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CAPITAL RAISING GUIDE

PC

Fundraising from UK Pensions: A Guide to Raising Capital

As the $4.84tn UK pension industry moves further into defined contribution (DC), schemes are rethinking current allocations and diversifying into alternatives. Our findings include:

- Their current allocations to alternatives outstrip public equities, with real estate and infrastructure attracting the highest target allocations at 10% and 8%. However, the smallest pension plans have fallen deeper into under-allocation
- Adoption of similar policy to Australia and Canada could see DC schemes in the UK further push into private markets, helped by new fund structures such as LTAF
- Managers of higher-risk assets are expected to target capital from the younger generations, with recent calls for early pension access for first-time buyers

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Real assets draw in UK pensions

UK pensions have moved beyond a 60/40 approach to embrace alternatives. Real assets and fixed income allocations represent entry points for fund managers

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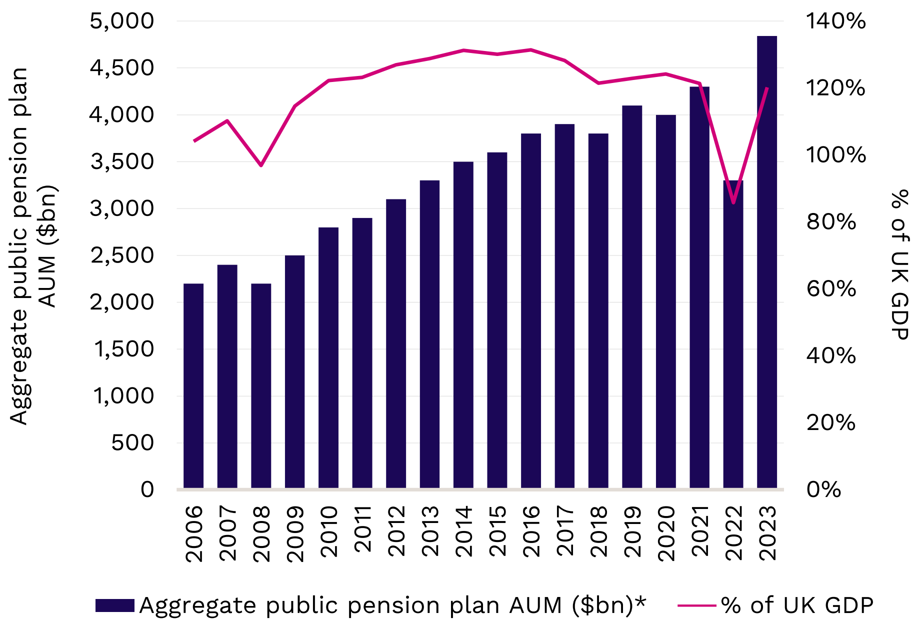
Pension funds are a core type of institutional investor, facilitating the flow of savings into investments in financial assets over the very long term. In May 2024, we examined capital raising trends among US public pensions,[1] which hold almost $5.9tn in total assets. In the UK, data on public pension plans alone shows assets under management within their broader portfolios amounted to $4.84tn in 2023.[2] As an indicator of scale, that equates to around 120% of UK GDP, having reached a peak of 131% in 2016 (Fig. 1.1).

Fig. 1.1: Pension assets reach $4.84tn

UK pension plan AUM, percentage of UK institutional AUM



Source: Preqin Pro. Data as of March 2024, The Investment Association*, World Bank

The considerable 23% drop in AUM by UK public pension plans in 2022 was driven by the falling value of both public stocks and bonds at the time, as higher interest rates brought in to contain surging inflation saw a typical 60/40 portfolio fall around 17% that year.[3] The strong bounceback in AUM in 2023 reflects the recovery of public markets despite rates having continued to increase. The increased correlation between public stocks and bonds[4] observed in recent years will contribute to UK pension funds' appetite for alternatives, with diversification a consistent driver of allocations across asset classes, according to Preqin's investor surveys.[5]

1 https://www.preqin.com/insights/research/reports/fundraising-from-us-pensions-a-guide-to-raising-capital

2 https://www.theia.org/sites/default/files/2024-10/Investment%20Management%20in%20the%20UK%202023-2024.pdf

3 https://www.ft.com/content/26de745d-9b98-4ca3-98c6-cb54db2bc095

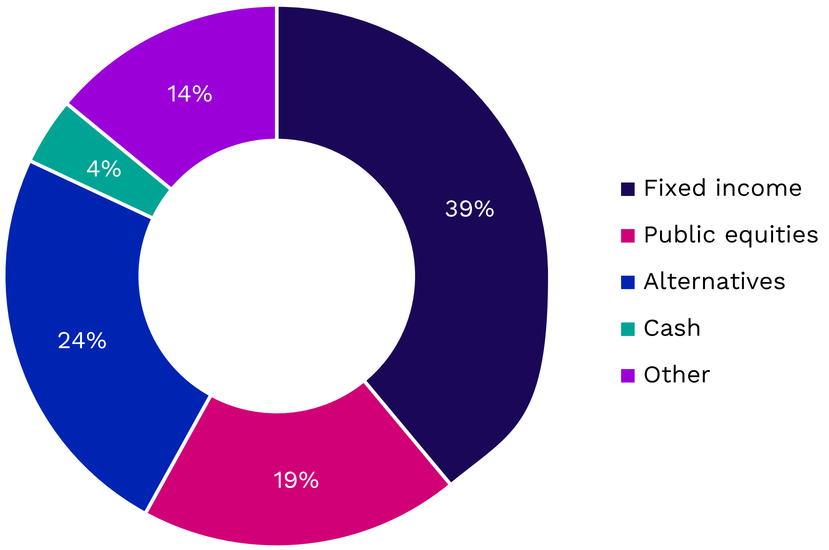
4 See slide 37: Preqin's State of the Market: H2 2024 - https://www.preqin.com/insights/research/reports/preqins-state-of-the-market-h2-2024

5 https://preqin.com/insights/research/reports/investor-outlook-h2-2024

UK pension alternatives allocations overshadowed by fixed income
Preqin data on the broad current portfolio allocations of UK pension funds, weighted by AUM to give more influence to larger plans, suggests that alternative allocations currently outstrip public equities, at 24% to 19% respectively (Fig. 1.2). However, fixed income allocations are considerably higher at 39% – this reflects the liability-driven nature of pension plans, with higher fixed income allocations providing greater certainty that the portfolios will be able to meet members' expected retirement incomes.

