NEWFINANCIAL
Rethinking capital markets

UNLOCKING THE CAPITAL IN CAPITAL MARKETS

ANALYSIS OF THE SHIFT IN RISK APPETITE & INVESTMENT AWAY FROM EQUITIES OVER THE PAST FEW DECADES BY UK PENSION FUNDS

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by William Wright

> This report highlights the dramatic shift over the past 25 years in the risk appetite and asset allocation of nearly £3 trillion in UK pension funds. The sharp drop in their allocation to the UK stock market since 1997 - from 53% to just 6% - is one of the fundamental structural challenges facing capital markets in the UK and it will require a renewed and concerted focus to change course.

Upstream vs downstream

Over the past few years, a huge amount of work has been done by the UK government, regulators, and the industry to reboot the framework for banking, finance, and capital markets to ensure that it is both competitive on the global stage and better able to support the UK economy. Much of this work - such as the listings review, the secondary capital raising review, and the Edinburgh Reforms package - and much of the debate around it has focused on what we call 'downstream' issues, such as changes to regulations to remove obvious barriers to more effective capital markets.

While this work is hugely valuable, the underlying challenges facing UK capital markets and the UK economy are much further 'upstream' than the detail of the listings regime. These embedded structural issues have been decades in the making - and none more so than the dramatic shift in risk appetite and investment by UK pensions over the past 25 years away from equities (and away from the UK stock market in particular) into bonds.

In our view, this structural shift - effectively sucking huge amounts of natural demand out of the UK market - has been one of the main causes of the challenges faced by UK capital markets today. While it is important to address the 'downstream' issues, they are not the root cause of the problem so addressing them will not solve it.

This short paper outlines the scale of this shift; compares the UK with other developed pension systems around the world; drills down into the asset allocation of different types of pension to uncover some positive news; identifies some of the main drivers behind it; and outlines some potential solutions. In theory, investors with long-term time horizons and long-term liabilities like pension funds should be ideally placed to invest in long-term productive assets like listed and unlisted equity to both generate returns for their members and to support the UK economy. In practice, we found that:

> Over the past 25 years, UK pension funds have reduced their allocation to equities from 73% to 27% - and they have slashed their allocation to UK equities from 53% to just 6%.

> Over the same period, they have quadrupled their allocation to bonds to 56%. UK pensions now have the highest allocation to bonds and lowest allocation to equities of any comparable pension system in the world.

> Since 2000, the share of the UK stock market owned by UK pensions and insurance companies has fallen from 39% to just 4%. And just 1% of the £4.6 trillion in pensions and insurance assets is invested in unlisted UK companies.

To be fair, pension funds and insurers have not so much lost their risk appetite as had it kicked it out of them over the past few decades by the cumulative impact of well-intended reforms to accounting standards, regulation, and tax. At every turn, they have responded rationally to the incentives and disincentives in front of them. It is also important to stress that there is no silver bullet to reverse course, and that much of the pensions money that has been sucked out of the UK equity market is not coming back.

While the headline numbers look bleak, we think there is a huge opportunity ahead to build on the strong foundations for pensions and insurance in the UK (the second largest pool of long-term capital in the world) and restructure the system to incentivise, enable, and empower pensions to invest more in productive assets. Given the importance of driving investment in every corner of the UK, it is vital for government and the industry to work together to develop a long-term sustainable plan - ideally with cross-party support - that may well need to include more radical reforms than have so far been proposed.

In this paper we have tried to reconcile different definitions and taxonomies across a wide range of complementary but sometimes conflicting data sources, building on our first attempt a few years ago to map out the problem. Our estimates may well be a few percentage points out here and there, but the direction of travel is clear. We have made some quite big assumptions, and no doubt some quite big mistakes, which are entirely my own. The data in this report was prepared for the UK's Capital Markets Industry Taskforce, but the report and analysis should not be taken as representing its views.

