

Helping Defined Contribution Schemes Go Private



This paper is intended for investors considering a long-term allocation to private market assets in their defined contribution (DC) default investment portfolios. Given the low uptake in private market investments in DC schemes, and the different investment and operational features compared with more traditional public market investments, there is a lot to consider. We believe that private markets offer compelling attributes that advocate their inclusion in many institutional investor portfolios however acknowledge that they are not for everyone. Our paper focuses on the importance of understanding risk and strong portfolio construction practices because private market valuations are not immune to bouts of volatility and will go through benign and tough market environments.

- To address this, we will touch upon the following topics:
- 1** What are private markets and what role do they play in defined contribution (DC) today?
 - 2** Key considerations when allocating to private markets
 - 3** Case study showing the impact of including private markets in a DC portfolio
 - 4** What's next?

1 Introduction

How do we define private market assets?

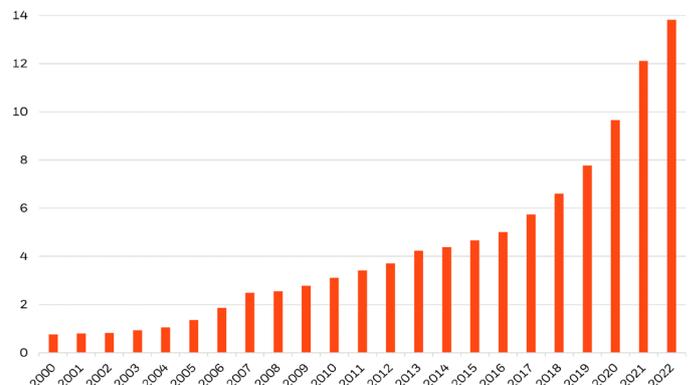
The asset class universe defined in the table shows a selection of some common private market asset classes, and is not a complete list of the private markets investment universe.

Equity	Private equity
	Real estate equity
	Infrastructure equity
Debt	Direct lending
	Real estate debt
	Infrastructure debt

This paper focuses on pure private market investments. We believe this is the area most underserved in DC default strategies today. Like public markets, private markets cover a range of asset classes.

Private assets have different characteristics to their public counterparts. For example, private assets are not listed on an exchange, or wrapped in publicly-available exchange traded funds or mutual funds.

As demonstrated by the chart below, private market assets are growing in absolute terms and as a % of total capital markets, and therefore, present an important consideration for long-term asset allocation decisions.



Source: BlackRock Investment Institute, with data from Preqin, May 2023. Notes: Bars represent the sum of net asset value of closed-end funds as well as dry powder of funds in these asset classes: private equity and venture capital, real estate, private debt, infrastructure and natural resources. The line shows the size of private markets relative to that of public markets.

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There are many “liquid alternatives” that are used by DC schemes directly (such as investments in real estate investment trusts) or indirectly (through allocations to multi-asset funds which can have small exposures to alternative assets). However, these liquid structures exhibit higher correlations with their public counterparts. They are also less exposed to the premium received from accessing the complexity of investing in pure private markets.

Background to private markets in DC

Over the past decade, there has been a significant increase in the use of private assets within institutional investment portfolios globally. Meanwhile, DC schemes in the UK have relied on public markets to generate both returns and diversify portfolio risk. This seems counterintuitive given the long-term time horizon of younger members, in particular, and given the importance of investment returns in achieving strong outcomes for retirement within the defined contribution pension structure. The Financial Conduct Authority (FCA) has reported that according to a recent survey commissioned by the UK’s Department for Work and Pensions (“DWP”), two-thirds of DC schemes do not invest in illiquid assets. They have noted low allocations to private markets relative to DC schemes’ long-time horizon.¹

There is no inherent barrier to DC schemes accessing private markets. Since the 2008 global financial crisis, many Australian superannuation schemes have already been establishing themselves as global leaders in terms of allocations to some alternative asset classes, particularly infrastructure. According to the 2020 Broadridge report, UK DC schemes allocation to alternatives is predicted to grow to 10% of total assets by 2029.

In the UK, policymakers are taking steps to allow DC schemes to increase their private market allocations. In January 2023, DWP confirmed requirements for DC schemes with over £100m in assets to disclose the percentage of illiquids in their default, a description of those allocations, and why they decided to make them would take effect from 1 October 2023. We view this development as a significant step towards supporting the inclusion of private market assets in DC portfolios going forward.

Schemes will have different objectives with varying constraints and investment beliefs, which means that private markets may not see mass adoption for many years. However, we believe that UK schemes can consider the adoption of private markets, in the same way other institutional investors have done across the globe. We believe it is important that schemes begin to adopt a framework to consider their inclusion.

¹ Source: Aon, 2022, “The Long-Term Asset Fund”.

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Aligning private markets allocations to best practices with default design

The DC default is required to solve the challenge of providing an appropriate risk/return exposure, based on the approximate year the participant would begin accessing their savings. In practice, this means managing important risks that members face through time including market risk, inflation risk and longevity risk as outlined on the right:



Market risk: This is when market movements lead to a fall in value of the investment portfolio. The principal way default funds manage market risk is through diversification across a range of risk factors.



