debt (e.g. infrastructure corporate bonds).

4. **Natural resources:** These assets include exposure to agriculture, oil, energy, and metals. Again, a mutual fund, index fund or exchange-traded fund (ETF) will provide exposure to those assets with greater liquidity.

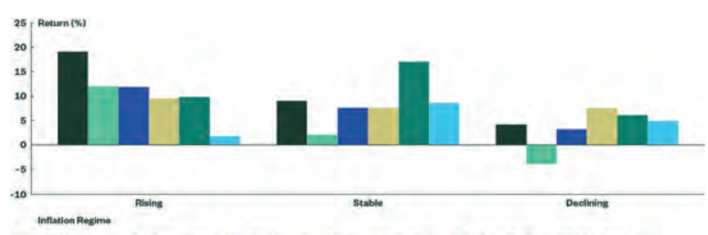
How can liquid real assets protect DC pension pots from inflation?

Inflation can eat away at nominal asset returns in DC pension pots over time. It is important to understand how asset classes perform across different inflation regimes. Figure 1 shows the quarterly real asset returns over the past 20 years for three discrete inflation regimes: rising, stable, and declining.

As seen in Figure 1, real assets provided attractive returns not only in rising inflationary regimes, but also during stable regimes. Even in declining regimes, many real assets may generate attractive returns compared to equities, offering an element of downside protection.

- **Real estate investment trusts (REITs)** perform well in stable, and even declining, inflationary environments. Their inflation-hedging ability is embedded in their rental agreement structures, which generally include inflation-linked adjustments or fixed percentage increases in rents.
- **Infrastructure** also performed well in stable and declining inflationary environments. Their revenues for "pureplay" infrastructure are typically stable and predictable given their long-dated underlying contracts and monopolistic assets.
- **Commodities and natural resources** provide efficient protection against unexpected and rising inflation. Commodity futures and natural resource equities have a strong, direct relationship to inflation given the nature of their businesses models (raw materials inputs).

Figure 1: Average return v/s inflation regimes (2003 – 2024)



Source: State Street Global Advisors, Bloomberg and FactSet, as at 30 September 2024 All average returns are calculated in GBP.
Note 1: Declining regime is an annual decrease in headline CPI of greater than 50bp. Rising regime is an annual increase in headline CPI of greater than 50bp. Stable regime is everything else in between. Historical annual index returns from 2003-2023.
Note 2: *Real Assets Portfolio consists of 20% S&P Global Infrastructure Index, 15% British Government Index-Linked All Stocks, 25% Bloomberg Commodity Total Return Index, 30% S&P Global Natural Resources Index, 10% Dow Jones Global Select Real Estate Securities Index.
Past performance is not a reliable indicator of future performance. Benchmark returns are unmanaged and do not reflect the deduction of any fees or expenses. Benchmark returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Figure 2: Historical Yields of Real Assets Components and Benchmark

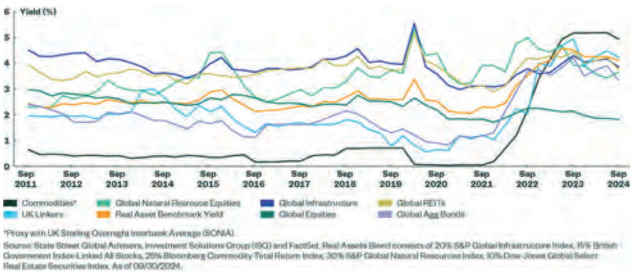
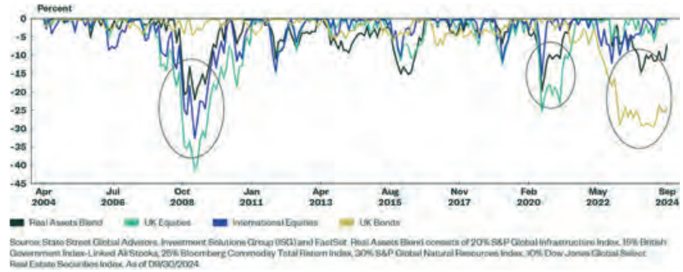


Figure 3: Drawdown Analysis: Real Asset Portfolio v/s UK Equites



Liquid real assets' role in DC plans

As DC funds grow in size in the UK, their investment strategies continue to evolve from investing in listed equities and bonds. Liquid real assets can provide an effective asset allocation tool in DC pension plans that not only protects against inflation, with a solid income, but also provides diversification benefits and downside protection.