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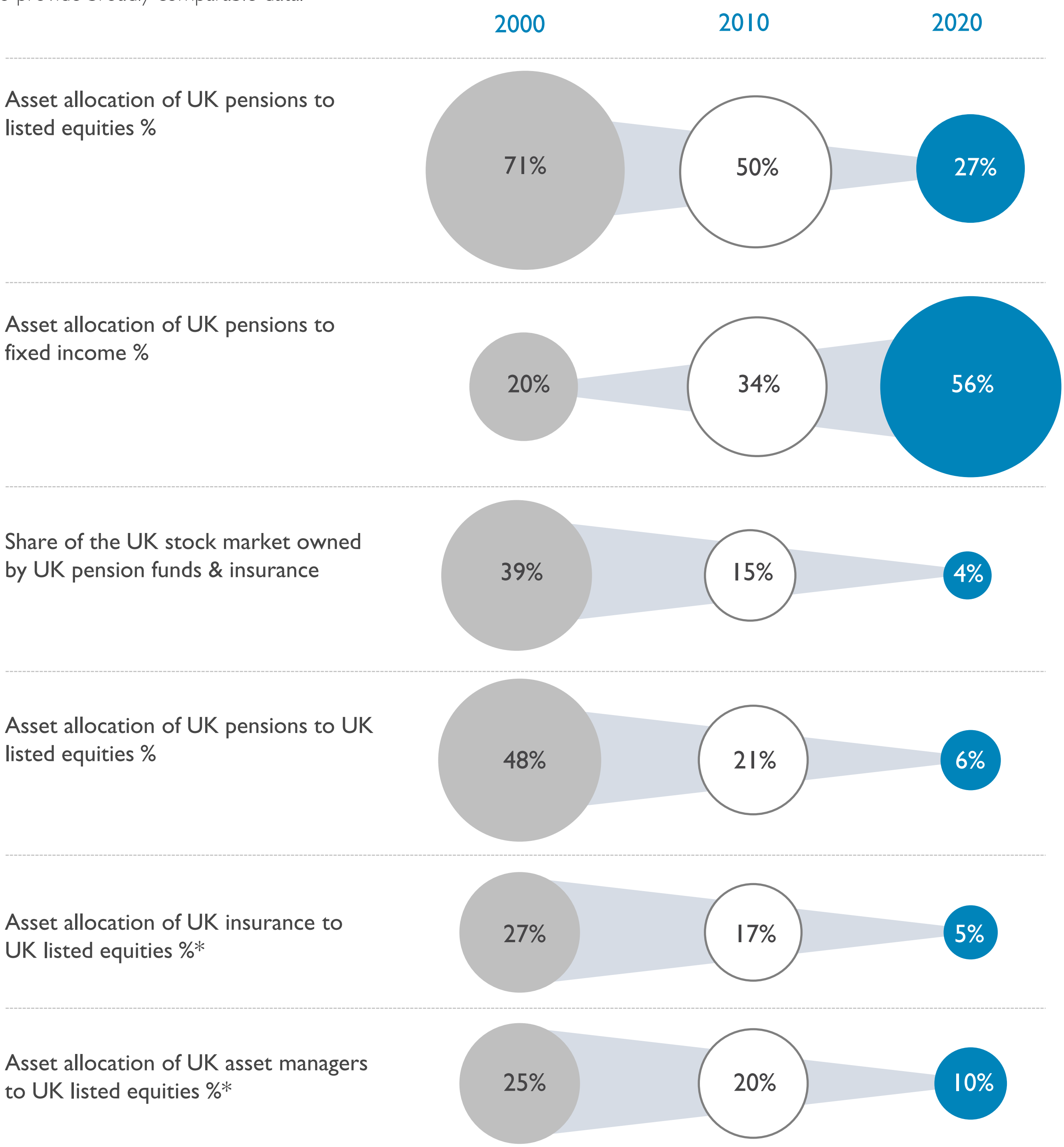
THE HEADLINE SHIFT IN INVESTMENT

Fig.1 A wholesale shift

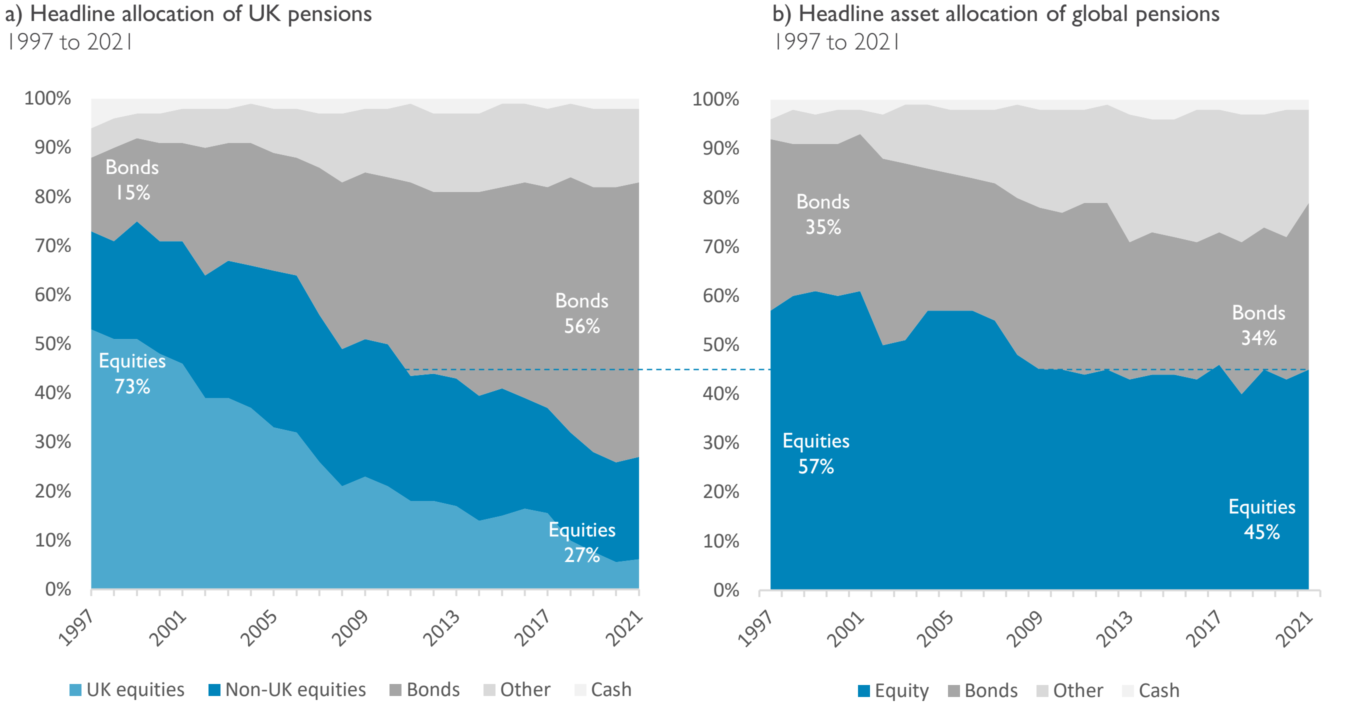
This chart summarises the dramatic shift in investment by UK pensions, insurers, and asset managers away from equities (and particularly UK equities) and into fixed income over the past 20 years. We have used 2000 as our starting point for this chart to provide broadly comparable data.