Inflation risk: This is when your investment portfolio fails to grow in line with inflation and therefore the value of your retirement savings falls in real terms. Retirement portfolios will allocate to “real assets” such as property, that seeks to accrete value more than inflation over the long term and have a positive correlation or sensitivity to inflation trends.



Longevity risk: Longevity risk is the risk of outliving your savings. The level of consumption that is sustainable in retirement largely depends on the ability of your pot to grow over time which, in turn, helps to mitigate against longevity risk.

How do private markets help manage these risks?

Private markets can benefit a lifecycle-based investment strategy by addressing the above risks in the following ways:



Market risk: Unique risk/return drivers of private assets enhance portfolio diversification.

How? Private markets exhibit some common risks to public markets (i.e. equity, interest rates, credit), but they also exhibit some diversifying features that are not represented in public markets.

Example: Infrastructure equity: Features, such as power purchase agreements or government subsidies within infrastructure equity assets can provide portfolio diversification. Under such arrangements, pricing can be contracted over the long term and can be directly linked to inflation. Revenue generation is thus less directly reliant on the

performance of broad market factors.



Inflation risk: Private market assets can alleviate inflation risk.

How? The long-term, buy-and-hold nature of many private market investments, as well as their ability to absorb or pass on cost increases means that, to an extent, these strategies can provide investors protection against inflation, both from a mark-to-market and fundamental perspective.

Example: Real estate: Real estate investments can incorporate inflation-linked rent reviews to directly mitigate inflation risk.



Longevity risk: Private market assets can generate excess returns relative to public markets.

How? The DC scheme relies on long-term investment returns to build retirement savings of adequate size to fund consumption in retirement. To manage the risk of outliving our savings (longevity) risk, higher returning assets are important in the accumulation phase. We observe, through BlackRock's Capital Market Assumptions, that certain private assets have higher growth estimations than their public counterparts.

Examples:

Private equity: BlackRock Capital Market Assumptions currently indicate a higher return in private equity assets than public equities, which would provide the member with a greater potential growth of the pension pot over time.

Private Credit: Below chart illustrates the spread differential between private middle market loans versus that of public leveraged loans. Private credit premium shows the additional spread associated with private credit over and above the spread of public leveraged loans.

Private credit premium

Spreads: US middle market minus leveraged loans



Source: S&P (LCD) as of May 2023.

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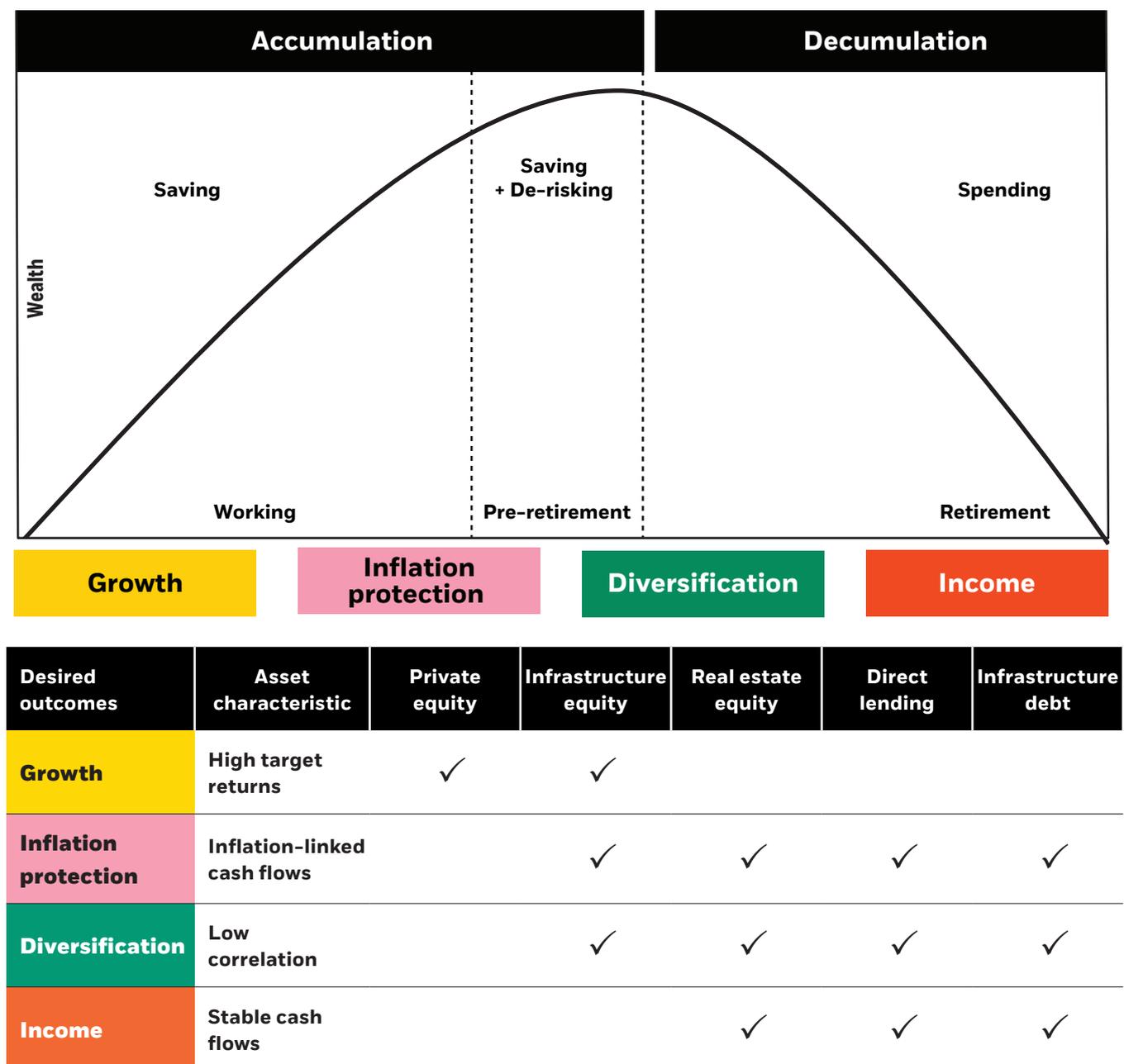
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How can different private market assets fit in a DC portfolio at different points of the lifecycle?