Liquid real assets key advantages:

- **Inflation protection:** Real assets have historically provided an inflation hedge in different inflationary environments, helping investors maintain purchasing power while ensuring adequate retirement income via stable and predictable income streams.
- **Performance:** Allocating to a diversified group of liquid real assets can potentially provide additional returns relative to traditional assets.
- **Downside protection:** Furthermore, liquid real assets have shown effective downside protection versus traditional asset classes, ensuring member pension values have been less impacted during broad market selloffs (e.g., equity market selloff in '08 and the recent UK bond crisis in '22).

Diversification: Liquid real assets have historically demonstrated correlation benefits vis a vis traditional asset classes, as well as with each other.

- **Cost efficient:** Real asset exposure can be obtained individually or managed as a composite strategy. Access through low-cost and liquid vehicles enables DC schemes to meet daily pricing and dealing requirements.
- **DC pensions friendly:** The investment concept is easily understood by members (contractual income from tangible assets and assets indirectly linked to inflation, e.g. commodities), while at the same time reducing complexity of compliance reviews for trustees versus other alternative investments.

Figure 4: Liquid Real Assets Correlation

Criteria	Commodities	Global Natural Resources	Global REITs	Infrastructure	UK Linkers	Global Equities	Global Agg Bonds
Commodities	1.00						
Global Natural Resources	0.51	1.00					
Global REITs	0.31	0.48	1.00				
Infrastructure	0.18	0.42	0.58	1.00			
UK Linkers	0.01	0.09	0.35	0.43	1.00		
Global Equities	0.29	0.64	0.72	0.65	0.24	1.00	
Global Agg Bonds	0.18	-0.02	0.31	0.46	0.48	0.23	1.00

Source: State Street Global Advisors. As of 09/30/2024.

Written by State Street Global Advisors retirement investment strategist, Christos Bakas, and portfolio specialist, strategist, Pradeep Channappa

Summary
• More and more pension funds view real assets as an important element of long-term investment portfolios.
• Some key advantages of real assets can include favourable expected future returns, open-ended investment structures, low fees and member value. They can also play a useful role in helping to align portfolios with sustainability goals.
• Some observers note the best approach is to pursue a blend of asset allocation across public and private markets.

A real opportunity?

Abigail Williams explores how real assets can provide benefits for UK DC funds

A growing number of pension funds now view real assets, or private markets, as a vitally important element of long-term investment portfolios, often for reasons of risk and return diversification or as a means of capturing regular and relatively stable, inflation-linked income.

So, what have been the recent trends and developments in the real asset investment space for UK DC pension funds? What are the key current opportunities? And how best can fund managers incorporate real asset investments and investment decisions into their portfolios and strategies?

Direct asset ownership

According to Aviva Investors head of institutional, UK, Heather Brown, real assets have performed extremely well throughout market cycles over the long term. In addition, the fact that some 57 per cent of global institutional investors have a commitment to reaching net zero means they "can also play a prominent role in helping to align portfolios with a just and socially equitable energy transition".

"The 2024 edition of our *Real Assets Study* highlighted that sentiment, with 17 per cent of respondents citing sustainability-related factors as being a critical and deciding factor in decisions to invest into real assets," she says.

Elsewhere, People's Partnership chief investment officer, Dan Mikulskis, notes that, when considering investment in private markets, the exact nature of a fund's access approach is important for member outcomes.

"We believe a core direct holding of private market assets is the most cost-effective way to own these assets, as opposed to funds, in a similar approach to large pension funds that we see in Canada and Australia, but this requires significant scale to generate a diversified portfolio," he says.

For Mikulskis, although private markets cover a broad range of assets, infrastructure and real estate "currently offer a workable combination of favourable, expected future returns, open ended investment structures, and good fee economics that leave value in the hands of members".

"UK real estate has had a few tough years but there are some interesting opportunities emerging, for example, in logistics buildings and data centres," he says.

Improved diversification

State Street Global Advisors (SSGA) head of retirement strategy and UK distribution, Alistair Byrne, also observes that he and his colleagues are seeing growing interest in real assets, and private markets assets more generally, for DC pension schemes.

"The thinking is that these investments can potentially improve diversification and risk-adjusted returns," he says.

