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# The liquidity kink

## Are pension schemes missing out on the illiquidity premium?

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Investing in secure income illiquid assets can bring more certainty to a scheme's journey plan. The 'liquidity kink' means schemes targeting buy-out believe they can't exploit the illiquidity premium. We look to dispel those myths by providing trustees with a checklist to help navigate their decision on whether to invest.

This paper has been written in collaboration with K3 Advisory – the buy-out and consolidation advisers.

According to recent research commissioned by AlphaReal, just over 90% of defined benefit pension schemes have 'developed' or 'very developed' long-term funding objectives. Schemes are typically targeting 'buy-out' (the transfer of a scheme's liabilities in full to an insurance company) or 'low dependency' (minimising the likelihood of continuing financial support being required from the sponsoring employer).

For schemes targeting low dependency, the demand for and use of illiquid assets is high and still increasing. However, we often see schemes that are targeting buy-out dismiss illiquid assets. The primary reason for this is because it is highly unlikely an insurer will take a scheme's illiquid assets, even though insurers themselves invest in them. We've termed this the 'liquidity kink', which we expand on below. Although the liquidity kink is an unwanted dynamic of the market, the question of whether schemes targeting buy-out can still benefit overall from investing in some level of illiquid assets is more nuanced and requires more detailed analysis.

In this paper, we have developed two checklists to help trustees consider whether illiquid assets might be right for their scheme.

## The liquidity kink

The long-term nature of defined benefit pension scheme liabilities means that they are ideal vehicles for investing in illiquid assets.

As such, schemes can hold assets to maturity and illiquid assets such as private credit, commercial property, ground rents and various types of infrastructure assets have become commonplace in asset portfolios.

The primary reason why schemes invest in such assets is that they reduce risk while still offering attractive returns, thus increasing the certainty with which schemes can reach their long-term funding targets. This is because:

1. They provide an illiquidity premium, which means they are generally expected to provide a materially higher return than otherwise equivalent liquid investments of a similar credit quality. For a scheme targeting buy-out, this enables the scheme to either:

A. Achieve buy-out sooner for running the same level of credit risk.

B. Achieve buy-out in the same timeframe but with greater certainty.

Clearly, either of these outcomes is desirable.

2. They provide contractual cashflows that enable schemes to match their liabilities more closely. Schemes can buy assets that provide contractual inflation linkage, which is in short supply for UK pension schemes. They can also match liabilities more accurately, for example 'LPI' benefits (pensions that increase in line with RPI or CPI up to an annual cap, such as 5%) can be matched exactly.

Insurers that take on pension schemes also recognise that illiquid assets are smart investments to match the liability profile of those schemes and to earn better expected returns. In fact, insurers' use of illiquid assets is one of the drivers behind attractive pricing in the bulk annuity market.

However, insurance companies are heavily regulated, and a critical part of this regulation relates to the type of assets insurers are permitted to hold. Taking on pension scheme assets as payment of their premium can become a highly bureaucratic and time-consuming process for insurers, so it is currently most common for schemes to have to sell their assets to pay the insurance premium.

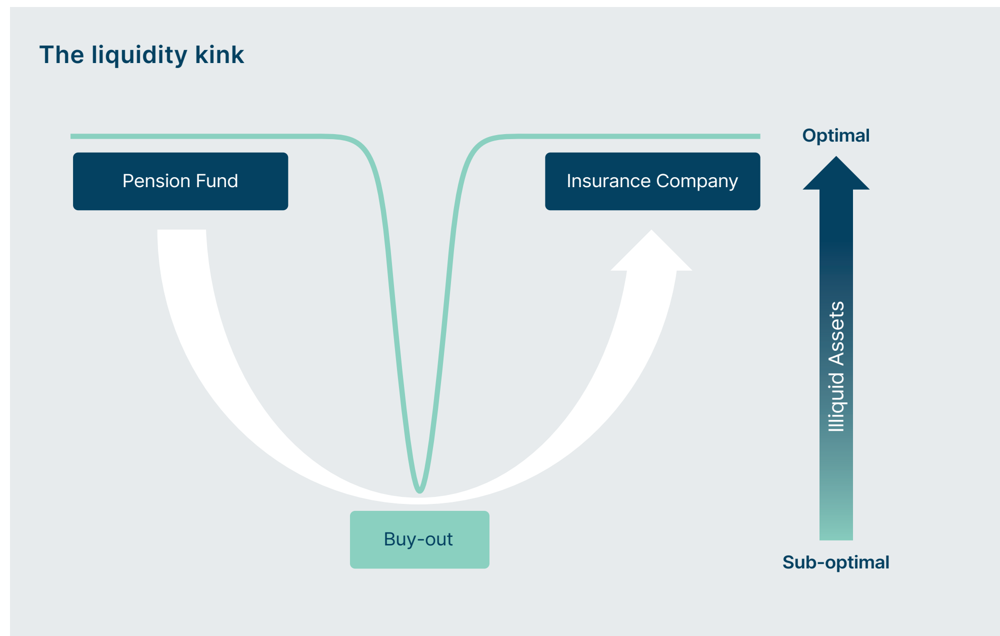
This creates the liquidity kink (see below). Both before and after a buy-out trade, there is a strong desire (by the scheme and insurer respectively) to hold some level of illiquid assets, but for the pension scheme and the insurer to trade with each other, the scheme assets normally must be fully liquid at the point of transacting.

