UK Finance

UK capital markets: risk and reward

When an economy and society suppress prudent risk-taking, they also suppress growth. The implications can range from a society with limited financial resilience to well-intentioned regulation that inadvertently hinders economic growth.

To understand and address the UK's evolving attitudes to risk, reward and the role of our capital markets, UK Finance supports:

- Building a stronger link between capital markets and society. Demonstrating why people need to prepare for their financial futures and how engaging our markets and companies can assist in achieving that objective.
- Doing more to build a system of financial education and advice that equips individuals to understand how to harness the power of risk and reward productively over their financial lifetime.
- A political and regulatory culture that both protects consumers and businesses and supports productive investment.
- Promoting a cultural shift in how we talk about the role of capital markets in the UK, how we celebrate entrepreneurship and how we empower individuals to have a greater stake in the country's growth.
- Reviewing and removing frictions that discourage UK pension funds and other institutional investors from owning UK shares and supporting UK companies.

GC Global Counsel Research Partner

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The UK capital markets are where risk and reward come together for UK savers. One of the most notable features of the last twenty years has been the withdrawal of UK savers from those markets, both directly and indirectly.

Economies with developed markets are underpinned by a willingness to embrace risk in the pursuit of future reward. Every society needs a mix of investors willing to invest capital in exchange for an appropriate reward to support economic progress. These investors need strong companies to invest in. The UK will need both in the years ahead as it transforms its energy system, renews its industrial base and deploys innovative new technologies. In pursuing those aims, weaker companies will likely fail and stronger and more adaptable ones will succeed, and from that risk-taking will emerge the reward of a dynamic and innovative economy. Who shares the benefits of that growth is central to the question of how UK savers connect to capital markets to better provide for their financial futures. It is also the question of how we support and celebrate entrepreneurship and empower individuals to have a greater stake in the country's growth.

Where risk and reward come together

Capital markets are where economic risk and reward come together. At the heart of capital markets is the simple but powerful idea that an investor is able to take a stake in a company's future growth and success. Such a stake generally represents a riskier type of investment, but it is also the fundamental way in which investors channel risk capital to companies in the UK and seek better returns. Without investors willing to take this risk, the wider economy loses the future reward of growing companies.

There are two ways in which UK savers can participate in the risks and rewards of capital markets. They can do this indirectly through a long-term savings vehicle such as a pension or directly as an individual owner of shares or bonds. Both approaches have potential advantages. Investing in shares or bonds through a fund or pension provides diversification of risk and access to expert management. Investing in shares or bonds directly provides greater flexibility and allows an individual to allocate their savings to specific companies, sectors or other values they wish to support.

In both cases, in the UK there has been a long-term transition away from investment in UK shares (see Figs 1-3). In the 1960s, more than half of the UK stock market was owned directly by UK individuals – today that number is closer to 12%.[1] The number of UK

1 By contrast, US savers directly hold around 35% of US shares. See SIFMA 2019.

UK investors and UK companies: a retreat from risk?

Fig 1: Over time, both UK pension funds and UK retail investors have played a smaller role in the UK market for shares, with foreign investors playing a much larger one.
% UK stock market held by investor type.

