3 TRENDS IN CLIENT ASSETS AND ALLOCATION

KEY FINDINGS

ASSETS BY CLIENT AND MANDATE TYPE

- In 2023, institutional client assets accounted for 72.7% of total UK AUM, down from 74.1% in 2022. Some of this decline is the result of performance in a more challenging market cycle.
- Retail assets rose to 26.4%, up from 24.7%. This compares with 20% in 2020. Low interest rates through the pandemic made investing attractive and many new investors had more disposable income and time to spend on investing. Through 2022 and 2023, the proportion of retail AUM has remained steady despite rising inflation, higher interest rates and the market shock caused by the Russia/Ukraine war.
- Pension fund assets as a share of total AUM fell to 31.5%, down from 33.9% in 2022. The gilt market crisis in September 2022 continues to impact asset values, particularly for pension funds.

TRENDS IN ASSET ALLOCATION

- Equity allocation remained constant at 42% in 2023 and is unchanged since 2021. North American equities have almost doubled over 10 years to 35% and UK equity allocations have declined to 20% in 2023, down by 10% over the past decade. Fixed income allocation increased to 30%, up 2% from 2022. Overseas bonds account for 59% of fixed income assets. The 'Other' category, which includes LDI and multi-asset strategies, rose by 3% to 20% in 2023.

INDEXING AND ETFs

- From 2013 to 2022, allocations to indexing strategies increased from 23% to 33%. In 2023, the proportion of indexing AUM dipped slightly to 32%.
- Global AUM in the ETF market reached $11.09trn, up 25% from $9.2trn in 2022. This growth outpaced the 17% annual growth rate observed over the last decade. Growth rates were highest for Europe, with AUM growing 28% in 2023 to reach $1.8trn. Over the past decade, growth in the total AUM in active ETFs has consistently outpaced index tracking ETFs, growing at double the rate in 2023 to reach $715bn.

INVESTMENT IN THE UK ECONOMY

- IA members invested £1.43trn in UK-listed equities, sterling denominated bonds, infrastructure and UK commercial property in 2023. Investment in UK equities slightly decreased to £778bn from £815bn in 2022. Sterling corporate bond assets grew by £56bn, reaching £396bn in 2023. Investments in UK infrastructure projects remained stable at £45bn.

ONGOING FOCUS ON LIQUIDITY MANAGEMENT

- A combination of events including the 2020 "Dash for Cash" and the LDI market turbulence in September 2022 have underscored the critical importance of liquidity management. A co-ordinated global regulatory reform agenda is focused on more effective liquidity management and in December 2023, the Financial Stability Board and IOSCO issued policy recommendations to address liquidity mismatches in open-ended funds focusing on liquidity bucketing, availability of liquidity management tools and anti-dilution measures. The UK industry broadly supports these efforts, while emphasising that funds have not been central drivers of redemptions during previous crises.

DEEPENING ACCESS TO PRIVATE ASSETS

- Globally, private market assets have grown substantially, with AUM in alternative investments reaching $17trn in 2023, up from $7trn in 2010 according to Preqin data. In the UK, the Government believes that private investment can play a key role in meeting its levelling up and net zero objectives.
- Barriers to investing in private markets are also being addressed. The launch of Long-Term Asset Funds (LTAFs) presents a further opportunity to increase DC pension participation and the momentum behind the Mansion House reform agenda aims to help channel pension capital into public and private UK companies.

This chapter offers insights into the structure of the UK-managed asset base of Investment Association (IA) members. We focus on three key aspects: client type; asset classes and geographies; and asset management styles and approaches.

CLIENT TYPES

The clients served by IA member firms can be broadly categorised as either retail clients or institutional clients, although the blurring of the lines between these groups remains a feature of the market (see Box 3). Chart 9 illustrates the breakdown of the £9.1 trillion of UK-managed assets by client type. We observe the following trends:

- The proportion of industry AUM managed on behalf of institutional clients is 72.7% in 2023 compared with 74.1% in 2022, a fall of just over 1%. The proportion of assets managed on behalf of retail clients is 26.4%, up from 24.7% the previous year, and assets managed on behalf of private clients remained steady at 0.9%, compared with 1.1% in 2022.
- In 2023, pension funds remained the largest client group, holding 31.5% of industry assets and 43.3% of institutional assets, down from 33.9% and 45.7% in 2022. The proportion of pension fund assets as a percentage of total AUM has consistently declined year-on-year since 2018.

BOX 3: BLURRING OF CLIENT TYPES

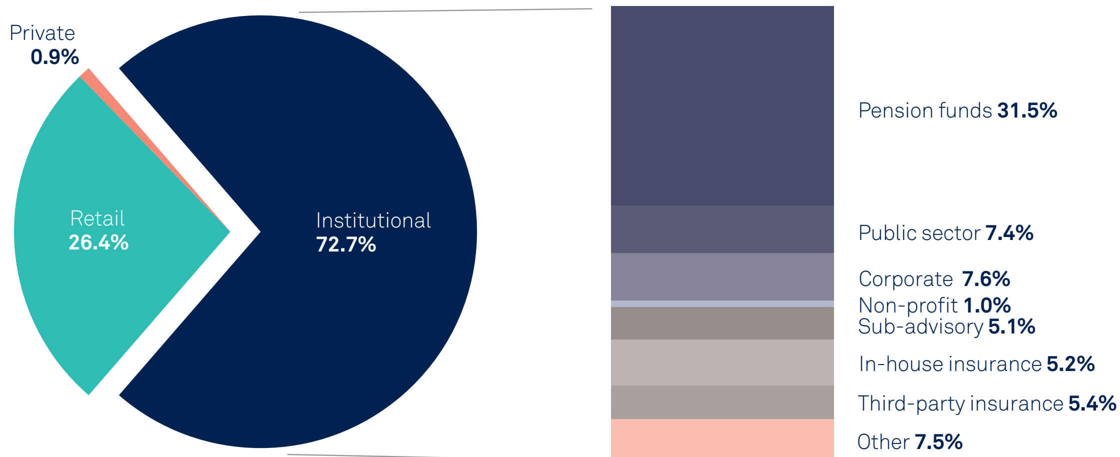
Insurance vs. Pension

Defined Contribution (DC) pension assets that are operated via life companies wrapping funds are not included in pension fund assets but are rather reflected in assets managed on behalf of insurance companies. This includes assets managed for personal pension and Group Personal Pensions (GPPs). This blurs the line between pension and insurance assets, meaning the allocation to pension funds understates actual pension investment.