This is clearly sub-optimal at an industry level, and in particular for pension schemes, as they are not able to invest in the most efficient manner and in line with the long-term nature of their liabilities.

For insurers at least, there may be some good news on the horizon. Currently, the UK Government and the insurance regulator (the Prudential Regulation Authority, (PRA)) are looking at various aspects of how insurers are regulated. In particular, the Government is keen for insurers to be investors for good in rebuilding the UK economy and making it more sustainable. Some estimate that this should make it easier for insurers to invest in a wider range of illiquid assets, unlocking up to £90 billion of insurer capital. This could in turn help with the liquidity kink.

Our guest contributor, Adam Davis, Managing Director of specialist buy-out advisory firm K3 Advisory, comments:

"Over time I expect insurers and pension schemes to become even more aligned in investment approach and insurers to become more flexible in their willingness to take on assets from schemes that buy-out. This will help to reduce the current liquidity kink that exists for schemes looking to buy-out."



# Are illiquid assets right for your scheme?

## We have created two checklists that will help trustees think about whether illiquid assets are right for their schemes.

The first is designed to help a scheme think about the various illiquid assets that could be used, while the second highlights the structural options open to a scheme on transacting and planning for a buy-out transaction, to help manage any illiquidity within the scheme's assets.

Before jumping into the detail, one key aspect of this strategic thinking is to make sure trustees understand the likely timescales to reach buy-out. Adam comments:

"In my experience, many schemes are making decisions based on out-of-date funding estimates that are crudely rolled forward. This is ill advised. Understanding a scheme's funding position to buy-out requires expert knowledge of insurer pricing and up-to-date membership data. This will help trustees more accurately determine how far away a scheme is to being able to buy-out."

# **Checklist 1:** Asset considerations

### Duration

It is a common misconception that illiquid assets are always very long in duration. There are a whole range of assets with different durations, meaning that there are options to invest in illiquid assets that are within a scheme's timescales to reach buy-out. The growth of private credit in pension scheme portfolios is an example of an asset class that, while having limited matching characteristics to long dated liabilities, does provide an illiquidity premium.

### Liquidity

Similarly, there are varying degrees of illiquidity. While there is always a price at which there is a buyer, the time taken and price at which assets can be sold can vary. Planning ahead can optimise outcomes. At AlphaReal, our long dated secure income asset funds have a redemption period of six months. A scheme's investment strategy should look to invest in the level of illiquidity it can comfortably manage, although for points discussed later in this paper, we would challenge trustees to think whether they need quite as much liquidity as they think.

### Size of holdings

With many long-dated illiquid assets currently expected to earn excess annual returns of 4% p.a. to 6% p.a. or more versus a scheme's gilt-based liabilities, a large allocation is not required to make a real difference. For example, a 10% holding would give an additional expected annual return of 40bps to 60bps or more. (It is worth noting that, at these levels, a 10% holding would in itself mean a de-risked scheme achieves the typical low dependency returns target.) This excess return can either be used to shorten a scheme's journey to buy-out or to allow further de-risking of other parts of its asset portfolio to increase the certainty of the journey to buy-out. As outlined below, a modest holding in illiquid assets can be dealt with more easily as part of the journey to buy-out.