Fig. 1.2: UK pensions more allocated to alternatives than equities

UK pension funds portfolio allocations* (weighted by AUM)



Source: Preqin Pro

*Allocation data as of most recent plan reported date.

Where investors provide specific alternative asset class allocations (current and target), these overall allocations tend to be higher than their peers that don't report exact allocations. UK pensions with specific allocations to alternatives report overall weighted current allocations of 39% against a 41% target. These are higher than their US peers at 26% and 29% respectively, as we reported in our US pension capital raising guide earlier this year.

The alternative asset classes attracting the highest target allocations from UK pensions are real estate at 10% and infrastructure at 8% (Fig. 1.3). This reflects a desire for cash yields which real assets provide. They can also hedge inflation risk through clauses in leases and offtake contracts, helping preserve the real value of cash flows for pension plan holders.

Fig. 1.3: UK pensions prefer real assets

Target vs. actual alternative asset class allocations* (weighted by AUM)

Source: Preqin Pro

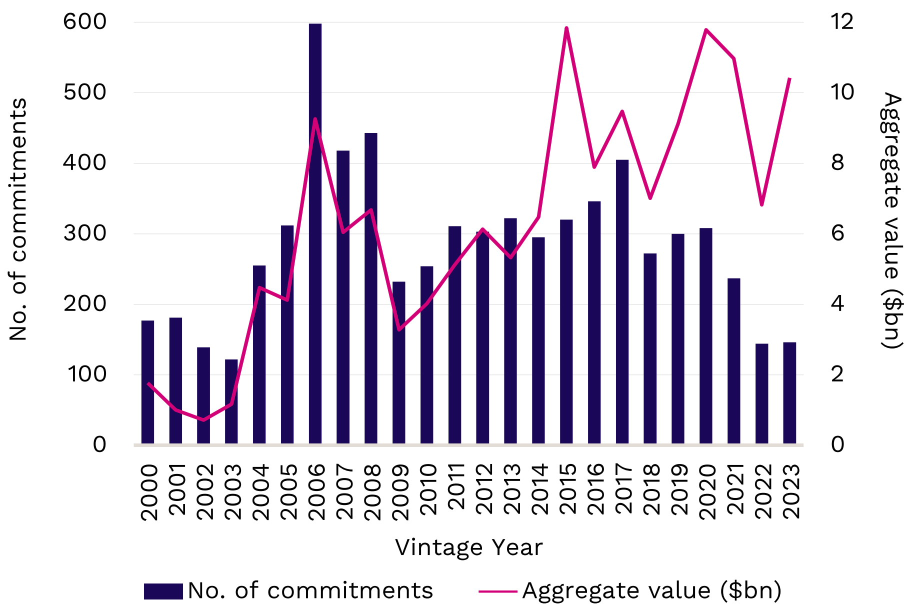
*Allocation data as of most recent plan reported date.

Although there has been an increase in alternative allocations by pension funds, the overall number of committments has been decreasing. Since the peak in 2006, the total number of commitments has fallen by 75.6%, although the aggregate value of capital seems to be returning to the highs seen in 2020 (Fig. 1.4). This indicates UK pensions are being more selective and follows the capital concentration trend[6] we have observed among managers in private markets over the past decade.

6 https://www.preqin.com/insights/research/research-notes/the-concentration-of-private-capital

Fig. 1.4: UK pensions making fewer but larger commitments

Number of commitments and aggregate capital committed by UK pension plans by fund vintage



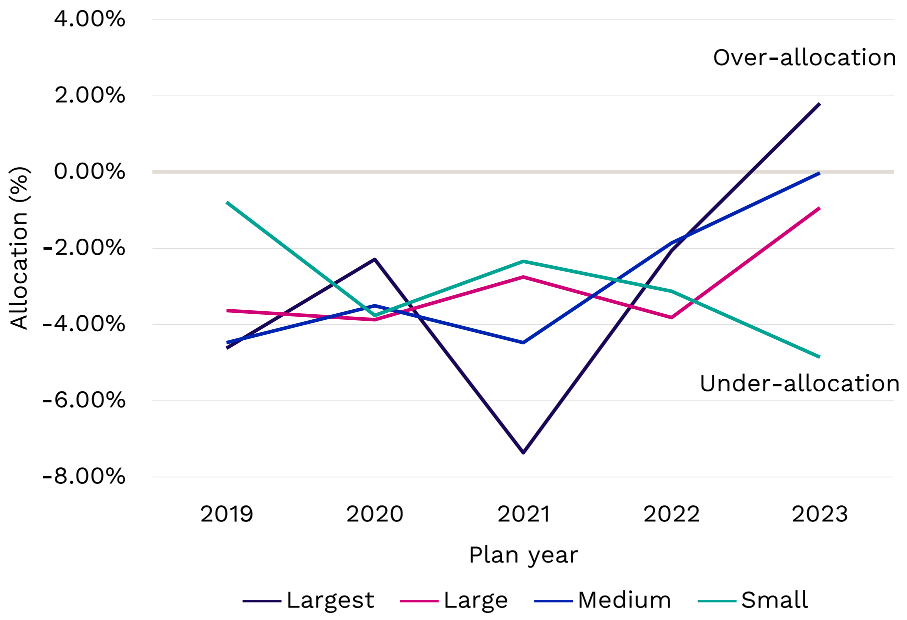
Source: Preqin Pro. Data as of August 2024

Smaller UK pension plans tend to be under-allocated to alternatives

Looking across the pension plan size distribution, we see that the largest plans in recent years have managed to move from being the most under-allocated to alternatives in 2021 based on their stated target allocations, to being slightly over allocated in 2023 (Fig. 1.5).

