Quoted Companies Alliance

6 Kinghorn Street
London EC1A 7HW

T +44 (0)20 7600 3745
mail@theqca.com

www.theqca.com

HM Treasury
1 Horse Guards Rd
London
SW1A 2HQ

pensions.review@hmtreasury.gov.uk

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Dear Treasury colleagues,

Pensions Investment Review: Call for Evidence

We welcome the opportunity to respond to your Call for Evidence: Pensions Investment Review.

The Quoted Companies Alliance *Investor Working Group* has examined the proposals and advised on this response from the viewpoint of small and mid-sized quoted companies. A list of Expert Group members can be found in Appendix A.

If you would like to discuss our response in more detail, please do not hesitate to contact us.

Yours sincerely,

James Ashton

James Ashton
Chief Executive

Section 1 – Scale and Consolidation

Q1 What are the potential advantages, and any risks, for UK pension savers and UK economic growth from a more consolidated future DC market consisting of a higher concentration of savers and assets in schemes or providers with scale?

Some of the potential advantages of consolidation include a shift towards value over costs as decreased fragmentation leads to a greater focus on longer-term investment decisions. In addition, it should simplify regulation across the industry with a greater concentration of fewer pension funds aiding regulatory alignment.

However, there are also risks to consolidation, particularly for smaller UK equities. These risks include the marginalisation of certain important asset classes, owing to their lack of scale. If pension funds consolidate, then it will be likely that they will focus on asset classes which can firstly, accommodate their larger "unit" sizes and secondly, provide sufficient liquidity. We have seen a similar trend as a result of consolidation in the wealth management industry.

In particular, consolidation has the potential to have negative consequences for smaller listed and quoted companies; it is important to note that whilst companies valued at less than £250m represent 1.6% of the UK public markets by value, they represent over 60% by number (LSE Main Market Factsheet, August 2024). Such smaller growing businesses will be the driving force behind improved productivity and economic growth in the UK. There is a risk that consolidation could undermine support for this important category of business, absent an explicit requirement to ensure a minimum level of ongoing exposure (please see our response to Q10).

Q2 What should the role of Single Employer Trusts be in a more consolidated future DC market?

Single Employer Trusts have a significant role in terms of both the journey and the destination of the future DC market. In terms of the journey, they will have enormous influence in the type and number of Master Trust schemes that make up the future consolidated market. These Master Trusts will offer an off-the-shelf model in hopes of absorbing as many schemes as practically possible. Given the size and success of some of these sole schemes, they will want to ensure certain bespoke features are offered in order to continue this performance. Where they are large enough, they might seek to continue on their own, with the level of influence on a Master Trust likely existing on a spectrum of success and size.

In terms of formal reporting, Single Employer Trusts should not just give prominence to their overall total return outcomes. They should be mandated to give even greater prominence to the current annual income on their capital, and its history in absolute terms since the scheme was first established.

During globalisation, institutional allocation has become heavily distorted by the ongoing and exceptionally strong capital appreciation of certain global assets. The nature of the current problem is that these asset valuations have appreciated so well, in a pattern that has persisted for so long, that the near-consistent upward trend has led many investors to become less wary of the scale of the downside risks that will come when economic momentum becomes less buoyant beyond globalisation.

Capital appreciation strategies have a major weakness, in that at their core their returns are reliant on transactions. In order to succeed, investors need to both buy and sell the investment with near-perfect market timing every time. Hence, the behaviour of investors invested in assets that generate return via capital appreciation are determined by the price changes of those assets. When popular assets consistently appreciate for decades for example, this pattern creates increasingly substantial additional investor demand as global capital crowds in, driving up asset prices well beyond their normal valuations. Unfortunately, when the prices of popular assets do suffer a drawdown, typically this initiates additional investor selling, in a self-feeding pattern that then exaggerates the downside as exiting global capital drives down valuations further, in a process that leads to yet more selling.

A policy of obliging Single Employer Trusts to give great prominence to the income generated by their assets and its history will naturally narrow their capital allocation into assets where return is principally driven by capital appreciation. Specifically, as the UK stock market contrasts with most others, in that it generates a much large portion of its return via the compounding of dividends, the policy would also encourage Single Employer Trusts to include a major allocation in UK quoted companies.