Retail vs. Institutional

DC pension schemes remain something of a hybrid between retail and institutional. Pension savers in DC schemes receive an income in retirement that is based on the value of the pension pot they have accrued during their working life. Unlike a Defined Benefit (DB) scheme, where their pension is based on their salary, the value of a DC pension is determined by the contributions an individual makes to their plan and the investment return they receive. The ultimate investment risk lies with the individual. In this regard, DC pensions are more akin to retail investments than institutional, albeit they will appear in the IA's data either as pension fund or insurance assets.

CHART 9: ASSETS MANAGED IN THE UK BY CLIENT TYPE (2023)



Source: The Investment Association

- We have seen a rise in the proportion of assets managed for in-house insurance clients, increasing from 5.7% to 7.3% of AUM, while third-party insurance assets declined from 6.5% to 5.4%. This rise can be partly attributed to developments in DB pension schemes, where the insurance buy-out market saw a record level of deals over 2023 as some schemes moved to full funding as a result of higher interest rates. This has benefited investment managers who are part of insurance companies where investment management has been distributed in-house. (See Chapter 4 for further analysis)

- Retail is the second-largest client group, growing annually since 2019 to reach 26.4% in 2023. The rise in the percentage of assets managed on behalf of retail clients in 2023 is largely the result of flat institutional AUM growth, however retail AUM has also been boosted by a rise in the number of investors through the pandemic.

Chart 10 offers a breakdown of UK-managed assets by client type over the ten-year period to December 2023.

- Retail client assets have seen the largest proportional increase over the last decade, rising from 20% in 2013 to 26% of total UK managed assets and are now the second largest client group. This compares with 20% in 2020 at the start of the pandemic. In 2020, the Bank of England cut the base rate to 0.1% to help kick start the economy and in November 2020, successful vaccine trials were announced and market performance rebounded strongly. This environment was attractive to retail investors, many of whom had more disposable income and time to spend on investing. Through 2022 and 2023, the proportion of AUM managed on behalf of retail investors has remained steady. This is in spite of rising inflation, higher interest rates and the market shock in 2022 caused by the Russia/Ukraine war.

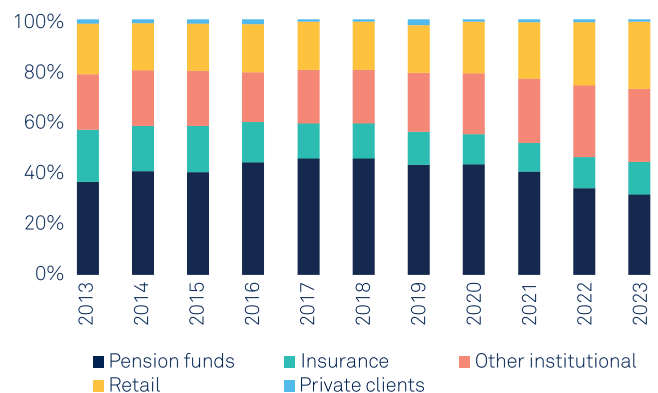
- Whilst pension funds remain the largest client group, the share of assets managed on behalf of pension funds has fallen further in 2023 to 31% of assets from 34% in 2022. The gilt market crisis in September 2022 caused gilt prices to fall steeply and affected the value of pension fund assets. The AUM managed on behalf of pension funds has yet to recover and this has caused the percentage of assets to continue to decline.

- There has been a percentage point rise in the assets managed on behalf of insurance clients to 13%, which has been driven by growth from in-house insurance clients. Insurance assets fell between 2017 and 2021 but the shift to higher interest rates has driven a rise in DB scheme insurance buy outs and has also made the annuity market more attractive, which may account for the growth in in-house insurance assets year on year.

- The 'Other institutional' category has consistently grown each year since 2018 from 21% to 29% of client assets in 2023. Assets managed on behalf of corporate (7.6%) and public sector clients (7.4%) make up the largest segments within the 'Other institutional' category.

- The share of assets managed for private clients has historically fluctuated between 1% and 2% but has held steady at 1% for the past three years.

CHART 10: ASSETS MANAGED IN THE UK BY CLIENT TYPE (2013-2023)



Source: The Investment Association

TRENDS IN ASSET ALLOCATION

IA members invest across all the major asset classes but their involvement varies depending on their expertise and specialisms. As highlighted in Table 2, nearly all survey respondents invest in equities (98%) and most invest in fixed income (85%). Other asset classes, such as cash and alternatives, are more specialised and are predominantly managed by the larger investment managers.

TABLE 2: PROPORTION OF IA MEMBERS INVESTING BY ASSET CLASS IN 2023

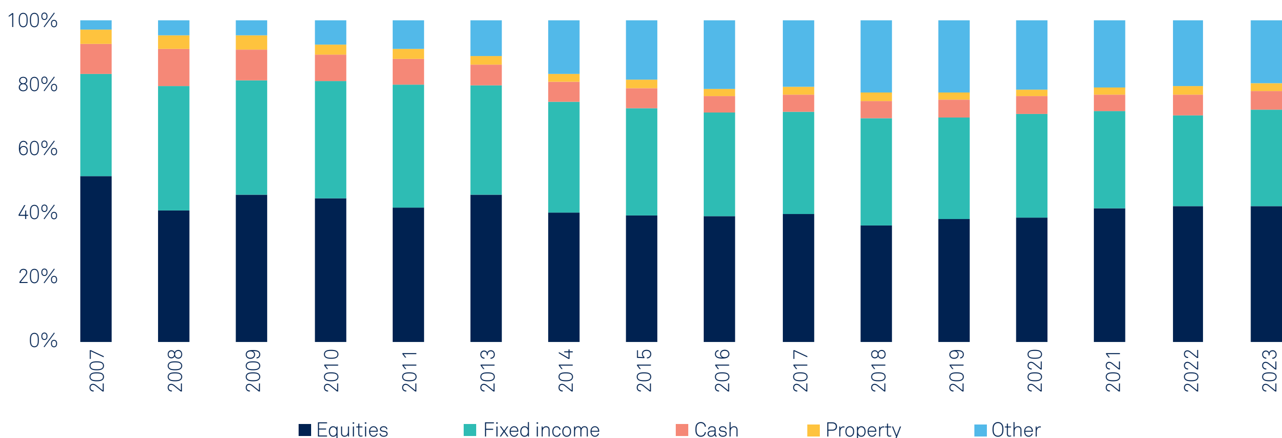
	Share of firms in a given asset class
Equities	98%
Fixed income	85%
Property	68%
Cash	15%
Alternatives (incl. private markets and cryptoassets)	27%

Source: The Investment Association

Chart 11 highlights the breakdown of assets under management by asset class over the last fifteen years. Year on year, asset allocation has hardly changed between 2023 and 2022 although there has been a slight rise of 2% in the allocation to bonds. Looking back longer term, there have been shifts in the allocation of assets and the most significant trend has been the volatility in the percentage of AUM allocated to equities:

- Allocation to equities was 52% in 2007 but the impact of the market downturn through the global financial crisis caused a steep fall to 41% in 2008. Central banks moved to cut interest rates to boost global economies and we see a rebound to 46% through 2009 but this period is indicative of the impact of market performance on equity asset values and allocation. We observe another steep fall through 2018 of 4% from 40% to 36% when markets tumbled following worries over US interest rates rises and global trade tensions between the US and China. However, the percentage of assets allocated to equities has stabilised between 2021 and 2023 at 42%. The market turbulence through the pandemic was relatively short lived and markets rebounded from November 2020. The fall in equity valuations was accompanied by a fall in bond prices in 2022, which may have offset any change to the proportion of assets managed in equities.