Fig. 1.5: Smallest plans struggle to meet allocation targets

Average plan under/over-allocation* to alternatives by quartile by UK pension plan size



Source: Preqin Pro

*Median Allocation

The continued growth in allocations in 2023 is echoed in all but the smallest pension plans, which have fallen deeper into under-allocation. While managers may believe that engaging with many smaller pension plans to raise capital is uneconomic in terms of time commitments, the prospect of establishing new relationships in a sector that has been encouraged to consolidate for many years[7] may pay off in the longer term if they establish relationships with pension plans that do merge and scale up.

Below the aggregate allocation data, around 60% of pension plans invest across the broader spectrum of alternatives (Fig. 1.6). While our data shows that real estate has the highest reported alternative allocation level at 10%, it is also the most popular, with 88% of plans committing to this asset class. Real estate has attracted a lot of negative attention in recent years as the deals market has contracted through 2022. Higher rates have constrained capital supply and hybrid working patterns continue to negatively impact demand for the once dominant office sector. Nevertheless, the long investment horizons of pension funds mean they react slowly to short-term cycles and focus more on longer-term returns, so any impact of recent cycles on pension fund allocations is yet to be seen.

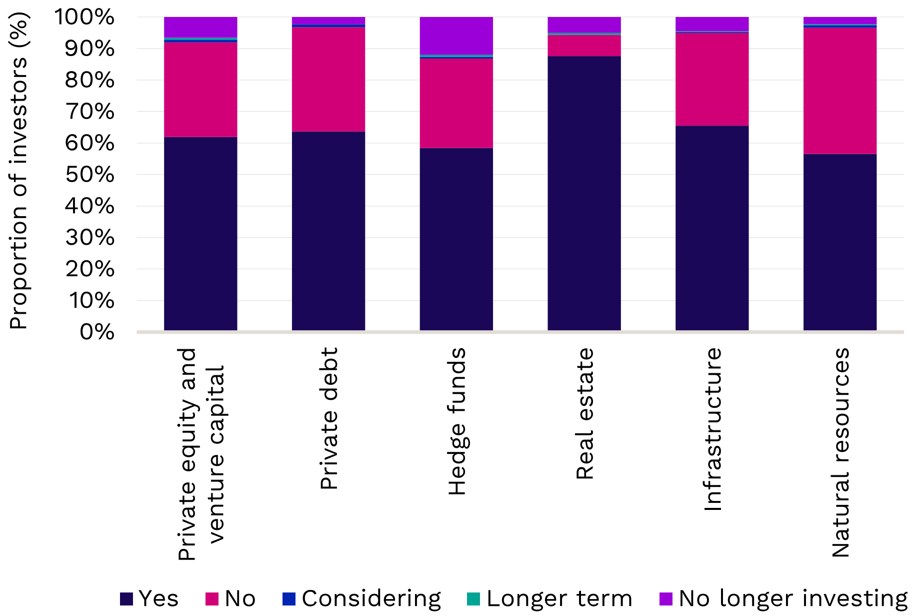
7 https://www.ft.com/content/eab8ba7f-0181-4f04-a18f-a5eee757d0cd

Real asset expertise gap justifies role for GPs

Just over 22% of pension funds pursue listed real estate exposure, whereas more than 89% utilize private real estate funds and 69% invest directly (Fig. 1.7). This is a strong signal that illiquidity is not a barrier to real estate allocations. Additionally, real estate generates a durable income stream that is linked to inflation, and provides valuable diversification, both of which are key drivers of the popularity of the asset in UK pensions.

Fig. 1.6: UK pensions allocated to wide array of alternatives

UK pension investment policy across alternative asset classes



Source: Preqin Pro

Fig. 1.7: Private real estate most utilized route to market for UK pensions

Proportion of UK pensions investing in real estate by route to market (weighted by AUM)

