PORTFOLIO INSTITUTIONAL APRIL 2023

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Bonds:
ACTIVE
meets
PASSIVE

BIG SOCIETY CAPITAL
Making an impact

COMMODITIES
Super markets

CARBON MARKETS
Bad credit

What does the industry say about real estate?
Read the roundtable on pages 34 to 41

PENSIONS ASPECTS LIVE

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BONDS: ACTIVE MEETS PASSIVE

It's a difficult time to invest in bonds. A cocktail of rising rates and volatility have turned what is considered by some to be a typically uneventful asset class into one that is a little more exciting.

An expected rise in defaults based on an economic outlook that makes difficult reading is one factor to consider when making investment decisions. In theory, this should offer opportunities for active fixed income strategies.

But while there has been some uptake in demand for actively managed bond fund strategies, investors are simultaneously increasing their exposure to passives.

What explains this paradox? Our cover story looks at how the balance between active and passive strategies in fixed income is changing (pages 16-20).

Also in this edition, we look at the problem with carbon markets. When they were introduced in the mid-90s it was hoped they would take the fight to climate change, but claims of poor governance and inadequate risk management have left some disillusioned. We look at how to fix the cap-and-trade system from page 28.

But one asset class where the outlook is bright is commodities. With demand for raw materials forcing prices higher, we look at what it could mean for institutional investors from page 42.

We also examine the case for investing in infrastructure, an asset class that the government is trying to drive institutional capital towards. Is this good news for long-term investors? We take a look from page 46.

For this month's interview, we speak with pensions specialist and academic Arun Muralidhar, who shares his ideas on how retirement savings can be more efficient. Read about how he would transform the industry from page 12.

We also catch up with the chief executive of Big Society Capital, who tells us about how he is trying to get more institutional investors to make a social impact (page 24).

Finally, we sit down with asset owners, their managers and a consultant to find out how institutional investors are approaching property. The conversation starts on page 34.

Mark Dunne
Editor
m.dunne@portfolio-institutional.co.uk

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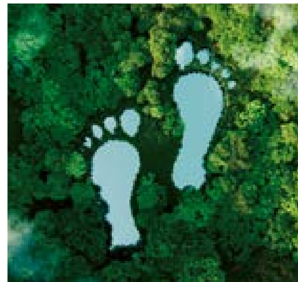

Carbon markets

In theory, putting a price on carbon should help reduce it. But with criticisms of the system piling up, what's gone wrong?

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DEFINED BENEFIT FUNDING CODE: "DON'T LUMP US ALL TOGETHER."

Rising gilt yields and the effects of last year's LDI meltdown have deepened the differences between open and closed DB schemes, a trend which poses a challenge for the funding rules. *Mona Dohle* reports.

With the second round of the defined benefit (DB) funding code consultation closing at the end of March, pension schemes, industry groups and consultants are calling on policymakers to push back on implementing new funding rules until next year, citing a greater need to distinguish between open and closed schemes.

Among the critics is USS, Britain's largest open DB pension scheme, which in a rare sign of unity sent an open letter signed by USS CEO Bill Galvin, UCU general secretary Jo Grady and Stuart McLean, director of pensions at Universities UK, urging The Pensions Regulator (TPR) and the government to establish greater awareness of the unique nature of open DB schemes, particularly multi-employer schemes. USS said that open schemes should not be "forced into an unnecessary de-risking journey" and suggested that funding rules for open schemes should be covered in a separate chapter of the code.

The PLSA backed calls to push back implementing the new funding rules until April 2024, on the grounds that "a disconnect between TPR's interpretations in the code and the requirements in the regulations which, in their current form, are more prescriptive in a number of areas". This included among others concerns about the requirement to invest in a so called "low dependence" strategy.

"It is important to point out that not all DB schemes are the same or are at the same stage in their journey to maturity," the PLSA's response said, warning that open DB schemes need greater flexibility in their investment strategies.

Unfortunate timing

The Department for Work and Pensions (DWP) launched the second consultation in July, with the aim of setting the rules on DB funding based on the 2021 Pension Schemes Act. The proposals included a requirement of "low dependency" for mature DB schemes, which effectively meant a transition to presumably lower risk fixed income assets. At the time, critics pointed out that this would effectively pressurise schemes to adopt a liability-driven investing (LDI) approach.

The consultation was meant to close in October but was overtaken by events – the autumn of 2022 turned out to be a spectacularly bad time to promote the low-risk nature of fixed income. Recognising the dramatic impact of last year's gilt crisis on DB schemes, the DWP and TPR agreed to push back the consultation until the end of March 2023, with the aim of implementing the new funding rules from October.

Open wounds

But seven months and two pensions ministers on from the mini-budget, much still remains to be clarified.DB schemes are still nursing considerable losses. At first glance, they were sitting on a considerable surplus of almost £400bn in February, according to the Pension Protection Fund (PPF).

But that was almost entirely due to the fall in liabilities as a result of rising gilt yields. On the asset side, the impact of the bond market meltdown has been devastating for LDI strategies, data from the Office for National Statistics (ONS) shows.

The market value of private sector DB and hybrid schemes fell by 12% between June and September last year, a drop to £1.28trn from £1.45trn, the ONS said. Throughout the same period, the value of defined contribution and public sector DB hybrid schemes fell by only 1%.

The ONS is clear on the culprits. "Greater exposure to rising gilt yields, including through liability driven investment, explains the larger percentage fall in private sector DB hybrid pension schemes' market value over quarter 2 and quarter 3, 2022."

But despite these dramatic losses, DB schemes did not sell their gilts for two obvious reasons: rising yields and the increased maturity of schemes. The combination of these factors accelerated the push for endgame strategies, including demand for buyouts.

The DB universe shrank to 5,131 from 5,220 last year. More than half are now closed to new benefit accrual, according to the PPF. Lane Clark & Peacock, a consultancy, predicts that this will accelerate the de-risking trend, breaking the £44bn record set in 2019. Phoenix Group predicts that bulk annuity deals could hit £60bn this year.

In asset allocation terms, demand for fixed income remains persistent, with more than 70% of DB schemes exposed at the end of last year. If anything, demand for cash has increased by nearly 40% throughout the crisis, ONS data showed.

Powerful allies

But open DB schemes are resisting the push towards de-risking. Schemes such as USS now argue that it is not in their interest to prematurely switch to fixed income assets. And USS, which manages more than £90bn, is mostly exposed to growth assets. Their call for greater flexibility on asset allocation might be music to the ears of some powerful allies. The treasury and fund managers have been pushing for pensions to allocate more of their assets to UK equities and infrastructure. While the merits of this strategy remain hotly contested, that, and the damages of last year's LDI crisis, could play into calls to rethink the DB funding code.

CHANCELLOR'S DC TECH INVESTMENT DRIVE RECEIVES WARM WELCOME

Jeremy Hunt's new workplace pension scheme proposals offer opportunities, but also pitfalls, finds *Andrew Holt*.

Jeremy Hunt's plans to nudge defined contribution (DC) pensions to fund innovation in the UK and to invest more in private markets have been broadly welcomed.

In the first instance, this will involve measures to boost the formation of vehicles for DC schemes to invest in science and tech companies.

Stephen Budge, a partner in Lane Clark & Peacock's DC team, said there are benefits to such an approach. "There have been a number of comments on the potential for mandating UK DC schemes to invest in UK growth. While mandating investment clearly has its issues, we also note that it offers some important benefits as well."

Investing in the UK

Here, Budge said, there is the strong engagement message for pension members – that they will be investing in the economic future of the UK and potentially innovative companies supporting the climate change agenda. There is also simplicity in its application, as all schemes will be in the same position, which would support liquidity requirements.

"Given the speed of take-up of private markets across the UK's DC market, such an action would significantly speed up private market allocations, leading to, in theory, better member outcomes," Budge said.

Phil Brown, director of policy at People's Partnership, which provides The People's Pension, also welcomed the move. "Policymakers are right to consider how defined contribution schemes could invest in less liquid assets in the future."

Although he added that pension funds have to think about other considerations. "While we are supportive of steps to enable schemes to invest in less liquid assets, consideration must be given to whether the risk-return profile of investments are right for their scheme and that liquidity risks are manageable."

Budge says the government must do more to incentivise pension funds. "If the government wants to speed up the unlocking of UK DC investment from the already substantial and fast growing pool of member savings, in our view, it must require schemes to invest through mandating, or if not, incentivise interest in some way."

Brown also said any investment alterations have to be seen in the context of the history and changing pensions landscape. "We must not forget that automatic enrolment is just over 10 years old, meaning that those schemes are not yet at scale.

"Once such scale is achieved and barriers to investment in less liquid assets, such as cost, are removed, then we are likely to see more investment in such assets by workplace pension funds – if it is in the interests of members to do so. Pensions exist to provide savers a reliable income in retirement and this is something that policymakers must not lose sight of."

This leads into DC funds committing to greater private market investment overall. "Private markets remain a new area for DC investment strategy design and while progress has been made with some innovative schemes, the approach is tending to focus on appointing a manager to access a broad spectrum of private market investments," Budge said.

This is important, he added, as it helps to diversify the liquidity risks, valuation points and reduces timing risks and means trustees do not need to assess each underlying allocation.

"Therefore, when it comes to thinking about specific investment in a niche sector, it will be down to the appointed fund managers to consider the merit of UK-focused science and tech opportunities, alongside investments in the other sectors – and likely across other countries," Budge added.

As such, it raises a question as to how much commitment these investments will see from the UK DC market until private markets gain traction amongst schemes, even with the government championing investment.

A natural link

It is an area the government, regulators and industry have been spending time on. The Productive Finance Working Group is one example. And the new Long-Term Asset Fund is designed for DC pensions to invest in private market assets.

Jeremy Hunt has said companies across science and tech sectors – including green industries, digital technologies, life sciences, the creative industries and advanced manufacturing – needed capital to start up and expand in the UK, creating a natural link with pension funds.

Budge added: "There remain significant challenges for trustees in allocating to private markets, such as the cost and fairness to members, as well as the structuring of these investments on institutional platforms through which most DC schemes access their investments."

This does, however, raise wider concerns for DC pensions. While there are opportunities in such new investment areas, questions will be raised about how much pensions are being asked to undertake the government's investment heavy lifting and how feasible are such investments to DC pensions funds.

Yet a spokesperson for Nest welcomed the opportunity for more pension schemes and UK workers to access private assets. Investors will therefore look forward with interest to Hunt's "ambitious package of measures" set to be unleashed in the autumn.

PEOPLE MOVES

Capital Cranfield has welcomed **Andy Cox** as its new chair, after Martin Jones stepped down.

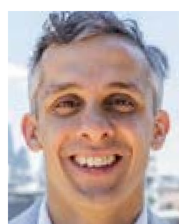
Cox has been a non-executive director of the professional trustee specialist for three years and is a professional trustee in his own right. He spent his early career in Aon's EMEA and global leadership teams.

Meanwhile, **Nicky Hardcastle** and **Bobby Riddaway** have joined the firm as professional trustees.

Hardcastle has spent more than a decade chairing defined benefit and defined contribution schemes, while Riddaway is an investment consultant who has held roles at Buck, Aon and HSBC.

Kieron Boyle is the new chief executive of the **Impact Investing Institute**.

He replaces Sarah Gordon, who left the institute at the end of last year. Bella Landymore and Sarah Teacher will continue as interim chief executives until he takes over in May.



Boyle (*pictured*) joins the institute after seven years as chief executive of the £1bn Guy's & St Thomas' Foundation. He brings a track record in impact investing to the role having previously been director of impact investment at the Cabinet Office. During this time, he oversaw the government's strategy to make the UK a global hub for impact investing.

Boyle is also chair of the Long-term Investors in People's Health programme, a $7trn (£5.8trn) global alliance of institutional investors.

In other news for **Guy's & St Thomas' Foundation, Cynthia Duodu** has been recruited as chief people officer. The role has been created to improve diversity, equity and inclusion at the organisation.

She brings public and private sector experience to the impact investor having worked in strategy, culture and transformation in the telecommunications, energy and health sectors, including at the NHS.

Duodu's (*pictured*) previous role was director of people and organisation development state-owned organisations the Low Carbon Contracts Company and the Electricity Settlements Company.

Meanwhile, a former chief investment officer of Border to Coast has joined California's public sector pension fund.

Daniel Booth (*pictured*) has taken up the newly created position of deputy chief investment officer of private markets at **CalPERS**, which manages $443bn (£364bn) of assets.

He joins from the UK Infrastructure Bank, where he has been a senior adviser establishing its investment platforms since February last year.

CALENDAR

Topics for confirmed upcoming *portfolio institutional* roundtables:

May
– Stewardship

May
– DC multi asset

June
– Biodiversity

July
– Private markets

September
– Defined contribution

October
– Fixed income

November
– Sustainable strategies

NOTICEBOARD

Pension Insurance Corporation (PIC) has bought an office building in Croydon for £268m.

The building, which is situated next to East Croydon train station, is to be let to the Government Property Agency. The insurer of defined benefit liabilities bought the property from Schroders.

PIC has also funded the construction of the UK's first new reservoir for around 30 years. It has lent £50m to **Portsmouth Water** to build the Havant Thicket Reservoir. The CPI-linked senior debt matures in 2037.

The reservoir is designed to ensure a constant supply of water, no matter the weather.

Elsewhere, PIC has agreed the largest bulk annuity transition to date after guaranteeing £6.5bn of liabilities for two schemes sponsored by insurer **RSA**. The deal covers the pensions of 40,000 members.

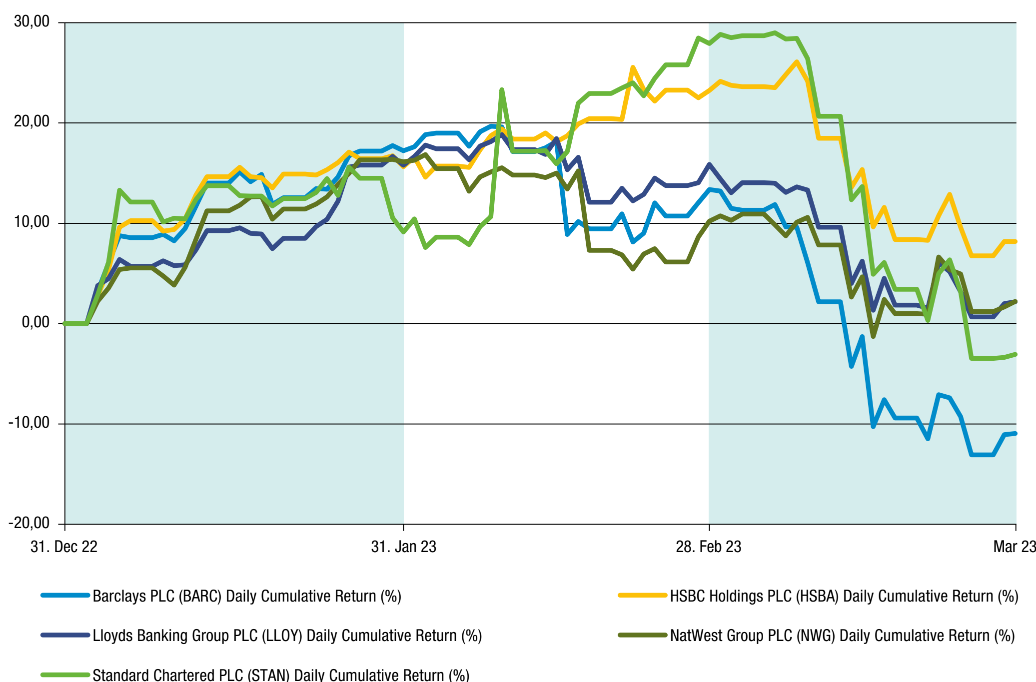
PIC has also completed a full buy-in of **Spirent Communications**' pension scheme. The £142m deal guarantees the benefits of its almost 2,000 current and former workers of the cybersecurity testing specialist.