A lifecycle strategy is an all-in-one investment default option that offers a diversified portfolio with an asset allocation that adjusts over time (reducing risk as we approach our retirement date/age). As we move through this retirement journey, the lifecycle risks will vary in importance. Growth is more critical for younger members, and as our savings build and we approach retirement, diversification becomes more important. As the DC pot is likely to be the source of retirement income (given the shift from Defined Benefit to Defined Contribution), it will also be required to distribute income, as well as to accumulate savings.

Private market assets are not homogeneous and as outlined below, they can bring a range of benefits to investment portfolios. For this reason, when we allocate to them within the lifecycle strategy is of key importance as schemes will want to access different features at different stages as illustrated below:

Applying lifecycle investing insights into our design



Source: BlackRock as of June 2023. For illustrative purposes only. Subject to change.

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2 Key considerations when allocating to private markets

1 Integrating sustainability

Our investment conviction is that climate risk is investment risk and that integrating climate and sustainability considerations into investment processes can help investors build more resilient portfolios and achieve better long-term, risk-adjusted returns. Environmental, Social and Governance (ESG) integration within private market portfolios is therefore a minimum requirement and it can go further than this. Private assets can access parts of the investment universe not represented in public indices and can therefore provide additional ways to increase the sustainable features of a portfolio. Pension savings, through investments in private markets, can therefore provide sources of capital that provide solutions to many of the world's sustainable investment challenges. This can include areas such as impact investments and climate solutions.

Private equity: While far less information is published by private companies, the thorough and lengthy due diligence that private equity investors can conduct allows for a truly deep dive into companies. You can get a comprehensive understanding of a private company's exposures and performance through unrestricted access to their information. Private equity investors often own controlling stakes in a business, can have Board or observer Board seats, and typically hold portfolio companies for many years. This enables them to ensure that a company adopts robust and continually improving ESG practices.

Infrastructure and real estate debt: An investor's approach to ESG integration in real assets reflects the physicality and complexity of these investments and the very "real" way in which they interact with their surrounding environments. During the due diligence stage, investors undertake more thorough assessments to identify, analyse and rate any ESG risks and opportunities.

In BlackRock, we believe real estate will play a central role in the global energy transition and the necessary move towards a lower carbon economy. With the built environment contributing to over 40% of global greenhouse gas emissions¹, and with half of a building's impact over its lifetime coming from embodied carbon emissions, there needs to be a major focus on how to decarbonise both commercial and residential real estate in order to achieve net zero. Over the next few decades our real assets team believe there will be significant scale up of existing technologies, such as energy efficiency solutions, on-site and off-site renewable energy production and carbon capture and storage, that

1. IEA, May 2022.

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RISK: Diversification and asset allocation may not fully protect you from market risk.

will evolve the existing infrastructure and pave the way for real estate to decrease its carbon footprint.

2 Forecasting or analysing expected returns

Before any asset allocation decision is made, we should assess how the overall portfolio will be impacted. Though the trend of increasing allocations to private market assets might be due to anticipated higher returns, there has been limited work done across the industry to form robust return expectations for private market assets. Our BlackRock Investment Institute "BII" team spends a lot of time researching and forecasting private asset returns which start with our Capital Market Assumptions "CMAs".

Determining an appropriate portfolio allocation should be informed by a few considerations: having a view on expected returns, an estimate of uncertainty in these assumptions to reflect the potential deviation from this forecast, tolerance for illiquidity at a total portfolio level, and individual constraints and objectives. These considerations help better understand how investors should appropriately size a target private market allocation. Forecasting private markets returns should reflect relevant fundamental data for private market asset classes and the current macroeconomic backdrop, as well as an assessment of alpha potential for each asset class informed by historical manager dispersion.

To provide insights into best practice relating to portfolio construction for private market portfolios, we have provided the following paragraphs that detail how our specialist multi-alternatives "BlackRock Alternatives Portfolio Solutions (APS)" team creates bespoke portfolios for clients.

