Thought leadership

A powerful boost to investment led growth

July 2021

Introduction

Elements of this thought leadership piece were referenced in a recent article by leading Financial Times columnist, Martin Wolf, ‘Radical reform of British pension provision is urgent’, FT June 13 2021.

The paper can be read in full here.

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Summary 1/3

- Domestic UK pools of capital – pension funds and insurance companies particularly - have over the past two decades steadily divested their ownership of UK public equities
- Much of the residual domestic ownership is indexed (eg Blackrock, L&G), with very few remaining fully active stock-picking managers, which tend to be either individual/partner or family owned (Lindsell Train, Fundsmith, Baillie Gifford, Schroders) and small in global terms
- UK pension and insurance portfolio composition now favours government bonds and foreign equities (a rare exception to the normally prevailing 'home bias' phenomenon), while UK domestic equities (FTSE 100) are held primarily for their yield, with little or no capital appreciation over the past twenty years
- This is best illustrated by the phenomenon of the chronic under-performance of listed UK companies when they 'graduate' from the FTSE 250 to the FTSE 100, with its accompanying shift to more indexed, institutional ownership and Boards with greater risk aversion and short-term dividend focus to appease their owners
- This combination of 'absent landlords', the passivity of the remaining 'local' ownership and its dividend dependence, together with its 'optical governance ' orientation, has sapped the listed UK corporate sector of its vitality, its risk appetite and its responsiveness to the demands of long-term ownership
- Indeed, the UK has very few large growth companies left in its listed sector, while the last major wave of outbound M&A took place in the late 1990s (BP, Vodafone, GSK etc), with little of significance since
- Dynamic UK companies are now mostly either private (Ineos, Dyson) or are sold too early in their life cycle (eg ARM) to foreign owners(corporate or private equity) who will provide the support and risk capital that better enables long-term wealth creation; foreign companies' equity markets or private foreign equity funds now value UK companies' prospects better than our own
- Moreover, the lack of a reliable UK capital markets exit arising from the thinness of the domestic UK shareholder base (ie UK IPOs are now dependent for their success on foreign investors) also inhibits the allocation of start-up and growth capital in the first place
- So rather than the UK's openness to acquisitions by foreign companies being a sign of health and confidence in the UK's economic prospects it is in fact a symptom of the dysfunction of the domestic capital markets and their inability to support companies in the 'scale up' phase – and the resultant cheapness and 'availability' of our companies to be acquired
- And in any event, the capital released from the sale of a 'UK' public company now flows largely to non-UK owners, with only a small % 'recycled' back into new UK opportunities, previously cited as one of the main benefits of maintaining an open market for corporate control

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Summary 2/3

- At the same time, the pension members on whose behalf the savings pool is managed remain exposed to a fragmented, high cost and inherently fragile system which is in turn a burden on the corporate sponsors, in many cases dwarfing the scale of the companies themselves and choking off long term investment in the business, with inevitable trustee risk aversion - the weaker the corporate sponsor the lower the returns on their DB funds given the inevitable migration into lower risk assets
- These two, intersecting phenomena:
(1) asset allocation/management of the domestic UK savings pool, and
(2) fragility of the DB pension system, are now in a negative feedback loop that, in our view, adversely affects the competitiveness of the UK corporate sector and deprives the UK economy of much needed capital for long-term growth, innovation and infrastructure
- Gradual, or incremental solutions are in our view highly unlikely to break this feedback loop, which in some respects is a classic collective action problem but, interestingly, one in which the number of beneficiaries from the status quo is vanishingly small, while the damage is widespread
- Accordingly, the weight of argument and evidence in our view favours a sweeping and decisive change but one which remains consistent with a market economy and retention of ultimate responsibility for company pension liabilities within the private sector
- This would entail the decoupling and aggregation of the UK's entire population of private sector DB pension schemes into three or four 'Superfunds' that, like their counterparts in Canada and Australia (ironically both Commonwealth countries with systems originally modelled on the UK as it was decades ago), would be professionally governed and managed, with a mix of in house and 'best in class' portfolio management contracted out by asset class specialization
- Companies would still have to meet all of their existing contribution and deficit reduction commitments but these would be frozen at the point of entry, reflecting that management responsibility of the funds would pass to the new consolidated funds
- Consolidation is already underway in the UK, particularly in the local authority sector and with the PPF, which has successfully consolidated over 1000 funds for the benefit of their members, at very low cost, and with significantly higher returns generated from the very same funds prior to their inclusion in the PPF (9.4% returns for the PPF versus 6.4% for the UK pension fund sector as a whole)
- Further, voluntary commercial consolidation however will be slow and comes at a high cost, both given private capital's need to earn a return in a highly opaque market with limited competition (i.e. rent capture), and where more commercial consolidation will further deplete the domestic markets' supply of risk capital given the resultant subsequent shift to bonds

