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Janus Henderson INVESTORS

CLOSED-ENDED FUNDS

AN UNDEREXPLORED ROUTE TO ALTERNATIVE ASSETS FOR DC SCHEMES

Dave Whitehair, Director of Institutional Business (DC), with James de Bunsen and Pete Webster, Portfolio Managers on Janus Henderson's UK-based Multi-Asset Team, make the case for closed-ended funds as a viable and useful tool for defined contribution schemes looking to gain exposure to the fast-growing alternatives asset class.

Key takeaways

- DC schemes may be missing an opportunity by not exploring the closed-ended market when reviewing how to access alternatives including private markets.
- As a permanent pool of capital, the closed-ended vehicle represents a potentially optimal match for more illiquid assets, such as infrastructure.
- There is a rapidly growing universe of closed-ended alternatives, offering access to the potential for long-term returns linked to the real economy.
- These highly governed vehicles offer a higher level of transparency and reporting than direct private market assets.
- Costs, when compared to accessing alternatives directly, can be substantially lower.
- Incorporating closed-ended funds into a diversified alternatives portfolio can play an important role in supporting better outcomes for DC members.

Authors

Dave Whitehair
- Director of Institutional Business, DC

James de Bunsen
- Portfolio Manager

Pete Webster
- Portfolio Manager

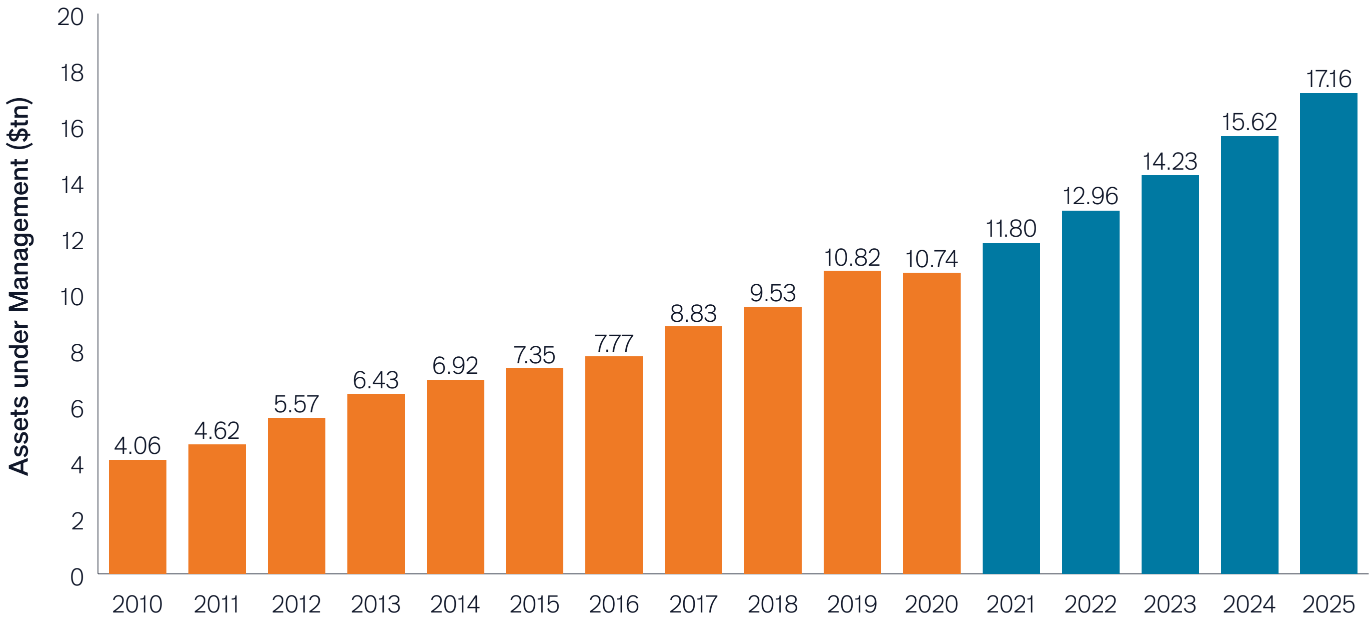
The UK government wants defined contribution (DC) pension schemes to play a much greater role in its' "levelling up" agenda. For this to happen, it is our view that DC must join other institutional markets in investing in alternative assets. We define alternative assets as those falling outside more traditional asset classes such as equities, fixed income and cash. Due to their alternative nature, these assets are often less liquid and may require a longer investment period before value is realised. Examples include private equity, private debt, venture capital, infrastructure, real estate and hedge funds.

A recent report by the Productive Finance Working Group[1] highlighted the very limited extent to which DC schemes currently invest in alternative assets, stating that *"two-thirds of DC schemes do not invest in longer-term, less liquid assets at all, and the rest invest only 1.5%–7.0% of their assets, much of which is in real estate"*.