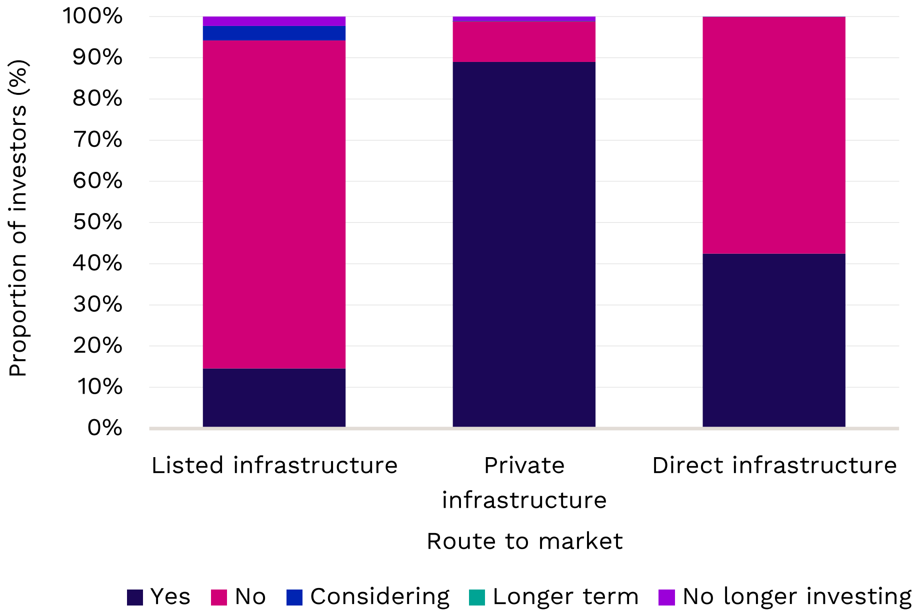
Source: Preqin Pro

Where pension funds have the in-house expertise to pursue direct investments, managers need to clearly demonstrate their value-add in deal origination and fund management. Fundraising managers can help define their value-add in certain strategies by understanding what type of investments a plan prefers to pursue directly. Pension plan direct investment may include less complex development plays in operational core real estate assets, rather than capital-intensive value-added and opportunistic plays which fund managers tend to focus on in the broader asset class. Managers may also find pensions with internal expertise are more interested in co-investments, offering them a chance to deploy larger sums in fewer assets that can meet their alternatives ambitions.

On the other side of real assets, a smaller share of UK pension plans (43%) report using direct routes to market in the infrastructure asset class (Fig. 1.8). Institutional investors, including pension funds, have been striving to build their in-house expertise in infrastructure as the asset class has grown strongly over the past decade, but gaps remain in their ability to appraise and transact assets. Infrastructure managers offering more core and core-plus strategies, which dominate the asset class, should have more fertile ground amongst the majority of plans that report being unable to go direct. For large pension funds with high enough allocations, managers that offer opportunities to co-invest could help establish new relationships.

Fig. 1.8: Listed infrastructure not a popular option for UK pensions as a route to market

Proportion of UK pensions by infrastructure investing policy and route to market (weighted by AUM)



Source: Preqin Pro

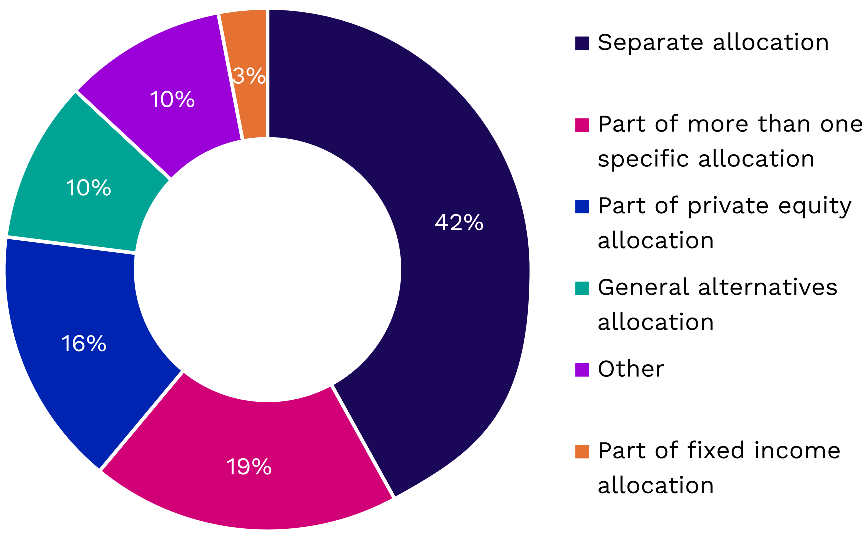
Co-investment can help LPs economize on management fees as well as deploy capital more quickly in larger deals on the side of pooled funds. While both GPs and LPs will want to build trust initially before pursuing these opportunities, just offering the option of co-investment could help when negotiating the first commitment to pooled funds.

Challenges in targeting fixed income allocations

The UK pension industry's reassessment of the traditional 60/40 portfolio model has resulted in a significant reduction in their public equity exposure (19%), which has facilitated an advance into alternatives (24%). Private debt managers are believed to be targeting commitments through UK pensions' fixed income allocations. However, Preqin data suggests that there may be challenges here, as UK pension private credit allocations tend to be held separately (42%) or as part of more than one specific allocation (19%), with just 3% using a fixed income allocation (Fig. 1.9).

Fig. 1.9: UK pension plans tend to use separate allocations for private credit

UK pension funds reported source of private debt allocation



Source: Preqin Pro

Given our data suggests pension plans have current allocations at target, this may limit the potential growth of their private debt appetite. However, managers should interrogate where individual investors' allocations come from to nuance their pitches, ensuring their proposal fits with the myriad of allocation sources. In this instance, if allocations to private debt are mainly separate, fundraising pitches can go deeper on the range of strategies available. If they are sourced from fixed income allocations, managers could look to assuage concerns about the liquidity they lose from moving into private debt.

Higher-risk strategies and interest rate hedging concerns

Defined contribution pensions, which require a different approach to portfolio construction than defined benefit pensions, are either accumulating (as younger members continue to contribute to their plans) or decumulating (as members have reached retirement and are drawing an income). The status of these funds is crucial for alternatives managers to understand the risk appetite they may have, based on their commitments. Earlier stage funds that are still accumulating are more likely able to bear higher risk and longer lock-in, compared to later-stage funds approaching decumulation stage that will be looking to de-risk nearer-term cash flows and avoid new sources of illiquidity.

Managers of higher-risk strategies should not be discouraged when searching for capital from UK pensions. Hedge fund managers specifically may find success in targeting small and mid-size pensions with interest rate hedging requirements. These requirements were exposed during the lower interest rate period[8] and post the liability-driven investment (LDI) crisis which followed the mini-budget in September 2022. Low-beta hedge fund strategies have the ability to close hedging gaps[9] as they can often generate excess returns and also leverage their currently weaker gilt assets.