The Shoe Zone Group Pension Scheme is now fully insured after **Rothesay** agreed a £34m buy-in. The deal, the third between the insurer and the footwear retailer, covers the benefits of more than 500 members.

Just is insuring the benefits of around 420 pensioners and 200 deferred members of two craft brewers in Cardiff. A £70m full scheme buy-in has been agreed with **SA Brain's** pension scheme and the **Crown Buckley Pension Scheme**.

Finally, **Punter Southall Governance Services** and **20-20 Trustees** have merged to create **Vidett**. The combined entity will have a team of 120 trustees and 475 clients.

THE BIG PICTURE: DON'T BANK ON FINANCIALS



Source: Morningstar Direct

The banking crisis should be viewed in a wider current context of rising rates and could take some time to fully play out, says *Andrew Holt*.

The fall of Silicon Valley Bank (SVB) followed by regulators closing Signature Bank and then struggling Credit Suisse bought by rival UBS for a discount led to a sharp selloff in financial stocks.

About $460bn (£373bn) was wiped off the sector's value when the negative headlines spread from California to New York and then Europe. The biggest losses occurred in the US where the KBW Bank index fell 18%, just ahead of Europe's Stoxx 600 Banks index dropping by 15%. The crisis even rippled through to Japan's Topix Banks index, which tumbled 9%. Something, no doubt, not lost on investors.

Whether banks started to crack under the strain of historic interest rate rises, or if the oversight of lenders introduced after the 2008 financial crisis failed, stocks nevertheless plummeted in March.

The rate rise narrative is a strong one. Rate rises – currently the central bank norm – can bring problems for lenders who find themselves exposed to duration risks in their credit portfolios. SVB's collapse sparked concerns over unrealised interest rate losses on assets held by the banks. Simultaneously, rapid cash withdrawals and declines of liquidity reserves can have a ripple effect in the more vulnerable parts of the economy, as banks restricted in their ability to provide credit.

Commentators keep repeating that this crisis is not comparable to 2008's financial catastrophe based on the view that the banking system is now built on stronger foundations. But the events in March question that premise.

How, and when, will the crisis abate? It is an interesting point given that Deutsche Bank was another big name caught up in the crisis. Yet those backing British banking institutions should be relatively safe.

Economic research firm Pantheon Macroeconomics has observed that stress levels are low among British banks, with none having been "mismanaged" like Credit Suisse or have a large destabilising pool of fixed income securities like SVB.

It is nevertheless a problematic picture for investors. Finance stocks are usually reliable up-tickers in a portfolio. This new crisis potentially shifts this narrative to one where financial institutions with sensitivities to rates will remain vulnerable. Something investors will have to consider, even if they have not been forced to do so already.

Crevan Begley is the investment director of Broadstone, which advises on pensions, investments and employee benefits.

CDI: A LIQUID STRATEGY

Cashflow driven investing (CDI) is an investment approach that helps defined benefit pension schemes pay their ongoing benefits and meet their long-term funding objectives.

To generate predictable cashflows, CDI strategies typically focus on high-quality fixed interest investments, such as investment-grade corporate bonds, arranged in a way that minimises the risk of having to disinvest assets at potentially inopportune times, especially in volatile markets. These types of assets can provide stable, predictable contractual income that is paid in line with the expected cashflow requirements of the pension scheme.

The erosion problem caused by volatile returns

As defined benefit pension schemes continue to mature (and in many cases become increasingly cashflow negative) the dangers of having to sell assets at a depressed level, to meet benefit payments, increases.

For example, a mature defined benefit pension scheme might require annual disinvestments of around 7% of its assets to meet benefit payments. Over three years, this would mean about 20% of total scheme assets are sold to pay benefits. For many schemes, this income yield level required will be considerably higher now than it was a year or more ago, due to the higher interest rate environment which has reduced asset values.

Financial market history tells us that market crashes (periods of poor investment returns) are often followed by market corrections (periods of high investment returns) and vice versa. Over time, the psychological and emotional factors that impact investment returns can be expected to cancel out, with long run investment returns ultimately being driven by more tangible, fundamental factors. However, cashflow negative investors don't have the luxury of long run averages. In volatile markets, chipping away a fifth or more of the portfolio's value during a downswing can seriously undermine the ability of the remaining assets to deliver the returns required to fulfil a scheme's funding plans.

The CDI solution

One way to manage the significant impact a market downturn could have is to ensure the investment strategy is able to generate a sufficient level of income each year. This income could be used to meet the expected amount to pay benefits without having to sell assets. Income can be provided by coupon and redemption payments from fixed interest holdings, the maturity of which can be structured to match the expected benefit outgo over the short term, for example, the next five years.

For every year that investment returns are in line with expectations or better (i.e., a scheme's funding position is at least on track), a tranche of the riskier assets such as equities can be sold, to fund the purchases of additional fixed income assets within the CDI strategy.

This could then maintain the expected cashflow matched position over the desired period (five years in this example), which would otherwise roll down every year. During a year when investment returns are poor, riskier assets could be retained rather than being sold, and the matched cashflow position would be allowed to roll down temporarily. Building in a sufficient period of cashflow coverage allows a scheme to be more patient in terms of the timing of any subsequent asset rebalancing and further purchases of CDI assets.

For a scheme that is already well-funded, there may be little or no need to continue to hold more volatile growth assets and a substantial proportion of the investments could be invested in a CDI strategy.

For these schemes, CDI reduces the variability of the future realised return. Market sentiment would no longer impact future realised returns, only the actual pattern of returns achieved from the investments held.

Depending on a scheme's funding position and circumstances, CDI will have differing levels of attractiveness. Given many defined benefit pension schemes are closed to new entrants and are becoming significantly mature, the application of the approach is likely to remain attractive and become even more widespread.

Publisher
portfolio Verlag
Smithfield Offices
5 St. Johns Lane
London
EC1M 4BH
+44 (0)20 7250 4700
london@portfolio-verlag.com

Editor
Mark Dunne
m.dunne@portfolio-institutional.co.uk

Deputy editor
Mona Dohle
m.dohle@portfolio-institutional.co.uk

Senior writer
Andrew Holt
a.holt@portfolio-institutional.co.uk

Publisher
John Waterson
j.waterson@portfolio-institutional.co.uk

Head of sales
Clarissa Huber
c.huber@portfolio-institutional.co.uk

Head of roundtables
Mary Brocklebank
m.brocklebank@portfolio-institutional.co.uk

CRM manager and business development
Silvia Silvestri
s.silvestri@portfolio-institutional.co.uk

Marketing executive
Sabrina Corriga
s.corriga@portfolio-institutional.co.uk

Ellie McLaughlin is the senior policy officer at ShareAction.

DO PENSION FUNDS HAVE THE POWER TO ACT IN SAVERS' BEST INTERESTS?

Last year, the demand for greener pensions soared to 21 million savers in the UK, according to campaign group Make My Money Matter. As awareness grows around the climate impacts of pension savings and their role in shaping the future savers will retire into, a spotlight has been put on pension funds and perceived legal uncertainty around action on sustainability.

Pension funds are uniquely positioned to influence the direction the world is going in and issues like climate change. As the stewards of future retirees' savings, their point of view must take the long-term into account. However, a gulf is emerging between what savers want and need from their pension providers, and trustees' understanding of what they are able to do within the current legal framework.

Pension funds' fiduciary duties require them to act in the 'best interests' of their beneficiaries – pension savers. Typically, this duty has been interpreted to mean maximising risk-adjusted financial returns. A report published in February by Pensions for Purpose found that many funds are concerned about the extent to which addressing climate change falls within this duty. There is likely even greater caution around how the social impacts of investments fit into this.

Internationally recognised climate science has made it clear that there is no room for new fossil fuel extraction if we are to limit global temperature rises and mitigate more extreme impacts of climate change. Yet, a pension fund considering a shareholder resolution calling on a portfolio company to stop new oil and gas field development may feel this conflicts with their fiduciary duty. This is despite the impacts of such a company potentially undermining a liveable future planet and society for their beneficiaries.

To the average pension saver, it is likely common-sense that their 'best interests' would include a stable, healthy society and planet now and in the future. Many experts have demonstrated that legal frameworks around fiduciary duty in the UK permit and, indeed, often require investors to consider sustainability where these impacts are instrumental to achieving financial return.

However, in the law, the ultimate purpose of pension schemes remains maximising risk-adjusted financial returns. Until it is clarified that investors may be motivated by broader factors, and they are given greater latitude to consider accepting slightly lower financial returns in the short term when deemed necessary to protect beneficiaries' broader interests, such as their quality of life or the environment, pension funds simply do not have the certainty to take action on environmental and social impacts that we need.

In the debates around the Financial Services and Markets Bill, questions have been raised around whether fiduciary duty is fit for purpose.

A proposed amendment in the House of Commons, which would have resulted in pension schemes considering the long-term impact of their investments on people and the planet, received cross-party support, but unfortunately did not pass.

Still under consideration is an amendment, which would call for the Department for Work and Pensions to issue statutory guidance on how trustees and fund managers should regard the impact of their investments on society and the environment.

Whilst this would be a welcome step in providing more clarity on how pension funds can incorporate sustainability considerations into their investing within our regulatory framework, it ultimately falls short of amending the 'black letter' of the law itself.

March's sobering Intergovernmental Panel on Climate Change report set out the slim window of opportunity for decisive action on climate change, pointing to the social and environmental devastation already wrought by extreme weather such as flooding and heatwaves.

Helping savers plan for their financial futures can and should entail considering the kind of world their pensions are building, and the price that will be paid if it doesn't. If the government wants to empower pension funds to act in the 'best interests' of savers, their children, their communities and the planet, we need legislative change to clarify fiduciary duty.

Design and production
portfolio Verlag

Printed in the UK by
Stephens & George

Subscription rates
UK £222 (9 issues),
Single issue price: £27.50
Overseas €270 (9 issues),
Single issue price: €33.50

Enquiries
+44 (0)20 7822 8522
j.waterson@portfolio-institutional.co.uk

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INTERVIEW – ARUN MURALIDHAR

"Sometimes, being an innovator is no fun because everyone throws stones at you."

Mona Dohle catches up with the academic and pensions expert to discuss the benefits of working in different countries, taking inspiration from the tech bubble, working with a Kennedy and proposing a new way to fund retirement.

Tell me about your roles on the advisory committee for the Virginia Retirement System's defined contribution plan and the academic advisory board of PGGM, a Dutch pension investor for healthcare workers.

Fundamental to what I'm doing is being a student of retirement security. I was blessed to work on the World Bank's pension plan in the 90s where we also advised predominantly poor countries about setting up a pension system.

The benefit of being globally active is that you realise what happens in the Netherlands is different from what happens in America. Unless you have a truly global perspective, you could make some bad decisions on behalf of your clients.

One the one hand, I'm constantly learning from these roles, but on the other, I'm telling the Dutch what the Americans are doing that is interesting and vice versa. It's a bit like being a fly on the wall and hopefully both sides can benefit.

And PGGM manages defined benefit assets, right?

Yes, but they are in a transition to some form of defined contribution. This is what's interesting about being involved with a Dutch pension fund: they are going through two major transitions, which affects the entire country, not just PGGM.

One is that the old defined benefit (DB) contract will not be around for much longer, with people skirting around two variations of DC.

On the one hand is the American style of DC where you have your own account and we are just the administrators. On the other, is an approach that allows for some form of risk sharing.

The second major transition is incorporating ESG into their pension objective, which is very forward-thinking.

Do you mean Collective Defined Contribution (CDC)?

Yes, but the Dutch model has not quite locked in because there are many stakeholders and there is also the question of how people are treated in the transition process.

CDC is also being discussed in the UK, but I'm not convinced that it solves a lot of the problems we need to solve.

In terms of risk sharing?

Yes, because when you are in a collective agreement, someone inevitably benefits at the expense of another.

For example, if you die young, you are subsidising the people who live longer. And typically, poorer segments of society tend to have a lower life expectancy, so you have poorer people subsidising the old, unintentionally of course.

Another challenge is that many central banks have caused pension schemes to become underfunded because of their low yield policies. In that case, the young

are subsidising the old. In a collective agreement it is challenging to make sure no one is disadvantaged. Typically, the young are not at the table during these discussions.

In one of the books you wrote [*A SMART Approach to Portfolio Management*] you advocate a rules-based technique for asset liability management. What does that mean for an institutional investor like PGGM?

One of the nice things about working for the World Bank in the 90s is that we learnt from institutions with state-of-the-art practices. Shell UK was one of the first pension funds we visited because it was professionally run, but it was focussed on the asset side of things. Whereas, when we went to the Netherlands, they were focussed on liabilities. The Dutch have always argued that liabilities are the starting point for a pension fund, so all investment decisions should be liability focused.

Ever since, I have had this hook with the Netherlands because that is the correct way to manage a pension fund. I transitioned from the World Bank's pension fund to a large asset manager in 1999 and received an enormous increase in salary, though with no increase in intelligence. But the asset manager had a rules-based approach. In 2000, when the global equity markets blew up in the tech bubble, a lightbulb popped up in my head: if pension funds could adopt the same practices that they expect from their external asset managers, which is often a rules-based process, they could have similar success. My mission, with my co-founder became: "let us teach pension funds to do this in-house".

Coincidentally, one of the case studies in our book is Abn Amro's pension fund, which applied a rules-based technique in 2008 and did extremely well because of this process. One of the things they did was to increase their liability hedge as risk came off the market. They executed that beautifully and did not suffer the challenges that 99% of funds experienced globally.

How is that approach different from liability-driven investing?