Source: New Financial analysis of data from the ONS, LGPS Advisory Board, PPF, UBS, & Willis Towers Watson
** Earliest consistent data for UK insurers and asset managers is from 2002*

Fig.2 Falling behind

A comparison of the headline asset allocation of UK pensions with the global average



Source: New Financial, ONS, LGPS Advisory Board, PPF, Willis Towers Watson, UBS

Source: Willis Towers Watson

Bringing up the rear

A good place to start in thinking about the risk appetite and asset allocation of UK pensions is to compare how things have changed over the past 25 years in the UK - the second largest pool of pensions in the world after the US - with other markets that have highly developed pensions systems. The charts above show the headline asset allocation between equities and bonds from 1997 to 2021 in the UK (Fig.2a on the left) and a universe of the seven largest pensions markets on the right based on our analysis of an annual study by the Thinking Ahead Institute, part of Willis Towers Watson.

It is striking that 25 years ago UK pensions had a significantly higher allocation to equities than the global average (73% vs 57%) and a significantly lower allocation to bonds (15% vs 35%). In the decades since, the UK allocation to equities has fallen to just 27%, compared with a more gentle decline in the global average to 45% (in the US, for example, pension funds have more than 50% of their assets in equities). Over the same period, the UK allocation to bonds nearly quadrupled to 56%, while the global average remained relatively constant at around 35%. The UK system now has the lowest allocation to equities and the highest allocation to fixed income of any of the seven biggest markets.

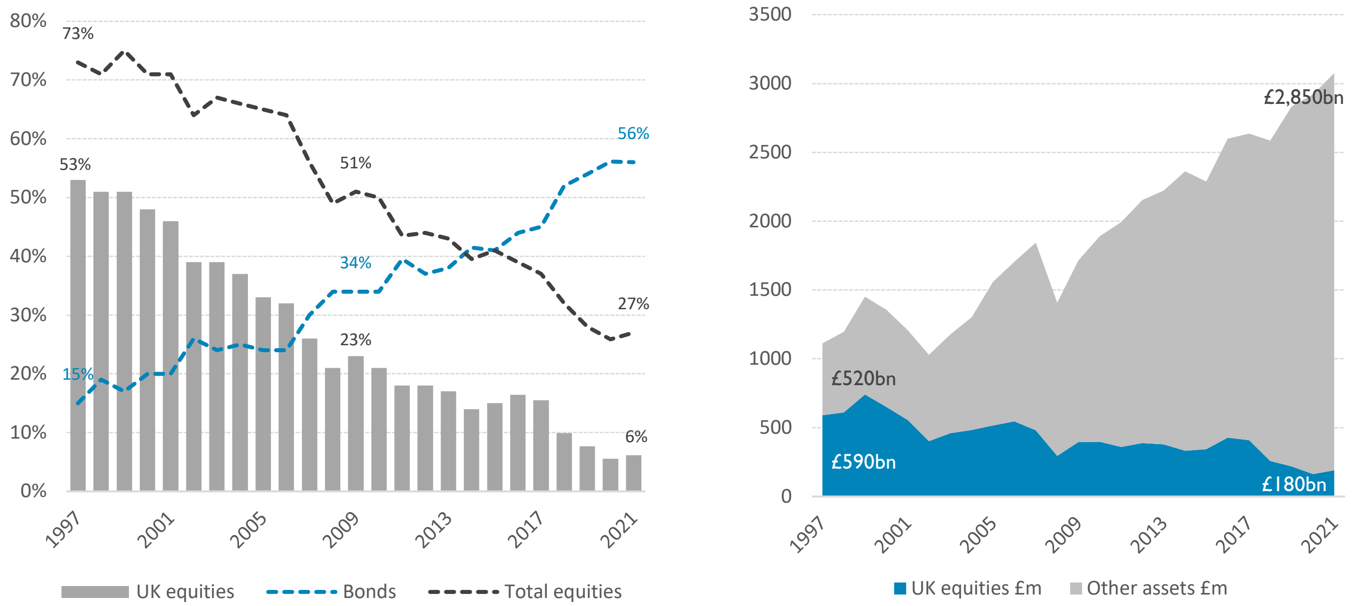
While it started in the lates 1990s, this shift only really took off after the financial crisis: the allocation to equities by UK pensions dipped below the global average in 2010 (as shown by the dotted blue line) and has continued to fall since. Over the past decade, Dutch and Swiss pensions have increased their allocation to equities; Australia, Japan, and the US have remained constant; and only Canada has reduced its equities exposure (though this has been offset by a significant increase in its allocation to unlisted equities and alternatives). It is also striking to see a significantly lower proportion of pensions assets in the UK invested in other assets, such as hedge funds, private equity, and infrastructure. In the UK we estimate this adds up to about 11%, little more than half the global average of 19%.

