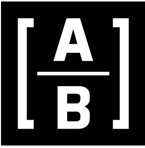

ALLIANCEBERNSTEIN

Grasping the Private Markets Opportunity: Accessing Private Credit for UK Defined Contribution Savers

David Hutchins • Henry Smith • Inigo Fraser-Jenkins

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It's getting harder for UK defined contribution (DC) savers to accumulate realistic amounts of capital for their retirement. Prospective real returns from most asset classes look unlikely to match those of recent years. And the cost-of-living crisis is making it harder for savers to maintain their current pension contributions, let alone increase them in future. How can DC savers get ahead?

At AB, we believe that allocating to private assets can help make a meaningful positive difference to DC savers' returns over time. As long-term investors, DC savers can and should benefit from the additional returns associated with the illiquidity premium, in our view.

In this paper, we address private assets with a focus on private credit. Specifically:

- we set out the practical problems with and hurdles for DC savers investing in illiquid assets and explain the solutions we have developed for investors in our own DC target date funds (TDFs). These funds already include allocations to private equity and sustainable infrastructure. We explain how we have built on that experience to enable us to allocate to private credit too.
- we show why and how DC portfolios can allocate to this asset class, and we assess the value such an allocation can add in terms of members' annual returns and compound growth in capital over time.
- we illustrate how DC private credit allocations can be tailored to meet the needs of specific age groups at realistic fee levels.

To overcome the challenges of investing DC savings in private assets, it's essential to use appropriate investment vehicles. Throughout the paper, we show how TDFs can incorporate complex asset classes while remaining simple for fiduciaries to use and easy for members to understand.

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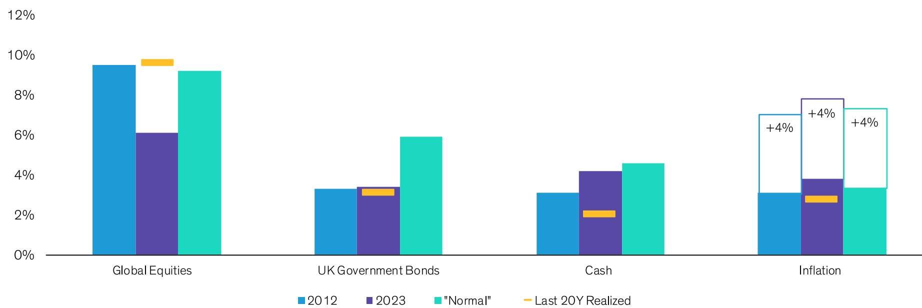
Moving Beyond Public Markets

Historically, public market investments have served DC savers well. Over the 20-year period to 31 December 2023, developed-market global equities (represented by the MSCI World Index) returned 9.6% on an annualized basis, while UK inflation ran at an annualized 2.8%. For much of this period, public bond markets also delivered positive real returns, while exhibiting low correlations to equities and so offering diversification. What more could DC savers ask for? Public equities offered ample growth, while public bonds provided both risk mitigation and real returns.

But looking ahead, few believe that public market investments (particularly equities) will continue to offer such attractive returns. To add to the challenge for public markets, we also expect inflation to settle at a higher level over the long term. The *Display* below shows how AB's 10-year median return expectations from our Capital Markets Engine (CME) have changed since 2012, and contrasts them with both our long-term "normal" expected returns and the realized 20-year returns. Considering the more challenging outlook, we believe DC fiduciaries need to reach deeper into the multi-asset toolkit in order to meet long-term real return objectives (often set at a level of about inflation +4% for younger members) and achieve positive retirement outcomes. Private markets—given their unique characteristics—have the potential to enhance returns and help make up some of the prospective return shortfall.

PAST PERFORMANCE IS UNLIKELY TO RESEMBLE FUTURE RETURNS

10-Year Median Return Forecasts (Annualized)



Past performance does not guarantee future results.

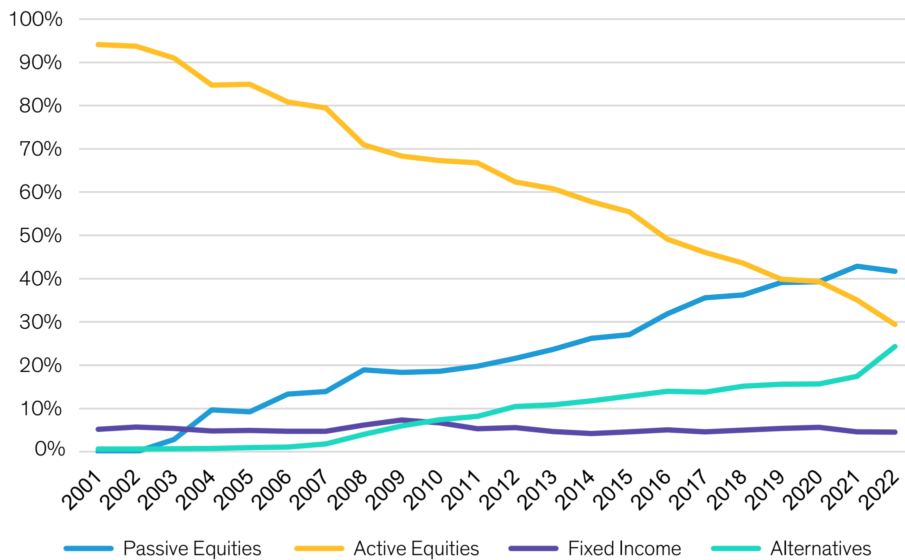
"Normal" is the long-term central case and one where assets are fairly priced. For Last 20Y Realized returns, Global Equities = MSCI World Index, UK Government Bonds = FTSE Actuaries UK Conventional Gilts All Stocks Index, Cash = 3m GBP LIBOR (prior to 1 January 2022) /ICE BofA SONIA (from 1 January 2022), Inflation = UK CPI. 10-year forecasts based on the AB Capital Markets Engine as of 31 December 2012 (2012) and 31 December 2023 (2023). Last 20-year Realized over period to 31 December 2023. Returns shown are in GBP. Source: Morningstar and AB

Private markets have the potential to enhance returns and help make up some of the prospective public market return shortfalls.