Liability-driven investing can be a naïve approach where you set a static liability hedge. You just define your liabilities and put 70% of your portfolio into the liability hedge.

But this number is not static, it depends on how the fund is doing. If it is doing well, you don't need to take a lot of risk, especially if your funding status is above a 100%. Then you can go to a 100% hedge, which coincidentally is something that the Boots Pension Scheme did very well. At the time, people were going on about how brilliantly the stock market is doing but what Boots did was absolutely correct.

Sometimes, being an innovator is no fun

because everyone throws stones at you. But what John Ralfe did for Boots back in the late 1990s was brilliant. The SMART model says that you should dynamically switch between risky assets and a liability hedge based on how well funded you are. If your funding status gets a lot worse, you shouldn't be taking a lot of risk. But a lot of pension funds ended up taking more risk the worse off they got.

But Dutch pension funds also ran into trouble with their LDI hedges.

More so on the inflation hedging side. On the interest rate hedge, Dutch funds are now above 100% funded. I have always been a proponent of the argument that central banks were destroying retirement funds with low yields to prop up the stock market. This has made the price of retirement very high. Dutch pension funds were at the mercy of the markets, just like every other pension fund in the world.

Moving from DB to DC, your latest work, *50 States of Gray*, addresses what you describe as the DC retirement crisis. What are you proposing?

I wrote a book on reforming social security with Professor Franco Modigliani, who is a Nobel Prize winner. We started writing the book in 1997 because we were concerned that the World Bank was telling poorer countries to privatise their social security systems.

We said that this is going to be a disaster because you are asking people to make decisions on how much to save and invest and they are not trained to make these decisions. This privatisation is only going to transfer wealth from poor people to rich asset managers.

Sadly, we were correct. Everything we warned about 25 years ago turned out to be true, but I take little solace in that.

I had given up on pension reforms but then I was approached by Kathleen Kennedy, the daughter of Bobby Kennedy, who was trying to focus on the segments of the population who are not covered by pension funds, which is also a big issue in the UK. In the US, 50% of people are not covered by a pension fund, so who is going to look after them?

She was trying to get state governors in America to implement a pension plan to provide these people with access to a safe retirement and she convinced me to get off my backside. This is how 50 States of Gray came about.

Did you get any responses from US policymakers?

At the time, a big part of the debate was if we should follow the Nest model, which has been successful in getting people into the UK's auto-enrolment system. I had a lot of global examples in the book to show them what people have done and that there is no need to reinvent the wheel for certain aspects of it.

Nest has done a phenomenal job of centralising the system and professionalising management, good board oversight and bearing the costs of setting it all up. But what I found lacking was that Nest did not have a good decumulation strategy and tried to enforce annuities on people.

That got me thinking that there has to be a better way of solving the decumulation problem. That is how the Retirement Security Bond idea came about (originally called "SeLFIES").

In a collective agreement it is challenging to make sure no one is disadvantaged.

How is the DC side of the Virginia Retirement System (VRS) coping with volatile markets and uncertainty on rates?

I am just taking part in a retreat for VRS where we are talking about the fact that we have higher rates, assets are expensive and cracks are starting to show in the global economy. It is not only Sri Lanka that has been challenged; we now have Silicon Valley Bank and Credit Suisse.

More importantly, every pension fund and endowment across the globe has gone into private assets. They have one good feature from an accounting perspective – they don't have to use mark-to-market. But the negative to that is the absence of transparency: you don't know what risks you are taking.

We now have a similar problem to 2008 with private assets coming under stress and people not managing that risk effectively.

In the UK there is now a big push by the government to get DC funds to invest more in private assets.

I would think twice about that. DC is a completely different ballgame.

If a DC plan wants to get private equity returns, they should just lever up on their equity portfolio. Private equity doesn't give you mark-to-market values and they might claim the broader market is down 10% and that their fund is only down 3%.

If I were a smart DC investor, I would say: "Give me all my money back." And when they mark it down, I would put my money back in.

But you can't do that with assets that don't price regularly if you allow people to borrow from their funds. That is going to create all sorts of incentive issues.

My personal opinion is that private assets don't belong in DC funds.

Instead, you are campaigning for the introduction of a retirement security bond. Is it similar to TIPS or linkers?

In concept yes, but the idea is slightly different. Ordinarily, your auto-enrolment

provider would send you a statement telling you what your savings pot is worth. But it doesn't tell you what income you are going to have when you are 65.

You are left guessing and, in some cases, the total number might look large and people might end up spending it without realising that in retirement terms, it is very low.

The idea behind the retirement security bond is simple. It pays you nothing until you retire. At 65 it could pay you £10 a year for 20 years, which is the average life expectancy in the UK and is indexed to inflation.

If your goal in retirement is to have an income of £50,000, the only thing you have to do is divide 50,000 by 10. So your goal is to buy 5,000 of these bonds until you retire. That is it.

All you need is to answer two simple questions: your date of retirement and your target income at retirement. This allows you to plan carefully and successfully. Everything else – accumulation, compounding interest, inflation indexing – is embedded in the bond.

How is it different from an annuity?

It is like an annuity. The problem with an annuity is that you have to look at a 40-page contract with an insurance company and if you die early, your heirs don't get the money. Whereas with this contract, your heirs get the money and they can either take the coupon or sell it. Additionally, you can sell this bond; and it is hard to cancel an annuity.

This is different from regular DC funds.

Exactly. You can also buy and sell these bonds if you change your date of retirement. This is zero cost, low risk because it is issued by the government and is extremely liquid.

What is the expected return?

It is market-based driven by interest rates. In Brazil, the initial coupon was real returns of 6.5% plus an inflation adjustment. The return will keep changing but the interest rate will be fixed.

Will this cut out consultants and insurers?

The bond doesn't cover longevity risk, so there is a role for insurance companies to play in managing that. They can still do that but with this instrument they can hedge themselves a lot better.

In a UK context, could this be aimed at members who have been auto enrolled and would be part of their decumulation fund?

The beauty of this innovation is that you don't have to be a member of an auto-enrolment provider. By buying the bond, you are buying a pension fund.

How has that worked out in Brazil?

I got supremely lucky because I was invited to speak at a conference on this topic in 2019 and the gentleman who had been tasked with improving private pensions, Paulo Valle, had also issued debt for the Brazilian government. We had a lovely lunch and a few months later they made phenomenal progress.

Brazil has a lot of people in the informal sector, and all it needed was an app to set this up and people were able to use it to secure their retirement.

In Brazil, they allow you to buy fractional shares of these bonds for as little as R$4 (63p) at a time. A taxi driver could put a bit of each fare straight into their pension.

For me, the UK issuing something like this is a no brainer.

Could this be another way for the government to attract infrastructure investment, albeit underwritten by them?

Absolutely. Look at what these bonds do. The cashflows are not needed for another 20 years, which is what you need for infrastructure. The cashflows for the bonds are the exact mirror of what you need to fund infrastructure.

Our hope is that once the government starts to issue this, infrastructure companies can start issuing their own version with a credit spread, so you get paid a little bit more.

If the government wants the private sector to take this on and run with it, they should get the ball rolling.

Is this not more expensive for governments, especially with rates rising?

It is no different from any other bond. But what I would say to the government is, if a lot of your people retire poor because they are invested in the wrong assets, you are going to have to bail them out. That is an expensive proposition which they are purposefully not accounting for. So why not pre-empt the problem?

ARUN MURALIDHAR'S CV

2022 – Present
Member of advisory committee
Virginia Retirement Systems' DC plan

2020 – Present
Member of academic advisory board
PGGM Investments

2007 – Present
Chair and chief investment officer
AlphaEngine Global Investment Solutions

2001 – Present
Chair and founder
Mcube Investment Technologies

2012 – 2022
Adjunct professor of finance
George Washington University

2015 – 2018
Academic scholar
Georgetown University

2001 – 2008
Managing director
FX Concepts (Hedge fund)

1999 – 2001
Managing director
JP Morgan

1992 – 1999
Manager, investment management dept
World Bank

1988 – 1989
Analyst
Asia Group

Bonds:
ACTIVE *meets* **PASSIVE**

Volatility in bond markets means that the way institutional investors use active and passive strategies in their fixed income portfolios is changing. *Mona Dohle* reports.

If the Silicon Valley Bank debacle has taught us anything, it is that the days when an institutional investor could simply store assets in long-dated government bonds and not worry about them have gone. Pension funds may have long-dated liabilities to which, in theory, fixed income should be the perfect match. But last year's liability-driven investing (LDI) crisis has shown that in practice, this match can be messy.

As uncertainty on inflation and rate hikes dominates the agenda, pension funds can face sudden liquidity pressures and end up as forced sellers of long-dated debt, just as prices are falling. For many institutional investors, these challenges could prompt a review of their fixed income portfolio.

In theory, a more volatile market environment should favour an active management approach. As rates rise, investors could be facing heightened duration and default risks in their fixed income assets, a challenge best left to a dedicated portfolio management team analysing the underlying credit quality of assets, rather than replicating an index, the argument goes.

But this does not explain why asset management giant Blackrock reported record inflows of more than $146bn (£118.5bn) into its bond ETF range last year. Historically, institutional investors have shown little interest in ETFs. But Blackrock's annual report also shows increased demand from institutional investors for its bond ETF range, precisely when bond markets are as volatile as they have been for a decade. What has happened?

A complex picture

A brief glance at the average allocation in institutional portfolios sketches a more complex picture than a simple juxtaposition of either active or passive strategies. Most large defined benefit (DB) pension funds already pursue an active approach to fixed income, but with a considerable allocation to passives alongside. Funds in excess of €2.5bn (£2.1bn) tend to have on average, three active bond fund mandates. Across the board, defined benefit schemes allocate about half of their fixed income assets to active strategies and half to passive, according to Mercer, a trend that has so far remained relatively constant.

In other words, institutional investors have

In times of market turmoil, you want to know exactly what is in your portfolio. If you buy an actively managed fund, you buy a black box.

Detlef Glow, Lipper

found a middle ground whereby they use a combination of active and passive funds to implement their fixed income strategy, with little evidence of dramatic swings towards either active or passive funds. Having said that, there appears to be increased appetite for fixed income overall.

Philip Kalus, chief executive of Accelerando Associates, a consultancy, says that this is not so much a tale of active versus passive, but more a case of the tide lifting all boats. "We need to bear in mind that passives have grown significantly, particularly in the ETF space, but active funds have grown more," he adds.

This pattern changes somewhat when factoring in defined contribution (DC) schemes, which due to the cost constraints of the charge cap have so far overwhelmingly opted for passive approaches to fixed income. But even here, a rethink is required because many index-based strategies have had a punishing year in 2022, says Joanna Sharples, chief investment officer in Aon's DC solutions team. "We have just come through a period where index investing has given you the best returns. We now have a period of potentially more market volatility so all this could change," she adds.

The government's announcement of significant exemptions to the charge cap could offer some room for DC schemes to invest more in actively managed funds, but these investors will have to be convinced, Sharples says. "The asset management industry will have to show us the value they can deliver through active management. We need concrete evidence of outperformance."

Concrete evidence

And when it comes to concrete evidence, last year has been an interesting test case as investors witnessed a significant increase in interest rates across developed markets and levels of bond market volatility not seen for more than a decade. So how did active and passive bond strategies perform?

Last year did indeed show a new trend, as Morningstar's latest active passive barometer indicates. While active equity funds still let investors down (less than a third outperformed passives), on the bond side, 46% of actively managed funds outperformed. "Shortening duration was an effective way to cushion the downside brought about by the rise in interest rates. Passive funds tracking all-maturity indexes were at a clear disadvantage in that environment," the report states.

This marks a significant turnaround. During a 20-year timeframe, less than 10% of active bond fund managers outperformed passives.

These results chime with asset owners' experiences. While last year was universally tough for bond investors, active strategies appeared to perform better, says Daniel Spencer, portfolio manager at Brunel Pension Partnership. The £30bn local government pension pool has about £5bn invested in fixed income, of which £4.4bn is actively managed.

"The rise in interest rates and credit spreads made it a tough year for active and passive approaches," Spencer says. "Our passive gilt portfolios performed in line with their benchmarks; the over 15-year and over 5-year index linked gilt funds fell by approximately -40 and -38%, respectively.

"The active portfolios performed better due to lower interest rate exposure," he adds. "Our sterling corporate bond and multi-asset credit funds returned approximately -18% and -8.5%, respectively in 2022."

But whether this outperformance could translate into increased appetite for active fixed income strategies among his partner funds remains to be seen. In the case of Brunel, partner funds are still considering their options, Spencer says.

Where active pays

Fund flow data for the past few months show that there has been an increased appetite for actively managed bond funds, Accelerando Associates' Kalus says. "Institutional investors have started to eye alternative asset classes as a fixed income substitute over the last five to six years. But things changed at the end of last year when fixed income started to make a comeback.

"At the same time, we saw a flip towards more active strategies," he adds. "This is the sort of environment active managers have been waiting for, there are now a lot more opportunities for actively investing in corporate bonds.

"We wouldn't even be surprised to see some money which has been in alternatives now going back into liquid fixed income funds. Nowadays, there is no point paying for an illiquidity pre-

mium if you can get similar returns in a fully liquid fixed income portfolio," Kalus says.

Investors who are considering exposure to actively managed fixed income funds might want to consider their sectors carefully. Unsurprisingly, for those who might need to sell bonds before they mature, long-dated treasuries or gilts remain a bad idea and the chances of outperformance are also slim. Investors in actively managed sterling inflation-linked bond funds had a 15% success rate over passives, according to Morningstar.

But in other segments, the odds have increased dramatically. For example, a whopping 85.9% of actively euro-denominated diversified bond funds outperformed passives last year, this stands against a 20-year track record of 7%. Similarly, euro-denominated money market funds and UK corporate bond funds also reported higher success rates last year, of 82.4% and 63.9%, respectively, Morningstar data shows.

While Brunel's asset allocation is ultimately set by the individual partner funds, Spencer does see why active bond fund management has become more appealing. "One reason is that we are seeing an increase in spread dispersion between issuers and sectors, an active approach allows investors to capitalise on this."

Another factor is that we could see higher default rates over the next two years, he adds. "For example, top-down based sell-side estimates for 2023 default rates have risen as high as 6% for US high-yield bonds.

"Bottom-up predictions from managers are equally concerning, with downside cases for 2024 default rates as high as 8% to 9% for US high-yield bonds," Spencer says. "A skilled active approach allows investors to undercut elevated market default rates."

The rise in interest rates and credit spreads made it a tough year for active and passive approaches.

Daniel Spencer, Brunel Pension Partnership

He argues that some areas within fixed income will behave in a heterogeneous manner if rates remain higher for longer. "For example, companies who issue leveraged loans have payments linked to floating rates. Periods of prolonged inflation and higher rates ultimately results in a higher interest burden and additional pressure on borrowers," he adds.

