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# A retiring couple – DC and infra

By Mlria **WHITTLE**

**The prevalence of Defined Contribution (DC) schemes continues to grow across the globe, with contributions to DC arrangements exceeding those to Defined Benefit schemes for the first time in 2018, in the UK. Despite this, DC investment strategies remain relatively unsophisticated. While infrastructure assets provide an arguably natural fit to the long-term liabilities, many schemes are not yet able to accommodate illiquid assets. This article explores the role listed infrastructure can play in bridging the gap.**

*Listed infrastructure can be considered to achieve some of the more attractive characteristics of the underlying, while avoiding some of the challenges that prohibit a more direct exposure.*

DC pension schemes are a core vehicle for retirement savings. While DC arrangements vary across the globe, the main principals are the same. Regular contributions, made by the individual and/or their employer, are invested into a pension pot. The pot grows with time, in line with returns net of fees (for management, administration etc.). The accumulated pot is then used to fund the individual's retirement and can be taken as a lump sum, used to buy an annuity or can be drawn, over time.

Fundamental to a positive retirement outcome is a good investment strategy. Typically, members choose how their pot is invested based on a list of investment options. Where members don't make an active choice, their funds are invested in line with a default strategy. Interestingly, the vast majority of DC pension assets are invested in the default (in some cases over 90%).

## Default design

Responsibility for the design of the default strategy depends on whether the DC arrangement is a trust- or contract-based scheme. Under trust-based schemes, e.g. superannuation in Australia and most occupational pensions in the UK, the default strategy is defined by the scheme trustees. With contract-based schemes the design is ultimately the employer's responsibility. They can choose between an off-the-shelf default strategy designed by their pension provider or a bespoke arrangement.

In general, those responsible for the default design will opt for a strategy that meets the following core objectives: provides strong returns in excess of inflation, effectively manages volatility (particularly as the member nears retirement age), is relatively simple and good value for money. Increasingly, designers will also favor environmentally and socially positive allocations.

Target date and lifestyle strategies are popular forms of default design as they are commensurate with the view that a member's risk/reward appetite changes over time. These strategies follow glidepaths that provide exposure to high growth assets in the early stages (known as the 'accumulation phase') and reallocate to lower risk assets as the member nears retirement.

## Investment case

Infrastructure is arguably well placed to meet the core objectives, in that infrastructure assets:

- provide access to strong returns, largely by providing essential services that have naturally high barriers to entry and monopolistic market positions;
- provide a natural inflation hedge as revenue streams often contain explicit inflation-links or inflation adjustment mechanisms through regulated income clauses;
- provide an income that is long-term, stable and predictable and is generally a diversifier to more traditional assets;
- are relatively simple for members to understand, in that returns are based on contractual income from a tangible asset; and
- can provide socially positive infrastructure (e.g. schools, universities, hospitals) and environmentally sustainable alternatives (e.g. wind, solar).

## Challenges

Despite this, there are a number of challenges that need to be overcome before an infrastructure exposure can be included within a default strategy and/or self-select fund range.

Theoretically DC schemes are a good fit for less liquid assets, given their long investment horizons. However, DC funds are often offered through platforms that have been designed to accommodate retail funds and therefore require daily pricing and dealing. This creates a challenge for assets like infrastructure that are priced less regularly and that are highly illiquid.

Another challenge is being able to access infrastructure in an economically viable way. Infrastructure by its very nature, requires a high level of upfront due diligence and ongoing management. Default strategies in particular have a heavy cost focus and, in some cases, there are regulatory restrictions on the charges permitted. For example, in the UK default strategies have a 0.75% fee cap (which includes administration and management charges).

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In some countries, regulation has acted to restrict DC portfolio access to alternative assets. For example, in the UK most DC schemes operate under Permitted Links rules which restrict the level of exposure to 'land and property' to 10% (though the FCA is currently consulting to remove this restriction and replace with an overall limit of 50% of illiquid assets). In some cases, this has acted to discourage trustees altogether.

Lastly, some DC schemes lack the scale to invest in direct infrastructure. This is particularly the case in more fragmented markets like the UK which has in excess of 1,250-plus individual DC schemes, compared to the Australia and the Netherlands which have close to 200 (albeit with smaller populations).

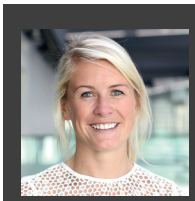
## Listed infrastructure

Listed infrastructure can be considered to achieve some of the more attractive characteristics of the underlying, while avoiding some of the challenges that prohibit a more direct exposure.

Listed infrastructure is tradeable through an exchange, therefore meeting DC pricing and liquidity needs. It typically has lower fees and is more accessible to smaller scale schemes both in terms of clip size but also because investors exhibit less control over the underlying, making it less onerous from a governance perspective.

While in the longer term, listed infrastructure is likely to exhibit characteristics close to that of the underlying, in the short-term it is understood to behave more like listed equity. As such, listed infrastructure is likely to be more suited to the 'accumulation' phase i.e. where members still have a considerable time left until they retire. In this instance, listed infrastructure will act as a diversifier to the more traditional equities and bonds that are commonly held within this phase.

There are clear benefits to an allocation to infrastructure within DC portfolios. However, there are significant barriers to taking a direct exposure to infrastructure. Listed infrastructure is understood to benefit from some of the more favorable characteristics of the underlying but with the added benefit of daily pricing and dealing making it a suitable investment for the Accumulation Phase of a DC investment strategy.



Miria **WHITTLE**

Miria Whittle is an Actuary within the EY Investment Advisory team and has over eight years' experience advising both pension schemes and insurers on how to make their assets work harder.
*mwhittle@uk.ey.com*