Government interest aside, large DC schemes and advisors have been exploring how accessing alternative markets could help to generate better member outcomes. This has contributed to a steady increase in assets under management and is expected to lead to further acceleration in the coming years (Exhibit 1). Reasons for this include the potential for:

- Higher returns from private markets compared with public markets
- Access to a growing opportunity set within alternatives
- Risk and return diversification from traditional publicly traded assets
- New ways in which to incorporate environmental, social and corporate governance (ESG) beliefs.

Exhibit 1: Alternative assets under management 2010-2025 (est.)



Source: Preqin, The Future of Alternatives 2025. Figures shown for full-year 2021 and beyond are forecasts/estimates. **Past performance is not a guide to future performance.** There is no guarantee that past trends will continue, or forecasts will be realised.

Why has DC been slow to invest in alternative assets:

The DC industry's interest in alternative assets is yet to translate into meaningful allocations. Key reasons cited by trustees and their advisors for hesitancy in this area include:

- A limited number of investable fund options
- Daily dealing is still required by many DC platforms
- Higher costs associated with investing directly into alternative assets
- A more complex governance process compared to traditional assets
- Permitted links rules causing DC platforms issues when life-wrapping funds

Progress is being made in several of these areas, namely movements around permitted links rules, driven in part by the FCA's Long Term Asset Fund (LTAF) proposals. However, for most DC schemes many of these challenges remain significant barriers.

Closed-ended funds – another option for DC schemes

For DC schemes unwilling or unable to invest directly into alternative assets via private unlisted structures, the closed-ended fund market provides a viable option – a point echoed in the Productive Finance Working Group report[1].

The popularity of closed-ended vehicles has been steadily rising, with alternative sectors driving that growth. As Exhibit 2 shows, equity raisings for alternatives are significantly outpacing those in traditional asset classes. The UK-listed, alternative, closed-ended market is now £100bn by market capitalisation (as at 30 September 2021).

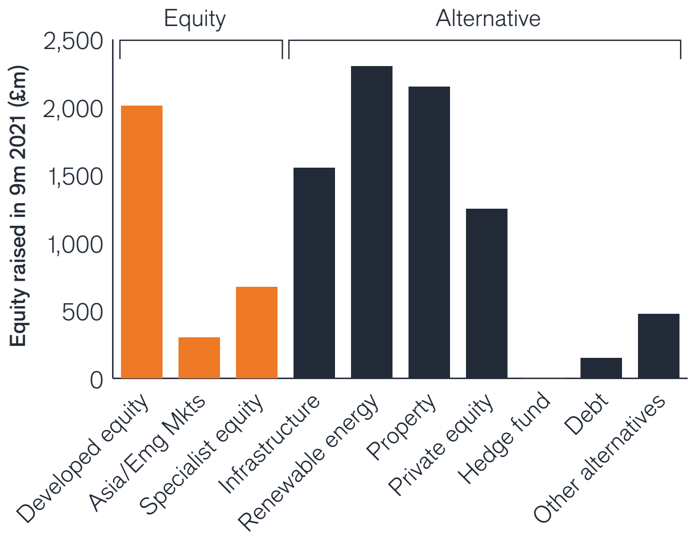
Closed-ended-funds list on an exchange via an Initial Public Offering (IPO) to raise capital. The shares of the fund are then bought and sold on the exchange, as with any other stock.

The Net Asset Value (NAV) of the fund is calculated regularly, based on the value of the underlying assets held. However, the (share) price that it trades for on the exchange is market driven. This means that a closed-end fund can trade at a premium or a discount to its NAV.

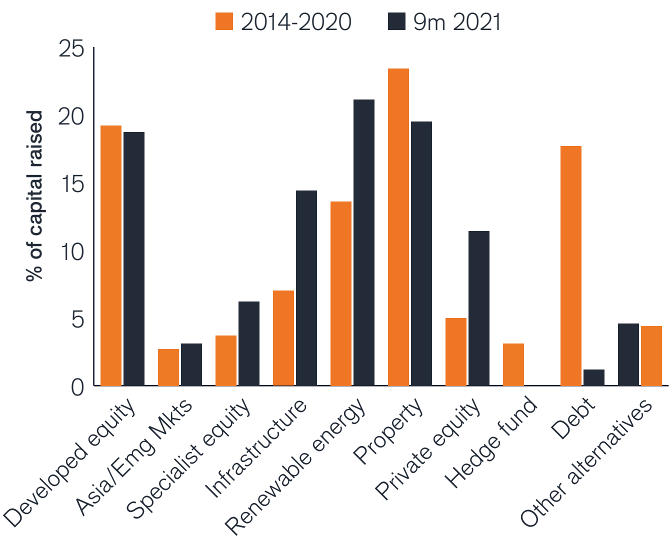
In the UK, a closed-ended fund typically takes the form of an Investment Trust, an Investment Company or, in the specific context of property assets, a Real Estate Investment Trust (REIT).

Exhibit 2: The investment landscape is changing

Fundraising by asset class in 2021 YtD (£m)



Fundraising by asset class (£m)



Source: Numia Securities Research, 1 January 2014 to 31 September 2021.