The Rise of Private Markets

Private assets are the fastest-growing area of asset management—in terms of both allocations and fees. Institutional investors' allocations to alternative assets have been growing for many years (*Display*, below), with the combined exposure now standing at around 25% of a typical portfolio's risk allocation. Most of this alternatives exposure is in private markets such as private equity, real estate, infrastructure and private debt. **According to McKinsey**, total assets in private markets reached US$11.7 trillion as of 30 June 2023—with approximately 65% in private equity, 11% in private credit, and 22% in real estate and infrastructure (both debt and equity) (*Display,* below).

INSTITUTIONAL INVESTORS ARE INCREASINGLY ALLOCATING RISK TO ALTERNATIVES



Historical analysis and current forecasts do not guarantee future results.

We use the capital allocation of US pension plans as the base and, for calculating risk contribution, assume that "alternatives" is a 50:50 combination of private equity and hedge funds. For private equity, we have used a public-market-equivalent time series (i.e. a smaller-cap, value-tilted index with leverage). For hedge funds, we have used the HFRX Aggregate Index. Given constraints on data availability for alternatives, we use a constant variance/covariance matrix over the full time period, rather than a rolling one. For fixed income, we use the Bloomberg Global Aggregate Total Return Index. As of 31 December 2022. Source: Public Pension Plan Database, Thomson Reuters Datastream and AB

Overcoming the Hurdles to DC Private Market Access

Although private markets now represent a significant proportion of both the global investment universe and institutional investors' portfolios, UK DC savers currently have only limited exposure.

Industry and regulatory initiatives are increasingly recognizing the need to access private markets in UK DC.

These initiatives have focused on reducing the hurdles that have prevented or severely limited exposure to private markets to date. We see five key groups of hurdles: managing illiquidity; management fees and costs; platform access; ensuring member fairness; and education and governance.

Managing Illiquidity Problems

Since private markets investments are—by nature—not listed, the underlying exposures are illiquid. Additionally, these investments are traditionally accessed in closed-ended funds with a limited numbers of shares that cannot be redeemed before a scheduled wind-down date.

DC retirement savers have long investment horizons, extending through their career lifetimes and potentially beyond (for savers who plan to remain invested and draw a regular income in retirement). These time frames mean that DC savers are well placed to benefit from any illiquidity premium or other return enhancement associated with private market investments. While liquidity needs are typically low for DC savers, they still need some cash-flow management—in particular, management of regular contributions, strategy rebalancing or de-risking, and withdrawals for those in retirement.

Daily liquidity is unnecessary. But it's still crucial to manage liquidity effectively to ensure that private market investments represent value for members and that default strategies continue to offer flexibility.

The traditional approach to delivering DC default strategies in the UK, known as lifestyle or lifecycle strategies, depends on asset allocation plans that are mechanistically implemented by scheme administrators. With these arrangements, there's no daily portfolio manager oversight at the strategy level, and strategy allocations are often managed independently. This lack of daily oversight, particularly regarding liquidity, has historically been prohibitive for private market investments. To overcome this problem, open-ended product and vehicle innovations have emerged, such as Long-Term Asset Funds (LTAFs). While these can enable DC pension portfolios to invest in private markets, we believe such approaches are often inefficient. They typically combine private and public market investments into a single fund vehicle, with the public market investments available to meet subscriptions/redemptions into/from the fund. For example, LTAF charges are typically higher than public market funds and are applied equally to both types of exposure. Many of these open-ended structures are also still subject to significant (e.g. 90-day) notice periods to redeem investments, and have limited dealing opportunities.

We see five key groups of hurdles: managing illiquidity; management fees and costs; platform access; ensuring member fairness; and education and governance.

Rather than focus on hybrid single-fund solutions to access private markets, we believe that it's more efficient to manage liquidity and costs at the overall default strategy level. TDFs—in which all asset allocation decisions over the term to and through retirement are applied within a single multi-asset fund—exemplify such an approach. With a dedicated portfolio manager directing cash flows for every TDF at the overall strategy level, there's no need to leverage hybrid private market exposures; savers' cash flows can instead be allocated directly to private market exposures within their existing TDF. This approach also avoids unnecessary trading costs because liquidity needs can be met at the TDF strategy level too.

Listed private market vehicles (such as investment trusts) offer an alternative way to access private market exposures and can be used to support greater liquidity. These vehicles reduce the need to transact underlying illiquid exposures, as investors can buy and sell shares daily on an exchange (without restriction). That said, these vehicles are less liquid than large publicly traded companies and still need liquidity management processes.

Higher Management Fees and Costs

Private market investments are inherently more expensive to access than public market investments. These asset classes are less mature than public markets, the investments are not easily replicable at low cost, and they rely on active management to drive exposure. Management fees are often in the 1%–2% range and additional performance fees are much more common than in public markets.

These higher (and potentially variable) fees can challenge cost-constrained DC schemes. At first glance, the default charge cap (0.75%) may provide sufficient scope for schemes to allocate meaningfully to private markets. However, a constant focus of regulators, commentators and brokers on cost over quality has deterred fiduciaries and created an unwelcoming commercial environment for master trusts. For the UK master trust industry (the now dominant force in DC pension provision, where market consolidation and competition are fierce), management fees have become a leading competitive focus. Most master trusts price considerably lower than the charge cap and they may be reluctant to incur the extra cost of more expensive private market allocations, which threaten to reduce their commercial attractiveness.

DC fiduciaries may also consider performance fees prohibitive because a good year for returns will increase fee costs (even though many schemes' fee costs are currently well below the charge cap). However, recent changes in regulation to exclude performance fees from the charge cap may improve sentiment among pension providers and their customers.