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Summary 3/3

- The difference in overall system stability, asset allocation and professionalism would be dramatic, as the ample precedents demonstrate; larger funds are far more cost efficient and are able to invest at higher returns, and are also better able to access choice investment opportunities, which in this country are presently claimed largely by non-UK funds (either private equity funded by US institutions or Canadian pension/infrastructure funds directly)
- These 'mega-funds' would also provide more active and stable long-term ownership to the UK's largest listed companies and help restore the natural home bias, much as we see in other market driven economies such as Canada, Sweden, Denmark for example, and help address the 'patient capital' gap as well as instill more accountability to active owners
- Simultaneously, and recognising the inherent fairness in enabling the new generation to have access to secure retirement savings, we would advocate creating a UK equivalent of the Canada Pension Plan which, in a little over 20 years, has become a global leader with assets of nearly C$500 billion. Contributions would be mandatory for all working adults and benefits linked to average earnings
- Interestingly, despite the larger scale of its economy, the largest UK pension fund barely makes the top 100 funds globally, whereas Canada, a much smaller economy, has 7 in the top 100, behind only the US. Having a handful of large-scale funds can also contribute to the UK's global scale and reach post Brexit
- The principles underlying the consolidation would need to be carefully weighed but this would be heavily mitigated by both the benefits of scale (i.e. the spreading of risk, economies of scale) and the materially higher returns larger funds can generate through different asset allocation and freedom from the strictures of individual sponsors' frailty
- A fair mechanism would also be required to re-balance between the contribution of funds in deficit and funds in surplus, although this should to a degree already be reflected in individual funds' contribution/recovery schedule, with a re-directed PPF levy also playing a role as 'system buffer' as now
- The template provided by the PPF, together with the visible success of the Canadian funds, should enable this concept to be more widely understood but also to provide the confidence that it would work, as it would simply be an acceleration/scaling up of a general direction of travel that is anyway superior for the UK economy and pensioners in the longer-term
- The conditions – and the acuteness of the problem - are now mature for a bold move in this area, with a twofold impact – kickstarting this country's economic renewal while securing members' benefits

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Analysis and assessment

What problem are we trying to solve?

- Insufficient investment in productivity enhancing technologies and growth industries
- Acute regional imbalances
- Insecure pension saving system
- Limited pools of capital for long term infrastructure funding
- Depleted UK investor base eroding domestic capital markets
- London’s position as a global financial centre unsustainable without domestic equity investors

UK pension system

Highly fragmented, insecurely funded and under invested in UK growth

UK pension system - key figures

- Total assets: ~£1.7tn
- ~5,700 schemes:1/3 in surplus, and 2/3 in deficit
- Average assets per scheme: <£300m
- Proportion of UK schemes with <1,000 members: 4/5

Asset allocation UK pension system today[1]	
Bonds	36%
Foreign equities	32%
Domestic UK equities	15%
Growth, Venture & Alternatives	9%
Infrastructure	2%
Other	6%