Note: For the left-hand chart, equity funds are shown in orange. Alternatives are shown in black. For the right-hand chart, the period 1 January 2014 to 31 December 2020 is shown in orange; the period from 1 January 2021 to 30 September 2021 is shown in black. Past allocations are not a guide to future investment intentions.

James de Bunsen
Portfolio Manager

> A key reason behind the growth in alternative closed-ended funds, as permanent pools of capital, is that they provide an ideal foundation for managers to invest in long-term opportunities, with the security that they will have no redemptions forcing them to sell down assets – a problem DC property funds have encountered several times in recent years.

What closed-ended funds can offer DC investors:

- **Liquid access to alternative assets:** Fund structures that provide DC clients with daily liquidity have no minimum holding period or redemption notice.
- **'Evergreen' investment:** In contrast to many private funds, closed-ended funds are effectively evergreen, with no end date for the portfolio, and they can support DC's ongoing cashflows requirements.
- **High governance standards:** Closed-ended funds operate with independent boards that hold fund managers to account and provide timely and transparent reporting.
- **Transparent performance returns:** Closed-ended funds returns are straightforward, based on reported NAV and share price returns. Direct private funds, however, can adopt various return calculation methodologies that may change through time.
- **Stewardship:** Investors in closed-ended funds get voting rights and can engage on important issues, such as ESG themes.
- **Long-term opportunities in Impact Investing and ESG:** Depending on their investment policies, closed-ended funds can provide bespoke access to the rapidly growing universe of impact and ESG-themed investment opportunities, such as social housing and renewable energy. There was more than £14bn invested in 25 impact investment trusts as at March 2021[2].
- **Cost-efficient way to access private markets:** Accessing private markets via closed-ended funds can often provide cost advantages, relative to investing directly into private funds.

Closed-ended alternative asset classes available to DC investors

Private equity

Provides access to early-stage, high-growth companies and buy-out opportunities. Private equity offers the opportunity to make higher returns than those of listed equivalents. An example is HgCapital Trust PLC, a long-established investment trust which buys stakes in private European technology companies. HgCaptial, via its private funds and investment trust, is Europe's second largest tech firm after SAP.

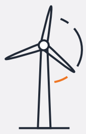
Specialist credit

Less liquid, often physically-backed and/or senior loans/bonds that typically have floating rate coupons, providing protection from rising interest rates. Biopharma Credit PLC is one example; a portfolio that offers loans to pharmaceutical companies, backed by the royalties from successful drugs and therapies.

Infrastructure

Funding long-term infrastructure projects, either privately or in partnership with public bodies. Revenues are typically inflation-linked and non-cyclical in nature, given assets are critical to a functioning modern economy. An example is HICL Infrastructure, which owns and operates assets such as schools, hospitals and military accommodation.

Renewable energy



Long-term funding of operational energy assets, predominately in the wind and solar sector, helping to tackle climate change. These deliver inflation-linked revenues and strong cash flow in the form of dividends. An example is The Renewable Infrastructure Group, an owner of wind and solar farms in the UK and Europe.

Property

Liquid, low-cost alternatives (REITs) investing in physical real estate. In some cases, these are more aligned to infrastructure assets in nature than commercial property, such as social housing. Other specialist sectors such as student housing can offer higher yields. An example is Urban Logistics PLC, which owns and leases out warehouse space in well-situated locations close to key transport links and large conurbations.

How DC schemes can access and incorporate closed-ended funds into DC investment design

The alternative investment universe is vast, with opportunities in many asset classes across the public and private market spectrum. Each asset class brings different economic sensitivities and therefore varied risk and return profiles. For this reason, we see benefit to DC investors allocating to a cross section of asset classes and incorporating closed-ended funds. This can be done in pre-existing DC-platform-friendly fund wrappers such as a Non-UCITs Retail Scheme (NURS).

For DC schemes not considering illiquid options, but looking to invest in alternatives, an allocation to a portfolio consisting of predominantly closed-ended funds could play a role in the following areas of lifestyle design:

- **Growth phase** – a potentially useful complement to equity exposure for those not taking 100% equity risk.
- **Consolidation phase** – as an alternative to packaged Diversified Growth Funds (DGF) or a component within a bespoke DGF.

For DC schemes already allocated to, or considering, a direct private markets allocation:

- An alternative fund delivered by incorporating closed-ended funds could deliver portfolio liquidity as opposed to holding cash or money market funds avoiding a drag on performance.

Dave Whitehair
Director of Institutional Business, DC

"We believe that as more DC investment decision makers turn their attentions to alternatives – and in particular private, illiquid assets – closed ended alternatives funds may represent a viable and useful tool for DC to gain exposure to this fast-growing asset class."

Source: [1] https://www.bankofengland.co.uk report/2021/a-roadmap-for-increasing-productive-finance-investment September 2021
[2] Jura Capital, March 2021

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