Summary

• Chancellor Jeremy Hunt's Mansion House Speech in July pushed the pensions industry's potential role in UK growth to the fore.
• Signatories of the Mansion House Compact committed to minimum UK stock investment before 2030.
• But lacklustre performance by UK equities in comparison with other global markets have necessarily made the UK market a small part of DC pension portfolios.
• DB schemes moving towards their endgame are unlikely to shift towards equities for different – de-risking – reasons.
• The industry is supportive of a move to invest in UK economic growth – PLSA has made this its priority for 2024 – but finding the most advantaeous ways in is essential.
• Meeting the needs of members remains the number one goal for schemes.

Best of British?

Sandra Haurant explores how UK pension funds are being encouraged to invest in ways that would boost UK economic growth

The Chancellor Jeremy Hunt's Mansion House speech, in July 2023, placed serious emphasis on the role pension funds could – and, Hunt argued, should – play in the growth of the UK's economy. "The UK has the largest pension market in Europe, worth over £2.5 trillion," said Hunt. "It plays a critical role in providing safe retirement income as part of the social contract between generations."

But the UK found itself in a "perverse situation," Hunt said. "UK institutional investors are not investing as much in UK high-growth companies as their international counterparts." Something, the Chancellor suggested, had to give.

As a starting point, he announced that some of the country's largest pension schemes – the likes of Aviva, Scottish Widows, M&G and more – had signed up to the Mansion House Compact. The compact, Hunt said: "Commits these defined contribution (DC) funds, which represent around two-thirds of the UK's entire workplace market, to the objective of allocating at least 5 per cent of their default funds to unlisted equities by 2030."

It's complicated

So how are things going, more than six months further down the line? The *Financial Times (FT)* reported in October that pension funds were pushing back against the government's aim to divert more than £50 billion of their money invested in UK projects and business.

Indeed, the *FT* reported that Nest – a Mansion House Compact signatory – was reluctant to move into early-stage, high-potential but equally high-risk companies. Nest chief investment officer, Elizabeth Fernando, speaking at the Pensions and Lifetime Savings Association (PLSA), said that proven business models were the way forward. "Our job is not to support levelling up. It is to build retirement funds," Fernando said.

It's a sentiment on which Legal and General Investment Management (LGIM) head of DC investments, Jesal Mistry, elaborates: "Investing in the UK can provide a multitude of opportunities for growth and UK pension schemes are well placed to take advantage of these. In addition, linking the member's investment portfolio to the UK, particularly investments that have a positive impact on society, can be a hugely powerful engagement tool which has a mutual benefit to the individuals in their everyday lives," he says.

But, Mistry adds (and it's a big 'but'): "Pension funds must not lose sight of our primary responsibility – to act in the interests of members – and investment in the UK could be seen as concentrating on a relatively small part of the global economy, missing out on growth and opportunities elsewhere. Over the past five years, the UK stockmarket has delivered a return of between 6 per cent

and 7 per cent per annum, whereas a global market cap portfolio would have delivered nearly double that."

Mistry explains that this, combined with DB schemes' necessary focus on the endgame, is behind the move away from UK stock market investments. Indeed, pension fund investment in UK shares was at a record low of 1.6 per cent in 2022, according to the Office for National Statistics (ONS).

Cardano senior investment strategist, Ina Rinas, agrees that there are solid reasons for these choices. "The UK stock market capitalisation as a percentage of global stock market capitalisation is small, at roughly 3 per cent, down from over 10 per cent in the early 2000s," says Rinas.

"UK equities have been an underperformer for over a decade, failing to keep up with the US, which is heavy in high-growth technology names. US companies have therefore grown their earnings at a faster pace and US equities have strongly outperformed many other regions. As a result, they now represent a greater share of global stock market indices, while non-US allocations have decreased."