### Income stream

Another common misunderstanding relates to the link between illiquidity and income. Many illiquid assets can and do provide regular income to pension schemes. This is worth bearing in mind when considering some of the structural options for buy-out transactions discussed later in this paper.

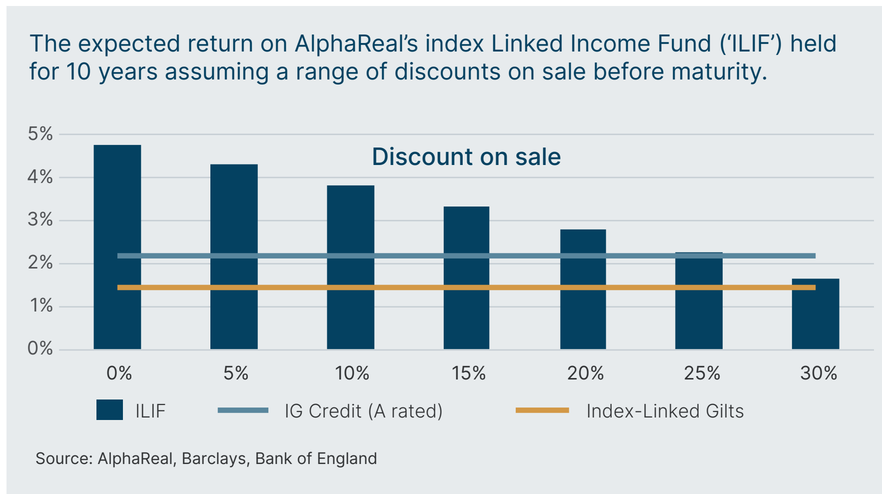
### Payback period

Buy-out opportunities sometimes arise sooner than expected, either because of asset out-performance or favourable insurance pricing or both. Even with good planning, this means a scheme could need to sell illiquid assets to take the opportunity.

Adam comments:

"In this situation, trustees often look on the negative side, that they may take some level of haircut on selling an illiquid asset. However, they should step back and consider that the reason they are faced with the issue is because other things have gone better than expected. In my experience, proper analysis can show the scheme is often a net winner in this situation."

## ILIF – returns (p.a.) after discount on sale




In light of these developments, it is AlphaReal's expectation that, over time, selling down illiquid assets should become easier not harder.

The chart shows that, after holding ILIF for 10 years, a scheme would have to sell its holdings at a discount of more than 30% to be worse off than investing in gilts. Similar analysis for a five-year holding period shows that a 10% to 15% discount is tolerable.

The good news is that illiquid assets are in high demand. Recent AlphaReal research* showed that 85% of UK professional pension fund investors say the scheme they work for will increase its allocation to illiquid assets over the next three years. It's not only true of pension schemes, as we are currently seeing insurers readying themselves to invest in a wider set of illiquid assets. For example assets, such as commercial ground rents and long term fixed rate mortgages. This is even before the potential relaxation of insurance regulations currently being discussed, which may result in illiquid assets being more attractive to insurers.

# Checklist 2: Structural options for buy-out

The buy-out market is highly innovative, with eight active insurers bidding to win business. Given the regulatory landscape is under discussion, insurers may be increasingly open to suggestion and it may be worth asking buy-out providers what their stance is regarding the inclusion of secure income illiquid assets as part of the transaction.

Nevertheless, there is very often significant flexibility for schemes in how a transaction is structured, particularly for larger schemes. Below is a checklist of considerations for how a buy-out can be structured to deal with illiquid assets within a scheme's portfolio.

### Dynamic journey planning

The best course of action for a scheme is to start considering issues, such as the liquidity of the asset portfolio, well before the point the scheme can transact a buy-out. As mentioned, we recommend trustees have a robust idea of their scheme's current funding position to buy-out, but it is critical to also monitor this over time accurately and to set funding triggers that determine future actions. For example, reaching 90% funded to buy-out could prompt a scheme to start preparing data and a benefit specification for buy-out. A trigger could also be set for the investment adviser/manager to start to prepare the scheme's assets for a trade. By dynamically tracking a scheme's buy-out funding position, trustees can make sure they can take the right course of actions at the right point in time and, therefore, have a strategy that adapts should buy-out move towards or away from the scheme.

