

DC views: how to achieve better member outcomes

October 2024

Client Directors Dawn Murdoch and Piers Lawson explore the UK DC market. They discuss their frustrations around cost and investment constraints, before concluding with how better member outcomes can be achieved through a shift from cost to value.

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Dawn Murdoch (DM): Piers, thanks for joining me today for a cuppa. The reason I wanted to sit down with you was because, well, you've been working in the industry a long time. How long has it been Piers?

Piers Lawson (PL): I'm not sure I want to answer that question.

DM: Okay okay, but I think you've been at Baillie Gifford for 15 years.

PL: Yes, that's right. I joined just before the global financial crisis.

DM: And both of us work in the Clients Department, but have slightly different roles. So I focus, as you know, on DC clients. I absolutely love that part of the market. It's such an important part of savings in the UK. And, you know, there's a great number of people working towards better member outcomes which is fantastic. But the truth is as an active manager at Baillie Gifford it's quite a frustrating market segment because as you know the way we're working with our clients is becoming so limited and it's really frustrating because you know I genuinely believe that the Baillie Gifford investment style has the potential to deliver excellent long-term value for clients. And DC is probably the segment that we need it the most.

Now, you, in contrast, work in DC, but also in LGPS, charities, family offices, etc. So I wanted to hear your perspective about how different is the DC experience?

PL: Okay. You know, I share your frustrations in many ways because certainly from an investment perspective, DC in the UK is very different because it's very much cost-constrained. So if we look at other asset groups, they invest in a completely different way. What DC does is obviously has a lot in passive management and very little with the exception of one or two quite large scheme investments in private markets. Looking at others, you've got the LGPS, for example, that's got around 6 per cent in private markets and over 20 per cent in private markets as a whole. If you look internationally at DC, in Australia, the numbers are broadly similar to the LGPS here, and in North America, the US and Canada you've typically got private equity weightings around on average I think of around 8 or 9 per cent.

DM: Yeah, so it's not actually DC, it's UK DC in particular. So you know, quickly can you remind us how did we get to this point?

PL: I guess we initially got to this point, as under auto enrolment DC was set with a price cap. This was very much the focus and it set the culture. I think the irony is that these days that the vast majority of schemes are operating at a fraction of the price cap. I think the second thing is that we're seeing such tremendous consolidation in DC, supported certainly by the regulator. We're seeing a lot of smaller single employer trusts moving to master trusts. We're seeing master trusts acquiring other master trusts and I think whilst ever this sort of land grabs going on, then price will be a focus and we will see this fee compression.

DM: Okay, but fee compression from a member's perspective should be a good thing shouldn't it?

PM: You'd kind of think so wouldn't you?

But I go back to, you know, what we were talking about a minute or so ago, is if you are having to invest in such a sort of cost-conscious way, I suspect there's probably two main drawbacks. Firstly, there are lots of asset classes and areas where you just can't go. So your investment universe is limited. And secondly, I think there's a real challenge to invest sustainably, which is what virtually all of DC is trying to do.

DM: Yeah, that's a really important point, isn't it? So what is it that you're giving up then if you're trying to do sustainable investing but at a low cost?

PL: Well, I think it's a real challenge to invest cheaply and sustainably. I think one of the things that is very tempting to do is for DC schemes to put a large proportion of their assets into a low carbon index fund. Now that in all honesty has no real-world impact but might make you feel a little bit better in the short term.

The second thing is a kind of reliance on ESG scores for individual companies which will dictate the weighting that you have these in a portfolio. Now ESG scores as I'm sure you're aware are based on historic data, they're unreliable, they're contradictory with different scores from different vendors telling you completely different things, and I think what we're seeing now is that companies are getting very good at gaming these metrics and getting themselves very high scores. Now, to us what's key to investing sustainably is to engage with investee companies. And that's each and every company that you invest in. And obviously that is hugely time-consuming and very resource intensive. And I think to a certain extent asset owners are being a little bit naive if they think that they can pay literally a handful of basis points to a manager and that they will be able to engage with their investee companies in anything like a meaningful way.

DM: Yeah I think that's clear Piers. Let's go to something more optimistic for our last point. You mentioned private equity earlier. Now isn't it that actually DC participants are allocating to private equity recently anyway?

PL: We're starting to see that, which I agree is encouraging, but certainly by international standards, coming off a very very low base. DC's been given a nudge by the last government through the Mansion House Compact, and I think the current government will go further and faster with that with the pensions review. We're having a lot of conversations. It's clearly difficult and there are challenges in order to get illiquid assets into DC.

Why is it important?

I saw an interesting piece of research recently which looked at all companies worldwide, public and private, that had gross revenue of more than a hundred million dollars per annum. Now obviously those are big companies. And the surprise sort of takeaway for me was that over 85 per cent of those companies were private companies. And I suspect if you asked most people they'd think those numbers were the other way around. So there's a huge amount of opportunity there. So I think if schemes don't have access to private equity, then they really are denying themselves a lot of opportunity.

DM: Yes, so important that we see change in that area.

To finish, Piers, can you leave us with what are the things that you would change as a priority?

PL: I guess as a priority, I would like to see value becoming the focus and not cost. People need to think what's good value, what's going to generate long-term good returns for members. And this will lead us to being able to invest more sustainably, having the budget to do that, and also be able to invest much more broadly in a number of different asset classes which historically have been more expensive to access but will generate very good long-term returns.

DM: Well let's hope we see some of this. And thanks for sitting down with me today.

PL: Pleasure.

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