CHART 11: OVERALL ASSET ALLOCATION OF UK-MANAGED ASSETS (2007-2023)



Source: The Investment Association

- Fixed income allocation rose by two percentage points to 30% in 2023, following a fall of 2% in 2022. As bond yields rose rapidly following swift moves by Central Banks to raise rates to offset escalating inflation, so bond prices moved inversely to yields. Bonds have consistently remained at around a third of total AUM over the last decade and typically have a stable performance trajectory – 2022's events were exceptional as we moved into a new economic cycle of higher interest rates.
- Allocations to cash remained steady at 6% in 2023. Cash allocations have remained stable at between 5% and 6% over the last ten years.
- Assets in the 'Other' category include LDI and multi-asset strategies and fell by 1% year-on-year. Over the long-term we have seen significant growth, however, as assets in 'Other' rose from 3% of UK-managed assets in 2007 to 20% in 2023.

DETAILED ASSET ALLOCATION

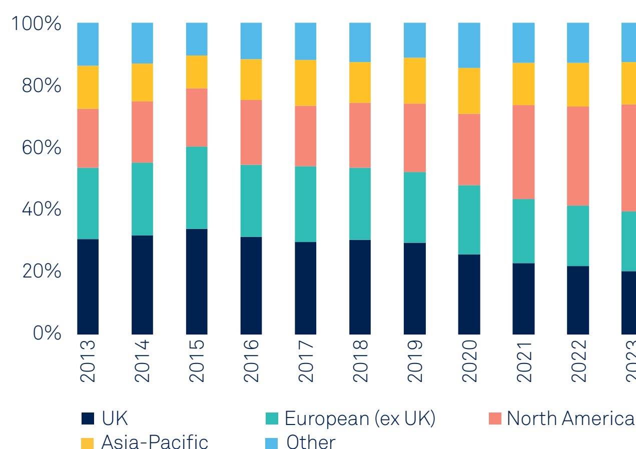
In addition to monitoring the shifts between asset classes, the IA monitors trends within equity and fixed income holdings according to type of exposure. This section considers these changes in more detail.

Equities by region

Chart 12 illustrates the change in proportion of equity assets over a ten-year period to December 2023. The growth of AUM in US equities outstrips all other markets accounting for 35% in 2023, compared with a 20% allocation to UK equities:

- The US stock market has significantly outperformed other equity markets over the last fifteen years. As a result, the proportion of UK-managed equities invested in North American companies has almost doubled over the last decade to 35%.
- Allocation to UK equities in 2023 is 20%, falling by 10% over ten years. This reflects the trend over the last fifteen years to greater global diversification in equities as assets have been allocated away from the UK. However, the performance of UK equities has improved over the last two years in comparison with other developed markets and the UK makes up the second largest equity allocation.
- Since peaking in 2015, European equities have steadily declined in allocation, falling from 22% in 2020 to 19% in 2022 and 2023, the lowest levels recorded.

CHART 12: ALLOCATION OF UK-MANAGED EQUITIES BY REGION (2013-2023)



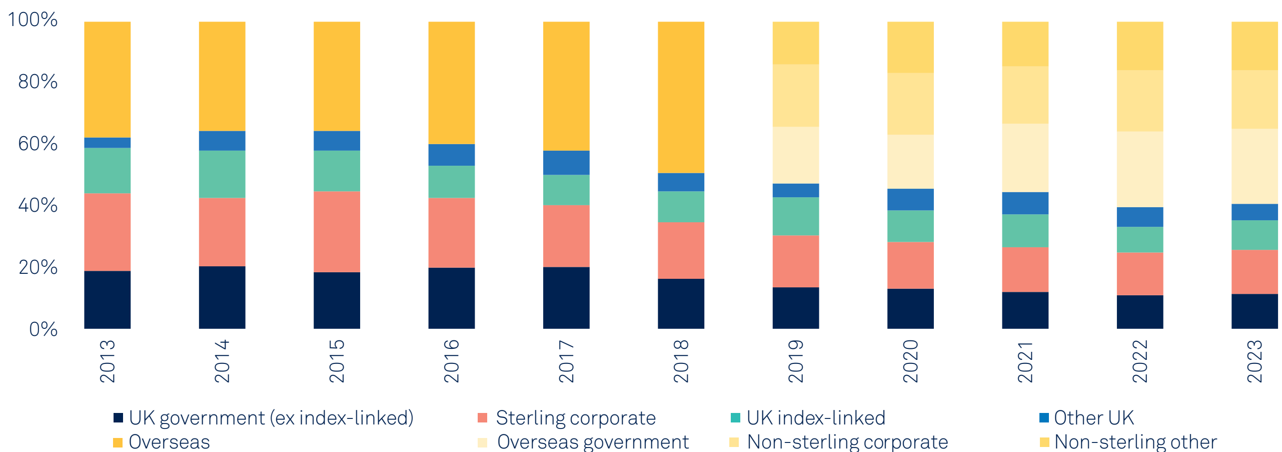
Source: The Investment Association

Fixed income assets by region

Global diversification of fixed income assets has increased over the past decade. Chart 13 highlights the evolving composition of fixed income investment over the past decade.

- Although down by one percentage point in 2023, overseas bonds still dominate fixed income assets, accounting for 59%. This reflects a continued preference for global diversification.
- Allocation to government bonds has dropped from 19% in 2013 to 11% in 2023. Despite the sharp fall in UK gilt prices in September 2022, UK government bond allocation remained steady in 2023.
- Allocation to UK index-linked bonds rose slightly to 9% in 2023 up from 8% in 2022 but has not yet recovered from the impact of the September 2022 fall in gilt prices on allocations. In 2021, the allocation to index-linked bonds, which provide protection against rising inflation, was 11%.
- Sterling corporate bond allocations rose by 1% year on year to 15% in 2023. Allocation has stabilised recently, fluctuating between 14% and 15% since 2020.
- Overall, non-sterling denominated bonds continue to make up a third of fixed income allocations, a 1% fall in 2023. The most significant growth in bond allocations has been to overseas government bonds, which are 24% of fixed income allocations compared with 22% in 2021. This also reflects the impact of the fall in UK gilt prices, which had a greater impact on the value of UK issued and sterling denominated bonds than on overseas government bonds.