While this might be bad news for the asset class as a whole, he believes that asset managers can produce better outcomes. "Some loan issuers have hedged their floating rate liabilities back to a manageable fixed level, meaning they are less implicated by rising floating rates," Spencer says.

Another factor to consider could be companies passing on inflation costs to the consumer and a strong dispersion of leverage and earnings before interest, taxes, depreciation and amortisation (EBITDA) stability across the loan universe, he predicts.

Sharples also sees increased opportunities for more actively managed bond exposure in DC, especially because many retirement date funds burnt their fingers on long-dated gilt exposures last year. Rather than just focusing on costs, DC investors should be focussing more on overall outcomes for members. "It's quite ironic that in the DC space, there has been so much focus on cost and you can haggle over and over on one or two basis points. But when you then look at the dispersion of returns between the best and worst performers, that overshadows the cost question," Sharples says.

Passives: when the going gets tough

Does this mean more investors could be ditching passives in favour of active managers? Fund flows since the start of this year suggest otherwise. While it remains difficult to gauge the exact scope of institutional flows, with most data providers focussing on mutual fund flow data, there nevertheless appears to be continued appetite for passives.

In the UK, money market funds, which had reported a surge of more than £60bn in inflows in September, are now reporting outflows as investors turn to bonds. While mutual fund flows are by no means a proxy for institutional allocations, it remains hard to explain this pattern in isolation from last year's LDI crisis.

In January, bonds celebrated a comeback, attracting £3.5bn, according to Lipper, roughly two thirds, or £2.1bn, of which went into passive funds. More than half (£1.6bn) went into passive mutual funds with the remainder into ETFs. Interestingly, passively managed corporate bond funds appear to be the main beneficiaries so far, with corporate sterling bond attracting more than £1bn in January alone, highlights Dewi John, head of UK and Ireland research at Lipper.

"While you might expect short-dated bonds to have been popular over the past year of rising rates, that's not been the case,

with the classification having suffered £3.9bn of outflows during the year to January," John says. "And, while bonds are back, baby, it's a tad surprising to see Bond Global High Yield GBP (£308m) appear in the top 10, with investors generally keeping high yield at arm's length, with the default rate expected to rise."

But fresher fund flow data from Blackrock shows that this trend might be about to reverse. After a record 2022, where the asset manager reported $146bn (£119bn) of flows into its exchange traded products (ETPs), accounting for more than half of all investment into such products globally. In February this year, Blackrock reported $1.6bn ($1.3bn) of outflows from investment-grade bond ETPs and a whopping $6.7bn (£5.4bn) from high-yield passive vehicles. Simultaneously, US treasury ETPs reported net inflows of almost $11bn (£9bn) in one month alone.

These sharp swings in sectors, depending on the interest rate outlook, suggest that investors might be using ETPs for short-term tactical trades. This may even include active bond fund managers, who might find it easier to implement a strategy using an ETF, rather than buying the underlying bonds, Kalus says.

Detlef Glow, head of EMEA research at Lipper, believes there are good reasons for investors to opt for passives in times of crisis. "Over the last 15 years, we have had three major market incidents with massive outflows from the active side where we still had inflows on the passive side. The 2008 crisis, the euro crisis in 2011 and the market turmoil during the second half of 2018, through all these three incidents, ETFs enjoyed inflows.

"I would say, investors are moving into the direction of passives when markets get tough. When the going gets tough, the tough get going," he adds.

Glow sees transparency and liquidity as the key factors driving investors towards passives during a crisis. "In times of market turmoil, you want to know exactly what is in your portfolio," he says. "If you buy an actively managed fund, you buy a black box. You might have country or sector allocation but you won't have full knowledge of all constituents of your portfolio so you can't hedge those risks, you do not know exactly what is in your portfolio."

Glow adds that institutional investors might use the liquidity of ETFs to execute tactical short-term portfolio adjustments in a volatile market environment. "An ETF can be bought and sold within a minute. Whereas on a mutual fund you have T+2 plus order deadlines. If you consider a situation like the crisis in gilt markets, it would have blown over before you had been able to liquidate," he says.

But the question of ETFs as liquidity providers in times of market stress remains hotly contested. This is because the arbitrage mechanism in bond ETFs is set up differently to equity ETFs. Bond ETF sponsors have greater levels of flexibility as to the composition of their baskets, rather than exactly replicating the index. Some academics warn that this feature can accelerate imbalances between creations and redemptions in times of market stress, as authorised participants might be reluctant to purchase more of the same titles that they already hold in their redemption basket. Indeed, evidence from the 2020 bond market volatility shows that some ETFs traded at discounts to their net asset value.

But advocates of the argument that bond ETFs bolster market liquidity would point to the fact that throughout these periods of market distress, overall ETF trading volumes reached record levels, while liquidity of the underlying bond markets dried up.

The asset management industry will have to show us the value they can deliver through active management. We need concrete evidence of outperformance.

Joanna Sharples, Aon

Best of both worlds

The jury is out on the active versus passive debate. Much will, as so often, depend on the needs of the individual investors. But rather than passives replacing actives or vice versa, a clear pattern seems to emerge whereby institutional investors are opting for a combination of active and passive strategies in their fixed income portfolios, even including ETFs in some cases.

The rising rate environment has offered interesting opportunities for active managers in some sectors, as the higher levels of outperformance in sectors such as corporate debt illustrates. But passive funds, and ETFs in particular, are also taking on an increasingly important role in institutional portfolios. In volatile markets, investors want to manage risks more actively. Paradoxically, this could be by using a passive vehicle.

Real Estate

What does the industry say?

Pages 34 to 41

pi ESG CLUB

A raft of negative headlines mean fewer corporates and individuals are using the voluntary carbon markets to offset their emissions. This month's ESG Club looks at how to fix what is an important issue in the fight against climate change.

Members

INSTITUTIONAL INVESTORS TARGETING BANKS ON FOSSIL FUEL LENDING

Are liquidity strains distracting banks from their responsibilities on climate change? With AGM season almost upon us, we are about to find out, says *Mona Dohle*.

Last year was big in terms of shareholder engagement on climate change and banks started to feel the heat.

Big lenders are increasingly in the firing line because despite pledges to tackle climate change, they continue to fund the expansion of the fossil fuel industry. Yet for this year's AGM season, no major climate resolutions have been filed. Does this represent a change in strategy?

Broken promises

While most big banks have joined networks such as the Net Zero Banking Alliance (NZBA) or the Glasgow Financial Alliance for Net Zero (GFANZ), their promises are not followed by action. Since the launch of NZBA in August, the world's 56 largest banks collectively lent $269bn (£219bn) to more than 100 fossil fuel companies, a report by Reclaim Finance revealed.

Only a week after signing the NZBA pledge, 19 banks, including Citi, BNP Paribas and HSBC, contributed to a $13.4bn (£10.9bn) syndicated loan to Saudi Aramco, the company with the largest fossil fuel expansion plans, Reclaim Finance highlighted. Such inconsistency has faced investor scrutiny.

Jeanne Martin, head of ShareAction's banking programme said that investors are increasingly considering bank funding through the prism of climate risk. "Investors can diversify their portfolio as much as they want," she added, "but if banks continue to finance high carbon sectors with no strings attached, the action that they take on other sectors will have limited effects."

Moving the goalposts

How are banks justifying the mismatch between words and deeds? According to Martin, banks tend to shift the goalposts when it comes to net zero. "In most cases, they will claim that those activities will be captured by 2050 targets but won't be captured by their 2023 or 2025 targets. Banks are reluctant to incorporate more short-term targets because they say there is no standardised methodology."

But there have been cases of banks including only a fraction of their financing for capital markets in their targets. This includes Barclays, but also North American banks such as Wells Fargo, Martin said.

The mission of developing common reporting standards on fossil fuel financing is now being pushed forward by the Partnership for Carbon Accounting Financials, a global network set up by Dutch banks, which has published guidance on accounting standards for banks committed to net zero. But in the absence of an independent regulator, it remains a case of banks writing their own rules, Martin said.

Investor pressure

Last year, Barclay's AGM was not only beleaguered by climate activists, but the lender also faced increased pressure from shareholders when almost a fifth rejected its climate strategy. Similarly, Credit Suisse faced pressure from a $2trn (£1.7trn) investor coalition last year to amend its articles of association to include a climate pledge. Swiss listing rules are restrictive on shareholder resolutions, with a change of the articles of association one of the few ways for investors to push for a vote. While the proposal, put forward by ShareAction, and backed among others by Publica and LGPS Central, was ultimately rejected by 77% of investors, it did have an impact. Credit Suisse announced a new policy, which committed the Swiss lender to phasing out arctic oil and gas.

As already highlighted, this year no major climate resolutions have been filed. Instead, banks are increasingly putting forward climate strategies themselves and asking investors for their backing, rather than facing shareholder resolutions. But this also creates the risk of a significant proportion of shareholders rejecting the plans, as last year showed.

Instead, banks like Credit Suisse have put forward their own climate policies and are asking investors to approve it. But critics already point out that the strategy is again missing specific short-term targets to reach the net-zero goals. In other cases, such as Barclays, the board merely puts forward an update on its climate strategy, without asking for investor approval.

Meanwhile, the focus of shareholder engagement has shifted towards a more personal approach. USS, the UK's largest DB fund, has confirmed that it will vote against the appointment of directors.

"This approach is a change from voting more generally against a company's annual report and accounts and allows us to hold individual directors accountable – research suggests taking a more personal approach to voting is more likely to drive change," said David Russell, head of responsible investment at USS. Last year, the fund has voted against Barclay's climate policy.

This year, ShareAction has sent a letter to Barclays, BNP Paribas, Credit Agricole, Deutsche Bank and Societe Generale, urging them to stop funding oil and gas fields. The letter is backed among others by LGPS Central, Brunel Pensions Partnership, Nest, LPFA, Smart Pension and Cardano.

Does this mean that investors are giving up on climate resolutions? Not quite, Martin said. "The way banks respond to this letter will determine what we do in 2024."

INTERVIEW – STEPHEN MUERS

“Our mission has been to build a market around social impact investing.”

Andrew Holt talks to Big Society Capital chief executive Stephen Muers about tackling social problems, creating a market, targeting areas where mainstream banks fear to tread and going beyond the S in ESG.

How is Big Society Capital making a social impact?

We invest in four main areas. One is social and affordable housing, where we provide homes for vulnerable people. These are typically people who would otherwise be in temporary accommodation or in care. We also house those dealing with domestic abuse or who are on a low income.

The second is social lending, or social debt finance, with social purpose organisations or large charities issuing bonds. In that lending space we also hold equity in social banks.

We also have an impact venture. This is where we invest in venture capital funds which specifically focus on tackling social problems and using tech-driven innovation to address social issues.

The fourth strand is focused on social outcomes. This is funding all the issues around delivering public service contracts on an outcome basis.

On geography, we are UK wide with about 75% of our interests being outside of London and the Southeast. The debt finance piece is in the more deprived parts of the country, targeting areas where mainstream finance is reluctant to tread.

For example, we back the Black Country Reinvestment Society, a non-profit that lends money to people who want to start micro businesses in areas where mainstream lenders are absent. We help to catalyse that.

Will any of those four approaches dominate going forward?

We try to be balanced. That is partly for portfolio reasons in that we do not want to be exposed to risk.

It is also because we see a different potential for impact. The route to impact is different when supporting different organisations. So, our strategy is to keep all these elements running.

How much have you invested?

To date, we have made £880m of commitments and there is currently more than £300m out there.

On Big Society’s website £2bn is cited.

That is the total if you include those who have invested alongside us. A big part of our mission is to enable others to invest with impact, so we invest in a way that encourages other investors to come with us. That is now up to £2.5bn.

How would you describe your investment approach?

Our mission has been to build a market around social impact investing. To enable more money to be invested in tackling social problems in the UK.

So, our investment approach is to balance three things: financial return, social impact and what we call ‘systems change’. That is building the market, helping others to invest alongside us and creating some momentum in this way of investing. Our mandate is to build that wider market.

Are all of your investment returns reinvested into your portfolio?

Yes. That is our model.

You split your portfolio into a range of specifically focused funds – from community investment, social outcomes, care and wellbeing, to name just a few. Why take this approach?

In some cases, fund managers approach us. In others, we see a need for a fund in a particular area and then find a manager to deliver that for us.

We have a range of managers, from big commercial fund managers to small managers focusing on impact.

So, you did not set out with the belief that you needed a fund in a particular area?

We have done that, say in the case of domestic abuse. There was a need in the women's sector to access properties and charities to house those who needed them. We worked with the women's sector to build a fund that was designed for their particular needs and found a manager who could deliver that.

In other areas, people have come to us with a great idea and asked if we wanted to be part of it. It works both ways.

Are fund managers up to speed on social impact investing?

Some are and some aren't. What is interesting to see is what you would call traditional fund managers realising that the social impact space is important and one they have to get involved with.

How do you decide what justifies a social impact investment?

We talk about impact that is intentional and measurable. You are investing in organisations that have a specific purpose to create positive social change.

It is different from the S in ESG. Often, and being overly simplistic, the S in ESG is making sure you are not doing something bad, such as having modern slavery in your supply chain. Social impact investing goes beyond that. It is about what can you positively achieve, to use money to make the world better.

We have reached thousands of people and we want to reach hundreds of thousands more.

Are pension funds up to speed on that nuance in definition and they could do more?

There is potential to do more. Some get it. Quite a few pension funds have invested alongside us.

The Greater Manchester Pension Fund, for example, invested alongside us in the housing area. The Teesside Pension Fund, among others, has also invested with us.

We did some research that found pension funds were increasingly engaged in this, with almost half having some form of impact in their portfolio.

I would like to see in 10 years' time when writing about how the UK has tackled homelessness, that social impact investing will be part of the story.

What about place-based investments?
There are different opportunities in using social impact investing in a place-based way, especially when a local authority gets this.
In Greater Manchester, there is a partnership with the local authority providing services to the region.
So, there are definitely opportunities, but we are not a pure place-based investor, because what we do is national.

Are different stakeholders buying into a key part of social impact investing?
There are opportunities to do more with more buy-in from central and local government. What is interesting about tackling big social issues, like homelessness and health, is you could think that government doesn't care. But we have dialogue with the government about how we can work together to gain social benefit from all of this.

But does the government listen?
It feels more so in the last couple of years. There was a period around Brexit, when they were not doing much else.
We have had more traction and more co-investment alongside us in the past two years than in our entire history, particularly in the housing area.
There is potential to do more.