If private market exposures are to become widespread, DC fiduciaries and asset allocators need to act collectively and change their mindset. They must leverage their scale to negotiate lower fee structures and originate novel implementation approaches that support value for money, while adapting to the unique fee characteristics of the market. And they will need to accept that including these investments will likely require an increase in fund charges—both directly through default allocations and indirectly through additional governance/oversight requirements.

Accessing Leading-Edge Investment Platforms

Most UK DC plans use investment platforms to construct and deliver their DC default strategies, due to the platforms' ability to support scale and streamline investment implementation. But private markets can potentially be problematic for investment platforms for several reasons. These include: illiquidity, operational challenges (for instance, limitations in systems capability, or inability to manage cash flows) and regulatory obstacles (for example, inability to meet "permitted links" liquidity requirements).

DC plans' demand to access private markets will incentivize and promote innovation among investment platforms. Those that fail to support such exposures will risk losing client assets. And those that develop ineffective solutions risk regulatory or reputational issues from any failure. We believe that it's critical to identify and partner with leading-edge investment platforms that are able to accommodate and effectively implement exposures to private markets.

Ensuring Member Fairness

As DC savers transition through their accumulation journey into retirement and decumulation, their asset allocation is continually evolving. Defaults' strategic investment designs also evolve as new investment opportunities emerge and/or the requirements of members change.

Mostly, institutional private market investors, such as Defined Benefit (DB) plans and sovereign wealth funds, can manage illiquidity and infrequent pricing. But these issues present particular problems for DC savers, because infrequent pricing can result in mismatches with the true asset value that typically favour members selling private market investments to the detriment of those buying. This can result in the unjust systematic transfer of wealth from sellers (i.e. older members) to buyers (i.e. younger members). Furthermore, poor macro-level management of private market investments can result in opaque (and higher) transaction costs or unfair pricing for those looking to transfer benefits or to draw down at retirement.

Hence, it's vital to consider pricing methodologies carefully when implementing private market exposures, to ensure fairness and transparency for members.

It's vital to consider pricing methodologies carefully to ensure fairness and transparency for members.

Education and Governance

Many DC fiduciaries have insufficient knowledge and experience of this segment of capital markets. Historically there was no perceived need for private assets, and accessing and adopting them was problematic. Consequently, many fiduciaries lack an understanding of the rationale and key risks of these asset classes, how to utilize them within the default strategy, how to appropriately select fund managers and different fund vehicles, and how to oversee and govern exposures on behalf of DC savers.

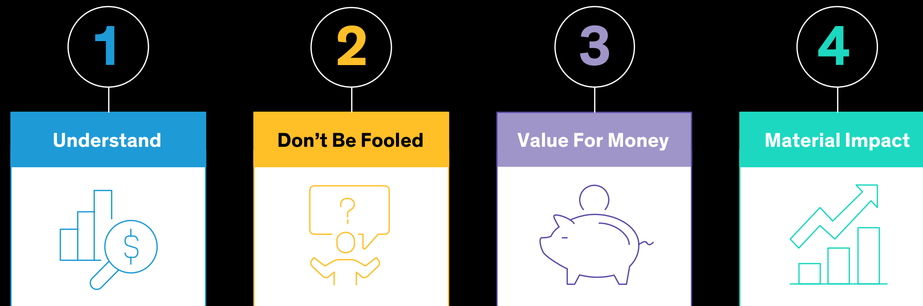
However, some DB pension plans in the UK have been significant investors in private markets. The trustees overseeing these schemes—and their advisors—will have first-hand experience of private investments. Many of the UK's DB schemes have associated DC sections and trustees may hold board positions across several pension plans. Even so, the delivery of DC in the UK—particularly following the boom of new savers arising from auto-enrolment—has been heavily concentrated through traditional pension providers, master trusts and retail self-invested pension plans. These typically have limited overlap with DB pension provision.

The inherent difference in fiduciary responsibilities and ability to fund shortfalls between DC and DB pensions may also result in some hesitancy by DC fiduciaries to allocate to more complex non-traditional investments like private markets. So, in addition to the removal of physical implementation hurdles, many recent industry and regulatory initiatives have focused on building confidence and collective understanding in private markets.

Time and resources can be a big constraint. Understanding and selecting managers and overseeing private market allocations is a labour-intensive challenge for DC fiduciaries, particularly considering their already heavy burden of regulatory reporting and overseeing service providers. These problems are aggravated by the relatively small allocations sizes that private markets will likely represent (at least initially). To ease this burden, advisors and outsourced managers can play an important role to help with training, manager research and daily portfolio oversight/management.

Our Philosophy for Approaching Private Markets

Our philosophy for approaching private market exposures covers four key pillars:



For illustrative purposes only
As of 31 December 2023. Source: AB

1 Understand the Asset Class

It's important to understand the unique characteristics of private market exposures. Private markets have been a hot topic in the UK DC market for several years and offer a potentially attractive opportunity for investors. However, they are not a "magic" new asset class with completely uncorrelated returns and limited linkage to the real economy.

2 Don't Be Fooled by Stale Prices

It's important to distinguish between the characteristics of the private assets themselves and those of the vehicle used to implement exposure. For example, infrequent pricing can lead to artificial smoothing between pricing points compared with a true asset value disclosed by daily pricing. Investors should therefore avoid using the same yardstick to assess both public and private market exposures, which may underestimate the volatility of the underlying private assets.

3 Focus on Value for Money

DC strategies need to offer value for money to savers by striving to deliver good outcomes and avoiding excessive costs. This doesn't mean aiming for the lowest costs—especially if this means attractive investment opportunities are missed. DC pension plans are cost-constrained and private market investments are more expensive. To make effective use of DC fee budgets, we believe that gaining access to private markets at realistic fee levels should be the first and foremost cost consideration. DC fiduciaries should avoid excessive fees and stop trying to identify and access the pinnacle of active management expertise (which carries higher fund costs) in this area.

4 Ensure the Impact Can Be Materially Positive

Accessing private markets must be worth the extra effort and cost—from the required research and innovation, managing new risks, additional governance and increasing fund costs. There needs to be a material positive impact on expected member outcomes associated with the investment.