CHART 13: ALLOCATION OF UK-MANAGED FIXED INCOME BY TYPE AND REGION (2013-2023)



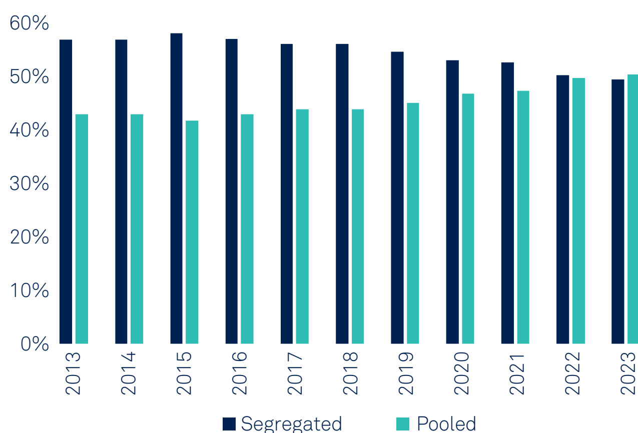
Source: The Investment Association

SEGREGATED VS. POOLED

Chart 14 shows a gradual shift from segregated mandates to pooled investments over the past decade.

The proportion of assets in segregated mandates was 57% in 2013 and held steady until 2016 before gradually falling to 50% by 2022. It has remained at 50% in 2023. Assets in pooled vehicles have risen from 42% in 2013 to 50% by 2022 and there is no change year on year. This trend reflects a shift toward greater use of indexing strategies, which are typically managed through pooled investment structures. We have also seen an increase in the use of products such as ETFs and we look at this trend in more detail later in this chapter.

CHART 14: SEGREGATED VS. POOLED INVESTMENTS (2013-2023)



Source: The Investment Association

INDEXING STRATEGIES

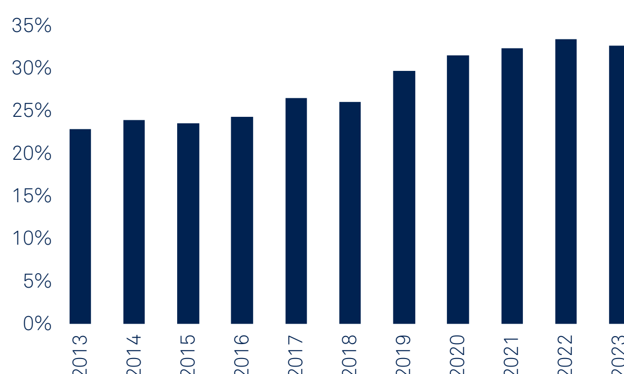
Chart 15 shows the evolution of indexing strategies as a proportion of UK-managed assets. From 2013 to 2022, there was a clear trend towards increasing allocation to passive investment strategies, rising ten percentage points from 23% to 33%. This shift reflects the appeal of lower fees and the strong performance of equity indices in a low-interest rate environment. The introduction of measures such as the charge cap in defined contribution pensions have also been a factor in the growth of indexing as DC schemes have made greater use of indexing strategies to keep costs underneath 75 basis points. Active strategies have seen a decrease in share of AUM from 77% to 67% between 2013 and 2022.

“It's a historical fact that passive is taking a large share out of the active industry, and it's also contributed to pricing coming down. Capacity in the active space has shrunk and probably will continue to shrink. That has consequences in terms of corporate governance, in terms of market efficiency, and in terms of market concentration and momentum investing, which we have seen.”

In 2023, there was a slight reversal in the trend as we saw the consistent growth in passive allocation halt as indexing AUM fell slightly by 1% to 32%. This change may reflect market volatility. Going forward, the outlook for active management may be more positive according to our interviews with senior industry representatives. We are operating in a new interest rate cycle that is less favourable for equity growth stocks and as markets grapple with volatility and greater economic uncertainty, there may be opportunities for active managers to exploit.

“From the global financial crisis till probably about 2021, passive delivered really good outcomes with fairly low volatility and that was all driven by falling interest rates. The reward for just owning beta is going to reduce quite materially.”

CHART 15: INDEXING STRATEGIES AS PROPORTION OF TOTAL UK ASSETS UNDER MANAGEMENT (2013-2023)



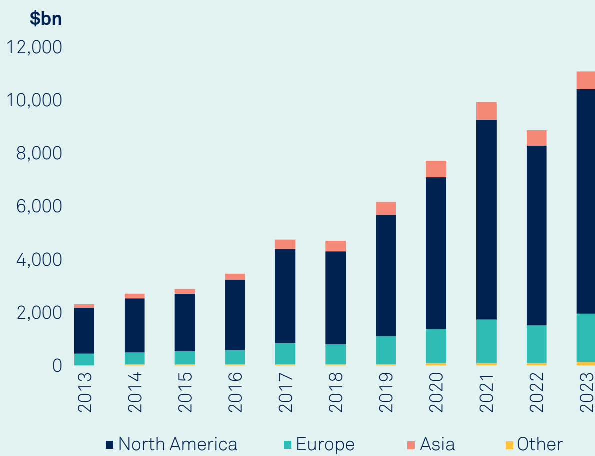
Source: The Investment Association

BOX 4: EXCHANGE TRADED FUNDS MARKET

An exchange traded fund (ETF) is an open-ended pooled investment vehicle with shares that, like a 'traditional' fund, will offer investors access to a portfolio of stocks, bonds, and other assets, most commonly aiming to track an index. Unlike a fund, it can be bought or sold throughout the day on a stock exchange, which is why ETFs are effectively a hybrid of a tradeable stock and an index-tracking fund. Among the IA's membership, just under a fifth of members manufacture ETFs as part of their product offerings.

Despite an uncertain economic environment over 2023, global AUM in the ETF market reached an all-time high of $11.09 trillion, up 25% from $9.2 trillion the previous year as illustrated in Chart 16. This was a notable reversal of the 11% decline in ETF assets witnessed in 2022 and outpaces the 17% annual growth rate over the past decade. Growth rates remained strong across all ETF domiciles and were highest for Europe, with AUM growing 28% in 2023 to reach $1.8 trillion. For North America and Asia, growth rates were 25% (as AUM reached $1.8 trillion) and 20% (where AUM reached $676 billion) respectively.