Did that tie-in with the government's levelling-up agenda?
Social impact investing speaks to the levelling-up agenda. There is good evidence in what social impact investing contributes. I have been speaking to senior government officials on how we can do more work on this. It is not the whole answer to society's problems, but it is a useful tool.

What could be done to improve social impact investing?
The important point is this whole field now has a real track record. The market is about £8bn and has grown tenfold over the last 10 years. And with fund managers who have been operating for 10-plus years. To take it all forward, to help more people, we need more capital. It is building on that emerging track record by establishing scale and bringing more investors to the market.

What has been Big Society Capital's biggest success?
It has been 10 years since we have been up and running and we have helped to grow the market. I am proud of that. Underpinning that tenfold growth are many thousands of people we have helped.

In what area could you have performed better?
Probably delivering public services differently. Radical or innovative approaches to delivering services to people with complex needs has not taken off in the way we hoped. There is still an opportunity there and we have not taken it.

What has been on your agenda since you were appointed chief executive in 2021?
At the beginning, it was surviving the pandemic. My number one priority is the team. We have a fantastic team. We have grown a fair bit but maintained the culture, mission and impact in helping organisations. Building on that is my priority.
We want people to come and work with us and be partners in the wider system. The more organisations we can connect with on this journey, the better.

What is your plan for growth in the next five to 10 years?
We see a great opportunity in creating platforms for investors to get involved in impact. In the past they haven't, for whatever reason. Here we have created an investment trust on social impact, which we think it is the first in the world of its type. This is a great example of a platform in which a whole new set of investors can get involved. And we are asking ourselves: are there other areas where we can create something?

What are your plans for the future?
To crack on and get to a bigger scale. We have reached thousands of people and we want to reach hundreds of thousands more.
I would like to see in 10 years' time when writing about how the UK has tackled homelessness, that social impact investing will be part of the story. So, making a real difference on an important social issue. We can make a real dent on social issues that really matter.

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CARBON MARKETS: A BIG PROBLEM

If climate change is the issue shouldn't putting a price on carbon be the answer? *Mark Dunne* looks at what's gone wrong.

Oil makes the world go round. Since the first commercial oil well opened almost 200 years ago, it has accelerated human evolution to what were once unthinkable levels of wealth and comfort for the masses.

It fuels our cars and airplanes, powers our homes and businesses, makes plastics and medicines while it helps grow food through fertilizing soil. Yet time has shown that there is a cost for such a high standard of living: a changing climate.

The abundance of carbon released into the atmosphere from burning fossil fuels stops heat from escaping into space causing average temperatures to rise and creating extreme weather events. Indeed, fossil fuels are being blamed for heatwaves, floods, droughts and wildfires.

Yet untangling oil from our lives is difficult if we want to maintain the same living standards. If proof was needed of how tough this task is, carbon markets are a case in point.

What's it worth?

Also known as cap-and-trade schemes, carbon markets were introduced in the mid-90s to provide a financial incentive for companies to reduce their greenhouse gas emissions. The idea is that governments committed to net zero limit the harmful gases heavy polluting industries emit. Those keeping within their quota receive carbon credits, or offsets, that they can sell through a trading system, known as a carbon market, to those who exceed their quota. This financially rewards those who keep their CO_2 emissions low and punishes those who don't.

The concept has been well received as voluntary carbon trading markets have since emerged. Here companies that are not considered to be major polluters but wish to offset their unavoidable emissions can buy carbon credits from those working to reduce or remove harmful gases from the atmosphere.

This is different from the compliance market. Instead of keeping harmful emissions low, the proceeds could fund innovation and development in areas such as reversing deforestation or carbon capture and storage technologies.

Putting a price on carbon is crucial to addressing the climate crisis, believes Nick Stansbury, head of climate solutions at Legal & General Investment Management (LGIM). "More than any other lever, any other regulatory measure, any other policy tool, head and shoulders above all of them would be for policymakers to put an effective price on carbon emissions."

Fit for purpose?

The voluntary carbon market is believed to have raised more than $1.2bn (£981m) for sustainable projects during 2022, which helped mitigate 161 mega-tonnes of carbon, according to Trove Research. But the success of these proceeds in fighting

climate change is coming under increasing scrutiny.
There are reports that voluntary carbon markets are illiquid, have scarce financing, inadequate risk management and offer limited data. "If you are looking at the whole market, then you could make those kinds of accusations of some of the projects," says Tim Currell, Aon's head of investment for international wealth. "But there are also some high-quality projects which are delivering real carbon capture and ancillary benefits too.
"The voluntary carbon market is not perfect," he adds, "but they are the best tool we have for encouraging money to flow into solutions for removing carbon from the atmosphere."
Stansbury adds that the voluntary carbon markets are complicated. "They are opaque, illiquid and you have lots of different types of carbon credit," he adds.
Another concern is that not all of the proceeds from carbon trading find their way into decarbonisation projects, with those brokering the deal pocketing a share.
Some of these issues could be why less than a quarter of companies committed to net zero intend to use the voluntary carbon markets, according to a survey by the World Economic Forum and Bain & Co, a consultancy.
Indeed, there were fewer transitions in 2022, down by a fifth in 12 months to 12.5 billion tonnes. In particular, demand for forestry-related carbon credits fell to 359 million from 380 million a year earlier, according to Trove Research and Allied Offsets.
Market imperfections as well as question marks over transparency and credit quality were given as reasons why these markets are not being included in decarbonisation plans. More of a concern is that the potential for public criticism was cited by 40% of respondents for not using them.
It appears that they are right to be cautious, if an investigation published in *The Guardian* earlier this year is accurate. The report claimed that 94% of the forest carbon offsets approved by Verra, a certification body, provide no benefit to the climate. These credits, which are bought by the likes of Shell, Easyjet, BHP and the rock band Pearl Jam, could even be making the planet warmer. Verra denies this.
Even before this report was published, the World Economic Forum called for the supply side of these markets to be reformed to reduce greenwashing.
Stansbury believes that three things must happen to build confidence in the voluntary market. One, better delineation between carbon removal and carbon avoided credits. Two, better transparency so that people can understand what they are buying. Three, investors need to see that carbon removal has an important role to play.
"It would help if prices went up," Stansbury says. "One of the big criticisms of the voluntary carbon market is that it creates incentives for companies to continue to emit and offset their emissions at an unrealistically low price."

Companies and governments should not rely on voluntary carbon markets to achieve net zero.

Tim Currell, Aon

For example, would companies rather pay $8 for emitting a tonne of carbon or change what they are doing? "Once pricing reaches levels where you are not creating false incentives, we will be in a much better position," Stansbury says.

A world of difference

Putting a price on carbon might be the best way to reduce climate-harming gases, but there are more than 40 carbon trading mechanisms around the world. A high price is important and when it rises, companies change how they allocate their capital, which, Stansbury says, has resulted in harmful emissions falling. "The trouble is that it is difficult to implement pricing equally to all regions," he adds.
The result of not having a universal price is that it creates the potential for industrial activity to move to other regions, allowing companies to escape financial penalties. "In our minds, it is clear: no effective carbon price, no net zero," Stansbury says.
Various markets around the world are experiencing different outcomes. China is a huge climate polluter but it only established a carbon market less than two years ago. It is not going well with transactions diving 71% last year.
Early pricing is typically low when a cap-and-trade system is introduced, as it takes a reasonable amount of time for allocations to settle, Stansbury says. "Imagine throwing a bunch of stones in a pond. Ripples and waves emerge, but gradually the water settles.
"In new carbon pricing cap-and-trade models, those waves need to settle until you get some idea of where equilibrium is," he adds. "Then the market can start to function effectively."

Providing an incentive

"Companies and governments should not rely on voluntary carbon markets to achieve net zero," Currell says. "It is important to understand that offsets are not a substitute for getting to grips with emissions. They should only be used for the residual, hard to abate emissions."

Stansbury is not convinced that voluntary carbon markets are driving decarbonisation. What they need to do is incentivise billions of tonnes of CO_2 to be removed from the atmosphere and stored primarily in trees. "That is true of pretty much any decarbonisation scenario you look at.

"Is the voluntary carbon market the most effective way to incentivise that economic activity? Probably not, but it is the market that we have today," he adds.

It's not only about funding regenerative power sources. Carbon emissions also emanate from agriculture, which is responsible for 8.5% of such gases globally, while deforestation weakens the world's natural defence against rising carbon levels and is believed to contribute almost 15% of global carbon emissions.

For Currell, voluntary carbon markets, although far from perfect, are part of the answer to tackling climate change. He adds that cutting emissions alone will not solve the problem and we need to channel funding towards technological and nature-based solutions to remove carbon from the atmosphere. "You need to scale them up almost as aggressively as you are trying to deal with reducing carbon emissions," he adds.

"The compliance markets do not withdraw carbon from the atmosphere. They just bear down on existing emissions," Currell says. "Voluntary carbon markets are the answer, or part of the answer, to that.

"Investors could buy land and let it grow wild, and low and behold, they have sequestered some carbon. Voluntary carbon markets enable investors to do that on a global scale. And they can also include all the other aspects of looking after local communities and biodiversity. There is a lot extra in the voluntary carbon market."

Once pricing reaches levels where you are not creating false incentives, we will be in a much better position.

Nick Stansbury, Legal & General Investment Management

Setting a standard

The credibility and effectiveness of these markets could be improved by setting universal standards. The Paris Climate Agreement has taken a huge step in this direction by adopting REDD+ sovereign credits, which 192 countries have agreed to trade.

Then there is the Integrity Council for the Voluntary Carbon Market, an independent body working to improve governance in the voluntary carbon markets. The Voluntary Carbon Markets Integrity Initiative is another organisation that wants to improve standards by introducing a code of practice.

For Currell, better reporting and verification will bring certainty of delivery to these markets. "Better use of technology to monitor those offsetting assets is needed to make sure they exist and that they are doing what is claimed.

"There is no question that historically there have been projects which have not delivered as they were expected to do," Currell says. "There is a wide variety of reasons for that, so definitely work is needed."

Stansbury has a specific idea of what is needed. "An awful lot of work needs to go into the voluntary carbon market to improve its transparency and the quality of the credits traded. We need to have an effective forward market where people can procure streams of credits into the future, like you can with other financial instruments."

He adds that one day the compulsory and voluntary markets will converge, which could be a good outcome for net zero. This is starting to happen in California, New Zealand and South Africa. "It is not sustainable for voluntary carbon markets to remain voluntary," Stansbury says, adding that converging with compliance markets will create the scale needed to be effective. "That will be the endgame, which will involve a mass repricing as the two pull together."

Despite the many issues deterring corporates from voluntarily using these markets, it appears that the premise is strong enough to make a difference in the fight against climate change. "If mankind is going to beat this crisis, then voluntary carbon markets are an important but under-utilised tool. They have a bad press, for reasons I agree with," Currell says. "I just feel they need to be nurtured rather than rejected."

THE ARC OF PROGRESS IN GLOBAL CARBON MARKETS BENDS TOWARD INTEGRITY

Eric Cooperström is managing director of impact investing and natural climate solutions at Manulife Investment Mangement, while Beatriz Zavariz is associate director of international carbon markets.

Carbon markets are integral to aiding the transition to net-zero emissions and must continue strengthening to build stakeholder confidence and ensure that climate mitigation is delivered.

Carbon markets have emerged as a high-potential tool to help companies, investors and governments transition to a sustainable, net-zero emissions reality. While not a panacea, carbon markets can aid the transition to a sustainable future.

We believe decarbonisation and direct abatement must be prioritised above all other climate mitigation activities. Success means getting as close to absolute zero emissions as possible – and only then identifying high-integrity ways to neutralise or offset remaining tail-end emissions that are the most difficult, expensive or technologically complex to abate. Compensation, or purchasing carbon credits to offset emissions, does not mean an emitter has achieved its climate goals but is nonetheless critical to supporting additional emissions reductions..

The evolution of carbon markets

Carbon markets have evolved to involve various methodologies eligible to generate carbon credits, including renewable energy and nature-based solutions such as improved forest management, afforestation, reforestation or avoided deforestation.

We believe that these efforts by registries and broader carbon market participants are directionally correct: using high-accuracy technology and tightening standards to improve rigor cannot happen soon enough and global developments that support these trends mean that a historically disjointed and opaque market is rapidly making strides toward transparency, quality, integrity and standardization within specific carbon project types.

Criticism of the integrity of certain carbon emission reductions standards and claims of over-crediting serve to underline the importance of continually tightening protocols to ensure that climate claims are tangible and scientifically defendable.

But progress is being made toward greater rigor. For example, new afforestation and reforestation methodologies are being developed that include high-accuracy technology and remote-sensing-enabled monitoring, verification and reporting; improvements to verifier training, audits and project reviews; and adoption of dynamic baselines that are intended to address over-crediting risks.

An embryonic market is making rapid progress toward transparency, quality, and standardisation within specific carbon project types that ensure project protocols reliably measure climate claims in quantifiable and objectively defensible ways.

Our carbon focus

Within our timberland business, our focus is on improved forest management (IFM)—reducing harvest volumes, improving forest stocking, or extending harvest rotations to intentionally sequester additional carbon compared with business-as-usual (BAU) practices—together with afforestation and reforestation (ARR) projects. Our IFM projects involve establishing realistic counterfactual baselines against which increased sequestration compared with BAU activities can generate avoided emissions carbon credits. This is in addition to the opportunity to generate removal credits from the enhancement of a forest's growth capacity. We manage IFM and ARR projects in the compliance and voluntary carbon markets, and we are adopting new technologies such as lidar imaging that can enhance the accuracy of our timber inventory, carbon measurement and reporting.

Our carbon principles are aligned with the emerging Integrity Council for the Voluntary Carbon Market Core Carbon Principles and are continuously reviewed against international best practices to ensure high-quality climate mitigation solutions using conservative baselines.

Our near 40-year experience provides us with deep knowledge of local harvest opportunities. We actively extend avoided emissions credit generation to more accurately reflect forest management practices on the ground and incorporate specific climate impact information requests from potential buyers of carbon credits we generate to guard against greenwashing in our sales and distributions.

Experience suggests that higher quality credits may command premiums that more than compensate for lower credit volumes, and we remain committed to high-integrity carbon activities that deliver real and durable climate mitigation.

Expect scrutiny to improve standards

Rapidly growing markets cannot mature effectively without close inspection, and an ecosystem of intermediaries, exchanges, consultants, agencies and reviewers has emerged to scrutinise carbon standards, which is critical to generating valuable ecological and financial outcomes. Demand must partner with credible carbon credit suppliers, and as carbon markets continue their journey toward high integrity, we will continue to strengthen our own carbon practices and do the right thing.