The track record of our own TDF ranges shows this is possible. Since the inception of our UK TDFs in 2009, we have included allocations to non-traditional investments, such as global real estate, to provide greater diversification and sensitivity to inflation. More recently, we have built significant experience in allocating DC default strategies' assets to private markets.

This began in 2018 with the successful implementation of a listed private equity allocation for a client's bespoke strategy. We subsequently expanded the allocation—made up of a diversified and managed exposure to several private equity pools and the public equity of private equity managers—to all our TDF clients in 2020 to serve as return enhancers for younger savers.

In 2021, we accessed further private market investments with a new allocation—Sustainable Opportunities. This allocation seeks non-traditional investments (e.g. real estate, infrastructure) that align with long-term sustainable growth themes and offer diversification with respect to income (i.e. attractive near-term cash flows that support total return), inflation (inflation-sensitivity or inflation-linked cash flows), and impact (deployment of new capital to sustainable projects).

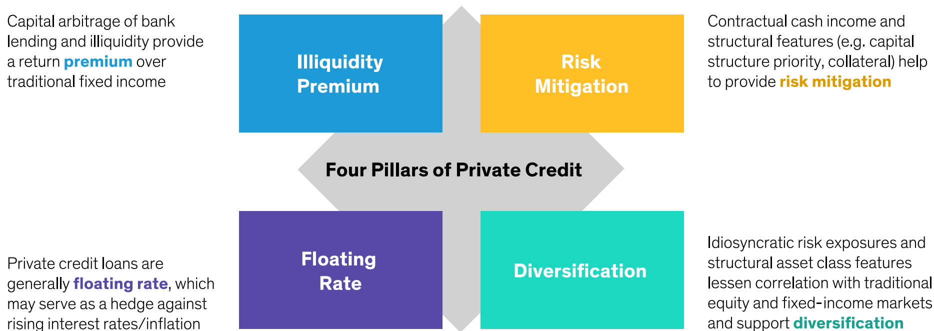
Currently, we are working to implement private credit allocations for a bespoke client strategy that is due to be completed in second quarter 2024. We expect to offer this allocation to our other clients in the remainder of the year. We will explore the key findings of this research and implementation project—including the rationale, approach, delivery and costs—in the following sections of this paper.

The Rationale for Private Credit

Larger corporates can access public corporate debt markets, while small- and medium-sized corporates have traditionally relied on banks for financing. But public credit markets may not offer enough flexibility, and bank borrowing is not always the most attractive option, or widely available. Hence corporates may choose to tap private credit solutions to support their financing needs.

In assessing the investment case for private credit, we can start by considering the key characteristics of the asset class: an illiquidity premium, risk mitigation features, floating rate coupon payments and diversifying properties (*Display*, below).

PRIVATE CREDIT MARKETS ARE BUILT ON FOUR PILLARS



There can be no assurances that any strategy will be met with comparable conditions or any investment objectives will be achieved.

Diversification does not eliminate risk. As of 29 February 2024. Source: AB

Importance of the Illiquidity Premium

Private credit has historically offered a return premium above public fixed income. Over the 10-year period to 31 December 2023, direct lending (measured by the Cliffwater Direct Lending Senior Index) returned 8.1% annualized in US dollar terms. This compared with a return of 4.6% for US high-yield credit (Bloomberg US High Yield 2% Issuer Cap Index) and 3.0% for US investment-grade credit (Bloomberg US Corporate Bond Index).

An illiquidity premium plays a significant role in that advantage. Given the lack of an established secondary market, direct loans require lenders to provide a long-term commitment to borrowers, funded by a long-term capital commitment from investors. In return, investors demand additional yield as compensation. Historically, this illiquidity premium has averaged around 2% and is most easily observed by comparing new issue yields in direct lending versus those in the broadly syndicated loan market.

Structural changes in the capital-raising function of the global economy have also supported this return premium, notably shrinking public-securities markets and the retreat of traditional capital providers.

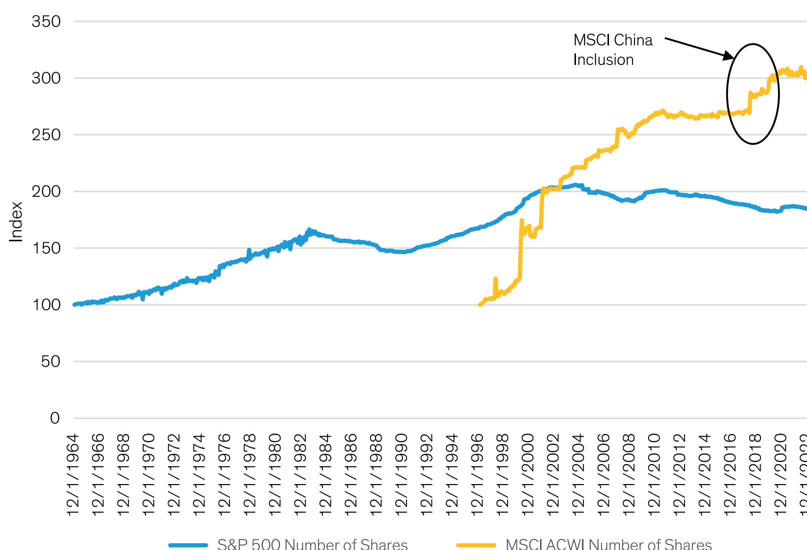
Recent higher demand for private investments, including credit, has been accompanied by a corresponding structural decline in the stock of public equity in developed markets. Share buybacks have exceeded issuance, reducing the amount of shares in circulation (*Display*, next page)—a trend we expect to continue over the next decade. In emerging markets, higher net supply in recent years has been mainly driven by changes in the inclusion factor for Chinese equities.

What exactly is private credit?