3 Portfolio construction

As discussed earlier, it is likely schemes will want to prioritise different types of private markets throughout the stages of the retirement journey. In order to manage governance considerations and gain access to a range of private markets, the scheme will also consider building a diversified multi-alternatives program. Portfolio construction is therefore key to achieving desired investment outcomes. Identifying unintended risks and correlations are critical for this outcome to guide asset allocation and investment selection.

As mentioned previously, private market assets are not immune to market cycles, and schemes that are new to private markets need to consider both the ramping up and maintenance of a diversifying private market assets

portfolio. This makes portfolio construction a critical component of a successful private market assets allocation.

Optimising across private markets: In private markets, translating target allocations into actual exposures is likely to take time, be inexact, and need regular revision as investments realise. A potential framework for optimising across private markets to mitigate these challenges should span the following three steps:

- I. Forecasting a distribution of performance for possible investment opportunities across time and asset classes.
- II. Using forecasted risk/return distribution to optimise a series of portfolio allocation.
- III. Simulating a series of plausible cash flows for each opportunity where returns are consistent with those forecasted in the first step.

For optimisation across private assets, a framework that weighs the risk/reward trade-off, and correlations across asset classes can be used. This also provides a facility for expressing an investor’s risk tolerance. With high risk aversion, the constructed portfolio is mostly direct lending; For low risk aversion, the portfolio concentrates in a few, riskier asset classes with the resulting allocation having a high probability of clearing a more aggressive target rate of return. More interesting and useful portfolios are found in between these two extremes.

The portfolio that is ultimately chose will therefore differ depending on a given investor’s goals, investment constraints and risk appetite. The chart below, “Optimising across a range of risk appetite levels”, depicts the different strategic private market asset allocations as a function of a risk aversion parameter.

4 Implementation

The nature of investing in private markets is evolving. Private market access – be it real estate, credit, or

private equity – is increasingly being gained via direct investments or co-investments, not just blind pools, or traditional funds. Further, the development of new investment vehicles, such as long-horizon private capital funds, or the Long-Term Asset Fund “the LTAF” in the UK provides new structures for investing in this space. The LTAF is an important development given the requirement for “open-ended” and “permitted links” within the DC market. When considering unitised vehicles, schemes can consider combining liquid and illiquid investments in a single structure that can align with the pricing and liquidity requirements for default portfolios.

Sourcing investments: Deal sourcing is an often underappreciated factor which can make a big difference to investors’ experience in private assets. In general terms, the more competitive the bidding process, the higher the price paid and the lower the expected return. Deals sourced through private networks of contacts can be completed with far less, or even no, competition, paving the way for more alpha opportunities. The ability to source deals globally and establish a broad network is a critical component of successfully sourcing investments in private markets. This is even more important for DC schemes given the large and growing asset base and requirement for evergreen solutions.

Value creation, monitoring and exit: Portfolios should be reviewed both from a holistic and investment-level perspective through time to track both deployment and performance. It is important to leverage fundamental and qualitative insights to ensure that exit options are evaluated. Technological solutions can assist in providing transparency for schemes and default managers.

Optimising across a range of risk appetite levels



Source: A better way to build private market portfolios, BlackRock, March 2023.