CHART 16: ETF ASSETS UNDER MANAGEMENT BY REGION OF DOMICILE (2013-2023)



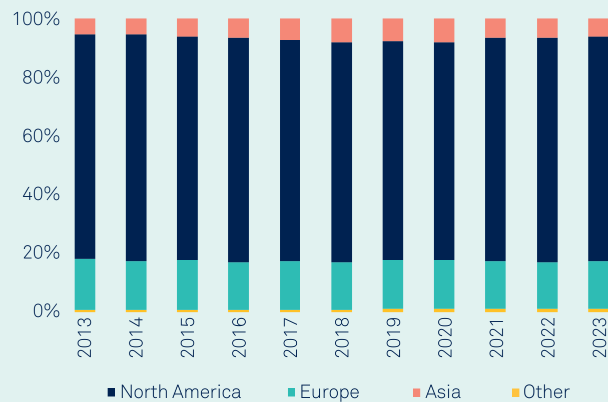
Source: Morningstar

US-domiciled ETFs continue to account for the vast majority of assets in the global ETF market, representing 76% of total North American ETF assets in 2023. High ETF adoption in the US can be explained by tax advantages facilitated by a favourable regulatory environment. Mutual funds are usually required to liquidate their positions to meet client redemptions. Capital gains events associated with buying and selling securities is minimised in ETFs, making them more desirable to US investors relative to mutual funds.

The European regulatory environment does not facilitate tax advantages for ETFs (except for Ireland-domiciled ETFs which benefit from the US-Ireland double-tax treaty rate). The AUM of European-domiciled ETFs lags North America but is growing at a faster rate. The German retail market has seen significant growth in the take up of ETFs. German banks and distributors have offered low-cost portfolios using ETFs that have attracted younger investors to save little and often into these portfolios. One key difference between the UK and Germany is that German ETF issuers are able to cover the execution/trading costs of ETFs for German investors, whereas in the UK this would breach commission and subsidy rules. UK investors can also be charged higher trading costs on some investment platforms as execution costs for exchange traded products are often higher than for mutual funds.

As illustrated in Chart 17, North America-domiciled ETFs continued to represent the largest proportion of total ETFs at 76% in 2023, equivalent to $8.4 trillion. Europe-domiciled ETFs accounted for $1.8 trillion with Ireland-domiciled ETFs the biggest driver of growth, accounting for 70% of European ETF assets which grew by a third over the previous year.

CHART 17: PROPORTION OF ETF ASSETS BY REGION OF DOMICILE (2013-2023)



Source: Morningstar

Despite growth in Asia-domiciled ETF assets lagging other regions, assets still witnessed notable growth of 20% to reach an all-time high of $676 billion. This acceleration in growth rate is consistent with other regions, which have all seen a reversal of last year's asset declines. Changes in ETF assets have been more volatile in Asia with South Korea seeing its highest historical growth rate (51%) whilst Vietnam saw its biggest historical decline in assets (-29%).

Long term trends in ETFs

The growth in the ETF market has been one of the most significant product developments within the investment management industry over the last two decades.

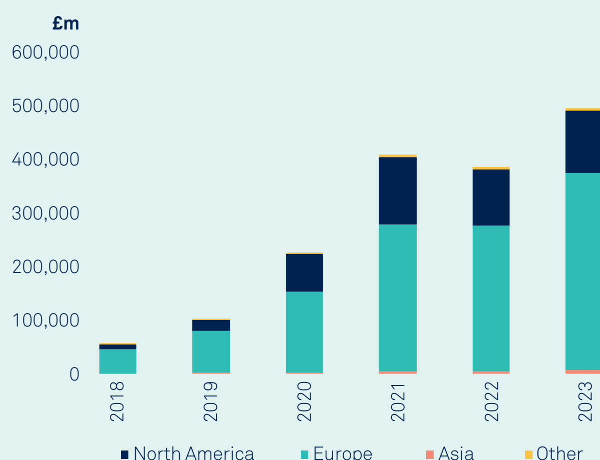
Two significant trends in ETFs in recent years are:

- the rise in sustainable investment ETFs,
- the rise in assets in actively managed ETFs.

1) Sustainable ETFs

Chart 18 illustrates total sustainable ETF assets reaching $495 billion in 2023, a rise of 29% over the previous year. This trend continues to be driven by Europe-domiciled ETFs, which account for 74% of sustainable ETF assets and grew 36% over the previous year. Inflows to European sustainable ETFs totalled $45 billion in 2023. Although this represents a 16% decline on 2022, this is still far higher than other regions including North America ($5 billion outflow) and Asia ($2 billion inflow).

CHART 18: SUSTAINABLE ETF ASSETS UNDER MANAGEMENT BY REGION OF DOMICILE (2018-2023)



Source: Morningstar

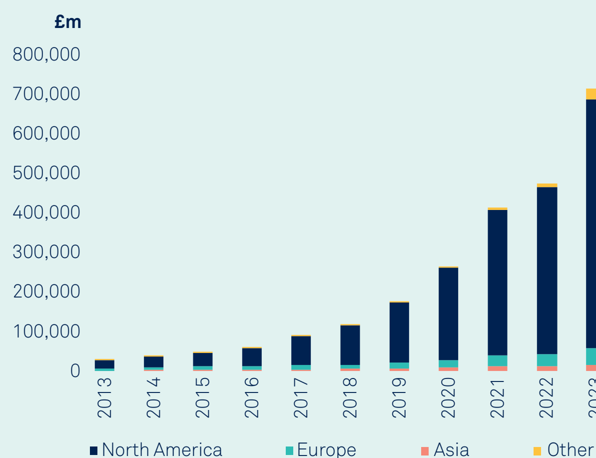
2) Active ETFs

ETFs are a product structure like a mutual fund and can accommodate active management as well as indexing strategies whilst retaining features specific to ETFs such as being traded on exchanges and offering intra-day pricing. Although the active segment remains a smaller part of the market, Chart 19 illustrates the growth in the AUM of active ETFs. Over the past decade, growth in total AUM in active ETFs has consistently outpaced index tracking ETFs, growing at double the rate in 2023 to reach $715 billion.

Asia-domiciled active ETFs grew by 221%, outpacing all other regions in 2023. Asia represents 4% of all active ETFs whilst Europe and North America represent 6% and 88% respectively. In Canada, active ETF issuers do not have to publish holdings on a daily basis, which is a feature of most ETFs. This allows them more protection for proprietary active allocation strategies and has helped to contribute to active ETF growth. The US market accounts for 74% of total active ETF AUM in 2023. In 2019, the US SEC adopted the "ETF rule", enabling ETF providers to more easily bring new strategies to market. Subsequently, active ETF growth is increasingly being driven by active fixed income.