To read the research paper, visit:
manulifeim.com/institutional/global/en/viewpoints/private-markets/carbon-standards-are-still-evolving

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DISCUSSION: REAL ESTATE

We live in them. We work in them. We buy our groceries from them. We make things in them, store things in them and we unwind, relax and are entertained in them: property is a diverse market, serving many of our needs. But as times change, markets change and property is no exception. Residential has become an institutional asset class as demand for housing grows due to shortages and changing lifestyles. Then there is retail, where, if you walk down many high streets, demand for space from household names is not as strong as for out of town warehousing, thanks to the growth in online shopping. Another issue is the growing demand for assets that are kind to the environment and society. ESG is not just about equities. To find out how this asset class is evolving, we sat down with a panel of experts to discuss how pension schemes and insurers are investing in property.

What real estate strategies are institutional investors following?

Louise Warden: LPPI's focus is predominantly core, with an element of value-add and opportunistic. A large proportion of our assets are in the UK, where we invest directly and via funds.

Ben Ward: Property sits within a few of our underlying asset classes. We have property equities, fixed income and private equity as well as a direct book, which is a growth strategy carrying more risk.

However, our largest exposure to property is in the secure income space. That is mostly UK long-lease and ground rents, which are a bond proxy with an illiquidity and complexity premium.

What interests Phoenix about real estate?

Tom Sumpster: The macro environment we are going into is dislocated compared to the last 10 years. That provides investment opportunity, typically in public markets where valuations have corrected.

In private markets, debt is far more appealing than equities. The relative value is tight and we are looking for corrections coming through.

We are risk-off in private markets, and risk-on in public markets. When we think about debt, we are looking to invest longer term into core real estate. So, we see parts of the market as a safe haven.

Charles, where are institutional property investors looking for growth?

Charles Baigler: Our funds have a pan-European outlook. For our value fund, we look for price dislocation. Where there is distress and forced sellers, the UK is probably ahead of Europe and offers a lot of opportunity.

We also see northern Europe as a more attractive proposition than southern Europe. Northern Europe overshot in terms of yield compression, so that is adjusting faster.

The availability of debt is also higher. Pressure from sellers who are over-levered tends to be a northern European phenomenon, which is a different proposition from the last cycle.

Has the macro picture impacted affordable housing?

Adrian D'Enrico: Thankfully not. It is almost the thesis for investing in affordable housing.

We don't have enough houses in this country. There are 1.2 million households on the waiting list and 123,000 children will not sleep in a permanent bed tonight. Demographic drivers and the economic situation will make it worse before it gets

better, so the thesis has not changed.

It does, however, make it slightly difficult in terms of financing. Leverage is not accretive to what we are trying to achieve, but equity investment is coming – we recently secured an investment from a local government pension scheme.

Investors are attracted to the long-dated, inflation-linked income while delivering an impact. We are an SFDR Article 9 fund. Affordable housing is seeing some appetite for people ticking a box in some instances, but there are parties who want to deliver a genuine, long-term impact and we can deliver that for them.

How has what institutional investors want from property changed in the past 10 years?

Nick Spencer: Ten years ago, we were coming out of the financial crisis and pension schemes started looking at private debt. I have always felt quite enthusiastic about private real estate debt because of the secure assets that sit behind it.

Defined contribution (DC) has also emerged. That has provided more renaissance in terms of listed equity, so more interest in real estate investment trusts (Reits).

Some development in DC strategies is needed because when you reach retirement there are still 20 to 30 years to fund. Having a real income that is secured long-term is a natural asset class for DC investors, especially post-retirement. I expect more developments there.

Those are the two trends if we go back 10 years. More recently, the focus has looked at place-based investing, such as social housing and the 'S' element of ESG. The new kid on the block is probably broader about the interaction with the environment, such as water usage.

In the current environment, are investors waiting to see what happens or, like Phoenix, planning to take advantage of the uncertainty?

Ward: I'm with Tom. Public markets are massively dislocated. Yields to maturity on high-quality bonds are quite staggering relative to property yields.

Sometimes you see negative gearing too. Taking less income yield than an ungeared property when refinancing is a phenomenon for some people, but it may be the only way they can keep that property.

Short term, it is all about public markets for us; in prior cycles that relative value always normalised, then property provided the private market premium. We will be back when it looks like better value.

The potential for real estate to outperform inflation means it plays a valuable role.

Nick Spencer
Sustainable investment adviser
Gordian Advice

Warden: We see opportunity in direct UK real estate this year. There was significant repricing in Q4, quite short and sharp. Those re-based valuations are an attractive entry point for equity investors like us.

Then there are assets that might come to market as people cannot refinance. We are well placed for that.

What has had a bigger impact on valuations: rising interest rates or working from home?

Sumpster: Interest rates play into a short-to-medium term situation. The question therefore is: will interest rates go back to the low yields that we have seen? Most commentators will say "unlikely" given that it was a 10-year period which probably will not be repeated. So, what will be the correction to equity values and how do we think about that? That is a big distinction.

Working from home is a fundamental change in the way people live, work and play. When we look at offices, less desk space is likely to be required in the future or perhaps it could be broader as employers try to encourage individuals to come into work.

Spencer: Part of that story is also going to be differentiation between properties. Prime will retain its cache, but if office or retail usage falls then it is the values of non-prime assets that are likely to drop away. But lower values should then catalyse change and re-usage.

One of the next changes is what to do with empty retail properties in town centres. There is an interesting set of opportunities for place-based investment to reinvigorate those.

D'Enrico: We have started to see that already with medical uses on the ground floor of retail frontages with the uppers converted into residential. It is about making it useful long term.

If we are focused just on the 1% of every market we are building new each year, we will not touch much of what needs to be around in 2050 to hit net zero. But we could achieve this as part of a change of use-led refurbishment of existing stock.

Baigler: The challenge is that you need a significant value alteration for that to make sense. The direction of travel is clear: we are going to see a huge obsolescence of secondary and tertiary real estate. So, how are we going to repurpose that?

Shopping centres are a prime example. They occupy the best locations in small towns and most people are realising that the best value is the land. The poorly configured building as an economic proposition does not make sense for most investors.

That is the big challenge: are the owners prepared to accept that the obsolescence of those buildings is so high that their residual value is possibly much lower than they believe? We have an industry where valuations are driven historically, and by the owners, so there is going to have to be some give there.

Does high inflation and rising interest rates mean investors could move away from traditional property assets?

Baigler: It depends on your cost of capital. As a value-add investor, change of use is where we want to deploy our capital. For longer-term investors, it is a far greater challenge.

Sumpster: From our perspective, ground rents are hugely appealing for long-term patient pension capital. It is where we want to play with our defined benefit schemes. But when we think about the future and how we can create a better yield pickup for defined contribution pension liabilities, it is looking at regeneration, the levelling up agenda and connecting a storyboard together.

This is a real assets play where we talk to the metro mayors and the combined authorities. We look at a landmass and try to understand what they want to do with it.

Decarbonising that land through the development is part of that. Older stock that is energy inefficient becomes redundant more quickly making refurbishments imperative, which is another investment opportunity.

How do valuations differ in private and public markets and what does it tell us about where we are going?

Spencer: We see this dislocation in Reits and other listed securities as well as in the better bets on the private debt side. The

question is how will that play out and how quickly.

People say that by Q3 it may work out. In the meantime, private investors should be patient with their capital and look for idiosyncratic opportunities. We will get some distressed sellers and some dislocations. Rarely seen assets will probably come on to the market – ones that you want as long-term keepers. Those are the opportunities to look for as those valuations reset.

Warden: The greatest impact to date has been on our UK portfolio. There is something to be said about it repricing faster than some other regions. That is why UK real estate might provide attractive opportunities.

What returns are investors expecting from property?

Baigler: Our target returns have not changed, but how we access them will. Two years ago, we were looking to generate returns using cheap leverage and reasonable rental growth forecasts to create alpha through change of use and development. That is starting to change depending on which country we are in.

Those returns may now be achieved from less risky assets at a time when there are strong rental growth forecasts in lots of markets. Again, that is only if you are creating the right products.

The most important thing we are going to see across all countries and sectors is a clear bifurcation. There are going to be assets which institutions and occupiers want, and assets which appear cheap but you will be catching a falling knife if you buy them. They are secondary assets, which you are going to either reposition or, in the worst case scenario, knock down.

This is almost exclusively ESG driven. If you are on the wrong side of this, it is going to be impossible to finance or occupy as new regulation comes in.

D'Enrico: We have not changed our expectations. We still target the same long-term inflation-linked income distribution of about 4%, with a total return of 6% to 7%. We cannot use leverage to enhance that, so returns reflect the individual tenure pricing, ranging from social and affordable at 3% to 4% all the way through to yields on extra care and homeless accommodation at 6% or greater. Pricing has remained remarkably stable, which is part of the attraction of the sector – long-term, dependable income which is inflation linked.

Ward: Returns are likely linked to inflation. How long are rates going up, and how much higher? Last time I looked at 10-year gilts forwards, there was an upwards curve arguably implying that with a fair value margin for property, things are going to get worse.

Once we hit fair value, it will restart the competition for the best quality assets. Before that though anyone sat on property portfolios should expect a bit more value movement downwards – whilst income generates positive total returns.

It is hard to call but some people will get the occasional bargain, whilst most sit on existing portfolios with weak returns in the short-to-medium term.

Warden: We are measured over a 10-year period, so we are somewhat insulated from short-term volatility. Being an open-ended defined benefit scheme also helps as the returns required from our real estate portfolio are not huge.

Spencer: It is hard to know when the market has yet to settle. But as we open the timescale up 10 or 15 years, what we can look for are the core portfolio characteristics.

The potential for real estate to outperform inflation means it plays a valuable role. Where are we going with inflation is unclear. To me, investing directly in real tangible assets has value against this uncertainty. Over the medium term, it has an incredibly valuable role.

The other aspect is the dislocation. Managers like this because there is a big role for alpha, and there is a lot of potential alpha in the market at the moment, albeit depending on the strategy and sector.

Ward: Although inflation might hit short-term returns by keeping rates high, long term there is likely to be a level of inflationary linkage to rents – and explicitly in some cases.

High inflation will, therefore, hurt short

Pricing has remained remarkably stable, which is part of the attraction of the sector – long-term, dependable income which is inflation linked.

Adrian D'Enrico
Fund manager, affordable housing
Edmond de Rothschild
Asset Management

term, but possibly help longer term. It will be interesting to see how that plays out and impact pricing.

Sumpster: As a result of the LDI situation that played out late last year, there has been a review of people's liquidity requirements. To a certain degree, portfolios are now more liquid.

When we think about that illiquid market, which a good part of real estate is exposed to, over the longer term it presents a yield pickup to public markets. There is a place in pension schemes for that because we have to solve the situation of many pension funds, certainly defined contribution, not paying out anywhere near the sums expected for people to maintain their lifestyles.

There needs to be the opportunity for defined contribution liabilities to invest in private markets.

There needs to be the opportunity for defined contribution liabilities to invest in private markets.

Tom Sumpster
Head of private markets
Phoenix Group

Today is probably not the right time, but planning for that opportunity when we are in a more stable environment is something we would welcome as a holder of a significant pool of defined contribution liabilities.

Are people demanding sustainable properties?

Warden: Absolutely. It is becoming more black and white in terms of tenants not wanting a 20% discount on their rent because the asset is not sustainable. They have made net-zero commitments and therefore that space does not measure up. It is a yes or no question. The sustainable space will continue to do well.

I sense a supply and demand imbalance coming up.

Warden: Particularly because developments have stalled due to a lack of financing. So sustainable assets, especially in the office sector, that come to market soon will see strong demand and perhaps command higher rents.

Occupiers look at how much it costs to occupy a property as a whole including rent, service charge and operating costs, and generally, sustainable real estate is more cost effective to maintain. This gives them potentially more room to pay higher rents. The all-in costs are quite important to tenants across asset classes.

Ward: Are you seeing that across all sizes of property?

Warden: It is being driven by larger companies. For anyone needing office space over 100,000-square foot, it is generally an absolute requirement. Interestingly, when inspecting our direct portfolio, which is across the UK, sustainability was a common theme of discussion amongst our tenants.

For some, it is because of requirements at a corporate level, while for others it is expensive to operate these buildings so they want PV panels on the roof to access cheaper energy, for example.

Ward: It is good for getting longer leases as well. For a 25-year power purchase agreement why wouldn't you sign a 25-year lease, which is value accretive for you, the occupier and the environment. There are ways that everyone can win.

Spencer: This is another part of the differentiation which is opening up in the market. Energy costs will not fall any time soon, added to which stricter regulations, requirements and minimum standards are coming.

In the US, there are already differentials on taxes based on energy efficiency. If this is already happening in the US then we should expect it to come to Europe.

With property responsible for 39% of greenhouse gas emissions, there is going to be much more emphasis on energy. Governments will offer carrots and sticks to help meet energy efficiency goals.

Baigler: If you are a large corporate, there are two ways of reducing your carbon footprint. One is your headquarters. You cannot occupy a building if it does not hit every low carbon and energy efficiency standard.

The other way is to stop international travel. You cannot change how your employees get to the office. What you can change is the office they are in and how much they move around once they work for you. Real estate has a huge role to play here.

On the other side of this is making sure that your buildings are energy efficient. The mantra is you need to buy high carbon buildings and sell low carbon buildings.

Within that you have the development

process. It is all very well building an energy efficient property, but that's not much use if you have generated a huge amount of carbon creating it. The only way to reduce your carbon footprint in a new development is to not develop at all. This means repurposing old buildings. That is more expensive, but it will be reflected in the rent.

It is a virtuous circle. A corporate will pay you a higher rent because they have to be in a new building, and a developer refurbishing a building is going to have to create it in the most carbon efficient way possible. A lot of this is going to fuel itself.

Spencer: The new demand is to consider at the broader impacts beyond energy. Particularly water use within buildings and how it gets back into the ground. This is unleashing a lot of innovation and creativity.

It is not just thinking about the energy envelope, but we are going to start expanding this conversation.

We have just about got our heads around embedded carbon, but now we are starting to think about how we are using all the resources. It also includes social use and inclusivity which will impact demand which is the mainstay of valuations and value.

Ward: With the E in ESG, we have a good idea about tenant behaviour drivers, regulation and the potential emergence of tax related to environmental performance. How can you do a cost benefit analysis on things like biodiversity though? It is difficult.

If you are spending millions of pounds more, and you are not getting a tangible value driver, that for me is hard to sell. But you know it is the right thing to do, so I can't quite square that circle.

Baigler: It's the liquidity point, right? If your building does not comply with every regulation and is not as environmentally friendly as possible, pension funds will not buy it.

You are then going to get a bifurcated market of a secondary world of people who are prepared to buy inefficient buildings and a core world where you have liquidity and a value-add existence of taking inefficient buildings and delivering them.