Pension funds
Collapse in holdings of listed UK equities

Pension fund asset allocation in UK
Average pension fund, 1990 – 2015

Equity divestment trend well underway for almost 20 years, pre-dating and accelerating after the financial crisis

This reflects in part maturity and closure of most funds, amplified by QE

Allocation to UK equities at historical lows, a high % of which is indexed

100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%

1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015

Alternative
Real Estate
Cash
Overseas Fixed Income
Indexed-linked Gilts
UK Fixed Income
Overseas Equities
UK Equities

Mirrored by collapse in overall market ownership

Down from over 50% to 15% of total UK equity market

Pension fund and insurance company ownership of UK equity market

Downward trend in holdings of both insurers and pension funds

60%
50%
40%
30%
20%
10%
0%

1963 1969 1975 1981 1989 1990 1991 1992 1993 1994 1997 1998 1999 2000 2001 2002 2003 2004 2006 2008 2010 2012 2014 2016

Insurers
Pension funds

FTSE 100

TSR has lagged other major indices, with dividends comprising the entire return

Index TSR Jan 2000 – Apr 2021

Index	Total	Dividends	Share price appreciation
RUSSELL 2000	526	153	373
FTSE 250 INDEX	433	238	195
SAP 500 INDEX	350	152	199
HANG SENG INDEX	245	176	68
STXE600 € PR	183	143	41
DAX INDEX			168
CAC 40 INDEX	144	115	29
NIKKEI INDEX	99	56	43
FTSE100 INDEX	80	92	

600%
500%
400%
300%
200%
100%
0%
AVERAGE 248%
C -353%
A -155%
B -12%
Share price appreciation
Dividends

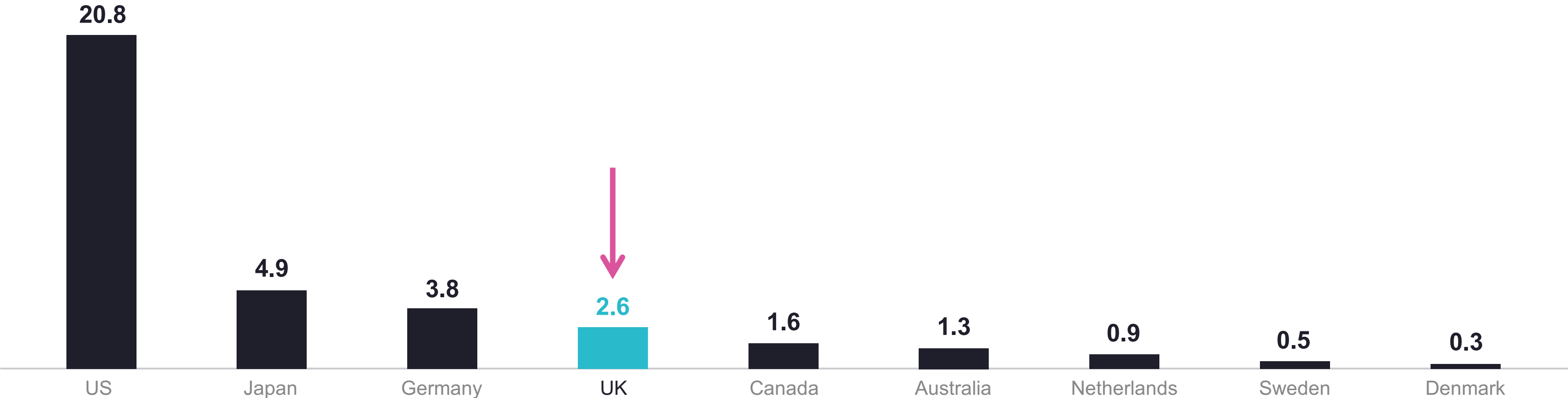
FTSE 100 had a lower TSR than all global market indices…