Fig.3 Going down

The change in the allocation of UK pensions to equities over the past 25 years

a) Allocation of UK pensions to UK equities, all equities & bonds
1997 to 2021

b) Value of UK pensions assets
1997 to 2021 in real terms (2022 money)



Source: New Financial analysis of data from the ONS, LGPS Advisory Board, PPF, Willis Towers Watson, UBS

A shift away from the UK

If you are surprised by the tiny proportion of UK pensions asset invested in UK equities, then you haven't been paying attention. Over the past 25 years, the overall asset allocation of UK pension schemes to the UK stock markets has fallen relentlessly from 53% in 1997 to just 6% in 2021, based on our estimates (see Fig. 3a). Over the same period, their headline allocation to equities has dropped by nearly two-thirds from 73% to 27%, and their headline allocation to bonds has nearly quadrupled to 56%.

This has real world consequences: in real terms, the value of UK pension assets has roughly tripled since 1997 to just over £3 trillion in 2022 money (see Fig. 3b). Over that period, UK pension schemes have reduced their exposure to UK equities by 70%, sucking roughly £400bn of demand in real terms for UK equities out of the market. Meanwhile, they have increased their exposure to other assets by more than £2.3tn, a fourfold increase. We do not have consistent data on investment in unlisted UK equities. However, we know that corporate DB schemes increased their allocation to unlisted equities from 1% in 2009 to just over 4% in 2021, and we estimate that roughly one third of that is invested in UK companies.

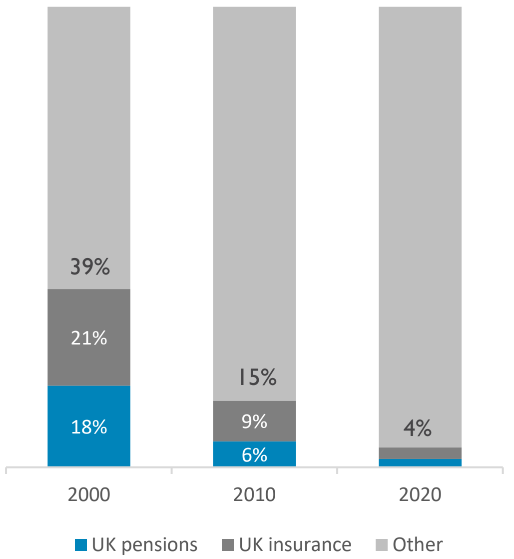
It is striking that the reduction in allocation to UK equities has been more pronounced than the overall allocation to equities: in 1997, UK equities accounted for more than 70% of all exposure to equities by UK pension funds. Fast forward 25 years and the UK market represents just a fifth of equity investment. The main driver for this change has been the wholesale closure of corporate defined benefit schemes (the largest single component of UK pensions with around £1.7tn of assets) in response to changes in accounting standards and regulation. Only 10% of corporate defined benefit schemes are open to new members, and their headline asset allocation to bonds has gone from 15% in 1997 to 72% today. A lot of this money is never coming back. But what if changes to tax, regulation, and accounting standards over the next 10 years were able to rewind the clock to where asset allocation was 10 years ago? That would translate into an injection by UK pensions of more than £360bn in today's money into the UK stock market.