Net flows to active ETFs have also increased year on year, accounting for 20% of the total ETF industry inflow in 2023, equivalent to $166 billion.

CHART 19: ACTIVE ETF ASSETS UNDER MANAGEMENT BY REGION OF DOMICILE (2013-2023)



Source: Morningstar

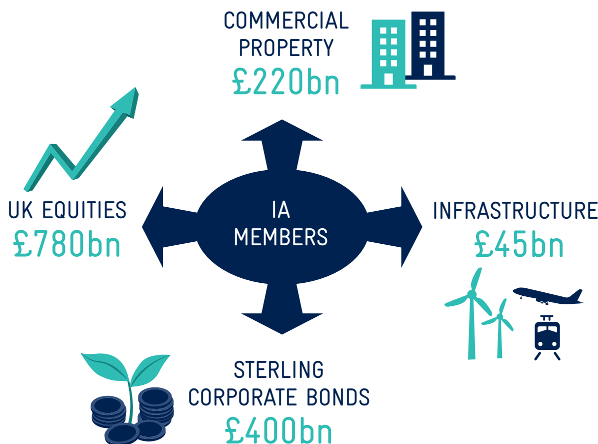
INVESTMENT IN THE UK ECONOMY

The investment management industry plays a significant role in channelling savings to investments in the domestic economy through both public and private markets. This role became more significant with the reduction in bank lending after the global financial crisis. The new Labour Government in the UK is committed to driving economic growth and financing the UK's transition to net zero is a key policy priority. The role of investment managers in financing the UK economy will continue to grow over the next five years.

IA members are helping to finance the UK economy through investments in UK listed equities, sterling denominated bonds, infrastructure and UK commercial property (see Figure 6) totalling £1.4 trillion in 2023. This figure remains stable year on year but is down from the £1.6 trillion in 2021. The proportion invested in UK equities is marginally down on 2022 at £780 billion (assets invested by IA members in UK equities were £815 billion the previous year). This is equivalent to almost one third (32%) of total UK equity market capitalisation.

Sterling corporate bond assets are up by £60 billion in 2023 to £400 billion following the steep fall of almost £100 billion in nominal terms over 2022 as UK bond prices fell sharply in a very tough year for performance across equities and bonds. Investments in UK social and economic infrastructure projects, which we explore in more detail in the next section, total £45 billion as of the end of 2023.

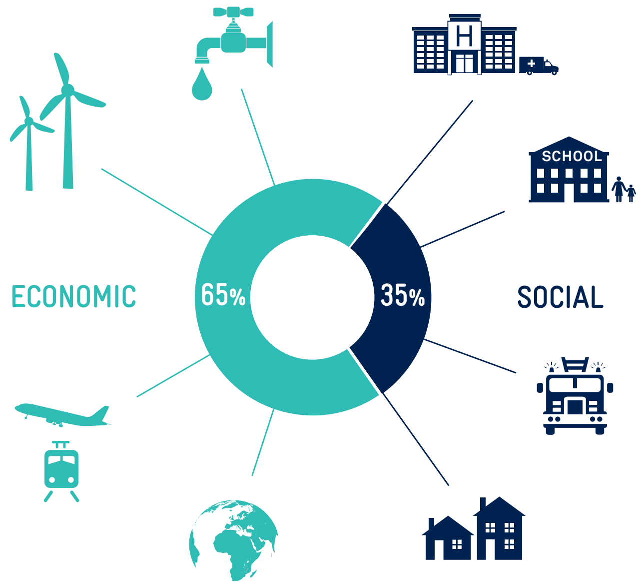
FIGURE 6: IA MEMBER HOLDINGS IN UK ASSET CLASSES (2023)



Source: The Investment Association

INVESTMENT IN UK INFRASTRUCTURE

FIGURE 7: INFRASTRUCTURE INVESTMENT BY IA MEMBERS (2023)



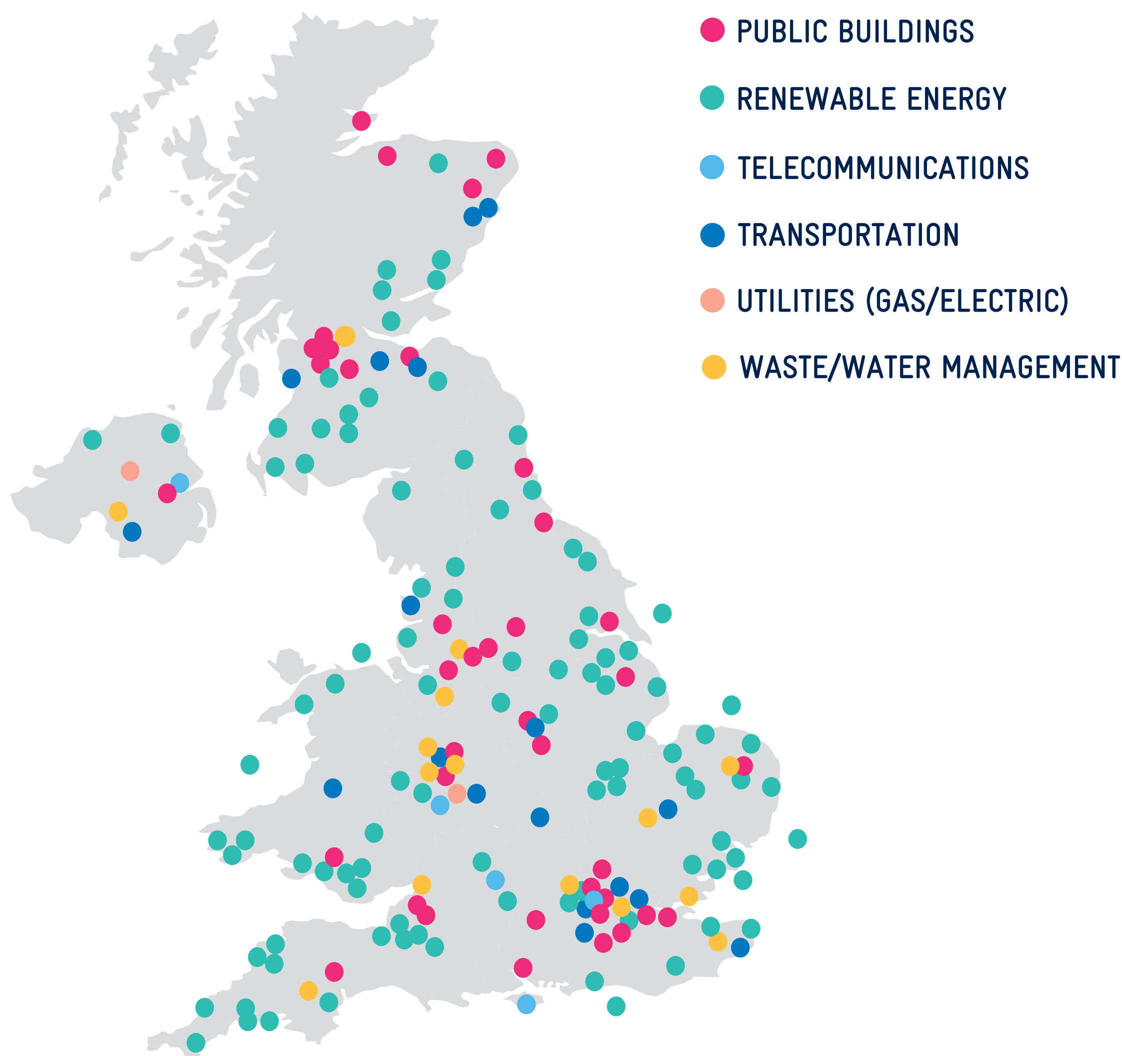
Infrastructure investments can broadly be categorised as economic, which include investments in renewable energy, utilities, transport and telecommunications, or social, which includes public health, education and building, construction and maintenance. It is estimated that the majority (65%) of infrastructure investments are invested in economic projects and a third (35%) are in social projects. IA data suggest that there has been growth in investment by IA members in social infrastructure projects over 2023 including investment in schools in Lancashire and London and in some economic projects including financing renewable energy and the UK fibre-optic network.