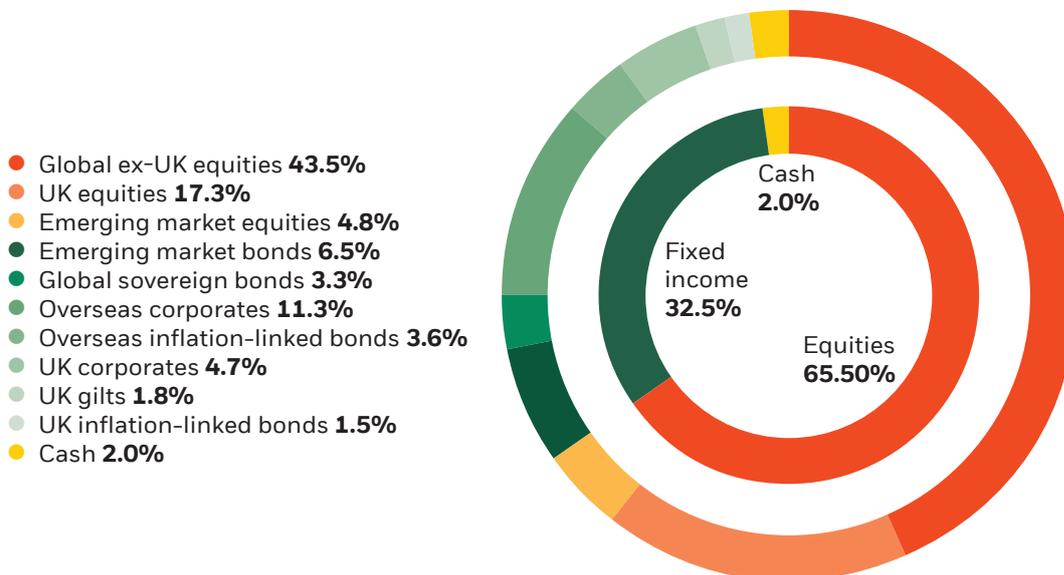
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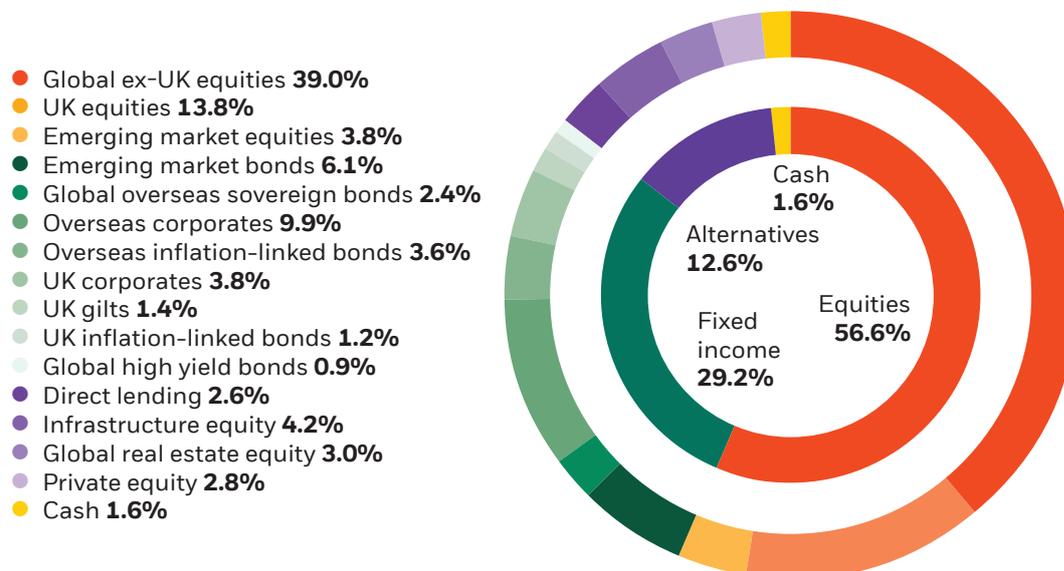
3 Illustrative case study

In addition to building an allocation to private markets, schemes will need to consider a “whole portfolio” approach when assessing how to include private markets in their default. For illustration, we model scenarios to show the impact on expected risk and return that an allocation to private market assets can have on an underlying DC beneficiary’s portfolio. Our starting point is a traditional growth DC pension portfolio (defined as “Traditional Growth Portfolio” throughout this paper) with c.70-30 Equity – Fixed Income/Cash split as shown below. Think of this portfolio as a growth asset that generates returns during the accumulation phase.



Below is a sample illustration of a “next generation of DC” portfolio incorporating 20% allocation to alternatives. The private assets are selected to deliver attractive returns whilst also managing the key member risks identified earlier in the paper (longevity, inflation, and market risk):

Next generation of DC portfolio (assuming 20% alternatives)



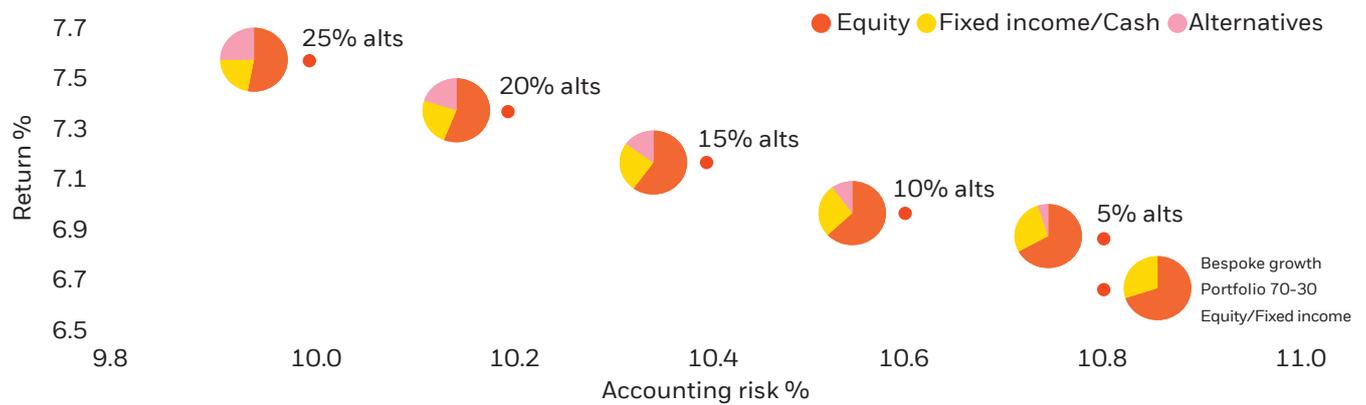
For illustrative purposes only. Source: BlackRock, as of March 2023. Traditional DC pension portfolio overlaid with 20% allocation to private market assets as illustrated above. Please note, figures may not add up to 100% due to rounding and may be subject to change in the future. For illustrative purposes only.

Risk: There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.