Q3 What should the relative role of master trusts and GPPs be in the future pensions landscape? How do the roles and responsibilities of trustees and IGCs compare? Which players in a market with more scale are more likely to adopt new investment strategies that include exposure to UK productive assets? Are master trusts (with a fiduciary duty to their members) or GPPs more likely to pursue diversified portfolios and deliver both higher investment in UK productive finance assets and better saver outcomes?

A key issue in this area is the definition and interpretation of trustees' fiduciary duty. For example, one could argue that the fiduciary duty is to the members of a scheme (the ultimate beneficiary). In practice, this means not simply the next member to draw down their pension but also a duty to the last member to do so. It follows therefore that this includes incorporating the economic landscape of the future and how best to achieve reasonable returns in the future. For example, productive finance, sustainability, and ESG all relate to the future members of these schemes.

A recent report from the Financial Markets Law Committee, *Pension Fund Trustees and Fiduciary Duties* (February 2024), sets out the above point in detail, focusing specifically on sustainability and climate change. However, the argument can be further extended to the future existence of a thriving public market and the prosperity of the domestic economy. Understood in this way, ensuring there is sufficient investment in UK equities as a precondition for a buoyant public market can and should be contained within a broader understanding of a fiduciary duty to members and as such, should lead to master trusts pursuing more diversified portfolios.

Q4 What are the barriers to commercial or regulation-driven consolidation in the DC market, including competitive and legal factors?

We have no comments.

Q5 To what extent has LGPS asset pooling been successful, including specific models of pooling, with respect to delivering improved long-term risk-adjusted returns and capacity to invest in a wider range of asset classes?

In terms of cost saving, it has proven very successful. We are still not far advanced enough to state with certainty that the specific investment related benefits have been secured. However, it is not unreasonable to consider that they will be.

The overall LGPS landscape has changed significantly and will continue to do so until these assets are mostly transitioned to the pool. A potential area of concern is meeting the demand of these pools for robust UK based opportunities given the amount of investment they can deploy. The allocator model (used by Wales Pension Partnership) is embryonic and therefore time is needed to determine how it will develop.

Section 2 – Costs vs Value

Q6 What are the respective roles and relative influence of employers, advisers, trustees/IGCs and pension providers in setting costs in the workplace DC market, and the impact of intense price competition on asset allocation?

We have no comments.

Q7 Is there a case for Government interventions, aimed at employers or other participants in the market, designed to encourage pension schemes to increase their investment budgets in order to seek higher investment returns from a wider range of asset classes?

We have no comments.

Section 3 – Investing in the UK

Q8 What is the potential for a more consolidated LGPS and workplace DC market, combined with an increased focus on net investment returns (rather than costs), to increase net investment in UK asset classes such as unlisted and listed equity and infrastructure, and the potential impacts of such an increase on UK growth?

The potential is profound, as the combination of higher returns for savers and capital deployed in more productive assets such as unlisted equity and smaller UK equities, should promote UK productivity, wealth creation and living standards over both the medium and longer term.

For example, the contribution of AIM companies to the UK economy is significant. In 2023, companies on AIM provided £35.7 billion Gross Value Added (GVA) to UK GDP; contributed £5.4 billion in corporation tax, and employed 778,888 people (Grant Thornton: The Economic Impact of AIM companies, 2024: p.6).

On average, AIM companies are more productive than the national average at £87,100 GVA per employee (compared to £58,327), and drive sustained growth across a number of metrics after initial public offering (IPO) including 12.7% employee growth and 40.8% operating profit growth five years after IPO (Ibid. p.10).

When assessing Compound Annual Growth Rate (CAGR) of revenue, AIM companies consistently outperform private companies across a number of key sectors including healthcare (17.2% vs. 10.8%), technology (14% vs. 10.8%), and industrials (10% vs. 8.3%). (Ibid. p.11).

However, consideration should be given to the risks of consolidation on certain asset classes (see question 1) and where any funding gaps exist. This will vary over time, and there should be flexibility on ensuring that certain elements of the UK's "growth escalator" are not compromised (which the UK's quoted SME market currently is), to ensure that the benefits of increased pension funding to these stocks is fully realised.

Q9 What are the main factors behind changing patterns of UK pension fund investment in UK asset classes (including UK-listed equities), such as past and predicted asset price performance and cost factors?

