Alpha Real Capital

ALPHA REAL CAPITAL WARNS THAT PENSION SCHEMES TARGETING BUY-OUTS MAY BE MISSING OUT ON THE ILLIQUIDITY PREMIUM

Alpha Real Capital ("Alpha"), the specialist manager of secure income real assets, is warning that defined benefit pension schemes targeting buy-out may be unnecessarily avoiding illiquid assets. They may be investing sub-optimally as illiquid assets not only bring return benefits but can be a good source of assets that match inflation linked liabilities. They also bring resilience to pension scheme portfolios. These illiquid assets include commercial ground rents and various types of private credit and infrastructure assets.

The reason pension schemes tend to avoid illiquid assets is a feature of the bulk-buyout market that Alpha has termed the 'Liquidity Kink'. While illiquid assets are attractive to buy-out providers to back the liabilities they take on from pension schemes, providers typically only accept cash or UK government bonds as part of the buy-out transaction. This means pension schemes are shying away from buying these assets if they are targeting buy-out and therefore have portfolios that carry more risk than they should.

Alpha contends that pension schemes targeting buy-out should still consider illiquid assets. This is based on a closer look at the illiquid assets and input from K3 - the buy-out advisory business - who point out that the typical buy-out transaction can take eight months or more and there are a number of options to allow for illiquid assets when transacting. All of this means it is worthwhile for schemes to consider illiquids even if buy-out is the end goal.

Shajahan Alam, Director, CDI at Alpha Real Capital said: "Our research shows that the demand for and use of illiquid asset classes is strong and still increasing. This is understandable given the attractive returns and cashflow matching characteristics of the assets. However, we often see schemes that are targeting buy-out dismiss illiquid asset classes. The primary reason for this is that insurers will typically only take cash and gilts as part of a buy-out transaction. This is the case even though insurers themselves invest in illiquid assets. We have termed this phenomenon the 'Liquidity Kink' as it forces pension schemes to invest sub-optimally, potentially making the journey to a scheme's end game longer or more risky than it could be."

Boris Mikhailov, Head of Client Solutions at Alpha Real Capital said: "Although the 'Liquidity Kink' is an unwanted dynamic of the market, whether schemes targeting buy-out can still benefit overall from investing in some level of illiquid assets is more nuanced, and it requires more detailed analysis before being dismissed. Illiquid assets can be a key part of an end-game portfolio to allow a pension scheme to accelerate its path to buy-out or make the journey less risky."

However, the good news is that long-term both Alpha Real Capital and K3 expect the liquidity kink to become less prevalent. Currently the UK Government and the insurance regulator (the Prudential Regulation Authority (PRA)) are looking at various aspects of how insurers are regulated. In particular, the Government is keen for insurers to be investors for good in rebuilding the UK economy and making it a greener one, some estimate that this should make it easier for insurers to invest in a wider range of illiquid assets, unlocking up to £90bn of insurer capital. This could in turn help with the liquidity kink.

Adam Davis, Managing Director of specialist buy-out advisory firm K3 Advisory, said: ""Over time I expect insurers and pension schemes to become even more aligned in investment approach and insurers to become more flexible in their willingness to take on assets from schemes that buy-out. This will help to reduce the current liquidity kink that exists for schemes looking to buy-out."

Alpha says it is worth considering illiquid assets even if a scheme is targeting a buy-out, as they may be missing out on returns and carrying unnecessary risks of not reaching that goal.

Alpha Real Capital has published a paper entitled "Are pension schemes missing out on the illiquidity premium?" which looks at these issues in more detail. It includes two check lists – one on asset considerations and the other on structural options for pension schemes planning for buy-outs. It can be downloaded by clicking here **(**https://bit.ly/3wdPkUT**)**.

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About Alpha Real Capital (https://alpharealcapital.com/)

Alpha is a specialist real assets investment manager focussed on secure income strategies. The firm invests in UK and European assets with predictable secure long-term cash flows. Alpha provides market leading and innovative real asset solutions across a range of investments such as commercial ground rents, UK renewable infrastructure, social infrastructure, and secured lending, combining operational real estate expertise and fixed income skills.

Alpha has a 160 plus strong professional team with over £4.7 billion of assets under management, including capital commitments.

Alpha operates across diversified investment markets: listed and unlisted property vehicles, open and closed ended property vehicles, UK, and international funds, working with large institutional investors as well as private investors, family offices and wealth managers.