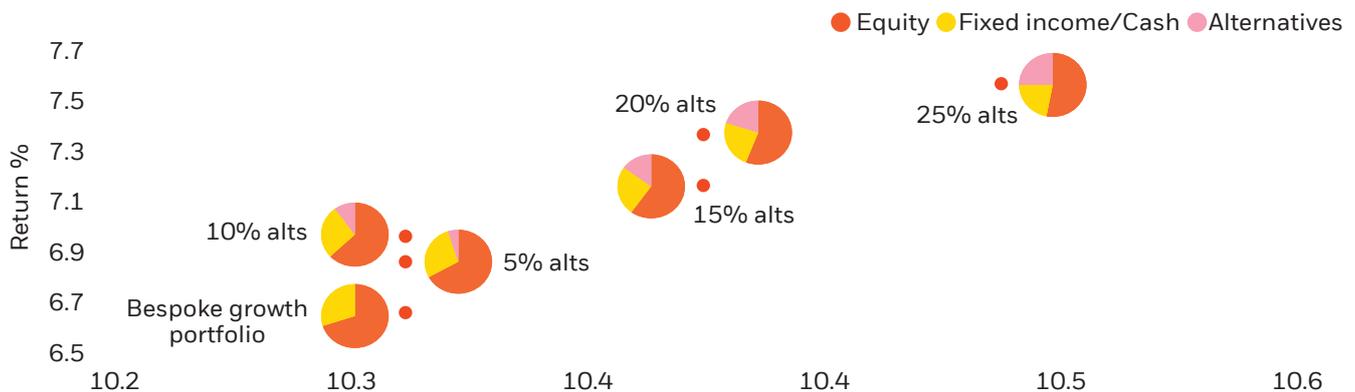
The investment opportunities that private markets offer to investors are well documented, but like all investments they are exposed to risks. It is therefore important to understand the drivers of these risks and the potential impact on long-term returns. The results of our analysis below is not to provide the only input into a private market investment but an illustration of part of the analysis that can be conducted as investors review the impact of a private market allocation in their portfolios.

In the following charts, we show how the expected risk and return profile of a portfolio can change as we start incorporating private market assets into the mix (in 5% increments). These charts show the change in expected net-of-fees (inc performance fees) return profile across both economic and accounting risk.

As illustrated in the first chart below, one consequence of incorporating private market assets into a portfolio is the smoothing effect. Owing to the relative infrequency of valuations in private markets, the prices of the assets can appear very stable. This makes the private market assets' returns appear less volatile over history and consequently the accounting risk is reduced. However, the accounting risk suffers from a tendency to underestimate both the variability in price that you would experience if you attempted to sell, and the correlation with public assets.



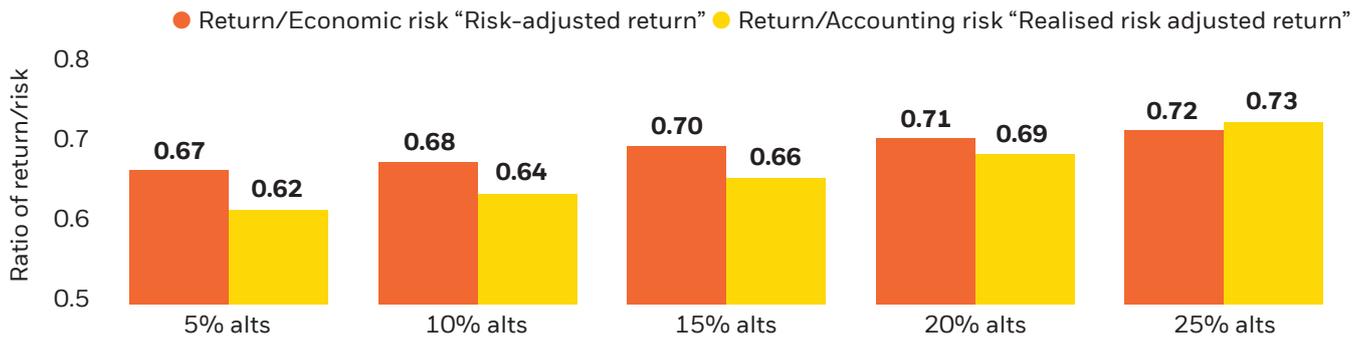
Therefore, any investment also requires an understanding of expected economic risk, which helps us better understand the risk drivers. BlackRock's proprietary risk management platform Aladdin allows us to overcome the limitations of accounting risk via incorporating economic risk. Economic risk is the analogous risk that a private, non-traded security would experience if it were publicly traded. We forecast economic risk by decomposing the risks of private market assets into comparable public market exposures, whilst maintaining due consideration for the unique characteristics of the former. We map the granular risk factors into Aladdin to understand how various alternative assets correlate to one another within the portfolio:



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In the chart below, we compare risk adjusted expected portfolio returns using both economic and accounting risk:

Risk adjusted returns (%) (Return/Risk)



Please note: Assumed time horizon for the investment is 20 years.