Ward: I understand that on net-carbon emissions and on various other measurable environmental metrics. What I was alluding to is that biodiversity is more difficult to measure. It is these softer measures which are not yet a core part of the reporting regime.

I find it harder considering things you cannot put in a spreadsheet, when you are paying more for them.

D'Enrico: We get that on social. In the past 20 to 30 years, we have made progress by focusing on the E. We have a lot of measures and standards to assess that, but the S is a nebulous thing that we have not agreed how to measure. It feels right, but it is hard to quantify and price.

We need standardised reporting measures from a social perspective. SFDR Article 9 is useful, but our assets are sustainable by virtue of being social housing. There is no more detail on that framework for us to show that we are doing it better than others. That needs to come through so we can work out where we are relative to our peers, what we need to improve on and what we can deliver.

ESG penetrates every area of real estate investment.

Louise Warden
Head of real estate
Local Pensions Partnership Investments

Baigler: A lot of this is going to end up being a value protection exercise, rather than value creation. All that will happen is that you will start losing tenants.

It is intangible and regulation always lags the market, but it is going to get to the point where if you are not doing what you need to do to your building, value and liquidity will drop.

Spencer: I have seen managers put a price on everything from social to the natural world. Within sustainability, there are mixed emotions about doing this: how can you put a monetary value on inclusive design?

It will get better, but in the meantime more sustainability is de-risking. Socially inclusive design makes it more available, so that you have more buyers because they want to be in an inclusive property.

Baigler: We have seen this before in less dramatic scenarios. When the Disability Discrimination Act became law it was clear that you had to have inclusive access to your office. There was a blind panic about the stairs. "I will never sell this office."

You start retrofitting. There is a cost implication and the value of the building has not gone up because you have created a complex ramp system. All you have

done is maintain liquidity in your building. We are now looking at a far larger, far more complex identical situation.

Sumpster: With the Article 9 situation, whilst you may not see additional value for areas not yet captured, you are future proofing and creating a certain type of brand, which is appealing to investors even if it costs a little more on yield reduction. We see the value in the long-term investment.

It is an exciting opportunity. As institutions with large capital, we can influence the way developers think about their buildings, but equally we are excited about the market leaders who are taking us into an ESG environment that is here to stay. The regulations around that will only get stronger, as we are seeing in the car industry.

Spencer: We have the potential to go through the next 20 to 30 years in a way that is radically different from the previous 20 to 30 years.

Sumpster: There is a generational change as well. People are growing up living with ESG and will be making investment decisions in the future based on it.

Baigler: Eventually there will be a regulatory standardisation. At the moment, you can get green certifications for your buildings in 10 European countries which include 10 acronyms. I cannot tell you what each acronym means, but this is all heading in the right direction.

Ward: Our equities team says ESG standards for property are highest in the UK, the Netherlands and Scandinavia. You have a pan-European portfolio, so how do you deal with softer regulatory regimes? Do you assume it will harmonise at some point?

Baigler: While certain countries clearly lag, if you are creating an institutional product, the pool of investors is quite centralised. You are correct that the wealthier European economies are leagues ahead in terms of sustainability and environmental compliance. One thing most European countries hate is when you turn up and tell them what they need to do to their buildings. But that is the reality. If you buy a warehouse in Spain, you need to comply with the most advanced regulations, which invariably are Scandi or in the UK. Even if those regulations do not exist in Spain they will one day, so I need to do this now otherwise I am going to fall foul of my own liquidity.

The only way to reduce your carbon footprint in a new development is to not develop at all.

Charles Baigler
Head of acquisitions, direct real estate
Pictet Alternative Advisors

ESG-compliant properties are in demand, so how do you prove that such assets are sustainable?

Baigler: Every asset we acquire, whether it is for long income, core or a value-add programme, is part of an ESG strategy.

Ten years ago, we were asked, what's your business plan? What's your capex? Today we are asked, what is your ESG strategy? Spending X millions of pounds to hit your targets will be a normalised part of a business plan. Then, invariably, you will need to think about what else you can do because you have a two-year business plan and regulation is almost certainly going to change in that time.

It is not about putting solar cells in or extra bike parking to charge an extra 10bps. You have to assume that if you don't do this, no one would want to buy the property. It is a defensive measure as much as it is necessary.

Spending on ESG is now part of the real estate universe and is being driven by the market because the liquidity will disappear.

What do you look for when selecting a real estate investment manager?

Warden: Sustainability is key to everything we do as an institutional investor. On the direct side, we have our partner KFIM managing assets to ensure they are aligned to our net-zero targets.

In terms of overseas managers, we definitely ask when the portfolio will reach net zero and what is the ESG plan.

The answers we get vary in terms of the regions we look at. Some of our UK and European managers are ahead of the curve. Australian managers seem to be way ahead, but some of our US managers are lagging, making it difficult to aggregate information at the portfolio level.

It is about engaging with our managers to align them with our path towards net zero.

Sumpster: When we are awarding mandates to managers, there is a meeting of ESG teams on both sides. If there is not an ESG team on the other side, we simply are not going to invest. It would suggest

that they are not taking ESG as seriously as we would like them to.

When we beauty parade investment managers, that ESG relationship needs to get over the line. It is important to align our ESG policies with the way asset managers invest on our behalf.

Spencer: It is better than three years ago, when there were a large number of managers who could barely spell ESG. These days anyone who cannot spell it cannot take part. A good manager can create double wins in terms of value creation and cost. I remember a story about renewable lighting installed in a car park. It had a payback of 18 months making it the fastest asset management value-add in their plan. So rather than having a sprinkling of words and general fuzziness, investors are looking for tangible and real examples.

D'Enrico: It is the integrity and transparency of what people are doing. If after the event they hire an external party to produce an ESG report, then it is not central to what they are doing – it's an afterthought.

A social impact adviser works with us from the first assessment of any opportunity that come across our desk. They also produce an impact report that is central to our due diligence for acquisitions. They then produce an annual report that critiques our social impact performance – this ensures we are continually assessing and adjusting the portfolio.

I have seen managers where impact is not embedded. It is just something that is measured afterwards. If it is central to what you are doing, it is something you will do throughout the investment process and holding period.

Warden: ESG penetrates every area of real estate investment. Managers who are not doing it are missing out. It is a risk like any other investment risk. If they have turned a blind eye to it they are not at the cutting edge.

What trends do you expect to see in real estate during the next five years?

Once we hit fair value, it will restart the competition for the best quality assets.

Ben Ward
Head of matching plus and property
BAE Systems Pension Funds Investment Management

Sumpster: I would hope this country gets its act together and supports the levelling up agenda across party politics. There is a long-term programme of investment opportunities based on regeneration through affordable housing, residential homes and commercial properties being developed that will create a better society.

It feels like it is coming. I attended the *Convention of the North*, where Michael Gove and the metro mayors were quite vocal around this. Devolution is important to remove the red tape around local investment.

When that happens there will be a suite of opportunities for long-term investors to take hold of.

Ward: We will see a changing dynamic of who is buying and who is selling. The derisking of DB pension schemes, larger DC funds coming back into the property space, the relaxation of Solvency II and an enormous glut of private wealth around the world will change the demand dynamic. It will be interesting to see how that plays out.

D'Enrico: Local authorities, housing associations and public bodies are financially constrained. There is an acceptance that private capital is increasingly essential to help develop accommodation across the affordable housing space – there is long-term alignment.

We always hear that there might be some headline risk of coming into these spaces but for me, the bigger headline risk investors face is going to come from not being involved. If you are not contributing to a solution, are they part of the problem?

Baigler: We are going to see a quite severe bifurcation as real estate becomes more institutionalised in the UK and Europe. Some assets are going to become obsolete faster than we perceive, while others are going to be in greater demand from a larger pool of institutional investors.

Ward: Interestingly no one mentioned tech. Whether that is digital securities for real assets, whether it is improving transparency on ESG or enabling occupier behaviours, it is gaining traction.

I don't know how that will play out, but it is another interesting space to watch.

Edmond de Rothschild

PICTET
1805
Asset Management

COMMODITIES:

The beginning of a new commodities supercycle was announced late in 2020 – albeit with some dissenting voices. Prices have since supported the call that demand for everything under the commodities banner is, as the title suggests, super.

For example, the Bloomberg Commodity Total Return index surged to a record first quarter gain of 38% in 2022 before closing with a 16% return for the year – an impressive number in any environment, but pure gold in this one.

Given that commodity supercycles are long-term affairs, typically lasting several years, this positive narrative looks like playing out for some time, offering investors strong returns along the way. Crucially, a number of factors are converging to contribute to this outlook.

First is the shifting macro-economic environment. The old deflationary world, which we seem to have left behind, meant many investors were not looking at commodities as an option. But rising rates and inflation have turned that on its head. The investment environment is shifting as a result, creating the emergence of that all-important commodities supercycle.

These asset allocation changes are a move to a "portfolio resiliency" to inflation and the on-going environment, says Simona Paravani-Mellinghoff, global chief investment officer of Blackrock's multi-asset strategies and solutions team. "This means more exposure than in the past to assets like inflation-linked bonds, commodities and infrastructure," she adds.

The second factor is that underinvestment from the world's largest commodity player, China, looks set to spur on commodities after ending its Covid restrictions. China has historically been the biggest buyer of natural resources, something it reneged on, even until last year, due to its zero-Covid approach.

The end of China's zero-covid policy is expected to have a positive influence on the demand for commodities at a time when the supply of several key resources from energy to metals and agriculture remain "tight", according to economic parlance.

China or bust

China is therefore the overriding spectre of the commodities market. Its presence is everywhere. Take copper and aluminium, which have led a strong start to 2023 for industrial metals. The focus here is on speculation, or even expectation,

Prices of raw materials are surging as the asset class enters a new "super" era. *Andrew Holt* looks at the impact on institutional investors.

GOLDEN YEARS

that China will step up its capital backing similar to levels seen in previous financial calamities.

This shows what China did stepping up in 2003, after its accession to the World Trade Organisation, 2009 – post the financial crisis, and 2016 following the devaluation of the yuan. This picture is heavily reliant on China to play its part, as is evident by these examples, in terms of capital input. It is safe to say commodities are China or bust.

Not surprisingly, there is a body of thought presenting a counter argument about how much of a boost China will actually provide to commodities overall – or importantly, whether it can be sustained.

This latter point suggests that once the initial rally is over, the hard work begins to support those gains with an underlying rise in physical demand needed to sustain the rally. All the suggestions indicate that within the global economy this demand exists – and it is the supply that is the issue – and this just needs to be unleashed.

The third attributing tailwind for commodities is an acceleration of the transition to lower or zero-carbon energy sources, which will likely lead to an even greater commodity supercycle – although you will need to be on the green side of the commodities divide to benefit.

In this way, many investors are bullish on industrial metals, led by copper, aluminium and lithium, due to the green transformation. Along with the massive political capital being invested in achieving the transition which means these investment trends are not short term.

Getting defensive

The fourth beneficial trend for commodities is the new geopolitical environment. One that looks set to result in a massive boost for the European defence industry and with it, a big impact on commodities. It has been predicted that we could see double-digit growth rates, close to 20% per year, during the next economic cycle as Europe doubles its military spending as a percentage of GDP. Rishi Sunak's commitment in March to increase Britain's defence spending by nearly £5bn during the next two years can be seen as an early precursor to this trend.

The fifth factor, which is key for portfolios, is that commodities are the only major asset class to provide a real hedge against inflation. This was a conclusion draw from research on global

investment returns by the London Business School and the Credit Suisse Research Institute published in February.
The obvious paradox is that rising commodity prices, particularly for oil and gas, have been a key contributing factor in the resurgence of inflation.

Investor response

Institutional investors, particularly pension funds, look to use commodities for some of these reasons.
At its February investment committee meeting, the Royal Borough of Kensington and Chelsea's pension fund noted how commodities appeal in this inflationary environment. "Safeguarding the fund's investment assets from undue risk and ensuring these are resilient to inflation are important. The use of commodities, gold, and sustainable natural resource equities can provide scenario specific inflation protection," its minutes read.
Diversification is another argument. Anders Lundgren, head of public markets and real estate at Nest, says that while commodities offer a diversifying element to its portfolio, it represents a small part of the defined contribution master trust's overall investments at around 1.7%. A level which is regularly assessed.
"We regularly review our asset allocation and may make alterations to our exposure to commodities, depending on how we see the markets developing," he adds.

Commodities are the future

There are other routes for investors to exploit the commodities market. For example, futures can be the simplest way of investing in commodities, especially when dealing with inflation.
Some pension funds use commodity derivatives. Analysis of European retirement funds by Lighthouse Reports shows that more than €30bn (£26bn) is tied up in such approaches, which are used to bet on the price of commodities.
Lundgren explains the benefits of such instruments for Nest. "Exposure to commodities is typically done via future derivatives on the underlying asset, to avoid the impracticalities of buying the underlying commodity," he says.
In a 2022 report, Antti Ilmanen, a principal at investment firm AQR, argued that commodity futures portfolios provide the instruments needed to hedge against different types of inflation.
Energy futures perform well during energy-driven cost-push inflation; industrial metals during demand-pull inflation; and precious metals, especially gold, perform well when central bank credibility is questioned.
The good news for investors is under these permutations it could be argued that all these definitions apply – to some degree – at the current time, an unusual outcome resulting from the global economy emerging from lockdowns.

On the specifics of inflation, Lundgren offers the Nest take: "When inflation is high but falling, the inflation hedging properties of commodities are diminished and we anticipate will remain at this current level for the foreseeable future."
Indeed, one could highlight that the inflationary threat looks to be on the wane. But the key point is it's not going to disappear, making an inflation hedge applicable going forward.

Golden demand

Breaking the commodities market down, which segment should appeal to investors and why?
Gold flew out of the gate at the beginning of 2023 with strong gains. And after a difficult period, particularly last year, the outlook for gold looks favourable going forward, says Catherine Doyle, investment strategist in the real return team at Newton Investment Management.
"We expect a softer US dollar to be a tailwind for gold, but we do not think real yields will fall materially in 2023, which will keep the opportunity cost of owning gold high," she says.
Gold is unique in that it is not just a commodity, but also a financial and cautionary investment. Some would argue it is also a currency – a legacy from the days of the gold standard.
The levers of financial power can therefore have an impact on gold. A point made by Doyle, who sees an increasing demand for gold from emerging market central banks. "The confiscation of Russia's sovereign currency reserves prompted some major emerging-market central banks to reduce their US treas-

We expect a softer US dollar to be a tailwind for gold, but we do not think real yields will fall materially in 2023, which will keep the opportunity cost of owning gold high.

Catherine Doyle, Newton Investment Management

ury bond holdings in favour of gold. We think this trend is likely to underpin demand," she says.