…dragged down by poor share price performances

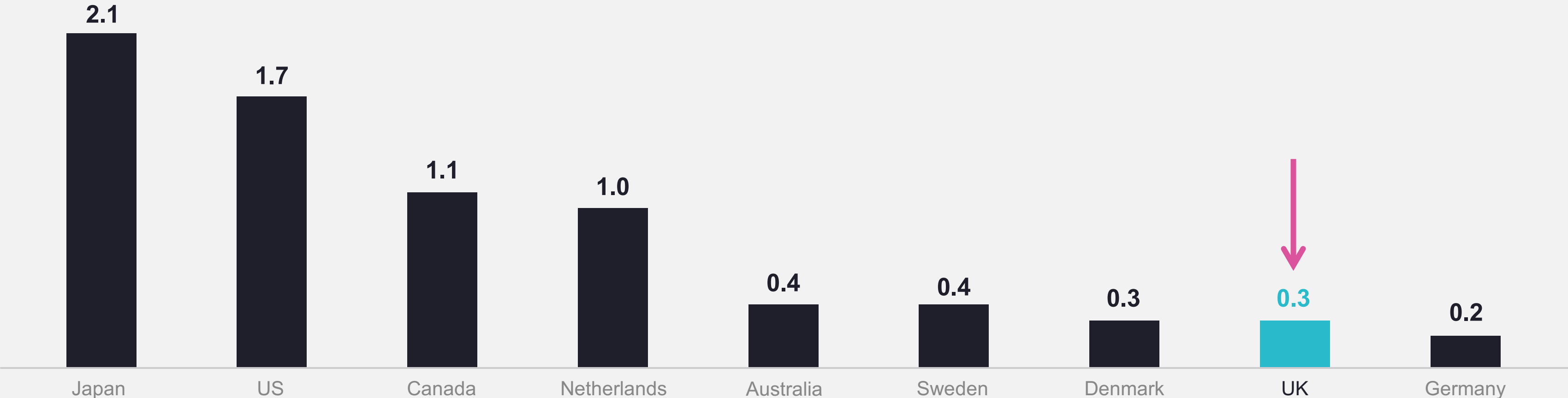
Within the UK, large companies significantly underperformed medium and small companies

Stark contrast between size of UK economy and its pension funds

GDP by country ($tn)



Top 5 pension fund assets by country ($tn)

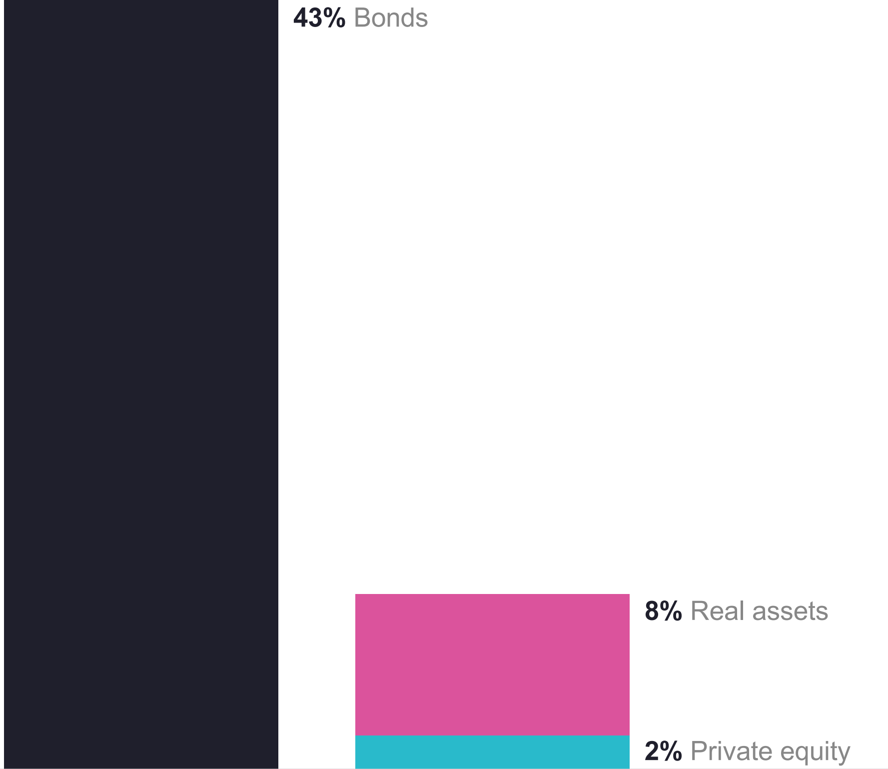


Scale drives asset allocation and returns

Scale allows greater focus on return seeking assets

Portfolio split by asset type, according to portfolio size:

£1bn



£100bn

PPF > 1,000 UK pension funds consolidated, asset allocation transformed, and higher returns generated

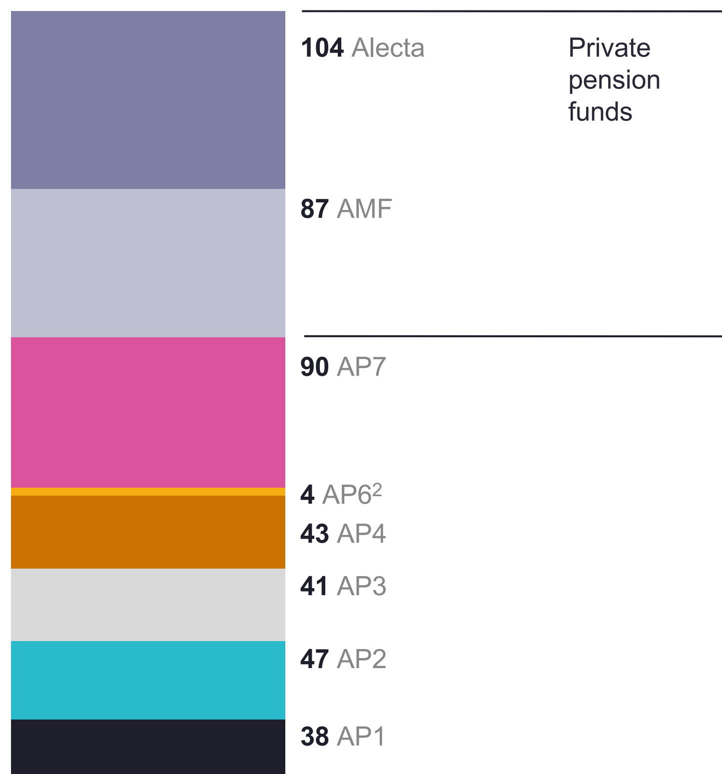
PPF assets under management (£bn)

Average 10 year return: 9.4% vs. 6.4% for UK pension funds

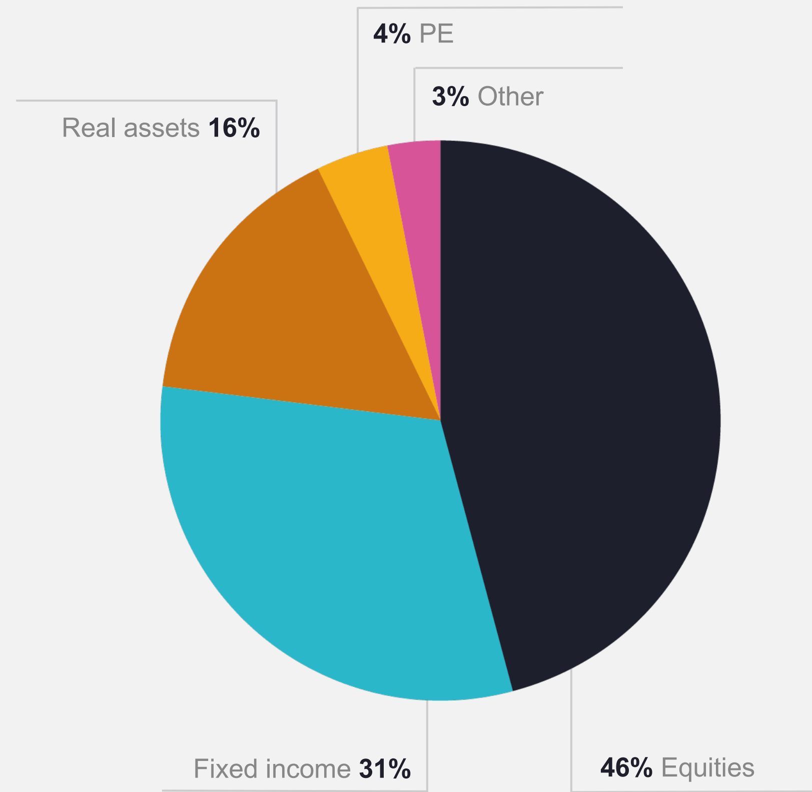
PPF asset allocation	
Liability hedging assets	40.0%
Return-seeking assets	47.5%
Hybrid assets	12.5%