8 https://www.ft.com/content/83927688-e0d1-4934-8d91-e279da6d6b6c

9 https://www.reuters.com/world/uk/pension-funds-rethink-hedging-tactics-after-uk-crisis-2024-10-04/

The rise of DC schemes

As the UK pension industry evolves from defined benefit to defined contribution schemes, the number of fundraising entry points is growing

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In the last two decades, the pension industry in the UK has evolved considerably. The two most prominent types of schemes currently are defined benefit (DB) and defined contribution (DC). Whilst DB schemes were originally the more popular type of scheme in the country, since the introduction of auto enrolment, the popularity of DC schemes has seen significant growth and the number of members in these schemes has also seen a huge uptick. As the number of enrolled members increases alongside a rising state pension age, the UK pension industry – and DC schemes in particular – represent a lucrative stream of capital to private capital fund managers.

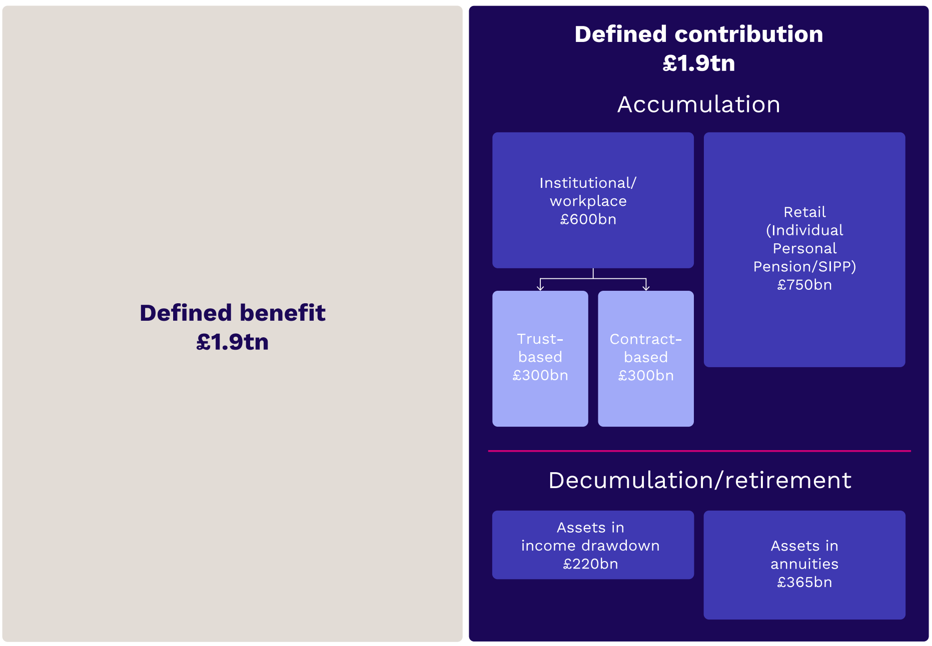
In the case of DC schemes, the employer contributes to an employee's pension account. Typically, this is invested in a mutual fund, often the default mutual fund. However, employees are responsible for which mutual fund their assets are invested in, and have a choice of several funds to pick from. To allow employees to reallocate, these are typically daily priced funds. Herein lies the crux of how managers should target capital from UK pensions. Whilst the individual is responsible for investment decisions and has freedom to change investments at will, offering both a wide array of products and being reactive to market shifts will be key to managers raising.

By 2022, close to 30% of employees were enrolled in DC schemes
As of the end of 2023, the UK pension industry is estimated to have £3.8tn in assets[10] split across the two types of schemes, both taking an equal share of £1.9tn (Fig. 2.1).

10 https://www.theia.org/sites/default/files/2024-10/Investment%20Management%20in%20the%20UK%202023-2024.pdf

Fig. 2.1: UK Pension industry at a glance

UK pension industry AUM

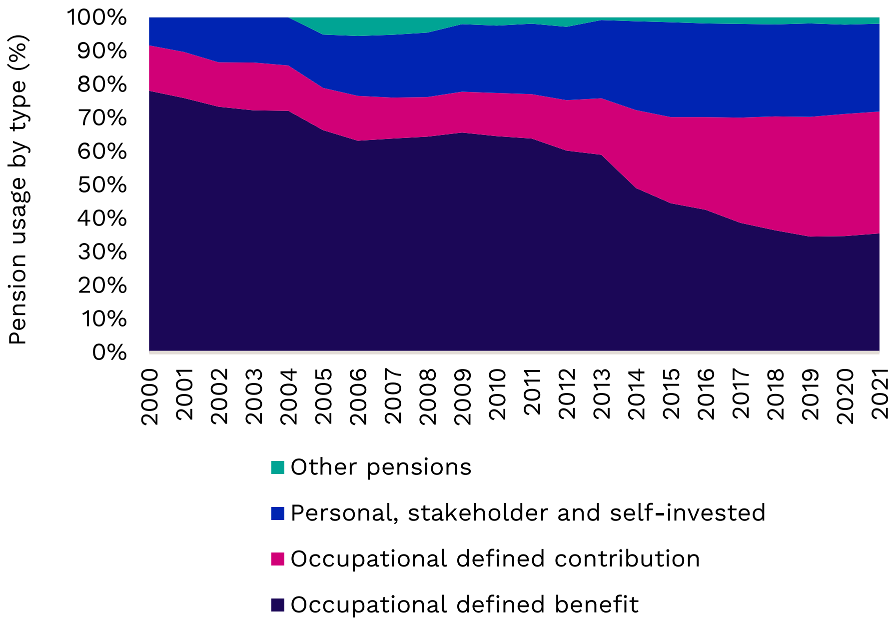


Source: The Investment Association's Investment Management in the UK 2023-24 using data from The Bank of England, Department for Levelling Up Housing & Communities, Financial Conduct Authority, MoreToSIPPs, Office of National Statistics, Pensions Policy Institute, Pension Protection Fund 7800 Index

At the end of 2007, before auto enrolment was introduced, 63.9% of employees that were enrolled in a workplace pension at this time were enrolled in a DB scheme. It is worth noting though that at this point only 52% of employees were enrolled in any pension at all (Fig. 2.2).