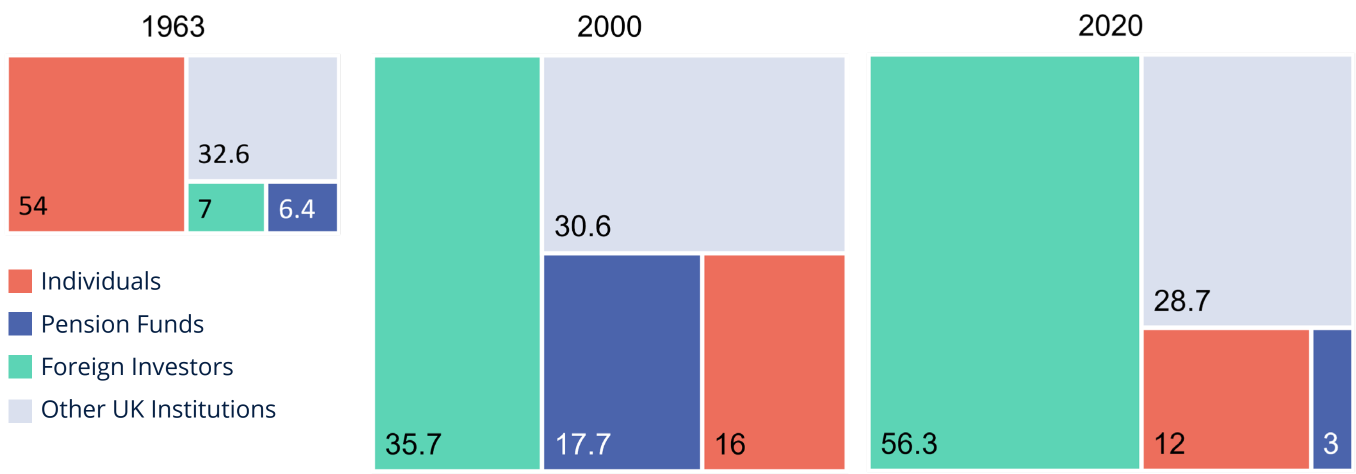
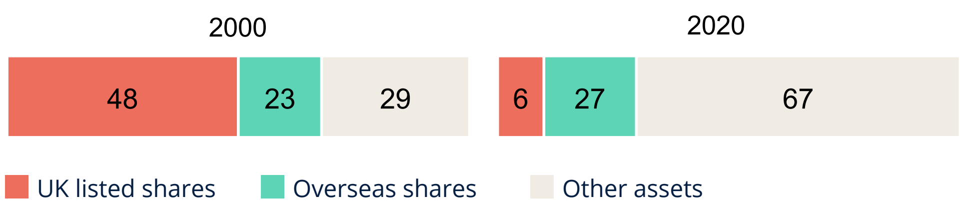


Fig 2: UK pension funds reduced their holdings of shares in general and UK shares in particular over the last twenty years.
% holdings.



New Financial March 2023, CMIT, UK ONS

households directly owning shares has fallen by more than a quarter from 15% to 11% over the last two decades - possibly reflecting the growth of Defined Contribution (DC) occupational pension schemes. Comparisons with other markets can be difficult as savings patterns can reflect a wide range of factors, including the role of property investment, but it is notable that twice as many American households as British ones held some of their savings directly in shares in 2022.[2] We see a similar pattern in investments made by UK pension funds on behalf of UK savers. These funds now hold less than a third of their assets in any form of company equity and only a small fraction of those shareholdings are in UK companies.

Outside of their pensions, UK savers hold a high proportion of their long-term savings in cash. This is reflected in the use of the

2 US Federal Reserve Triennial Consumer Finance Survey 2023.

UK individuals have an expectation of long-term financial security. However, these expectations will only be met in a political culture that supports them in taking informed risk. Protecting consumers must also mean ensuring they have the resources for long-term financial security.

UK Individual Savings Account (ISA) product, which gives every holder a choice between investing in cash or stocks and shares. Of the 11.8mn ISAs actively subscribed to in 2022, only a third (36%) were Stocks and Shares ISAs. Most savers choose cash ISAs or conventional savings accounts (see Fig 3). These significant cash holdings are vulnerable to inflation – a risk that UK savers remain more exposed to than they may appreciate.

Cash is typically recognised to be an important element of a balanced portfolio of savings. However, to maximise an individual's lifetime savings, it is generally accepted as preferable for cash holdings to be complemented by investments such as shares that can produce returns that outpace inflation over the long-term. This is especially true early in a financial life when a saver has more time to compensate for any short-term losses in their retirement portfolio.