As of December 2023, UK asset managers held an estimated £45 billion in infrastructure projects, consistent with the 2022 AUM. From 2022, we have asked member firms to report all infrastructure investments regardless of where the portfolio manager is located.

Though limited to a selection of projects, Figure 8 maps out the types of infrastructure projects facilitated by IA members on behalf of their clients. These investments appear across the length and breadth of the UK, although investments in public buildings are often clustered around major cities.

Renewable energy projects make up a significant proportion of investment in UK infrastructure, which mainly consist of offshore and onshore wind farms. The new Government's election pledge to remove some of the planning obstacles to building onshore wind farms may drive an increase in investment and the development of onshore wind farms. In 2022, we have seen an increase in investment by IA members in social infrastructure projects including in new schools around the country. The map does not cover nationwide initiatives that span the UK but these are a significant area of investment for IA members and include regional waste and water management services, national grids for the provision of fibre broadband and international transportation networks.

FIGURE 8: SELECTION OF UK INFRASTRUCTURE INVESTMENT FACILITATED BY IA MEMBERS (2022)



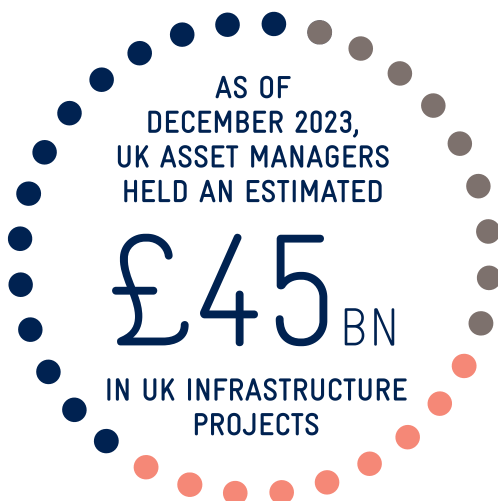
ONGOING FOCUS ON LIQUIDITY MANAGEMENT

The focus on how to better manage liquidity in open-ended investment funds gained urgency in 2016 following the Brexit referendum when UK direct property funds were forced to suspend in order to meet investor redemption requests. The debate around opening up access to investing in private markets has also reinforced the importance of effective liquidity management in open ended fund structures.

In the near term, a combination of events since the beginning of the pandemic have highlighted the importance of liquidity management in different ways:

- The March 2020 'Dash for Cash' sparked a renewed debate between industry and regulators globally about liquidity measurement and management. In the mainstream investment fund universe, the dynamic illiquidity of corporate bonds was a particular focus for regulators. Investing in direct property, an inherently illiquid asset, was also in the spotlight as funds again had to suspend because of an inability to fairly value commercial property under the conditions of lockdown.
- The start of the Russia/ Ukraine war in February 2022 caused significant challenges for assets held in Russia, Ukraine and Belarus. This initiated a rapid review of the extent to which investment funds had the necessary tools to separate what had become untradeable assets from the rest of the fund. While some jurisdictions had measures in place to permit side pockets where funds could ringfence Russian assets and then wind them down, further work was undertaken by regulators and industry at speed in the UK to enable this.
- Following the UK Fiscal Event of late September 2022, an unprecedented spike in gilt yields created a severe challenge for liability driven investment (LDI) strategies – in both segregated and pooled vehicles – in meeting collateral calls against derivative instruments used to hedge liability risk for DB pension schemes (see chapter 4).

While separate issues requiring distinct approaches to resolution, the 'Dash for Cash' and LDI market turbulence have led to significant central bank concern in the UK about the significance of Non-Bank Financial Institutions (NBFIs) to financial stability. The industry has been closely engaged on ensuring appropriate approaches are put in place to address the challenges arising.



LIQUIDITY MANAGEMENT IN CONVENTIONAL INVESTMENT FUNDS

The focus for the Bank of England, UK financial regulators and other regulators internationally is on a coordinated global regulatory reform agenda to support more effective liquidity management.

In December 2023, the Financial Stability Board and International Organisation of Securities Commissions (IOSCO) published Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds. There are four key recommendations:

- **Fund liquidity bucketing:** the revised recommendations place funds into three buckets based on the liquidity of the assets held (e.g. liquid, less liquid and illiquid). The liquidity bucket that a fund is placed in will inform its redemption terms and conditions with less liquid funds moving away from daily dealing. This recommendation is intended to achieve greater adoption of anti-dilution liquidity management tools (LMTs)[12] and consistency in the use of anti-dilution LMTs in normal and stressed market conditions.

- **Availability of liquidity management tools:** this recommendation emphasises the need for authorities to make available a broad set of LMTs for use by funds in both normal and stressed market conditions.

- **Use of anti-dilution LMTs:** this recommendation aims to increase the use of anti-dilution LMTs and make use of LMTs more consistent in both normal and stressed market conditions. The FSB attempts to achieve this by imposing the explicit and implicit costs, including of any significant market impact on redeeming investors. UK authorised funds already use anti-dilution LMTs as part of their day-to-day management but use is not as widespread as in other jursidictions.