Sweden
Scale drives asset allocation

Significant scale…



…driving balanced asset allocation



The funds are subject to capital allocation restrictions

Average annual returns circa 8%

Heavy exposure to domestic equities

Circa one fifth of portfolios are managed externally predominantly for foreign exposure

Canada Pension Plan Investment Board (CPPIB)

Scale, dynamic asset allocation and strong returns over 20 years

Net assets of the CPPIB at year end 1999 – 2020 (C$bn)

Year	Net assets (C$bn)
1999	$12m
2000	2
2001	7
2002	14
2003	17
2004	33
2005	59
2006	98
2007	116
2008	123
2009	106
2010	128
2011	148
2012	162
2013	183
2014	219
2015	265
2016	279
2017	317
2018	356
2019	392
2020	410
2021	476

10-year annualised return of 10.8%

CPPIB was created by the Canadian Government in 1999 with an initial injection of $12m, which has since received contributions from the entire working population above 18 years

Asset allocation[1]	
Public equities	28
Private equity	25
Credit	12
Real estate	11
Bonds & cash	11
Infrastructure	9
Other real assets	4

Clear relationship between scale and returns

10 year annualised returns

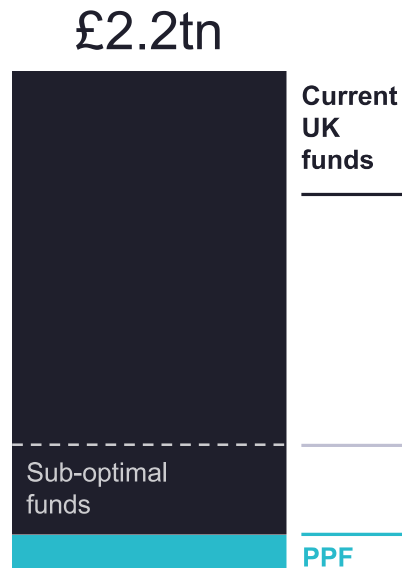
	10 year annualised returns (%)
CPPIB	10.8
OTPP	9.8
AP4	9.7
PPF	9.4
CDPQ	8.6
AP2	7.7
AMF	7.4
Average[1] UK Funds	6.2
FTSE100	3.8