Fig. 2.2: UK workplace pension participation rates

Proportion of employees with workplace pension by type of pension, UK, 2000 to 2021



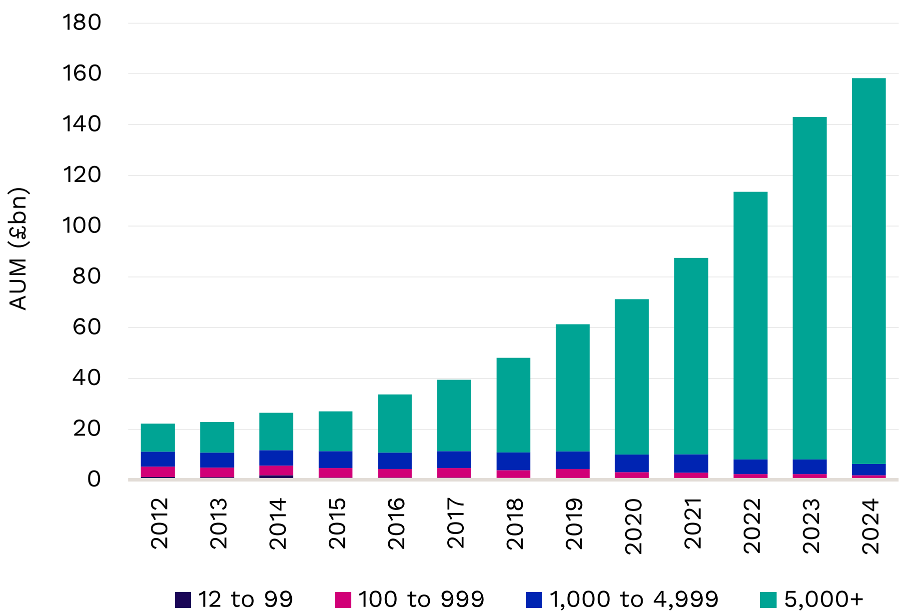
Source: Office for National Statistics, Employee workplace pensions in the UK: 2021 provisional and 2020 final results

Since then, the percentage share of employees enrolled in the different schemes has become more varied, and by the end of 2019, DC overtook DB to become the scheme with the highest participation rate. By the end of 2021, overall participation rates for pensions across all scheme types increased to 79.4%, with 28.9% of employees enrolled in DC schemes. The already high usage rates of DC schemes in the country means that there is a potential £1.9tn market for fund managers to access. With public interest in private markets growing in the UK, managers may more easily be able to pitch their private capital funds when targeting UK DC pension plans.

Coinciding with the increase in overall enrolment, the total assets in the schemes have also increased significantly. Since 2012, total assets in DC schemes with at least 12 members have increased sixfold, 11% of which was in the last year (Fig 2.3). When looking at the funding ratios of DC schemes, 26 million of the 27 million DC scheme members are in funds still open to new joiners, according to The Pensions Regulator.

Fig. 2.3: DC scheme assets continue to grow

Assets (£bn) in occupational DC schemes by membership size group



Source: The Pensions Regulator[11], Occupational defined contribution landscape in the UK 2023

In stark contrast to this, 86% of DB members[12] are currently in schemes that are either closed to new members or closed to future accruals, which could impact the growth of assets in these schemes. Managers looking to attract capital from UK pensions have historically advertised their products to DB scheme managers. As DC schemes become the more dominant model in the UK and are now looking to increase allocations into private markets, fund managers are exploring how they can successfully offer their products to this segment of the market too. For example, Invesco Real Estate launched their Global Direct Property Fund[13] this year, exclusively designed for UK DC schemes to gain access to private core real estate whilst still providing daily liquidity.

Risk appetite across different generations underlines asset allocation

The pension age for both public and private pensions in the UK is increasing – state pension age is currently 66 and will rise to 67 between 2026 and 2028, while private pension age is 55 and will rise to 57 in 2028. This means UK pension plans must balance different investment approaches across multiple generations. Those closer to retirement age typically start to reduce exposure to higher-growth assets[14] and move to lower-risk allocations. With auto-enrolment, pension participation among the different age categories is over 80% on average across all employees (Fig. 2.4). Fund managers must be wary that the approach to asset allocation and diversification from both DC and DB pension plan investors can differ drastically depending on the composition of age categories in the pension.

11 TPR do not report on assets held in DC sections of hybrid schemes or micro schemes as their reporting requirements in the scheme return are different from those for non-micro schemes. Therefore, these results are not comparable to findings in the Office for National Statistics (ONS) Funded Occupational Pension Schemes statistical bulletin, which includes micro schemes and hybrid schemes