Summary (based on the above forecast)

- 1** It is evident from the charts on page 8 that by incorporating a carefully selected mix of private market assets into a traditional DC growth portfolio, it is possible to achieve a return uplift. However, the distinction between accounting risk and economic risk is critical in understanding the impact of a private markets portfolio.
- 2** When we account for realised risk (i.e., accounting risk), the overall risk of the portfolio can start to meaningfully reduce as you introduce more private market assets into the portfolio. This is mainly due to the volatility smoothing efforts of less frequent valuations of private market investments allowing for the difference between forecasted economic and accounting risks.
- 3** Even when we account for economic risk in portfolios, the differentiated risk profile of the private market assets means the additional forecasted returns generated from inclusion of these assets does not materially increase the portfolio's expected economic risk profile. As outlined before, in this analysis we define economic risk as annualised volatility based on risk modelling on Aladdin.
- 4** Overall, the forecasted risk-adjusted return uplift from incorporating private market assets into a traditional DC portfolio is evident both from an economic and an accounting risk perspective as outlined in the return/risk ration chart above. Better risk-adjusted return on investments pave the way for better retirement savings and outcomes for members.
- 5** The results here are estimates based on our recent Capital Market Assumptions. It is critical to revisit the assumptions that drive any output and continually review the output to help inform strategic asset allocation considerations. Using Capital Market Assumptions should be part of the assessment of the additivity of private markets, other considerations such as manager selection are also critical.

This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise – or even estimate – of future performance. Forecasts are not a reliable indicator of future performance.

Source: BlackRock, data as of March 2023. Notes: Return assumptions are total nominal sterling returns.

Please note that capital market assumptions for private market asset classes include generic alpha assumptions and are net of generic fee (management fee and performance fee) assumptions. Capital market assumptions are shown for a 20-year time horizon. Private markets realised/accounting risk is calculated on 6 years of quarterly data, using Thompson data as a source, as of Q4 2020. Public markets realised/accounting risk is calculated on 6 years of quarterly data as of Q4 2020 using Lipper ABI 40-85 fund as proxy. Capital market assumptions are sourced from BlackRock Investment Institute. There is no guarantee that the capital market assumptions will be achieved, and actual risk and returns could be significantly higher or lower than shown. Hypothetical portfolios are for illustrative discussion purposes only and no representation is being made that any account, product or strategy will or is likely to achieve results similar to those shown.

In this analysis we calculated the realised volatility of the illustrative "Next generation of DC default" portfolio over the past 6 years, using quarterly returns of the Thompson data as of Q4 2020 for private markets assets. For public markets, we used 6 years of quarterly return data using Lipper ABI 40-85 fund as proxy for the bespoke growth portfolio.

4 What's next?

Private markets can improve outcomes, with careful consideration of our framework. Areas for further consideration include, but are not limited to, the following:

1 Structure

Innovation in product structuring will help make private market strategies more accessible. The key things to consider here are the ability to grow the private markets portfolio over time so the scheme can invest contributions, in addition to meeting any liquidity requirements the scheme will need. As private markets assets are not valued as frequently as public markets, schemes will need to understand the terms of the private market assets (subscription, redemption, settlement) and the use of valuation models to provide regular pricing (including the need for stale prices).

When accessing illiquid investments, rebalancing processes, as well as a policy for meeting capital calls, will also need to be considered. Investing in alternatives that are illiquid can become challenging if the allocation and rebalancing process is automated. In order to manage cashflows, maintain allocation ranges and meet capital calls, allocating to private assets within a holistic solution may be preferable. For example, a target-date fund manager can facilitate an ongoing allocation to the private markets portfolio. In addition, this approach would allow a target date fund to potentially achieve different risk and return profiles from private market alternatives for different participant age cohorts. For example, targeting the enhanced return and higher illiquidity of private equity in young participant vintages and shifting to more “contracted cash flow” private market opportunities, like private credit and infrastructure, over time as members approach retirement.