Part of that demand is being driven by a handful of central banks wanting to reduce their dollar exposure through a "de-dollarisation" and a general appetite for gold should ensure another strong period for it.

Some also point to silver, which initially struggled to keep up with gold, but the potential for silver outperforming has been cited on many fronts. A significant one being that the war in Ukraine has had a positive effect on the silver market.

On oil, crude oil demand will, according to the International Energy Agency, rise by 1.9 million barrels per day in 2023 – its highest on record. The main apparatus behind this call is a robust recovery in China as the country shifts from lockdowns towards a growth-focused recovery, driven not only by boosted mobility on the ground, but also backed by a post-Covid recovery in jet fuel consumption, as a stifled travelling demand is released. To repeat, as with most commodities, China is a driving force.

Re-setting the picture

And those fundamental economic principles – supply and demand – make up the essence of commodities, as least measured from an investment perspective. And the Ukraine war has troubled the commodities picture in this regard. The war continues to upset the regular movement and prices of commodities from industrial metals and key crops to gas, fuel products and not least crude oil.

Sanctions by the European Union and G7 against Russian oil since December has created several new price tiers of oil where quality differences and distance to users are no longer the only drivers of price differentials between oil grades. Such developments will continue to impact supply and demand.

And to further complicate matters, it should be noted that commodity supercycles never move in a straight line. They are usually a sequence of price spikes, with each high and low higher than the previous spike.

This can make it difficult for investors to fully understand what is happening in the market. The result is that the peak and trough can be difficult to ascertain: is this an advancement in the supercycle or an end to it?

Though other events have provided a surprising boost to the demand for natural resources, the demise of Silicon Valley Bank has led to some market commentators to recommend commodities as a potential safe haven. The basis of this is the banking upheaval is part of a wider, and potentially deeper, credit crunch.

Although at the same time, some parts of the commodities market have not escaped the bank's collapse in many "risk-off" moves. This defies, some suggest at least in this scenario, its potential defensive abilities. Though this is an extremely selective interpretation, given this affair rippled throughout the whole market.

Oil and gas will still be needed to meet future energy demand under any plausible transition.

Hannah Johnson, Blackrock

All gas

And while the narrative is on net-zero transition commodities going forward, traditional commodities will not diminish in their importance. In fact, far from it.

"Oil and gas will still be needed to meet future energy demand under any plausible transition," says Hannah Johnson, natural resources portfolio manager at Blackrock.

A point broadened out by Lundgren. "The transition to low carbon economies will present risks and opportunities to investors which need to be carefully considered," he says.

This in turn could reshape the commodities fusion, says Lundgren. "Decarbonisation and electrification over the coming years could trigger a change in the commodity mix used in the economy and a supercycle due to demand outstripping the current low supply of key metals such as copper, nickel and lithium," he adds.

The good thing for investors is that, while commodities are typically unpredictable in the short run, they are more predictable longer term. The exact timing of short-term price spikes is difficult to forecast, but if you are in them for the long term, does it really matter?

Conversely, the state of the market is predictable in the long term as supply and technological trends are far more persistent. The good news is that all the conditions required for another spike are present in 2023 and beyond.

Putting the positive commodities picture in perspective, many forecasts predict another positive year for commodities resulting in a 10%-plus rise in the Bloomberg Total Return index.

This gives investors much to consider.

INFRASTRUCTURE: BUILD, REPAIR, UPGRADE

Infrastructure's influence over institutional investor portfolios is growing. Roads, bridges, trains, trams, electric vehicle charging points, hospitals, broadband networks and wind farms are just some of the assets that help the economy to operate smoothly. Long-term income to match the liabilities carried by pension schemes and insurers when the yields on quality bonds have been low since the last financial crisis is why institutional investors have turned to the asset class.

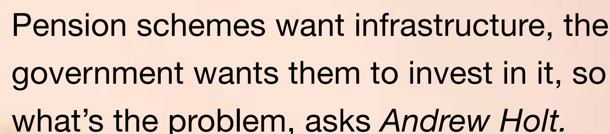
Political will is also on their side. The government needs to repair the UK's crumbling infrastructure, while it needs to bring the economy into the digital age. It is a similar story in Europe and North America, which unlike the oil-rich nations of the Middle East cannot afford to pay billions of dollars to repair, replace and upgrade their infrastructure.

So the UK government is turning to the savings managed by defined benefit and defined contribution schemes.

The government set out its case in December. The then new chancellor Jeremy Hunt made the push for more institutional infrastructure investment particularly from pension funds a central pillar of his policy proposals. A few months earlier, at the PLSA's annual conference in Liverpool, Alex Burghart, during his short-lived time as pensions minster, was eager to spread the word of the government's infrastructure ambitions. This was during the equally short-lived premiership of Liz Truss.

In the surreal evolvement of many governments in a short period of time, the commitment to infrastructure is one that has been an impressive continuation of a policy held since Boris Johnson became prime minister in 2019. By undertaking this, Hunt was keeping consistent with the government's levelling up agenda.

This context is important. It immediately places infrastructure within a political milieu that cannot be ignored. Investors are influenced to fulfil government ideas – more investor capital put into infrastructure boosts UK plc and such investment in local infrastructure meets levelling up social requirements. The Whitehall mandarin or special adviser who concocted this probably received a knighthood.



Pension schemes want infrastructure, the government wants them to invest in it, so what's the problem, asks *Andrew Holt.*

Infrastructure support

Whether by clever policy planning or pure accident, the government has stumbled on to something with their infrastructure rhetoric. GLIL, an infrastructure collaboration between like-minded institutional investors, embraces the government's approach to infrastructure.

Ted Frith, GLIL's chief operating officer, says: "We're supportive of the government's call for institutional investors to drive capital into infrastructure, including renewable energy projects in the UK, because the expected cashflows are beneficial to the broader pension fund portfolio."

Part of the government's drive to get pension funds involved with infrastructure is to boost the UK's economic position. One that Frith says is valid and one that also has wider societal benefits along the way.

"As well as contributing to national economic growth, infrastructure investing helps pension schemes to make a valuable, economic contribution to local communities as well as provide stable returns for their members, at a time when investment activity is under more scrutiny than ever before," Frith says.

Local communities can be reshaped by substantial infrastructure investment that can recast old buildings into social or affordable housing and to build new homes from scratch. In a small but also significant way, the Lambeth Pension Fund invested into the London CIV UK Housing Fund to meet its objective of boosting social and affordable housing in its local community.

The great transition

Another part of the overall infrastructure investment narrative is that pension schemes are able to access stakes in projects that are supporting the UK's transition to a more sustainable, lower carbon economy. "Investment in infrastructure is consistent with the government's growth agenda and its net-zero ambitions, and it will generate significant employment across the UK," Frith says.

The net zero and green credentials argument is getting stronger within infrastructure, as projects big and small are

constructed with ESG considerations at their heart. The government's Green Infrastructure Framework has been launched with the intention of providing a structure to analyse where greenspace in urban environments is needed most.

And there are practical reasons for investors to embrace infrastructure. "Through infrastructure investing, pension schemes have access to reliable, inflation-linked returns, with significant cash yields," Frith says.

A point supported by West Yorkshire Pension Fund's chief investment officer Leandros Kalisperas, who lists the benefit infrastructure brings to the fund's portfolios. "Inflation linkage, predictable identifiable cashflows, asset duration and income yield," he says.

Councillor Adrian Garden, the London Borough of Lambeth's pension committee chair, also highlights how his fund's commitment to housing provides diversification, impact and secures long-term income. Proving that infrastructure investment is multi-layered in its benefits.

That said, Kalisperas offers another investment perspective on the asset class. "Risk and return profiles for infrastructure assets are heterogenous, as they are for many private assets, which makes them hard to benchmark, often leaving an absolute return focus," he says.

"This can make it harder for chief investment officers to have confidence in allocating greater amounts when looked at in the full round of the strategic asset allocation," Kalisperas adds.

Investors to the rescue

But ultimately, the investment case in infrastructure is a solid one: centred around the diversifying returns and providing long-term cashflows. Anne Valentine Andrews, global head of alternatives, infrastructure and real estate at Blackrock, presents this case, despite other overbearing factors from the likes of the government.

"We believe infrastructure can help diversify returns and provide stable long-term cashflows – even with risks such as governments imposing artificial price caps amid political pressure," Andrews says.

In addition, she adds: "Infrastructure earnings are often less tied to economic cycles than corporate assets. Contracts can be long-term and span decades."

This trend is already evident. According to a survey from asset manager Nuveen, institutional investors are set to almost double their allocation to infrastructure this year, as they alter portfolios to deal with persistent inflation and volatility.

Investors are therefore creating their own new narrative on infrastructure, resulting in a move from it being a theoretical benefit for investors to one in which they embrace as part of the wider investor landscape.

For the West Yorkshire Pension Fund, infrastructure is a key

All countries need to upgrade their infrastructure and pension funds are long-term investors which can match the long-term nature of infrastructure.

Leandros Kalisperas, West Yorkshire Pension Fund

investment. "Infrastructure is important to the West Yorkshire Pension Fund from two key perspectives: investing in the UK and with a focus on greener infrastructure, and accessing inflation-linked returns which help match our liabilities," Kalisperas says.

The West Yorkshire scheme has a 7% allocation in infrastructure: a function of the strategic asset allocation, Kalisperas says, which in turn, is derived from the scheme's funding requirement and asset risk-return projections.

And Frith highlights that GLIL, as a collaboration between UK pension funds and pools for the last seven years, has seen its members deploy more than £2.7bn into largely UK infrastructure projects with a significant focus on the energy transition.

A further £1bn of committed capital is to be further deployed in the UK. A clear indication that the capital drive into infrastructure from institutional investors is already happening, big time.

Suitable assets

But Frith marks out an important criterion on how the infrastructure journey going forward can be improved. "More needs to be done to increase the supply of infrastructure investment opportunities with the appropriate risk versus reward profile for pension schemes," he says.

Another big issue within the debate from an investor perspective is a lack of supply of suitable infrastructure projects for investors to invest in. But for Kalisperas, this comes back to the same argument highlighted by Frith.

"If by 'suitable' we mean projects that offer a good risk-return payoff, then yes," Kalisperas says. "However, it is also about the

high level of investor demand in recent years which for one reason or other may have a lower cost of capital than UK pension funds."

How can the divide in the investor-investment needs within infrastructure projects be addressed? Frith says that the creation of the UK Infrastructure Bank can play a key role in bridging this gap between investors and investments.

"One of the key developments has been the creation of the UK Infrastructure Bank, which is approaching its second anniversary," he says. "We see the bank as a platform that the government can use to help bring more projects to the market."

Frith's point is that the capital is there in the pension fund community to support these projects and the regional and national governments have a significant demand for funding – accepting the government's premise that pension capital should be directed towards infrastructure.

"But it feels that more needs to be done, however, to create a longer list of suitable projects for pension funds to invest in. We continue to hope that the UK Infrastructure Bank will play a significant role in this regard as it matures," he adds.

Kalisperas also highlights the case of a unified approach in addressing the infrastructure investment gaps to create suitable opportunities. "There are clearly multiple parties that need to play their part in this. Moderate cost vehicles such as GLIL that have developed capacity and capability to invest in infrastructure assets at scale should be considered a good start," he says.

A $15trn hole

And for all the debate surrounding the UK government, there is a wider issue to address looking at infrastructure challenges on a more global level. Meaning issues around the supply of infrastructure projects are not just down to the Conservative government – or even previous Con-Dem coalition, or the Labour government that came before that.

World Bank data points to a gap of about $15trn (£12trn) between existing investments and what is needed to meet global infrastructure demand over coming decades. That is some shortfall.

A point highlighted by Kalisperas. "All countries need to upgrade their infrastructure and pension funds are long-term investors which can match the long-term nature of infrastructure," he says.

It highlights that Westminster political debates, centred on party politics of vague left and rightist ideas, are not at the heart of the problem. Nor will they solve the problem.

But Kalisperas notes the importance of pension funds sticking to what suits them as funds. "The terms of our involvement have to make financial sense from an investment perspective and fit our investment strategy as we have a fiduciary duty to members."

A record year

For all the challenges and considerations investors have to take on board when investing in infrastructure, GLIL's work is leading the way in infrastructure investment.

"2022 was a record-breaking year that saw us conclude four significant transactions," says Frith. "We have a £3.6bn investment fund with more than £2.7bn deployed into a growing portfolio of assets – from ports, trains and roads to renewable energy, utilities, and schools."

GLIL's investments include the acquisition of a significant stake in M6 Toll in the West Midlands, as well as its first investment in offshore wind with the purchase of a 12.5% stake in Hornsea One, which at the time was the world's largest operational offshore wind farm.

"We also made significant further investments into Semperian, which focuses on the delivery of high quality public sector buildings, such as schools and hospitals, as well as into 11 onshore wind farms in the Republic of Ireland," Frith adds.

GLIL's work is not going to stop there. "We remain committed to allocating capital to core UK infrastructure assets, and thereby generating sustainable, above-target, long-term returns for millions of pension fund members," Frith says.

And given the macro-economic outlook, infrastructure is an appealing investment not just on all the reasons that have been mentioned – but also because it ultimately delivers.

For example, between December 2019 to December 2022, infrastructure investments delivered an annualised total return of 7.36%. It even generated positive returns in the challenging 2022 environment, according to Boston Consulting and indices company EDHECInfra.

Nice numbers to build any portfolio on.

Infrastructure earnings are often less tied to economic cycles than corporate assets. Contracts can be long-term and span decades.

Anne Valentine Andrews, Blackrock

THE FINAL COUNTDOWN

6%

British pension schemes' allocation to domestic equities, down from 53% 25 years ago.

Source: New Financial

47%

...of LGPS professionals say a lack of meaningful data is the main challenge in meeting their ESG reporting obligations.

Source: Alpha Real Capital

$6.3bn

Inflows into European equity-focused exchange-traded products during February, down from $7.3bn in January.

Source: iShares

94%

The level of directors at FTSE250 companies expecting to undertake some form of M&A this year, up from 86% in 2022.

Source: Numis

£981m

The amount raised for sustainable projects during 2022 through the voluntary carbon markets.

Source: Trove Research

£1,645

The record price per ounce of gold following fears of a banking crisis after troubled lender Credit Suisse was sold at a discount to rival UBS.

Source: BullionVault

15%

The number of female directors at companies that listed on the London Stock Exchange in 2022, or 31 out of 209.

Source: Investec

£25bn

UK defined benefit pension liabilities de-risked by insurers during 2022.

Source: Legal & General

88%

The level of real estate managers in the UK who have seen "green" commercial property values increase by between 16% and 25%.

Source: Deepki

Quote of the Month

"The mantra is you need to buy high carbon buildings and sell low carbon buildings."

Charles Baigler, Pictet Alternative Advisors

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