At its simplest level, it's another form of lending. Private credit encompasses many forms of lending (for instance, corporate lending, commercial real estate lending, specialty finance, etc.), each with its own risk and return profile. That said, private credit is most commonly considered as private corporate credit—directly sourced and privately negotiated credit investments with a single or small group of lender(s)—with direct lending as its largest segment. Accordingly, when we reference "private credit" in this paper, we are primarily considering direct lending strategies.

THE NUMBER OF PUBLICLY LISTED DEVELOPED-MARKET SHARES IS FALLING

World Equities' Growth Reflects the Partial Admission of China to Global Indices



Historical analysis and current estimates do not guarantee future results.

The circled area shows the impact of change in the MSCI inclusion factor for China equities. For S&P 500, 31 December 1964 = 100; for MSCI ACWI, 31 January 1997 = 100. As of 31 January 2023. Source: Bloomberg, MSCI, Thomson Reuters Datastream and AB

First published in **"The Role of Private Assets in Strategic Asset Allocation: a Macro Perspective"** by AB's Inigo Fraser Jenkins and Matt Bass, April 2023

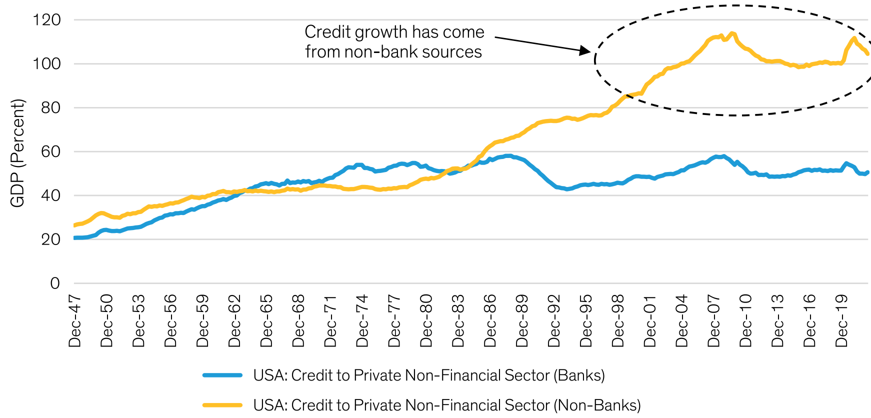
Private credit today is a credit arbitrage opportunity—the ability to fill a void left by a more cautious banking sector. Since the global financial crisis (GFC), banks have rapidly scaled back lending activities, initially to improve their troubled balance sheets and then to comply with subsequent regulation changes aimed at reducing future risks. The net effect: less credit offered by banks to small- and medium-sized businesses.

Banks have continued to retrench in the current environment. Sharply rising rates have raised borrowing costs, removed excess liquidity across the economy and fuelled competition as consumers withdraw deposits in pursuit of higher cash yields. After the Silicon Valley Bank's demise and ensuing banking turmoil, we expect more regulation to further limit banks' credit creation.

In the US, the share of private sector credit provided by non-bank sources overtook bank sources in the mid-1980s; since then, all net credit growth (as a share of GDP) has come from the non-bank sector (*Display*, next page).

Private credit today is a credit arbitrage opportunity—the ability to fill a void left by a more cautious banking sector.

CREDIT GROWTH IS COMING FROM NON-BANK SOURCES



Historical analysis and current estimates do not guarantee future results.

As of 30 June 2022. Source: BICS and AB

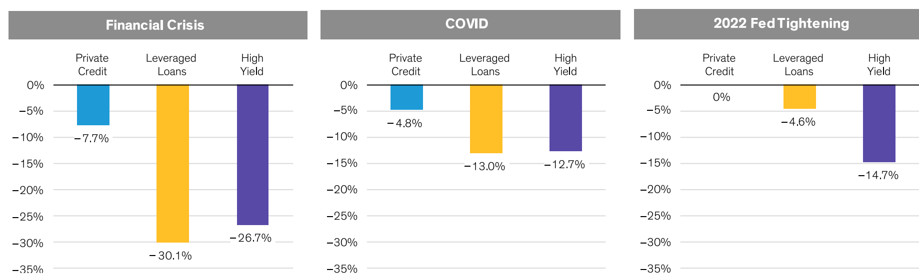
First published in "The Role of Private Assets in Strategic Asset Allocation: a Macro Perspective" by AB's Inigo Fraser Jenkins and Matt Bass, April 2023

The situation in Europe is similar. Even though overall credit growth has been muted since the European Debt Crisis, non-bank sources have taken market share from traditional banks. Emerging-market corporates, naturally more dependent on bank funding today, could usher in a further boom in private credit growth if they follow the direction of developed markets.

Risk Mitigation Features

Private credit has historically provided stability during volatile economic environments and periods of market stress. For instance, drawdowns, which measure the decline from a market peak to its trough, were much more severe for public credit markets during the GFC and the COVID-19 pandemic than for direct lending. Since the Federal Reserve began its tightening cycle in early 2022, direct lending has continued to generate positive returns (*Display*, below).

PRIVATE CREDIT HAS EXPERIENCED SHALLOWER DRAWDOWNS THAN PUBLIC DEBT MARKETS



Past Performance does not guarantee future results.

Maximum peak-to-trough drawdown reflects the largest peak-to-trough drawdown in quarterly index value during the specified periods: Financial Crisis: 3Q 2007–4Q 2008, COVID: 1Q 2020–4Q 2020, 2022 Fed Tightening: 1Q 2022–4Q 2022. Direct Lending is represented by the Cliffwater Direct Lending Index, which reflects the unlevered performance of US middle market corporate loans. High Yield is represented by the Bloomberg US Corporate High Yield 2% Issuer Cap Index. Leveraged Loans is represented by the Morningstar LSTA US Leveraged Loan Index. As of 31 December 2023. Source: Bloomberg, Cliffwater, Morningstar and AB

First published in "Offense or Defense? Direct Lending Can Play Both" by AB's Brent Humphries and David Kuck, September 2023

But why is this? We think the important structural benefits of private credit provide the explanation. Private credit typically features a single entity lending to a borrower, which creates important advantages:

- Since managers generally don't actively trade in and out of loan positions (instead, holding them until they are repaid by borrowers), private credit is more insulated from the technical selling pressure that is typical in down markets in traditional, publicly traded asset classes.
- Direct loans are often executed at the top of the capital structure and therefore benefit from large equity cushions to absorb potential declines in a borrower's value. These loans are also typically structured to give lenders a priority claim on a borrower's assets, including equity in the underlying business.
- Lenders can negotiate protective covenants, such as a cap on the amount of borrowers' leverage or a required minimum liquidity level. These covenants provide lenders with negotiating power to amend loan terms in their favour or to effect other resolutions if a borrower underperforms.
- Direct lenders typically lend to companies on their own or with a small group of like-minded co-lenders, which promotes regular communication among lender groups, borrowers and sponsors. This can result in quicker and more efficient outcomes—and potentially greater recovery—in case of default, compared with public debt that features multiple lenders with competing priorities.

Floating Rate Coupon Payments

Unlike traditional publicly traded fixed income, most private credit loans are floating rate. This means that the interest rates paid by borrowers move in tandem with changes in benchmark interest rates. This dynamic provides a natural hedge against rising interest rates and means that private credit is less sensitive to monetary policy (i.e. has no duration risk).

This is particularly important against the backdrop of the exceptionally rapid increases in interest rates following the pandemic to tackle multi-decade high inflation. Not only do these rate rises leave private credit investments with very attractive levels of yield, but they also serve as a reminder of the significant losses that duration risk can inflict on holders of long-dated public fixed income.

Diversification Properties

Private credit has relatively low correlations with traditional equity and fixed-income markets for both idiosyncratic and structural reasons. Within the broad private credit asset class, the diversity of available credit strategies means that investors have greater control over their exposure to the economic health of corporate borrowers and consumers, or to real assets.

Of course, investors cannot determine the attractiveness of private credit in isolation—the macro backdrop is key. Our strategic view is that the post-pandemic world presents investors with a new macroeconomic equilibrium.

Our expectations for weaker returns and lower Sharpe ratios in traditional public market investments demand additional asset allocation building-blocks to address a shifting opportunity set. In our recently published paper entitled **"A Painful Epiphany: Investing in a Post-Pandemic, Post-Global World,"** we provide several points supporting this outlook including:

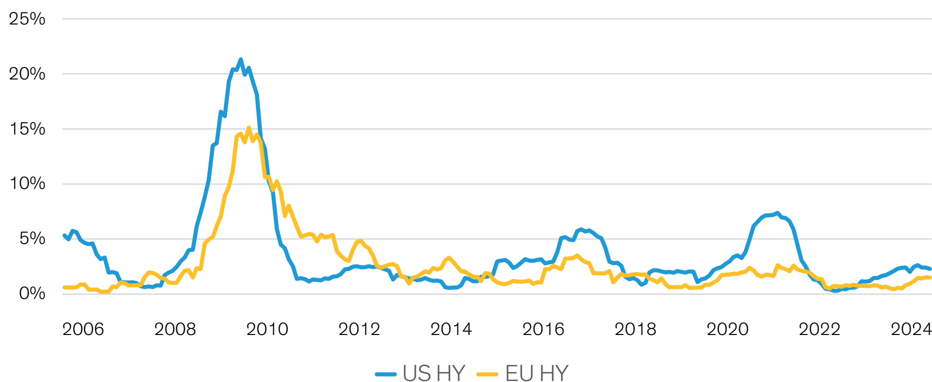
- Inflation will likely find a strategic equilibrium level higher than the pre-pandemic level, forcing investors to raise their return targets to maintain purchasing power.
- Growth will be lower compared with the norms of recent decades, with declining corporate margins.
- Macro volatility will likely be higher because of greater government involvement in the economy, the transition from monetary to fiscal policy, the higher level of debt/gross domestic product (GDP), and the direct and indirect effects of climate change.
- Bonds are less likely to be as effective a diversifier, and the bond-market drawdowns of 2022 should be a wake-up call to investors.
- Consequently, investors will have a greater need for active returns, as returns from passive exposure to asset-class "betas" fall.

Issues with Private Credit Manager Selection

Despite an uptick in issuer defaults during the pandemic, the credit environment has been relatively benign since the GFC, supported by an extended period of low interest rates. Using public high-yield markets as a proxy, we see that debt default rates have not spiked anywhere close to the levels seen during the crisis. While this has been positive for credit investors, it means that today's generation of private credit managers may have limited experience of significant credit stress and debt restructuring. This poses a challenge in identifying true manager skill.

DEFAULT RATES REMAIN LOW—FOR NOW

High-Yield Default Rates (Trailing 12 Months)



Past Performance does not guarantee future results.

US HY shows the trailing 12-month default rate for high-yield rated USD bonds from US corporate issuers. EU HY shows the default rate for EUR and GBP bonds from European corporate issuers. Default rates based on par bond values. As of 31 January 2024. Source: Bank of America and AB

By inference, we note that more challenging market conditions in recent years—namely higher interest rates, weak market sentiment and manager revenue headwinds—could expose a lack of resources in typically smaller-scale private credit managers should a significant credit event force the restructuring of multiple loans. This effect could be exacerbated by staff retention issues (i.e. staff feeling under-rewarded) and a lack of remuneration alignment (if management fees are not used to reward additional effort or skill in restructuring).

Some private credit managers are unwilling to adopt daily pricing for UK DC savers. We see transparent daily pricing—even if enabled by using public market proxies—as a critical requirement for ensuring inter-saver fairness in UK DC. Daily pricing also helps reduce managers' leeway to market their products based on potentially unrealistic risk-return assumptions. Given this fundamental issue, daily pricing is a precondition for our DC TDF manager selection.

We see transparent daily pricing as a critical requirement for ensuring inter-saver fairness in UK DC.

How We're Allocating to Private Credit

To add private credit in our UK TDFs, we've structured an allocation consisting of multiple distinct strategies—each used at different points along the journey to retirement and each offering differentiated approaches to private credit investment.