2 Costs

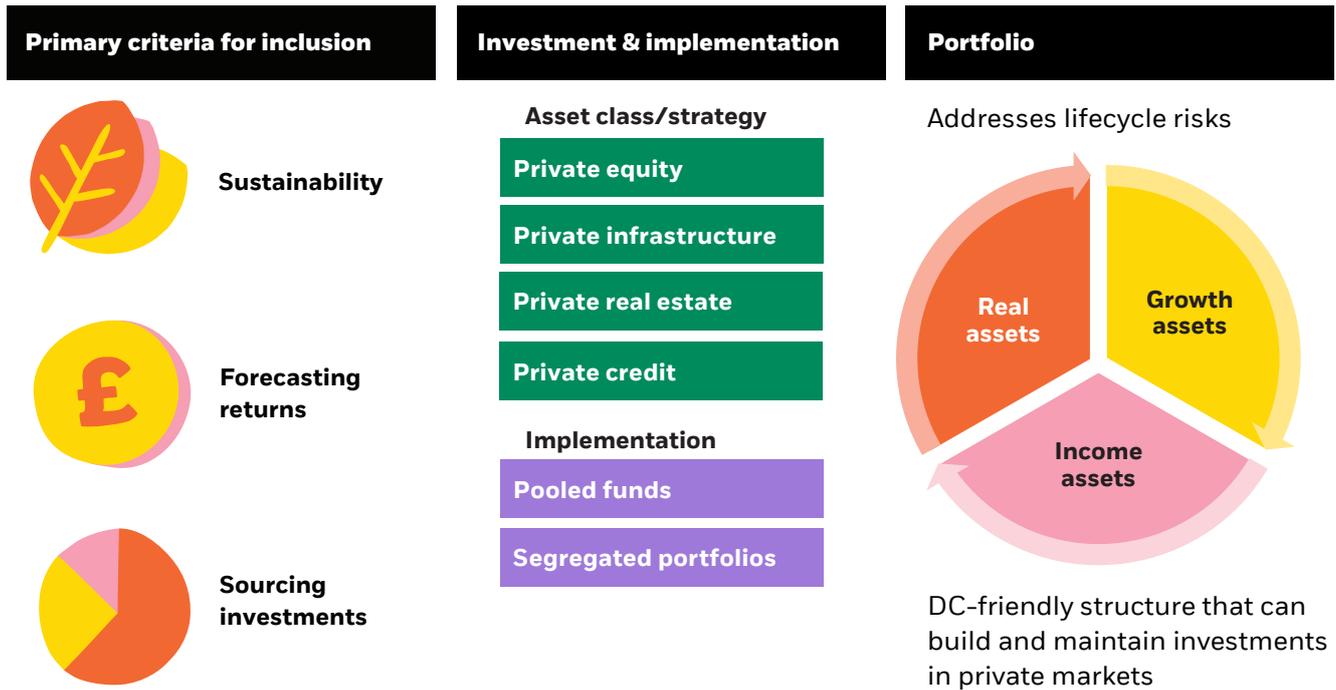
In alternative investments, the manager typically creates value through close monitoring of the operational performance of companies in which they invest and enhanced ongoing due diligence. This comes at a greater cost compared with public markets but offers the opportunity to generate superior returns. DC schemes make extensive use of low-cost index products and for good reason as they provide transparent and cost-effective exposure to a range of asset classes. This starting point does mean that any inclusion of private assets may lead to an increase in overall fees. With this in mind, it is important to demonstrate the net-of-fee economic benefit to the scheme. Many schemes, given the current usage of low-cost building blocks, will have the fee budget to allocate to private markets whilst still providing value for money to investors.

Flexible fee models and an understanding of regulatory developments will therefore make these types of investments more viable. The DWP has accommodated fees within the DC charge cap to ensure rules do not present a barrier to the success of the inclusion of private assets in DC portfolios.

RISK: There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.

RISK: There is no guarantee that a positive investment outcome will be achieved.

There's a lot to consider for schemes so we have provided an illustration of how combining these key areas of criteria for investment, implementation can deliver a DC-friendly portfolio below:



Source: BlackRock, as of May 2023. For illustrative purposes only.

Conclusion

Our paper has detailed some key considerations for schemes as they seek to include private markets in their DC default. Whilst there is much to do to facilitate broad adoption of private market assets in DC portfolios, we believe that the barriers are not insurmountable, and much progress has been made by stakeholders to overcome legacy challenges.

As outlined at the outset of this paper, we set out to conclude answers to 4 questions. Our takeaways are summarised below:

1 What role do private market assets play in DC today?

We expect more and more DC schemes to consider private market assets, but allocations should align with lifecycle considerations such as management of longevity, inflation and market risk.

2 What are the key considerations when allocating to private market assets?

We concluded private markets can have the potential to unlock attractive long-term sources of returns and sustainable investment opportunities within a well constructed and diversified allocation.

Nevertheless, private market assets are heterogeneous, and the risk profile of the allocation will depend on the mix of assets used. In addition, there are critical components, such as sourcing and ramp up processes, that should be part of the selection process.

3 Case study

We concluded, with specific examples, that private market assets are not just about returns, but more about risk-adjusted returns. Through understanding the drivers of economic risk and the impact of accounting risk, we can better assess the impact of a private markets allocation at the whole portfolio level.

4 What's next?

DC defaults should consider how best to incorporate less liquid strategies into the operating model and asset allocation policy. The answer is not to force illiquid strategies into liquid structures where there is a mismatch between top-level and underlying liquidity. Additional research and education on the inclusion of private market alternatives in DC schemes are needed.

As discussed earlier in the paper, a planned ramp-up to private market assets in a portfolio may be a more sensible approach, depending on the timeframe of the consideration.

Furthermore, a flexible approach to fees that recognises the potential net-of-fee benefit of including private markets, and the adherence to regulations is required.

In summary, we believe that if schemes do not incorporate alternatives, they will miss out on opportunities harvested by institutional investors globally. Private market assets may not be suitable for all schemes but their ability to manage key member risks makes them an attractive consideration for the next generation of defaults.

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Risks

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results.

Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time.

ESG Screening Risk

The benchmark index only excludes companies engaging in certain activities inconsistent with ESG criteria if such activities exceed the thresholds determined by the index provider. Investors should therefore make a personal ethical assessment of the benchmark index's ESG screening prior to investing in the Fund. Such ESG screening may adversely affect the value of the Fund's investments compared to a fund without such screening.

Liquidity Risk

The Fund's investments may have low liquidity which often causes the value of these investments to be less predictable. In extreme cases, the Fund may not be able to realise the investment at the latest market price or at a price considered fair.

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