The irresistible force paradox – getting illiquid assets into DC portfolios

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"When an irresistible force, such as mounting defined contribution pension money, meets an immovable object, like illiquid assets, you can bet just as sure as you live, something's gotta give…"

These are not the exact lyrics of the 1950s jazz classic, but the irresistible force paradox is something regulators, investors and asset managers are grappling with (albeit without the catchy beat and squalling trumpets).

How can managers create vehicles to hold illiquid assets, including property, infrastructure and thinly-traded private debt securities, but make them flexible enough to enable DC investors – who require daily liquidity – to use them?

So far, the paradox has confounded the market.

Unlike defined benefit investment funds, which have a set amount, timeline and aim – and give plenty of notice to unwind positions in the case of withdrawals – DC funds are a mishmash of contributions, retirement dates and changing views on where to invest. They are also of a much smaller size than DB schemes that have been built up centrally over decades.

Add to that, how do managers package all those considerations up and remain under the government-imposed charge cap?

The government itself has made no secret of wanting UK pension money – so-called 'patient capital' – to fund infrastructure and other society-supporting projects around the country, all of which fall into the illiquid bucket. The question is how to bring DC into the mix. As it stands, the 1,500 or so pure DC schemes, with an average of GBP47 million in each, are not going to provide the funding the government needs.

With this in mind, the Department for Work and Pensions launched a consultation on the matter earlier this year, which closed at the start of April. Within it, was a thinly veiled attempt to nudge smaller schemes to consolidate by moving to a mastertrust.

It makes sense. By using a mastertrust, investors can come together and pool their assets into a critical mass, which could rival the size of some of the UK's largest DB funds. This mass can then buy into bridges, high-quality private debt and many other securities that offer the valuable illiquidity premium that has so far only been available for large DB funds or other long-term investors.

This premium rewards investors for the inconvenience of not being able to sell at a moment's notice, and while ideal for slow-moving DB funds, with some ingenuity can be channelled into DC funds, too.

And where there is a will, there is a way. The Chief Investment Officer of Nest, Mark Fawcett, pre-empted the government's consultation, by throwing down the gauntlet to the industry himself. In a blog published in September, Fawcett said the national DC fund had issued a "challenge for fixed income managers to come up with scalable, open-ended structure for private debt."

As mastertrusts come online after receiving authorisation from the regulator, this challenge is going to become one we in the fixed income market cannot ignore – and we are already addressing it.

Conveniently, the regulator has decided to limit the number of mastertrusts it will authorise, which will mean fewer, larger asset pools that are prime vessels for investment in illiquid assets.

With innovation, experience and engagement with the market, the conundrum around how to get illiquid assets into DC is likely to be resolved just as the irresistible force paradox, which is not really a paradox at all.

The lyrics of the song are right, something eventually will give and a breakthrough will be found – and DC investors will reap the premium and its rewards.

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