- **Disclosure:** to improve investor awareness of liquidity management measures, the FSB will require clearer public disclosures from managers on the availability and use of LMTs in normal and stressed market conditions.

In the UK in June 2024, the Bank of England announced that it was undertaking the second round of its system-wide exploratory scenario exercise (SWES). This exercise is aimed at better understanding the behaviours of banks and NBFIs[13] in stressed conditions. It is designed to help the Bank understand the risks in the system and how different actors interact. The results of this exercise will be published at the end of 2024.

The UK industry is broadly supportive of the objectives of strengthening the liquidity management toolkit available to fund managers, although still stresses that funds are not the central drivers of redemptions during crises. The implementation of new standards of liquidity management combined with the ability of investment platforms to accommodate tools such as notice periods, where investors have to give notice before a redemption rather than being able to deal that day, will shape the evolution of the liquidity management toolkit. This will affect the way in which access is provided to less liquid asset classes and strategies such as direct property or private assets in the DC and retail markets.

[12] Liquidity management tools include tools such as swing prising or anti-dilution levies. Swing pricing is designed to protect existing investors in the fund from the costs incurred when other investors buy or sell units in that fund. A dilution levy is an explicit charge that a fund manager can choose to apply to a client's dealing or trading activity. It is designed to counteract the effects of a 'dilution' or reduction in the net asset value of the fund due to dealing costs.

[13] Investment managers fall into the category of NBFI.

BOX 5: DEEPENING ACCESS TO PRIVATE MARKETS, AMIDST REFORM TO PUBLIC MARKETS

Private market assets have seen significant growth globally over the last decade. Preqin data sizes global assets under management in alternative investment strategies at $17 trillion in 2023, up from $7 trillion in 2010. However, as we move into a new economic cycle and leave behind the benign conditions of the last decade where low interest rates and quantitative easing helped to support asset growth in public and private markets, we must determine how the growth in private markets could be affected by the shift to higher interest rates.

“Private equity has been favoured by strong tailwinds of falling interest rates. It's not a growth business over the next 10 years. For a lot of people, it's going to be a shrinking business because there's going to be a very difficult refinancing period for some of the existing investments.”

Over the past decade, investors have also experienced low yields from conventional fixed income - private credit, infrastructure and real estate have provided a diversified yield. This is changing as interest rates have risen, substantially improving bond yields. This could dampen the search for diversified sources of yield through private markets, although in 2024, it is likely that we have reached the peak of the interest rate cycle and rates will come down.

Structurally, however, there remain important drivers of growth in private markets. There are simply fewer companies listing and many companies are choosing to stay private for longer, which means that private equity and venture capital offers the opportunity to investors to access companies through their lifecycle of development and growth. In private credit, high capital requirements under Basel III for banks is also reducing the appetite of banks to lend to companies and private credit is providing vital private lending.

“There has definitely been a rotation to private credit. It makes sense because there has been a huge amount of readjustment and companies have not been able to deal with some of the repayment cycles.”

Private investment can also play a key role in helping the Government to meets its levelling up and net zero objectives, supporting infrastructure and social projects. According to the UK’s National Infrastructure Commission, around half of infrastructure investment is financed and delivered through the private sector, with much of this being delivered through private markets funding. The Government’s Net Zero Strategy estimates that an additional £50-60bn per year in capital investment will be needed in order to achieve net zero, with most of this coming from private capital. The development of a National Industrial Strategy, to complement the work of the National Infrastructure Commission, should help to unlock investment opportunities in UK infrastructure.

“Approximately 64% of institutional investors are still looking to increase allocation to private markets over the next two years. That's been a great area for us and there are lots of positive trends out there in the UK. The Mansion House Compact, the Solvency II reform, and potential National Growth Fund of a new government are all very positive for increasing institutional investment into private markets in the UK against the positive backdrop of lower interest rates and inflation.”

Private markets are structurally now a much more significant part of the investing landscape and this is reflected in the emergence of new vehicles that are designed to better accommodate less liquid private assets such as the UK Long-Term Asset Fund (LTAF) and the overhauled EU vehicle, the European Long-Term Investment Fund (ELTIF). It is perhaps an inevitable consequence of the growth in private markets that regulators are now scrutinising liquidity, fee structures and the valuation of private assets more closely. In March 2024, the FCA sent a Dear CEO letter to investment managers announcing

its intention to review the way that investment funds value private assets. This reflects a maturing market.

"You have got private assets that are locked up for a 10-year period and you can in many ways determine the price because you're best placed, you know the company and investors better than anyone else....The experts that really truly know how to value private assets are the actual owners."

Tokenisation also has the potential to transform access to private assets by bringing down minimum investment levels and allowing fractionalisation to help to improve liquidity.

The shift to greater private market finance requires a range of measures to open up demand and one critical element for broadening the UK customer base will be DC pension scheme participation, which has been constrained historically by a range of factors including:

- A highly cost-focused investment governance process, which does not easily accommodate access to alternative asset classes;
- An incomplete set of fund vehicles for pooled investment;
- Insufficient scale for certain kinds of direct investment; and
- A distribution infrastructure focused predominantly on providing access to daily-dealing investment funds.

"I'm convinced that alternatives will continue to be an asset class that is looked at very carefully by institutional investors. It's an area in which I would expect the pension sector in the UK will have more appetite for risk."

As we embrace the new Government's vision of driving UK economic growth, our industry is ready to deploy capital for attractive investment opportunities but this also requires the UK to address the shortage of investible projects that have hampered growth in recent years.

However, some of these obstacles are now being addressed in the UK, notably:

- The authorisation and launch of the first Long Term Asset Funds (LTAFs) in the UK.
- The publication of rules allowing broader distribution of LTAFs to retail investors, including advised and discretionary managed retail investors by enabling LTAFs to be held in ISAs.
- The completion of the Productive Finance Working Group's work to facilitate greater access to private markets for DC decision makers.
- Further momentum to deliver the Autumn 2022 Mansion House reform agenda to unlock pension capital so that it can flow into UK companies including private assets.

Both DB and DC schemes are cautious – understandably – about the kinds of funding needs that they are prepared to support and are sometimes critical of prevailing fee structures. There remains quite a significant road to travel to engineer the cultural shift necessary to embed greater private market investment into DC default strategies. Further challenges remain in operationalising access to private assets as firms grapple with infrastructure that is not set up to cater to differing notice periods and new fund structures. The investment industry will be engaging closely with policymakers and regulators to facilitate further change.