These figures relate to large caps, which, says Rinas: "Are not representative of the domestic UK economy as they derive a large share of their revenues abroad. This means that they are more sensitive to movements in the exchange rate, which is why UK large cap stocks are often seen as a play on the currency rather than the domestic UK economy and its underlying earnings potential."

Nonetheless, the stateside slant creates other challenges. "The US accounts for about 63 per cent of a global market cap equity portfolio, of which about a quarter to a third is invested in the top 10 companies," says Mistry. "Thinking about it from a risk perspective, this feels like too many eggs in one basket, and while they continue to deliver strong returns, very few would argue for a different approach. But we don't have to look too far back to see that large companies can fall or worse, fail – such as the impact on tech in 2022, BP, Lehmann Brothers, Enron, etc."

Pressure to increase domestic investment seems set to grow, as the government recently announced plans to require DC schemes to publicly disclose their level of investment in UK businesses by 2027.

"Policymakers' appetite to stimulate the UK economy and encourage investment in UK productive assets, in particular, is laudable," Rosenberg says. "However, with the majority of DB schemes closed and de-risking, we see more obvious solutions available to make it a reality, that don't involve ripping up the regulatory rulebook."

Rosenberg highlights "successful examples" abroad, citing the Canadian, Nordic and Dutch pension schemes as some of those that show the potential for superfund-style schemes to power economic investment.

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"Creating a public or state pension fund with similar investment strategies as global peers, including Canada Pension Plan, Sweden's AP funds and the Netherlands' ABP and PFZW, could be an option," Rosenberg says. "There would be no need to significantly change the existing regulatory and legal framework."

What's more, Rosenberg says: "The UK's LGPS provides an established domestic model to build on; and it would be much easier for the government to mandate a minimum exposure to UK productive assets for a state or public pension fund rather than corporate funds."

Indeed, Hunt's latest Budget confirmed that LGPS funds will be expected to publicly disclose their level of investment in UK businesses as "early as April 2024", around three years earlier than the broader DC market.

Nonetheless, there is room for a shift in internal investment structure for DB schemes as they move closer to maturity, suggests LGIM infrastructure strategist, Marija Simpraga. And this is where investment in the UK's foundations could come to the fore.

Finding other ways

On the DB side, plans to introduce a permanent superfund regulatory regime, "to provide sponsoring employers and trustees with a new scaled-up way of managing DB liabilities," were pushed to centre stage in July 2023, while more recent developments have seen the government hone in options to relax DB surplus extraction rules.

Looking back at the announcements, Cardano CEO, Kerrin Rosenberg, says: "A public and state pension superfund could become a significant contributor to UK economic growth, while also freeing up funds from national insurance contributions to support state spending commitments in other socially important areas."

"Debt investments in investment-grade infrastructure assets can provide a resilient source of income and diversification," says Simpraga. "The appetite from DB schemes, but also banks, insurers and other capital providers for these high-quality assets has exceeded available supply for several years. This has led to return compression and often means large infrastructure assets are financed via bank loans rather through institutional debt capital markets."

And, warns Simpraga: "This in turn means that pension investors often have to look beyond the UK infrastructure market for appropriate risk-adjusted returns that match their requirements."

All eyes on the prize

"For pensions to play a critical part in the growth of the UK economy, I believe we need to not only focus on the UK stock market, but also look beyond this to providing pension schemes, particularly DC schemes, with access to investment opportunities that they can't access elsewhere which resonate better with the end member," Mistry argues. "This is where I believe the private markets – including allocations to infrastructure – can play a critical part in driving better DC outcomes as well as benefiting communities and society in the UK."

Whichever new pathways open up, and whatever shape any new regulatory framework takes, the pensions industry remains broadly supportive of the idea that investing in the UK's growth is a positive move. Indeed, the PLSA announced in January that its top strategic priority for 2024 would be the role that pension schemes can play in supporting the UK economy. But, Mistry says: "It is critical that investment decisions are made with the best interests of members in mind, driving better member outcomes."

Written by Sandra Haurant, a freelance journalist