### Timescales

The schematic (overleaf) shows that a typical buy-out process can take 8 to 12 months:

This process includes the phase where scheme data and a benefit specification are prepared to the standard required before approaching the insurance market. This alone gives trustees several months to start working with their investment adviser and asset managers on any illiquid holdings. Note that this is often longer than the redemption notice required on many illiquid funds. For larger schemes the buy-out process to safely trade can take several years.

## A typical buy-out process, taking 8 to 12 months

| Stage | Duration | Description |
|---|---|---|
| Planning | 2-4 months | This phase is critical to ensure a scheme transacts safely with an insurance company and to help present the scheme in the best light to the insurance market.<br>It is also the time to bring in all key advisers, including the investment adviser, so the planning can start to deal with illiquid assets.<br>There are various structural options to give schemes more flexibility over the payment of premium, so understanding upfront the position regarding illiquid assets enables the buy-out process to be run in a way that will manage this safely for the scheme. |
| Engage market | 2 months | This is the stage where the scheme is presented to insurers. For larger schemes, it is sensible to discuss the current asset portfolio and see what appetite there is from insurers to take any of the scheme's assets in specie. |
| Drive best terms | 2 months | This stage is all about driving the best commercial terms for the scheme and would involve getting a transparent price-lock for consideration by the investment adviser. |
| Securely implement | 2 months | This stage finalises the insurance contract and the process for the payment of the premium. |

### Premium payment

It is common for insurers to allow a small amount (up to 5%) of the premium to be paid at the end of the post-transaction data cleansing period, typically a 12 to 18 month process. Combined with the time it takes to plan for and implement a transaction, a scheme could have up to two years to make good the last 5% of the premium, which provides considerable additional flexibility to sell illiquid assets.

### Deferred premium

Where schemes need further flexibility, some insurers offer the ability to defer more of the premium for longer. For example, it might be possible to defer up to 10% of the premium for five years. Some insurers also offer lots of flexibility around when the deferred amount is paid, for example making good the whole amount deferred only at the end of the deferral period. There would likely be an interest charge for premium deferral, but it is then straightforward to undertake a cost-benefit analysis of the deferral against any haircut for selling illiquid assets sooner.

### Deferred start

Under this option, a scheme only insures its future benefit payments starting N years from transacting. As the first N years' cash flows remain a liability of the scheme, the buy-out premium payable is lower, and this could be structured so the premium is at a level that avoids the need to sell illiquid assets. However, the scheme does still need to meet benefit cash flows in the first N years. If the scheme's illiquid assets provide income, this could be used to meet those cash flows. There may be other options such as short-term finance or borrowing from the sponsoring employer that could bridge the gap to fund those cash flows and avoid selling illiquid assets. Deferred start solutions are typically more suitable to more mature schemes with a decent proportion of their liabilities relating to retired members.

### Financing

Where a deferred premium or deferred start are not feasible or desirable options, a scheme could look to borrow against the illiquid assets to provide the liquidity so that the buy-out premium can be met in full, but without the scheme having to sell illiquid assets with a haircut.

### Sponsor asset transfer

A scheme's trustees and sponsor would need to take appropriate advice, but it may be an option for the sponsor to agree to take any illiquid assets, to avoid the need to sell them. In return, the sponsor would provide the scheme with the funds to meet the insurance premium. This is likely only to be an option for larger employers and where the illiquid asset is material enough to make the effort and receive the advice needed to make this worthwhile.

## Our key points for trustees:

- Make sure you have an up-to-date and robust estimate of your timescales to buy-out and start to track it accurately over time.
- Make sure you are aware of the universe of illiquid assets available to you and their varying terms and levels of illiquidity.
- Consider engaging with a risk reduction adviser to work with your investment adviser to make sure a joined-up strategy is developed that will enable a smooth transition to buy-out when the time comes.
- Set funding triggers to start preparing the scheme for buy-out earlier in the journey so issues don't crop up at the point you want to transact.

Even if buy-out is your target, illiquid assets could accelerate the path to buy-out or make the journey less risky.

# About us

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We provide market leading and innovative real asset solutions across the UK and Europe, specialising in commercial ground rents, social infrastructure, and renewable infrastructure.

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