The withdrawal from UK capital markets by UK savers both individually and through their pension funds is masked in part by inflows of capital from overseas investors (see Fig 1). Overseas investors are an important feature of UK capital markets and the UK's funding mix. However, this should be complementary to a healthy domestic investor base.
On balance, UK-based investors – both institutions and individuals – are not only more likely to know the UK better but are more likely to invest long-term in the companies that will contribute to the UK's economic success.

The drivers of this change - and how to address them

This retreat from UK capital markets has many drivers. One is an ageing UK population which enjoys the benefits of Defined Benefit (DB) pension schemes. Around 30% of UK households are estimated to be participating in such a pension scheme (see Fig 4) and almost half their members have already retired. The fund managers for these pension schemes are required to focus on generating reliable income, rather than capital growth. In many cases this has pushed them away from investments in equities over recent decades.

Most of these schemes are now being replaced by Defined Contribution (DC) pension schemes. Individuals who have DC schemes have an imperative to grow their capital. This creates a strong incentive to focus on the kinds of risk assets that generate the reward of capital growth, including UK equities. But for that to happen the UK will need several generations of savers newly engaged in how their pensions are being invested. It will also need a large stock of investable companies for those savers to invest in. Without the latter, fund managers will have little option but to continue to seek higher returns outside the UK.

A second driver is the way in which insurance and pension regulation has required larger holdings of liquid and 'safe' assets. These approaches may make sense for individual institutions, but for capital markets they can reduce demand for 'riskier' assets such as shares. While this trend in DB pensions will be hard to reverse, over the years ahead it will be important to ensure that UK liquidity and solvency regulation does not create unnecessary disincentives for financial institutions to hold UK equities.

Thirdly, levels of adult financial literacy in the UK suggest that there is a need for a new mix of education and basic advice and guidance for potential investors, especially when they are at the stage in their financial life when beginning to plan for their financial future is key. In comparison to peers in similar OECD countries, many UK individuals reach adulthood with material gaps in their financial literacy, especially around key investment concepts.[3] Combined with obstacles to accessing investment advice, this can leave many savers poorly equipped to understand how to invest for their futures, both in their direct investments and in the management of any DC pension they may hold.

3 See our third briefing in this series for a discussion of the potential implications of gaps in financial literacy in the UK.

The changing face of UK savings and investment

Fig 3: Cash is by far the most common form of non-pension saving.
% households, 2-year periods, 2006-2020.

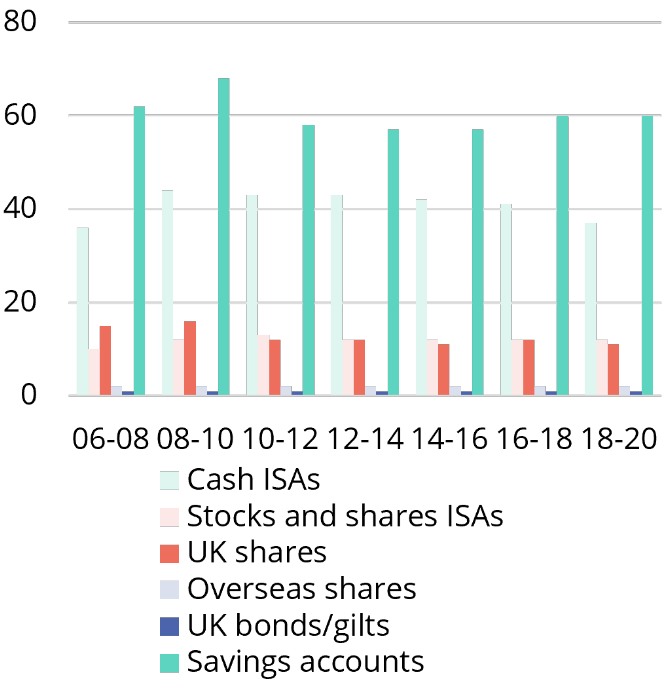
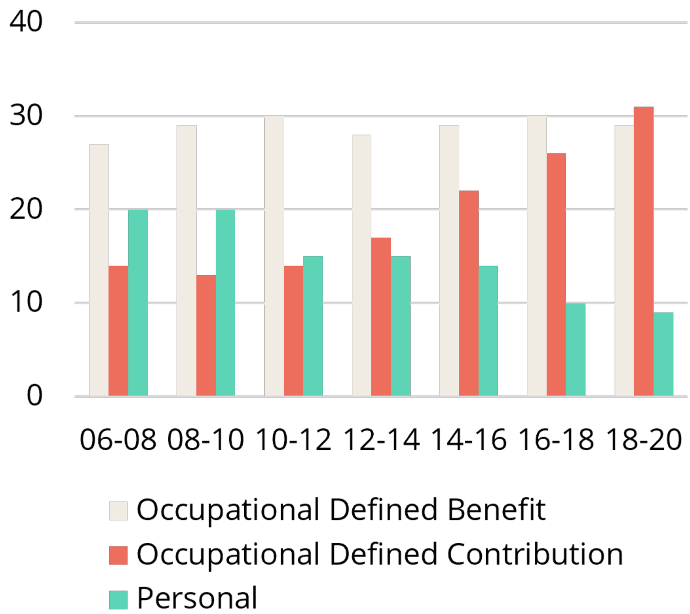