THE DECLINE IN INVESTMENT IN UK EQUITIES

Fig.4 Investing in UK plc

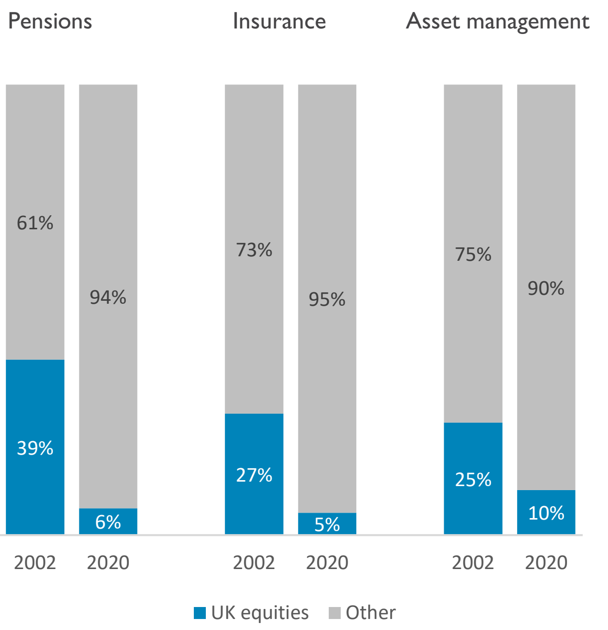
The decline in ownership of UK plc by pensions, insurance companies, and asset managers over the past 20 years

a) Share of UK stock markets owned by UK pensions and insurance
2000 to 2020



Source: ONS

b) UK institutional asset allocation to UK equities
2002 to 2020



Source: New Financial, ABI, IA, ONS, LGPS, PPF

A concerted shift

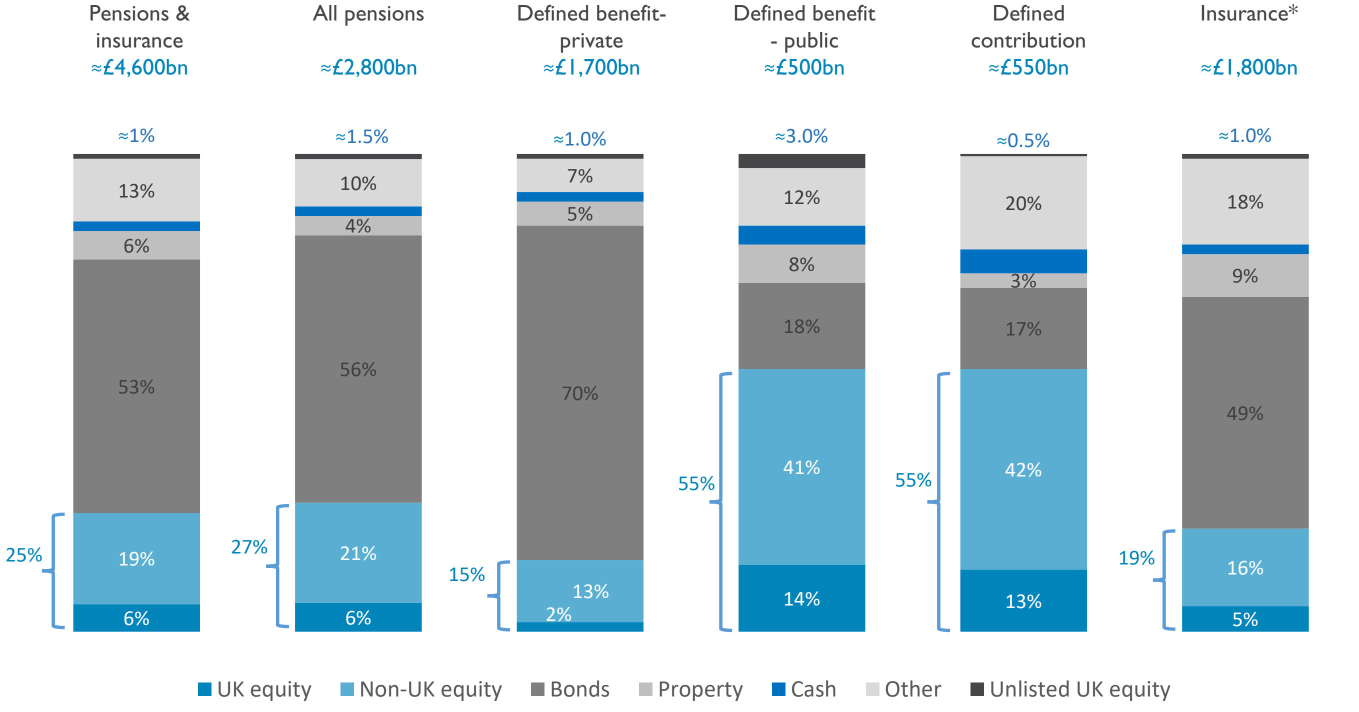
Another way of thinking about this shift in asset allocation is to look at the share of the UK stock market that is owned by UK pension schemes and insurance companies. Back in 2000, pension funds and insurance companies owned 39% of the UK market between them, according to data from the ONS. By 2020, this had slumped to just 4% (see Fig. 4a). In other words, UK institutional investors have effectively vacated more than a third of the UK market. This gap has been filled by investors from overseas, such as non-UK pension funds: their share of the UK stock market has increased from 36% in 2000 to more than 56% in 2020. This reduction in natural demand for UK equities risks creating a self-fulfilling downward spiral: selling by UK pensions and insurance companies reduces valuations, which reduces the weight of the UK in global indices, which reduces demand, which reduces valuations…and so on.

