THE RISE OF DC ASSETS

DC asset allocations: A seismic shift or tentative beginnings?

As DC schemes become more popular, the allocation approaches funds are taking are indicative of the opportunities and challenges facing the market

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Defined contribution (DC) schemes are on an unrelenting rise in Europe. As the bricks and mortar of the European pensions sphere undergo significant change, investment strategies are coming to the fore that remain largely untested in many parts of Europe.

The European DC space is yet to reach the level of maturity seen in some individual markets, such as the UK, but the shift is already pronounced. More governments and corporations are exploring the cost benefits of DC schemes as a long-term replacement for increasingly expensive defined benefit (DB) guarantees.

European DC pension assets are expected to exceed the €10 trillion mark by 2030, up from €4 trillion at the beginning of 2020, according to research by Indefi, marking a significant change to the makeup of pensions across the continent.

Within the world's seven largest pensions markets, known within the *2021 Global Pension Assets Study* from the Thinking Ahead Institute as the P7, leading European DC-dominant nations are driving global trends.

The Netherlands, Switzerland and the UK have all contributed to a remarkable shift in the European pensions landscape, with DC assets accounting for over 53 per cent of the assets held among the P7. In 2000, DC assets represented only 35 per cent of total pension assets among the seven largest markets.

Spurring this rise, the European front runners are all at different stages in their shift to DC. The Netherlands still holds 94 per cent of its pension assets in DB schemes, while in the UK, 81 per cent of assets are still in DB schemes. But the inevitable growth in DC across European markets is forcing pension schemes to reconsider the makeup of their allocations, and review both where they put their money and how they utilise various approaches to achieve desired objectives.

Illiquidity issues

It is not simply a case of looking for opportunities and asset classes that provide good returns, says Mercer Ireland partner and DC & master trust market leader, Caitriona MacGuinness.

She says that one fundamental issue that dictates much of the asset allocation decision making is that it is more difficult for DC investors to hold illiquid asset classes, as individual members need the "ability to access their savings in certain circumstances".

In practice, this means that DC schemes lean towards asset classes that can be liquidated quickly, "generally those offering daily liquidity," says MacGuinness.

But LCP Ireland investment consultant, Odhrán Mulrooney, says that the habit of investing in daily dealing funds for DC schemes needs to be addressed as it "limits the investable universe and puts DC members at a relative disadvantage," in comparison to the opportunities available to DB clients.

Meanwhile in the Netherlands, Kempen Capital Management fiduciary manager, Frank van der Ploeg, says that a similar pattern can be seen in his domestic market, although DC pension funds will still make "significant allocations" to illiquid assets – often around a fifth of total assets.

Yet there is a case to be made for a greater allocation of illiquid assets, Mulrooney says. Between 80-90 per cent of DC members are invested in the default option in Ireland, and with investment horizons often being over 30 years, Mulrooney believes that schemes of a certain size should be more willing to utilise illiquid opportunities in the default offering.

"This is something we have worked on with some larger DC schemes in the UK and is something we'd like to see adopted in the Irish market."

Likewise, MacGuinness says that while there has been some evolution in this area, there are not yet solutions in Ireland that meet the reality of the fee constraints facing DC funds.

"Some more developed DC markets, such as Australia and New

Zealand, have the scale to incorporate illiquid elements, but this is not yet a feature of most Irish DC funds and could improve outcomes for members," she says.

But the wave of greater consolidation coming to the Irish pensions market may bring the need to facilitate more illiquid assets to the fore. In August, the Irish Pensions Regulator, Brendan Kennedy, said the consolidation of pension schemes was "fundamental".

Technicalities take precedent

To say that the European pensions space is nuanced would be an understatement, and various intricacies from across the continent are set to dictate future allocations, resulting in myriad approaches.

In the Netherlands, hedging against inflation risks is not a "hard requirement" for DB schemes, van der Ploeg says, while many schemes consider the cost of inflationary hedging for the whole population to be too high. Yet this attitude may undergo a significant shift as the DC transition continues in the Netherlands.

"For DC schemes, the more relaxed regulatory framework such as the absence of liabilities, allows pension investors to re-evaluate inflation hedging. Specifically for older participants, it might be reasonable to pay 1-2 per cent, per year to avoid the risk of high inflation affecting real pensions," he says.

Broadening equity horizons

Equities continue to be at the core of a DC growth portfolio, helping to achieve the growth required to support retirement goals as well as providing the liquidity needed for individual members.

But Irish Association of Pension Funds (IAPF) CEO, Jerry Moriarty, says that in recent years, there has been a growth in allocation to alternatives, with equity allocation dipping to below 50 per cent for the first time, according to the latest *IAPF Annual Investment Survey*.

Of this allocation, 3.5 per cent of DC assets are in absolute return funds, 5.1 per cent in diversified growth funds, 0.1 per cent in hedge funds and 5.3 per cent is invested in "other alternatives".

But one inescapable trend that is influencing DC asset allocations across Europe is the shift towards sustainability and the rise of environmental, social and governance (ESG) investing.

As an element of the equity universe, approaches to ESG investing are nuanced and varied across the pensions landscape. Whereas some DC providers will utilise ESG investments, including novel sovereign green bonds, as the backbone to a portfolio for sustainably-conscious members through the default offering, others may utilise the performance and momentum of ESG opportunities within a broader range of equities through self-selection or a niche fund.

Legislative drivers

On the continent, the introduction of the IORP II Directive has further accelerated the integration of ESG into asset allocations. Under the ruling, pension providers in EU member states must invest prudently in the best long-term interest of members and beneficiaries and operate an effective governance system that includes consideration of ESG factors.

And while this has predominantly resulted in an increase in allocation to sustainably-focused equity products, there is an emergent demand for other asset classes, such as corporate bonds and emerging market debt. Mulrooney believes that this area is set to develop significantly over the coming years, with new products set to come to market.

But the bigger picture still remains uncertain and untested. The transition to DC schemes is set to intensify, with ever great flows of capital set to facilitate the ever-increasing number of DC scheme members, intensified by the prevalence of auto-enrolment practices.

Yet many issues remain unaddressed, particularly in how the composition of the default offering can best serve both the financial needs of savers alongside the growing necessity to incorporate sustainability alongside effective corporate governance.

So far, the shift in allocations may not be hugely pronounced, but the momentum looks unlikely to dissipate. ■