Fig 4: DC pensions are rapidly growing as a savings vehicle.
% households, 2-year periods, 2006-2020.



UK ONS

Finally, alongside our evolving tolerance for risk there is a perceived vacuum of support and 'championing' for entrepreneurs and those willing to take risk in the pursuit of commercial and personal success. UK authorities and industry alike should consider how to better promote and celebrate success and how this promotion could be made visible to overseas investors and businesses in efforts to attract them to the UK.

Addressing these drivers will require a mixture of solutions including regulatory change, some of which is underway, alongside improved financial education to help drive a sense of ownership over our financial futures. For this to work, the UK will also need to produce a steady supply of strong companies to invest in. But at the heart of all of this is a recognition of the role of risk and reward.

The consumer interest

The other important dimension of the UK's overall balance of risk and reward relates to how risk is perceived by society and governments and therefore how it is regulated. As noted above, well-intentioned regulation focused on risk-reduction has, in places, unintentionally disincentivised or removed support for UK equities. In some cases, such as reform of the UK listing regime, regulatory authorities have actively supported capital markets to better support the economy and companies. In other cases however, such as consumer and investor protection, the focus has often been rightly on the rights and recourse of retail financial services users but without an equivalent focus on producing informed and active savers who are better equipped to reach an appropriate level of personal financial security and standard of living in later life.

Regulators themselves recognise this imbalance. However, a risk-averse regulatory culture is often a reflection of the societal context. Regulators that face undue criticism when an informed individual or company loses money on an investment are likely to focus largely on consumer protection at the cost of longer term personal financial stability, financial wellbeing and economic growth. This backdrop will collectively push regulators, government, society and the economy into a position where risk is seen as entirely negative, hindering future reward and dampening productivity and growth.

This theme also goes to the heart of what we mean by putting consumer interests at the centre of the UK's regulatory ethos. Individuals have an expectation of long-term financial security. Yet UK data continue to indicate inadequate preparation for financial self-sufficiency later in life.
As such, regulators, governments and society should see the delivery of personal financial security as integral to consumer protection. Protecting consumers must mean ensuring they have the resources for long-term financial security if we are to avoid a future generation depending on savings and investments that fall short in later life and retirement. Political leadership will be required to ensure regulators are empowered to account for long term consumer financial resilience within the mission of consumer protection. These are the two sides of the consumer interest coin.

Conclusion

The UK is failing to maximise the potential of its capital markets to deliver long-term financial prosperity for its citizens; now is the time to address this. One of the most notable trends over the last twenty years has been the withdrawal of UK savers from UK capital markets, both directly and indirectly. This suggests a market and political culture in the UK that risks under-investing in its own national strength. Reversing this will not be simple. However, with the right political leadership, regulatory approach and cultural change, there are huge opportunities to improve the way UK savers invest in, and benefit from, the UK's long-term future growth.