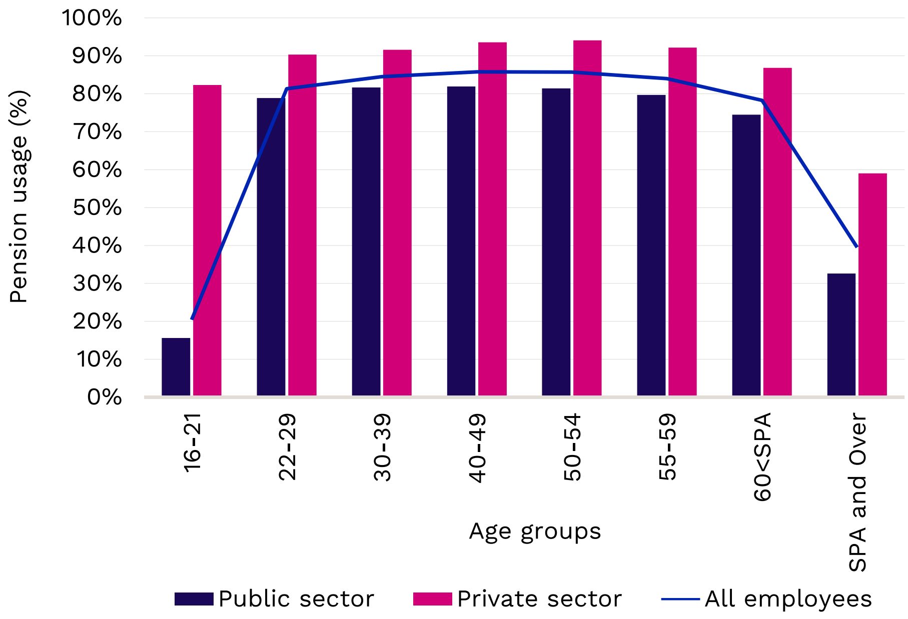
12 https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/occupational-defined-benefit-landscape-in-the-uk-2023

13 https://www.invesco.com/uk/en/capabilities/global-direct-property-fund.html?msockid=369280cb390960391058945838c2616b

14 https://www.alliancebernstein.com/gb/en-gb/institutions/insights/retirement-insights/uk-dc-pensions-overcoming-the-hurdles-to-investing-in-private-markets.html

Fig. 2.4: UK workplace pension participation high across all ages

Split of pension usage by age (%)



Source: Office for National Statistics, Employee workplace pensions in the UK: 2021 provisional and 2020 final results

For DC schemes specifically, younger age groups will have approximately 30% more exposure to public and private equity[15] than those closer to retirement age, and are more likely to make changes to their allocations compared to older generations. For example, the highest usage rate for the Canada Pension Plan[16] is from the 20-34 age range, and this plan has the highest current exposure to private markets,[17] with 31% in private equity and an additional 16% in other private assets.

Private equity and venture capital's outperformance compared to public equities are likely to attract allocations from plans targeted at younger pension holders seeking to grow value. Whilst the resilience of private debt may appeal to the more prudent nature of those closer to retirement age, fund managers are already experimenting with new fund structures in a variety of private asset classes to appeal across generations and risk appetites.

Early pension access in UK could offer deeper entry point for alternatives

Recent calls on the UK government[18] for pensions to adopt a similar model to the US and Australia which allows earlier access to pensions by employees for housing and financial hardship may invoke a change in how the younger generation views the value of pension saving. In Australia, superannuation funds have been increasingly investing in private markets as traditional assets play a smaller role. Private equity and venture capital in the country has seen a 30% growth in AUM in the last 18 months. Part of this growth has been attributed to allocation from these schemes. If early access becomes an option for UK pension plans, similar to the Australian model, pension managers here are likely to reconsider offering a deeper entry point for alternatives managers.

15 https://www.weforum.org/agenda/2019/08/attitudes-investing-vary-according-age-group/#:~:text=Every%20generation%20thinks%20about%20investing%20a%20little%20differently.,that%20investment%20objectives%20can%20differ%20by%20age%20group.

16 https://www.osfi-bsif.gc.ca/en/oca/actuarial-reports/actuarial-report-31st-canada-pension-plan

17 https://www.cppinvestments.com/wp-content/uploads/2024/07/CPP-Investments-F2024-Annual-Report.pdf

18 https://www.ft.com/content/d3fa1844-30fd-4258-80f4-89f022899ed1?shareType=nongift

Policy favors fundraising

UK government efforts to promote longer–dated assets are starting to bear fruit

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The mini budget announced by the UK Government in September 2022 under then Prime Minister Liz Truss was viewed by the market as unsustainable, and it caused a sharp increase in government bond yields. This drove owners of liability-driven investment (LDI) products, often held by defined benefit pension funds in particular, to make collateral calls to restock the cash buffers required to meet the liabilities of leveraged positions. This forced some pension funds to sell out significant gilt positions, further reducing prices and contributing to a vicious cycle. The situation threatened the solvency of major pension plans and forced the hand of the Bank of England. While mostly of concern to pension funds, this caught the attention of regulators globally and prompted some to assess the use of LDIs. An International Monetary Fund paper[19] on lessons to be learnt from this event stressed the relevance of the topic for the non-bank financial institution sector, not just in the UK, but in other countries as well.

The decline in the value of gilts meant that portfolios needed to be rebalanced, cutting other positions. This was an instance of the widely discussed denominator effect – where performing assets (such as private market alternatives) are affected by losses in completely different asset classes, as investors cut their winners to rebalance portfolios back to target weights. In situations such as these, investors often turn to secondary sales to liquidate their alternatives positions. In this chapter, we look at the implications for UK pension allocations from more recent policy and regulatory signals.

Recent initiatives affecting private market investments by UK pensions

While liquidity risk still needs to be managed, the UK government has actively encouraged DC pensions to be allocated to illiquid assets. This is coming to fruition with fundraising for Long Term Asset Funds (LTAF) in particular.

In July 2023, 11 of the UK's largest DC pension providers signed up to the Mansion House Compact,[20] where they committed to invest 5% of their default funds' AUM in unlisted equities by 2030. In August 2023 the UK Pensions Regulator[21] updated its guidance for schemes' statement of investment principles (SIP),[22] requiring them to state their policy on investing in illiquid assets. It is also notable that performance fees have been excluded from the fee cap since April 2023. This is significant because DC funds faced challenges paying carry for positively performing funds when performance fees were previously included in the fee cap. Both of these developments have paved the way for trustees to add private markets alternatives to the default fund.