Pension funds are not alone in this dramatic shift: over a similar time period, asset managers and insurance companies in the UK have also significantly reduced their asset allocation to UK equities (Fig. 4b). In 2002, UK-based asset managers who were members of the Investment Association invested around a quarter of their assets under management in UK equities, but this has since more than halved to just 10% in 2020. This shift mainly reflects the changing demands of their biggest clients (UK pension funds), and the growth and internationalisation of the industry.

With insurance, we estimate that the total allocation to UK equities has fallen more sharply, from a total of 27% in 2002 to just 5% in 2020. Both figures are higher that the stated headline allocation to UK equities in the annual state of the market report by the ABI (of 24% in 2002 and 4% in 2020), but we have adjusted the figures for the industry's stated allocations to unit trusts. A combination of the internationalisation of the investment industry, the poor performance of UK equities, changes in regulations, and higher capital requirements for insurers have contributed to this dramatic institutional shift away from UK equities.

Fig.5 A more detailed picture

Estimated asset allocation of different pools of long-term capital in the UK in 2021 (approximate value of assets in blue)



Source: New Financial, ONS, LGPS Advisory Board, PPF, ABI

** Insurance asset allocation as of 2020*

The wrong sort of assets?

The problem is that while there is no shortage of pensions and insurance assets in the UK, most of it is invested in the 'wrong' sort of assets. Our analysis in Fig.5 shows that just 6% of the £4.6tn in pensions and insurance assets in the UK is invested in UK listed equities, with roughly 1% invested in unlisted UK equities (such as private equity or venture capital). Only a quarter overall is invested in equities, just over half is invested in fixed income, and the rest is held in property, alternatives, and cash.

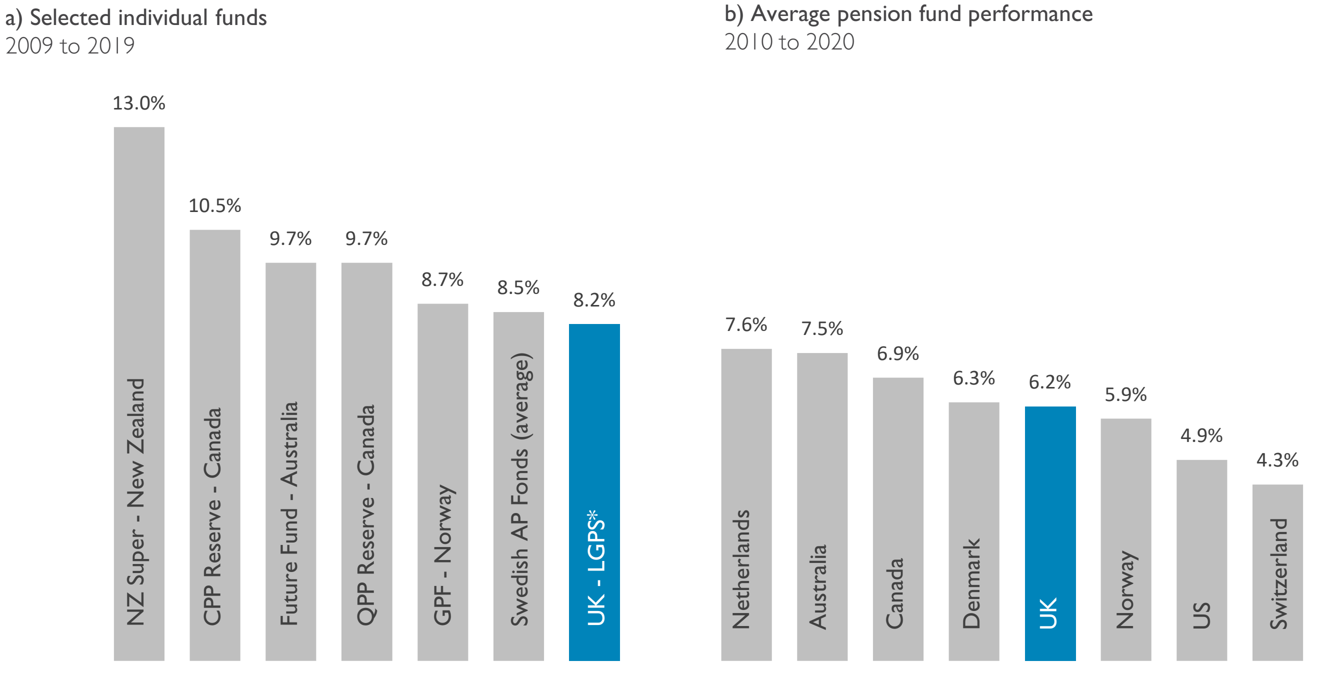
The chart provides a broad breakdown of the asset allocation to UK equities, other equities, fixed income and other investments in each of the main 'buckets' of pensions and insurance. The main reason for the low overall allocation to UK equities by pension funds is that the headline figure is dragged down by private sector DB pensions (the largest component of pensions with roughly £1.7tn in assets) which allocate less than 2% of their assets to UK equities.