Journey to Canada

Scale and long-term pension security

Today

~6,000 schemes



Significant numbers of under-funded schemes with limited scale

Post-reform

5 funds

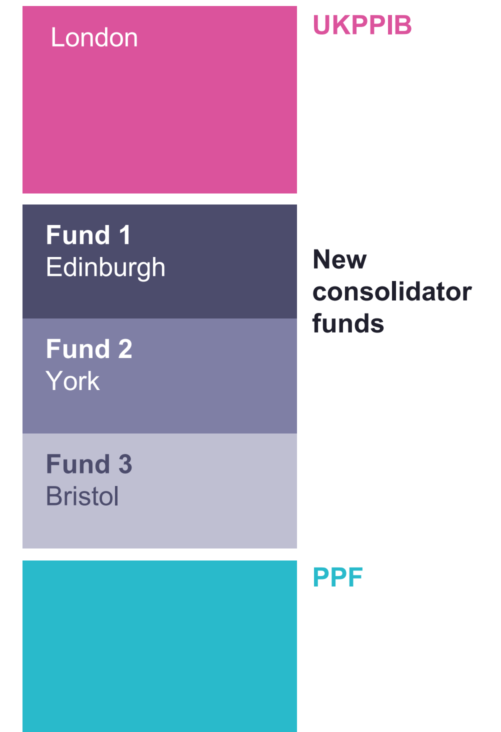
PPF to aggregate sub-optimal funds

Corporate pension contributions frozen at entry level, PPF levy

“New” employees contribute directly into UKPPIB

Medium-term

5 funds



New UKPPIB to achieve scale thanks to growing contributions and good returns

Other 3 funds to reduce in scale due to limited new contributions

Restoring the UK's reservoir of domestic focused capital

	Existing UK pension system	Typical large fund allocation	Delta (£bn)
Bonds	36%	25.0%	-242
Foreign equities	32%	17.5%	-319
Domestic UK equities	15%	27.5%	+275
Growth, venture & alternatives	9%	15.0%	+132
Infrastructure	2%	10.0%	+176
Other	6%	5.0%	-22

What problem are we trying to solve?

- Insufficient investment in productivity enhancing technologies and growth industries ✓
- Acute regional imbalances ✓
- Insecure pension saving system ✓
- Limited pools of capital for long term infrastructure funding ✓
- Depleted UK investor base eroding domestic capital markets ✓
- London's position as a global financial centre unsustainable without domestic equity investors ✓

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- **Significant economic benefits…**
  - Rebuilds a deep reservoir of long-term home market support for UK companies' global ambitions
  - Establishes long term pension security through lower cost, higher returns and professionalisation
  - Investment in innovation and growth – retain and build home grown science and technologies here in the UK, helping boost productivity
  - "Applies the paddles" to the UK's domestic equity capital markets for both primary (capital raising, IPOs) and secondary capital
  - Enables a surge of accountable investment in UK infrastructure – no more "begging bowl" trips to Canada, Australasia or Middle East
  - Reduces UK regional imbalances – attract talents to various UK regions and provide capital to local enterprises
  - Addresses a long-term threat to London's place in global financial markets, which is unsustainable without domestic equity investors
- **…with resolvable implementation issues (see page 24)**
- **New vehicles at scale will earn superior returns and spread UK values globally, especially post-Brexit**
- **A once and for all fix for an antiquated system that will eventually need a solution anyway**

Helps restore the social contract that allows markets to operate, ie by creating wealth in the first place!

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Appendix

Key implementation issues

- **Legal responsibility for the pension promise** – taken over by new funds (beyond annual contributions), just as done by the PPF
- **Responsibility for company failure to make contributions** – is an event of default for original sponsor
- **Accounting for surplus / deficit** – to be determined, companies may account for their share of enlarged surplus / deficit
- **How to true up at entry point between deficit and surplus funds** – all contributions frozen at entry point with one-time top up for deficits, if able to. If not, then taken over by PPF
- **Establishing new independent organisations to govern and manage the consolidated funds** – The UK has the most developed fund management infrastructure and expertise of all the OECD countries
- **Phasing of transfer – weaker funds first into existing or expanded PPF while new fund organisations are created**
- **Establish the parameters for the new funds** – Limits on holdings, types of investments and minimum cash buffer
- **Creation of new "UKPPIB" for all employees over the age of 18** – should follow broad outlines of CPPIB, need to consider interaction with existing social security fund and dealing with those less well off / unemployed
- **Role of pension regulator in new construct**
- **PPF levy – quantum, duration and scope**