For younger and mid-life savers, our private credit allocations focus more on higher expected returns, but with greater potential volatility. Through a focus on senior secured loans together with some second lien and mezzanine/subordinated debt in Europe, we expect these allocations to return approximately cash + 4% p.a. over the longer term.

For mid-life and older savers, we favour a higher-quality lending strategy where investment risks are shared with a partner investor (e.g. a bank) that is also undertaking due diligence on the lending activity. Owing to the lower-risk nature of this strategy, we expect returns of about cash + 2.5% p.a. over the long term.

Because of its importance for DC investors, we are using implementation approaches that offer daily pricing—whether that's fund pricing enabled by a model or daily pricing facilitated by an open market, as summarized in the *Display* below:

DIFFERING STRATEGIES PROVIDE GRADUATED RISK AND RETURN

Younger Savers Can Tolerate More Risk

Younger Members — Journey to Target Date → Older Members

	Subordinated Debt	Senior Debt
Fair Pricing	Mark to Model – Point in Time	Mark to Model – Point in Time
Glidepath Usage	Younger/Mid-Life Savers	Mid-Life/Older Savers
Market	Europe	Europe
Our Return Expectation	Cash + 4.5%	Cash + 2.5%

For illustrative purposes only. There can be no assurance that any investment objectives will be achieved.

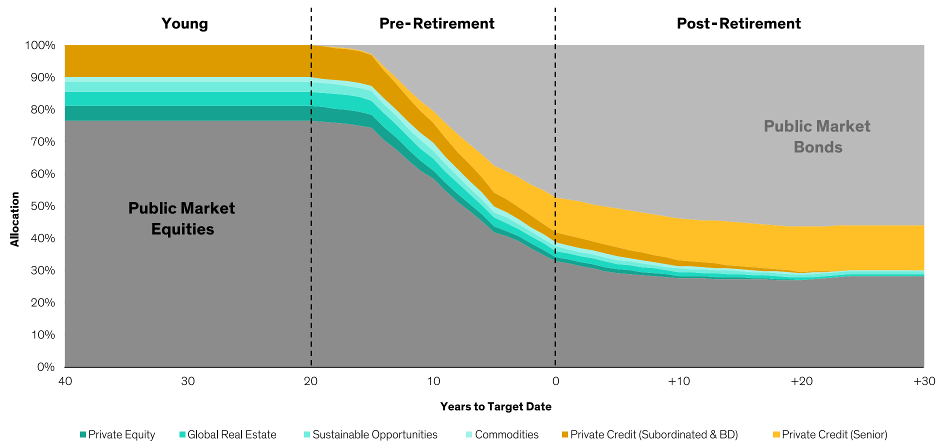
This is not intended to be a comprehensive summary of all investment terms that may be relevant to each prospective investor. The information contained herein is subject to change, completion or amendment, and will be superseded in its entirety by the Fund's specific offering document(s). As of 31 December 2023.
Source: AB

The aggregate exposure to private credit sits alongside our other private market and illiquid asset exposures—including private equity, sustainability-oriented diversifiers, and global real estate. These assets provide diversification and return-enhancement for our TDFs' public market equities and bonds, as shown in the illustrative asset allocation glide path *Display* below.

The aggregate exposure to private credit sits alongside our other private credit and illiquid exposures.

PRIVATE MARKETS EXPOSURES ARE ADJUSTED OVER TIME

Illustrative Asset Allocation Glidepath



For illustrative purposes only

As of 31 December 2023. Source: AB

Expected Characteristics of Private Credit and Impact on Member Outcomes

Private market investments must deliver a materially positive expected impact on DC member outcomes, in our view. The expected incremental return impact of an allocation was therefore a key element in our research.

After considering historical returns for the asset class and following discussions with various research professionals across AB, we have established forward return expectations for the private credit exposures that we seek to access. These are cash +4.5% p.a. for the higher-risk allocations used further from retirement, and cash + 2.5% p.a. for the allocation used nearer to target date.

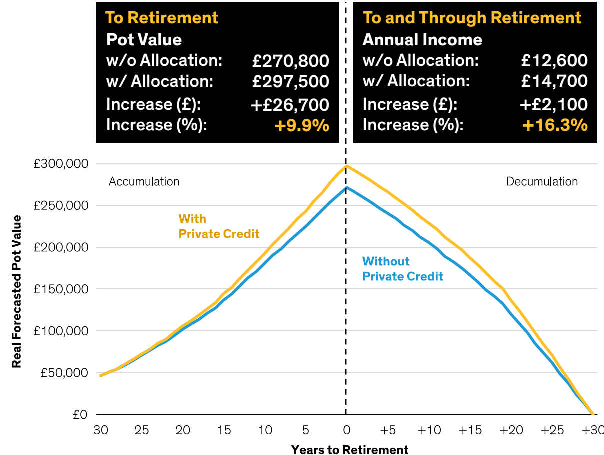
When integrated into a glide path strategy, we expect the addition of private credit allocations could provide a real return enhancement in the order of 0.4% over the long term, after the deduction of fees. We expect to achieve this by investing the glide path allocation within the same risk profile—so the additional return involves no increase to the strategy's risk budget.

On an annualized basis, this return enhancement may not sound substantial. However, the compounding effect can be material, particularly for savers with longer horizons—younger members, or those targeting continued investment and income drawdown in retirement. We outline modelling of some potential outcomes for an indicative UK DC saver in the *Display* below.

A PRIVATE CREDIT ALLOCATION CAN MAKE A MEANINGFUL POSITIVE DIFFERENCE TO CUMULATIVE RETURNS

Illustrative Member Experience

- **Income:** UK Average (c. £35,000)
- **Current Pot Size:** £43,000
- **Contributions:** Auto-Enrolment Minimum (8%)
- **Age:** 35 Years
- **Selected TDF Vintage:** 2053–2055
- **Time to Retirement:** 30 Years
- **Investment Horizon:** 60 Years (Income for Life)



Data do not represent past performance and are not a promise of actual results or a range of future results. There can be no assurance that any investment objectives will be achieved.