There is some good news: public sector DB pensions and defined contribution pensions have a very different risk appetite and a much higher allocation to equities (and to UK equities). They each have about 55% of their assets in equities, with around a quarter of that in UK equities. This profile is much closer to the asset allocation of private sector DB schemes 15 to 20 years ago before they started closing en masse, and reflects the fact that both public sector DB and DC schemes are 'open' in the sense that employers and employees are still paying in contributions.

The bad news is that both 'buckets' are relatively small (at about £500bn each) and fragmented. For example, as of March 2021, the Local Government Pension Scheme had combined assets of £410bn in the UK but this is split between 100 separate pension funds. On the defined contribution side, there are nearly 27,000 schemes in the UK. This fragmentation reduces the efficiency of the schemes, limits their investment horizons, and eats into returns.

Fig.6 Bringing up the rear

Annualised 10 year returns for a selection of pension schemes and countries



Source: New Financial, OECD, LGPS Advisory Board

A real world cost?

This paper has highlighted what we think is one of the fundamental 'upstream' structural challenges facing the UK capital markets: the wholesale shift in asset allocation away from equities and UK equities over the past 25 years that has sucked natural demand out of the market and contributed to a more risk averse investment culture in the UK. This would matter less if UK pension funds were knocking the lights out in terms of returns to help generate a more prosperous retirement for their members.

Unfortunately, this does not appear to be the case. UK pensions appear to be firmly in the bottom half of the pack when it comes to their performance, according to data from the OECD (which we think should be treated with a degree of caution given the difficulty in comparing pension funds in different countries). Fig.6 shows the 10 year annualised returns for a selection of individual pension funds and the average returns by country over slightly different periods. At a country level, the average for the UK is 6.2% a year, some way behind the Netherlands, Australia, and Canada, but ahead of Norway, the US (where the figure of 4.9% looks odd) and Switzerland. This performance gap matters: over 30 years, it translates into Dutch pensions being worth 50% more than their UK counterparts - and that is before you even get into the issue of the higher costs of running the fragmented UK system eating into returns.

At an individual fund level, it is striking to see that some of the largest funds that continue to invest heavily in equities, alternatives, and other return seeking assets have generated much higher long-term returns. The New Zealand Superannuation Fund (which invests 52% of its money in equities and a further 18% in private equity, infrastructure, and alternatives) posted the highest return with 13%. It is also interesting to note that LGPS schemes in the UK (which have a 55% allocation to equities) generated a 10 year annualised return of 8.2%, significantly higher than the UK average and in line with some of the best performing individual funds. This is an area on which we will be conducting more research in the coming year.

Drifting upstream

Here is a summary of some of the main drivers of the shift in risk appetite and asset allocation in UK pensions over the past few decades:

- **Closing the door:** the biggest single cause of the shift away from equities by UK pension funds over the past 25 years has been the wholesale closure of most corporate defined benefit schemes. From the 1990s onwards, many companies started to close their schemes to new members or to new contributions over concerns around the cost of employer contributions (often in the region of 15% of salary). With no new contributions coming in the door, these schemes de-risked and focused more on investing to ensure they meet their future cashflows and less on return-seeking investments such as equities and alternatives to increase the value of the scheme.

  Today, 90% of corporate defined benefit schemes in the UK are either closed to new members or to new benefit accruals, according to the Pension Protection Fund (compared with 34% in 2006). There are just 930,000 active members of corporate DB schemes in the UK paying contributions into their pensions (along with their employer), down from 3.6 million back in 2006. Unless companies reopen these schemes - which is unlikely to happen - this money is not coming back into UK equities.

There are three main causes behind the rush to close the door on most of these schemes:

- **Changes in accounting standards** and the treatment of pensions (such as FRS 17 in 2001 and FRS 102 in 2014) moved the risk of a scheme onto a company's balance sheet. A big deficit in an underfunded scheme became a drag on a company's P&L and accelerated the trend to shut them down. Under these new rules, investing in equities became significantly less attractive.

- **Regulatory and tax changes** over the past few decades underpinned this shift. For example, changes to the tax recoverability on dividends in 1991 and the abolition of advanced corporation tax dividend tax credits in 1997 - along with constant tinkering with allowances, reliefs and tax rates - significantly reduced the attractiveness for pensions of investing in pensions. In insurance, Solvency II increased the cost of investing in equities.

- **A shift in thinking** around the financial theory pensions from the late 1990s onwards triggered a wholesale shift among actuaries and pension consultants about how to measure the liabilities of schemes and a transition from focusing on asset growth to matching future cashflows (by investing, for example, in index-linked gilts).