UK pension funds barely exposed to infrastructure

% of assets in infrastructure

	JBIC	OMERS	AustralianSuper	AIMCo	PSP	OTPP	BCI	CPPIB	CDPQ	PGGM	UK funds
Total assets	170	60	70	70	135	117	100	280	190	200	
Assets in infra	42	13	7	6	11	10	6	15	10	6	
% of assets in infrastructure	24.0	22.0	10.0	8.9	8.2	8.2	6.0	5.5	5.2	3.0	2.0

Canada's pension system

A three pillar system

Canadian retirement income system

Pillar	I	II	III
Programmes	Old age security Guaranteed income supplement Other government funded programmes such as Spouses Allowance	Canadian Pension Plan Quebec Pension Plan	Workplace pension plans • Defined benefit • Defined contribution (including PRPPs) Tax-assisted private savings (such as RRSPs, TFSAs)
Characteristics	Paid from general revenues Based on income, age, years of residence	Mandatory and universal coverage Earnings based Partially prefunded	Voluntary Privately administered Minimum standards set in each province and federally based on employment sector

It is estimated that Canadian pension funds have added additional value of $4.2 billion annually[1]

Pillar I	OAS - Means tested flat rate pension paid to most Canadians above 65, financed from government tax revenues GIS - Guaranteed by the government and targeted at lower income seniors
Pillar II	CPP - Mandatory earnings-related programmes. Monthly contributions from salaries go to the CPP via the ESDC* and CRA** who collect and record contributions The CPPIB invests these contributions with the statutory mandate to maximise returns without undue risk of loss
Pillar III	Employment pension plans and individual savings – privately managed away from the CPP

Sources and footnotes

Page	
3	Source: Llewellyn Consulting, the PPF website 1. Global Pension Assets Study 2017, Willis Towers Watson
4	Preqin 2016
5	Source: UBS Pension Fund Indicators, 2016
8	Source: Thinking Ahead Institute (Sep-2020), fund information, GDP as of 2020 per IMF in US $ Canada's top 10 funds used: CPPIB, CDPQ, OTPP, BCI, PSP, AIMCo, OMERS, HOOPP, OPB and OP Trust UK's top 10 funds used: USS, BT, RBS, Lloyds Banking Group, Electricity Supply Pension, Barclays, Railway Pensions, HSBC, BP and British Airways 1. Only 8 funds disclosed in the Thinking Ahead Institute report
10	Source: Department of Work & Pensions – Protecting Defined Benefit Pension Schemes
11	Source: PPF financials, PPF Long-Term Funding Strategy Update (July 2014) Note: Should the PPF's liabilities exceed assets, the PPF has the following options: • Increase the levy • Alter the investment strategy, or as a last resort, • The Board has the power to ask the Government to reduce the level of compensation payments
12	Source: AP Funds websites, annual report, fund information 1. Average asset allocation of AP Funds 1,3 and 4 as of 30th June 2020 and AP 2 as of 31st December 2020 2. Closed fund

Page	
13	Source: CPPIB information, Currency = Canadian $, World Bank – 'The Evolution of the Canadian Pension Model' 1. Asset allocation as of FY20
14	Source: Bloomberg, fund information 1. Average pension fund return over 2006-2015 per UBS Pension Fund Indicators, 2016
15	Source: Ondra analysis, Note: * includes funds with smaller sponsors and weaker growth
16	Source: UBS Pension Fund Indicators, 2016, Global Pension Assets Study 2017, Willis Towers Watson
21	Source: World Bank – 'The Evolution of the Canadian Pension Model' – Practical Lessons for Building World-class Pension Organisations *ESDC: Employment and Skills Development Canada **CRA: Canada Revenue Agency 1. Relative to other comparable global funds. Between 2006-2015 per Keith Ambachtsheer's Letter 'The Canada Model For Pension Fund Management: Past, Present, and Future' (August 2017)
22	Source: Company information, asset allocation of USS Retirement Income Builder as of 31 March 2020, 'The Story of the USS Pension Fiasco' (Institutional Investor, September 20, 2017) Note – deficit values stated as per annual reports on a restated basis

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