UK average pay based on Office for National Statistics data published in November 2023. Retirement income calculated as the maximum annual amount that can be withdrawn to deplete pot value to zero at age 95 (i.e. 30 years after retirement). Illustrative outcome shown is the smoothed median pathway modelled by the AB Capital Markets Engine, a proprietary model that uses our research and historical data to simulate a large range of market returns and investment outcomes. Illustration shown based on real return forecasts as of 31 December 2022. Figures shown are rounded. Source: Office for National Statistics and AB

The holding period of a private credit allocation matters too. To maximize the positive impact on member outcomes, we believe that the expected return and diversification benefit of private credit justifies an allocation both in accumulation and decumulation. Of course, this approach requires that illiquidity be appropriately managed to accommodate flexibility for retirees who do not wish to pursue an income-for-life strategy. To demonstrate this, we also modelled the impact of holding a private credit allocation until 10 years to retirement and phasing out this allocation over five years, to ensure it is removed by around 60 years of age. Our modelling indicated that phasing out the allocation in this way could reduce the expected pot size by around £8,800 at retirement thereby cutting annual income by £430 per year and so potentially reducing the benefits by 2.9%.

Investment Delivery: Efficiently Structuring Exposure to Private Credit

TDFs are an effective default strategy delivery vehicle for DC savers and can readily expand their investment universe to include private markets. From a fiduciary perspective, all TDF asset allocation is wrapped within a single fund and the strategy can be holistically managed from the top-down level—critical for the effective management of cash flows and liquidity. From a member and pension scheme administration perspective, investment complexity is greatly reduced, and members' only decision is their choice of target retirement date.

To implement and efficiently manage our private credit allocations as part of a diversified default strategy, we are building on our experience in managing private equity exposures, which have been part of our investment solutions since 2018.

With the support of leading platform partner capabilities, we will proactively manage the private credit allocations through the use of blended fund structures. Our TDF glide path strategy will allocate to these blended funds directly. For liquidity management purposes, all cash flows into and out of the blended funds will be directed to/from other pre-defined investment sub-funds within the TDFs. These will act as a liquidity reserve and destination for blended fund cash flows, and provide market exposure.

Costs and Charges

Private market investments such as private credit involve higher investment management charges, as well as increased governance and transaction costs. Consequently, an allocation will mean some form of upward pressure on investment costs. Over time we expect these costs to reduce and in the meantime an implementation through TDFs could be helpful from a cost perspective.

While the findings are a few years old now, **a survey commissioned by the Department for Work & Pensions in 2020** found that the average charges for members in auto-enrolment qualifying schemes were 0.48%—considerably below the default charge cap of 0.75%. We acknowledge that UK master trusts are operating in a highly competitive fee environment currently. Working with a TDF manager that builds scale in its private markets' exposure may help to alleviate some of the associated costs and fee pressure.

Since performance fees no longer need to be included within the charge cap, we believe that many UK pension plans should now have sufficient scope to increase member-borne charges if fiduciaries agree that there's a compelling enough investment case for private market exposures.

Employing a wider range of different vehicle types to gain access to private markets—including both unlisted and listed—can help contain costs and charges. Each approach has unique pros and cons, and what works best for one pension scheme arrangement may not work for another. Furthermore, listed vehicles should not be dismissed as "watered down" or second-rate private market exposures—the additional liquidity that they provide can help reduce transaction costs, and their inclusion in a single stock-like structure can be helpful when it comes to charges disclosure.

We believe TDFs are ideally suited to support DC fiduciaries because of their continuous professional management and oversight of the total investment strategy. Accordingly, they can provide a route to widespread adoption of private market exposures in UK DC. An outsourced manager, such as a TDF manager, may also be able to leverage the scale of their clients' collective assets to negotiate reduced management costs with underlying private market managers.

Contact Us

AB has committed significant time and resource to researching private credit implementation for UK DC savers, and we will be happy to share our findings in greater detail with interested fiduciaries and their advisers.

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About AllianceBernstein

AllianceBernstein is a leading investment-management firm with US$725 billion in client assets under management, as of 31 December 2023. We offer a unique combination of expertise across equities, fixed-income, alternatives and multi-asset strategies, and we pursue responsibility at all levels of the firm. By tapping a global network of diverse perspectives, we generate differentiated insights and distinctive solutions to address increasingly complex challenges and advance our clients' success.

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The value of an investment can go down as well as up and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

Some of the principal risks of investing in Target Date Funds include:

Market Risk: The market values of the Fund's holdings rise and fall from day to day, so investments may lose value. **Interest Rate Risk:** Bonds may lose value if interest rates rise or fall—long-duration bonds tend to rise and fall more than short-duration bonds. **Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or capital—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered and the bond's value may decline. **Allocation Risk:** Allocating to different types of assets may have a large impact on returns if one of these asset classes significantly underperforms the others. **Foreign Risk:** Investing in non-UK assets may be more volatile because of political, regulatory, market and economic uncertainties associated with them. These risks are magnified in assets of emerging or developing markets. **Currency Risk:** If a non-UK asset's trading currency weakens versus sterling, its value may be negatively affected when translated back into sterling terms. **Reinsurance Risk:** The underlying fund(s) is accessed via another insurance provider, also known as a reinsurance arrangement; creating a direct counterparty exposure. In the event of default by an insurance provider, the value of the assets will likely fall, which will be reflected in the value of our Fund price.

Target Date Retirement Funds (TDFs) are designed for a typical pension fund saver intending to retire in or around the years stated in the name of the Fund. As the Funds are intended to be default pension saving vehicles which seek to meet the requirements of a broad range of persons, they do not take into account an individual's personal circumstances and may not be suitable for a particular individual or group of individuals with complex financial or personal circumstances.

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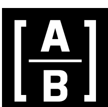

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June 2024