In addition, several other factors have contributed to the shift:

- **A self-fulfilling downward spiral:** the wholesale shift away from equities (and UK equities in particular) has created a self-fulfilling downward spiral. Concerted selling by a large part of the market to reduce their allocation reduces a large source of natural demand, which reduces valuations, which reduces the weight of the UK market in global indices, which reduces demand, which….and so on.

- **Structural problems:** if you were designing the UK pensions system from scratch, you probably would not start from here. There are more than 5,200 defined benefit schemes in the UK with combined assets of £2.1 trillion - an average of just under £400m per scheme. The LGPS scheme may be a bright spot in UK in terms of equity investment (with 2 million active members and an allocation to equities of 55%) but it is fragmented with 100 schemes across the UK. Meanwhile, defined contribution pensions are ludicrously fragmented with around £550bn spread across nearly 27,000 schemes. While it is great (or at least better than nothing) that more than 26 million citizens now have some form of DC pension, contributions are woefully low (3% employer, 5% employee) to generate the scale needed. It is almost as if the UK managed to accidentally kill off DB pensions before it had something else ready to replace it.

Unlocking productive investment

A full analysis of potential solutions is far the beyond the scope of this report: this paper focuses instead on where we are now and how we got here. However, here is a selection ideas that would help reverse the shift in risk appetite of the past 25 years and help enable and empower pensions in the UK to invest more in productive assets. Addressing these issues will be a core part of our work at New Financial in the coming year:

- >>> **Topping up the pool:** a short-term priority should be to get more money into the pensions system by expanding the number of people saving for their retirement and encouraging them to contribute more to their pensions. Removing the age and earnings limits on auto-enrolment is a good start, as would gradually raising contributions from employer (3%) and employees (5%) over time to something closer to 15% to 20% combined.

- >>> **More efficient pools:** existing pools of capital could be made significantly more efficient. For example, the government should accelerate its approach to consolidating DC schemes ('consolidate or explain') and expand it to the thousands of small and inefficient DB schemes. The government could consider using tax or administration costs as a lever: one idea that has been recently floated is to remove capital gains tax relief for schemes under a certain size or which invest less than a particular proportion of their assets in the UK.

- >>> **A structural shift:** a common thread running through many of the most sustainable pensions systems in the world is that they are dominated by large, industry-wide schemes. In the Netherlands, for example, schemes are run mainly at an industry level, and more than 60% of pensions assets are managed by just seven funds. A good place to start would be the 100 public sector LGPS schemes across the UK: while they have started to pool their assets, a more radical consolidation to perhaps five or 10 schemes would dramatically shift the picture.

- >>> **A collective approach:** one way of thinking about DC pensions in the UK is that they are not pensions at all. Instead, they are a tax efficient savings vehicle for individuals with no collective risk sharing. Embracing a more collective model (again, a common feature of systems in Canada, Denmark and the Netherlands) building on the newly approved collective DC legislation in the UK could unlock huge benefits.

- >>> **A national experiment:** the elephant in the room is the vast unfunded / pay-as-you-go system of public sector pensions. In schemes such as the NHS, employers and employees between them pay around 30% of salaries in notional pension contributions to pay the pensions of retired staff. Gradually shifting these contributions over time to a funded model - say, by one or two percentage points a year - would rapidly create a large fund and a more sustainable system in the longer-term.

- >>> **Increasing demand:** investing in listed and unlisted UK equities and other productive assets could be made more attractive to a wider number of people through tax incentives, such as simplifying capital gains tax and / or reintroducing indexation to encourage longer term investing. Could UK dividends be taxed at a lower rate? Or perhaps tax breaks could be reserved for investors with a minimum level of investment in UK assets (as was originally the case with Personal Equity Plans, the predecessors of ISAs).

- >>> **Build it and they will come:** increasing the supply of equity by making equity funding more attractive would help create increased demand. Addressing the tax differential between debt and equity funding and increasing the tax relief on R&D (on a more permanent basis) would encourage and more equity funding in the economy.

- >>> **Education, education, education:** financial education is not the silver bullet it is often painted to be, but a concerted industry-wide and government campaign to encourage individuals, pension fund trustees, and institutions to take a longer-term approach to their investments, to rethink their approach to risk (particularly the long-term risk of taking no risk), and to broaden their investment horizons.

- >>> **Better data:** for such an important area of the UK economy, the quality and consistency of data in and around pools of long-term capital and productive investment is terrible (from how big are different buckets to how they are invested). A combined industry and government taskforce could develop a better and more useful dashboard.

About New Financial

New Financial is a think tank that believes Europe needs bigger and better capital markets to help drive growth and prosperity.

We think this presents a huge opportunity for the industry and its customers to embrace change and rethink how capital markets work. We work with market participants and policymakers to help make a more positive and constructive case for capital markets around four main themes: rebooting UK capital markets; reforming EU capital markets; ESG and sustainability; and driving diversity.

We are a social enterprise funded by institutional membership from different sectors of the capital markets industry. For more information on our work, please contact us:

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