Historically, behaviour has been driven by risk aversion, partly driven by regulation, and a focus on cost rather than value, resulting in a "race to the bottom" on fees, alongside increased use of high volume-low fee asset classes, and passive tracker funds. High volume-low fee asset classes tend to not be as economically productive, and passive tracker funds to not contribute to fundraising activities (IPOs, or further issues), nor contribute to efficient markets as they do not aid price discovery.

Stamp duty on the trading of UK shares has also contributed to the shift in UK pensions' allocation away from domestic stocks. Given that stamp duty is not applied to non-UK shares, this tax acts as a disincentive for pension funds to invest in UK equities.

Looking forward, consideration should be given to value (returns vs fees) and risk (both volatility and financial risk). UK listed equities have, over the long term, delivered very attractive returns (69-year-CAGR of the Deutsche Numis 1000 is 15.6%; Deutsche Numis Smaller Companies 14.1%; Deutsche Numis Mid cap 12.8%) (Deutsche Numis, January 2024), fee rates remain modest (relative to private equity), and most listed funds lack financial gearing.

Q10 Is there a case for establishing additional incentives or requirements aimed at raising the portfolio allocations of DC and LGPS funds to UK assets or particular UK asset classes, taking into account the priorities of the review to improve saver outcomes and boost UK growth? In addition, for the LGPS, there are options to support and incentivise investment in local communities contributing to local and regional growth. What are the options for those incentives and requirements and what are their relative merits and predicted effectiveness?

As we work towards reviving the UK capital markets, the time has come to crowd UK pension funds back into UK equities. This can be done in a number of ways – but it is vital it is done immediately as the number of UK public companies continues its sharp decline.

A voluntary target for UK equity exposure encouraged by government could be as effective as formal mandation, with LGPS leading the way. Alternatively, UK pension funds could be required to radically upgrade their UK equities exposure in order to retain their tax-advantaged status.

The objective should be to bring UK pension asset allocation at least back into line with the level of domestic weighting adopted by a broad range of other developed economies. The focus should be to channel returning funds into smaller stocks, which have suffered most from the shift away from the UK and are less likely to be on the radar of international investors.

Figures for 2023 show that 4.4% of UK pension funds are allocated to UK equities, which is down from around half 25 years ago (New Financial: Comparing the asset allocation of global pension systems: p.5). This compares unfavourably to some of the UK's international competitors. For example, U.S. pension funds have a 44% domestic allocation; Australia 24% (Ibid. p. 7).

In this regard, the UK remains a relative outlier to the extent that it lacks a domestic bias relative to other countries, which increases the cost of capital for domestic businesses, both directly and indirectly. Having a level of home bias increases the depth of capital markets, stimulates liquidity and enhances the prospect of "crowding in" overseas capital into the UK economy.

Incentivisation through specific tax credits could be achieved by focusing existing pension tax reliefs on investing in equities below the FTSE 100 and those on the UK's quoted SME markets (AIM and Aquis). One of the primary reasons Australia has a high domestic bias for equities is due to tax credits for investors on dividends paid by Australian companies (Ibid. p.20).

Additional requirements should include a disclosure regime that monitors pension funds' progress and requires them to report clearly on their allocations across various asset classes and geography.

Similarly, the success of the pension reforms in boosting economic growth will also depend on effective government communications to market participants to ensure that the eligibility of different asset classes under the reforms is understood. For example, under the Mansion House Compact, DC pension fund allocations to 'unlisted equity' is not always understood as including public equities quoted on AIM and Aquis.

The Mansion House Compact also acts as a reminder that voluntary schemes can be problematic. This initiative comes from a good place but has been slow to take effect, with progress poorly evidenced. To underscore its credibility, signatories should be asked to commit 20% - or one percentage point of their 5% commitment - to unlisted equities quoted on AIM and Aquis, amounting to a putative £10bn by 2030.

<u>Appendix A</u>

The Quoted Companies Alliance *Investor Working Group*

Paul Stevens (Chair)	**Business Growth Fund (BGF)**
Fraser Elms	Herald Investment Management Ltd
James Goodman	Schroders Investment Plc
Judith MacKenzie	Downing LLP
Katie Potts	Herald Investment Management Ltd
Richard Power	Octopus Investments
Eustace Santa Barbara	Canaccord Genuity
Gervais Williams	Premier Miton Group Plc