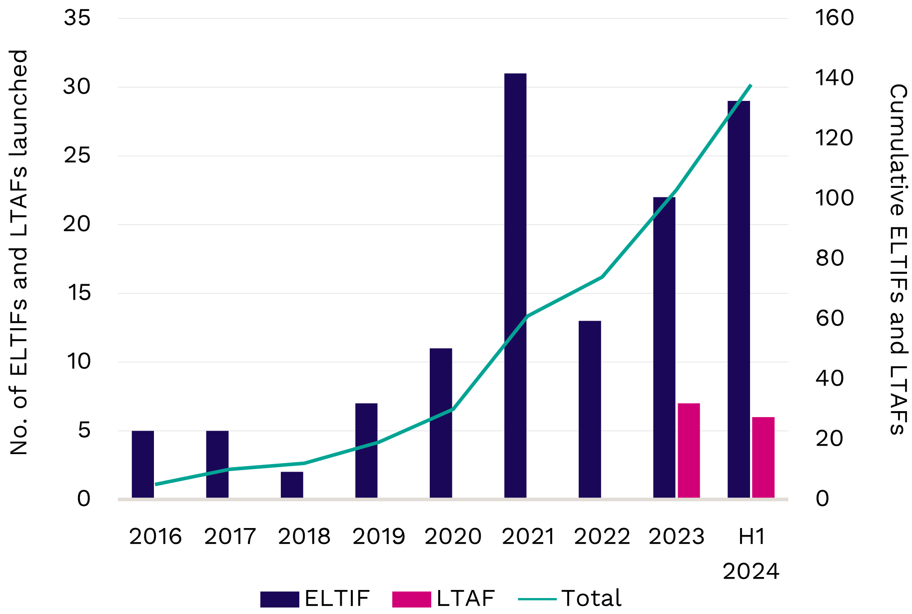
In January 2024 The Pensions Regulator[23] re-iterated that private market assets can play a valuable part in a diversified portfolio, with LTAF funds highlighted as providing 'more opportunities for DC schemes to invest in private market assets'.

19 https://www.elibrary.imf.org/view/journals/002/2023/253/article-A002-en.xml
20 https://www.bvca.co.uk/Research/BVCA-Publications/Details/Pensions-and-Private-Capital-Expert-Panel-Interim-Report
21 https://www.nortonrosefulbright.com/en/knowledge/publications/9c7d2d42/pensions-regulator-updates-dc-schemes-guidance-on-illiquid-assets-disclosure
22 https://www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/investment-guide-for-dc-pension-schemes-
23 https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2024-press-releases/new-tpr-guidance-on-private-market-investments-helps-trustees-boost-saver-outcomes

As LTAFs started to launch in 2023 and 2024, we saw a continuation of the trend established by the European Long-Term Investment Fund (ELTIF). LTAFs, which are UK-specific, are seen as similar to ELTIFs but have higher minimum investment requirements (Fig. 3.1).

Fig. 3.1: The start of 2024 shows promise for ELTIF and LTAF

ELTIF* and LTAF launches



*Includes ELTIF 2.0s

Source: Preqin, Data as of August 2024

Prominent asset managers have launched LTAF funds targeting DC pensions. In April WTW[24] announced it was launching a private equity-focused LTAF with DC pensions in mind. The fund will invest in private equity, including co-investments, and will be the first private equity fund the firm has brought to market as a pooled fund, allowing easier access for DC pension savers.

In July 2024, L&G launched its Private Markets Access Fund[25], specifically aimed at its 5.2 million DC investors, offering them a 'single point of access' to a portfolio of private market assets. The fund allocates to a wide range of private asset classes including private equity, natural resources, infrastructure, real estate and private debt, which would not typically be available to DC schemes and their members.

Policy may continue in this direction under the new government with the Chancellor Rachel Reeves[26] stating in August 2024 that she 'wants the UK to learn lessons from the "Canadian Model"', widely seen as a call for consolidation within the pension industry. The pension investment review initiated by the UK government will look into consolidation of the many smaller local government pension schemes in the UK, using Canada's mega-funds as a template.[27]

For GPs targeting UK pensions for fundraising, the policy environment is moving in their favor. The direction of travel from policymakers has addressed obstacles to investment, such as the fee cap and the lack of a suitable structure (now addressed by LTAF). Policymakers are also on the record encouraging investment into illiquid asset classes. In a heavily regulated environment, these changes represent a long-term positive driver to the fundraising environment for GPs targeting UK pensions.

24 https://www.wtwco.com/en-au/news/2024/04/wtw-to-launch-dedicated-private-equity-ltaf
25 https://group.legalandgeneral.com/en/newsroom/press-releases/l-g-unlocks-private-markets-access-for-5-2-million-dc-members-through-launch-of-private-markets-access-fund
26 https://www.gov.uk/government/news/chancellor-reeves-pension-funds-can-fire-up-the-uk-economy
27 https://www.ft.com/content/eab8ba7f-0181-4f04-a18f-a5eee757d0cd

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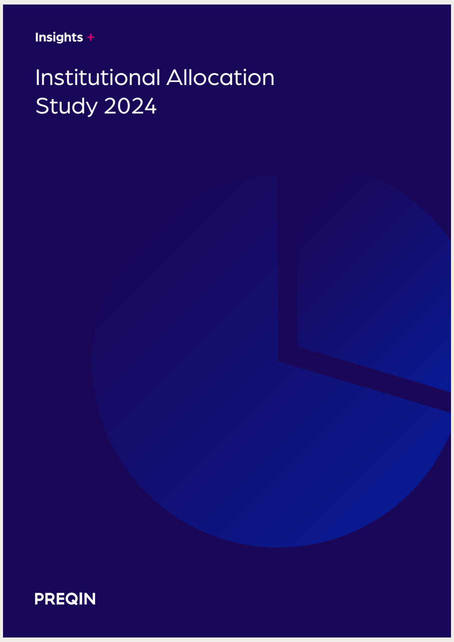

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