"There are challenges, though, in the relatively high management costs – higher than most DC schemes are used to – and in dealing with the illiquidity. In most cases, this means allocations will be quite modest, less than 10 per cent. New investment vehicles such as the LTAF help to make the administration easier," he adds.

Meanwhile, Legal & General (L&G) head of DC investments, Jesal Mistry, points out that private markets have really taken hold of the DC market's imagination in 2024, with a number of providers launching private markets solutions specifically for DC investors.

"We announced our Private Markets Access Fund in July, for example, which includes exposure to a diversified range of private markets assets, including property - such as UK affordable housing and global real estate – and infrastructure, through our L&G NTR Clean Power Europe Fund and partnership with IFM," he says.

By creating a structure that can deliver on the daily dealing, liquidity needs of DC investors while offering exposure to asset classes that have the potential to act as a diversifier and alternative driver of

returns, Mistry believes UK DC pension funds can benefit from having exposure to a realm of the investment universe that has historically been unavailable to them at scale.

"One of the powerful potential benefits of real assets is their ability to diversify a portfolio. Many real assets can offer a degree of inflation protection that is not always present in traditional public market investments. They also often have a low performance correlation with public equities and bonds, helping to protect against downside risk in volatile markets," he says.

"We also believe there's a real opportunity to engage DC members with their pension through investing in real assets. These are tangible assets which members can see the immediate benefits of. Research we conducted this year suggests DC members want to see their pension investing in assets such as affordable homes, renewable energy infrastructure and university spin-out companies, which have the potential to benefit members' outcomes in retirement, as well as boosting the broader economy," he adds.

Liquid alternatives

When it comes to real asset investment strategies, Mikulskis confirms that he and his colleagues have set out several tests that they think private market assets need to meet in order for them to be confident they could add real value to our members. These tests relate to the expected return net of fees above global listed equity and fair sharing of economics between manager and members, as well as low absolute fees "so that the allocation could become a meaningful part of the portfolio".

In his view, a key issue with deploying capital at scale into the UK market has been the historical lack of enough assets and projects coming to market to actually get investor capital deployed, "an issue which is often underappreciated".

"Historically this has been due partly to planning restrictions and grid connection queues. There are good signs this might be changing but for this reason there is still hesitancy to allocate large sums focusing only on the UK," he says.

"Ultimately good and bad investments both exist in private markets. Compounding this, due to the high costs involved with private markets, there is a risk that any advantage of the underlying assets can be reduced or given away entirely through costs paid to the manager. This makes the area tricky to navigate. Overall, we believe that funds like ours, owning assets directly, will allow more returns to stay in the hands of members," he adds.

"The thinking is that *[real assets]* can potentially improve diversification and risk adjusted returns"

Byrne observes that schemes may also consider liquid alternatives, such as listed infrastructure and real estate investment trusts, alongside private assets to act as a liquidity buffer and as a way of reducing costs.

"We can expect more focus on this area as the UK government continues to promote investment in productive assets in the UK," he says.

Growing positivity

Mistry also confirms that he is seeing "growing positivity" from pension savers towards asset classes that "resonate with them closely".

"Our research suggests savers would feel particularly positive about their pension investing in assets like affordable housing strategies. This type of strategy can offer portfolio diversification, long term inflation-linked returns through rental and development cashflow, and positive social benefits within local communities facing drastic housing shortages. Affordable housing delivery also has a direct impact on economic growth and life chances, contributing to a more dynamic and efficient labour market, while creating jobs in the process," he says.

More generally speaking, he believes the best approach is to have the ability to blend asset allocation across public and private markets.

"In our own DC private markets fund, the overall asset allocation framework is set by our multi-asset team – they have the ability to look across the entire spectrum of investment opportunities and construct a portfolio which meets the needs of DC schemes," he says.

"I think we'll continue to see the market shift from focusing exclusively on cost and moving to a more holistic understanding of value for money. This is critical if the integration of private markets investments is to be a success for DC," he adds.

Looking ahead, Brown also notes that investment in more idiosyncratic infrastructure and real estate assets, and higher risk, illiquid growth investments, has been inhibited by practical logistics issues for a long time, but as those challenges are addressed, the hope is that investment horizons will broaden.

"As a result, we expect investment in private market assets by UK DC schemes and others to pick up, as they seek to leverage the growth in this universe. Ultimately, exploring the diversification- and return-enhancing characteristics of private market assets could create more value in savers' pension pots and contribute towards a better retirement," she adds.

Written by Abigail Williams, a freelance journalist